InDret
REVISTA PARA EL
ANÁLISIS DEL DERECHO

WWW. INDRET.COM

Should We Trust the Gatekeepers?

Auditors' and Lawyers' Liability for Clients' Misconduct

Juan José Ganuza
Fernando Gómez
Universitat Pompeu Fabra

310

BARCELONA, OCTOBER 2005

Summary

ABSTRACT

Many corporate scandals of the past years (Enron, Worldcom, Parmalat, etc.) have made apparent the potential role of professional service providers, such as auditors and lawyers, in detecting and revealing corporate misconduct on the part of their clients. Political and legal responses in the aftermath of those scandals have increased the level of regulatory intervention upon the professional relationship between auditors and lawyers, on the one hand, and corporate clients, on the other. For instance, several measures trying to reinforce the independence of auditors were introduced in the Sarbanes-Oxley Act of 2002 (§ 201 and following), and were recommended by the European Commission (Commission Recommendation May 16 2002). Concerning lawyers, § 307 of the Sarbanes-Oxley Act of 2002 imposes a duty to "up-the-ladder" report evidence of likely wrongdoing.

The imposition of duties of care and reporting on gatekeepers such as auditors or lawyers, conditional on their having observed an underlying wrongdoing or misconduct of their clients is, however, more complicated at a theoretical level than what policymakers and commentators believe. Using a similar framework as the one we have recently employed to analyze heterogeneous victims in terms of their costs of care [Ganuza and Gomez (2005, forthcoming)] we model the interaction as one in which the gatekeeper observes the state of the world affecting misconduct with a given probability, and Courts or regulators imposing duties or liabilities are unable to verify whether, in fact, misconduct had or not been observed by the lawyer or auditor. The wrongdoing by the client, however, is ex post costlessly verifiable by the Courts or regulators. Information on wrongdoing is thus, hard information in the sense of Tirole (1986, 1992) –that is, verifiable but hideable. In this setting we show that general (albeit increased) standards of professional behavior by auditors or lawyers may well be sufficient as incentives. If those standards can be adequately set by Courts or regulators, in anticipation of the opportunities for strategic behavior derived from the imperfect observation and the unverifiability of actual observation, legal rules do not need to rely on more complex policies of trust or distrust towards the statements, or on the proofs, provided by the gatekeepers, concerning the actual observation of clients' misbehavior. The implications of the model tend to give theoretical support to legal measures that serve to increase in general terms the level of professional standards when gate-keeping is a relevant phenomenon (as recent experiences suggest may well be) over those other measures that condition increased standards and duties on the observation of the underlying wrongdoing. In legal terms, this means that the distinction between voluntary violation (scienter) of duties, and mere negligence, contrary to existing Law, is not very useful in this context.

KEYWORDS: Auditors, lawyers, gatekeepers, Professional Standards and Negligence.

JEL classification numbers: D44, D82, D83.

* This paper has been originally typed using Scientific WorkPlace in order to enhance the presentation of the formulas. InDret apologizes for not being able to fulfill the requirements of the Style Sheet.

1 Introduction

In the aftermath of the corporate scandals that reached headlines worldwide in the first years of this decade (Enron, Worldcom, Parmalat) investors, and the general public, reacted with surprise at first, and then with indignation. Politicians, regulators, and lawmakers felt the pressure to increase and strengthen the range of measures to combat corporate misconduct and fraud. Probably the most ambitious and extensive legislative reaction to the problem, and the best-known, at any rate, has been the American Sarbanes-Oxley Act 2002[1].

Some of the proposed or adopted policies to check corporate behavior for the benefit of investors and the public at large deal with general corporate governance issues, ranging from measures trying to reinforce the role and independence of non-executive directors, to improve the amount and quality of corporate disclosure, to increase participation of shareholders in corporate decision-making, and to subject to more detailed scrutiny the remuneration practices of firms with regard to top management[2].

Other policies refer to the role and regulation of gatekeepers[3], or potential

[1] See Ribstein (2002) for an extensive academic overview -and critique- of the major changes in the Sarbanes-Oxley Act. Though less far reaching, Europe has not lacked initiatives along similar lines, not only at the national level in several Member States, but also at the European Level: Commission Recommendation of May 16, 2002 on Auditor's Independence, Winter Report on Corporate Governance.

[2] No doubt the public perception of managers has deteriorated very significantly as a result of corporate scandals. As Ribstein (2002) very aptly puts it, the managers in the world of Enron are ".. Machiavellian, narcissistic, prevaricating, pathologically optimistic, free from self-doubt and moral distractions, willing to take great risk as the company moves up and to lie when things turn bad, and nurtured by a corporate culture that instills royalty to insiders, obsession with short-term stock price and intense distrust of outsiders."

[3] The notion and earliest analysis of gatekeepers and their functions in improving the operating of markets and preventing misconduct by some market participants, originate in Gilson and Kraakman (1984), and Kraakman (1986).

gatekeepers, such as auditors, lawyers or securities analysts, who may play a role in detecting and helping to deter corporate misconduct. In the case of auditors, whose role as gatekeepers in the corporate context does not seem to be seriously questioned, the issue of independence from clients has been on top of the regulatory agenda. Matters such as the provision of non-audit (typically, consulting) services to audit clients, the permanence of key audit partners for the same client over a period of years, the selection of auditors by corporate clients, or the employment of former audit partners by former corporate clients as senior management, have been seriously put into question, and even some of the previously existing and accepted (or at least, tolerated) practices have been prohibited[4].

Concerning securities analysts, securing independence of analysis research has also been a top concern of the regulatory wave following the corporate scandals, thus attempting to disclose[5] , and eventually, avoid, conflicts of interest between the work of securities analysis and the investment banking activities (and the ensuing profits) carried out within the same firm.

Lawyers have proven more reluctant candidates, both at the theoretical and at the practical level, to be conceptualized as gatekeepers and regulated as such. It could be argued that lawyers play a role with regard to clients that is more complex (the lawyer is not just a screener of legality of past or future client actions, but is also advocate, transaction designer, defender, etc.) and privi-

[4] See Commission's Recommendation on auditor's independence, and §§ 201 and following, Sarbanes-Oxley Act.

[5] For a recent experimental critique of disclosure policies concerning conflicts of interest, see Cain, Loewenstein and Moore (2005).

leged (confidentiality) than those of auditors, securities underwriters, and other gatekeepers in the corporate context[6]. It is hard to deny, though, that, all the differences with auditors notwithstanding, lawyers do play, in many situations involving the operations of corporations, a substantial gate-keeping function, to the extent that they screen and verify the legality of planned actions, disclosure and filings before a wide variety of private and public outsiders[7]. Clear examples of these relevant gate-keeping functions of lawyers can be found in the area of corporate disclosures by issuers to raise capital both in the equity market and in private finance.

Whatever the theoretical answer, the fact is that § 307 Sarbanes-Oxley Act has tried to enlist lawyers in the campaign to prevent corporate misconduct by gatekeepers, by imposing upon lawyers the duty to report evidence of likely violations of the Law to the chief legal counsel or the chief executive officer of the corporation[8]. In the process of implementation of this provision, and using the authority granted by the Act to that effect, the SEC proposed a rule

[6] In fact, the notion of gatekeeper itself is not straightforward. Some defend a broad notion of gatekeeper, as any party who could prevent misconduct by a market participant by withholding cooperation with him, specially by refusing to provide a product or service that is necessary -de facto- to enter a market or engage in a given activity: Kraakman (1986), Hamdani (2003). Others stress the feature of gatekeepers as reputational intermediaries who provide necessary verification or accreditation services to agents operating in a given market or activity: Coffee (2004).

[7] Most commentators, albeit emphasizing the distinctiveness of the lawyers' gate-keeping role, accept its existence: Painter (2004), Coffee (2003, 2004), Henning (2004), Zacharias (2004). For a dissident view, see Fisch and Rosen (2003).

[8] This § 307 directs the SEC to adopt rules (1) requiring attorney to report evidence of a material violation of securities law or breach of fiduciary duty or similar violation by the company or any agent thereof, to the chief legal counsel or the chief executive officer of the company (or the equivalent thereof); and (2) if the counsel or officer does not appropriately respond to the evidence (adopting, as necessary, appropriate remedial measures or sanctions with respect to the violation), requiring such attorney to report the evidence to the audit committee of the board of directors of the issuer or to another committee of the board of directors comprised solely of directors not employed directly or indirectly by the issuer, or to the board of directors.

imposing upon lawyers a "noisy withdrawal" communicated to the SEC in case of corporate inaction after the "up-the-ladder" report on corporate misconduct. The latter proposal has not been finally adopted due to the fierce opposition of the American bar[9].

The logical corollary of imposing gate-keeping duties on service providers such as auditors or lawyers is the determination of the appropriate legal liabilities, if any, that should arise from the violation or non-compliance with such duties. In this paper we do not intend to present a complete policy proposal concerning the optimal design of the system and level of liabilities for gatekeepers. There is already a substantial amount of literature dealing with this matter. Part of this literature is skeptical about the role that explicit and mandatory legal liability (based on Tort, Regulatory, or Criminal Law) can play to provide proper incentives for gatekeepers, given that the strong reputational bonds that large audit or law firms have built, at great cost, over the years, are powerful enough to ensure the right level of gate-keeping effort on their part[10] . Others, in turn, at least for auditors, defend a strict liability system with liability insurance, or a modified -capped, either at a multiple of revenue from the corporate client who broke the law, or at a given percentage of the liabilities of the corporate client- strict liability regime[11]. Finally, another section of the literature, generally or with respect to some gatekeepers, positions itself in favor of

[9] The proposal generated a large amount of literature in the legal professional area. For a summary, see Henning (2004).

[10] See Goldberg (1988), Choi (1998), Ribstein (1998, 2002). Arruñada (1999) explores in detail the diverse and powerful role of market forces in providing incentives for audit quality, but does not shun the likelihood that legal liability might also be helpful to this goal.

[11] See Ewert, Feess, and Nell (2000), Partnoy (2001, 2004), Coffee (2004).

a negligence- or duty-based kind of liability[12].

In the paper we try to model some of the issues raised by the current system of liability for clients' misconduct imposed upon auditors and lawyers as gate-keeping third-party allies of the public enforcement authorities. Both auditors and lawyers are subject to regulation of their verification and certification functions with respect to their clients[13]. Their duties and resulting liabilities, however, are substantially altered when they observe or encounter evidence of wrongdoing on the part of their clients. Auditors, for instance, are subject to the statutory obligation to report to the SEC any information regarding an illegal act committed by the client that they may have uncovered in the course of their auditing activities. And we have already mentioned the "up-the-ladder" reporting duty imposed upon lawyers by § 307 Sarbanes-Oxley Act, and the failed attempt by the SEC to even expand them in its own favor.

Observation of clients' misconduct seems, thus, to play a major role in the definition of required behavior of lawyers and auditors as gatekeepers[14]. The imposition of duties of care and reporting, conditional on their having observed an underlying wrongdoing, misconduct, action, or type of clients is, however, complicated at a theoretical level.

In section 2 we model this strategy of regulating gatekeepers' liability using a similar framework as the one we have employed to analyze heterogeneous

[12] See Willekens, Steele, and Miltz (1996), Coffee (2003), Hamdani (2003), Schäfer (2003).

[13] In the US, auditors are regulated by the new Public Company Accounting Oversight Board, established by the Sarbanes-Oxley Act, and lawyers are regulated by state bar associations. In Europe, the division of regulatory functions is similar, with public (or self-regulating) bodies dealing with auditors, and bar associations at the National or Regional level regulating lawyers.

[14] This role is applauded by part of the literature: See Hamdani (2003).

victims in terms of their costs of care [Ganuza and Gomez (2005, forthcoming)]. The interaction is modeled as one in which the gatekeeper observes the state of the world with a given probability, and Courts or regulators imposing duties or liabilities are unable to verify whether, in fact, observation had taken place. The wrongdoing by the client, however, is assumed to be ex post costlessly verifiable by Courts or regulators. Information on wrongdoing is thus, hard information in the sense of Tirole (1986, 1992) -that is, verifiable but hideable.

In section 3 we show that, in this setting, general standards of professional behavior by auditors or lawyers that do not take into account actual observation may well be sufficient to induce gate-keeping. If those standards can be adequately set by Courts or regulators, in anticipation of the opportunities for strategic behavior derived from the imperfect observation and the unverifiability of actual observation, legal rules do not need to rely on more complex policies of trust or distrust towards the statements, or towards the evidence, provided by the gatekeepers on the observation of clients' misbehavior. We also derive some implications for legal policy concerning gatekeepers regulation and liability, implying that the distinction between voluntary violation (scienter) of duties and mere negligence (omission of due diligence) should not be a cornerstone of the Law in this context, and that legal systems, when employing gatekeepers to deter corporate misconduct, should instead focus attention on the substantive control duties of professionals acting as gatekeepers.

2 The model

We study a model in which a gatekeeper has to control the behavior of a firm in order to reduce the expected harm to investors, which depends both on the control effort by the gatekeeper, and on the underlying state of the firm. We assume that all actors are risk neutral, and that it is costly for the gatekeeper to exercise control efforts on the behavior of the firm. Let $C(x)$ be the gatekeeper cost of exerting a control effort x. We assume $C'(0) = 0$, $C^{'}(x) > 0$ and $C''(x) > 0$. The state of the firm affects the productivity of the control effort in reducing the expected harm to the investors. In particular, we assume that there are two different states of nature, $w \in \{H, C\}$, where the ex-ante probability of $w = H$ (Honest state) is α, and the ex-ante probability of $w = C$ (Corrupt state) is $(1 - \alpha)$. By the honest state $w = H$, we mean that firm's managers have behaved honestly[15] and we assume that in this state, independently of the control effort x exerted by the gatekeeper, there are no investors' losses, $L_H = 0$[16]. Thus the efficient level of care in the honest state, $w = H$, is 0, $x_H^E = 0$. By the corrupt state $w = C$, we mean that there has been manager misbehavior. In this state, thus, there will be expected losses for investors, but these losses will be decreasing on the control effort exerted by the gate keeper, $L_C(x) = \int l f(l|x) dl$, and we assume $\frac{\partial L_C(x)}{\partial x} < 0$, $\frac{\partial^2 L_C(x)}{\partial x^2} > 0$. Thus the

[15] We are well aware of the fact that the behavior of firms' managers is not fixed, but will be shaped by legal liability and other incentives. However, given that we are not interested here in analysing the behavior of managers, nor issues of collusion, or other instances of joint liability of managers and gatekeepers, but only the gate-keeping efforts of auditors and lawyers, we treat managers' behavior as exogenous. A similar assumption, in Ewert, Feess, and Nell (2000).

[16] This assumption is made without loss of generality. All the results follow equally if we simply assume that there are investor's losses in both states, but they are higher in the corrupt state.

efficient level of gate-keeping effort in the corrupt state, $w = C$, is characterized by the level of control effort in which the marginal cost of control equals its marginal productivity, $L'_C(x_C^E) = C'(x_C^E)$. Hence, we have characterized the efficient level of effort when the gatekeeper knows the state of the firm (if it is observable). In this case, the efficient solution can be easily implemented by a Court or regulator[17] using a rule of differentiated standards of effort or professional conduct ol lawyers and auditors, based on underlying the state of the firm. This differentiated rule determines that the gatekeeper is liable of investors' losses when he has exerted lower level of control effort than the required standard $\bar{x}_i$where i is the state of nature.

Proposition 1 *A differentiated rule implements the first best solution, if the standard of control effort is* $x_H^E = 0$ *when* $w = H$, *and* x_C^E *when* $w = C$.

Thus according to Proposition 1, if Courts or regulators are able to set control efforts at the efficient levels for each underlying state of the firm, the differentiated rule can directly induce the first-best solution when the state of nature is observed prior to the adoption of effort by the gatekeeper.

2.1 Second Best Solution

In the second best solution we consider that the gatekeeper can not observe the state of the firm, so he has to choose the same kind of control effort with respect to the firm in both states of nature.

[17] Standards can be though of as being imposed by Courts in order to determine gatekeepers' tort liability, or by a regulator (the SEC or a similar kind of agency) of the professional behavior of auditors or lawyers.

$$\min_{x_N}(1-\alpha)L_C(x)+C(x)$$

The next Proposition states that the second-best solution leads the gatekeeper, as might be expected, to exert an intermediate level of control effort. Moreover, this control effort is decreasing in the ex-ante probability of being in the honest state.

Proposition 2 *$x_N^E \in [x_H^E = 0, x_C^E]$ where $(1-\alpha)L_C(x_N^E) = C'(x_N^E)$, x_N^E is decreasing on α. If $\alpha = 1$ then $x_N^E = x_H^E = 0$ and , if $\alpha = 0$ then $x_N^E = x_C^E$.*

This second best solution is again easily implementable by using a rule which sets a single standard for the gatekeeper control effort $\bar{x}_N = x_N^E$.

In summary, the efficient solution requires, on the one hand, that if the gatekeeper observes the state of the firm, he should be required to exert 0 control effort in the honest state, and x_C^E in the corrupt state. On the other hand, the efficient solution in the case that the gatekeeper does not observe the state of the firm, requires the gatekeeper to exert an intermediate level of control effort x_N^E.

3 Asymetric Information Setting

We consider that the gatekeeper can observe the state of the firm with probability σ, being this probability common knowledge. We assume that the regulator (henceforward we will speak of regulator, on the understanding that the same applies to Courts in the context of Tort Law) uses for regulating the activity

a differentiated rule, but she does not know for sure whether or not the gatekeeper had in fact observed w or not. In case that investors suffer losses due to the misbehavior of the firm, regulators are able to verify the state of the world (the underlying state of the firm causing losses) and the level of control effort by the gatekeeper, and the latter can report to the regulator whether or not he had observed the underlying state of the firm (the evidence he had observed concerning the managers' misbehavior or honest behavior, at the time he had chosen the level of control effort). In particular, the setting can be characterized as a game with the following sequence of actions:

1. The regulator sets standards for the gatekeeper's control effort with the goal of maximizing social welfare.

2. Nature decides the state of the firm, and if the gatekeeper observes or not the state of the firm.

3. Gatekeeper chooses a level of control effort for the firm who is his client.

4. Investors' losses materialize or not, according with the probabilities generated by the chosen levels of control effort and the state of the firm.

5. In the case investors' losses materialize, the gatekeeper submits to the regulator a statement concerning observation of the state of the firm, and the regulator decides liability based on the statement (according to the policies of trust and distrust described below), the state of nature, and the anounced standards on gatekeeping control effort.

We consider that the gatekeeper's information on the underlying state of the firm is "hard" information[18]. Roughly speaking, what we mean by this term is that the gatekeeper can only hide his information by pretending that he did not observe the misbehavior of the client (the state of the firm) when he in fact had observed it. However, the gatekeeper cannot lie regarding the state of firm he observed, and thus he cannot report that he observed $w = H$, when he in fact had observed $w = C$, and vice-versa[19].

We solve this game by backwards induction. We look first at the liability decision by the regulator, then we analyze the choice of control effort by the gatekeeper, and finally we study the optimal standards of control effort set by the regulator.

We assume that the regulator could use a complex regulatory regime comprising three levels of control effort. Given the previous results, it is clear that the optimal standards must satisfy $x_H^S \leq x_N^S \leq x_C^S$. In words, a higher level of control effort for gatekeepers who observe $w = C$, x_C^S, a low level of control effort for gatekeepers who observe a $w = H$, x_H^S, and an intermediate level of control effort for ignorant (non-observing) gatekeepers x_N^S. Therefore, in this scenario there is ample room for gatekeeper's opportunistic behavior, given that he can observe $w = C$ and later pretend (something that Courts cannot tell if it is true or false) that he had not observed the state of firm, in order to ex-

[18] The concept of "hard" information was introduced by Tirole (1986) and (1992) in a model of collusion where the private information held by the agent was verifiable but hideable. The concept of "hard" information have been also used in the theoretical accounting literature (Ante (1984), Ijiri (1984), Kofman and Lawaree (1993), (1996) and Villadsen (1995)) and in the regulation literature (Laffont and Tirole (1991) and (1992)).

[19] It is obvious that an gatekeeper, if possible, would prefer to lie in the first case and never to lie in the second.

ert a lower level of control effort and save control costs. At first blush, what seems to be crucial in this setting is the policy that Courts or regulators would adopt concerning the credibility of the gatekeepers' statements. We consider that Courts may follow two extreme and radically opposite policies:

1. A policy of complete trust towards the statements made by gatekeepers and

2. A policy of complete distrust, whereby the regulator never gives credit to the statements by the gatekeeper in those situations in which opportunism may play a role. Therefore, if the gatekeeper claims that he did not observe the underlying state, and there was misbehavior by the managers, that is, the firm is shown later to have been corrupt, Courts or regulators would require of gatekeepers compliance with the level of control effort corresponding to a corrupt firm. In other words, under the policy of distrust, Courts or regulators will require for corrupt firms the level of effort care designed for them, independently of the observability of the state of the firm.

3.1 Policy of trust

Let $x_1^{TS} \leq x_N^{TS} \leq x_2^{TS}$ be the optimal standards set by the regulator under the policy of complete trust. Provided that the regulator believes the gatekeeper's statement claiming that he did not observe the firm's state, and the firm is shown to be corrupt, it is not in the interest of the gatekeeper to exert the effort required for $w = C$. Consequently, the gatekeeper will never exert more

than the intermediate (non-observability) required level x_N^{TS}. Thus, gatekeepers observing the state of the firm, either H or C, have a dominant strategy: those observing $w = H$ always choose x_H^{TS} and those observing $w = C$ always choose x_N^{TS} (of course, they would like to lie fully and claim to have observed an honest firm, but our informational assumptions rule out this possibility).

Notice that the adoption of a policy of trust does not mean that the regulator is naive, and that she ignores the possibility of opportunistic behavior on the part of gatekeepers having observed a corrupt firm. When the regulator sets levels of control effort, she takes into account the fact that the gatekeeper will behave opportunisticaly, and so, gatekeepers who have observed $w = C$ will report that they had not observed the state of nature at all. In fact, we will show that a policy of complete trust, which may be considered as entailing an overconfident attitude on the side of the regulator might be an optimal policy that maximizes social welfare, given the informational constraint that impedes the regulator to verify whether or not the gatekeeper had observed the underlying state of the firm.

Hence, the regulator is going to set the standards maximizing the expected social welfare

$$\min_{x_1^{TS}, x_N^{TS}, x_2^{TS}} \sigma \left[\alpha[C(x_1^{TS})] + (1-\alpha)[L_C(x_N^{TS}) + C(x_N^{TS})]\right] +$$
$$(1-\sigma)[(1-\alpha)L_C(x_N^0) + C(x_N^0)]$$

Notice that x_2^{TS} is irrelevant here since it will never be adopted by a gatekeeper

in equilibrium. Contrary to the conventional asymmetric information setting, here the incentive problem of the ignorant gatekeeper is more complicated than that of the informed gatekeeper. As we saw above, informed gatekeepers have a dominant strategy. If gatekeepers observe $w = H$ they will exert x_1^{TS}, which is clear that will be $x_1^{TS} = 0$. If gatekeepers observe $w = C$, they will exert x_N^{TS}. We denote by x_N^0 the optimal choice of non informed gatekeepers, who do not observe the state of the firm. Non-informed gatekeepers have basically two options: $x_N^0 \in \{x_N^E, x_N^{TS}\}$. They can either comply with the standard x_N^{TS} and not be held liable for investors' losses, or they can minimize the expected cost of being held liable, by exerting the efficient solution x_N^E, where $x_N^E \in \arg\max (1-\alpha)L_C(x) + C(x)$.

$$x_N^0 = \begin{cases} x_N^{TS} & \text{if } (1-\alpha)L_C(x_N^E) + C(x_N^E) > C(x_N^{TS}) \\ x_N^E & \text{otherwise} \end{cases}$$

Let $(1-\alpha)L_C(x_N^E) + C(x_N^E) = C(x_N^{Lim})$, then $x_N^{Lim} > x_N^E$. We can rewrite x_N^0 as

$$x_N^0 = \begin{cases} x_N^{TS} & \text{if } x_N^{TS} < x_N^{Lim} \\ x_N^E & \text{otherwise} \end{cases}$$

The optimal solution is characterized by the following proposition.

Proposition 3 *The optimal standards under the policy of trust are,* $x_1^{TS} = 0$, x_2^{TS}, *which can be arbitrary, and*

$$x_N^{TS} = \begin{cases} x_C^E & \text{if } x_C^E \geq x_N^{Lim} \\ x_N^{Lim} & \text{if } x_C^E < x_N^{Lim} \text{ and } F(x_N^E, x_N^{Lim}) < F(x^*, x^*) \\ x^* & \text{if } x_C^E < x_N^{Lim} \text{ and } F(x_N^E, x_N^{Lim}) > F(x^*, x^*) \end{cases}$$

where $F(x_1, x_2) = (1-\sigma)[(1-\alpha)L_C(x_1) + C(x_1)] + \sigma(1-\alpha)[L_C(x_2) + C(x_2)]$ *and* $x^* \in \arg\min\{F(x,x)\}$.

The intuition behind Proposition 3 is the following: if the condition $x_C^E \geq x_N^{Lim}$ is satisfied, then the efficient solution can be implemented, and this is the best outcome that the regulator can induce. The intuition is that when the standard for the non-observing gatekeepers is equal to the efficient control effort required for the gatekeeper observing a corrupt state, this standard is going to be chosen by the gatekeeper who has observed the corrupt state, which is efficient. The gatekeepers not observing the underlying state will be held liable, but they would have the appropriate incentives for exerting the efficient effort level by a non-observing gatekeeper. If the condition $x_C^E \geq x_N^{Lim}$ is not satisfied, however, we cannot obtain the efficient solution, and there will be some welfare loss. Essentially, we can have two solutions:

(i) a Pooling Equilibrium: the regulator minimizes social costs knowing that the standard chosen will be adopted both by the gatekeepers not observing the firm's underlying state, and by those gatekeepers that observe a corrupt firm, or

(ii) a Separating Equilibrium: The non observing gatekeepers will exert their efficient level of control effort, and the regulator sets the standard for non-observing gatekeepers anticipating it will be chosen in fact only by the gatekeepers who observe a corrupt state of the firm, and thus sets this standard at the minimun level of effort that satifies that there will be a separating equilibrium. Those observing the corrupt firm adopt it, and are not held liable, and those not observing the underlying state choose a (lower) level of effort, that minimizes costs given they will be held liable for investors' losses. For a

situation in which this separation equilibrium can be optimal, think for example of circumstances in which α and σ are low, and there is a big difference between the efficient control effort of the gatekeepers observing $w = C$ and the ones who do not observe the state of the firm.

3.2 The opposite policy of distrust

Let $x_1^{DS} \leq x_N^{DS} \leq x_2^{DS}$ be the optimal standards set by the regulator under the policy of distrust. Under a policy of complete distrust, the regulator does not believe the gatekeeper's statement claiming that he did not observe the firm's type when misbehavior on the part of the firm's managers comes later to light. There is no room, thus, for the informed gatekeeper to behave opportunistically. As in the previous case, the informed gatekeeper has a dominant strategy: He chooses x_1^{DS} when observing an honest firm, and chooses x_2^{DS} when observing a corrupt firm. The uninformed gatekeeper can also opt for three different strategies: Exerting x_1^{DS}, x_2^{DS}, or an intermediate level between both of them, but not necessarily the intermediate announced standard, x_N^{DS}, which, as such, will not play any role in this case, since it is only useful for avoiding liabilities when the firm was honest, and in this case, the informed gatekeeper would prefer to save control effort costs by exerting x_1^{DS}. Hence, for the case of observing an honest firm, the choice of x_N^{DS} is dominated by x_1^{DS}. We denote by x_N^0 the optimal choice of non-informed gatekeepers, who have not observed the underlying state of the firm. Therefore, as in the previous case, ignorant gatekeepers have basically two options, x_N^E or x_2^{DS}. They can opt for complying with the standard x_2^{DS} and, thus ,will not be held liable, or they can choose to

minimize the expected cost of being held liable for investors losses, by exerting the efficient (for non-observing gatekeepers) solution x_N^E, where $x_N^E \in \arg\max (1-\alpha)L_C(x) + C(x)$. Consequently, x_N^{DS} is not going to be played in equilibrium. The following proposition describes the optimal levels of control effort and the resulting effects on social welfare

Proposition 4 *The optimal levels of care coincide with the trust policy ones, replacing x_N^{TS} by x_2^{DS}. Hence, $x_1^{DS} = 0$, x_N^{DS} can be arbitrary, and*

$$x_2^{DS} = \begin{cases} x_C^E & \text{if } x_C^E \geq x_N^{Lim} \\ x_N^{Lim} & \text{if } x_C^E < x_N^{Lim} \text{ and } F(x_N^E, x_N^{Lim}) < F(x^*, x^*) \\ x^* & \text{if } x_C^E < x_N^{Lim} \text{ and } F(x_N^E, x_N^{Lim}) > F(x^*, x^*) \end{cases}$$

Thus, policies of trust and distrust generate the same expected social cost.

The intution behind Proposition 4 is that the difference between the trust and distrust policies is simply a question of labeling the higher level of care imposed by Courts, as x_N^{TS} or x_2^{DS}. Contrary to intuition, and given that the labeling of choice variable is of no substance, the same outcomes can be interchangeably achieved using the trust policy and the distrust policy. Both policies generate the same equilibria and payoffs, thus making irrelevant the choice by the regulator of policies concerning the credibility of the injurers' statements.[20] Only the actual choice by the regulator of the adequate standards of control effort is what induces the desired behavior on the part of the gatekeepers.

4 Implications and conclusions

In the previous section, we have showed how, under what we believe are plausible informational assumptions regarding the verifiability of the gatekeepers

[20] We conjecture that this result can be extended to mixed strategies as well.

observation of the firms underlying misbehavior or honest conduct, the policies towards the credibility of the gatekeepers' statements on actual observation, do not induce diverse gate-keeping efforts on the part of professional service providers such as auditors or lawyers.

The paper is agnostic with regard to the desirability of imposing gate-keeping functions upon auditors, or, even more, upon lawyers. It is a fact of most legal systems, however, that such functions are legally required of auditors, and increasingly, due to the political and social relevance of corporate misbehavior affecting markets and large numbers of investors, of lawyers. We simply assume, thus, that such professionals as auditors and lawyers are in a legal position of gatekeepers, and that their efforts in controlling (checking information, supervising past and present corporate action, reporting findings) corporate clients do in fact positively help in reducing the losses resulting from the dishonest corporate clients of auditors and lawyers[21].

The paper is also agnostic with respect to the second step of determining the desirable liability regime for gatekeepers, once decided that a gate-keeping role should be legally imposed. So we do not reject[22] the possibility that the optimal liability regime for auditors or lawyers as gatekeepers should be a strict liability regime, maybe with some liability cap or compulsory insurance, as part or the recent literature seems to suggest. The fact is that most legal systems have

[21] It is true that even if gatekeepers were assumed to be unable to detect or prevent misconduct, or to reduce its negative consequences, imposing liability on those "blind and ineffective" gatekeepers could affect the underlying behavior through the increase in the price for those services (which, by hypothesis, are necessary for firms to enter the market or the activity) arising from the imposition of liability. The effects from this price increase on social welfare are, however, indeterminate overall, although probably negative: Hamdani (2003).

[22] But we do not embrace it either.

not currently adopted a strict liability regime for gatekeepers such as auditors and lawyers, but impose on them various standards of professional behavior, and liability is contingent on the violation or breach of those standards, that is, most legal systems use a negligence-like liability regime.

Our paper, consequently, is positive, and not normative in spirit, as it tries to shed light on the effects of the actual regimes of negligence liability for client misconduct imposed upon gatekeepers. For this purpose, our informational assumptions in the previous section seem to us as the most helpful in illuminating the consequences of current regimes. In effect, if we thought that gatekeepers could perfectly observe corporate conduct, and Courts or regulators could perfectly verify that observation, and assuming a negligence-like regime, differentiated standards would in a straightforward manner provide the optimal gate-keeping incentives. On the contrary, if one thought that observation was impossible, the best a regime based on imposing standards of professional behavior on gatekeepers could do is to require an intermediate average standard of behavior.

We assume in section 3, more realistically, that observation of the underlying state of the firm is imperfect on the part of the gatekeeper. If observation or non-observation could be ex-post perfectly verifiable by Courts or regulators, again diversified standards (three, this time, because one is necessary for the ignorant gatekeeper) could achieve adequate provision of incentives for gatekeeping. In an opposite way, if Courts or regulators would be entirely unable to verify observation by gatekeepers of the underlying behavior of their clients,

that is, if gatekeepers could lie with impunity about observation and its content, we would be thrown back in a situation in which the best regulatory strategy would be to require one intermediate average standard of behavior.

Perfect verifiability is, however, unimaginable in this context, and no verifiability seems too at odds with the actual tendency of legal systems in this respect to make liability usually contingent on the fulfillment of requirements of scienter (knowledge of the underlying misbehavior of the client) to impose liability upon the gatekeeper[23]. We think it is better to assume the information on observation of misconduct to be verifiable but hideable.

What we show is that, if this is the case, the great pains that legal systems[24] take to determine the circumstances of gatekeepers' knowledge of the underlying misconduct on the part of their clients is largely superfluous. If gatekeepers can reasonably pretend to have been ignorant of the honest or corrupt behavior of management in the firms that form their client base, Courts and regulators will achieve identical results regardless whether they are more credulous or more disbelieving of the word of the professional gatekeepers. When gatekeepers can hide information about what they knew at the time they reached a decision on the control measures to be exerted upon their clients, a situation we think,

[23] § 10A(b) of the Securities Exchange Act foresees auditor's liability when he "detects or otherwise becomes aware of information indication that an illegal act (whether or not perceived to have a material effect on the financial statement of the issuer) has or may have occurred". And the SEC's initial proposal on professional standards for lawyers following § 307 of the Sarbanes-Oxley Act defined the trigger of reporting duties as circumstances in which it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a violation has occurred, is occurring or will occur. If gatekeepers' observation is non-verifiable by Courts or regulators, provisions of this kind become entirely moot.

[24] For a discussion of these issues on US Law, see Koniak (2003), Steinberg (2003), Simon (2004).

for the reasons stated above, and also intuitively, highly plausible, the policy of concentrating legal efforts on issues of trusting or distrusting auditors or lawyers does not improve social welfare.

If those policies concerning gatekeepers' statements about their knowledge of what was going on in the firm are costly[25], they are mostly a waste of time, and it would not be socially desirable to pursue them. It would be more efficient to shift the focus of legal systems, when dealing with corporate misconduct, away from issues of scienter and knowledge by gatekeepers, and towards the adequate definition of the substantive standards of professional behavior themselves. If Courts and regulators can optimally set standards (a big if, no doubt) for professional behavior of gatekeepers such as auditors and lawyers, we have theoretically shown that, under some circumstances, even if information and verifiability are far from perfect, they can achieve optimal incentives for gatekeeping behavior. We do not believe that, in the real world, policy-makers will in fact be able to act optimally. But we do believe that, under the conditions of imperfect information and verifiability that prevail in these contexts, legal systems should not divert attention and effort concentrating on the issues of trustworthiness of gatekeepers. The design of substantive standards of professional control by auditors and lawyers should take preeminence in public policy to curtail corporate misconduct.

[25] If the trustworthiness of the gatekeepers' statements on observation is a relevant circumstance affecting the imposition of liability, the costs are clear: Plaintiffs (the investors having experienced losses, the Government) would devote resources to claiming and producing evidence that the gatekeepers must have known the pertinent circumstance or state of the firm. Defendants (auditors and lawyers) would combat these claims and evidence with their own trying to show their ignorance of fraud when they had their professional dealings with the corporation that has caused losses to investors.

References

[1] Antle, R. (1984), "Auditor Independence", 22, Journal of Accounting Research, 1-20.

[2] Arruñada, B. (1999), The Economics of Audit Quality, Boston: Kluwer Academic Publishers.

[3] Cain, D. M., Loewenstein, G., and D. A. Moore (2005), "The Dirt of Coming Clean: Perverse Effects of Disclosing Conflicts of Interest", 34 J. Leg. Stud., 1-25.

[4] Choi, S. (1998), "Market Lessons for gatekeepers", 92 Nw. U. L. Rev., 916-966.

[5] Coffee, J. Jr. (2003), "The Attorney as gatekeeper: An Agenda for the SEC", 103 Colum. L. Rev., 1293-1316.

[6] Coffee, J. Jr. (2004), "Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms", 84 B. U. L. Rev., 301-364.

[7] Ewert, R., Feess, E., and M. Nell (2000), "Auditor Liability Rules Under Imperfect Information and Costly Litigation: The Welfare Increasing Effect of Liability Insurance", 9 Eur. Acc. Rev., 371-385.

[8] Fisch, J. E., and K. M. Rosen (2003), "Is There a Role for Lawyers in Preventing Future Enrons?", 48 Vill. L. Rev., 1097-

[9] Ganuza, J., and F. Gomez (2005), "Caution, Children Crossing! Heterogeneity of Victim's Cost of Care and the Negligence Rule", 1 Rev. L. & Ec. (forthcoming).

[10] Gilson, R. J., and R. H. Kraakman (1984), "The Mechanisms of Market Efficiency", 70 Va. L. Rev., 549-621.

[11] Goldberg, V. P. (1988), "Accountable Accountants: Is Third-Party Liability Necessary?", 17 J. Leg. Stud., 295-312.

[12] Hamdani, A. (2003), "Gatekeeper Liability", 77 S. Cal. L. Rev., 53-118.

[13] Henning, P. J. (2004), "Sarbanes-Oxley Act § 307 and Corporate Counsel: Who Better to Prevent Corporate Crime?" 8 Buffalo Crim. L. Rev., 101-161.

[14] Karpoff, J. M., Scott Lee, D., and G. S. Martin (2004), "The Cost of Cooking the Books", Working paper, University of Washington.

[15] Kofman, F., and J. Lawaree (1993), "Collusion in Hierarchical Agency", 61 Econometrica, 629-656.

[16] Kofman, F., and J. Lawaree (1996), "On the Optimality of Allowing Collusion", 61 Journal of Public Economics, 383-407.

[17] Koniak, S. P. (2003), "When the Hurlyburly's Done: The Bar's Struggle with the SEC", 103 Colum. L. Rev., 1236-.

[18] Kraakman, R. H. (1986), "Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy", 2 J. L. Econ. & Org., 53-

[19] Laffont, J.-J., and J. Tirole (1991), "The Politics of Government Decision-Making A Theory of Regulatory Capture" 106 Q. J. Econ., 1089-1127.

[20] Laffont, J.-J., and J. Tirole (1992), "Cost-padding, Auditing and Collusion" 25-26, Annales d'Economie et Statistique, 205-226.

[21] Painter, R. W. (2004), "Convergence and Competition in Rules Governing Lawyers", University of Illinois College of Law, Law and Economics Working Paper LE04-003.

[22] Partnoy, F. (2001), "Barbarians at the gatekeepers? A Proposal for a Modified Strict Liability Regime", 79 Wash. U. L. Q., 491-

[23] Partnoy, F. (2004), "Strict Liability for gatekeepers: A Reply to Professor Coffee", University of San Diego School of Law, Legal Studies Research Paper No. 05-21.

[24] Ribstein, L. E. (1998), "Ethical Rules, Agency Costs and Law Fiorm Structure", 84 Va. L. Rev., 1707-

[25] Ribstein, L. E. (2002), "Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002", University of Illinois College of Law, Law and Economics Working Paper LE02-008.

[26] Schäfer, H.-B. (2003), "Efficient Third-Party Liability of Auditors in Tort Law and in Contract Law", German Working Papers in Law and Economics, Vol. 2003, Paper 21.

[27] Simon, W. H. (2004), "Wrongs of Ignorance and Ambiguity: Lawyer Responsibility for Collective Misconduct", Columbia Law School, Columbia Public Law and Legal Theory Working Papers, Paper 0480.

[28] Steinberg, M. I. (2003), "Lawyer Liability after Sarbanes-Oxley- Has the Landscape Changed?", 3 Wyo. L. Rev., 371-385.

[29] Tirole, J. (1986), "Hierarchies and Bureaucracies: On the Role of Collusion in Organizations", 2 J. L. Econ. & Org., 181-214.

[30] Tirole, J. (1992), "Collusion and the Theory of Organizations", in J.-J. Laffont (ed.), Advances in Economic Theory, Vol. 1. Cambridge: Cambridge University Press.

[31] Villadsen, B. (1995), "Communication and Delegation in Collusive Agencies", 19 Journal of Accounting and Economics, 3, 15-44.

[32] Willekens, M., Steele, A., and D. Miltz (1996), "Audit Standards and Auditor Liability: A Theoretical Model", 26 Accounting and Business Research, 249-264.

[33] Zacharias, F. (2004), "Lawyers as gatekeepers", University of San Diego School of Law, Legal Studies Research Paper No. 05-12.