Washington and Lee Law Review Online

Volume 73 | Issue 2 Article 5

3-10-2017

The Limits of Gatekeeper Liability

Andrew F. Tuch
Washington University School of Law

The Limits of Gatekeeper Liability

Andrew F. Tuch*

Table of Contents

I. Introduction

Among the many legal strategies for controlling corporate wrongdoing, gatekeeper liability is perhaps the most complex and difficult to justify. As conventionally understood, this strategy involves imposing liability on "gatekeepers"—actors such as lawyers, investment bankers, and accountants—for the wrongs of their corporate clients, thus giving gatekeepers incentives to use their power to monitor and to control, or at least to influence, the conduct of their corporate clients and thereby to deter wrongdoing by them.[1] In business transactions, client wrongdoing

* Associate Professor, Washington University School of Law. For helpful comments and discussions, I thank Linda Liang and Tun-Jen Chiang. For excellent research assistance, I thank Tyler Nullmeyer.

1. *See* Reinier H. Kraakman, *Corporate Liability Strategies and the Costs of Legal Controls*, 93 YALE L.J. 857, 890 (1984) [hereinafter Kraakman, *Corporate Liability Strategies*] ("The first requisite for gatekeeper liability is, of

often takes the form of disclosure misstatements to investors. Gatekeeper liability is premised, first, on the ability of gatekeepers to influence their clients' conduct.[2] Second, it is premised on the incapacity of more direct forms of liability—namely, individual and enterprise liability—to effectively deter wrongdoing by corporate entities.[3] Third, it is premised on the inability of gatekeepers' reputations and of other market mechanisms to appropriately shape gatekeepers' conduct in the absence of liability.[4] Fourth, and somewhat paradoxically, it is also premised on the adequacy of gatekeepers' reputations—on the idea that gatekeepers can "stake" their reputations on the accuracy and completeness of their clients' assertions to investors.[5]

Other factors also complicate the design of conventional gatekeeper liability regimes. Gatekeepers often respond to new regimes with countermoves, seeking to comply with the law without honoring its spirit, which makes the task of delineating gatekeepers' duties difficult.[6] Gatekeepers' incentives routinely

---

course, an outsider who *can* influence controlling managers to forgo offenses."); Reinier H. Kraakman, *Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy*, 2 J. L. ECON. & ORGAN. 53, 62–66 (1986) [hereinafter Kraakman, *Gatekeepers*] (discussing the monitoring function of gatekeepers).

2. Kraakman, *Corporate Liability Strategies*, *supra* note 1, at 890.

3. *See id.* at 868 ("[Gatekeeper liability] serves to remedy enforcement insufficiencies . . . ."); *id.* at 888 ("Enforcement insufficiency occurs when both enterprise and individual penalties fail to elicit sufficient compliance at an acceptable cost."); Howell E. Jackson, *Reflections on* Kaye, Scholer*: Enlisting Lawyers To Improve The Regulation of Financial Institutions*, 66 S. CAL. L. REV. 1019, 1048 (1993) (describing gatekeeper liability in the field of financial regulation as "at most, a supplement to the dominant form of regulation in the field: direct controls over financial intermediaries").

4. *See* Kraakman, *Gatekeepers*, *supra* note 1, at 94 ("[G]atekeeper liability is valuable only if both of these private alternatives [reputation and contractual arrangements] prove inadequate . . . .").

5. *See* Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 620 (1984) ("[T]he investment banker rents the issuer its reputation. The investment banker represents to the market . . . that it has evaluated the issuer's product and good faith and that it is prepared to stake its reputation on the value of the innovation."); *see also* JOHN C. COFFEE JR., GATEKEEPERS: THE PROFESSIONS AND CORPORATE GOVERNANCE 3 (2006) ("Central to this model [of gatekeepers] is the concept of reputational capital and the subsidiary idea that it can be pledged or placed at risk by the gatekeeper's vouching for its client's assertions or projections.").

6. *See* Kraakman, *Corporate Liability Strategies*, *supra* note 12, at 893–96

diverge from those of their employees and others who act on their behalf, a misalignment that gatekeepers' clients may use to undermine the deterrent force of gatekeeper liability. Gatekeepers often have long-standing relationships with their clients and are beholden to them for fees, creating powerful forces that may counter the intended effects of gatekeeper liability. There is also the so-called multiple gatekeeper phenomenon in business transactions—in which multiple distinct gatekeepers serve clients, acting interdependently, rather than independently of one another, and forming "an interlocking and interacting web of protection" against corporate wrongdoing.[7] Nevertheless, despite this complexity and these challenges, gatekeeper liability has become a popular strategy for controlling corporate wrongdoing, especially in business transactions.[8]

The gatekeeper liability strategy has also attracted close scholarly attention. In *Collaborative Gatekeepers*,[9] an important, recent contribution to this literature, Professor Stavros Gadinis and Mr. Colby Mangels draw on techniques that have been successful in anti-money laundering (AML) regulation to propose a regulatory strategy to induce gatekeepers to effectively deter client wrongs.[10] Their strategy is designed to avoid many of the challenges facing conventional gatekeeper liability regimes.[11] It is ambitious, original, and provocative. In this response, I assess the proposal's likely effectiveness by first distinguishing it from conventional gatekeeping regimes and then assessing the extent to which it overcomes the common shortcomings of such regimes. I argue in favor of the proposal but suggest that its success is likely to depend on the particular ways in which it interacts with these (conventional) gatekeeping regimes—because the proposal is intended to be overlaid on these regimes, rather than to amend or replace them. I also explain how the proposal will, inevitably,

---

(discussing difficulties with the design of gatekeepers' duties).

7. Andrew F. Tuch, *Multiple Gatekeepers*, 96 VA. L. REV. 1583, 1602 (2010).

8. For an overview of contexts in which gatekeeper liability is used, see Coffee, *supra* note 5, at 103–07.

9. Stavros Gadinis & Colby Mangels, *Collaborative Gatekeepers*, 73 WASH. & LEE L. REV. 797 (2016).

10. *See id.* at 893–910.

11. *See infra* notes 18–34 (discussing these challenges).

prove difficult to justify—not because it lacks justification, but because gatekeeper liability, by its nature, hinges on the satisfaction of numerous complex conditions that cannot be established—easily, or at all—at least to the satisfaction of those inclined to oppose new liability regimes. Nevertheless, Gadinis and Mangels's proposal is so cautiously and richly developed, and its own potential shortcomings so frankly acknowledged and assessed, that it warrants close investigation in the settings in which it could be applied.

II. The Proposal: Collaborative Gatekeepers

Professor Gadinis and Mr. Mangels propose a regime inspired by requirements in AML regulation for banks to lodge suspicious activity reports with banking authorities.[12] Under the proposed regime, which they would overlay on existing regulation,[13] gatekeepers would be required to collaborate with regulators by reporting (to regulators) any conduct on the part of their clients that they suspect involves wrongdoing.[14] Gatekeepers would report anonymously, a feature designed to shield them from client retribution,[15] and they would face civil liability for failing to report as required. If gatekeepers discharged this reporting duty, they would enjoy immunity from subsequent actions, both public and private, related to the content of their reports "provided they continue[d] to act in good faith."[16] Although gatekeepers might well intervene in a prospective business transaction in order to deter wrongdoing by their clients, such as by actively disrupting wrongdoing or by "closing the gate" on the transaction, what the duty requires is

12. *See* Gadinis & Mangels, *supra* note 9, at 869–74.

13. Professor Gadinis and Mr. Mangels note that "the[ir] collaborative gatekeeping model simply adds a reporting obligation," without suggesting that any existing laws be amended or replaced. *Id.* at 913.

14. *See id.* at 838 ("The central part of this Article's proposal is a new obligation for gatekeepers: to file a report alerting regulators to suspicious activities by their clients.").

15. *See id.* at 836 (noting that "[a]nonymity shields gatekeepers from clients' objections").

16. *Id.* at 910; *see also id.* at 836 ("In return for submitting their suspicions, gatekeepers gain immunity with regard to client misconduct.").

simply for gatekeepers to report their suspicions about their clients' activity to regulators, rather than to take other corrective or preventive action. The proposed technique is thus not gatekeeping as conventionally understood, but a novel, targeted technique intended to ensure a particular form of gatekeeper involvement in business transactions.[17]

The proposed regime is also intended to sidestep many of the core challenges facing commonly existing gatekeeper liability regimes, which Professor Gadinis and Mr. Mangels describe as "conventional" regimes.[18] First, gatekeeper liability regimes typically impose knowledge-based or fault-based duties on gatekeepers—standards that may invite strategic conduct by gatekeepers designed more to avoid liability than to halt client wrongdoing. They explain that scienter-based duties give gatekeepers incentives to "avert[] their gaze, so that they limit the chances of coming across information that would compromise their unawareness."[19] Fault-based gatekeeper duties are similarly problematic: although often "less demanding" than scienter-based duties, they "still require[] gatekeepers to turn away their clients only after evidence starts mounting against them."[20] Under either approach, therefore, gatekeepers "often find themselves tiptoeing around the red line of illegality, putting up a shield around their own liability, rather than worrying about the impact of their client's actions for third parties and the financial system as a whole."[21] In consequence, Professor Gadinis and Mr. Mangels explain, "information that does not render gatekeepers knowledgeable or negligent, but could still offer helpful tips in investigations, never reaches enforcement authorities."[22]

---

17. The proposal might even be considered a hybrid between gatekeeping and whistleblowing. It imposes potential liability on gatekeepers in a manner that effectively ensures a form of gatekeeper monitoring, while also requiring the disclosure of suspected wrongdoing to enforcement officials.

18. *See id.* at 806, 814, 847, 913 (referring to "conventional" gatekeeper liability regimes).

19. *Id.* at 821.

20. *Id.* at 823.

21. *Id.*; *see also id.* at 834–35 ("Not surprisingly, gatekeepers have directed their energy in clearly demarcating their knowledge or negligence, as the case may be, so that they can avoid liability.").

22. *Id.* at 835. Professor Gadinis and Mr. Mangels further note that "gatekeepers have an incentive to suppress this information, for fear that, if

To escape this concern, the proposal "effectively expand[s] the scope of [gatekeepers'] obligations beyond the safe haven of awareness to the unchartered territory of suspicions and doubts."[23] It does so by adding their new reporting regime to the existing framework.[24] Under the new regime, gatekeepers must report when they "come across some indications that raise suspicions [about their clients' conduct] that fall far short of confirming problems."[25] The duty would be harder to "game" than knowledge-based or fault-based duties, making gatekeepers more likely to comply with it than those conventionally articulated duties and potentially giving regulators more information and thus more effectively deterring wrongdoing than existing gatekeeper regimes operating alone.

The second challenge concerns gatekeepers' bonds with their clients. As a transaction progresses, these bonds can strengthen, diminishing the likelihood that the gatekeeper will interdict wrongdoing by its client and even increasing the risk that the gatekeeper will actively assist its client in wrongdoing. By effectively lowering the triggering event or threshold to "suspicion"—or, more accurately, by adding such a duty to the conventional regimes—the proposed regime makes it more likely that gatekeepers will not only be required to act, but be required to act sooner—"at a very early stage in the development of [the gatekeeper-client relationship]," before strong client bonds have been able to develop.[26] The presumption is that gatekeepers are more likely to act against their clients early in relationships than after they have invested in these relationships and grown loyal to their clients.[27]

Third, the interests of individuals acting on behalf of gatekeepers may diverge from those of the gatekeepers. In consequence, individual agents of a gatekeeper may find it

---

found out, it might be considered incriminatory in hindsight." *Id.*

23. *See id.* at 854 (describing the anti-money laundering laws on which the proposed regime is based, and therefore referring specifically to the obligations of "banks" rather than to those of "gatekeepers").

24. *See supra* note 13 and accompanying text (discussing the reporting feature of Gadinis and Mangels's proposal).

25. Gadinis & Mangels, *supra* note 9, at 836.

26. *Id.* at 844.

27. *Id.*

cost-beneficial to acquiesce in client wrongdoing while the gatekeeper's incentives are to oppose it.[28] For example, a law firm partner may choose to overlook a key client's wrongdoing to avoid losing that client's business, even though in doing so he or she may be exposing the law firm to significant harm. Responding to this challenge, Professor Gadinis and Mr. Mangels suggest imposing liability for violations of the reporting duty on individual agents as well as on gatekeepers.[29] They also suggest that gatekeepers might, in response to the proposed reporting duty, engage compliance officers to report suspicions, effectively "delinking" the reporting duty from the individuals most likely to have personal ties to clients and thus most likely to acquiesce in client wrongdoing.[30]

The proposed regime also addresses the so-called multiple gatekeeper phenomenon that afflicts gatekeeper liability regimes. As I have argued elsewhere, the unitary gatekeeper rarely exists in corporate and securities transactions, even though the literature has generally modeled the liability of either a single gatekeeper or each of several gatekeepers independently of one another.[31] Rather, gatekeepers are more accurately envisioned as acting interdependently and thus as forming an interlocking and interacting web of protection against corporate wrongdoing.[32] Effectively deterring client wrongdoing in a transaction may require multiple gatekeepers—each with distinct spheres of influence and expertise—to take precautions and to cooperate in doing so.[33] By having gatekeepers all report to a single regulator, the Gadinis-Mangels proposal enables a single entity—the relevant regulator—to piece together fragmented information that no single gatekeeper possesses, to draw upon additional expertise as needed, and thereby to overcome the possibility of gatekeepers not cooperating when effective deterrence requires that they do so. Accordingly, gatekeepers that have "only partial

28. *Id.* at 815–17.

29. *See id.* at 840 ("[I]ndividual employees may be subject to monetary penalties or other disciplining sanctions.").

30. *Id.* at 845.

31. *See* Tuch, *supra* note 7, at 1589–91.

32. *See id* at 1591–1604.

33. For a more detailed discussion on the issue of multiple gatekeepers, see *id.* at 1601–04, 1622–23.

information" will report it to regulators, allowing regulators to "utilize their investigatory powers to extract valuable evidence" and possibly fill in the remaining pieces.[34]

III. Assessment of the Proposal

A. The Challenges of Conventional Gatekeeper Liability

The proposal astutely responds to many of the limitations of gatekeeper liability regimes. By lowering the threshold at which gatekeepers must act, it requires vigilance by gatekeepers early in the transactional process, diminishing the chance that strong client bonds will lead gatekeepers and their representatives to acquiesce in client wrongdoing. By formulating that threshold in terms that gatekeepers are less likely to strategically defeat, such as by adopting a "head-in-the-sand" approach, the strategy promises greater gatekeeper vigilance than otherwise. And by feeding this information to a single party (a designated regulator) that has the potential to draw on additional expertise, as needed, the proposal attempts to correct for the fragmented nature of the gatekeeping net.

To be sure, as Professor Gadinis and Mr. Mangels acknowledge, the proposed strategy cannot address all of the challenges facing conventional gatekeeper liability regimes, and it has potential shortcomings of its own. Under the proposed regime, gatekeepers might seek to comply with the reporting obligation in order to gain immunity but without providing useful information to regulators.[35] Gatekeepers might have strong ties with clients that pre-exist the transaction in question, diminishing the promise of early reporting. Gatekeepers might find themselves torn between reporting on their clients and discharging duties, such as fiduciary duties, toward their clients[36]—potentially compromising the quality of their advice,

34. Gadinis & Mangels, *supra* note 9, at 838.

35. *See id.* at 843 ("Strategically minded gatekeepers might wish to provide regulators with just enough facts so as to secure the immunity benefits, while also discouraging the regulator from actually conducting further investigations.").

36. *See id.* at 844 (exploring the dynamics between "[s]uspicious activity reporting" and "the gatekeeper-client relationship").

diminishing clients' willingness to seek it, and reducing the economies of expertise that can arise where corporations turn to outside advisors. For their part, regulators might lack the competence necessary to piece together information fragments from multiple gatekeepers that point to wrongdoing, thus failing to correct for the presence of multiple gatekeeper on major transactions. Regulators might even fail to pursue wrongdoing clearly identified by a single gatekeeper, simply lacking the capacity to sift through the avalanche of new reports they receive.

Collaborative Gatekeepers thoroughly and methodically assesses many of these objections, as well as others, to the proposal, explaining why the proposal nevertheless holds promise. Although, inevitably, I have different views on some issues than Professor Gadinis and Mr. Mangels, I find their arguments eminently reasonable. Indeed, what lends particular force to their arguments is their carefully documented case study of an analogous strategy operating in AML regulation. They show how that analogous strategy "was implemented with some success" and "grew[] stronger . . . in recent years"[37] and how many of the risks that face their own proposal did not materialize under that strategy. There is good reason to think that the proposal would avoid many of the central problems afflicting gatekeeper liability.

B. How the Proposal Interacts with Conventional Gatekeeper Liability

1. Distinctive Features of the Proposal

To fully assess the proposal, however, we must understand how it operates in combination with conventional gatekeeper liability regimes. Recall that the proposed strategy is overlaid on existing regulation, including conventional gatekeeper liability regimes. Professor Gadinis and Mr. Mangels are clear that their strategy would not amend or replace existing gatekeeper liability provisions. For instance, core anti-fraud provisions in federal securities laws—including Section 11 of the Securities Act[38] and

37. *Id.* at 893.
38. 15 U.S.C. § 77k(a) (2012).

Rule 10b-5[39] promulgated under Section 10 of the Securities Exchange Act[40]—would continue to apply.[41] The proposal would "simply add[] a reporting obligation" to these and other existing liability rules.[42]

What the proposal adds is a relatively narrowly tailored obligation. It requires gatekeepers to report when they suspect wrongdoing by their clients, not to take additional action that might disrupt or otherwise deter such wrongdoing. The proposal thus requires a particular form of gatekeeping intervention—reporting to a designated regulator. The duty might require some probing by a gatekeeper of its client's activities, but that would be to allow the gatekeeper to determine whether the client's conduct in fact "raise[d] suspicions" within the scope of the duty.[43] The duty would not require the gatekeeper to go further, such as to confirm or dispel its suspicions or even to take corrective action, but instead would be discharged when the gatekeeper reported its suspicions.[44]

Conventional gatekeeper liability regimes, by contrast, typically require gatekeepers to take action beyond the reporting of suspicions to regulators. These actions, or precautions, represent the mechanisms through which gatekeepers exercise their influence over their clients. Generally speaking, such precautions include activities that affect the probability of their clients' actually engaging in wrongdoing. In business transactions, precautions include measures to detect and prevent wrongdoing, such as conducting due diligence, discussing a client's activities with its individual managers, and reviewing

39. 17 C.F.R. § 240.10b-5 (2016).

40. 15 U.S.C. § 78j(b) (2012).

41. *See* Gadinis & Mangels, *supra* note 9, at 841 (suggesting that Rule 10b-5 would continue to apply under the new regime).

42. *Id.* at 913; *see also id.* at 910 ("[I]f [gatekeepers] choose not to report promptly, then they will be subject to sanctions for failing to report, on top of any other violations they might be committing.").

43. *Id.* at 837 ("Gatekeepers should evaluate this information and, if necessary, make additional inquiries to supplement their intelligence. . . . Through this process, gatekeepers could assess whether their clients' conduct raises suspicions.").

44. In fact, gatekeepers must file reports "even when they do not believe that their client is actually violating any laws"—provided they nevertheless suspect misconduct by the client. *Id.* at 844.

and revising disclosure documents intended for investors.[45] In some cases, precautions would include "closing the gate" to a transaction, such as refusing to provide a written opinion on which completion of a deal is conditioned.[46]

Accordingly, the proposed strategy is more narrowly circumscribed than conventional gatekeeper liability. Its requirements would be satisfied by gatekeepers submitting reports to regulators rather than by taking other precautions to deter wrongdoing by clients. By design, the strategy would be completed early in the transactional process,[47] before many of the precautions contemplated by conventional gatekeeper liability regimes could occur. It would require gatekeepers to report their suspicions, empowering regulators to take corrective action rather than requiring gatekeepers themselves to take such action.

2. Interpreting Immunity under the Proposal

How would this proposal interact with conventional gatekeeper liability regimes? They are intertwined in a critical respect. Under the proposal, gatekeepers that discharge their reporting duty would gain immunity "from actions arising out of their reports by regulators and private investors alike, provided they continue to act in good faith"[48]—thus potentially immunizing gatekeepers from liability that they would otherwise face under existing gatekeeper liability regimes.[49]

---

45. For a discussion of due diligence activities, see Andrew F. Tuch, *Conflicted Gatekeepers: The Volcker Rule and Goldman Sachs*, 7 VA. L. & BUS. REV. 365, 376–77 (2012).

46. Ronald Gilson observes that a "legal opinion is typically necessary to complete a placement of securities under the private offering exemption from registration under the Securities Act of 1933"; by "refusing to provide the necessary opinion," a lawyer could exercise his capacity to control his client's conduct—and, here, prevent misconduct. Ronald J. Gilson, *The Devolution of the Legal Profession: A Demand Side Perspective*, 49 MD. L. REV. 869, 883 (1990).

47. *See* Gadinis & Mangels, *supra* note 9, at 838 ("[T]he proposal encourages gatekeepers to come forward at a much earlier stage.").

48. *Id.* at 910.

49. *See, e.g.*, *id.* at 842 ("T]he immunity attaches to the actions reported, irrespective of the specific statutes or rules violated [by the gatekeeper].").

Consider the possible interpretations of this immunity through the application of Section 11 of the Securities Act and Rule 10b-5 under the Securities Exchange Act to an initial public offering of securities, perhaps the quintessential gatekeeping context.[50] Consider in this context an underwriter that reported to the relevant regulator its suspicions about its corporate client's public disclosures (in the corporation's registration statement) of off-balance sheet activities. Assume that by so reporting the underwriter discharged its reporting duty under the proposed regime. Assume also that the suspected wrongdoing eventuated—the corporation's registration statement materially misstated its off-balance sheet activities. Precisely what immunity would this gatekeeper receive? More specifically, to what extent would the underwriter be relieved of potential liability under the existing gatekeeper provisions, in particular Section 11 and Rule 10b-5?

The answer depends on the interpretation given to the condition that the immunity apply "provided [the gatekeeper] continue[s] to act in good faith" after satisfying its reporting duty.[51] Of course, we are assuming here that the required connection existed between the reported conduct and the eventual wrongdoing to satisfy the immunity's requirement that the action "aris[e][] out of [gatekeepers'] reports."[52]

In interpreting the proposed immunity, one can imagine a spectrum of possibilities. At one extreme, the immunity could be given narrow effect, under which the underwriter would not easily be relieved of liability under the existing gatekeeper liability provisions, that is, Section 11 and Rule 10b-5. The proviso for underwriters to "continue to act in good faith" would require gatekeepers *in fact* to discharge their obligations under these anti-fraud provisions, effectively requiring gatekeepers to,

50. Although they regard their proposal as best suited to transaction types that are "standardized" or "relatively homogeneous," and to wrongdoing that follows "standardized" or "well-trodden paths," Professor Gadinis and Mr. Mangels argue for its use even in highly complex transactions. *Id.* at 894–95. Indeed, they show how the proposal would apply in settings that diverge widely in transactional complexity—the execution of trades by broker-dealers and the auditing of financial statements in securities offerings by accountants.

51. Gadinis & Mangels, *supra* note 9, at 910. Professor Gadinis and Mr. Mangels also describe the immunity as applying "for reported actions provided [gatekeepers] submitted reports in good faith." *Id.* at 841.

52. *Id.* at 910 (emphasis added).

for argument's sake, continue with due diligence after reporting their suspicions to either dispel or confirm their suspicions and then to take additional precautions, including having the client revise its disclosures of off-balance sheet activities.

Though this interpretation would ensure that gatekeepers continued taking precautions to deter the suspected wrongdoing even after having reported their suspicions, it would effectively require the underwriter in the hypothetical scenario to act as it would have acted under the conventional regime, except for the additional requirement that it would have to report its initial suspicions under the newly imposed overlay. So interpreted, the proposal would represent an additional cost to the underwriter, rather than potentially offering it relief from its existing obligations through the immunity.

Such a narrow interpretation could even heighten the underwriter's liability risks under the existing provisions.[53] This possibility arises because of the importance under existing gatekeeper liability provisions of gatekeepers performing due diligence.[54] Under Section 11, gatekeepers can avoid liability where they make out a so-called due diligence defense. Section 11 subjects underwriters to strict liability for misstatements or omissions anywhere in a registration statement (other than in so-called expertised portions),[55] unless they can establish a due diligence defense, which they can do by proving that "after reasonable investigation, [they had] reasonable ground to believe and did believe . . . that the statements therein were [not false or

---

53. Professor Gadinis and Mr. Mangels suggest this possibility in general terms:

> [I]magine that you are advising a gatekeeper who has just come across indications of client misconduct. A comprehensive report of these indications immediately creates a record of the extent of gatekeeper suspicions at the time. If it turns out that the client is indeed committing fraud, victims will ask the court to evaluate this record ex post. Clearly, there is a risk that the court will . . . hold that the record meets the fault standard for gatekeeper liability . . . .

Id. at 842.

54. This description of the liability framework is largely drawn from Tuch, *supra* note 7, at 1636–45.

55. These are parts of the registration statement purported to be authorized by an expert, such as an accountant, lawyer or other non-underwriter professional.

misleading]."[56] Underwriters can also face liability in connection with expertised portions of registration statements, but here they benefit from a more generous defense than the due diligence defense. Known as the reliance defense, it omits any requirement for a "reasonable investigation"; it protects underwriters from liability where they prove they lacked a belief or reason to believe that the relevant statements were untrue or that there was a material omission.[57] The due diligence defense is also relevant under Rule 10b-5, the broadest anti-fraud rule in the securities regulatory arsenal, because it tends to negate the existence of scienter[58] and thus liability.

In determining whether the due diligence defense has been established, courts have paid attention to the concept of "red flags" or "storm warnings."[59] These have been variously defined as "facts which come to a defendant's attention that would place a reasonable party in [the] defendant's position 'on notice that the [issuer] was engaged in wrongdoing to the detriment of its investors,'"[60] and as any information that "strips a defendant of his confidence" in the accuracy and completeness of statements in relevant portions of a registration statement.[61] Under Section 11, the existence of red flags may deprive a gatekeeper of the benefit of either the due diligence defense or the reliance defense under Section 11. For the due diligence defense, red flags will require

---

56. Securities Act, 15 U.S.C. § 77k(b)(3)(A) (2012).

57. 15 U.S.C § 77k(b)(3)(C). Experts—that is, non-underwriter professionals such as auditors and lawyers—also face liability for misstatements or omissions in expertised portions of registration statements, but benefit from a due diligence defense.

58. *Cf.* John C. Coffee, Jr., *A Statutory and Case Law Primer on Due Diligence Under the Federal Securities Law*, *in* CONDUCTING DUE DILIGENCE 11, 13 (1995). For example, in *In re Software Toolworks Inc. v. Dannenberg*, 50 F.3d 615, 626–27 (9th Cir. 1994), the court explained as follows: "Because we conclude that the Underwriters acted with due diligence in investigating [the company's business and revenues], we also hold that the Underwriters did not act with scienter [under § 10(b)] regarding those claims."

59. *See* Tuch, *supra* note 7, at 1639 ("Red flags, or 'storm warnings' . . . . may be sufficient to deprive a gatekeeper of the benefit of either the due diligence or reliance defense.").

60. *In re* Worldcom, Inc. Sec. Litig., 346 F. Supp. 2d 628, 672 (S.D.N.Y. 2004) (quoting *In re Sunterra Corp. Sec. Litig.*, 199 F. Supp. 2d 1308, 1333 (M.D. Fla. 2002)).

61. *Id.* at 673.

the gatekeeper to "look deeper and question more" in order to be considered to have conducted a "reasonable investigation."[62] For the reliance defense, red flags will give the underwriter "reason to believe" an inaccuracy exists in the registration statement.[63]

The risk for the underwriter under the proposed regime is that by reporting its suspicions early in a transaction, as required, it will be taken to have signaled the existence of "red flags" that are relevant in determining the reasonableness of its investigations—and thus whether it exercised due diligence—under Section 11 and Rule 10b-5. If, as seems possible, its suspicions constituted "red flags," the underwriter might well need to then probe further than it would otherwise, seeking to confirm or dispel its suspicions, in order to avoid liability under these existing gatekeeper liability provisions—potentially exposing the underwriter to greater liability risk than it might have faced in the absence of the newly proposed reporting regime.

This narrow interpretation of the proposal's immunity thus complicates the proposed strategy's appeal. Under this interpretation, the reporting duty could add to gatekeepers' burdens in two ways: first, by exposing them to liability for failing to report suspicious activity by their clients; and second, by increasing their expected liability under existing gatekeeper liability rules. In response, gatekeepers might be wary of lodging reports—and even more inclined to avoid knowledge of facts that might raise their suspicions than they would be otherwise. Professor Gadinis and Mr. Mangels describe the immunity as providing gatekeepers with an "important incentive" to report[64] and suggest that it could "allow [gatekeepers] to report all relevant facts and avoid unwanted legal and regulatory adventures"[65]—suggesting they intended a broader operation for the immunity.

---

62. *Id.* at 677 (quoting *In re* Enron Corp. Sec., Derivative & ERISA Litig., 235 F. Supp. 2d 549, 707 (S.D. Tex. 2002)). This is not to say that an underwriter's precautions will necessarily satisfy the due diligence defense in the absence of red flags. Determining whether the due diligence defense is satisfied requires more than "a determination of whether any red flags existed that would put [the underwriters] on notice of a duty to make an inquiry of [the non-expertised portion of the registration statement in question]." *Id.* at 683.

63. *Id.* at 681.

64. *See* Gadinis & Mangels, *supra* note 9, at 841.

65. *Id.* at 842.

Consider then moving toward the opposite end of the interpretive spectrum and giving the immunity an expansive interpretation. Under such an interpretation, the underwriter that discharged its reporting obligation would in most cases be relieved of liability under existing rules, including Section 11 and Rule 10b-5—assuming, again, that the eventual client wrongdoing was connected with the gatekeeper's reported suspicions (such that the wrongdoing "ar[o]se out of the [gatekeeper's] report"). Applying recent corporate law authorities, the gatekeeper would fail to act in good faith (or, equivalently,[66] act in bad faith) and therefore fall afoul of the immunity's proviso if it "intentionally fail[ed] to act in the face of a known duty to act, demonstrating a conscious disregard for [its] duties."[67] Except in the (presumably) unusual case where bad faith was shown to exist—such as where the gatekeeper made no attempt at due diligence post-reporting—the gatekeeper that complied with its reporting duty would face no liability under conventional gatekeeper liability regimes.

Such an interpretation would give the immunity far-reaching effect. It would provide gatekeepers with powerful incentives to report their suspicions and, therefore, provide regulators with much new and potentially useful information. Of course, on the other hand, such an interpretation could seriously undermine the force of existing gatekeeper liability provisions. If gatekeepers were largely protected from liability under conventional gatekeeper provisions for their post-reporting conduct once they discharged their reporting duty, they would have weaker liability incentives to take post-reporting precautions to deter client wrongdoing, although they would still have reputational incentives to take these precautions.

This interpretation also complicates the proposed strategy's appeal. As explained above,[68] under conventional regimes,

66. While these concepts (bad faith and the failure to act in good faith) are not self-evidently equivalent, courts have treated them as generally equivalent. *See, e.g.*, *In re* Walt Disney Co. Deriv. Litig., 906 A.2d 27, 67 n.111 (Del. 2006); *Stone v. Ritter*, 911 A.2d 362, 369 (Del. 2006) (equating the concepts in analysis).

67. *Stone*, 911 A.2d at 369 (noting that, in these circumstances, a corporate director may be found to have breached his or her fiduciary duty of loyalty by failing to act in good faith). Other conduct regarded as bad faith includes conduct intended to violate applicable positive law. *Id.*

68. *Supra* note 46 and accompanying text.

gatekeepers have incentives to take a range of precautions—considerably broader than those contemplated by the proposal—to deter client wrongdoing. A broad immunity may diminish the likelihood that gatekeepers will take precautions other than reporting their suspicions. For instance, it may diminish the likelihood that the hypothetical underwriter will either confirm or dispel any suspicions it has about its client and, ultimately, "close the gate" on the proposed IPO, such as by refusing to sign the underwriting agreement. It may also heighten risks associated with regulator incompetence or incapacity because it shifts the burdens of disrupting corporate wrongdoing onto regulators once gatekeepers have reported their suspicions and further requires regulators to determine whether gatekeepers have acted in good faith and thus come within the terms of the immunity. The precise scope of the immunity is thus critical to how the proposal would affect gatekeepers' incentives.

C. The Calibration of Gatekeeper Liability

There are other complexities involved in assessing whether the proposal is justified, or desirable. As is well known, gatekeeper liability exists as part of a larger legal liability framework. In this framework, the relevant acts making up the wrongdoing are performed by the corporation or, more accurately, by an individual or individuals who act for or on behalf of the corporation. To (directly) deter that wrongdoing, liability can be imposed on the corporate enterprise, as well as on the corporation's managers. Such liability creates incentives for the corporation and its managers to take precautions by exercising their control over the individual perpetrators. (Obviously, the individual perpetrators can face liability as well.)

Gatekeeper liability supplements these more direct forms of liability for controlling corporate wrongdoing.[69] In the commonly adopted paradigm, initially employed by Professor Reinier Kraakman in his pioneering work and now routinely used, gatekeeper liability regimes aspire to optimally deter wrongdoing, that is, to "yield the 'right' amount of compliance

69. *See supra* note 3.

with legal rules—bearing in mind that enforcing these duties is itself costly."[70] Thus, gatekeeper liability regimes find justification when both enterprise and individual liability "fail to elicit sufficient compliance at an acceptable cost."[71]

Still more must be shown to justify imposing liability on gatekeepers for the wrongdoing of their clients. Gatekeepers must have the capacity to monitor and to control, or at least to influence, the conduct of their clients and thereby to deter wrongdoing by them.[72] Because gatekeepers' reputations may provide powerful incentives for them to disrupt wrongdoing, even in the absence of gatekeeper liability, these forces must—in combination with more direct forms of liability—fail to "yield the 'right' amount of compliance with legal rules,"[73] such that further incentives for gatekeepers to oppose wrongdoing would be desirable. Gatekeepers' reputations must also be substantial enough that they can be "staked" by gatekeepers on the accuracy and completeness of their clients' assertions.[74] Making the case for gatekeeper liability—and justifying extensions to it—is thus fraught with complexity.

This complexity of a conventional gatekeeper liability regime arises from the interdependencies between gatekeeper liability and both direct liability mechanisms and market-based incentives.[75] Gatekeeper liability serves to supplement these other forces for deterring wrongdoing, and is justified only where, together with them, it deters corporate wrongdoing more cost effectively than alternative regimes.[76] As Reinier Kraakman has explained, "the task is to pick the optimal joint strategy."[77] In theory, it is thus not enough for gatekeeper liability to deter

70. Kraakman, *Corporate Liability Strategies*, *supra* note 1, at 857–58. Professor Kraakman cites as authority for this statement Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76 J. POL'Y ECON. 169 (1968) and Frank H. Easterbrook, *Criminal Procedure as a Market System*, 12 J. LEGAL STUD. 289 (1983).

71. Kraakman, *Corporate Liability Strategies*, *supra* note 1, at 888–89.

72. *See supra* notes 1–2 and accompanying text (emphasizing this requirement for liability).

73. *Supra* note 70.

74. *Supra* note 5.

75. Kraakman, *Gatekeepers*, *supra* note 1, at 55.

76. *See id.* at 88.

77. *Id.* at 87–88 (emphasis added).

greater harm than the costs it imposes; rather, because gatekeeper liability regimes are inseparable from direct liability rules and market-generated incentives, gatekeeper liability will only be justified when it and the deterrent measures that it supplements produce benefits (reduced wrongdoing) that cannot "be purchased more cheaply."[78]

Though the proposed strategy may well avoid many of the shortcomings of conventional gatekeeper liability regimes, its desirability seems likely to hinge on an especially complex calculus. Would the proposal's benefits—its additional deterrent force—more than offset its costs? Answering this question will require a precise articulation of the scope of the proposal's immunity. Even if the proposal's cost-benefit comparison is favorable, the harder question is why policymakers should resort to the proposed regime to bolster the existing deterrence of corporate wrongdoing, rather than to alternative measures such as tightening up existing liability regimes by increasing sanctions on corporate wrongdoers or on the individual perpetrators acting on their behalf. In examining these questions, policymakers would need to predict gatekeepers' likely response to the proposed regime; would they, for example, adopt contractual risk-shifting devices to shift the incidence of liability—such as requiring their clients to indemnify them for liability under the regime?[79] How would clients respond? Because they control the selection and involvement of gatekeepers, might clients simply distance gatekeepers from their business dealings or decide to "make" rather than "buy" gatekeeping services by bringing gatekeepers within the boundaries of the firm? How effective will regulators be in disrupting wrongdoing that gatekeepers suspected and reported? Policymakers would also need to consider, in addition

---

78. Kraakman, *Corporate Liability Strategies*, *supra* note 1, at 866; s*ee also* Kraakman, *Gatekeepers*, *supra* note 1, at 87–88 ("Gatekeeping might yield enforcement benefits and still be a poor strategy if, for example, additional penalties directed against wrongdoers could avert the same harm more cheaply.").

79. Gatekeepers face incentives to adopt risk-shifting measures. *See* Kraakman, *Corporate Liability Strategies, supra* note 1, at 859–62 (noting that gatekeepers can avoid liability by shifting risks). In securities transactions they routinely adopt such measures. *See* Tuch, *supra* note 7, at 1646 ("In response to potential liability under Section 11, underwriters routinely adopt risk-shifting arrangements with other gatekeepers, namely accountants and lawyers.").

to the proposal's basic costs—e.g., the costs of enforcement (public and private) and the costs of compliance for law-abiding corporations[80]—the proposal's effects on existing liability regimes, including, for example, whether they may reduce the deterrent force of existing regimes (as they would seem to do under a broad interpretation of the immunity).

As now-Justice Stephen Breyer has observed, "to know that change [to an industry or regulation] is truly desirable and practical[,] the problem must be investigated further—empirically and in depth."[81] New studies will often be required, because existing studies often lack adequate information.[82] The complex analysis required to justify imposing gatekeeper liability invites scientific precision, and yet will inevitably rest on judgments that will be political and contested. The analysis will be complicated by the interactions between the proposal and conventional gatekeeper liability regimes. The apparent success of a similar reporting-based regime in AML regulation provides some comfort, although one may question how generalizable that experience is to other financial settings.[83] The proposal will prove difficult to justify—not because it lacks justification, but because gatekeeper liability, by its nature, hinges on the satisfaction of numerous complex conditions that may not be easily established. Nevertheless, while it is not clear how the assessment of the proposal would come out in the settings in which the proposal could apply, there is more than enough in *Collaborative Gatekeepers* to regard this novel proposed strategy as not only feasible but deserving further serious inquiry.

---

80. *See* Kraakman, *Corporate Liability Strategies*, *supra* note 1, at 878 (discussing the costs of liability regimes).

81. STEPHEN BREYER, REGULATION AND ITS REFORM 318 (1982).

82. Gadinis & Mangels, *supra* note 9, at 318–19.

83. Professor Gadinis and Mr. Mangels regard their proposal as best suited to transaction types that are "standardized" or "relatively homogeneous," and to wrongdoing that follows "standardized" or "well-trodden paths," but also argue for its use even in highly complex transactions, including those that may differ significantly from transactions subject to AML regulation. *Id.* at 894–95.

IV. A Possible Extension

I conclude by briefly suggesting an extension to the Gadinis-Mangels strategy to address one of the dangers of the multiple gatekeeper phenomenon.[84] The concern here is not that multiple information fragments need to be pieced together (a concern the proposal addresses), but that suspicions will not arise—to trigger the reporting requirement—unless information is first pooled or expertise first combined. This concern arises from the specialization of gatekeepers and the possibility that suspecting wrongdoing that is underway may require the combined specialized skills of multiple gatekeepers. This concern would be greatest with complex, low-visibility wrongs. It is possible that no single gatekeeper (acting unilaterally) would possess the knowledge or expertise required to suspect wrongdoing that is afoot in circumstances where multiple cooperating gatekeepers would indeed suspect such wrongdoing.

I briefly propose a possible solution to this problem as food for thought. It involves imposing the proposed reporting duty not on all gatekeepers, but on a single gatekeeper—the anointed "best briber."[85] In a securities transaction, especially with regard to defects in non-expertised portions of the registration statement, this could be the underwriter. Putting liability on the underwriter alone to report suspicions and holding it responsible for reporting wrongdoing that could have been suspected by multiple gatekeepers would provide powerful incentives for the underwriter to ensure it possesses the expertise required (such as by employing lawyers and auditors), thus acting much like a multi-disciplinary gatekeeper. To the extent it does not (or cannot) do this, it could rely on other gatekeepers—as it typically does in a securities transaction. What it normally does is employ risk-shifting devices—such as so-called "comfort" or "negative assurance" letters—designed to ensure that the gatekeepers on which it relies are liable to it to the extent it faces liability for wrongdoing.[86] But for this regime to work, the underwriter would

84. *Supra* note 7 and accompanying text.

85. This is likely to be the actor that can most cheaply coordinate with other gatekeepers in order to reduce the costs of wrongdoing. GUIDO CALABRESI, THE COSTS OF ACCIDENTS: A LEGAL AND ECONOMIC ANALYSIS 150 (1970).

86. For a description of these risk-shifting devices among gatekeepers on

need to face liability not only for its conduct, but also for the conduct of the gatekeepers on which it relied. Then it would have incentives to ensure that those other gatekeepers passed on relevant information or used the right expertise—so effectively that, though distinct, they operated as a single multi-disciplinary gatekeeper, thus overcoming the defects associated with the fragmentation of the gatekeeping net. This preliminary proposal addresses potentially troubling products of the multiple gatekeeper phenomenon—the opportunity it creates for clients to disaggregate their work among multiple gatekeepers for the purpose of minimizing the ability of any individual gatekeeper to deter or suspect wrongdoing and, for that matter, for gatekeepers themselves to narrow their scope of services or alleged expertise to avoid responsibility for wrongdoing that, with a broader focus or help from other gatekeepers, they might have suspected. This suggestion is premised on the idea that gatekeepers are in the best position to apportion liability among themselves.

V. Conclusion

Conventional gatekeeper liability regimes face formidable challenges. They are hard to justify and to design. Professor Gadinis and Mr. Mangels's ambitious proposal deftly navigates this terrain. Their proposal is rooted in precedent and yet novel in application. Whether it is justified in particular settings must be left for future work to determine, but there is more than enough promise in the proposal to warrant scholars and policymakers pursuing the research agenda that *Collaborative Gatekeepers* has laid out.

---

securities transactions, see Tuch, *supra* note 7, at 1645–48.