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GATEKEEPER LIABILITY

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GATEKEEPER LIABILITY

ASSAF HAMDANI*

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ABSTRACT

The recent crisis in the wake of the Enron debacle has demonstrated the importance of enlisting gatekeepers—such as accountants, underwriters, and lawyers—to prevent corporate fraud. But while a consensus may exist over the basic need to expand liability to gatekeepers, little is known about the appropriate scope of such liability. Going beyond the capital market context, this Article develops a framework to determine the scope of gatekeeper liability for client misconduct. Specifically, the Article analyzes the fundamental tradeoff between the potentially adverse impact of gatekeeper liability on relevant markets and the incentives such liability provides for gatekeepers to foil wrongdoing. Expanding the scope of their liability will make gatekeepers increase the price of their services to reflect their liability exposure. Although initially appealing as a means to screen out wrongdoers, this price increase may turn out to have adverse consequences when clients vary with respect to their wrongful intentions: rather than screen out wrongdoers, gatekeeper liability may drive out only law-abiding clients. Enhanced liability, however, will also induce gatekeepers to monitor clients and prevent them from committing misconduct. The Article explores the policy implications of this analysis for determining which third parties should face gatekeeper liability, identifying the adequate scope of gatekeeper liability, and recognizing the shortcomings of gatekeeper liability as an instrument of social policy. The Article concludes by putting forward a tentative outline of the proper regime of gatekeeper liability for securities fraud.

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GATEKEEPER LIABILITY

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I. INTRODUCTION

Recent corporate scandals, most notably the collapse of Enron, Worldcom, and Global Crossing, have highlighted the importance of enlisting various gatekeepers—auditors, lawyers, underwriters, lenders and stock analysts—to prevent corporate fraud.¹ It is thus not surprising that the goal of harnessing gatekeepers to the task of ensuring the accuracy of corporate disclosure has occupied a central role on the post-Enron regulatory agenda.²

Yet, despite the apparent consensus that insufficient deterrence of gatekeepers, such as accountants, is to blame for debacles like Enron,³ there has been virtually no attempt to go down the simple path of making gatekeeper liability more stringent—by moving in the direction of strict liability, for example.⁴ To be sure, the Sarbanes-Oxley Act⁵ did create new

1. See, e.g., *Financial Oversight of Enron: The SEC and Private-Sector Watchdogs* (Report to the Staff of the Senate Committee on Governmental Affairs, Oct. 8, 2002), available at <http://govt-aff.senate.gov/100702watchdogsreport.pdf>. (reviewing the role of auditors, securities analysts, and credit rating agencies in the collapse of Enron); Jonathan D. Glater, *Round Up the Usual Suspects. Lawyers, Too?*, N.Y. TIMES, Aug. 4, 2002, at C4. In a recent decision, a U.S. district court in Houston ruled that certain investment banks and law firms, including Citigroup, J.P. Morgan Chase, Merrill Lynch, and Vinson & Elkins, could be sued by Enron investors. See *In Re Enron Corp. Secs., Derivative & Erisa Litig.*, 235 F.Supp 2d 549 (S.D. Tex. 2002); Kurt Eichenwald, *Ruling Leaves Most Players Exposed to Suits on Enron*, N.Y. TIMES, Dec. 21, 2002, at C3.

2. Most notably, the Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002), requires the SEC to promulgate rules concerning auditor independence, requiring lawyers to report wrongdoing by public companies, and ensuring the independence of stock analysts. For a somewhat skeptical overview, see Lawrence Cunningham, *The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (and It Might Just Work)*, 35 CONN. L. REV. 915. (2003) (discussing the implications of the Sarbanes-Oxley Act).

3. See, e.g., John C. Coffee, Jr., *Understanding Enron: "It's About the Gatekeepers, Stupid,"* 57 BUS. LAW. 1403, 1409–12 (2002) (positing that the decline in auditors' liability costs during the 1990s is a plausible explanation for recent widespread auditor failures to prevent fraud). The failures uncovered by those scandals go beyond the performance of gatekeepers. See, e.g., Jeffrey N. Gordon, *What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections*, 69 U. CHI. L. REV. 1233 (2002) (exploring the implications of the Enron debacle for corporate governance).

4. One plausible explanation is that private securities litigation is poorly suited, due to the potential for frivolous litigation, to achieving optimal deterrence for issuers and gatekeepers. See, e.g., John C. Coffee, Jr., *The Acquiescent Gatekeeper: Reputational Intermediaries, Auditor Independence, and the Governance of Accounting* 7 (Working Paper, 2001), available at http://papers.ssrn.com/paper.taf?abstract_id=270994; Donald Langevoort, *Deconstructing Section 11: Public Offering Liability in a Continuous Disclosure Environment*, 63 LAW & CONTEMP. PROBS. 45, 53–

crimes and enhanced the penalties on several existing ones.⁶ When it came to gatekeepers, however, Congress opted only to instruct the Securities and Exchange Commission (“SEC”) to further regulate accountants, lawyers, and investment banks.⁷

This failure to expand gatekeeper liability is even more puzzling when one realizes that the strategy of imposing liability on third parties is neither confined to a particular area of law nor limited to specific market participants. Indeed, the ubiquitous need to improve enforcement has presented courts, lawmakers, and academics with a host of difficult third-party liability dilemmas, including the following: Should lenders be responsible for cleanup costs when polluting borrowers lack the resources to pay?⁸ What is the appropriate scope of liability for a service provider that enables Internet users to swap unauthorized copies of copyrighted music?⁹ Under what conditions, if at all, should handgun manufacturers be liable for damages resulting from the criminal misuse of a firearm?¹⁰ Finally, how far should courts go in holding a bank’s lawyers and auditors responsible when the bank misleads regulators concerning its financial reserves?¹¹

54 (Summer 2000). In Part IV.C, *infra*, I will offer another explanation for the tendency to favor regulation over expanding gatekeeper liability.

5. The Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002).

6. For an overview, see Michael A. Perino, *Enron’s Legislative Aftermath: Some Reflection on the Deterrence Aspects of the Sarbanes-Oxley Act of 2002*, 76 ST. JOHN’S L. REV. 671, 676 (2002).

7. See *supra* note 2. See also John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 7 (Columbia Law & Econ. Working Paper No. 237, 2003), available at <http://www.ssrn.com> (noting that the Sarbanes-Oxley Act did not adopt the strategy of enhancing gatekeeper liability).

8. See, e.g., Michael I. Greenberg & David M. Shaw, Note, *To Lend Or Not to Lend—That Should Not Be the Question: The Uncertainties Of Lender Liability Under CERCLA*, 41 DUKE L.J. 1211, 1211–13 (1992) (reviewing lender liability under U.S. environmental law).

9. See *A&M Records, Inc. v. Napster, Inc.*, 239 F.3d 1004, 1025–27 (9th Cir. 2001) (granting a limited injunction against a company offering a peer-to-peer service); *MGM Studios, Inc. v. Grokster, Ltd.*, 259 F. Supp. 2d 1029 (C.D. Cal. 2003) (holding that vendors of file sharing software are not liable for copyright infringement by users); *In re Aimster Copyright Litig.*, 252 F. Supp. 2d 634 (N.D. Ill. 2002) (granting the music industry an injunction against the operator of an Internet file sharing service).

10. See, e.g., *Hamilton v. Beretta U.S.A. Corp.*, 264 F.3d 21, 25–26 (2d Cir. 2001). For a general analysis of the proper scope of liability imposed on the firearm industry for misuse of firearms, see Paul R. Bonney, *Manufacturers’ Strict Liability For Handgun Injuries: An Economic Analysis*, 73 GEO. L.J. 1437 (1985); Timothy D. Lytton, *Lawsuits Against The Gun Industry: A Comparative Institutional Analysis*, 32 CONN. L. REV. 1247 (2000).

11. See, e.g., Howell E. Jackson, *Reflection on Kaye, Scholer: Enlisting Lawyers to Improve the Regulation of Financial Institutions*, 66 S. CAL. L. REV. 1019, 1021 (1993); David B. Wilkins, *Making Context Count: Regulating Lawyers After Kaye, Scholer*, 66 S. CAL. L. REV. 1145 (1993) (discussing attorney liability in the aftermath of the savings and loan crisis).

Despite its importance, however, the topic of third-party liability has received only scant attention by legal academics.¹² The basic need to expand liability to third parties is generally justified by the failure of primary liability to produce sufficient deterrence.¹³ But while the fundamental reason for expanding liability to third parties is well established, little is known about the appropriate scope of third party liability. Specifically, legal scholarship has little to say about the standard of liability that should apply to third parties.¹⁴

In this Article, I seek to rectify this gap by offering a framework for determining the proper scope of gatekeeper liability. Specifically, I explore the inevitable tradeoff between the costs of gatekeeper liability—disrupting the access of law-abiding clients to the market—and its benefits—inducing third parties to hinder client wrongdoing. I then consider the policy implications of this fundamental tradeoff for devising gatekeeper liability and for evaluating the current regulatory scheme, and illustrate the usefulness of this analysis by exploring the optimal regime of gatekeeper liability for securities fraud.

This Article aims to add several key insights to the analysis of third-party liability. First, the article provides policymakers with a consistent framework for evaluating proposed expansion of liability to third party gatekeepers. While the framework offered here does not produce simple answers for all third party liability problems, it does supply a common metric for evaluating all such schemes that involve gatekeepers, from electronics retailers facing liability for their sale of radar detectors to Big

12. A notable exception is the seminal article by Reinier Kraakman offering important insights concerning gatekeeper liability. See Reinier Kraakman, *Gatekeepers: The Anatomy of a Third Party Enforcement Strategy*, 2 J.L. ECON. & ORG. 53 (1986). In a previous article, I explored third party liability in the context of Internet service providers. See Assaf Hamdani, *Who's Liable for Cyberwrongs?*, 87 CORNELL L. REV. 901 (2002).

A related topic that the literature has explored in depth is vicarious liability. See Jennifer Arlen, *The Potentially Perverse Effects of Corporate Criminal Liability*, 23 J. LEGAL STUD. 833 (1994); Lewis A. Kornhauser, *An Economic Analysis of the Choice Between Enterprise and Personal Liability for Accidents*, 70 CAL. L. REV. 1345 (1982); Alan O. Sykes, *The Economics of Vicarious Liability*, 93 YALE L.J. 1231 (1984). Also, criminal law scholarship has devoted considerable attention to the study of accomplice liability. See, e.g., Sanford H. Kadish, *Complicity, Cause and Blame: A Study in the Interpretation of Doctrine*, 73 CAL. L. REV. 323 (1985) (analyzing accomplice liability in criminal law).

13. See Reinier H. Kraakman, *Corporate Liability Strategies and the Costs of Legal Controls*, 93 YALE L.J. 857, 865–67 (1984) (arguing that third party liability is required to address “enforcement failures” leading to under-deterrence).

14. But see Neal Kumar Katyal, *Criminal Law in Cyberspace*, 149 U. PA. L. REV. 1003, 1095–1101 (2001) (exploring the optimal regime of ISP liability for user crimes); Kraakman, *supra* note 12, at 76 (suggesting that strict gatekeeper liability might be undesirable); William Landes & Douglas Lichtman, *Indirect Liability for Copyright Infringement: Napster and Beyond*, 17 J. ECON. PERSPS. 113 (Spring 2003) (providing a framework for evaluating indirect liability for copyright infringement).

Four accounting firms who turn a blind eye to their clients' fraudulent bookkeeping.

Second, the Article shows that, despite its persistent appeal to both academics and courts,¹⁵ the natural starting point in the quest for the appropriate regime for gatekeeper liability—the economic position favoring strict liability—is likely not the best rule for such liability.

Third, the Article offers general prescriptions concerning the proper scope of gatekeeper liability. Specifically, it explains which third parties should face liability, explores the desirable standard for gatekeeper liability, and highlights the shortcomings of gatekeeper liability as an instrument of social policy.

Finally, the Article demonstrates the potential applications of my framework by outlining the desirable scheme of gatekeeper liability for securities fraud.

The term “gatekeeper” has been assigned different definitions in the past.¹⁶ In this Article, I use this term to refer to parties who sell a product or provide a service that is necessary for clients wishing to enter a particular market or engage in certain activities.¹⁷ The services of auditors and underwriters are practically necessary for a company wishing to offer their shares to the public. Some clients who enter the relevant market will

15. See, e.g., Coffee, *supra* note 7, 67-68 (proposing that gatekeepers (other than lawyers) face strict liability with modified penalties); Ralf Ewert, Eberhard Feess & Martin Nell, *Auditor Liability Rules Under Imperfect Information and Costly Litigation: The Welfare Increasing Effect of Liability Insurance* (Working Draft, 1999) (positing that strict auditor liability is superior to negligence-based liability in ensuring optimal level of auditing); Jane C. Ginsburg, *Putting Cars on the “Information Superhighway”*: *Authors, Exploiters, and Copyright in Cyberspace*, 95 COLUM. L. REV. 1466, 1493-4 (1995) (arguing for imposing strict liability for copyright infringement on commercial ISPs); Trotter Hardy, *The Proper Legal Regime for “Cyberspace,”* 55 U. PITT. L. REV. 993, 1044 (1994) (arguing for imposing strict liability on Internet service providers); Frank Partnoy, *Barbarians at the Gatekeepers?: A Proposal for a Modified Strict Liability Regime*, 79 WASH. U. L.Q. 491, 491 (2001) (proposing a regime of modified strict gatekeeper liability for securities fraud). See also Alfred C. Yen, *Internet Service Provider Liability for Subscriber Copyright Infringement, Enterprise Liability and the First Amendment*, 88 GEO. L.J. 1834, 1851-52 and 1856-57 (2000) (emphasizing that the risk of courts' holding ISPs strictly liable is real).

16. See Kraakman, *supra* note 12, at 53 (defining “gatekeepers” as “private parties who are able to disrupt misconduct by withholding their cooperation from wrongdoers”); Coffee, *supra* note 3, at 1405 (referring to gatekeepers, in the capital market context, as reputational intermediaries who provide verification and certification services to investors).

17. My definition, therefore, closely follows the one used by Kraakman, *id.* I find this broad definition useful for two reasons. First, while many parties subject to secondary liability for securities fraud are indeed reputational intermediaries, this is not the case with respect to parties subject to secondary liability in other areas. Second, starting off with a broader definition is useful for purposes of exploring the important question of which third parties should be subject to liability.

use the services of the gatekeeper only for legal purposes.¹⁸ Others, on the other hand, may engage in unlawful activities. An important challenge for policymakers, therefore, is to induce gatekeepers to prevent wrongdoing while minimizing the disruption of lawful activities.

In Part II, I begin the analysis by exploring the cost of the most expansive standard—strict liability. Ordinarily, in the context of primary wrongdoing, strict liability offers two advantages over negligence-based liability.¹⁹ First, it provides wrongdoers with optimal incentives to exercise precaution while relieving courts from entering the thicket of determining what constitutes “reasonable care” in a given set of circumstances.²⁰ Second, strict liability compels wrongdoers to adopt an optimal level of activity.²¹ In other words, strict liability not only makes potential wrongdoers exercise due care as in negligence schemes, it also forces the wrongdoers to consider whether the activity is worthwhile altogether.

At first sight, these dual advantages seem to make a strong case for holding gatekeepers strictly liable whenever their clients act unlawfully. Consider the liability of auditors for securities fraud, for example.²² Strict liability, the argument goes, will provide accounting firms with the incentive to implement the optimal combination of measures aimed at detecting client fraud without imposing an onerous burden on courts.²³

18. For expositional convenience, I shall refer throughout to the gatekeeper as offering a service and to clients as entering a market.

19. By “negligence-based” liability, I mean all standards under which gatekeepers will be held liable for client misconduct only when they fail to comply with a standard of conduct set by the government—either by courts (under negligence) or by regulators (under some form of regulation). On the choice between negligence and regulation in the context of third party liability, see Hamdani, *supra* note 12, at 935–36.

20. See Steven Shavell, *ECONOMIC ANALYSIS OF ACCIDENT LAW* 4 (1987).

21. See *id.* at 5–7; Steven Shavell, *Strict Liability v. Negligence*, 9 J. LEGAL STUD. 1, 2–3 (1980). In this Article, I generally assume that only wrongdoers should be provided with incentives to prevent harm. Where both wrongdoers and victims can affect the likelihood of harm, the need to provide victims with incentives to take care may undermine the superiority of strict liability. See *id.* at 6.

22. Following existing doctrine, this Article generally proceeds under the assumption that holding gatekeepers liable for securities fraud is justified. It has been argued, however, that market forces would result in the optimal level of gatekeeper screening and monitoring even in the absence of legal intervention. See Victor P. Goldberg, *Accountable Accountants: Is Third Party Liability Necessary?*, 17 J. LEGAL STUD. 295, 300–01 (1988). See also Stephen Choi, *Market Lessons for Gatekeepers*, 92 NW. U. L. REV. 916, 949–52 (1998) (proposing a self-tailored regime of gatekeeper liability for securities fraud). As I explain in Part V, however, the existence of a market relationship between investors and issuers does have implications for the optimal regime of gatekeeper liability for securities fraud.

23. See, e.g., Partnoy, *supra* note 15, at 514 (contending that imposing strict liability for securities fraud on underwriters, auditors, and lawyers would provide those gatekeepers with superior incentives to scrutinize issuers). But see Coffee, *supra* note 3, at 1407 n.21. 11 (criticizing Partnoy’s proposal).

Moreover, since they control access to capital markets, making auditors pay for issuer fraud will guarantee that issuers will offer shares to the public only when it is socially desirable to do so. To the extent that they cannot stop issuers from misleading investors, accounting firms will increase their fees and require each issuer to pay, *ex ante*, the expected social cost of its fraud. Thus, the only issuers to go public will be those for whom the value of public financing exceeds the harm caused by fraud.²⁴

Although intuitively appealing as a means to screen out wrongdoers, the fee hike triggered by gatekeeper liability may turn out to have negative consequences. Thus, as Part II will explain, strict liability is a potentially costly tool for inducing gatekeepers to thwart client misconduct.²⁵

As a practical matter, auditors will inherently lack the information necessary to assess precisely the likelihood of fraud by each prospective issuer. Thus, they will charge all issuers a fee based on the average likelihood of fraud by unseasoned companies as a whole. Put differently, the fee imposed on each issuer will not equal the expected social harm such issuer may cause. Accordingly, holding gatekeepers strictly liable will not guarantee that clients enter the market only when it is socially desirable to do so.

In the economic jargon, this phenomenon is referred to as the *adverse selection* problem. As the literature on adverse selection shows, the precise impact of the increase in gatekeeper fees on the relevant market—and thus on social welfare—will depend on a range of market-specific characteristics. This Article will focus on three plausible outcomes:²⁶ Gatekeeper liability may drive out only law-abiding clients and leave intact the number of wrongdoers. Alternatively, it may lead to the unraveling of the relevant market. Finally, it may have no impact on the number and quality of clients entering the market.²⁷

24. For an example of an article applying this logic to third parties, see Hardy, *supra* note 15, at 1045 (contending that imposing strict liability on ISPs will make them internalize the social costs of wrongdoing and adjust the scope of their activity accordingly).

25. For other works identifying potential costs of strict liability, see Arlen, *supra* note 12, at 833–37, 840–50; Jennifer Arlen & Reinier Kraakman, *Controlling Corporate Misconduct: An Analysis of Corporate Liability Regimes*, 72 N.Y.U. L. REV. 687, 689–91 (1997); Oren Bar-Gill & Assaf Hamdani, *Optimal Liability for Libel*, 2 CONTRIBUTIONS TO ECON. ANALYSIS & POL'Y (2003), at <http://www.bepress.com/cgi/viewcontent.cgi?article=1065&context=bejeap>; Keith N. Hylton, *A Missing Markets Theory of Tort Law*, 90 NW. U. L. REV. 977, 982–84 (1996).

26. As Part II will more fully explain, this list is not a conclusive one. Its goal is merely to demonstrate the range of potential consequences arising from the impact of liability on gatekeeper pricing.

27. As the analysis below demonstrates, the potential for market distortions exists to a lesser degree even under a negligence-based regime. See *infra* Part III.B.

Legal commentators have long recognized that gatekeeper liability may affect the market for gatekeeper services. Yet, there seems to be little agreement over the precise nature of this effect. Some have argued that gatekeepers, to minimize their exposure to liability, will refuse to contract with clients who intend to commit misconduct.²⁸ Others have maintained that gatekeeper liability will prevent access to the relevant market for clients with no wrongful intentions, and might even lead to the collapse of the market for gatekeeper services.²⁹ This Article, in contrast, shows that neither of these approaches is categorically correct. Instead, I identify the set of market-specific factors that would determine the precise impact of gatekeeper liability.

Having uncovered the potential for market distortions, I explore in Part III the benefits of expanding gatekeeper liability. Strict liability induces gatekeepers to take adequate measures to prevent client misconduct while relieving the government of the daunting task of identifying such measures and observing gatekeeper compliance. This advantage is particularly appealing in the gatekeeper setting, where the government is likely to err in identifying the appropriate combination of screening, monitoring and perhaps even product and organizational design measures that gatekeepers should implement. The benefits of strict gatekeeper liability thus depend on the extent to which the government lacks the information necessary for implementing a negligence-based regime.

In Part IV, I consider the policy implications of the analysis. First, I explore the question of which third parties should be designated as gatekeepers and held accountable for their clients' wrongdoing. Concretely, I will argue that third parties should face liability only if they can both (i) distinguish law-breaking from law-abiding clients at a reasonably low cost, and (ii) cheaply prevent wrongdoing.³⁰

28. See, e.g., Bruce A. Lehman, Report at WORKING GROUP ON INTELLECTUAL PROPERTY RIGHTS, in INFORMATION INFRASTRUCTURE TASK FORCE, INTELLECTUAL PROPERTY AND THE NATIONAL INFORMATION INFRASTRUCTURE 114–124 (1995) (advocating the application of strict liability to ISPs for subscriber copyright infringement).

29. See *id.* at 116 (noting the concern that imposing strict liability on Internet service providers would drive service providers out of business and result in the failure of the Internet); JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET 77 (2d ed. 1995) (reporting concerns that the imposition of liabilities on gatekeepers under the Securities Act of 1933 would dry up American capital raising); Michael P. Dooley, *The Effects of Civil Liability on Investment Banking and the New Issues Market*, 58 VA. L. REV. 776, 776–7 (1972) (noting the concern that the expansion of liability to underwriters would “discourage practically all financing”).

30. The analysis thus extends the point made by Kraakman. See Kraakman, *supra* note 12, at 61 (positing that liability should be imposed on gatekeepers who can and will prevent misconduct reliably and whom legal rules can induce to prevent misconduct at a reasonable cost).

Most importantly, I outline the set of considerations that should guide policymakers in choosing liability standards for gatekeepers. When the government possesses the necessary information, negligence-based liability will result in optimal monitoring without disrupting market access by law-abiding clients. On the other hand, gatekeepers undoubtedly should face strict liability when they can either (i) price-discriminate among prospective clients based on their likelihood of engaging in misconduct, or (ii) take steps that would eliminate wrongdoing by all clients.

In all other cases, the proper scope of gatekeeper liability will be determined by balancing the potentially adverse impact of gatekeeper liability on relevant markets against the incentives such liability provides for gatekeepers to foil wrongdoing. As the measures that gatekeepers can adopt to reduce their liability exposure become more effective in preventing misconduct, moving in the direction of strict liability becomes more appealing. On the other hand, when gatekeeper compliance costs are sufficiently large, even a negligence-based standard will be too costly.

Since devising an optimal regime of gatekeeper liability requires an answer to a complex set of empirical questions, policymakers will likely make their decision under conditions of uncertainty.³¹ Granted the potential for substantial costs associated with gatekeeper liability, policymakers responding to enforcement failures can resort to two relatively safe strategies: adopting knowledge-based standards, and explicitly requiring gatekeepers to implement policing measures that are known to be cost effective.

Finally, I show that the inevitable tradeoff between preventing misconduct and market distortions undermines the value of gatekeeper liability as an instrument of social policy, thereby making other strategies, such as government regulation, a relatively appealing alternative.

In Part V, I utilize this Article's framework to outline a proposed scheme of secondary liability for securities fraud, focusing on the liability of gatekeepers under Rule 10b-5.³² The general prohibition on fraud under Rule 10b-5 covers an unlimited number of transactions and an undefined range of capital market participants. Granted this far-reaching scope, expanding gatekeeper liability is a recipe for both benefits—since the government cannot set standards that would apply to all conceivable ways

31. See also Lucian A. Bebchuk & Assaf Hamdani, *Optimal Defaults for Corporate Law Evolution*, 96 NW. U. L. REV. 489 (2002) (exploring the default rules of corporate law that should be adopted under conditions of uncertainty).

32. Employment of "Manipulative and Deceptive Devices," 17 C.F.R. § 240.10b-5 (2001).

in which companies may mislead investors—and costs—since the impact on fees will be substantial.

The regime that I propose, therefore, consists of three basic elements. First, the sweeping prohibition on fraud under Rule 10b-5 should be coupled with a knowledge-based standard for gatekeeper liability. Thus I would keep the current standard of gatekeeper liability intact, but reinstate the doctrine of aiding and abetting liability for securities fraud. Second, the SEC should continue with the limited practice of regulating gatekeepers with respect to practices that are clearly either desirable or undesirable. Finally, auditors should be required to certify the annual reports of their clients. If they fail to detect fraud in such reports, auditors will face strict liability, but will be entitled to a due diligence defense and to rely on the opinions of other experts.

II. COSTS: MARKET DISRUPTION

Strict liability makes defendants internalize the full social cost of misconduct. In the context of primary liability, this attribute of strict liability is beneficial as it makes defendants adopt optimal activity levels. As this Part explains, however, this insight does not extend to gatekeeper liability. Concretely, I demonstrate in this Part that making gatekeepers internalize the cost of wrongdoing will likely drive law-abiding clients out of the relevant market.³³

Section A introduces the basic setting analyzed in this Part and explains why ex post risk shifting between gatekeepers and wrongdoers is unlikely to occur. Section B shows that strict gatekeeper liability is optimal when gatekeepers can tailor fees to each client's likelihood of committing misconduct. Section C explores the case in which gatekeepers cannot distinguish between clients based on their likelihood of wrongdoing.

33. Economists have studied the effect of lender liability on the market for loans. The loan market, however, differs from the gatekeeper context in two major respects, which have implications for the design of liability rules. First, borrowers repay their loans at the end of the period. Thus, subjecting lenders to liability, and the resulting increase in interest rates, might further induce borrowers to engage in misconduct. See Rohan Pitchford, *How Liable Should a Lender Be? The Case of Judgment-Proof Firms and Environmental Risks*, 85 AM. ECON. REV. 1171, 1173 (1995). Second, if borrowers have some initial wealth, lender liability might actually induce riskier borrowers to leave the market. See Anthony G. Heyes, *Lender Penalty for Environmental Damage and the Equilibrium Cost of Capital*, 63 ECONOMICA 311, 315-16 (1996).

A. THE GATEKEEPER SETTING

In this Part, I focus on the following basic setting. Gatekeepers offer a service or sell a product that is necessary for clients wishing to enter a particular market or engage in certain activities.³⁴ Under this definition, gatekeepers might include accounting firms providing auditing services necessary for firms wishing to offer shares to the public and the makers of personal computers that consumers must use to access the Internet.³⁵ Once they enter the market, clients might commit misconduct. Firms going public may defraud investors, and the owner of a personal computer might use it to access the Internet and distribute bootlegged copies of recently released films.

Clients, however, might enter the market for perfectly lawful purposes. For simplicity, assume that prospective clients are of two types with respect to their likelihood of committing misconduct. Good, or law-abiding, types have no intention of committing misconduct. Bad types, or wrongdoers, will commit misconduct with certainty.³⁶ Moreover, from a wrongdoer's perspective, the sole value of engaging in the relevant activity, or of entering the market, is the expected gain from misconduct. Wrongdoing is strictly undesirable; the benefit associated with wrongdoing is always lower than the resulting social harm.³⁷

34. The analysis assumes that the services of the gatekeeper are *necessary* for entering a particular market. Realistically, however, this assumption often turns on the cost of entering a market without the services of the gatekeeper. Furthermore, relaxing this assumption might lead to interesting results. For example, when the services of a gatekeeper are optional, but gatekeepers can reduce the risk of wrongdoing, it might be socially desirable to reduce the scope of gatekeeper liability to encourage clients to hire gatekeepers. See Kraakman, *supra* note 12, at 77 (noting the risk that gatekeeper liability will lead clients to waive the use of gatekeeper services). The analysis of this unique case is beyond the scope of this Article.

35. The Article does not distinguish between gatekeeping functions arising out of market conditions—securities underwriting, for example—and such functions mandated by law—such as auditor certification of the reserves of financial institutions and ratings by bond rating agencies. For an analysis of this distinction, see Kraakman, *supra* note 12, at 61–62. See also Merritt B. Fox, *Rethinking Disclosure Liability in the Modern Era*, 75 WASH. U. L.Q. 903, 913–17 (1997) (advocating a regime of underwriter certification of annual reports of public companies); Luigi Alberto Franzoni, *Independent Auditors as Fiscal Gatekeepers*, 18 INT. REV. LAW & ECON. 365 (1998) (developing a model to determine when mandating taxpayers to use gatekeepers is socially desirable); John C. Coffee, Jr., *The Attorney as Gatekeeper: An Agenda for the SEC*, 103 COLUM. L. REV. 1293, 1312–15 (2003) (proposing that the SEC impose limited certification requirements on attorneys responsible for preparing a disclosure statement or report filed with the SEC).

36. Put differently, the assumption is that the *ex ante* likelihood of wrongdoing is exogenous. The reasons underlying the difference between client types may be differences in tastes for wrongdoing, differences in levels of income, or the extent to which nonlegal constraints, such as social norms and reputational concerns, bind a particular client.

37. These assumptions, which suggest that wrongdoers are motivated by the prospect of misconduct to enter the market, that wrongdoing is intentional, and that wrongdoers should not enter the

Law-abiding clients vary in the value they attach to entering the market. To simplify the analysis, I will assume that law-abiding clients are divided into two types with respect to their benefit from entering the market: those that attach a small value to the relevant market, and those that attach a large value to the relevant market. The market for gatekeeper services is competitive.³⁸ Gatekeepers, therefore, price their services to recover their marginal cost of providing the service and their expected liability.³⁹

A critical premise underlying this Article's analysis is that wrongdoers are judgment proof. In other words, they will have no assets to pay the penalty or the damages for misconduct.⁴⁰ Under this assumption, primary liability—imposing liability for securities fraud exclusively on issuers, for example—would fail to prevent wrongdoers from committing misconduct. This assumption, therefore, provides the standard justification for expanding liability to gatekeepers.⁴¹ The analysis will thus focus on the appropriate scope of gatekeeper liability and not on the basic justification for holding gatekeepers liable.⁴²

For expositional convenience, it will be useful to consider the following example. An entrepreneur wishing to take her company public approaches a law firm and asks it to represent the company in its IPO.⁴³ At

market, might not capture all cases of wrongdoing. Yet they provide a useful starting point for exploring the effect of gatekeeper liability when it is clear that wrongdoers should not enter the relevant market. The usefulness of these assumptions and the implications of relaxing them are discussed *supra* Part II.C.

38. This assumption implies that there will be no bargaining between gatekeepers and clients concerning the fees charged by the gatekeeper. On the implications of such bargaining, see Heyes, *supra* note 33, at 319–22.

39. See also Ronald A. Dye, *Auditing Standards, Legal Liability, and Auditor Wealth*, 101 J. POL. ECON. 887, 908 (1993) (arguing that auditors will price their services according to the audit cost and their expected liability); Ananth Seetharaman, Ferdinand A. Gul & Stephen G. Lynn, *Litigation Risk and Audit Fees: Evidence from UK Firms Cross-listed on US Markets*, 33 J. ACCT. & ECON. 91, 93 (2002) (reporting evidence that litigation risk affects audit pricing).

40. The assumption that wrongdoers have no assets, and thus would have virtually no incentive to avoid misconduct, is made for simplicity. For a formal analysis of the implications of asset insufficiency for deterrence, see Steven Shavell, *The Judgment-Proof Problem*, 6 INT. REV. LAW & ECON. 45 (1986); Comment, *The Case of the Disappearing Defendant: An Economic Analysis*, 132 U. PA. L. REV. 145 (1983).

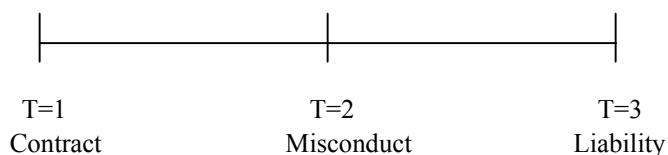
41. See Kraakman, *supra* note 13. Another justification is that primary wrongdoers are difficult to detect and hold liable. See e.g., Jonathan Zittrain, *What the Publisher Can Teach the Patient: Intellectual Property and Privacy in an Era of Trusted Privication*, 52 STAN. L. REV. 1201, 1207–08 (2000) (describing the cost of prosecuting Internet users that engage in copyright infringement).

42. See also *supra* note 22.

43. For expositional convenience, this example abstracts from the potential impact of the dual role of victims as purchasers of stock on the cost and benefits of gatekeeper liability. The implications of this dual role are discussed *infra* in Part V.A.

time T=1, the law firm decides whether to serve as the issuer counsel in the IPO and what fees to charge for such representation. At time T=2, the company files its registration statement with the SEC; the registration statement might include misleading statements or other material inaccuracies, thereby subjecting the issuer and its counsel to liability. At time T=3, if misleading statement have been made by the company, investors will bring suits against the issuer and its law firm.⁴⁴ Both the company and the entrepreneur will be judgment-proof at time T=3. Figure A describes this basic example.

Figure A



Holding third parties liable might affect primary wrongdoers in a myriad of ways. For example, imposing liability on third parties might encourage them to ensure that potential wrongdoers have sufficient wealth to pay the sanctions associated with misconduct.⁴⁵ The analysis in this Part, however, will be restricted to one dimension through which gatekeeper liability might prevent wrongdoing—the impact of such liability on the terms under which gatekeepers will take on clients and on the related decision of prospective clients to enter the market. Hence, with respect to the IPO example, this Part will explore how holding law firms liable for client fraud will affect capital markets.

To achieve this goal, this Part assumes that gatekeepers can neither police client conduct nor screen prospective clients to detect wrongdoers.⁴⁶ In the IPO example, this assumption implies that at time T=2 the law firm cannot independently investigate the accuracy of statements made by the issuer and prevent it from including inaccurate and misleading statements

44. For a comprehensive review of the liability of lawyers under the 1933 Act, see ROBERT J. HAFT, *LIABILITY OF ATTORNEYS AND ACCOUNTANTS FOR SECURITIES TRANSACTIONS*, Ch. 1 (2003).

45. See Kraakman, *supra* note 13, at 868–71. On the desirability of limiting market entry to clients with sufficient wealth, see Steven Shavell, Minimum Asset Requirements (Harvard Olin Discussion Paper No. 389, 2002), *available at* www.ssrn.com.

46. Likewise, gatekeepers cannot offer prospective clients contracts that would either screen out prospective wrongdoers or provide them with incentives to forego misconduct. In the latter respect, the case here differs from the one under liability insurance. Cf. Steven Shavell, *On the Social Function and the Regulation of Liability Insurance*, 25 *GENEVA PAPERS ON RISK & INS.* 166, 167–72 (2000) (providing one example of how liability insurance can incentivize foregoing misconduct).

in its SEC filings. Stated differently, the cost of such investigation, which the analysis will take to be exogenous, is prohibitive. Likewise, the law firm is incapable of scrutinizing entrepreneurs at time $T=1$ to determine whether they have unlawful intentions. Under this assumption, which will be relaxed in Part III, the sole decision made by gatekeepers is whether, and under what terms, to offer their services to prospective clients.

Although this no-monitoring assumption might seem too restrictive, exploring gatekeeper liability under these conditions is useful for two reasons. First, there are many cases in which gatekeepers, although capable of preventing misconduct by denying access to the market, cannot police client behavior and stop clients wishing to do so from committing misconduct. Manufacturers of personal computers, for example, generally lack the capacity to monitor and prevent the unlawful use of their products by those who purchase them.⁴⁷ Under these circumstances, one might still argue that gatekeeper liability is desirable because it ensures that only clients for whom the benefit captured by entering the market exceeds social costs will use the services of the gatekeeper. Uncovering the precise impact of gatekeeper liability under the no-monitoring assumption will illuminate whether, and to what extent, such gatekeepers should be held liable.

Second, even where monitoring client conduct is practical, such monitoring will not always allow gatekeepers to prevent fully all instances of wrongdoing. Auditors, for example, do have the ability to scrutinize an issuer to determine whether its financial statements comply with accounting principles and accurately reflect its revenues and expenses. Yet even auditors making appropriate investigations might fail to identify all misstatements by management.⁴⁸ The assumption that monitoring is impossible serves as a useful starting point for evaluating the effect of gatekeeper liability in those cases in which, notwithstanding their monitoring effort, gatekeepers will fail to prevent client misconduct.

Before proceeding to analyze gatekeeper liability in this setting, I would like to address the possibility of risk-shifting ex post. The analysis of secondary liability should commence with the basic Coasean insight: The legal allocation of liability should not matter when gatekeepers and wrongdoers are parties to a contract because the parties can assign liability

47. In principle, computer manufacturers might be able to design their computer in a manner that would interfere with the use of computers for unlawful purposes. If this indeed is the case, holding computer manufacturers strictly liable for user misconduct may provide them with optimal incentives to offer such design. This advantage of strict gatekeeper liability is discussed in Part III.A *infra*.

48. See, e.g., Roger Lowenstein, *Even Vigilant Gatekeepers Can Blow It*, WALL ST. J., Oct. 10, 1996, at C1 (discussing one case in which the current system of gatekeeping failed).

to its optimal target.⁴⁹ This logic implies, for example, that if the issuer is the optimal target of liability, the issuer and its attorney will privately shift the cost of liability to the issuer even if the law imposes liability on the attorney. In the remainder of this section, I argue that this insight, although useful as an analytical starting point, is unlikely to apply to gatekeeper liability.

When risk-shifting is indeed costless, strict gatekeeper liability is clearly superior to alternative standards of liability, such as negligence and knowledge-based liability. Under strict liability, the law firm in the IPO example would be required to pay the full social harm associated with the issuer's fraud. The law firm would in turn ask its client for indemnification. Since issuers would ultimately indemnify the law firm for its liability costs, which by hypothesis would equal social harm, they would refrain from engaging in fraud. By contrast, under negligence, the issuer will incur the cost of its fraud only in a limited set of cases where the law firm turns out to be negligent. Accordingly, the issuer might find it worthwhile to defraud investors when its law firm is liable under a negligence-based regime.

Gatekeepers, however, will find it very costly to shift the effective cost of liability to primary wrongdoers. As mentioned earlier,⁵⁰ gatekeeper liability is introduced where the legal system is unable to subject primary wrongdoers to optimal penalties because those wrongdoers either are judgment-proof or cannot be detected. A scenario where risk-shifting is costless *and* gatekeeper liability is necessary is therefore unrealistic.⁵¹ Specifically, full *ex post* risk-shifting will be plausible only when the gatekeeper has superior ability to the state (or the victim bringing the suit) to detect wrongdoers or to coerce wrongdoers into paying for harm they cause.

49. This starting point is analogous to the starting point of the literature on vicarious liability - under costless risk shifting, the legal allocation of liability between the employer and the employee doesn't matter. See Lewis A. Kornhauser, *An Economic Analysis of the Choice Between Enterprise and Personal Liability for Accidents*, 70 CAL. L. REV. 1345, 1347-48 (1982); Alan O. Sykes, *The Economics of Vicarious Liability*, 93 YALE L.J. 1231, 1239-41 (1984).

50. See *supra* notes 40-42 and accompanying text.

51. The analysis focuses on practical obstacles to risk shifting. In some instances, courts may impose legal limitations on the parties' ability to enter into indemnification agreements. See, e.g., *Globus v. Law Research Servs., Inc.*, 418 F.2d 1276, 1288 (2d Cir. 1969) (holding that the policy underlying the Securities Act of 1933 renders void an indemnification agreement to the extent that it covers fraudulent conduct).

Granted its power to imprison wrongdoers, the state is likely to possess greater coercive power than gatekeepers.⁵² To be sure, gatekeepers' contractual relationships with their clients might put them in a better position than victims or courts to uncover the identity of wrongdoers. This superior ability, however, does not mean that gatekeepers should face strict liability for the social harm caused by primary wrongdoers. Instead, since courts have greater power to coerce defendants into paying for harm they cause, gatekeepers' ability to identify wrongdoers will be best utilized by requiring them to provide courts with whatever information they possess.⁵³

In principle, then, strict gatekeeper liability will result in the first-best level of deterrence if gatekeepers are able to secure full indemnification at time $T=3$. But given the enforcement failures that require the expansion of liability to third parties, it is very unlikely that gatekeepers will indeed be able to shift their liability costs to their clients *ex post*. Accordingly, in the remainder of this Part, I explore the effect of gatekeepers' attempts to shift their liability costs to their clients *ex ante*.

B. PRICE DISCRIMINATION

The initial appeal of strict gatekeeper liability is premised on the assumption that a fee increase under such a regime will make wrongdoers internalize, *ex ante*, the expected cost of their misconduct. As this section explains, this intuition is correct in the ideal case in which gatekeepers can tailor their fees to the likelihood of misconduct characterizing each client.⁵⁴ In the next section, I will argue that this intuition does not apply in the case

52. See also A. Mitchell Polinsky & Steven Shavell, *Should Employees Be Subject to Fines and Imprisonment Given the Existence of Corporate Liability?*, 13 INT'L REV. L. & ECON. 239, 250–51 (1993) (justifying criminal liability of corporate employees when their limited wealth makes the state, through the use of imprisonment sanctions, more effective than employers in providing employees with incentives to avoid misconduct). There are two exceptions to that observation. First, the parties might have a long-term contractual relationship that enables third parties to overcome the limited wealth of the primary wrongdoer by denying the wrongdoer future products or services. Third parties may be better positioned than the state when the sanction they impose on the primary wrongdoer is the withholding of future exchange opportunities. Second, third parties might employ various bonding mechanisms that would enable them to obtain full indemnification in case primary wrongdoers commit misconduct. Bonding mechanisms, however, are costly. See *infra* Part III.D.3.

53. In a recent decision, a federal district court ordered Verizon to disclose the identity of an alleged peer-to-peer pirate to the music industry. See *In re Verizon Internet Servs.*, 257 F. Supp. 2d 244, 246–47 (D.D.C. 2003), *stay pending appeal vacated by* Recording Indus. Ass'n of Am. v. Verizon Internet Servs., 2003 WL 21384617 (D.C. Cir. June 4, 2003). See Declan McCullagh, *RIAA Wins Battle to ID Kazaa User*, CNET NEWS.COM, at <http://news.com.com/2100-1023-981449.html> (Jan. 21, 2003).

54. The analysis also applies to the case in which prospective clients are homogenous with respect to their risk of wrongdoing.

in which gatekeepers cannot distinguish between clients based on their wrongful intentions.

Strict liability and negligence differ in their effect on the price charged by the gatekeeper for its services. Under strict liability for client fraud, the law firm will be required to pay damages for all cases of fraud committed by its client. Recognizing its inability to verify the accuracy of the disclosure the company makes at $T=2$, the law firm will seek to compensate itself *ex ante* for its expected liability costs at $T=3$. Conversely, under negligence-based liability, the law firm will incur no liability costs (under the assumption that it cannot verify the accuracy of the statements made by the issuer). Accordingly, it would have no reason to add any liability premium to its fee.

Under symmetric information, strict gatekeeper liability guarantees that clients will enter the relevant market only when the value they capture by entering the market exceeds the social harm they might cause. The logic is simple. Aware of the likelihood that any given prospective client would engage in misconduct, gatekeepers would charge each client a fee that equals the expected liability cost arising from rendering services to that particular client. If gatekeepers are liable for the full social harm produced by client misconduct, the fees that they will charge each client will equal the social harm associated with that client. This in turn will ensure that only clients for whom the value of accessing the market exceeds the expected social harm they produce will use the services of the gatekeeper.⁵⁵

This argument is best illustrated by the following numerical example. Assume that the marginal cost of representing a company in its IPO is 100, the cost of investigating statements made by the company is prohibitive, and the harm associated with fraud (and the sanction for fraud) is 2,000. Companies of law-abiding entrepreneurs commit no fraud. Companies of wrongdoer entrepreneurs always commit fraud. Any fraud is ultimately detected, and the law firm will be held liable.⁵⁶ The benefit derived by an

55. The analysis assumes that the gatekeeper can enforce its differential pricing policy, *i.e.*, that clients cannot engage in arbitrage whereby a law-abiding client would pay the lower fee and then have the wrongdoer use the service. See JEAN TIROLE, *THE THEORY OF INDUSTRIAL ORGANIZATION* 142–52 (1988) (reviewing the arbitrage constraint on nonlinear pricing strategies). Clients are more likely to engage in arbitrage where the gatekeeper sells a product—a modem, for example—that enables purchasers to engage in unlawful activity—downloading child pornography from the Internet, for example. Arbitrage would be difficult with respect to certain services—such as auditing or legal representation—that require direct, ongoing interaction between gatekeepers and clients.

56. When the probability of detection is lower than one, the optimal penalty should be such that the expected penalty remains equal to social harm. That is, the sanction should equal social harm multiplied by the inverse of the probability of detection. See Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76 *J. POL. ECON.* 169 (1968).

entrepreneur from committing fraud is 500, say from using the proceeds of the offering for buying a luxurious apartment rather than investing them in projects on behalf of the company. Law-abiding entrepreneurs, in contrast, derive a more modest value from an IPO, as they plan on investing the proceeds in the company's business and enjoy larger salaries only in the future, if such an investment turns out to be successful. Specifically, 25% of the law-abiding entrepreneurs (or 20% of all entrepreneurs) will derive a value of 200 from going public, and 75% of them (or 60% of all entrepreneurs) derive a value of 400.

From society's perspective, it is clear that all law-abiding entrepreneurs should take their companies public because the value they attach to doing so exceeds the cost of raising capital. Wrongdoers, in contrast, should not go public because the benefit derived by a wrongdoer, 500, is smaller than the harm the wrongdoer will surely cause, 2,000.

Under symmetric information, this desirable outcome will be achieved by subjecting law firms to strict liability for client fraud. The only decision that entrepreneurs make in this scenario (in which gatekeepers cannot require entrepreneurs to take preventive effort to reduce the risk of fraud) is whether to take their companies public. The expected sanction for fraud does not affect wrongdoers directly because, by hypothesis, they are judgment-proof and thus will not incur liability costs if they commit fraud.⁵⁷ Rather, the decision of an entrepreneur to take her company public would be affected by the value she attaches to public financing and the fees charged by the law firm.

The law firm knows whether an entrepreneur is a wrongdoer or law-abiding. Under strict gatekeeper liability, the law firm would impose a fee of 2,100 ($100 + 2,000$) on a wrongdoer and a fee of 100 on a law-abiding issuer. The liability premium imposed on wrongdoers under strict liability, 2,000, equals the expected social harm from fraud. Therefore, strict gatekeeper liability would ensure that companies offer their shares to the public only when the expected cost of doing so is smaller than the corresponding social benefit. Put differently, strict gatekeeper liability ensures that the decision by companies to go public will be optimal.

Under the assumption that wrongdoers should not enter the market—i.e., that the gain that wrongdoers capture from misconduct is always lower than the social harm they cause—this effect of gatekeeper liability is

57. One might argue that, under the assumptions made thus far, there will be no reason why all companies will not commit fraud. For a discussion of plausible reasons for why law-abiding entrepreneurs might refrain from wrongdoing even in the absence of an effective sanction, see footnote 37, *supra*.

socially desirable. This is because gatekeeper liability prevents wrongdoer entrepreneurs from taking their companies public without interfering with the decision of law-abiding entrepreneurs whether to proceed with an IPO. Stated differently, gatekeeper liability eliminates issuer fraud without adversely affecting capital markets.

This desirable outcome would not be achieved under a negligence-based regime. Under such a regime, both law-abiding and wrongdoers would be charged a fee of 100. This fee, in turn, will have no impact on the decision of prospective clients, whether wrongdoers or law-abiding, to enter the market. Thus, in the remainder of this Part, I will assume that gatekeepers are held strictly liable for client misconduct.

The premise underlying this Part is that wrongdoers should not enter the market. In some cases, however, it may be socially desirable for wrongdoers to enter the market notwithstanding the risk of misconduct. The analysis thus far has assumed that wrongdoers commit misconduct with certainty and that the sole value wrongdoers attach to the market is the benefit they derive from misconduct. But some clients entering the market might wish to engage in both lawful and unlawful activities. Consider Internet users, for example. Those who use the Internet to publish hate speech may also use the Internet for lawful purposes, such as sending emails to friends or reading the news. If the sum of the values of all uses—lawful and unlawful—exceeds the social harm from misconduct, wrongdoers should enter the market notwithstanding their intentions to commit misconduct.⁵⁸

Under these circumstances, strict liability would produce neither costs nor benefits. On the benefit side, making wrongdoers pay for the expected social harm would have no impact on misconduct. On the cost side, strict gatekeeper liability would not distort client market entry decisions. Under conditions of symmetric information, therefore, strict gatekeeper liability would never be costly and would thus tend to be desirable.⁵⁹

58. More generally, under these circumstances charging fees that equal expected social harm as a precondition to entering the market will not result in the first-best level of deterrence, which will be achieved only when wrongdoers pay for harm they cause upon committing misconduct. This, however, is unlikely to happen if wrongdoers are judgment-proof.

59. The text abstracts from administrative costs. When administrative costs are present, strict gatekeeper liability should be adopted under symmetric information only if the social value of regulating entry to the market exceeds the administrative costs associated with a regime of strict gatekeeper liability.

C. THE ADVERSE SELECTION PROBLEM

The analysis in the previous section has assumed that gatekeepers can distinguish among clients and impose differential fees based on their likelihood of committing misconduct. This section, by contrast, explores the potential impact of gatekeeper liability when gatekeepers cannot distinguish between prospective clients based on wrongful intentions. The basic thesis advanced by this section is that, under such conditions of asymmetric information, it is no longer the case that the only clients to enter the market are those for whom the value of the market exceeds expected social harm. Rather, gatekeeper liability may result in a variety of potentially costly scenarios, which this section sets out to explore.

By asymmetric information, I mean that prospective clients hold private information, which they cannot credibly communicate to gatekeepers, about their likelihood of committing misconduct.⁶⁰ That is, gatekeepers do not know whether a prospective client is a wrongdoer or law-abiding. A person purchasing a VCR, for example, will likely know whether she intends to use the VCR for lawful purposes—such as watching movies rented at a video store—or for unlawful purposes—making copies of newly released films for commercial distribution. The manufacturer of the VCR, however, cannot distinguish among purchasers based on their intended use. Gatekeepers, therefore, cannot tailor their fees to the type of client with whom they contract. Instead, they will ask all prospective clients to pay a uniform fee, based on the average likelihood of wrongdoing characterizing the relevant population of prospective clients.

Clearly, in the absence of the information necessary to engage in price discrimination, gatekeeper liability will not guarantee that the decisions of prospective clients, whether wrongdoers or law-abiding, to enter the market would be consistent with the social interest. This is because the fees charged by gatekeepers will no longer reflect the actual probability of wrongdoing characterizing each client.

To economists, these circumstances represent another case of the adverse selection problem.⁶¹ As economic theory shows,⁶² the precise

60. In this Part, I assume that prospective clients cannot signal their type to gatekeepers, and that gatekeepers do not offer prospective clients a menu of contracts that would make such clients reveal their type. In Part III.D *infra*, I analyze the implications of relaxing these assumptions.

61. On the problem of adverse selection generally, see, for example, George A. Akerlof, *The Market for Lemons: Quality Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488 (1970); Michael Rothschild & Joseph Stiglitz, *Equilibrium in Competitive Insurance Markets: An Essay on the Economics of Imperfect Information*, 90 Q.J. ECON. 629 (1976).

impact of asymmetric information on clients' decisions to enter the market cannot be determined a priori. Rather, this effect would be dictated by a set of variables, such as the value attached by wrongdoers and law-abiding clients to entering the market,⁶³ the distribution of wrongdoers and law-abiding clients, and the expected social harm from wrongdoing. In the context of our IPO example, the effect of attorney liability on capital markets will depend on the value attached by wrongdoers and law-abiding entrepreneurs to going public, the proportion of wrongdoers among prospective issuers, and the expected social harm from securities fraud.

In the following subsections, I will rely on the IPO example to illustrate several potential effects of gatekeeper liability when gatekeepers are incapable of distinguishing between clients. I will focus on three plausible scenarios: (i) capital markets unravel; (ii) only certain law-abiding clients abandon the market; and (iii) all clients access the market. The list of scenarios I put forward represents the likely outcomes under the stylized assumptions made thus far, but is by no means a conclusive one. Nevertheless, this list is useful in demonstrating the range of potential consequences of gatekeeper liability under conditions of asymmetric information.

1. Market Unraveling

Imposing liability on gatekeepers will result in the unraveling of the market when the fee hike under gatekeeper liability makes the cost of entering the market exceed the value attached to the market by law-abiding clients. As law-abiding clients start departing, gatekeepers update their fees to reflect the increase in the proportion of wrongdoers in the prospective client pool, which in turn further encourages law-abiding clients to abandon the market. Ultimately, only wrongdoers remain in the prospective client pool. Gatekeepers, however, will further increase their fees to reflect their expected cost of taking on wrongdoers as clients. Under the assumption that the benefit from wrongdoing is smaller than social harm, those fees will exceed the benefit that wrongdoers attach to the market. Thus, wrongdoers will also decline to enter the market.

This state of affairs will emerge when the "liability premium" incorporated into gatekeeper fees is sufficiently large in comparison to the

62. See generally ANDREU MAS-COLELL, MICHAEL D. WHINSTON & JERRY R. GREEN, MICROECONOMIC THEORY 437–43 (1995).

63. As will be explained below, the value attached by clients to entering the market will determine their response to a change in the price of the gatekeeper service. Cf. Landes & Lichtman, *supra* note 14, at 120–21 (emphasizing the importance of elasticity of demand).

value that law-abiding clients attach to accessing the market. Accordingly, other things being equal, the market is likely to collapse when the social harm produced by client misconduct is relatively large, the proportion of wrongdoers among prospective clients is significant, or the value of the market for law-abiding clients is relatively small.

Consider the following example. Wrongdoers constitute 20% of entrepreneurs. Accordingly, the fee charged by a law firm for representing a company going public will be 500 ($100 + 0.2 \times 2,000$). This fee would induce both types of law-abiding entrepreneurs to avoid an IPO and seek capital elsewhere. Once all law-abiding entrepreneurs depart, law firms would realize that the pool of prospective clients consists solely of wrongdoers. Law firms would therefore set their fees to equal their expected costs of representing wrongdoers, 2,100. This in turn would discourage even wrongdoers from taking their companies public. Table I summarizes this example.

TABLE 1. MARKET COLLAPSE

Type	Value of Market	Effective Fee ⁶⁴	Go Public?	Should Go Public?
Law-abiding (low value)	200	500	No	Yes
Law-abiding (high value)	400	500	No	Yes
Wrongdoers	500	2,100	No	No

Having determined that imposing liability on gatekeepers will result in the unraveling of the market, we next should consider the social welfare implications of this outcome. Remarkably, from society's perspective, the unraveling of a market is not necessarily undesirable. To be sure, the departure of law-abiding clients represents a loss that equals the net benefits that the departing clients would have captured by entering the market. Yet, the unraveling of the market also means that wrongdoers no longer cause harm. Whether gatekeeper liability enhances welfare overall will depend how the decrease in social harm associated with blocking wrongdoers measures against the social loss associated with driving out law-abiding clients.

64. By "effective fee," I mean the fee that would have been imposed on a prospective client at the time it has decided to leave the market.

In the IPO example, social welfare under a regime of primary liability—where all clients enter the market—would equal (-120) $\{Social\ welfare = [0.2 \times (500 - 2000)] + [0.2 \times 200] + [0.6 \times 400] - 100\}$, whereas social welfare under gatekeeper liability would equal 0. Thus, holding attorneys liable would actually increase social welfare by 120.⁶⁵

2. Only Law-Abiding Clients Leave

Perhaps the most intriguing scenario is the one under which gatekeeper liability will not only fail to screen out wrongdoers, but also drive only law-abiding clients out of the market. The intuition underlying this outcome is as follows. The increase in fees associated with gatekeeper liability first drives out law-abiding clients for whom the value of the relevant market is relatively low. Once those clients depart, the proportion of wrongdoers among prospective clients increases. Gatekeepers then further increase their fees to reflect the increase in the proportion of wrongdoers in the prospective client pool. The magnitude of this fee hike, however, is insufficient to drive out law-abiding clients for whom the value of the market is high. Instead, those clients will prefer to be pooled with wrongdoers, pay higher fees, and access the market.

The scenario under which only law-abiding clients are driven out will take place if the increase in fees triggered by gatekeeper liability makes such fees exceed the value of the market only for those law-abiding clients for whom the benefit of entering the market is relatively low. Other things equal, this would happen where the range of values that law-abiding clients attach to entering the market is relatively broad, or where the proportion of law-abiding clients with low valuations in the prospective client pool is relatively small.

Consider again the IPO example. Assume that all variables are the same, except for the social harm from fraud, which equals 800. Law firms will initially set their fee at 260 $[100 + (0.2 \times 800)]$. Since this fee exceeds the value of raising capital for entrepreneurs with a low valuation, 200, those entrepreneurs will decline to take their companies public. As law-abiding entrepreneurs with a low valuation depart, the proportion of wrongdoers among prospective issuers increases to approximately 25%, and the fee charged by law firms is adjusted accordingly to 300.⁶⁶ This fee

65. However, as discussed in Part II.C.3 *infra*, the fact that the market collapse outcome is socially desirable does not imply that gatekeeper liability is the best way to achieve this goal.

66. Law-abiding companies with low valuation constitute 20% of prospective issuers. *See supra* text accompanying note 60. After these companies leave the market, the relative share of wrongdoers among prospective issuers equals $0.2 / (0.2 + 0.6) = 0.25$.

is lower than the value of the market for both the remaining law-abiding issuers and wrongdoers. Thus, the sole impact of attorney liability on the market for capital would be that law-abiding entrepreneurs that attach a low value to going public would not offer their shares to the public. Table 2 summarizes this example.

TABLE 2. ONLY LAW-ABIDING LEAVE

Type	Value of Market	Effective Fee	Go Public?	Should Go Public?
Law-abiding (low value)	200	260	No	Yes
Law-abiding (high value)	400	300	Yes	Yes
Wrongdoer	500	300	Yes	No

Under the market collapse scenario, the social welfare implications of gatekeeper liability may vary across markets. Under this scenario, in contrast, gatekeeper liability clearly *reduces* social welfare. Wrongdoers are not prevented from entering the market, whereas law-abiding clients are discouraged from tapping the market. Thus, the sole impact of liability would be to decrease social welfare by an amount equal to the loss associated with discouraging certain law-abiding clients from entering the market.

In our example, social welfare without liability (or under primary liability) equals 120. $\{Social\ welfare = [0.2 \times (500 - 800)] + [0.2 \times 200] + [0.6 \times 400] - 100\}$ With gatekeeper liability, social welfare equals 100. $\{Social\ welfare = [0.2 \times (500 - 800)] + [0.6 \times 400] - [0.8 \times 200]\}$ Imposing strict gatekeeper liability thus reduces social welfare by 20.

One might argue that the scenario in which only law-abiding clients leave the market is unrealistic, since it relies on the assumption that the gain of wrongdoers from defrauding investors is greater than the benefit that law-abiding entrepreneurs derive by taking their companies public. In the absence of evidence concerning the values that entrepreneurs attach to going public, the argument goes, there is no reason to assume that the value for wrongdoers would exceed the value for law-abiding clients. If this

assumption does not hold, it will not be the case that only law-abiding clients depart.⁶⁷

The argument correctly highlights the importance of the assumption that wrongdoers' benefits exceed those of at least some law-abiding clients. This assumption implies that the first to abandon the market upon a fee increase would be law-abiding clients rather than wrongdoers. The argument is also correct in suggesting that the extent to which this assumption is accurate has to be verified empirically. This assumption, however, does not purport to characterize all instances of gatekeeper liability. Rather, this assumption seeks to highlight one of the key elements that will determine the ultimate market impact of gatekeeper liability—the value of market access for different types of clients. Moreover, at least as a starting point, this assumption seems to capture a substantial share of the cases in which gatekeeper liability might be justified.

To begin, this assumption might characterize the cases in which the intent to commit misconduct is the exclusive motivation for clients' desire to enter the market. This could be the case, for example, with respect to entrepreneurs who wish to go public solely to defraud investors.⁶⁸ While law-abiding entrepreneurs will use the proceeds to invest in actual projects, which might turn out to be profitable for both shareholders and the entrepreneur, wrongdoers might simply use the entire proceeds of an IPO for their personal purposes.⁶⁹ At least for the short run—the period immediately following the offering—it seems reasonably likely that the benefits to wrongdoers would exceed those for law-abiding entrepreneurs. Similarly, Internet users who sign up for Internet services solely to engage in misconduct, such as the commercial online distribution of copyrighted

67. See also Landes & Lichtman, *supra* note 14, at 120 (noting that when distinguishing legal from nonlegal copyright activity is prohibitively costly, the social welfare implications of liability for indirect copyright may depend on whether wrongdoers are more sensitive to price changes).

68. The extent to which securities fraud, at least when committed by existing public companies, is the result of intentional management conduct is unclear. See, e.g., Jennifer H. Arlen & William J. Carney, *Vicarious Liability for Fraud on Securities Markets: Theory and Evidence*, 1992 U. ILL. L. REV. 691, 724–27 (1992) (finding evidence that inaccurate disclosure is often the result of last-period agency problem); Donald C. Langevoort, *Organized Illusions: A Behavioral Theory of Why Corporations Mislead Stock Market Investors (and Cause Other Social Harms)*, 146 U. PA. L. REV. 101, 130–35 (1997) (arguing that various individual and organizational biases in risk perception can lead to disclosure failures).

69. See, e.g., Floyd Norris, *A Car Shipper Sold Shares; S.E.C. Implies It Sold Illusions*, N.Y. TIMES, Oct. 9, 2002, at C1 (reporting the case of a Cyprus corporation that misled investors about the existence of revenues and the ownership of assets on its books).

works, might derive benefits significantly higher than the ones derived from the ordinary use of Internet access.⁷⁰

Secondly, for cases in which misconduct is not intentional, this assumption might apply when the difference between wrongdoers and law-abiding clients is that only law-abiding clients take costly measures to reduce the likelihood of misconduct. When only law-abiding clients bear the cost of precaution, their overall benefit is likely to be smaller than the one derived by wrongdoers. Two companies, for instance, might attach identical value to going public, but while one company adopts a costly compliance program to prevent securities fraud, the other does not. In this case, it is apparent that the wrongdoer company derives a larger gain—reflected in its savings on compliance costs—than the law-abiding company.⁷¹

Finally, one might depict wrongdoers as law-abiding clients who use the services of the gatekeeper for an additional, unlawful purpose. For example, like law-abiding users, wrongdoers might access the Internet to send e-mails to friends and family, read the news and perhaps pay their bills. In that respect, there is no reason to assume that the value wrongdoers attach to using the Internet is either larger or smaller than the value of Internet access for law-abiding clients. Wrongdoers differ from law-abiding Internet users, however, in that they might also use their Internet access to engage in unlawful conduct, such as exchanging illegal copies of copyrighted music. Thus, other things equal, it is reasonable to assume that the overall value of the market for such wrongdoers exceeds its value for at least some of the law-abiding clients.

Whether wrongdoers benefit from entering the market to a greater degree than do law-abiding clients is, of course, an empirical question. In markets where this assumption does not hold, two additional scenarios should be considered.

If gains from entering the market are randomly distributed across wrongdoers and law-abiding clients, the impact of gatekeeper liability might be mixed—some wrongdoers and law-abiding clients would remain in the market and others would leave. In this case, the value of gatekeeper liability will depend on the tradeoff between the cost resulting from driving out law-abiding clients and the saving in social harm associated with preventing wrongdoers from entering the market.

70. Note, however, that the fact that a particular conduct is prohibited does not necessarily imply that the gains to those who commit it outweigh gains from lawful activities.

71. Notice that if the existence of an effective compliance program is observable to the gatekeeper, the assumption of asymmetric information underlying the analysis in this part may not hold.

Alternatively, if wrongdoers' benefits are smaller than those of law-abiding clients, an increase in fees would first drive out wrongdoers rather than law-abiding clients. Accordingly, a scenario where only wrongdoers leave the market would be possible. If this scenario indeed materializes, gatekeeper liability would tend to be desirable even under the assumption that gatekeepers cannot take any steps to prevent misconduct.

3. No Impact (Cross Subsidization)

Gatekeeper liability might turn out to have no impact on the number of clients entering the market. Instead, all types of clients will simply pay the increased fees, and law-abiding companies will essentially subsidize wrongdoers. The logic underlying this outcome is as follows. When the fee increase is too small, the new fee will not exceed the value of the market even for those law-abiding clients for whom the benefit of entering the market is relatively small. Other things being equal, this outcome is likely to take place when the fraction of wrongdoers is sufficiently low, the social harm caused by misconduct is sufficiently small, the value that law-abiding clients attach to the market is relatively large, or a combination of all three.

Consider the IPO example. Again, assume that all variables are the same, except for the social harm from fraud, which equals 450, and the benefit that wrongdoers capture by going public, which equals 400. In this case, law firms would charge all companies wishing to go public a single "liability premium" of 90 (0.2×450). The total fee charged by the law firm for its services would thus equal 190 ($100 + 90$). Under these circumstances, all companies, whether wrongdoers or law-abiding, would go public because the value that all entrepreneurs attach to doing so exceeds the cost. Table 3 presents clients' decisions to go public in this example.

TABLE 3. NO IMPACT

Type	Value of Market	Fee	Go Public?	Should Go Public?
Law-abiding (low value)	200	190	Yes	Yes
Law-abiding (high value)	400	190	Yes	Yes
Wrongdoer	400	190	Yes	No

In this example, all companies would prefer to pay the legal fees and go public. Thus, law-abiding entrepreneurs will also agree to pay the fee charged by the law firm even though this fee overestimates their likelihood of committing fraud. Furthermore, wrongdoers may enter the market even when, from society's perspective, they should not do so because their benefit is lower than the expected social harm produced by their misconduct.

From a social welfare perspective, the value of holding gatekeepers liable under this scenario is no different than the value of primary liability.⁷² Gatekeeper liability would produce no social gains because the number of wrongdoers taking their company public to defraud investors under gatekeeper liability would equal their number under a primary liability regime. Likewise, holding gatekeepers liable would produce no social costs because the number of law-abiding entrepreneurs engaging in an IPO would not change. Furthermore, the increased fees (and the fact that law-abiding client essentially subsidize wrongdoers) constitute transfer payments and thus have no social welfare consequences.

Taking administrative costs into account, however, might change the picture. This is because subjecting gatekeepers to liability would increase the operating cost of the legal system while affecting neither the number of companies going public nor the overall likelihood of securities fraud. Thus, in the absence of some additional advantages of gatekeeper liability, perhaps in the form of inducing gatekeepers to monitor clients, gatekeeper liability will likely be undesirable even when it has no impact on the market for gatekeeper services.

This Part has explored how the increase in gatekeeper fees under strict gatekeeper liability is likely to impact the market for gatekeeper services. In the case of primary wrongdoers, the price increase is commonly accepted as desirable. As this Part has shown, this is not the case with respect to gatekeepers. Rather, when monitoring and screening are prohibitively costly, the impact of gatekeeper liability may vary across markets. The ultimate consequences of imposing gatekeeper liability under such conditions, and the resulting social welfare implications, depend on market-specific variables, such as the distribution of law-abiding clients

72. In this Article, I focus on the impact of liability on the relevant market and on the occurrence of wrongdoing. Thus, the analysis does not take into account the potential role of gatekeeper liability in providing insurance to victims against wrongdoing or redistributing wealth. Under these theories of liability, the no-impact scenario may have different implications. For a general analysis of the proper role of distributional goals in designing liability regimes, see generally Louis Kaplow and Steven Shavell, *Why the Legal System Is Less Efficient than the Income Tax in Redistributing Income*, 23 J. LEGAL STUD. 667 (1994).

and wrongdoers, the distribution of values attached to the market by each type of clients, and the magnitude of the social harm produced by client misconduct.

The immediate implication of this Part's analysis is that, where gatekeepers cannot police client conduct, holding them liable is probably a bad idea. Gatekeeper liability will turn out to be socially desirable only if the saving in social harm associated with denying wrongdoers access to the market exceeds the loss produced by driving law-abiding clients out of the market. Under certain assumptions, this may happen only if the market unravels. Gatekeeper liability, however, seems to be a poor tool for bringing about the collapse of the market. Stated differently, if the sole motivation for holding gatekeepers liable is to bring about the demise of a particular market, it might be wiser simply to ban the relevant service, product or technology altogether.

The implications of this Part's analysis, however, transcend those instances where gatekeepers lack the ability to police client conduct. Even when gatekeepers are positioned to identify wrongdoing and thwart client misconduct, some wrongdoers will elude any policing measures. Thus, gatekeeper liability will very often have a residual effect on gatekeeper pricing. As the next Part will show, the potential cost associated with this effect on prices should be weighed against the benefits of holding gatekeepers liable for all instances of client misconduct.

III. BENEFITS: PREVENTING MISCONDUCT

The previous Part has uncovered the potential costs—in the form of distorting market entry decisions—of gatekeeper liability. This Part completes the analytical picture by exploring the benefits of gatekeeper liability and outlining the nature of the tradeoff between such costs and benefits.

Section A identifies the potential advantage of expanding the scope of liability imposed on gatekeepers. Section B considers the benchmark case in which gatekeepers can fully eliminate wrongdoing. Section C analyzes the more realistic case of imperfect gatekeeper prevention. Concretely, this section will identify the inevitable tradeoff between preventing client misconduct and distorting market entry by law-abiding clients. Turning to a different dimension, section D explores how gatekeeper liability may induce clients to disclose information to gatekeepers.

A. IMPERFECT GOVERNMENT INFORMATION

Gatekeepers can often take a variety of steps to prevent their clients from acting unlawfully. Gatekeepers can screen prospective clients prior to selling them a product or offering them a service; they may also be positioned to observe client conduct and prevent wrongdoing from taking place. ISPs, for example, may be positioned to scrutinize prospective clients to determine whether they intend to use their Internet access for unlawful purposes. ISPs may also be in a position to filter out illegal web sites and otherwise police users' Internet activities in order to block users from engaging in misconduct. For expositional convenience, I shall refer to all actions gatekeepers can take to detect and thwart client wrongdoing as "monitoring."

Assume that, from society's perspective, certain monitoring measures are optimal. Which regime would induce gatekeepers to implement those measures?

In principle, both regimes—strict liability and negligence—can induce gatekeepers to adopt the optimal level of monitoring. These regimes differ, however, in the informational requirements they entail. The chief advantage of strict liability over negligence or regulation is that it induces gatekeepers to adopt optimal monitoring steps without requiring the government—courts or regulators—to possess the information that is necessary for implementing a negligence-based regime.⁷³

Under strict liability, courts have to determine whether a client engaged in misconduct and set the level of damages. Gatekeepers will then decide what monitoring measures to adopt in light of their expected sanction. A negligence-based regime, in contrast, imposes a heavier informational burden on the government. Under negligence, for example, courts have to specify the "due" level of monitoring. Likewise, when the monitoring measures are specified in a regulation or a statute, regulators or lawmakers must possess the information necessary to identify the optimal level of monitoring. Under both forms of negligence-based liability, courts will have to determine whether the gatekeeper has implemented the optimal level of monitoring.

When the government can accurately specify the appropriate level of gatekeeper monitoring and fully observe the actual level of monitoring that gatekeepers have adopted, both negligence and strict liability will provide

73. In Section III.D, I explore an additional advantage of strict gatekeeper liability, namely, encouraging law-abiding clients to communicate their lawful intentions to gatekeepers.

gatekeepers with optimal monitoring incentives.⁷⁴ Under these conditions, therefore, a negligence-based regime would be generally superior to strict liability. This is because the benefits of both regimes—preventing client wrongdoing—would be identical, whereas a negligence-based regime would be less costly than strict liability.⁷⁵ Stated differently, the risk of adversely affecting the relevant market cautions against the use of strict liability when a negligence-based regime can produce comparable monitoring incentives.⁷⁶

Note that this prescription differs from the accepted economic wisdom concerning primary liability. The traditional economic position favors strict liability over negligence even under conditions of fully informed courts because strict liability ensures that defendants adopt the optimal level of activity.⁷⁷ In the gatekeeper context, in contrast, strict liability is potentially costly; thus, if strict liability is not superior in inducing gatekeepers to police client conduct, there is no justification for favoring it over other forms of liability.

When the government is imperfectly informed, however, a negligence-based regime may result in either over-deterrence or under-deterrence of gatekeepers.⁷⁸ Under these circumstances, therefore, strict liability would outperform a negligence-based regime in encouraging optimal monitoring of clients.

Whether the government—courts, legislatures or regulatory agencies—is able to overcome the informational hurdles associated with a negligence-based regime is an empirical question, which I have no intent to resolve in this Article. Notably, however, defendants are generally assumed to be better positioned than courts or lawmakers to assess the

74. See, e.g., Shavell, *supra* note 21, at 8.

75. Both negligence and strict liability will make gatekeepers increase their fees to reflect their monitoring cost. In principle, this fee increase may also impact the market in the manner described in Part II. The implications of this point are discussed in Part III.B *infra*.

76. This would not be the case when the market impact of strict gatekeeper liability is overall desirable—for example, if it turns out that wrongdoers, rather than law-abiding clients, would be the first to leave the market upon an increase in gatekeeper fees. See discussion in Section II.C.3 *supra*.

77. See Arlen & Kraakman, *supra* note 25, at 689–93; Hylton, *supra* note 25, at 981–83. But see Alan O. Sykes, *The Boundaries of Vicarious Liability: An Economic Analysis of the Scope of Employment Rule and Related Legal Doctrines*, 101 HARV. L. REV. 563, 592 (1988) (arguing that employers should not be strictly liable for torts committed outside the scope of employment).

78. It has been shown that negligence standards tend to induce defendants to be overly cautious when courts are prone to error. See Richard Craswell & John E. Calfee, *Deterrence and Uncertain Legal Standards*, 2 J. L. ECON. & ORG. 279, 286 (1986); Louis Kaplow & Steven Shavell, *Accuracy in the Determination of Liability*, 37 J.L. & ECON. 1 (1994). Solely for expositional convenience, the remainder of the analysis will assume that negligence would result in under-deterrence of gatekeepers.

costs and benefits of their actions.⁷⁹ This presumption may prove to be significant in the context of gatekeeper liability, where the “due level” of monitoring often translates into a combination of complex steps taken at different time periods. As the optimal monitoring policy becomes more complex and multi-faceted, courts will be less likely to possess the information necessary to apply a negligence standard.⁸⁰

For example, assume that the optimal auditing policy requires auditors to apply a combination of various actions and procedures—independently review some of the company’s books and records, interview company employees, implement a system of peer review, adopt a policy of auditor rotation, and perhaps even refrain from offering consulting services to clients. Under a negligence-based regime, courts or regulators might fail to prescribe the optimal auditing policy and determine whether an auditor has indeed implemented all the practices required under such policy. Conversely, strict auditor liability will result in optimal monitoring by auditors without requiring courts to determine the optimal policy.

Strict liability is even more appealing in cases involving the *ex ante* design of products or technologies. Consider a developer of a P2P file sharing technology. The software (or other aspects of the system’s architecture) may be designed in a manner that prevents the developer of the software or the operator of a file sharing service from distinguishing lawful and unlawful uses of the system *ex post*. *Ex ante*, however, it might have been desirable to design the system in a manner that would make it easier to track users and prevent them from committing misconduct. Again, under the assumption that courts are fully informed, they would be able to determine whether the design of the system is optimal taking into account all the relevant considerations. Realistically, however, it appears that courts would find it difficult to undertake such a task successfully.⁸¹

79. See, e.g., Katyal, *supra* note 14, at 1098–99 (arguing, with respect to ISP liability, that “[t]he government is likely to over- or underestimate the costs and benefits of [ISP] prevention”); Louis Kaplow & Steven Shavell, *Property Rules Versus Liability Rules: An Economic Analysis*, 109 HARV. L. REV. 713, 726–727 (1996); Richard A. Epstein, *A Theory of Strict Liability*, 2 J. LEGAL STUD. 151, 188 (1973) (under strict liability, “there is no need to ask the hard question of which branch of government is best able to make cost-benefit determinations, because the matter is left in private hands”). *But see* Kraakman, *supra* note 12, at 79–81 (discussing circumstances under which it would be possible to overcome the informational hurdles associated with a negligence-based regime of gatekeeper liability).

80. See, e.g., Steven Shavell, *Liability and the Incentive to Obtain Information About Risk*, 21 J. LEGAL STUD. 259, 266–69 (1992) (showing that a simple negligence rule might fail to provide optimal incentives to acquire information).

81. Another example of product design involves the liability of gun manufacturers for misuse of their products. See sources cited *supra* note 10.

The foregoing discussion does not aim at arguing that the government will necessarily lack sufficient information for successfully implementing a negligence-based regime. Rather, the purpose of the discussion is to demonstrate why considering strict gatekeeper liability is important. In the next two sections, therefore, I will analyze gatekeeper liability under the assumption that strict liability indeed performs better than negligence in inducing gatekeepers to police client conduct.

B. ELIMINATING MISCONDUCT

Having identified the chief advantages and shortcomings of strict liability and negligence, the remainder of this Part seeks to delineate the optimal scope of gatekeeper liability. This section explores the benchmark case where gatekeepers are capable of successfully eliminating client wrongdoing. The next section discusses gatekeeper liability under the more realistic assumption that gatekeepers can prevent client misconduct only imperfectly.

Assume that the socially desirable measures of gatekeeper monitoring will successfully eliminate client wrongdoing. For example, assume that if ISPs implement the socially desirable filtering and screening technology, they can prevent subscribers from using the Internet to access and distribute pornographic materials depicting minors. In this ideal scenario, a regime of strict ISP liability would undoubtedly be desirable.⁸²

Consider first the benefits of gatekeeper liability, i.e., the decrease in social harm associated with preventing the dissemination of child pornography. As the available monitoring technology becomes more potent in disrupting subscriber misconduct, the benefits of inducing ISPs to implement such technology increase as well. Under the assumption that strict liability is best suited for making ISPs implement this technology, strict ISP liability will dominate other forms of gatekeeper liability.

Relatedly, by eliminating the prospects for successfully engaging in misconduct, gatekeeper liability reduces the attractiveness of market access in the eyes of wrongdoers. Stated differently, by reducing the benefit that clients with unlawful intentions can expect to derive from entering the market, monitoring by gatekeepers serves an inherent screening function. The prospect of perfect monitoring by ISPs, for instance, may drive wrongdoers out of the market for Internet access. This screening effect

82. The text assumes that the value of eliminating wrongdoing exceeds the administrative costs of expanding liability to gatekeepers. When this is not the case, gatekeeper liability will be undesirable even when holding gatekeepers liable eliminates wrongdoing.

reduces not only the probability of wrongdoing, but also the magnitude of monitoring costs gatekeepers will have to incur.⁸³

On the cost side, when gatekeepers successfully eliminate wrongdoing, they will incur no liability costs. In the full prevention case, therefore, ISP fees will increase to reflect only the cost of implementing the filtering technology.⁸⁴ This will generally mean that holding gatekeepers strictly liable will likely have only a modest impact on the use of the Internet by law-abiding subscribers.

To be sure, if monitoring costs are sufficiently large, the fee increase necessary for compensating gatekeepers for the cost of monitoring may trigger any of the outcomes outlined in Part II even in the case in which wrongdoing is eliminated. Yet, as the fee increase in this case reflects merely the cost of monitoring, it will take place under both strict and negligence-based ISP liability, whereas, by hypothesis, strict liability outperforms negligence in inducing gatekeepers to monitor client conduct.⁸⁵

The last observation demonstrates that, while the discussion thus far has focused on the choice between strict and negligence-based liability, the framework developed in this Article is applicable to any expansion of gatekeeper liability. Even negligence will produce a fee hike (albeit generally smaller than the one under strict liability), which in turn may distort market entry decisions. If those costs of negligence are sufficiently high, policymakers may opt for exempting gatekeepers from monitoring client misconduct altogether and holding them liable only when they know about specific violations.⁸⁶

83. When some wrongdoers leave the market, the proportion of wrongdoers among clients decreases as well. This reduces the expected liability cost for the gatekeeper, which in turn leads to a decrease in the level of monitoring that gatekeepers will adopt. Moreover, in the ideal case in which all wrongdoers are discouraged from entering the market by the prospect of perfect monitoring, ISPs will incur no monitoring costs. Whether that will indeed be the case will depend on the extent to which gatekeepers can quickly detect a change in their client pool and employ their monitoring capabilities once wrongdoers attempt to use their services. As the perfect-prevention assumption is made for illustrative purposes only, I will not further elaborate on this point.

84. Notably, in the benchmark case where the potential for effective gatekeeper monitoring drives out all wrongdoers, gatekeeper liability may have no impact on fees. This will happen if in equilibrium gatekeepers exercise no monitoring and no wrongdoer enters the market.

85. If courts are imperfectly informed, the actual level of gatekeeper monitoring may turn out to be lower or greater than the socially optimal one. See *supra* text accompanying note 78. If the level of monitoring under a negligence-based regime turns out to be higher than under strict liability, the fee increase under negligence might exceed the one under strict liability.

86. For the implications of this observation, see Part IV.B *infra*.

Although unrealistic, the scenario underlying this section underscores the importance of considering, when choosing a regime of gatekeeper liability, the degree to which gatekeepers are positioned to monitor client conduct. As the next section shows, as gatekeepers become more adept in disrupting misconduct, strict gatekeeper liability becomes more appealing.

C. IMPERFECT PREVENTION

Even when they implement the appropriate level of monitoring, gatekeepers are unlikely to foil all instances of client wrongdoing. The optimal technology for preventing access to online child pornography, for example, may fall short of fully blocking the distribution of all sexually explicit material depicting minors. What should be the scope of gatekeeper liability under these conditions of imperfect prevention?

Unfortunately, given the variety of factors involved, no single prescription can universally apply to all instances of gatekeeper liability. Rather, to identify the optimal regime, policymakers must consider the costs and benefits of gatekeeper liability—which should be familiar to the reader at this stage. On the benefit side, expanding the scope of gatekeeper liability reduces social harm by encouraging gatekeepers to thwart wrongdoing and by discouraging wrongdoers from entering the market. On the cost side, fees will increase to reflect not only the cost of gatekeeper monitoring but also the cost of the residual liability faced by gatekeeper. This fee increase, in turn, may trigger the adverse consequences highlighted in Part II.

Thus, the range of scenarios that Part II identified can arise not only when gatekeepers cannot monitor client conduct, but also when they can prevent misconduct only imperfectly. As this section explains, however, the social welfare implications of these scenarios under imperfect prevention will differ from their implications under the no-monitoring assumption. Furthermore, the degree to which gatekeepers can prevent wrongdoing will determine which of these scenarios ultimately materializes: As monitoring becomes more effective, it is less likely that the fee hike would be sufficiently large to drive out clients. The following subsections summarize the likely outcomes under the imperfect prevention assumption and their social welfare implications.

1. Market Unraveling

As explained earlier,⁸⁷ the market will unravel when the increase in gatekeeper fees is sufficiently large to drive all clients—whether wrongdoers or law-abiding—out of the market. In the imperfect prevention case, this would happen when, notwithstanding the measures that gatekeepers take to disrupt wrongdoers, the expected harm from misconduct remains substantial.⁸⁸ Other things being equal, this would be the case when monitoring is relatively ineffective—for example, when the desirable level of gatekeeper monitoring fails to detect a considerable proportion of wrongdoers.

When the market unravels, social welfare will generally be the same regardless of whether gatekeepers are capable of monitoring clients. Concretely, social welfare will consist of the social loss associated with the decision of law-abiding clients to leave the market and the gain from eliminating the risk of misconduct. Gatekeeper liability is thus desirable only if the relevant market should not exist—for example, if the overall gain from the entry of law-abiding clients is always smaller than the social harm associated with wrongdoer misconduct.

This, however, does not imply that gatekeepers' ability to police clients is unimportant. Effective monitoring reduces the likelihood that gatekeepers will be found liable and thus the impact of liability on gatekeeper fees. Hence, holding other variables constant, the market collapse outcome is less likely to occur when gatekeepers do have the capacity to foil unlawful conduct.

2. Only Law-abiding Clients Leave

This outcome will take place when the fee increase resulting from gatekeeper liability is large enough to induce law-abiding clients for whom the value of the market is relatively small to leave the market, but is not sufficiently significant to induce law-abiding clients for whom the value of the market is relatively large to do the same. Holding other things constant, this will happen when the optimal level of gatekeeper monitoring leaves a substantial portion of wrongdoing undetected, although not sufficient to increase gatekeeper fees to a level at which all law-abiding clients would leave.⁸⁹

87. See Part II.C.1 *supra*.

From a social welfare perspective, the value of gatekeeper liability is determined by weighing the social loss associated with those law-abiding clients who leave the market against the savings in social harm associated with those wrongdoers who are prevented from committing misconduct.⁹⁰ Gatekeeper liability will be desirable when the decrease in social harm resulting from misconduct is greater than the forgone value of the market for those law-abiding clients who decide to leave. Other things equal, the value of gatekeeper liability increases when gatekeepers become more effective in preventing misconduct because this increases the benefit associated with gatekeeper liability.

As Part II has shown,⁹¹ when monitoring is impossible, the fact that only law-abiding clients leave the market necessarily implies that gatekeeper liability is undesirable. In contrast, where liability makes gatekeepers engage in monitoring, the fact that the fee hike encourages only law-abiding clients to leave does not necessarily indicate that strict gatekeeper liability is counter-productive. This is because the social costs of disrupting the market access of some law-abiding clients should be weighed against the social benefit of preventing some wrongdoers from committing misconduct.

3. No Impact

The last scenario is the one where gatekeeper liability does not affect the demand for gatekeeper services, i.e., where all clients, whether wrongdoers or law-abiding, enter the market. Gatekeepers, in turn, police clients' activities and partially succeed in foiling wrongdoing. As explained earlier,⁹² this will happen when the fee increase is so insignificant that even law-abiding clients for whom the value of the market is relatively small will find it worthwhile to enter the market. Other things equal, the increase in fees will be insignificant when gatekeeper monitoring is relatively effective, resulting in a significant decline in expected liability costs for gatekeepers.

From society's perspective, gatekeeper liability will be undoubtedly desirable under the no-impact scenario. On the cost side, gatekeeper liability does not adversely impact the relevant market as all law-abiding clients enter the market notwithstanding the increase in fees. On the benefit side, it induces gatekeepers to police clients and thus reduces expected social harm. To be sure, gatekeeper liability makes law-abiding

91. See Part II.C.1 *supra*.

92. See Part II.C.2 *supra*.

clients pay for the service at stake a price higher than the one they would have paid under a regime of primary liability. This price increase, however, is a mere transfer and thus has no efficiency consequences within this Article's framework of analysis.⁹³ The social welfare implications of this outcome thus differ from its implications under the no-monitoring assumption, where gatekeeper liability would have no impact on social welfare.⁹⁴

The case of imperfect gatekeeper prevention is therefore characterized by a tradeoff between the potentially disruptive effect of liability on market access and the decrease in social harm resulting from gatekeeper policing. Although the precise outcome of this tradeoff will depend on a variety of market-specific factors, the analysis thus far points to the following observation: other things being equal, the more effective are gatekeepers in preventing wrongdoing, the more likely is an expansive regime of gatekeeper liability to be desirable.

Although the outcomes that Part II has identified may arise even under conditions of imperfect prevention, social welfare under each outcome is likely to increase (compared to the case in which gatekeeper monitoring is prohibitively costly) when gatekeepers can imperfectly prevent client wrongdoing.

Perhaps more importantly, an increase in the degree to which gatekeepers are successful in disrupting misconduct reduces the risk that gatekeeper liability would disrupt the market. An increase in the success of gatekeepers in preventing misconduct will reduce gatekeeper liability exposure and thus gatekeeper fees. A decrease in gatekeeper fees, in turn, will make it less likely that law-abiding clients will find it worthwhile to leave the market. Furthermore, an increase in the rate of gatekeeper success in preventing misconduct will decrease the value of the market for wrongdoers, thereby further reducing wrongdoing and making more likely that an increase in gatekeeper fees will first drive out wrongdoers. This is illustrated by Table 4, which compares social welfare for each scenario under no monitoring and imperfect prevention.

TABLE 4.

GATEKEEPER LIABILITY: IMPERFECT PREVENTION V. NO MONITORING

93. Although it does not impact relevant markets, the increase in fees imposed on clients may be significant from the perspective of redistribution, which this Article does not address. *See also* note 72, *supra*.

94. *See* Part II.C.2 *supra*.

<i>Scenario</i>	<i>No Monitoring</i>	<i>Imperfect Prevention</i>
Market Unraveling	Depends on variables	Depends on variables
Law-abiding Leave	Clearly undesirable	Depends on variables
No Impact	No change in social welfare	Clearly desirable

D. CLIENT RESPONSES

Before proceeding to explore the policy implications of the analysis, I would like to highlight another dimension through which liability may affect the market for gatekeeper services. The analysis thus far has focused on the impact of liability on *gatekeeper* incentives. This section, in contrast, shall consider the extent to which gatekeeper liability provides *clients* with incentives to alleviate the problem of informational asymmetry underlying the potential costs of gatekeeper liability. The analysis will draw on the economic theory of contracts, which provides a rich framework for analyzing the likely effect of strict liability in this context.⁹⁵

The potential distortion under strict gatekeeper liability arises due to the asymmetry of information between clients and gatekeepers.⁹⁶ One may argue, however, that the assumption of asymmetric information overlooks the incentives provided by gatekeeper liability for clients to disclose their intentions to gatekeepers. Strict liability, the argument goes, creates an incentive for law-abiding clients to reveal their lawful intentions in order to enjoy lower fees. Granted these incentives, it is less likely that gatekeepers will increase their fees indiscriminately.

The key flaw of this objection lies in its incompleteness. Although correct in recognizing the nature of the incentives provided for clients, it overlooks the potential constraints on clients' ability to do so credibly.

Unlike negligence, strict liability provides law-abiding clients with an incentive to communicate their low likelihood of engaging in misconduct

95. For a general overview, see JEAN-JACQUES LAFFONT & DAVID MARTIMORT, *THE THEORY OF INCENTIVES* (2002).

96. See Part II.B *supra* (showing that strict liability would not be costly when gatekeepers can distinguish among clients based on their wrongful intentions).

to gatekeepers.⁹⁷ In the IPO example, law-abiding entrepreneurs have a clear incentive to convince their law firm about their zero likelihood of committing fraud. This is because when they are pooled with wrongdoers, law-abiding entrepreneurs pay higher fees, or leave the market altogether.⁹⁸ But were gatekeepers aware of their low likelihood of committing misconduct, law-abiding clients would only have to compensate the gatekeeper for its marginal cost of providing them with service.

For similar reasons, however, strict liability also provides *wrongdoers* with an incentive to present themselves to gatekeepers as law-abiding in order to enjoy the lower fees imposed on such clients. As a result, gatekeepers will reduce fees based only on credible information as to the likelihood of committing misconduct by a prospective client. In economic terms, the client incentives provided by gatekeeper liability would eliminate the costs of strict gatekeeper liability only to the extent they could produce a separating equilibrium.⁹⁹ Such equilibrium is attainable only if prospective clients can devise a credible signal for communicating their type.

In the balance of this section, I will examine several mechanisms through which law-abiding clients might be able to credibly communicate their lawful intentions to gatekeepers. To be sure, the effectiveness of each mechanism may vary across markets. Yet, the analysis is required to complete the analytical framework concerning gatekeeper liability.

97. In addition, some gatekeepers may be motivated by various business reasons to screen prospective clients. It is commonly assumed, for example, that underwriters' concern for their reputation would make them investigate the quality of prospective issuers even in the absence of liability. See Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 619 (1984). For evidence concerning the effect of underwriter and auditor reputation on IPO returns, see Randolph P. Beaty, *Auditor Reputation and the Pricing of Initial Public Offerings*, 64 ACCT. REV. 693 (1989); Richard Carter & Steven Manaster, *Initial Public Offerings and Underwriter Reputation*, 45 J. FIN. 1045, 1056–62 (1990). Likewise, the sole function of bond rating agencies, for example, is to evaluate the creditworthiness of companies issuing bonds. On whether bond rating agencies should face liability for incorrect ratings, see Gregory Husisian, Note, *What Standard Of Care Should Govern The World's Shortest Editorials?: An Analysis Of Bond Rating Agency Liability*, 75 CORNELL L. REV. 411 (1990). See also Frank Partnoy, *Two Thumbs Down for the Credit Rating Agencies*, 77 WASH. U. L.Q. 619 (1999) (discussing problems with bond rating agencies and potential liability for failures).

98. Negligence too may provide some incentive for clients that would like to convince gatekeepers that monitoring is unnecessary in their case, and that the fees they are required to pay should thus not incorporate monitoring costs.

99. To the extent that only some clients would be able to separate themselves from the remaining pool of clients, the analysis of Part II should be modified to apply only to the remaining pool of clients.

1. Signaling

A familiar mechanism for overcoming pre-contracting informational asymmetries is sending a signal by prospective clients.¹⁰⁰ A signal will succeed in setting wrongdoers apart from law-abiding clients if only law-abiding clients can afford the cost of sending it. The availability of signals meeting this description depends on the particular market.

For example, consider the market for Internet access, where law-abiding users use the Internet for lawful purposes while wrongdoers use the Internet for downloading copyrighted music. Under a regime of strict ISP liability, law-abiding users would have an incentive to signal their type to ISPs in order to reduce the fees they pay for Internet access. But in order to credibly communicate their type to ISPs, law-abiding users will have to identify a signal that would be less costly for them than for wrongdoers. That is, law-abiding clients must identify a course of action that would be costly for them, but sufficiently costlier for wrongdoers to replicate. Since it is difficult to identify such a signal,¹⁰¹ it is likely that imposing strict liability on ISP would not reduce informational asymmetry between ISPs and prospective users.¹⁰² Strict ISP liability, therefore, would likely fail to result in a separating equilibrium.

Things become murkier with respect to capital markets. Financial markets are characterized by informational asymmetries between entrepreneurs and the providers of capital because entrepreneurs possess private information about the value of their projects.¹⁰³ The financial economics literature has identified several ways in which entrepreneurs can signal their private information to investors. In the context of an IPO,

100. See ROBERT GIBBONS, *GAME THEORY FOR APPLIED ECONOMISTS*, 183–210 (1992) (discussing signaling generally).

101. With respect to the music example, the speed of the Internet connection that clients purchase may serve as a useful signal. Since music files are relatively large, wrongdoers would find it more costly to agree to limits on their bandwidth usage. But some law-abiding users, such as those who use the Internet for video conferencing, might find bandwidth limitations very costly too. Cf. Neil Weinstock Netanel, *Impose a Noncommercial Use Levy to Allow Free P2P File-Swapping and Remixing*, 40-41 (Working Paper No. 44, 2002), available at <http://www.ssrn.com> (arguing that ISPs can use the speed and character of the Internet connection of a user as a proxy for the user's file sharing activities).

102. But see ERIC POSNER, *LAW AND SOCIAL NORMS* (2001) (developing a theory under which signals concerning a person's discount rate may distinguish between law-abiding types and wrongdoers in certain contexts).

103. For an example of the implications of this asymmetry for corporate governance, see Lucian Arye Bebchuk, *Asymmetric Information and the Choice of Corporate Governance Arrangements*, (Harvard Olin Discussion Paper No. 398 2002), available at <http://www.ssrn.com> (analyzing how asymmetric information affects corporate governance choices).

plausible signals include stock ownership by the entrepreneur and IPO underpricing.¹⁰⁴

At first glance, the availability of these signals suggests that imposing strict liability would not adversely affect capital markets since law firms, accountants, and underwriters would be able to distinguish among prospective clients based on their risk of engaging in fraud. Two difficulties, however, caution against the reliance on these signaling models to conclude that all law-abiding entrepreneurs would succeed in separating themselves from wrongdoers.

First, if these signals were indeed successful in producing a separating equilibrium, there would be little justification for legal intervention to expand liability to gatekeepers to begin with.¹⁰⁵ Second, it is important to bear in mind the context within which these signaling models have emerged. Existing signaling models generally assume that entrepreneurs differ with respect to the value of the projects they are interested in financing. Entrepreneurs, however, are generally assumed to be honest in the sense they invest the IPO proceeds in actual projects rather than appropriate the proceeds and disappear. But if wrongdoers are assumed to be of the latter type,¹⁰⁶ some signals that the financial literature currently identifies may turn out to be ineffective because the assumption under which wrongdoers cannot replicate the signal (such as retaining a large share of stock) no longer holds.

2. Reputation

Another mechanism through which law-abiding clients could overcome informational asymmetry is reputation.¹⁰⁷ The basic logic of the reputation mechanism is as follows. Law-abiding clients seeking to communicate their type to gatekeepers will establish a reputation for being law-abiding. Wrongdoers, on the other hand, will not invest in developing

104. See Franklin Allen & Gerald Faulhaber, *Signalling by Underpricing in the IPO Market*, 23 J. FIN. ECON. 303 (1989); Mark Grinblatt & Chuan Yang Hwang, *Signalling in the Pricing of New Issues*, 44 J. FIN. 393, 393 (1989); Hayne E. Leland & David H. Pyle, *Informational Asymmetries, Financial Structure, and Financial Intermediation*, 32 J. FIN. 371 (1977) (insider retention).

105. See also Ian Gale & Joseph E. Stiglitz, *The Informational Content of Initial Public Offerings*, 44 J. FIN. 469 (1989) (showing that pooling equilibria are plausible when entrepreneurs can trade their shares after the IPO).

106. See, e.g., Roger Lowenstein, *Even Vigilant Gatekeepers Can Blow It*, WALL ST. J., Oct. 10, 1996, at C1.

107. See Benjamin Klein & Keith B. Leffler, *The Role of Market Forces in Assuring Contractual Performance*, 89 J. POL. ECON. 615 (1981) (constructing a model under which sellers invest in reputation to overcome informational asymmetry concerning the quality of their products). Note that analytically, investment in reputation can be interpreted as a signal.

reputation because by committing misconduct they will tarnish their reputation and thus make them lose their investment.

A good reputation will undoubtedly assist law-abiding clients in setting themselves apart from wrongdoers. Several attributes of the gatekeeper setting, however, cast doubt on the extent to which the reputation mechanism can realistically be expected to alleviate informational asymmetry between prospective clients and gatekeepers.

Consider first the securities example. While issuers or entrepreneurs with an established reputation in the product or financial markets may convince attorneys, accountants, and underwriters of their lawful intentions, many prospective issuers are companies in their early stage of development, which lack the opportunity to develop reputation prior to going public. In addition, developing a reputation is costly and unseasoned entrepreneurs will often lack the capital to invest in reputation. As a result, young companies may find it prohibitively costly to establish a reputation that would be sufficient to convince gatekeepers of their type. Thus, for small, young companies, whether law-abiding or wrongdoers, the reputation mechanism is virtually unavailable. In fact, this may be the reason why unseasoned issuers need the services of reputational intermediaries to begin with.¹⁰⁸

Now consider the case of Internet service providers and their prospective subscribers. In this market as well, it seems unlikely that reputation could serve as a useful mechanism to distinguish law-abiding users and wrongdoers. To begin, it is not clear what investments could a prospective subscriber take to establish a reputation for being law-abiding. Second, given the large amount of prospective Internet users, it would be very costly for a prospective subscriber to convey its reputation to Internet service providers. As long as the costs of establishing a reputation and conveying it to ISPs is smaller than the fee increase resulting from strict ISP liability, a prospective user will opt for paying higher fees. Finally, the relatively low cost of switching Internet service providers makes the cost of tarnishing one's reputation relatively insignificant.¹⁰⁹

108. The notion that securities underwriters serve as "reputation intermediaries" originated with Gilson and Kraakman. See Gilson & Kraakman, *supra* note 96, at 618–21. While issuers might use reputational intermediaries to communicate their private information to investors, they may be unable to use the reputation mechanism to communicate private information to these intermediaries.

109. Of course, if the incentive is large enough, one could imagine a scenario in which holding ISPs strictly liable results in the development of a system, such as the consumer credit system, that would enable ISPs to distinguish among prospective subscribers based on their risk of misconduct.

3. Posting Bonds

The final mechanism I will consider is posting a bond by clients.¹¹⁰ By bond I mean an asset pledged by a client to the gatekeeper with the understanding that the gatekeeper would be able to exercise the bond in case the clients commits misconduct. Posting a bond not only limits clients' incentives to engage in misconduct, but also serves as a credible signal because the cost of posting a bond for wrongdoers—who will ultimately lose the bond in case of misconduct—is higher than the cost for law-abiding clients.

Bonding mechanisms pose several practical problems for clients and gatekeepers. To begin, posting a bond is costly. Clients may lack the assets necessary for posting a bond in an amount equal to the social harm resulting from wrongdoing.¹¹¹ To be sure, one may argue that clients will not be required to post a bond in an amount that equals social harm; rather, clients could reduce their costs by purchasing liability insurance. This, however, would be analytically equivalent to the case of asymmetric information analyzed in Part II, because the cost of such insurance would equal expected social harm, which in turn would equal the increase in gatekeeper fees under strict gatekeeper liability.¹¹²

This section has outlined three devices through which law-abiding clients may succeed in distinguishing themselves from wrongdoers. It is important to stress, however, that all these devices are costly. Even when they can identify a credible signal, law-abiding clients will compare its cost to their expected benefits from setting themselves apart from wrongdoers. When the cost of employing these signals exceeds the expected benefit from being perceived as a law-abiding type, clients will prefer a pooling to a separating equilibrium. This, in turn, will mean that the incentives provided by gatekeeper liability to law-abiding clients to set themselves apart from wrongdoers will not eliminate the impact of gatekeeper liability on gatekeeper fees and thus will not prevent the potentially adverse

110. For an analysis of the use of bonds to resolve problems of information asymmetry in commercial transactions, see generally David Charny, *Nonlegal Sanctions in Commercial Relationships*, 104 HARV. L. REV. 373, 406–407 (1990); Ronald J. Mann, *Verification Institutions in Financing Transactions*, 87 GEO. L.J. 2225, 2231–41 (1999).

111. I do not consider “relational assets”—investment by the clients in transaction-specific assets whose value is significantly lower outside the relevant market. See Mann, *supra* note 116, at 2249–50. Also, due to the reasons explained earlier, clients may be unable to use their reputation as a bond.

112. This assumes that liability insurers are unable to monitor clients and prevent them from engaging in misconduct. If this assumption does not hold, the cost of liability insurance may be cheaper than the increase in gatekeeper fees in the absence of insurance. See Shavell, *supra* note 46, at 168.

consequences of gatekeeper liability with respect to the market for gatekeeper services.

IV. GATEKEEPER LIABILITY: A ROADMAP

In the preceding Parts, I have uncovered the inevitable tradeoff between the need to provide gatekeepers with adequate incentives to thwart misconduct and the desire to minimize the disruption of market access. While this fundamental tradeoff underlies virtually all cases in which enforcement failures mandate the expansion of liability to third parties, no single regime should govern all instances of gatekeeper liability. Rather, the proper regime for a particular misconduct should be tailored taking into account the factors highlighted by this Article—such as the extent to which gatekeepers can effectively monitor client conduct and the proportion of wrongdoers among prospective clients—as well other market-specific characteristics—such as the role of victim precaution and the presence of multiple gatekeepers.

Outlining the optimal scope of gatekeeper liability in specific settings is, therefore, beyond the scope of this Article. Instead, this Part will explore some general implications for the design of gatekeeper regimes. The analysis will unfold in three stages. First, I will consider which third parties should be designated as gatekeepers and thus held accountable for client misconduct. Next, I will outline the desirable scope of gatekeeper liability. Finally, I will consider the implications of the analysis for recognizing the shortcomings of gatekeeper liability as an instrument of social policy.

A. WHO SHOULD BE A GATEKEEPER?

In many settings, more than one party is positioned to prevent misconduct by denying primary wrongdoers access to an activity or a product.¹¹³ Modems and personal computers, for example, are as critical for surfing the Internet as the services of an ISP.¹¹⁴ The challenge facing policymakers under these circumstances is to single out the parties who should be designated as gatekeepers and become the target of liability.

113. In this sense, such parties fall within my definition of gatekeepers and the one adopted by Reinier Kraakman in his seminal article on gatekeeper liability. *See* Kraakman, *supra* note 12, at 53 (defining “gatekeepers” as private parties who are able to disrupt misconduct by withholding their cooperation from wrongdoers).

114. *See, e.g.,* Yen, *supra* note 15, at 1840, 1864 (noting that, in theory, all providers of information technology could be held liable for copyright infringement by users).

The framework developed in this Article counsels against imposing liability on third parties merely because they possess the power to restrict wrongdoer access and thus have the “technical” capacity to prevent wrongdoing. Rather, third parties should face liability only if they can (i) detect wrongdoing at a reasonable cost, and (ii) prevent clients they know to be wrongdoers from committing misconduct. Stated differently, third parties should face liability only when their cost of acquiring information about client conduct is relatively low.¹¹⁵

Consider the possibility of holding the makers of personal computers liable for copyright infringement by Internet users. Personal computers are no doubt a critical tool for accessing the Internet. Moreover, for the makers of personal computers, the cost of preventing wrongdoing is trivial—refrain from selling computers to wrongdoers. But if makers of personal computers can neither identify wrongdoers at the time they purchase computers nor monitor their subsequent use of the computers they purchase, then holding them liable will be counter-productive. The sole effect of such liability will be an increase in the price of personal computers. As Part II has shown, the impact of that price increase is unlikely to be desirable.¹¹⁶ Thus, notwithstanding their ability to control Internet access, the makers of personal computers should not be liable for copyright infringement by their clients.¹¹⁷

At first blush, this conclusion may appear to be rather straightforward. This initial impression, however, is misleading. To begin, this conclusion introduces a new insight into the economic theory of deterrence. Legal economists have shown that holding a wrongdoer liable may be justified even if the wrongdoer cannot prevent harm, because making wrongdoers internalize social harm will ensure that they will adopt an optimal level of activity or, in the case of corporations, an optimal scale of production. Relying on this position, legal academics have argued for imposing strict liability on gatekeepers in order to induce them to offer an optimal scale of services.¹¹⁸ This Article, however, shows why this “optimal activity” goal should not be extended to the domain of gatekeeper liability. Put

115. Gatekeepers should also face strict liability when they can engage in price discrimination based on prospective clients’ likelihood of acting unlawfully. See discussion in Part II.B, *supra*.

116. See discussion in Part II.C, *supra*.

117. This assumes that the goal of imposing liability is to deter the misuse of personal computers for copyright infringement. If the goal is compensating copyright owners, the conclusion may differ. For the proposal to impose levies in order to compensate copyright owners, see sources cited in note 156, *infra*.

118. See, e.g., Hardy, *supra* note 15, at 1044.

differently, the need to ensure optimal levels of client activity cannot serve as a justification for imposing liability on gatekeepers.¹¹⁹

The significance of this insight, however, is not a merely a matter of refining an economic theory. Courts and policymakers frequently must decide whether to impose liability on third parties regardless of their ability to distinguish wrongdoers from law-abiding clients.

This dilemma is best illustrated by the controversy surrounding the doctrine of vicarious copyright infringement, which has served as a key weapon of content owners in their battle for holding ISPs and the providers of P2P file-swapping technologies liable for digital piracy.¹²⁰ To establish vicarious infringement, a plaintiff must show that the defendant has the right and ability to control the direct infringement.¹²¹ The proper interpretation of this requirement has turned out to be one of the mostly litigated issues concerning vicarious infringement.¹²²

Under one approach, this “control” element merely requires that the third party possesses the technical ability to control the infringement. This approach, therefore, finds control in any relationship in which the third party has technical control—by facilitating access to a product or activity, for example—even when effectively exercising such control—distinguishing between infringing and non-infringing conduct and preventing only the former—is impractical.¹²³ This approach is best

119. See also Sykes, *supra* note 77 (developing the notion of enterprise causation to identify cases in which employers ought to face strict liability under the premise that third parties should not face strict liability).

120. The doctrine of vicarious infringement has been relied upon by the music industry in all the recent cases involving liability for copyright infringement by Internet users. See *A&M Records, Inc. v. Napster, Inc.*, 239 F.3d 1004 (9th Cir. 2001) (granting a limited injunction against a company offering a peer-to-peer service); *MGM Studios, Inc. v. Grokster, Ltd.*, 259 F. Supp. 2d 1029, 1043–46 (C.D. Cal. 2003) (holding that vendors of file-sharing software are not liable for copyright infringement by users); *In re Aimster Copyright Litig.*, 252 F. Supp. 2d 634, 665–66 (N.D. Ill. 2002) (granting the music industry an injunction against the operator of an Internet file sharing service), *aff'd*, 334 F.3d 643 (7th Cir. 2003).

121. The plaintiff must also show that the defendant had a direct financial interest in the exploitation of the copyrighted material. See *Shapiro, Bernstein & Co. v. H.L. Green Co.*, 316 F.2d 304, 307 (2d Cir. 1963) (“When the right and ability to supervise coalesce with an obvious and direct financial interest in the exploitation of copyrighted materials—even in the absence of actual knowledge that the copyright monopoly is being impaired—the purposes of copyright law may be best effectuated by the imposition of liability upon the beneficiary of that exploitation.”)

122. See generally Hamdani, *supra* note 12, at 941–45; Charles S. Wright, *Actual Versus Legal Control: Reading Vicarious Liability for Copyright Infringement into the Digital Millennium Copyright Act of 1998*, 75 WASH. L. REV. 1005, 1012–20 (2000).

123. See R. Carter Kirkwood, Comment, *When Should Computer Owners Be Liable for Copyright Infringement by Users?*, 64 U. CHI. L. REV. 709, 719 (1997). See also *Gershwin Publ’g Corp. v. Columbia Artists Mgmt., Inc.*, 443 F.2d 1159, 1162 (2d Cir. 1971) (finding that the defendant, an organizer of a circuit of community concerts, had satisfied the “control” requirement merely because

illustrated by the position of the district court in the *Napster* case. Refusing to examine Napster's argument that it could not distinguish legal and non-legal downloads, this court has ruled that Napster must screen out *all* infringing files on its server, regardless of its ability to identify them as infringing.¹²⁴

The competing, narrower approach requires third parties to be practically able to distinguish infringing and non-infringing conduct.¹²⁵ This approach is best illustrated by the position adopted by the Ninth Circuit in *Napster*, which provided that the injunction had to be limited only to those files that Napster could identify as infringing.¹²⁶

The choice between those two interpretations will drastically impact the Internet industry. ISPs and the providers of P2P file-swapping technologies have the technical ability to prevent infringement, and they will thus face substantial liability under the broad approach.¹²⁷ Under the narrow approach, in contrast, those parties will be held liable only to the extent that they can distinguish infringing and non-infringing user activities. As should be clear by now, the framework put forth by this Article clearly favors the narrow interpretation of vicarious copyright infringement.¹²⁸

under the relevant contract he had the "ultimate right of supervision"); *Polygram Int'l Publ'g, Inc. v. Nevada/TIG, Inc.*, 855 F. Supp. 1314, 1325–26 (D. Mass. 1994). Note that the third party needs to reserve itself the "right" to control as well.

124. See *A&M Records, Inc. v. Napster, Inc.*, 114 F. Supp. 2d 896, 918–27 (N.D. Cal. 2000).

125. See, e.g., *Artists Music, Inc. v. Reed Publishing, Inc.*, 31 U.S.P.Q. 2d 1623, 1627–28 (S.D.N.Y. 1994) (explicitly considering the prohibitive supervision cost by a trade-show organizer with respect to music played by exhibitors in refusing to find "control"); Wright, *supra* note 122, at 1014 (stating that "[t]he cost of policing can also preclude finding of actual control").

126. See *A&M Records, Inc. v. Napster, Inc.*, 239 F.3d 1004, 1023–24 (2001) (criticizing the district court for failing to recognize that Napster's ability to control subscriber infringement is "cabined by the system's current architecture").

127. Thus, the risk of strict ISP liability has sparked vigorous criticism of the adoption of the broad interpretation of the control element with respect to ISPs. See Yen, *supra* note 15, at 1843–72; Niva Elkin-Koren, *Copyright Law and Social Dialogue on the Information Superhighway: The Case Against Copyright Liability of Bulletin Board Operators*, 13 *CARDOZO ARTS & ENT. L.J.* 345, 399–410 (1995).

128. *But see* Hamdani, *supra* note 12, at 945–46 (exploring the limited circumstances under which the broad approach should be adopted). In a recent development in the battle against online piracy, a court held that the providers of file-sharing software lack the control necessary for finding vicarious copyright infringement. See *MGM Studios, Inc. v. Grokster, Ltd.*, 259 F. Supp. 2d 1029 (C.D. Cal. 2003).

This Article also sheds light on the traditional reluctance to impose liability on "common carriers"—third parties who lack the ability to investigate the content of the information transmitted through their services or network. For an overview, see Henry H. Perritt, Jr., *Tort Liability, the First Amendment, and Equal Access to Electronic Networks*, 5 *HARV. J. L. & TECH.* 65, 95–111 (1992) (reviewing tort doctrine granting immunity to common carriers against tort liability for unlawful content); Michael I. Meyerson, *Authors, Editors, and Uncommon Carriers: Identifying the "Speaker" Within the New*

B. HOW LIABLE SHOULD A GATEKEEPER BE?

With some modifications,¹²⁹ legal economists generally take the position that primary wrongdoers should face strict liability. This Article, however, cautions against extending that prescription to gatekeepers. Relying on the extensive analysis of the previous Parts, this section will outline the considerations that should guide policymakers in crafting gatekeeper liability.

Under ideal conditions, choosing an optimal regime is a relatively simple task. Gatekeepers should face strict liability for client misconduct when they can either (i) price-discriminate among prospective clients based on their likelihood of engaging in misconduct,¹³⁰ or (ii) take steps that would eliminate wrongdoing by all clients.¹³¹ A negligence-based regime, on the other hand, will be desirable when the government possesses the information necessary for specifying the due level of gatekeeper policing and determining whether gatekeepers have complied with the specified level of policing.¹³²

As a practical matter, however, those conditions will rarely apply. Information costs will hinder gatekeepers' ability to tailor fees to the risk of misconduct characterizing clients, and technological constraints will limit their ability to foil wrongdoing. Likewise, the complex, multi-faceted nature of gatekeeper monitoring will often make it virtually impossible for the government to specify the proper level of gatekeeper policing. Inevitably, therefore, policymakers devising gatekeeper liability will have to consider the tradeoff between further preventing misconduct and distorting market entry decisions.¹³³

Strict v. Negligence-based Liability. Let us begin with the choice between strict liability and negligence. The benefit of moving in the direction of strict liability depends on the extent to which the government fails in implementing a negligence-based regime. Stated differently, the

Media, 71 NOTRE DAME L. REV. 79, 122 (1995). The tendency to exempt common carriers from liability can also be explained by the existence of network effects, which imply that neither carriers nor their clients internalize the full social cost of screening out clients. See Katyal, *supra* note 14, at 1084–85 (exploring the impact of network effects on defensive measures against Internet crime).

129. See sources cited *supra* note 25.

130. See analysis in Part II.B *supra*.

131. See analysis in Part III.B *supra*.

132. See analysis in Part III.A *supra*.

133. See also Joel Seligman, *The Implications of Central Bank*, 49 BUS. LAW. 1429, 1442 (1994) (noting that the question underlying the decision to adopt secondary liability for securities fraud is “whether increasing the costs of providing services, such as accounting, can be justified in terms of the amount of fraud that may be deterred”).

value of strict liability will equal the difference between the combined cost of wrongdoing and gatekeeper monitoring under strict liability and such combined cost under negligence.¹³⁴ The cost of moving in that direction comprises of the distortion of market entry decisions as a result of the increase in gatekeeper fees. That cost, in turn, will depend on market-specific factors—such as the proportion of wrongdoers in the client pool—that impact both the size of the fee hike and client responses.

Whether the benefits of strict liability outweigh its costs is an empirical matter. Other things equal, however, moving in the direction of strict liability will become more appealing when (i) the government does a poor job in implementing a negligence-based regime, and (ii) gatekeepers become more effective in preventing client wrongdoing.

Negligence v. Scierter. As explained earlier,¹³⁵ a negligence-based regime is not costless. Under negligence, gatekeepers will increase their fees to reflect their compliance costs. When compliance costs are sufficiently large, the substantial increase in gatekeeper fees will disrupt market access by law-abiding clients.

If negligence turns out to be overly costly, policymakers could opt for a knowledge-based regime. Under a knowledge-based regime, gatekeepers will be liable only if they know of unlawful behavior but fail to prevent it. Unlike negligence, this standard imposes no policing duties on gatekeepers. Hence, the costs of gatekeeper compliance, if any, will be borne only by those clients that gatekeepers know to be wrongdoers.¹³⁶ The obvious flaw of knowledge-based standards, however, is that they provide gatekeepers with no incentives to scrutinize client conduct even when detecting misconduct is relatively easy.¹³⁷

For expositional convenience, I have restricted the discussion to three broadly defined groups of standards—strict liability, negligence, and scierter. Practically, however, policymakers can adopt a variety of multi-dimensional regimes that may involve components of strict, negligence-based, and knowledge-based liability.¹³⁸ While I have not elaborated on such “mixed” regimes of gatekeeper liability, the analytical framework developed in this Article is applicable to them as well.

134. Note that a shift from negligence to strict liability may turn out to reduce (rather than increase) the cost of gatekeeper compliance. *See supra* note 78.

135. *See* Part III.B *supra*.

136. *See also* Kraakman, *supra* note 12, at 76–77.

137. *See* Hamdani, *supra* note 12, at 936–38.

138. Laurie L. Levenson, *Good Faith Defenses: Reshaping Strict Liability Crimes*, 78 CORNELL L. REV. 401, 405 (1993) (proposing, in the criminal law context, the adoption of “good faith defense” to strict liability offenses involving imprisonment).

As this section demonstrates, crafting an optimal regime of gatekeeper liability requires policymakers to answer a complex set of empirical questions. Realistically, therefore, policymakers are likely to make their decision under conditions of uncertainty concerning the proper regime. Granted the potential for substantial costs associated with gatekeeper liability, policymakers can resort to two relatively safe strategies: adopting knowledge-based standards, and explicitly requiring gatekeepers to adopt policing measures that are known to be cost effective (or prohibiting gatekeeper practices that are clearly undesirable).¹³⁹ As I will explain below,¹⁴⁰ these strategies are unlikely to provide gatekeepers with sufficient incentives to foil misconduct. Yet, these strategies will prevent some wrongdoing at a relatively low cost.

The analysis in this section illuminates some intriguing aspects of existing doctrine. Typically, gatekeepers do not face strict liability even when their clients are subject to strict liability for their misconduct. There are numerous examples for this tendency to refrain from holding third parties strictly liable.

Section 11 of the Securities Act of 1933,¹⁴¹ for instance, imposes strict liability on issuers when their registration statement contains an untrue statement of material fact or omits to state a material fact.¹⁴² Other defendants, however, are not subject to strict liability. Rather, they are entitled to a negligence-based “due diligence” defense or, in the case of certain outside directors, a knowledge-based defense.¹⁴³

Likewise, the rules governing secondary liability for copyright infringement treat gatekeepers less harshly than their clients. Whereas the liability for direct infringement in copyright is strict,¹⁴⁴ the liability for secondary infringement is not. Rather, some form of culpability—

139. The Digital Millennium Copyright Act, for example, employs this strategy by specifying certain procedures that Internet service providers must implement to avoid liability for copyright infringement by their subscribers. See 17 U.S.C. § 512 (1999). For an analysis of this aspect of the Digital Millennium Copyright Act, see Hamdani, *supra* note 12, at 949–54.

140. See Part V.B *infra* (discussing the appropriate regime under Rule 10b-5).

141. 15 U.S.C. § 77(k)(a) (2000).

142. See *In re Cendant Corp. Litig.*, 264 F.3d 201, 233 (3d Cir. 2001); Allan Horwich, *Section 11 of the Securities Act: The Cornerstone Needs Some Tuckpointing*, 58 BUS. LAW. 1, 10 (2002).

143. For an overview, see THOMAS LEE HAZEN, *THE LAW OF SECURITIES REGULATION* § 7.4 (4th ed. 2002) (describing how courts impose a sliding scale defense depending on the defendant’s knowledge, expertise, status, and degree of participation in preparation of the materials in question).

144. See 3-13 NIMMER ON COPYRIGHT § 13.08 (2003) (good-faith mistakes and ignorance do not constitute a defense to a finding of direct infringement, though they might affect remedies).

knowledge of the infringement or the ability to prevent wrongdoing—is required in order to hold a third party liable for copyright infringement.¹⁴⁵

The final example is secondary liability for defamation. The common law of libel distinguishes among three types of defendants. *Publishers* of libelous material will be held liable for defamation regardless of their state of mind.¹⁴⁶ *Common carriers* (such as telephone companies) are not liable for defamation. *Distributors* of published material, such as bookstore owners, are liable only when they have actual knowledge or should have known of the defaming nature of the publication.¹⁴⁷

The consistently disparate treatment of gatekeepers and primary wrongdoers is best explained by the significant costs associated with strict gatekeeper liability. Since it has the potential to distort market entry decisions by law-abiding clients, strict gatekeeper liability is likely to be overly costly. Thus, even when there are good reasons for imposing strict liability on primary wrongdoers, strict gatekeeper liability is unlikely to be implemented.

C. THE LIMITS OF GATEKEEPER LIABILITY

Third party liability involves an inevitable tradeoff between preventing misconduct and minimizing the disruption of market access. Granted this tradeoff, no regime of gatekeeper liability is likely to produce the first-best outcome, i.e., gatekeeper liability will nearly always turn out to be a costly, imperfect mechanism. This underscores the limited usefulness of gatekeeper liability as an instrument of social policy aimed at preventing misconduct.

Legal economists often prefer liability rules to government regulation. The principal justification for this preference is that the former harness the

145. Under the doctrine of contributory infringement, the third party defendant generally must know about the infringing conduct of the primary wrongdoer. See *Gershwin Publ'g Corp. v. Columbia Artists Mgmt., Inc.*, 443 F.2d 1159, 1162 (2d Cir. 1971). Several courts, however, have determined that it is sufficient, for establishing contributory liability, that the third party should have known about the infringing conduct. See *Cable/Home Communication Corp. v. Network Prods., Inc.*, 902 F.2d 829, 845, 846 n.29 (11th Cir. 1990) (requiring that the secondary infringer “know or have reason to know” of the infringement); *Religious Tech. Ctr. v. Netcom On-Line Communication Servs., Inc.*, 907 F. Supp. 1361, 1373–4 (N.D. Cal. 1995) (framing the issue as “whether Netcom knew or should have known” of infringing activities). On vicarious liability, see discussion in the text accompanying notes 120–126 *supra*.

146. This rule was modified on First Amendment grounds in the seminal decision of the U.S. Supreme Court in *New York Times Co. v. Sullivan*, 376 U.S. 254, 279–80 (1964) (adopting a requirement of “actual malice” for statements concerning public figures).

147. See, e.g., Barry J. Waldman, *A Unified Approach to Cyber-Libel: Defamation on the Internet, A Suggested Approach*, 6 RICH. J.L. & TECH. 9, 33 (1999).

knowledge held by defendants concerning the costs and benefits of precaution.¹⁴⁸ Granted its lack of information, the state is bound to make errors in prescribing the course of action that private actors should take.¹⁴⁹ Thus, the argument goes, the government should limit its role to setting penalties that reflect social harm. Under this position, the socially desirable outcome would emerge as long as the government imposes the “correct” penalties on average.¹⁵⁰

This Article, however, shows otherwise. In the domain of gatekeeper liability, setting penalties to equal social harm may fail to produce the socially optimal outcome. The government, therefore, cannot limit its role to making wrongdoers or gatekeepers internalize the costs of misconduct.¹⁵¹ This insight undermines the case for an exclusive reliance on gatekeeper liability and renders regulation (and other strategies) a more attractive option for dealing with enforcement failures. To be sure, government regulation suffers from flaws of its own, including the lack of information and the omnipresent susceptibility to regulatory capture and rent seeking. Yet, since gatekeeper liability is also an imperfect, costly mechanism, policymakers should weigh the costs of government regulation against the costs of gatekeeper liability.

Consider the choice that Congress and the SEC faced in the aftermath of the recent corporate accountability crisis concerning the proper response to the apparent need to provide capital market intermediaries with sufficient incentives to prevent public companies from misleading investors. Policymakers could have pursued two alternative strategies for aligning the interests of gatekeepers with those of investors. The first strategy was to expand gatekeeper liability exposure, by reinstating aiding and abetting liability for securities fraud, for example.¹⁵² The second was

148. See, e.g., Kaplow & Shavell, *supra* note 79, at 749–51 (advocating greater reliance on liability rules instead of regulation in preventing pollution).

149. See, e.g., Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359, 2378–80 (1998) (arguing that the SEC is bound to err in promulgating regulations).

150. See, e.g., Kaplow & Shavell, *supra* note 79, at 725–27.

151. See also Lucian A. Bebchuk, *Property Rights and Liability Rules: The Ex Ante View of the Cathedral*, 100 MICH. L. REV. 601 (2001) (showing that liability rules may fail to produce optimal incentives to make investment *ex ante*); Steven Shavell, *Liability for Harm Versus Regulation of Safety*, 13 J. LEGAL STUD. 357 (1984) (exploring conditions under which regulation is superior to liability for harm).

152. See discussion in Part V.B *infra*. See also Mark Klock, *Two Possible Answers to the Enron Experience: Will It Be Regulation of Fortune Tellers or Rebirth of Secondary Liability?*, 28 J. CORP. L. 62 (2002) (juxtaposing the two strategies as plausible responses to the recent corporate governance crisis). For the view that the best response would have been allowing the market to self-correct, see Larry E. Ribstein, *Market Vs. Regulatory Responses to Corporate Fraud: A Critique of The Sarbanes-Oxley Act of 2002*, 28 J. CORP. LAW 1, 47–48 (2002).

to regulate the relevant industries—by promulgating rules to ensure auditor independence, for instance.

Under the traditional economic approach, the liability route may seem to be rather appealing.¹⁵³ This Article, however, has shown that expanding the scope of gatekeeper liability may impose substantial costs on capital markets, thereby casting doubt on the extent to which expanding gatekeeper liability is indeed superior to government regulation.

Recognizing the limited usefulness of gatekeeper liability also illuminates the recent dilemma concerning the legal response to P2P file-swapping technologies. Consider a company (such as *Grokster*) developing P2P file-swapping software (*Morpheus*) that allows users to exchange files over the Internet.¹⁵⁴ This software can be used for both lawful and unlawful (copyright infringement) purposes. For simplicity, assume that *Grokster* can take no steps to monitor user conduct. The question facing policymakers is what strategy to adopt with respect to such technology.

The traditional economic position makes an appealing case for reliance on liability rules. Holding *Grokster* fully liable for the unlawful uses of its technology would make it internalize the social cost of such technology. If the value of the lawful uses of the technology exceeds the value of the bad uses, the argument goes, *Grokster* would develop the technology notwithstanding the liability costs imposed on it for doing so.

This Article, however, casts doubt on this position. As Part II has shown, setting the penalties imposed on *Grokster* to equal harm will not ensure that the technology will be developed when it is socially optimal to do so. Thus, we cannot rely on the strategy of holding the developer of a technology like *Morpheus* liable for its social costs to determine the fate of such technology.

Instead, the government should take a more active role in evaluating the costs and benefits of such technology. This goal can be achieved by assigning courts the task of evaluating the relevant technology to determine whether it should be introduced into commerce.¹⁵⁵ Alternatively,

153. See Klock, *supra* note 154, at 109 (contending that expanding the liability of gatekeepers rather than further regulation is the best response to the current crisis).

154. A district court recently held that *Grokster* is not liable for copyright infringement by the users of its software. See *MGM Studios, Inc. v. Grokster, Ltd.*, 259 F. Supp. 2d 1029 (C.D. Cal. 2003).

155. This is one way to justify the “substantial non-infringing use” doctrine adopted by the U.S. Supreme Court in *Sony Corp. of Am. v. Universal City Studios, Inc.*, 464 U.S. 417, 440 (1984). For a critique of the specific considerations employed by the Supreme Court to find substantial noninfringing use, see Landes & Lichtman, *supra* note 14, at 117–18. For an analysis of the applicability of *Sony* to P2P cases, see Stacey L. Dogan, *Is Napster a VCR? The Implications of Sony for Napster and Other Internet Technologies*, 52 HASTINGS L.J. 939, 954–59 (2001).

policymakers can decide to abandon the liability system altogether and devise a central system of imposing levies on the providers of technologies and services used for file swapping.¹⁵⁶ Whatever strategy turns out to work best, they are both likely to be superior to merely requiring the providers of P2P technologies to internalize the social cost of their product.

V. SECURITIES FRAUD: PRELIMINARY OBSERVATIONS

One of the omnipresent dilemmas in securities laws is the extent to which capital market intermediaries should be held liable for fraud committed by public companies.¹⁵⁷ This question has taken an urgent dimension with the recent discoveries about the involvement of auditors, lawyers, and investment banks in the events that culminated in highly publicized corporate debacles.¹⁵⁸ But while the common presumption is that some reform is needed, there is widespread disagreement over the proper means through which to harness gatekeepers to the task of improving the quality of corporate disclosure.

Due to obvious space constraints, a comprehensive analysis of the proper regime of gatekeeper liability for securities fraud is beyond the scope of this Article.¹⁵⁹ Instead, relying on the framework that this Article has developed, this Part will offer some preliminary observations concerning secondary liability for securities fraud, focusing mostly on the general antifraud provisions of section 10(b) of the 1934 Act¹⁶⁰ and Rule 10b-5. First, I will discuss some unique features of the securities market.

156. See Netanel, *supra* note 101, at 19–21 (advocating the substitution of noncommercial use levies for damages to compensate copyright owners for the noncommercial exchange of files on P2P networks); Brandon Mitchener, *German Mediator Recommends Copyright Levy on Computers*, WALL ST. J., Feb. 5, 2003 (reporting a proposal to make personal-computer makers compensate copyright owners for digital copying).

157. For representative examples of scholarship addressing this topic, see James D. Cox, *Just Deserts for Accountants and Attorneys After Bank of Denver*, 38 ARIZ. L. REV. 519 (1996); Daniel R. Fischel, *Secondary Liability Under Section 10(b) of the Securities Act of 1934*, 69 CAL. L. REV. 80 (1981); Lewis D. Lowenfels, *Expanding Public Responsibilities of Securities Lawyers: An Analysis of the New Trend in Standard of Care and Priorities of Duties*, 74 COLUM. L. REV. 412 (1974); Richard W. Painter, *Toward A Market for Lawyer Disclosure Services: In Search of Optimal Whistleblowing Rules*, 63 GEO. WASH. L. REV. 221 (1995)..

158. Recent examples include the alleged failure of PricewaterhouseCoopers to blow the whistle on loans to senior executives at Tyco, and the complaint filed by the SEC against KPMG concerning its failure to stop fraudulent accounting at Xerox. See Matthew Breilis & Jeffrey Krasnerto, *Auditor Knew of Tyco Deals, Prosecutor Says*, BOSTON GLOBE, Feb. 9, 2003, at E1; Floyd Norris, *S.E.C. Says KPMG Helped Xerox Inflate Profits*, N.Y. TIMES, Jan. 30, 2003, at C1.

159. Merritt Fox has put forward a thoughtful proposal for overhauling the current regime of liability for securities fraud. See generally Fox, *supra* note 35.

160. 15 U.S.C. § 78j-1(b) (2000).

Then, I will put forward several tentative proposals concerning gatekeeper liability for securities fraud.

A. MARKET OVERVIEW

The analysis thus far has focused on the basic common factors underlying gatekeeper liability across a variety of markets. Before moving on to consider secondary liability for securities fraud, therefore, I would like to highlight some important features of the market for capital that may affect the appropriate regime of gatekeeper liability.

Private Litigation. Securities laws are enforced through a combination of private litigation—typically class actions—and public enforcement—actions brought by the SEC and, in criminal cases, the Department of Justice. The prominent role of the plaintiff bar in the enforcement of securities laws creates a risk of frivolous suits,¹⁶¹ which could undermine the deterrent effect of securities laws and further increase the costs of preventing fraud through gatekeeper liability.¹⁶² One may argue, therefore, that narrowing the scope of gatekeeper liability is necessary in order to mitigate the risk of frivolous litigation.¹⁶³

Narrowing the scope of gatekeeper liability would indeed discourage frivolous suits, but also meritorious ones. The question, therefore, is whether this blunt response is the best mechanism for addressing the risk of excessive litigation. Procedural reforms aimed at filtering suits based on their quality, for example, appear to be better designed to restrict only frivolous suits.¹⁶⁴ Moreover, even if the risk of frivolous litigation justifies a decrease in the extent to which gatekeepers are liable to private plaintiffs,¹⁶⁵ or the elimination of such liability altogether,¹⁶⁶ the question

161. For a thoughtful articulation of the definition of “frivolous” claims, see Robert Bone, *Modeling Frivolous Suits*, 145 U. PA. L. REV. 519, 531 (1997) (“A lawsuit is frivolous if a plaintiff files suit knowing facts that decisively establish little or no chance of the defendant’s objective liability *on the basis of any of the legal theories plaintiff alleges.*”).

162. Strike suits undermine the deterrent power of gatekeeper liability because the cost difference between acting properly and failing to do so decreases. *See generally* Kaplow & Shavell, *supra* note 84.

163. On the modification of liability standards to address problems of excessive litigation, see Ronald A. Cass & Keith N. Hylton, *Antitrust Intent*, 74 S. CAL. L. REV. 657 (2001) (positing that intent standards are necessary to prevent over-deterrence in the antitrust context).

164. The best known example is the pleading standards imposed on plaintiffs under the Private Securities Litigation Reform Act of 1995, 15 U.S.C. § 78u-4(b)(1), (2) (2000). On the effectiveness of the Private Securities Litigation Reform Act in curbing frivolous litigation, see Michael A. Perino, *Did the Private Securities Litigation Reform Act Work?*, 19–20 (Columbia Law & Econ. Working Paper No. 211, 2002), available at <http://www.ssrn.com>.

165. *See* Langevoort, *supra* note 4 (advocating a distinction between the standard of liability that should apply in private lawsuits and the standard of liability that should apply in lawsuits brought by the SEC).

remains what should be the scope of gatekeeper liability for actions brought by the SEC. The analysis, therefore, will proceed under the assumption that while the threat of frivolous litigation may justify certain procedural reforms, it should not be addressed by narrowing the substantive standards governing gatekeeper liability.

Multiple Gatekeepers. Public companies use the services of multiple parties, including lawyers, auditors, and investment bankers. In principle, the presence of multiple parties complicates the task of designing an optimal regime of gatekeeper liability by requiring policymakers to identify which third parties should be designated as gatekeepers and held liable for client misconduct. In the context of securities fraud, however, this risk is somewhat mitigated, because the third parties involved can often contract privately to ensure that the party best positioned to ensure compliance will ultimately incur the cost of liability.¹⁶⁷ Underwriters, for example, can require opinions from auditors and lawyers concerning certain aspects of a transaction that lie within the realm of their expertise. Private contracting can also take the form of entering into indemnification and contribution agreements between various gatekeepers.¹⁶⁸

Policymakers, therefore, should aim at devising a regime that would utilize the ability of gatekeepers to allocate the risk of liability. This, in turn, will require policymakers to tackle issues such as the proper treatment of indemnification agreements,¹⁶⁹ and the choice between joint-and-several and proportionate liability for gatekeepers.¹⁷⁰ The analysis in the next section illustrates, first, how the cost of gatekeeper liability may increase due to the presence of multiple gatekeepers, and, second, the manner in which the ability of third parties to shift the cost of liability can be incorporated into a broader scheme of gatekeeper liability.

166. Thus, for example, only the SEC is currently allowed to bring suits against gatekeepers for aiding and abetting securities fraud. See 15 U.S.C. § 78b, d, t(f) (2000). For a review of the standards of liability that govern the SEC's aiding and abetting actions, see Lewis D. Lowenfels & Alan R. Bromberg, *A New Standard for Aiders and Abettors under the Private Securities Litigation Reform Act of 1995*, 52 BUS. LAW. 1 (1996).

167. For an analysis of the implications of the ability to shift the risk of legal liability, see Part II.A, *supra*.

168. See, e.g., Stephen E. Older & Joshua M. Bloomstein, *Indemnification and Contribution in Underwritten Offerings*, 15 INSIGHTS 17 (2003) (reviewing prevailing practices concerning indemnification provisions in underwriting agreements).

169. See, e.g., *Globus v. Law Research Servs., Inc.*, 418 F.2d 1276, 1288 (2d Cir. 1969) (holding that the policy underlying the Securities Act of 1933 renders void an indemnification agreement to the extent it covers fraudulent conduct). See also Helen S. Scott, *Resurrecting Indemnification: Contribution Clauses In Underwriting Agreements*, 61 N.Y.U. L. REV. 223 (1986).

170. See Donald Langevoort, *The Reform of Joint and Several Liability Under the Private Securities Litigation Reform Act of 1995: Proportionate Liability, Contribution Rights and Settlement Effects*, 51 BUS. LAW. 1157 (1996).

Victims as Consumers. Unlike other victims, such as copyright owners who are victims of infringement, victims of securities fraud are often investors who purchase securities from the issuer-wrongdoer (or from investors who purchased their shares from the issuer). Conceptually, this casts doubt on the basic justification for expanding liability to third parties, and even on the basic need for the current system of mandatory disclosure.¹⁷¹ This is because investors presumably would be willing to pay a higher price for stock issued under credible commitment on the part of the issuer to refrain from fraud. Following existing doctrine, however, I will assume that, notwithstanding the dual role of victims, both mandatory disclosure and gatekeeper liability are justified

The dual role of victims, however, may impact the optimal scope of gatekeeper liability for securities fraud. Specifically, this phenomenon may reduce the costs associated with expanding gatekeeper liability. The intuition is that the fee hike under strict gatekeeper liability, for example, would approximate the discount in the price that investors would have paid for the securities of a company going public in the absence of gatekeeper liability.¹⁷² Thus, even the most expansive form of gatekeeper liability would arguably not make issuers worse off than they would have been under a regime of primary liability.¹⁷³ In other words, assuming that the expected costs of fraud are generally reflected in the price investors are willing to pay for the securities offered to the public, introducing strict gatekeeper liability would have virtually no adverse impact on capital markets.

This potential effect of victims' dual role may be substantial in the case in which liability is triggered by fraud in connection with the sale of securities to the public, which is governed by Section 11 of the 1933 Act. In contrast, this effect will be rather remote when liability is imposed in

171. See sources cited *supra* note 22; Shavell, *supra* note 21, at 21–22 (contending that firms will take optimal care even in the absence of liability when customers are informed about product risk). On the case for mandatory disclosure, see, for example, Paul G. Mahoney, *Mandatory Disclosure as a Solution to Agency Problems*, 62 U. CHI. L. REV. 1047, 1095–1104 (1995); John C. Coffee, Jr., *Market Failure and the Economic Case for Mandatory Disclosure*, 70 VA. L. REV. 717, 728–34 (1984).

172. This intuition can be illustrated by a numerical example. Assume that wrongdoers constitute 10% of all issuers, and that the harm to investors from fraud is 1,000. In the absence of gatekeeper liability, investors will discount the prices of the securities of all new issuers by 100. Now assume that auditors are subject to strict liability for issuer fraud. For the sake of simplicity, assume that auditors lack the ability to detect fraud. In this case, the fee hike would be 100. On the other hand, investors would agree to increase the purchase price by 100, because they would expect to collect damages from the auditor gatekeeper in case of fraud.

173. Others have relied on the dual role of victims to suggest that gatekeepers should be allowed to choose the extent to which they will be held liable for issuer fraud. See Choi, *supra* note 22, at 951–54; Partnoy, *supra* note 15, at 541–42.

connection with fraud in the secondary market, which may take place years after the company last sold securities to the public. Thus, my analysis of gatekeeper liability under Rule 10b-5 below will proceed under the premise that expanding gatekeeper liability can have potentially disruptive effects on capital markets.

Reputation. Some capital market participants, especially auditors and underwriters, serve as “reputational intermediaries” on behalf of issuers.¹⁷⁴ Those gatekeepers arguably derive significant returns from maintaining a reputation for certifying only high-quality issuers and thus have strong non-legal incentives to ensure that their clients do not commit fraud.

A regime aimed at providing gatekeepers with optimal incentives to prevent securities fraud should obviously take such non-legal incentives into account. But while reputation undeniably has some impact on capital market gatekeepers, recent events cast significant doubts over the nature of this impact and its interaction with other market forces and thus on the extent to which reputation can be relied upon to replace or supplement gatekeeper liability.¹⁷⁵ Given the limited understanding concerning the actual impact of reputation on gatekeeper actions, it is unclear what effect the reputation factor should have on the scope of gatekeeper liability. Accordingly, the next section will not address the impact that the presence of reputational concerns should have on the scope of gatekeeper liability for securities fraud.

B. RULE 10B-5

The primary remedy for securities fraud is the antifraud provisions found in section 10(b) of the 1934 Act and in Rule 10b-5. Unlike Section 11 of the 1933 Act, which covers only fraud in connection with the offering of securities pursuant to a registration statement, the general prohibition on fraud covers virtually all instances of fraud with respect to the securities of public companies.

The broad, unlimited range of practices potentially covered by Rule 10b-5 is perhaps best illustrated by the distinct ways in which lawyers have been implicated in the *Enron* debacle. In a lawsuit filed by *Enron* shareholders under Rule 10b-5 (and other causes of action), the plaintiffs

174. See Gilson & Kraakman, *supra* note 96, at 618–21

175. See, e.g., Coffee, *supra* note 3, at 1409, 1412–16 (providing an explanation for the failure of their concern with their reputation to induce accounting firms to prevent fraud); Gordon, *supra* note 3, at 1240; Robert A. Prentice, *The Case of the Irrational Auditor: A Behavioral Insight into Securities Fraud Litigation*, 95 NW. U. L. REV. 133, 143–48 (2000) (providing behavioral reasons for the failure of auditors to preserve their firm’s reputation).

accuse some law firms that had represented *Enron* of structuring and documenting deceptive transactions, issuing “true sale” opinions that facilitated the use of off-balance-sheet entities, and failing to conduct proper internal investigation of employee allegations of improper accounting.¹⁷⁶

The extensive range of transactions and parties subject to Rule 10b-5 affects both the costs and the benefits of gatekeeper liability under this rule. Unfortunately, the impact in both cases is in the same direction.

To begin, the potential benefits of moving in the direction of strict gatekeeper liability are very significant. Neither courts nor regulators are likely to possess sufficient foresight or information to apply with precision a negligence-based regime to the constantly growing list of fraudulent transactions and innovative schemes that public companies and their advisors may employ to manipulate earnings or conceal information about the financial condition of issuers.¹⁷⁷ A negligence-based regime, therefore, would produce either under-deterrence or over-deterrence or both. Strict liability, in contrast, would provide gatekeepers with the optimal incentives to monitor clients and to avoid complicity in fraudulent transactions.

At the same time, however, the wide range of transactions and actors covered by Rule 10b-5 creates the risk that an expansive standard of gatekeeper liability would produce substantial costs. Not all gatekeepers are equally positioned to learn that their client contemplates misleading shareholders. Holding gatekeepers liable for misconduct they cannot prevent would merely induce them to raise the fees that they impose on issuers. Thus, combining a broadly defined prohibition on fraud with an expansive standard of liability may substantially distort capital markets. In fact, the potential for significant costs may justify not only the abandonment of strict liability, but also a departure from negligence in favor of a more restrictive standard of liability.¹⁷⁸

The adverse impact of expansive gatekeeper liability on capital markets could take three concrete forms. First, an increase in gatekeeper fees may encourage existing public companies to consider delisting. Although conceptually feasible, this threat seems to be not too

176. See Roger C. Cramton, *Enron and the Corporate Lawyer: A Primer on Legal and Ethical Issues*, 58 *BUS. LAW.* 143, 172 (2002).

177. For a review of the various techniques employed by public corporations to misstate their financial conditions, see Richard C. Sauer, *Financial Statement Fraud: The Boundaries of Liability Under the Federal Securities Laws*, 57 *BUS. LAW.* 955, 958–91 (2002).

178. See discussion in Part IV.B *supra*.

significant.¹⁷⁹ Second, substantial fee increases could discourage new companies from going public. Finally, fee increases could discourage public companies from engaging in specific transactions, such as structured finance transactions, which gatekeepers will deem to be riskier from a liability exposure perspective. Regardless of the precise form of such an impact, however, a significant increase in gatekeeper fees is likely to undermine access to capital markets.

In light of the costs and benefits described above, it is unlikely that any single standard of gatekeeper liability under Rule 10b-5 would achieve optimal deterrence of securities fraud. Thus, the best strategy would be to adopt a mixed regime that would provide gatekeepers with adequate incentives while seeking to minimize the adverse impact on capital markets. My proposal for such a regime consists of the three principal elements: adopting a background rule of secondary liability for securities fraud accompanied with a knowledge-based standard of liability, regulating gatekeepers, and expanding the liability of designated gatekeepers for specific transactions or with respect to certain SEC filings by their clients.

1. Aiding and Abetting and Scienter

Gatekeepers should generally be subject to liability under the broadly defined Rule 10b-5 under a narrow knowledge-based standard. On the benefit side, a sweeping, open-ended antifraud rule is necessary to tackle the multiple ways in which gatekeepers can be accomplices to, or act to prevent, the various forms of securities fraud. On the cost side, as explained earlier,¹⁸⁰ such a sweeping rule could be significantly costly to the extent that it is accompanied by an expansive standard of liability. Thus, to minimize its disruptive impact on capital markets, gatekeeper antifraud liability should be accompanied with a narrow, knowledge-based standard.

Thus far, my proposal is consistent with current doctrine, which requires plaintiffs to show that defendants in actions under Rule 10b-5 acted with “scienter.”¹⁸¹ I also propose, however, to allow private plaintiffs

179. *But see* Greg Farrell, *Accounting Costs Rising as Wary Companies Play It Safe*, USA TODAY, July 31 2003 at B.02 (reporting an increase in the number of companies going private apparently as a result of the increased compliance costs under the Sarbanes-Oxley Act).

180. *Id.*

181. *See* *Aaron v. SEC*, 446 U.S. 680, 691 (1980) (ruling that the scienter standard applies also to actions by the SEC); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 206 (1976) (adopting a scienter requirement for claims under Section 10(b) of the 1934 Act). Some courts have adopted a broad interpretation of the scienter standard, suggesting that mere recklessness may suffice. *See, for example, In re Silicon Graphics Inc.*, 183 F.3d 970, 976-977 (9th Cir. 1999).

to bring aiding and abetting actions under Rule 10b-5. This, of course, will require Congress to overrule the holding of the Supreme Court in *Central Bank*,¹⁸² which provides that Section 10(b) of the 1934 Act does not allow private aiding and abetting actions. Since the scienter requirement significantly constrains the costs associated with gatekeeper liability, there seems to be no justification for further limiting the scope of actions covered by Rule 10b-5, especially when the lack of private enforcement of aiding and abetting liability for securities fraud may have been one of the reasons for the gatekeeper failures underlying the recent string of corporate debacles.¹⁸³ Moreover, explicitly reinstating aiding and abetting liability will eliminate costly litigation over the proper boundaries of primary liability in securities fraud.¹⁸⁴

2. SEC Regulation

As explained earlier, government regulation can play an important role when gatekeeper liability is potentially costly. In the context of securities fraud, if certain gatekeeper practices are known to be desirable (or undesirable), requiring gatekeepers to implement (or avoid) such practices via government regulation may turn out to be the least costly way to make gatekeepers do so. For example, if policymakers determine that accounting firms should not provide certain non-auditing services to their public company clients, promulgating a rule prohibiting auditors from providing such services might be a less costly method of achieving this goal than holding auditors strictly liable for client fraud. Thus, the current practice under which the SEC sets specific standards to govern capital market participants, such as attorneys and auditors,¹⁸⁵ seems to be

182. See *Cent. Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 177–78 (1994) (holding that civil liability under Section 10(b) does not extend to actions for aiding and abetting).

183. See Coffee, *supra* note 3, at 1409–12 (positing that the decline in auditors' liability costs during the 1990s is a plausible explanation for recent widespread auditor failures to prevent fraud) See also Donald C. Langevoort, *Managing the "Expectations Gap" in Investor Protection: The SEC and the Post-Enron Reform Agenda*, 48 VILL. L. REV. 1139, 1162 (2003) (arguing that "*Central Bank* should be overruled legislatively").

184. On the elusive distinction between primary and secondary liability in the aftermath of the *Central Bank* decision, see, for example, Jill E. Fisch, *The Scope of Private Securities Litigation: In Search of Liability Standards for Secondary Defendants*, 99 COLUM. L. REV. 1293, 1300–03 (1999); Robert A. Prentice, *Locating That "Indistinct" and "Virtually Nonexistent" Line Between Primary and Secondary Liability under Section 10(b)*, 75 N.C. L. REV. 691, 723–26 (1997).

185. See, for example, Final Rule: Strengthening the Commission's Requirements Regarding Auditor's Independence, Release No. 33-8183 (January 28, 2003) (adopting various requirements designed to ensure auditor independence); Final Rule: Implementation of Standards of Professional Conduct for Attorneys, Release No. 33-8186 (January 23, 2003) (requiring attorneys to report "up the ladder" evidence of certain violations). For a critique of the SEC rules concerning attorneys, see Jill E.

appropriate notwithstanding the imperfect nature of this process and of the resulting regulations.

To emphasize, I do not argue that all rules promulgated by the SEC are necessarily optimal. Nor do I argue that the SEC rulemaking process is free of rent-seeking behavior and other pathologies associated with government regulation.¹⁸⁶ Rather, I believe that, as a matter of principle, regulating gatekeepers may sometime be less costly than subjecting them to broad antifraud liability.

Both knowledge-based standards and SEC rules provide a certain level of deterrence while keeping the cost of gatekeeper liability relatively low. A regime consisting merely of these two elements, however, will be incomplete. The SEC is unlikely to address in its rules all the innovative transactions that may serve as a basis for fraud, whereas knowledge-based standards provide gatekeepers with no incentive to monitor client conduct. The challenge, therefore, is to find rules that would tap the benefits of strict liability without triggering its costs. The remaining element of my proposal aims at achieving this goal.

3. Selective Expansion of Gatekeeper Liability

The principal reason for why expanding the scope of antifraud liability would be costly is that Rule 10b-5 covers a broad range of transactions and virtually all of capital market participants. Those costs could be reduced, therefore, by expanding the scope of liability, but only with respect to (i) a narrowly defined activity, and (ii) a party who is expected to be relatively successful in detecting issuer fraud.

This strategy can be implemented, for example, by designating one party who will vouch for the accuracy of the portion of the issuer disclosure that lies within its field of expertise on a periodic basis, say with respect to the annual Form 10-K filed by public companies.¹⁸⁷ Such party, in turn, will be subject to strict liability for certifying statements that later turn out to be false.

Fisch & Kenneth M. Rosen, *Is There a Role for Lawyers in Preventing Future Enrons?*, 48 VILL. L. REV. 1097 (2003).

186. See Jonathan R. Macey, *Administrative Agency Obsolescence and Interest Group Formation: A Case Study of the SEC at Sixty*, 15 CARDOZO L. REV. 909 (1994) (providing a public choice explanation for the SEC's continued existence).

187. Cf. Fox, *supra* note 35, at 713–719 (proposing a regime of annual underwriter certification); James D. Cox, *The Fundamentals of Electronic-Based Federal Securities Act*, 75 WASH. U.L.Q. 857, 883–86 (1997) (proposing a regime of triennial certification).

As Donald Langevoort has argued, auditors currently seem to be the best candidates for facing such liability.¹⁸⁸ Since they already conduct a costly audit process concerning the financial condition of the issuer, they are well positioned to scrutinize issuer disclosure and certify its accuracy. Stated differently, the added policing cost due to the certification requirement are likely to be low, and auditors will be relatively effective in preventing fraud.¹⁸⁹

On the benefit side, the auditor certification rule would overcome the shortcomings of the scienter standard and SEC regulations. It would provide at least one capital market participant with the incentives to scrutinize public company disclosure without requiring regulators to anticipate in advance the variety of innovative ways through which issuers may mislead investors. Be it textbook accounting fraud (like in the case of *Worldcom*) or the sophisticated use of off-balance sheet entities (*Enron*), auditors will face appropriate incentives to ensure that the disclosure fairly presents the financial situation of the issuer.

188. See Langevoort, *supra* note 4, at 60. Langevoort, however, posits that auditors should face negligence-based liability. See *id.* at 61. Note that I do not argue that auditors are always capable of detecting all instances of issuer fraud. See, for example, Joshua Ronen, *Post-Enron Reform: Financial Statement Insurance and GAAP Re-visited*, 8 STAN. J. L. BUS. & FIN. 39, 41 (2002) (calling for a reform of GAAP so that “financial statement elements that inherently are not verifiable should not be audited”).

189. My tentative proposal differs from two recent thoughtful proposals. Under Frank Partnoy’s innovative proposal, gatekeepers would face a modified regime of strict liability under which the client and the gatekeeper would contract for the gatekeeper to bear a minimum percentage of the issuer’s losses. See Partnoy, *supra* note 15, at 540-46. See also Choi, *supra* note 22, at 951-59 (suggesting that the issuer and the gatekeeper should contract over the share of the gatekeeper’s liability). In a forthcoming article, John Coffee advocates a regime of “stricter” auditor liability. The novelty of his proposal is that the auditor would be converted into the functional equivalent of an insurer, with a minimum floor on the auditor’s insurance policy equal to an adequate multiple of the highest annual revenues received by the auditor from its client over the last several years. See Coffee, *supra* note 7, at 67-68. See also Ronen, *supra* note 188 (advocating a system of financial statement insurance provided by third parties). Since this Article did not undertake an in-depth analysis of the proper role of reputation in devising a regime of gatekeeper liability, I take no position as to whether auditors and issuers should be allowed the freedom to determine the magnitude of their liability. In addition, my proposal would set the penalties imposed on auditors to equal social harm. By reducing the level of the penalties imposed on gatekeepers, the proposals made by Partnoy and Coffee would mitigate the potentially disruptive impact of gatekeeper liability on capital markets. On the other hand, by allowing the sanction to differ from social harm, both proposals might fail to provide gatekeepers with adequate incentives to monitor issuers and prevent fraud and thus undermine the fundamental advantage of strict liability. See also A. Mitchell Polinsky & Steven Shavell, *Should Liability Be Based on the Harm to the Victim or the Gain to the Injurer?*, 10 J. L. ECON. & ORG. 427 (1994) (showing that making damages equal the gain to the injurer would likely fail to produce optimal deterrence); Frank Partnoy, *Strict Liability for Gatekeepers: A Reply to Professor Coffee*, (Working Paper, 2003) available at www.ssm.com (criticizing Coffee’s proposal to set penalties based on auditor revenues).

On the cost side, limiting the broad rule of auditor liability to the financial information contained in a discreet disclosure document caps the litigation exposure of auditors and thus their fees. In order to further limit the impact of enhanced auditor liability on accounting fees, auditors should be allowed to rely on the opinions of experts, such as legal opinions by attorneys or other opinions by investment banks structuring complex financial transactions.¹⁹⁰ Practically, this would mean that auditors would be allowed to enter into indemnification and contribution agreements with such experts.

Finally, to further limit the increase in auditing fees, auditors should be entitled to a defense modeled after the “due diligence” defense currently awarded to gatekeepers under Section 11 of the 1933 Act.¹⁹¹ This would generally shift the burden of proof to auditors to show that they could not have detected the fraud. The logic underlying this defense is that auditors should not be liable when it is clear that detecting misstatements was beyond their capacity.¹⁹² This is because imposing liability under such circumstances would increase auditing fee without producing any offsetting benefits. On the other hand, shifting the burden of proof to auditors would alleviate the informational burden imposed on courts or regulators under a negligence-based regime.

To be sure, the proposals I put forward are imperfect and incomplete. The proposals are imperfect in the sense that they will neither prevent all cases of securities fraud nor eliminate the potential disruption of capital markets associated with gatekeeper liability. Yet, as this Article has shown, no regime of gatekeeper liability can achieve the first-best outcome of ensuring issuer candor at zero cost. My proposals, therefore, will offer some of the advantages of enhancing gatekeeper liability without creating substantial costs.

190. On the role of investment banks involved in sophisticated finance transactions, see, for example, Jathon Sapsford & Paul Beckett, *Citigroup Deals Helped Enron Disguise Its Debts as Trades*, Wall. St. J., July 22, 2002 at A1. (detailing Citigroup’s Involvement in Enron’s attempt to recharacterize some of its income)

191. See also Fox, *supra* note 35, at 915–17713–719 (proposing a due-diligence defense for underwriters’ annual certification). As John Coffee notes, an additional advantage of a due diligence defense is that it would make a reform aimed at enhancing auditor liability more likely to be endorsed by the political system. See Coffee, *supra* note 7, at 72.

192. Another component of the regime is the consistent application of the respondeat superior doctrine to gatekeeper liability. See Donald C. Langevoort, *Words from on High About Rule 10b-5: Chiarella’s History, Central Bank’s Future*, 20 DEL. J. CORP. L. 865, 893–897 (1995) (reviewing the role of the respondeat superior doctrine in the aftermath of the *Central Bank* decision); Robert A. Prentice, *Conceiving the Inconceivable and Judicially Implementing the Preposterous: The Premature Demise of Respondeat Superior Liability Under Section 10(b)*, 58 OHIO ST. L.J. 1325 (1997) (contending that respondeat superior should apply to violations of section 10(b)).

Moreover, the analysis in this Part does not aim at providing a detailed blueprint for overhauling gatekeeper liability for securities fraud. Rather, its main goal is merely to illustrate the implications of the analytical framework that this Article has developed for capital markets. Accordingly, the specifics of my proposals would undoubtedly need to be worked out and further calibrated to incorporate the multiple institutional, regulatory, and political factors that characterize modern capital markets. For example, the proposal for expanding auditor liability would require policymakers to determine the scope of financial information as to which the auditor would be liable, the relationship between such liability and existing auditing norms, the frequency of issuer disclosure that would be subject to auditor certification, and the extent to which other parties should be subject to a similar type of liability.¹⁹³ Yet, the analysis in this Part does provide policymakers with an overview of the principal building blocks of a liability regime that could provide gatekeepers with adequate incentives to prevent securities fraud without significantly disrupting capital markets.

VI. CONCLUSION

Like the S&L crisis and the emergence of Internet piracy before them, recent high-profile corporate debacles have spawned controversy over the proper strategy for enlisting gatekeepers to prevent misconduct. If history is of any predictive value, however, the fascination of policymakers and academics with the intricacies of gatekeeper liability will surely abate soon. In the aftermath of the next crisis, whatever it may turn out to be, policymakers and academics will again have available only a balkanized, doctrine-specific body of knowledge to guide them in their pursuit of the desirable gatekeeper scheme.

In this Article, I have attempted to rectify this unsatisfactory pattern by developing an analytical framework for evaluating gatekeeper schemes across doctrinal contexts. Specifically, I have shown that all instances of gatekeeper liability are characterized by an inherent tradeoff between providing third parties with adequate incentives to hinder wrongdoing, on the one hand, and minimizing liability's perverse impact on law-abiding clients, on the other.

193. For example, the proper scope of auditor liability will depend on the system of accounting in effect. A shift to a principles-based system of accounting, for example, would likely increase liability exposure for auditors. See Coffee, *supra* note 7, at 57-58. This in turn would require policymakers to narrow the scope of auditor strict liability in order to reduce the expected cost of such a regime. See also Ronen, *supra* note 188.

Crafting an optimal regime of gatekeeper liability requires policymakers to balance carefully the value of improved gatekeeper incentives against the potentially disruptive impact on the relevant market. A single article, therefore, cannot provide answers for all third party liability problems. This Article's analysis, however, does provide important insights and policy recommendations. Specifically, I have identified those third parties that should face gatekeeper liability, explored the complex set of considerations that should guide policymakers when choosing the standard of liability that will govern gatekeepers, and highlighted the limited role of gatekeeper liability as an instrument of social policy. More concretely, I have put forward several preliminary proposals for reforming gatekeeper liability for securities fraud in light of this Article's analysis.

The principal aim of this Article, however, is not to generate specific proposals with respect to particular types of misconduct. Rather, it is to supply both academics and policymakers with a consistent metric for evaluating gatekeeper liability schemes across a wide range of markets and activities. After all, the emergence of a new crisis, or the development of a new technology, that will once again increase the pressure for expanding liability to gatekeepers is just a matter of time. Thus, it is very likely that policymakers will need to rely on this framework, while adapting it to new markets, novel activities, and innovative forms of law-breaking.