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It's About the Gatekeepers, Stupid**

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Understanding Enron: "It's About the Gatekeepers, Stupid"

by John C. Coffee, Jr.

What do we know after Enron's implosion that we did not know before it? The conventional wisdom is that the Enron debacle reveals basic weaknesses in our contemporary system of corporate governance.¹ Perhaps, this is so, but where is the weakness located? Under what circumstances will critical systems fail? Major debacles of historical dimensions (and Enron is surely that) tend to produce an excess of explanations. In Enron's case, the firm's strange failure is becoming a virtual Rorschach test in which each commentator can see evidence confirming what he or she already believed.²

Nonetheless, the problem with viewing Enron as an indication of any systematic

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¹ As a result, proposals to reform corporate governance through legislation, codes of best practice, and heightened listing standards are proliferating. See, e.g., Tom Hamburger, "Corporate-Governance Bill Weighed," *The Wall Street Journal*, May 3, 2002 at p. C-10 (discussing proposed "Shareholder Bill of Rights"); Kate Kelly, "Stock Exchanges Fortify Watchdog Roles," *The Wall Street Journal*, April 30, 2002 at p. C-1. The SEC has proposed changes in financial reporting, which proposals have encountered mixed reviews. See Gretchen Morgenson, "Information Sooner, Yes, But Make It Better Too," *New York Times*, May 5, 2002, Section 3-1. Other recurring legislature proposals address auditors and the Financial Accounting Standards Board. See Michael Schroeder, "Tauzin Bill Aims to Bolster FASB With Firms' Fees," *The Wall Street Journal*, April 30, 2002 at p. A-4.

² This observation applies with special force to academics. Those who doubted stock market efficiency before Enron doubt it even more afterwards, pointing to the slow fall of Enron stock over the last half of 2001. Those who are skeptical of outside directors are even more convinced that their wisdom has been confirmed. For example, my Columbia colleague, Jeffrey Gordon, has proposed a new model of "trustee/directors" to populate the audit committee and perform certain other guardian roles. See Jeffrey N. Gordon, What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reactions, 69 *U. Chi. L. Rev.* __ (forthcoming in 2002).

governance failure is that its core facts are maddeningly unique. Most obviously, Enron's governance structure was sui generis. Other public corporations simply have not authorized their chief financial officer to run an independent entity that enters into billions of dollars of risky and volatile trading transactions with them; nor have they allowed their senior officers to profit from such self-dealing transactions without broad supervision or even comprehension of the profits involved.³ Nor have other corporations incorporated thousands of subsidiaries and employed them in a complex web of off-balance sheet partnerships.⁴

In short, Enron was organizationally unique - - a virtual hedge fund in the view of some,⁵ yet a firm that morphed almost overnight into its bizarre structure from origins as a stodgy gas pipeline company. The pace of this transition seemingly outdistanced the development of risk management systems and an institutional culture paralleling those of traditional financial firms. Precisely for this reason, the passive performance of Enron's board of directors cannot fairly be extrapolated and applied as an assessment of all boards generally.⁶ Boards of directors may or

³ Although no substantive findings have yet been made by any court or agency, these are the essentially findings of a special committee of Enron's own board. See REPORT OF INVESTIGATION BY THE SPECIAL INVESTIGATIVE COMMITTEE OF THE BOARD OF DIRECTORS OF ENRON CORP. (the "Powers Report"), February 1, 2002.

⁴ Although complete information is still lacking, Enron appears to have established nearly 3,000 subsidiaries and partnerships in Delaware, the Cayman Islands, the Netherlands and elsewhere. See Glenn Kessler, "Enron Agrees to Let Congress See Tax Returns," Washington Post, February 16, 2002 at p. A13.

⁵ Indeed, some commentators view Enron as virtually a hedge fund. See Frank Partnoy, "Enron and Derivatives" (available on Social Sciences Research Network at www.ssrn.com at id=302332) (testimony of Professor Frank Partnoy before Senate Committee on Governmental Affairs).

⁶ No doubt, there are other corporations in which an entrepreneurial founder has dominated the board and caused it to approve dubious self-dealing transactions. WorldCom Inc. and Global Crossing quickly come to mind, and the resignation of the former's chief executive and the bankruptcy of the latter suggests that firms

may not perform their duties adequately, but, standing alone, Enron proves little. In this sense, Enron is an anecdote, an isolated data point that cannot yet fairly be deemed to amount to a trend.

Viewed from another perspective, however, Enron does furnish ample evidence of a systematic governance failure. Although other spectacular securities frauds have been discovered from time to time over recent decades,⁷ they have not generally disturbed the overall market. In contrast, Enron has clearly roiled the market and created a new investor demand for transparency. Behind this disruption lies the market's discovery that it cannot rely upon the

with weak corporate governance do not perform well during market downturns. See Rebecca Blumenstein and Jared Sandburg, "WorldCom CEO Quits Amid Probe of Firm's Finances," *The Wall Street Journal*, April 30, 2002 at p. A-1. The starting point of this article is not the premise that contemporary corporate governance is fundamentally sound, but rather that there is high variance among boards - - some very good, and others quite bad. Its conclusion is, however, that reliable corporate governance is not possible without reliable gatekeepers - - because boards necessarily depend on professional assistance from gatekeepers.

⁷ Many of these frauds have involved far more sinister and predatory conduct than has yet come to light in Enron. For example, officers of Equity Funding of America counterfeited bogus insurance policies in order to convince their auditors that their product was selling. See *Dirks v. United States*, 463 U.S. 646, 648-50 (1983) (discussing the basic fraud in the course of analyzing the liability of a tippee who advised clients to sell this stock). More recently, officers of Bre-X Minerals Ltd. apparently salted mining samples taken from the firm's properties in Indonesia to convince the market that it had discovered one of the largest gold mines in history. During the period that these false statements were issued, Bre-X's stock price rose from \$2.85 per share to \$224.95; on discovery of the fraud, the stock collapsed and the company went into bankruptcy. See, *McNamara v. Bre-X Minerals Ltd.*, 2001 U.S. Dist. LEXIS 4571 (E.D. Tex. March 30, 2001). Similar observations could be made about other recent scandals, including OPM in the early 1970's, Lincoln Savings & Loan in the 1980's, or the massive BCCI bank failure in the 1990's. Each dwarfs Enron in terms of the culpability of senior management. Nor are the market losses greater in Enron. The stock declines in 2001 in Lucent Technologies and Cisco Systems were considerably greater in terms of decline in total market capitalization, even though neither of these cases has elicited any public enforcement proceeding.

professional gatekeepers - - auditors, analysts, and others - - whom the market has long trusted to filter, verify and assess complicated financial information. Properly understood, Enron is a demonstration of gatekeeper failure, and the question it most sharply poses is how this failure should be rectified.

Although the term “gatekeeper” is commonly used,⁸ here it requires special definition. Inherently, gatekeepers are reputational intermediaries who provide verification and certification services to investors.⁹ These services can consist of verifying a company’s financial statements (as the independent auditor does), evaluating the creditworthiness of the company (as the debt rating agency does), assessing the company’s business and financial prospects vis-a-viz its rivals (as the securities analyst does), or appraising the fairness of a specific transaction (as the investment banker does in delivering a fairness opinion). Attorneys can also be gatekeepers when they lend their professional reputations to a transaction, but, as later discussed, the more typical role of attorneys serving public corporations is that of the transaction engineer, rather than the reputational intermediary.

Characteristically, the professional gatekeeper essentially assesses or vouches for the corporate client’s own statements about itself or a specific transaction. This duplication is necessary because the market recognizes that the gatekeeper has a lesser incentive to lie than

⁸ The term “gatekeeper” is not simply an academic concept. In Securities Act Release No. 7870 (June 30, 2000), the SEC recently noted that “the federal laws .. make independent auditors ‘gatekeepers’ to the public securities markets.” 2000 SEC LEXIS 1389 *

⁹ For a fuller, more theoretical consideration of the concept of the gatekeeper, see R. Kraakman, Corporate Liability Strategies and the Costs of Legal Controls, 93 Yale L.J. 857 (1984); R. Kraakman, Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy, 2. J.L., Econ. & Org. 53 (1986); S. Choi, Market Lessons for Gatekeepers, 92 Nw. U.L. Rev. 116 (1998).

does its client and thus regards the gatekeeper's assurance or evaluation as more credible. To be sure, the gatekeeper as watchdog is typically paid by the party that it is to watch, but its relative credibility stems from the fact that it is in effect pledging a reputational capital that it has built up over many years of performing similar services for numerous clients. In theory, such reputational capital would not be sacrificed for a single client and a modest fee. Here, as elsewhere, however, logic and experience can conflict. Despite the clear logic of the gatekeeper rationale, experience over the 1990's suggests that professional gatekeepers do acquiesce in managerial fraud, even though the apparent reputational losses seem to dwarf the gains to be made from the individual client.¹⁰

Why has there been an apparent failure in the market for gatekeeping services? This brief comment offers some explanations, but also acknowledges that rival explanations lead to very different prescriptions. Thus, the starting point for responding to the Enron debacle begins with asking the right question. That question is not: why did some managements engage in fraud? But rather it is: why did the gatekeepers let them?

I. The Changing Status of the Gatekeeper

In theory, a gatekeeper has many clients, each of whom pay it a fee that is modest in proportion to the firm's overall revenues. Arthur Andersen had, for example, 2,300 audit clients.¹¹ On this basis, the firm seemingly had little incentive to risk its considerable reputational capital for any one client. During the 1990's, many courts bought this logic hook,

¹⁰ This observation is hardly original with this author. See, for example, Robert A. Prentice, The Case of the Irrational Auditor: A Behavioral Insight Into Securities Fraud Litigation, 95 Nw. U. L. Rev. 1333 (2000).

¹¹ See Michelle Mittelstadt, "Andersen Charged With Obstruction, Vows to Fight," Dallas Morning News, March 15, 2002 at p.1.

line and sinker. For example, in DiLeo v. Ernst & Young,¹² Judge Easterbrook, writing for the Seventh Circuit, outlined precisely the foregoing theory:

“The complaint does not allege that [the auditor] had anything to gain from any fraud by [its client]. An accountant’s greatest asset is its reputation for honesty, closely followed by its reputation for careful work. Fees for two years’ audits could not approach the losses [that the auditor] would suffer from a perception that it would muffle a client’s fraud ... [The auditor’s] partners shared none of the gain from any fraud and were exposed to a large fraction of the loss. It would have been irrational for any of them to have joined cause with [the client].”¹³

Of course, the modest fees in some of these cases (the audit fee was only \$90,000 in Robin v. Arthur Young & Co.)¹⁴ were well less than the \$100 million in prospective annual fees from Enron that Arthur Andersen & Co. explicitly foresaw. But does this difference really explain Arthur Andersen’s downward spiral? After all, Arthur Andersen earned over \$9 billion in revenues in 2001.¹⁵

Once among the most respected of all professionals service firms (including law, accounting, and consulting firms), Andersen became involved in a series of now well-known securities frauds - - e.g., Waste Management, Sunbeam, HBOCMcKesson, The Baptist Foundation, and now Global Crossing - - that culminated in its disastrous association with Enron. Little, however, suggests that Arthur Andersen was more reckless or less responsible

¹² 901 F.2d 624 (7th Cir. 1990); see also Melder v. Morris, 27 F.3d 1097, 1103 (5th Cir. 1994); Robin v. Arthur Young & Co., 915 F.2d 1120, 1127 (7th Cir. 1990) (mere \$90,000 annual audit fee would have been an irrational motive for fraud).

¹³ Id. at 629.

¹⁴ See Robin v. Arthur Young & Co., 915 F.2d 1120, 1127 (7th Cir 1990).

¹⁵ Arthur Andersen’s website reports that revenues for 2001 were \$9.34 billion. See www.andersen.com.

than its peers.¹⁶ Instead, the evidence suggests that something led to a general erosion in the quality of financial reporting during the late 1990s. During this period, earnings restatements, long a proxy for fraud, suddenly soared. To cite only the simplest quantitative measure, the number of earnings restatements by publicly held corporations averaged 49 per year from 1990 to 1997, then increased to 91 in 1998, and finally skyrocketed to 150 and 156, respectively, in 1999 and 2000.¹⁷

What caused this sudden spike in earnings restatements? Because public corporations must fear stock price drops, securities class actions, and SEC investigations in the wake of earnings restatements, it is not plausible to read this sudden increase as the product of a new tolerance for, or indifference to, restatements. Even if some portion of the change might be attributed to a new SEC activism about “earnings management,”¹⁸ which became an SEC priority

¹⁶ Compared to its peers within the Big Five accounting firms, Arthur Andersen appears to have been responsible for a less than its proportionate share of earnings restatements. While it audited 21% of Big 5 audit clients, it was responsible for only 15% of the restatements experienced by the Big Five firms between 1997 and 2001. On this basis, it was arguably slightly more conservative than its peers. See “Periscope: How Arthur Andersen Beggars for Business,” *Newsweek*, March 18, 2002 at p. 6. In discussions with industry insiders, the only respect in which I have ever heard Andersen characterized as different from its peers in the Big Five was that it marketed itself as a firm in which the audit partner could make the final call on difficult accounting questions without having to secure approval from senior officials within the firm. Although this could translate into a weaker system of internal controls, this hypothesis seems inconsistent with Arthur Andersen’s apparently below average rate of earnings restatements.

¹⁷ See Moriarty and Livingston, Quantitative Measures of the Quality of Financial Reporting, 17 *Financial Executive* 53, at 54 (July/August 2001).

¹⁸ Accounting firms have sometimes attempted to explain this increase on the basis that the SEC tightened the definition of “materiality” in the late 1990’s. This explanation is not very convincing, in part because the principal SEC statement that tightened the definition of materiality - - Staff Accounting Bulletin No. 99 - - was issued in mid-1999, after the number of restatements had already begun to soar in 1998. Also, SAB No. 99 did not truly mandate restatements, but only

in 1998,¹⁹ corporate issuers will not voluntarily expose themselves to enormous liability just to please the SEC. Moreover, not only did the number of earnings restatements increase over this period, but so also did the amounts involved.²⁰ Earnings restatements thus seem an indication that earlier earnings management has gotten out of hand. Accordingly, the spike in earnings restatements in the late 1990's implies that the Big 5 firms had earlier acquiesced in aggressive earnings management - - and, in particular, premature revenue recognition - - that no longer could be sustained.

This apparent pattern of increased deference by the gatekeeper to its client during the 1990's was not limited to the auditing profession. Securities analysts have probably encountered even greater recent public and Congressional skepticism about their objectivity. Again, much of the evidence is anecdotal, but striking. As late as October 2001, 16 out of the 17 securities analysts covering Enron maintained "buy" or "strong buy" recommendations on its stock right up until virtually the moment of its bankruptcy filing.²¹ The first brokerage firm to downgrade

suggested that a rule of thumb that assumed that amounts under 5% were inherently immaterial could not be applied reflexively. See Staff Accounting Bulletin No. 99, 64 F.R. 45150 (August 19, 1999).

¹⁹ The SEC's prioritization of earnings management as a principal enforcement target can be approximately dated to SEC Chairman Arthur Levitt's now famous speech on the subject in 1998. See Arthur Levitt, "The Numbers Game, Remarks at NYU Center for Law and Business" (September 28, 1998).

²⁰ According to Moriarty and Livingston, *supra* note 17, companies that restated earnings suffered market losses of \$17.7 billion in 1998, \$24.2 billion in 1999, and \$31.2 billion in 2000. *Id.* at 55. Expressed as a percentage of the overall capitalization of the market (which was ascendingly hyperbolically over this period), these losses for 1998 through 2000 came to 0.13%, 0.14% and 0.19%, respectively, of market capitalization. In short, however expressed, the losses increased over this period.

²¹ See "Statement of Frank Torres, Legislative Counsel, Consumers Union, Before the United States Senate, Committee on Governmental Affairs, on the Collapse of Enron: The Role Analysts Played and the Conflicts They Face," February 27,

Enron to a “sell” rating in 2001 was Prudential Securities, which no longer engages in investment banking activities.²² Revealingly, Prudential is also believed to have the highest proportion of sell ratings among the stocks it evaluates.²³

Much like auditors, analysts are also “reputational intermediaries,” whose desire to be perceived as credible and objective may often be subordinated to their desire to retain and please investment banking clients. One statistic inevitably comes up in any assessment of analyst objectivity: namely, the curious fact that the ratio of “buy” recommendations to “sell” recommendations has recently been as high as 100 to 1.²⁴ In truth, this particular statistic may not be as compelling as it initially sounds because there are obvious reasons why “buy” recommendations will normally outnumber “sell” recommendations, even in the absence of conflicts of interest.²⁵ Yet, a related statistic may be more revealing because it underscores the

²² 2002, at p.6 (AIn the case of Enron, 16 out of 17 analysts had a buy or a strong buy rating, one had a hold, none had a sell - - even as the company stock had lost over half its value and its CEO suddenly resigned.@). 2002 WL 2011028; see also testimony of Frank Partnoy, Professor of Law, University of San Diego School of Law, Hearings before the United States Senate Committee on Governmental Affairs, January 24, 2002 (similar 16 out of 17 tabulation). See Lauren Young, “Independence Day,” SMARTMONEY, May 1, 2001, p. 28. Vol. XI, No. V, 2002 WL 2191410.

²³ Id.

²⁴ A study by Thomas Financial/First Call has found that less than one percent of the 28,000 stock recommendations issued by brokerage firm analysts during late 1999 and most of 2000 were “sell” recommendations. See Opening Statement of Congressman Paul E. Kanjorski; Ranking Democratic Member, House Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, “Hearing on Analyzing the Analysts,” June 14, 2001 at p. 1 (citing and discussing study).

²⁵ “Sell-side” analysts are employed by brokerage firms that understandably wish to maximize brokerage transactions. In this light, a “buy” recommendation addresses the entire market and certainly all the firm’s customers, while a “sell” recommendation addresses only those customers who own the stock (probably well less than 1%) and those with margin accounts who are willing to sell the

apparent transition that took place in the 1990's. According to a study by Thomson Financial, the ratio of "buy" to "sell" recommendations increased from 6 to 1 in 1991 to 100 to 1 by 2000.²⁶ Again, it appears that something happened in the 1990's that compromised the independence and objectivity of the gatekeepers on whom our private system of corporate governance depends.²⁷ Not surprisingly, it also appears that this loss of relative objectivity can harm investors.²⁸

II. Explaining Gatekeeper Failure

None of the watchdogs that should have detected Enron's collapse - - auditors, analysts or debt rating agencies - - did so before the penultimate moment. This is the true common denominator in the Enron debacle: the collective failure of the gatekeepers. Why did the watchdogs not bark in the night when it now appears in hindsight that a massive fraud took place? Here, two quite different, although complementary, stories can be told. The first will be called the "general deterrence" story; and the second, the "bubble" story. The first is essentially economic in its premises; and the second, psychological.

stock "short." In addition, "sell" recommendations annoy not only the issuer company, but also institutional investors who are afraid that sell recommendations will "spook" retail investors, causing them to panic and sell, while the institution is "locked into" a large position that cannot easily be liquidated.

²⁶ See Opening Statement of Congressman Paul E. Kanjorski, *supra* note 24, at 1. (citing study by First Call).

²⁷ Participants in the industry also report that its professional culture changed dramatically in the late 1990's, particularly as investment banking firms began to hire "star" analysts for their marketing clout. See Gretchen Morgenson, "Requiem for an Honorable Profession" *New York Times*, May 5, 2002 at Section 3-1 (suggesting major change dates from around 1996).

²⁸ Although the empirical evidence is limited, it suggests that "independent" analysts (i.e., analysts not associated with the underwriter for a particular issuer) behave differently than, and tend to outperform, analysts who are associated with the issuer's underwriter. See R. Michaely and K. Womack, Conflict of Interest and the Credibility of Underwriter Analyst Recommendations, 12 *Review of Financial Studies* 653 (1999).

a. The Deterrence Explanation: The Underdeterred Gatekeeper

The general deterrence story focuses on the decline in the expected liability costs arising out of acquiescence by auditors in aggressive accounting policies favored by managements. It postulates that, during the 1990's, the risk of auditor liability declined, while the benefits of acquiescence increased. Economics 101 teaches us that when the costs go down, while the benefits associated with any activity go up, the output of the activity will increase. Here, the activity that increased was auditor acquiescence.

Why did the legal risks go down during the 1990's? The obvious list of reasons would include:

(1) the Supreme Court's Lampf, Pleva decision in 1991, which significantly shortened the statute of limitations applicable to securities fraud;²⁹

(2) the Supreme Court's Central Bank of Denver decision,³⁰ which in 1994 eliminated private "aiding and abetting" liability in securities fraud cases;

(3) the Private Securities Litigation Reform Act of 1995 ("PSLRA"), which (a) raised the pleading standards for securities class actions to a level well above that applicable to fraud actions generally; (b) substituted proportionate liability for "joint and several" liability; (c) restricted the sweep of the RICO statute so that it could no longer convert securities fraud class

²⁹ Lampf, Pleva, Lipkind & Petigrow v. Gilbertston, 501 U.S. 350, 359-61 (1991) (creating a federal rule requiring plaintiffs to file within one year of when they should have known of the violation underlying their action, but in no event more than three years after the violation). This one to three year period was typically shorter than the previously applicable limitations periods which were determined by analogy to state statutes and often permitted a five or six year delay - - if that was the period within which a common law fraud action could be maintained in the particular state).

³⁰ Central Bank of Denver, N.A., v. First Interstate of Denver, N.A., 511 U.S. 164 (1994).

actions for compensatory damages into actions for treble damages; and (d) adopted a very protective safe harbor for forward-looking information; and

(4) the Securities Litigation Uniform Standards Act of 1998 (“SLUSA”) which abolished state court class actions alleging securities fraud.³¹

Not only did the threat of private enforcement decline, but the prospect of public enforcement similarly subsided. In particular, there is reason to believe that, from some point in the 1980's until the late 1990's, the SEC shifted its enforcement focus away from actions against the Big Five accounting firms towards other priorities.³² In any event, the point here is not that any of these changes were necessarily unjustified or excessive,³³ but rather that their collective impact was to appreciably reduce the risk of liability. Auditors were the special beneficiaries of many of these provisions. For example, the pleading rules and the new standard of proportionate

³¹ See Pub. L. No. 105-353, 112 Stat. 3227 (codified in scattered sections of 15 U.S.C.). For an analysis and critique of this statute, see Richard Painter, Responding to A False Alarm: Federal Preemption of State Securities Fraud Causes of Action, 84 Cornell L. Rev. 1 (1998).

³² This point has been orally made to me by several former SEC officials, including Stanley Sporkin, the long-time former head of the Commission’s Division of Enforcement. They believe that the SEC’s enforcement action against Arthur Andersen, which was resolved in June, 2001, was one of the very few (and perhaps the only) enforcement action brought against a Big Five accounting firm on fraud grounds during the 1990's. See Securities and Exchange Commission v. Arthur Andersen LLP, SEC Litigation Release No. 17039, 2001 SEC LEXIS 1159 (June 19, 2001). Although the Commission did bring charges during the 1990's against individual partners in these firms, the Commission appears to have been deterred from bringing suits against the Big Five themselves because such actions were extremely costly in manpower and expense and the defendants could be expected to resist zealously. In contrast, during the 1980's, especially during Mr. Sporkin’s tenure as head of the Enforcement Division, the SEC regularly brought enforcement actions against the Big Five.

³³ Indeed, this author would continue to support proportionate liability for auditors on fairness grounds and sees no problem with the PSLRA’s heightened pleading standards, as they have been interpreted by some courts. See, e.g., Novak v. Kasaks, 216 F.3d 300 (2d Cir.), cert. denied 531 U.S. 1012 (2000).

liability protected them far more than it did most corporate defendants.³⁴ Although auditors are still sued today, the settlement value of cases against auditors has gone way down.

Correspondingly, the benefits of acquiescence to auditors rose over this same period, as the Big Five learned during the 1990's how to cross-sell consulting services and to treat the auditing function principally as a portal of entry into a lucrative client. Prior to the mid-1990's, the provision of consulting services to audit clients was infrequent and insubstantial in the aggregate.³⁵ Yet, according to one recent survey, the typical large public corporation now pays its auditor for consulting services three times what it pays the same auditor for auditing services.³⁶ Not only did auditing firms see more profit potential in consulting than in auditing,

³⁴ At a minimum, plaintiffs today must plead with particularity facts giving rise to a “strong inference of fraud.” See, e.g., Novak v. Kasaks, supra note 33. At the outset of a case, it may be possible to plead such facts with respect to the management of the corporate defendant (for example, based on insider sales by such persons prior to the public disclosure of the adverse information that caused the stock drop), but it is rarely possible to plead such information with respect to the auditors (who by law cannot own stock in their client). In short, the plaintiff faces a “Catch 22” dilemma in suing the auditor: it cannot plead fraud with particularity until it obtains discovery, and it cannot obtain discovery under the PSLRA until it pleads fraud with particularity.

³⁵ Consulting fees paid by audit clients exploded during the 1990's. According to the Panel on Audit Effectiveness, who was appointed in 1999 by the Public Oversight Board at the request of the SEC to study audit practices, “audit firms’ fees from consulting services for their SEC clients increased from 17% ... of audit fees in 1990 to 67% . . . in 1999.” See the Panel on Audit Effectiveness, REPORT AND RECOMMENDATIONS (Exposure Draft 2000) at p. 102. In 1990, the Panel found that 80% of the Big Five firms’ SEC clients received no consulting services from their auditors, and only 1% of those SEC clients paid consulting fees exceeding their auditing fees to the Big Five. *Id.* at 102. While the Panel found only marginal changes during the 1990's, later studies have found that consulting fees have become a multiple of the audit fee for large public corporations. See text and note infra at note 36.

³⁶ A survey by the Chicago Tribune this year finds that the one hundred largest corporations in the Chicago area (determined on the basis of market capitalization) paid on average consulting fees to their auditors that were over three times the audit fee paid the same auditor. See Janet Kidd Stewart and

but they began during the 1990's to compete based on a strategy of “low balling” under which auditing services were offered at rates that were marginal to arguably below cost. The rationale for such a strategy was that the auditing function was essentially a loss leader by which more lucrative services could be marketed.

Appealing as this argument may seem that the provision of consulting services eroded auditor independence, it is subject to at least one important rebuttal. Those who defend the propriety of consulting services by auditors respond that the growth of consulting services made little real difference, because the audit firm is already conflicted by the fact that the client pays its fees.³⁷ More importantly, the audit partner of a major client (such as Enron) is particularly conflicted by the fact that such partner has virtually a “one-client” practice. Should the partner lose that client for any reason, the partner will likely need to find employment elsewhere. In short, both critics and defenders of the status quo tend to agree that the audit partner is already inevitably compromised by the desire to hold the client. From this premise, a prophylactic rule prohibiting the firm's involvement in consulting would seemingly achieve little.

While true in part, this analysis misses a key point: namely, how difficult it is for the client to fire the auditor in the real world. Because of this difficulty, the unintended consequence of combining consulting services with auditing services in one firm is that the union of the two enables the client to more effectively threaten the auditing firm in a “low visibility” way. To

Andrew Countryman, “Local Audit Conflicts Add Up: Consulting Deals, Hiring Practices In Question,” Chicago Tribune, February 24, 2002 at p. C-1. The extreme example in this study was Motorola, which had over a 16:1 ratio between consulting fees and audit fees.

³⁷ For the academic view that “auditor independence” is an impossible quest, in large part because the client pays the auditor's fees, see Sean O'Conner The Inevitability of Enron And the Impossibility of 'Auditor Independence Under the Current Audit System, (forthcoming in 2002).

illustrate this point, let us suppose, for example, that a client becomes dissatisfied with an auditor who refuses to endorse the aggressive accounting policy favored by its management. Today, the client cannot easily fire the auditor. Firing the auditor is a costly step, inviting potential public embarrassment, public disclosure of the reasons for the auditor's dismissal or resignation, and potential SEC intervention.³⁸ However, if the auditor also becomes a consultant to the client, the client can then easily terminate the auditor as a consultant (or reduce its use of the firm's consulting services) in retaliation for the auditor's intransigence. This low visibility response requires no disclosure, invites no SEC oversight, and yet disciplines the audit firm so that it would possibly be motivated to replace the intransigent audit partner. In effect, the client can both bribe (or coerce) the auditor in its core professional role by raising (or reducing) its use of consulting of services.

Of course, this argument that the client can discipline and threaten the auditor/consultant in ways that it could not discipline the simple auditor is based more on logic than actual case histories. But it does fit the available data. A recent study by academic accounting experts, based on proxy statements filed during the first half of 2001, finds that those firms that purchased more non-audit services from their auditor (as a percentage of the total fee paid to the audit firm) were more likely to fit the profile of a firm engaging in earnings management.³⁹

³⁸ Item 4 ("Changes in Registrants Certifying Accountant") of Form 8-K requires a "reporting" company to file a Form 8-K within five days after the resignation or dismissal of the issuer's independent accountant or that of the independent accountant for a significant subsidiary of the issuer. The Form 8-K must then provide the elaborate disclosures mandated by Item 304 of Regulation S-K relating to any dispute or disagreement between the auditor and the accountant. See 17 CFR 228.304 ("Changes in and Disagreements With Accountants on Accounting and Financial Disclosure").

³⁹ See Richard Frankel, Marilyn Johnson, and Karen Nelson, The Relation Between Auditors' Fees for Non-Audit Services and Earnings Quality, MIT Sloan Working

b. The Irrational Market Story

Alternatively, Enron's and Arthur Andersen's downfalls can be seen as consequences of a classic bubble that overtook the equity markets in the late 1990's and produced a market euphoria in which gatekeepers became temporarily irrelevant. Indeed, in an atmosphere of euphoria in which stock prices ascend endlessly and exponentially, gatekeepers are largely a nuisance to management, which does not need them to attract investors. Gatekeepers are necessary only when investors are cautious and skeptical, and in a market bubble, caution and skepticism are largely abandoned. Arguably, auditors were used in such an environment only because SEC rules mandated their use or because no individual firm wished to call attention to itself by becoming the first to dispense with them. In any event, if we assume that the auditor will be largely ignored by euphoric investors, the rational auditor's best competitive strategy (at least for the short term) was to become as acquiescent and low cost as possible.

For the securities analyst, a market bubble presented an even more serious problem: it is simply dangerous to be sane in an insane world. The securities analyst who prudently predicted reasonable growth and stock appreciation was quickly left in the dust by the investment guru who prophecized a new investment paradigm in which revenues and costs were less important than the number of "hits" on a website. Moreover, as the IPO market soared in the 1990's, securities analysts became celebrities and valuable assets to their firms;⁴⁰ indeed, they became

Paper No. 4330-02 (available from Social Sciences Research Network at www.ssrn.com at id= 296557). Firms purchasing more non-audit services were found more likely to just meet or beat analysts' forecasts, which is the standard profile of the firm playing "the numbers game."

⁴⁰ For the view that investment banking firms changed their competitive strategies on or around 1996 and thereafter sought the "popular, high-profile analyst" as a means of acquiring IPO clients, see Morgenson, *supra* note 27 at Section 3-1 (quoting chief investment officer at Trust Company of the West).

the principal means by which investment banks competed for IPO clients, as the underwriter with the “star” analyst could produce the biggest first day stock price spike. But as their salaries thus soared, analyst compensation came increasingly from the investment banking side of their firms. Hence, just as in the case of the auditor, the analyst’s economic position became increasingly dependent on favoring the interests of persons outside their profession (i.e., consultants in the case of the auditor and investment bankers in the case of the analyst) who had little reason to respect or observe the standards or professional culture within the gatekeeper’s profession.

The common denominator linking these examples is that, as auditors increasingly sought consulting income and as analysts increasingly competed to maximize investment banking revenues, the gatekeepers’ need to preserve their reputational capital for the long run slackened. Arguably, it could become more profitable for firms to realize the value of their reputational capital by trading on it in the short-run than by preserving it forever. Indeed, if it were true that auditing became a loss leader in the 1990’s, one cannot expect firms to expend resources or decline business opportunities in order to protect reputations that were only marginally profitable.

c. Towards Synthesis

These explanations still do not fully explain why reputational capital built up over decades might be sacrificed (or, more accurately, liquidated) once legal risks decline and/or a bubble develops. Here, additional factors need to be considered.

a. The Increased Incentive for Short Term Stock Price Maximization

The pressure on gatekeepers to acquiesce in earnings management was not constant over time, but rather grew during the 1990’s. In particular, during the 1990’s, executive compensation

shifted from being primarily cash based to being primarily equity based. The clearest measure of this change is the growth in stock options. Over the last decade, stock options rose from five percent of shares outstanding at major U.S. companies to fifteen percent - - a three hundred percent increase.⁴¹ The value of these options rose by an even greater percentage and over a dramatically shorter period: from \$50 billion in 1997 in the case of the 2,000 largest corporations to \$162 billion in 2000 - - an over three hundred percent rise in three years.⁴² Stock options create an obvious and potentially perverse incentive to engage in short-run, rather than long-term, stock price maximization because executives can exercise their stock options and sell the underlying shares on the same day.⁴³ In truth, this ability was, itself, the product of deregulatory reform in the early 1990's, which relaxed the rules under Section 16(b) of the Securities Exchange Act of 1934 to permit officers and directors to exercise stock options and sell the underlying shares without holding the shares for the previously required six month period.⁴⁴

⁴¹ See Gretchen Morgenson, "Corporate Conduct: News Analysis; Bush Failed to Stress Need to Rein in Stock Options," New York Times, July 11, 2002 at C -1; see also Gretchen Morgenson, "Market Watch: Time Fo r Accountability At the Corporate Candy Store," New York Times, March 3, 2002, Section 3, p.1.

⁴² See Morgenson, "Corporate Conduct," supra note 41, at C-1 (citing study by Sanford C. Bernstein & Co.). Thus, if \$162 billion is the value of all options in these 2,000 companies, aggressive accounting policies that temporarily raise stock prices by as little as ten percent create a potential gain for executives of over \$16 billion - - a substantial incentive.

⁴³ This point has now been made by a variety of commentators who have called for minimum holding periods or other curbs on stock options. These include Henry M. Paulson, Jr., chief executive of Goldman, Sachs, and Senator John McCain of Arizona. See David Leonhardt, "Corporate Conduct: Compensation: Anger At Executives' Profits Fuels Support for Stock Curb," New York Times, July 9, 2002 at A-1.

⁴⁴ Rule 16b-3(d) expressly permits an officer or director otherwise subject to the "short-swing" profit provisions of Section 16(b) of the Securities Exchange Act of 1934 to exercise a qualified stock option and sell the underlying shares immediately "if at least six months elapse from the date of the acquisition of the derivative security to the date of disposition of the ... underlying equity security."

Thus, if executives inflate the stock price of their company through premature revenue recognition or other classic earnings management techniques, they could quickly bail out in the short term by exercising their options and selling, leaving shareholders to bear the cost of the stock decline when the inflated stock price could not be maintained over subsequent periods. Given these incentives, it becomes rational for corporate executives to use lucrative consulting contracts, or other positive and negative incentives, to induce gatekeepers to engage in conduct that made the executives very rich. The bottom line is then that the growth of stock options placed gatekeepers under greater pressure to acquiesce in short-term oriented financial and accounting strategies.

b. The Absence of Competition. The Big Five obviously dominated a very concentrated market. Smaller competitors could not expect to develop the international scale or brand names that the Big Five possessed simply by quoting a cheaper price. More importantly, in a market this concentrated, implicit collusion develops easily. Each firm could develop and follow a common competitive strategy in parallel without fear of being undercut by a major competitor. Thus, if each of the Big Five were to prefer a strategy under which it acquiesced to clients at cost of an occasional litigation loss and some public humiliation, it could more easily observe this policy if it knew that it would not be attacked by a holier-than-thou rival stressing its greater

See 17 C.F.R. 240.16b-3(d). The SEC comprehensively revised its rules under Section 16(b) in 1991, in part to facilitate the use of stock options as executive compensation and to “reduce the regulatory burden” under Section 16(b). See Securities Exchange Act Release No. 34-28869 1991 SEC LEXIS 171 (February 8, 1991). A premise of this reform was that “holding derivative securities is functionally equivalent to holding the underlying equity security for purpose of Section 16.” *Id.* at *35 to *36. Hence, the SEC permitted the tacking of the option holding period with the stock’s holding period, thereby enabling officers and directors to exercise options and sell on the same day (if the option had already been held six months).

reputation for integrity as a competitive strategy. This approach does not require formal collusion but only the expectation that one's competitors would also be willing to accept litigation losses and occasional public humiliation as a cost of doing business.

Put differently, either in a less concentrated market where several dozen firms competed or in a market with low barriers to entry, it would be predictable that some dissident firm would seek to market itself as distinctive for its integrity. But in a market of five firms (and only four for the future), this is less likely.

c. Observability. That a fraud occurs is not necessarily the fault of auditors. If they can respond to any fraud by asserting that they were victimized by a dishonest management, auditors may be able to avoid the permanent loss of reputational capital - - particularly so long as their few competitors have no desire to exploit their failures because they are more or less equally vulnerable. Put differently, a system of reputational intermediaries works only if fault can be reliably assigned.

d. Principal/Agent Problems. Auditing firms have always known that an individual partner could be dominated by a large client and might defer excessively to such a client in a manner that could inflict liability on the firm. Thus, early on, they developed systems of internal monitoring that were far more elaborate than anything that law firms have yet attempted. But within the auditing firm, this internal monitoring function is not all powerful. After all, it is not itself a profit center. With the addition of consulting services as a major profit center, a natural coalition developed between the individual audit partner and the consulting divisions; each had a common interest in checking and overruling the firm's internal audit division when the latter's prudential decisions would prove costly to them. Cementing this marriage was the use of incentive fees. If those providing software consulting services for an audit firm were willing to

offer the principal audit partner for a client a fee of 1% (or so) of any contract sold to the partner's audit client, few others within the firm might see any reason to object. If software consulting contracts (hypothetically, for \$50 million) were then sold to the client, the audit partner might now receive more compensation from incentive fees for cross-selling than from auditing and thus had greater reason to value the client's satisfaction above his interest in the firm's reputational capital. More importantly, the audit partner now also had an ally in the consultants' who similarly would want to keep their mutual client satisfied, and together they would form a coalition potentially able to override the protests of their firm's internal audit unit (if it felt that an overly aggressive policy was being followed). While case histories exactly matching this pattern cannot yet be identified, abundant evidence does exist for the thesis that incentive fees can bias audit decision-making.⁴⁵ Interestingly, Enron itself presents a fact pattern in which the audit firm's on-the-scene quality control officer was overruled and replaced.⁴⁶

III. Implications

A. Models for Reform

⁴⁵ One of the most famous recent accounting scandals involved the Phar-Mor chain of retail stores. There, after the audit partner for Coopers & LyBrand was denied participation in profit sharing because he had insufficiently cross-sold the firm's services, he sold \$900,000 worth of business in the next year (most of it to Phar-Mar and its affiliates), but then failed to detect \$985 million in inflated earnings by Phar-Mor over the following three years. See Prentice, *supra* note 10, at 184; Max Bazerman et. al., The Impossibility of Auditor Independence, Sloan Management Review (Summer 1997) at 89.

⁴⁶ Carl E. Bass, an internal audit partner, warned other Andersen partners in 1999 that Enron's accounting practices were dangerous. David Duncan and Enron executives are alleged to have had Mr. Bass removed from the Enron account within a few weeks after his protest. See Robert Manor and Jon Yates, "Faceless Andersen partner in spotlight's glare; David Duncan vital to federal probe after plea," Chicago Tribune, April 14, 2002 at p. C-1. If nothing else, this evidence suggests that the internal audit function within one Big Five firm could be overcome when the prospective consulting fees were high enough.

Does it matter much which of the foregoing two stories - - the deterrence story or the bubble story - is deemed more persuasive? Although they are complementary rather than contradictory, their relative plausibility matters greatly in terms of deciding what reform are necessary or desirable. To the extent one accepts the deterrence story, we may need legal changes. In principle, these changes could either raise the costs or lower the benefits of acquiescence to auditors. To the extent one accepts the bubble story, the problem may be self-correcting. That is, once the bubble bursts, gatekeepers come back into fashion, as investors become skeptics who once again demand assurances that only credible reputational intermediaries can provide. To the extent, one takes the reverse position, regulatory action is needed.

This comment is not intended to resolve this debate, except in one small respect. Alan Greenspan has recently espoused the bubble story and expressed the view that the market will largely self-correct on its own.⁴⁷ His arguments have some merit. Although reasonable people can certainly debate the degree to which markets can reform themselves and the reciprocal degree to which legal interventions are necessary, one special area stands out where regulatory

⁴⁷ See "Remarks by Chairman Alan Greenspan, 'Corporate Governance' at the Stern School of Business, New York University, New York, New York, March 26, 2002" (available on the Federal Reserves website at www.federalreserve.gov/boarddocs/speeches). In his view, earnings management came to dominate management's agenda, and as a result: "It is not surprising that since 1998 earnings restatements have proliferated. This situation is a far cry from earlier decades when, if my recollection serves me correctly, firms competed on the basis of which one had the most conservative set of books. Short-term stock price values then seemed less of a focus than maintaining unquestioned credit worthiness." *Id.* at p. 4. He goes on to predict that: "A change in behavior, however, may already be in train." *Id.* at p. 5. Specifically, he finds that "perceptions of the reliability of firms' financial statements are increasingly reflected in yield spreads of corporate bonds" and that other signs of self-correction are discernible. *Id.*

interventions seem essential, because ultimately the market cannot easily self-correct within this area without external interventions. Enron has shown that we have a “rule-based” system of accounting that arguably only asks the gatekeeper to certify the issuer’s compliance with an inventory of highly technical rules - - without the auditor necessarily taking responsibility for the overall accuracy of the issuer’s statement of its financial position. Understandably, the SEC has called for a shift to a “principles-based” system of accounting,⁴⁸ and this shift cannot come simply through private action.

Even as a matter of theory, the gatekeeper’s services have value only if the gatekeeper is certifying compliance with a meaningful substantive standard. Yet, it is seldom not within the power of the individual gatekeeper to determine that standard of measurement. In the case of auditors, organizational reform of the accounting firm thus will mean little without substantive reform of substantive accounting principles.

Again, reasonable persons can disagree as to the best means of improving the quality of the financial standards with which the auditor measures compliance. One means would be to require the auditor to certify not simply compliance with GAAP, but to read the auditor’s certification that the issuer’s financial statements “fairly present” its financial position to mean that these financial statements provide the necessary disclosures for understanding the issuer’s overall financial position. This probably was the law (and may still be). Interestingly, the SEC’s staff has recently sought to resurrect the classic decision of Henry Friendly in U.S. v. Simon⁴⁹ by arguing that compliance with GAAP was not itself the standard by which the auditor’s

⁴⁸ See Bloomberg News, February 19, 2002, Judy Mathenson and Neil Roland, “SEC’s Pitt Calls for ‘Principles-Based’ Accounting” (available on LEXIS/NEXIS; news; curnws file).

⁴⁹ 425 F.2d 796 (2d Cir. 1969).

performance was to be measured.⁵⁰ The alternative route, which does not involve greater reliance on litigation, is to depend upon substantive regulation: here, this would require greater activism by the Financial Accounting Standards Board (“FASB”), which in the past has been constrained by industry and Congressional interference. Insulating the FASB and assuring its financial independence would thus be appropriate initial steps toward reform.⁵¹

B. Lessons for Lawyers

What are the lessons for lawyers that emerge from this tour of the problems and failings of our allied professions? Arguably, just as analysts and auditors do, securities lawyers serve investors as the ultimate consumers of their services. Conceptually, however, differences exist because lawyers specialize in designing transactions to avoid regulatory, legal, and other costly hurdles, but seldom provide meaningful certifications to investors. Still, the same “commodification” of professional services that reshaped the accounting profession has also impacted the legal profession. Thus, there may be handwriting on the wall in fact that, as auditing firms evolved from offering a single professional service into a shopping center of

⁵⁰ See Floyd Norris, “An Old Case Is Returning to Haunt Auditors,” *New York Times*, March 1, 2002, at C-1 (noting that SEC Chairman Harvey Pitt has taken to citing Simon).

⁵¹ In this author’s judgment, Congress has no more business legislating laws of accounting than it does legislating a law of gravity. But it can create a neutral and independent body to promulgate substantive accounting rules. At present, FASB receives much of its revenues from charitable contributions from persons interested in accounting. Unfortunately, those most interested in accounting (i.e., Enron) have the worst incentives. In addition, insulated bodies may need to be subjected to greater sunlight and transparency. These issues were recently the focus of hearings on June 26, 2002 before the Subcommittee on Commerce, Trade and Consumer Protection of the Committee on Energy and Commerce of the House of Representatives, at which this author testified. See Federal Document Clearinghouse Congressional Testimony, June 26, 2002, House Energy and Commerce Committee Hearings, “Strengthening Accounting Oversight” (available on LEXIS/NEXIS news library; curnws file).

professional services, they lost internal control. Bluntly, the same fate could face lawyers.

Indeed, the audit firm always knew that the individual audit partner serving the large client could become conflicted (because the audit partner's job depended on satisfying its single client), but the audit firm also knew that it could monitor its individual audit partners to manage this conflict. For a long time, monitoring seemingly worked - - at least passably well. More recently, incentive-based compensation has exacerbated the monitoring problem, and similarly the evolution of the auditing firm into a financial conglomerate has seriously compromised old systems of internal control.⁵²

Whatever the control problems within accounting firms, law firms have nothing even remotely approaching the substantial system of internal controls employed by audit firms (which still did not work for them). The contrast is striking. Both audit firms and broker-dealers have far more advanced systems of internal quality control than do law firms. For example, audit firms typically have an in-house "internal standards" or "quality assurance" division, and they rely on periodic "peer review" of their audits by similarly situated firms. Although peer review, at least as a formal system, may not work for law firms (because law is an adversarial profession and also one obsessed with protecting the attorney client privilege), this conclusion only raises the larger question: what will work?⁵³

⁵² Enron itself shows this pattern, as the Andersen audit quality partner who challenged some of the aggressive accounting policies that Enron wanted to pursue was outflanked and eventually transferred. See Manor & Yates, *supra* note 46.

⁵³ This short Comment is not the best vehicle in which to outline specific reforms. Nonetheless, one could imagine law firms creating a "quality control" office and staffing it with the sixty-year-old partners who today tend to be pushed into retirement because they no longer can work the around-the-clock pace of young partners. Precisely because such partners have experience, they would have credibility with their peers in the firm in seeking to maintain firm quality.

In overview, law firms are today positioned on a learning curve that seems at least a decade behind auditing firms, as the law firms are moving, much later than auditing firms, from “ma and pa” single office firms to multi-branch organizations. Across the legal landscape, the combination of lateral recruitment of partners, based on revenues generated, plus the movement toward multi-branch law firms means that law firms as an organization are at least (and probably more) vulnerable to quality control problems as auditing firms. Yet, they lack the minimal institutional safeguards that the latter have long used (with only limited success) to protect quality control. Logically, law firms should perceive the need to institutionalize a greater quality control function. Realistically, however, law firms have not experienced the same pattern of devastating financial losses that, during the 1980's, threatened the very viability of auditing firms.⁵⁴ Thus, as a practical matter, law firms will probably not respond before the first large

⁵⁴ Various reasons can be given for the expansion of auditors' liability during the 1970's and 1980's. Some stress the revision of the Restatement (Second) of Torts, whose Section 552, adopted in 1975, vastly expanded the auditor's liability for negligence by substituting a foreseeability standard for the former privity test. See Thomas L. Grossman, The Fallacy of Expanding Accountants' Liability, 1988 Colum. Bus. L. Rev. 213, 221-225 (1998). Others emphasize the development of the class action in the 1980's, and in particular the “fraud on the market” doctrine, developed by the lower federal courts in the early 1980's and accepted by the Supreme Court in Basic, Inc. v. Levinson, 485 U.S. 224 (1988), which dispensed with the need to prove individual reliance and thereby increased the likelihood of class certification. Whatever the cause of the litigation explosion, the impact of litigation costs on accounting firms is clearer. By 1992, securities fraud litigation costs for simply the six largest accounting firms accounted for \$783 million or more than 14% of their audit revenues. In addition, they faced billions of dollars in potential exposure. See Private Litigation Under the Federal Securities Laws: Hearings Before the Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs, 103rd Cong., 1st Sess. No.103-431 (1993) (statement of Jake L. Netterville), reprinted in Fed. Sec. L. Rep. (CCH) No. 1696, (January 10, 1996). One major auditing firm, Laventhol & Horwath, did fail and enter bankruptcy as a result of litigation and associated scandals growing out of the savings and loan scandals of the 1980's. See “What Role Should CPA's be Playing in Audit Reform?,” Partner's Report for CPA Firm Owners, April, 2002

financial disaster befalls a major law firm and motivates greater attention to internal control. Predictably but sadly, only then will “bottom line”-oriented law partners recognize that the “bottom line” includes liabilities as well as revenues.

CONCLUSION

This essay has sought to explain that Enron is more about gatekeeper failure than board failure. It has also sought to explain when gatekeepers (or “reputational intermediaries”) are likely to fail. Put simply, reputational capital is not an asset that professional services firms will inevitably hoard and protect. Logically, as legal exposure to liability declines and as benefits of acquiescence in the client’s demands increase, gatekeeper failure should correspondingly increase - - as it did in the 1990’s. Market bubbles can also explain gatekeeper failure (and this perspective probably works better in the case of the securities analysts, who faced little liability in the past), because in an environment of euphoria investors do not rely on gatekeepers (and hence gatekeepers have less leverage with respect to their clients).

Popular commentary has instead used softer-edged concepts - - such as “infectious greed”⁵⁵ and a decline in morality - - to explain the same phenomena. Yet, there is little evidence that “greed” has ever declined; nor is it clear that there are relevant policy options for

(discussing experience of Laventhol & Horwath). The accounting profession’s bitter experience with class litigation in the 1980’s and 1990’s probably explains why it became the strongest and most organized champion of the Private Securities Litigation Reform Act of 1995.

⁵⁵ Federal Reserve Chairman Alan Greenspan has coined this rhetorical phrase, saying that “An infectious greed seemed to grip much of our business community.” See Floyd Norris, “The Markets: Market Place; Yes, He Can Top That,” New York Times, July 17, 2002 at A-1. This article’s more cold-blooded approach would say that the rational incentives created by stock options and equity compensation overcame the limited self-regulatory safeguards that the accounting profession had internalized.

addressing it. In contrast, focusing on gatekeepers tells us that there are special actors in a system of private corporate governance whose incentives must be regulated.

Reasonable persons can always disagree what reforms are desirable. But the starting point for an intelligent debate is the recognition that the two major, contemporary crises now facing the securities markets - - i.e., the collapse of Enron and the growing controversy over securities analysts, which began with the New York Attorney General's investigation into Merrill, Lynch - - involve at bottom the same problem: both are crises motivated by the discovery by investors that reputational intermediaries upon whom they relied were conflicted and seemingly sold their interests short. Neither the law nor the market has yet solved either of these closely related problems.