U.S. House of Representatives Committee on Financial Services
Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises
Hearing on "The Role of Attorneys in Corporate Governance"
10 a.m., Wednesday, February 4, 2004
Room 2128 Rayburn House Office Building
Written Testimony of Professor Richard W. Painter
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Mr. Chairman and Members of the Committee:

I believe that it is preferable, where possible, to leave regulation to the states rather than to the federal government.[1] There are, however, exceptions, and Section 307 of the Sarbanes-Oxley Act is one of them. I pointed out in the early 1990's my frustration that, out of dozens of lawyers accused by federal banking regulators of aiding and abetting savings and loan fraud costing taxpayers billions of dollars, not one lawyer was disciplined by a state bar association. This was so even though many lawyers settled cases brought by federal regulators for twenty, thirty and even over forty million dollars.[2] Fact is that state bar discipline is virtually meaningless for policing the practice of securities and banking law.

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[1] See my Testimony and Prepared Statement Before the United States Senate Committee on Banking, Housing and Urban Affairs Subcommittee on Securities, reprinted in Hearing on S. 1260, The Securities Litigation Uniform Standards Act of 1998 (February 23, 1998) (stating reasons why federal preemption of state securities class actions was premature); and my Testimony and Prepared Statement Before the House of Representatives Committee on Commerce Subcommittee on Finance and Hazardous Materials, reprinted in Hearings on H.R. 1689, The Securities Litigation Uniform Standards Act of 1998 (No. 105-85) at 73-84 (May 19, 1998) (same).

[2] See Roger C. Cramton, Enron and the Corporate Lawyer: A Primer on Legal and Ethical Issues, 58 The Business Lawyer 143 (2002) (discussing how state bar discipline committees have failed to act against securities lawyers, including the savings and loan lawyers in the early 1990's); Richard W. Painter, The Moral Interdependence of Corporate Lawyers and their Clients, 67 S. Cal. L. Rev. 507, 572 (1994) (discussing large settlements paid by lawyers in the savings and loan crisis and the bar's failure to respond).

It is for this reason that I proposed in a 1996 law review article that Congress enact a statute requiring securities lawyers to report known illegal acts of corporate clients up-the-ladder to the client's full board of directors.[3] It is for this reason that I also appealed to the ABA in 1998 to amend its Model Rules of Professional Conduct to require such up-the-ladder reporting,[4] only to have my proposal rejected in favor of the then prevailing opinion that such matters lie with the discretion of the lawyer. Finally, it is for this reason that, in March of 2002, I and forty other law professors wrote SEC Chairman Harvey Pitt asking that the SEC promulgate rules requiring up-the-ladder reporting by securities lawyers.[5] The SEC in its reply letter deferred action on this proposal and cited my 1996 article for the proposition that Congress ought to be the body to enact such a rule.[6] That summer, Congress took up this invitation and, in a bipartisan amendment that became Section 307 required the SEC to promulgate an up-the-ladder reporting rule, along with whatever other rules for securities lawyers the SEC believes are necessary for the protection of investors.

Section 307 and the SEC rules thereunder appear to be working. Just last month the new York Times reported that because of Section 307 outside lawyers for TV Azteca, Mexico's second largest broadcaster, told its board that the company violated United States securities laws.[7] For the most part, I support the SEC's final rules under Section 307 and would be happy to go into further detail in my testimony if you would like.[8]

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[3] See Richard W. Painter and Jennifer E. Duggan, Lawyer Disclosure of Corporate Fraud: Establishing a Firm Foundation, 1996 SMU Law Review 225, 263 (1996).
[4] See Proposal to Amend Model Rule 1.13 (Organization as Client), presented in testimony before the ABA Ethics 2000 Commission, May 1998, and reprinted in The Professional Lawyer, Spring 1998 at 10 (ABA).
[5] See Letter dated March 7, 2002 from Richard W. Painter et. al, to Harvey Pitt, Chairman of the Securities and Exchange Commission (proposing a mandatory up-the-ladder reporting rule).
[6] See Letter dated March 28, 2002, from David Becker, General Counsel for the Securities and Exchange Commission, to Richard W. Painter ("As you noted in the 1996 SMU Law Review article which you enclosed, there may be reasons to prefer having one uniform nation-wide rule governing lawyers who participate in nation-wide securities practices; but there are also good reasons why consideration of such a significant change in established practice should be undertaken in the context of Congressional legislation, as opposed to agency rulemaking, As I understand it, your 1996 article concludes that any such changes to the rules governing lawyers should be the result of Congressional changes to the securities laws, analogous to Section 10A's rules for accountants.").
[7] See Patrick McGeehan, Lawyers Take Suspicions on TV Azteca to its Board, New York Times, December 24, 2003 at Page C1 (reporting that "In one of the first applications of a new provision of the Sarbanes-Oxley Act, outside lawyers [at Akin Gump Strauss Hauer & Feld in New York] for Mexico's second-largest broadcaster have told its board -- and, possibly, federal regulators -- that they think that the company violated United States securities laws.")
[8] My comments on the proposed rules are in my letter dated December 12, 2002 to Jonathan Katz, Secretary of the SEC. See http://www.sec.gov/rules/proposed.

With respect to the SEC's proposed rules which have not yet become final, the most controversial would require "noisy withdrawal" if up-the-ladder reporting is unsuccessful.[9] Withdrawal from a securities representation is necessary if the client insists on violating the securities laws. Indeed, a law firm that wants to limit its liability exposure almost certainly would withdraw. While I do not strongly oppose the SEC's proposal, I am not convinced that mandating the "noise" is necessary. Even a quiet withdrawal should convey the message to vigilant regulators, underwriters and others that something is wrong. Furthermore, few lawyers, once they withdraw, will allow a former client to perpetrate a fraud for which the lawyers themselves could be sued. In sum, the SEC should require prompt withdrawal from securities law representation of a client that refuses to obey the securities laws, but should probably leave the amount of noise accompanying the withdrawal up to the lawyer.

There are also other issues that the SEC should address that are more important than the debate over noisy withdrawal. One is the fact that up-the-ladder reporting is triggered by a knowledge requirement in the final SEC rules that is too stringent and arguably does not comply with the broader language of the statute which requires lawyers to report "evidence" (not just "knowledge") of a violation. Section 307 thus requires the SEC to

> "issue rules, in the public interest and for the protection of investors . . . requiring an attorney to report *evidence* of a material violation of securities law or breach of fiduciary duty or similar violation by the company . . . " (emphasis added).[10]

Section 307 thus clearly states, without limitation or other qualifying language, that evidence of a violation should be reported by the attorney. The SEC's final rules under Section 307, however, define "evidence" so narrowly as to eviscerate this reporting obligation. "Evidence of a material violation" is defined in the final rules to mean

> "credible evidence, based upon which it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation has occurred, is ongoing, or is about to occur."[11]

With this double negative, the definition appears to say that all reasonable attorneys would have to agree that a violation is likely for a report to be required. In circumstances where a reasonable attorney could fail to conclude that a violation is likely, up-the-ladder reporting apparently is not required under this definition, even if the vast majority of reasonable attorneys would disagree and believe that a violation is likely. If Congress's objective in Section 307 was to require lawyers to report evidence of violations that

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[9] See Release No. 33-8186; 34-47282; IC-25920 (proposing 17 C.F.R. Parts 205, 240 and 249). See http://www.sec.gov/rules/proposed.shtml

[10] Sarbanes-Oxley Act Section 307, codified at 15 U.S.C.A. Section 7245 (Supp. 1 2003).

[11] 17 C.F.R. Part 205.2(e) (definition of "Evidence of a material violation"), adopted in Release No. 33-8185; 34-47276; IC-25919. See http://www.sec.gov/rules/final.shtml.

senior officers and directors should be aware of because the circumstances pose substantial risk to the corporation and its investors, this threshold definition fails to do the trick.

Second, the SEC needs to consider how easy or difficult it is for issuers to use the alternative provided for in the rules, which is reporting to a Qualified Legal Compliance Committee (QLCC) instead of to the client's full board. I urged in earlier law review articles[12] and commentary letters to the SEC that such opt-out mechanisms are useful because they allow client directors flexibility in deciding how future violations will be dealt with. If, however, the composition and responsibilities of the QLCC are such that few clients plan to use them, the opt-out mechanism is meaningless. Of particular concern is whether qualified individuals are willing to serve on such committees or decline to do so because of liability concerns. The SEC should continue to solicit commentary on how this aspect of its rules is working in practice.

Third, the SEC should be cognizant of the extraterritorial application of its rules under Section 307. Lawyers perform different tasks for clients in different countries, and boards of directors are structured differently. For example, the SEC's rule requiring a QLCC to consist solely of independent directors is probably unworkable for issuers incorporated in Germany and other jurisdictions that require employees to sit on corporate supervisory boards. The SEC should thus consider permitting non-U.S. issuers to include an employee on the QLCC.[13] Perhaps most important, the proposed noisy withdrawal rule conflicts with attorney regulations in many countries. These include Japan,[14] a country with far fewer lawyers that the U.S. and whose lawyers rarely advise clients on U.S. securities laws.[15] Given the limited role that foreign attorneys have in

[12] See Painter and Duggan, *Lawyer Disclosure of Corporate Fraud*, supra, at 266-270 (1996) (describing advantages of using such default and opt-out rules for reporting of corporate fraud); Richard W. Painter, Rules Lawyers Play By, 76 NYU Law Review 665, 719 (2001) (suggesting that a client should be allowed to direct up-the-ladder reporting to a compliance committee instead of to a client's full board of directors).

[13] See Letter dated April 7, 2003 from Sullivan & Cromwell to Jonathan G. Katz, Secretary of the SEC (suggesting such an exemption). Similar issues are also discussed in various comment letters by foreign lawyers and bar associations to the SEC, available at http://www.sec.gov/rules/proposed/s74502.shtml.

[14] See letters dated December 14, 2002 and March 31. 2003 from The Japan Federation of Bar Associations (Nihon Bengoshi Rengokai) to Jonathan G. Katz, Secretary of the SEC (stating that the noisy withdrawal proposal directly conflicts with the duty of confidentiality under Article 23 of Chapter IV of the Practicing Attorney Law of Japan, and that the SEC's alternative proposal of requiring issuer disclosure of the attorney's withdrawal, while not directly conflicting with Japanese law, would undermine the purpose of that law, which is to facilitate open attorney-client communication).

[15] See letter dated December 14, 2002 from The Japan Federation of Bar Associations to Jonathan G. Katz, supra (stating that "In practice, Japan Attorneys usually play only a supporting role in assisting U.S. attorneys in the submission of registration statements

advising their clients on U.S. securities laws, the SEC should be reticent about applying its Section 307 rules to attorneys outside our borders.

In this respect, the SEC's final rules are a significant improvement over its proposed rules.[16] It is possible that exemptions for foreign lawyers will drive legal business overseas, but such fears are exaggerated because U.S. securities lawyers are usually best positioned to represent clients in connection with U.S. securities laws. Furthermore, lawyer reporting rules are unlikely to be a deciding factor in selection of counsel because an issuer, by setting up a QLCC, can also avoid a required report to its full board, and avoid the proposed noisy withdrawal provision. Issuer selection of foreign counsel in order to avoid the SEC rules is thus both unnecessary and unlikely.

Finally, Congress in Section 307 gave the SEC a broad mandate to promulgate those rules of professional responsibility for securities lawyers that the SEC believes necessary for the protection of investors, a mandate not limited to up-the-ladder reporting.[17] The SEC should give serious thought to other ways it can promote high standards of professionalism among lawyers who represent issuers before it.

On one clearly relevant topic, I have asked the SEC to consider whether it is appropriate for lawyers to charge contingent fees in securities transactions.[18] I pointed out that in the Time-Warner/AOL merger, one of the most disastrous mergers in corporate history, Time-Warner's counsel was reported in the press to have received a $35 million fee that was contingent on the deal closing (the fee would have been closer to $5 million if the deal had not closed).[19] While I do not believe that Time-Warner received anything other

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and other securities filings with the Commission. . . . [and] are necessary to assist in the filing process in the role of local counsel to Japanese issuers").

[16] See 17 C.F.R. Part 205.2(j) (definition of "Non-appearing foreign attorney"), adopted in Release No. 33-8185; 34-47276; IC-25919. This definition was absent from the proposed rules, which would have covered a broad range of foreign attorneys involved in securities filings.

[17] See Sarbanes-Oxley Act Section 307, codified at 15 U.S.C.A. Section 7245 (Supp. 1 2003) (stating that the "Commission shall issue *rules*, in the public interest and for the protection of investors, setting forth *minimum standards* of professional conduct for attorneys appearing and practicing before the Commission in any way in the representation of issuers, *including* . . . [the up-the-ladder reporting rule set forth in subsections (1) and (2) of the statute]." (emphasis added) The plain text of the statute – its use of the plural for "rules" and "standards" and the word "including" – clearly demonstrates that up-the-ladder reporting was not the only subject matter that Congress expected to be covered by the SEC's rules for attorneys.

[18] See my Letter dated September 10, 2002 to Mike Eisenberg, SEC Deputy General Counsel (setting forth suggestions for SEC rules under Section 307, and asking that the SEC consider whether contingent fees are appropriate in securities transactions).

[19] Id. Before it became clear in 2003 that the Time-Warner/AOL merger was a debacle and questions arose about the integrity of AOL's prior financial reporting, press reports praised both the merger and Time-Warner's contingent fee arrangement with its lawyers

than the most competent and loyal advice from counsel, this is not the type of transaction for which a contingent fee is appropriate.[20] Counsel should be paid to ferret out problems with a transaction as well as to promote its virtues, and legal fees that depend so much on whether a deal closes undermine this objective.[21] The SEC should, under its Section 307 mandate, say something about fee structures that create perverse incentives for lawyers in situations where a transaction may be ill advised, or worse yet where closing a transaction would violate federal securities laws.[22]

In conclusion, while the noisy withdrawal debate has received much attention, I urge the SEC to consider requiring withdrawal without requiring noise, and then to move on to other more pressing issues in carrying out its Congressional mandate.

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at Cravath, Swaine and Moore. See e.g. Karen Hall and Kristin Eliasberg, Cravath's Contingency, The American Lawyer, February, 2001 (describing the fee arrangement as a "win-win" deal for Time-Warner and Cravath) ("each side deserves credit for structuring it so that the other was satisfied at the end. . . "). Accounting considerations may in part motivate such contingent fee arrangements. If a deal does not close, the company normally must account for legal fees spent on the transaction as an operating loss. If the deal closes, however, legal fees can be accounted for "below the line" as a capital expenditure. This meant that "Time Warner essentially hedged its earnings downside in the event the deal bombed." Id. Once again, the fact that the deal eventually would "bomb" a little over a year after its "successful" closing was apparently not known at the time.

[20] My knowledge of the fee agreement is from news reports rather than first hand, and I am not aware of any evidence that Time Warner's lawyers did less than exemplary work on the Time-Warner/AOL merger. My concern here is to point out that such fee arrangements may in other contexts discourage lawyers from putting a stop to transactions that are not in the interests of clients or investors. A lawyer's job is sometimes to say "no" to a deal, and a contingent fee arrangement makes it very hard to say anything but "yes."

[21] Although fee agreements that give lawyers stock in a client pose conflict problems of their own, they are superior to contingent fees for corporate transactions because at least the lawyers have an incentive to look out for the long term interests of the client, which may or may not be in closing a particular deal.

[22] See Hall and Eliasberg, supra ("'If the goal was to get Cravath highly focused, it worked,' says a lawyer close to the deal. 'The whole firm focused on getting this transaction done.'"). Although the legal work consisted in large part of wrangling with the FTC over antitrust issues connected with the merger, it appears that collapse of the deal for any reason – including if Time-Warner had uncovered problems in AOL's financial reporting – would have jeopardized Cravath's fee.