MULTIPLE GATEKEEPERS

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INTRODUCTION

THE liability of lawyers, investment bankers, and accountants for misstatements and omissions in the public disclosure documents of their corporate clients is an intensely controversial issue. After each wave of corporate upheaval, scrutiny invariably descends on business transactions and on apparent errors in corporate disclosures that accompanied them. Professionals often find themselves implicated for having facilitated transactions and having failed to avert disclosure errors. The focus on lawyers’ conduct in the controversial merger of Bank of America and Merrill Lynch is a case in point.¹ Known as gatekeeper liability, the liability of professionals for the wrongs of their clients is premised on the ability of professionals to monitor and control their clients’ conduct. The imposition of potential liability provides powerful incentives for professionals to exercise their ability to monitor and control, and thereby to deter, corporate wrongs. While the professions oppose the notion of themselves as gatekeepers,² U.S. federal securi-

¹ Bank of America settled charges with the Securities and Exchange Commission (“SEC”) that it failed to properly disclose employee bonuses and losses at Merrill Lynch before its shareholders approved the merger of the companies in December 2008. Bank of America Corp., SEC Litigation Release No. 21,407, 2010 LEXIS SEC 305 (Feb. 4, 2010). After Bank of America agreed to waive attorney-client privilege, the conduct of its attorneys has been subject to close scrutiny, including by congressional investigators. See, e.g., Louise Story & Eric Dash, Deal Advice On Merrill To Be Aired, N.Y. Times, Oct. 13, 2009, at B1.

This Article focuses on a significant phenomenon concerning gatekeepers that has been overlooked in the literature. Multiple distinct gatekeepers participate in business transactions, forming an interlocking web of protection against securities fraud. For business transactions, including high-stakes securities offerings and mergers and acquisitions, a corporation will routinely engage a law firm, investment bank, and an accounting firm—and often several of each—to plan, negotiate, and execute these transactions. After all, business transactions are complex and raise myriad legal, financial, accounting, and other hurdles for the corporations that undertake them.

The literature on gatekeeper liability has overlooked this multiple gatekeeper phenomenon, or simply failed to account for it. The paradigmatic conception of the gatekeeper is as a unitary actor.\footnote{See infra notes 12–18 and accompanying text.} Scholars have assumed either that it alone acts on a business transaction or that, where it is one of multiple gatekeepers participating, each gatekeeper’s action is independently capable of deterring corporate wrongdoing. They have failed to recognize that some wrongs may be optimally deterred by \emph{multiple} gatekeepers taking precautions and that some wrongs may even be optimally deterred by particular gatekeepers taking \emph{no} precautions. Recognizing this
empirical phenomenon represents the point of departure of this Article from existing literature.

Drawing on the theory of industrial organization and the theory of the firm, this Article investigates this phenomenon. It considers the factors contributing to interdependencies among gatekeepers, which include the blurring of the traditional roles and skills among gatekeepers, as well as the retention of particular areas of expertise and spheres of influence in transactions. The analysis also demonstrates that the phenomenon may result in each gatekeeper having but a small, fragmented knowledge of both its client and the proposed transaction and having incentives to narrow the scope of its activities to reduce the likelihood that it will acquire knowledge sufficient to attract gatekeeper liability.

This Article extends the literature on gatekeeper liability by analyzing how the phenomenon alters the prescriptions of optimal deterrence theory, which is the prevailing economic approach for evaluating liability regimes to deter wrongdoing. To date, uncertainty has pervaded the issue of what liability regime would lead gatekeepers to take optimal precautions to deter securities fraud by their corporate clients, with scholars split between strict liability and fault-based liability regimes. A primary contribution of this Article is to address this problem by analogizing the position of multiple gatekeepers to that of joint tortfeasors. While tortfeasors typically contribute to the risk of harm because of their capacity to create it, the contribution of gatekeepers is the mirror image—they contribute to the risk of harm by possessing the capacity to deter it. This Article thus draws on scholarship concerning the optimal deterrence of joint torts with a view to identifying liability regimes that would lead multiple gatekeepers to deter securities fraud optimally.

Explicitly connecting gatekeeper liability with tort liability enables the development of a simple taxonomy of interactions among multiple gatekeepers as either independent or interdependent gatekeepers. The analysis shows that scholars until now have focused only on independent gatekeepers, for which both strict and fault-based regimes are optimal—hence the split of scholarly opinion. This Article goes further, considering the position of interdependent gatekeepers and showing under relevant simplifying assumptions that only a fault-based regime would induce gatekeepers
to take optimal precautions. A strict liability regime would be inefficient because the existence of multiple gatekeepers reduces the benefit to any one gatekeeper of taking precautions. Under usual apportionment rules, liability would be shared among the gatekeepers, and for any one gatekeeper the benefit of taking precautions may be outweighed by its cost. This insight should dispel the notion that strict gatekeeper liability is desirable.

The Article then turns to assess the existing federal securities law regime. The liability of gatekeepers under the securities regulatory regime is highly complex, but may be viewed as imposing a fault-based regime on gatekeepers, in consonance with the prescriptions of optimal deterrence theory developed here. Any gatekeeper that can establish a due diligence defense—which applies a reasonableness-based standard—is relieved of strict liability in the case of primary offerings under Section 11 of the Securities Act. It would also be relieved of scienter-based liability under Section 10(b) of the Securities Exchange Act and the associated Rule 10b-5. Although the regime in some cases imposes liability on a single gatekeeper for disclosure misstatements or omissions without the express recognition of possible contributions from other gatekeepers, gatekeepers have established among themselves elaborate risk-shifting mechanisms in response to possible interdependencies. The effectiveness of these mechanisms, this Article explains, is impeded by the uncertainty of relevant case law and the efforts of professional self-regulatory organizations to narrow the scope of these mechanisms. Assessing the regime from the perspective of multiple gatekeeper liability sharpens policy analysis by revealing potential distortions of incentives. It also offers guidance on reforms implemented by the Dodd-Frank Wall Street Reform and Consumer Protection Act (‘‘Dodd-Frank Act’’) that expose credit rating agencies to gatekeeper liability under Section 11 of the Securities Act. The merits and possible unanticipated consequences of these reforms are discussed.

This Article makes a number of modest proposals for dealing with the consequences of the multiple gatekeeper phenomenon.

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1 See infra notes 191–93 and accompanying text.
2 See infra notes 212–21 and 231–32 and accompanying text.
One draws on a United Kingdom practice of multiple gatekeepers participating in so-called verification meetings to share their knowledge and, in an important sense, acting as a unified gatekeeping body for the purpose of verifying corporate disclosures. Another encourages cooperation among professional self-regulatory bodies to clarify how the gatekeeping net might be reinforced, perhaps by identifying issues where precautions by multiple gatekeepers would be desirable and to identify and fill any areas over which all gatekeepers disclaim responsibility. This Article also suggests concrete proposals for reinterpreting underwriters’ due diligence defense under Section 11 of the Securities Act to avoid gaps in liability created by existing judicial interpretations. Finally, and less modestly, the Article briefly explores the notion of removing the legal barriers that prevent the formation of multidisciplinary gatekeepers that would bundle multiple gatekeeping services.

The remainder of this Article proceeds as follows. Part I explains the conception of the unitary gatekeeper adopted in the literature on gatekeeper liability and describes the multiple gatekeeper phenomenon in business transactions. It addresses why corporations rely on the market for professional services at all, rather than employing individuals with the desired skills, and why, having decided to rely on the market for gatekeeping services, corporations turn to a multiplicity of service providers, rather than to a single service provider offering the multiple skills required. Part I also describes the production cost advantages, such as economies of scale, scope, and experience, arising from relying on the market for gatekeeping services and explains the function of gatekeepers as reputational intermediaries that certify the accuracy of corporate disclosures to investors and so economize on information costs. Part II discusses optimal deterrence theory generally and situates gatekeeper liability within that larger framework. It also develops a simple taxonomy of interactions among gatekeepers, which is illustrated by a case study of the collapse of Commercial Financial Services, Inc., formerly the world’s largest securitizer of credit card receivables. Part III extends the analysis to consider the desirability of various liability regimes for enlisting multiple gatekeepers to deter securities fraud, showing why fault-based regimes are optimal for multiple gatekeeper contexts. The implications of the analysis in Part III for the regulation of gatekeepers under the federal securities laws
and for recent reforms to the regulation of credit rating agencies are discussed in Part IV. A brief conclusion follows.

I. GATEKEEPERS AND BUSINESS TRANSACTIONS

This Part describes the paradigmatic conception of the gatekeeper as a unitary actor. It then explains the multiple gatekeeper phenomenon, analyzing why gatekeepers exist at all in the context of business transactions and why corporations rely on a multiplicity of gatekeepers in a single business transaction. It then describes potentially adverse consequences arising from the phenomenon.

A. The Unitary Gatekeeper

In laying the theoretical foundation for gatekeeper liability, Reinier Kraakman conceived of the gatekeeper as an actor with the capacity to monitor and to control, or at least to influence, the conduct of its corporate client and thereby to deter wrongdoing by it. Drawing on Gary Becker’s seminal work on the economics of crime and punishment, Professor Kraakman framed his inquiry as a search for external legal controls that would “yield the ‘right’ amount of compliance with legal rules—bearing in mind that enforcing these duties is itself costly.” He conceived of gatekeepers as occupying a position within the larger legal framework and regarded liability as a mechanism to ensure the optimal deterrence of corporate wrongs. In this framework, wrongdoing could be directly deterred by the imposition of liability on corporations and on individual corporate managers. Only where supplemental deterrence was required were gatekeepers to face potential liability to provide incentives for them to exercise their ability to monitor and con-
Gatekeepers were thus considered in terms of their capacity to deter corporate wrongdoing. Since Professor Kraakman’s pioneering work, scholars have either modeled the liability of a single gatekeeper or analyzed the liability of each of several gatekeepers independently of one another. In early work, Howell Jackson considered the possibility of imposing gatekeeper liability on lawyers in the context of advising financial institutions. Stephen Choi developed an analytical framework for the role of gatekeepers, taking into account variations in the accuracy with which they monitor and control client conduct, and applied the framework to the position of underwriters in securities offerings. John Coffee, in his book Gatekeepers, traced the historical evolution of numerous gatekeeping professions and considered, for each, reforms that would improve the gatekeeping effectiveness of these actors. Assaf Hamdani modeled the paradigmatic relationship between a gatekeeper and a client and warned of the adverse selection problems that may arise where a gatekeeper is unable to distinguish among its clients based on their potential wrongdoing. Numerous other important contributions have been made. Scholars, however, have yet to question

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11 Professor Kraakman observes that gatekeeper liability supplements direct forms of liability as well as private enforcement devices. See Kraakman, Corporate Liability Strategies, supra note 8, at 888–89, 898. The private devices include the established reputations of gatekeepers. See id. at 891–93, 894 n.114.
13 Professor Choi refers to the screening accuracy of gatekeepers, rather than to their ability to monitor and control, although the concepts are analogous. See Stephen Choi, Market Lessons for Gatekeepers, 92 Nw. U. L. Rev. 916 (1998). One reform he advocates is a system of self-tailored gatekeeper liability, under which each gatekeeper would choose to face liability for failing to satisfy a duty that it tailors for itself. See id. at 951–58.
14 Professor Choi’s framework does not contemplate the involvement of multiple gatekeepers in a transaction.
16 Hamdani, supra note 3.
17 See, e.g., Lawrence A. Cunningham, Beyond Liability: Rewarding Effective Gatekeepers, 92 Minn. L. Rev. 323 (2007) (recommending that gatekeepers be rewarded for successfully performing gatekeeping functions, rather than simply punished for failing to do so); Sung Hui Kim, Gatekeepers Inside Out, 21 Geo. J. Legal Ethics 411 (2008) (challenging the notion that gatekeepers must be external to the corporation that they monitor and control); Partnoy, Barbarians, supra note 3 (chal-
the unitary conception of the gatekeeper and, correspondingly, have failed to recognize the interdependencies existing among multiple gatekeepers in terms of their capacity to deter corporate fraud.\textsuperscript{18}

B. The Multiple Gatekeeper Phenomenon

A pattern of multiple gatekeeper involvement characterizes business transactions. Typically, a corporation will engage a law firm, an accounting firm, and an investment bank\textsuperscript{19}—and often several of each—to assist it whenever it undertakes a business transaction of any significance.\textsuperscript{20} Investigating this phenomenon involves asking two questions. First, why do corporations rely on the market leveraging the conception of gatekeepers as reputational intermediaries, claiming that they benefit from the regulatory framework, and recommending a modified strict liability regime without a due diligence defense).

\textsuperscript{18} Professor Kraakman notes that wrongdoing might be deterred by “an interacting network of gatekeepers,” at least for complex offenses. See Kraakman, Corporate Liability Strategies, supra note 8, at 893–94. He does not, however, pursue the insight. Professor Hamdani also observes that legal regimes should take into account “market-specific characteristics,” such as the “presence of multiple gatekeepers.” Hamdani, supra note 3, at 98. Hamdani further observes that the presence of multiple gatekeepers “complicates the task of designing an optimal regime of gatekeeper liability” in the context of securities fraud, but notes that the “risk is somewhat mitigated because the third parties involved can often contract privately to ensure that the party best positioned to ensure compliance will ultimately incur the cost of liability.” Hamdani, supra note 3, at 111. Professor Hamdani does not, however, pursue the matter further or recognize the possibility of interactions among gatekeepers.

\textsuperscript{19} In this Article, an investment bank is understood as a financial institution that provides traditional investment banking services. These services are underwriting securities offerings and advising on mergers and acquisitions. See Charles R. Geisst, Investment Banking in the Financial System 2–3 (1995).

\textsuperscript{20} See James D. Cox et al., Securities Regulation: Cases and Materials 118–21, 132–33 (6th ed. 2009) (describing typical contractual arrangements among underwriters, lawyers, and accountants in public securities offerings); id. at 156 (providing the estimated costs for a “significant” initial public offering, which includes fees for lawyers, auditors, and underwriters). As to the involvement of investment banks in underwriting securities offerings, Professor Langevoort observes that corporations rely on investment banks in “most public offerings.” Donald C. Langevoort, Information Technology and the Structure of Securities Regulation, 98 Harv. L. Rev. 747, 769 (1985). But see Steven L. Schwarz, To Make or To Buy: In-House Lawyering and Value Creation, 33 J. Corp. L. 497 (2008). Professor Schwarz presents survey evidence indicating that corporations are increasingly using internal lawyers for transactions. Id. at 498 n.2. The survey, however, adopts a broad notion of “transaction,” one that encompasses small and repetitive dealings by lawyers. Id. at 506–07. The focus of the present Article is on transactions holding greater significance to a corporation.
for gatekeeping services at all? That is, why do corporations choose to “buy” these inputs into the transactional process, rather than to “make” them? Second, having decided to rely on the market for gatekeeping services, why do corporations rely on multiple distinct gatekeepers?  

1. Why Gatekeepers Exist

Theoretically, the services of gatekeepers can be performed from within or outside the corporation. Legally, corporations undertaking business transactions must have their accounts audited by an external auditor but are otherwise free to choose whether to rely on the market for gatekeeping services. Typically, they choose to rely on external gatekeepers.

Analysis of the question begins with Ronald Coase’s seminal insight that a firm will make products or services internally until the costs of doing so exceed the costs of relying on the market. In applying this criterion to the market for gatekeeping services, the

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21 A full response to this question would be multidimensional and consider such factors as the number and size distribution of the buyers and sellers of the services, the degree of differentiation among services, the existence of barriers to the entry of new firms, the shapes of cost curves and, of course, government regulation. See F.M. Scherer & David Ross, Industrial Market Structure and Economic Performance 4–6 (3d ed. 1990) (identifying factors relevant to market structure in the theory of industrial organization). The more limited focus of this Article is on particularly salient considerations, namely cost structures and government regulation.

This Section answers these questions, drawing on insights from the theory of industrial organization and the theory of the firm. It investigates the existence or use of gatekeepers in business transactions. Because investment banks may perform numerous functions other than advising on business transactions, such as taking deposits and lending, their existence may be explained by other factors. See Gary Gorton & Andrew Winton, Financial Intermediation, in Handbook of the Economics of Finance, 1A Corporate Finance 431 (George M. Constantinides et al. eds., 2003).

22 See Ronald J. Gilson, The Devolution of the Legal Profession: A Demand Side Perspective, 49 Md. L. Rev. 869, 905 (1990) (suggesting that in-house lawyers will replace outside lawyers as gatekeepers). As to the limitations on the ability of in-house lawyers, and chief legal officers in particular, to perform a gatekeeping role, see Deborah A. DeMott, The Discrete Roles of General Counsel, 74 Fordham L. Rev. 955, 965–68 (2005).

23 Financial statements that are included in registration statements must be audited by independent or certified public accountants. See SEC Regulation S-X, 17 C.F.R. §§ 210.2–3 (2010). Nothing in U.S. federal securities law requires a corporation to rely on an investment bank or law firm in undertaking securities offerings.

24 See Langevoort, supra note 20, at 769 (regarding reliance on investment banks).

firm will weigh production cost advantages of relying on the market against the transaction cost disadvantages of doing so. Transaction costs are the costs of searching for, contracting with, and monitoring the market providers of the services. In the gatekeeping context, corporations must also weigh the information cost advantages of relying on the market.

The production cost advantages of relying on the market arise from economies of scale, scope, and experience. Economies of experience—the cost advantages resulting from the accumulated experience over an extended period of time, also known as “learning by doing”—can be substantial in industries involving complex labor-intensive activities. For example, bankers will develop skill in structuring and negotiating transactions, in applying valuation techniques, and in conceiving business transactions; lawyers will become more adept at negotiating and drafting underwriting and acquisition agreements, responding to regulatory hurdles, and conducting due diligence, a process involving the review of hundreds, even thousands, of documents, many of which adhere to standard forms. Economies of scale—the decrease in production costs that occurs as volume of production increases—may also be realized by relying on the market for gatekeeping services. With a large transactional flow, gatekeeping firms will build up a greater reservoir of knowledge of transaction structures and standard form

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26 Don E. Waldman & Elizabeth J. Jensen, Industrial Organization: Theory and Practice 56–57 (1998); see also Oliver E. Williamson, The Economic Institutions of Capitalism: Firms, Markets, Relational Contracting 18–22 (1985) (distinguishing between production costs, the category of costs on which neoclassical microeconomic analysis has focused, and transaction costs, the “costs of running the economic system”), But cf. Paul Milgrom & John Roberts, Economics, Organization and Management 33–34 (1992) (cautioning against the notion that a distinct conceptual separation exists between production and transaction costs).


29 See generally Schwarcz, supra note 20, at 517 (presenting survey evidence suggesting that advantages accrue to outside lawyers “who engage in multiple transactions . . . especially where [they] are complex”).

30 Besanko & Braeutigam, supra note 27, at 274.
and thus be able to provide their services more cheaply than could a corporation with a weaker transactional flow. The need for indivisible units, such as document management systems and physical libraries, the costs of which are invariable to the number of users, would also favor relying on external firms, since unit costs would decrease as output (or the number of users) increases. Further cost advantages stem from the ability of external gatekeeping firms to absorb the risk of lumpy demand for professional services more effectively.

A key feature of gatekeepers is their role in economizing on the information costs that exist due to information asymmetry between the two sides to a business transaction. In the context of a securities offering, where this role is most salient, investors face high costs associated with acquiring information with which to accurately value the assets to be transferred and greet a corporation’s disclosures with caution, aware of its incentives to mislead. By associating themselves with a transaction by acting for the corporate issuer, gatekeepers certify that corporation’s disclosures. Gatekeepers thus represent a response—either legal or market, depending on whether the gatekeeper’s role is legally mandated—to the problem of information asymmetry.

In the legal context, the cost savings associated with repeat deals may explain why corporations select law firms with prior experience of working on the particular matter at hand. Michele DeStefano Beardslee et al., Hiring Teams from Rivals: Theory and Evidence on the Evolving Relationships in the Corporate Legal Market 26–27 (Feb. 21, 2010) (unpublished manuscript, available at http://ssrn.com/abstract=1442066) (finding, based on interview and survey data, that when choosing law firms for “‘very significant’ matter[s],” including strategic transactions such as mergers and acquisitions, corporations identify “[r]esults in similar cases” as one of the three most influential criteria for engaging a law firm).

Corporations engage in business transactions sporadically. See id. at 12 (“Because legal needs are variable and unpredictable, it is not cost-effective for companies to keep enough qualified lawyers on their full-time payrolls to respond to surges in legal demand.”). External firms provide services to numerous corporations and thereby face less risk of loss than a corporation providing the services internally.

Techniques for corporations to self-certify their disclosures, such as assuming liability for misstatements, have their limits. For example, enterprise and individual managerial liability will not deter corporate wrongdoing where the corporation and its managers are judgment proof. For a discussion of other reasons for the limited effectiveness of self-certification techniques, see Ronald J. Gilson, Value Creation by Business Lawyers: Legal Skills and Asset Pricing, 94 Yale L.J. 239, 288–89 (1984).
Gatekeeper certifications provide a measure of assurance to investors as to the accuracy of corporate disclosures, reducing the extent to which investors, fearing they will be sold “lemons,” discount the value of the asset being sold. In metaphorical terms, gatekeepers are regarded as renting their reputations to corporations, a function that economizes on information costs and creates value for the relevant corporations. Gatekeepers thus function as so-called reputational intermediaries.

This reputational function of gatekeepers is one clearly suited to the external gatekeeping firm. As an external firm, it can serve as a repeat advisor to corporations. Expecting to be engaged in future transactions to perform the certification role, an external gatekeeper will have strong reasons both to build and to preserve a reputation for diligence and honesty. In contrast, corporations will have weaker incentives and opportunities to build and preserve reputations since they usually undertake transactions infrequently. They also have direct financial stakes in transactions,
weakening their incentives to certify disclosures accurately.\textsuperscript{39} Thus, the certification function of gatekeepers also favors corporations relying on the market for gatekeeping services.

The final piece to the analysis concerns transaction costs, which are the costs to corporations associated with searching for, contracting with, and monitoring providers of gatekeeping services.\textsuperscript{40} These costs are weighed against the production cost and information cost advantages of relying on the market for gatekeeping services. Transaction costs arise from both the difficulty of writing complete contracts and the opportunism of outside service providers.\textsuperscript{41} Incomplete contracts may fail to fully constrain opportunistic conduct, the consequences of which will be more severe when transactions involve greater asset specificity, are more frequent, and are more uncertain.\textsuperscript{42} When transaction costs associated with relying on the market exceed the cost advantages of doing so, a corporation will be likely to produce the necessary inputs internally.\textsuperscript{43}

Assessing the transaction costs associated with relying on the market for gatekeeping services presents an empirical challenge. We may infer from the pervasive use of gatekeeping firms in business transactions that the cost advantages of relying on the market exceed the associated costs of transacting. This inference is sup-

\begin{footnote}
\textsuperscript{39} See Margaret M. Blair et al., The New Role for Assurance Services in Global Commerce, 33 J. Corp. L. 325, 356 (2008) (suggesting that a third party assurance firm may operate as a reputational intermediary because such a firm has “little in the way of assets except its reputation, and it has no direct stake in the outcome of any evaluation it performs”).

\textsuperscript{40} See supra note 26 and accompanying text.

\textsuperscript{41} Contracts may be incomplete because the firm, as a decisionmaker, has (by assumption) bounded rationality. This assumption recognizes limits to an individual’s knowledge, foresight, skill, and time available to solve complex problems. Opportunism, which is also assumed, refers to the inclination of individuals to “try to mislead, disguise, and confuse others if it is to their advantage to do so and if they think such activities cannot be detected easily.” Waldman & Jensen, supra note 26, at 56. Oliver Williamson, whose work has been particularly influential in the development of transaction cost economics, defines opportunism as “self-interest seeking with guile.” Williamson, supra note 26, at 90–95 (discussing the tradeoff between transaction costs and production costs).

\textsuperscript{42} Assets are considered specific to a particular transaction where they hold greater value to it than to another transaction; put differently, the asset would lose much of its value outside that particular transaction. See Milgrom & Roberts, supra note 26, at 30–31.

\textsuperscript{43} See supra note 26 and accompanying text.
\end{footnote}
ported by the observation that, for some business transactions, standardized practices and contracts have developed that would reduce transaction costs. Of course, the picture is more complicated than this: corporations do rely on the market for gatekeeping services, but their internal “deal teams” also provide some gatekeeping services. Nevertheless, even the most sophisticated corporations continue to turn to external advisors for major transactions and may even demand a greater breadth of advice from them than they have in the past.

2. Why Multiple Gatekeepers Exist

Having decided to rely on the market for gatekeeping services for a transaction, corporations will turn to multiple distinct gatekeeping firms rather than a single multidisciplinary firm that bundles legal, accounting, financial, and other services. This phenomenon is the immediate result of legal regulation.

The relevant professional bodies have “fought zealously to protect their professional autonomy,” prohibiting their practitioners from forming multidisciplinary firms and preventing other professions from making incursions onto their turf. These measures may be explained as the product of demand for favorable regulation by

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44 See Cox et al., supra note 20, at 128–33 (describing the typical matrix of contracts between a corporate issuer and gatekeepers, particularly the underwriters, in securities offerings); James C. Freund, Remembrances of (M&A) Things Past: Plus, My Ten Commandments for Negotiating Deals, 9 M&A Law. 1, 1 (2005) (describing how, in the mergers and acquisitions setting, techniques and forms of agreement that needed to be developed “virtually from scratch” a few decades ago “are today embedded in the boilerplate and largely taken for granted”).


46 Id. (describing how the greater sophistication of corporations in deal-making and the expertise of their in-house professionals have changed expectations of outside advisors, forcing advisors to have greater breadth of expertise).

47 Coffee, supra note 15, at 104.

the professions acting as political interest groups.\textsuperscript{49} The legal profession, in its Model Rules of Professional Conduct, prohibits lawyers from forming partnerships or professionally associating with non-lawyers, including auditors and underwriters.\textsuperscript{50} Accountants are subject to strict rules preventing them from simultaneously providing auditing services and other services that may be seen to impair the auditor’s independence of judgment.\textsuperscript{51} An auditor cannot, for example, venture into the investment banking field, such as by underwriting a securities offering for one of its auditing clients.\textsuperscript{52} These rules requiring auditor independence were reinforced by provisions of the Sarbanes-Oxley Act of 2002.\textsuperscript{53} While the Financial Industry Regulatory Authority, the securities industry’s self-regulatory body,\textsuperscript{54} does not similarly restrict the activities of in-

\textsuperscript{49} Viewing regulation as a product subject to the laws of supply and demand, regulation protecting the professions could be hypothesized to result from the coordinated efforts of the professions demanding regulation that advances their own interests. See George J. Stigler, The Theory of Economic Regulation, 2 Bell J. Econ. & Mgmt. Sci. 3, 13–17 (1971) (suggesting that licensing of occupations—including lawyers—may be explained by the economic theory of regulation); Richard A. Posner, Theories of Economic Regulation, 5 Bell J. Econ. & Mgmt. Sci. 335, 344–50 (1974) (suggesting that the economic theory of regulation may be used to explain the existence of protective legislation within industries).

\textsuperscript{50} See Model Rules of Prof’l Conduct R. 5.4 (2009). This publication of the American Bar Association (“ABA”) provides a pattern for state legal ethics codes, which regulate the professional conduct of lawyers based on a lawyer’s state of admission. Restatement (Third) of the Law Governing Lawyers § 1 cmt. b (1998).

\textsuperscript{51} The Code of Professional Conduct of the American Institute of Certified Practicing Accountants (“AICPA”), the profession’s self-regulatory organization, restricts auditors from providing other professional services to audit clients where doing so would impair the auditor’s independence. AICPA Professional Standards, Code of Professional Conduct § 101.02, Interpretation of Rule 101 (Am. Inst. of Certified Pub. Accountants 2004).

\textsuperscript{52} See id.


\textsuperscript{54} The Financial Industry Regulatory Authority (“FINRA”) is a self-regulatory organization of securities firms. Its members include the country’s major investment and commercial banks. FINRA administers a qualification and registration system for the employees of member firms that are actively engaged in their employers’ investment banking or securities business. For example, a member performing investment banking functions, including advising on securities offerings, mergers and acquisitions, and financial restructurings, may be registered as a General Securities Representative, pursuant to the National Association of Securities Dealers (“NASD”) Rule 1032(a)
vestment banks, the rules of the legal and accounting professions, together with the legislative overlay of the Sarbanes-Oxley Act, effectively prevent investment banks from providing auditing and legal services for business transactions.\textsuperscript{55}

Whether the legal framework preventing the formation of multidisciplinary gatekeeping firms simply reflects economic forces or stands in opposition to them is a more difficult issue to assess. One economic explanation for the lack of multidisciplinary firms is the concern among corporations about conflicts of interest that would afflict the independence of judgment of gatekeepers. While the provision of multiple products and services may provide economies of scale and scope, it also produces conflicts of interest that risk impairing a gatekeeper’s judgment and thus the certification role the gatekeeper performs. In an extreme case, one could imagine lawyers or auditors in a multidisciplinary gatekeeping firm acquiescing in corporate conduct (which they might otherwise oppose) for the purpose of facilitating a transaction that would be particularly lucrative to the firm’s investment banking unit. This tension between multi-product or multidisciplinary practice and the potentially adverse effects of conflicts of interest has been particularly

evident in the accounting profession. The concern stems from pressures facing auditors to skew audit reports where doing so could win their firm other, more lucrative business, such as consulting work. Parallel issues arise in the debate concerning the merits of financial conglomerations. In the investment banking context, client concerns about conflicts of interest are manifested in corporations increasingly hiring so-called independent investment banks as “a counterpoint to the advice of integrated firms.” Client concerns may also explain the failure of multidisciplinary firms, which arose in continental Europe from combinations of accounting and law firms, to break into advising on global securities offerings, a context in which the reputations of advisors is of considerable importance.

Cost advantages, or synergies, and conflicts of interest may well be two sides of one coin, a point suggested by the now disgraced former securities analyst Jack Grubman, who was quoted as saying (before his ban from the securities industry), “What used to be a

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56 See generally Frederic S. Mishkin, The Economics of Money, Banking and Financial Markets 191 (9th ed. 2010) (discussing the tension between economies of scale and scope, on the one hand, and risks associated with conflicts of interest, on the other hand, in the context of accounting firms).

57 See id. (“First, auditors may be willing to skew their judgments and opinions to win consulting business from these same clients. Second, auditors may be auditing information systems or tax and financial plans put in place by their nonaudit counterparts within the firm . . . .”); see also Coffee, supra note 15, at 26–30, 39–42, 65–66 (discussing how organizational pressures on auditors to win non-audit business may have contributed to the corporate failures of Enron and Worldcom).

58 See, e.g., Too Big to Fail or Too Big to Save? Examining the Systemic Threats of Large Financial Institutions: Hearing Before the J. Economic Comm., 111th Cong. 53–59 (2009) (statement of Dr. Joseph E. Stiglitz) (discussing, in the context of the commingled activities of financial institutions, the tension between economies of scale and scope, on the one hand, and conflicts of interest, on the other).

59 Philip Augar, The Greed Merchants: How the Investment Banks Played the Free Market Game 34 (2005). Independent, or boutique, investment banks typically provide a narrow range of services to clients and avoid acting as principals in transactions, thus diminishing the risk of conflicts with the interests of their clients. In recent years, some integrated investment banks have spun off business units, in apparent response to concerns by market participants about conflicts of interest. See, e.g., Merrill Lynch: BlackRock and A Hard Place, Economist, Feb. 18, 2006, at 73.

60 See Flood, supra note 48, at 264–68 (describing the “minimal effectiveness” of multidisciplinary firms attempting to break into global capital markets work).
conflict [of interest] is now a synergy.” Conflicts of interest afflicting gatekeepers, and the corresponding lack of independence, can impair a gatekeeper’s reputation and the quality of its certification as to the accuracy of a corporation’s disclosures. For this reason, doubt exists as to whether, if the existing legal barriers were removed, multidisciplinary firms would evolve and be relied upon by corporations undertaking business transactions. While this issue need not be pursued for present purposes, it is sufficient to note that particular consequences associated with the multiple gatekeeper phenomenon, which are discussed next, are the immediate product of legal rules and might therefore be alleviated if market forces were given greater reign.

C. The Gatekeeping Web

Various consequences flow from the multiple gatekeeper phenomenon. One is that the services performed by gatekeepers intersect, overlap, and complement one another. The boundaries among the skills that are “legal,” “accounting,” and “financial” are not clearly delineated. The traditional distinctions among professionals have blurred and broken down and are likely to continue to do so. For example, business lawyers must know and use accounting concepts, since they “affect the structuring of deals, their disclosure, the form and amount of consideration, and other aspects of negotiations and compliance.” Investment bankers today are tested on their knowledge of federal securities laws, corporate law

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62 In his classic book, The Anatomy of a Merger, lawyer James Freund described his experience as follows: “There is a great intermeshing of disciplines in connection with a merger negotiation. My experience is that everyone else involved—accountants, businessmen, investment bankers—contribute [sic] ideas that could be termed ‘legal,’ while the lawyer himself is frequently pointing out considerations that could be considered ‘accounting’ or ‘business’ or ‘financial.’” James C. Freund, Anatomy of a Merger: Strategies and Techniques for Negotiating Corporate Acquisitions 4–5 (1975); see also Milton C. Regan, Jr., Teaching Enron, 74 Fordham L. Rev. 1139, 1247 (2005) (“Accounting and legal issues can be intricately intertwined and difficult to untangle.”).

63 Gilson, supra note 33, at 295.

principles, and other legal matters in order to receive industry certification.\textsuperscript{65} Still, each profession has particular areas of expertise and spheres of influence in transactions.\textsuperscript{66} The professions can also be expected to vary in terms of the information they hold, and their means of gathering information, about their client. Accordingly, a gatekeeper may need to rely on the information or advice of another gatekeeper in order to perform its role.\textsuperscript{67}

Against this backdrop, it is unsurprising that optimally deterring securities fraud may require more than a single gatekeeper to take precautions. By extension, gatekeepers are more accurately envisioned as an interlocking and interacting web of protection against securities fraud than as a single guardian or even a series of guardians acting in isolation of one another, as portrayed by existing literature.\textsuperscript{68}

A further consequence of the multiple gatekeeper phenomenon concerns the variability of the contours of the gatekeeping web. Where overlaps among the functions of gatekeepers exist, corporations may have less success with a strategy of shopping for gatekeepers, using them sequentially until finding one that acquiesces in corporate wrongdoing.\textsuperscript{69} On the one hand, the presence of multiple gatekeepers increases the likelihood of cross-checks and greatly

\textsuperscript{65} See FINRA, Investment Banking Representative Qualification Examination (Test Series 79): Content Outline 9, 11–13 (2009), available at http://www.finra.org/web/groups/industry/@ip/@comp/@regis/documents/industry/p119446.pdf (describing the topics covered in the exam, known as test series 79, for qualifying entry-level investment bankers).

\textsuperscript{66} See, e.g., William Powers, Jr. et al., Report of Investigation by the Special Investigative Committee of the Board of Directors of Enron Corporation 26 (Feb. 1, 2002), available at http://news.findlaw.com/hdocs/docs/enron/sicreport/sicreport020102.pdf (describing a law firm’s internal investigation of alleged wrongdoing by its corporate client and finding that “[i]t would be inappropriate to fault [the law firm] for accounting matters, which are not within its expertise”).

\textsuperscript{67} For lawyers, for example, relying on the information or advice of other actors, including accounting firms and investment banks, has been regarded as “integral” to the provision of legal advice in the corporate context. Michele DeStefano Beardslee, The Corporate Attorney-Client Privilege: Third-Rate Doctrine for Third-Party Consultants, 62 SMU L. Rev. 727, 735 (2009).

\textsuperscript{68} See supra Section I.A.

\textsuperscript{69} See Kraakman, Gatekeepers, supra note 3, at 72–74 (describing how the “determined wrongdoer might yet evade interdiction” by engaging—and terminating—numerous gatekeepers, either serially or simultaneously, to increase the probability of locating a less than diligent gatekeeper).
complicates that strategy, diminishing its appeal. On the other hand, the existence of multiple gatekeepers may lead each to become a mere functionary, responsible only for a limited portion of the transactional process and with correspondingly diminished knowledge of both the client and the nature of the transaction. This latter scenario relates to the deterioration of gatekeepers’ capacity to monitor and control corporate conduct, potentially giving rise to gaps in gatekeeper oversight that permit corporate wrongdoing. It may even create incentives for gatekeepers to minimize their involvement in transactions, since doing so would allow them plausibly to deny knowledge of client wrongdoing—a relevant consideration when liability under Rule 10b-5, the broadest antifraud provision in the regulatory arsenal, as well as rules of professional responsibility, requires proof of scienter. This concern is borne out by the practice of professionals in providing opinion letters to clients (as to the accuracy of the corporation’s disclosures) of heavily qualifying their assertions and narrowly defining their area of expertise and scope of involvement in the transaction. In the event that securities fraud did occur, the concern would be manifested by each of multiple gatekeepers pointing an accusatory finger at other gatekeepers.

Another potentially troubling product of the multiple gatekeeper phenomenon is the opportunity it creates for clients to dis-

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70 A simple requirement that would also diminish the appeal of serial contracting for gatekeepers by corporations is disclosure of the reasons for switching gatekeepers. See Gilson, supra note 22, at 909–13; Jackson, supra note 12, at 1054.

71 See Report of the New York City Bar Association, supra note 2, at 498 (explaining how lawyers’ lack of knowledge about accounting concepts relevant to their clients may produce “a gap between the roles of auditors and lawyers [that] permits corporate fraud”).

72 17 C.F.R. § 240.10b-5 (2010) (forbidding, among other things, the making of “any untrue statement of a material fact . . . in connection with the purchase or sale of any security”); Model Rules of Prof’l Conduct R. 4.1 (2009) (forbidding lawyers from, among other matters, “knowingly” making false statements of material fact or law to a third person).

73 For a detailed discussion of the possibility of lawyers “taking refuge” in the division of responsibilities among professionals in the context of transactions undertaken by Enron prior to its collapse, see Regan, supra note 62, at 1166–72, 1231–32, 1246–48; see also Bevis Longstreth, Corporate Law: Problems in the Corporate Bar (As It Appears to a Retired Practitioner), Mont. Law., Feb. 2006, at 22–23 (referring to the “narrowing of vision” by some professionals to “avoid the difficulty of having to say ‘no’ to a client).
aggregate their work among multiple gatekeepers for the purpose of minimizing the ability of any individual gatekeeper to deter securities fraud. The adverse effects of such a practice could be exacerbated if the client also interposes itself between the various gatekeepers, rather than allowing them to interact with each other directly. The 2008 merger of Bank of America and Merrill Lynch illustrates this concern. That transaction dominated financial media headlines and attracted congressional and regulatory scrutiny after revelations that Bank of America knew of massive losses by Merrill Lynch, the company with which it merged, but failed to adequately disclose information about these losses to its shareholders. Bank of America’s law firm, which possessed no independent knowledge of the quantum of Merrill Lynch’s losses, advised the bank to disclose those losses prior to the shareholder vote, according to allegations of the New York Attorney General. The firm was then allegedly “marginalized” by the bank from decisionmaking concerning the disclosure issue. The bank’s accounting firm, another gatekeeper centrally involved in the deal, noted the disclosure problem, since the firm was involved in quantifying the losses, and recommended that the bank seek the advice of legal counsel. But by this time the legal advisor had already been marginalized. The fragmented nature of gatekeeping services and the interposition of the client appear to have weakened the gatekeeping net, diminishing the capacity of the gatekeepers to deter potential securities fraud.

II. HARNESSING MULTIPLE GATEKEEPERS OPTIMALLY

This Part describes optimal deterrence theory, the prevailing paradigm for considering gatekeeper liability. It then provides a case study involving multiple gatekeepers and develops a simple taxonomy of interactions among gatekeepers that serves as a basis for extending the literature on gatekeeper liability.

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74 See supra note 1 and accompanying text.
76 Id.
77 Id. at 26–27.
A. Optimal Deterrence Theory

1. General Principles

Securities fraud compromises the accuracy of the price of the corporation’s securities relative to its fundamental value and thereby reduces social welfare. In the present context, securities fraud concerns intentional, material misstatements or omissions in corporate disclosure in the course of a business transaction (although, of course, securities fraud may also occur outside this context, such as in connection with a corporation’s periodic reporting requirements). For securities offerings, in particular, securities fraud typically takes the form of misstatements or omissions in offering documents provided to investors to induce them to purchase the securities. It is the anticipation by investors of trading on unfavorable terms, rather than simply the existence of inaccurate prices, that reduces social welfare. Anticipating unfavorable terms, investors may discount the price they are willing to pay for securities. This would increase corporations’ cost of capital, leading to its misallocation among corporations and alternative uses. In the secondary market, investors may be reluctant to trade at all. This would reduce the liquidity of securities, increasing transaction costs and possibly leading investors to hold non-optimal portfo-

78 Fundamental value is “the best estimate at any time, and given all information available at such time, of the discounted value of all distributions (such as dividends, liquidation, and merger distributions) accruing to a stockholder who continues to hold the stock.” Marcel Kahan, Securities Laws and the Social Costs of “Inaccurate” Stock Prices, 41 Duke L.J. 977, 979 n.11 (1992).

79 The mere existence of inaccurately priced trades in the secondary market does not itself constitute a social loss because such trades represent a redistribution of wealth between the two parties to a transaction. See Amanda M. Rose, The Multi-Enforcer Approach to Securities Fraud Deterrence: A Critical Analysis, 158 U. Pa. L. Rev. 2173, 2179–80 (2010).

80 In the primary market, where investors cannot distinguish among the quality of issuers, they will be inclined to discount shares according to their expectation of securities fraud. They may apply an average discount to all firms, which would increase the cost of capital to high-quality corporations. See Frank H. Easterbrook & Daniel R. Fischel, Mandatory Disclosure and the Protection of Investors, 70 Va. L. Rev. 669, 673–75 (1984); Rose, supra note 79, at 2179–80. Faced with this possibility, some corporations may adopt costly measures to signal their honesty—a further social cost. For an analysis challenging claims regarding the social cost of securities fraud, see Lynn A. Stout, The Unimportance of Being Efficient: An Economic Analysis of Stock Market Pricing and Securities Regulation, 87 Mich. L. Rev. 613, 618, 665 (1988).
lios. Merritt Fox explains that securities fraud may also reduce the effectiveness of corporate governance mechanisms and may distort a corporation’s investment decisions, leading it to reject socially desirable investment projects or to accept socially undesirable projects.

Optimal deterrence theory prescribes the legal rules that optimally deter socially harmful conduct. Developed by Steven Shavell and others, the theory predicts how particular rules of liability will affect the conduct of actors and makes normative claims as to the desirability of those rules based on a particular criterion of social welfare. In predicting the conduct of actors, the framework draws on the expected utility theorem and decisionmaking under risky conditions. It adopts the standard neoclassical assumption of complete and perfect rationality by actors. Accordingly, actors are assumed to behave as if they evaluate and choose among expected consequences at no cost. After evaluating expected consequences

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81 The prospect of inaccurate share prices may make some investors reluctant to trade their stock, particularly if they have no reason to believe that their stock is over- or under-priced. This would reduce the liquidity of their stock and, necessarily, the liquidity of stock of other investors (who would have fewer trading partners). Reduction in liquidity is a social loss. Kahan, supra note 78, at 1017–19.

82 Corporate governance mechanisms are designed to align the interests of corporate management with those of shareholders. See Merritt B. Fox, Civil Liability and Mandatory Disclosure, 109 Colum. L. Rev. 237, 253–54 (2009). Professor Fox explains that accurate information enhances the effectiveness of legal and market mechanisms to align management interests. These include mechanisms under which shareholders enforce directors’ fiduciary duties and exercise their franchise, as well as the market for corporate control and share-price-sensitive executive compensation packages. Id. at 255–60; see also Kahan, supra note 78, at 1029–31.

83 An inaccurate share price may skew a corporation’s investment decision. For example, a corporation with an inaccurately low share price may reject a positive net present value (“NPV”) project because funding the project by a share offering at an inaccurately low price may, due to the dilution resulting from the higher number of shares that must be issued to raise a given amount of funds, depress share value more than the adoption of a positive NPV project would increase share value. Fox, supra note 82, at 262. This example assumes that the corporation lacks sufficient internal funds to finance the project. Id.


85 See Shavell, supra note 84, at 1–3, 20–21.

86 The decisionmaker does not know the future with certainty. Rather, she acts rationally in accordance with some ordering of alternatives, or more specifically as if to...
based on their expected utility, actors will act as if to maximize their expected utility.\footnote{Shavell, supra note 84, at 2 n.2 ("[G]iven the definition of utility, parties make choices as if they were bent on maximizing some numerical magnitude, but not because they are in fact doing that.").}

In making normative claims as to the desirability of legal rules, optimal deterrence theory adopts the social goal of minimizing the sum of the expected social costs of the wrongdoing, the costs of precautions, and the administrative costs associated with enforcement.\footnote{Id. at 1–3; see also Calabresi, supra note 84, at 26.} Since administrative costs—the costs associated with “detecting, prosecuting, defending, and adjudicating securities fraud cases”\footnote{Rose, supra note 79, at 2183. Professor Rose refers to these costs as direct enforcement costs. Id.}—are not within the control of actors, they are set aside for present purposes (although they must, of course, be considered in determining optimal arrangements). Where legal rules lead actors to satisfy this criterion—that is, to minimize the expected social costs of the wrongdoing and the costs of precautions—optimal deterrence is achieved. Acting optimally, actors would in effect bear the costs of precautions until their marginal costs exceed the marginal reduction in the costs of expected wrongdoing.\footnote{David Rosenberg, Joint and Several Liability for Toxic Torts, 15 J. Hazardous Materials 219, 225 (1987). This principle reflects Judge Learned Hand’s famous notion in United States v. Carroll Towing Co., 159 F.2d 169, 173 (2d Cir. 1947), for deciding questions of negligence.}

It follows from the theory that conduct should not be regulated simply because it reduces social welfare.\footnote{See Rose, supra note 79, at 2183 (“That securities fraud produces social costs is not itself a sufficient rationale for government intervention.”). Even without any regulation, issuers would have incentives to signal their quality to distinguish themselves from low-quality firms in order to raise money. By doing so, they “would offer investors substantial protection.” Easterbrook & Fischel, supra note 80, at 676. For a critique of this view, see John C. Coffee, Jr., Market Failure and the Economic Case for A Mandatory Disclosure System, 70 Va. L. Rev. 717, 722, 738–43 (1984) (asserting that the view of Professors Easterbrook and Fischel “assumes much too facilely that manager and shareholder interests can be perfectly aligned” and arguing that the preconditions necessary for managers to voluntarily and adequately disclose information are unlikely to exist).} Regulation is costly and desirable only where the social welfare criterion would be satisfied.
For similar reasons—because precautions are costly—the optimal level of precautions may not be that which *prevents* the wrongdoing or even minimizes the probability of it. Again, this is because desirable precautions are those under which the social welfare criterion would be satisfied. Applying the theory requires that liability rules be finely calibrated: the adoption of greater precautions would over-deter securities fraud, just as the adoption of lesser precautions would under-deter securities fraud.  

2. The Gatekeeping Context  

As explained above, gatekeepers occupy a position within a broader legal framework. Since a corporation is simply a fictional person, the relevant acts comprising securities fraud are performed by an individual or individuals. The fraud may be deterred directly by the imposition of potential liability on the corporate enterprise, as well as on individual corporate managers. Such liability would create incentives for the corporation and its managers to take precautions to exercise their control over individual wrongdoers. The fraud may also be deterred by gatekeepers, who have existing incentives—even without those created by gatekeeper liability—to monitor and control corporate conduct. As repeat players expecting to engage in future transactions, gatekeepers have incentives to build and preserve good reputations, since a good reputation will enhance a gatekeeper’s prospects of acting on future transactions. The reputational mechanism operates to produce incentives for gatekeepers to certify the disclosures of their clients diligently and honestly. Gatekeeper liability would only be desirable to supplement enterprise liability and individual managerial liability where these more direct forms of liability and reputational constraints fail to provide sufficient deterrence.
keeper liability is desirable arises where the corporation is insolvent. More direct forms of liability would likely then fail to pro-

rate Liability Strategies, supra note 8, at 888–89 (arguing that gatekeeper liability is desirable when both enterprise and individual liability “fail to elicit sufficient compliance at an acceptance cost”). Put differently, gatekeeper liability would only be desirable if the benefits of imposing liability on gatekeepers, as reflected in the increased deterrence, outweighed the costs of imposing liability. See Victor P. Goldberg, Accountable Accountants: Is Third Party Liability Necessary?, 17 J. Legal Stud. 295, 300, 304 (1988) (identifying the cost-benefit tradeoff required to determine whether accountants should be liable, under either tort law or securities law, to investors for negligently conducting audits).

The benefits of gatekeeper liability would include not only increased deterrence, but also decreased expenditure by investors on protecting themselves. See Goldberg, supra, at 300, 304. Costs of gatekeeper liability would include costs of litigating the fault question, as well as “defensive gatekeeping”—conduct that may help to avoid legal liability without deterring wrongdoing. Id. at 306–07. Focusing on the liability of accountants to investors for negligent audits, Professor Goldberg asserts that the costs of such liability would likely exceed the benefits, arguing that if investors or other third parties wanted the benefit of a liability rule from accountants they could contract for it; but they would not do so because the costs would exceed the benefits. Id. at 304–05. Professor Goldberg does not consider the existence of gatekeepers other than accountants. Since gatekeeper liability does exist today, it cannot be inferred that the failure of investors to contract for a liability rule provides evidence about the relative costs and benefits of such a rule. Also, defects in the market for gatekeepers may provide a case for gatekeeper liability. Choi, supra note 13, at 939–49.

A doctrinal question, on which U.S. jurisdictions are split, concerns the right of a corporation to claim against its gatekeepers in contract or tort for failing to avert the wrongdoing of the individual perpetrators—the corporation’s own employees. In Cenco, Inc. v. Seidman & Seidman, 686 F.2d 449 (7th Cir. 1982), a corporation under new management claimed against its auditors for failing to prevent fraud by the corporation’s former managers. At issue was whether the accounting firm was entitled to use the wrongdoing of the corporation’s managers as a defense against the corporation’s claims. That is, the issue concerned the attribution to the corporation of the guilty knowledge of its personnel. Id. at 453. Other representative cases raising the so-called “imputation-of-fraud” rule include O’Melveny & Myers v. FDIC, 512 U.S. 79 (1994), and NCP Litigation Trust v. KPMG LLP, 901 A.2d 871 (N.J. 2006). Permitting corporate claims against gatekeepers may weaken the corporation’s own incentives to monitor and control the conduct of its personnel. But see A.C. Pritchard, O’Melveny & Myers v. FDIC: Imputation of Fraud and Optimal Monitoring, 4 Sup. Ct. Econ. Rev. 179, 197 (1995) (suggesting that shareholders cannot realistically monitor and control the conduct of their managers). Corporate claims may also exacerbate deterrent effects of securities fraud claims against gatekeepers. I am indebted to Deborah DeMott, who referred me to these cases.

See Jackson, supra note 12, at 1047–48 (explaining that gatekeeper liability “makes sense” when a corporation “becomes insolvent or otherwise judgment-proof before [its] wrongdoing comes to light”); Pritchard, supra note 96, at 191–99 (arguing that a corporation’s insolvency justifies imposing liability on gatekeepers for failing to detect the corporation’s wrongdoing).
duce sufficient deterrence. The graphical representation below illustrates the relationships among the various actors.

![Diagram showing relationships between Corporation, Gatekeepers, and Individual Perpetrators.]

Having situated the gatekeeper in the wider regulatory context, let us now focus on identifying the liability regime that would induce gatekeepers to take optimal precautions to deter securities fraud. Securities fraud is intentional wrongdoing, and individuals are therefore assumed to be able to avoid it without cost. By taking precautions, gatekeepers exercise their capacity to monitor and control the corporation's conduct. As depicted by the diagram above, gatekeepers may exercise this power over both corporate management and other corporate employees.

Applying optimal deterrence theory first requires predicting the gatekeeper’s response, in terms of the precautions it takes, to particular liability regimes. For a type of securities fraud, each gatekeeper must choose the particular level of precautions to take as she performs her gatekeeping functions. The probability of the fraud occurring will be a function of the level of precautions taken. Typically, the greater (or the higher the level of) the precautions, the more likely the securities fraud will be deterred—that is, the lower its probability of occurrence. The gatekeeper must also weigh the cost of precautions. It will choose among levels of

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*It is assumed that the expected wrongdoing equates to the expected social costs. As described above, though, the social costs of fraud are extraordinarily difficult to quantify with precision.*
precautions—and thus the expected consequences (namely, the securities fraud occurring with a particular probability)—as if it were acting to maximize its expected utility. It will prefer one level of precautions to another only if its consequences yield a greater expected value of utility.99

Applying the theory also requires the identification of liability regimes under which gatekeepers will be led to act optimally—that is, to take precautions that would minimize the sum of the costs of the expected wrongdoing and costs of precautions. An optimal regime would thus force gatekeepers to internalize the social costs of their clients’ wrongdoing, providing incentives for gatekeepers to invest in a socially optimal level of precautions.100

In practical terms, what are precautions for gatekeepers? In business transactions they would include fraud-detection and fraud-prevention measures, such as the conduct of due diligence, discussions with management and other personnel about the corporation’s operations, and attendance at meetings to draft the offering document. Precautions would also include verifying the information or advice of another gatekeeper and asking for changes to proposed corporate disclosures. In some cases, precautions would include shutting the “gate” to a transaction, such as refusing to provide a written opinion on which execution of the transaction is conditioned.101 Broadly speaking, precautions represent the mechanisms through which gatekeepers exercise their control over the conduct of their corporate clients and include any activities that affect the probability of securities fraud in the form of disclosure misstatements or omissions.102

99 Arrow, supra note 86, at 53.
100 See generally Rose, supra note 79, at 2186–89 (discussing the setting of sanctions under optimal deterrence theory). The analysis assumes here that clients do not already internalize social costs of their wrongdoing.
101 Ronald Gilson observes that a legal opinion is typically necessary to complete a placement of securities under the private offering exemption from registration under the Securities Act of 1933. By refusing to provide the opinion, a lawyer could exercise her capacity to control her client’s conduct—and, here, prevent misconduct. See Gilson, supra note 22, at 883.
102 The effectiveness of precautions may vary among gatekeepers. For example, courts have recognized the unique position of underwriters in the sale and distribution of securities. See, e.g., SEC v. Tambone, 597 F.3d 436, 449 (1st Cir. 2010) (“We agree that underwriters have a special niche in the marketing of securities and, thus, have a special set of responsibilities.”); In re Worldcom, Inc. Sec. Litig., 346 F. Supp.
3. Analogy with Joint Tortfeasors

The position of gatekeepers is conceptually similar to that of tortfeasors. Both types of actors must determine what level of precautions to take to deter a particular securities fraud or accident, as the case may be. More specifically, the gatekeeper’s position is akin to that of the accidental tortfeasor in a unilateral accident. The gatekeeping context is unilateral in the sense that the victims of any failure by gatekeepers to take adequate precautions—namely, the investors—do not contribute to the risk of securities fraud. Investors typically exercise no control over a corporation’s disclosure decisions in business transactions. Gatekeepers’ conduct is also more likely to be accidental than intentional, although the analysis adopted in this Article—of identifying liability regimes that will lead gatekeepers to adopt efficient precautions to deter harm—does not turn on a gatekeeper’s state of mind.

2d 628, 662 (S.D.N.Y. 2004) (“[I]n enacting Section 11, ‘Congress recognized that underwriters occupied a unique position that enabled them to discover and compel disclosure of essential facts about the offering.’” (quoting The Regulation of Securities Offerings, Securities Act Release No. 7606A, 63 Fed. Reg. 67174, 67230 (Dec. 4, 1998))); see also Ernest L. Folk, III, Civil Liabilities Under the Federal Securities Acts: The BarChris Case, 55 Va. L. Rev. 1, 56 (1969) (“[T]he underwriter is uniquely able to adopt an objective or even adverse posture towards the issuer regarding the accuracy of the registration statement.”).

As reputational intermediaries expecting to participate in future transactions, gatekeepers have strong incentives to resist engaging in intentional wrongdoing. See Rose, supra note 79, at 2182 n.26. Moreover, they typically have no direct stake in the transaction, see Blair et al., supra note 39, at 43, and thus less to gain than the corporation from engaging in wrongdoing.

To achieve optimal deterrence of potentially harmful activities, the sanction, or the magnitude of liability, imposed on a risk-neutral wrongdoer is generally set equal to the resulting harm. By effectively requiring the wrongdoer to internalize the harm he or she causes (whether caused intentionally or not), a rule of liability with sanctions equal to harm will deter undesirable behavior. In principle, it follows that the drafting of optimal liability rules involving the use of monetary sanctions requires only that the harm be measured, not that either the strength of the wrongdoer’s gain from an act or the motive for it be identified. See Steven Shavell, Foundations of Economic Analysis of Law 500 (2004). In the context of torts, what distinguishes intentional from unintentional torts in an economically relevant sense, according to Richard Posner, is simply that the ratio of the marginal costs of precautions to the resulting marginal benefits (of diminished expected harm) for intentional torts is “dramatically lower.” See Posner, Economic Analysis of Law 205–06 (7th ed. 2007). This characteristic of intentional torts tends to correspond with factors that may support the imposition of a punitive sanction (that is, a sanction exceeding the resulting harm). See Posner, supra, at 205–08. It is not the actor’s state of mind, however, that
One potential distinction between tortfeasors and gatekeepers is that tortfeasors typically contribute to the risk of the accident because of their capacity to create it, whereas gatekeepers contribute to the risk of the fraud by having the capacity to deter it. More specifically, gatekeepers contribute to the risk of corporate wrongdoing by having the power to monitor and control corporate conduct, power which they may exercise by taking precautions. Thus, gatekeeper liability attaches not for gatekeepers’ own wrongs—although gatekeepers can indeed inflict harm directly on investors—but for the wrongs attributed to the corporation that could have been optimally deterred by the taking of precautions by gatekeepers. Gatekeepers’ contribution to the risk of wrongdoing is the mirror image of that of most tortfeasors. In any case, for analytical purposes, a strong analogy exists between gatekeeper liability and tortfeasor liability in unilateral accidents.

4. Limits of Reputation

Gatekeeper liability would be desirable only where other deterrence measures, including the disciplining effect of reputation on gatekeeper behavior, are insufficient. The effectiveness of reputation as a constraint on gatekeepers is subject to real limits that are worth briefly exploring. One such important limit concerns the informational content of reputation and its sensitivity to gatekeeper failure in past transactions. Given the nature of the gate-

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5\textsuperscript{th} It may well be more accurate to regard gatekeepers as more closely aligned with that class of tortfeasor facing liability for failing to take precautions to prevent harm caused by another actor. Tortfeasors in this class are often considered to face liability for nonfeasance, rather than misfeasance. Nonfeasance can roughly be understood as an actor’s failure to act to prevent wrongdoing arising from another source. On the distinction between nonfeasance and misfeasance, see John C.P. Goldberg et al., Tort Law: Responsibilities and Redress 75–76 (2d ed. 2008).

6I have found the analysis of Rachel Brewster helpful on the effectiveness of reputation as a device for ensuring legal compliance. See Rachel Brewster, Unpacking the State’s Reputation, 50 Harv. Int’l L.J. 231 (2009). Although Professor Brewster’s work focuses on the reputation of nation states rather than firms, strong parallels exist between rationalist accounts in international relations theory of the influence of reputation on conduct by nation states with that of reputation on the conduct of firms. For example, just as governments will have shorter time horizons than states, individuals at firms may have shorter horizons than firms themselves.
keeping role, the relevant firm reputation reflects its performance as a certifier of the accuracy of the disclosures of its corporate client—in other words, its reputation for honesty and diligence. But information about past gatekeeper conduct may not be widely disseminated, and even where it is, it may not allow a reliable assessment of the gatekeepers’ performance. In business transactions, much of gatekeepers’ work is never publicly disclosed, and, when allegations of securities fraud arise, most disputes settle before the underlying facts are fully ventilated in a trial. Even where facts are revealed, perceptions as to propriety differ, and difficulties exist in distinguishing between the conduct of the various actors. Moreover, gatekeepers may well rehabilitate their reputations by changing personnel or improving internal controls. All this suggests that reputations may not be well-calibrated to the quality of gatekeeper performance in past transactions and are thus noisy, or crude, indicators of gatekeeper performance.

A further potential limit on reputation as a deterrence measure arises because the relevant reputation for constraining misconduct is that of the gatekeeping firm, while the incentives of individuals at the firm may diverge from those of the firm. Since the interests of individuals may diverge from those of the firm, perhaps due to

107 See Gilson, supra note 33, at 292 (referring to the lawyer’s reputation “for diligence and honesty” that is placed at risk when the lawyer certifies the information disclosed by its client). Firms might also acquire reputations as unreliable certifiers or, put differently, as gatekeepers that will “look the other way” at management’s behest. But such pliant gatekeepers would be valuable to corporations only if they maintained good reputations with investors. Goldberg, supra note 96, at 303. The resulting divergence of reputations may not be sustainable where investors include repeat players such as pension funds, insurance companies, and other institutional investors, id., especially in markets with numerous sources of financial information and analysis available to investors.

108 The difficulty of identifying and evaluating the performance of professionals, such as gatekeepers, contrasts with the ability of consumers to assess the safety of widely sold products. Cf. A. Mitchell Polinsky & Steven Shavell, The Uneasy Case for Product Liability, 123 Harv. L. Rev. 1437, 1445–50 (2010) (listing the vast array of sources through which consumers can easily obtain product information). Problems with services are likely to be more difficult to identify and evaluate than defects with products.


110 Cf. Brewster, supra note 106 (analyzing how the concern for reputation may affect a nation-state’s incentives to comply with international law).
individuals’ shorter time horizons,\textsuperscript{111} firm reputation will act as an imperfect constraint on individual conduct.\textsuperscript{112} Ultimately, though, whether the reputational mechanism is sufficient is an empirical question.

\textit{B. Interactions Among Multiple Gatekeepers}

\textit{1. A Case Study}

A case study of Commercial Financial Services, Inc. (\textquotedblleft CFS\textquotedblright), formerly the world’s largest securitizer of credit card receivables, portrays some of the possible interactions among multiple gatekeepers.\textsuperscript{113} CFS collapsed just months before Enron’s downfall, and its story, while widely reported,\textsuperscript{114} was overshadowed by the media firestorm engulfing Enron. Like Enron, CFS was a company known for its innovation and stunning growth and for the flamboyance of the individuals associated with it. Its collapse also brought allegations of securities fraud that focused attention on the conduct of gatekeepers in its business transactions. Unlike many other examples of securities fraud, however, the alleged gatekeeper failures

\textsuperscript{111} Where individuals’ time horizons are shorter, they would discount future costs to reputation of engaging in misconduct (compared with benefits from that misconduct), and their calculus would differ from that of the firm. Analogous issues arise in multi-office firms: incentives of individuals may be aligned with the reputation of their department or office, which may diverge from that of the firm.

\textsuperscript{112} The same criticism of imperfect constraint on individual conduct may be leveled at gatekeeper liability, at least to the extent it is imposed on gatekeeping firms, rather than on the individuals who comprise them.

\textsuperscript{113} One could also imagine interactions occurring in other settings for which the analysis pursued in this Article could be employed. One context involves the regulation of financial institutions in the United States by multiple agencies, a scenario that has prompted calls for the consolidation of agencies. See, e.g., Howell Jackson, A Pragmatic Approach to the Phased Consolidation of Financial Regulation in the United States (Harvard Law Sch. Pub. Law & Legal Theory Working Paper Series, Paper No. 09-19, 2008), available at http://ssrn.com/abstract=1300431. Another context concerns the enforcement of securities fraud by multiple agencies, including the SEC and its state counterparts. See Rose, supra note 79. In assessing the desirability of a multi-actor approach to regulation, the possible interactions among regulators should be considered, particularly if some regulated activities are optimally deterred by cooperation among regulators with distinct areas of expertise or experience.

in CFS arose when an identifiable opportunity existed—a proverbial “smoking gun”—for uncovering the alleged fraud.

CFS was in the business of collecting delinquent credit card receivables, sums owed by consumers who have defaulted under the terms of their credit cards. CFS bought the receivables from credit card issuers, using funds raised through a financing process similar to mortgage securitization. Using a bankruptcy-remote vehicle, CFS would issue to institutional investors securities “backed” by expected recoveries on the receivables. Since these assets were unsecured (unlike mortgages), the securities’ value depended on CFS’s collections ability. Under the securitization arrangements, CFS was required to meet minimum monthly collection targets. The securities received an “A” rating, or the equivalent, from credit rating agencies. At the time of its collapse, CFS had issued around $1.6 billion in securities from thirteen transactions.

CFS’s collapse came after rating agencies received an anonymous letter insinuating that the company was a Ponzi scheme that had been meeting its collection targets, in part, by selling receivables at inflated prices to a corporate affiliate. After the letter

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115 See Third Amended Complaint at 28, MBF Ltd. v. Bartmann, No. 99-CV-0829-K(J) (N.D. Okla. June 19, 2000) [hereinafter CFS Third Amended Complaint]. Multiple lawsuits were commenced in federal courts, alleging violations of federal securities law and claims under state law, concerning the collapse of CFS. The specific allegations made against each of the gatekeepers vary across the complaints. For expository purposes, this Article describes the content of the numerous alleged misrepresentations in summary form. As the matter settled before trial, the allegations presented here were not determined to be fact and are not presented as such.

116 Report and Recommendation at 2, In re CFS-Related Sec. Fraud Litig., No. 99-CV-825-K(J) (N.D. Okla. Dec. 21, 2001) [hereinafter CFS Report and Recommendation] (“During the relevant period, CFS raised $1.6 billion by issuing 13 asset-backed securitizations.”); Pacelle, supra note 114, at A1 (referring to CFS defaulting on more than $1.6 billion in bonds). The securitization process involved CFS buying pools of receivables from major credit card issuers (using lines of credit) and on-selling them—for profit—to a wholly-owned subsidiary corporation. The subsidiary paid CFS for them with funds raised from issuing to investors securities backed by those assets. The securities were “backed” in the sense that investors received cash flows generated by the assets. See CFS Report and Recommendation, supra, at 4; id. at Exhibit E.

117 See CFS Report and Recommendation, supra note 116, at Exhibit D (setting out a copy of the anonymous letter, which outlined “certain facts . . . relevant to your rating of asset-backed securities issued by [CFS]”); see also CFS Third Amended Complaint, supra note 115, at 36–37 (describing events surrounding receipt of the anonymous letter).
was made public and the company admitted “some basis” in truth for the allegations,\textsuperscript{118} the ratings of the CFS-sponsored securities were downgraded.\textsuperscript{119} With its funding source cut off, CFS soon filed for bankruptcy, and the issuer defaulted on the securities.\textsuperscript{120} Aggrieved investors sued, pointing to alleged misstatements in the offering documents and alleged failures by the gatekeepers to take adequate precautions to prevent the fraud.

The ensuing litigation subjected the gatekeepers—in particular, CFS’s law firm, accounting firm, and investment bank—to close scrutiny. They had been integrally involved in structuring each of the relevant transactions.\textsuperscript{121} But they had apparently overlooked a golden opportunity to uncover and prevent the alleged fraud. That opportunity occurred when the company’s Chief Executive Officer, Mitchell F. Vernick, the first outsider ever admitted to the company’s senior management, resigned.\textsuperscript{122} At that time, within four months of starting his job, he aired his concerns in writing and in meetings with the company’s gatekeepers. In his resignation letter, Vernick discussed the “viability” of CFS’s securitization model, saying that he was no longer comfortable representing to investors his “high confidence that they will be repaid in full.”\textsuperscript{123} He referred

\footnotesize
\textsuperscript{119} See CFS Third Amended Complaint, supra note 115, at 37.
\textsuperscript{120} See Pacelle, supra note 114.
\textsuperscript{121} CFS’s law firm designed the legal arrangements and assisted in drafting the offering document. See CFS Third Amended Complaint, supra note 115, at 9–16, 92–94. Its accounting firm audited the company’s financial statements, which were included in the offering document. See id. at 4–6, 80–87. Because the securities were issued to large institutions or foreign investors pursuant to Rule 144A and Regulation S, promulgated under the Securities Act of 1933, CFS Report and Recommendation, supra note 116, at 3, no registration statement was prepared for the offerings. The company’s appointed investment bank allegedly performed multiple roles: it underwrote the securities offerings, buying the issued asset-backed securities and then placing them with various institutional buyers; as financial adviser, it assisted in structuring the securitization transactions; through its parent company, it served as the company’s primary lender; and it sold credit card receivables to CFS. See CFS Complaint, supra note 118, at 39–40; CFS Third Amended Complaint, supra note 115, at 6–9.
\textsuperscript{123} CFS Report and Recommendation, supra note 116, at Exhibit G (copy of Vernick’s resignation letter); see also Report and Recommendation Against Law Firm,
to his resignation as “an issue of professional integrity—something I must do . . . to maintain my professional integrity.”

The gatekeepers’ conduct at the time of Vernick’s resignation was a focus of the plaintiffs’ attention. CFS’s lawyers had met with Vernick, at the company’s request, and with other senior managers of CFS to discuss the resignation. During discussions that took “several hours over the course of two days following his announced intention to resign,” Vernick had attempted to convince the lawyers that the CFS model did not work and that the securitizations should stop. He showed them a chart showing transactions apparently designed to make CFS appear (falsely) to be meeting its collection targets.

On the chart, one lawyer wrote, “selling / PUT to meet base?” In his notes, another lawyer wrote, “Mitch [Vernick] showed chart that breaks CF [cash flow] into components . . . settlements[,] puts and conversion rates.” Next to the words “conversion rates,” the lawyer wrote, “disguised by sales.” On another copy of the chart, another lawyer wrote, “How much sales?” The evidence is scant, and the picture that emerges is inconclusive (since the matter settled before discovery and trial), although one plausible—and perhaps generous—interpretation is confusion, or lack of understanding, on the part of the lawyers. Perhaps they failed to appreciate the gravity of Vernick’s complaints and, as they later claimed, were in no position to determine their veracity.

For their parts, the accounting firm and investment bank were also aware of Vernick’s resignation and were keenly interested in his reasons. Vernick discussed his concerns with the audit partner

supra note 122, at 22–23 (summarizing the plaintiffs’ allegations regarding the disclosure of Vernick’s resignation from CFS).

124 CFS Report and Recommendation, supra note 116, at Exhibit G.
126 Id. at 16.
127 Id. at 30–31.
128 Id. at 30.
129 Id.
130 Id.
131 Id. at 31.
132 See Pacelle, supra note 114, at A1 (quoting the law firm’s lawyer as commenting on the firm’s inability “to determine whether the ex-CEO’s complaint about CFS’s business model would prove correct”).
in charge of the CFS account, as well as with the investment bankers. There is a paucity of evidence about these discussions, and it is unclear whether the auditors and bankers were also shown the chart depicting the sham transactions.

The meetings between Vernick and the auditors and bankers were allegedly conducted under restricted waivers of Vernick’s confidentiality agreement with CFS. That agreement appears to have been associated with the company’s employment termination agreement with Vernick, which required Vernick to keep corporate information confidential. Vernick allegedly received $10 million in severance pay. After these investigative efforts and Vernick’s departure, CFS continued financing its activities via securitization transactions and was assisted in doing so by the same gatekeepers.

Over the next thirteen months, CFS sold securities valued at $1.2 billion. In the offering documents for these transactions, estimates of amounts CFS would collect on the receivables, as well as CFS’s collections abilities and track record, were misstated, according to the plaintiffs. Plaintiffs also alleged that disclosures regarding Vernick’s resignation—which was referred to in benign terms, without specifying his concerns—were also inaccurate.

133 See CFS Third Amended Complaint, supra note 115, at 44, 82.
134 Id. at 44–45, 92; see also CFS Complaint, supra note 118, at 41–42.
136 See Report and Recommendation Against Law Firm, supra note 122, at 23 (summarizing the plaintiffs’ allegations regarding the disclosure of Vernick’s resignation from CFS).
137 See Pacelle, supra note 114, at A1.
138 See CFS Third Amended Complaint, supra note 115, at 66–67; CFS Complaint, supra note 118, at 19–22.
139 The offering document explained Vernick’s resignation in the following terms:
At the request of the Chairman of the Board of CFS, effective May 30, 1997, Mitchell F. Vernick resigned from his position as Chief Executive Officer of CFS which he had held since January 13, 1997. Both the Chairman of the Board of CFS and Mr. Vernick considered his resignation appropriate in light of their different perspectives and opinions relating to a variety of issues concerning the business of CFS, including, among other matters, the management of the collection process, its capital market strategy and the value of the assets serviced by it.

CFS Report and Recommendation, supra note 116, at Exhibit E at 16.
2. A Taxonomy

This fact pattern illustrates a variety of potential interactions among the gatekeepers and suggests a number of plausible scenarios in which gatekeepers’ precautions might have deterred securities fraud optimally. These scenarios are described here in terms that are analytically useful for optimal deterrence theory. One scenario is that precautions by the lawyers alone would have deterred the fraud optimally. This might have involved the lawyers asking questions, probing for additional information, questioning other members of senior management to understand fully Vernick’s expressed concerns, and then ensuring that the offering documents for any future securitizations were accurate. Under this scenario, other gatekeepers would not have needed to take precautions, despite their involvement in the transaction.

An alternative scenario is that multiple gatekeepers, rather than a single gatekeeper, contributed to the securities fraud. Such a harm is one that multiple gatekeepers—all or some combination of them—should have taken precautions to deter optimally. Assume that the fraud would have been optimally deterred by the lawyers and accountants taking precautions—a plausible assumption. Perhaps deterring the wrong required both gatekeepers to take precautions simultaneously because of their differing (though occasionally intersecting and overlapping) areas of expertise. For example, it might be that in asking questions of Vernick, the lawyers would have appreciated the potential materiality and need for disclosure of the financial shenanigans (though maybe not their implications for the company’s operations), as well as the need to show the Vernick chart to the accountants. The accountants, though possibly unaware of the full legal implications of CFS’s activities, would have fully understood the nature of the transactions, their effect on the financial statements, and their implications for the viability of the business. Acting simultaneously and joining the various legal and accounting dots, together the gatekeepers would have constructed a picture of securities fraud and corporate collapse.

Alternatively, perhaps deterring the wrong required the accountants and lawyers to take adequate precautions sequentially.

140 These hypothetical scenarios assume the commission of securities fraud by CFS.
Here, the accountants initially would have taken the lead, probing the alleged sham transactions and the chart. They would have deciphered the transactions, explained them and their business implications to the lawyers, and relied on the lawyers to handle disclosure matters. The lawyers, relying on the information and advice of the accountants, would have determined the appropriate disclosure in the offering documents for any future securitizations and liaised with CFS management over the form and manner of disclosure. The distinction between the simultaneous and successive exercise of precautions by multiple gatekeepers is somewhat artificial (and for this reason it does not feature in the taxonomy developed next), but it does capture the ways in which deterring securities fraud may require multiple gatekeepers to exercise precautions and, specifically, how a gatekeeper may need to rely on the precautionary activities of another gatekeeper and even to delegate questions to another gatekeeper.

Within the framework of optimal deterrence theory, a simple taxonomy of interactions among multiple gatekeepers presents itself. It draws on the analogy between gatekeepers and tortfeasors, explained above in Subsection II.A.3. For a wrong to which a single gatekeeper contributes—namely, a wrong that is optimally deterred by a single gatekeeper taking precautions—that gatekeeper’s activities are considered to be independent of the activities of the other gatekeepers participating in the transaction. For a wrong to which multiple gatekeepers contribute—namely, a wrong that is optimally deterred by multiple gatekeepers taking precautions—those gatekeepers’ activities are considered interdependent. In the latter case only, the wrong is a joint wrong and is analogous to a joint tort in the context of joint tortfeasors in unilateral accidents.

III. ASSESSING THE DESIRABILITY OF LEGAL REGIMES

This Part applies optimal deterrence theory to assess the desirability of various liability regimes for multiple gatekeepers. For both independent and interdependent gatekeepers, it considers the liability regimes that would lead gatekeepers to act optimally, that is, in accord with the social welfare criterion.
A. Multiple Independent Gatekeepers

In a business transaction involving multiple gatekeepers, gatekeepers will be independent for a particular type of securities fraud where that fraud would be optimally deterred by a single gatekeeper taking precautions. This is the world of the unitary gatekeeper that scholars have inhabited until now. Since optimal deterrence would be served by a single gatekeeper taking precautions, a regime imposing liability on that actor alone would be desirable. Borrowing from tort law, that actor should be the “cheapest cost avoider,” that is, the actor that can reduce the cost of accidents most effectively. In these circumstances, it would be desirable for the other actors to take no precautions, despite their involvement in the transaction.

A standard of either strict liability or fault-based liability would lead this gatekeeper to take optimal precautions to deter securities fraud. A rule of strict liability under which the lowest-cost gatekeeper would bear liability for all of the client’s wrongdoing would be efficient, since it would force the gatekeeper to fully internalize the social costs of that wrongdoing and thus to adopt optimal precautions. A fault-based rule would also be efficient, provided the gatekeeper escaped liability only by adopting optimal precautions.

Although both rules are efficient, some scholars prefer a rule of strict liability because it leads wrongdoers to engage in the optimal level of activity and relieves courts of having to determine what constitutes optimal precautions.

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141 In tort law, Guido Calabresi introduced the notion that liability should be imposed on the cheapest (or easiest) cost avoider. Calabresi, supra note 84, at 135; see also Shavell, supra note 84, at 17 (referring to this actor as the least cost avoider); id. at 17 n.17 (explaining that the principle extends to accidents that would not be avoided or averted by all actors taking precautions). According to the “cheapest cost avoider” principle, where a tort can be avoided by more than one tortfeasor taking precautions, “the lower-cost accident avoider [should] do so, since that will avert the accident.” Posner, supra note 104, at 190.

142 See Shavell, supra note 84, at 8–9.

143 See, e.g., Partnoy, Barbarians, supra note 3, at 540–41; cf. Coffee, Gatekeeper Failure and Reform, supra note 3, at 346–53 (advocating a strict liability regime for auditors, with modifications to account for perceived problems of strict liability). As to the activity-level advantage of strict liability over fault-based liability rules in the context of torts, see Shavell, supra note 104, at 196–97.
B. Multiple Interdependent Gatekeepers

Gatekeepers will be interdependent for a particular wrong where that wrong is optimally deterred by more than one gatekeeper taking precautions. This Section introduces a stylized example in which gatekeepers face a choice among sets of precautions. In consonance with optimal deterrence theory, the gatekeepers evaluate the expected consequences of each choice based on its expected utility and act as if to maximize their expected utility. A particular liability regime is optimal if it would induce gatekeepers to satisfy the social welfare criterion. The following liability regimes are considered:

<table>
<thead>
<tr>
<th>Liability Rule</th>
<th>Apportionment Rule</th>
<th>Liability Regime</th>
</tr>
</thead>
<tbody>
<tr>
<td>Strict</td>
<td>Joint and several</td>
<td>(i) Strict: joint &amp; several with contribution</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(ii) Strict: joint &amp; several without contribution</td>
</tr>
<tr>
<td>Fault-based</td>
<td>Joint and several</td>
<td>(iii) Fault: joint &amp; several with contribution</td>
</tr>
<tr>
<td></td>
<td>Several</td>
<td>(iv) Fault: joint &amp; several without contribution</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(v) Fault: several</td>
</tr>
</tbody>
</table>

144 Shavell, supra note 84, at 2 n.2 (“[G]iven the definition of utility, parties make choices as if they were bent on maximizing some numerical magnitude, but not because they are in fact doing that.”).

145 Under a strict liability regime, no difference exists in terms of the properties of economic efficiency between joint and several liability and several liability rules of apportionment, provided both gatekeepers are fully solvent, as they are assumed to be for present purposes. (This assumption is relaxed in Section III.C.) As to the definition of these rules of apportionment, see infra note 147. The distinction collapses because the victims under both rules of apportionment would be compensated for the full damage they incur. See Lewis A. Kornhauser & Richard L. Revesz, Sharing Damages Among Multiple Tortfeasors, 98 Yale L.J. 831, 842 (1989) [hereinafter Kornhauser & Revesz, Sharing Damages]. In contrast to fault-based regimes, no occasion will arise where the victims will suffer a share of the damage contributed by a defendant. See Lewis A. Kornhauser & Richard L. Revesz, Joint and Several Liability, in Tort Law and Economics 109, 122 (Michael Faure ed., 2009) [hereinafter Kornhauser & Revesz, Joint and Several Liability].
1. Strict Liability

Consider first whether a regime under which multiple gatekeepers face strict liability for the corporation’s wrongdoing would induce the gatekeepers to take optimal precautions. Under this regime, irrespective of fault, the gatekeepers would face liability for the wrongdoing of their corporate client. The gatekeepers must share the liability in some proportion, and because fault is of no moment under a strict liability regime, they will do so in some fixed proportion unrelated to their respective contributions to the risk of wrongdoing.  

This regime, under which liability is apportioned among gatekeepers on a fixed share basis, corresponds to a rule of joint and several liability with a right of contribution (Liability Regime (i) above). Joint and several liability is a method of apportionment under which each gatekeeper is alternatively liable, at the option of the plaintiff, for all or any part of the harm assessed. In other words, from the plaintiff’s perspective in any proceedings, the full liability for the harm assessed may rest on any gatekeeper individually or on all gatekeepers collectively. As between the gatekeepers, though, where the regime includes a right of contribution, any gatekeeper that has paid to the plaintiff more than its share of liability, as measured by its contribution to the wrongdoing, may recoup that excess from another liable gatekeeper or gatekeep-

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146 The analysis here assumes that where multiple gatekeepers are liable, they will share liability based on a fixed share, according to the number of liable gatekeepers. An alternative method of apportionment, which is common under fault-based regimes, is a proportional basis—that is, according to the level of care taken by each gatekeeper. See Kornhauser & Revesz, Sharing Damages, supra note 145, at 843–44. For analytical purposes, both methods of apportionment are equivalent to a framework of joint and several liability with a right of contribution. Under both, liability is apportioned on a predetermined basis, rather than according to the preferences of the plaintiff. The fixed share basis of apportionment is typically used to apportion damages under federal securities law. Id. at 842–43 & n.53; see also Shavell, supra note 84, at 164 (assuming, in the context of strict liability in tort, that “each injurer is liable for a fraction (possibly zero) of losses,” independent of her level of care).

147 Rosenberg, supra note 90, at 220. The law and economics literature assumes that the harm assessed under joint and several liability includes harm attributable to both negligent and non-negligent actors. Kornhauser & Revesz, Sharing Damages, supra note 145, at 841–42. In contrast, under a rule of several liability, which is considered later in this Article, negligent actors are not liable for harm attributable to non-negligent actors. See infra note 170 and accompanying text.
Thus, where liability is ultimately apportioned among gatekeepers on a fixed share basis, the regime is equivalent to joint and several liability with a right of contribution; whether the plaintiff targets the gatekeepers jointly or severally, the right of contribution ensures liability is ultimately apportioned in fixed shares.

Such a strict liability regime may not lead gatekeepers to take optimal precautions. This conclusion follows from the possibility that the gatekeepers may not cooperate, but instead may act in isolation from each other in determining whether to take precautions in response to the risk of a particular wrong. The reasons for this are best illustrated with a basic numerical example. Assume that two gatekeepers—a law firm and an accounting firm—contribute to the risk of a particular type of securities fraud, in the sense that the fraud is optimally deterred by both taking precautions. Assume also that if the fraud occurs it will produce social harm of 1000. Let us consider a strict liability rule that allocates liability equally between the two gatekeepers.

The following table shows how the particular liability regime will affect the gatekeepers’ behavior.

<table>
<thead>
<tr>
<th>Does each gatekeeper take precautions?</th>
<th>Costs to each gatekeeper of taking precautions</th>
<th>Probability of securities fraud, given precautions taken by gatekeepers</th>
<th>Expected costs of securities fraud</th>
<th>Total expected costs of securities fraud*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lawyers, Acc’tants</td>
<td>Lawyers, Acc’tants</td>
<td>Probability of securities fraud, given precautions taken by gatekeepers</td>
<td>Expected costs of securities fraud</td>
<td>Total expected costs of securities fraud*</td>
</tr>
<tr>
<td>No, No</td>
<td>0, 0</td>
<td>10%</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Yes, No</td>
<td>8, 0</td>
<td>9%</td>
<td>90</td>
<td>98</td>
</tr>
<tr>
<td>No, Yes</td>
<td>0, 6</td>
<td>9%</td>
<td>90</td>
<td>96</td>
</tr>
<tr>
<td>Yes, Yes</td>
<td>8, 6</td>
<td>8%</td>
<td>80</td>
<td>94</td>
</tr>
</tbody>
</table>

* This example illustrates a multiple interdependent gatekeeper harm. This is evident from the fact that the total expected costs of securities fraud are lowest when both gatekeepers take precautions.

Where both gatekeepers take precautions, the total expected costs of wrongdoing—comprising the sum of the expected costs of

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148 See Rosenberg, supra note 90, at 224.
149 This example is adapted from an example by Steven Shavell involving joint tortfeasors, or multiple injurers. See Shavell, supra note 84, at 164–65.
150 Id. at 165.
wrongdoing and the costs of precautions—would be minimized and thus optimal deterrence would be achieved. Even taking into account the costs of both gatekeepers exercising precautions (equal to 14), the total expected costs of securities fraud (equal to 94) would be minimized relative to the costs had only one or neither taken precautions. The question is whether this particular liability regime would induce the gatekeepers to act optimally by taking precautions.

Consider the law firm’s behavior. If the accounting firm fails to take precautions, the law firm’s liability would be 50 if it also fails to take precautions (representing 50% of the expected costs of corporate wrongdoing of 100) or 45 if it takes precautions (representing 50% of the expected costs of corporate wrongdoing of 90). However, if the accounting firm takes precautions, the law firm’s liability would be 45 if it fails to take precautions (representing 50% of the expected costs of 90) or 40 if it also takes precautions (representing 50% of the expected costs of corporate wrongdoing of 80). Whether or not the accounting firm takes precautions, the law firm would reduce its liability by 5 by taking precautions. But because the costs of precautions (8) exceed the expected benefits (5), the law firm would lack incentives to take precautions, despite it being socially desirable for the firm to do so.¹⁵¹

The accounting firm would face parallel incentives. If the law firm takes precautions, the expected benefit to the accounting firm of taking precautions relative to not taking precautions would be 5 (representing its share of the costs of securities fraud being reduced from 45 to 40). Similarly, if the law firm fails to take precautions, the expected benefit to the accounting firm of taking precautions relative to not taking precautions would be 5 (representing its share of the costs of corporate wrongdoing being reduced from 50 to 45). Like the law firm, however, the accounting firm’s costs of precautions (6) exceed the expected benefits from taking precautions (5), and therefore, like the law firm, the accounting firm would not take precautions. Because it fails to ensure that the gatekeepers would adopt precautions, this liability regime is not efficient.¹⁵²

¹⁵¹ Id. at 164–65.
¹⁵² Id.
Altering the sharing of liability would not change the economic efficiency properties of the liability regime. For example, increasing the accounting firm’s share of liability might lead it to take precautions, but it would leave the law firm with even less incentive to take precautions.\footnote{For example, if the accounting firm’s share of liability were 70%, then it would have incentives to take precautions. By doing so, its liability would be reduced by 7, which would be partially offset by costs of 6. But then the law firm would benefit only by 3 (as opposed to 5 when liability is shared equally) for taking care, and yet face costs of 8 for doing so. Professor Shavell notes that “there is no division of liability that will induce [gatekeepers] to behave optimally in the example.” Shavell, supra note 84, at 165. Even so, he observes, “the best division will be such that an injurer will bear more liability the lower his cost of [taking precautions] and the greater its effectiveness in reducing risk.” Id. at 165 n.2.}

Extending the analysis to three or more gatekeepers also would not change the demonstrated inefficiency of this regime. For the intuition behind this, consider a transaction involving an accounting firm, a law firm, and an investment bank, in which all gatekeepers contribute to the risk of corporate wrongdoing. Consider the decision facing the law firm if the investment bank and accounting firm are taking precautions. If the law firm decides against taking precautions, it would be relieved of the cost of precautions and bear only a proportion (1/3 in this example) of the increase in the costs of the wrongdoing arising from it not taking precautions.\footnote{This intuition is analogous to that behind the inefficiency of a strict liability rule (with fixed sharing) in the context of multiple tortfeasors, as described by Kornhauser & Revesz, Sharing Damages, supra note 145, at 856–57 (attributing the inefficiency to the fact that an actor who causes more harm “does not bear the full increase in damages that she imposes on society” under a fixed share rule). The point was first made—in reverse terms—by Professor Shavell. He explains: “[T]he expected liability of each [gatekeeper] will fall by only a fraction of the reduction in expected losses in which his exercise of [precautions] will result.” Shavell, supra note 84, at 164.}

If the costs of precautions exceed its share of the increase in liability, the gatekeeper would not take precautions. This example shows why the analysis in the numerical example above is not contingent on the proportions in which the gatekeepers share liability or on how many gatekeepers contribute to the risk of wrongdoing.\footnote{Indeed, no division of strict liability would guarantee optimal behavior by the gatekeepers. See Shavell, supra note 84, at 165 n.2.}

Now consider a strict liability regime in which liability is apportioned jointly and severally but without a right of contribution (Li-
ability Regime (ii) above). Under this regime, each gatekeeper would be held alternatively liable, at the option of the plaintiff, for all or any part of the harm assessed. For similar reasons to those provided above, this regime may not lead gatekeepers to take precautions. Consider the same example in which an investment bank and accounting firm are taking precautions and a law firm must decide whether to do so. The law firm would decide against taking precautions if the costs of precautions exceed the law firm’s expected share of liability—an expectation that would depend on the likelihood of the law firm being the plaintiffs’ chosen target. As before, this method of apportionment would not guarantee optimal behavior by the law firm—or, indeed, by any gatekeeper facing that predicament—and thus would be undesirable.

2. Fault-Based Liability

Let us now consider the desirability of fault-based liability regimes. Under these regimes, a gatekeeper would bear liability only where it fails to take adequate precautions and, correspondingly, is at fault or negligent. In the discussion below it is assumed that the legal standard of care is set equal to the socially optimal level of care and corresponds to the taking of precautions.

156 Rosenberg, supra note 90, at 220.
157 Kornhauser & Revesz, Sharing Damages, supra note 145, at 861.
158 This conclusion is subject to a special exception. Under such a regime (Liability Regime (ii)), gatekeepers would have incentives to take optimal precautions if each gatekeeper expected with a probability of 100% to be held entirely responsible by the plaintiff for the full harm to which it contributed. Kornhauser & Revesz, Sharing Damages, supra note 145, at 861. Except for this special case, which would be efficient, no method of apportionment under a regime of strict liability would lead gatekeepers to take optimal precautions.
159 As for the analysis under strict liability, it is assumed here that where multiple gatekeepers are negligent, they will share liability based on a fixed share, according to the number of negligent gatekeepers, not in proportion to their level of care. In addition, negligent defendants are assumed to be liable for the full loss to which their conduct contributes, undiminished by the fact that some losses would have occurred even if adequate precautions had been taken. Professors Kornhauser and Revesz refer to this rule as a “full liability” rule and to the competing rule, under which a defendant faces liability only for those losses that would have been prevented by the taking of adequate precautions, as a “partial liability” rule. Kornhauser & Revesz, Sharing Damages, supra note 145, at 837–40. The efficiency properties of rules of joint and several liability do not depend on whether they are full liability or partial liability rules. Id. at 847.
Consider first the fault-based regime under which liability is apportioned among negligent gatekeepers jointly and severally with rights of contribution (Liability Regime (iii)). Multiple gatekeepers would be led to take precautions. The explanation is apparent in light of two scenarios related to the numerical example above. First, either gatekeeper alone could act negligently, by failing to take precautions, and thereby avoid the costs of precautions (either 6 or 8) but face liability of 90. Second, both gatekeepers could act negligently, by failing to take precautions, and thereby avoid the costs of precautions, but each would face liability of 50 (representing the total expected costs of corporate wrongdoing of 100 shared equally). As Professor Shavell recognizes in the analogous context of joint tortfeasors, neither of these alternatives can be an equilibrium. Each gatekeeper in both scenarios would reason that, whatever the conduct of the other gatekeeper, it is better off taking precautions. Under this regime, a negligent actor would avoid the costs of precautions by failing to take care, but would “bear the full brunt of liability” if it alone does not take precautions. Unlike under strict liability, the other gatekeeper will not be required to share liability where it takes precautions. Since social welfare is maximized when all the actors take precautions, the liability borne by the negligent gatekeeper must exceed the costs of precautions avoided. Thus, both gatekeepers would be led to act optimally under this regime by taking precautions.

Parallel incentives arise in scenarios involving more than two gatekeepers. It would not be rational for all gatekeepers to be negligent since, irrespective of how the costs of securities fraud were allocated among the gatekeepers, at least some would have to pay more than they would save by not taking precautions. This is because the aggregate costs of securities fraud exceed the aggregate costs of precautions. Regarding the same liability regime in the

\[\text{[160 Shavell, supra note 84, at 165.}\]
\[\text{[161 Id. at 165–66.}\]
\[\text{[162 Id. at 165.}\]
\[\text{[163 Kornhauser & Revesz, Sharing Damages, supra note 145, at 848 (“Since social welfare is maximized when all the actors meet the standard of care, the increase in damages must exceed the increase in benefits.”).}\]
\[\text{[164 Id. at 848–49.}\]
analogous joint tortfeasor context, Professors Kornhauser and Revesz explain as follows:

Any actors who had to pay more than their increased benefits would opt to be non-negligent. But once those actors chose to be non-negligent, the apportionment rule would allocate to other actors damages exceeding their increased benefit, since regardless of how many actors are negligent, the increase in aggregate damage caused by that negligence would continue to be greater than the increase in the aggregate benefit.165

It would not be an equilibrium for more than one gatekeeper to be negligent. Nor would it be an equilibrium for one gatekeeper to be negligent, since it would bear the full brunt of liability alone. Correspondingly, the regime creates incentives for all gatekeepers to take precautions.

Consider now the same fault-based liability regime but without rights of contribution (Liability Regime (iv)). Where no rights of contribution exist, liability is apportioned according to the preferences of the plaintiff.166 This regime is also efficient. A no-contribution regime is equivalent to a rule of contribution "in which an actor’s share is her estimate of the probability that she will be the one to be held jointly and severally liable and therefore responsible for the full damage."167 Such a regime thus shares the efficiency properties of a fault-based regime with joint and several liability and a right of contribution.168

Finally, let us consider a fault-based liability regime coupled with several (or non-joint) liability only for negligent gatekeepers (Liability Regime (v)). In contrast to the joint and several liability framework, negligent gatekeepers would not face liability for corporate wrongdoing attributed to non-negligent gatekeepers.169 They

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165 Id. at 848.
166 See supra note 156 and accompanying text.
167 Kornhauser & Revesz, Sharing Damages, supra note 145, at 860.
168 This is subject to the qualification that efficiency requires the sum of the probabilities that the gatekeepers attach to the risks of being held responsible for the full harm to equal at least one. Id. at 861. Professors Kornhauser and Revesz observe that no risk of over-deterrence occurs, even when the sum of the probabilities exceeds one, because all actors can avoid all liability by satisfying the standard of care. Id. at 861 n.107.
169 See supra note 147.
would face liability only for the contribution of negligent gatekeepers, and they would share that liability according to the predetermined basis of sharing. This regime may not be efficient, a result arising from the fact that a negligent gatekeeper may face only a fraction of the liability for the securities fraud to which its negligence contributes. The fraction would depend on the method of sharing with other negligent gatekeepers. In the joint tort context, it has been established that whether several liability would lead actors to take optimal precautions depends on the benefit and damage functions as well as on the number of actors. In short, a fault-based regime coupled with several liability may be inefficient, creating incentives for gatekeepers to act negligently.

C. Summary and Extensions

This Part has analyzed the efficiency properties of the main liability regimes for independent and interdependent gatekeeper harms. For multiple independent gatekeepers, the analysis showed that either strict or fault-based liability would lead the relevant gatekeeper to take optimal precautions. For multiple interdependent gatekeepers, the analysis showed the following. First, a regime of strict liability under which gatekeepers are jointly and severally liable may not lead gatekeepers to take precautions when it would be desirable for them to do so. This conclusion does not depend on whether rights of contribution exist or on how liability is shared among liable gatekeepers. Second, a regime of fault-based liability under which gatekeepers are jointly and severally liable would be efficient, a conclusion that also stands whether or not rights of contribution exist. Finally, a fault-based regime under which gatekeepers are severally liable may not be efficient.

Importantly, gatekeepers have been assumed in the analysis thus far to be capable of bearing the full liability imposed on them. In-
centive problems will arise where this assumption is relaxed. Gatekeepers’ incentives to take precautions are diluted where they are protected from the full liability arising from their activities. In examining the properties of liability regimes for joint torts, and allowing for the potential insolvency of some of the actors, Professors Kornhauser and Revesz show that no general conclusion can be drawn, on efficiency grounds, as to which liability regime is the most desirable, casting doubt on the generality of the results above. The relative efficiency of regimes will depend on factors including, obviously, the particular solvency levels of the actors in

172 See generally Shavell, supra note 84, at 167–68 (discussing the dilution of incentives arising from a wrongdoer’s inability to pay for the losses it causes).
173 Where actors are not fully solvent, Professors Kornhauser and Revesz demonstrate in the context of joint torts that the conclusions regarding the efficiency properties of various liability regimes above may not apply. Lewis A. Kornhauser & Richard L. Revesz, Apportioning Damages Among Potentially Insolvent Actors, 19 J. Legal Stud. 617, 649–50 (1990) [hereinafter Kornhauser & Revesz, Apportioning Damages]. Indeed, generalizations may not be made with confidence under rules of strict liability or fault-based liability as to whether an apportionment rule of several liability only or joint and several liability would dominate the other. Kornhauser & Revesz, Joint and Several Liability, supra note 145, at 122–24; see also Kornhauser & Revesz, Apportioning Damages, supra. Professors Kornhauser and Revesz also show that inefficiencies may arise from insolvency under strict liability regimes, since one actor’s insolvency affects the incentives of joint actors. Kornhauser & Revesz, Apportioning Damages, supra, at 637–44. In particular, it may prove rational for an actor to take a level of precautions that would expose it to liability in excess of its solvency. Id. at 631. The other actors would bear a portion of the liability of the insolvent actors and, correspondingly, may similarly choose to become insolvent, by taking a level of precautions that would expose them to liability beyond their capacity to pay. Id. at 640–42. The authors refer to this as the “domino effect” of the first actor’s insolvency. Id. at 640. The intuition is that the first actor’s insolvency may increase the liability of other actors, driving them to insolvency when they otherwise would be solvent. The domino effect may arise where strict liability is apportioned on the basis of joint and several liability or several liability only. Id. at 642–44. For joint and several liability, solvent actors bear a portion of liability of an insolvent actor. Id. at 641–42. For several liability also, the insolvency of one actor may increase the liability of other solvent actors; although the liability attributable to the insolvent actor is not apportioned to the solvent actors, as it is under joint and several liability, the insolvent actor’s likely failure to take adequate precautions would have the effect of increasing the total liability and, correspondingly, each other actor’s share of this liability. Id. at 642. Although the domino effect does not arise under fault-based liability regimes, other inefficiencies exist, id. at 644–46, and it is not possible to conclude that such regimes are categorically superior to others, id. at 648–49. But see William M. Landes, Insolvency and Joint Torts: A Comment, 19 J. Legal Stud. 679 (1990) (arguing that, allowing for the possibility of insolvent actors, a fault-based liability regime is more likely than strict liability to lead joint tortfeasors to take due care).
question. Once the potential insolvency of an actor is introduced, inefficiencies may arise even under a fault-based regime with joint and several liability—the regime shown above to lead gatekeepers to take precautions where doing so would be desirable. A gatekeeper may be shielded from the full effects of a liability regime by a simple insufficiency of assets to satisfy the liability that arises from the harm to which the gatekeeper’s activities contribute. The gatekeeper might also be shielded by a legal barrier, such as the principle of limited liability, which protects the assets of owners of incorporated entities from exposure to the liabilities of the corporation. Nevertheless, the incentive problems associated with the shielding of liability should not be overstated. To begin, casual empiricism suggests that gatekeepers rarely become insolvent, with the collapse of Arthur Andersen being an obvious exception. The insolvency of the corporation (the gatekeepers’ client) is a more common occurrence than the insolvency of gatekeepers and is the basis upon which an analysis of gatekeeper liability typically proceeds. Furthermore, even though the personal assets of individuals associated with a gatekeeping firm may be protected from exposure to creditors of the firm by virtue of the firm’s incorporation, individuals’ interests will often be closely aligned with those of the firm, since a substantial portion of their wealth—indeed, often their livelihood—is tied up in it.

A further factor to consider is the risk of legal error. Even under an efficient liability regime, under which gatekeepers are led to take optimal precautions, gatekeepers may be found liable. This result may arise from legal error by a court, from inadvertence by gatekeepers, or from agency problems within gatekeeping firms. Where legal error exists, the presence of multiple gatekeepers and the consequent sharing of liability would dilute the incentives of gatekeepers individually to take care, relative to scenarios involving a unitary gatekeeper.

Kornhauser & Revesz, Apportioning Damages, supra note 173, at 644–46.

Id.

Shavell, supra note 84, at 168 (describing the practice of a corporation creating wholly-owned subsidiaries with assets that represent only a fraction of its own assets).

See generally James Kelly, The Power of an Indictment and the Demise of Arthur Andersen, 48 S. Tex. L. Rev. 509 (discussing the demise of Arthur Andersen, a gatekeeper in transactions undertaken by Enron).

See supra note 97 and accompanying text.
One response to the problem of inadequate incentives is to require firms to purchase liability insurance, which may counteract the dilution of incentives caused by asset insufficiency. It may also prompt gatekeepers to take more care where insurers are able to determine the gatekeepers’ levels of precautions and to link the insurance premium, or other policy terms, to the gatekeepers’ precautions. Where insurers cannot do this, gatekeepers’ incentives may be further diluted by reason of the insurance coverage. Another response is to hold principals of a gatekeeping firm personally liable where the gatekeeping firm is unable to meet its debts. A further response is to discipline individuals at gatekeeping firms. Professional self-regulatory organizations might perform such a role. In sum, incentive problems associated with asset insufficiency of gatekeepers may well arise, and various techniques exist for attempting to solve them.

IV. IMPLICATIONS

This Part discusses the implications of the analysis in Part III for the liability of gatekeepers under U.S. federal securities laws. It begins with a reassessment of the conception of gatekeeper liability.

A. The Conception of Gatekeeper Liability

The analysis above casts fresh doubt on the suitability of strict liability for gatekeepers, at least in contexts characterized by multiple gatekeeper involvement. A prominent scholarly view, however, endorses the application of strict liability to gatekeepers. As Assaf Hamdani, a critic of this view, explains, proponents of strict liability point to the advantages of that standard of liability over

179 Shavell, supra note 84, at 169.
180 Id. at 241.
181 Id.
182 Id. at 170–71 (discussing the imposition of liability on a principal for some or all of the losses caused by another actor that has insufficient assets to pay for the losses).
183 Partnoy, Barbarians, supra note 3, at 540; see also Coffee, Gatekeeper Failure and Reform, supra note 3, at 347–53 (also recommending a modified strict liability regime for auditors).
fault-based liability. But, crucially, these scholars are operating in a unitary gatekeeper world, assuming that a single gatekeeper acts on a business transaction or that, where multiple gatekeepers are involved, gatekeepers are independently capable of deterring securities fraud. The analysis in this Article has shown that such a unitary conception of gatekeepers is unlikely to reflect reality accurately or to provide a firm basis for policy prescription. As this analysis has illustrated, for multiple interdependent gatekeepers, strict liability would not necessarily lead gatekeepers to take precautions to deter securities fraud where doing so would be socially desirable.

A related implication of the analysis in this Article concerns the conception of gatekeeper liability as a form of vicarious liability. Under vicarious liability, the wrong of an agent is imputed to its principal, with the principal and agent facing liability jointly and severally. In a sense, the principal is strictly liable for its agent’s wrong, because liability attaches to the principal without any requirement that the principal be at fault. Under optimal deterrence theory, however, this Article has demonstrated that gatekeeper liability may also be conceived of as direct liability, with gatekeepers facing liability directly on account of the precautions they take to exercise their power to monitor and control corporate conduct. Conceiving of gatekeeper liability as vicarious liability in the context of business transactions also overlooks the inevitability that gatekeepers already face some measure of deterrence by vir-

184 According to the reasoning of proponents of strict liability, gatekeepers would be led by a strict liability regime to adopt the optimal combination of measures to detect client fraud, while relieving courts of having to determine the optimal standard of care. Hamdani, supra note 3, at 59–60. Professor Hamdani recounts this reasoning in order to critique it. He does so first by establishing the dominance of strict liability over fault-based liability under conditions of symmetric information, and then by exploring the potentially undesirable effects of adverse selection—more specifically, the inability of gatekeepers to distinguish ex ante between clients according to the risk of wrongdoing they pose—under a strict liability regime. Id. at 72–74. Nevertheless, the framework adopted regards the gatekeeper as a unitary actor.

185 See Shavell, supra note 104, at 233 n.9 (referring to liability “imposed on suppliers of services (such as lawyers, accountants, and lenders) to possibly judgment-proof parties” as a “particular form of vicarious liability”).

186 Goldberg et al., supra note 105, at 507–08, 512.


188 See id. (describing the distinction between direct and vicarious liability).
tue of the vulnerability of their reputations to damage. It follows from this that holding gatekeepers vicariously liable for securities fraud perpetrated by their clients would lead to over-deterrence. It may well also lead to the unraveling of gatekeeping markets, as Professor Hamdani has shown for strict liability.\footnote{See Hamdani, supra note 3, at 60.}

B. Federal Securities Laws

Focusing on securities offerings, this Section describes the liability of gatekeepers under U.S. federal securities laws and the framework of risk-shifting mechanisms that has developed among gatekeepers.\footnote{Gatekeepers will often be met with state law claims by aggrieved investors, in addition to claims under the federal securities laws. The patchwork of relevant laws is complex. The current discussion is confined to federal securities laws.} It then assesses the regime in light of the prescriptions of optimal deterrence theory developed in Part III.

1. Section 11 of the Securities Act

Under Section 11 of the Securities Act, gatekeepers face potential civil liability for material misstatements or omissions in the registration statements of their clients.\footnote{Section 11 imposes civil liability for misstatements in registration statements (a type of disclosure document) for public offerings and identifies various gatekeepers among the potential defendants it enumerates. The provision refers specifically to underwriters as well as to “any person whose profession gives authority to a statement made by him,” a notion encompassing accountants (explicitly) and lawyers. See Securities Act § 11(a), 15 U.S.C. § 77k(a) (2006).} Since the provision does not require gatekeepers directly to make a statement or omission for liability to arise, conceptually it can be understood to impose gatekeeper liability—that is, liability on gatekeepers for failing to adequately deter wrongs committed by their clients.\footnote{See Stephen J. Choi & A.C. Pritchard, Securities Regulation 261–62 (2008) (suggesting that § 11 implicitly includes a concept of aiding and abetting liability).} Although framed as a strict liability provision, Section 11 relieves gatekeepers of liability where they establish a due diligence defense, which has the effect of converting the provision into a fault-based regime for gatekeepers.\footnote{See 15 U.S.C. § 77k(b)(3). The due diligence defense is understood to apply a negligence standard. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 208 (1976) (“Experts such as accountants who have prepared portions of the registration statement are accorded a ‘due diligence’ defense. In effect, this is a negligence standard.”).} This is consonant with the prescriptions of opti-
mal deterrence theory, as is the Section 11 requirement that liability be apportioned according to a rule of joint and several liability. On its terms, however, Section 11 overlooks the possibility of interdependencies among gatekeepers. It makes underwriters the “first line of defense” among gatekeepers, imposing liability on them alone for misstatements or omissions anywhere in the registration statement, other than in a so-called expertised portion (that is, one purporting to be authorized by an expert, such as an accountant, lawyer, or other non-underwriter professional). Among the multitude of gatekeepers participating in a transaction, only the underwriter faces potential liability for misstatements or omissions in non-expertised portions of the registration statement. It is strictly liable unless it can establish a due diligence defense, which it does by proving that “after reasonable investigation, [it had] reasonable ground to believe and did believe . . . that the statements therein were [not false or misleading].” Put in affirmative terms, to avoid liability, Section 11 requires the underwriter to reasonably investigate matters disclosed in non-expertised portions of the registration statement and to form a reasonably grounded belief as to their veracity.

Non-underwriter defendants, including accountants and lawyers, face potential liability under Section 11 for misstatements or omissions in so-called expertised portions of registration statements. These gatekeepers may be experts for statutory purposes, and thus face Section 11 liability, where they authorize expertised portions. They would then face strict liability, but because they benefit from a due diligence defense, they are effectively exposed to fault-based liability under Section 11. In practical terms, accountants will typically face potential liability for audited financial statements, which are expertised portions that accountants will authorize. Lawyers, however, rarely authorize expertised portions of

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194 Section 11 also includes a right of contribution. See 15 U.S.C. § 77j(f)(1).
197 See id. § 77k(a)(4). The underwriter is not an “expert” for purposes of § 11. Folk, supra note 102, at 52; Stephen J. Choi & A.C. Pritchard, Securities Regulation: Cases and Materials 506 (2d ed. 2008) (“Among the class of non-experts [in § 11] are . . . underwriters . . . .”), Lawyers may also be experts. Folk, supra note 102, at 58.
registration statements, except perhaps where they opine in the registration statement on the validity and tax consequences of issued securities, and so generally avoid exposure to Section 11 liability.

Underwriters also face potential liability for expertised portions of registration statements. They benefit, however, from a more generous defense than the due diligence defense. Known as the reliance defense, it immunizes an underwriter from strict liability where the underwriter proves it lacked a belief or reason to believe that the relevant statements were untrue or that there was a material omission. The defense omits any requirement for a “reasonable investigation.”

The liability framework under Section 11 is depicted in summary form below.

<table>
<thead>
<tr>
<th>Registration Statement</th>
<th>Gatekeepers Facing Potential Liability Under § 11</th>
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<tr>
<td>Non-expertised portion</td>
<td>Underwriters, subject to due diligence defense</td>
</tr>
<tr>
<td>Expertised portion</td>
<td>(1) Professionals that authorized the relevant portion, subject to due diligence defense</td>
</tr>
<tr>
<td></td>
<td>(2) Underwriters, subject to reliance defense</td>
</tr>
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</table>

Case law on the due diligence and reliance defenses, on which gatekeeper liability under Section 11 turns, is sparse. Determin-
ing whether the due diligence defense has been established requires “exquisitely” fact-intensive inquiries. In view of this Article’s focus on multiple gatekeepers, attention is given here to judicial or other authoritative guidance concerning interdependencies among gatekeepers. In this regard, courts have paid attention to the concept of “red flags.” Red flags, or “storm warnings,” have been variously defined as “facts which come to a defendant’s attention that would place a reasonable party in [the] defendant’s position ‘on notice that the [issuer] was engaged in wrongdoing to the detriment of its investors,’” and as any information that “strips a defendant of his confidence” in the accuracy and completeness of statements in relevant portions of a registration statement. The existence of red flags may be sufficient to deprive a gatekeeper of the benefit of either the due diligence or reliance defense. For the due diligence defense, red flags will require the gatekeeper to “look deeper and question more” in order to be considered to have conducted a “reasonable investigation.” For the reliance defense,


202 See In re Worldcom, 346 F. Supp. 2d. at 678–79 (referring in these terms to the determination of what constitutes a “red flag” for purposes of establishing a defense under § 11).

203 Id. at 672 (quoting In re Sunterra Corp. Sec. Litig., 199 F. Supp. 2d 1308, 1333 (M.D. Fl. 2002)).

204 Id. at 673.

205 Id. at 677 (quoting In re Enron Corp. Sec., Derivative & ERISA Litig., 235 F. Supp. 2d 549, 707 (S.D. Tex. 2002)). This is not to say that an underwriter’s precautions will necessarily satisfy the due diligence defense in the absence of red flags. Determining whether the due diligence defense is satisfied requires more than “a determination of whether any red flags existed that would put [the underwriters] on notice of a duty to make an inquiry of [the non-expertised portion of the registration statement in question].” Id. at 683. For example, the receipt of comfort letters will be “important evidence” to establish the defense. Id.; see also infra note 238. But see In re Countrywide Fin. Corp. Sec. Litig., 588 F. Supp. 2d 1132, 1175 (C.D. Cal. 2008) (suggesting that reliance may be sufficient to establish the defense absent red flags: as to the due diligence defense, “underwriters may reasonably rely on auditors’ statements, absent red flags that the underwriters were in a position to see”). As these cases illus-
red flags will give the underwriter “reason to believe” an inaccuracy exists in the registration statement.\(^{206}\)

The critical relevance of these concepts for present purposes concerns whether and when one gatekeeper may rely on the information or advice of another gatekeeper or, put differently, the extent to which one gatekeeper must verify the work of another in order to benefit from a defense under Section 11. In a multiple gatekeeper setting, this issue carries enormous practical importance. Although underwriters may be the first line of defense, their skills and spheres of influence over clients are limited—an inevitable consequence of the specialization of labor and the fragmentation of gatekeeping services. When will relying on the services of another gatekeeper be sufficient to satisfy an underwriter’s obligation to conduct a reasonable investigation? Similarly, when will relying on another gatekeeper satisfy the reliance defense, particularly if red flags exist that give the underwriter a “reason to believe” that the registration statement may contain inaccuracies?

In the latter instance, where red flags do provide such a reason to believe, courts have instructed that an underwriter is obliged to “make sufficient inquiry to satisfy [itself] as to the accuracy of the [expertised portion],” if it is to establish the reliance defense.\(^{207}\) A “sufficient inquiry” for these purposes may require the underwriter to hire its own experts, although not necessarily to duplicate the work of other gatekeepers, courts instruct.\(^{208}\) As a practical matter, underwriters will typically engage their own lawyers to perform in-

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\(^{206}\) In re Worldcom, 346 F. Supp. 2d at 681. The underwriter’s reliance on another gatekeeper’s authorization of the expertised portion of a registration statement cannot be blind. Id. at 672. Where red flags regarding the reliability of statements in an expertised portion of a registration statement emerge, “mere reliance” on that expert will not satisfy the reliance defense. Id.; see also In re Software Toolworks Inc., 50 F.3d 615, 624 (9th Cir. 1994).

\(^{207}\) In re Worldcom, 346 F. Supp. 2d at 684. In Worldcom, the expertised portion was the corporation’s audited financial statements. Id. at 664.

\(^{208}\) Id. at 684.
vestigations, and courts have not objected to this practice. The court in Escott v. BarChris Construction Corp., 283 F. Supp. 643, 697 n.26 (S.D.N.Y. 1968), did not regard as suspect the underwriter’s practice of relying on its lawyers to perform investigative functions—although the lawyers’ investigations were, in fact, inadequate for the underwriter to establish the due diligence defense. See Folk, supra note 102, at 72.

What constitutes a red flag is said to depend “on the facts and context of a particular case.” In re Worldcom, 346 F. Supp. 2d. at 673. Practitioners suggest it can be difficult to predict what a court will consider a “red flag.” See, e.g., Youngwood, supra note 201, at 79 (commenting that the court in Worldcom adopted an “aggressive” view of red flags).

For a discussion of primary violations of Rule 10b-5, see supra notes 220–30 and accompanying text. For aiding and abetting liability, see supra notes 217–19 and accompanying text.

See supra note 212.

See supra note 121.
closure document that will attract potential liability under Rule 10b-5.\footnote{1642}

Gatekeepers may face liability for the wrongdoing of their corporate clients—or, more specifically, for aiding and abetting corporate wrongdoing. This form of liability most closely resembles gatekeeper liability. Since the decision of the Supreme Court in \textit{Central Bank of Denver v. First Interstate Bank of Denver},\footnote{216} gatekeepers have been shielded from aiding and abetting liability under Rule 10b-5 in private actions, although, pursuant to Section 20(e) of the Securities Exchange Act, they do face such liability in actions brought by the SEC.\footnote{217} In 2010, the Dodd-Frank Act expanded the scope of aiding and abetting liability under Section 20(e) to cover any person who “knowingly or recklessly”—rather than simply “knowingly”—provides substantial assistance to another person in violation of the Securities Exchange Act or its rules.\footnote{218}

Gatekeepers may also face liability under Rule 10b-5 as primary violators for their involvement in securities fraud, including in private securities litigation.\footnote{219} For liability to attach, a gatekeeper’s

\footnote{216} Report of the Subcommittee on Securities Law Opinions, Committee on Federal Regulation of Securities, ABA Section of Business Law, Negative Assurance in Securities Offerings (2008 Revision), 64 Bus. Law. 395, 396–97 (2009) [hereinafter ABA Negative Assurance Report] (describing the practice in unregistered offerings of corporations preparing disclosure documents that are both comparable to the statutory prospectus that forms part of a registration statement and prepared in a process comparable to that followed for a registered offering).

\footnote{217} 511 U.S. 164, 185 (1994) (holding that nothing in § 10(b) of the Securities Exchange Act could give rise to liability for aiding and abetting a violation of the provision).

\footnote{218} As § 20(e) made explicit after the Supreme Court’s \textit{Central Bank} decision, secondary actors face aiding and abetting liability in actions brought by the SEC. Securities Exchange Act of 1934 § 20(e), 15 U.S.C. § 78t(e) (2006). The textual and structural analysis of § 10(b) employed by the Supreme Court in \textit{Central Bank} could have been interpreted to shield gatekeepers from SEC actions too. See Lewis D. Lowenfels & Alan R. Bromberg, A New Standard for Aiders and Abettors Under the Private Securities Litigation Reform Act of 1995, 52 Bus. Law. 1, 2 (1996) (“The Court’s decision in \textit{Central Bank} . . . left in serious question the SEC’s authority to maintain civil enforcement actions in court for aiding and abetting. Congress responded to \textit{Central Bank} [with § 20(e)] . . . [to] unequivocally reaffirm the SEC’s authority to maintain civil enforcement actions in court for aiding and abetting.” (citations omitted)).

\footnote{219} See Dodd-Frank Wall Street Reform and Consumer Protection Act § 929O (2010).

\footnote{219} \textit{Central Bank}, 511 U.S. at 191 (“The absence of § 10(b) aiding and abetting liability does not mean that secondary actors in the securities markets are always free from liability
misstatement or omission must be made with scienter—that is, recklessly or with an intent to deceive, manipulate, or defraud. In private actions in which a final judgment has been entered, Section 21D(f) of the Securities Exchange Act provides that each defendant shall be “liable solely for the portion of the judgment that corresponds to the percentage of [its] responsibility,” unless the defendant knowingly committed a violation of the securities laws. The merits of this provision have been closely analyzed. Determining the apportionment of liability for defendants against whom judgment is entered in a private action requires assessments, which the jury is to provide, of whether the defendant violated the securities laws and, if so, whether such violation was knowingly committed, as well as the percentage of responsibility of that defendant, measured as a percentage of the total fault of all persons who caused or contributed to the loss incurred by the plaintiff. The apportionment scheme for reckless violations of Rule 10b-5 generally corresponds to one of several liability, under which each de-

under the securities Acts. Any person or entity, including a lawyer, accountant, or bank, . . . may be liable as a primary violator under 10b-5 . . . .”). In some cases, lawyers have faced 10b-5 liability on their negative assurance letters and auditors for certifying financial statements. See Choi & Pritchard, supra note 192, at 142 (regarding accountants’ liability for certifications in audited financial statements). The scope of primary liability of lawyers, accountants, and banks is highly contested. See, e.g., Thomas Lee Hazen, 4 Treatise on the Law of Securities Regulation 514–54 (6th ed. 2009); Cox et al., supra note 20, at 755–58.


fendant faces liability according to its proportional share of responsibility, or fault, for the violation in question. Defendants found to have knowingly violated securities laws face liability for damages jointly and severally.\textsuperscript{225}

According to Professor Langevoort, the significance of the adoption of proportionate liability relates to the issue of where the risk of insolvent or judgment-proof defendants should fall.\textsuperscript{226} "The primary intended consequence of any system of proportionate liability is to shift the risk of [such] insolvency . . . from the solvent defendants to the plaintiffs."\textsuperscript{227} Concerns about insolvency arise under a regime of joint and several liability because the insolvency of a defendant exposes the solvent defendants to the full measure of liability, allocating liability to them rather than to issuers.\textsuperscript{228} Significantly, the insolvency concerns that appear to have prompted the adoption of several liability (for reckless violations) were associated with the effects of a corporation’s insolvency—\textsuperscript{229} —the very context where, from the perspective of optimal deterrence theory, the case for holding gatekeepers liable is likely to be strongest.\textsuperscript{230} A several liability regime would place the risk of a corporation’s insolvency on investors. It would also place the risk of one gatekeeper’s insolvency on investors, rather than on solvent gatekeepers.

Establishing the due diligence defense is crucial for gatekeepers in actions under Rule 10b-5, since doing so will tend to negate the existence of scienter,\textsuperscript{231} a relevant consideration for both primary

\textsuperscript{225} \textsection 21D(f)(2)(A).
\textsuperscript{226} Langevoort, supra note 222, at 1160 ("As between innocent investors and defendants who recklessly caused a securities fraud, why should the risk of defendant insolvency fall on the victims rather than the participants?").
\textsuperscript{227} Id. at 1159. On its terms, \textsection 21D(f) also permits the allocation of liability to actors not named as defendants by the plaintiff.
\textsuperscript{228} Id.
\textsuperscript{229} The concerns included that auditors would be targeted as “deep pockets” for the purpose of holding them jointly liable for wrongs for which others may have been largely culpable. See Choi & Pritchard, supra note 192, at 145–46 (discussing the adoption of \textsection 21D(f) as a congressional response to calls from auditors and others for reform).
\textsuperscript{230} See supra note 97.
liability and aiding and abetting liability. In consequence, just as gatekeepers will focus on the reasonableness of their investigations to negative scienter, plaintiffs will attempt to establish scienter by demonstrating recklessness—which can constitute scienter—by asserting that a defendant ignored red flags of another actor’s wrongdoing. The same issues discussed in the context of Section 11 concerning one gatekeeper’s reliance on or verification of the information or advice of another gatekeeper arise here. Legal uncertainty abounds.

3. Risk-Shifting Among Gatekeepers

Turning now to consider in more detail the interactions among multiple gatekeepers, the question arises as to why gatekeepers would not bargain among themselves to apportion liability efficiently. This question is especially pertinent considering that the underwriter is identified as the prime target of liability under Section 11 and yet the wrongs may be contributed to by multiple gatekeepers.

According to the Coase Theorem, voluntarily bargaining parties in a world without transaction costs will reach a mutually beneficial—and thus, efficient—agreement where the opportunity exists for them to do so, provided legal rights are well-defined. While the Theorem was originally formulated in the context of parties bargaining over property rights, its claim applies in the current context. A study of gatekeeper practices in securities transactions reveals that gatekeepers do bargain among themselves to apportion liability arising from disclosure wrongs.

Court explained as follows: “Because we conclude that the Underwriters acted with due diligence in investigating [the company’s business and revenues], we also hold that the Underwriters did not act with scienter [under § 10(b)] regarding those claims.”

232 See, e.g., In re Worldcom, Inc. Sec. Litig., 346 F. Supp. 2d 628, 672 (S.D.N.Y. 2004) (“[I]n an attempt to demonstrate recklessness [and, therefore, scienter], plaintiffs in Section 10(b) cases often assert that a defendant ignored ‘red warning flags’ of another actor’s wrongdoing.” (citing Chill v. Gen. Elec. Co., 101 F.3d 263, 269 (2d Cir. 1996))).


234 More specifically, the negotiation envisaged by Coase was between two parties, one of whom created an externality that affected the other. See id. at 1–2. The current context is analogous in the sense that, by cooperating, gatekeepers may reduce the cost being imposed on the other party.
In response to potential liability under Section 11, underwriters routinely adopt risk-shifting arrangements with other gatekeepers, namely accountants and lawyers. As a condition precedent to underwriting a proposed securities offering, underwriters will receive “comfort letters,” which are also often referred to as “negative assurance letters,” from other gatekeepers attesting to the accuracy of various parts of the registration statement. These arrangements are directed to non-expertised portions of registration statements since Section 11 imposes liability solely on the underwriter, irrespective of which gatekeeper or gatekeepers contribute to the wrong in question, whereas the (non-underwriter) gatekeeper that authorizes an expertised portion of the registration statement is the prime target of liability for wrongs in those portions. The risk-shifting framework is depicted graphically below. The corporation’s law firm will provide a negative assurance letter (the linguistic terms of which track Rule 10b-5) attesting that the law firm or relevant individual lawyers are unaware of any material misstatements or omissions in the registration statement. The accounting firm, similarly, will provide to underwriters a comfort letter giving assurance concerning a wide array of financial information throughout the registration statement, including information disclosed in the text, charts, and graphs—information that is separate from the audited financial statements, which are expertised portions of a registration statement.

See Cox et al., supra note 20, at 132–33.
These risk-shifting arrangements are intended to serve dual purposes. Primarily, the arrangements are designed to apportion liability. They create devices “by which [the underwriters] can recover on a theory of negligent or fraudulent preparation of the [negative assurance or] comfort letter for any liability the underwriters incur to investors, provided sued-upon misrepresentations were also the subject of [such] a . . . letter.”\footnote{Id. In addition to receiving negative assurance letters from the corporation’s lawyers, the underwriters receive equivalent letters from their own lawyers. Although the device referred to here contemplates the corporation’s lawyers facing liability for negligent or fraudulent preparation, the same would apply to the underwriter’s own lawyers, especially since the lawyer-client relationship exists. See generally Restatement (Third) of the Law Governing Lawyers § 48 (2000) (describing the duty of care owed by a lawyer to its client); Folk, supra note 102, at 12 n.54 (justifying the omission of lawyers from the list of defendants facing liability under § 11 on the ground that they face potential liability for professional malpractice to their client).} It would be optimal for these arrangements to allocate liability so that any gatekeeper contributing to a wrong—and not simply the underwriter—would face potential liability and thus have incentives to take precautions to exercise its power to monitor and control the corporation’s conduct. More specifically, where multiple gatekeepers contribute to a particular wrong (in the sense that optimally deterring the wrong would re-
quire those gatekeepers to take precautions), it would be desirable for the liability regime to lead those gatekeepers to take precautions. Arrangements among gatekeepers are designed to achieve this outcome, rather than to leave the underwriter as the sole bearer of liability. The second, and related, purpose of these risk-shifting arrangements is to buttress the underwriters’ due diligence defense. In determining whether the defense is established, the underwriters’ “receipt of [a] comfort letter[] will be important evidence, but is insufficient by itself to establish the defense,” especially where red flags exist.

4. Assessment

The multiple gatekeeper analysis gains most traction when one considers the liability of gatekeepers for non-expertised portions of the registration statement. In terms of optimal deterrence theory, the selection of underwriters as the first (and only) line of defense might reflect Congress’s intuition that underwriters are either the “cheapest cost avoiders”—and therefore able most effectively among all gatekeepers to reduce the costs of securities fraud—or, to use another Calabresian notion, the “best bribers”—the actors that can most cheaply identify and enter into arrangements with other gatekeepers in order to reduce the costs of securities fraud.

In view of the dynamics of the securities offering process, includ-

237 See ABA Negative Assurance Report, supra note 216, at 396, 401, 406. Establishing a due diligence defense would protect the underwriter against actions based on alleged violations of § 11 of the Securities Act or Rule 10b-5. “‘Due diligence’ as such is not a defense [to liability arising] under Rule 10b-5, but, if established, it would help to demonstrate the absence of scienter.” Id. at 397 n.16.

238 In re Worldcom, Inc. Sec. Litig., 346 F. Supp. 2d 628, 683–84 (S.D.N.Y. 2004) (“In assessing the reasonableness of the investigation, [the underwriters’] receipt of the comfort letters will be important evidence, but it is insufficient by itself to establish the defense . . . . If their initial investigation leads them to question the accuracy of financial reporting, then the existence of an audit or a comfort letter will not excuse the failure to follow through with a subsequent investigation of the matter.”); see also supra note 205 and accompanying text.

239 As to the best briber notion, see Calabresi, supra note 84, at 150.

240 Underwriters incur no contractual obligations to underwrite a securities transaction until the eve of the deal, when the underwriting agreement with the corporate issuer is executed. Folk, supra note 102, at 55. Until that time, underwriters will studiously avoid any such obligations and may withdraw from the offering. Cox et al., supra note 20, at 128. They thus have strong incentives to continue due diligence until that time, Folk, supra note 102, at 55, and they can exert pressure on other gatekee-
ing the likelihood that optimal deterrence will require precautions to be taken by multiple gatekeepers, the “best briber” explanation is the more plausible interpretation. Correspondingly, the Section 11 approach of making underwriters the sole target of liability appears to reflect a nuanced congressional attempt to deal with the possibility that disclosure wrongs may be optimally deterred by multiple gatekeepers, and the elaborate risk-shifting framework described above represents a market response to that approach.

The framework may well fail in its apparent mission. The first problem concerns the risk-shifting arrangements among gatekeepers, which appear not to reflect the forces of free bargaining. To begin, the assurances given to underwriters are carefully framed within the guidance offered by professional regulatory bodies. The assurances are often extraordinarily narrow. Both the American Bar Association (“ABA”) and the American Institute of Certified Practicing Accountants (“AICPA”) have issued guidance to their practitioners as to the terms of their letters. In its guidance, the ABA asserts that a “lawyer is not an insurer of the adequacy of the disclosure in an offering document or a ‘reputational intermediary.’” It then describes with approval the following customary qualifications in letters by lawyers:

Virtually all negative assurance letters state that counsel does not assume any responsibility for the accuracy, completeness, or fairness of the offering document, except to the extent that specific sections are addressed in a separate opinion or confirmation. Some letters refer to limitations on counsel’s professional engagement and the fact that many of the disclosures in an offering document are of a non-legal character. Some state that counsel is relying on the judgment of management or others regarding the

\[\text{\footnotesize\textsuperscript{241}}\] In their negative assurance letters, law firms make representations that are “extraordinarily narrow.” Partnoy, Barbarians, supra note 3, at 492.


\[\text{\footnotesize\textsuperscript{243}}\] ABA Negative Assurance Report, supra note 216, at 402; see also Report of the New York City Bar Association, supra note 2, at 457–59.
adequacy of disclosure. Many [letters] state that counsel has not undertaken to verify the facts contained in the disclosure document.\footnote{ABA Negative Assurance Report, supra note 216, at 402.}

As an example of the limited terms of assurance given by lawyers, the negative assurance letters in CFS were addressed to the underwriter and opined, in relevant part, that

\[N\]o facts have come to our attention which lead us to believe that as of its date, the [offering document] (other than the financial and statistical data included or not included therein, as to which we express no opinion) contains an untrue statement of a material fact or omits to state a material fact necessary to make the statements therein, in the light of the circumstances under which they were made, not misleading.\footnote{CFS Report and Recommendation, supra note 116, at Exhibit F (opinion letter by Mayer Brown dated August 6, 1997, issued in connection with the SMART 1997-4 Transaction).}

In addition to expressly carving out “financial and statistical data”—about which the departing CEO had allegedly expressed concerns—the letter was confined to facts within the “actual knowledge” of lawyers who worked on the matter, and it cautioned that the firm had undertaken no “independent investigation to determine the existence or absence of such facts.”\footnote{Id.} In subsequent litigation, the law firm asserted that its assurance was deliberately narrow: it “was not opining that there was no fraud . . . but rather that the lawyers . . . did not subjectively believe, based on the facts they had seen, that there was an untrue statement of material fact or material omission.”\footnote{Pacelle, supra note 114.}

Still, the question arises as to why underwriters do not bargain more fiercely with other gatekeepers, but instead settle for such delicately tailored assurances. Part of the answer rests with legal uncertainty—that is, the lack of clarity of the initial definition of the rights of each gatekeeper. The sparse doctrine concerning the due diligence defense is ambiguous in important respects. The defense turns partly on the existence of red flags—a plastic concept.\footnote{See supra note 205 and accompanying text.}
Multiple Gatekeepers

It is also uncertain just what comfort written assurances from auditors and lawyers provide to underwriters seeking to establish the defense. Conclusive guidance is lacking as to the scope of liability that auditors and lawyers face for their written assurances, particularly because customary practices will be relevant to determining the scope of the duty owed. As for lawyers, at least, “[c]ourts have historically appeared inclined to protect [them] from third-party claims on a variety of theories, including the absence of reliance on the opinion, the absence of privity of contract, and a relaxed standard of care.”

To the extent that doctrine does provide guidance on the due diligence defense, it suggests that determining whether the underwriter satisfied the defense depends on the reasonableness of its precautions, including, in turn, on the existence of red flags and whether it obtained comfort and negative assurance letters. Such guidance has produced incentives for the underwriter to obtain written assurances in standard terms from the other gatekeepers in the hope and expectation that doing so will constitute due diligence while, simultaneously, producing incentives for the other gatekeepers to craft assurances that would minimize their liability if underwriters fail to establish due diligence. Legal uncertainty, coupled with the presence of a multitude of potentially liable gatekeepers, may dilute the incentives of each gatekeeper to take precautions, in much the same way as the strict liability regimes evaluated in Part III.

Another explanation for the willingness of underwriters to settle for narrowly drawn assurances from other gatekeepers concerns gaps in liability resulting from the Section 11 framework and the judicial interpretation of it. Consider, for example, a misstatement or omission in a non-expertised portion of a registration statement

A law firm will typically owe a duty of care to the underwriter in issuing a negative assurance letter, even though the underwriter is a third party, rather than the law firm’s client. See generally Restatement (Third) of the Law Governing Lawyers § 51 cmt. e (1998); id. § 95 cmts. a, e. Since the underwriter will be represented by its own lawyers, who will negotiate and review the negative assurance letter, customary practices in securities offerings will be relevant to determining the scope of the duty of care. See id. § 95 cmt. e; Statement on the Role of Customary Practice in the Preparation and Understanding of Third-Party Legal Opinions, 63 Bus. Law. 1277 (2008).


See supra note 205 and accompanying text.
to which an underwriter and an accounting firm jointly contribute (in the sense, used above, that the wrong would be optimally deterred by both firms taking precautions). Section 11 provides incentives for the underwriter to exercise precautions, but what of the accounting firm? The underwriter would be relieved of liability where it satisfied the due diligence defense, a question turning on the reasonableness of the underwriter's precautions, including, on the existence of red flags and whether it obtained comfort and negative assurance letters.\(^{252}\) Significantly, the accounting firm would face no liability under Section 11 for such a misstatement or omission since it is not an enumerated defendant in Section 11; the underwriter alone stands liable among gatekeepers for non-expertised portions of a registration statement. The accounting firm would also face no liability based on the assurances in its comfort letter (such as in a malpractice claim brought by the underwriter)—irrespective of the precautions the firm actually took—where the underwriter satisfied the due diligence defense. Perversely, by relieving the underwriter of liability for relying on another gatekeeper, without any examination of the adequacy of that other gatekeeper’s precautions, the current judicial approach effectively also relieves that other gatekeeper of liability, since there is no liability to apportion.

Plugging this liability gap requires a judicial reinterpretation of Section 11 and, more specifically, of whether and when underwriters may be relieved of liability under the due diligence defense for relying on other gatekeepers. To begin, one must observe that for the joint wrong contemplated in the example above involving the underwriter and accounting firm, a liability regime directly exposing both gatekeepers to fault-based liability, with liability apportioned jointly and severally, would lead them to take optimal precautions, for the reasons outlined in Part III. But where the underwriter alone faces liability, as it does under Section 11, an interpretation that relieves the underwriter of liability where it alone takes adequate precautions may produce undesirable consequences. Such an interpretation of Section 11 may provide insufficient incentives for the underwriter—as the anointed “best briber”—to apportion liability in order to ensure that the account-

\(^{252}\) Id.
ing firm, or any other non-underwriter gatekeeper that contributed to the risk of wrongdoing, will take adequate precautions. The current judicial focus on the existence of red flags and well-formulated written assurances is not to the point, since it overlooks the importance of assessing precautions taken by any gatekeeper on which an underwriter relies.

Instead, under Section 11 the underwriter should be given incentives to focus squarely on the precautions in fact taken to deter wrongdoing. In the example above involving the underwriter and accounting firm, the underwriter should also be assessed on the precautions exercised by the gatekeeper on which it relies, the accounting firm. Put differently, in determining whether the underwriter exercised due diligence, the conduct and precautions of the accounting firm—and any other gatekeeper on which the underwriter relies—should, in a sense, be attributed to the underwriter. This would amount to treating the underwriter much like a multidisciplinary gatekeeper. Courts would determine whether the underwriter satisfied the due diligence defense on the basis of precautions taken, whether by the underwriter or another gatekeeper on which the underwriter relied. Faced with liability for the conduct of the multiplicity of gatekeepers, the underwriter would have powerful incentives to apportion that liability among those gatekeepers efficiently, bargaining fiercely in doing so and, in all likelihood, opposing the delicately crafted assurances recommended by professional regulatory bodies. Given the influence of investment banks and both the repeated dealings and enduring relationships among the small number of firms that routinely act on major business transactions, it is realistic to envisage more robustly negotiated comfort and negative assurance letters if courts were to adopt the approach being suggested here.

253 The inadequate focus by underwriters on actual precautions taken by other gatekeepers is perhaps illustrated by the timing of the due diligence process. Due diligence efforts by the various gatekeepers are conducted over the course of the business transaction, which can take three to six months or longer, and yet the terms of the letters—and thus the scope of the assurances given—are typically subject to extensive negotiation, Cox et al., supra note 20, at 132–33, and often not settled until late in the transaction, perhaps on the eve of closing, at a time when the opportunity to expand or otherwise adjust the actual due diligence efforts has long passed.

254 See Flood, supra note 48, at 253 ("In the USA a . . . small number of New York law firms . . . are consistent repeat players in capital markets work . . . . This concen-
This reinterpretation of the due diligence defense under Section 11 is premised on the idea that gatekeepers are in the best position to apportion liability among themselves. It would fill the gap in liability arising when underwriters are absolved of liability without any assessment of the precautions taken by other gatekeepers (on which underwriters rely) that contribute to the wrong in question, providing incentives for gatekeepers that contribute to the risk of wrong to take due care. The reinterpretation would thus overcome disaggregation problems associated with multiple gatekeepers that afflict the Section 11 regime and, importantly, provide much-needed doctrinal clarity.

The liability regime for expertised portions of registration statements under Section 11 is less problematic than that for non-expertised portions. The regime might reflect the congressional view that authorization by an expert is a proxy for that expert alone being able to deter wrongdoing optimally—by exercising due diligence—in that portion of the registration statement. The existence of a red flag, which prevents underwriters from relying on the reliance defense and activates an affirmative duty of further in-

tration of expertise is also found in the investment banks, the other side of the equation here, where seven banks tend to dominate this work and all are US based.’’); John Flood, Capital Markets, Globalisation and Global Elites, in Transnational Legal Processes 128–29 (Michael Likosky ed., 2002) (‘‘The numbers of active players in capital markets are relatively small.’’). Investment banks are prized clients of law firms, investing banks with influence over the law firm even in transactions in which the law firm is acting for the corporate issuer, rather than the bank. See John Flood, Ambiguous Allegiances in the Lawyer-Client Relationship: The Case of Bankers and Lawyers 3 (May 2009) (unpublished manuscript, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=962725) (‘‘Upset [investment banks] and law firms can expect to see a significant part of their fee income evaporate.’’); see also Nick Ferguson, What the Client Demands, 16 Int’l Fin. L. Rev. 33, 33 (1997) (discussing the influence of investment banks in securities offerings and the enduring relationships among particular investment banks and law firms). A related consideration for a law firm is the possibility that, in a future transaction, it will act for an investment bank, demanding that the corporation’s law firm provide a more broadly worded negative assurance letter. As for accounting firms, the largest four firms audit “almost all large public companies” in the United States. Gov’t Accountability Office, Audits of Public Companies: Continued Concentration in Audit Market for Large Public Companies Does Not Call for Immediate Action 1 (Jan. 2008), available at http://cpatrendlines.com/wp-content/uploads/2008/01/gao-on-audits-of-public-companies-january-2008.pdf. The influence of investment banks over accounting firms may be weaker, although it is conceivable that corporations could bring pressure on accounting firms to broaden the assurances in their comfort letters.
vestigation, might be considered to indicate a wrong that is likely to be optimally deterred by multiple gatekeepers—and thus both the relevant expert and the underwriter would face Section 11 li-
ability. This framework appears to expressly contemplate a form of multiple gatekeeper liability. Still, it also suffers from the problem of lack of doctrinal clarity, due to uncertainties associated with the concept of red flags.\textsuperscript{255}

One live issue concerns when an underwriter must hire its own experts to verify the authorizing expert’s work in an expertised portion of the registration statement in order to establish the reliance defense. In vague terms, courts have noted the possibility that underwriters will have to engage their own experts, without offering guidance on when such an obligation would arise.\textsuperscript{256} For present purposes it can be noted that the suggestion that still more gatekeepers may be engaged—with the underwriter hiring its own experts, duplicating the expertise already employed by the issuer—would heighten concerns associated with the fragmentation of services. For this reason, courts should show reluctance in requiring underwriters to hire their own experts.

We turn now to an assessment of aiding and abetting liability of gatekeepers under Rule 10b-5 in actions brought by the SEC. As mentioned above,\textsuperscript{257} the Dodd-Frank Act enlarged this form of liability to cover persons who recklessly, and not simply knowingly, provide substantial assistance to a primary violator of Rule 10b-5. This change reflects an acknowledgement of one of the deficiencies of the fragmentation of gatekeeping services—that gatekeepers may have opportunities to minimize their involvement in transactions, possibly becoming mere functionaries, in order plausibly to deny knowledge requisite to attract liability under the securities laws. By broadening the knowledge requirement, the Dodd-Frank Act diminishes this danger.

In private actions against gatekeepers under Rule 10b-5, the issue of apportionment of liability deserves attention.\textsuperscript{258} A reckless gatekeeper found liable as a primary violator under Rule 10b-5 faces liability solely for the “percentage of [its] responsibility . . .

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\textsuperscript{255} See supra note 210.
\textsuperscript{256} See supra notes 207–10 and accompanying text.
\textsuperscript{257} See supra note 219.
\textsuperscript{258} See supra note 220–25 and accompanying text.
measured as a percentage of the total fault of all persons who caused or contributed to the loss incurred by the plaintiff.\footnote{15 U.S.C. § 78u-4(f)(3)(A)(ii) (2006).} For reckless conduct, the apportionment rule under Rule 10b-5 may well be inefficient. The conception of percentage of responsibility is open to varying interpretations, including one that would allow a jury, in determining a defendant’s responsibility, to apportion some percentage of responsibility to actors that contributed to the loss but face no legal liability under Rule 10b-5.\footnote{See Choi & Pritchard, supra note 192, at 146 (“Note that the allocation of responsibility is not limited to persons named as defendants by the plaintiffs.”).} In the context of tortious conduct, such actors would be analogous to non-negligent actors that contributed to the harm in question, yet discharged their duty of care by virtue of the precautions they took. For similar reasons that a regime of fault-based liability coupled with several liability may fail to induce optimal behavior by tortfeasors,\footnote{See supra notes 169–70 and accompanying text.} an approach to Rule 10b-5 under which non-liable actors are apportioned responsibility may fail to induce actors to take optimal precautions.\footnote{The intuition for this result can be illustrated by an example involving harm of $h$ to which actors $A$ and $B$ contribute but for which only $A$ faces liability. Assume that the harm would not have occurred either if $A$ had satisfied the relevant legal duty or if $B$ had not been involved with $A$ in joint conduct. If $A$ were liable for only part of $h$—perhaps because some percentage of responsibility were apportioned to $B$—then $A$ may lack incentives to behave optimally. I thank Steven Shavell for suggesting this example to me in a related context.} This analysis would counsel against a broad interpretation of “percentage of responsibility,” as that expression is used in apportioning liability under Rule 10b-5, and in favor of one that would confine the apportionment of responsibility only to those actors facing liability under Rule 10b-5.

One should bear in mind that the analysis in Part III proceeded initially on the assumption that the defendants were fully solvent. When this assumption is relaxed, the social welfare properties of neither joint and several liability nor several liability dominate the other.\footnote{See supra note 173 and accompanying text.} Accordingly, the economic analysis of liability regimes in Part III does little to sharpen the analysis of the desirability of the 10b-5 liability regime in the context of gatekeeper insolvency. Still, gatekeeper insolvency is rare and less salient than the insolvency of...
the corporation, the gatekeeper’s client, upon which an analysis of gatekeeper liability typically proceeds.\textsuperscript{264}

One apparent gap in liability under Rule 10b-5 concerns the basis of knowledge on which lawyers’ negative assurance rests. A standard form for law firms issuing negative assurance letters, promulgated by a committee of the ABA Section of Business Law, states that “nothing came to our attention that caused us to believe” certain matters regarding the accuracy of the disclosure.\textsuperscript{265} According to the committee’s commentary, a law firm adopting this standard language is expressing only the “actual subjective belief” or “conscious awareness” of those lawyers in the law firm who have “actively participated in the process of preparing the offering document.”\textsuperscript{266} The commentary opposes any interpretation that would base the assurance on the knowledge of all lawyers at the firm—which would encompass other lawyers that have acted for the corporation other than in preparing the particular disclosure document in the transaction at hand—as being “impractical and uneconomic.”\textsuperscript{267} The question of lawyers’ knowledge would assume significance in an action against underwriters under Rule 10b-5: in that scenario, underwriters would seek to demonstrate due diligence—and thus a lack of scienter—in part by relying on the law firm’s written assurance, despite that firm’s assurance being framed to exclude the penumbra of circumstances (recklessness, for instance) that constitute scienter. If the legal opinion were dispositive in successfully establishing a lack of scienter by the underwriters while also limiting the law firm’s liability, a gap in liability would appear to exist.

\textsuperscript{264} See supra notes 177–78 and accompanying text.

\textsuperscript{265} ABA Negative Assurance Report, supra note 216, at 408.

\textsuperscript{266} Id. at 403. The law firm in the CFS litigation was more explicit, stating that “[w]henever in this letter, the existence or absence of facts is indicated to be based on our knowledge or awareness, we are referring to the actual knowledge of the [law firm’s] attorneys who have represented CFS [and its subsidiaries on the relevant transactions].” See CFS Report and Recommendation, supra note 116, at Exhibit F (opinion letter by Mayer Brown dated August 6, 1997, issued in connection with the SMART 1997-4 Transaction).

\textsuperscript{267} ABA Negative Assurance Report, supra note 216, at 403 n.46.
C. Compelling Cooperation Among Gatekeepers

One practical challenge this Article presents is how to operationalize its analysis by identifying scenarios calling for precautions being exercised by multiple gatekeepers. Put differently, what wrongs are optimally deterred by the exercise of precautions by multiple gatekeepers? Once these scenarios are identified, one could compel cooperation in an attempt to alleviate problems associated with the fragmentation of gatekeeping services. Cooperation in this sense would involve gatekeepers sharing information and expertise to settle particular disclosure questions. The approach would promise to overcome, and thereby discourage, the practices of some clients or gatekeepers of failing to consult with other gatekeepers on some questions and of clients interposing themselves between gatekeepers. The approach would also promise to overcome the rigid separation of functions among various gatekeepers that may produce gaps in oversight as well as gatekeeper attempts to adopt a “head-in-the-sand approach” to avoid having to say “no” to a client.\footnote{268 Longstreth, supra note 73, at 23.}

One model approach, adopted in the United Kingdom and other British Commonwealth jurisdictions, is the practice of formal verification meetings for securities offerings, in which the various gatekeepers meet to substantiate the contents of the offering document. So rigorous and detailed is the process that a comprehensive report is often produced that substantiates each material statement of fact in the offering document by reference to independent written material.\footnote{269 See Herbert Smith, Hong Kong IPO Guide 18 (2006) (on file with author) (“[A] set of verification notes are ... prepared which endeavour to verify all material statements made in the draft prospectus, where possible by reference to independent written material.”); see also Valerie Ford Jacob, Due Diligence on Non-U.S. Companies, in Conducting Due Diligence in M&A and Securities Offerings, supra note 201, at 181, 186 (“In order to avoid liability under U.K. law it is sometimes necessary in U.K. securities offerings to embark upon a lengthy verification process, the aim of which is to ensure that the prospectus is wholly accurate. As part of the verification process, issuer’s counsel breaks out each and every statement of fact in the prospectus. Counsel then requests that the company or the underwriters provide back-up for each statement.”).} Multiple gatekeepers will attend to ensure that their collective expertise and knowledge is brought to bear on disclosure issues. The novelty of the approach is that it requires multiple
gatekeepers not simply to exercise precautions, but to cooperate in doing so. It also diminishes the extent to which gatekeepers may plausibly deny knowledge of information. Such precautions might be expected to deter that form of misconduct susceptible only to the expertise of multiple, specialized actors cooperating to connect the various dots that will reveal fraud.

Verification meetings have their genesis in domestic U.K. offerings. Nevertheless, practices in the U.K., especially for major transactions, have evolved with the increasing influence in Europe of U.S.-headquartered investment banks, which underwrite major securities offerings. One result has been the adoption of U.S. due diligence practices in the United Kingdom in securities transactions by corporations seeking to raise funds internationally, including from U.S. institutional investors. A significant feature of this trend is the resistance of U.S. investment bankers, familiar with U.S. due diligence practices, to the preparation of written verification reports for fear that the reports may include “smoking guns” that might be seized upon by plaintiff lawyers in any litigation. The approach of other British Commonwealth jurisdictions, particularly Australia and Singapore, which have been less influenced by U.S. practices, may be more instructive and is the focus of the discussion below.

Several features of the verification process deserve elaboration. The first is its integrated nature. Multiple advisers, including underwriters, accountants, and lawyers, meet with representatives of the issuer to pool their expertise and knowledge. In Australia, for

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271 In Singapore, underwriters will frequently request a “verification/due diligence meeting” with the corporate issuer, the auditors, and lawyers, at which the respective parties will respond to specific questions raised by the underwriters. The Institute of Certified Public Accountants of Singapore, Proposed Audit Guidance Statement on Comfort Letters and Other Assistance for Public Offerings of Equity Securities in Singapore 17–18 (2008) [hereinafter Singapore Proposed Audit Guidance Statement]. In Australia, representatives of the corporate issuer, the underwriter, the issuer’s lawyers, the audit firm and, occasionally, the underwriter’s lawyers will form a Due Diligence Committee to verify the disclosure document on an “integrated” basis. See Ian M. Ramsay & Baljit K. Sidhu, Underpricing of Initial Public Offerings and Due Diligence.
example, representatives of the issuer and its various advisers form a committee, referred to as the Due Diligence Committee, which formally delegates the verification of particular aspects of the offering document to individual advisers, charging them with responsibility for reporting back to the committee. The committee is responsible for coordinating and overseeing the due diligence process. In Singapore, auditors often participate in verification meetings without the presence of corporate management, perhaps allowing them to speak more openly regarding disclosure issues than they otherwise might.\(^{272}\)

A second feature concerns the lack of duplication of due diligence. For example, rarely will an underwriter’s law firm duplicate the due diligence of the issuer’s law firm, as typically occurs in U.S. securities offerings. Instead, for matters in which lawyers are considered to possess suitable expertise, the committee will task the issuer’s lawyers with reporting the findings of its due diligence to the committee, which as a body—drawing on the expertise and information of its various members—will determine whether to probe further into various matters as it assesses the accuracy of the offering document. The committee will identify key issues for investigation, review reports provided to it, and determine what disclosure response is required. Although information and expertise is inevitably pooled, the general approach is for each adviser on the committee to rely without independent verification on the information or advice for which another adviser on the committee has been delegated responsibility.\(^{273}\)

\(^{272}\) See Singapore Proposed Audit Guidance Statement, supra note 271, at 18 (“Reporting auditors should ordinarily be able to participate in meetings with the [underwriters] and legal counsels [sic] without the presence of Issuer’s management and speak openly at such meetings unless limited by the Issuer in which case this should be made known by the reporting auditors to the [underwriters].”).

\(^{273}\) The Australian accounting profession has made explicit the entitlement of its practitioners participating in a due diligence committee to rely on other advisers to the committee. See Accounting Professional & Ethical Standards Board, APES 350 Participation by Members in Public Practice in Due Diligence Committees in Connection with a Public Document, para. 3.16 (2009) (explaining that accountants may gen-

A further feature of the verification process is the preparation of a written report, which will be provided to the corporate issuer’s board of directors. In Australia, the committee will prepare a verification report to verify material statements of fact and opinion in the offering document. It will also prepare a key issues report, which details the important disclosure issues and how they were dealt with, by disclosure or otherwise. The committee will thus coordinate its efforts with the drafting of the offering document. In sum, the verification process involves the pooling of information and expertise, minimal duplication of due diligence, and the production of a written report attesting to the accuracy of the relevant offering document.

Formal verification meetings are not a part of securities law practice in the United States. No due diligence report is prepared for securities offerings, and no formal meeting is held at which the numerous gatekeepers simultaneously attempt to verify material statements in the offering document. Yet the practice has the distinct advantage of marshalling the various talents of gatekeepers and bringing them to bear on disclosure issues, and perhaps also of dulling incentives that a knowledge-based standard of liability creates to have only a fragmented knowledge of a corporation’s activities. Still, the process is expensive and the issue arises as to whether it would be worth its cost. The production of a report is anathema to U.S. securities law practice. One compromise, though, that would capture many of the benefits and avoid much of the cost would be to require gatekeepers to meet to discuss any particularly vexing disclosure issues, possibly even in the absence of management. Examples of such issues would include how to disclose the reasons for departure of a CEO and how to describe the extent of expected losses of a business being acquired. Not every material statement need be verified, but any particularly sensitive statements would be discussed, with the objective of sharing expertise and knowledge, to the extent that doing so is considered to reduce the risk of securities fraud at an acceptable cost. Carefully framing the terms of such a requirement would be crucial—and the pro-

274 See, e.g., supra Subsection II.B.1.
275 See, e.g., supra notes 74–77 and accompanying text.
proposal is simply suggested here as food for thought. An alternative proposal in a similar vein would be to permit, or even to require, a gatekeeper not simply to “report up” potential wrongdoing to a corporate client’s general counsel or audit committee, but to “report across” to other gatekeepers that have expertise or other characteristics suited to assessing and deterring potential corporate wrongdoing.

A further approach would be for professional self-regulatory organizations such as the ABA, the Financial Industry Regulatory Authority, and the AICPA, to consult to identify those situations where experience suggests cooperation among gatekeepers might optimally deter securities fraud. A model is offered by the treaty between the ABA and AICPA in 1975, which continues in force, concerning how lawyers and auditors should cooperate in the financial statement disclosure of litigation matters. That area is one calling for precautions by multiple gatekeepers since it involves reliance by auditors on the information and expertise of a client’s lawyers, who are the best source for information about client litigation. It also presents opportunities for clients to interpose themselves between the gatekeepers, for example, by instructing lawyers not to disclose particular claims to auditors. It may also create incentives for lawyers to narrow their scope of involvement. The treaty sets out the terms on which lawyers and accountants should cooperate, including emphasizing lawyers’ professional responsibility to avoid “knowingly [participating] in any violation by the client of the disclosure requirements of the securities laws.” An advantage of such a consultative approach is that it allows the crafting of terms of cooperation to account for differences in expertise among gatekeepers and to preserve the attorney-client privilege.

276 ABA, Statement of Policy Regarding Lawyers’ Responses to Auditors’ Requests for Information, 31 Bus. Law. 1709 (1976). The policy was approved by the Board of Governors of the ABA in 1975, and a Statement on Auditing Standards, which reflects the policy, was approved by the AICPA Auditing Standards Executive Committee in 1976. Id.

277 Id. at 1714. The policy asserts that the “lawyer also may be required under the Code of Professional Responsibility to resign his engagement if his advice concerning disclosures is disregarded by the client.” Id.

278 The privilege may be lost when gatekeepers other than lawyers are involved in the formulation of legal advice. See generally Beardslee, supra note 67.
Another area potentially calling for multiple gatekeeper precautions concerns disclosure of the results of independent investigations. Often conducted by law firms with narrow terms of reference, these investigations tackle sensitive issues, possibly going to the existence of securities fraud, and would require disclosure if their timing coincided with a business transaction. The CFS case study provides an example: the CEO’s resignation, which prompted an independent investigation of sorts, was relevant to the company’s securitization transactions and thus required disclosure. The investigation conducted in Enron of the whistle-blowing claim that the corporation would “implode in a wave of accounting scandals” provides another salient example of a matter where precautions by multiple gatekeepers would possibly have deterred the fraud optimally.

Professional regulatory bodies would do well to provide guidance on scenarios involving possible wrongdoing, the detection and deterrence of which would demand the expertise of multiple professionals.

A potential proposal for ensuring cooperation is to remove the existing barriers in the United States to the formation of multidisciplinary gatekeeping firms. Individuals at such firms could cooperate in sharing information and expertise and thereby alleviate problems associated with the fragmentation of gatekeeping services. The merits of such a change could be offset by the adverse effects of conflicts of interest arising from housing various gatekeeping services in a single firm. One would also expect gatekeepers at a multidisciplinary firm to have weaker incentives to cross-check—and potentially challenge—the work of other gatekeepers within the firm, relative to the incentives of gatekeepers interacting with gatekeepers in distinct firms. Challenges would also arise concerning incompatibility in the roles of different gatekeepers; lawyers, for example, owe duties to act in the interests of their client, whereas accountants’ overriding duty is to the public.

In sum, the possibility of conflicts of interest, the weakening of cross-checking among gatekeepers, and the potential incompatibil-

279 See supra Subsection II.B.1.

280 See Powers et al., supra note 66, at 172; id. at 26 (examining the narrow inquiry undertaken by lawyers without the assistance of accounting experts).

281 See supra notes 56–61 and accompanying text.

282 See supra note 55.
ity of longstanding legal duties all caution against permitting multidisciplinary firms. Whether they offset the benefits associated with the sharing of information and expertise is a complex issue deserving deeper inquiry.

D. Credit Rating Agencies as Gatekeepers

A fundamental—and timely—issue concerns which actors should be regarded as gatekeepers. In particular, should credit rating agencies be so regarded? If so, the application of the analysis in this Article would be broadened, since these actors, like the traditional gatekeepers already mentioned, could well find themselves among the multiple actors facing potential liability for failing to deter securities fraud. Before offering some preliminary observations on the recently enacted Dodd-Frank Act, which reveals Congress’s apparent conception of credit rating agencies as gatekeepers, it is worth considering the question of identifying, or defining, a gatekeeper.

This question connects with an important fault line in the literature on gatekeeper liability. Referring to Professor Kraakman’s definition of gatekeepers as private actors who are able to prevent wrongdoing, Professor Coffee has offered “a second and superior definition of the gatekeeper [as] an agent who acts as a reputational intermediary to assure investors as to the quality of the ‘signal’ sent by the corporate issuer.” The difference in definition apparently turns on Professor Kraakman’s requirement that gatekeepers have the capacity to monitor and control corporate con-

283 Kraakman, Gatekeepers, supra note 3, at 53 (defining gatekeepers as “private parties who are able to disrupt misconduct by withholding their cooperation from wrongdoers”). This definition focuses on the capacity of gatekeepers, rather than their willingness, to disrupt misconduct. As to the distinction, see Geoffrey Miller, From Club to Market: The Evolving Role of Business Lawyers, 74 Fordham L. Rev. 1105 (2005). Professor Miller discusses how the transformation of the market for legal services and market conditions eroded the willingness (or incentives) of lawyers to perform a gatekeeping role, id. at 1106; the tentative recommendations offered for reform, id. at 1126–36, suggest that he believes that lawyers maintain the capacity to do so. But see Kim, supra note 17, at 418 (distinguishing between capacity and willingness to disrupt misconduct and regarding both as characteristics of gatekeepers). This Article regards the willingness, or incentives, of gatekeepers to perform a gatekeeping role as being affected by both the reputational mechanism and the imposition of liability.

duct, a requirement Professor Coffee intentionally omits from his conception of gatekeeper. The difference may be overstated, though, since Professor Kraakman’s conception necessarily incorporates the notion of the gatekeeper as a reputational intermediary, and it is the gatekeeper’s capacity to monitor and control corporate conduct, particularly conduct concerning disclosure, that could well invest gatekeepers with reputations for certifying the accuracy of corporate disclosures. Nevertheless, the distinction affects the range of actors that may be considered gatekeepers, since some reputational intermediaries might lack the capacity to monitor and control corporate conduct. It is on this question that the characterization of credit rating agencies—as gatekeepers or not—would seem to turn.

Whether credit rating agencies have the capacity to monitor and control corporate conduct goes to the issue of whether gatekeeper liability theory provides a justification for a liability regime that would treat credit rating agencies as gatekeepers, equivalent to lawyers, underwriters, and accountants. If credit rating agencies possessed that capacity, this important category of actor would fall within both gatekeeper definitions in the literature, since credit rating agencies clearly have reputational capital to lend.

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285 Although Professor Kraakman refers to the ability of gatekeepers to “prevent” wrongdoing, it is apparent from his analysis that he adopts a broader conception of a gatekeeper as an actor capable of monitoring and controlling, but not necessarily preventing, wrongdoing. He refers to gatekeepers’ capacity to monitor, saying that each gatekeeper performs a “monitoring service” by virtue of its role as a participant in transactions. Kraakman, Corporate Liability Strategies, supra note 8, at 891. He refers also to their ability to “influence [corporate] managers to forgo offenses.” Id. at 890; see also supra note 8.

286 Professor Kraakman expressly acknowledges this, asserting that “[a]ccounting, law, and investment banking firms serve as private gatekeepers because they are ‘reputational intermediaries’ in the securities markets” and that “[t]hey increase the confidence—and reduce the information costs—of disaggregated investors by implicitly offering their market reputations as ‘hostages’ for the quality of their clients.” Kraakman, Gatekeepers, supra note 3, at 61 n.20 (internal citations omitted).

287 Put differently, gatekeepers’ reputations operate to assure the accuracy of disclosures precisely because gatekeepers have—or are presumed to have—the capacity to monitor and control corporate conduct.

288 Coffee, supra note 15, at 2–3 (explaining that gatekeepers need not have the “capacity to veto or withhold consent,” that their distinctive feature concerns their service as a reputational intermediary certifying the quality of the “signal” sent by its principal, and that under this definition credit rating agencies are gatekeepers); see also Frank Partnoy, How and Why Credit Rating Agencies Are Not Like Other
could point to the certification that credit rating agencies provide and observe that, unlike traditional gatekeepers that certify the accuracy of a corporation’s disclosures, credit rating agencies “certify the credit risk of company debt,” and for this purpose evaluate not the accuracy of a corporation’s disclosures, but its credit risk, or risk of default. Indeed, credit rating agencies have expressly disclaimed any responsibility to verify or otherwise conduct due diligence concerning the corporate information on which they base their ratings. This issue is significant since it would serve no allocational purpose to impose gatekeeper liability on credit rating agencies were they simply unable, by exercising precautions, to monitor and control corporate conduct and thereby to affect the probability of securities fraud in the form of disclosure misstatements or omissions.

The Dodd-Frank Act appears to have clarified the conception of credit rating agencies. It does so rather indirectly by allowing a plaintiff to survive a motion to dismiss a claim based on Rule 10b-5 against a credit rating agency in circumstances where the agency has not, generally speaking, alleged facts concerning the agency’s failure to reasonably investigate or verify the information on which the agency’s rating is based. More specifically, the Dodd-Frank


After all, the reputations gatekeepers “rent” are reputations for diligently and honestly certifying the corporation’s disclosures.

For example, Fitch Ratings asserted that it “shall have no obligation to verify or audit any information provided to it from any source or to conduct any investigation or review, or to take any other action, to obtain any information that the issuer has not otherwise provided to Fitch.” The Committee of European Securities Regulators, Report to the European Commission on the Compliance of Credit Rating Agencies with the IOSCO Code 13 (Dec. 2006), available at http://www.cesr.eu.org/data/document/06_545.pdf; see also Joseph R. Mason & Joshua Rosner, Where Did the Risk Go? How Misapplied Bond Ratings Cause Mortgage Backed Securities and Collateralized Debt Obligation Market Disruptions 12–14 (May 14, 2007) (unpublished manuscript, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1027475) (assessing the legitimacy of rating agencies not verifying the information on which they rely).

Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 933(b), 124 Stat. 1376, 1883–84 (2010). The Dodd-Frank Act confirms the availability of civil remedies against credit rating agencies by providing that the en-
Act lowers the pleading standard in this context by amending the Securities Exchange Act to allow a plaintiff to survive a motion to dismiss by pleading facts giving rise to

a strong inference that the credit rating agency knowingly or recklessly failed—(i) to conduct a reasonable investigation of the rated security with respect to the factual elements relied upon . . . ; or (ii) to obtain reasonable verification of such factual elements . . . from other sources that the credit rating agency considered to be competent and that were independent of the issuer and underwriter.\(^{293}\)

Importantly, this pleading standard does not purport to change the elements ultimately needed to be established to make out a successful Rule 10b-5 claim. Nevertheless, that a plaintiff may survive a motion to dismiss by establishing that a credit rating agency has failed to engage in the specified conduct provides incentives for credit rating agencies to engage in precisely that conduct. In fact, in the light of the Dodd-Frank Act, one credit rating agency has indicated that it would “heighten” its verification of the information with which it is provided by issuers and underwriters.\(^{294}\) Thus, the legislative reform may well motivate credit rating agencies to modify their practices to investigate or verify the information on which they rely to rate securities. In doing so, to the extent that rating agencies rely on information disclosed by corporations, rating agencies may be taken to certify that information, exercising an ability to monitor and control corporate conduct, and thereby to

\(^{293}\) Id. § 933(b).

\(^{294}\) Stephen W. Joynt, Market Letter by Fitch with Perspectives on Implementing Dodd-Frank Act (July 23, 2010), available at http://sg.finance.yahoo.com/news/Fitch-Releases-Market-Letter-bw-820885489.html?x=0 (“As Fitch addresses the enhanced regulation of the Dodd-Frank Act, as well as the increased expectations created by worldwide regulatory reform, Fitch will keep the market informed of its changes . . . . Fitch expects to continue to make changes that will provide greater transparency, more rigorous processes and heightened verification of the information Fitch is provided by issuers and underwriters.”) (emphasis added). Interestingly, prior to the Dodd-Frank Act, this agency disclaimed any responsibility to verify or investigate information. See supra note 291.
perform a gatekeeping role similar to that of the traditional gatekeepers already mentioned. By articulating the pleading standard in the way it has, Congress has assisted in resolving a question as to the gatekeeping function of credit rating agencies.

Another important reform implemented by the Dodd-Frank Act potentially exposes credit rating agencies to liability under Section 11 of the Securities Act. In particular, the Dodd-Frank Act nullifies the effect of Rule 436(g) of the Securities Act, a provision that shielded credit rating agencies from Section 11 liability for credit ratings included in a registration statement. This change exposes credit rating agencies to Section 11 liability, provided they have consented to being named as certifying the expertised portion of a registration statement. In a related development, the SEC has recently proposed requiring the disclosure by registrants of credit ratings used in connection with registered securities offerings. Nevertheless, some rating agencies have indicated that they are unwilling to deliver consents for the disclosure of their ratings, a practice that would be expected to lead to an increase in...
transactions for which the disclosure of credit ratings are not required under the proposed rules.\textsuperscript{301}

Whether or not rating agencies deliver consents, unintended consequences may arise from the nullification of Rule 436(g). A rating agency that refuses consent avoids exposure to Section 11 liability and thus sidesteps the intended deterrent effect of the reform. Yet, a rating agency that delivers its consent simply adds to the potential number of liable gatekeepers, thus diluting the incentives to deter wrongdoing that traditional gatekeepers would otherwise face under the existing Section 11 regime described above. A defense of traditional gatekeepers may well become that they reasonably relied on the efforts of rating agencies as part of their own due diligence efforts.

While the Dodd-Frank Act provides some measure of certainty as to the required role of credit rating agencies, it also raises questions. For example, what conduct will constitute a reasonable investigation for the due diligence defense of credit rating agencies under Section 11? More specifically, to what extent may a credit rating agency rely on the advice or information of other gatekeepers for purposes of establishing the due diligence defense? May it rely without verification on another gatekeeper if no red flags appear? The references in the Dodd-Frank Act to sources “independent” of the issuer and underwriter,\textsuperscript{302} although in the context of pleading standards in 10b-5 actions, might be interpreted to suggest that a reasonable investigation to establish the due diligence defense.

\textsuperscript{301} The proposed release does not require the disclosure of ratings for certain transactions based on Rule 144A, 17 C.F.R. § 230.144A (2010), which provides a safe harbor from registration requirements for certain transactions. See Credit Ratings Disclosure, 74. Fed. Reg. 53,086, 53,090 (proposed Oct. 15, 2009).

\textsuperscript{302} Section 933(b) of the Dodd-Frank Act amends the Securities Exchange Act to allow a plaintiff to survive a motion to dismiss by pleading facts giving rise to “a strong inference that the credit rating agency knowingly or recklessly failed—(i) to conduct a reasonable investigation of the rated security with respect to the factual elements relied upon . . . ; or (ii) to obtain reasonable verification of such factual elements . . . from other sources that the credit rating agency considered to be competent and that were independent of the issuer and underwriter.” Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 933(b) (2010).
defense under Section 11 requires a resort to similarly independent sources of information. However, for reasons outlined in Section IV.B, it would be desirable for gatekeepers to coordinate their efforts and contract among themselves to ensure the adoption of efficient precautions. Coordination among gatekeepers would not be facilitated by courts limiting in advance the sources of information on which credit rating agencies may rely to establish the due diligence defense. Accordingly, no judicial regard should be had for the pleading standard for Rule 10b-5 actions against credit rating agencies in determining what constitutes reasonable investigation for purposes of the due diligence defense in Section 11.

Finally, it is worth observing that the distinction concerning the ability to monitor and control corporate conduct may be relevant to the securities analyst and the proxy advisory firm, other actors regarded as gatekeepers by some scholars. For their part, securities analysts opine on the merits of a corporation’s securities as investment opportunities, including whether the investor should buy, sell, or hold them. They should not have access to non-public information about a corporate issuer, or any opportunity to review the veracity of a corporation’s disclosures before they are made public. In these circumstances, it is difficult to regard securities analysts as certifying the accuracy of the corporation’s disclosures. An analysis of the gatekeeping status of proxy advisory firms would require a close examination of their existing practices, including their access to non-public information and the certification role they perform. Their relevance for present purposes concerns

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303 Coffee, supra note 15, at 2–3 (explaining that gatekeepers need not have the “capacity to veto or withhold consent” that their distinctive feature concerns their service as a reputational intermediary certifying the quality of the “signal” sent by its principal, and that under this definition securities analysts, among others, are gatekeepers); id. at 3 (referring to proxy advisors as the most recent and notable of the “[n]ew gatekeeping professions”).

304 Pursuant to Regulation FD, securities analysts obtain corporate disclosures by public corporations no earlier than other market participants. 17 C.F.R. § 243.100 (2010). In its Proposing Release to the regulation, the SEC explained that it had grown concerned about public corporations disclosing nonpublic information to securities analysts, among others, ahead of other investors. Selective Disclosure and Insider Trading, 64 Fed. Reg. 72,590, 72,591–92 (proposed Dec. 28, 1999). Together with rules prohibiting disclosure to analysts at the time of securities offerings, Regulation FD severely constrains analysts’ ability to verify the accuracy of corporate disclosures. See 17 C.F.R. § 243 (2010).
the difficult question of how to treat attempts by gatekeepers to influence the recommendations of proxy advisory firms or even the ratings of credit rating agencies. Some lawyers advocate engaging with proxy advisory firms on behalf of their corporate clients to seek to influence the advisory firm’s recommendations on how shareholders should vote on a business transaction. Such conduct raises the issue, not pursued in this Article, of how to treat a gatekeeper that seeks to influence another gatekeeper or a reputational intermediary to prevent that actor from taking adequate precautions.

CONCLUSION

This Article has considered the widely observable pattern of multiple gatekeeper involvement in business transactions. It has considered why corporations undertaking these transactions rely on the market for gatekeeping services and, in particular, on multiple distinct gatekeepers, rather than on multidisciplinary gatekeeping firms. As actors with the capacity to monitor and control the conduct of corporations, gatekeepers certify the accuracy of disclosures by their clients, economizing on transaction costs and creating value. They also bring to bear expertise in an area where economies of expertise are especially significant.

This Article has extended gatekeeper liability theory to account for the phenomenon of multiple gatekeepers. It has developed a simple taxonomy of interactions among multiple gatekeepers, based on whether their activities are independent or interdependent of each other in deterring corporate wrongs; shown that previous scholars have occupied the world of independent, or unitary, gatekeepers; and shown further that a regime of fault-based liability coupled with joint and several liability would be optimal for advancing the cause of optimal deterrence.

The Article has also explored the potential implications of its analysis for U.S. federal securities regulation, showing that the leg-

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islative framework appears remarkably attuned to the potential of multiple gatekeepers to deter wrongdoing. But it has suggested that doctrinal uncertainty, the intrusion of professional self-regulatory organizations, and judicial interpretations of the due diligence defense may have stymied congressional efforts to harness the deterrence capacity of multiple gatekeepers and produced gaps in liability. The Article has proposed a reinterpretation of the due diligence defense, offered guidance on the apportionment of liability under Rule 10b-5, and suggested a number of modest reform proposals associated with compelling cooperation among gatekeepers. All fall short, however, of the most obvious proposal of allowing the formation of multidisciplinary firms that would provide bundled gatekeeping services. Such a development would bring within the boundaries of the firm the various cooperative efforts necessary to certify corporate disclosures, yet would create problems arising from conflicts of interest.

If one message stands out in this Article, it is that interdependencies exist among the multiplicity of gatekeepers that participate in business transactions. To harness their capacity to deter, we need to begin thinking about gatekeeper liability in a fresh way.