

WHISTLEBLOWERS UNDER THE DODD-FRANK ACT AND THEIR
IMPACT ON GATEKEEPERS

EMERICH GUTTER*

*“But who is to stand guard over the guards themselves?”¹***I. Introduction**

Tucked away amid more than 2,000 pages of legislation, Section 922 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”) appears innocuous enough.² The provisions are less than fifty pages long and do not establish a new regulatory agency or limit investment activity. Instead, section 922 establishes a framework for providing pecuniary rewards to individuals that report information pertaining to violations of U.S. securities laws.³ Despite their diminutive appearance, the whistleblower provisions threaten to undermine certain professions that serve as “gatekeepers” by protecting the public from corporate fraud.⁴ In doing so, the whistleblower provisions inadvertently impose avoidable costs on corporations while exposing the market to an increased risk of corporate fraud.

This note expands on Professor John Coffee’s research on gatekeepers by reflecting on gatekeeper failure prior to the 2008 Financial Crisis and examining the impact of whistleblower provisions on these professions. The note begins with background information on how gatekeepers function and why they sometimes fail. Next, a brief description of the Enron bankruptcy and Sarbanes-

* J.D. Candidate 2012, Boston University School of Law; B.A., 2008, The University of North Carolina at Chapel Hill. I wish to thank Professor Cornelius Hurley for his guidance throughout the development of this note. Additionally, I greatly appreciate the help I received from Valentina Elzon, Jameson Rice and the rest of the staff on the *Boston University Review of Banking and Financial Law*. Finally, I owe thanks to Jeff Zack, Professor Perry Mehrling and Raj Date for their insight into the financial industry.

¹ JUVENAL, THE SIXTEEN SATIRES 45 (Peter Green trans., Penguin Books 3d ed. 1999).

² Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 922, 124 Stat. 1376, 1841-49 (2010).

³ *Id.*

⁴ JOHN C. COFFEE JR., GATEKEEPERS: THE PROFESSIONS AND CORPORATE GOVERNANCE 2 (2006).

Oxley Act illustrates gatekeeper failure and past government responses. The note then examines similarities between the Enron and Lehman Brothers bankruptcies. An overview of Dodd-Frank's whistleblower provisions is followed by statutory analysis asserting that the current program will weaken gatekeepers. Finally, the note proposes regulatory reforms that would maximize the oversight roles of both whistleblowers and gatekeepers.

II. *The Gatekeeper Theory*

A. **The Gatekeeper Profession**

A gatekeeper is an “outside or independent watchdog or monitor”⁵ that is “able to disrupt misconduct by withholding their cooperation from wrongdoers.”⁶ A gatekeeper’s support of a financial statement or transaction is often essential because it confirms the statement or transaction’s legitimacy.⁷ The ability to certify business activities depends on the gatekeeper’s “reputational capital,” which refers to the gatekeeper’s ability to lend credibility to an activity and thereby “assure investors as to the quality of the ‘signal’ sent by the issuer.”⁸ The term “gatekeeper” therefore encompasses many professions, most notably certified public accountants, corporate lawyers, credit rating agencies and securities analysts.

Gatekeepers prevent corporate fraud by withdrawing or threatening to withdraw their reputational capital from questionable transactions.⁹ For example, a venture capitalist might refuse to invest in a start-up company without an independent accountant first reviewing and approving the company’s financial statements. This accountant can provide feedback and help resolve any inaccuracies in the financial statements. Moreover, the accountant effectively

⁵ *Id.*; see also Merritt B. Fox, *Gatekeeper Failures: Why Important, What to Do*, 106 MICH. L. REV. 1089, 1089 (2008) (defining gatekeepers as “watchdog[s] for the public”).

⁶ Reinier H. Kraakman, *Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy*, 2 J.L. ECON. & ORG. 53, 53 (1986).

⁷ See John C. Coffee Jr., *Understanding Enron: “It’s About the Gatekeepers, Stupid,”* 57 BUS. LAW. 1403, 1405 (2002) (“Inherently, gatekeepers are reputational intermediaries who provide verification and certification services to investors.”).

⁸ COFFEE, *supra* note 4, at 2.

⁹ See *id.*

controls the start-up's access to capital because the investment decision's outcome hinges on the accountant's approval. A gatekeeper can therefore "close the gate . . . to the capital markets" by withdrawing its reputational capital from a transaction.¹⁰

Conversely, the investment of reputational capital reduces the cost of capital.¹¹ Informational asymmetries between market participants and issuers are common in financial markets and increase the probability of incorrect valuations. The result is a "market for lemons," in which the inability to discern between low- and high-quality goods causes purchasers to demand lower prices, the "lemon price" for all goods.¹² Issuers therefore sell securities at lower prices due to potential inaccuracies or misrepresentations in the market.¹³ Gatekeepers help prevent the formation of a market for lemons by reducing the impact of informational asymmetries. Because gatekeepers are perceived as credible, independent parties, their investment of reputational capital assures the market of an activity's legitimacy.¹⁴ Corporations therefore can sell securities at higher prices because market participants are able to rely on the gatekeeper's credibility despite informational asymmetries.¹⁵ Consequently, the issuer's cost of capital is reduced because the issuer need not discount its securities to compensate for potential inaccuracies.¹⁶

Theoretically, gatekeepers will not risk reputational capital for an individual client's benefit because credibility is difficult to obtain and critical to the gatekeeper's efficacy. Gatekeepers amass

¹⁰ *Id.*; see also Kraakman, *supra* note 6, at 54.

¹¹ COFFEE, *supra* note 4, at 6-7.

¹² *Id.*; see generally George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488, 490 (1970).

¹³ See COFFEE, *supra* note 4, at 6-7.

¹⁴ John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U. L. REV. 301, 309 (2004) ("Characteristically, the professional gatekeeper essentially assesses or vouches for the corporate client's own statements about itself or a specific transaction. This duplication is desired because the market recognizes that the gatekeeper has a lesser incentive to deceive than does its client and thus regards the gatekeeper's assurance or evaluation as more credible.")

¹⁵ See COFFEE, *supra* note 4, at 2; see also Akerlof, *supra* note 12, at 497 (quoting HUGH TINKER, *SOUTH ASIA: A SHORT HISTORY* 119 (2d ed. 1990)) (describing how investors in underdeveloped countries rely on credible third parties to "encourage confidence in [a] venture and stimulate investment").

¹⁶ COFFEE, *supra* note 4, at 6-7.

reputational capital by repeatedly providing accurate analysis and quality services over a long period of time.¹⁷ Many gatekeepers acquire additional reputational capital by virtue of a license or other certification.¹⁸ For example, a securities analyst gains credibility by becoming a registered representative and continually providing useful recommendations. Similarly, a corporate lawyer obtains reputational capital by passing the bar and structuring successful transactions. Thus, the accumulation of reputational capital requires significant time and effort.¹⁹ Furthermore, gatekeepers cannot certify transactions without credibility, an outcome that causes lost clients and possibly dissolution.²⁰ Because a gatekeeper's reputational capital is both hard-earned and crucial to its success, the risk of losing reputational capital should deter gatekeepers from acquiescing in fraud.²¹

B. Gatekeeper Failure

Gatekeeper failure has grown increasingly common, suggesting that reputational capital is not nearly as valuable as once thought.²² Gatekeeper failure occurs when a gatekeeper lends credibility to a client's fraudulent activity and thereby conveys a false signal to the market.²³ Gatekeeper failure also occurs if a gatekeeper discovers fraud but fails to withdraw its reputational capital.²⁴

¹⁷ See COFFEE, *supra* note 4, at 3.

¹⁸ See Akerlof, *supra* note 12, at 500.

¹⁹ See Coffee, *supra* note 7, at 1405.

²⁰ See Frank Partnoy, *Barbarians at the Gatekeepers?: A Proposal for a Modified Strict Liability Regime*, 79 WASH. U. L. Q. 491, 497 (2001); COFFEE, *supra* note 4, at 4 (arguing that Arthur Andersen's failure was the result of "'negative' reputational capital" due to its involvement in the Enron collapse).

²¹ See Coffee, *supra* note 7, at 1405 ("In theory . . . reputational capital would not be sacrificed for a single client and a modest fee.").

²² See COFFEE, *supra* note 4, at 4 (suggesting that previous assertions that risking reputational capital is "irrational" are flawed).

²³ See COFFEE, *supra* note 4, at 15.

²⁴ COFFEE, *supra* note 4, at 15-16 ("Because [gatekeepers] did not bark, the United States' much-vaunted system of corporate governance was suddenly compromised. Red flags had not simply been missed; rather, the sentries upon whom investors relied appeared to have willfully shut their eyes. . . .

Professor Coffee proposes a “deterrence” explanation and a “market bubble” explanation for gatekeeper failure.²⁵ According to the deterrence theory, a gatekeeper is more likely to fail if the incentives to acquiesce to its client exceed the potential costs.²⁶ Incentives might stem from a variety of sources. Highly competitive business environments may cause gatekeepers to yield to clients in order to retain clients.²⁷ Corporate executives that receive substantial equity-based compensation may coerce gatekeepers into approving questionable activities that create short-term gains in the corporation’s stock price.²⁸

Legislation and judicial opinions have decreased gatekeepers’ potential liability.²⁹ For example, the Private Securities Litigation Reform Act of 1995 increased the pleading requirements for class actions, abolished joint and several liability, and limited the availability of treble damages.³⁰ More recently, the Supreme Court, in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, held that no implied private right of action exists against aiders and abettors under section 10(b) of the Securities Exchange Act of 1934.³¹ Although perhaps individually acceptable, the net effect of these trends is a decline in gatekeeper liability.³²

[I]t was as if the lookouts on the Titanic had seen the iceberg—and then collectively pretended it was not there.”) (emphasis added).

²⁵ Coffee, *supra* note 7, at 1409. See also COFFEE, *supra* note 4, at 55-56.

²⁶ See Coffee, *supra* note 7, at 1409.

²⁷ See Geoffrey Miller, *From Club to Market: The Evolving Role of Business Lawyers*, 74 *FORDHAM L. REV.* 1105, 1106 (2005) (arguing that increased competition between law firms pressures lawyers into unethical behavior); Sarah Kellogg, *Financial Crisis 2008: Where Were the Lawyers?*, *WASHINGTON LAWYER*, Jan. 2010, at 26 (“Today’s competitive business climate—and this was true before the economy faltered—makes it tricky to sustain long-term relationships between clients and outside counsel, or even in-house counsel for that matter. It also makes it difficult to give advice to clients who may not want to hear it.”).

²⁸ COFFEE, *supra* note 4, at 62-64; John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 *B.U. L. REV.* 301, 327-28 (2004).

²⁹ See *id.* at 318-19.

³⁰ *Id.* at 319.

³¹ *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 159 (2008).

³² See Coffee, *supra* note 28, at 320.

According to the market bubble theory, gatekeepers fail because they become “temporarily irrelevant” in a bubble market.³³ Bubble economies form when market participants assume that some previous outcome will persist.³⁴ Investors therefore depend on the continuation of previous events rather than the credibility of gatekeepers,³⁵ and corporations are less reliant on reputational capital.³⁶ Thus, the value of reputational capital declines.³⁷ Additionally, conservative investors are normally overshadowed by aggressive investors during a bubble economy.³⁸ In such an environment, simply acquiescing to one’s client becomes a logical, low-cost strategy.³⁹

The deterrence theory and market bubble theory can be reconciled. Both explanations assume that gatekeepers are economically rational actors that seek to minimize costs and maximize benefits.⁴⁰ Gatekeeper failure, therefore, is more likely in circumstances where the benefits of acquiescing to a client exceed the costs. For example, gatekeeper failure will occur in competitive environments because the benefit of retaining clients exceeds the risk of lost reputational capital. Similarly, gatekeeper failure is likely during a bubble economy because the potential cost of lost

³³ Coffee, *supra* note 7, at 1412.

³⁴ See COFFEE, *supra* note 4, at 68.

³⁵ COFFEE, *supra* note 4, at 67. See also Coffee, *supra* note 28, at 324-25. The recent housing bubble exemplifies this pattern. Consistent growth in housing prices throughout the 1990s and early 2000s produced a notion that a crash was virtually impossible. Participants in the housing market therefore invested heavily, assuming that the pattern would continue. Max Fraser, *The House Folds: The Housing Market and Irrational Exuberance*, THE NATION, available at <http://www.thenation.com/article/house-folds-housing-market-and-irrational-exuberance> (Nov. 25, 2008).

³⁶ See Coffee, *supra* note 7, at 1412 (“Gatekeepers are necessary only when investors are cautious and skeptical, and in a market bubble, caution and skepticism are largely abandoned.”).

³⁷ See COFFEE, *supra* note 4, at 67.

³⁸ COFFEE, *supra* note 4, at 69. See also Coffee, *supra* note 7, at 1412 (“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 prophesized a new investment paradigm in which revenues and costs were less important than the number of ‘hits’ on a Web site.”).

³⁹ Coffee, *supra* note 7, at 1412.

⁴⁰ See Partnoy, *supra* note 20, at 497. But see Coffee, *supra* note 7, at 1413-16 (highlighting additional complications to this simple economic explanation).

reputational capital is less than the benefits of approving a questionable transaction.

III. Enron: A Case Study in Gatekeeper Failure

A. Overview

The most widely cited case of gatekeeper failure is the 2001 bankruptcy of Enron Corporation.⁴¹ Originally a natural gas pipeline company, Enron entered the energy trading industry during the 1990s.⁴² The company acted as a middleman between energy suppliers and buyers, offering long-term energy contracts at fixed prices.⁴³ By 2001, Enron had become the seventh largest company in the United States.⁴⁴ It was voted “Most Innovative” on *Fortune*’s list of “Most Admired” corporations for six years in a row,⁴⁵ and, on July 2001, the company reported a forty percent gain in net profits.⁴⁶ Six months later, Enron filed what was then the largest corporate bankruptcy in U.S. history, listing assets of more than \$49.8 billion⁴⁷

Enron, however, was involved in more dangerous innovation, stretching accounting rules to assemble inflated financial statements. For example, the company used “mark-to-market accounting” when reporting its long-term contracts, which required that it include as revenue the projections of future cash flows from long-term contracts.⁴⁸ Enron grossly overstated the value of many of these arrangements. For example, it reported the value of a fifteen-year contract with Indiana-based Eli Lilly at approximately \$500 million, basing this projection largely on optimistic predictions of when the state would deregulate electricity.⁴⁹

Enron also sought to improve its credit rating by selling fixed assets that produced minimal returns and accounted for

⁴¹ See, e.g., COFFEE, *supra* note 4, at 18; Coffee, *supra* note 7, at 1403; Fox, *supra* note 5, at 1090.

⁴² COFFEE, *supra* note 3, at 19-20; S. REP. NO. 107-70, at 7 (2002).

⁴³ Paul M. Healy & Krishna G. Palepu, *The Fall of Enron*, 17 J. ECON. PERSP. 3, 6 (2003).

⁴⁴ S. REP. NO. 107-70, at 6 (2002).

⁴⁵ COFFEE, *supra* note 4, at 18.

⁴⁶ *Enron Net Rose 40% in Quarter*, N.Y. TIMES, July 12, 2001, at C12.

⁴⁷ Richard A. Oppel, Jr. & Andrew Ross Sorkin, *Enron’s Collapse: The Overview*, N.Y. TIMES, Dec. 3, 2001, at A1.

⁴⁸ Healy & Palepu, *supra* note 43, at 9-10; COFFEE, *supra* note 4, at 21.

⁴⁹ Healy & Palepu, *supra* note 43, at 10.

substantial debt.⁵⁰ Where it could not find a buyer, Enron shifted assets to “special purpose entities” (“SPEs”). SPEs are “shell firms to which a parent corporation may transfer both assets and associated liabilities in order to avoid showing them on its own balance sheet.”⁵¹ Accounting rules required that third parties make a “substantive residual equity capital investment” in the SPE, which was interpreted as only three percent.⁵² Several of Enron’s SPEs fell short of this threshold, however, and the company failed to fully disclose its use of SPEs despite shifting billions of dollars in assets to these entities.⁵³ Thus Enron appeared “asset light” by moving fixed assets off its balance sheet while remaining liable for the significant debt used to finance those assets.⁵⁴

Doubts about Enron’s financial statements and business operations caused the company’s stock to decline in late 2001.⁵⁵ Enron soon reported a net loss of \$618 million,⁵⁶ causing its stock price to plummet further⁵⁷ and casting doubt on its investment-grade rating.⁵⁸ Because many of Enron’s loans were contingent on the company retaining an investment-grade rating, Enron appeared likely to default on its debt.⁵⁹ Enron attempted to arrange a last minute merger with Dynergy, a competitor, but the deal fell through once Dynergy investigated Enron’s financial statements.⁶⁰ Left without a white knight, Enron filed for bankruptcy on December 2, 2001.⁶¹

⁵⁰ COFFEE, *supra* note 4, at 20; S. REP. NO. 107-70, at 7.

⁵¹ COFFEE, *supra* note 4, at 22.

⁵² IMPACT OF NONSUBSTANTIVE LESSORS, RESIDUAL VALUE GUARANTEES, AND OTHER PROVISIONS IN LEASING TRANSACTIONS, Emerging Issues Task Force Issue No. 90-15 (Fin. Acct. Standards Bd. 1990); *see also* COFFEE, *supra* note 4, at 23.

⁵³ Healy & Palepu, *supra* note 43, at 11.

⁵⁴ *See* COFFEE, *supra* note 4, at 22.

⁵⁵ *See* COFFEE, *supra* note 4 at 18.

⁵⁶ Kenneth N. Gilpin, *Enron Reports \$1 Billion in Charges and a Loss*, N.Y. TIMES, Oct. 17, 2001, at C5.

⁵⁷ Alex Berenson & Richard A. Oppel, Jr., *Once-Mighty Enron Strains Under Scrutiny*, N.Y. TIMES, Oct. 28, 2001, at A1.

⁵⁸ COFFEE, *supra* note 4, at 18.

⁵⁹ *Id.*

⁶⁰ *Id.* at 18-19.

⁶¹ *Id.*

B. The Gatekeepers Who Failed

The circumstances preceding Enron's collapse created an environment conducive to gatekeeper failure. For example, Enron's executives received considerable equity-based compensation. As of Dec. 31, 2000, employee stock option plans accounted for 96 million of Enron's shares, almost thirteen percent of the company's common stock outstanding.⁶² Enron's use of equity-based compensation may have caused the company's management to pressure gatekeepers into approving questionable activities to accelerate short-term stock price growth.⁶³ Additionally, the potential liability faced by gatekeepers had decreased. In 1991, the Supreme Court rejected an argument for a five-year statute of limitations on securities fraud, instead opting for a three year maximum.⁶⁴ Congress passed the Private Securities Litigation Reform Act in 1995 and enacted the Securities Litigation Uniform Standards Act of 1998 shortly thereafter, the latter of which prohibited securities fraud class action suits filed in state court.⁶⁵ Gains in Enron's stock price also caused market euphoria. In 2000, the stock price swelled 87 percent, despite the bursting of the Dot Com bubble.⁶⁶ The growth in Enron's stock may have caused the value of reputational capital to decline.⁶⁷

Accountants, attorneys and credit rating agencies played significant roles in Enron's collapse. During the late 1980s and 1990s, many accounting firms shifted their emphasis toward more lucrative consulting work.⁶⁸ Enron's accounting firm, Arthur Andersen, epitomized the transition. Of the major U.S. accounting

⁶² Healy & Palepu, *supra* note 43, at 13-4; COFFEE, *supra* note 4, at 24.

⁶³ Healy & Palepu, *supra* note 43, at 14; COFFEE, *supra* note 4, at 24.

⁶⁴ See *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350, 360-61 (1991).

⁶⁵ Coffee, *supra* note 14, at 319; see generally Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, § 101, 112 Stat. 3227, 3227-28 (1998) (Congress enacted SLUSA to prevent private state securities class action lawsuits alleging fraud from being used to frustrate the objectives of the PSLRA).

⁶⁶ COFFEE, *supra* note 4, at 18.

⁶⁷ *Id.* at 67.

⁶⁸ See Janet Kidd Stewart & Andrew Countryman, *Local Audit Conflicts Add Up*, CHI. TRIB., Feb. 24, 2002, at C1 (stating that, on average, Chicago's largest corporations spend three times what they pay for audit services on consulting services by their auditor); COFFEE, *supra* note 4, at 27.

firms, Arthur Andersen had the largest consulting revenues.⁶⁹ In 2000, Enron paid Arthur Andersen \$27 million for its consulting services, \$2 million more than what it paid for audit services.⁷⁰ Enron therefore may have used consulting contracts to coax Arthur Anderson into certifying inaccurate financial statements, further distorting the costs-benefits analysis in favor of gatekeeper failure.⁷¹ Indeed, evidence suggests that the firm was aware of improprieties in Enron's financial statements. On February 5, 2001, Enron's auditors discussed their discomfort with Enron's use of SPEs.⁷² Despite their apprehension, the accountants failed to report their concerns to Enron's audit and compliance committee at a subsequent meeting just one week later.⁷³

The law firm Vinson & Elkins occupied a similar role. Attorneys from the firm were heavily involved in the structuring of

⁶⁹ *Id.*

⁷⁰ Healy & Palepu, *supra* note 43, at 15.

⁷¹ See COFFEE, *supra* note 4, at 64-65 (“[I]f the issuer cannot easily threaten the auditor, it can attempt to seduce it with highly lucrative consulting contracts. Bribes work better than threats for a variety of reasons . . .”).

⁷² Kurt Eichenwald & Diana B. Henriques, *Enron's Many Strands: The Company Unravels; Enron Buffed Image to a Shine Even as It Rotted From Within*, N.Y. TIMES, Feb. 9, 2002, at A1.

⁷³ Berenson & Oppel, Jr., *supra* note 57. Arthur Andersen's actions extend beyond its failure to notify Enron's audit and compliance committee:

When the credit risks at the special purpose entities became clear, requiring Enron to take a write-down, the auditors apparently succumbed to pressure from Enron's management and permitted the company to defer recognizing the charges. Internal controls at Andersen, designed to protect against conflicted incentives of local partners, failed. For example, Andersen's Houston office, which performed the Enron audit, was permitted to overrule critical reviews of Enron's accounting decisions by Andersen's Practice Partner in Chicago. Finally, Andersen attempted to cover up any improprieties in its audit by shredding supporting documents after investigations of Enron by the Securities and Exchange Commission became public.

Healy & Palepu, *supra* note 43, at 15.

Enron's SPEs,⁷⁴ which were so complex that Enron may have been unable to use the entities without the firm's assistance.⁷⁵ Even more concerning, Vinson & Elkins responded to concerns that Enron would "implode in a wave of accounting scandals" by issuing a report stating that the company need not reevaluate its use of SPEs.⁷⁶ Enron announced a \$1 billion deduction from its third-quarter earnings the next day.⁷⁷

Credit rating agencies also failed to fulfill their oversight role. Significantly, credit rating agencies are paid by the companies that they rate.⁷⁸ An issuer therefore can coerce a credit rating agency into preserving a favorable rating by threatening to take its business to a competitor.⁷⁹ Additionally, credit rating agencies may be susceptible to concerns that the negative effect of a downgrade could cause financial instability.⁸⁰ Regardless of the cause, credit rating agencies failed to downgrade Enron despite obvious signs that the company was unraveling, and Enron's rating remained investment grade until four days before the company declared bankruptcy.⁸¹

⁷⁴ William S. Lerach, *Plundering America: How American Investors Got Taken for Trillions by Corporate Insiders*, 8 Stan. J.L. Bus. & Fin. 69, 113 (2002).

⁷⁵ John Schwartz, *Enron's Many Strands: The Lawyers; Troubling Questions Ahead for Enron's Law Firm*, N.Y. TIMES, Mar. 12, 2002, at C1.

⁷⁶ Eichenwald & Henriques, *supra* note 72.

⁷⁷ *Id.*

⁷⁸ Claire A. Hill, *Regulating the Rating Agencies*, 82 WASH. U. L.Q. 43, 50 (2004).

⁷⁹ COFFEE, *supra* note 4, at 34. *but see id.* (noting that the potential conflict of interest is not as significant as what is presented by the relationship between auditors and their clients because credit rating agencies have more clients); Hill, *supra* note 78, at 50-51, 74-76 (arguing that the value of a credit rating agency's credibility will prevent the agency from failing to fulfill its gatekeeper responsibilities).

⁸⁰ "One factor is pressure on the rating agency because of the devastating consequences of a rating downgrading. In early November, 2001, Moody's was approached by prominent persons to warn it that a downgrading of Enron below investment grade would plunge Enron into bankruptcy and disrupt the nation's capital markets. . . . The risk that one will trigger a major bankruptcy (and possibly be sued for doing so unjustifiably) has to slow anyone down." COFFEE, *supra* note 4, at 35.

⁸¹ COFFEE, *supra* note 4, at 34; Richard A. Oppel Jr., *Enron's Many Strands: The Hearings; Credit Agencies Say Enron Dishonestly Misled Them*, N.Y. TIMES, Mar. 21, 2002, at C6.

C. The Sarbanes-Oxley Act of 2002

Congress responded to the Enron debacle by enacting the Sarbanes-Oxley Act of 2002 (“Sarbanes-Oxley”) on July 30, 2002.⁸² Although focused on regulating the accounting industry, Sarbanes-Oxley also includes provisions for the protection of whistleblowers and “up-the-ladder” reporting requirements for corporate attorneys.

Sarbanes-Oxley seeks to prevent gatekeeper failure by blocking efforts to place excessive pressure on accounting firms. Section 103 requires that auditors confirm that financial statements are prepared according to generally accepted accounting principles and disclose any “material weaknesses” in the client’s internal controls.⁸³ Sarbanes-Oxley established the Public Company Accounting Oversight Board to promulgate and enforce rules promoting auditor independence.⁸⁴ Meanwhile, section 303 authorizes the SEC to penalize corporate executives for “fraudulently influenc[ing], coerc[ing], manipulate[ing], or mislead[ing] any independent or certified accountant engaged in the performance of an audit”⁸⁵ Sarbanes-Oxley also requires that public companies establish committees composed of independent board members to oversee the company’s auditor.⁸⁶ The act therefore seeks to maintain a cost-benefits balance in favor of gatekeeper oversight by preventing corporate clients from exerting excessive pressure on accounting firms.

Sarbanes-Oxley also institutes protections for whistleblowers. Section 806 prohibits public companies from retaliating against employees that communicate information regarding a securities law violation to a federal agency, member of Congress or work supervisor.⁸⁷ Such information must pertain to the violation of a rule or regulation of the Securities and Exchange Commission

⁸² Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002); Elisabeth Bumiller, *Bush Signs Bill Aimed at Fraud in Corporations*, N.Y. TIMES, July 31, 2002, at A1.

⁸³ § 103, 116 Stat. at 756.

⁸⁴ *Id.*; See JAMES HAMILTON & TED TRAUTMANN, SARBANES-OXLEY MANUAL: A HANDBOOK FOR THE ACT AND SEC RULES 15 (3d ed. 2008) (stating that the PCAOB is a “non-governmental and non-profit corporation”).

⁸⁵ § 303, 116 Stat. at 778.

⁸⁶ § 301, 116 Stat. at 775-77.

⁸⁷ § 806, 116 Stat. at 802-03.

(“SEC”), a federal law protecting shareholders from fraud, or an otherwise specified statute pertaining to fraud.⁸⁸ If an employer violates Section 806, the employee must file a claim within ninety days of the retaliatory action.⁸⁹

Additionally, Sarbanes-Oxley establishes unique “up-the-ladder” reporting requirements that are designed to compel attorneys to report fraud without violating attorney-client confidentiality.⁹⁰ Section 307 requires that the SEC issue rules imposing a duty on corporate attorneys to report internally any information pertaining to the violation of securities law.⁹¹ The reporting requirements apply to all attorneys “appearing or practicing before the [SEC]”,⁹² a broad phrase encompassing any attorney performing transactional, litigation or advisory services involving the SEC or its rules.⁹³ The SEC may file a civil suit against attorneys that fail to comply with the reporting requirements.⁹⁴

Under the rules promulgated by the SEC, attorneys that become aware of a material violation of securities law must report the violation to the company’s chief legal officer, or to the chief legal officer and the chief executive officer.⁹⁵ If the attorney reasonably believes that the chief legal officer or chief executive officer did not respond appropriately, he or she may report the violation to the company’s audit committee or another committee composed solely of independent board members.⁹⁶ If no such committee exists, the attorney may inform the board of directors.⁹⁷ Sarbanes-Oxley

⁸⁸ These statutes are 18 U.S.C. 1341, 1343, 1344 and 1348. *Id.* at 803.

⁸⁹ *Id.*

⁹⁰ See 17 C.F.R. § 205.3(b)(1) (2003) (“By communicating [information regarding a violation of securities law] to the issuer's officers or directors, an attorney does not reveal client confidences or secrets or privileged or otherwise protected information related to the attorney's representation of an issuer.”); see generally MODEL RULES OF PROF'L CONDUCT R. 1.6 (2007) (articulating the general principle that attorneys should not disclose confidential information pertaining to the representation of a client).

⁹¹ § 307, 116 Stat. 745, 784.

⁹² 17 C.F.R. § 205.3(b)(1) (2003).

⁹³ See HAMILTON & TRAUTMAN, *supra* note 84, at 141 (defining the broad coverage of “appearing or practicing before the Commission”).

⁹⁴ 17 C.F.R. § 205.6(a) (2003).

⁹⁵ 17 C.F.R. § 205.3(b)(1) (2003).

⁹⁶ § 205.3(b)(3).

⁹⁷ *Id.*

therefore provides protection to whistleblowers while requiring that corporate attorneys assist in preventing securities fraud.

IV. *Lehman Brothers: A New Case Study in Gatekeeper Failure*

Although identifying a single event as the central catalyst for the 2008 Financial Crisis remains premature, Congress has recognized a number of potential causes, including monetary policy, deregulation and compensation structures.⁹⁸ The role of gatekeepers remains largely unaddressed, however, despite evidence suggesting that widespread gatekeeper failure contributed to the Crisis. The bankruptcy of the investment bank Lehman Brothers (“Lehman”) underscores the continuing problem of gatekeeper failure.

A. Overview

On September 15, 2008, Lehman filed for Chapter 11 bankruptcy, surpassing Enron as the largest corporate bankruptcy in U.S. history.⁹⁹ The 158 year-old Wall Street firm had reported \$4 billion in profit in 2007, a 22.9 percent increase from its profit in 2005.¹⁰⁰ Lehman was a member of the “shadow banking system,” a \$20 trillion network of nonbank financial institutions.¹⁰¹ Similar to commercial banks, shadow banks are “financial intermediaries that conduct maturity, credit, and liquidity transformation without access to central bank liquidity or public sector guarantees.”¹⁰² Shadow banks compensate for the absence of government support by

⁹⁸ See e.g. Fraud Enforcement and Recovery Act of 2009, Pub. L. No. 111-21, § 5(c)(1), 123 Stat. 1617, 1626-27 (2009).

⁹⁹ See Yalman Onaran & Christopher Scinta, *Lehman Files Biggest Bankruptcy Case as Suits Balk*, BLOOMBERG.COM, available at <http://www.bloomberg.com/apps/news?sid=awh5hRyXkvs4&pid=newsarchive> (Sept. 15, 2008).

¹⁰⁰ Fortune 500: Lehman Brothers Holdings, FORTUNE, available at <http://money.cnn.com/magazines/fortune/fortune500/2007/snapshots/780.html> (last visited Nov. 8, 2010).

¹⁰¹ Tobias Adrian & Hyun Song Shin, *The Shadow Banking System: Implications for Financial Regulation 7* (Fed. Reserve Bank of N.Y., Working Paper No. 382); see also Zoltan Pozsar et al., *Shadow Banking 13-14* (Fed. Reserve Bank of N.Y., Working Paper No. 458).

¹⁰² *Id.* at abstract.

dispersing the underlying risk on their assets.¹⁰³ By grouping loans together into a single security, shadow banks reduce their exposure to risk due to the low probability that the underlying loans will simultaneously default.¹⁰⁴ This securitization process is complex and involves activities such as originating loans, issuing asset-backed securities, underwriting collateralized debt obligations for the security, and then using the security to obtain wholesale funding.¹⁰⁵ Many of these steps involve gatekeepers, including the familiar cast of accountants, lawyers and credit rating agencies.¹⁰⁶

The gatekeeper failure preceding the Lehman bankruptcy involved Lehman's use of repurchase agreements, a form of wholesale funding. In a typical repurchase agreement, an investment bank sends assets, often an asset-backed security or collateralized debt obligation, to another party in exchange for cash.¹⁰⁷ The investment bank then agrees to repay the cash and reclaim the assets at a later date.¹⁰⁸ Although the investment bank only transfers its assets temporarily, accounting rules allow companies to classify repurchase agreements as sales.¹⁰⁹ Lehman grossly misrepresented its financial status by shifting more than \$50 billion in toxic assets off its books in undisclosed repurchase agreements.¹¹⁰ The value of the underlying assets on Lehman's securities plummeted during the Crisis,¹¹¹ however, and the counterparties to Lehman's repurchase

¹⁰³ See Pozsar et al., *supra* note 101, at 14 (“[T]he shadow banking system transforms risky, long-term loans (subprime mortgages, for example) into seemingly credit-risk free, short-term, money-like instruments, such as the \$1, stable net asset value (NAV) shares that are issued by 2(a)-7 money market mutual funds, and are “withdrawable” on demand, much like a demand deposit at bank.”).

¹⁰⁴ Zoltan Pozsar et al., *supra* note 101, at 1-3.

¹⁰⁵ *Id.* at 11.

¹⁰⁶ Ronald S. Borod, Esq., DLA Piper, LLP, Financial Services Basics: Lord of the Flies (Aug. 26, 2009).

¹⁰⁷ Alistair Barr, *Do Other Firms Use Lehman's Accounting Drug?*, MARKETWATCH.COM, available at <http://www.marketwatch.com/story/do-other-firms-use-lehmans-accounting-drug-2010-03-12> (Mar. 12, 2010).

¹⁰⁸ *Id.*

¹⁰⁹ *Id.*

¹¹⁰ Michael J. de la Merced & Andrew Ross Sorkin, *Lehman Bros. Hid Borrowing*, *Examiner Says*, N.Y. TIMES, Mar. 12, 2010, at A1.

¹¹¹ See Susanne Craig & Mike Spector, *Repos Played a Key Role in Lehman's Demise—Report Exposes Lack of Information and Confusing Pacts With Lenders*, WALL ST. J., Mar. 13, 2010, at B1 (“The basic

agreements demanded additional collateral.¹¹² Lehman's inability to meet these demands ultimately drove the company to bankruptcy.

B. The Gatekeepers Who Failed

Similarities between the Enron and Lehman bankruptcies suggest that gatekeeper failure contributed to Lehman's collapse. The circumstances prior to Lehman's failure featured characteristics similar to those that preceded Enron's bankruptcy. For example, Lehman executives earned total cash salaries of approximately \$17.5 million between 2000 and 2008.¹¹³ By comparison, Lehman's chief executive officer received approximately \$461 million from the sale of Lehman shares during that period.¹¹⁴ Other evidence suggests that competition among gatekeepers may have facilitated gatekeeper failure as well.¹¹⁵

Furthermore, the legislative and judicial response to Enron's bankruptcy did not increase the potential liability faced by gatekeepers.¹¹⁶ Sarbanes-Oxley did not reform the Private Securities Litigation Reform Act or the Securities Litigation Uniform Standards Act.¹¹⁷ Additionally, Sarbanes-Oxley did not establish a private right

problem is that the investment banks have become highly dependent on the repo markets for their funding . . . but they were using a whole bunch of nontraditional securities for those repo agreements . . . As we got into the second half of 2008, it became very unclear what the value was on a lot of those things” (quoting Prof. Stephen Lubben of Seton Hall University School of Law).

¹¹² *Id.*

¹¹³ Lucian A. Bebchuck, Alma Cohen, and Holger Spamann, *The Wages of Failure: Executive Compensation at Bear Stearns and Lehman 2000-2008* 11 (John M. Olin Center for Law, Economics, and Business, Discussion Paper No. 657), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1513522 (2010) (stating that between 2000 and 2008, the top executive teams of Bear Stearns and Lehman received cash salaries of \$9 million and \$17.5 million respectively).

¹¹⁴ *Id.* at 15.

¹¹⁵ See Kellogg, *supra* note 27, at 26.

¹¹⁶ See *id.* at 23.

¹¹⁷ See Joseph F. Morrissey, *Catching the Culprits: Is Sarbanes-Oxley Enough?*, 2003 COLUM. BUS. L. REV. 801, 855-56 (2003) (arguing that Sarbanes-Oxley should have abolished the Private Securities Litigation Reform Act and the Securities Litigation Uniform Standards Act).

of action against aiders and abettors for securities fraud,¹¹⁸ which the Supreme Court confirmed in its decision in *Stoneridge Investment Partners, LLC*.¹¹⁹ Meanwhile, gatekeepers experienced a decline in the value of their reputational capital due to the pre-Crisis bubble in the housing market.

Although details are still emerging, evidence suggests that accountants, attorneys and credit rating agencies failed to fulfill their responsibilities as gatekeepers. Lehman's accounting firm, Ernst & Young, allegedly knew about Lehman's use of repurchase agreements for years¹²⁰ and may have ignored warnings about the company's accounting practices. According to reports, Matthew Lee, one of Lehman's Senior Vice Presidents, submitted a letter to Lehman's managers on May 16, 2008, that questioned Lehman's use of repurchase agreements.¹²¹ Lehman directed Ernst & Young to investigate Lee's letter, requesting a "full and thorough investigation into each allegation."¹²² Subsequent interviews between Ernst & Young and Lee revealed that Lehman had used repurchase agreements to temporarily transfer \$50 billion off its balance sheets.¹²³ Despite the license to conduct a "full and thorough investigation," however, Ernst & Young failed to report Lee's allegations to Lehman's Audit Committee.¹²⁴

Credit rating agencies failed to downgrade Lehman's rating below investment grade until shortly before the investment bank filed for bankruptcy, despite months of uncertainty surrounding its financial state.¹²⁵ Although the credit rating agencies expressed some

¹¹⁸ See *id.* at 852-55 (arguing that Sarbanes-Oxley should have instituted aiding and abetting liability for securities fraud).

¹¹⁹ *Stoneridge* *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 159 (2008).

¹²⁰ Report of Anton R. Valukas, Examiner, In re. Lehman Brothers Holdings Inc., et al., XXX B.R. 1, 948 (Bankr. S.D.N.Y. 2010) (No. 08-13555).

¹²¹ Michael Corkery, *Lehman Insider's Letter Warned About Violating Code of Ethics—Top Officers Were Told Firm Misled Investors on Assets*, WALL ST. J., Mar. 20, 2010, at B1.

¹²² Report of Anton R. Valukas, Examiner, *supra* note 120, at 945-46.

¹²³ *Id.* at 957.

¹²⁴ *Id.* at 956-59.

¹²⁵ David Evans & Caroline Salas, *Flawed Credit Ratings Reap Profits as Regulators Fail*, BLOOMBERG.COM, Apr. 29, 2009, <http://www.bloomberg.com/apps/news?sid=au4o1x.judz4&pid=newsarchive>

discomfort,¹²⁶ Standard & Poor's, Moody's and Fitch gave Lehman's bonds an A rating or higher until the day Lehman filed for bankruptcy.¹²⁷

Although evidence suggests that gatekeeper failure occurred, the involvement of attorneys in Lehman's bankruptcy is complicated. Prior to Lehman's collapse, the SEC began filing an increasing number of enforcement actions against corporate attorneys.¹²⁸ Additionally, Sarbanes-Oxley's up-the-ladder provisions may have altered the perceived duties of corporate attorneys to include gatekeeper responsibilities.¹²⁹ Nonetheless, the English law firm Linklaters' involvement in Lehman's use of repurchase agreements raises concerns. Lehman needed a "true sale opinion letter" from an attorney before entering into repurchase agreements.¹³⁰ Although it could not procure the letter from a U.S. law firm,¹³¹ Lehman found a willing party in Linklaters, which provided a true sale opinion letter based on English law.¹³² Although perhaps technically legal, the letter raises ethical concerns because Linklaters presumably knew that American investors would rely on Lehman's financial statements. Linklaters' provision of a true sale opinion letter therefore suggests that attorneys may have failed despite Sarbanes-Oxley's up-the-ladder reporting requirements.

¹²⁶ See Yalman Onaran, *Lehman Said to Be in Discussions About Potential Sale*, BLOOMBERG.COM, Sept. 11, 2008, <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=a5UcJOBnEwT0> ("Without a 'strategic arrangement' in the 'near term,' Lehman's credit-ratings may be downgraded, Moody's said yesterday after the New York-based investment bank announced the biggest loss in its 158-year history.").

¹²⁷ See *id.*; see also Evans & Salas, *supra* note 125.

¹²⁸ Peter C. Kostant, *From Lapdog to Watchdog: Sarbanes-Oxley Section 307 and a New Role for Corporate Attorneys*, 52 N.Y.L. SCH. L. REV. 535, 548 (2007-2008) ("In the post-Sarbanes-Oxley legal environment, the liability climate for corporate lawyers has grown much hotter. Two civil actions have been brought against general counsels alleging breaches of fiduciary duty and fraud, and there have been three criminal proceedings with two convictions and several guilty pleas. Over the past three years [sic] the SEC has also brought thirty enforcement actions, an unprecedented number, against corporate lawyers.").

¹²⁹ *Id.* at 536.

¹³⁰ Report of Anton R. Valukas, Examiner, *supra* note 120, at 783.

¹³¹ *Id.* at 784.

¹³² *Id.*

The circumstances preceding Lehman's collapse indicate that gatekeeper failure is a continuing problem. Additionally, the Lehman and Enron bankruptcies demonstrate that the probability of gatekeeper failure increases in the context of bubble economies and distorted incentive structures. Given the relative frequency of these events, policymakers should enact regulation that strengthens gatekeepers and avoids exacerbating these conditions. Unfortunately, Dodd-Frank falls short of this objective.

C. Dodd-Frank and The Whistleblower Provision

Congress' response to the Crisis, Dodd-Frank, drastically expands preexisting whistleblower law. Section 922 establishes a "Securities and Exchange Commission Investor Protection Fund," in which the SEC deposits monetary sanctions that it collects under securities law.¹³³ The SEC will pay whistleblowers a reward from this fund for "original information" that results in a monetary sanction exceeding \$1 million.¹³⁴ Whistleblowers must disclose such information to the SEC within 180 days of discovering the violation.¹³⁵ The amount rewarded will be determined on a case-by-case basis, but must be between ten and thirty percent of the monetary sanction.¹³⁶ To encourage whistleblowers to fully disclose all valuable information, the SEC is directed to consider the value of the information and the extent of the whistleblower's assistance when determining a reward.¹³⁷

The whistleblower provisions allow any individual, including an employee of the company in question, to act as an informant.¹³⁸ A whistleblower is simply defined as "any individual who provides . . . information relating to a violation of the securities laws to the Commission"¹³⁹ Significantly, this definition could include lawyers, accountants and other gatekeepers. Furthermore, the

¹³³ § 922, 124 Stat. 1376, at 1844.

¹³⁴ *See id.* at 1841-42.

¹³⁵ *Id.* at 1848.

¹³⁶ *Id.* at 1842.

¹³⁷ *Id.* at 1842-43.

¹³⁸ *Id.* at 1842 (defining whistleblower as "any individual who provides, or 2 or more individuals acting jointly who provide, information relating to a violation of the securities laws" to the SEC).

¹³⁹ *Id.*

whistleblower provisions would apply to both private and public corporations.¹⁴⁰

The provisions' more unique aspects are the protections afforded to whistleblowers against retaliatory action by employers.¹⁴¹ Whistleblowers are protected regardless of whether they provide information about violations of Sarbanes-Oxley, the Securities Exchange Act of 1934, or any other law within the SEC's jurisdiction.¹⁴² Additionally, whistleblowers are permitted to make anonymous claims¹⁴³ and have a private right of action against employers that take retaliatory action against them.¹⁴⁴ Such claims are subject to a generous statute of limitations of ten years from the date of the employer's retaliation.¹⁴⁵

Compared to Sarbanes-Oxley, Dodd-Frank expands the statute of limitations, the requirements for claiming a reward, and the laws under which an individual may report a violation.¹⁴⁶ Dodd-Frank therefore broadens the pool of potential whistleblowers while providing additional incentives to disclose information. Unsurprisingly, the SEC reported "hundreds" of reports by whistleblowers within months of Dodd-Frank's enactment.¹⁴⁷ This growth in

¹⁴⁰ See David Martin et al., *Enhanced Protection for Whistleblowers Against Employer Retaliation*, COVINGTON & BURLING LLP, July 29, 2010, <http://www.cov.com/files/Publication/7ed821ac-f749-485a-9554-a06fde78bdc8/Presentation/PublicationAttachment/e7ed9251-9fa6-46ac-b963-a1ed93390779/Dodd-Frank%20Act%20-%20Enhanced%20Protection%20for%20Whistleblowers%20Against%20Employer%20Retaliation.pdf>.

¹⁴¹ See *id.* (arguing that the whistleblower provisions are a significant expansion of the protections afforded by Sarbanes-Oxley).

¹⁴² § 922, 124 Stat. 1376, at 1846; see also Martin et al., *supra* note 141 (comparing the scope of Sarbanes-Oxley's protection to the protection afforded by Dodd-Frank); Ashby Jones & Joann S. Lublin, *Critics Blow Whistle on Law*, WALL ST. J., Nov. 1, 2010, at B1 ("The sweeping Dodd-Frank financial reform law passed in July will apply . . . financial rewards to a much larger universe of wrongdoing, including many types of securities or accounting fraud or bribery allegations, not covered by prior whistleblowing laws.").

¹⁴³ See § 922, 124 Stat. 1376, at 1843.

¹⁴⁴ *Id.* at 1846.

¹⁴⁵ *Id.* at 1846; see also Martin et al., *supra* note 141.

¹⁴⁶ See Martin et al., *supra* note 140.

¹⁴⁷ See Jones & Lublin, *supra*, note 142. The history of *qui tam* actions is significant in this context. *Qui tam* actions, which refer to whistleblower suits under the False Claims Act, increased significantly after the Federal

litigation will have a profound effect on corporations; the potential ramifications for gatekeepers, however, are far less clear.

D. The SEC's Proposed Rulemaking

On November 3, 2010, the SEC released its proposed whistleblower rules for comment.¹⁴⁸ Although not yet finalized, the rules would mitigate Dodd-Frank's potential impact on gatekeepers.

Under Dodd-Frank, "original information" must be "derived from the independent knowledge or analysis of a whistleblower."¹⁴⁹ The proposed rules define independent knowledge as "factual information in your possession that is not derived from publically available sources."¹⁵⁰ The rules include seven exceptions from the definition of independent knowledge, five of which are pertinent to this analysis. These exceptions exclude most information derived from gatekeepers.¹⁵¹ Additionally, the proposed rules would

Rules of Civil Procedure was amended to decrease the cost of *qui tam* suits in 1993. In fact, the Department of Justice recovered \$378 million from *qui tam* actions in 1994, more than double what was recovered in the six years prior to the amendment of the Federal Rules of Civil Procedure; see Todd B. Castleton, *Compounding Fraud: The Costs of Acquiring Relator Information Under the False Claims Act and the 1993 Amendments to Federal Rules of Civil Procedure*, 4 GEO. MASON L. REV. 327, 344 (1996) (arguing that the erosion of "entry barriers to litigation" caused an increase of *qui tam* actions).

¹⁴⁸ Press Release, Securities Exchange Commission, SEC Proposes New Whistleblower Program Under Dodd-Frank Act, available at <http://www.sec.gov/news/press/2010/2010-213.htm> (Nov. 3, 2010).

¹⁴⁹ § 922, 124 Stat. 1376, at 1842.

¹⁵⁰ Proposed Rules for Implementing the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934, 75 Fed. Reg. 221, at 70520 (proposed Nov. 3, 2010, to be codified at 17 C.F.R. pts. 240, 249).

¹⁵¹ These provisions are as follows:

The [SEC] will not consider information to be derived from your independent knowledge or independent analysis if you obtained the knowledge or the information upon which your analysis is based:

- (i) Through a communication that was subject to the attorney-client privilege, unless disclosure of that information is otherwise permitted . . . ;
- (ii) As a result of the legal representation of a client on whose behalf your services, or the services of your employer or firm, have been

exclude information from individuals that obtain the information from gatekeeper “tips”.¹⁵²

In general, gatekeepers may only act as whistleblowers if the corporation communicates information to the gatekeeper and then acts in “bad faith” or fails to report the information to the SEC “within a reasonable time.”¹⁵³ The exception for bad faith is sensible. Presumably, corporations that act in bad faith should be forced to internalize the costs of securities fraud.¹⁵⁴ Additionally, this bad faith exception will capture many of the legitimate claims that would be disregarded by excluding gatekeepers from the whistleblower program. The exception for corporations that fail to report violations within reasonable time is questionable, however. As every law student is painfully aware, the word “reasonable” is particularly vague, and the SEC’s proposed rules have compounded this problem by intentionally leaving the term open to interpretation.¹⁵⁵ The possibility that an overeager gatekeeper will construe the phrase as

retained, and you seek to use the information to make a whistleblower submission for your benefit, unless disclosure is [otherwise] authorized . . . ;

- (iii) Through the performance of an engagement required under the securities laws by an independent public accountant, if that information relates to a violation by the engagement client or the client’s directors, officers or other employees;
- (iv) Because you were a person with legal, compliance, audit, supervisory, or governance responsibilities for an entity, and the information was communicated to you with the reasonable expectation that you would take steps to cause the entity to respond appropriately to the violation, unless the entity did not disclose the information to the [SEC] within a reasonable time or proceeded in bad faith; or
- (v) Otherwise from or through an entity’s legal, compliance, audit or other similar functions or processes for identifying, reporting and addressing potential non-compliance with law, unless the entity did not disclose the information to the Commission within a reasonable time or proceeded in bad faith;

Id. at 70520-21.

¹⁵² *Id.* at 70516-17.

¹⁵³ *Id.* at 70488.

¹⁵⁴ See Kraakman, *supra* note 6, at 59-60.

¹⁵⁵ See Proposed Rules for Implementing the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934, 75 Fed. Reg. 221, at 70494.

referring to an unduly short time period is a legitimate concern that could lead to erroneous suits.

V. *The Tension Between Dodd-Frank and Gatekeepers*

A. Comparing Whistleblowers and Gatekeepers

Although not mutually exclusive,¹⁵⁶ gatekeeper and whistleblower regimes should be understood as different mechanisms for preventing corporate fraud.¹⁵⁷ Whistleblower regimes provide employees with incentives to report information that will result in government penalties,¹⁵⁸ whereas gatekeepers withhold reputational capital from fraudulent transactions.¹⁵⁹ Gatekeepers therefore act internally, without the use of judicial remedies.¹⁶⁰

This difference is the basis for why gatekeeper regimes are an advantageous enforcement strategy. Efficiency is commonly understood as the central goal of corporate law.¹⁶¹ Consequently, the government should choose between whistleblower and gatekeeper strategies based on whichever strategy is more efficient. This goal is accomplished if the chosen enforcement strategy reduces misconduct while imposing the fewest costs possible.¹⁶²

¹⁵⁶ Gatekeeper and whistleblower regimes have long co-existed. *Qui tam* actions date back to the fifteenth century. In modern American history, *qui tam* law has co-existed with traditional gatekeeper professions since the Civil War, when Congress passed the False Claims Act. Major John C. Kunich, USAF, *Qui Tam: White Knight or Trojan Horse*, 33 A.F. L. REV. 31, 31-32 (1990).

¹⁵⁷ See Kraakman, *supra* note 6, at 56.

¹⁵⁸ See *id.*

¹⁵⁹ See COFFEE, *supra* note 4, at 2.

¹⁶⁰ See Kraakman, *supra* note 6, at 59).

¹⁶¹ WILLIAM T. ALLEN, REINIER KRAAKMAN & GUHAN SUBRAMANIAN, COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATION 2-3 (3d ed. 2009) (“[T]he modern law of organizational forms—most notably corporation law—is premised on the idea that facilitating individuals’ efforts to create wealth is wise public policy. . . . If we accept the classical liberal perspective that corporation law succeeds to the extent that it enables individuals to increase their utility, we implicitly agree that *economic efficiency* is the principal standard by which this law should be evaluated.”).

¹⁶² See Kraakman, *supra* note 6, at 57 (“Alternative measures [to traditional deterrence strategies] are justified only if they . . . can lower the total costs of direct enforcement and residual misconduct.”).

In general, gatekeeper regimes are more efficient than whistleblower regimes. Three points illustrate this claim. First, the gatekeeper model only imposes the costs of abstaining from a profitable activity.¹⁶³ Whistleblower regimes, however, impose the costs associated with legal defense, negative publicity and, possibly, an unfavorable decision.¹⁶⁴ Second, the gatekeeper model prevents fraud before it occurs by empowering gatekeepers to close “the gate” by withholding reputational capital.¹⁶⁵ The gatekeeper model therefore does not require that the victim incur any cost due to fraudulent activity, whereas the whistleblower model’s use of litigation requires that some injury occur.¹⁶⁶ Third, the gatekeeper’s ability to certify a corporation’s activities facilitates the corporation’s access to capital. Investors can rely on the assurances of a gatekeeper, thereby lending credibility to the corporation and lowering its cost of capital.¹⁶⁷ The gatekeeper model therefore is more efficient, although a carefully tailored whistleblower program can complement gatekeeper regimes. Legislation therefore should strengthen gatekeepers while utilizing whistleblowers to supplement gatekeepers.

B. How Dodd-Frank Undermines Gatekeepers

By bestowing unprecedented power on individuals to exact financial rewards from corporations, the Dodd-Frank Act may obstruct gatekeeper access to information channels that are critical to building and allocating reputational capital. The gatekeeper-client relationship is symbiotic. Each party to the relationship relies on the other for some benefit: the client relies on the gatekeeper to invest reputational capital in its activity,¹⁶⁸ whereas the gatekeeper relies on

¹⁶³ *Id.* at 59.

¹⁶⁴ *Id.*

¹⁶⁵ See COFFEE, *supra* note 4, at 2.

¹⁶⁶ Admittedly, whistleblower systems can be understood as *ex ante* approaches because they encourage whistleblowers to disclose information before the fraud occurs. However, whistleblower regimes are not “purely preventative” in the way that gatekeeper regimes are because whistleblowing inevitably involves some form of punishment. See Kraakman, *supra* note 6, at 59 n.16 (“[I]t is difficult to hold whistleblowing in a purely preventative, *ex ante* role; whistleblowing almost invariably punishes as well, if only because it reveals damaging information about attempted misconduct.”).

¹⁶⁷ COFFEE, *supra* note 4, at 6-7.

¹⁶⁸ *Id.*

the client to provide information that the gatekeeper can use to determine whether to invest its reputational capital.¹⁶⁹

The gatekeeper's weakness may be its lack of control over the accuracy of the information upon which it relies. Normally, this is not a concern because the costs of providing inaccurate or false information are substantial. For example, accurate disclosure of information is often required by law.¹⁷⁰ Furthermore, the gatekeeper would presumably withdraw its reputational capital upon the discovery of an intentional inaccuracy, thereby restricting access to capital markets.¹⁷¹

Dodd-Frank's whistleblower provisions will upset this relationship. As demonstrated in Part III, the breadth of the provisions will cause significant growth in whistleblower-originated litigation.¹⁷² The rise in litigation will impose tremendous costs on corporations,¹⁷³ resulting in a growing mistrust between corporations and potential whistleblowers.¹⁷⁴ Gatekeepers will experience this tension in particular because their access to inside information places them in the position to act as a whistleblower.¹⁷⁵ The ultimate result

¹⁶⁹ See Fox, *supra* note 5, at 1089; Reinier H. Kraakman, *Corporate Liability Strategies and the Costs of Legal Controls*, 93 YALE L.J. 857, 868 n.28 (1983).

¹⁷⁰ Sarbanes-Oxley is an example. Section 302 requires that various corporate officers "certify" financial reports that are filed pursuant to Sarbanes-Oxley. This approval indicates that the officers have reviewed the report, that the report contains no significant inaccuracies, and that the report accurately represents the corporation's financial status. See § 302, 116 Stat. 745, at 777.

¹⁷¹ See COFFEE, *supra* note 4, at 4.

¹⁷² See Jones & Lublin, *supra* note 142 ("The SEC said it has already received hundreds of whistleblower tips since the passage of [Dodd-Frank]. . .").

¹⁷³ In 1993, Congress amended the Federal Rules of Civil Procedure to decrease the cost of *qui tam* suits in 1993. Between 1986 through 1992, the department of justice recovered \$147 million from *qui tam* suits. In 1994 alone, the year after the amendments, the department of justice recovered \$378 million from *qui tam* suits. Castleton, *supra* note 147, at 344. Importantly, these numbers only reflect monetary sanctions that were accumulated in successful *qui tam* suits. The actual cost of *qui tam* suits would probably greatly exceed \$378 million if defense, public relations and other intangible costs were added.

¹⁷⁴ See Kraakman, *supra* note 6, at 60.

¹⁷⁵ See Dionne Searcey, *Toyota Gets Favorable Ruling—Arbitrator Dismisses Claim That Auto Maker Improperly Withheld Evidence*, WALL

is that corporations are likely to restrict gatekeeper access to inside information.¹⁷⁶

The whistleblower provisions would be less alarming if culpable corporations alone bore the costs, as the internalization of costs in the context of legitimate suits seems justifiable.¹⁷⁷ Innocent corporations are also likely to bear these litigation costs and therefore restrict information because the growth in whistleblower litigation will probably include a number of “erroneous and abusive” suits.¹⁷⁸ Innocent and culpable corporations alike will therefore restrict information channels to the detriment of gatekeepers.¹⁷⁹

ST. J., Jan. 6, 2011, at B3 (describing how Toyota attorney Dimitrios Biller used privileged information to allege that Toyota had withheld information when investigating rollover accidents). The potential for mistrust between gatekeepers and their clients is analogous to the policy concerns that give rise to the attorney-client privilege. The policy justification of the attorney-client privilege is to encourage trust between attorneys and their clients: “the assumption [behind the attorney-client privilege] is that the normal person’s fear of compelled public disclosure would have a ‘chilling effect’ on the person’s willingness to confer and communicate.” EDWARD J. IMWINKELRIED, *THE NEW WIGMORE: A TREATISE ON EVIDENCE* 161 (2d ed. 2010) (citing Note, *The Chilling Effect in Constitutional Law*, 69 COLUM. L. REV. 808 (1969)); see also Joseph C. Daley and Roberta S. Karmel, *Attorneys’ Responsibilities: Adversaries at the Bar of the SEC*, 24 EMORY L.J. 747, 816-18 (1975) (extending this policy justification to relationships between corporate attorneys and their clients). Compelled disclosure that is encouraged by law, as in the case of whistleblowing, evokes the same concerns regarding trust. See Kraakman, *supra* note 6, at 60 (“[T]he erosion of trust . . . is often said to be the price of compelled disclosure in any context, and particularly in a lawyer-client relationship.”) (citing Daley & Karmel, *supra* note 175, at 817-23).

¹⁷⁶See Edward J. Kane, *Continuing Dangers of Disinformation in Corporate Accounting Reports*, 13 REV. OF FIN. ECON. 149, 152 (2003); Kraakman, *supra* note 6, at 60 (“[W]histleblowing leaves all regulatory targets at the mercy of their private monitors. Whatever their actual intentions, then, all regulatory targets have a powerful incentive to withhold information from potential whistleblowers and to refrain from transaction with anyone of suspect loyalties.”)

¹⁷⁷See Kraakman, *supra* note 6, at 59-60.

¹⁷⁸Frivolous *qui tam* suits are common. Between 1986 and 1992, the government declined to pursue approximately eighty percent of the *qui tam* suits filed. Thirty-eight percent of the cases that the government did not pursue were either dismissed or abandoned. Castleton, *supra* note 147, at 345.

¹⁷⁹See Kraakman, *supra* note 6, at 60.

C. Consequences

The immediate effects of restricting the flow of insider information could increase fraud and increase the cost of capital. In the short-term, the inability to gain full access to information will undermine a gatekeeper's ability to assess transactions and prevent fraud. Without reliable data, a gatekeeper is unable to accurately determine where it should invest or withdraw reputational capital.¹⁸⁰ Additionally, restrictions on a gatekeeper's access to information will undermine its ability to prevent fraud by performing its role as "public watchdog."¹⁸¹

The inability to accurately assess information may have a less obvious impact on gatekeepers. As previously described, reputational capital is not easily acquired and normally requires years of consistent, high-quality service.¹⁸² When relying on flawed information, however, gatekeepers will be unable to detect fraud and inaccuracies, and are more likely to make poor decisions when investing reputational capital. This will erode the gatekeeper's credibility, preventing market participants from distinguishing between legitimate and illegitimate business activity. The resulting informational asymmetries will create a market for lemons and thereby raise the cost of capital.¹⁸³

In the worst case, the whistleblower provisions could create a greater risk of corporate fraud. Because gatekeepers require access to sensitive information, corporations may hesitate to hire gatekeepers or become more likely to switch gatekeepers, thereby increasing competition.¹⁸⁴ As a result, gatekeepers will be more likely to acquiesce to fraudulent activity because the benefits of retaining clients in a competitive market exceed the potential cost of lost reputational capital. Equity-based compensation arrangements¹⁸⁵

¹⁸⁰ See Kraakman, *supra* note 169, at 868 n.28.

¹⁸¹ See Fox, *supra* note 5, at 1.

¹⁸² Coffee, *supra* note 7, at 1405; Kraakman, *supra* note 6, at 54.

¹⁸³ COFFEE, *supra* note 4, at 6-7.

¹⁸⁴ See Coffee, *supra* note 7, at 1419 ("Logically, as legal exposure to liability declines and as the benefits of acquiescence in the clients demands increase, gatekeeper failure should correspondingly increase"); Miller, *supra* note 27, at 1106 (arguing that competition between law firms leads to unethical behavior).

¹⁸⁵ See COFFEE, *supra* note 4, at 62-64.

or a bubble economy¹⁸⁶ would only exacerbate these conditions. Such an environment favors gatekeeper failure and could expose market participants to an increased risk of corporate fraud.

VI. Recommendations

Although the current whistleblower provisions may prevent some fraud, the statute will impose significant costs on corporations while weakening gatekeepers. A preferable system would employ both whistleblowers and gatekeepers in a more efficient fashion. The following reforms seek to establish a two-tiered enforcement system by excluding gatekeepers from the whistleblower program and increasing the cost of gatekeeper acquiescence.

Future regulation must exclude gatekeepers from the whistleblower program to preserve the relationship between corporations and gatekeepers. As previously described, the current whistleblower program will cause corporations to withhold information from gatekeepers. The SEC's proposed rules would exclude gatekeepers from the whistleblower provision, fortifying the trust that epitomizes the gatekeeper-client relationship and allowing corporations to continue providing gatekeepers with access to inside information.¹⁸⁷ The SEC must, however, remove the exception for corporations that fail to disclose violations in "reasonable" time. This provision is ambiguous and could expose innocent corporations to erroneous suits based on misinterpretations over what constitutes "reasonable time."

The SEC's proposed exclusion for gatekeepers is insufficient in isolation because it fails to address the underlying causes of gatekeeper failure. Future reform must tilt the cost-benefit balance in favor of the gatekeeper's oversight role. Admittedly, Dodd-Frank

¹⁸⁶ *See id.* at 67.

¹⁸⁷ *Cf.* Kraakman, *supra* note 6, at 60 (suggesting that the "erosion of trust" is "the price of compelled disclosure"). An added benefit of the SEC's proposed rule is its consistency with rules for ethical conduct. For example, provisions that encourage attorneys to disclose information regarding a client's violation of securities law would presumably violate the American Bar Association's Model Rules of Professional Conduct. *See e.g.* MODEL RULES OF PROF'L CONDUCT R. 1.6(a) ("A lawyer shall not reveal information relating to the representation of a client unless the client gives informed consent, the disclosure is impliedly authorized in order to carry out the representation or the disclosure is [otherwise] permitted . . .").

took steps toward decreasing gatekeeper failure by regulating executive compensation. The act requires that corporations hold a non-binding shareholder vote on executive compensation every three years¹⁸⁸ and establishes a claw-back provision requiring that executives repay any incentive-based pay received due to “material non-compliance.”¹⁸⁹ The value of a “non-binding vote” is questionable, however, and previous attempts to regulate executive compensation, including Sarbanes-Oxley’s claw-back provision,¹⁹⁰ did not prevent the gatekeeper failure that contributed to Lehman’s bankruptcy.

Rather than regulating executive compensation, policy-makers should increase the potential liability faced by gatekeepers. Although gatekeeper liability is politically unpopular,¹⁹¹ informational asymmetries are invariably a feature of market economies,¹⁹² and investors rely on gatekeepers to reduce those asymmetries.¹⁹³ In exchange for the market’s trust, gatekeepers assume a “public responsibility transcending any employment relationship with the client.”¹⁹⁴ By certifying fraudulent activity, however, gatekeepers exploit the market’s trust by misleading market participants into investing under the pretense that the activity is legitimate.¹⁹⁵ Enron and Lehman demonstrate that the threat of lost reputational capital alone is an ineffective deterrent for such behavior. Regulation therefore should impose meaningful penalties that reflect the market’s reliance on gatekeepers’ independence and honesty.¹⁹⁶

¹⁸⁸ § 951, 124 Stat. at 1899.

¹⁸⁹ § 954, 124 Stat. at 1904.

¹⁹⁰ § 304, 116 Stat. at 778-779.

¹⁹¹ See COFFEE, *supra* note 4, at 372.

¹⁹² See Kane, *supra* note 176, at 156.

¹⁹³ See *id.* at 2.

¹⁹⁴ *United States v. Arthur Young & Co.*, 465 U.S. 805, 817 (1984); see also David Satava et al., *Ethics and the Auditing Culture: Rethinking the Foundation of Accounting and Auditing*, 64 J. BUS. ETHICS 3, 272 (2006) (“The role of the audit function is “covenantal” to the degree that the audit profession represents itself as a guardian of public interest. As quid pro quo for being certified by society as professional and competent, auditors owe society a citizen’s duty to follow principles as well as rules faithfully.”) (citations omitted).

¹⁹⁵ Morrissey, *supra* note 117, at 853.

¹⁹⁶ See *id.* Similar forms of reliance have traditionally prompted a finding of securities fraud. See *Stoneridge Investment Partners, LLC v. ScientificAtlanta, Inc.*, 552 U.S. 148, 160 (2008) (requiring that the plaintiffs in securities fraud actions rely directly on the defendant); *Basic, Inc. v.*

Congress should establish an explicit private right of action against gatekeepers that knowingly or recklessly further securities fraud.¹⁹⁷ In general, a private right of action will increase the costs of acquiescence by simply widening the pool of potential plaintiffs. Admittedly, gatekeepers will incur additional costs under this liability regime, some of which will be shifted to clients.¹⁹⁸ Policymakers can constrain these costs by imposing a “ceiling” on the damages extracted from gatekeepers.¹⁹⁹ Furthermore, recent evidence suggests that lawsuits against gatekeepers for securities fraud are rare,²⁰⁰ which suggests that a controlled increase in liability costs would not be unduly burdensome.²⁰¹

Furthermore, the approach’s concentration on gatekeepers that “knowingly or recklessly further securities fraud” tailors liability

Levinson, 485 U.S. 224, 245-7 (1988) (adopting a presumption that securities fraud plaintiffs rely on the “integrity of the markets”); *see also* John C.P. Goldberg et al., *The Place of Reliance in Fraud*, 48 ARIZ. L. REV. 1001, 1020 (2006) (arguing that reliance is fundamental to securities law because it ensures that the plaintiff only recovers damages resulting directly from the defendant’s misrepresentation).

¹⁹⁷ *See* Robert John Grubb II, *Attorneys, Accountants, and Bankers, Oh My! Primary Liability for Secondary Actors in the Wake of Stoneridge*, 62 VAND. L. REV. 275, 305-09 (2009) (providing an in-depth discussion of a statute in which a gatekeeper would be “liable . . . if he or she knowingly or recklessly engages in any activity that has the effect of misrepresenting or omitting the material information available to investors, or otherwise misleads investors through a false appearance of fact, whether or not the actor is personally identified as engaging in the activity.”); *see generally* Kraakman, *supra* note 6.

¹⁹⁸ *See* Coffee, *supra* note 14, at 347 (stating that increasing gatekeeper liability will cause gatekeepers to “raise their fees to cover their increased liability”).

¹⁹⁹ *See* COFFEE, *supra* note 4, at 334 (noting that the potentially excessive costs of liability can be reduced by a combination of strict liability and a “ceiling on liability”). Professors Coffee and Partnoy propose liability regimes in which damages are limited to the extent that gatekeepers “insure” the transaction in question. Coffee, *supra* note 14, at 349-53; Partnoy, *supra* note 20, at 540-46.

²⁰⁰ *See Securities Class Action Filings: 2010 Year in Review*, 2011 CORNERSTONE RES. 32 (stating that only four percent of the class action complaints for securities fraud were filed against auditors).

²⁰¹ *See* COFFEE, *supra* note 4, at 373 (arguing that aiding and abetting liability will not cause gatekeeper insolvency because “auditors and other secondary participants are seldom sued in securities class actions”).

toward culpable parties. This standard limits liability by requiring scienter, which excludes suits against gatekeepers that were unaware of or deceived by their client and reduces the costs imposed on “innocent” gatekeepers.²⁰² At the same time, the standard expands liability to gatekeepers that might otherwise avoid it. The act of “furthering” securities fraud would include gatekeepers that discover fraud but do not withdraw their reputational capital.²⁰³ Furthermore, this flexible standard avoids overly technical rules that allow gatekeepers to ignore their oversight role by simply satisfying technical requirements.²⁰⁴ A private right of action could therefore prevent gatekeeper failure by increasing the potential liability faced by gatekeepers and tilting the cost-benefit balance in favor of the gatekeeper’s oversight role.

VII. Conclusion

The collapse of Enron and Lehman demonstrate that gatekeeper failure remains problematic, and future reform should avoid inadvertently creating conditions that further weaken gatekeepers. Unfortunately, Dodd-Frank’s whistleblower provisions will increase whistleblower litigation and cause corporations to restrict gatekeeper access to inside information. Although not yet finalized, the SEC’s proposed rules reveal sensitivity to the impact that a sweeping whistleblower program would have on gatekeeper-client relationships. The exclusions would be a significant, albeit obvious, step in the right direction: without it, the whistleblower program would undermine the gatekeeper’s oversight role by creating distrust between gatekeepers and their clients. Additionally, regulation establishing a private right of action against gatekeepers would complement the SEC’s proposed rules by increasing the potential liability faced by gatekeepers. Ultimately, these are critical steps toward protecting our economy.

²⁰² Grubb II, *supra* note 197, at 305.

²⁰³ *Id.* at 306.

²⁰⁴ See COFFEE, *supra* note 4, at 370 (stating that gatekeepers respond to increased liability by “seeking narrow, hyper-technical rules that protect them from exercising judgment.”); Satava et al., *supra* note 194, at 281 (“Unfortunately, evidence from the recent past suggests that far too many accountants, auditors, and executives have misrepresented financial information, participated in fraudulent financial deceptions, and hidden behind loopholes in the law that have been rule-based.”).