Of the Conditional Fee as a Response to Lawyers

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OF THE CONDITIONAL FEE AS A RESPONSE TO LAWYERS, BANKERS AND LOOPHOLES

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I. INTRODUCTION

Crises inevitably bring cries for new legislation, and the 2008 financial crisis was no exception. Dodd-Frank[1] is approximately 850 pages long, and the regulations it contemplates will be voluminous as well.

There are radically differing views as to whether Dodd-Frank took the right approach, and whether it will be successful or even beneficial. But even the most optimistic scenario leaves a significant problem unaddressed. One important cause of the crisis was that some banks and their lawyers had been looking for—and finding—clever ways to honor the letter of the law while violating its spirit, including by "pushing the envelope" as far as it will go (and in some cases, further). The legal opinion rendered in Lehman Brothers' Repo 105 transaction, discussed more fully below, is but one example of the type of lawyering that gave clients what they wanted in the short term while ignoring the true meaning of the law. We call this type of lawyering "loophole lawyering."

This type of lawyer behavior presents a significant challenge for regulation. Rules-based approaches are of limited value. Indeed, the "better"—the more specific—the rule, the better a roadmap it may provide for finding loopholes. Standards-based regulation could be more effective, but ultimately, it has significant limitations. In the business context, predictability is highly valued, including by courts. Predictability and broad standards are in considerable tension, insofar as the standards' reach is only determined *ex post*, after the conduct occurs. Moreover, once

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[1] Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Public Law No: 111-203, 12 Stat. 1376 (to be codified as 12 U.S.C. § 5301) (Supp. IV 2010).

standard-based regulations are interpreted, they become more rule-like, and hence more vulnerable to avoidance using loophole lawyering.

In this essay, we make a concrete proposal to limit the extent to which lawyers facilitate problematic transactions of the sort that contributed to, and may have caused, the financial crisis. We propose that the fees of securities lawyers and perhaps other regulatory lawyers such as banking lawyers be "conditional." If the client became insolvent and was found to have materially violated the relevant regulations in the period leading up to insolvency, outstanding legal fees would not be payable and any fees paid to the lawyers by the client during the period of the violation would be disgorged. A finding of legal malpractice or other fault on the part of the lawyer would not be necessary, nor would proof that the violation caused the insolvency be required.

Constraints on bad lawyer behavior in this area are quite limited. First, existing malpractice law discourages lawyers from giving incompetent legal advice, but only to a limited extent: the doctrine of *in pari delicto* makes it difficult for bankruptcy trustees to assert claims against lawyers, accountants and other professional service providers in many jurisdictions including, most notably, New York.[2] A bankrupt entity that became bankrupt due in part to its wrongful conduct cannot proceed against those who helped the entity act wrongfully; thus, the bankrupt entity's estate cannot assert a claim that the bankrupt could not have asserted. Second, lawyers will very rarely be liable for their client's securities fraud. The federal courts have held that aiders and abettors of securities fraud[3] and even co-conspirators[4] cannot be sued by injured investors. It will be almost impossible to sue lawyers as primary violators in their clients' frauds; in 2011, the Supreme Court defined the category of primary violator very narrowly.[5] Third, bar disciplinary authorities rarely bring charges against securities and banking lawyers. Fourth, while the Securities and Exchange Commission (SEC) has been given authority in the Sarbanes-Oxley Act (SOX) to promulgate professional responsibility rules for securities lawyers,[6] and did enact the up-the-ladder reporting rule that Congress mandated in SOX (this provision requires securities lawyers to report

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[2] *See* Kirschner v. KPMG LLP, 938 N.E.2d 941, 950, 958-59 (N.Y. 2010) (applying principles of *in pari delicto* to bar a trustee's suit against professional services providers to a failed entity).

[3] *E.g.*, Cent. Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164,177-80 (1994).

[4] *E.g.*, Stoneridge Inv. Partners v. Scientific Atlanta, Inc., 552 U.S. 148, 153, 166-67 (2008).

[5] Janus Capital Grp. v. First Derivative Traders, 131 S. Ct. 2296, 2301-02 (2011).

[6] Sarbanes-Oxley Act of 2002, 15 U.S.C. § 7245 (2006).

securities law violations, breaches of fiduciary duty and similar violations to the board of directors of a client if lower-level reporting does not result in an appropriate response to the violation)[7] the SEC has not promulgated additional rules to address the problem of loophole lawyering. Furthermore, there have been few if any SEC enforcement proceedings under the SOX rules. Most important, all of these rules and enforcement mechanisms require a finding of fault on the part of the lawyer—e.g. that the lawyer did not follow the rule—to impose a sanction. This lawyer regulation regime would be much more effective if lawyers, including those not at fault, had an economic incentive to do their best to assure that clients follow the law, particularly in situations where the clients might become insolvent. The conditional fee and fee disgorgement mechanism we propose here provide that incentive. A conditional fee and fee disgorgement mechanism could be enacted by regulation; it also, however, could be voluntarily adopted by boards of directors, perhaps as a result of shareholder activism directed to that end.

II. THE SKEWED INCENTIVES OF BANKERS

An important cause of the financial crisis was badly-understood low-quality financial instruments conceived and marketed as high-quality, and financial techniques that ingeniously concealed deeply flawed finances; both were crafted by bankers who were richly compensated for doing so. This banker behavior is not uncommon or new. Enron provides a plethora of examples. It used novel and complex techniques crafted by bankers (and lawyers) to create a wholly false financial appearance. One banker described to another banker Enron's reaction to a technique his bank had developed: "Enron loves these deals as they are able to *hide* debt from their equity analysts because they (at the very least) book it as deferred rev[enue] or (better yet) *bury* it in their trading liabilities."[8]

In some cases, such as Enron and more recently, when bankers helped Greece hide significant amounts of debt, bankers engaged in or aided and abetted concealment.[9] In other cases, bankers structured, marketed and sold

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[7] Standards of Professional Conduct for Attorneys Appearing and Practicing Before the Commission in the Representation of an Issuer, 17 C.F.R. § 205.3 (2011).

[8] *The Role of the Financial Institutions in Enron's Collapse: Hearing Before the Subcomm. of Investigations of the S. Comm. on Governmental Affairs*, 107th Cong. 232 (2002) (emphasis added) (quoting email from one Chase banker to another, November 11, 1998).

[9] *See, e.g.*, Beat Balzli, *How Goldman Sachs Helped Greece Mask its True Debt*, DER SPIEGEL ONLINE (Feb. 8, 2010, 6:55 PM), http://www.spiegel.de/international/europe/0,1518,druck-676634,00.html (discussing Goldman's transactions for Greece), *and* Claire Hill, *Why Did the Rating Agencies Do Such A Bad Job Rating Subprime Securities?* 71 U. PITT. L. REV. 585 (2010) (discussing concealment in the case of Enron).

subprime securities and credit default swaps, with little regard for the risk to their customers, their banks, and to some extent, themselves.

Financial institutions can be difficult clients for securities and banking lawyers precisely because the economic incentives of the persons running those institutions are skewed toward risk taking, and away from the conservative approach with which lawyers often are most comfortable. Financial institutions are run by people who can take enormous risks on the institutions' behalf and profit personally when those risks pay off, yet have no personal liability for the institutions' debts. We have elsewhere considered how banker behavior might be improved.[10] We have proposed that senior managers in financial institutions should have some personal liability if their institutions become insolvent.[11] We made two specific proposals: (1) that highly-compensated bankers would be subject to personal liability up to all but a few million dollars of their assets, and/or (2) that such bankers would receive some proportion of their compensation in stock for which additional payment (an "assessment") could be required. Thus, if the financial institution became insolvent, bankers would be required to make payments to the institution for the benefit of its creditors. Our personal liability proposal would allow bankers to keep some of their assets even if their financial institution's creditors were not repaid in full; thus, it is more lenient than the unlimited personal liability regime that prevailed when most investment banks were general partnerships up through the 1980s.[12] Our proposal would, we think, bring back some of the conservatism and sound judgment that used to be associated with investment banking and financial institutions generally.

III. THE LAWYERS

What can be done about lawyers? How can we minimize their willingness to aid irresponsible bankers in structuring and selling problematic financial instruments (such as subprime securities constructed of defective mortgages) and techniques (such as debt-concealment techniques)?

Lawyers help structure transactions and write the necessary disclosure; they also provide legal opinions that say that their clients' transactions will

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[10] Claire Hill & Richard Painter, *Berle's Vision Beyond Shareholder Interests: Why Investment Bankers Should Have (Some) Personal Liability*, 33 SEATTLE U. L. REV. 1173 (2010) ("Imposing genuine downside risk through [various] vehicles for personal liability may be the best way to make bankers approach risk in a manner that reflects the potential for externalities of the sort the crisis has so dramatically demonstrated."). *Id.* at 1174.

[11] *Id.* at 1189-92.

[12] *Id.* at 1187.

have the legal effects that the clients desire. Throughout this process, they are giving advice as to what the law requires. Difficulties arise when what is contemplated is aggressive or even arguably deceptive.

Clients typically want to structure their securities to obtain the most favorable regulatory treatment possible. Lawyers have sometimes become involved in transactions involving securities that can be "all things to all people"—debt to the taxing authorities, equity to rating agencies, etc.[13] As discussed below, these arbitrage opportunities are controversial: some people may consider them unobjectionable, but others may feel, especially if many regimes are being arbitraged, that a transaction goes too far.

Lawyers also may help issuers with strategies to improve financial appearance. An issuer might want to appear to have very little debt; it might want to appear to have very few assets as well, in order to appear to have a higher "return on assets." Thus, an issuer might "sell" income-producing assets rather than borrowing money secured by those assets. Lawyers would be involved in structuring these transactions, and are often asked to give an opinion that the desired treatment is appropriate.

The applicable laws in these areas are often rule-based, and reward creative envelope-pushing. Rules necessarily draw lines; clever structuring gets a client on the desired side of the line. If a client does not want to "own" an asset, the client leases the asset. Leasing cannot be identical to ownership but for the label: for instance, the lease cannot be for the whole useful life of the asset. A line is drawn (by the relevant authorities, tax or accounting) at, say, 80%; the client leases the asset for 79% of its useful life. Is this acceptable conduct or not? Reasonable people differ. There are many other examples such as a "triple-dip lease:" a transaction where elements of differing regimes are combined to give regulatory advantages—'dips' in each regime.[14] The advantages tend to come from different—one might say conflicting—characterizations. X and Y might

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[13] *See generally* Victor Fleischer, *Regulatory Arbitrage*, 89 TEX. L. REV. 227 (2010) for a discussion of regulatory arbitrage. The author defines regulatory arbitrage as "the manipulation of a structure of a deal to take advantage of a gap between the economic substance of a transaction and its regulatory treatment." *Id.* at 230. As Fleischer notes, regulatory arbitrage is "perfectly legal." *Id.* at 229.

[14] One definition of "triple-dip lease" is: a lease that uses significant tax or funding incentives from three sources, usually involving at least two countries. The American Society of Appraisers Principles of Valuation, Student Manual, *ME204: Machinery and Equipment Valuation—Advanced Topics and Report Writing* 121 (2005), *available at* http://www.asaeduc.com/index.php?page=shop.getfile&file_id=80&product_id=19&option=com_virtuemart&Itemid=26 (change the name of the file downloaded from index.php to index.zip and then unzip the file ME204stu122905.pdf); *see also* Christian Broderson et al., *Germany Sees the First Stirrings of an Appetite*, 2 INT'L TAX REV., no. 9, Supp., Sept. 1991, at 35, 40 (describing how double or triple dip leasing can be achieved in Germany).

both, for instance, count as owners of the same asset. Another example involves financial instruments intended to obtain favorable characterizations from regulators and quasi-regulators such as rating agencies. As described in a publication by a leading San Francisco law firm, Morrison and Foerster:

> JPMorgan Securities structured a winning product with CENts, Capital Efficient Notes. In July 2006, we represented the underwriters, led by JPMorgan, in the first CENts transaction for Morrison & Foerster client Capital One Financial Corporation. CENts represents a real innovation in hybrids. It was the attainment of what bankers have referred to as the Holy Grail—a hybrid that qualifies for D-basket equity credit from ratings agencies, qualifies for Tier 1 capital treatment for bank holding company issuers, and permits issuers to make tax-deductible interest payments.[15]

Going further, some transactions would seem to have as their entire purpose the tax or accounting treatment they permit. A continuum can be drawn, with transactions done purely to achieve a regulatory or quasi-regulatory purpose such as reducing taxes or improving financial appearance at one end and, at the other end, transactions with a straightforward business purpose,[16] done without regard to regulatory or other costs, and accounting treatment. Many—probably most—transactions are somewhere in between. While non-wealthy individuals in their daily lives engage in transactions without regard to regulatory and like costs with some regularity, businesses generally do not; no matter what kind of transaction they are doing, they typically take into account minimization of tax and other costs, as well as the most advantageous accounting treatment.[17] To restate the question asked above: how far will they go? How far should they go? If they err and go too far—i.e. break the law—who should have to pay for that mistake?

In some cases, banks and other clients go too far, with the help of their lawyers—too far for society's comfort and too far in the eyes of the law. Sometimes there is technical compliance with the particular laws that lawyers are asked to opine on, but other legal obligations—such as general disclosure obligations to investors—are violated. When this occurs, the

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[15] *Hybrids: A Case Study: Saving Tax Dollars Makes CENts*, MORRISON & FOERESTER LLP, www.mofo.com/files/Uploads/Documents/Cents.pdf.

[16] We are mindful of the difficulties in articulating, much less applying these concepts. *See* Fleischer, *supra* note 13, at 257 for a discussion of anti-abuse doctrines in tax such as "economic substance" and "business purpose" that have attempted to do so with pretty dismal results. But for purposes of our account, appealing to common-sense interpretations of this language suffices.

[17] We suspect that few people really oppose *all* efforts by corporations to minimize their tax liability or improve their financial appearance—the problem is when they go too far.

lawyers who blessed a transaction bear part of the blame and should perhaps bear part of the cost.

One of the most notorious transactions at issue in the financial crisis was Lehman Brothers' Repo 105.[18] In Repo 105, lawyers assisted Lehman with its efforts to conceal $50 billion in debt on its quarterly balance sheets. Lehman sold some of its lower-quality assets to other financial institutions for cash, which it used to pay down debt at the end of each quarter. But the "sales" and the "repayments" were temporary, to be unwound a few days later. Even though Lehman and the counterparty agreed that the transaction would be soon unwound, English law apparently allowed it to be treated as a "sale" if the assets were valued at 105% or more of the cash "paid" for them. It did not matter that the parties contemplated that substantially equivalent assets would be transferred back to Lehman and the cash returned a few days later.[19] Lehman could not find New York lawyers who would agree to characterize the transaction as a sale under United States law, but Linklaters in London was willing to opine that the sale coupled with a repurchase agreement was a true sale under English law.[20] To accomplish its aim, Lehman had to transfer the securities involved to London (this transaction no doubt was done with the knowledge if not the assistance of United States lawyers). In London, the transaction was executed through LBIE, Lehman's European broker-dealer in London. It was reported to Lehman's auditors in the United States as a true sale under English law—something a hyper-technical reading of the rules could be stretched to support—and recorded as such on Lehman's consolidated balance sheet for its quarterly report. After the transaction was unwound, it could be repeated at the end of the next quarter and so on. Substantial fees were paid to the counterparty each time, all for only one apparent purpose: dressing up Lehman's quarterly balance sheet to look better than it actually was.

There is no mention in the Linklaters opinion of the reason why Lehman wanted to do the transaction. There is no mention of the fact that even if the transaction was a true sale under U.K. law, there was still a risk that Lehman Brothers could violate U.S. securities laws if it reported quarterly financial results based on the transaction without also telling its investors in the United States that Lehman Brothers contemplated unwinding the

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[18] Report of Exam'r at 783-86, *In re* Lehman Bros. Holdings Inc., No. 08-13555 (JMP) (Bankr. S.D.N.Y Mar.11, 2011).

[19] *Id.*

[20] *See id.* app. 17 at 20, 31 (Linklaters Letter to Lehman Brothers International (Europe) on May 31, 2006) (reading in part as follows: "Subject to the qualifications set out in this opinion, in respect of each Transaction, following the transfer by Seller to Buyer of the Purchased Securities, in our opinion, Seller will have disposed of its entire proprietary interest in the Purchased Securities by way of sale.").

transaction shortly thereafter. There is no mention in the opinion letter that Lehman Brothers' senior management should at least tell Lehman Brothers' board of directors about the transaction and its purpose.

Lehman engaged in Repo 105 to falsely improve its financial appearance. Lehman "sold" some assets (for amounts in the tens of billions of dollars) and used the proceeds to "pay off" liabilities. But the "sales" were actually borrowings—Lehman was to repurchase the assets it had purportedly sold, at higher prices several days later, something not reflected on its balance sheet.

An article on Repo 105 discussed the unsuccessful search for a New York law firm, the subsequent choice of the well-regarded English firm Linklaters, and the substance of the opinion given:

> When Lehman first designed Repo 105 in 2001, however, there was one catch. The firm couldn't get any American law firms to sign off on the aggressive accounting, namely that these transactions were true sales instead of what amounted to the parking of assets. From the firm's own Repo 105 accounting policy document, according to the report:
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> > Repos generally cannot be treated as sales in the United States because lawyers cannot provide a true sale opinion under U.S. law.
>
> Enter Linklaters, which grounded its legal brief in English, rather than American, law. The firm explicitly said: "This opinion is limited to English law as applied by the English courts and is given on the basis that it will be governed by and construed in accordance with English law."
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> Otherwise, Linklaters provided Lehman with exactly what it wanted to hear. The law firm decreed in its briefs, at least as outlined in the 2006 iteration obtained by Mr. Valukas [the Bankruptcy Examiner], that intent matters. If two parties intend to exchange assets for cash, and then later the party receiving the assets decides to hand back "equivalent assets (such as securities of the same series and nominal value) rather than the very assets that were originally delivered," that amounts to a sale.[21]

Contrast the foregoing description to a sale by an ordinary individual. Smith sells his house to Jones, who wants the house. Smith walks away with money, and Jones has the house. Assume Smith had debt equal to the amount of the house proceeds, which he repays with the house proceeds. Jones may or may not keep the house, but neither he nor Smith would contemplate that he would resell it to Smith—after all, if Smith wanted the house, why would he sell it? Someone looking to lend money to Smith after he sells the house will see in Smith's financial statements no house

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[21] Michael J. De La Merced & Julia Werdigier, *The Origins of Lehman's 'Repo 105'*, N.Y. TIMES DEALBOOK, (Mar. 12, 2010, 7:02 AM), http://dealbook.nytimes.com/2010/03/12/the-british-origins-of-lehmans-accounting-gimmick/.

and lower debt. Someone looking to lend money to Jones after he buys the house will see in his financial statements the house and less money (or an obligation to pay the bank). What Lehman wanted with Repo 105 was for people to see the financial statements with no "house"—in fact, assets of very questionable value—and less debt; Lehman intended, however, to quickly repurchase the assets for more money than it had been "paid" for them. Anyone looking at Lehman's financial statements during the period when the assets had been sold would—and did—get a profoundly false picture of Lehman's financials.

Even relatively unsophisticated individuals structure some, and certainly their more consequential, transactions to minimize adverse tax and regulatory consequences. For instance, the availability of a mortgage interest deduction encourages people to buy homes rather than rent. But when structuring is tantamount to deception, something is amiss. We take no position as to whether there is 'acceptable' planning of this type[22]—our position here is simply that whether because of differences in degree or in kind from what is acceptable, certain types of lawyer behavior need to be constrained. Business clients use lawyers to help them with structuring transactions and in particular, with minimizing costs and maximizing benefits (such as accounting appearances). Whether or not the lawyers are instigators, they are necessary participants in transactions and share responsibility for the outcome of those transactions.[23] Constraining lawyers—or creating incentives for lawyers to constrain themselves—should help limit this behavior.

IV. THE CONDITIONAL FEE

Contingent fees (usually based on a percentage of a judgment or a transaction) are common in the United States, but prohibited in many other jurisdictions.[24] In some of those jurisdictions, such as England, conditional fees are used to align the lawyers' interests with those of the client.[25] If the client succeeds in accomplishing its objectives the lawyer is paid a fixed fee; if the client does not succeed the lawyer is not paid all or most of the fee. Because the fee is conditional, it is usually higher than a fee that must be paid regardless of the results obtained.

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[22] *See, e.g.*, David A. Weisbach, *Ten Truths About Tax Shelters*, 55 TAX L. REV. 215, 220-22 (2002) (arguing that there is no "right" to do tax planning).

[23] *See* Richard W. Painter, *The Moral Interdependence of Corporate Lawyers and Their Clients*, 67 S. CAL. L. REV. 507, 511-12 (1994).

[24] *See* Richard W. Painter, *Litigating on a Contingency: A Monopoly of Champions or a Market for Champerty?*, 71 CHI.-KENT L. REV. 625, 626-27 (1995) (discussing contingent fees in the United States).

[25] *See id.* at 627 n.10 (discussing the conditional fee in England and other jurisdictions that prohibit contingent fees).

We propose that fees for securities lawyers representing financial institutions and perhaps some bank regulatory lawyers be conditional. If the client complies with the law during the legal representation, the fee is paid. If the client does not comply and yet remains solvent, the fee still is paid—the client should not be permitted to avoid paying the lawyer because of its own misconduct (if the lawyer truly neglected his duties, the client can sue for malpractice). If, however, the client violates the laws in connection with which the lawyer has been retained and becomes insolvent within a period of three years, the lawyer is not paid any amounts still due and must disgorge for the benefit of the client's creditors legal fees paid during the period of noncompliance. The lawyer's fault is irrelevant, although the lawyer can work hard to protect a conditional fee by making sure that the client takes steps to comply with the law, particularly if there is a risk of future insolvency. While a lawyer might seek to protect a portion of his or her fees by delaying client insolvency, there is a limited amount lawyers can do to stop a client from sliding into insolvency other than what they are supposed to do, which is to get senior management, directors, and perhaps even the outside creditors to focus on rectifying the situation. In any event, a lawyer who cannot prevent either illegal client conduct or client insolvency will end up doing a substantial amount of legal work for free.

We also propose that lawyers writing opinions relied upon by a client's accountants be required to disgorge fees if 1) the client subsequently becomes insolvent, 2) the lawyers' opinion was relied upon by the accountants, and 3) a causal connection is established between the opinion and the accountants' improper certification of financial statements (this part of our proposal would require an adjudication—probably by a court—before a fee disgorgement could be ordered). A showing of causal connection with the insolvency would not be required.

Although the category of lawyers who should receive conditional fees can be expanded (either by regulation or by private agreement with a client), we suggest starting with lawyers who are "practicing before the SEC"—a term broadly defined under SEC rules to include the provision of any securities compliance advice[26]—and lawyers such as Linklaters in the Repo 105 transaction, who provide legal opinions that are relied upon by the auditors of a client that is a publicly held company, whether or not they practice before the SEC. Some banking and other regulatory lawyers could be included as well, either through voluntary private arrangements with clients or through regulations promulgated by the relevant banking regulators. This proposal might be enacted by regulation. But we must be

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[26] Standards of Professional Conduct for Attorneys Appearing and Practicing Before the Commission in the Representation of an Issuer, 17 C.F.R. § 205.2(a) (2011).

realistic: such a regulation is probably unlikely. What may be more realistic, though, is private adoption. Some client boards of directors might ask lawyers for a conditional fee premised upon a combination of client compliance and solvency, both as a way of improving the quality of services from lawyers charged with compliance work, and, if the arrangement is publicized, as a way to reassure investors, counterparties, and regulators that the client wants to do everything possible to assure its own compliance and solvency. And shareholder activists might submit proposals urging adoption of conditional fee and disgorgement arrangements.

A conditional fee approach avoids many of the difficulties present in a fault-based malpractice regime. A fault-based regime requires finding counsel to sue other lawyers; it also requires establishing fault or failure to adhere to the prevailing standard of care, and loss causation. Moreover, fault-based regimes may allow for the *in pari delicto* defense, under which professional service providers for a failed entity can attribute wrongdoing of their client's officers and directors to a trustee representing the now-bankrupt client's creditors.[27] Civil litigation is in any event unpredictable and in all events costly, further limiting the ex ante motivations of lawyers to avoid bad behavior, and the ex post ability to recover for lawyer bad behavior.

While we do not suggest replacing the malpractice regime with a conditional fee, we believe that a conditional fee could be useful for avoiding the type of loophole lawyering that brings clients too close to legal lines and too close to insolvency, a combination likely to injure persons other than the client, including its creditors, and to potentially cause harm to the financial system as a whole. The conditional fee provides an additional incentive for cautious lawyering without many of the costs that would be incurred from an alternative approach of making legal malpractice suits easier to win or increasing the size of judgments against lawyers.

The conditional fee also fills an enforcement gap in bar association regulation of the legal profession. As noted above, very few bar disciplinary proceedings are brought against lawyers for advice they give clients about compliance with securities laws and banking regulations. Many disciplinary authorities do not fully understand these practice areas, and have difficulty determining when lawyers have been incompetent[28] or have assisted with a client crime or fraud.[29] Disciplinary authorities are

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[27] *See, e.g.*, Kirschner v. KPMG LLP, 938 N.E.2d 941, 950 (N.Y. 2010).

[28] *See* MODEL RULES OF PROF'L CONDUCT R. 1.1 (2009) (describing compliance).

[29] *See* MODEL RULES OF PROF'L CONDUCT R. 1.2(d) (2009) (prohibiting lawyer assistance with client crime or fraud).

reluctant to pursue charges of lawyer malfeasance except in the rare cases when the lawyer has been subject to an administrative sanction by a government agency or a criminal conviction.[30]

Regulation of lawyers by the SEC or bank regulators is somewhat more vigorous because these agencies are experts in the relevant area. Congress gave the SEC new powers to regulate lawyers in SOX, and the SEC's professional responsibility rules have addressed some areas of responsibility such as reporting corporate client noncompliance up the ladder to boards of directors. The more general responsibilities of securities lawyers to assure client compliance with the law, are not, however, addressed in the SEC's rules. The SEC rules also do not address the consequences for lawyers who render legal opinions blessing transactions despite warning signs that those transactions are part of a plan to deceive investors. Furthermore, the rules contain confusing language defining when evidence of a violation has to be reported up the ladder.[31] The rules also only apply to lawyers representing issuers (lawyers representing underwriters and other financial advisors are excluded unless the lawyers represent these entities as issuers of their own securities), and there is a broad carve-out for foreign lawyers (it is debatable, for example, whether Linklaters was practicing before the Commission when its London office issued the Repo 105 opinion letter with a specific disclaimer saying the letter was not providing advice under U.S. securities laws, even though the opinion also said that Lehman's auditors would rely upon the opinion in blessing the financial statements attached to its 10K filed with the SEC).[32] In any event, there have been few, if any, SEC proceedings against lawyers for violating the SEC's SOX rules even in situations where it is clear that the rules do apply.

We do not propose that the SEC rules for securities lawyers be abandoned—indeed they should probably be expanded to address new

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[30] This concern about lack of enforcement by state bar disciplinary committees motivated one of the authors of this article to urge the federally mandated up-the-ladder reporting requirement that eventually was adopted in Section 307 of SOX. *See* Richard W. Painter & Jennifer E. Duggan, *Lawyer Disclosure of Corporate Fraud: Establishing a Firm Foundation*, 50 SMU L. REV. 225, 261 (1996).

[31] *See* 17 C.F.R. §205.2(e) (defining evidence of a material violation as "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").

[32] *See id.* § 205.2(a)(2)(ii) (stating that the definition of an attorney appearing and practicing before the Commission "[d]oes not include an attorney who . . . is a non-appearing foreign attorney"). Other difficulties with pursing Linklaters under the SEC's SOX rules include that it may not have been apparent at the time—particularly to Linklaters—that Lehman was violating the securities laws (although serious inquiry into the purpose of the Repo 105 transaction would likely have revealed that Lehman was trying to dress up its balance sheet).

areas such as legal opinions[33]—but we do not believe these rules, alone or in combination with the legal malpractice and lawyer discipline regimes, provide sufficient incentive for lawyers to be proactive in assuring client compliance in those situations where persons other than the client—e.g. creditors and the financial system as a whole—are most likely to be harmed. Unlike these fault-based regimes, the conditional fee that we propose focuses on lawyer compensation and compensates the attorney based on an important component of the results obtained for the client,[34] which is the client's compliance with the law, at least in those situations where the client is at risk of insolvency. If the client does not comply and becomes insolvent, the lawyer does not get paid.

The conditional fee we propose is principally an incentive mechanism, not a way to compensate creditors (an issuer's legal fees are likely to be a small percentage of creditors' overall losses in a situation such as the Lehman Brothers bankruptcy). Nonetheless, disgorgement of conditional fees may be the only recovery creditors get from the issuer's lawyers. As discussed above, private securities fraud suits cannot be brought under federal law against aiders and abettors of securities fraud, or even co-conspirators, and the definition of the primary violator is exceedingly narrow.[35] In some states, lawyers sued by a bankruptcy trustee can raise the defense of *in pari delicto*, claiming that the conduct of the defunct debtor's officers and directors are attributable to the bankruptcy estate, thereby blocking most suits for malpractice and breach of fiduciary duty against professional service providers.[36] Finally, the SEC has to date not used the SOX rules or any other securities laws to require disgorgement of fees or other payments by lawyers except in situations where the lawyers themselves are found to have violated the securities laws.

This conditional fee disgorgement rule, like our proposed personal

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[33] The SEC's rules should require that lawyers opining on large transactions report basic facts about those transactions to issuer boards of directors, unless the chief legal officer or outside securities counsel has reviewed the transaction and affirmatively opined that the issuer is in compliance with US securities laws. The SEC should also clarify that these and other SOX Section 307 rules apply to any lawyer providing an opinion or other work product to be relied upon by the issuer's auditors. Finally, lawyers providing opinions should have affirmative duties to investigate transactions to satisfy themselves that they are not assisting a client in committing a fraud. The extent of required investigation should depend on the nature of the transaction.

[34] *See* MODEL RULES OF PROF'L CONDUCT R. 1.5 (2009) (listing factors to be used in determining the reasonableness of legal fees, including the results obtained).

[35] *See* Janus Capital Grp. v. First Derivative Traders, 131 S. Ct. 2296, 2301-02 (2011); Stoneridge Inv. Partners v. Scientific Atlanta, 552 U.S. 148, 153, 166-67 (2008); Cent. Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164, 177-80 (1994); *supra* text accompanying notes 3-5.

[36] *See* Kirschner v. KPMG LLP, 938 N.E.2d 941, 950, 955-57 (N.Y. 2010).

liability rule for investment bankers discussed briefly above,[37] would impose strict liability, unrelated to a showing of the lawyers' culpability. Lawyers would be required to accept responsibility for the outcome of their legal representation in those situations where bad outcomes are particularly likely. Because only fees would be lost and personal liability would not be imposed on lawyers absent a finding of fault, this proposal is not as onerous as our personal liability proposal for investment bankers. There is, however, a common theme: in this regime of personal and professional responsibility the "it's not my fault" argument would be irrelevant.

Will a conditional fee discourage lawyers from taking on some financial services firms and other issuers of securities as clients? Perhaps, unless lawyers are compensated for the fact that the fee is conditional. Legal representation in securities and banking matters would probably be of higher quality under the conditional fee regime, but it would be more expensive, especially for clients that take bigger risks.[38]

What if, in the course of a representation, the client increases its risky behavior or otherwise comes closer to insolvency? Will lawyers respond to increased risk of client noncompliance and insolvency in the middle of a representation by raising the conditional fee rather than addressing the underlying problem? Perhaps clients should be required to report material changes in their fee arrangements with their lawyers during the course of a representation on a Form 8-K (this is the same SEC form used to report developments such as resignation of accountants and the reasons behind them in Item 401; the same form could require reporting changes in fee arrangements with lawyers and the reasons behind them).[39]

V. CONCLUSION

We may no longer be in the midst of a full-blown financial crisis, but our economy is scarcely healthy. Indeed, we risk entering into a second "dip"

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[37] *See* Hill & Painter, *supra* note 10.

[38] Perhaps a rule requiring the conditional fee should contain an exception for smaller clients whose legal fees are already large compared with their market capitalization (unlike Lehman Brothers these smaller institutions are also unlikely to pose a systemic risk to the economy). For larger financial institutions, however, more effective and more conservative–if marginally more expensive–legal representation is worth it.

[39] Even if the specifics of the legal representation are not disclosed under client confidentiality rules, investors as well as regulators should be entitled to see the conditional fee increase reflected in the client's securities filings. *See* MODEL RULES OF PROF'L CONDUCT R. 1.6 (2009) (describing confidentiality as well as common law governing the attorney-client privilege); *see also*, U.S. v. Amerada Hess Corp., 619 F.2d 9080, 985-96 (1980) (discussing federal common law attorney client privilege). Information about lawyers' fees generally is not considered to be privileged (although the nature of the legal services sometimes is privileged), and basic information about legal fees probably should not be kept confidential when the client is a public company.

or recession. Unemployment remains very high, and the housing market is deeply depressed. The stock market remains volatile. Many laws and regulations have been adopted in response to the crisis; there have been other changes as well, including some changes in norms and behavior. There are debates as to how well the law changes will work, and how much we have learned about what to do and what not to do; few if any observers, though, think that we have solved the problem. Indeed, many commentators are suggesting that the next crisis is not far off; some are suggesting it will be even worse than the crisis just past.

Banker behavior was a significant cause of the crisis. We have argued elsewhere that existing law, including the law as changed in response to the crisis, does not sufficiently address banker behavior; we have argued that bankers should bear more liability for their banks' excessive risk-taking.[40]

Here, we briefly consider lawyer behavior. Lawyers designed many of the exotic financial instruments that caused the crisis, and provided securities and other compliance work to large financial institutions that in some cases were not complying with the law. Lawyers blessed transactions such as Repo 105 that helped conceal these problems from investors. Lawyers should accept responsibility for the consequences of their actions, not only in a fault based liability or disciplinary regime, but also by sometimes not getting paid for the work they do when that work does not accomplish its objective—i.e. when compliance work does not cause the client to comply with the law—and the client also becomes insolvent.

Our conditional fee proposal will not prevent all loophole lawyering. The client may be close to the line, but remain on the "right side"—our proposal only addresses violations of law, not aggressive interpretations. Our proposal also does not address violations of law that cause dramatic losses for shareholders or other parties such as customers, counterparties and investors, but do not result in the client's insolvency. For these reasons the conditional fee is only part of the solution to the problem of loophole lawyering and lax compliance oversight by lawyers. An effective legal malpractice liability regime, a more diligent lawyer disciplinary regime, and more assertive oversight of lawyers by the SEC and bank regulators, will also be necessary. In a limited range of circumstances, however, the conditional fee could realign lawyer incentives toward more conservative assessment of risk than their clients' assessment. Conditional fees thus should help some banking lawyers and securities lawyers do a better job representing their clients.

We think our proposal can play an important role in preventing, or at least limiting the effect of, future financial crises. Problematic transactions

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[40] Hill & Painter, *Berle's Vision Beyond Shareholder Interests*, *supra* note 10.

should become more difficult to do because lawyers will be less willing to help, particularly if a transaction poses a risk of both legal violation and future insolvency. Lawyers who fear loss of conditional legal fees under a no-fault regime in addition to their existing exposure to malpractice liability and other sanctions when fault can be shown, would presumably conduct more due diligence, and might refuse to participate in transactions unless problematic elements were eliminated. Lawyers would be encouraged to err on the side of caution. The benefits of our proposal come at a cost: fewer transactions and higher legal fees. But on balance, this cost seems worthwhile.

This proposal is less ambitious and hence perhaps more likely to be effectively implemented than our proposal regarding bankers' personal liability. While we hope that a conditional fee regime, whether implemented by financial regulators, state bar ethics committees or by private parties themselves, could motivate lawyers to limit or even eliminate their involvement in problematic client behavior, much more needs to be done. Our broader conclusion is that the ethos that prioritizes and rewards financial and legal risk taking needs to change. Our hope, with this proposal, our proposal regarding bankers, and other reforms we are suggesting elsewhere,[41] is that such an ethos will begin to change in the financial services industry, and be supplanted by an ethos of professional and personal responsibility.

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[41] In a book tentatively titled THE PERSONAL AND PROFESSIONAL RESPONSIBILITIES OF INVESTMENT BANKERS, we will discuss several suggested reforms, including personal liability of investment bankers for firm debts, limiting compensation for investment bankers on the premise that investment banking plays a facilitating rather than a primary role in economic development and is *not* the place for either excessive innovation or big risk—big reward business decisions, promoting regional investment banking to reinforce social and economic ties with clients and other economic actors affected by bankers' actions, and promoting specialized investment banking that focuses on services such as underwriting securities or retail brokerage to increase the value of reputation for high quality services rather than the current emphasis on propriety trading in an investment bank's own account.