

# BARBARIANS AT THE GATEKEEPERS?: A PROPOSAL FOR A MODIFIED STRICT LIABILITY REGIME

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## I. INTRODUCTION

Legal scholars long have recognized that investment banking, accounting, and law firms can act as private gatekeepers to financial markets.<sup>1</sup> However, scholars have not settled the questions of when and whether such gatekeepers<sup>2</sup> should be liable for misrepresentations or fraud by public issuers of securities.<sup>3</sup> The answers to these questions depend, of course, on both the reputational and legal constraints imposed on gatekeepers' activities. Because scholars continue to debate the scope of these constraints, it is unsurprising that the question of what role gatekeepers should play in modern, rapidly-evolving financial markets remains open.

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1. See Stephen Choi, *Market Lessons for Gatekeepers*, 92 NW. U. L. REV. 916, 934-49 (1998); Michael P. Dooley, *The Effects of Civil Liability on Investment Banking and the New Issues Market*, 58 VA. L. REV. 776, 794-95 (1972); Ronald J. Gilson, *Value Creation by Business Lawyers: Legal Skills and Asset Pricing*, 94 YALE L.J. 239, 288-93 (1984); Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549 (1984); Howell E. Jackson, *Reflections on Kaye, Scholer: Enlisting Lawyers to Improve the Regulation of Financial Institutions*, 66 S. CAL. L. REV. 1019, 1049-72 (1993); Reinier H. Kraakman, *Corporate Liability Strategies and the Costs of Legal Controls*, 93 YALE L.J. 857, 895-96 (1984) [hereinafter Kraakman, *Corporate Liability Strategies*]; Reinier H. Kraakman, *Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy*, 2 J.L. ECON. & ORG. 53 (1986) [hereinafter Kraakman, *Gatekeepers*].

2. Legal scholars are not entirely clear about what they mean by "gatekeeper", especially regarding which gate is being kept and who or what is on either side of this gate. Reinier H. Kraakman has argued that the essential certification for an issuer's wrongdoing to proceed is, at least in theory, the "gate" the gatekeeper keeps. See Kraakman, *Gatekeepers*, *supra* note 1, at 54. This definition is not entirely consistent with the historical meaning of "gatekeeper". Ronald J. Gilson suggested that "gatekeeper" and "reputational intermediary" may have entirely different meanings. Ronald Gilson, Remarks at the Washington University Law School and Institute for Law and Economic Policy *Corporate Accountability* Symposium (Mar. 9-10, 2001). In any event, whatever the definition of the term "gatekeeper", this Article assumes it includes investment banking, accounting, and law firms in their activities related to securities issues.

3. See, e.g., Choi, *supra* note 1 (advocating intermediate market-based due diligence regime for gatekeepers); Victor P. Goldberg, *Accountable Accountants: Is Third-Party Liability Necessary?*, 17 J. LEGAL STUD. 295 (1988) (advocating against third party liability for auditors and arguing that reputation provides a sufficient incentive for auditors to detect fraud); Kraakman, *Gatekeepers*, *supra* note 1 (advocating due diligence duties and liabilities for underwriters to protect against issuer fraud).

At the same time, a substantial number of problems and costs associated with gatekeepers have come to plague financial markets. Expenses associated with underwriting are considerable, yet investment banks face demonstrated conflicts of interest, frequently do not uncover issuer misrepresentations or fraud, and, in part because they generally are indemnified by issuers, rarely pay securities fraud-related damages. Accounting firms earn substantial fees but often lack independence and increasingly fail to detect errors in financial statements; the number of restated financial statements from the past two years was staggering. Law firms spend untold hours engaging in due diligence activities but offer extraordinarily narrow representations in their legal opinions related to securities issues. Most importantly, litigation against gatekeepers is increasingly costly and uncertain, a situation that also increases the ex ante costs of insuring against liability.

This Article fills a few of the gaps in current scholarship about gatekeepers and sets forth a proposal for a modified strict liability regime that would avoid many of the problems and costs associated with the current due diligence-based approaches. Under the proposed regime, gatekeepers would be strictly liable for any securities fraud damages paid by the issuer pursuant to a settlement or judgment. Gatekeepers would not have any due diligence-based defenses for securities fraud. Instead, gatekeepers could limit their liability by agreeing to and disclosing a percentage limitation on the scope of their liability for the issuer's damages.

For example, a gatekeeper for an issue might agree ex ante to strict liability for ten percent of the issuer's liability related to the issuance, measured by the actual cash paid by the issuer pursuant to a settlement or judgment, or by the present value of such amount. A particular gatekeeper's liability would be limited to the issuer's liability related to that gatekeeper's role (for example, counsel for the issuer or the underwriters generally would not be liable for material misstatements or omissions in audited financial statements). The percentage for each gatekeeper could range based on competitive bargaining and market forces, with a minimum limit, such as the amount of the gatekeeper's fee<sup>4</sup> or perhaps a fixed amount of one to five percent, set by law.

This modified strict liability proposal solves two important and parallel problems in securities regulation. The first problem is the rapidly increasing and substantial cost related to the role of gatekeepers in securities fraud, including both the costs of behavior designed to capture the benefit of due diligence-based defenses and, more importantly, the costs of resolving

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4. The author would like to thank Jim Cox for this suggestion.

disputes about gatekeeper behavior. The securities law defenses available to gatekeepers have created incentives for them to engage in costly activities they otherwise might avoid and have resulted in deadweight costs associated with concentrated market structures, high barriers to entry, and inefficient winner-take-all markets.<sup>5</sup>

A second problem is that the value of gatekeeper certification is declining while costs are increasing. Gatekeepers are failing to uncover financial fraud in an increasing number of cases.<sup>6</sup> In modern financial markets, gatekeepers simply do not have the time or resources to undertake adequate investigation of many securities issues. Examples pervade the investment banking, accounting, and securities law industries.<sup>7</sup>

This combination of high costs and low accuracy should be troubling to legal scholars, especially when coupled with abundant evidence of the dominant cultures and norms of gatekeepers, and most particularly (hence the title of this Article) underwriters. Although much of this evidence is anecdotal, it suggests that such cultures and norms concur with the notion that gatekeepers profit from certain structural advantages created by securities regulation in order to leverage their accumulated reputation capital in financial markets in ways that generate great private benefits but greater social costs.

Part II of this Article assesses some of the arguments about gatekeepers as reputational intermediaries. In particular, it considers arguments that reputation alone might not be a sufficient incentive to create optimal gatekeeper behavior. Part III challenges the assumption that gatekeepers act as reputational intermediaries and argues that legal scholars have prematurely assumed that particular gatekeepers (for example, Underwriters Laboratories, Inc. and bond credit rating agencies) prosper because of incentives to preserve their reputational capital. Part III also considers the role of regulation, regulatory costs, and “regulator licenses” (valuable property

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5. For a description of the phenomenon of winner-take-all markets, see generally ROBERT H. FRANK & PHILIP J. COOK, *THE WINNER-TAKE-ALL SOCIETY: WHY THE FEW AT THE TOP GET SO MUCH MORE THAN THE REST OF US* (1995).

6. Numerous recent cases demonstrate the failure of gatekeepers to detect various types of financial fraud. See, e.g., Michael Brick, *4 Former Executives Charged With Doctoring Profit Data*, N.Y. TIMES, Jan. 24, 2001, at C9 (describing the indictment against managers of Aurora Foods for manipulation of financial statements where managers allegedly fooled auditors from PricewaterhouseCoopers by disabling their accounting software and creating another set of accounting books and records); Mark Maremont, *Lawsuit Details Rite Aid's Accounting Woes*, WALL ST. J., Feb. 8, 2001, at C1, C14 (describing a major accounting scandal at Rite Aid Corp. involving former auditor KPMG, L.L.P.). The Aurora Foods example is notable because it would have been very costly for any gatekeeper to have uncovered the fraud. Consequently, any ex ante costs incurred to detect the fraud and any ex post costs incurred to determine the auditors' liability would be of negligible societal value.

7. See *infra* Part III.C.

rights created by regulation) in distorting the reputational incentives of gatekeepers. In addition, it explains where applicable securities regulation might create regulatory costs or regulatory licenses of the type that would enable gatekeepers to engage in reputation-depleting activities with relatively little cost. Part IV outlines the modified strict liability approach described briefly above and explains some of its advantages and weaknesses.

## II. A REASSESSMENT OF THE ROLE OF REPUTATIONAL INTERMEDIARIES

The literature on financial market gatekeepers relies on various theoretical arguments about reputation, including a characterization of gatekeepers as reputational intermediaries. This Part considers these theoretical arguments and discusses additional points that both support and undercut what seems to be a dominant scholarly view of the role of reputational intermediaries in financial markets. Part II.A attempts to persuade scholars to focus more carefully on particular details in arguments that gatekeepers serve the role of reputational intermediary. Part II.B explores arguments related to some of those details.

### A. *Theoretical Bases for the Reputational Intermediaries Argument*

For centuries, scholars have noted the importance of reputational capital in sustaining a self-policing society.<sup>8</sup> Over time, individuals or institutions acquire reputations based on their behavior. A “good” reputation is valuable in transacting with other parties, and reputational capital enables parties to use trust to reduce the costs of transacting. On the other hand, a “bad” reputation is costly in future transactions, because other parties will demand assurances that future behavior will differ from past behavior.

In theory, these long-standing arguments about reputational capital apply to the sellers of all goods, including securities or advice related to securities. As the argument goes, an issuer of securities has an incentive both to disclose to investors the quality of the securities it is selling and to invest in its reputation for quality in order to persuade investors that the issuer is bonded

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8. See ADAM SMITH, LECTURES ON JUSTICE, POLICE, REVENUE, AND ARMS 253-54 (Edwin Cannan ed., 1896) (noting that a person engaging in a substantial number of repeated transactions with neighbors cannot cheat because of the reputational consequences, while a person dealing with strangers is disposed to cheat because of the lack of reputational consequences). See also DOUGLAS G. BAIRD ET AL., GAME THEORY AND THE LAW 159-87 (1994) (describing reputational effects generally in repeated games); Douglas W. Diamond, *Reputational Acquisition in Debt Markets*, 97 J. POL. ECON. 828 (1989) (setting forth a detailed economic model of reputational capital as applied to debt issuers).

to provide high-quality securities, as disclosed. If the securities turn out to be of low quality and investors observe this fact, the issuer will suffer a reputational loss and will incur a higher cost of capital in the future.

Thus, one can view a reputation for quality in the issuance of securities as an investment that bonds the issuer by forcing the issuer to incur costs if the securities turn out to be of low quality.<sup>9</sup> When information is expensive *ex ante*, but not *ex post*, issuers can make capital investments in brand name or reputation as a way of signaling the quality of information, as follows: issuers signal their belief that when investors learn the truth about this information *ex post*, the issuers' representations will prove correct. Issuers with plans to access the capital markets repeatedly will consider the fact that investors who are disappointed *ex post* will demand a higher cost of capital for future issues. Issuers will internalize these costs and, as the argument goes, will disclose material facts to investors in current issues to avoid increases in costs of future issues.

This "classical" view of reputational capital echoes the mandatory disclosure debate about whether issuers have adequate incentives (based on their reputational capital) to disclose material facts or whether issuers instead have incentives to behave opportunistically and therefore should be constrained. However, this Article is not the appropriate place to revisit the mandatory disclosure debate, and the argument about gatekeeper liability, while based on the above arguments, does not require such an extensive discussion.

Instead, the arguments about gatekeeper liability assume that issuers do not have adequate incentives to disclose all material facts. The arguments in favor of gatekeeper liability assume that when it is too costly for the issuer to bond itself (for example, the issuer lacks the capital or time necessary for a credible investment in reputation), one or more third party intermediaries will be able to step in to offer their reputation as a replacement for the issuer's bond.

Like issuers, gatekeepers face reputation-related incentives. If buyers of securities find it too expensive to determine on their own whether an issue is worth the price, or if an issuer finds it too costly to convince buyers that the issuer's information is accurate, a reputable gatekeeper might be able to

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9. See, e.g., Gilson & Kraakman, *supra* note 1, at 604 (noting that "[a] typical but costly form of signaling is the investment by sellers in firm-specific capital, such as reputation and advertising, whose value would be reduced if the quality of the product were lower than represented"). Generally, bonding occurs when the originator of information puts at risk an asset to be forfeited if information is less accurate than warranted. See generally Yoram Barzel, *Measurement Cost and the Organization of Markets*, 25 J.L. & ECON. 27 (1982).

bridge this gap.<sup>10</sup> If reputational markets work efficiently, then gatekeepers should screen against fraudulent transactions to safeguard their reputations, even without the prospect of legal liability.<sup>11</sup> But why would reputational markets be efficient for gatekeepers and not for issuers?

For scholars who believe issuer regulation is necessary, the question becomes how and whether a regulatory regime governing gatekeepers might improve upon the regulatory regime governing issuers. In other words, what is added by imposing liability on gatekeepers? Alternatively, are there reasons why reputational arguments might carry the day for gatekeepers when they could not do so for issuers?

In this context, rejection of issuer reputation arguments but acceptance of gatekeeper reputation arguments without some strong justification should seem odd. Yet this is precisely what many legal academics apparently have done.<sup>12</sup> Legal scholars frequently assume that gatekeepers do not knowingly certify low-quality issuers as high-quality, although some academics have recognized the possibility of economic benefit from inaccurate certification.<sup>13</sup> Since Reinier Kraakman first introduced the general argument for imposing gatekeeper liability in 1986,<sup>14</sup> even commentators who favor gatekeeper liability have done so primarily because liability forces the gatekeeper's

10. See John C. Coffee, Jr., *Re-Engineering Corporate Disclosure: The Coming Debate over Company Registration*, 52 WASH. & LEE L. REV. 1143, 1169 (1996) (arguing that underwriters of a public offering certify the quality of the offering); Gilson & Kraakman, *supra* note 1, at 619, 616 n.180 (“[T]he investment banker has a role to play whenever verification is costly.”). In addition, by hiring a gatekeeper intermediary, directors delegate their duties to a third party who does not owe the same duties to shareholders. See, e.g., Robert J. Guiffra, Jr., Note, *Investment Bankers’ Fairness Opinions in Corporate Control Transactions*, 96 YALE L.J. 119, 120-21 (1986) (noting that courts have held that directors discharge their fiduciary duties by hiring investment bankers and that courts have not held that investment bankers rendering fairness opinions owe fiduciary duties to shareholders).

11. See Kraakman, *Gatekeepers*, *supra* note 1, at 61.

12. Numerous legal scholars seem persuaded by the reputational arguments as they relate to gatekeepers and especially as to underwriters of securities. Consider the following example:

Finally, the underwriters have reputations at stake every time they do an offering. If the public perceives that it has been defrauded, it will not only blame the company's managers for the fraud, but also the underwriters for a failure to do adequate diligence in investigating the company (if not blaming them for collusion with the company managers). Hence, if the underwriters know there is likely to be undisclosed, but material, negative unripe information they will request: (1) a lower initial price for the securities, and (2) disclosure of the information or a forecast that will convey the gist of the information. *Therefore, even if the company's management is in its final period and has an incentive to withhold material unripe information, the underwriters serve a gatekeeping function in ensuring that this does not happen.*

Mitu Gulati, *When Corporate Managers Fear a Good Thing Is Coming to an End: The Case of Interim Nondisclosure*, 46 UCLA L. REV. 675, 711 (1999) (emphasis added).

13. See, e.g., Choi, *supra* note 1, at 925 (beginning with arguments based on these assumptions); *id.* at 928 (recognizing limitations of these assumptions).

14. See generally Kraakman, *Gatekeepers*, *supra* note 1.

reputation to operate as a constraint.<sup>15</sup>

Several scholars have used Kraakman's framework to argue that liability should not be imposed on gatekeepers in various contexts. For example, Howell Jackson has argued against the current system of attorney-gatekeeper liability.<sup>16</sup> Stephen Choi has argued against the current system of underwriter-gatekeeper liability.<sup>17</sup> Several legal scholars have argued that outside of the United States, other organizational structures evolve to serve the monitoring or gatekeeping function.<sup>18</sup> Perhaps most significantly, Donald Langevoort has suggested that technological changes could expand the range of capital raising options, thereby eliminating the role of "gatekeeper", at least for investment bankers.<sup>19</sup>

However, absent from much of this scholarly debate is a focus on the argument that economically rational gatekeepers, like economically rational issuers, will balance the benefits and costs of accurate (or inaccurate) certification in an effort to maximize profits. On one hand, gatekeepers may achieve short-term gains<sup>20</sup> by providing inaccurate certification or by overstating the value of securities. On the other hand, gatekeepers could suffer long-term losses from a decline in reputation if investors realize that the gatekeeper originally overstated the assessment of value.<sup>21</sup> Although

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15. "Although there are multiple forces that drive our disclosure system, the risk of liability is one of the most significant, and it motivates independent gatekeepers to test and, if necessary, challenge the issuer's proposed disclosure." RICHARD W. JENNINGS ET AL., *SECURITIES REGULATION: CASES AND MATERIALS* 924 (8th ed. 1998) (citing separate statements of John C. Coffee, Jr., Edward Greene, and Lawrence W. Sonsini, that the Form 8-K requirement is one means of increasing gatekeeper liability).

16. See Howell E. Jackson, *supra* note 1, at 1049-72 (disfavoring gatekeeper liability of attorneys). Howell Jackson has argued that holding companies can play a self-monitoring and a gatekeeping role. See Howell E. Jackson, *The Expanding Obligations of Financial Holding Companies*, 107 HARV. L. REV. 507, 559-72 (1994).

17. See Choi, *supra* note 1, at 934-49 (disfavoring gatekeeper liability of underwriters).

18. See, e.g., Ronald J. Gilson & Reinier H. Kraakman, *Investment Companies as Guardian Shareholders: The Place of MSIC in the Corporate Governance Debate*, 45 STAN. L. REV. 985 (1993) (discussing the role of European MSICs); Ronald J. Gilson & Mark J. Roe, *Understanding the Japanese Keiretsu: Overlaps Between Corporate Governance and Industrial Organization*, 102 YALE L.J. 871 (1993) (discussing the role of monitoring structures in Japan).

19. See Donald C. Langevoort, *Information Technology and the Structure of Securities Regulation*, 98 HARV. L. REV. 747, 778 (1985). Donald Langevoort also has noted that if investment bankers are not serving a gatekeeping function, there is little rationale for burdening investment bankers with due diligence requirements. *Id.*

20. The gains might be from higher fees or future business generated by the gatekeeper's willingness to engage in inaccurate certification.

21. To clarify this point, suppose an issuer sells securities with a value of fifty dollars. The buyer does not trust the issuer's representation that the securities are worth fifty dollars. If a gatekeeper can credibly represent the actual value of the securities to the buyer (i.e., if transaction and information costs are zero), the buyer will pay fifty dollars. If the gatekeeper represented to the buyer that the securities were worth fifty dollars, when they actually were worth only twenty-five dollars, the buyer

investors will discount the securities of issuers who use disreputable intermediaries, gatekeepers should be willing to incur losses in reputational capital so long as the gains from inaccurate certifications exceed the costs. Gatekeepers facing substantial expected costs from a loss of reputational capital generally will not seek short-term gains from inaccurate certifications. Gatekeepers who, for whatever reason, would not expect substantial reductions in future fees from an inaccurate certification, or who greatly discount such reductions, will have an incentive to engage in inaccurate certification.

Gatekeepers will not necessarily find it economically rational to engage in reputation-depleting activities. Nevertheless, a strong theoretical argument exists supporting the conclusion that gatekeepers might rationally decide to deplete their reputational capital (just as they would deplete any other capital asset) in an attempt to maximize expected profits. If this argument is correct, then proponents of the reputational intermediary view should take the argument seriously and either refute it (if the arguments or empirical evidence support such a refutation) or incorporate it as a possible alternative view.

Reputational arguments related to gatekeepers are complex. Based on the complexity of the arguments, it seems just as inappropriate to assume gatekeepers always will play the role of reputational intermediary as it is to assume issuers always will choose to make complete and accurate disclosures. Why assume IBM will act to maximize the value of its reputational capital by depleting such capital when the benefits exceed the costs but not also assume Goldman Sachs will do the same? With this caveat, the next section considers in greater detail some specific arguments that reputation alone is not a viable constraint on gatekeeper certification.

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might pay fifty dollars in a one-off transaction. But if the buyer paid fifty dollars, and later discovered that the securities were worth only twenty-five dollars and that the gatekeeper knew this, the buyer would discount the gatekeeper's future representations of the value of securities. The next time the gatekeeper tried to certify a securities issue, the buyer, and perhaps other buyers, would refuse to buy the securities for the represented value. (In the limit, the buyer would pay nothing for the issuer's securities.) To the extent the gatekeeper anticipated future issuances, the gatekeeper would need to factor in these future costs. An economically rational gatekeeper would face powerful incentives to invest in his or her reputation and to represent the true value of his or her securities. However, if the gatekeeper could capture a substantial fee (say five dollars) for representing that securities were worth fifty dollars when they actually were worth only twenty-five dollars, the gatekeeper might rationally choose to make such a misrepresentation if the expected present value of the reduction in future fees was less than the fee to be earned for the current issue.



*B. Limits to the Reputational Intermediaries Argument as Applied to Gatekeepers*

This section considers some arguments about when gatekeepers might add value in the certification process. The specific question is when might gatekeepers fulfill functions that issuers cannot fulfill because of the high transaction costs of proving to investors that the issuer's assessment of quality is truthful and accurate. In these instances, the reputational intermediaries argument is the strongest; and so, perhaps, is the rationale for imposing additional liability on gatekeepers.

Gatekeepers are most likely to add value when more direct forms of antifraud liability are weak, for example, when issuers make judgments that the expected cost of material misrepresentations or omissions is less than their benefits. This expected cost might be low either because the magnitude of punishment is low or because the probability of detection is low.<sup>22</sup> Constraints on issuers might fail for many reasons,<sup>23</sup> seven of which follow.

*1. Issuer Misconduct and Asset Inadequacy*

First, issuer misconduct might be expensive to detect or prosecute. If the probability of detection is low or if the probability of successful prosecution is low, issuers might rationally elect to engage in an activity even if the stated penalty associated with that activity is very high. Put another way, it might be necessary to set penalties at a very high level in order to prevent issuers from engaging in misconduct. Moreover, because penalties on issuers are limited to the issuers' net assets, gatekeeper liability might be necessary in order to police issuers who otherwise would avoid paying the full cost of expected liability.<sup>24</sup>

There are several limits, however, to the argument about issuer assets and expected liability. First, issuers could post bonds to cover any shortfall in net assets, although they would be limited in the collateral they could pledge to support such bonds. Second, issuers could incur the full expected cost of a penalty by purchasing insurance, although again issuers might favor the

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22. See, e.g., A. Mitchell Polinsky & Steven Shavell, *The Optimal Tradeoff Between the Probability and Magnitude of Fines*, 69 AM. ECON. REV. 880, 884 (1979) (discussing difficulties of making such tradeoffs when probability of detection is low).

23. See Kraakman, *Gatekeepers*, *supra* note 1, at 56-57.

24. To the extent there are practical limitations on issuer liability, a whistleblowing regime might be an attractive theoretical alternative to a regime of gatekeeper liability. "As compared to gatekeeping, mandatory whistleblowing imposes much larger potential losses on suspected wrongdoers." Kraakman, *Gatekeepers*, *supra* note 1, at 59.

possibility of uninsured bankruptcy rather than the certainty of paying the full expected cost of penalty. Third, gatekeeper net assets will not necessarily be greater than issuer net assets or at least not sufficiently greater to make a difference to investors. Firms with net assets greatly in excess of a gatekeeper's net assets frequently choose to use a gatekeeper. In addition, a gatekeeper with a higher cost of capital or higher probability of bankruptcy would not be as valuable in a third party certification role. Notwithstanding these limits, the argument about asset inadequacy makes some sense; to the extent issuer net assets are not sufficiently deep to make securities fraud penalties viable, the gatekeeper's role may fill a gap.

## *2. Agency Costs*

A second reason why reliance on gatekeepers might improve the reputational and legal constraints on issuers is that agency costs might prevent issuers from reaching optimal decisions without third party intervention. If managers can act to benefit themselves at the expense of investors (even if investors would be better off increasing managers' compensation in an amount equal to the value of this benefit), third party gatekeepers can act as monitors of management.

This argument also has limits because gatekeepers face agency costs as well. Agency costs facing smaller "partnership"-oriented gatekeepers (including, perhaps, some law firms) are likely to be less than those that face large publicly held firms with centralized management. However, the major gatekeepers, especially gatekeepers for underwriting and independent auditing, are large, multinational companies with tens of thousands of employees. Even if gatekeeper managers do not face incentives to deplete the reputation of the entity for short-term gain, lower-level employees might face precisely those incentives. It is especially costly to monitor such employees, given the annual bonus compensation structure of most gatekeepers and the incentives for employees to maximize short-term profits. Thus, some gatekeepers likely apply a very high discount rate to the expected future costs associated with engaging in potentially reputation-depleting activity.

## *3. Repeat Play*

A third reason for the reliance on gatekeepers is the extent to which issuers and gatekeepers are repeat players in their respective businesses. The amount of expected repeat play greatly affects decisions by both issuers and gatekeepers about whether to engage in reputation-depleting activities. The costs of such activities relate directly to the expected future cost of a depleted

reputation, which depends on the extent to which the issuer or gatekeeper expects to have future dealings with investors. So far as issuers have incentives to make false representations in order to maximize their own profits, gatekeepers might also face such incentives. Gilson and Kraakman have recognized that an investment in reputation cannot wholly eliminate the incentive to behave opportunistically, especially in an end period when, as they put it, a seller has an incentive to invest in reputation as bait to catch more valuable fish.<sup>25</sup> The same factors that limit the ability of reputational and legal constraints to discourage securities fraud among issuers in an end period apply equally to gatekeepers in an end period.

If a particular gatekeeper is more certain to be repeat player than the issuer, the gatekeeper can “rent” its reputation to the issuer. Gatekeepers will have less of an incentive to engage in fraud if they are more likely to be repeat players or if they are less likely to be in or near an end period. Although this argument has intuitive appeal, it is unclear whether gatekeepers’ frequency of play is sufficiently greater than that of issuers to matter to investors. To the extent that an investor perceives a gatekeeper’s credit quality as being lower than that of the issuer (which might occur even if the gatekeeper is a more frequent financial market participant than the issuer), the gatekeeper might face a more costly end period discount than the issuer. Nevertheless, it seems true that by their nature, gatekeepers are likely to have more frequent contact with financial markets than issuers.

#### 4. *Buyers’ Ability to Verify Quality Ex Post*

A fourth (and related) reason is the ability of buyers to verify the quality of securities purchased after the consummation of the transaction. Gatekeepers might have a comparative advantage over issuers in making representations as to the quality of securities. Gatekeepers interact with numerous issuers and are skilled in complex valuation techniques. Therefore, gatekeepers might add value by providing ex ante representations about the quality (i.e., value) of securities. Both issuers and investors might benefit from these ex ante representations.

In general, reputation is most valuable when buyers cannot verify the quality of goods before they purchase them. However, the value of reputation ultimately is established only ex post when buyers verify the quality of goods they have purchased in order to confirm or deny the veracity of the seller’s initial representations. To the extent a seller disappoints buyers, buyers will

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25. See Gilson & Kraakman, *supra* note 1, at 620 (“The gains from opportunism may well exceed the costs of lost reputation.”).

discount the value of that seller's reputation and the seller will not be able to charge as high a price in subsequent transactions. To the extent all sellers disappoint buyers, buyers will discount all reputations and the market will unravel.

This argument breaks down, however, if buyers cannot verify the quality of a product *ex post*. If buyers are unable to verify the quality of a product before or after purchase, sellers will have an incentive to reduce the quality of the product or increase its price (i.e., to "milk" their reputations). In securities markets, buyers typically are not able to verify with any great accuracy the quality of securities after purchase because their only proxy for quality is the price of the securities, and numerous variables influence price, including random chance. In some circumstances, buyers are able to obtain a reasonable proxy during a short time period. For example, buyers of an initial public offering (IPO) can observe the difference between the price they paid and the value of the stock soon after the offering. If the stock drops in price, investors assume the seller has misrepresented the value of the stock. Accordingly, sellers and gatekeepers undertake tremendous efforts to ensure that IPOs do not go down in price soon after offering. Nevertheless, even if buyers have plausible arguments that some IPOs are mispriced, in general, it is difficult for a buyer to argue *ex post* that a gatekeeper's representations relating to the quality or value of securities were inaccurate.<sup>26</sup>

As a consequence, buyers of securities tend to focus not on verifying the quality or value of the securities themselves, but instead on verifying the quality of disclosure related to the securities.<sup>27</sup> To the extent investors focus on disclosure rather than value, the comparative advantage of gatekeepers is reduced. Gatekeepers should not necessarily be superior to issuers (or other third parties) in their ability to describe material facts about a securities issue.<sup>28</sup>

As with issuer representations, investors may not be able to verify the accuracy of individual gatekeeper representations in a particular disclosure. If such verification is prohibitively expensive, investors will make some estimate about the expected accuracy of gatekeepers in the market overall and apply that estimate to the individual instance. In such circumstances, individual gatekeepers will have an incentive to overstate the value of issues

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26. If investors could easily make such representations, there would not be much controversy surrounding the filing of securities fraud suits.

27. The quality or value of the securities remains important because it sets the amount of damages.

28. Of course lawyers should have superior abilities in this area, but they typically do not certify the accuracy of such material facts. *See infra* Part III.C.3.

more than the average, and the market for gatekeeper certification will unravel.

Thus, the argument about the value of gatekeepers depends on whether it is more difficult for investors to verify the accuracy of issuer disclosure ex post than it is for investors to verify the accuracy of gatekeeper certification of such disclosure ex post. Like issuers, gatekeepers will have an incentive to deplete their reputational capital if investors cannot verify ex post that the gatekeeper has performed its function in an adequate and honest manner. If investors cannot objectively value issuer representations or if it is costly for issuers to persuade buyers that such representations are accurate, gatekeepers might add value. On the other hand, if investors cannot objectively value gatekeeper representations, or if it is costly for gatekeepers to persuade buyers that such representations are accurate, gatekeepers will face the same difficulties as issuers.

Accordingly gatekeepers are most valuable when it is substantially less costly for them to persuade investors of the veracity of representations than it is for issuers to do so. As investors' perception of issuers improves, the value of certification declines.<sup>29</sup> Accordingly, gatekeepers are more valuable in markets where investors perceive that issuers are of lower quality. Paradoxically, in a market where issuers are of high quality (and where gatekeeper certification arguably is less necessary), there will be little difference between certified and noncertified issuers, and therefore gatekeepers will have an incentive to overstate the quality of the issues. The more difficult it is to discern the quality of issuer ex post, the greater are the incentives for gatekeepers to engage in reputation-depleting activities.

### 5. Information Costs

A fifth issue involves information costs generally. The value of the gatekeeper function depends greatly on the information cost structure of an economy.<sup>30</sup> On one hand, high information costs do not create strong capital market mechanisms, and therefore, the argument goes, it may be necessary to impose a regulatory regime encouraging gatekeepers to provide information

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29. See Choi, *supra* note 1, at 931.

30. Information costs include: (1) costs of acquisition, (2) costs of processing, and (3) costs of verification. See Gilson & Kraakman, *supra* note 1, at 594. Verification costs might include hiring a third party expert to evaluate information or the costs of direct investigation. *Id.* at 603. It is difficult and costly to assure the value of purchased information. See Jack Hirschleifer, *The Private and Social Value of Information and the Reward to Inventive Activity*, 61 AM. ECON. REV. 561 (1971); Oliver E. Williamson, *Transaction-Cost Economics: The Governance of Contractual Relations*, 22 J.L. & ECON. 233, 234 n.3 (1979).

about securities.<sup>31</sup> On the other hand, as information costs decline, the financial markets will perform many of these functions on their own. Thus, variation in the cost structure of information in particular segments of an economy supports the existence of differential regulatory regimes based on the sophistication of participants and on the amount and quality of information likely to be reflected in securities prices. As information costs decline, the importance of the role of gatekeepers (and reputational and legal constraints on gatekeepers) also should decline.

#### 6. *Free Riding*

A sixth issue addresses the problem that, absent a regulatory solution, gatekeepers might face a free-rider problem in adopting standards to govern their own conduct. One way to approach the question of the role of gatekeepers is to ask why private contracting alone has failed to establish a level of adequate constraints on gatekeepers. One reason might be that any gatekeeper who initially attempted to devise an appropriate constraint (for example, a contractually specified level of due diligence defense) would face great uncertainty. It would need to incur the initial costs associated with persuading investors, either through repeated interactions or through litigation that upheld its defense, of the viability and boundaries of the contractual terms. Once the constraint was established, other gatekeepers would be able to use the terms at very low cost. Initially, no gatekeeper would have an adequate incentive to include such terms.<sup>32</sup>

#### 7. *The Term Structure of Interest Rates*

Finally, the term structure of interest rates and the gatekeepers' cost of capital are relevant to the question of whether gatekeeper constraints are necessary or effective. Legal scholars do not appear to have considered the fact that any cost-benefit calculus by issuers, gatekeepers, and investors, assuming that they make such a calculus, is intertemporal, and therefore necessarily involves questions about the levels of interest rates and costs of

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31. Gilson and Kraakman have stated:

High information costs, then, lead to a narrow distribution of fully understood and verified information, a comparatively ineffective set of capital market mechanisms, and market prices that remain in the inefficient range of the relative efficiency continuum. If information costs are high enough, the issuer might not realize any return on its investment in developing a better security, and market inefficiency would operate as a complete barrier to innovation.

Gilson & Kraakman, *supra* note 1, at 616.

32. This argument disfavors Stephen Choi's proposal that gatekeepers privately establish individualized levels of due diligence defense. *See* Choi, *supra* note 1, at 919.

capital of relevant parties. For example, because gatekeepers certifying an issue are balancing short-term gains against longer-term losses, interest rates generally and the gatekeepers' costs of capital more specifically will play an important role in the calculus. In a high interest rate environment (or with a steep yield curve), gatekeepers will discount future losses more, and therefore will be more likely to engage in overstating the value of an issue. In a low interest rate environment (or with an inverted yield curve), gatekeepers will discount future losses less and therefore will be less likely to engage in such overstatement. These differential judgments based on interest rates will not affect social welfare if gatekeepers and investors (i.e., society generally) face the same cost of capital rate structure. However, to the extent gatekeepers have a higher cost of capital, they will discount future costs more. The result with respect to the cost of capital is indeterminate, although it is possible gatekeepers would choose to engage in reputation-depleting activities if they faced a high long-term cost of capital, perhaps because of high debt levels or risk associated with other business lines.<sup>33</sup>

The point of this section has been to set forth some of the nuances of the argument that gatekeepers can act as viable reputational intermediaries. The argument is complex and depends on numerous factors comparing issuers and gatekeepers, some of which legal scholars have, unfortunately, not taken very seriously.

### III. OF REPUTATIONAL CAPITAL, REGULATORY COSTS, AND REGULATORY LICENSES

Notwithstanding the above caveats, the reputational intermediary arguments (to which this Article collectively refers as the "reputational capital view") have persuaded numerous legal scholars. The persuasive power of reputation intermediary arguments derives not only from the theoretical arguments assessed in Part II but also from certain assertions about empirical support. However, there is not factual support for many of those assertions.

This Part addresses some of these assertions about empirical support and describes evidence supporting an alternative view: the success of some gatekeepers derives, at least in part, from the existence of certain direct and indirect regulatory costs, as well as from legal rules (such as regulatory licenses) granting those gatekeepers valuable property rights independent of their investment in reputational capital. Most importantly, gatekeepers

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33. For example, in a world where investment banks are highly leveraged, a high cost of capital would reduce the present value cost of future reputational losses.

benefit to some extent from the direct and indirect effects of legal rules, and it is not immediately obvious how those benefits compare to the benefits associated with preserving reputational capital.

*A. Two Asserted Paradigmatic Cases*

In describing their view of reputational intermediaries in their leading article on financial markets, information, and reputation, Gilson and Kraakman assert that: “[e]xamples of such specialists in the products market are the Underwriter’s Laboratory and the Good Housekeeping Seal; in the financial markets, the most obvious example is the role played by rating agencies such as Standard & Poor’s and Moody’s.”<sup>34</sup> Moreover, they state that the paradigmatic cases of Underwriters Laboratories, Inc. (UL) and bond credit rating agencies closely resemble the role of financial market gatekeepers who “[r]ather than demonstrating confidence in the accuracy of the seller’s information by staking their reputation on it, [instead] . . . signal their belief by purchasing the seller’s offering for their *own* account, thereby staking *their* future directly on the accuracy of the seller’s information.”<sup>35</sup>

Many legal academics have followed the assertions of Gilson and Kraakman that UL and the bond credit rating agencies serve as two paradigmatic examples of the reputational capital view.<sup>36</sup> In reality, neither of these examples supports the view. Instead, in each case, the private certifier has survived and prospered over an extended period of time, not exclusively because of its investment in reputational capital as a provider of accurate and reliable certification, but also to an important extent because extensive regulations have subsidized the provision of certification-related services.

*1. Underwriters Laboratories, Inc. (UL)*

Legal scholars have cited UL as supporting the reputational capital view, apparently based on a generalized understanding that consumers rely on UL as an effective, third party monitor of the quality of consumer products.<sup>37</sup> There is a tendency to think of UL as similar to Consumer Reports a purely private certifier.

Unfortunately, abundant empirical evidence shows that UL is an

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34. See Gilson & Kraakman, *supra* note 1, at 604-05.

35. *Id.* at 605 (emphasis in original).

36. See Frank Partnoy, *The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies*, 77 WASH. U. L.Q. 619, 633-34 n.62, 685-86 (1999).

37. See, e.g., Gilson & Kraakman, *supra* note 1, at 604-05; Kraakman, *Gatekeepers*, *supra* note 1, at 93-94.



especially poor example of a private gatekeeper. This evidence shows that UL has not survived and prospered during the last century exclusively because of its reputation for quality; instead, it has derived great value from monopoly property rights based on regulatory requirements and preferences related to UL labels.<sup>38</sup>

Initially, UL was a purely private market gatekeeper and provider of (hopefully accurate) information of consumer products. Several insurance companies established UL in November 1901 to undertake uniform testing of appliances and other consumer products, and thereby provide important and valuable information.<sup>39</sup> These tests were designed to generate credible information about hazards associated with the tested products, and UL began providing labels to help consumers distinguish easily between approved and disapproved products. The labels caught on, and by the early 1920s consumers were relying extensively on both tests and labels. Companies even began developing products with a view to secure UL's certification.<sup>40</sup> At this point in time, legal academics indeed would have been correct to rely on UL as a paradigmatic example of the reputational capital view: UL was a nonprofit corporation, not supported by regulation, it did not favor particular manufacturers, and it was able to provide valuable information and credible certification of consumer products.<sup>41</sup> At this time, UL survived and prospered based on a well-deserved reputation for quality.

The modern UL is a very different story. UL has become a giant in certification, with 3,900 employees. UL tests 75,000 products and UL marks appear on more than sixteen billion new products each year.<sup>42</sup> The key factor in the dramatic success and growth of UL in recent decades has been the introduction of numerous legal rules (i.e., regulatory licenses) that depend explicitly on the UL label.

UL is specifically mentioned as the basis for regulation in more than one hundred provisions in the Code of Federal Regulations, ranging from agriculture to consumer products to energy to shipping.<sup>43</sup> In other words,

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38. See Partnoy, *supra* note 36, at 685-86.

39. See Harry Chase Bready, *A Symbol of Safety: The Origins of Underwriters Laboratories*, in REPUTATION: STUDIES IN THE VOLUNTARY ELICITATION OF GOOD CONDUCT 75, 77-79 (Daniel B. Klein ed., 1997).

40. See Partnoy, *supra* note 36, at 685 n.313.

41. As Harry Bready noted, "As a result, the labels of Underwriters' Laboratories *mean something*. They are recognized as incontrovertible evidence that the goods which bear them really possess the qualities of their rating." Bready, *supra* note 39, at 83.

42. See Daniel B. Klein, *Trust for Hire: Voluntary Remedies for Quality and Safety*, in REPUTATION: STUDIES IN THE VOLUNTARY ELICITATION OF GOOD CONDUCT, *supra* note 39, at 97, 114-15. See also UL Homepage, at <http://www.ul.com> (last visited Aug. 10, 2001).

43. To come to the conclusion, I searched the Lexis-Nexus Code of Federal Regulations database

more than one hundred legal rules depend on whether and how UL has certified a particular product. This dependence creates valuable regulatory licenses for UL; product manufacturers must obtain the UL seal to capture the benefits associated with these legal rules. For example, the Occupational Safety and Health Administration (OSHA) has specified UL as an authorized independent certification organization for the purposes of satisfying certain OSHA procedures.<sup>44</sup> One scholar has described the UL-based regulations as resulting in an “OSHA monopoly” for UL.<sup>45</sup>

To clarify, the argument is not that UL labels necessarily are inaccurate; instead, it is that UL’s dominance is only partially sustained by its reputation for quality certification. Anyone doubting this should simply type “Underwriters Laboratories” into any legal database search of federal regulations to see the vast array of rules that depend explicitly on UL certification. Simply put, UL is not an ideal reputational intermediary. Even for scholars who reject the proposals made in this Article, it is my more limited hope to persuade them to stop citing UL as a certification entity that prospers in private markets based solely on its reputation. That reputational capital story is simply not true.

## 2. Bond Credit Rating Agencies

If UL is a poor example, what about bond credit rating agencies? Are Standard & Poor (S&P) and Moody’s, which control ninety percent of the U.S. credit ratings market,<sup>46</sup> ideal reputational intermediaries? Legal scholars have placed great faith in bond credit rating agencies as a paradigmatic example of the reputational capital view.

For example, in a 1998 article, Choi began his discussion of market defects and legal intervention by asserting that: “[i]n many markets, intermediaries play a certification role *without any regulatory intervention*. Standard & Poor’s (“S&P”) and Moody’s, for example, certify the credit risk of company debt.”<sup>47</sup> After discussing several reasons why S&P and Moody’s might have such large market shares (for example, ninety percent), Choi concluded that: “the most compelling justification for the high market concentration in the debt rating market lies with the need for Moody’s and

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on Jan. 31, 2001.

44. See Partnoy, *supra* note 36, at 686 (describing such regulations).

45. In fact, the market power derived from these regulations was a duopoly, not monopoly, because they authorized certifications from both UL and the Factory Mutual Research Corporation (FMRC). See Klein, *supra* note 42, at 115 n.32.

46. See Partnoy, *supra* note 36, at 649-50.

47. Choi, *supra* note 1, at 934 (emphasis added).

S&P to develop strong reputations for screening accuracy, quality, and fidelity.”<sup>48</sup> Numerous other academics have made this point about credit rating agencies,<sup>49</sup> although more recently a few scholars have noted that the assumptions about credit rating agencies might not be accurate.<sup>50</sup>

As with UL, extensive empirical evidence suggests that the credit rating agency story does not support the reputational capital view. Hundreds of legal rules depend substantively on certification by credit rating agencies.<sup>51</sup> Although the regulatory dependence on credit ratings is not as direct as the dependence on UL, the statutes and regulations refer to Nationally Recognized Statistical Ratings Organizations (NRSROs), which effectively include just Moody’s, S&P, and one other agency. Unlike the UL-based regulations, the ratings-related regulations do not specifically name the relevant rating agencies.<sup>52</sup> Nevertheless, the rating agencies benefit indirectly from this grant of valuable regulatory licenses.

Because of the wide range of regulation that depends substantively on specified credit ratings, the assumption that credit rating agencies have survived and prospered based on a reputation for quality simply does not hold. Credit ratings and default experience are correlated, but much of that correlation is due to after-the-fact adjustments in ratings in response to public news. Issuers pay substantial fees to credit ratings agencies because much of the value of credit ratings is derived from regulatory licenses, which since the 1970s increasingly have come to pervade securities, banking, insurance, and pension regulation.<sup>53</sup>

Once rulemaking began to depend substantively on ratings in 1973, there was an avalanche of such ratings-based rules, which quickly spread to other substantive areas. After several decades of this practice, the rating agencies

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48. *Id.* at 961.

49. *See, e.g.,* Yakov Amihud et al., *A New Governance Structure for Corporate Bonds*, 51 *STAN. L. REV.* 447, 481 (1999) (“Bond rating agencies such as Moody’s and Standard and Poor’s perform their tasks diligently without such compensation. The economic interest of the rating agencies in preserving their reputations suffices as an incentive for diligent service.”). *See also* Partnoy, *supra* note 36, at 633-34 n.62 (quoting from several examples).

50. *See* Bernard S. Black, *The Legal and Institutional Preconditions for Strong Securities Markets*, 48 *UCLA L. REV.* (forthcoming 2001), available in Social Science Research, at [http://papers.ssrn.com/paper.taf?abstract\\_id=182169](http://papers.ssrn.com/paper.taf?abstract_id=182169); Lawrence White, *The Industrial Organization of the Global Ratings Business* (2001) (working paper, on file with author). Regulators also have noticed problems associated with regulatory dependence on credit ratings. *See* FDIC Regional Directors Memorandum re: Examination Treatment for Certain Types of Credit-Linked Notes, at <http://www.fdic.gov/news/news/financial/2000/fil0088a.html> (Dec. 13, 2000).

51. *See* Partnoy, *supra* note 36, at 690-703.

52. *See id.* at 690 n.341.

53. It also is worth noting that in 1982 credit rating agencies were excluded from § 11(a)(4) and, therefore, were insulated from § 11 liability. *JENNINGS ET AL.*, *supra* note 15, at 918.

have a concentrated and powerful interest in maintaining these rules, whereas investors, who might lobby for eliminating regulatory dependence, are diffuse and relatively powerless. Consequently, reform proposals that do not address the regulatory dependence on ratings are unlikely to change the structural problems in the fixed income industry. For example, Choi's assertion that his proposal for self-tailored liability "may offer small competitors a means of entering the debt rating market"<sup>54</sup> seems unlikely to be proven correct.

Several themes emerge from the examples of UL and credit rating agencies. First, it is dangerous to rely on assertions that third party certifiers can serve as effective private market gatekeepers. Second, the fact that a third party certifier survives and prospers over time is not necessarily an indication that it is fulfilling a valuable private gatekeeping function. Instead, the certifier may simply be profiting from property rights granted to it by virtue of legal rules or regulation. Third, when discussing the reputation of certifiers, scholars should include an analysis of the effects of legal rules that depend on certifiers. To the extent overall costs of such rules exceed their benefits, scholars should begin to consider alternative regimes. Finally, there is a range of possible regulatory dependence on gatekeepers and, therefore, a range of importance of regulatory licenses. At one extreme is a pure government rater, such as the United States Department of Agriculture, which rates beef, for example. At the other extreme is a purely private rater, such as *Consumer Reports*, which rates consumer products.

Pure Gov't Rater		Pure Private Rater	
USDA	UL	Moody's/S&P	Consumer Reports

The main question with respect to any third party certifier is: where does it fall along this continuum? The next section considers this question with respect to financial market gatekeepers.

### *B. Securities Regulation and the Proliferation of Regulatory Licenses*

If many legal scholars misunderstood the role of reputation for UL and the bond credit rating agencies, it is also possible that they also misunderstood the role of reputation for investment banking, accounting, and law firms. Are these financial market gatekeepers similar to UL or Moody's, or are they more like purely private third party certifiers? Do regulations

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54. Choi, *supra* note 1, at 961.

exist granting these gatekeepers valuable property rights, enabling them to profit even if they are not playing an optimal private third party certification role?

This section addresses these questions and offers some preliminary answers. A complete answer to these questions will require a great deal more study, thought, and empirical research. Nevertheless, it is worth noting now that some legal scholars' almost wholesale acceptance of assertions related to the reputational capital view as it applies to financial market gatekeepers that is eerily similar to legal scholars' acceptance of similar assertions as applied to UL and credit rating agencies.

Moreover, although there is little evidence of any systematic bias towards fraud at more prestigious gatekeeping institutions, the perpetrators of most major securities frauds since the 1960s have employed top gatekeeping firms.<sup>55</sup> Even if most gatekeepers fall into a middle region, where they might or might not engage in reputation-depleting activities based on their assessment of the expected costs and benefits of such activities,<sup>56</sup> it is worth considering the extent to which some of those benefits might stem from regulatory licenses.

An alternative view is that securities regulation has created profit opportunities for and protected the upper echelons of gatekeepers, including investment banking, accounting, and law firms. Some of these protections seem to have been by design; others seem to have been inadvertent. Collectively, these protections have generated direct and indirect regulatory costs, as well as regulatory licenses, which, although costly, do not appear to be as costly as the regulatory licenses created by regulations that depend substantively on UL symbols or bond credit ratings. Gatekeepers are most likely somewhere between Moody's/S&P and Consumer Reports on the continuum. My modest goal in the discussion to follow is to persuade scholars that gatekeepers benefit at least somewhat from securities-related regulatory costs and regulatory licenses.<sup>57</sup>

The analysis begins with the well-known "due diligence" defense. In theory, a "reasonableness" or "due diligence" standard for gatekeepers would result in optimal deterrence. Faced with a rule requiring them to engage in reasonable monitoring of issuers or to satisfy a due diligence requirement,

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55. See Kraakman, *Gatekeepers*, *supra* note 1, at 68 n.46.

56. *Id.* at 69-70.

57. Put another way, there are two parts to the argument about gatekeepers and the cost structure of the industry. The first relates generally to direct and indirect regulatory costs and does not depend on the existence of regulatory licenses. The second relates to the regulatory license theory described *supra* Part III.A.

gatekeepers would engage in whatever monitoring activities would minimize their net expected liability costs. Put another way, gatekeepers would expend resources to engage in monitoring of issuers to the extent the marginal cost of those expenditures was less than the expected marginal gain in terms of liability.<sup>58</sup>

However, what makes sense in theory, does not hold true in practice. In applying due diligence-related standards, courts and regulators inevitably err in specifying the optimal level of gatekeeper monitoring and, more importantly, in adjudicating disputes about whether gatekeepers engaged in adequate monitoring. These errors are magnified when the gatekeeper activity is complex (as it increasingly is, given rapidly evolving financial technologies) and when the law is ambiguous (as it increasingly is, given the dearth of reported and relevant gatekeeper cases).<sup>59</sup>

For example, liability for securities fraud has generated concerns about the large number of allegedly frivolous lawsuits. Regardless of one's position as to the whether securities litigation generally is frivolous or meritorious, it is undeniable that such suits are very costly to resolve.<sup>60</sup> The costs of resolving these disputes are imposed, at least in part, on gatekeepers.

Gatekeepers are able to pass on a portion of the costs of these suits to issuers, investors, and, to some extent, insurers.<sup>61</sup> To the extent gatekeepers are able to pass these costs along, there are few nonreputational incentive effects imposed on gatekeepers to act in a police role insuring that issuers avoid committing securities fraud.<sup>62</sup> To the extent gatekeepers are unable to pass these costs along, the costs make the gatekeepers' role more expensive and uncertain and are a barrier to entering the gatekeeper industry.

Although individual gatekeepers complain about particular securities fraud lawsuits, gatekeepers overall (especially those with the most substantial investments in reputational capital) arguably benefit from the complexity of

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58. This analysis assumes gatekeepers are risk-neutral with respect to liability. If gatekeepers are risk-averse, they might expend additional resources to engage in monitoring to avoid liability.

59. See Kraakman, *Gatekeepers*, *supra* note 1, at 76.

60. Kraakman made this point in his initial proposal. See Kraakman, *Gatekeepers*, *supra* note 1, at 75 (stating that "courts are not necessarily adept at evaluating gatekeeping efforts *ex post*").

61. Although insurance against securities fraud generally is not available to gatekeepers in the United States, gatekeepers frequently engage in insurance pooling and may nevertheless find methods of purchasing third party insurance. For example, the "Big 5" accounting firms and many "top" law firms enter into pooling agreements in which they agree to insure each other's liability for very large damage awards. Such pooling agreements also benefit elite firms by preventing each firm from playing a role against any firm that is a member of the pooling agreement in any dispute covered by the agreement. In addition, insurance policies that would be void on public policy grounds in the United States could be purchased in other jurisdictions.

62. Moreover, to the extent only the most reputable gatekeepers can pass these costs along, the potential for liability creates incentives for a more concentrated market structure.

securities litigation. The best evidence of this benefit is that gatekeepers (through professional organizations) have been closely involved in developing a set of evolving standards to describe some of the open-ended elements of securities regulation, including the due diligence defense. For example, lawyers and accountants have specified minimum standards for audit procedures and legal opinions that would satisfy the due diligence defense.<sup>63</sup> Consequently, gatekeepers must go through the fifty or so discrete steps necessary to meet these minimum standards or else suffer the risk of losing their due diligence defense.<sup>64</sup> Gatekeepers must follow these procedures to obtain a due diligence benefit regardless of whether they otherwise would choose to follow those procedures. At least to some extent, these costs are passed on to investors who pay a higher cost of capital overall as a result.

Given that securities regulation as applied to gatekeepers is based on a substantive review of the gatekeeper's role (for example, the due diligence defense), courts are forced into a delicate balancing act. An overly harsh liability regime penalizes gatekeepers for misconduct they could not detect, while an overly lenient liability regime insufficiently deters misconduct. The uncertainty associated with litigating these issues is very costly. The most prominent examples of this uncertainty are the liability regimes and available defenses associated with claims against gatekeepers based on violations of §§ 11 and 12(a)(2) of the 1933 Act and of § 10(b) and Rule 10b-5 of the 1934 Act. Part III.C will discuss these statutory claims in greater detail as they apply to individual gatekeepers. The following discussion is intended to outline some of the issues arising under each statute.

Section 11 of the 1933 Act<sup>65</sup> generates a range of regulatory costs that benefit top-tier gatekeepers. Section 11 imposes strict liability on issuers for any misstatement in a registration statement filed with the SEC<sup>66</sup> and imposes liability on other persons associated with an offering, including the relevant gatekeepers, but also allows those parties a due diligence defense.<sup>67</sup> The "expert" parties entitled to the due diligence defense include accountants, engineers, appraisers, or any other person "whose profession

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63. See Kraakman, *Gatekeepers*, *supra* note 1, at 80, 83.

64. *Id.* at 83 (noting that "for a sophisticated lawyer, much of it [the due diligence 'checklist'] is almost as operational as the bouncer's duty to check the identification of underage patrons").

65. 15 U.S.C. § 77k (1994 & Supp. 1997).

66. *See id.* § 77k(a).

67. Section 11 also limits the damages to be paid by gatekeepers to the difference between the offering price and the subsequent price in the market and allows the gatekeepers to interpose a defense that the decline in market value was caused by some factor other than the misstatement. *Id.* § 77k.

gives authority to a statement made by him.”<sup>68</sup> Under § 11, these experts may escape liability by showing that, after reasonable investigation, they had reasonable grounds to believe that the materially misleading statements were in fact true.<sup>69</sup>

Because the § 11 due diligence defense is so vague and imprecise, and because there is little case law and only a few pointers from the SEC,<sup>70</sup> parties can have little faith that they are entitled to the due diligence defense unless they satisfy all of the minimum standards specified by industry, courts, and regulators. Thus, the due diligence requirements force gatekeepers to engage in liability-avoiding procedures they otherwise might avoid and that might not be of value to investors or issuers. Instead, gatekeepers must follow these procedures to avoid liability for fraudulent issues or to insure that other parties receive the protections associated with reasonable reliance on gatekeepers (for example, an underwriter relying on underwriter’s counsel or a director relying on the opinion of an accounting firm or investment bank).

The case of *Escott v. BarChris Construction Corp.*<sup>71</sup> is a good example of statutory and judicial creation of regulatory costs in the context of § 11. By imposing liability on parties for failing to engage in particular specified practices, this case created new minimum standards for gatekeepers. Any gatekeeper seeking to avoid legal liability who reads *BarChris* would be foolish not to engage in the minimum level of monitoring practice the court intimated would satisfy the due diligence requirements. Alternatively, any gatekeeper would be similarly foolish to engage only in the same level of care as the gatekeepers did in that case. By enshrining a particular standard within a legal opinion, the court created a valuable property right in gatekeepers: issuers who did not hire gatekeepers satisfying these minimum standards would be forced to pass on to their investors a higher expected cost of liability and, therefore, would face a higher cost of capital. Accordingly, issuers could reduce their cost of capital by hiring gatekeepers who would satisfy the requirements articulated in the opinion, even if those requirements would not otherwise have been economically rational for the gatekeepers.

At least some gatekeepers, particularly those gatekeepers with the greatest investment in reputational capital, benefit from these open-ended standards,

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68. *Id.* § 77k(a)(4).

69. *See id.* § 77k(f). Different standards apply to the expertised and nonexpertised portions of the registration statement with respect to a particular gatekeeper.

70. *See* 17 C.F.R. § 230.176 (1999) (rule setting forth levels of due diligence requirements); Kraakman, *Gatekeepers*, *supra* note 1, at 83 n.87 (stating that Rule 176 is “too general to provide much real guidance”).

71. 283 F. Supp. 643 (S.D.N.Y. 1968).



and the resulting regulatory costs. It is difficult to argue that gatekeepers lobbied for these standards in the same way private parties in other areas have “captured” regulators, especially in the context of an individual judicial decision. Nevertheless, the top gatekeepers have approved of these rules ex post by acquiescing to the due diligence defenses of § 11; in fact, certain gatekeepers, including top underwriters and securities lawyers, even have played an active role in articulating the boundaries of the defenses.<sup>72</sup>

Like § 11, § 12(a)(2) imposes negligence liability on issuers and gatekeepers selling a security using a prospectus (or oral statement) that is false or misleading, and, like § 11, § 12(a)(2) provides a limited affirmative defense.<sup>73</sup> In simple terms, gatekeepers face liability unless they can show their conduct was reasonable and not merely without recklessness or intent. Thus, § 12(a)(2) creates a defense of reasonable investigation similar to the due diligence defense of § 11.

Notwithstanding some recent limitations on the scope of § 12(a)(2),<sup>74</sup> investors persistently have sought to establish liability against gatekeepers (attorneys and accountants in particular) under § 12 because the provision can be viewed as imposing strict liability on anyone violating it as a “seller.” For example, an attorney who prepares false or misleading documents in connection with the sale of a new securities offering will be subject to liability under § 12, and the availability of a reasonable defense will turn on an analysis of whether the attorney was a “seller” under Section 12. The attorney may or may not be provided statutory defenses similar to those provided under § 11. Obviously, investors have a great interest in establishing that a gatekeeper played the role of “seller” in a particular transaction, and it is a frequently litigated and difficult question whether a particular gatekeeper has “seller” status by virtue of its participation in the registration and sales processes.<sup>75</sup>

Although the standards for liability under § 10(b) and Rule 10b-5 of the 1934 Act are even murkier, there is an argument that these standards also

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72. See Choi, *supra* note 1, at 949 (noting that in influencing the due diligence rules the securities bar and underwriters “bring a desire to maximize their importance and role in securities offerings”); Kraakman, *Gatekeepers*, *supra* note 1, at 83.

73. 15 U.S.C. § 771(a)(2).

74. In particular, in *Gustafson v. Alloyd Co.*, 513 U.S. 561 (1995), the Supreme Court interpreted § 12(a)(2) to apply only to misrepresentations in public offerings, thereby removing private offerings from the scope of § 12(a)(2).

75. Legal academics have noted the complexity of these issues. For example, Therese Maynard has noted that complications similar to those raised by the due diligence defense of § 11 also arise under the reasonable care defense of § 12(a)(2). See Therese H. Maynard, *The Affirmative Defense of Reasonable Care Under Section 12(2) of the Securities Act of 1933*, 69 NOTRE DAME L. REV. 57 (1993).

create regulatory costs of the type created by § 11. Rule 10b-5 provides remedies and creates defenses for any buyer or seller of securities who proves the following elements: (1) a misstatement or an omission, (2) of material fact, (3) made with scienter, (4) on which the plaintiff relied, and (5) that proximately caused his injury. Gatekeepers frequently are sued based on Rule 10b-5, and are most successful in defending those claims by attacking the first and third elements. Of these two, scienter is often the most difficult for a plaintiff to establish.<sup>76</sup>

Federal courts generally have held that the scienter requirement is satisfied by proof of recklessness or an extreme departure from the applicable standard of care.<sup>77</sup> Michael Dooley's comments on the Rule 10b-5 scienter requirement were as true in the 1970s as they are today: it is "one of the most elastic concepts devised by the common law."<sup>78</sup> The requirement and its defenses make liability risks highly unpredictable.<sup>79</sup> As with the §§ 11 and 12(a)(2) defenses, this unpredictability benefits gatekeepers by generating indirect regulatory costs. Investors will only benefit from any passed-along reduction in issuer costs to the extent gatekeepers being used for a particular issue have taken adequate precautions to minimize their expected liability under Rule 10b-5.

This section has focused on those regulatory costs created by securities regulation as it relates to litigation risk.<sup>80</sup> The high costs of evaluating securities litigation ex post based on current securities law standards create valuable property rights in regulatory licenses that gatekeepers otherwise would not enjoy. The next section lists some representative sources of other regulatory licenses: the provisions of the securities laws, regulations, and rules that might benefit gatekeepers by enabling them to profit from some legal requirement.

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76. See David J. Beck, *Legal Malpractice in Texas*, 50 BAYLOR L. REV. 761, 794 (1998).

77. See Hillary A. Sale, *Disappearing Without a Trace: Sections 11 and 12(a)(2) of the 1933 Securities Act*, 75 WASH. L. REV. 429, 438-39 (2000).

78. Dooley, *supra* note 1, at 814.

79. See Dooley, *supra* note 1, at 822. In some circumstances, especially where deterrence is a primary objective and cannot otherwise be accomplished, such unpredictability or uncertainty can benefit society. Regulation of financial markets can be such an area, especially when it will be impossible to deter damaging behavior in any other way. See Frank Partnoy, *Financial Derivatives and the Costs of Regulatory Arbitrage*, 22 J. CORP. L. 211, 246-54 (1997) (discussing potential benefits of uncertain regulation in the financial derivatives industry).

80. Arguably, the effects of these regulatory costs are not as direct or extreme as the effects of regulatory licenses generated by rules that depend directly on third party behavior.

### *C. The Role of the Major Financial Market Gatekeepers*

This section considers some specific evidence and arguments with respect to each of the three major financial market gatekeepers—investment banks, accounting firms, and law firms—supporting the view that securities regulation has created regulatory costs and regulatory licenses that convey benefits to some of these gatekeepers. The evidence does not support the extreme situation of UL or even the indirect regulatory licenses associated with bond credit ratings, and this Article should not be interpreted to assert any such argument. However, there are some direct and indirect regulatory costs, and in certain instances, particularly for accounting firms, explicit and implicit regulatory licenses. Scholars should consider the existence and effects of regulatory costs and regulatory licenses, to the extent they exist.

#### *1. Investment Banking Firms*

Issuers, and therefore investors, benefit from underwriters in numerous ways entirely unrelated to regulation. Underwriters (i.e., investment banking firms) serve to some extent as reputational intermediaries, underwriters have expertise and can advise issuers regarding the potential market for an offering, underwriters provide some insurance that the financial markets will absorb an offering, and underwriters commit to stabilize an offering after the issue is first purchased by investors.

John Coffee has described two alternative conceptions of the role of the securities regulation as applied to underwriters. According to one view, securities regulation acts as a “lever by which to increase corporate efficiency.”<sup>81</sup> The underwriter disciplines management, improves corporate accountability, and makes securities pricing more accurate. This view is increasingly the focus of modern scholarship. As Coffee states: “[B]y its association with a securities offering, a high prestige underwriter places its ‘seal of approval’ on the offering. In ‘law and economics’ shorthand, the underwriter pledges its reputational capital and thereby becomes a reputational intermediary.”<sup>82</sup>

A second conception of the role of securities regulation as applied to underwriters assumes that the underwriter can serve a risk-bearing function. In the U.S. securities markets, underwriters have come to serve this function

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81. John C. Coffee, Jr., *Re-Engineering Corporate Disclosure: The Company Debate Over Company Registration*, 52 WASH & LEE L. REV. 1143, 1169 (1995).

82. See Coffee, *supra* note 81, at 1169.

less and less. In general, underwriters do not provide insurance.<sup>83</sup> In the context of the traditional underwriting function, underwriters typically have commitments for their allotments before they buy them and thus bear little risk. Nevertheless, the fact that underwriters do not play a risk-bearing or insurance function does not mean that they could not in the future. Moreover, it seems odd that the underwriter role would be valued so highly if it is limited to certifying the integrity of an offering.

Gilson and Kraakman argue that the role of the investment banker is not explained entirely by the dual function of distributing securities for the issuer and risk-sharing or insurance in connection with underwriting. They suggest a third role of “information and reputation intermediary.”<sup>84</sup> The finance literature supports this argument that the reputation of investment bankers acts to certify securities offerings,<sup>85</sup> and legal academics seem to assume that investment bankers will suffer negative reputational consequences from failing to engage in proper due diligence with respect to securities issues.<sup>86</sup>

Gilson and Kraakman argue that viewing the underwriters’ role as that of reputational intermediary helps to answer several puzzling questions about financial markets. For example, the question of why IPOs are consistently underpriced can be explained if the underwriter is investing in its reputation by passing on to the buyer a portion of the returns. The explanation seems especially perverse given recent concern about investment banks making side-payments to customers.<sup>87</sup>

Yet these explanations of the role of underwriters are incomplete. For example, they do not explain why underwriters have agreed to the web of securities regulation applicable to investment banks. Investment banks and underwriters have not always faced such regulation. Certainly in the days of J.P. Morgan, before the 1933 and 1934 Acts, the underwriting role was governed almost entirely by reputational constraints. The regulatory regime

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83. See Dooley, *supra* note 1, at 788.

84. Gilson & Kraakman, *supra* note 1, at 618, 605 n.161.

85. See, e.g., James R. Booth & Richard L. Smith, II, *Capital Raising, Underwriting and the Certification Hypothesis*, 15 J. FIN. ECON. 261 (1986) (discussing certification function in the context of IPOs).

86. See, e.g., Gulati, *supra* note 12, at 710 (“Further, the intermediaries such as underwriters and lawyers are subject to both legal liability and reputational costs if they are negligent in their due diligence.”).

87. “This is, in fact, consistent with the common practice of allocating ‘hot issues’ to one’s best customers, thereby both insuring that the investors’ overall return will approximate the mean regardless of the variance, and nicely limiting the investment in reputation to the most important audience.” Gilson & Kraakman, *supra* note 1, at 621-22 n.197; *but see* eToys Press Release, *Milberg Weiss Announces Class Action Suit Against eToys, Inc.*, at <http://www.milberg.com/etoys> (last visited Sept. 29, 2001) (describing complaint filed against underwriters of eToys for making such side payments to certain investors in the eToys IPO).

of that time was substantially less onerous (in some areas, nonexistent) with a mixed effect. As a result, gatekeepers did not greatly benefit from regulatory costs or regulatory licenses; in fact, the gatekeeping industry was much smaller in terms of revenues and market capitalization. On the other hand, evidence of substantial abuse and fraud involving gatekeepers arose during this period.<sup>88</sup>

In any event, following the Great Crash of 1929, blaming underwriters became politically popular, and therefore some form of underwriter liability seemed inevitable by the early 1930s.<sup>89</sup> However, underwriters were not even mentioned in the first securities legislation introduced in the 1933 Congress, and there were substantial questions about whether underwriters should be included at all within § 11.<sup>90</sup>

The original version of § 11 created what has been called an “astronomical” risk of liability for underwriters.<sup>91</sup> Because it was short lived, it is impossible to know what its effects would have been. The investment banking industry immediately brought pressure to modify portions of § 11, such as limitations on damages, shortened statute of limitations, and reliance and causation requirements.<sup>92</sup>

Ultimately, underwriters, notwithstanding their obvious lobbying power and enormous resources, accepted § 11’s imposition of liability. At first glance, the acquiescence of underwriters with respect to § 11 seems puzzling.<sup>93</sup> Even if underwriters were unable to overcome the public’s disdain during the 1930s, why would they have continued to accept the imposition of liability during more recent decades<sup>94</sup> when they have proven to be successful in lobbying against financial regulation in other areas?<sup>95</sup>

Many possible explanations exist. Underwriters might be satisfied with

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88. A complete normative assessment of these phenomena in the pre-1933 regime is well beyond the ambition of this Article.

89. See Dooley, *supra* note 1, at 794-95.

90. See *id.* at 793. See generally JOEL SELIGMAN, *THE TRANSFORMATION OF WALL STREET* 39-72 (rev. ed. 1995).

91. See Dooley, *supra* note 1, at 802.

92. See *id.* at 804-05.

93. See Kraakman, *Corporate Liability Strategies*, *supra* note 1, at 895-96.

94. Underwriters have remained satisfied with § 11 for at least four decades. Michael Dooley has asserted that before and during the 1960s underwriters typically decided to underwrite a particular issue only after carefully investigating the issuer and evaluating its prospects, but that by the 1970s, this was no longer true. See Dooley, *supra* note 1, at 785. It certainly is not true today. Underwriters frequently do not have the time for such careful investigation and evaluation, and many issues do not require the same sort of detailed investigation. Moreover, in many instances the costs of investigation outweigh the benefits.

95. Investment banks have been very effective in lobbying for deregulation of the derivatives industry, even at times of significant scandal and public concern about industry practices. See Partnoy, *supra* note 79, at 255-56.

§ 11 because its liability provisions have no teeth: they are rarely found liable for § 11 damages, and when they are, they are indemnified by issuers.<sup>96</sup> Alternatively, Gilson and Kraakman have argued that investment bankers actually need § 11 liability in order to signal quality in a way that could not be imitated by a lower quality firm.<sup>97</sup> One implication of this argument is that costly ex post adjudication of gatekeeper liability based on open ended standards gives a few high quality investment bankers market power and acts as a powerful barrier to entry.<sup>98</sup> To the extent § 11 liability falls more heavily on low quality investment banks, high quality investment banks will have an interest in the existence and enforcement of such liability provisions. Costly liability provisions could operate as an effective barrier to entry for new, less reputable firms, which are more likely to be found liable and which, therefore, will find it costly to imitate the signals of higher quality investment banking firms.

In fact, the existence of costly ex post adjudication of liability might be a plausible alternative explanation of how a few investment banks have maintained their collective market share while earning what appear to be enormous profits. The bulge bracket of investment banking has been highly resistant to change over time. It is plausible, then, that the top investment banks have acquired and maintained market power in part because of valuable property rights deriving from the possible imposition of liability for securities fraud. If so, the normative implications for securities regulation are startling. The more vigorously the securities laws are enforced in court, particularly against lower quality gatekeepers, the higher the barrier to entry in those areas. As securities fraud lawsuits have recently proliferated, the increased costs associated with such litigation might have helped to cement the investment banks' role.<sup>99</sup>

The explanation offered by Gilson and Kraakman is closely related to the regulatory license theory advocated here, that is, that some underwriters benefit from regulatory entitlements associated with the securities laws (for example, they are able to charge additional fees associated with the

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96. To the extent § 11 is effectively irrelevant to underwriters, the modified strict liability proposal set forth in this Article (at least to the extent it eliminates due diligence-related defenses) would be a reasonable way of changing securities regulation to reflect practice. Under the proposal, underwriters could simply choose to fix their liability at a low level.

97. See Gilson & Kraakman, *supra* note 1, at 605-06 n.164.

98. See Kraakman, *Gatekeepers*, *supra* note 1, at 70.

99. In one study, James Bohn and Stephen Choi found contrary evidence based on a relationship between the reputation of underwriters and the likelihood of a securities fraud suit. See James Bohn & Stephen Choi, *Fraud in the New-Issues Market: Empirical Evidence on Securities Class Actions*, 144 U. PA. L. REV. 903 (1996). James Cox, however, has pointed out numerous flaws in this study. See James D. Cox, *Making Securities Fraud Class Actions Virtuous*, 39 ARIZ. L. REV. 497, 506-08 (1997).

regulatory benefits from their role). Merritt Fox has noted that the due diligence defense has depended on various surrounding circumstances since 1934,<sup>100</sup> and that variation in circumstances is the basis for the uncertainty supporting the existence of regulatory costs that benefit top-tier underwriters.

Can a similar argument be made about regulatory licenses and underwriters in other contexts? The securities laws do not require the use of an underwriter, and most issuers use one or more underwriters for their securities issues. As a result, it is difficult to argue that underwriters play a role similar to that of UL. Moreover, evidence exists that as technology improves and information costs decline, issuers more frequently choose not to use underwriters.<sup>101</sup> Although there is no obvious regulatory obstacle to an issuer choosing not to use underwriters, few issuers have attempted to do so, presumably because they would incur a higher cost of capital without an underwriter.

As noted above, §§ 11 and 12 of the 1933 Act and § 10(b) and Rule 10b-5 of the 1934 Act impose liability risk on underwriters.<sup>102</sup> In fact, the scienter requirement of Rule 10b-5 may actually create a disincentive for underwriters to engage in due diligence by making ignorance bliss: underwriters who were totally ignorant of a fraud are safe from liability, even if they were grossly negligent, whereas underwriters who conduct some investigation may have the requisite scienter.<sup>103</sup> Where both Rule 10b-5 and other liability provisions apply, the disincentive might not exist. But where § 11 liability is not relevant (for example, in private placements), underwriters have an incentive to avoid conducting due diligence at all.

In addition, although *Central Bank of Denver N.A. v. First Interstate Bank*

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100. Merritt B. Fox, *Shelf Registration, Integrated Disclosure, and Underwriter Due Diligence: An Economic Analysis*, 70 VA. L. REV. 1005, 1031 n.81 (1984) (citing legislative history of 1934 amendment deleting the term “fiduciary relationship” because that term had been “terrifyingly portrayed”).

101. Several issuers, including municipalities such as the City of Pittsburgh, recently have attempted to access the financial markets without the use of an underwriter.

102. In another context, Randall Thomas and Robert Hansen have made this argument with great force:

Imposing gatekeeper liability is costly though . . . [because] investment bankers will demand compensation for assuming these duties. This demand will penalize innocent clients and encourage the entry into the market of low-quality competitors. Investment bankers may also refuse to accept high risk cases, precisely the group of firms most in need of their services. It may also be easy for management to select investment bankers that are corrupt or willing to assume personal liability for a price, although this will be more difficult with diversified investment banking firms that have widespread client bases and well-known reputations, and to fire bankers that try to stop abuses.

Randall S. Thomas & Robert G. Hansen, *A Theoretic Analysis of Corporate Auctioneers' Liability Regimes*, 1992 WIS. L. REV. 1147, 1178.

103. See Coffee, *supra* note 81, at 1173 n.85.

of *Denver N.A.*<sup>104</sup> limited the application of § 10(b) to gatekeepers based on aiding and abetting theories, courts in recent years have held that claims for primary § 10(b) violations can be asserted against underwriters merely based upon their participation in the issuance of a prospectus.<sup>105</sup> For example, in *Phillips v. Kidder, Peabody & Co.*,<sup>106</sup> the court noted that in order to subject an underwriter to primary § 10(b) liability the underwriter itself must have made the statements in the offering documents.<sup>107</sup> The Court reasoned that an underwriter can make a statement in the offering documents merely by drafting or helping to draft the documents for the issuer.<sup>108</sup>

Moreover, in a market with rapidly evolving technologies, it is reasonable to question whether the underwriter's "due diligence" role is justified at all. Legal scholars debated this issue during the 1980s after the SEC adopted Rule 415 for shelf registrations.<sup>109</sup> The recent evidence associated with Rule 415 shows that for shelf registrations, disinterested advance due diligence is the exception, not the rule.<sup>110</sup> Coffee has noted that "it is costly to structure the system so that no one is well positioned to perform the certification function. If underwriters cannot do it within the time constraints they are given, other reputational intermediaries need to be identified and their services induced."<sup>111</sup> Another possibility arises in a market in which gatekeepers cannot perform an economically valuable certification function. In such a case, securities regulation would be better off not identifying any reputational intermediary at all. The act of "inducing" the services of a reputational intermediary is precisely the kind of regulatory intervention that creates regulatory licenses.

To see one context in which regulatory costs or regulatory licenses might benefit underwriters indirectly, consider the effects of securities regulation

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104. 511 U.S. 164 (1994).

105. See *In re USA Classic Sec. Litig.*, 1995 WL 363841, at \*5 (S.D.N.Y. 1995); *In re College Bound Consol. Litig.*, 1994 WL 172408, at \*4 (S.D.N.Y. 1994) (holding that primary violations can be established where underwriters either make the allegedly offending statement or disseminate the statements of others). *But see In re MTC Elec. Tech. Shareholders Litig.*, 898 F. Supp. 974, 986-87 (E.D.N.Y. 1995) (holding that participation by the underwriter in the drafting and circulation of the prospectus does not create a primary § 10(b) violation).

106. *Phillips v. Kidder, Peabody & Co.*, 933 F. Supp. 303, 316-17 (S.D.N.Y. 1996), *aff'd*, 108 F.3d 1370 (2d Cir. 1997).

107. *Id.*

108. *Id.*

109. See, e.g., Barbara A. Banoff, *Regulatory Subsidies, Efficient Markets, and Shelf Registration: An Analysis of Rule 415*, 70 VA. L. REV. 135, 184 (1984) (arguing that underwriter due diligence was no longer worth the cost because investors were—or could be—diversified); Fox, *supra* note 100, at 1010 (arguing that due diligence was worth the cost because of reductions in agency costs).

110. See Coffee, *supra* note 81, at 1170 ("Perhaps irretrievably, underwriters have lost their role as reputational intermediaries in shelf registrations.")

111. *Id.* at 1171.



related to underwriters from the perspective of the issuer, rather than the underwriter. From the issuer's perspective, there are regulatory benefits associated with hiring an underwriter. Indeed, the issuer benefits most from hiring the most reputable underwriter. Is it possible that from the issuer's perspective, the underwriter's gatekeeping role is one that is influenced by regulatory costs or regulatory licenses dependent on securities regulation?

First, consider the issuer's decision to issue securities publicly or in a private placement. Public issues generate expected costs associated with §§ 11 and 12 whereas private placements generate expected costs associated with Rule 10b-5 but not § 11 or § 12. Accordingly, issuers have an incentive to prefer private placement deals with lower liability risks over riskier public offerings.<sup>112</sup> Of course, a private placement might contain covenants and/or representations that would leave an issuer in the same position as in a public deal. If so, the costs of this private contracting could be minimized by a modified strict liability regime. In any event, the current regime seems suboptimal. As Coffee has noted, "[T]he unfortunate choice today may be between too much liability under Section 11 and too little liability in a private placement subject only to Rule 10b-5."<sup>113</sup>

Second, for public issues, the greater risks of liability create a regulatory entitlement among the certifying underwriter. For example, the directors in *Smith v. Van Gorkom* did not follow the then relatively common practice of soliciting a fairness opinion from an investment bank.<sup>114</sup> The court in *Van Gorkom* suggested that although such fairness opinions were not required by law, the directors would have obtained some advantage in the case if they had obtained a fairness opinion. Thus, *Van Gorkom* created a regulatory entitlement related to fairness opinions.<sup>115</sup> Similarly, SEC Rule 13e-3 requires issuers to state whether a transaction is fair or unfair to unaffiliated shareholders and to disclose any fairness opinions prepared by investment bankers.<sup>116</sup> State law also requires that directors consider valuation

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112. One consequence of the modified strict liability proposal offered here might be to encourage issuers to return more frequently to public markets.

113. Coffee, *supra* note 81, at 1173.

114. 488 A.2d 858, 874-77 (Del. 1985). The Delaware legislature has effectively overruled the holding in this case. DEL. CODE ANN. tit. 8, § 102(b)(7) (1999).

115. See, e.g., Daniel R. Fischel, *The Business Judgment Rule and the Trans Union Case*, 40 BUS. LAW. 1437, 1453 (1985) (predicting that the most immediate effect of the opinion in *Trans Union* would be that "no firm considering a fundamental corporate change will do so without obtaining a fairness letter or other similar documentation from outside consultants"). Daniel Fischel argued that the cost of obtaining fairness opinions was effectively a judicial tax on fundamental corporate changes, the effect being that fewer such transactions would occur and shareholder returns would be reduced accordingly. *Id.*

116. 17 C.F.R. § 240.13e-3 (1997); SEC Schedule 13E-3, Items 8 and 9, 17 C.F.R. § 240.13e-100 (1999).

information before acting on a transaction.<sup>117</sup> These requirements create regulatory costs and regulatory licenses by virtually requiring the use of an investment banker.<sup>118</sup>

Moreover, because managers of the issuer typically are risk-averse and have a disproportionate amount of their human capital invested in the issuer, they will have incentives to spend whatever fees are required to obtain the highest quality investment banker's opinion for a particular transaction. Assuming there are sufficient agency costs to enable managers to expend corporate resources on the highest quality opinions, the market for opinions from investment bankers becomes a winner-take-all market in which, because of regulation, the top investment banks are able to charge much higher fees than they would otherwise.<sup>119</sup> Thus, the rules decouple the decision about how much to charge for an opinion (which now depends primarily on the value of the regulatory license) from the decision about how much in resources to spend supporting an opinion (which previously could vary in quality, based on the time spent and the number and quality/seniority of people assigned to work on the matter).<sup>120</sup> Regulatory licenses thus reduce the incentives for competition among investment banks based on quality of service.

Finally, abundant anecdotal evidence suggests that investment banks engage in potentially reputation-depleting activities in order to maximize profits. The relentless focus on annual bonuses and the dominant short-term profit maximization culture of investment banking is consistent with such activities. Substantial agency costs at investment banks prevent managers from restraining lower-level employees who have incentives to deplete the firm's reputation to increase their own profits.<sup>121</sup> Moreover, because of the

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117. Robert J. Giuffra, Jr., Note, *Investment Bankers' Fairness Opinion in Corporate Control Transactions*, 96 YALE L.J. 119, 124 (1986).

118. Several commentators have suggested that investment bankers should be liable to shareholders for negligent fairness opinions. See Ted J. Filis, *Responsibility of Investment Bankers to Shareholders*, 70 WASH. U. L.Q. 497 (1992). See also Lucian A. Bebchuk & Marcel Kahan, *Fairness Opinions: How Fair Are They and What Can Be Done About It?*, 1989 DUKE L.J. 27 (arguing that judges should carefully scrutinize fairness opinions); Charles M. Elson, *Fairness Opinions: Are They Fair or Should We Care?*, 53 OHIO ST. L.J. 951 (1992); Giuffra, *supra* note 117 (arguing for increased obligations of directors in obtaining fairness opinions); Dale A. Osterlie, *Fairness Opinions as Magic Pieces of Paper*, 70 WASH. U. L.Q. 541 (1992) (arguing that fiduciary principles should govern the investment banker's relationship with the issuer).

119. Another problem with rules requiring fairness opinions is that they create incentives for directors or managers to rely on an investment bank instead of gathering information and forming and opinion on their own.

120. See Thomas & Hansen, *supra* note 102, at 1178.

121. See Dooley, *supra* note 1, at 840 ("[E]ven the most conscientious underwriter must expect occasional human error.").

short-term compensation structure, it may be in managers' collective interest to let such lower-level activities go unmonitored if reputational costs will be incurred, even by managers, only in future periods. Also, to the extent managers do not suffer along with their firm from reputation-depleting activities, they will not have adequate incentives to police such activities. In short, although the issue is complex,<sup>122</sup> the dominant culture can fairly be described as somewhat barbaric: investment bankers "eat what they kill" and have few incentives to look beyond the next meal.

Employees of investment banks have an enormous amount of power, much more than shareholders.<sup>123</sup> Compensation accounts for roughly sixty percent of an investment bank's costs, a very high percentage compared with other firms. Moreover, second-tier firms must pay even higher salaries and bonuses to attract top people.<sup>124</sup> What are these employees doing to generate such great value? This section concludes with a few examples.

The focus on short-term bonus compensation has affected the behavior of investment bankers in a variety of areas. Consider as one example equity analysts at investment banks. Such analysts are popular, powerful, and well-paid, yet they generally are regarded by experts as adding very little social or informational value.<sup>125</sup> Moreover, analysts face a serious conflict of interest: on one hand, they are supposed to be providing objective advice regarding companies; on the other hand, what they say has a dramatic effect on whether the company they are covering will hire the investment bank in future transactions. This corruption of securities analysts is a relatively recent phenomenon. One study, based on data from 1988 to 1994, indicated that analysts were an effective mechanism in reducing agency costs, thereby increasing shareholder value.<sup>126</sup> Yet, by the end of 2000, the upward bias of analyst recommendations was both apparent and absurd, even to an

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122. In a related context of rogue brokers, Donald Langevoort has remarked on the difficulty of balancing arguments on behalf of investment bankers against arguments on behalf of investors. See Donald C. Langevoort, *Selling Hope, Selling Risk: Some Lessons for Law from Behavioral Economics About Stockbrokers and Sophisticated Customers*, 84 CALIF. L. REV. 627, 629-31 (1996). Are rogue brokers acting against or in favor of the interests of management? Of the investment bank generally? Are investors themselves to blame for the broker's actions? The questions depend greatly on how likely it is that individuals at investment banks will suffer much or all of the costs associated with potentially reputation-reducing activities. See *id.*

123. In fact, for scholars interested in the stakeholder model of the corporation, there is no better example of an employee-focused firm than top-tier (i.e., "bulge-bracket") investment banks, a fact supporters of the stakeholder model may be reluctant to recognize.

124. See *Powers of Concentration*, THE ECONOMIST, July 15, 2000, at 71.

125. See Eli Amir et al., *What Value Analysts?* (July 2000) (NYU Stern School Working Paper, on file with author).

126. See John A. Doukas et al., *Security Analysis, Agency Costs and Firm Characteristics*, at <http://papers.ssrn.com> (last visited Aug. 10, 2001).

unsophisticated investor. Of 8,000 recommendations made by analysts covering companies in the Standard & Poor's 500 stock index, only twenty-nine were sells.<sup>127</sup>

When a Goldman Sachs stock analyst recently grouped electronic commerce companies into "winners" and "losers", it turned out that all of the winners except one were Goldman banking clients.<sup>128</sup> Are investors surprised by such news? Does it deplete a bank's reputation? Such practices certainly raise questions about the effectiveness of the "chinese walls" between investment banks' research and investment banking activities, which in theory are independent. The fact that compensation of research analysts is linked to the fee revenue they generate for the investment banking unit also should harm the reputations of banks.<sup>129</sup> Yet despite these questionable activities, the top investment banks have been able to preserve their reputations. In fact, it is fair to say that these banks have maintained their reputations notwithstanding the extraordinary attempts of their employees to deplete them.

Investment banks move quickly into new business based on which business will maximize profits for that year.<sup>130</sup> These moves tend to create concentrations of market power among a few banks, at least in the short run. Many parts of investment banking are quickly turned into commodity businesses, and those businesses are likely to receive fewer resources. The fact that half of some investment bank's revenues are from trading should raise questions about how banks can earn unusual high profits in highly competitive stock, bond, foreign exchange, and derivatives markets. These profits indicate that investment banks are doing something more than just intermediating trades. What could generate such profits? Possibly, banks are trading based on favorable information, front-running clients, colluding to increase bid-offer spreads, or manipulating markets. Again, there is anecdotal evidence about top-tier banks engaging in these practices.<sup>131</sup> Of course,

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127. See Gretchen Morgenson, *How Did So Many Get It So Wrong?*, N.Y. TIMES, Dec. 31, 2000, at 1.

128. See Susan Pulliam, *Goldman's E-Commerce List Reduces Nonclients to Low Tiers*, WALL ST. J., June 20, 2000, at C1. None of the companies in the bottom tier was a Goldman Sachs banking client. *Id.* at C2.

129. See *id.*

130. For example, the top five investment banks doubled their market share of U.S. mergers and acquisitions activity from 1990 to 2000. *Powers of Concentration*, *supra* note 124, at 71-72.

131. For example, Goldman Sachs was not overtly tarnished by its alleged failure to inform investors that Nina Brink, chair of internet company World Online, had sold most of her shares before an offer managed by Goldman. Goldman, drew threats from the Japanese government to exclude Goldman from a series of privatizations, potentially worth hundreds of millions of dollars in fees. See Garth Alexander, *The Tipsters Who Never Say "Sell,"* LONDON SUNDAY TIMES, Apr. 23, 2000, at <http://www.Sunday-times.co.uk/news/sti/2000/04/23/stibusnews02011.html> (last visited Aug.

evidence of such behavior is very difficult to detect and is spotted only occasionally. The goal here is not to submit evidence of nefarious activities by investment bankers. Instead, the point is that the substantial profits from investment banking at least raise questions about whether investment banks are engaging in what scholars would regard as reputation-depleting activities without actually depleting their reputations.

Investment banks also have engaged in potentially reputation-depleting behavior with respect to venture capital investing and IPOs. Banks frequently engage in venture capital investing and then sell their shares following an IPO in a market supported by the banks' equity analysts. In 1999-2000, up to twenty-two percent of some investment bank's profits were from "private equity" and venture capital investing; in 1998, the percentage was approximately four percent.<sup>132</sup> Moreover, there is evidence that banks collude to set fees in the IPO market, although some of that evidence has been disputed.<sup>133</sup> The SEC recently has investigated whether investment banks have engaged in the practice of asking a small number of large investors to pay above-average commissions in exchange for allocations in certain "hot" IPOs.<sup>134</sup>

These anecdotes might simply be isolated instances of abuse that can be explained away. They are not offered as anything more than mere anecdotes to illustrate a few examples of facts consistent with the arguments about regulatory licenses offered in the first part of this section. In other words, if regulatory costs have resulted in high barriers to entry, investment banks have had incentives to engage (without much reputational consequence) in activities that otherwise would have depleted their reputations. These barriers exist because issuers and investors need to return to one of a small number of top-tier members of the resulting oligopoly, even if those members have less-than-pristine records. This argument, if plausible, is consistent with economically rational behavior by investment banking gatekeepers, and scholars should not expect reputational constraints to prevent such behavior in the future. Again, this is not an attempt to make any well-supported set of empirical allegations against investment banks. Instead, the points are that economically rational investment banks have incentives to engage in reputation-depleting activity when the expected benefits exceed the expected

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10, 2001). The goal here is not to isolate Goldman Sachs. In fact, the only reason to select stories about Goldman Sachs is that the firm seems to be regarded as having the highest reputation for quality in numerous areas.

132. Mark Maremont, *Raising the Stakes*, WALL ST. J., July 24, 2000, at A1.

133. See generally Initial Public Offering Resources, at <http://www.iporesources.org> (last visited Sept. 8, 2001).

134. See eToys Press Release, *supra* note 87.

costs, that investment banks at least occasionally engage in such activities, and that there may be regulatory cost- or regulatory license-related explanations of why investment banks would perceive that the expected benefits of such activities exceed their expected costs.

One final reason why investment banks can preserve reputations for quality, notwithstanding potentially reputation-depleting activities, is that it is difficult for investors to know which “brand name” to punish. The banking industry has undergone numerous mergers resulting in constant changes, making it virtually impossible for investors to gauge reputational capital with any accuracy. For example, the National Association of Securities Dealers (NASD) recently alleged that Morgan Stanley Dean Witter committed securities fraud by misstating risks of \$2.1 billion of closed-end bond funds based on disclosures, sales, and losses that occurred before Morgan Stanley merged with Dean Witter in 1997.<sup>135</sup> Should investors punish the Morgan Stanley Dean Witter name based on this alleged fraud? Or should investors assume that Morgan Stanley’s role in future business will not be tarnished by the merger with Dean Witter? Does it matter whether the institution is called Morgan Stanley Dean Witter, or as of January 29, 2001, again just Morgan Stanley?

## 2. Accounting Firms

As with underwriters, Gilson and Kraakman have argued that accounting firms serve as reputational intermediaries.<sup>136</sup> However, as with underwriters, an argument can be made that accounting firms do not survive and prosper solely based on their reputational capital. Instead, accounting firms benefit directly and indirectly both from regulatory costs and from regulatory licenses stemming from extant securities regulation.

First, for accountants, there are some direct regulatory licenses of the type that benefit UL and bond credit rating agencies. These regulatory licenses are derived from SEC rules and regulations setting forth standards with respect to accountants and the audit function. In addition, there are indirect regulatory licenses stemming from the fact that the securities laws envision and authorize a self-regulatory apparatus that imposes additional standards and consequently benefits top-tier accounting firms the most.

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135. See Randall Smith, *NASD Alleges That Dean Witter Misstated Risks on Bond Funds*, WALL ST. J., Nov. 21, 2000, at C1.

136. Gilson & Kraakman, *supra* note 1, at 607-08 n.166 (“While part of their value lies in their ability to exploit economies of scale and scope, third-party verifiers such as certified public accountants also function as reputational intermediaries . . . only if the accountant can be expected to treat the client at arm’s length is its message of verification believable.”).

Title 17 of the Code of Federal Regulations Part 210 sets forth in great detail the minimum qualifications for certified and public accountants and for accountants' reports.<sup>137</sup> The SEC will not recognize any person as a certified public accountant who is not registered and in good standing in the relevant state. The regulations also set forth extensive restrictions on financial, employment, and business relationships. In general, the SEC requires that accountants be independent.<sup>138</sup> Non-audit-related ties to other firms (especially to the issuer) can jeopardize an accountant's independence.<sup>139</sup> In recent years, serious questions have arisen regarding potential conflicts of interest between the audit function of an accounting firm and its more lucrative consulting function. In response to these concerns, the SEC sought to segregate the audit and consulting functions of major accounting firms and ultimately reached agreement with those firms, which have proceeded to

137. 17 C.F.R. § 210 (1999). These qualifications depend on certification requirements specified by the relevant state licensing agency. Qualifications of Accountants, 17 C.F.R. § 210.2-01(a) (1999).

138. Sections 210.2-01(b) & (c) provide as follows:

(b) The Commission will not recognize any certified public accountant or public accountant as independent who is not in fact independent. For example, an accountant will be considered not independent with respect to any person or any of its parents, its subsidiaries, or other affiliates

(1) in which, during the period of his professional engagement to examine the financial statements being reported on or at the date of his report, he, his firm, or a member of his firm had, or was committed to acquire, any direct financial interest or any material indirect financial interest;

(2) with which, during the period of his professional engagement to examine the financial statements being reported on, at the date of his report or during the period covered by the financial statements, he, his firm, or a member of his firm was connected as a promoter, underwriter, voting trustee, director, officer, or employee. A firm's independence will not be deemed to be affected adversely where a former officer or employee of a particular person is employed by or becomes a partner, shareholder or other principal in the firm and such individual has completely disassociated himself from the person and its affiliates and does not participate in auditing financial statements of the person or its affiliates covering any period of his employment by the person. For the purposes of 210.2-01(b), the term *member* means

(i) all partners, shareholders, and other principals in the firm,

(ii) any professional employee involved in providing any professional service to the person, its parents, subsidiaries, or other affiliates, and

(iii) any professional employee having managerial responsibilities and located in [the engagement office] or other office of the firm which participates in a significant portion of the audit.

(c) In determining whether an accountant may in fact be not independent with respect to a particular person, the Commission will give appropriate consideration to all relevant circumstances, including evidence bearing all relationships between the accountant and that person or any affiliate thereof, and will not confine itself to the relationships existing in connection with the filing of reports with the Commission.

17 C.F.R. §§ 210.2-01(b) & (c) (emphasis added).

139. *See id.*

segregate the functions.<sup>140</sup> These rules effectively grant regulatory licenses to established accounting firms and impose barriers to entry on other firms. Accordingly, they generate value and some market power for top-tier accounting firms.<sup>141</sup>

Federal regulations also require registered companies to file audited financial statements, including audited statements from the previous three fiscal years.<sup>142</sup> There are detailed instructions regarding income statements,<sup>143</sup> changes in stockholders' equity,<sup>144</sup> financial statements covering businesses acquired or to be acquired,<sup>145</sup> and numerous other detailed requirements, including instructions related to financial derivatives.<sup>146</sup>

Other regulations cover the content and quality of accountant reports.<sup>147</sup> For example, accountant reports must be in good form with all the relevant titles, dates, the auditor's name and address, and a list of statements covered.<sup>148</sup> Any accountant report must state whether it was made in

140. See Revision of the Commission's Auditor Independence Requirements, Release Nos. 33-7919; 34-43602; 35-27279; IC-24744; IA-1911; FR-56; File No. S7-13-00, Fed. Sec. L. Rep. (CCH) ¶ 86,406 (Dec. 1, 2000).

141. In addition, these rules can affect the status of accounting firms in litigation. For example, a nonindependent accounting firm arguably is more likely to be deemed a "seller" under § 12(a)(2).

142. See 17 C.F.R. § 210.3-01-02 (year).

143. See *id.* § 210.3-03.

144. See *id.* § 210.3-04.

145. See *id.* § 210.3-05.

146. See *id.* § 210.3-06-20. See also *id.* § 210.4-08(n) (providing instructions for derivatives).

147. See *id.* § 210.2-02.

148. *Id.* Section 210.2-02 provides as follows:

(a) *Technical requirements.* The accountant's report:

- (1) Shall be dated;
- (2) Shall be signed manually;
- (3) Shall indicate the city and State where issued; and
- (4) Shall identify without detailed enumeration the financial statements covered by the report.

(b) *Representations as to the audit.* The accountant's report:

- (1) Shall state whether the audit was made in accordance with generally accepted auditing standards; and

(2) Shall designate any auditing procedures deemed necessary by the accountant under the circumstances of the particular case, which have been omitted, and the reasons for their omission. Nothing in this rule shall be construed to imply authority for the omission of any procedure which independent accountants would ordinarily employ in the course of an audit made for the purpose of expressing the opinions required by paragraph (c) of this section.

(c) *Opinion to be expressed.* The accountant's report shall state clearly:

- (1) The opinion of the accountant in respect of the financial statements covered by the report and the accounting principles and practices reflected therein; and

(2) the opinion of the accountant as to the consistency of the application of the accounting principles, or as to any changes in such principles which have a material effect on the financial statements.

(d) *Exceptions.* Any matters to which the accountant takes exception shall be clearly identified, the



accordance with generally accepted accounting principles (GAAP),<sup>149</sup> thereby effectively requiring that accounting firms use GAAP in their reports.<sup>150</sup> The rules refer to accounting principles more generally, and thereby grant power to the accountants' self-regulatory organization and its interpretation of appropriate standards. The rules also increase the value of deviations from professional standards.<sup>151</sup>

The dependence of federal regulation on a private body of self-regulatory auditing standards also benefits top-tier firms by creating indirect regulatory licenses. The preparation of financial reports is governed by a body of auditing standards. Statement on Auditing Standards No. 1 states that the goal of an audit is the expression of an opinion about the fairness of financial statements.<sup>152</sup> This opinion requires judgment and must be based on sound reasoning and GAAP.<sup>153</sup> The American Institute of Certified Public Accountants also promulgates standards that implicitly are approved of in federal regulations.<sup>154</sup>

In addition to the GAAP rules, there are generally accepted auditing standards (GAAS) that require, among other things, that auditors be both independent and technically competent. In particular, GAAS General Standard 3 requires the use of "due professional care"—the typical standard of care expected of a reasonable and prudent accountant. These standards require that accounting firms employ proper procedures for review and approval of audits and audit opinions, and also that firms engage in adequate training and supervision. Requiring such practices might seem uncontroversial. However, enshrining standards in a self-regulatory framework creates incentives for firms to engage in activities designed not only to satisfy the standards for valid business reasons but also to obtain assurance that the firm will not be found liable in the event there are material misrepresentations or omissions related to the audit. For example, comfort

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exception thereto specifically and clearly stated, and, to the extent practicable, the effect of each such exception on the related financial statements given. (See section 101 of the Codification of Financial Reporting Policies.)

*Id.*

149. *See id.* § 210.2-02(b).

150. *See also* Reg. S-X, Rule 4-01(a)(1), 17 C.F.R. § 210 (1999).

151. Public corporations can dismiss their accountants in disputes over auditing practices, and, although it is impossible to quantify, at least a portion of these dismissals are "shopping" efforts by issuers seeking accountants willing to certify their financial statements on favorable terms. *See* Kraakman, *Gatekeepers*, *supra* note 1, at 73 n.62. Such dismissals, however, require disclosure on Form 8-K and are almost always referred to the SEC's Division of Enforcement.

152. Statement of Auditing Standards No. 1.

153. *Id.*

154. *See* 17 C.F.R. § 210.2-02(b)-(c).

letters from auditors typically not only state that the auditor is independent, but also comment on financial statement compliance with securities registration requirements and changes in various required financial information, all with a view of complying with regulations and self-regulatory standards. Plaintiffs in suits against accounting firms can point to these standards in alleging violations of the securities laws.

Finally, accountants, like underwriters, face uncertain liability for violations of the securities laws because of ambiguity in judicial decisions. Accountants arguably face a higher probability of liability than underwriters, and the standards applicable in cases involving accountants are even less certain. This uncertainty forces accountants to take great precautions to protect themselves from future litigation and therefore increases the barriers to entry.

Commentators have documented the myriad ways in which accountants can be held liable as gatekeepers.<sup>155</sup> For accounting firms, the uncertainty associated with potential liability costs generates valuable property rights and increases the barriers to entry imposed on new, potentially lower quality firms. At the same time, accounting fraud can be virtually impossible to detect, so imposing liability may not generate deterrence benefits.<sup>156</sup>

The same legal rules governing liability of underwriters apply to accounting firms performing audit functions for securities issues. As with the rules and cases for underwriters, there is great uncertainty surrounding the question of when and whether accountants can be liable for misleading statements.<sup>157</sup> Adding to the uncertainty of federal rules is the fact that various state courts have found accountants liable to foreseeable third parties for material mistakes in financial statements.<sup>158</sup> Courts have held that an

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155. See Jack E. Karns et al., *Accountant and Attorney Liability as "Sellers" of Securities Under Section 12(2) of the Securities Act of 1933: Judicial Rejection of the Statutory, Collateral Participant Status Cause of Action*, 74 NEB. L. REV. 1 (1995); Richard M. Weinroth, *Overview of Civil and Criminal Liability of Clients and Attorneys for Federal and Arizona Securities Violations*, 26 ARIZ. ST. L.J. 1 (1994).

156. See *In the Matter of Cendant Corp.*, Admin. Proc. No. 3-10225, 2000 SEC LEXIS 1237 (June 14, 2000). The Cendant matter involved accounting fraud at CUC International Inc., which became Cendant following a merger with HFS Incorporated. *Id.* at \*4-\*5 CUC provided membership-based consumer services, such as auto, dining, shopping, and travel "clubs". *Id.* at \*3. Cendant was found to have violated the securities laws based on CUC senior managers' practice of comparing preliminary quarterly results with analysts' expectations and directing that income be adjusted to correspond with expectations. *Id.* at \*14.

157. See, e.g., *Anixter v. Hane-Stake Prod. Co.*, 77 F.3d 1215, 1226 (10th Cir. 1996) (holding that an accountant must actually make a misleading statement to be liable); *In re JWP, Inc. Sec. Litig.*, 928 F. Supp. 1239, 1256 (S.D.N.Y. 1996) (holding that a defendant may not be liable under 10(b) unless it actually made a misrepresentation); *In re MTC Elec. Tech. S'holders Litig.*, 898 F. Supp. 974, 987 (E.D.N.Y. 1995) (same).

158. See *Walpert, Smullian & Blumenthal P.A. v. Katz, Md.*, 762 A.2d 582, 608-09 (Md. App.

accountant's good faith compliance with GAAP discharges the accountant's professional obligation to act with due care, making compliance with GAAP even more important.<sup>159</sup> Compliance with GAAP, however, does not insulate an accountant from liability.<sup>160</sup>

There also is a lack of clear judicial direction about the scope of accountant liability after several different interpretations of the *Central Bank of Denver's* holding limiting on secondary liability. Many of the cases addressing the scope of gatekeeper liability after *Central Bank of Denver* have involved accountants. A brief sample is illustrative.

In *In re Software Toolworks, Inc.*, the Court of Appeals for the Ninth Circuit stated that an accountant could be held primarily liable under § 10(b) for misrepresentations contained in a client's letter to the SEC if the accountant played a "significant role" in drafting the letter.<sup>161</sup> Conversely, in *Anixter v. Home-Stake Production Co.*, the Court of Appeals for the Tenth Circuit declared that a misstatement must have been made by the accountant rather than by his client,<sup>162</sup> and it disapproved of decisions such as *Software Toolworks* that "allow liability to attach without requiring a representation to be made by [the accountant] defendant" as inconsistent with *Central Bank of Denver*.<sup>163</sup> In *In re ZZZZ Best Securities Litigation*, the U.S. District Court for the Northern District of California held that it was not necessary for investors to know that statements in the offering documents were attributable to the accountant; instead, where the accountant was "intricately involved" in the preparation of solicitation documents, it was up to the accountant to ensure that statements in those documents were correct.<sup>164</sup> In *O'Neil v. Appel*, the U.S. District Court for the Western District of Michigan held that accountants who merely review and approve their clients' offering documents are not subject to liability, but noted that accountants who had "assisted in the drafting" might be liable.<sup>165</sup> Finally, in *Picard Chemical, Inc.*

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2000); *Credit Alliance Corp. v. Arthur Andersen & Co.*, 483 N.E.2d 110, 120-21 (N.Y. 1985).

159. *See Monroe v. Hughes*, 31 F.3d 772, 775-76 (9th Cir. 1994); *SEC v. Arthur Young & Co.*, 590 F.2d 785, 788-89 (9th Cir. 1979).

160. *See Monroe*, 31 F.3d at 774.

161. 50 F.3d 615, 628 n.3 (9th Cir. 1994).

162. 77 F.3d 1215, 1226-27 (10th Cir. 1996).

163. *Id.* at 1226 n.10.

164. 864 F. Supp. 960, 970 (C.D. Cal. 1994). *See also Adam v. Silicon Valley Bancshares*, 884 F. Supp. 1398, 1401 (N.D. Cal. 1995) (holding that an accountant who provided "significant assistance" in preparing offering violated § 10(b)); *Cashman v. Coopers & Lybrand*, 877 F. Supp. 425, 432-34 (N.D. Ill. 1995) (same).

165. 897 F. Supp. 995, 1000 (W.D. Mich. 1995). *See also In re Kendall Square Research Corp. Sec. Litig.*, 868 F. Supp. 26, 28 (D. Mass. 1994) (holding that an accountant who reviews and approves of quarterly financial statements does not make a statement).

*Profit Sharing Plan v. Perrigo Co.*,<sup>166</sup> the same Michigan district court stated that misstatements must actually be made by the accountant, but by citing *O'Neil v. Appel*,<sup>167</sup> the *Picard Chemical* court created uncertainty about whether statements drafted by accountants were "made" by them.<sup>168</sup> Based on these cases, it is fair to say that the state of the law with respect to accountant liability is uncertain.

As a brief case study, it is worth considering the role of accountants in supporting corporate tax shelters. Admittedly, writing opinion letters for corporate tax shelters is a different function than auditing financial statements or certifying new securities issues. Nevertheless, recent data with respect to accountants' roles in corporate tax shelters sheds some light on the more difficult to observe audit function. Moreover, Kraakman has cited tax practitioners and tax shelter opinions as a type of gatekeeping function.<sup>169</sup>

All of the major accounting firms and many investment banks sell such corporate tax shelter products. Interestingly, the firms charge fees based on the tax savings the shelters generate.<sup>170</sup> Very few tax shelters are uncovered and criminal penalties are rare. From a cost-benefit perspective, the potential profits seem worth the extremely small risk of being caught. In fact, some practitioners have spoken in precisely these "expected value" terms. Consider the following comments by Paul J. Sax, formerly chair of the ABA tax section and a partner at the firm of Orrick, Herrington & Sutcliffe in San Francisco:

I have a chance of being hit by the I.R.S. with a 20 percent penalty . . . . Based on my experience I calculate that chance to be one in 50 because the likelihood of the I.R.S. detecting this transaction in my very large tax return is small, the chance of them pursuing it correctly is small, the chance of them pursuing through to litigation is small, the chance a judge will uphold the penalty is small.<sup>171</sup>

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166. See *Picard Chem., Inc. Profit Sharing Plan v. Perrigo Co.*, 940 F. Supp. 1101, 1119 (W.D. Mich. 1996).

167. See *O'Neil*, 897 F. Supp. at 999.

168. See *Picard Chem., Inc.*, 940 F. Supp. at 1120.

169. Kraakman, *Gatekeepers*, *supra* note 1, at 65, 68 n.45.

170. Many accounting and tax professionals view charging a fee based on taxes avoided as unethical. See David Cay Johnston, *Sham Shelters for Business Flourish as Scrutiny Fades*, N.Y. TIMES, Dec. 19, 2000, at A1, available at 2000 WL30526201 (reporting that the United States Tax Court ruled that the deal was a sham, and that ruling was upheld on appeal). An alternative to such fees is "value pricing," which is based on the client's willingness to pay and therefore is only indirectly based on taxes avoided. In 1990, for example, Merrill Lynch created a deal that saved Allied Signal \$180 million in one transaction and received a \$25 million fee. *Id.*

171. *Id.*

Suppose a deal involves a tax savings of \$100 million and would pay a \$7 million fee. As Sax puts it, that means that “once I get past ‘I know I am doing something wrong here,’ the arithmetic settles it for me. What is \$7 million for at least an 80 percent chance at \$100 million?”<sup>172</sup>

Those numbers are from the taxpaying firm’s perspective. From the perspective of the provider of the shelter, the arithmetic also makes sense. Practitioners have estimated that it takes about one hundred hours for an expert to create a tax shelter so it can be sold.<sup>173</sup> The calculus also works for lawyers asked to render an opinion characterizing tax-avoidance transactions as legitimate. Clients offer tax lawyers up to one million dollars for such opinions. Buck Chapoton, a tax lawyer at Vinson & Elkins in Washington and a former tax policy chief for President Reagan, said that “[f]or those kinds of fees, purveyors are not buying your professional advice. They are buying your good name and, sadly, at those prices there are lawyers and law firms that will sell.”<sup>174</sup>

Some firms refuse to participate in questionable tax shelters, although it is difficult to argue that they acquire reputation capital as a result. Is Ford Motor Company, which has not done such deals, more reputable than Colgate-Palmolive or United Parcel Service, which have?<sup>175</sup>

The role of accountants in supporting tax shelters illuminates the problems associated with relying on accountants’ opinions. If accountants are willing to engage in potentially reputation-depleting activities with respect to tax shelters, they should be willing to engage in potentially reputation-depleting activities with respect to audits and other functions, too. The direct and indirect benefits associated with regulatory licenses stemming from securities rules, self-regulatory standards, and ambiguous court decisions allow accountants to engage in such activities without suffering the reputational losses predicted by the reputational intermediary arguments.

### 3. *Securities Lawyers*

Securities lawyers benefit less directly from regulatory costs and regulatory licenses than do underwriters and accountants. Nevertheless, there is some evidence of direct benefit, and the due diligence defense and related cases have generated substantial indirect benefits for lawyers. Moreover, the

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172. *Id.* Even U.S. Treasury officials estimate that audits uncover only approximately ten percent of illegitimate tax shelters. The Treasury often learns of shelters from anonymous mailings of documents. *Id.*

173. *Id.*

174. *Id.*

175. *Id.*

SEC has acted informally to impose additional burdens on lawyers. In general, the SEC has influenced the behavior of securities lawyers with the view that lawyers involved in securities transactions are the guardians of the interests of the investing public.<sup>176</sup> According to one commentator, SEC pronouncements have “terrified the general practitioner, segregated a uniquely complex area of highly-specialized practice, and upgraded the standards of care applicable to securities lawyers.”<sup>177</sup> Even so, these costs are difficult to quantify and might not exceed the reputational constraints securities lawyers would face even absent SEC pressure.

Any regulatory licenses, to the extent they exist, stem from the securities law requirement of an opinion from counsel regarding registration statements. Like other gatekeepers, securities lawyers provide opinions about elements of a financial transaction. Legal opinions arise in various contexts in a registered public offering of securities. Although one expects publicly offered securities to be traded after the offering, attorneys rarely give opinions to the public with respect to the offering. Instead, counsel for the issuer typically gives a public opinion limited to the minimum necessary to satisfy the requirements of the 1933 Act.<sup>178</sup> As the scope of this opinion is typically quite narrow, regulatory licenses are likely to be of only minor value. Item 601 Exhibits of Regulation S-K requires only that registration statements contain as an exhibit “[a]n opinion of counsel as to the legality of the securities being registered, indicating whether they will, when sold, be legally issued, fully paid and non-assessable, and, if debt securities, whether they will be binding obligations of the registrant.”<sup>179</sup> Nevertheless, an issuer’s counsel can charge a fee for preparing this opinion, regardless of whether it has any value apart from satisfying the regulatory requirement.

The more troublesome area with respect to the role of securities lawyers concerns opinions that are not given to the public. Issuers typically receive a much more detailed nonpublic opinion regarding an issuance of securities from their counsel.<sup>180</sup> The underwriters, who are the initial purchasers in the

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176. James H. Cheek, III, *Professional Responsibility and Self-Regulation of the Securities Lawyer*, 32 WASH. & LEE L. REV. 597, 617 (1975).

177. Manning Gilbert Warren, III, *The Primary Liability of Securities Lawyers*, 50 SMU L. REV. 383, 397 (1996).

178. For example, such opinions typically cover only the validity of the securities. See Richard R. Howe, *The Duties and Liabilities of Attorneys in Rendering Legal Opinions*, 1989 COLUM. BUS. L. REV. 283, 287 (1989).

179. 17 C.F.R. § 229.601(b)(5) (1999).

180. See Keith L. Kearney & Robert Lovejoy, *Underwriter and Dealer Materials*, in MICHAEL J. HALLORAN ET AL., *VENTURE CAPITAL & PUBLIC OFFERING NEGOTIATION* 32-66-73 (3d ed. Supp. 2001).

offering, typically receive a nonpublic opinion from separate counsel.<sup>181</sup> Both counsel for the issuer and counsel for the underwriters typically provide the underwriters an opinion stating that, based on their preparation and review, they believe the information in the prospectus is materially accurate.<sup>182</sup>

What is the purpose of the separate legal opinions? At the outset, it is worth noting that only a portion of the opinion of the issuer's counsel, which typically is limited to a statement about the validity of the securities, is disclosed to the public. It is difficult to argue that any private opinion of underwriter's counsel (e.g., with respect to broader issues, such as Rule 10b-5) serves a *public* gatekeeping function. If the opinion is not publicly available, it cannot be an important factor in the investors' investment decision.<sup>183</sup>

However, this analysis leaves open the more important question of why underwriters demand separate, nonpublic opinions from both issuer's counsel and their own counsel. Here, the answer is more complex. One possibility is that the primary purpose is to assist the underwriters in establishing an iron-clad due diligence defense.

An underwriter does not necessarily establish its due diligence defense simply because it receives an opinion from a law firm. Reliance on a "reputable" law firm is an important factor in establishing the defense. Underwriters typically require that the issuer's counsel be a top-tier law firm. To some extent, underwriters send a signal to investors through the reputational quality of issuer's counsel. Interestingly, the 1933 Act requires that registration statements disclose "the names and addresses of counsel who have passed on the legality of the issue."<sup>184</sup> One reason for the requirement is to ensure that investors learn when less reputable law firms certify the legality of an issue. Of course, an underwriter might disclose the names of its law firms without such a rule, but the rule nonetheless ensures that all underwriters do so. This rule works to the benefit of the most prestigious firms. An underwriter who knows that the name and address of its counsel will be displayed prominently on a prospectus will have an incentive

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181. *Id.* at 75-77. The opinion of underwriters' counsel like the nonpublic opinion of issuer's counsel, typically would cover not only the validity of the securities, but other issues as well. These issues include the absence of conflicts with specified agreements and instruments, representations related to defaults under any other outstanding securities, and assurances regarding potential violations of law in connection with the issuance of the securities. *Id.* See also Howe, *supra* note 178, at 287.

182. See Howe, *supra* note 178, at 287.

183. On the other hand, sophisticated investors are aware that these opinions are given and have general knowledge about the contents of these opinions. Moreover, if counsel is unwilling to give an opinion, the underwriters will not proceed with the offering.

184. See Item (23) of Schedule A to the Securities Act of 1933, 15 U.S.C. § 77aa(23) (1934).

to pick a marquis law firm.

Perhaps most importantly, § 11(b)(3)(C) of the 1933 Act states that a person other than the issuer who otherwise would be liable for a false or misleading statement in a registration statement may avoid liability by proving that “he had no reasonable ground to believe and did not believe” that statements made on the authority of an “expert” other than himself were untrue.<sup>185</sup> This provision enables an underwriter to rely on the expertise of outside counsel. It is unclear whether simply rendering an opinion as to the legality of securities qualifies counsel as an “expert” for these purposes.<sup>186</sup> Opinions of counsel typically state that the attorney assumes no responsibility for the accuracy, completeness, or fairness of statements in the prospectus; instead, underwriters bear this responsibility. Accordingly, an underwriter is provided assurance by the involvement of a top-tier law firm, especially as to the opinion of the issuer’s counsel. Put another way, an underwriter who decided not to engage a top-tier law firm to perform this task, or who decided to rely on a less reputable issuer’s counsel, would risk losing an argument about the reasonableness of its reliance if the due diligence defense is litigated. Consequently, top-tier firms benefit from these regulatory entitlements and can charge a premium for their opinions.

Finally, like accountants, attorneys involved in securities transactions are frequently sued based on various state and federal claims,<sup>187</sup> and judicial decisions related to attorney liability have created uncertain standards.<sup>188</sup> Plaintiffs frequently base lawsuits against lawyers on the opinions given by counsel as part of an offering, and, like accountants, courts have held attorneys liable under Rule 10b-5 for tax opinion letters that recklessly included materially false statements.<sup>189</sup> Courts also have held attorneys liable for drafting false and misleading offering documents because they failed to investigate disclosed facts or because they breached a duty owed to investors.<sup>190</sup> Furthermore, courts have held attorneys liable for drafting

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185. *Id.* § 77k(b)(3) (2000).

186. *See* Howe, *supra* note 178, at 286 n.9.

187. These claims include §§ 11, 12(1), 12(a)(2), 15, and 17(a) of the Securities Act of 1933; §§ 10(b) and 20(a) of the Securities Exchange Act of 1934; the Racketeer Influenced and Corrupt Organizations Act; and state blue sky laws. *See* Beck, *supra* note 76, at 794.

188. Warren, III, *supra* note 177, at 398-402.

189. *See* Beck, *supra* note 76, at 794 (listing cases where attorneys were found liable under Rule 10b-5).

190. The Supreme Court has not specifically addressed the question of what duty an attorney owes to third parties under Rule 10b-5. Lower courts have taken widely varying approaches depending on the facts of the particular cases, including the characteristics of a particular defendant and transaction. *See* Breard v. Sachnoff & Weaver, Ltd., 941 F.2d 142 (2d Cir. 1991); *Employers Ins. v. Musick, Peeler, & Garrett*, 871 F. Supp. 381 (S.D. Cal. 1994); *Walco Invs., Inc. v. Thenen*, 881 F. Supp. 1576 (S.D. Fla. 1995); *In re Flight Transp. Corp. Sec. Litig.*, 593 F. Supp. 612 (D. Minn. 1984).



opinion letters containing misstatements about tax shelters.<sup>191</sup> In addition, even after *Central Bank of Denver*, an attorney may be liable for drafting disclosure documents or opinion letters, although the courts are split on this issue.<sup>192</sup> Substantial uncertainty still surrounds the liability of attorneys after *Central Bank of Denver*.<sup>193</sup>

For example, in *Employers Insurance of Wausau v. Musick, Peeler & Garrett*, the court held that attorneys who draft offering documents for clients can be primarily liable under § 10(b) for misstatements or omissions in those documents.<sup>194</sup> In *Klein v. Boyd*, the court held that attorneys are not liable under § 10(b) unless the misstatements or omissions appear in opinions that the attorneys issued and signed.<sup>195</sup> In addition, the court found that even attorneys who do not issue or sign offering documents “may be liable for a primary violation of Section 10(b) and Rule 10b-5 when the [attorney’s] participation in the creation of a statement containing a misrepresentation or omission of material fact is sufficiently significant that the statement can properly be attributed to the lawyer as its author or co-author.”<sup>196</sup>

The uncertainty generated by such cases has existed since *Escott v. BarChris*, where the court held the underwriters, accountants, and attorneys all liable for failure to perform a reasonable investigation under the circumstances.<sup>197</sup> The attorney, who was also a director, was held to a higher due diligence standard in part because he was an attorney. One way of interpreting this requirement is that it keeps the standards of the legal profession high. This argument has been used to impose heightened duties on

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191. See *Ackerman v. Schwartz*, 947 F.2d 841, 843 (7th Cir. 1991) (holding that an attorney could be held liable even though he owed no duty to the individual investors because he allowed promoters to release letter to representatives of investors).

192. See *Beck*, *supra* note 76, at 794.

193. Although attorneys can still be held liable for their own misrepresentations under a theory of primary liability, courts have split over when liability will attach to attorneys for the misstatements of others. See also *Employers Ins. v. Musick, Peeler & Garrett*, 871 F. Supp. 381, 388-89 (S.D. Cal. 1994) (denying attorney’s motion to dismiss Rule 10b-5 claim for drafting a misleading prospectus); *Walco Invs., Inc. v. Thenen*, 881 F. Supp. 1576, 1582-83 (S.D. Fla. 1995) (denying attorney’s motion for summary judgment based on false statements made by the client but contained in an offering document prepared by the attorney). As with accountants, this split has generated great confusion. See generally Cynthia A. Bedrick, *Defining the Duty: Attorneys’ Obligations Under Rule 10b-5*, 74 IND. L.J. 1297 (1999); Ann Maxey, *Competing Duties? Securities Lawyers’ Liability After Central Bank*, 64 *FORDHAM L. REV.* 2185 (1996).

194. 871 F. Supp. 381, 389 (S.D. Cal. 1994).

195. *Klein v. Boyd*, 1998 WL 55245, at \*1 (3d Cir. Feb. 12, 1998).

196. *Id.* at \*12. The court in *In re Towers Fin. Corp. Noteholders Litig.*, 1995 WL 571888, at \*18 (S.D.N.Y. Sept. 20, 1995), also held that issuer’s counsel, who had no “direct communication” with the investor plaintiffs, owed no § 10(b) duty disclosure to them. In *Towers*, however, the lawyers did not prepare any of the offering documents used to solicit investors. *Id.* at \*2-4.

197. 283 F. Supp. 643, 682-84 (S.D.N.Y. 1968).

attorneys investigating the accuracy of prospectuses. An alternative interpretation is that it forces attorneys to bear costs they otherwise would not incur and, as a result, both raises the barriers to entry in the securities law area (further entrenching established firms with top reputations) and provides a regulatory justification for attorneys to bill untold hours on tasks of dubious social value.

This section has attempted to set forth some of the ways in which lawyers can benefit from the existence of regulatory costs and regulatory licenses. There are statutory and self-regulatory provisions, as well as judicial opinions, all of which benefit to top-tier law firms. These provisions, as interpreted, may explain to some extent why some top-tier law firms continue to engage in an arduous, time-consuming due diligence exercise even when the costs seem to exceed the expected benefits (for example, for established public issuers). Perhaps most importantly, underwriters faced with potential liability have incentives to hire only the best issuer's counsel to insure the viability of a due diligence defense.

#### IV. A MODIFIED STRICT LIABILITY REGIME

Part III argued that gatekeepers profit not only from their accumulated reputational capital but also, to a large extent, from the structure of securities regulation. This Part outlines a possible solution to that problem. My hope is that even scholars who are not sympathetic to this solution will recognize that imposing gatekeeper liability through a due diligence approach generates unwarranted costs.

The proposal is simple: impose strict liability on gatekeepers for material misstatements and omissions in offering documents and remove any due diligence-based defenses from securities regulation. For example, Congress should amend § 11 to impose strict liability not only on the issuer and directors, but also on all experts. Congress should add an additional provision to enable experts to specify the range of liability as a percentage of the issuer's liability, subject to a specified minimum percentage.

This proposal is not as radical as it might seem. In fact, several proposals have gone part way down this road. Rule 176 and Choi's proposal for a market-based due diligence system are examples. The problems with these alternatives is that they do not go far enough and, as a result, generate additional costs.

The SEC has promulgated Rule 176 to clarify what factors are relevant in determining whether the defendant has met her burden of proof in asserting the due diligence defense. These factors include the type of firm, the type of security, the sophistication of the defendant, and the reasonable reliance on

reports.<sup>198</sup> The key point is that the multifactor test of Rule 176 anticipates allowing the level of due diligence required to vary based on several variables, which makes adjudication costly.

Rule 176 identifies a limited number of factors that constitute “relevant circumstances” for the purpose of determining whether a defendant has satisfied the due diligence defense provided by § 11(b)(3) of the 1933 Act.<sup>199</sup> Unfortunately, the multifactor test of Rule 176 has not proved useful in practice; to my knowledge, no court has dismissed any § 11 claim on the basis of Rule 176. This result is not surprising: the costs associated with applying this multifactor test would be even greater than those of a universally applicable due diligence defense. Accordingly, Rule 176 is too costly to be useful.

Choi’s proposal suffers from similar problems. Choi has recommended a self-tailored liability regime in which gatekeepers would establish their own procedures appropriate to a transaction.<sup>200</sup> The notion of applying different standards to different issuers and gatekeepers is attractive in theory. However, in reality the proposal likely would be even more costly than a Rule 176 regime. Issuers and gatekeepers would find it very costly to specify individually tailored due diligence details. Regulators and investors would find it very costly to interpret those details. Furthermore, the *ex ante* costs would be minimal compared to the *ex post* costs of resolving securities fraud litigation under such a regime.

Moreover, Choi assumes that gatekeepers would compete based on the quality of standards and that this competition would mitigate the public choice problems associated with the capture of regulators by gatekeepers.<sup>201</sup> However, historically when gatekeepers have been presented with an array of potential standards for such defenses, they have been very effective in agreeing on a single standard. Whether these agreements constituted collusion or competition is beside the point; if market forces push gatekeepers to gravitate to a single standard, Choi’s proposal also will face such forces.

The central problem with these proposals is their intermediate nature, in that they rely too much on a combination of regulatory pressure and reputational influences to motivate gatekeeper behavior. There is a tradeoff between gatekeeper liability and issuer liability. At one theoretical extreme is a regime in which only issuers are liable for fraud and gatekeepers play a role

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198. See 17 C.F.R. § 230.176 (1996).

199. *Id.*

200. See Choi, *supra* note 1, at 951-59.

201. See *id.* at 954.

constrained only by their willingness to deplete reputational capital. In such an idealized “issuer liability” regime, there is little need for gatekeeper liability. At the other extreme is a regime in which only gatekeepers are liable for fraud, and issuers play a role constrained only by their willingness to deplete reputational capital. In such an idealized “gatekeeper liability” regime, there is little need for issuer liability.

Intermediate regimes between these two theoretical extremes are costly compromises. Not only are multiple parties made liable for the same fraud, but disputes must be resolved with respect to both issuers and gatekeepers. Accordingly, one of the primary advantages of a strict liability regime is the fact that disputes must be resolved only with respect to the issuer, and not with respect to underwriters, accounting firms, and law firms. Moreover, the modified strict liability regime avoids the central opposition to strict liability: its perceived harshness to gatekeepers. The modified regime allows both investors and gatekeepers to share the anticipated reduction in costs.

A modified strict liability regime also should apply pressure to reduce market concentration by encouraging competition based on the willingness of the gatekeeper to assume the expected liability of the issuer and by reducing direct and indirect regulatory costs and regulatory licenses, which tend to benefit only top-tier firms and to encourage market concentration. It is worth noting that the cost-benefit analysis of a concentrated gatekeeper market is not entirely clear. On one hand, a concentrated market has substantial costs. In general, market power reduces consumer welfare as producers with market power increase price (or reduce quality) and reduce quantity to maximize profits. Consumers purchase fewer products at higher prices and there is a related deadweight loss. Distributional issues aside, this deadweight loss argues for avoiding market power when possible. Put another way, market power is justified only when its benefits exceed this deadweight loss.

On the other hand, a concentrated market and market power are evidence that the participants in the market have more to lose from a decline in their reputational capital. According to this argument, a more concentrated certification market would be more effective in policing issuers because certifiers would have more to lose and therefore could make a more credible commitment to investors who will be more likely to trust the certifier. Put in these terms, my claim here has been that the costs of market power exceed its reputation-related benefits. Even oligopolist gatekeepers appear not to have enough to lose by engaging in reputation-depleting activities.

Another way of assessing the benefits of a modified strict liability regime is by considering the regime from the perspective of insurance and indemnification. Essentially, this Article recommends the creation of a

reinsurance market for securities fraud risks, much like the existing reinsurance markets generally, by attempting to shift the focus of the gatekeeper's role to more of an insurance role and less of a policing role. Reinsurance has been successful in other contexts, partially because of its unregulated nature, but also because of the focus on specifying liability using percentages and caps. As parties seek to offload portions of risk, the methods of dividing risk enable the parties in the best position to bear those risks in an efficient manner. The reinsurance markets are not burdened by an array of regulatory licenses, and reputational constraints continue to operate effectively in such markets. Under a modified strict liability regime, gatekeepers still would have incentives to preserve their reputational capital. The major difference would be that they no longer would benefit from regulatory costs and regulatory licenses and, instead, would be compensated based solely on their reputation and their willingness to assume the liability risks of issuers.

Viewing the proposal through the lens of insurance raises several important issues. First, to the extent parties voluntarily agree to provide insurance under this regime, the agreement should be enforced. However, there have been some problems associated with the use of insurance and indemnification in the securities industry. In general, insurance against intentional securities fraud should be void on public policy grounds,<sup>202</sup> although my research has not revealed any recent case addressing the legitimate boundaries of securities fraud insurance. The SEC generally takes the position that such insurance is void<sup>203</sup> and lawyers typically include an undertaking in registration statements to this effect, but the law remains unclear. As a modified strict liability regime would face some of the same issues, my suggestion would be to allow gatekeepers and issuers to specify the boundaries of particular insurance policies by contract. The more difficult question would be how much insurance gatekeepers would be permitted to purchase; if gatekeepers were permitted to insure all of their risks, the deterrence function of liability would be eliminated.

Interestingly, any perceived public policy limitations to insurance and indemnification have not stopped issuers and underwriters from entering into

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202. For example, today, although indemnification by a corporation of directors and officers is allowed, corporations are not permitted to indemnify officers for actions not taken in good faith or actions contrary to the best interests of the corporation. *See* DEL. CODE ANN. tit. 8 § 145(a) (2000); MODEL BUS. CORP. ACT § 8.51(a) (1994). As a result, most Director and Officer (D&O) insurance includes claims under the federal securities laws. *See* 2 WILLIAM E. KNEPPER & DAN A. BAILEY, LIABILITY OF CORPORATE OFFICERS AND DIRECTORS § 25-17 (5th ed. 1993 & Supp. 1996).

203. The SEC also disapproves of indemnification against § 11 liability. *See* 17 C.F.R. § 230.461 (1999). *See also* Reg. S-K, Item 512(h), 17 C.F.R. § 210 (1999).

such arrangements. Underwriters consistently contract for very broad indemnification provisions. For example, the supplement to one of the leading securities law casebooks includes an underwriting agreement with a typical indemnification provision.<sup>204</sup> In the provision, the issuer agrees to indemnify and hold harmless the underwriters for material misstatements in the offering documents.<sup>205</sup> There also are contribution provisions limiting the contribution of any underwriter based on the amount of shares purchased by that underwriter; contribution can be used as an alternative to indemnification if those provisions are found to be unenforceable.<sup>206</sup> The fact that these provisions are negotiated is evidence that issuers and gatekeepers should be able to apportion liability based on their level of involvement in the offering under a modified strict liability regime.

If such contractual risk shifting already is common, there should be concerns about the current system of indemnification.<sup>207</sup> Gatekeepers, particularly underwriters, already are shifting risks in ways courts might regard as impermissible and using contribution provisions as a backstop in case a court found an indemnification provision to be unenforceable. Top-tier gatekeepers engage in self-insurance pools with troubling results.<sup>208</sup>

In other words, gatekeepers already are engaging in the kind of insuring activities envisioned under a modified strict liability regime, but they are doing so in a much more expensive insurance environment. Insuring investors against all types of losses is prohibitively expensive.<sup>209</sup> Instead of providing general insurance, the current regime of securities regulation allows for a specific and limited form of insurance: insurance against fraud, recklessness, or negligent conduct, depending on the statutory provision. Yet because the terms of this insurance contract are difficult to specify, and therefore it is difficult to predict *ex ante* what type of conduct will be deemed to fall within the parameters of the contract *ex post*, the cost of such

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204. See JENNINGS ET AL., *supra* note 15, at 281 (Section 8(a) of the Nov. 28, 1998, Underwriting Agreement for Pixar Common Stock).

205. See *id.*

206. See *id.* at 26 (Section 8(d) of the Underwriting Agreement).

207. See generally Helen S. Scott, *Resurrecting Indemnification: Contribution Clauses in Underwriting Agreements*, 61 N.Y.U. L. REV. 223, 224 (1986).

208. See *supra* note 61.

209. Moreover, if investors really wanted such insurance, they could purchase it in the options markets in the form of put options, but they choose not to make such purchases. The government could purchase put options for investors, but such options would be enormously expensive and would create great moral hazard. Therefore, the government would be (and should be) reluctant to make such purchases. Alternatively, investors could purchase call options instead of stock to capture the upside of stock but insure their downside, and there is evidence of increasing use of call options based on individual stocks. It is doubtful, however, that the purpose of such purchases generally is to limit the investor's downside.

insurance is very high.

The advantage of a modified strict liability regime is that it reduces the cost of insurance, both by and for gatekeepers, by eliminating the costs associated with adjudicating gatekeepers defenses. This advantage generally accrues to any strict liability regime, and the primary argument against such a regime then becomes that it deters gatekeepers too much. Put more strongly, a strict liability regime would make the gatekeeping function so costly that no one would engage in the function and the market for securities issues would collapse.

Indeed, Kraakman has argued that a strict liability standard would overdeter.<sup>210</sup> However, that analysis did not include the possibility that gatekeepers could reduce the expected penalties associated with a strict liability standard through the modified regime advocated here. In fact, Kraakman noted in a footnote that although diffuse gatekeeper duties could force gatekeepers to monitor at just the right level, “the catch is that diffuse duties are likely to be very costly. We might wish to retain such duties only if we can limit their costs by limiting gatekeeper liability.”<sup>211</sup> This Article offers a means of imposing such limitation while retaining the prospect of potentially broad gatekeeper monitoring duties and avoiding the ex post costs (and related ex ante costs) necessary to a reasonableness or due diligence standard.

Even under the modified strict liability regime, the question that remains is how much liability a party should be permitted to shift or distribute through indemnification agreements or insurance. Apart from deterrence, under a negligence or strict liability regime, society generally will benefit from allowing defendants to protect themselves by insuring. However, there might be reasons to force defendants to bear the full economic cost of a penalty and prohibit indemnification or insurance, namely, to cause defendants to take precautionary conduct or to deter misstatements. Courts will need to decide these issues of public policy. Under the modified strict liability regime, courts could expend resources deciding these issues instead of resolving other aspects of disputes in current litigation against gatekeepers.

Finally, the proposed regime obviously would not eliminate all litigation risks and costs. For example, questions would remain about whether a particular fraud was covered by a particular gatekeeper. Does the underwriter’s coverage apply to liability for financial statement fraud? To which misstatements does a law firm’s coverage extend? To some extent,

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210. See Kraakman, *Gatekeepers*, *supra* note 1, at 76.

211. See *id.*

parties already incur costs related to these boundary issues. For example, § 11(a)(5) already attempts to resolve such issues by covering any expert named as having prepared or certified any part of the registration statement.<sup>212</sup> Accordingly, apportioning liability for portions of the registration statement among gatekeepers might not be much more difficult or costly than it is under the current regime. Nevertheless, parties would face difficult line-drawing decisions related to the boundaries of their insurance contracts.

In general, the arguments in favor of a modified strict liability regime depend mostly on the analysis in Part III regarding reputational capital, regulatory costs, and regulatory licenses. If the ambiguity associated with the application of securities regulation is sufficiently costly and is not generating commensurate benefits, investors and issuers would be better served by a gatekeeper regime that did not attempt to assess gatekeeper fault *ex post*, but, instead, encouraged gatekeepers to compete based on their willingness to certify public issues of securities and to insure a portion of expected damages from securities fraud associated with those securities.

## V. CONCLUSION

Legal scholars have taken for granted the role of financial market gatekeepers as reputational intermediaries. This Article attempts to reassess the assumption that financial market gatekeepers must be serving a valuable function because, if they were not, their reputations would suffer and investors and issuers would not use them. Legal scholars incorrectly made similar assumptions about other third party certifiers (for example, UL and bond credit rating agencies), and therefore, the assumptions about financial market gatekeepers deserve more careful review.

An alternative to these assumptions is the view that gatekeepers also benefit from valuable property rights created by securities regulation, which generates both regulatory costs and regulatory licenses. It is difficult to separate these benefits from reputational issues, and it may be the case that reputational capital dominates any effects of regulatory costs or regulatory licenses. Nevertheless, the fact that gatekeepers benefit from certain securities regulation should not be ignored.

The central problem this Article addresses is the skyrocketing cost of securities litigation, which also imposes substantial *ex ante* costs on investors. The high costs are due in part to uncertain legal rules created by

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212. 15 U.S.C. § 77k(a)(4) (2000).



due diligence-related defenses available to gatekeepers. Some top-tier gatekeepers benefit greatly from these rules and face very low expected liability costs.

As a possible solution to this problem, this Article proposes a modified strict liability regime for gatekeepers. Such a proposal might have been attractive to investors, issuers, and gatekeepers in 1933, and could have become law if it had been considered. The drafters of the securities laws considered a strict liability regime, but abandoned the idea in the face of intense opposition, particularly from underwriters. Ultimately, due diligence defenses were added as a compromise, but those defenses have only increased the aggregate costs of securities regulation with few benefits. The modified strict liability proposal allows for a safety valve whereby gatekeepers can reduce their expected liability costs by contract.

If investors and issuers value due diligence efforts by gatekeepers, a modified strict liability regime will not prevent such due diligence even if gatekeepers select very low levels of liability. In fact, it is very possible that a modified strict liability regime would not differ dramatically from the current regime in several key areas: gatekeepers would engage in some due diligence, investors and issuers would rely on gatekeepers' reputations, gatekeepers would contract for indemnification or insurance to reduce their expected liability to appropriate levels, and issuers would continue to face liability for securities fraud. The major difference would be that the ex post costs of litigating securities disputes against gatekeepers would be almost entirely eliminated. This difference is an important one worth considering.

If investors prevail against an issuer for securities fraud, they should not need to litigate any issues against gatekeepers, other than the boundary issues discussed in Part IV. Instead, investors automatically should win damages against the relevant gatekeepers, with only the liability limitations placed on such damages ex ante by the gatekeepers themselves.







