Certification Drag: The Opinion Puzzle and Other Transactional Curiosities

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Financial markets are populated by a host of reputable intermediaries, including law firms, auditors, underwriters, investment banks, and credit rating agencies, which provide various stamps of approval attesting to costly-to-verify characteristics of the relevant asset. The law-and-economics literature has typically observed that these "certification intermediaries" have low rational incentives to endanger hard-won reputational capital by acting fraudulently or even negligently and therefore are generally viewed as enhancing market efficiency by mitigating informational asymmetries that may otherwise distort or even frustrate mutually beneficial transactions.[1] But it has largely gone unrecognized that this "happy" efficiency story has found at best mixed and often inconclusive empirical support in the case of certain commonly used certification instruments in the financial and other markets.[2] Nor, as has been increasingly recognized in the wake of Enron and other contemporary scandals (including by some of its original exponents),[3] does this unqualified "certification -thesis"[4] sit comfortably with the historical and recent recurrence of fraudulent and similar conduct even in sophisticated business environments monitored by a large population of prestigious (and expensive) intermediaries.[5]

In this Article, I tell a "not-so-happy" story of certification intermediaries that anticipates in part these otherwise curious failures of the financial markets to satisfy the sanguine expectations of the standard certification thesis. Specifically, I identify a perverse "two-sided" incentive structure, which, through a combination of agency-cost and adverse-selection effects, sustains minimally informative but non-cost-justified certification practices even in sophisticated markets, thereby imposing a levy on business

1. *See infra* Part I.A.

2. *See infra* Part I.B.

3. *See* Ronald J. Gilson & Reinier Kraakman, *The Mechanisms of Market Efficiency Twenty Years Later: The Hindsight Bias*, 28 J. CORP. L. 715, 736-37 (2003) (stating that "recent scandals demonstrate that we . . . were too sanguine about the role of the institutions that we termed 'reputational intermediaries'—the established investment banks, commercial banks, accounting firms, and law firms"); Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 J. CORP. L. 1, 30 (2002) (noting that, in light of the Arthur Andersen scandal, reputational pressures and even stiff regulatory penalties apparently are insufficient to restrain fraudulent auditor behavior).

4. A closely equivalent claim is the "reputational intermediary" thesis, which captures some, but not all, of the practices that fall under the rubric of the "certification thesis" insofar as the latter encompasses non-reputational bonding mechanisms (e.g., a warranty or other contractual guarantee backed up by judicial enforcement).

5. For discussions of the implications of Enron and other recent scandals for confidence in the "gatekeeping" capacities of certifiers and other intermediaries, see JOHN C. COFFEE, JR., GATEKEEPERS 2-3 (2005) [hereinafter COFFEE, GATEKEEPERS]; John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U. L. REV. 304 (2004) [hereinafter Coffee, *Gatekeeper Failure*] (attributing "the wave of accounting and financial reporting irregularities that surfaced in 2001-2002," in part, to gatekeepers' failure); John C. Coffee, Jr., *Understanding Enron: "It's About the Gatekeepers, Stupid,"* 57 BUS. LAW. 1403 (2002) [hereinafter Coffee, *Understanding Enron*] (offering some explanations for the "apparent failure in the market for gatekeeping sources"); Frank Partnoy, *Barbarians at the Gatekeepers?: A Proposal for a Modified Strict Liability Regime*, 79 WASH. U. L.Q. 491, 492 (2001) [hereinafter Partnoy, *Barbarians*] (proposing a modified strict liability regime that holds gatekeepers liable for securities fraud damages).

transactions—or, as referenced in this Article's title, a "certification drag"—without generating commensurate benefits in the form of improved transaction pricing or structuring. To oversimplify only slightly: these certification instruments cost *something* but often appear to say *almost nothing* (or more precisely, almost nothing *new*). Contrary to the standard account (and without assuming any of the "usual suspects" behind market failure, as identified below), non-cost-justified bonding practices that generally do little to facilitate efficient transactions may persist in a sophisticated market over a substantial period, with attendant social losses as a result. Hence it is not necessarily puzzling that routinely used certification practices fail to yield substantial informational value or that a gold-plated array of third party intermediaries fails to screen out recurrent patterns of fraudulent behavior.

I develop this "degenerate" certification thesis through a detailed examination of the third party legal opinion (or in short, "closing opinion"), which is commonly issued by law firms at the consummation of certain significant business transactions such as acquisitions and financings. For the analytical purpose of identifying practical limits to the standard certification thesis, this narrow (but to practitioners, familiar) corner of business-law practice provides an unusually "clean" setting that substantially lacks several distorting characteristics that would otherwise be obvious sources of market failure: (1) both providers and recipients of the certification instrument are sophisticated, thereby probably barring any undersupply or oversupply inefficiencies characteristic of a "credence good" market;[6] (2) depending on market definition, there are at least tens and probably hundreds of actual and potential certification providers, thereby sharply reducing the reasonable likelihood of any collusion-related inefficiencies; and (3) there are few legal requirements or other regulatory interventions that would otherwise skew the market's "natural selection" of the most efficient certification practice.[7]

Following the standard certification thesis, most of the limited academic literature[8]

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6. A "credence good" market is a market where (1) sellers are more sophisticated than buyers, and (2) the quality of the relevant good cannot be ascertained pre-purchase and can only be imperfectly ascertained post-purchase. Classic examples are car repair and medical services (and legal services where clients are unsophisticated).

7. These potentially distorting factors are, however, not entirely absent in the closing-opinion setting. For further discussion, see *infra* Part IV.D.

8. For the only other dedicated scholarly treatment of closing opinions, see Jonathan C. Lipson, *Price, Path & Pride: Third-Party Closing Opinion Practice Among U.S. Lawyers (A Preliminary Investigation)*, 3 BERKELEY BUS. L.J. 59 (2005) (providing a qualitative, empirical analysis of third party closing opinion practice). For additional relevant discussion, see Steven L. Schwarcz, *To Make or to Buy: In-House Lawyering and Value Creation* (Duke Law School Legal Studies Research Paper Series, Research Paper No. 133, 2006) [hereinafter Schwarcz, *To Make or to Buy*], *available at* http://ssrn.com/abstract=941135. Two previous law review symposia dedicated in part to legal opinions contain helpful contributions: a spring 1995 edition of the *Oregon Law Review* and a 1989 edition of the *Columbia Business Law Review*. *Symposium: Business Lawyering and Value Creation for Clients*, 74 OR. L. REV. 1 (1995); *Symposium: Rethinking Legal Opinion Letters: Current Trends in Legal Opinion Liability*, 1989 COLUM. BUS. L. REV. 235. Additionally, a few publications have recently appeared relating specifically to legal opinions in structured finance transactions. *See* John C. Coffee, Jr., *Comment: Can Lawyers Wear Blinders? Gatekeepers and Third-Party Opinions*, 84 TEX. L. REV. 59 (2005) [hereinafter Coffee, *Comment*]; Jonathan Macey, *The Limits of Legal Analysis: Using Externalities to Explain Legal Opinions in Structured Finance*, 84 TEX. L. REV. 75, 76 (2005); Steven L. Schwarcz, *The Limits of Lawyering: Legal Opinions in Structured Finance*, 84 TEX. L. REV. 1 (2005) [hereinafter Schwarcz, *Limits of Lawyering*]; Steven L. Schwarcz, *We Are All Saying Much the Same Thing: A Rejoinder to the Comments of Professors Coffee, Macey and Simon*, 84 TEX. L. REV. 93 (2005) [hereinafter

and some, but not all, of the voluminous practitioner literature[9] teaches that a closing opinion provides meaningful assurance from a trustworthy intermediary as to various fundamental matters that I group under the rubric of "contracting quality," which includes most notably the enforceability of the contractual obligations undertaken by the firm's client.[10] Contrary to this position, however, some legal practitioners (including the Business Law Section of the California Bar)[11] and other industry participants express concern that at least some closing opinions may be a costly distraction leading to no appreciable value-enhancing result. A close examination of closing opinion practice provides strong support for this alternative view, revealing multiple factors that substantially impede any meaningful assurance function, including most notably: the highly qualified language used in closing opinions, an opining firm's inherent conflict of

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Schwarcz, *Same Thing*].

9. The leading legal opinion treatise is DONALD W. GLAZER ET AL., GLAZER & FITZGIBBON ON LEGAL OPINIONS (2d ed. 2001 & Cum. Supp. 2006). The national, regional, and specialized bar associations have produced a plethora of reports on various types of legal opinions. The "TriBar Opinion Committee," initially consisting of members drawn from New York bar associations and now including representatives from bar associations in other major metropolitan areas, has produced various reports, including: TriBar Opinion Comm., *Special Report of the TriBar Opinion Committee: The Remedies Opinion—Deciding When to Include Exceptions and Assumptions*, 59 BUS. LAW. 1483 (2004) [hereinafter *2004 TriBar Special Report*]; TriBar Opinion Comm., *Third-Party "Closing" Opinions*, 53 BUS. LAW. 592 (1998) [hereinafter *1998 TriBar Report*]; TriBar Opinion Comm., *Special Report By the TriBar Opinion Committee: The Remedies Opinion*, 46 BUS. LAW. 959 (1991) [hereinafter *TriBar Remedies Opinion*]; TriBar Opinion Comm., *Second Addendum to Legal Opinions to Third Parties: An Easier Path*, 44 BUS. LAW. 563 (1989); TriBar Opinion Comm., *Third-Party "Closing" Opinions: A Report of the TriBar Opinion Committee*, 34 BUS. LAW. 1891 (1979). The American Bar Association ("ABA") has also issued several releases pertaining to legal opinions. *See* COMM. ON LEGAL OPINIONS, ABA & TRIBAR OPINION COMM., THE COLLECTED ABA AND TRIBAR OPINION REPORTS (2005) (which usefully includes all of the recent ABA and TriBar Committee reports on legal opinions); Comm. on Legal Opinions, ABA, *Third-Party Legal Opinion Report, Including the Legal Opinion Accord*, 47 BUS. LAW. 167 (1991) [hereinafter ABA, *Legal Opinion Accord*], *reprinted in Certain Guidelines for the Negotiation and Preparation of Third-Party Legal Opinions*, *in* LEGAL OPINIONS: THE IMPACT OF THE TRIBAR COMMITTEE'S NEW REPORT ON LEGAL OPINION PRACTICING 175, 177-86 (PLI, Course Handbook Series No. B-1054, 1998); Comm. on Legal Opinions, ABA, *Legal Opinion Principles*, 53 BUS. LAW. 831 (1998) [hereinafter ABA, *Legal Opinion Principles*]; Comm. on Legal Opinions, ABA, *Guidelines for the Preparation of Closing Opinions*, 57 BUS. LAW. 875 (2002) [hereinafter ABA, *Guidelines*]. Also of note are reports issued by the California, Texas, and Michigan bars: Opinions Comm., Cal. State Bar Bus. Law Section, *Toward a National Legal Opinion Practice: The California Remedies Opinion Report*, 60 BUS. LAW. 907 (2005) [hereinafter *California Remedies Opinion Report*]; CORPS. COMM., CAL. STATE BAR, LEGAL OPINIONS IN BUSINESS TRANSACTIONS (EXCLUDING THE REMEDIES OPINION) (2005) [hereinafter 2005 CALIFORNIA BAR REPORT], *available at* http://www.calbar.ca.gov (search "Search Calbar Site" for "Legal Opinions in Business"; then follow "Corporations Committee 2005 Opinions Report . . ." hyperlink); BUS. LAW SECTION, STATE BAR OF CAL., REPORT ON THIRD-PARTY REMEDIES OPINIONS (2004) [hereinafter 2004 CALIFORNIA BAR REPORT], *available at* http://www.calbar.ca.gov (search "Search Calbar Site" for "Report on Third-Party Remedies Opinions"; then follow "Report on Third-Party Remedies Opinions" hyperlink); BUS. LAW SECTION, STATE BAR OF TEX., REPORT OF THE LEGAL OPINIONS COMMITTEE REGARDING LEGAL OPINIONS IN BUSINESS TRANSACTIONS (1991) [hereinafter TEXAS BAR REPORT]; BUS. LAW. SECTION, STATE BAR OF MICH., REPORT OF THE AD HOC COMMITTEE OF THE BUSINESS LAW SECTION OF THE STATE BAR OF MICHIGAN ON STANDARDIZED LEGAL OPINIONS IN BUSINESS TRANSACTIONS (1991) [hereinafter MICHIGAN BAR REPORT]. This is by no means a complete list of all relevant bar association reports and trade publications.

10. *See infra* Part II.A.

11. *See* 2004 CALIFORNIA BAR REPORT, *supra* note 9; 2005 CALIFORNIA BAR REPORT, *supra* note 9, at 4, 14-15. For further discussion, *see infra* notes 33-38 and accompanying text.

interest and minimal legal and reputational liability exposure (as shown in part through a detailed survey of relevant case-law over the past 20 years), and the availability of more robust diligence alternatives. Taken together, these factors cast serious doubt on whether a closing opinion typically contributes significant incremental information to opinion recipients and therefore has any appreciable capacity to mitigate informational asymmetries that would otherwise generate pricing or structural distortions.

Assuming, at least sometimes, that the incremental informational value typically conveyed by a closing opinion does not exceed the costs of preparing and negotiating it, why would this instrument persist as a routine transactional practice in sophisticated market settings? As a solution to this emergent "opinion puzzle" (and, by extension, other entrenched certification practices upon which market participants and observers routinely cast doubt), I propose a two-sided incentive structure that operates as follows: (1) demand is sustained by an agency-cost mechanism as a result of which a "requesting agent" requests a non-cost justified but entrenched certification instrument in order to mitigate the reputational penalty for perceived professional incompetence, and (2) supply is sustained by an adverse-selection mechanism as a result of which "requested parties" provide the requested certification in order to avoid being placed on the extreme low end of a contracting quality spectrum. So long as demand is sustained as a result of the misalignment of incentives between the requesting principal and its agent, supply usually follows; given that the requested certification is easily obtainable and customarily issued, failure to provide it triggers the negative implication that there exists a highly problematic fact that has not been previously disclosed, thereby resulting in a substantial quality discount up to and including termination of the proposed transaction.

This incentive structure shows how a competitive market may rationally overinvest in minimally informative certification instruments that generate nontrivial transaction costs without at least commensurate benefits in the form of incremental informational value. While developed within the closing-opinion context, this structure is formulated generically and, as I show preliminarily with respect to credit ratings in the debt offering markets, fairness opinions in the corporate acquisitions market, and certain forms of contractual boilerplate in corporate law practice, offers a diagnostic tool for identifying and accounting for other certification practices that are both widely used in sophisticated settings and frequently questioned by the practitioner, policymaking, and scholarly communities. But this is not to say that "certification drag" is necessarily incurable. The relevant market may ultimately remedy this state of affairs through the pioneering actions of certain "lead" participants who are sufficiently confident in being able to accrue substantial reputational gains by deviating from inefficient industry convention. This self-curative outcome finds support in several modest contractions in the use of closing opinions and more radical contractions in the use of certain other legal opinions. However, any self-curative outcome may be substantially delayed where regulatory distortions, trade associations, entry barriers, or other market imperfections unduly increase the anticipated costs of deviating from entrenched industry protocol.

This Article is organized as follows. In Part I, I describe the standard certification thesis and review relevant portions of the associated theoretical and empirical literature. In Part II, I examine the typical procedural and cost burdens in connection with issuing a closing opinion and describe multiple factors that may dilute its informational value, which together identify the emergent opinion puzzle. In Part III, I present the aforementioned incentive structure as a possible solution to the opinion puzzle. In Part IV, I assess the capacity of the legal market (and by implication, other certification markets) independently to correct a degenerate certification practice. In Part V, I explore applications of the proposed incentive structure to other widely used *and* widely questioned certification practices in sophisticated business transactions.

I. CERTIFICATION REVISITED

In this Part, I describe the standard certification thesis, as it has typically been presented and applied in the legal economic (and *some* of the associated economic) literature, and then review empirical efforts to assess the informational benefits conferred by commonly employed certification practices in the financial markets. As described below, while the certification thesis cogently explains how third party intermediaries can improve market efficiency by relieving informational asymmetries between contracting parties, empirical attempts to validate this thesis in core transactional settings often reach surprisingly mixed results.

A. Theory

It is well known that informational asymmetries can prevent, or at least distort, the pricing or other terms of efficient transactions where sellers find it too costly to credibly convey private information to potential buyers. It is also well known that sellers sometimes overcome these informational asymmetries by recourse to trustworthy third parties who issue certification instruments that credibly signal the quality of the relevant asset, thereby allowing buyers to distinguish between higher-quality and lower-quality sellers.[12] Crucially, the signaling capacity of any certification instrument depends on the extent to which the higher-quality seller thereby incurs a cost that a lower-quality seller cannot bear (because it will not be able to recoup the cost of the signal once its low quality is revealed), which in turn permits buyers to distinguish between higher- and lower-quality sellers, thereby enabling the former to earn an appropriate quality premium. Certification proxies (or more generally, signaling instruments) that meet this condition generate efficiency benefits (net of resources expended on the certification process) by mitigating informational asymmetries that may otherwise frustrate or distort mutually beneficial exchanges.

This is a cogent thesis and law-and-economics scholars have widely cited it as an efficiency explanation for the role of attorneys, auditors, underwriters, investment bankers, and other costly intermediaries that commonly accompany the diligence, negotiation, and execution of sophisticated business transactions.[13] These discussions,

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12. For the leading source, see Michael Spence, *Job Market Signaling*, 87 Q. J. ECON. 355 (1973).

13. *See* COFFEE, GATEKEEPERS, *supra* note 5, at 2-3 (describing the general assumption that financial market gatekeepers act as reputational intermediaries); Partnoy, *Barbarians*, *supra* note 5, at 546 (same). For specific examples, see Ronald Gilson, *Value Creation by Business Lawyers: Legal Skills and Asset Pricing*, 94 YALE L.J. 239, 290-91 (1984) [hereinafter Gilson, *Value Creation*] (arguing that lawyers act as "reputational intermediaries" and that an effective reputational intermediary will emit a credible quality signal because he or she has rational incentives to maintain a trustworthy reputation in order to attract further business); Victor P. Goldberg, *Accountable Accountants: Is Third-Party Liability Necessary?*, 17 J. LEGAL STUD. 295, 312 (1988) (arguing that auditors have adequate market-based incentives to act diligently insofar as failure to do so results

however, rarely make reference to a complex and well-developed body of economic models that identify multiple conditions for *inefficient* outcomes in signaling markets, generally, and certification markets, in particular.[14] A somewhat skewed intellectual genealogy seems to exist. While the law and economics literature widely cites Nobel Prize winner Michael Spence for the proposition that signaling opportunities can generate efficiency *gains* by enabling uninformed parties to distinguish between higher- and lower-quality counterparties, it hardly ever seems to cite Spence's other (and, in his work, arguably more central) proposition that signaling opportunities can generate efficiency *losses* by inducing dissipative investments that redistribute existing resources at a positive transaction cost without generating commensurate productivity or other social gains.[15] To be sure, the law and economics literature generally acknowledges some inherent limits to the bonding capacity of reputational intermediaries, thereby giving rise to a second-order "lemons" problem that must be mitigated by imposing legal liability or other measures.[16] And in the post-Enron period, several scholars have identified other conditions where the reputational constraints of third party intermediaries may fail to

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in a reputational penalty).

14. This economic literature is extensive. For overviews, see John G. Riley, *Silver Signals: Twenty-Five Years of Screening and Signaling*, 39 J. ECON. LIT. 432 (2001); Joseph E. Stiglitz, *Information and the Change in the Paradigm in Economics*, 92 AMER. ECON. REV. 460 (2002). For references to some of the limited economic literature on certification inefficiencies in particular, see *infra* note 17, and for specific applications of excessive signaling models, see *infra* note 125.

15. This thesis (which Spence develops in the education context) requires that signaling investments do not enlarge the total social product by generating "matching efficiencies" or "human capital" effects that increase productivity. While this assumption may be somewhat unrealistic in its unqualified form, some portion of a signaling investment will always be purely redistributive (and therefore, socially excessive) to the extent that the private return from any such investment exceeds the social return. *See* MICHAEL SPENCE, MARKET SIGNALING: INFORMATIONAL TRANSFER IN HIRING AND RELATED SCREENING PROCESSES (1974); Michael Spence, *Competition in Salaries, Credentials, and Signaling Prerequisites for Jobs*, 90 Q.J. ECON. 51 (1976); Michael Spence, *Job Market Signaling*, 87 Q.J. ECON. 355 (1973). As a somewhat crude proxy, a preliminary survey of the Westlaw "Journals & Law Review" database generates 167 references to "Spence" and "signal" in the same sentence, of which only two appear to refer to Spence's inefficiency result. A notable exception to the statement above is the recent widely-noted article by Philippe Aghion & Benjamin Hermalin, *Legal Restrictions on Private Contracts Can Enhance Efficiency*, 6 J.L. ECON. & ORG. 381 (1990).

16. *See* Reinier H. Kraakman, *Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy*, 2 J.L. ECON. & ORG. 53 (1986) (stating that investors trust the monitoring services provided by underwriters, accounting firms, and law firms because these intermediaries are believed to be repeat players subject to reputational pressures to detect and prevent issuer carelessness or deceit, but otherwise noting that reputational pressures are inherently limited, therefore sometimes requiring the imposition of legal liability). For more extended analyses that specifically emphasize the inherent limitations of certification intermediaries, see Stephen Choi & Jill E. Fisch, *How to Fix Wall Street: A Voucher Financing Proposal*, 113 YALE L.J. 269 (2003) (arguing that inherent free-riding on information provided to the market by securities intermediaries necessitates funding mechanisms that in turn create conflicts of interests, thereby impeding the quality of the information provided); Stephen Choi, *Market Lessons for Gatekeepers*, 92 NW. U. L. REV. 916 (1998) [hereinafter Choi, *Market Lessons*] (showing that certification intermediaries can fail depending on the size of the certification fee, the level of screening accuracy, and the anticipated proportion of low-quality and high-quality firms in the relevant market, but arguing that this does not recommend the straightforward imposition of mandatory legal liability). More formal analyses of "reputational failure" are found in the small economic literature that specifically models certification behavior. *See, e.g.*, Luigi Alberto Franzoni, *Imperfect Competition in Certification Markets*, *in* ORGANIZED INTERESTS AND SELF-REGULATION: AN ECONOMIC APPROACH (Bernardo Bortolotti & Gianluca Fiorentini eds., 1999); Gian Luigi Albano & Alessandro Lizzeri, *Strategic Certification and Provision of Quality*, 42 INT'L ECON. REV. 267 (2001).

generate the efficient outcome anticipated by the standard certification thesis,[17] including conflicts of interest, limited screening capacities, differential sophistication, and entry barriers in the certification market.[18] Nonetheless, it is fair to say that the law and economics literature generally counsels confidence in the net social value of certification intermediaries, who are typically presumed to alleviate informational obstacles that may distort or impede efficient market transactions. Some courts have even put this optimistic view to practice; most notably, the Seventh Circuit denied an aiding-and-abetting claim against a then-leading accounting firm on the ground, in part, that the prestigious defendant would not rationally endanger its vast reputational capital on the profits to be gained in facilitating a single client's fraudulent action.[19] In the wake of Arthur Andersen's fall from grace and Enron's subsequent implosion, this unqualified confidence in the socially efficient behavior of even well-established intermediaries appears to have some serious practical limitations.

B. Evidence

Even if the certification thesis is entirely cogent as a theoretical matter, empirical attempts to validate the thesis in real-world settings surprisingly often reach mixed and occasionally even contrary results. While the certification thesis finds some (mostly qualitative) support in certain (mostly historical) market settings,[20] reviews of the relevant empirical literature agree that generally the data is not abundant and often mixed.[21] In particular, ambiguous findings have been reached with respect to the marginal informational value of several certification practices routinely used in high-stakes financial transactions: audit reports and other financial statements released by

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17. *See, e.g.*, Frank Partnoy, *Strict Liability for Gatekeepers: A Reply to Professor Coffee*, 84 B.U. L. REV. 365, 375 (2004) [hereinafter Partnoy, *Strict Liability*] (arguing that prior literature on gatekeepers rested on untenable assumptions as to the effectiveness of reputational constraints on gatekeeper misconduct).

18. For the most complete inventory of potential defects in the gatekeeping capacity of market intermediaries, see John C. Coffee, *Conclusion*, *in* FINANCIAL GATEKEEPERS 177-89 (Yasuyuki Fuchita & Robert E. Litan eds., 2005). For additional relevant discussions, see Coffee, *Gatekeeper Failure*, *supra* note 5; Coffee, *Understanding Enron*, *supra* note 5; Partnoy, *Strict Liability*, *supra* note 17; Partnoy, *Barbarians*, *supra* note 5.

19. *See* DiLeo v. Ernst & Young, 901 F.2d 624, 629 (7th Cir. 1990). This logic has apparently been followed in other court decisions concerning accountants' liability. *See* Robert A. Prentice, *The Case of the Irrational Auditor: A Behavioral Insight into Securities Fraud Litigation*, 95 NW. U. L. REV. 133, 135-39 (2000).

20. For a collection of such studies, see REPUTATION: STUDIES IN THE VOLUNTARY ELICITATION OF GOOD CONDUCT (Daniel B. Klein ed., 1997) [hereinafter REPUTATION]. For a review of more quantitative studies, see Ginger Zhe Jin et al., *That's News to Me! Information Revelation in Professional Certification Markets* (Nat'l Bureau of Econ. Research, Working Paper No. W12390, 2006), *available at* http://www.nber.org/papers/w12390.

21. *See* Stefano Gatti et. al., Arranger Certification in Project Finance (Mar. 19, 2007) (unpublished working paper) (noting that "empirical research has found little unambiguous evidence of third-party certification in capital markets financings"), *available at* http://efmaefm.org/Symposium2007/gatti.pdf; Jin et al., *supra* note 20, at 1 (noting that little is known empirically about when certification products add informational value to relevant transactions); Riley, *supra* note 14, at 455 (noting that little empirical research exists to confirm the multiple signaling theories with respect to advertising, warranties, and pricing strategies, and that the existing research draws mixed conclusions).

publicly traded corporations to the equity markets,[22] bond ratings issued by credit rating agencies to the debt markets,[23] and some "fairness opinions" issued by investment bank advisers in merger and acquisition transactions.[24] While finance economists have devoted considerable attention to assessing the certification benefits of prestigious intermediaries in initial public offerings, these efforts have not always yielded compelling results;[25] reasonably persuasive support exists for the certification benefits conferred by prestigious underwriters (although these findings, too, are periodically qualified or reversed),[26] but

22. *See* Maria Benau et al., *Reactions of the Spanish Capital Market to Qualified Audit Reports*, 13 EURO. ACCT. REV. 689 (2004) (reviewing stock-price reaction of Spanish public stocks to issuance of a qualified audit and finding that qualified audit reports have no incremental information value for investors); John A. Elliott, *"Subject to" Audit Opinions and Abnormal Security Returns—Outcomes and Ambiguities*, 20 J. ACCT. RES. 617 (1982) (finding that informational content of audit opinions qualified by a material contingency is unresolved and noting evidence that suggests the informational value is small relative to information already available to the market); Clive Lennox, *The Accuracy and Incremental Informational Content of Audit Reports in Predicting Bankruptcy*, 26 J. BUS. FIN. & ACCT. 757 (1999) (based on sample of 976 UK public companies during 1987-1994, finding that audit reports were not accurate signals of impending bankruptcy or the probability of its occurrence). More generally, see Jin et al., *supra* note 20 (noting that empirical literature shows that only some audit reports yield informational value to the market), and for a more popular account of the questionable informational value of audit reports, see MICHAEL POWER, THE AUDIT EXPLOSION 13 (1994).

23. *See* Frank Partnoy, *The Paradox of Credit Ratings*, *in* RATINGS, RATING AGENCIES AND THE GLOBAL FINANCIAL SYSTEM 65-84 (Richard M. Levich et al. eds., 2002) (arguing that there is little empirical data showing that credit ratings contribute new information to the market and that credit rating changes often lag, and are anticipated by, the market); Jin et al., *supra* note 20, at 6-7 (noting that the empirical literature on the informational value of bond ratings is inconclusive); Robert C. Merton & Zvi Bodie, *On the Management of Financial Guaranties*, FIN. MGMT., Winter 1992, at 87 (arguing that credit rating agencies may have rational incentives to ignore contrary private information where market consensus recommends downgrade, given large reputational injury in the event a positive rating, contrary to market consensus, proves to be erroneous). For a similar phenomenon in credit ratings of insurance companies, see Ajai K. Singh & Mark L. Power, *The Effects of Best's Rating Changes on Insurance Company Stock Prices*, 59 J. RISK & INS. 310 (1992) (finding that rating changes of leading third party ratings provider in insurance industry generate little stock price reaction).

24. *See* Lucy Huajing Chen, Merger Abnormal Returns and the Use of Independent Fairness Opinions (Oct. 2006) (unpublished working paper) (showing that, for an 18-month period following consummation of the relevant merger, acquirers that obtain fairness opinions from independent advisers outperform (during the three-day window around merger preannouncements) acquirers that obtain a nonindependent fairness opinion, but finding no such relationship with respect to target firms), *available at* http://www.ssrn.com/abstract=942802; Darren J. Kisgen et al., Are Fairness Opinions Fair? The Case of Mergers and Acquisitions (Jan. 28, 2007) (unpublished working paper), (finding that deal premiums are reduced when acquirers obtain fairness opinions, long-term stock performance improves when an acquirer obtains a second fairness opinion, but target fairness opinions appear to have no effect on the quality of the transaction), *available at* http://ssrn.com/abstract=850804. For a qualitative analysis expressing doubt as to the informational value of fairness opinions, see Lucien Bebchuk & Marcel Kahan, *Fairness Opinions: How Fair Are They and What Can Be Done About It?*, 1989 DUKE L.J. 27.

25. *See* Gatti et al., *supra* note 21, at 1 (stating that "there is very little empirical support for issuer certification in the finance literature"). This same source supplies an exception to the "rule" stated above, finding support for certification benefits in project-finance transactions as a function of arranger prestige, which apparently facilitates arrangement of larger and more highly leveraged loans. *Id.* at 12-13.

26. *See, e.g.*, Randolph P. Beatty & Ivo Welch, *Issuer Expenses and Legal Liability in Initial Public Offerings*, 39 J.L. & ECON. 545, 576-85 (1996) (showing that IPO underpricing falls when issuers hire elite underwriters and attributing this result to the fact that elite underwriters provide investors with improved quality assurance); Richard B. Carter et al., *Underwriter Reputation, Initial Returns and the Long-Run Performance of IPO Stocks*, 53 J. FIN. 285 (1998) (noting findings in prior literature establishing that underwriter reputation limits short-term underpricing and further showing that underwriter reputation correlates with reduced

support for the certification benefits routinely attributed to prestigious auditors[27] and venture capitalists[28] remains almost consistently mixed.

underperformance during three-year period following IPO); Kenneth N. Daniels & Jayaraman Vijayakumar, *Does Underwriter Reputation Matter in the Municipal Bond Market?*, J. ECON. & BUS., Nov. 16, 2006, *available at* http://sciencedirect.com (search "Title, abstract, keywords" for "Does Underwriter Reputation Matter"; then follow "PDF" hyperlink) (using large sample of tax-exempt municipal bonds, showing that bond issues managed by more prestigious underwriters have lower borrowing costs and lower underwriting spreads, suggesting that underwriters do confer meaningful certification benefits). Some recent studies are more equivocal. *See, e.g.*, Hoje Jo et al., *Underwriter Choice and Earnings Management: Evidence from Seasoned Equity Offerings*, REV. ACCT. STUD., Feb. 21, 2007, *available at* http://www.springerlink.com/content/578v647237848tg6/fulltext.pdf (arguing that negative correlation between underwriter prestige and earnings management by relevant client suggests that prestigious underwriters provide quality certification, which is further supported by positive correlation between underwriter prestige and post-issue performance in the "seasoned equity" market, although this latter relationship does not last long); Steven D. Dolvin, *Market Structure, Changing Incentives and Underwriter Certification*, 28 J. FIN. RES. 403 (2005) (noting divergence in empirical literature on certification value of underwriter reputation, with results finding positive and negative correlations between underwriter reputation and underpricing, but arguing that negative correlation is consistent with certification thesis insofar as effects associated with larger market share are responsible for "reversed" correlation).

27. The literature is not uniform. For affirmative results, see Sattar A. Mansi et al., *Does Auditor Quality and Tenure Matter to Investors? Evidence from the Bond Market*, 42 J. ACCT. RES. 755 (2004) (finding that auditor quality and tenure are negatively related to the cost of financing, suggesting that auditor reputation and longevity confers certification benefits on the relevant issuer); Stephanie Rauterkus & Kyojik Song, *Auditor's Reputation and Equity Offerings: The Case of Arthur Andersen*, FIN. MGMT., Winter 2005, at 121 (finding differential pricing of IPOs based on comparison of Arthur Andersen clients and other firms during period surrounding criminal indictment of Arthur Andersen, suggesting that auditors provide certification benefits to clients). For mixed to affirmative results, see Ronald J. Balvers et al., *Underpricing of New Issues and the Choice of Auditor as a Signal of Investment Banker Reputation*, 63 ACCT. REV. 605 (1988) (noting difficulty in prior studies in establishing the expected negative correlation between auditor reputation and underpricing of new issues, but showing this correlation is robust when issuers retain both prestigious investment banker and auditor); Krishnagopal Menon & David D. Williams, *Auditor Credibility and Initial Public Offerings*, 66 ACCT. REV. 313 (1991) (finding that few IPO firms switch from a local to a more prestigious auditor prior to offering but that firms that do switch tend to be represented by a prestigious investment banker and pay a lower investment banking fee, suggesting that retention of a prestigious auditor provides the IPO firm with certification benefits). For mixed to contrary results, see Mason Gerety & Kenneth Lehn, *The Causes and Consequences of Accounting Fraud*, 18 MANAGERIAL & DECISION ECON. 587 (1997) (finding that frequency of accounting fraud does not vary significantly among firms audited by "Big Eight" auditors relative to firms audited by other auditors, suggesting that firm reputation plays little role in deterring management from engaging in fraudulent activity); Xin Chang et al., The Effect of Audit Quality on Initial Public Offerings in Australia (Sept. 2005) (unpublished working paper) (finding that, while there is a fee premium for elite auditors in the Australian IPO market, there is a positive correlation between audit quality and underpricing, which suggests that a prestigious auditor is not providing certification benefits, and finding no correlation between audit quality and long-term performance, which suggests that any certification benefits are unjustified), *available at* http://ssrn.com/abstract=830584.

28. The literature is not uniform, with more recent findings generally reaching ambiguous results. For a review of the literature, see Elke J.E. Klaasen & J. Henk von Eije, Earnings Growth and Underpricing with Venture Capital Backed Initial Public Offerings (Mar. 1, 2007) (unpublished working paper), *available at* http://www.ssrn.com/abstract=945587. For specific examples, see *id.* (using sample of 55 initial public offerings in the Netherlands and finding ambiguous certification benefit as a result of venture-capital backing, with venture-capital backing increasing underpricing in IPOs that showed large net earnings growth and decreasing it in IPOs that showed small net earnings growth, and tentatively attributing these results to differential sophistication between informed and less informed investors); Alon Brav & Paul Gompers, *Myth or Reality? The Long-Run Underperformance of Initial Public Offerings: Evidence from Venture and Nonventure*

As I describe in greater detail subsequently,[29] these middling findings in the scholarly literature are matched by skepticism expressed by some industry participants, judges, regulators, and/or policy commentators as to the informational value of some of these widely distributed certification practices. Legal practitioners' and bar associations' discussions of closing opinion practice sometimes voice similar doubts. In a straightforward application of the certification thesis, the standard efficiency rationale for closing opinions holds that the opining firm certifies as to the matters addressed in the opinion on the assumption that the firm's reputational and legal exposure would not lead it to do so recklessly or dishonestly.[30] This in turn implies that transacting parties rationally expend resources on a closing opinion only so long as the anticipated informational value yielded as a result exceeds anticipated resource expenditures. Nonetheless some lawyers and other industry participants, as reported in trade publications and practitioner surveys[31] and some bar association reports, question whether these research, drafting, and negotiation efforts always or even usually pass this cost-benefit test.[32] These doubts "on the ground" raise concerns as to whether closing

Capital-Backed Companies, 52 J. FIN. 1791 (1997) (finding that, in a sample of approximately 900 firms during 1972-1992, venture-capital-backed IPO firms outperform non-venture-capital backed IPO firms, but only when returns are weighted equally); Thomas J. Chemmanur, The Role of Venture Capital Backing in Initial Public Offerings: Certification, Screening, or Market Power? (Sept. 2006) (unpublished working paper) (finding little support that venture capitalists confer certification benefits on IPO firms, some support that venture capitalists perform a screening and monitoring function with respect to IPO firms and strong support that venture capitalists improve IPO performance by their ability to attract higher-quality investment bankers, underwriters, analysts, and other intermediaries), *available at* http://www.ssrn.com/abstract=604882; Georg Rindermann, Venture Capitalist Participation and the Performance of IPO Firms: Empirical Evidence from France, Germany, and the UK (Sept. 2003) (unpublished working paper) (finding that venture-backed IPOs do not generally perform better than non-venture-backed IPOs, aside from the subgroup of internationally operating venture capitalists), *available at* http://www.ssrn.com/abstract=425080; Stefanie Franzke, *Underpricing of Venture-Backed and Non Venture-Backed IPOs: Germany's Neuer Markt*, *in* THE RISE AND FALL OF EUROPE'S NEW STOCK MARKETS 201 (Giancarlo Giudici & Peter Roosenboom eds., 2004) (finding a positive correlation between underpricing and venture-backed or non-venture-backed IPOs, suggesting that venture capitalists do not provide any certification benefits to IPO firms).

29. *See infra* Part V.

30. *See* Gilson, *Value Creation*, *supra* note 13, at 290-92; LEGAL OPINIONS IN INTERNATIONAL TRANSACTIONS (Michael Gruson et al. eds., 2d ed. 1989); Arthur J. Dillon, Statement of Expectations of Counsel for Institutional Investors, Delivered at the American College of Investment Counsel Annual Meeting (Sept. 15, 1988), *reprinted in* ABA, SILVERADO SUMMIT: THE STANDARDIZATION OF LEGAL OPINIONS—ORDER OUT OF CHAOS 3 (1989); Karl S. Okamoto, *Reputation and the Value of Lawyers*, 74 OR. L. REV. 15, 27 (1995).

31. For existing surveys of practitioners with respect to closing opinions (among other topics), see Lipson, *supra* note 8; 2004 CALIFORNIA BAR REPORT, *supra* note 9; and Schwarcz, *To Make or to Buy*, *supra* note 8.

32. *See, e.g.*, 2004 CALIFORNIA BAR REPORT, *supra* note 9; J. Fuld & A. Field, *Toward Eliminating Differing Interpretations of Opinions Relating to Agreements*, *in* BUSINESS OPINIONS 1990, at 313 (PLI Corp. L. & Practice, Course Handbook Series No. 674, 1990); Dillon, *supra* note 30, *reprinted in* SILVERADO SUMMIT, *supra* note 30; Lipson, *supra* note 8; *see also* TEXAS BAR REPORT, *supra* note 9 (stating that costs of rendering a legal opinion even in a simple transaction are significant and may not always be cost-effective); Mason & Snider, *Those Third-Party Closing Opinions: Can Loan Transaction Costs Be Reduced?*, BUS. L. TODAY, Sept.-Oct. 1997, at 48, 48 (expressing doubt with respect to whether UCC and enforceability opinions that lenders typically request from borrower's counsel are cost-justified); 2004 CALIFORNIA BAR REPORT, *supra* note 9 (noting a long-standing frustration among lawyers and clients with the burdens imposed on transactions by the preparation and negotiation of enforceability opinions); Thomas L. Ambro & J. Truman Bidwell, Jr., *Some Thoughts on the Economics of Legal Opinions*, 1989 COLUM. BUS. L. REV. 307, 307 (noting that several types

opinion practice actually generates the efficiency gains anticipated by the certification thesis. Based in part on a 2004 survey of California practitioners, the Business Law Section of the California Bar has expressed the view that some (but, it emphasizes, not all) closing opinions may increase transaction costs without "any real benefit"[33] and that certain opinions that were previously considered customary should "now be considered inappropriate . . . because their scope is not reasonably within the competence of the opinion giver or they are not cost-justified."[34] To a lesser extent, other bar associations have noted periodically that the opinion process often imposes costs on the opinion-giver in excess of any benefit to the opinion recipient.[35] Reflecting this state of uncertainty, the California Bar committee further notes that "[f]rustration over the burdens placed on transactions by third party closing opinions . . . is understandably high."[36] In the next Part, I assess these skeptical views more systematically through a detailed examination of closing opinion practice, concluding based on available information that these views have significant merit and that the certification thesis cannot account adequately for the continued widespread use of closing opinions in sophisticated transactions.

II. IDENTIFYING THE OPINION PUZZLE

If confirmed, the standard certification thesis would easily account for closing opinion practice as another efficient mechanism for resolving informational asymmetries that would otherwise distort transactional pricing and structuring. To assess this proposition, I proceed in two steps. First, I review the typical scope of a closing opinion and describe the key procedural and cost burdens of the closing opinion process. Second, I evaluate factors that apparently dilute the incremental informational value of a closing opinion, including most notably the limited legal and reputational exposure typically assumed by opining law firms. On the basis of this discussion, an emergent puzzle takes shape; that is, subject to the inherent constraints of available information, the certification thesis does not adequately account for the widespread usage of closing opinions over a broad range of sophisticated transactional settings

A. Content

A closing opinion is commonly requested and issued at the consummation of a variety of business transactions.[37] Delivery of the opinion letter is made to and at the request of one of the parties to the transaction, and, when requested, a closing opinion is

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of highly qualified opinions have doubtful meaningful value or, absent such qualifications, require investigation by the opining firm that is not cost-effective); *California Remedies Opinion Report*, *supra* note 9, at 910 (arguing that the opinion process can generate lengthy discussion while rarely raising any enforceability issues unknown to the opinion recipient or its counsel).

33. *See* 2004 CALIFORNIA BAR REPORT, *supra* note 9. To be clear, the California bar committee states that, while it believes usage of closing opinions in certain transactions may not be cost-effective, it does not feel that the closing opinion in general is an "anomaly." *See id.*

34. *See id.*

35. *See* MICHIGAN BAR REPORT, *supra* note 9; TEXAS BAR REPORT, *supra* note 9.

36. *See* 2004 CALIFORNIA BAR REPORT, *supra* note 9.

37. *See* GLAZER ET AL., *supra* note 9, § 1.1, at 1; ABA, *Legal Opinion Principles*, *supra* note 9, at 192; ABA, *Guidelines*, *supra* note 9, at 875.

made a condition precedent to the "closing" of the transaction.[38] The most typical closing scenarios are (1) some private acquisition transactions (as distinguished from the acquisition of a publicly traded corporation);[39] and (2) most (probably almost all) substantial financing transactions.[40] While the broader category of legal opinions issued to third parties encompasses a variety of other settings, I will focus on so-called "classic" closing opinions issued to third parties in the context of an acquisition or financing transaction.[41] Unless otherwise indicated, I will use the term "closing opinion" or simply "opinion" to refer solely to this particular (but the most common and most widely discussed) type of third party legal opinion.

Irrespective of transactional setting, a closing opinion can best be described as a reasonable prediction based on professional knowledge of how courts in specified jurisdictions will rule on a particular legal question with respect to a certain set of facts.[42] The types of commonly issued opinions are highly standardized, almost all of which repeat (and almost never go beyond) the content of the representations and warranties made by the opining firm's client in the principal transaction documents but with far fewer qualifications and disclaimers (if any).[43] The most widely issued opinion is a statement that the contractual obligations being assumed by the opinion issuer's client are "valid, binding and enforceable" against it (the "enforceability" or "remedies" opinion).[44] Other familiar but substantially less commonly issued opinions (most of which support the core enforceability opinion) are described in the Table below. Any of these standard opinion formulations are generally accompanied by substantial qualifications, assumptions, and disclaimers, which normally form the bulk of the opinion letter.[45] These standard qualifications—the most common of which are set forth in the Table

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38. *See 1998 TriBar Report*, *supra* note 9, at 592; Bart Schwartz, *The Case for In-House Opinion Letters: You Don't Have to Go to Outside Counsel*, BUS. L. TODAY, Jan.-Feb. 2002, at 3.

39. *See* GLAZER ET AL., *supra* note 9, § 1.1, at 1-3.

40. *See id.*, § 1.2, at 2 n.2.

41. More specifically, "closing opinion" as used in this Article excludes: title opinions, oil and gas opinions, "bond counsel" opinions, legality or similar opinions given in connection with a sale of securities, tax opinions, and "UCC" and perfection opinions. These opinions are generally agreed to fall outside the scope of the "classic" third party legal opinion. *See* William Freivogel, *The Ethics and Lawyer Liability Issues Raised by Third-Party Opinion Letters*, *in* LEGAL OPINIONS: THE IMPACT OF THE TRIBAR COMMITTEE'S NEW REPORT ON LEGAL OPINION PRACTICE 225, 232 (PLI, Courses Handbook Series No. B-1054, 1998). Analytically, these excluded opinions exhibit varying degrees of differential sophistication and legal distortion; as noted above, it is the substantial lack of these characteristics that allows for a reasonably "clean" analytical setting that isolates the factors that perpetuate "classic" closing opinions.

42. *See 1998 TriBar Report*, *supra* note 9 (describing closing opinion characteristics); ABA, *Legal Opinion Principles*, *supra* note 9, at 192.

43. *See* LEGAL OPINIONS IN INTERNATIONAL TRANSACTIONS, *supra* note 30, at 5 (summarizing circumstances where a party may require legal opinions from its own counsel and from the other party to the agreement); Ambro & Bidwell, *supra* note 32, at 310 (noting that the opinion will reflect many representations and warranties of the contract).

44. *See* Michael Gruson, *Legal Opinions of New York Counsel in International Transactions*, 1989 COLUM. BUS. L. REV. 365, 366 (discussing the scope of legal opinions).

45. *See 1998 TriBar Report*, *supra* note 9. On the assumptions and qualifications that commonly appear in legal opinions, see TriBar Opinion Comm., *Special Report of the TriBar Opinion Committee: The Remedies Opinion--Deciding When to Include Exceptions and Assumptions*, 59 BUS. LAW. 1483 (2004) [hereinafter *Special Report*] (stating that opinion preparers may look to general principles of contract law in the absence of statute or controlling precedent).

below—considerably dilute the substantive force of the enforceability and other commonly included opinions. While the American Bar Association ("ABA") and the various regional bar associations regularly call for such qualifications to be used judiciously,[46] it is widely observed that many or even most practitioners use them liberally, employing what is sometimes derided as a "kitchen sink" approach.[47] A survey of practitioners recently conducted by the Business Law Section of the California Bar confirms this impression, showing universal usage of a "laundry list" of exceptions and widespread usage of some more aggressive exceptions.[48]

TABLE 1
Standard Content of a Closing Opinion

Standard Opinion Formulations	Principal Exceptions and Other Limitations
Enforceability/Remedies Opinion: Contractual obligations being assumed by client are enforceable against it. *"No-Conflicts" Opinion*: Contractual obligations being assumed by client do not conflict with certain of its existing contractual obligations or organizational documents. *"No-Violations" Opinion*: Client's performance of the relevant agreement(s) will not violate any applicable law. *"No-Consents" Opinion*: Client's performance of its contractual obligations does not require consent or approval of any governmental entity or other third party. *Due Organization Opinion*: Relevant client entity is duly organized (that is, all required formation steps were properly taken under state law).[49]	*Client information not independently verified:* Opinion assumes that all information provided by client is true and accurate without opining firm undertaking any independent verification. *Audience limitation*: Class of parties that may rely on the opinion is limited to the recipient and any additional specifically designated parties. *No updating obligation*: Opinion is limited to the date on which it is issued; opining firm disclaims any obligation to update opinion in case of changes of law or fact. *Equitable principles exception:* Enforceability may be limited by courts' use of equity powers. *Bankruptcy/insolvency exception*: Enforceability may be limited by federal bankruptcy laws.

46. *See, e.g.*, Comm. on Legal Opinions, ABA, *Guidelines for the Preparation of Closing Opinions*, 57 BUS. LAW. 875 (2002) (discussing the standards for preparing legal closing opinions).

47. *See* GLAZER ET AL., *supra* note 9, § 1.1, at n.8, § 3.2; 2004 CALIFORNIA BAR REPORT, *supra* note 9; *California Remedies Opinion Report*, *supra* note 9, at 925 (stating that lawyers who adopt the "New York view" believe that "laundry lists and a generic exception are often overused in California remedies opinions").

48. *See* 2004 CALIFORNIA BAR REPORT, *supra note* 9 (out of survey sample of 35 California law firms (predominately mid- to large-size), 100% report customary use of a"laundry list" of exceptions in remedies opinion and 54% report customary use of a more aggressive "generic exceptions" qualification).

49. A milder variation is the "due incorporation" opinion, which simply requires obtaining from the

Standard Opinion Formulations	**Principal Exceptions and Other Limitations**
Valid Existence Opinion: Relevant client entity is legally existing on the date of the opinion letter.[50]	*Clauses of doubtful enforceability:* Multiple specialized contractual clauses are noted to have inherently limited enforceability given uncertainty in existing case law.[51] *"Generic exception"*: General qualification that the enforceability of certain remedies may be limited (especially common in connection with loans).

B. Costs

The issuance of a legal opinion (which generally follows detailed standing instructions updated periodically by the law firm's opinions committee) is undertaken with significant care and review in the typical corporate law practice.[52] This internal review process, together with the research, preparation, and sometimes extensive negotiation of closing opinions,[53] generates nontrivial direct and indirect costs. As observed by practitioners, from the perspective of a large corporate client, the most relevant cost is probably not monetary fees but rather the fact that preparation and negotiation of the opinion could delay closing and otherwise distract attention (often the attention of the most senior attorneys handling the transaction) from more substantive matters.[54] As is well-known among corporate law practitioners, negotiation or finalization of closing opinions is often deferred until "the eve of closing" and can result in lengthy and arcane discussions among senior counsel to finalize the opinion language, thereby heightening these "distraction costs" and the possibility of a costly last-minute delay.[55] In certain transactions involving issues specific to foreign jurisdictions, out-of-state jurisdictions, or particularly contentious factual issues, the opinion giver may

relevant Secretary of State a list of all filed charter documents and then reviewing those documents to confirm that the corporation has not been dissolved. *See* GLAZER ET AL., *supra* note 9, at 49-51 (citing *1998 TriBar Report*, *supra* note 9).

50. This is usually rendered on a certificate from the relevant state's department of corporation. *See* GLAZER ET AL., *supra* note 9, at 51.

51. These include clauses such as: (1) "forum selection" clauses, *see Special Report*, *supra* note 45, at 1498-1503; (2) waivers of the right to trial by jury, *see id.*, at 1493 n.51; and (3) certain remedial provisions, especially relating to the attachment of assets by creditors in the case of a borrower default.

52. *See* GLAZER ET AL., *supra* note 9, § 1.2.

53. *See* 2004 CALIFORNIA BAR REPORT, *supra* note 9.

54. *See* GLAZER ET AL., *supra* note 9, § 9.1.2 at n.23; *California Remedies Opinion Report*, *supra* note 9, at 915; 2004 CALIFORNIA BAR REPORT, *supra* note 9.

55. *See, e.g.*, 2005 CALIFORNIA BAR REPORT, *supra* note 9, at 20 (observing that "the exact text of the opinion . . . should be agreed upon as early as possible in the transaction . . ."); Jeff R. Hudson et al., *Third Party Legal Opinions in Acquisitions of Privately Held Companies*, *in* ACQUIRING OR SELLING THE PRIVATELY HELD COMPANY 440 (PLI, Course Handbook Series No. B-1610, 2001) (discussing "eve of closing" activities).

require additional opinions from out-of-state counsel and/or officer's certificates from the client's management, all of which can generate additional costs and delays.[56] Other related costs include the fixed costs incurred in order to sustain the law firm's opinion committee and the periodic review of a law firm's standing instructions with respect to opinion preparation,[57] which may be passed on to clients through higher billing rates. There is little available data on the precise fees generated solely or primarily by attorney hours spent on closing opinions, in part because these fees are generally folded into the total "billables" for the relevant transaction and a substantial portion of the supporting diligence behind an opinion is performed for other purposes in a typical transaction. A safe estimate, however, would probably settle on a range of several to tens of hours, which, assuming participation by associates and partners and an average hourly billing rate at a medium to top-tier national law firm of approximately $200 to over $800 depending on attorney seniority, office location, and firm prestige,[58] translates into a dollar range of several thousand to (in more complex and/or tendentious situations) several tens of thousands of dollars.[59]

C. Value

In this Section, I review multiple factors that may limit the incremental informational value of a closing opinion. These factors fall under three categories: (1) "obvious" limiting factors, which I believe should be uncontroversial among informed market practitioners and observers, (2) legal exposure, which I show is probably minimal in typical circumstances—a claim that I believe should be almost equally uncontroversial, and (3) reputational exposure, which I argue is substantially limited in typical circumstances, but recognize that this claim is subject to some uncertainty given inherent constraints on available information.

1. "Obvious" Limiting Factors

The "obvious" limiting factors are as follows: (1) limited substantive content, (2) conflict of interest, and (3) superior diligence alternatives. I will discuss each in turn. First, as noted above,[60] the abundant standard disclaimers and other qualifications considerably dilute the core opinion formulation, so much so that practitioners sometimes

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56. *See* Stephan Hutter, *The Corporate Opinion in International Transactions*, 1989 COLUM. BUS. L. REV. 427 (discussing the need for opinions on foreign law); Albert S. Pergam, *Transnational Opinions: Selecting and Collaborating with Foreign Counsel*, 1989 COLUM. BUS. L. REV. 413.

57. For a description of these costs, see Ambro & Bidwell, *supra* note 32, at 311.

58. For a range of billing rates based on a 2006 *National Law Journal* survey, see *Firm-by-Firm Sampling of Billing Rates Nationwide*, NAT'L L.J., Dec. 11, 2006, *available at* http://www.law.com/jsp/nlj/PubArticleNLJ.jsp?id=1165582055311. These numbers are probably an underestimate given that many of the highest-billing national law firms decline to take part in the *National Law Journal* survey.

59. The distribution of fees within this range is not clear, although in routine transactions the fees presumably tend toward the lower end of the range. *See* Lipson, *supra* note 8, at 87 (noting that lawyers indicate that a closing opinion generally adds at least $5000 to the transaction fee "and, depending on the type of transaction, substantially more").

60. *See supra* Tbl. 1 and notes 47 & 50 together with accompanying text.

doubt whether the underlying opinion is "saying anything at all."[61] Consider in particular the standard disclaimer that the opinion issuer assumes without independent verification the authenticity of all documents and the accuracy of all information provided to it: this means there is little assurance that, unbeknownst to the opining lawyer (who cannot rely on information that he or she knows, or has substantial reason to believe, to be untrue),[62] the opinion is based upon fraudulent or materially inaccurate information. Second, the opining law firm is subject to a conflict of interest given that its failure to issue an opinion would almost certainly terminate its relationship with its client at a crucial juncture (immediately prior to closing), thereby cutting off any future expected revenue stream and possibly alienating other actual and potential clients. Rhode Island has taken the view that this conflict is so strong that, subject to certain exceptions, it now prohibits lenders from requiring that borrower's counsel render an enforceability opinion as a condition to closing.[63] Third, opining counsel may not be in any better position (and there may sometimes be reason to believe that it is in a *worse* position) than recipient's counsel to opine as to the enforceability of the relevant transaction documents and other fundamental legal matters.[64] Moreover, an opinion recipient usually has access to more robust diligence alternatives to verify the matters typically addressed by a closing opinion. In the case of any serious enforceability or other fundamental legal issues, the opinion recipient will rationally rely on a combination of (1) the non-conflicted advice of its own counsel,[65] who will spend considerable time reviewing the counterparty's relevant contractual and other documents, and (2) the counterparty's express representations and warranties in the principal transaction documents,[66] which generally duplicate the standard enforceability, no-conflicts, no-violations, and due organization

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61. *See* Dillon, *supra* note 30, *reprinted in* SILVERADO SUMMIT, *supra* note 30.

62. *See* RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 98 (2000) (stating that a "lawyer communicating on behalf of a client to a non-client may not knowingly make a false statement of material fact or law to the nonclient").

63. *See* R.I. GEN. LAWS § 19-9-7 (1995) (stating that "no lending institution making a loan in this state . . . shall . . . require any attorney representing a borrower . . . to give an opinion to the validity . . . of the loan documents or the availability of remedies thereunder"). The legislation apparently originated in a state supreme court ethics advisory panel opinion. *See also* R.I. Supreme Court Ethics Advisory Panel, General Information Op. 3 (1991) (responding "to an inquiry as to whether it is proper for an attorney who is representing a borrower in a loan transaction to furnish to the lender an opinion that loan documents prepared by lender's counsel are 'legal, valid, binding and enforceable'").

64. *See California Remedies Opinion Report*, *supra* note 9, at 912-13 (noting that the opinion recipient and its counsel are often more knowledgeable than the opinion giver about the matters covered in the opinion); Schwarcz, *Same Thing*, *supra* note 8, at 97-98 (noting that, in loan transactions, it is the lender's rather than the borrower's counsel who is in the best position to give an enforceability opinion given its greater familiarity with the loan documentation); Lipson, *supra* note 8, at 64 (making a similar point with respect to enforceability opinions generally); 2004 CALIFORNIA BAR REPORT, *supra* note 9 (same).

65. *See* 2004 CALIFORNIA BAR REPORT, *supra* note 9; 2005 CALIFORNIA BAR REPORT, *supra* note 9, at 22 (recommending that opinion recipient can sometimes forego opinion and rely on its own diligence investigation); 2004 CALIFORNIA BAR REPORT, *supra* note 9, app. 4 at 2 (noting that "[i]n the vast majority of transactions, a third-party remedies opinion does not result in the identification of enforceability issues unknown to the opinion recipient or its counsel").

66. 2004 CALIFORNIA BAR REPORT, *supra* note 9; 2005 CALIFORNIA BAR REPORT, *supra* note 9, at 22 (recommending that opinion recipient can sometimes forego opinion and rely on appropriate representations and warranties in the underlying agreement).

opinions[67] while being encumbered with far fewer qualifications and assumptions (if any) and sometimes supported by specific contractual indemnities and supporting escrow, deferred payment, or other enforcement mechanisms.

2. Legal Exposure

A lawyer undertakes to exercise "ordinary skill and knowledge" when serving clients, and failure to do so can provide grounds for negligent malpractice, negligent misrepresentation, or other claims.[68] Given the erosion of common-law privity barriers, this negligence standard now normally covers legal opinions issued to non-client third parties.[69] In addition to a negligence claim filed by an opinion recipient, there are a number of other formal sanctions to which an attorney could be subject as a result of having issued a negligent or otherwise defective opinion. These include: disciplinary action by state authorities under state bar association rules,[70] a common law fraud action,[71] "aiding and abetting" claims,[72] a civil conspiracy suit, and securities-law violations.[73] Despite this laundry list of potential liability horrors, several factors suggest

67. *See* Mark Suchman & Mia Cahill, *The Hired Gun as Facilitator: Lawyers and the Suppression of Business Disputes in Silicon Valley*, 21 L. & SOC. INQUIRY 679, 694-96 (1996) (arguing that opinion letters in venture-capital transactions are "informationally superfluous" because they just restate representations and warranties that have already been negotiated by the client).

68. John P. Freeman, *Current Trends in Legal Opinion Liability*, 1989 COLUM. BUS. L. REV. 235, 242 ("Though opinion lawyers are not insurers, they, like all lawyers, undertake to exercise ordinary skill and knowledge when serving their clients."); Richard R. Howe, *Rethinking Legal Opinion Letters*, 1989 COLUM. BUS. L. REV. 283, 290 (noting that, "At common law, a negligence standard is applied to legal opinions; a lawyer is expected to exercise the standard of care that would be exercised by another attorney of ordinary skill performing a similar task"). "Ordinary skill and knowledge" is defined by reference to the customary practices of other similarly situated attorneys. *See 1998 TriBar Report*, *supra* note 9, at 6.

69. This barrier has disappeared with respect to direct recipients of legal opinions, although in certain important jurisdictions such as New York and Texas, this was not definitively settled until 1992 and 1999, respectively. *See* Prudential Ins. Co. v. Dewey, Ballantine, Bushby, Palmer & Wood, 605 N.E.2d 318 (N.Y. 1992) (holding that the author of an opinion letter did not breach his or her duty to a client even though the letter expressed incorrect opinions because the author had properly qualified his statements); McCamish, Martin, Brown & Loeffler v. F.E. Appling Interests, 991 S.W.2d 787 (Tex. 1999) (holding that the lack of privity between defendant and plaintiff, a non-client of defendant, did not bar defendant from owing a duty to the plaintiff the breach of which may be actionable).

70. *See* RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 95 cmt. a (2000) (stating that "[a] lawyer is subject to professional discipline for failure to comply with professional rules governing evaluations to a third person . . . such as when a lawyer knowingly makes a material misstatement of fact to the third person").

71. Under state common law of fraud, a lawyer generally has a duty not to knowingly or recklessly make material misrepresentations or conceal information when the lawyer has a duty to disclose and the other party has a right to rely. *See* Donald C. Langevoort, *Where Were the Lawyers? A Behavioral Inquiry into Lawyers' Responsibility for Clients' Fraud*, 46 VAND. L. REV. 75, 83 (1993) [hereinafter Langevoort, *Where Were the Lawyers*?].

72. Attorneys can be held liable for assisting in the fraudulent scheme of a client, provided certain *scienter* (conscious intent) and, in some jurisdictions, fiduciary relationship requirements are met. *See id.* at 84-86.

73. In the securities context, attorneys could theoretically be subject to liability for a "primary violation" of Rule 10b-5 of the Securities Exchange Act of 1934, which relates to fraud concerning the purchase or sale of a security. *See 1998 TriBar Report*, *supra* note 9, at 9. However, there are two practical limitations: (1) any 10b-5 claim would require proof of scienter (which has the important effect of excluding negligence-based claims), and (2) under the Supreme Court's decision in *Central Bank of Denver v. First Interstate Bank of Denver*, 511

(and the practitioner literature tends to agree)[74] that the legal exposure typically assumed by an opining firm is relatively low in typical circumstances.

The reason is straightforward: any negligence or similar claim against an opining firm must overcome the abundant qualifications, assumptions, and disclaimers that protect the core opinion formulation. Far from empty words, these qualifications are litigation-tested barriers that courts generally respect, thereby shielding the opining attorney from potential liability. In judicial decisions involving closing opinions and other legal opinions,[75] courts generally respect the standard qualifications, such as the "equitable principles" exception,[76] the "bankruptcy and insolvency" limitation,[77] the qualification noting failure to independently verify information provided by the client,[78] the qualification limiting the opinion to the laws of specified jurisdictions,[79] and the audience limitations specified in almost all opinion letters.[80]

U.S. 164 (1994), a private plaintiff cannot bring a 10b-5 aiding and abetting claim against an attorney. With respect to (2), the practical effect of *Central Bank of Denver* has been eroded substantially in most circuits by alternative theories of "primary violation," "scheme liability," and other arguments. *See* Matthew L. Mustokoff, *"Scheme" Liability Under Rule 10b-5: The New Battleground in Securities Fraud Litigation*, FED. LAW. June 2006, at 20.

74. *See* Freeman, *supra* note 68, at 252; Ambro & Bidwell, *supra* note 32, at 308; Freivogel, *supra* note 41, at 232.

75. By "other legal opinions," I mean to indicate that the ensuing discussion concerning courts' treatment of typical opinion disclaimers draws in part on case law involving legal opinions other than closing opinions, it being reasonably assumed that a court adjudicating a case involving a closing opinion would draw by close analogy on this related jurisprudence.

76. *See, e.g.*, Wash. Elec. Coop., Inc. v. Mass. Mun. Wholesale Elec. Co., 894 F. Supp. 777, 789 (D. Vt. 1995) (finding that the statement in an opinion letter that legal obligations were subject to judicial discretion absolved the lawyer from any liability for not predicting changes in the law).

77. *See TriBar Remedies Opinion*, *supra* note 9, at 962.

78. For cases upholding such disclaimers, see Mark Twain Kan. City Bank v. Jackson, Brouilletee, Pohl & Kirley, P.C., 912 S.W.2d 536, 540 (Mo. Ct. App. 1995) (finding that a sophisticated lender represented by counsel could not have justifiably relied on factual statements in an opinion letter in light of an adequate disclaimer stating that the opining firm took no responsibility for information in the letter and declining to "read in" missing language that would limit disclaimer to a no-updating obligation); Fortson v. Winstead, McGuire, Sechrest & Minick, 961 F.2d 469, 473-75 (4th Cir. 1992) (noting that issuance of opinion clearly limited to tax matters imposed no duty on opining firm to verify veracity of financial data provided to it by client or to reveal in the opinion client's past troubled commercial ventures). *But see* Kline v. First W. Gov't Sec., Inc. 24 F.3d 480, 486 (3d Cir. 1994) (finding that statement that opinion is based on assumed facts does not bar Rule 10b-5 liability under federal securities laws when the lawyer had good reason to know of a material inaccuracy given a long close relationship with seller). At least one court has since criticized the *Kline* decision. *See In re* Infocure Sec. Litig., 210 F. Supp. 2d 1331, 1359 (N.D. Ga. 2002) (following dissent in *Kline* and stating that there is "no compelling public policy justification for disregarding disclaimers in third-party opinion letters in complex transactions involving sophisticated" parties with independent counsel).

79. *See, e.g.*, Resolution Trust Corp. v. Latham & Watkins, 909 F. Supp. 923 (S.D.N.Y. 1995) (finding that lawyer who issued opinion letter relating solely to Florida law issues was not liable for failing to discuss the law of other states). For additional discussion, see LEGAL OPINIONS IN INTERNATIONAL TRANSACTIONS, *supra* note 30, at 366-67; *1998 TriBar Report*, *supra* note 9, at 4, 38; ABA, *Legal Opinion Principles*, *supra* note 9, at 193.

80. *See* Howe, *supra* note 68, at 294 (observing that "there are few examples in which attorneys have been liable for allegedly incorrect opinions to persons other than the addressees of their opinions"). For an indicative decision, see Merkel v. Livestock Breeders Int'l of N.J., Inc., No. 86-4003, 1988 WL 66864, at *6 (D.N.J. June 21, 1988) (ruling that a disclaimer as to the class of reliant parties can preclude a finding that a representation was made to the plaintiff or that the plaintiff reasonably relied on the alleged representation).

The dilutive force of these standard qualifications yields the prediction that an opining firm's legal exposure is relatively low in the case of a typically formulated opinion letter. The legal and insurance trade literature concurs, observing that courts generally are reluctant to impose liability on opining attorneys,[81] reflected by the fact that cases involving closing opinions are infrequent, summary judgment in favor of law-firm defendants is frequently granted, and decisions finding opining lawyers ultimately liable are rare.[82] To confirm this view independently (as well as to obtain greater detail on historical trends), I surveyed the Westlaw database of reported federal and state court decisions from 1986 through 2006, supplemented by a search for additional relevant cases referenced in the practitioner literature, and identified federal and state court decisions involving suits against law firms that had issued closing opinions in connection with an acquisition or loan transaction.[83] These findings, summarized in the Table immediately below, are consistent with the aforementioned view.[84]

81. *See* Freeman, *supra* note 68, at 235, 279-80 (noting that courts are reluctant to impose liability on lawyers for opinions); Ambro & Bidwell, *supra* note 32, at 308 n.3 (same); Freivogel, *supra* note 41, at 230 (noting a " relatively benign legal climate" for third party opinions).

82. *See* Freivogel, *supra* note 41, at 227 (stating that the number of reported decisions involving third party legal opinions is "incredibly small").

83. To be clear, for purposes of this search and the Table below, the definition of "classic" third party legal opinion has been used, as described previously. *See supra* note 41 and accompanying text.

84. The specific cases (and principal holdings) are listed in the Appendix, *infra*. Note that opinion-related cases often raise multiple other claims involving the same and/or co-defendants. As a result, there cannot be complete certainty that all judicial decisions involving closing opinions in loan and acquisition transactions during the relevant period have been located. Where there was ambiguity as to whether a specific decision fell within this Article's definition of "closing opinion," the case was included. Additionally, note that the identified cases include (and extend substantially beyond) all cases identified in the only prior published systematic review of the relevant case-law record through 1998, *see* Freivogel, *supra* note 41, app. A (other than a single case involving a no-liens opinion, which has been excluded given its proximity to a "UCC" opinion, which is generally not included under the rubric of a "classic" closing opinion). For a discussion of the prior study by leading commentators on legal opinions, see ARTHUR N. FIELD & JEFFERY M. SMITH, LEGAL OPINIONS IN BUSINESS TRANSACTIONS § 3-2 (2005).

Table 2
Identified Decisions Involving Closing Opinions in Loan and Acquisition Transactions (1986-2006)

	1986-2002	2003-2006	Total (1986 -2006)
Total reported decisions	17	14	31
Reported decisions per year	1.06	3.5	1.55
Number and percentage of decisions granting summary judgment	7 (41%)	6 (43%)	13 (42%)
Number of decisions involving enforceability opinions; percentage granting summary judgment[85]	7 (71%)	5 (60%)	12 (67%)
Decisions where opining firm ultimately found liable	0 (0%)	2 (14%)	2 (0.07%)
Geographic distribution of reported decisions[86]	N.Y.: 5/17 Conn.: 2/17 Tex.: 1/17 Other: 9/17	N.Y.: 5/14 Conn.: 2/14 Mass.: 3/14 Tex.: 1/14 Other: 3/14	N.Y.: 10/31 Conn.: 4/31 Mass.: 3/31 Tex.: 2/31 Other: 12/31

As the Table indicates, over the 20-year period from 1986 through 2006, judicial decisions relating to closing opinions are infrequent (between one and two decisions per year on average) and dismissed at summary judgment in more than one-third of all such cases. Additionally, in litigation involving the "core" enforceability opinion (more than one-third of all decisions involving closing opinions), summary judgment has been granted to the defendant more than two-thirds of the time.[87] While there has been a

85. Where some opinion-related claims against an attorney were dismissed on summary judgment and some were remanded to the trial court, I categorized the litigation as *not* having been dismissed on summary judgment.

86. Note that, with respect to decisions issued by a federal appeals court having jurisdiction over multiple states, the "jurisdiction" for purposes of this column was assumed to be the state in which the initial action was brought in the district court.

87. By way of comparison, a Federal Judicial Center study, using a sample of 3600 federal district court cases in selected jurisdictions, found the following percentage rates for civil cases terminated by summary judgment: 7.7% in 2000, approximately 6% in 1995, and 5% in 1990. *See* JOE S. CECIL ET AL., DIV. OF

historically significant upsurge in litigation starting in 2003, it appears possibly to be a short-lived effort by plaintiff attorneys to test judicial receptiveness to opinion-based claims in the charged post-Enron climate,[88] and most such cases are concentrated in the New York, Connecticut, and Massachusetts courts. In any case, even these courts have acted consistently with historical tendencies. Defendants' summary judgment motions are still granted at high rates and the post-2002 decisions have not yielded any substantive rulings that shift the generally lenient standards of relevant case-law,[89] in which case there is probably little basis to believe that opining firms' legal exposure has increased materially.

This view must be qualified by the fact that low judgment rates may not reflect higher settlement rates, although informal investigations indicate that taking into account the latter variable would not alter the low liability exposure of an opining firm,[90] and available data shows low reported claim rates in the broader category of all legal opinions.[91] Consistent with this limited litigation activity, the practitioner literature almost uniformly advises that it would be imprudent for an opinion recipient to rely on any reasonable prospect of monetary recovery against a lawyer who negligently issued a legal opinion.[92] Judicial decisions concerning closing opinions and other legal opinions appear to be guided by the view that opinions, as subjective professional judgments, should be strictly distinguished from (and relied upon to a significantly lesser degree than) objective representations of fact,[93] which in turn has generated the proposition that

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RESEARCH, FED. JUDICIAL CTR., TRENDS IN SUMMARY JUDGMENT PRACTICE: A PRELIMINARY ANALYSIS 4 (2001).

88. This flurry of opinion-related litigation may have specifically followed Judge Melinda Harmon's refusal in 2002 to dismiss claims against Vinson & Elkins, Enron's principal external counsel, in the Enron litigation, in part due to the fact that Vinson & Elkins had issued opinion letters in connection with certain of Enron's structured-finance transactions. *See* Memorandum and Order Re Secondary Actors' Motion to Dismiss, *In re* Enron Corp. Sec., Derivative and ERISA Litig., 235 F. Supp. 2d 549 (S.D. Tex. 2002) (No. H-03-3624). Plaintiffs in this litigation have since dropped these claims against Vinson & Elkins. *See* Brenda Jeffreys, *Texas Court Dismisses Vinson and Elkins from Enron Shareholders' Suit*, LEGAL INTELLIGENCER, Jan. 30, 2007.

89. *See* Richard M. Zielinski, *Differences of Opinion: Understanding Liability Issues Regarding Opinion Letters*, LAW FIRM PARTNERSHIP & BENEFITS REPORT (Law Journal Newsletters, New York, NY), Aug. 2005 (reviewing recent opinion-related litigation and arguing that these cases "do not break any significant new legal ground" but may limit opining firm's ability to rely on "our knowledge" and "have made no independent investigation" qualifiers); *see also Arthur Field on Dean Foods*, LEGAL OPINION NEWSLETTER (ABA, Wash., D.C.), Mar. 2005 (statement by Arthur Field, leading commentator, that much-discussed *Dean Foods* decision in Massachusetts "makes no new law, merely confirming established customary practice obligations").

90. *See* 2004 CALIFORNIA BAR REPORT, *supra* note 9, at n.21 (stating that, based on an informal survey of insurance carriers, "legal opinions have not historically been a significant source of professional negligence claims").

91. A 2003 ABA study notes that only 179 opinion-related claims (excluding claims relating to title opinions but including all claims relating to all other legal opinions) were filed against law firms during 2000-2003, 48 claims were filed during 1996 to 1999, and 66 claims were filed during 1986 to 1995. *See* STANDING COMM. ON LAWYERS' PROF'L LIAB., ABA, PROFILE OF LEGAL MALPRACTICE CLAIMS 7 tbl.3 (2005).

92. *See, e.g.*, Schwartz, *supra* note 38 (stating that "any comfort derived from the assumption that the recipient of a misleading opinion letter can recover damages from the law firm that rendered it may prove illusory, since litigation against law firms on opinion letters is rare" and that case law tends to support the conclusion that "opinions are not of significant value for the legal remedies they provide to opinion recipients").

93. *See, e.g.*, Wash. Elec. Coop., Inc. v. Mass. Mun. Wholesale Elec. Co. 894 F. Supp. 777, 790 (D. Vt. 1995) (rejecting plaintiffs' breach of warranty claim in connection with an allegedly inaccurate legal opinion, and stating further that the court has "searched in vain for a case in which an attorney has been sued

an opining attorney's error should not give rise to liability if the opinion reflects the lawyer's informed judgment.[94] Even in more ambiguous cases, courts generally make efforts to protect opining lawyers who become entangled with a client's fraudulent behavior, absent compelling evidence of the lawyer having consciously rendered substantial assistance to the relevant scheme.[95] Notwithstanding the general rule that lawyers cannot rely on information that they know, or have substantial reason to believe, to be untrue, even lawyers who have made only a minimal factual investigation when rendering an erroneous opinion have successfully escaped malpractice liability.[96] Cases where a law firm has been sued or held liable for a closing opinion (or other legal opinion) generally involve either an omission by the opining attorney of such qualifying language,[97] inclusion by the opining attorney of uncustomary "factual" representations, active involvement by the opining attorney in a client's scheme,[98] or simply representation of a client that happened to be engaged in fraud, which then *incidentally* leads to the opining attorney being targeted under an aiding and abetting theory.[99] In the latter category, the closing opinion is just one of several elements used by the claimant to show the lawyer's involvement in the alleged fraud, for which he or she would most likely have been sued whether or not an opinion had been issued, in which case the opinion likely had little marginal effect on the attorney's legal exposure.

Even in the unlikely scenario where a plaintiff has a strong negligence or similar claim against an opining firm, it faces an unattractive litigation target. To see why, observe that legal exposure is a function not only of governing legal precedent but of the

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successfully on a breach of warranty theory for representations made in an 'opinion letter.' Based on their very title, these documents defy Plaintiffs' efforts to characterize them as factual guarantees").

94. *See* Peter G. Beeson, *The MMWEC Case: The Federal District of Vermont Reviews the Scope of Attorney Liability for Opinion Letters*, 609 PLI/Lit 125, 138-39 (1999).

95. For a description of these cases, see Freeman, *supra* note 68, at 250-52. *See, e.g., In re* Citisource, Inc. Sec. Litig., 694 F. Supp. 1069, 1083 (S.D.N.Y. 1988) (finding no liability on the part of the lawyer rendering a legal opinion to an underwriter on behalf of a corrupt issuer on the ground that the law firm did not engage in any culpable misconduct and declining to adopt the "novel proposition" that "the mere fact of its status as issuer's counsel permits a strong inference of recklessness"). *See generally* Langevoort, *Where Were the Lawyers?*, *supra* note 71, at 87 (stating that "[w]hen the attorneys are not actually responsible for preparing the communications containing the misstatements or omissions—for instance, where they simply prepared contracts or closing materials—there is a strong tendency [among courts] to find insufficient assistance on which to impose liability").

96. *See, e.g.*, First Interstate Bank of Nev., N.A. v. Chapman & Cutler, 837 F.2d 775, 782 (7th Cir. 1988) (finding no malpractice liability where law firm rendered inaccurate opinion in connection with bond issue based on certain hypothetical facts, assumed to be true without further investigation and later determined to be inconsistent with actual facts); Abell v. Potomac Ins. Co., 858 F.2d 1104, 1147 (5th Cir. 1988), *vacated on other grounds*, Fryar v. Abell, 492 U.S. 914 (1989) (finding no malpractice liability where counsel to the underwriters in a bond offering had rendered an opinion concluding that nothing had come to the law firm's attention indicating that there was any misstatement or omission in the offering prospectus (although the law firm had invested few resources in investigating the truth of statements in the prospectus), with grounds for the court's decision being, in part, insufficient evidence of actual participation in the issuer's fraudulent scheme).

97. *See* Howe, *supra* note 68, at 307 (arguing that, in *First Interstate Bank of Nev.*, the law firm "might never have been sued had they made clear in their opinion that they had not investigated the facts and assumed no responsibility for the facts in rendering their opinion").

98. *See* Freeman, *supra* note 68, at 252 (discussing *Abell*, 858 F.2d 1104).

99. *See* Freivogel, *supra* note 41, at 230-32 (discussing Klein v. Boyd, Nos. 97-1193, 97-1261, 1998 U.S. App. LEXIS 2004 (3d Cir. Feb. 12, 1998)).

available assets that may be accessed by plaintiffs to satisfy any judgment, *net* of the costs of obtaining judgment and then enforcing it. A strong claim against an asset-poor client (or alternatively, a strong claim against an asset-poor client that will require litigation expenditures in excess of the anticipated damages award) is practically meaningless. This statement can easily describe even a well-grounded claim against even a well-established opining firm. First, given the attorney-friendly case law history, the legal fees incurred in connection with obtaining judgment against a law firm that issued a typically qualified opinion are likely to be substantial and, absent an unusual fee-shifting award, will capture a substantial portion of any final judgment. Second, given that all but a handful of even the most elite national law firms are now organized as limited liability partnerships,[100] the available asset pool is typically limited by the cap on the law firm's malpractice insurance policy, which, while it may be substantial in absolute terms, will effectively be reduced by any legal fees incurred by the law firm in connection with the litigation, and, in any case, may be insubstantial in relative terms when compared to the far richer asset pools that could be targeted by an aggrieved counterparty in a high-stakes transactional setting. Plaintiffs' attorneys in the Enron shareholder class action apparently reached precisely this conclusion, electing to drop claims against the Texas law firm of Vinson & Elkins, apparently in part because the available compensation under the firm's malpractice policy was insufficient to justify the necessary legal fees to pursue final judgment, especially when compared to the far deeper corporate pockets of some of the other defendant parties.[101]

3. Reputational Exposure

Even assuming that the opining firm typically has a relatively low expectation of legal liability, it may fairly be argued that this observation partially misses the point insofar as a practitioner's expectation of reputational liability for inaccurate opinions is likely to be far more significant.[102] Following the certification thesis, retention of a prestigious law firm sends a credible signal regarding its client's contracting quality because the law firm is unlikely to have a rational incentive to risk hard-earned reputational capital by assisting in any individual fraudulent action. It therefore follows

100. Personal observation; *see also* Robert W. Hillman, *Organizational Choices of Professional Service Firms: An Empirical Study*, 58 BUS. LAW. 1387, 1401-02 (2003) (finding that the LLP is the most popular associational choice for law firms having over 750 lawyers). I note that the relevant statutes usually preserve residual levels of personal liability even for partners in law firms that adopt the LLP form, although these levels are among the lowest in such major jurisdictions as New York and Texas. *See* Susan Saab Fortney, *Professional Responsibility and Liability Issues Related to Limited Liability Partnerships*, 39 S. TEX. L. REV. 399, 404 (1998).

101. *See* Brenda Jeffreys, *Texas Court Dismisses Vinson and Elkins from Enron Shareholders' Suit*, LEGAL INTELLIGENCER, Jan. 30, 2007 (quoting judge's statement that "the court recognizes the right of the lead plaintiff to control its suit, to streamline it for trial, and to pursue the 'deepest pockets' without expending further time and money on defendants from which it does not expect to be able to collect substantial funds"). Apparently Vinson & Elkins did agree to certain cash settlements in connection with the Enron bankruptcy litigation. *See Vinson & Elkins, Enron Reach Settlement*, HOUSTON BUS. J., June 2, 2006 (discussing Enron settlement), *available at* http://houston.bizjournals.com/houston/stories/2006/05/29/daily30.html.

102. *See* Coffee, *Comment*, *supra* note 8, at 61-62 (noting that, when issuing a closing opinion, the opining law firm's reputational liability exposure is likely to be of greater concern than its legal liability exposure, principally due to its ability to limit legal liability exposure through use of disclaimers).

that a law firm should be highly sensitive to reputational damage for issuing an erroneous opinion, which in turn implies that a closing opinion from any repeat-player law firm should offer significant assurance with respect to the matters it addresses, even in the absence of any meaningful legal penalty for doing so negligently or erroneously.[103] But this argument relies on two unstated assumptions: namely, it must be true that (1) law firms generally play a meaningful function as a "reputational intermediary,"[104] and (2) issuance of an inaccurate opinion actually causes substantial reputational damage to the opining firm. It is not clear that either assumption is generally justified.

As a practical matter, the "lawyer as reputational intermediary" thesis may be substantially overstated with respect to at least current corporate-law practice, where sophisticated clients may value law firms primarily as a means of obtaining vigorous negotiation services, astute transactional design, specialized legal guidance, or accurate documentation of business agreements rather than as a bonding mechanism to demonstrate contracting quality to any potential counterparty.[105] Some lawyers say so themselves: a 2004 report issued by an ABA "task force" (on securities-law opinions) *expressly rejects* the proposition that an opining lawyer acts as a reputational intermediary with respect to its client.[106] In particular, two historically novel characteristics of the current legal market probably erode the reputational value of external legal counsel: (1) larger corporations have virtually abandoned the "permanent retainer" model and often use multiple external counsel on a rotating basis that gives each firm limited opportunity to gain intimate knowledge of the client;[107] and (2) as a result of internal growth and acquisitions, leading corporate law firms typically employ several hundreds of lawyers in multiple offices, making it difficult for any such firm to credibly monitor the actions of all its partners and associates.[108] Moreover, any residual

103. Some would replace "even in" with "precisely because of." *See* Arnoud W.A. Boot et al., *Reputation and Discretion in Financial Contracting*, 83 AM. ECON. REV. 1165, 1167-78 (1993) (arguing that legal nonenforceability may be a precondition for enabling a promisor to accrue reputational capital by voluntarily adhering to "discretionary" commitments). For reasons discussed in the text above, it is unclear whether law firms contribute meaningful levels of incremental reputational capital to business transactions and even if this were the case, whether an erroneous opinion (and therefore, refusing to "honor" an opinion) would cause the law firm material reputational injury. However, Boot et al.'s argument may have an alternative application in the closing opinion context insofar as it could provide the basis for arguing that the increase in perceived legal liability of opining firms starting in the early 1970s undermined the reputational force that may have once stood behind opinion letters.

104. For skeptical treatments of the reputational intermediary thesis with respect to legal services, see Langevoort, *Where Were the Lawyers?*, *supra* note 71, at 112; and George M. Cohen, *When Law and Economics Met Professional Responsibility*, 67 FORDHAM L. REV. 273, 287-89 (2003).

105. *See* Langevoort, *Where Were the Lawyers?*, *supra* note 71, at 112 (stating that some clients are more interested in strategic representation than reputational support); and Coffee, *Understanding Enron*, *supra* note 5, at 1405 (defining the lawyer's role as a "transaction engineer" more so than a "reputational intermediary").

106. *See* Task Force on Sec. Law Opinions, ABA, Section of Bus. Law, *Negative Assurance in Securities Offerings*, 59 BUS. LAW. 1513, 1515-16 (2004) (stating counsel is not a "reputational intermediary").

107. *See* COFFEE, GATEKEEPERS, *supra* note 5, at 194. For a related point, see Ronald J. Gilson, *The Devolution of the Legal Profession*, 49 MD. L. REV. 870, 900-03 (1990) [hereinafter Gilson, *Devolution*] (arguing that increased sophistication of law firm clients has reduced a law firm's market power (by reducing costs of switching law firms) and in turn reduced a law firm's ability to act as a gatekeeper).

108. *See* Schwarcz, *To Make or to Buy*, *supra* note 8 (manuscript at 32-42) (stating that opportunistic behavior reduces a firm's reputational value). Other commentators have argued that large size *increases* reputational capital by making it less likely that the relevant firm will risk injuring its extensive operations in

reputational capital that may be attributed to external counsel has limited *incremental* value in sophisticated transactional settings, given that: (1) on the "buy-side," a business party often has ample capacities to independently perform a rigorous diligence process with respect to any possible counterparty;[109] and (2) on the "sell side," a business party often is itself a repeat-player in the relevant market and therefore has substantial incentives to safeguard reputational capital through good faith behavior. The declining incremental value of law firms' reputational capital is reflected by the increasing substitution of external counsel by internal counsel in non-specialized transactional functions as well as the virtually universal adoption by even the most elite law firms of limited liability organizational forms:[110] both phenomena would presumably be less prevalent if clients attributed unique reputational value to outside counsel.[111]

These observations are broadly consistent with the few empirical efforts to confirm the reputational value of law firms, which are confined to the securities offering context and find mixed or no support outside of a limited set of elite firms.[112] Even if it were

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order to enjoy gains on a single fraudulent action. *See* J. Bradford DeLong, *Did J.P. Morgan's Men Add Value? An Economist's Perspective on Financial Capitalism*, *in* REPUTATION, *supra* note 20, at 195-96 (discussing the reputational capital increase in firms with large market share). The argument above is not inconsistent insofar as it recognizes that large size also *reduces* reputational capital insofar as the market appreciates that a larger firm has less capacity to monitor the actions of its employees, who as nominal owners do not share a similar interest in safeguarding the reputational capital of the firm as a whole. Which effect prevails is an open empirical question.

109. *See* Okamoto, *supra* note 30, at 19-20 (noting that reputational value of outside lawyers has been reduced as a result of lower costs of information verification, which can now be handled more easily by clients internally). For a similar observation with respect to stock exchange listings, see Jonathan Macey & Maureen O'Hara, *Stock Transfer Restrictions and Issuer Choice in Trading Venues*, 55 CASE W. RES. L. REV. 587, 593 (2005) (arguing that an exchange listing now has reduced reputational value given the ability of institutional investors to monitor the performance of companies in which they are invested or may invest).

110. *See* Okamoto, *supra* note 30, at 43 (noting that migration to LLP organizational form constitutes "disinvestment" in the reputational value of the firm).

111. I grant that firms could still ascribe positive marginal reputational value to outside counsel but either (1) take the view that any such value is exceeded by the cost-savings enjoyed by bringing certain legal services "in house," or (2) "go in-house" at higher or lower rates in different transactional settings where external counsel has higher or lower marginal reputational value. However, it seems to me the continued retention of external counsel for large-scale and/or highly complex transactions or customized regulatory advice is primarily driven by the non-cost-effectiveness on the client-side of maintaining what would be an often idle inventory of legal personnel and/or highly specialized intellectual capital.

112. *See* Okamoto, *supra* note 30, at 31-51 (based on data concerning retention of legal counsel in sample of securities offerings from January 1993 through December 1995, finding that the reputational value of external counsel is declining during the relevant period outside of a small group of elite firms, which solely represent the most established securities issuers); Beatty & Welch, *supra* note 26, at 576-85 (showing that IPO underpricing and underwriter compensation falls when issuers hire more expensive law firms and interpreting this result to mean that elite law firms provide either improved quality assurance or superior negotiation in setting terms with issuer). As suggested by Beatty & Welch's second alternative, these results could be construed as a professional (rather than a moral) variant of the reputational intermediary thesis: that is, these data could support a correlation between a reputation for honesty and firm prestige and/or a correlation between a reputation for high-quality work product and firm prestige. Additionally, note that the securities offering context involves an issuer and multiple dispersed investors, a substantially different transactional environment than an acquisition or financing transaction in which closing opinions are normally issued and the counterparties have extensive prior interaction; in the latter scenario, the business parties have ample opportunity to conduct diligence, thereby reducing the relative value of any reputational capital pledged by an external legal advisor. *See also* Schwarcz, *To Make or to Buy*, *supra* note 8 (manuscript at 32) (surveying

nonetheless assumed that law firms *do* contribute substantial reputational capital to sophisticated business negotiations, there is no reason to conclude that issuance of an erroneous opinion would necessarily cause substantial reputational injury to the opining firm. Contrary to the required assumptions of the certification thesis, there is no clear empirical evidence that perceived misconduct by a law firm will consistently result in a swift market penalty (which, working backwards, will then deter any such behavior in the first place). Several law firms that have been sued or found liable for negligently issued opinions or been accused of gross unethical conduct have apparently suffered little if any long-term damage to their prestige or ability to retain or attract clients.[113] I preliminarily confirmed further the sedate reaction of the reputational market to allegedly negligent opinion-giving by searching Westlaw news databases (including local practitioner journals) for articles concerning the litigations identified in Table 2 above (and the Appendix); generally, there is little coverage (if any) beyond a one-time description of the relevant decision[114] and no mention of any actions taken by the relevant law firm that are normally indicative of reputational injury in the commercial context (e.g., resignations, public announcements of changed policies, etc.). This pattern is consistent with sleepy market reactions to more dramatic allegations of law firm malfeasance in other legal opinion contexts. In 1972, the Securities & Exchange Commission (SEC) brought a widely-noted securities fraud action against the law firm of White & Case for alleged involvement in a client's fraudulent merger and related securities transaction (the "National Student Marketing" episode), including issuance of a closing opinion;[115] however, there is no evidence the law firm suffered any serious decline in prestige or other economic injury as a result. And more recently, the Texas law firm of Vinson & Elkins has apparently emerged largely unscathed from its close involvement in the Enron scandal, especially after being dismissed as a defendant from the pending Enron shareholders' class action, in which it became ensnared largely as a result of issuing "true sale" and "non-consolidation" opinion letters in connection with certain structured-finance transactions.[116]

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general counsels and finding that the majority attributes reputational value to outside counsel, but only a small minority attributes substantial reputational value. I note that Schwarcz appears to use "reputational value" primarily to mean professional competence rather than moral trustworthiness).

113. *See* Lipson, *supra* note 8, at 110 (noting that White & Case, Hale & Dorr, and Dewey Ballantine have been or are involved in litigation concerning possible liability for negligently issued opinions and are still considered prestigious firms); *see generally* Langevoort, *Where Were the Lawyers?*, *supra* note 71, at 112 (arguing that law firms likely suffer little reputational damage when found to have been involved in the fraudulent conduct of a client).

114. The sole exception appears to be *Banco Popular N. Am. v. Gandi*, 876 A.2d 253 (N.J. 2003), a 2005 New Jersey Supreme Court decision, which primarily concerned a "creditor fraud" claim against an attorney who advised a delinquent borrower on an allegedly fraudulent asset transfer, in the context of which it issued an allegedly misleading legal opinion. The press coverage relates primarily to the possible expansion of attorney liability to non-clients, and not to the particular law firm involved in the relevant litigation. *See, e.g.*, Robert B. Hille, *Duty to Non-Clients:* Banco Popular *Raises Double Exposure*, N.J. LAW., Jan. 2004 (discussing Banco Popular North America v. Gandi, 184 N.J. 161 (2005)).

115. *See* SEC v. Nat'l Student Mktg. Corp. et al., 457 F. Supp. 682, 717 (D.D.C. 1978) (holding that defendants did violate securities laws; however, injunctive relief is not necessary).

116. Michael Orey, *Enron's Last Mystery*, BUS. WK., June 12, 2006, at 28. The opinion letters have received attention in the popular press. *See* Mike France, *What About Enron's Lawyers*, BUS. WK., Dec. 23, 2002.

This state of affairs is not altogether surprising. Even when a law firm is sued for allegedly issuing a negligently prepared opinion, the suit may be seen as having little merit (for example, the enforcement action against White & Case mentioned above was widely criticized in the New York bar),[117] or may not be widely publicized. Even if widely publicized, the suit may be credibly attributable to an "honest mistake" or a "rogue" attorney not indicative of the firm's general practice as represented by its hundreds of other lawyers.[118] The same factors that compromise a law firm's reputational value generally speaking also support the weaker claim that, even if law firms do retain some meaningful reputational function, issuance of a perceived erroneous legal opinion inflicts little reputational injury. This is due to the large size of the typical national law firm (thereby limiting its known capacity to monitor and restrain attorney conduct) and, in many or most cases, the lack of any long-term relationship between external counsel and its client (thereby limiting its known capacity to verify client-supplied information). The resulting "noise" surrounding the substantive content of a closing opinion may substantially insulate a law firm from reputational injury in connection with even highly adverse transactional outcomes. Given the foregoing considerations, and barring cases in which an attorney is obviously engaged in criminal or fraudulent activities with a client, it is unclear whether a sophisticated market assesses a meaningful reputational penalty against a reputable firm that "happened" to issue a closing opinion in connection with the nefarious schemes of a client who had otherwise appeared to be a reputable enterprise.

D. Evaluation: The Puzzle Emerges

On a theoretical level, the certification thesis puts forward a straightforward account of efficiency benefits accruing from closing opinions, which in turn anticipates widespread usage in business transactions. But theory must ultimately rest on some empirical basis. As described above, the closing opinion process generates nontrivial costs, including most notably the opportunity costs relating to a potential delay in consummating a transaction typically having a value in the tens or hundreds of millions of dollars together with diverting limited attorney resources in the sensitive period immediately prior to closing. It would therefore be expected that closing opinions would typically confer nontrivial benefits by materially reducing informational asymmetries among contracting parties, thereby generating efficiency gains by modifying the price or transactional design so as to better reflect underlying asset values. So long as these anticipated efficiency gains typically exceed anticipated resource expenditures on the

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117. *See Report of the New York City Bar Association Task Force on the Lawyer's Role in Corporate Governance–November 2006*, 62 BUS. LAW. 427 (2007).

118. *See* Kraakman, *supra* note 16, at 100 (noting that reputation is a "noisy" signal, which can limit the deterrent effect of reputational penalties on gatekeeper misconduct); Cohen, *supra* note 104, at 287-89 (arguing that it is often difficult to assess law firms' reputational capital, it is often ambiguous whether bad results should be attributed to lawyers' misconduct or negligence, and large law firms can often attribute any misconduct or negligence by one of their lawyers to a "bad apple" without casting serious aspersions on the firm's reputation). *See generally* Stephen J. Choi, *A Framework for the Regulation of Securities Market Intermediaries*, 1 BERKELEY BUS. L. J. 45, 54 (2004) (noting that, in the securities intermediary context, there is an "observability problem" with respect to intermediary quality insofar as it is often difficult to ascribe investment failure to auditor or analyst error, since a wide range of other plausible explanations for an adverse business outcome may exist).

closing opinion process, there would be no curiosity at all. Consistent with some practitioners' impressions, the discussion above casts substantial doubt on the incremental informational value typically yielded by a closing opinion, thereby raising the possibility that opinion-related expenditures may at least sometimes fail a cost-benefit test, in which case the continued widespread use of closing opinions *does* become curious. While the certification thesis would presumptively identify the closing opinion as a typically effective quality proxy, close examination shows this assumption to rest on shaky ground. Given an opinion's minimal substantive content, an opinion giver's constrained liability exposure, the availability of robust diligence alternatives, and other limiting factors, it seems unlikely that a sophisticated attorney or business client ever relies on a conventionally hedged closing opinion to allay material doubts concerning enforceability or other fundamental matters. Any other policy would be imprudent. Courts have expressly admonished (or disbelieved) sophisticated parties who claimed to have done so, refusing to honor the closing opinion precisely in the contingency for which, following the certification thesis, it is issued! In a decision that vividly illustrates this point, a Michigan appeals court ruled that a lender's reliance on a closing opinion that later proved to be inaccurate was not justifiable because the lender, as a sophisticated party, was aware that the issue of authority covered by the opinion was in dispute and elected to close the transaction anyway.[119] It may be equally striking to learn that there is no assurance that a closing opinion can estop the opining firm's client from later contesting the enforceability of the relevant transaction, which is precisely the core issue purportedly being "certified."[120]

At best, a typical closing opinion appears to provide its recipient with a positive but minimal level of incremental information with respect to the counterparty's contracting quality. Recall that the strength of a quality signal depends on the extent to which the costs of obtaining the signal are substantially greater for lower-quality parties relative to higher-quality parties, such that generally only the latter can afford to supply the signal, which in turn permits higher-quality parties to distinguish themselves from lower-quality parties. But an opinion is *not* substantially more costly for all but the lowest-quality parties to obtain relative to higher-quality parties that occupy the remaining portion of the contracting quality spectrum. Given the wide array of limiting factors discussed above, together with the constrained screening resources and capacities of even a well-established law firm, both the high-quality client with a pristine business record and the somewhat unsavory client with a significantly less than pristine history (but still lying above the criminal or otherwise distasteful level) can probably obtain the services of a prestigious law firm, assuming only sufficient financial resources.[121] As a result, it

119. *See* City Nat'l Bank of Detroit v. Rodgers & Morgenstein, 399 N.W.2d 505 (Mich. Ct. App. 1986); *see also* Greyhound Leasing & Fin. Corp. v. Norwest Bank, 854 F.2d 1122 (8th Cir. 1988) (ruling that a lender's negligence in not investigating lien status precluded lender from bringing negligence claim against opining law firm that relied solely upon its client's representations without conducting a lien search).

120. *See* 2004 CALIFORNIA BAR REPORT, *supra* note 9 (rejecting notion that issuance of enforceability opinion bars client from later contesting enforceability of the relevant agreement, but adding that there may be an informal estoppel benefit insofar as the opinion could limit reasonable latitude in settlement negotiations to contest the enforceability of the relevant agreement); Schwarcz, *Limits of Lawyering*, *supra* note 8, at 11 n.55 (same, but stating that issuance of an opinion may still hamper the opining attorney's client from later contesting the relevant transaction).

121. A similar observation has been made with respect to the informational value of letters of credit. *See*

appears that the opinion does not typically transmit anything more than a weak quality signal that tells the recipient *something but very little* about where its potential business partner lies on the contracting quality spectrum, doing nothing more than allowing opinion recipients to distinguish between extremely low-quality counterparties and the undifferentiated remainder.

The certification thesis would only offer a *complete* explanation for currently robust levels of closing opinion practice if all of the following propositions were true: (1) closing opinions generally contain meaningful substantive content, (2) law firms take on significant legal and/or reputational exposure in issuing an opinion (and therefore would only issue opinions on behalf of clients that exhibit confirmed high contracting quality) and, (3) opinion recipients do not already have access to more robust diligence instruments. The certification thesis would offer a *partial* explanation for current levels of closing opinion practice if at least the second and third propositions were true (this explanation would be partial because it could not immediately account for the typical opinion's highly diluted content). Based on the foregoing discussion, the first proposition is almost certainly unfounded (that is, it should be uncontroversial that the substantive content of most closing opinions is highly limited); the second proposition is highly unlikely with respect to legal exposure and subject to serious doubt with respect to reputational exposure (that is, opining lawyers probably do not assume significant legal exposure and most likely do not assume more than limited reputational exposure); and the third proposition is usually untrue in sophisticated business transactions (that is, opinion recipients usually do have access to alternative robust diligence alternatives). It is therefore difficult to confidently attribute anything more than minimal certification value to a typically qualified closing opinion, which in turn yields a reasonable likelihood that the expenditures devoted to preparing and negotiating it may at least sometimes fail the cost-benefit condition assumed by the standard certification thesis.[122]

Clayton P. Gillette, *Letters of Credit as Signals*, 98 MICH. L. REV. 2537, 2543 (2000) (arguing that the quality signal provided by a letter of credit is opaque because both an applicant with pristine credit and an applicant that just passes the creditworthiness threshold will have its letter of credit application approved by the issuing bank).

122. Assuming constant costs, the likelihood that a closing opinion fails a cost-benefit test would appear to vary inversely with transaction value: i.e., at high transaction values, it may be "worth it" to expend resources on even a minimally informative closing opinion. But even this is not clear. Suppose a transaction fails in part due to an enforceability issue addressed by the closing opinion, generating catastrophic losses. Even in this worst-case scenario, it is not clear that the aggrieved counterparty will devote *any* litigation resources to suing the opining attorney. That is because (1) given existing case law, it will be difficult to obtain a favorable judgment, which in turn will generate substantial legal fees, which, absent an unusual fee-shifting order, will capture part of the final judgment; (2) assuming typical organization as a limited-liability partnership, the law firm's liability is effectively capped by its malpractice insurance; and (3) the insurance cap probably pales in comparison to the attachable assets of the law firm's corporate client (in which case, it is precisely in the highest-value transactions that the aggrieved counterparty may conclude that it is *not* worth it to sue on the opinion). Incidentally, these appear to be precisely the reasons why the shareholder plaintiffs in the Enron class action elected to drop Vinson & Elkins from the suit, *see supra* note 88 and accompanying text (discussing the effect of opinion letters in the Enron litigation). For further discussion, see *supra* notes 100-102 and accompanying text (addressing levels of personal liability for partners in LLP firms and the dismissal of Vinson and Elkins from Enron shareholders' suit).

III. SOLVING THE OPINION PUZZLE

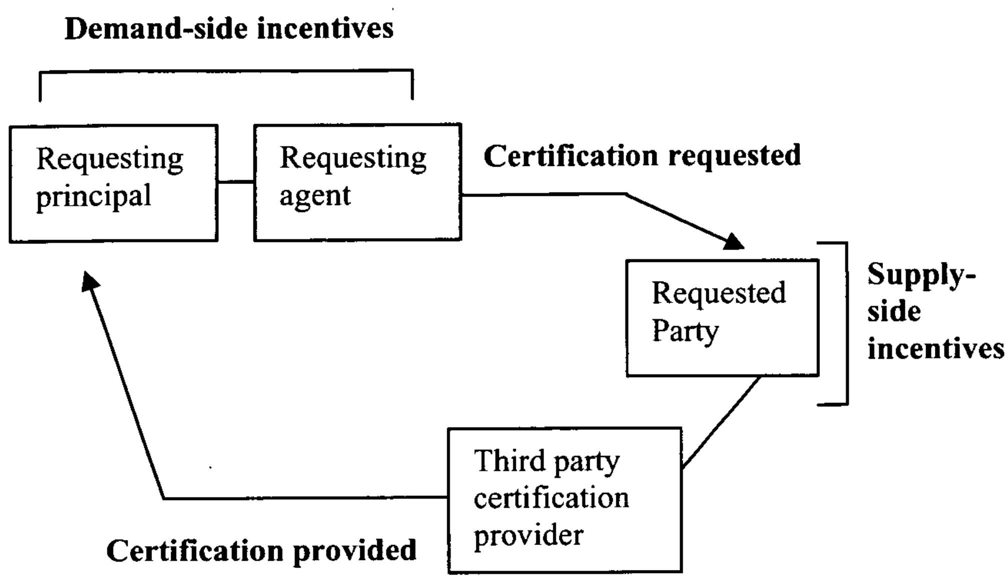
At this point, the emergent opinion puzzle should be clear: it is subject to serious doubt whether closing opinions typically yield significant certification benefits, but rational economic actors are willing to expend nontrivial resources on obtaining them in a broad range of business transactions. In this Part, I address this puzzle by identifying an incentive structure that would induce a requesting party to request a closing opinion and a requested party to satisfy any such request, independent of the parties' belief as to whether this exercise is cost-justified. This structure consists of two components, which operate in sequence: (1) an agency-cost effect on the demand-side, where an agent acting on behalf of the requesting party is exposed to distorted incentives to make a standard certification request; and (2) an adverse-selection effect on the supply side, where the requested party is exposed to distorted incentives to satisfy any standard certification request. On the demand side, the requesting agent is rationally biased to conform to entrenched certification practice in order to avoid any reputational penalty for perceived professional incompetence and, given its nominal or zero ownership in the principal (and zero ownership in the counterparty), is rationally indifferent to all or almost all of the costs of doing so.[123] On the supply side, assuming the certification instrument is easily available to a broad (but not the entire) range of transacting parties and has been entrenched as standard practice, requested parties are rationally biased to satisfy any certification request (through the third party certification provider) in order to avoid a punitive quality discount for failure to do so.[124] Together these demand-side and supply-

123. This claim relates to the extensive literature on agency costs and resulting distortions in project selection. For a foundational analysis of how agents' career concerns yield underinvestment in risky projects, see Bengt Holmstrom, *Managerial Incentive Problems: A Dynamic Perspective*, 66 REV. ECON. STUD. 169 (1999). Two specific contributions are especially relevant to the discussion above. *See* Todd T. Milbourn et al., *Managerial Career Concerns and Investments in Information*, 32 RAND. J. ECON. 334 (2001) (showing how a manager's reputational incentives can lead to overinvestment in information acquisition with respect to possible investments); David S. Scharfstein & Jeremy C. Stein, *Herd Behavior and Investment*, 80 AM. ECON. REV. 465, 466 (1990) (showing that managers may have incentives to accrue reputational capital by "following the crowd," and as a result, some managers may forego actions having positive net expected value if there is a substantial risk of being judged less talented by the labor market in the event the action proves to be erroneous).

124. This claim relates to the economic literature on excessive signaling outcomes. The seminal source is found in the "unproductive" signaling models developed by Michael Spence in the education context. For further discussion, see *supra* note 15 and accompanying text (discussing Michael Spence's signaling models). For more specific applications, see Danny Ben-Shahar, *Productive Signaling Equilibria and Over-Maintenance: An Application to Real Estate Markets*, 28 J. REAL ESTATE FIN. & ECON. 255, 256 (2004) (arguing that, as a result of adverse-selection effects, sellers of real estate, or other durable assets where quality is imperfectly observable, may overinvest in improvements in order to signal quality to potential buyers); Charles F. Mason & Frederic P. Sterbenz, *Imperfect Product Testing and Market Size*, 35 INT'L ECON. REV. 61, 62 (1994) (arguing that introduction of inaccurate product quality certification can aggravate the "lemons problem" (i.e., causing further exit of higher-quality sellers) where test cost exceeds incremental additional revenues from undergoing testing, and noting that higher-quality sellers who remain in the market will nonetheless incur certification costs because failure to do so would result in even greater reduction in revenues); Philippe Aghion & Benjamin Hermalin, *Legal Restrictions on Private Contracts Can Enhance Efficiency*, 6 J.L. ECON. & ORG. 381, 382 (1990) (arguing that, in the absence of restrictions on contractual penalties for breach, entrepreneurs with "good" projects are forced to signal excessively in order to avoid being perceived as "bad," whereas, when contractual penalties for breach are restricted, they may be better off to the extent they are perceived as "average" but save on signaling costs); Nahum D. Melumad & Lynda Thoman, *On Auditors and the Courts in an Adverse Selection Setting*, 28 J. ACCT. RES. 77, 78-79 (1990) (arguing that, even if auditors

side incentives can support rational overconsumption of a minimally informative and non-cost-justified certification instrument. Figure 1 below depicts this incentive structure, which is then described more fully in the following discussion.

Figure 1: Generic Two-Sided Incentive Structure



A. Demand-Side Incentives

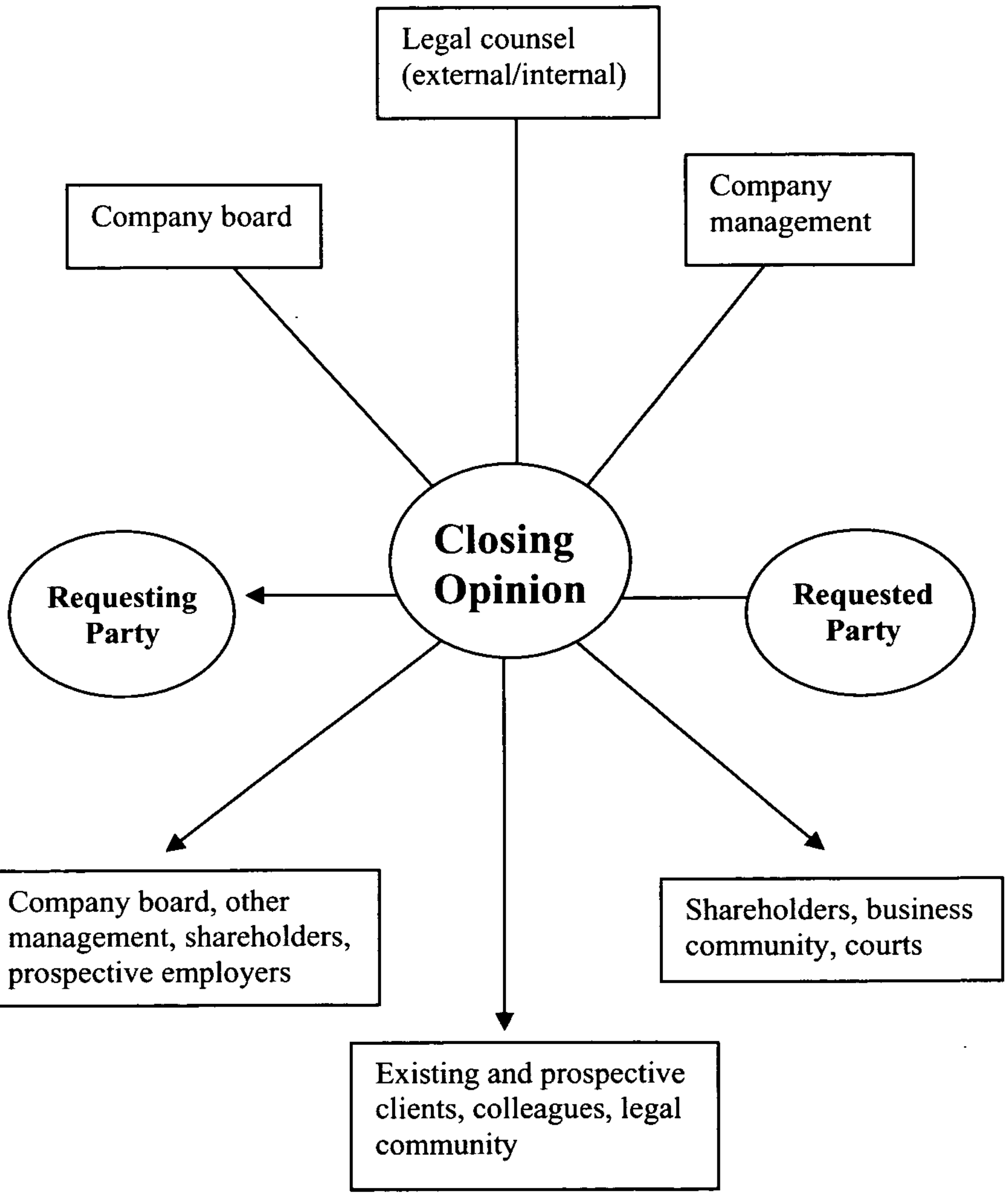
The requesting party faces the following choice: if the anticipated informational value obtained by adhering to the certification convention exceeds the anticipated certification costs, then conform to convention (i.e., request the certification); otherwise deviate (i.e., do not request the certification). As a practical matter, the requesting party makes this election indirectly through its agent (whether a lawyer, manager, or board director). In turn, the requesting agent makes this election while being subject to anticipated evaluation in an internal or external "reputation market" where it is assessed penalties for perceived incompetence and rewards for perceived competence in making its election whether to conform or deviate from convention (e.g., request or not request an opinion).[125] As illustrated in the Figure below, while the closing opinion (or other relevant certification) is ostensibly issued between two counterparties, it transmits

provide uninformative reports, a company will rationally obtain these reports because not doing so (assuming most other companies also do so) would result in lenders viewing the company as a high risk rather than an average risk).

125. If, as argued above, the reputation market does not regularly assess penalties for opinion-related litigation against law firms, it may seem unlikely that the reputation market would regularly assess penalties for individual lawyers' deviations from an opinion-requesting convention. However, the "noise" that surrounds collective law firm misbehavior is considerably "louder" than the "noise" that surrounds individual lawyer misbehavior, given that (1) only the former can be attributed to monitoring costs (the "rogue employee" defense) or lack of knowledge (the "devious client" defense); and (2) deviations from a "bright-line" norm ("always request an opinion") are easier to detect (and harder to contest) than deviations from a fuzzy standard of good faith conduct.

information concerning the professional competence of the requesting agent to a collateral set of reputation markets: (1) in the case of a manager, to other managers, shareholders, the company board, and prospective employers; (2) in the case of a director, to shareholders, the business community, and even courts; and (3) in the case of a lawyer, to colleagues, the legal community, and existing and prospective clients.

Figure 2: Reputation Markets



If socially preferred action could be enforced without costs, the requesting agent would elect to conform only so long as the incremental informational value of the opinion exceeds certification costs, in which case any non-cost justified certification instrument would disappear from the market. However, the requesting agent is inherently liable to violate this social cost-benefit test. There are two reasons. First, provided the agent holds a zero ownership interest in the counterparty (always the case) and less than a substantial ownership interest in its principal (typically the case and almost always the case for an attorney), it is rationally indifferent to all of the costs incurred by the counterparty and most (or even all) of the costs incurred by the principal in connection with the certification process.[126] As a result, the agent is virtually indifferent to any cost savings that may be enjoyed by deviating from convention. Second, the agent is uniquely exposed to reputational rewards and penalties that will be assessed against it in the relevant reputation markets for perceived professional competence or incompetence in connection with any deviation from conventional practice that is perceived to be, respectively, successful or erroneous. Together these factors generate a disproportionate risk-allocation to the benefit of the principal and the detriment of the agent; while the anticipated cost savings and other economic gains from a successful deviation are entirely, or almost entirely, allocated to the principal (and the counterparty), the anticipated reputational losses from an erroneous deviation are entirely allocated to the agent. Subject to the assumption, as argued immediately below, that these anticipated reputational losses typically exceed the anticipated reputational gains from a contemplated deviation,[127] this asymmetrical relationship between a low upside in the case of a "good" deviation, and high downside in the case of a "bad" deviation logically drives the agent to "play it safe" and conform to standard practice, even if doing so is neither socially cost-justified nor cost-justified from the perspective of the principal.[128]

Given that the agent is rationally indifferent to any potential cost savings (in which it holds a nominal or insubstantial stake) and rationally sensitive to any potential

126. For this purpose, certification costs incurred by the principal refer both to (1) certification costs allocated directly to the principal (e.g., legal fees paid by lender to its counsel), and (2) certification costs that are allocated directly to the counterparty (e.g., legal fees paid by borrower to its counsel) to the extent these are borne indirectly by the principal (e.g., the counterparty's costs are reflected in the negotiated price or other deal terms or reduce the counterparty's ability to perform its contractual obligations).

127. Note that this assumption is subsequently relaxed in the case of certain "lead" market participants, which then allows for the possibility that the market will independently correct a non-cost justified certification practice. *See infra* Part IV.

128. For excerpts from attorney interviews that echo the discussion above, see Lipson, *supra* note 8, at 114-15. For a similar argument with respect to lawyers' incentives in rendering advice on the legal risks of a particular transaction, see Larry E. Ribstein, *Ethical Rules, Agency Costs, and Law Firm Structure*, 84 VA. L. REV. 1707, 1709-10 (1998) (arguing that because lawyers suffer harm in the form of reputation and malpractice liability in the case of a bad result for the client but do not share in the client's gain in the case of a good result, they prefer to adhere to standard practice and standard forms); Donald C. Langevoort & Robert K. Rasmussen, *Skewing the Results: The Role of Lawyers in Transmitting Legal Rules*, 5 S. CAL. INTERDISC. L.J. 375, 378 (1997) (noting "an asymmetry in the observability of good and bad advice that leads naturally to an incentive to err on the side of caution"); *id.* at 396 (arguing that potential reputational penalties for transactions gone awry lead attorneys to overstate legal risks). For a similar argument in the contracting context, see Marcel Kahan & Michael Klausner, *Path Dependence in Corporate Contracting: Increasing Returns, Herd Behavior and Cognitive Biases*, 74 WASH. U. L.Q. 347, 361-62 (1996) (arguing that the failure of an incorrectly formulated contract term weighs more heavily in a lawyer's reputational payoff than the success of a correctly chosen term, for which the attorney is generally not given any "extra credit," and, therefore, standardized terms will be preferred over customized terms in drafting, given that they have a lower variance of potential outcomes). On this point more generally, see Gilson, *Devolution*, *supra* note 107, at 892 (arguing that lawyers have an incentive to err on the side of overinclusion in drafting and negotiating contractual provisions, insofar as reducing such provisions to a more reasonable scope is unlikely to be observable by clients).

reputational losses or gains (in which it holds an undiluted stake) from any contemplated deviation, its behavior is easily anticipated: so long as the anticipated net reputational payoff for deviating is negative, the agent will shield its reputational capital by rationally conforming to standard practice, even if doing so fails to generate informational value in excess of certification costs. Whether this inefficient outcome—what I call an "agency-cost distortion"—is practically realized then depends on whether the requesting agent typically attributes a negative value to the net reputational payoff for electing to deviate. There are three familiar scenarios in the legal and managerial setting where this would reasonably be the case. First, the requesting agent may anticipate that deviating will immediately trigger a reputational penalty to the extent that the relevant market believes the attorney, manager, or director exhibited ignorance or imprudence by failing to follow customary practice. Illustrating these pressures, a typical justification that attorneys offer when requesting an opinion is simply that "it is market,"[129] meaning that other lawyers are obtaining the opinion in similar transactions, and *not* insisting on it would expose the attorney to reputational penalties for perceived incompetence. Second, if the relevant transaction is consummated but ultimately generates an adverse outcome for the principal and a causal link plausibly exists between the adverse outcome and the agent's failure to conform to convention, the agent is likely to suffer a substantial penalty for incompetence for what is perceived to be an erroneous deviation from industry practice. Third, while clients (or other managers) will be eager to *shift* reputational liability to the requesting agent who erroneously deviated, they will be eager to *appropriate* reputational gains from the requesting agent who successfully deviated, thereby magnifying reputational losses in the case of an erroneous deviation and diluting reputational gains in the case of a successful deviation.[130] Interestingly, virtually all these scenarios can operate collectively to generate multiple-order agency-cost distortions. For example, a corporate manager may follow convention and request an opinion in order to limit the anticipated reputational penalty for a perceived erroneous deviation, a rationale that may in part be supported by the fact that the corporation's law firm has advised the manager that it is "prudent" or "customary" to request an opinion, which the law firm itself may have given based on the same incentives to limit *its* reputational downside.

Taken as a whole, this analysis provides a rational-choice explanation for the stereotypical figure of the overly cautious lawyer or junior manager: largely unexposed to cost-savings or other economic benefits in the case of a successful deviation from convention but fully exposed to reputational penalties in the case of an erroneous deviation, the agent literally "errs on the safe side," rationally insisting on strict adherence to standard procedure even if doing so is not cost-justified from the

129. *See California Remedies Opinion Report*, *supra* note 9, at 912.

130. I note additionally that the agent's conformity incentives may be bolstered further to the extent it believes that any "base" reputational penalty for perceived incompetence that it otherwise suffers in the event of an adverse business outcome would be mitigated by the fact that it had undertaken all customary diligence procedures. *See* GLAZER ET AL., *supra* note 9, § 1.3.2, at 10 n.6 (noting judicial decisions where the court used evidence of an opinion having been obtained as the grounds on which to find that the board took the requisite level of care in approving a particular transaction). There are grounds for this view under the Delaware corporate code, which provides that a board member may be fully protected in relying in good faith upon "information, opinions, reports or statements" presented to the board by any competent expert. *See* DEL. CODE ANN. tit. 8, § 141(e) (2007).

perspective of the principal. It is important to note, however, that this rational conservatism relies strictly on the assumption that the requesting agent at least partially discounts the certification costs borne by the requesting principal. To the extent that the requesting principal institutes reasonably effective monitoring or other corrective mechanisms, the agent may not fully discount the certification costs borne by the principal (e.g., an attorney may consider the client's certification costs in order to avoid a reputation for "overlawyering" and an in-house lawyer may consider the employer's certification costs in order to avoid internal sanctions for permitting the accrual of large legal bills). In this case, the agency-cost distortion would be mitigated and any degenerate certification practice would be expected to disappear more rapidly from the market.

B. Supply-Side Incentives

Demand-side incentives only solve half of the opinion puzzle, for it can obviously be argued that, even assuming that agency-cost pressures regularly induce requesting agents to request a non-cost-justified certification, this does not resolve the matter because the convention would ultimately *not* be sustained so long as requested parties refuse to satisfy an "unnecessary" formality. While this is not an implausible possibility, it may be the exception in transactional settings where closing opinions are routinely granted as a matter of standard practice and widely available to a transacting population occupying a broad (but not the entire) portion of the contracting-quality spectrum. The intuition behind this claim is as follows: if the certification is available to all parties other than extreme low-quality parties, then failure to satisfy a certification request logically causes the requesting party to apply a punitive transaction discount to reflect the implication that the counterparty belongs to the extreme low-quality segment.[131] While a requested party's customary willingness to provide a standard and widely available certification transmits a weak "affirmative" quality signal, *un*customary insistence on *not* providing the certification transmits a strong "negative" quality signal, implying that there is some highly problematic fact that has not been disclosed to the requesting party. Hence, absent exorbitant certification costs, even a high-quality counterparty who is being asked to issue an opinion rationally conforms to convention in order to avoid the anticipated transactional discount for failing to do so, independent of its belief as to

131. For examples of other inefficient market conventions persisting due to similar "involuntary" implications, see Omri Ben-Shahar & John A.E. Pottow, *On the Stickiness of Default Rules*, 33 FLA. ST. U. L. REV. 651, 651-52 (2006) (arguing that parties may not opt out of inefficient default rules, even when a superior alternative can be identified and formulated at negligible cost because the counterparty will suspect that deviation from the norm is an indication of "secret" bad intentions); Walter Kamiat, *Labors and Lemons: Efficient Norms in the Internal Labor Market and the Possible Failures of Individual Contracting*, 144 U. PA. L. REV. 1953, 1957-62 (1996) (arguing that the standard practice of at-will employment may persist inefficiently because, given the presence of shirking employees, no employer can offer "just cause" employment without attracting such employees and even non-shirking candidates cannot negotiate for a just cause provision without raising the implication of being a shirking candidate); and Donald C. Langevoort, *Organized Illusions: A Behavioral Theory of Why Corporations Mislead Stock Market Investors (and Cause Other Social Harms)*, 146 U. PA. L. REV. 101, 115-16 (1997) (arguing that where it has become the norm for corporations to engage in "puffery," a corporation that elects to deviate from the norm and provide truthful disclosure may suffer a disproportionate penalty insofar as the market will interpret truthful disclosure as an indication that a seriously adverse situation has materialized).

whether or not the relevant instrument is cost-justified.

Let's explore this claim in greater detail, in particular for the purpose of identifying at least some of the conditions that must be satisfied for this result to be realized in practice. Faced with an opinion (or other certification) request, the requested party will grant it so long as the pricing gains for providing the opinion *plus* the avoided transaction discount for failing to do so exceed the certification costs allocated to it. If we assume that pricing gains monetize on a "dollar-for-dollar" basis the incremental informational value of the requested certification, then the requested party should elect to conform so long as the incremental informational value *plus* the avoided transaction discount exceed the certification costs allocated to it. Now assume that the requested party's contracting quality is entirely unknown, in which case the requesting party initially assigns the requested party a contracting quality equal to the average quality of the total counterparty population.[132] If we then assume (consistent with the discussion above) that the closing opinion is available to all potential counterparties other than an extreme low-quality segment, the incremental informational value conveyed by the opinion will simply be the difference between (1) the average quality of the total counterparty population and (2) the average quality of the total counterparty population *excluding* the extreme low-quality segment. That is, the opinion simply confirms that the requested party occupies a position somewhere within the large undifferentiated population of potential counterparties who lie above the opining firm's "cutoff point" for delivery of an opinion. Assuming (consistent with the discussion above) that the extreme low-quality segment that lies below the cutoff point represents a nominal proportion of the total counterparty population, this difference is minimal, and delivery of the opinion yields little upward adjustment to the perceived quality of the requested party. As a result, the requested party can expect to accrue few pricing gains by providing the opinion and, depending on the certification costs allocated to it, might be inclined to decline the certification request.

However, it will rationally avoid this temptation, for in the event the requested party did *not* provide the opinion and thereby enjoyed gains in the form of avoided certification costs, it would likely suffer even greater pricing *losses*. This is because failure to provide the opinion will drive the agent to conclude that the requested party belongs to the extreme low-quality segment that lies below the cutoff point, which it will then "price in" by applying an appropriate discount to the deal consideration. This downward adjustment will simply be the difference between (1) the average quality of the total counterparty population and (2) the average quality of the extreme low-quality segment.[133] So long as the extreme low-quality segment is believed to be sufficiently "bad" relative to the "remainder" higher-quality population, this discount will be large and the counterparty will rationally incur the costs of providing the requested certification in order to avoid the even greater cost that would be incurred by "killing the deal" or reducing the deal

132. As used in this and the immediately following paragraph, "average" values are understood to be weighted as required to reflect the expected proportions of low-quality and high-quality types in the counterparty population.

133. Note that a more complex formulation would reduce the value of this discount by a certain factor to reflect the requesting party's belief that some deviating counterparties may be higher-quality parties who lie above the cutoff point but do not wish to provide the opinion on the "principled" grounds that it is a wasteful convention. This belief may be more plausible, and the discount would then be decreased accordingly in the case of established firms with respect to which there are other reliable indications of contracting quality.

consideration.

This analysis identifies an interesting relationship. Paradoxically (and subject to the assumptions stated above), as the incremental informational value of the certification instrument (the "affirmative" quality signal) falls to minimal but still positive levels such that it does nothing but exclude a small sub-population consisting of the most extreme low-quality counterparties, the transaction discount assessed for failing to provide it (the "negative" quality signal) increases, up to and including failure to consummate the relevant transaction. If the informational value *does* reach zero, then the conformity incentive disappears since failure to honor a certification request would by necessity have no negative quality implication and the transaction discount would then fall to zero. By analogy, consider a law school professor who is known to give "A" grades to 95 out of every 100 students: the grade conveys minimal incremental information to a prospective law-firm employer concerning its holder's future performance prospects since almost all of the candidate population has it. However, given its widespread dissemination, any student who fails to obtain the "A" grade incurs a drastic quality discount that blocks even preliminary consideration in the hiring process (assuming employers believe that students who do not receive "A" grades have sufficiently inferior talents relative to students who do receive "A" grades). Similarly, in the typical case where a closing opinion has low incremental informational value but is widely used among the relevant transacting population (and requesting parties believe that counterparties who cannot obtain opinions are sufficiently inferior to counterparties who can obtain opinions), a requested party who declines to conform to standard practice may generate a substantial discount or even endanger a transaction having a value in the tens or hundreds of millions of dollars. Thus, barring astronomical certification costs, even a high-quality counterparty rationally grants a customary opinion request so as to avoid the drastic implication that its contracting quality lies on the extreme end of the contracting-quality spectrum. This outcome persists independently of the requested party's belief as to whether the relevant instrument is socially cost-justified.

IV. FIXING THE OPINION PUZZLE

The agency-cost distortion that sustains (in part) a non-cost-justified certification practice necessarily assumes that the requesting agent does not assign a sufficiently high value to the expected net reputational payoff upon deviating from convention (i.e., in the typical case, this value is assumed to be negative). In this Part, I argue that this assumption may not hold true for highly confident "lead" market participants, who, for reasons identified below, may assign an idiosyncratically large value to any anticipated reputational payoff so that deviation is the rationally preferred course of action.[134] Thus,

134. This claim is consistent with subsequent refinements of the reputational herding model initially developed by Scharfstein and Stein, as described above, *see supra* note 123. Specifically, Jeffrey Zwiebel argues that a manager's susceptibility to herding behavior may be in part a function of the ability level of the relevant manager, such that average-ability agents will be most susceptible to hewing to the standard protocol while high-ability and low-ability agents will be least susceptible (the former having less risk of being misidentified as bad managers, the latter already categorized as low-ability and therefore willing to bet on a possibly successful innovation and a resulting reputational upgrade). Jeffrey Zwiebel, *Corporate Conservatism and Relative Compensation*, 103 J. POL. ECON. 1, 2-4 (1995).

the same incentive structure that accounts for the persistence of a non-cost-justified certification practice also anticipates that such a practice may ultimately disappear as lead market participants emerge with sufficiently high valuations of the reputational payoff from electing to deviate. If any of these market leaders deviates and then realizes its anticipated reputational gain (which implies that the market views the deviation as successful), it may progressively eliminate a non-cost-justified certification practice by reducing the expected reputational penalties incurred by other market participants that subsequently elect to deviate, thereby establishing a new standard that is then imitated by all "follower" participants pursuant to the same reputation-driven incentives that supported the previous (and now-lapsed) convention.[135] To illustrate this self-correction capacity, I identify three potential leaders in the legal market who appear at least to have the capacity to set new practice conventions: (1) elite and "upstart" law firms, (2) collective organizations (most notably, the bar associations), and (3) insurance carriers. This analysis (which is accompanied by evidence of modest historical contractions in closing opinion practice apparently initiated by some of these market leaders) is followed by a discussion of obstacles (mostly legal) that may prevent the emergence of these lead participants, thereby perpetuating value-depleting certification practices.

A. Law Firms

The law-firm market provides two possible candidates: (1) the relatively small group of elite national law firms, and (2) the new "upstart" firm that contests the older elite's market share. Both market players are credited with developing new practices and contractual instruments that, where successful, are in turn adopted by the remaining mass of competing firms.[136] Elite firms may have incentives to deviate from convention to the extent they accrue reputational and other forms of capital (specifically, in the form of additional clients and higher billing rates) by successfully deviating from the conventional practices employed by other firms.[137] An elite law firm may also expect a

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135. *See* Antonio E. Bernardo & Ivo Welch, *On the Evolution of Overconfidence and Entrepreneurs*, 10 J. ECON. & MGMT. STRATEGY 301, 326 (1997) (arguing that overconfident entrepreneurs generate positive externalities by deviating from the herd and revealing private information contrary to a locked-in convention, thereby providing a mechanism for overcoming incorrect informational cascades); John C. Persons & Vincent A. Warther, *Boom and Bust Patterns in the Adoption of Financial Innovations*, 10 REV. FIN. STUD. 939, 957-63 (1997) (arguing that pioneering innovations in financial markets are rapidly imitated by "waiting" firms when the relevant innovation generates observable positive returns, even if not as large as expected).

136. *See* Michael J. Powell, *Professional Innovation: Corporate Lawyers and Private Lawmaking*, 18 L. & SOC. INQUIRY 423, 450 (1993) (noting the importance of large specialist firms in legal innovation).

137. It might be argued that this self-distinguishing incentive to accrue reputational capital by deviating from "mass-market" practices is neutralized to some extent by a countervailing incentive to preserve a large accumulated stock of reputational capital by conservatively hewing to market-accepted practices. The finance literature is in disagreement as to whether herding behavior is more or less likely to occur among market participants who have already accumulated significant reputational capital. *Compare* Scott E. Stickel, *Predicting Individual Analyst Earnings Forecasts*, 28 J. ACCT. RES. 409, 414 (1990) (observing that the highest-ranked investment advisers tend to "follow the crowd" less than other advisers), *with* John R. Graham, *Herding Among Investment Newsletters: Theory and Evidence*, 54 J. FIN. 237, 237-38 (1999) (arguing that high-reputation investment newsletters have enhanced incentives to herd on the behavior of the market leader in order to protect their high status and pay), *and* Douglas W. Diamond, *Reputation Acquisition in Debt Markets*, 97 J. POL. ECON. 828, 828-31 (1989) (arguing that more established borrower firms have incentives to select less risky projects since the cost of default increases as reputational capital accumulates, and therefore, the

lower reputational penalty for unsuccessfully deviating from convention to the extent that it has an established reputation as a high-ability participant, and consequently, the market does not automatically "demote" it based on a single unsuccessful departure from conventional practice.[138] A young firm lacks almost any reputational capital (other than reputational capital accumulated by founding partners from previous affiliations) and therefore has incentives to acquire such capital by offering a product that is recognizably different from its more established competitors. The new law firm cannot offer the reputational capital and prestigious brand name held by its more established competitors so it seeks to acquire market share by taking a position that is noticeably different from established convention, thereby demonstrating high confidence in its novel approach relative to the market standard.[139] In the closing opinion context, elite or upstart law firms may expect to accrue reputational capital by deviating from the opinion-requesting convention and, barring an adverse transactional outcome, thereby build a reputation as a business-friendly firm that "gets the deal done" efficiently. Lending some credence to this possibility, in the past decade or so the usage of closing opinions in certain settings appears to have contracted to a certain extent. Examples include: (1) the virtually complete withdrawal of closing opinions in the public mergers and acquisitions market, (2) a possible slowdown in the use of closing opinions in the private acquisitions market;[140] and (3) the reportedly increasing abandonment by California practitioners of requesting closing opinions in smaller acquisition and financing transactions.[141]

B. Collective Organizations

The second candidate in the closing-opinion market is the bar association, which, as a collective organization, may be uniquely situated to push the market toward a superior certification practice. Relative to any individual certification provider, a collective organization would appear to have the strongest incentives to implement an efficient modification in industry practice, because (1) to the extent it has the capacity to coordinate industry standards, it can rapidly neutralize any reputational penalty for deviations from a now-lapsed convention, and (2) as a collective organization, it largely internalizes the positive externalities generated by a value-enhancing innovation in industry practice (unlike a pioneering law firm that cannot internalize the benefits it confers on "bandwagon" firms who imitate its innovation). While bar associations may

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payoff from a risky project declines relative to that of a safe project).

138. *See* Owen Lamont, *Macroeconomic Forecasts and Microeconomics Forecasters*, 48 J. ECON. BEHAV. & ORG. 265, 268 (2002) (finding that an economic forecaster's age negatively correlates with herding tendencies and attributing this result to the fact that as a forecaster ages, evaluators develop "tighter priors" about his ability and hence the forecaster has reduced incentives to herd with the group).

139. *See generally* Canice Prendergast & Lars Stole, *Impetuous Youngsters and Jaded Old-Timers: Acquiring a Reputation for Learning*, 104 J. POL. ECON. 1105, 1106 (1996) (providing a theoretical model where young or new market participants have enhanced incentives to take more extreme positions (even positions that the participant knows to be objectively unjustified), because younger participants wish to demonstrate having novel information relative to the accumulated pool of historical information represented by existing practices).

140. *See* Schwartz, *supra* note 38, at 59 (stating that recently "some lawyers have relaxed traditional requirements for closing opinions in connection with mergers and acquisitions").

141. *See* 2004 CALIFORNIA BAR REPORT, *supra* note 9 (based on informal survey of California practitioners).

theoretically be an effective tool for facilitating abandonment of an obsolete industry standard, something approaching the opposite seems to have been the case historically in closing opinion practice, where the bar associations' standardization efforts, while perhaps reducing the transaction costs of the closing opinion process, appear for the most part to have endorsed, and therefore simply further entrenched, existing certification practices.[142] As noted elsewhere, the California Bar (and, to a lesser extent, some other regional bar associations) recently appears to have departed to a certain degree from these historical tendencies, specifically raising doubts as to whether it is cost-effective to require enforceability opinions in certain transactions.[143] The driving force behind these and other more discrete contractions in closing opinion practice[144] appears to be a creeping recognition by portions of the bar of the limited incremental value provided by a closing opinion and certain other legal opinions. As an illustration, in 1991, due to what it described as the dilutive force of standard qualifications that "swallow the bite" of the opinion, the ABA Committee on Legal Opinions recommended that legal opinions with respect to fraudulent conveyance issues "should not normally be requested,"[145] advice that the market is reported to have followed widely,[146] thereby illustrating the bar's potentially potent coordinating power to correct inefficient industry practice.

C. Insurance

The third candidate is the insurance industry. It has a profit incentive to offer a superior bonding mechanism that either overcomes requesting agents' rational disinclination to deviate from existing practice or prompts requested parties to seek to distinguish themselves by offering a more potent bonding mechanism. The transformation of real estate transfer practices in the past several decades illustrates this

142. The standardization efforts of the various bar associations, and the expansion of qualifying language in closing opinions, appear to have progressed simultaneously, with both phenomena commencing approximately in the early 1970s, roughly coinciding with several events that appear to have increased opining attorneys' actual or perceived liability in issuing opinions: (1) the 1972 enforcement action by the SEC against prominent law firms involved in a fraudulent securities transaction (the "National Student Marketing Association" episode, *see* SEC v. Nat'l Student Mktg. Corp. et al., 457 F. Supp. 682 (D.D.C. 1978)); and possibly (2) the increased use (or perceived increased use) of equitable and other discretionary powers by courts in overriding the literal terms of contractual agreements; (3) the decline of the traditional business model in which a corporation retained a single law firm on a "retainer" basis; and (4) the erosion in most jurisdictions of the privity rule (which had previously protected lawyers from malpractice suits by non-clients). On the historical escalation in the use of disclaimers and other qualifying language, see James J. Fuld, *Lawyers' Standards and Responsibilities in Rendering Opinions*, 33 BUS. LAW. 1295, 1307 (1978); Dillon, *supra* note 30, *reprinted in* SILVERADO SUMMIT, *supra* note 30. *See also* Arthur Field & Steven Weise, *Remedies Opinions and Exceptions*, *reprinted in* SILVERADO SUMMIT, *supra* note 30 (noting that the "clean" remedies opinion did not contain, until recently, any limitation other than an exception for insolvency laws). On the erosion of the privity rule and other events in the early 1970s that increased opining firms' perceived liability, see John Freeman, *Opinion Letters and Professionalism*, 1973 DUKE L.J. 371.

143. *See supra* notes 32-36 and accompanying text.

144. Another instance includes the recommendation by the *1998 TriBar Report* to discontinue the practice of rendering foreign qualification and foreign good standing opinions because such opinions simply confirm that the opinion issuer has no reason to doubt the reliability of the government-issued certificates on which such opinions are based. *See 1998 TriBar Report*, *supra* note 9, at 647.

145. ABA, *Guidelines*, *supra* note 9, § I.C(i), *cited in* GLAZER ET AL., *supra* note 9, § 9.10.2

146. *See* GLAZER ET AL., *supra* note 9, § 9.10.2.

phenomenon. The once-entrenched practice of issuing title opinions in real estate transactions in the United States has now been largely displaced by title insurance, which is a superior bonding mechanism insofar as title insurance companies probably have superior ability to identify title defects and clearly have superior financial ability to indemnify the buyer for title defects.[147] Assuming the potentially serious moral hazard difficulties could be overcome (and further assuming sufficient demand in light of other available bonding mechanisms), an insurance substitute could plausibly enter the closing opinion market. Illustrating this possibility, a California insurer has begun marketing to lenders a policy that covers losses based on failure of perfection or priority of a lender's security interests in borrower collateral,[148] which is presented as an alternative to the highly qualified perfection opinion typically issued by borrower's counsel.

D. Obstacles to Self-Correction

The extent of justifiable optimism as to the capacity of a degenerate certification market to correct itself should not be unduly exaggerated. The market leader may be slow in coming if it does not expect any net gains from migrating to a novel practice, which would arise either because the anticipated reputational penalties in the event of an erroneous deviation are sufficiently high or the anticipated reputational gains in the event of a successful deviation are sufficiently low. Two aggravating factors in particular can increase the costs of abandoning conventional practice. First, certain forms of cooperative action among certification intermediaries can increase a market leader's anticipated costs of deviating from industry practice. As noted previously, the national and regional bar associations have made extensive efforts to standardize opinion language (and in particular, the qualifying language used in opinions). While these efforts may have reduced transaction costs by streamlining opinion negotiations, they have also effectively blessed and possibly "frozen" existing forms of closing opinion practice,[149] thereby increasing the anticipated reputational penalty for an unsuccessful deviation from industry practice. Second, legal requirements that require or strongly encourage use of a particular certification instrument can distort substantially the market's "natural" abandonment of an obsolete or otherwise non-cost-justified certification practice. There are a few minor examples that can be cited in the legal opinion context (and, as discussed subsequently, major examples in the fairness opinion and credit ratings contexts).[150] In the financing context, "prudential" management requirements under certain banking regulations may support U.S. institutional lenders' policies that require delivery of a

147. *See* Benito Arrunada, *A Transaction Cost View of Title Insurance and its Role in Different Legal Systems*, 27 GENEVA PAPERS ON RISK & INS. 582, 582 (2002) [hereinafter Arrunada, *Title Insurance*] (generally discussing a transactional cost theory of title insurance); Michael Braunstein, *Structural Change and Inter-Professional Competitive Advantage: An Example Drawn from Real Estate Conveyancing*, 62 MO. L. REV. 241, 257-58 (1997) (discussing the surge in popularity of title insurance).

148. *See* Eagle9 UCC Insurance Policy for Lenders, http://www.eagle9.com/policydescriptions.html (last visited Oct. 22, 2007).

149. *See generally* Coffee, *Comment*, *supra* note 8, at 62-63 (arguing that bar associations have made efforts to insulate opining attorneys from legal exposure by limiting issues as to which an opinion can be requested and limiting the agreed-upon scope of legal opinions).

150. *See infra* Part V.A–B.

closing opinion from borrowers' counsel in large financing transactions.[151] In the acquisition context, state corporate law in some jurisdictions (notably, Delaware) may distort opinion practice insofar as the fact of having obtained a closing opinion may be used as grounds for showing that the board took the requisite level of care in approving the relevant contested transaction.[152] These legal interventions may do little to improve the diligence investments of the relevant fiduciaries while entrenching non-cost-justified certification practices that may otherwise have contracted or disappeared. In turn, these legal entrenchments induce rent-seeking investments by interested intermediaries that may prolong the usage of value-depleting certification instruments; thus, some intermediaries may lobby for the retention or introduction of legal requirements that block any future migration by market leaders to a more efficient certification alternative. Illustrating this danger, notary organizations in a variety of civil law jurisdictions have repeatedly blocked simplification of business formation procedures,[153] and, with the advent of title insurance, real estate lawyers lobbied in some U.S. states for requiring the use of lawyers in real estate transfers "to defend consumers' interests," apparently in response to the advent of competing title-insurance products.[154]

V. SOME MORE PUZZLES: APPLICATIONS AND EXTENSIONS

This Article's analysis of the emergent opinion puzzle, and in particular, the incentive structure that may lie behind that puzzle, has been couched in generic terms to the maximum extent feasible so as to be applicable across a wide variety of transactional settings. The model of a degenerate certification practice, as sustained by agency-cost and adverse selection effects, has potential application as a diagnostic tool for identifying and accounting for the otherwise curious persistence of non-cost-justified certification instruments in the financial markets and other settings. While developed in the context of closing-opinion practice, this degenerate certification model yields a potentially broader insight: some markets may be afflicted not by the more commonly identified shortage, but rather by an *excess*, of certification instruments, which, once entrenched (and then further entrenched by legal requirements), impose a cost of doing business that does little to alleviate informational asymmetries while being difficult to dislodge given the incentive structure and other factors described above. The resulting allocation distortion can be substantial. While an extraneous certification practice may generate relatively low costs on a "per-usage" basis, the social losses resulting from the inefficient persistence of any such practice may easily accelerate in the aggregate by force of multiplication across thousands of transactions annually.[155] Illustrating the potentially large social costs

151. *See California Remedies Opinion Report*, *supra* note 9, at 914 n.32 (noting that while regulations by the Comptroller of the Currency or Federal Reserve Board do not mandate that an opinion should be obtained, "safe and sound banking practices" are sometimes the bases for requesting an opinion).

152. *See supra* text accompanying note 130.

153. THE WORLD BANK, DOING BUSINESS IN 2004, at 19-27 (2004), *available at* http://rru.worldbank.org/Documents/DoingBusiness/2004/DB2004-full-report.pdf.

154. *See* Arrunada, *Title Insurance*, *supra* note 147, at 586 (describing title insurance products).

155. To see how quickly these costs can multiply, let's make the artificially conservative assumption that there are approximately 1000 financing and acquisition transactions on average in the United States annually that are accompanied by a closing opinion and further assume a low-end average of $5000 per opinion. This generates total annual expenditures of $5,000,000 on closing opinions, all of which would represent a net social

imposed by extraneous certification practices, the World Bank identifies the legally required use of notarial services (as in part sustained by strong lobbying efforts) as substantially inflating business formation costs in civil law jurisdictions, thereby constraining entrepreneurial activity and economic development.[156]

Identifying a purportedly degenerate certification convention, especially where entry barriers in the certification market are low, market participants have roughly equal sophistication, and distorting legal interventions are largely absent, is by definition fraught with uncertainty as it requires overriding the decision of a competitive market subject to pressures that would normally be expected to rapidly eliminate inefficient practices. As a general matter, however, any such market failure is not entirely surprising in light of the well-developed body of economic models that have always anticipated the theoretical possibility of socially excessive investments in signaling activities.[157] Broadly consistent with this more pessimistic (and complex) view of certification intermediaries, this Article's thesis may potentially account for the surprising number of widely used but widely doubted certification products in the financial markets. These additional "suspects" include: fairness opinions issued by investment banks; bond ratings issued by credit rating agencies; and potentially redundant forms of contractual boilerplate used in sophisticated deal documentation. As discussed further below, the net social value of these routine transactional practices is subject to ongoing dispute by academic researchers, market practitioners, and, in some cases, regulators and judges. These doubts generally reflect some or all of the same factors that cast doubt on the certification value of closing opinions, including: (1) other information and/or diligence instruments already being available to transaction participants, (2) limited or zero legal liability of the certification provider, (3) conflicts of interest on the part of the certification provider, and (4) concentrated conditions in the certification market.

Given the potentially constrained informational value of these routine practices, there is some analytical curiosity as to why these practices widely persist in sophisticated business settings, although entry barriers and legal requirements (largely absent in the closing-opinion context) make it more difficult to pinpoint the principal source of any potential inefficiencies. To advance these intuitions somewhat further, I show below how this Article's two-sided incentive structure can, with minimal customization, account preliminarily for the potentially surprising persistence of fairness opinions, credit ratings, and redundant contractual boilerplate. Given that some of these practices generate substantially greater costs than closing opinions (with fees extending into the millions of dollars in the case of a fairness opinion), and without taking a definitive position as to whether these costs likely exceed the incremental informational value typically yielded as a result, these practices provide preliminary indications of both the ability of a degenerate certification practice to persist over a fairly broad range of cost conditions and the outside magnitude of any resulting social losses in the form of misallocated resources.

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loss after deducting for any incremental informational value, not to mention the opportunity costs of any transactional delays due to the closing-opinion process and law firms' fixed costs of maintaining an opinion "infrastructure."

156. Based on a database containing information on 130 jurisdictions, the World Bank reports that notarial requirements on average increase the time and cost of forming a business by, respectively, 15 days and an amount equal to 7% of per capita income. THE WORLD BANK, *supra* note 153, at 118-20.

157. For further discussion, see *supra* notes 14-15 and 124 and accompanying text.

A. Credit Ratings

A credit rating purportedly provides new information concerning an issuer's financial condition to prospective buyers and existing holders of the issuer's debt securities, as provided by a trustworthy third party intermediary with an established market reputation. Fees (which are paid by the issuer) are substantial and vary based on offering values, with the cap usually set at $300,000.[158] The academic literature, market practitioners, agency regulators, and congressional committees have widely observed that credit ratings in the debt offering market have questionable *incremental* informational value in light of the fact that the rating agencies (1) are subject to limited legal liability in light of regulatory exemptions and court decisions granting First Amendment protections, (2) rely on the accuracy of information provided by issuer management, (3) have an overwhelming market share, (4) are subject to a conflict of interest (given that the issuer funds the rating process), and (5) as empirical evidence shows (and as can be observed anecdotally by the rating agencies' famously tardy downgrades in the Enron implosion and slow reaction to the August 2007 turmoil in the mortgage-backed securities market),[159] despite the purported disciplining effect of reputational penalties, tend to follow, rather than lead, the market consensus.[160] In a telling observation, a Senate committee notes that 95% of corporate bonds are held by institutional investors who have in-house research departments to assess the value of bond securities, thereby casting doubt on the incremental value of credit ratings for most bondholders.[161] Taken together, the import of these findings is clear: credit ratings typically do not seem to tell the bond market (or most of the bond market) substantially (if anything) more than it knew already. The credit ratings market would therefore appear to have the "flavor" of a degenerate certification practice: widespread skepticism about its marginal informational value coupled with widespread usage in the relevant market.

A credit rating can be viewed as a certification instrument that is provided by an issuer (through the third party rating agency) pursuant to the "constructive request" of the investor population (largely represented by agents in the form of money-managers and other investment fiduciaries). (Prior to the 1970s, this structure would have literally described the credit ratings process, which was then funded through subscriptions paid by

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158. More specifically, rating agency fees range from three to four "basis points" (i.e., one-hundredths of a percentage point) of the face amount for the rated debt issue up to the cap stated above. *See* Frank Partnoy, *How and Why Credit Rating Agencies Are Not Like Other Gatekeepers*, *in* Fuchita & Litan, FINANCIAL GATEKEEPERS, *supra* note 18, at 60 n.4, 69.

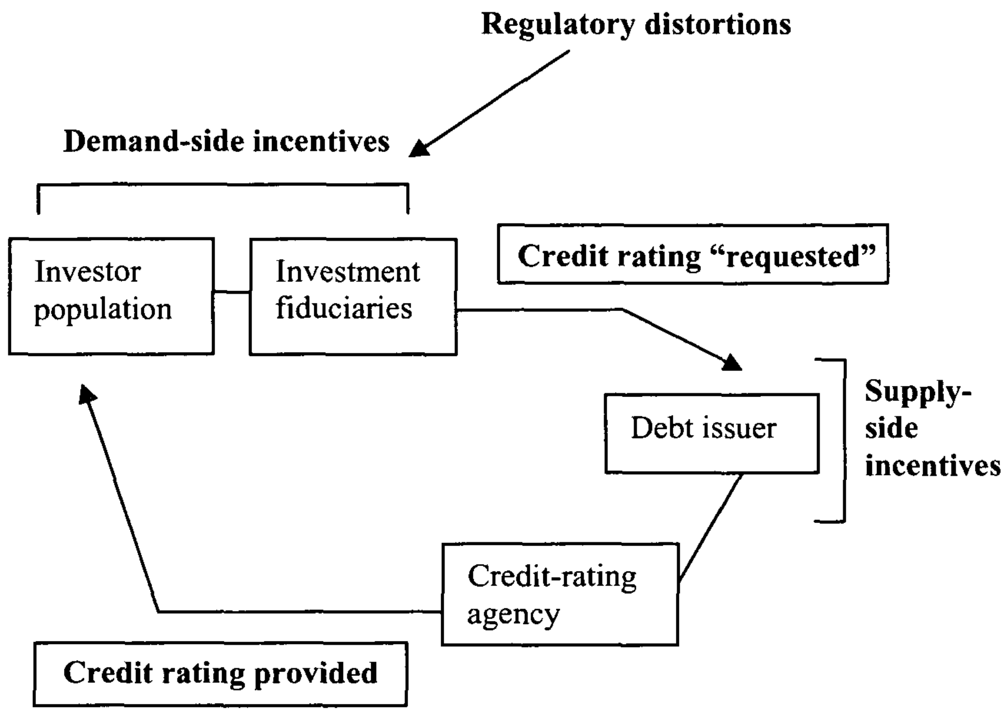
159. On the latter phenomenon, see James Kanter, *Europeans Plan to Investigate Ratings Agencies and Their Warnings*, N.Y. TIMES, Aug. 17, 2007.

160. For congressional reports, see *Rating the Raters: Enron and the Credit Rating Agencies, Hearing Before the S. Comm. on Governmental Affairs*, 107th Cong. 471 (2002) (statement of Prof. Jonathan R. Macey, Cornell Law School) (stating that credit ratings do not provide useful information to the market); SEC, REPORT ON THE ROLE AND FUNCTION OF CREDIT RATING AGENCIES IN THE OPERATION OF THE SECURITIES MARKETS 4 (2003) [hereinafter ROLE AND FUNCTION OF CREDIT RATING AGENCIES] (noting that, because credit rating agencies are subject to little regulation and liability is limited by regulatory exemptions and First Amendment protections, there is little penalty for poor performance), *available at* http://sec.gov/news/studies/creditratingreport0103/pdf.

161. *See* SENATE COMM. ON GOV'T AFFAIRS, FINANCIAL OVERSIGHT OF ENRON: THE SEC AND PRIVATE-SECTOR WATCHDOGS (2002) [hereinafter PRIVATE-SECTOR WATCHDOGS], *available at* http://hsgac.senate.gov/100702watchdogsreport.pdf.

institutional investors.)[162] Below I provide a graphical illustration of this proposed framework, which applies the two-sided incentive structure developed in the closing-opinion context while incorporating distorting external factors derived principally from applicable government regulation.

Figure 3: Credit Ratings–Proposed Incentive Structure



On the demand side, agency-cost pressures are strong insofar as a credit rating provides strong legal and reputational protection for the investment fiduciary—that is, the requesting agent—in the event it makes an "unsuccessful" investment choice.[163] As indicated in the Figure above, these demand-side incentives to conform to standard practice are then further exacerbated by several regulatory regimes mandating the use of credit ratings by fiduciaries and other actors for certain investment and regulatory purposes.[164] On the supply side, adverse selection pressures are powerful insofar as failure to deliver a strong credit rating is a formidable obstacle in widely marketing a debt offering transaction (and certainly results in a substantial pricing discount). Clearly a low credit rating catapults the issuer into the lower extremes of the issuer-quality spectrum, with potentially substantial pricing losses as a necessary result. Potentially illustrating this effect, it is reported that the Moody's rating agency was once accused of obtaining some issuers' business by issuing an unsolicited low rating, following which, given the

162. *See* COFFEE, GATEKEEPERS, *supra* note 5, at 295-97.

163. *See id.* at 287, 294.

164. These regimes generally require the use of credit ratings provided by entities that have received the SEC's "NRSRO" designation, which has currently only been assigned to a handful of firms. *See* PRIVATE-SECTOR WATCHDOGS, *supra* note 160, at 78-80; ROLE AND FUNCTION OF CREDIT RATING AGENCIES, *supra* note 160, at 6-10.

actual or potential harm to the offering price, the issuer typically agreed to fund the agency's rating process and provide it with access to company information.[165]

B. Fairness Opinions

A fairness opinion is usually issued by a financial advisor (typically, an investment bank) to a target or, less commonly, an acquirer corporation in a merger or acquisition transaction, and provides the adviser's view as to the "fairness from a financial point of view" of the proposed deal consideration, based on valuation methodologies selected by the adviser in its discretion. A "fair" price for purposes of a fairness opinion is understood to mean not the highest price obtainable, but rather a price within the range that a reasonable and prudent board would accept in similar circumstances.[166] The adviser who renders the opinion is usually the "deal adviser" to the corporation for the transaction generally, although increasingly an additional third party adviser is retained solely for the purpose of rendering an "independent" fairness opinion. Historically the opinion-related fees have been bundled together with the financial adviser's "success fee," payable at closing, with the opinion fee generally representing up to 10% of the sum of the total fees payable at closing (amounting to millions of dollars in any substantially sized transaction).[167] The academic literature,[168] the financial press,[169] some judges,[170] regulators, and portions of the institutional-investor community[171] have observed that the informational value of fairness opinions is limited in light of the adviser's conflict of interest resulting from the contingent fee structure, the unavoidably subjective and uncertain valuation methodologies,[172] and the abundant use of disclaimers and qualifying language (which, as in the closing-opinion context, limits the reliant audience to the

165. *See* COFFEE, GATEKEEPERS, *supra* note 5, at 294-96.

166. *See* Bebchuk & Kahan, *supra* note 24, at 30-34 (discussing the various definitions of fair price).

167. *See* Charles M. Elson et al., *Fairness Opinions—Can They Be Made Useful?*, 6 MERGERS & ACQUISITIONS L. REP. 924, 927-28 (2003). In recent practice, the fees are sometimes segregated from the "deal fee" and are payable independent of whether or not closing occurs.

168. *See, e.g.*, Bebchuk & Kahan, *supra* note 24, at 29 (noting that "investment banks can arrive at widely differing estimates of 'fair price,' all of which would be reasonable and none of which could be shown to be 'wrong' (or unfair) under objective criteria").

169. *See, e.g.*, Ann Davis & Monica Langley, *Open Secrets—Good Reviews: Opinions Labeling Deals 'Fair' Can Be Far From Independent*, WALL ST. J., Dec. 29, 2004, at A1.

170. *See* Elson et al., *supra* note 167 (noting that courts "have harshly criticized investment banks and/or counsel for poorly crafted fairness opinions").

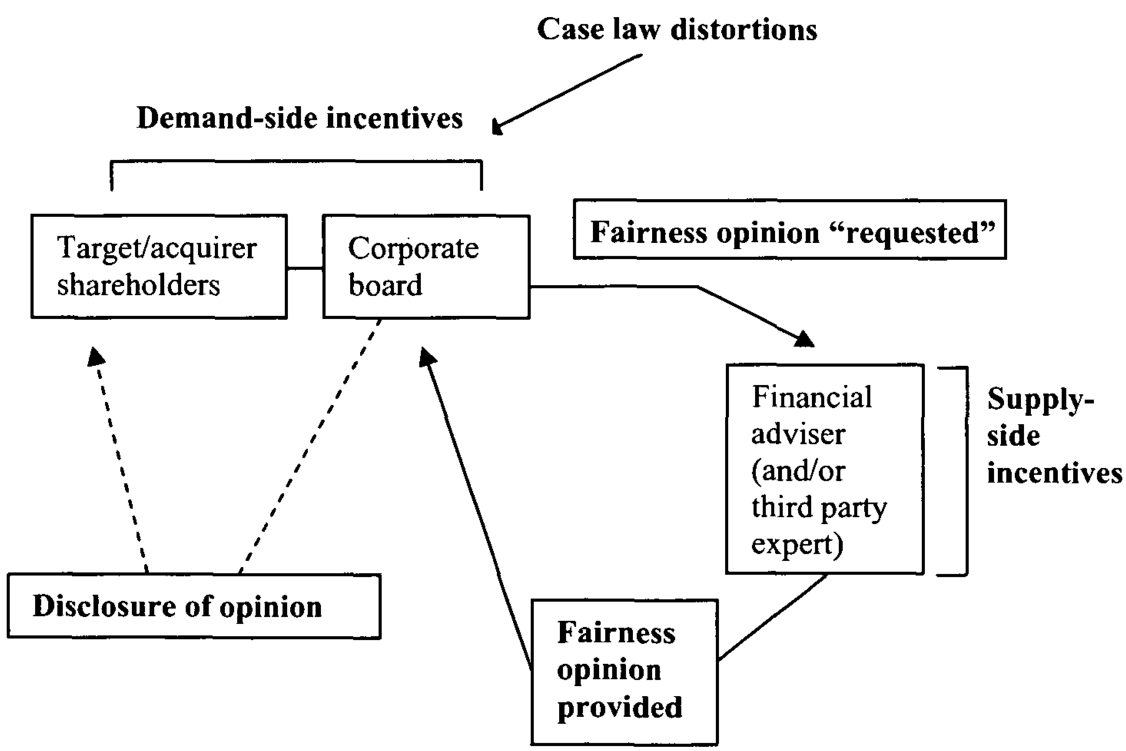
171. *See* Ann Davis, *Wall Street's 'Fairness Opinions' Draw Fire from Calpers*, WALL ST. J., Feb. 8, 2005, at C1 (noting that the largest U.S. pension fund takes the position that investment banks should be barred from delivering fairness opinions on acquisition transactions in which they act as the main adviser and that other large investors argue that NASD rules governing fairness opinions should be overhauled).

172. *See* Elson et al., *supra* note 167, at 1009-12 (noting that bankers are free to use a variety of valuation methods with the results sensitive to small changes in underlying assumptions). Other than the standard discounted cash flow ("DCF") analysis (which estimates the present value of the projected cash flows of a business), the investment banker has discretion to choose among a variety of other commonly employed methodologies to arrive at a fairness conclusion. Note that even the DCF analysis requires subjective judgment as to several potentially determinant variables, including the discount rate (the rate at which expected cash flows are discounted back to the present, taking into account investment risk, opportunity cost of capital, and expected returns, so that the higher the discount rate chosen, the lower the resulting valuation, and *vice versa*); adjustments to "EBITDA" (earnings before interest, taxes, depreciation, and amortization); the EBITDA growth rates used to determine projected cash flows; and the terminal value.

recipient board and disclaims independent verification of information supplied by the client).[173] As a result of these concerns, fairness opinions have received scrutiny from the New York State Attorney General's office, and subsequently the SEC, which has led to hesitant efforts since 2004 by the National Association of Securities Dealers ("NASD"), the self-regulatory body for brokerage firms, to propose certain new rules (principally, disclosure requirements).[174]

In the fairness opinion context, we again seem to encounter the strong "flavor" of a degenerate certification practice: widespread skepticism as to the practice's informational value coupled with widespread usage amid largely stalled regulatory efforts to make some corrections. As the Figure below illustrates, the two-sided incentive structure that may sustain closing opinion practice can be applied with modest customization to construct a closely analogous incentive structure that accounts for the potentially curious persistence of fairness opinions.

Figure 4: Fairness Opinions–Proposed Incentive Structure



173. For an example of this disclaimer "in action," see AOL Time Warner Inc. Sec. and ERISA Litig., 381 F. Supp. 2d 192 (S.D.N.Y. 2004) (rejecting claims that the investment bank was recklessly indifferent to the accuracy of the information on which its fairness opinion was based, on grounds that the investment bank disclosed that it was relying on information provided to it without independent verification of its accuracy or completeness).

174. The proposed rules would require NASD member firms, among other things, to give greater disclosure of any possible conflicts of interest, including compensation arrangements. *See* NASD, Form 19b-4, Proposed Change to Establish New NASD Rule 2290 Regarding Fairness Opinions, SR-NASD-2005-080 (proposed June 22, 2005); NASDAQ, Inc., Form 19b-4 Proposed Rule Change by National Association of Security Dealers, Inc. (June 22, 2005), *available at* http://www.finra.org/web/groups/rules_regs/documents/rule_filing/p014558.pdf.

Within this structure, a fairness opinion operates as a certification instrument that is requested by the corporate board, the requesting agent acting on behalf of its principal, the shareholders of the target (or, less commonly, the acquirer) corporation. The "twist" in this case (which requires some modification as shown above)[175] is that the certification is requested from and provided by the financial adviser who has been retained by the requesting party, rather than by the counterparty in the relevant transaction. Interestingly, this implies that the fairness opinion constitutes a certification instrument that operates to ameliorate an informational asymmetry—essentially, concerning whether the proposed consideration is "at or above market"—between the corporate board and its agent, the investment bank, which has self-interested incentives to consummate the transaction in light of the "all or nothing" contingent fee structure (i.e., the investment bank receives no compensation if the transaction does not close). On the demand-side, the board may obtain a typically formulated fairness opinion even if it is highly uncertain as to whether doing so yields substantial incremental information, so long as *not* doing so is anticipated to trigger a sufficient reputational penalty in the event of an adverse transactional outcome. These demand-side incentives are enhanced substantially by Delaware case law holding that failure by a target board to obtain a fairness opinion can be evidence of failure to satisfy its duty of care.[176] On the supply side, adverse selection pressures easily drive the requested party (i.e., the investment bank) to comply with standard practice insofar as failure to provide a fairness opinion is a near certain "deal breaker" in most acquisition transactions (again, due in part to the foregoing Delaware case law), which, as noted above, would typically result in a loss to the bank of virtually all fees payable in connection with the proposed transaction.

C. Contractual Boilerplate

As any corporate lawyer knows, business people (and sometimes lawyers, too) commonly lament the length of standard legal documentation used in sophisticated transactions, especially in U.S. legal practice, where business contracts are usually substantially longer than legal documentation used in other developed-country jurisdictions,[177] often casting doubt on whether some commonly included contractual clauses (often derided as mere "boilerplate") are "absolutely necessary."[178] In economic terms, these doubts (which recall the frustrations expressed by some legal and industry practitioners with respect to apparently "unnecessary" closing opinions) may be reformulated as uncertainty as to whether or not the contracting costs expended on some

175. As shown in Figure 4, the incentive structure is also modified to reflect the fact that the corporate board (i.e., the requesting agent) only delivers the certification instrument "in part" (hence, the dashed lines) to the firm shareholders (i.e., the requesting principal). In the standard case of a negotiated acquisition of a public company, the fairness opinion analysis is summarized in the proxy solicitation materials sent to target shareholders and the fairness opinion letter (but not the internal presentation containing the bank's detailed financial analysis) is included as an exhibit.

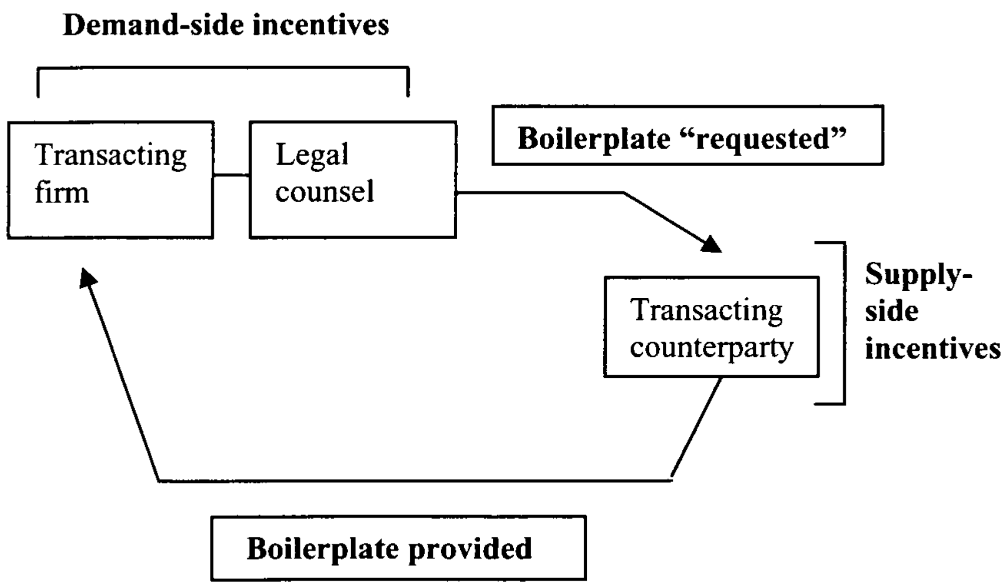
176. Smith v. Van Gorkom, 488 A.2d 858, 877-78 (Del. 1985).

177. Thomas Lundmark, *Verbose Contracts*, 49 AM. J. COMP. L. 121, 121 (2001).

178. There has recently been a flowering of scholarship on contractual boilerplate, to which Part V.C is merely a preliminary contribution. For a recent collection, see Robert B. Ahdieh, *Boilerplate: Foundations of Market Contracts Symposium*, 104 MICH. L. REV. 1033 (2006).

standard provisions generate at least commensurate benefits in the form of incremental assurance value. While the reasons for the potentially excessive length of sophisticated deal documentation remain unclear (in addition to whether any of this deal documentation is in fact non-cost-justified taking all relevant factors into account), the interaction between agency-cost and adverse-selection effects proposed in this Article may shed some light. As illustrated in Figure 5 below, "excessive" contractual boilerplate—let's say, a representation that has minimal incremental assurance value in light of other contractual provisions and implied legal protections—can be viewed as a certification instrument that is requested in the course of business negotiations by an attorney acting on behalf of its principal, a transacting party; the requested certification is then agreed to by the counterparty's attorney acting on behalf of the transacting counterparty.[179]

Figure 5: Contractual Boilerplate—Proposed Incentive Structure



A simple example from corporate law practice can illuminate this structure. Sophisticated business agreements commonly include a clause whereby each party covenants to act in good faith in rendering performance of its contractual obligations. But it should be widely known among even not-so-sophisticated business attorneys that the duty of good faith generally is implied in every contract and, moreover, cannot even be expressly waived.[180] Thus, at most, reiterating the good faith obligation is a legally redundant exercise that may have some speculative rhetorical value in any subsequent litigation; if that is the case, then the contracting resources devoted to negotiating and drafting this clause may well be a net loss.[181] The two-sided incentive structure can

179. Note that application of this structure to the boilerplate context requires modification to reflect the fact that the contractual certification is provided directly by the counterparty, as agreed to by counsel acting as its agent.

180. RESTATEMENT (SECOND) OF CONTRACTS § 205 (1981).

181. I note that in some transactions, sophisticated parties expressly negotiate for a "reasonable best

account for the otherwise curious persistence of contractual redundancies. On the requesting side, reputational pressures drive the requesting attorney to conform to standard practice by insisting on inclusion of the "unnecessary" clause; hence, corporate lawyers' frequent reference to "market standard" (rather than any "stand-alone" substantive rationale) in negotiating deal terms constitutes a rational strategy in light of anticipated exposure to reputational losses in the case of erroneous deviations (and, for reasons discussed above, minimal reputational gains in the case of a "successful" deviation). On the requested side, the prospect of a disproportionate quality discount (to reflect the understandable risk of contracting with a counterparty who unusually refuses to represent that it will act in good faith) then drives the requested attorney almost always to accede to the request. The result: "excessively" lengthy contractual documentation persists because no participant (or, at least, no individual agent) has any rational incentive to deviate unilaterally from an entrenched drafting convention, in each case independently of any individual participant's uncertainty as to whether the relevant convention is cost-justified from a social point of view.

VI. CONCLUSION

Given the obvious importance of certification intermediaries to the efficient operation of the financial markets and the responsible design of appropriate regulatory interventions, our understanding of the circumstances under which certification intermediaries are or are not likely to remedy informational asymmetries at a net social gain is surprisingly still in its relative infancy.[182] Reflexive application of the certification thesis makes things simple: repeat-player intermediaries are presumptively an effective market-generated mechanism for resolving informational asymmetries that may otherwise frustrate or distort efficient transactions. But this easy presumption is *too* simple: it does not adequately describe an economically important category of certification practices that are widely used at positive resource cost but do not clearly appear to alleviate informational asymmetries. This apparent discrepancy raises a puzzle: why would non-cost-justified certification practices persist in a sophisticated market? This Article's degenerate certification model provides a potential solution: reciprocal demand-side and supply-side incentives drive market participants rationally to request and deliver a minimally informative certification instrument, even in the presence of widespread uncertainty as to whether doing so is always or usually cost-justified. This perverse outcome extends the growing taxonomy of "certification pathologies" assembled by legal scholars who have recently revisited the certification (or "reputational intermediary") thesis, in the process identifying certain aggravating market-specific conditions (most notably, conflicts of interest, differential sophistication, and market concentration) that may cause certification intermediaries to fail to screen out fraudulent and similar practices.[183] Importantly, the "pathological" outcome proposed in this Article does not rely on any of the conventionally mentioned aggravating conditions (in particular, it drops the assumption that certification recipients are unsophisticated), and,

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efforts" or "best efforts" obligation that probably goes beyond the implied good faith duty. That of course would be a case of a non-redundant provision.

182. For similar views, see Riley, *supra* note 14, and Jin et al., *supra* note 20.

183. *See supra* notes 17-18 and accompanying text.

as a result, it potentially covers an additional range of sophisticated market settings where value-depleting certification practices might persist over a substantial period of time. Contrary to standard expectations, even routinely employed certification practices may convey little new information to contracting parties, thereby doing nothing more on a net social basis than imposing a costly "drag" on market transactions.

APPENDIX

Identified Federal and State Court Decisions (1986-2006) in Litigations Against Attorneys Involving "Closing Opinions" in Loan or Acquisition Transactions

Case	**Relevant Action**
Mega Group, Inc. v. Pechenik & Curro, P.C., 819 N.Y.S.2d 796 (N.Y. App. Div. 2006)	Granted summary judgment for defendant law firm with respect to negligence claim concerning opinion letter.
Distinctive Home Builders, LLC v. Copar Constr., LLC, No. CV054019423S, 2006 WL 2556138 (Conn. Super. Ct. Aug. 6, 2006)	Denied motion to strike complaint against defendant attorney, on ground that attorney owes a duty of care to a nonclient when attorney invites the nonclient to rely on its legal opinion.
First Mass. Bank, N.A. v. Florian, No. 03-P-1139, 2005 WL 820536 (Mass. App. Ct. Apr. 8, 2005) (unpublished opinion)	Reversed summary judgment for defendant law firm, given outstanding disputed issues of material fact concerning whether defendant exercised reasonable care in issuing opinion letter.
Conn. Res. Recovery Auth. v. Murtha Cullina, LLP, No. X02CV0201745695, 2005 WL 3291920 (Conn. Super. Ct. Oct. 31, 2005)	Granted summary judgment for defendant law firm, on ground that the law firm's opinion addressed only the enforceability of its client's obligations and not the entire transaction.
Banco Popular N. Am. v. Gandi, 876 A.2d 253 (N.J. 2005)	Denied summary judgment for defendant law firm with respect to negligent misrepresentation claim concerning opinion letter issued to bank.
Keybank Nat'l Ass'n v. Reidbord, No. Civ. A. 05-144, 2005 WL 3184781 (W.D. Pa. Nov. 29, 2005)	Dismissed legal malpractice and fraud claims against attorney who rendered opinion letter, due to inability to show damages.
Finova Capital Corp. v. Berger, 794 N.Y.S.2d 379 (N.Y. App. Div. 2005)	Dismissed legal malpractice claim because plaintiff failed to show the opinion letter was the proximate cause of incurred damages.

Case	Relevant Action
Dean Foods Co. v. Pappathanasi, No. Civ. A. 01-2595 BLS, 2004 WL 3019442 (Mass. Super. Ct. Dec. 3, 2004)	Found law firm liable for negligent misrepresentation in connection with opinion letter, on ground that it failed to conduct factual inquiry following customary practice.
Nat'l Bank of Can. v. Hale & Dorr, No. 2000000296, 2004 WL 1049072 (Mass. Super. Ct. Apr. 28, 2004)	Upheld and denied in part summary judgment for defendant law firm with respect to negligent misrepresentation and other claims concerning erroneous "no-litigation" opinion.
Marcus v. Frome, 329 F. Supp. 2d 464 (S.D.N.Y. 2004)	Denied motion for summary judgment for defendant attorney with respect to fraud claims concerning "no-conflicts" opinion letter that allegedly contained material misrepresentation.
In re Precept Bus. Serv., No. 01-31351-SAF-7, 04-3216, 2004 WL 2074169 (Bankr. N.D. Tex. Aug. 23, 2004)	Granted summary judgment for defendant law firm with respect to negligent misrepresentation claim concerning opinion letter.
Reich Family LP v. McDermott, Will & Emery, No. 101921-03 (N.Y. Sup. Ct. Oct. 29, 2003)	Denied summary judgment for defendant attorney on ground that, even absent privity, a third party can assert a negligence claim against an opining attorney if the attorney is aware that the opinion letter is to be used for a specific purpose.
Republic First Bank v. Abrahams, Lowenstein & Bushman, P.C., No. 00409, 2003 WL 23812027 (Pa. Commw. Ct. May 1, 2003)	Denied summary judgment for defendant law firm due to outstanding genuine issues of material fact.
Goldfine v. DeEsso, 309 A.D.2d 895 (N.Y. App. Div. 2003)	Upheld summary judgment for defendant law firm with respect to negligent misrepresentation claim concerning allegedly false opinion letters, on ground of lack of privity, but denied summary judgment with respect to fraud claims concerning failure to disclose material information to plaintiff.

Case	Relevant Action
Zimmerman v. Dan Kamphausen Co., 971 P.2d 236 (Colo. Ct. App. 1998)	Reversed summary judgment for defendant law firm with respect to negligent misrepresentation claim concerning opinion letter, on ground that there exist genuine issues of material fact, but upholding summary judgment for defendant law firm with respect to general negligence claim.
Mark Twain Kan. City Bank v. Jackson, Brouilletee, Pohl & Kirley, P.C., 912 S.W.2d 536 (Mo. Ct. App. 1995)	Upheld summary judgment for defendant law firm, on ground that sophisticated lender could not justifiably rely on an opinion letter that contained disclaimer.
Wash. Elec. Coop. v. Mass. Mun. Wholesale Elec. Co., 894 F. Supp. 777 (D. Vt. 1994)	Upheld summary judgment for defendant law firms who included qualification for judicial discretion in enforceability opinions but denied summary judgment for law firm who did not include this qualification.
Resolution Trust Corp. v. Farmer, 836 F. Supp. 1123 (E.D. Pa. 1993)	Denied summary judgment for defendant law firm with respect to fraud claim concerning opinion letter.
Scientific Leasing, Inc. v. Windle, No. 05-92-00469-CV, 1993 WL 25336 (Tex. App. Feb. 4, 1993) (unpublished opinion)	Upheld summary judgment for defendant law firm with respect to professional malpractice claim concerning opinion letter, given lack of privity, but reversed summary judgment for defendant law firm with respect to negligence and negligent misrepresentation claims.
Geaslen v. Berkson, Gorov & Levin, Ltd., 613 N.E.2d 702 (Ill. 1993)	Reversed summary judgment for defendant law firm who issued opinion letter, on ground that plaintiff must be given opportunity to allege breach of duty of care.
Prudential Ins. Co. v. Dewey, Ballantine, Bushby, Palmer & Wood, 605 N.E.2d 318 (N.Y. 1992)	Found no liability for opining law firm, on ground that, although relationship between law firm and third party recipient was sufficiently close to support negligence liability, assertions in law firm's opinion letter did not cause third party's loss.
Cambridge Factors v. Sturges & Mathes, No. 107418, 1992 WL 174744 (Conn. Super. Ct. July 15, 1992) (unpublished opinion)	Denied motion to strike claim of negligent misrepresentation on ground that law firm can be liable to third party for negligent misrepresentation in connection with opinion letter.

Case	Relevant Action
Stock W. Corp. v. Taylor, 942 F.2d 655 (9th Cir. 1991)	Denied summary judgment for defendant (Indian reservation attorney) with respect to negligent misrepresentation claim concerning opinion letter, on ground that deference to tribal court jurisdiction was not required and exercise of jurisdiction over attorney under Oregon's long-arm statute was proper.
Terremar, Inc. v. Ginsburg & Ginsburg, No. 29 43 21, 1991 WL 57815 (Conn. Super. Ct. Apr. 5, 1991)	Denied defendant law firm's motion to strike complaint, on ground that an attorney or law firm could be liable to a third party for negligent misrepresentation in issuing opinion letters.
Gibraltar Sav. v. Commonwealth Land Title Ins. Co. v. Popham, Haik, Schnobrich, Kaufman & Doty, Ltd., 907 F.2d 844 (8th Cir. 1990)	Upheld summary judgment for defendant law firm, on ground that there was no chain of proximate causation between law firm's alleged negligence in rendering legal opinion and litigation expenses subsequently incurred by plaintiff title insurer.
United Bank of Kuwait PLC v. Enventure Energy Enhanced Oil Recovery Assocs., 755 F. Supp. 1195 (S.D.N.Y. 1989)	Granted summary judgment for defendant law firm, on ground that absence of privity precluded attorney from being held liable to third party recipient of opinion, where third party, rather than client, instructed attorney to prepare letter.
JST Props. v. First Nat'l Bank, 701 F. Supp. 1443 (D. Minn. 1988)	Noted previous summary judgment for third party defendant law firm that issued "no-violations" opinion letter in connection with disputed transaction, in part on ground that opinion was technically correct.
Crossland Sav. FSB v. Rockwood Ins. Co., 700 F. Supp. 1274 (S.D.N.Y. 1988)	Denied defendant law firm's motion for partial summary judgment, on ground that law firm assumed duty to surety, solely in the surety's capacity as subrogee of Crossland (assignee of financing entity to which opinion letter was addressed), if it is found that law firm was instructed by its client to prepare opinion for the benefit of third party and its assignee.

Case	**Relevant Action**
Crossland Sav. FSB v. Rockwood Ins. Co., 692 F. Supp. 1510 (S.D.N.Y. 1988)	Granted partial summary judgment for law firm that issued opinion letter, on ground that, absent privity, law firm could not be liable to third party surety that was not addressee of the opinion, even if it relied on it.
Vereins-Und Westbank v. Carter, 691 F. Supp. 704 (S.D.N.Y. 1988)	Denied summary judgment for law firm on ground that, under *Ultramares* doctrine, law firm could be held liable in connection with opinion letters issued to third party nonclients, especially where letters are prepared at client's request for benefit of nonclient.
City Nat'l Bank of Detroit v. Rodgers & Morgenstein, 399 N.W.2d 505 (Mich. Ct. App. 1986)	Upheld summary judgment for defendant law firm because defendant's legal opinion was a statement of opinion, not fact, and further finding that bank's reliance on legal opinion was unjustifiable in light of bank's own counsel's ability to determine relevant issue.