

**DEGENERATE CERTIFICATION:
THE OPINION PUZZLE AND OTHER TRANSACTIONAL CURIOSITIES**

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ABSTRACT

The law-and-economics literature generally (but not uniformly) depicts certification intermediaries, such as law firms, accountants, underwriters, investment banks, rating agencies, and other third-party professionals, as socially valuable market participants who ameliorate informational asymmetries that would otherwise distort pricing or transaction structures. This standard view is incomplete. Using the example of the “closing opinion”, a third-party legal opinion commonly delivered at the consummation of a variety of business transactions, I argue that intermediaries, even when operating under substantially competitive conditions and in sophisticated market settings, may consistently supply certification products that fail to mitigate informational asymmetries while increasing transaction costs. Based primarily on the highly qualified language used in closing opinions, an opining firm’s limited legal and reputational liability exposure (shown in part through a detailed survey of relevant case-law over the past 20 years), the availability of more robust diligence mechanisms and other factors, there is substantial doubt as to whether closing opinions convey any significant incremental informational value. Nonetheless the widespread use of closing opinions persists. To account for this potential anomaly (and, by extension, other potentially anomalous certification mechanisms in sophisticated market settings), I use a simple formal model to construct a two-sided incentive structure whereby: (i) demand is sustained by an agency cost effect as a result of which “requesting agents” obtain a minimally informative but entrenched certification product in order to mitigate any reputational penalty in the event of an adverse transactional outcome, and (ii) supply is sustained by an adverse selection effect as a result of which “requested parties” provide a minimally informative but entrenched certification instrument in order to avoid triggering a substantial transaction discount. On the basis of this structure, I then describe how the market may ultimately cure a non-cost-justified (or “degenerate”) certification practice through the actions of “lead” participants who anticipate unusual reputational gains by deviating from inefficient industry convention. Finally, I show how the two-sided incentive structure developed in the closing-opinion context can be tailored and applied to account preliminarily for the curious persistence of other commonly questioned certification practices in the financial markets.

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Financial markets are populated by a host of reputable intermediaries, including law firms, auditors, underwriters, investment banks, venture capitalists and credit rating agencies, that provide various stamps of approval attesting to costly-to-verify characteristics of the relevant asset. The law-and-economics literature has typically (but not uniformly) observed that these “certification intermediaries”¹ 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.² While this “happy” efficiency story has found empirical support in some market settings, it has largely gone unrecognized that this is not the case with respect to certain commonly used certification instruments in the financial and other markets, where attempts to assess the informational value of these instruments have often reached inconclusive or even contrary results.³ Nor, as *has* been increasingly recognized in the wake of Enron and other contemporary scandals (including by some of its original exponents⁴),

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¹ A related term is “gatekeepers”, which generally designates a subset of “certification intermediaries” whose approval is required for entry into a particular market. For discussion of the relevant terminology, see JOHN C. COFFEE, JR., *GATEKEEPERS* 2-3 (2005).

² *See infra* Part I.A.

³ *See infra* Part I.B.

⁴ *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 Arthur Andersen scandal, reputational pressures and even stiff regulatory penalties apparently are insufficient to restrain fraudulent auditor behavior).

does this unqualified “certification thesis”⁵ sit comfortably with the historical and recent recurrence of fraudulent and similar conduct even in sophisticated business environments monitored by prestigious intermediaries.⁶

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. As described further below, I identify a set of reciprocal “demand-side” and “supply-side” incentives that drive transacting parties to use entrenched but minimally informative certification products that fail to mitigate informational asymmetries while imposing positive resource costs. This two-sided incentive structure shows how non-cost-justified certification products rationally persist even in sophisticated markets, thereby imposing a levy on business transactions without generating commensurate social 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, almost nothing *new*). Contrary to the standard account (and without assuming any of the “usual suspects” behind market failure, as described further below), even degenerate bonding practices that generally do little to facilitate efficient transactions may rationally persist in a sophisticated market over a substantial period, with attendant social losses as a result. Hence it is not necessarily puzzling to observe that accepted certification practices fail to generate

⁵ 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).

⁶ For discussions of the implications of Enron and other recent scandals for what I call the certification thesis, see COFFEE, *supra* note __; John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U. L. REV. 301 (2004) [hereinafter Coffee, *Gatekeeper Failure*]; John C. Coffee, Jr., *Understanding Enron: “It’s About the Gatekeepers, Stupid”*, 57 BUS. LAW. 1403 (2002) [hereinafter Coffee, *Understanding Enron*]; Frank Partnoy, *Barbarians at the Gatekeepers? A Proposal for a Modified Strict Liability Regime*, 79 WASH. U. L. Q. 491 (2001) [hereinafter Partnoy, *Barbarians*].

substantial informational value or that a gold-plated array of certification intermediaries fails to screen out recurrent 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 exchanged 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 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” market⁷, (2) depending on market definition, there are at least tens and probably hundreds of actual and potential certification providers (i.e., corporate law firms), 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.⁸ Following the standard certification thesis, most of the limited academic literature⁹ and some, but not all, of the

⁷ A “credence good” market is a market where (i) sellers are more sophisticated than buyers and (ii) 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).

⁸ These potentially distorting factors are however not entirely absent in the closing-opinion setting. For further discussion, see *infra* Part IV.D.

⁹ For the only other dedicated scholarly treatment of closing opinions, see Jonathan C. Lipson, *Price, Path and Pride: Third-Party Closing Opinion Practice Among U.S. Lawyers (A Preliminary Investigation)*, 3 BERKELEY BUS. L. J. 59 (2005). For additional relevant discussion, see Steven L. Schwarcz, *To Make or To Buy: In-House Lawyering and Value Creation* (Oct. 2006), avail. at www.ssrn.com [hereinafter Schwarcz, *To Make or To Buy*]; Karl S. Okamoto, *Reputation and the Value of Lawyers*, 74 OR. L. REV. 15 (1995); Ronald Gilson, *Value Creation by Business Lawyers: Legal Skills and Asset Pricing*, 94 YALE L. J. 239 (1984) [hereinafter Gilson, *Value Creation*]. Two previous law review symposia dedicated in part to legal opinions contain helpful contributions from scholars and practitioners: a Spring 1995 edition of the Oregon Law Review and a 1989 edition of the Columbia Business Law Review. Additionally, a number of publications have recently appeared relating specifically to legal opinions

voluminous practitioner literature¹⁰ teaches that a closing opinion provides meaningful assurance from a trustworthy intermediary as to various fundamental matters that I group under the rubric

in structured-finance transactions. See Steven L. Schwarcz, *The Limits of Lawyering: Legal Opinions in Structured Finance*, 84 TEXAS L. REV. 1 (2005) [hereinafter Schwarcz, *Limits of Lawyering*]; Jonathan Macey, *The Limits of Legal Analysis: Using Externalities to Explain Legal Opinions in Structured Finance*, 84 TEX. L. REV. 75, 76 (2005); John C. Coffee, Jr., *Comment: Can Lawyers Wear Blinders? Gatekeepers and Third-Party Opinions*, 84 TEX. L. REV. 59 (2005) [hereinafter Coffee, *Comment*]; 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 Schwarcz, *Same Thing*].

¹⁰ The leading legal opinion treatise is: DONALD W. GLAZER ET AL., *GLAZER & FITZGIBBON ON LEGAL OPINIONS: DRAFTING, INTERPRETING AND SUPPORTING CLOSING OPINIONS IN BUSINESS TRANSACTIONS* (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 the New York City, New York County and New York State bar associations and now including representatives from bar associations in other major metropolitan areas, has produced various reports, including: TRIBAR OPINION COMMITTEE, *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*], reprinted in GLAZER ET AL., *supra* note __, at App. 4A; TRIBAR OPINION COMMITTEE, *Third-Party “Closing” Opinions: A Report of the TriBar Opinion Committee*, 53 BUS. LAW. 591 (1998) [hereinafter, *1998 TRIBAR REPORT*], reprinted in GLAZER ET AL., *supra* note __, at App. 4A; TRIBAR OPINION COMMITTEE, *Special Report of the TriBar Opinion Committee: The Remedies Opinion*, 46 BUS. LAW. 959 (1991) [hereinafter, *TriBar Remedies Opinion*]; TRIBAR OPINION COMMITTEE, *Second Addendum to Legal Opinions to Third Parties: An Easier Path*, 44 BUS. LAW. 563 (1989); TRIBAR OPINION COMMITTEE, *An Addendum – Legal Opinions to Third Parties: An Easier Path*, 36 BUS. LAW. 429 (1981); TRIBAR OPINION COMMITTEE, *Third-Party “Closing” Opinions: A Report of the TriBar Opinion Committee*, 34 BUS. LAW. 1891 (1979). The ABA has also issued several releases pertaining to legal opinions. See AMERICAN BAR ASSOCIATION SECTION OF BUSINESS LAW, COMMITTEE ON LEGAL OPINIONS AND THE TRIBAR OPINION COMMITTEE, *THE COLLECTED ABA AND TRIBAR OPINION REPORTS* (2005) (which usefully includes all of the recent ABA and TriBar Committee reports on legal opinions); AMERICAN BAR ASSOCIATION, SECTION OF BUSINESS LAW, COMMITTEE ON LEGAL OPINIONS, *Third-Party Legal Opinion Report, Including the Legal Opinion Accord*, 47 BUS. LAW. 167 (1991), reprinted in PRACTICING LAW INSTITUTE, *LEGAL OPINIONS: THE IMPACT OF THE TRIBAR COMMITTEE’S NEW REPORT ON LEGAL OPINION PRACTICE 177-186* (1998) [hereinafter, *ABA Legal Opinion Accord*]; AMERICAN BAR ASSOCIATION, SECTION OF BUSINESS LAW, COMMITTEE ON LEGAL OPINIONS, *Legal Opinion Principles*, reprinted in GLAZER ET AL., *supra* note __, at App. 3 [hereinafter, *ABA Legal Opinion Principles*]; AMERICAN BAR ASSOCIATION, SECTION OF BUSINESS LAW, COMMITTEE ON LEGAL OPINIONS, *Report: 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 CMTE. OF THE CALIFORNIA STATE BAR BUSINESS LAW SECTION, *Toward a National Legal Opinion Practice: The California Remedies Opinion Report*, 60 BUS. LAW. 907 (2005) [hereinafter *California Remedies Opinion Report*]; THE CORPORATIONS COMMITTEE OF THE BUSINESS LAW SECTION OF THE STATE BAR OF CALIFORNIA, *Legal Opinions in Business Transactions (Excluding the Remedies Opinion) (Exposure Draft)* (Jan. 28, 2005), avail. at www.calbar.ca.gov [hereinafter, *2005 CALIFORNIA BAR REPORT*]; THE STATE BAR OF CALIFORNIA BUSINESS LAW SECTION, *REPORT ON THIRD-PARTY REMEDIES OPINIONS* (Sept. 2004), reprinted in GLAZER ET AL., *supra* note __, at App 9A [hereinafter, *2004 CALIFORNIA BAR REPORT*], also avail. at www.calbar.ca.gov; THE STATE BAR OF CALIFORNIA, *1989 Report of the Committee on Corporations of the Business Law Section of the State Bar of California Regarding Legal Opinions in Business Transactions*, 45 BUS. LAWYER 2169 (1990), reprinted in GLAZER ET AL., *supra* note __, at App. 9 [hereinafter, *CALIFORNIA BAR REPORT*]; STATE BAR OF TEXAS, BUSINESS LAW SECTION, *REPORT OF THE LEGAL OPINIONS COMMITTEE REGARDING LEGAL OPINIONS IN BUSINESS TRANSACTIONS* (1991), reprinted in GLAZER ET AL., *supra* note __, at App. 21 [hereinafter, *TEXAS BAR REPORT*]; and REPORT OF THE AD HOC CMTE. OF THE BUSINESS LAW SECTION OF THE STATE BAR OF MICHIGAN ON STANDARDIZED LEGAL OPINIONS IN BUSINESS TRANSACTIONS, reprinted in GLAZER ET AL., *supra* note __, at App. 17 [hereinafter, *MICHIGAN BAR REPORT*]. This is by no means a complete list of all relevant bar association reports and publications.

of “contracting quality”, which includes most notably the enforceability of the contractual obligations being undertaken by the firm’s client.¹¹ Contrary to this position, however, many legal practitioners (including most recently, the Business Law Section of the California Bar) and other industry participants view at least some closing opinions as a costly distraction leading to no appreciable value-enhancing result.¹² A close examination of closing opinion practice provides strong (albeit, not unequivocal) support for this alternative view, revealing multiple factors that substantially impede any meaningful certification function, including most notably: the highly qualified language used in closing opinions, an opining firm’s minimal legal and reputational liability exposure (as shown in part through a comprehensive survey of relevant case-law over the past 35 years), conflicts of interest and constrained screening technologies, and the common availability of more robust diligence mechanisms. Taken together, these factors cast serious doubt whether a closing opinion 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 for purposes of further analysis that, based on available information, a closing opinion usually fails to offer substantial incremental informational value, and assuming further that any residual incremental informational value usually does not exceed the costs of preparing and negotiating the opinion, why does this entrenched practice persist in a sophisticated market across broad categories of transactional settings? As a solution to this emergent “opinion puzzle” (and, by extension, other entrenched and structurally analogous certification practices whose cost-effectiveness stands in doubt), I propose a two-sided incentive structure, which is illustrated through a simple formal model as follows: (i) demand is sustained by an agency-cost

¹¹ See *infra* Part II.A.

¹² See *infra* Part I.B.

mechanism as a result of which “requesting parties” request a non-cost-justified certification instrument in order to mitigate the reputational penalty for perceived incompetence in the event of an adverse transactional outcome, and (ii) supply is sustained by an adverse selection mechanism as a result of which “requested parties” provide the same instrument 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 underlying 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 punitive quality discount up to and including failure to consummate the proposed transaction.

This incentive structure shows how a competitive market rationally overinvests in certification practices that generate nontrivial costs without at least commensurate benefits in the form of substantial incremental information. While developed within the closing-opinion context, this incentive structure is formulated generically and, as I show preliminarily with respect to credit ratings in the debt markets and fairness opinions in the corporate acquisitions market, offers a diagnostic tool for identifying and accounting for other widely used certification practices whose informational value is frequently questioned. But this is not to say that any such adverse market outcome necessarily demands an aggressive, or even any, regulatory remedy. The relevant market may ultimately cure a degenerate certification practice 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 practice. This self-curative outcome finds support in several recent and historical contractions in the use of closing opinions and certain other legal opinions. However, where legal distortions, trade associations,

entry barriers or other market imperfections increase the costs of deviating from an entrenched convention and thereby delay any self-curative outcome, remedial governmental intervention may be appropriate.

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 closely examine closing opinion practice, with special attention paid to the legal and reputational exposure typically assumed by opining attorneys. In Part III, I use a simple formal model to present the aforementioned incentive structure as a possible solution to the emergent opinion puzzle. In Part IV, I assess the capacity of the legal market (and by implication, other certification markets) independently to correct a degenerate bonding convention. In Part V, I explore applications of the proposed incentive structure to other potentially degenerate certification practices in the financial markets.

I. *The Certification Thesis Revisited.* In this Part, I describe the standard certification thesis, as it typically has been presented and applied in the law-and-economics (and *some* of the associated economics) 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, empirical attempts to validate these models in core transactional settings often reach surprisingly mixed results.

A. *Theory.* It is well known that informational asymmetries can frustrate the execution, or at least distort the pricing or other terms, of efficient transactions where one party finds it too costly to credibly convey private information to the potential counterparty. It is also well known that sellers sometimes overcome these informational asymmetries by recourse to trustworthy third parties and other proxy instruments that can credibly demonstrate the quality of the relevant asset (or more precisely, can do so at a lower cost than the seller).¹³ Crucially, the ability of any certification instrument to mitigate informational asymmetries depends on the extent to which the higher-quality seller thereby incurs a cost that a lower-quality seller cannot bear (presumably because it will not be able to recoup the cost of the bond 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 a premium and remain in the market. Certification proxies that meet this condition generate efficiency benefits by overcoming informational asymmetries that could prevent the execution of, or distort the pricing or other terms of, mutually beneficial exchanges.

Legal scholars have widely cited this certification thesis as an efficiency explanation for the role of attorneys, auditors, underwriters, investment bankers and other costly intermediaries that commonly accompany sophisticated business transactions.¹⁴ These discussions, however, rarely make any reference to a well-developed body of economic research that identifies multiple

¹³ For the leading source, see Michael Spence, *Job Market Signaling*, 87 Q. J. ECON. 355 (1973).

¹⁴ See COFFEE, *supra* note __, at 2-3 (describing general assumption that financial market gatekeepers act as reputational intermediaries); Partnoy, *Barbarians*, *supra* note __, at 546 (same); John C. Coffee, Jr., *The Acquiescent Gatekeeper: Reputational Intermediaries, Auditor Independence, and the Governance of Accounting*, WORKING PAPER NO. 191, COLUMBIA CENTER FOR LAW & ECONOMICS STUDIES 7 (May 2001), available at www.ssrn.com [hereinafter Coffee, *The Acquiescent Gatekeeper*] (same). For specific examples, see Gilson, *Value Creation*, *supra* note __, at 290-91 (arguing that lawyers act as “reputational intermediaries” and that an effective reputational intermediary will emit a credible quality signal because it 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 in a reputational penalty).

conditions for *inefficient* outcomes in signaling markets generally and certification markets in particular.¹⁵ A somewhat skewed intellectual genealogy seems to exist: while the law-and-economics literature widely cites economist 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 cites Spence's other (and, in his work, arguably more central) proposition that signaling opportunities can generate efficiency *losses* by inducing dissipative signaling investments that redistribute existing resources without generating any commensurate productivity or other social gains.¹⁶ 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.¹⁷ And in the post-Enron period, several scholars have identified other (often market-specific or regulatory-specific) conditions where the

¹⁵ 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 [22].

¹⁶ A preliminary survey of the Westlaw "Journals & Law Review" database generates 167 references to "Spence" and "signal" in the same sentence, of which only 2 appear to refer to Spence's inefficiency result. For a brief discussion of this result (which is certainly not without infirmities), see *infra* note [].

¹⁷ 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 emphasizes the inherent limitations of certification intermediaries, see Stephen Choi & Jill E. Fisch, *How to Fix Wall Street: A Voucher Financing Proposal*, __ Yale L. J. __ (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) (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 Bernardo Bortolotti & Gianluca Fiorentini (eds.), ORGANIZED INTERESTS AND SELF-REGULATION: AN ECONOMIC APPROACH (1999); Gian Luigi Albano & Alessandro Lizzeri, *Strategic Certification and Provision of Quality*, 42 INT'L ECON. REV. 267 (2001).

reputational constraints of third-party intermediaries may fail to generate the efficient outcome anticipated by the standard certification thesis¹⁸, including conflicts of interest, limited screening and monitoring capacities, differential sophistication, entry barriers and cyclical demand for certification services.¹⁹ Nonetheless the predominant tenor of the relevant mainstream legal literature historically counsels confidence in the net social value of certification intermediaries, who are generally presumed to alleviate informational obstacles that may otherwise distort or even impede efficient market transactions. Moving from theory to practice, some courts have even adopted this generous approach to certification intermediaries in reaching judicial outcomes; 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.²⁰ In the wake of Arthur Andersen's fall from grace and Enron's subsequent implosion, this otherwise cogent (and widely applied) logic would seem to have some serious practical limitations.

B. *Evidence.* Even if the certification thesis is entirely cogent as a theoretical matter, empirical attempts to validate it in real-world settings surprisingly often reach mixed and sometimes even contrary results. While the standard certification thesis certainly finds support

¹⁸ See 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).

¹⁹ The principal contributors in this vein are John Coffee and Frank Partnoy. For references to related discussions of the practical constraints to the reputational intermediary thesis by Coffee, see *infra* notes [107] and [118] and by Partnoy, see *infra* notes [154] and [166]. For further references, see *supra* note [6] and *infra* notes [170-173] and accompanying text.

²⁰ See *DiLeo v. Ernst & Young*, 901 F.2d 624, 629 (7th Cir. 1990). This logic has apparently been followed in a 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).

in some market settings²¹, generally the data is not abundant and often mixed²². In particular, ambiguous or even contrary 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 publicly traded corporations to the equity markets²³, bond ratings issued by credit-rating agencies to the debt markets²⁴ and at

²¹ For a collection of such studies, see Daniel B. Klein (ed.), REPUTATION: STUDIES IN THE VOLUNTARY ELICITATION OF GOOD CONDUCT 195-96 (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. Res., Working Paper #12390 (July 2006), also avail. at www.ssrn.com.

²² See Jin et al., *supra* note __ (noting that little is known empirically about when certification products add informational value to relevant transactions); Riley, *supra* note __, at 455 (noting that there is little empirical research to confirm the multiple signaling theories with respect to advertising, warranties and pricing strategies and that the existing research draws mixed conclusions).

²³ See Clive Lennox, *Evaluating the Accuracy and Incremental Information Content of Audit Reports* (Feb. 1998), avail. at www.ssrn.com (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); Maria Benau et al., *Reactions of the Spanish Capital Market to Qualified Audit Reports*, 13 EURO. ACCOUNTING REV. __ (200_) (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. ACCTG. 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). More generally, see Jin et al., *supra* note __ (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 (1999) and

²⁴ 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); Mariano, *supra* note __ (noting that credit rating agencies have only downgraded ratings following or shortly preceding multiple adverse events, thereby simply reflecting information that had already been priced into the relevant market, and describing empirical literature's failure to conclusively determine whether rating changes affect market pricing of bond issues); Jin et al., *supra* note __, at 6-7 (noting that the empirical literature on the informational value of bond ratings is inconclusive); Robert C. Merton & Zvie Bodie, *On the Management of Financial Guaranties*, 21 FIN. MGMT. 87 (1992) (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 & INSURANCE 310 (1992) (finding that rating changes of leading third-party ratings provider in insurance industry generate little stock price reaction). The Senate Report makes the important observation that 95% of corporate bonds are held by institutional investors who have in-house research departments to assess the value of existing and potential bond investments, suggesting that the credit ratings have minimal incremental informational value for most bondholders. See PRIVATE-SECTOR WATCHDOGS, *supra* note __, at 78.

least some fairness opinions²⁵ issued by investment-bank advisors in merger and acquisition transactions.²⁶ 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: reasonably persuasive support consistently exists for the certification benefits conferred by prestigious underwriters²⁷ but support for the certification benefits conferred by prestigious auditors²⁸ and venture capitalists²⁹ remains mixed. As

²⁵ Fairness opinions are based on a variety of financial analyses performed by the third-party financial advisor to an acquirer or, more typically, a “target” corporation in a merger or acquisition transaction, which expresses the advisor’s view as to the “fairness from a financial point of view” of the proposed deal consideration.

²⁶ See Darren J. Kisgen et al., *Are Fairness Opinions Fair? The Case of Mergers and Acquisitions* (Apr. 2006), available on www.ssrn.com (finding that deal premiums are reduced when acquirers obtain fairness opinions, long-term stock performance improves when an acquirer obtains a second fairness opinion, and target fairness opinions appear to have no effect on the quality of the transaction); Huajing Chen, *Merger Abnormal Returns and the Use of Independent Fairness Opinions* (Nov. 2006), avail. at www.ssrn.com (showing that, for an 18-month period following consummation of the relevant merger, acquirors that obtain fairness opinions from independent advisers outperform acquirors that obtain a nonindependent fairness opinion, but finding no such relationship with respect to target firms). 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.

²⁷ See, e.g., 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 underperformance during 3-year period following IPO); 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); Kenneth N. Daniels & Jayaraman Vijayakumar, *Does Underwriter Reputation Matter in the Municipal Bond Market?*, J. ECON. & BUS. (forthcoming 2006) (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. Acctg. Stud. (2006) (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*, __ J. FIN. RES. __ (2004) (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).

²⁸ The literature is not uniform. For affirmative results, see Stephanie Rauterkus & Kyojik Song, *Auditor’s Reputation, Equity Offerings and Firm Size: The Case of Arthur Andersen* (Feb. 2004), avail. on www.ssrn.com (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); Sattar A. Mansi et al., *Does Auditor Quality and Tenure Matter to Investors? Evidence from the Bond Market?* (2006), avail. at www.ssrn.com (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). For

described in greater detail elsewhere in this Article, these middling findings (which, to a certain extent, may reflect methodological challenges) are matched by intuitively grounded skepticism among some industry participants, judges, regulators and/or policy commentators as to the informational value of some of these widely distributed certification practices.³⁰

Similar doubts are voiced from time to time in some practitioners' discussions of closing opinion practice. Following 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 substantial reputational and legal exposure would not lead it to do so

mixed to affirmative results, see Ronald J. Balvers et al., *Underpricing of New Issues and the Choice of Auditor as a Signal of Investment*, 4 ACCTG. 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 Deviate. Williams, *Auditor Credibility and Initial Public Offerings*, 66 ACCTG. REV. 313 (1991) (finding that few IPO firms switch from local to 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 MANAG. & DEC. 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), avail. on www.ssrn.com (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 no correlation between audit quality and long-term performance, which suggests that any certification benefits are unjustified).

²⁹ See Alon Brav & Paul Gompers, *Underperformance of Initial Public Offerings: Evidence from Venture and Nonventure Capital-Backed Companies*, 52 J. Fin. 1791 (1997) (finding that, in 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?* (Mar. 2006), avail. on www.ssrn.com (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 ability to attract higher-quality investment bankers, underwriters, analysts and other intermediaries); Georg Rindermann, *Venture Capitalist Participation and the Performance of IPO Firms: Empirical Evidence from France, Germany and the UK* (2003), avail. on www.ssrn.com (finding that venture-backed IPOs do not generally perform better than non-venture-backed IPOs, aside from subgroup of internationally operating venture capitalists); Stefanie Franzke, *Underpricing of Venture-Backed and Non Venture-Backed IPOs: Germany's Neuer Markt* (2003), avail. on www.ssrn.com (finding 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).

³⁰ See *infra* notes [] and accompanying text.

recklessly or dishonestly.³¹ This in turn implies that market actors rationally expend resources on a closing opinion only so long as the anticipated informational value yielded as a result exceeds anticipated preparation, research, negotiation and other expenditures. Nonetheless some legal practitioners and other industry participants, as expressed in the trade literature, some bar association reports and survey interviews³², question whether these expenditures always or even usually pass this cost-benefit test.³³ These doubts “on the ground” raise global concerns as to whether closing opinion practice actually generates the efficiency benefits anticipated by the certification thesis. Based in part on a 2004 survey of California practitioners, the Business Law Section of the State of California Bar has recently expressed the view that some (but, it emphasizes, not all) closing opinions may often increase transaction costs without “any real

³¹ See Gilson, *Value Creation*, 290-92, *supra* note __; Michael Gruson et al., LEGAL OPINIONS IN INTERNATIONAL TRANSACTIONS (1989, 2d ed.), at 4; Deer, *supra* note __, at I-2; Dillon, *supra* note __, at 3; Okamoto, *supra* note __, at 27. For a similar efficiency explanation of legal opinions in the structured-finance context, see Schwarcz, *Limits of Lawyering*, *supra* note __, at __, and Macey, *supra* note __, at 76.

³² For existing surveys of practitioners with respect to closing opinions (among other topics): see Lipson, *supra* note __; 2004 CALIFORNIA BAR REPORT, in GLAZER ET AL., *supra* note __, at App. 9A:80-88; and Schwarcz, *To Make or To Buy*, *supra* note __.

³³ See, e.g., 2004 CALIFORNIA BAR REPORT, *supra* note __, in GLAZER ET AL., *supra* note __ at App. 9A:6; James Fuld and Arthur Field, *Toward Eliminating Differing Interpretations of Opinions Relating to Agreements*, May 24, 1988, reprinted in AMERICAN BAR ASSOCIATION, NATIONAL INSTITUTE, THE SILVERADO SUMMIT: THE STANDARDIZATION OF LEGAL OPINIONS – ORDER OUT OF CHAOS (1989); Dillon, *supra* note __; Lipson, *supra* note __, at __. See also TEXAS BAR REPORT, in GLAZER ET AL., *supra* note __, at App. 21:78 (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?*, 7 BUS. L. TODAY 48 (Sept./Oct. 1997) (expressing doubt with respect to whether UCC and enforceability opinions that lenders typically request from borrower’s counsel are cost-justified); R. Bradbury Clark, *The Remedies Opinion*, printed in AMERICAN BAR ASSOCIATION, NATIONAL INSTITUTE, THE SILVERADO SUMMIT: THE STANDARDIZATION OF LEGAL OPINIONS – ORDER OUT OF CHAOS (1989) 3-9 (questioning expenditure of enormous time to negotiate certain opinions that result in a “largely useless product” given narrow scope); 2004 CALIFORNIA BAR REPORT, in GLAZER ET AL., *supra* note __, at App 9A:21 (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 (1989) (noting that several types 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 __, at 910 (arguing that opinion process can generate lengthy discussion while rarely raising any enforceability issues unknown to the opinion recipient or its counsel).

benefit”³⁴ while, to a lesser extent, various 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 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 that these views have significant merit and that the certification thesis probably cannot account adequately for the continued widespread use of closing opinions in sophisticated transactions.

II. *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 test this proposition, I proceed in two steps: first, I review the typical scope of a closing opinion and key procedural and cost elements of the closing process; and second, I assess the legal and reputational exposure likely assumed by opining law firms. On the basis of this discussion, I consider whether the certification thesis adequately accounts for the apparently low incremental informational content of closing opinions in the face of nontrivial preparation, negotiation and other costs, concluding that it probably cannot. Hence the puzzle emerges.

³⁴ In particular, the California bar committee expressed these doubts based on the fact that (i) the opinion duplicates representations and warranties in the underlying transaction agreement, and (ii) the opinion provides information that is often more effectively verified by other methods, including the recipient’s own diligence efforts. See 2004 CALIFORNIA BAR REPORT, *supra* note __, in GLAZER ET AL., at App. 9A:9-10. To be clear, the California bar committee does state 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.*

³⁵ See TEXAS BAR REPORT, in GLAZER ET AL., *supra* note __, at App. 21:78; MICHIGAN BAR REPORT, in GLAZER ET AL., *supra* note __, at App. 17:8.

³⁶ See *California Remedies Opinion Report*, *supra* note __, at 938.

A. *Standard Content of a Closing Opinion.* 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 is made a condition precedent to the “closing” of the transaction.³⁸ The most typical closing scenarios are (i) some private acquisition transactions (as distinguished from the acquisition of a publicly traded corporation)³⁹; and (ii) 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 transaction⁴¹ and, unless otherwise indicated, will use the term “closing opinion” or simply “opinion” to refer solely to this particular (but the most common and most widely discussed) 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

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

³⁸ See 1998 TRIBAR REPORT, *supra* note __; Bart Schwartz, *The case for in-house opinion letters: You don't have to go to outside counsel*, BUSINESS LAW TODAY, Vol. 11, No. 3 (Jan./Feb. 2002), available at www.abanet.org/buslaw.

³⁹ See GLAZER ET AL., *supra* note __, at §1.1.

⁴⁰ See *id.*, at §1.2 n.2.

⁴¹ More specifically, “closing opinion” as used in this Article excludes: title opinions, oil and gas opinions, bond opinions, 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 PRACTICING LAW INSTITUTE, LEGAL OPINIONS: THE IMPACT OF THE TRIBAR COMMITTEE'S NEW REPORT ON LEGAL OPINION PRACTICE 232 (1998), and exhibit varying degrees of differential sophistication and legal distortion the substantial lack of which allows for a reasonably “clean” analytical setting in the case of “classic” closing opinions, as noted above.

⁴² See 1998 TRIBAR REPORT, *supra* note __, at 2; *ABA Legal Opinion Principles*, *supra* note __, at 192.

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 below—considerably dilute the substantive force of the enforceability and other standard opinions. While the American Bar Association (the "ABA") and the various regional bar associations call for such qualifications to be used judiciously⁴⁶, it is widely observed that many or even most practitioners use them liberally, employing what is sometimes derided as a "kitchen sink" approach.⁴⁷ The aforementioned practitioners survey conducted by the Business Law Committee of the California Bar soundly confirms this impression, showing universal usage of a "laundry list" of exceptions and widespread usage of some more aggressive exceptions.⁴⁸

⁴³ See GRUSON ET AL., *supra* note __, at 5; Ambro & Bidwell, *supra* note __, at 310.

⁴⁴ See Michael Gruson, *Legal Opinions of New York Counsel in International Transactions*, 1989 COLUM. BUS. L. REV. 365, 366.

⁴⁵ See 1998 TRIBAR REPORT, *supra* note __, at 3. On the assumptions and qualifications that commonly appear in legal opinions, see TRIBAR OPINION CMTE., *Special Report of the TriBar Opinion Committee: The Remedies Opinion—Deciding When to Include Exceptions and Assumptions*, 59 BUS. LAWYER 1483 (Aug. 2004) [hereinafter, *Special Report*].

⁴⁶ See, e.g., THE COMMITTEE ON LEGAL OPINIONS OF THE AMERICAN BAR ASSOCIATION'S SECTION OF BUSINESS LAW, *Guidelines for the Preparation of Closing Opinions*, 57 BUS. LAW. 876 (2002).

⁴⁷ See GLAZER ET AL., *supra* note __, at §1.1 n.8, §3.2; 2004 CALIFORNIA BAR REPORT, *supra* note __, in GLAZER ET AL., at App. 9A:88-89; *California Remedies Opinion Report*, *supra* note __, at 925.

⁴⁸ See, e.g., 2004 CALIFORNIA BAR REPORT, *supra* note __, in GLAZER ET AL., at App. 9A:80-85 (out of survey sample of 35 California law firms (predominately mid-size to large-size), 100% report customary use of

Table 1: Standard Content of a Closing Opinion

<u>Standard Opinion Formulations</u>	<u>Principal Exceptions and Other Limitations</u>
<ul style="list-style-type: none"> • <i>Enforceability/Remedies Opinion</i>: Contractual obligations being assumed by opinion issuer’s client are enforceable. • <i>“No-Conflicts” Opinion</i>: Contractual obligations being assumed by client do not conflict with its existing contractual obligations or organizational documents. • <i>“No-Violations” Opinion</i>: Client’s performance of the relevant agreement(s) will not violate any applicable law. • <i>“No-Consents” Opinion</i>: Client’s performance of its contractual obligations does not require consent or approval of any governmental entity or other third party.⁴⁹ • <i>Due Organization Opinion</i>: Relevant client entity is duly organized (that is, all required steps were properly taken under state law in order to form the relevant entity).⁵⁰ • <i>Valid Existence Opinion</i>: Relevant client entity is legally existing on the date of the opinion letter, on the basis of a certificate from the relevant state’s department of corporation.⁵¹ 	<ul style="list-style-type: none"> • <i>Client information not independently verified</i>: Opinion assumes that all information provided by client is true and accurate without opining firm having undertaken any independent verification. • <i>Audience limitation</i>: Class of parties that may rely on the opinion is limited to the recipient and any additional specifically designated parties. • <i>No updating obligation</i>: 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. • <i>Equitable principles exception</i>: Enforceability may be limited by courts’ use of equity powers. • <i>Bankruptcy/insolvency exception</i>: Enforceability may be limited by federal bankruptcy laws. • <i>Clauses of doubtful enforceability</i>: Numerous specialized contractual clauses are noted to have inherently limited enforceability given uncertainty in existing case law.⁵² • <i>“Generic exception”</i>: General qualification that the enforceability of certain remedies may be limited (especially common in loans). • <i>“California” materiality limitation</i>: Enforceability opinion limited to “material” portions of the transaction documents.⁵³

“laundry list” of exceptions in remedies opinion and 54% report customary use of more aggressive “generic exceptions” qualification)

⁴⁹ See 1998 TRIBAR REPORT, *supra* note __, at 68-69.

⁵⁰ A milder variation is the “due incorporation” opinion, which simply requires obtaining from the 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 1998 TRIBAR REPORT, *supra* note __, at 49-51.

⁵¹ See *id.*, at 51.

⁵² These include clauses such as: (i) “forum selection” clauses, see *Special Report*, *supra* note __, at 1498-1503); (ii) waivers of the right to trial by jury, see *Special Report*, *supra* note __, at 1493 n.51; and (iii) certain remedial provisions, especially relating to the attachment of assets by creditors in the case of a borrower default.

⁵³ This position was historically adopted by the California Bar and rejected by the New York and other bars included in the “TriBar group” and other regional bar associations. While the issue has generated much debate, it is not clear whether the California position is different practically from the “New York/TriBar” position, which does not include this limitation, given that the New York/TriBar position qualifies the enforceability position by numerous limitations that probably arrive at roughly the same result. See 2004 CALIFORNIA BAR REPORT, in GLAZER ET AL., *supra* note __, at App. 9A:3.

B. *Closing Opinion Process and Related Costs.* The issuance of a legal opinion (which generally follows detailed standing instructions updated periodically by the opining firm's opinions committee) is undertaken with significant care and review in the typical corporate law practice.⁵⁴ This internal review process, together with the research, preparation and sometimes extensive negotiation of closing opinions⁵⁵, generate nontrivial direct and indirect costs.⁵⁶ 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 from more substantive matters.⁵⁷ It is typically observed that negotiation or at least finalization of closing opinions is often deferred until "the eve of closing", thereby heightening the possibility of a costly last-minute delay.⁵⁸ In certain transactions involving issues specific to foreign or out-of-state jurisdictions or particularly contentious factual issues, the opinion giver may 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, fees and delays.⁵⁹ Other related costs include the fixed costs incurred in order to sustain a law firm's opinion committee and the periodic review of a law firm's standing

⁵⁴ See GLAZER ET AL., *supra* note __, at §1.2.

⁵⁵ See 2004 CALIFORNIA BAR REPORT, *supra* note __, in GLAZER ET AL., *supra* note __, at App. 9A:6-7; Felton, *supra* note __, at 52.

⁵⁶ See 2004 CALIFORNIA BAR REPORT, *supra* note __, in GLAZER ET AL., *supra* note __, at App. 9A:2; TEXAS BAR REPORT, in GLAZER ET AL., *supra* note __, at App. 21:78.

⁵⁷ See GLAZER ET AL., *supra* note __, at §9.1.2 n.23; *California Remedies Opinion Report*, *supra* note __, at 915; 2004 CALIFORNIA BAR REPORT, in GLAZER ET AL., *supra* note __, App. 9A at 9A:47.

⁵⁸ See, e.g., Jeff R. Hudson et al., *Third Party Legal Opinions in Acquisitions of Privately Held Companies*, Practising Law Institute (June-July 2006), at 468.

⁵⁹ See Albert S. Pergam, *Transnational Opinions: Selecting and Collaborating with Foreign Counsel*, 1989 COLUM. BUS. L. REV. 413; Stephan Hutter, *The Corporate Opinion in International Transactions*, 1989 COLUM. BUS. L. REV. 427.

instructions with respect to opinion preparation,⁶⁰ which may be effectively passed on to clients in the form of 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 law firm of approximately \$300-800 depending on attorney seniority, office location and firm prestige, translates into a dollar range of anywhere from several to tens of thousands of dollars.⁶¹ Given that the transactions in which closing opinions are issued usually take place in the private market, it is similarly difficult to obtain reliable data on the total number of annual financing and acquisition transactions where closing opinions are issued. However, in order to get a general sense of the total amounts involved, if we make the artificially conservative assumption that there are approximately 1000 financing and acquisition transactions on average in the U.S. 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. Note that even this “bare minimum” amount would almost certainly be an underestimate since it covers neither the opportunity costs of a delayed closing nor each firm’s fixed costs of maintaining an “opinion infrastructure” as described above.

⁶⁰ For a description of these costs, *see* Ambro & Bidwell, *supra* note __, at 311.

⁶¹ 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 __, 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”).

C. *Liability Exposure of Opining Attorneys.* In this Section, I use case-law evidence, practitioner commentary and other sources to arrive at a reasonable assessment of the legal and reputational exposure assumed by a law firm when issuing an opinion. This information is critical: following the logic of the certification thesis, a legal opinion would have no meaningful bonding value if the opining firm did not undertake any substantial legal or at least reputational exposure in the event the opinion were shown to have been issued fraudulently or negligently. As I describe below, there are compelling grounds to believe that an opining attorney typically faces a low probability of any significant legal liability and reasonable grounds to support the position that an opining attorney faces only a somewhat higher probability of significant reputational liability.

1. *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.⁶² Barring any residual privity-related barriers in certain jurisdictions⁶³, this negligence standard normally extends to opinions issued to non-clients.⁶⁴ 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

⁶² See John P. Freeman, *Current Trends in Legal Opinion Liability*, 1989 COLUM. BUS. L. REV. 235, 242; Howe, *supra* note __, at 290. “Ordinary skill and knowledge” is defined by reference to the customary practices of other similarly situated attorneys. See 1998 TRIBAR REPORT, *supra* note __, at 6.

⁶³ Privity-related restrictions on professional negligence liability were first lifted in California, see *Biakanja v. Irving*, 320 P.2d 16 (Cal. 1958), which has been followed by most other states. See *infra* note [].

⁶⁴ See Freivogel, *supra* note __, at 229; 1998 TRIBAR REPORT, *supra* note __, at 1.

under state bar association rules⁶⁵, a common law fraud action⁶⁶, “aiding and abetting” claims⁶⁷, a civil conspiracy suit and securities-law violations.⁶⁸ Despite this laundry list of potential liability horrors, several factors suggest (and the practitioner literature tends to agree⁶⁹) 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. This standard “hedging” practice often leaves doubt as to whether the underlying opinion is “saying anything at all”.⁷⁰ Two standard qualifications in particular protect the opining firm against potential claims. First, because the opinion issuer normally assumes without independent verification the authenticity of all documents and the accuracy of all

⁶⁵ See RESTATEMENT LGL §95, Comment (a) (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 a third person”); AMERICAN BAR ASSOCIATION, CENTER FOR PROFESSIONAL RESPONSIBILITY, ANNOTATED MODEL RULES OF PROFESSIONAL CONDUCT (2004) [hereinafter, ABA RULES OF PROFESSIONAL CONDUCT] (noting that the lawyer issuing an opinion is at risk of a disciplinary proceeding “if in the course of making the evaluation he or she violates applicable ethics obligations”).

⁶⁶ Under state common law of fraud, lawyers generally have 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?*].

⁶⁷ 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.

⁶⁸ 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 __, at 9. However, there are two practical limitations: (i) any 10b-5 claim would require proof of scienter (which has the important effect of excluding negligence-based claims), and (ii) under the Supreme Court’s decision in *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994), a private plaintiff cannot bring a 10b-5 aiding and abetting claim against an attorney. With respect to (ii), 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”, 53 FED. LAWYER 20 (2006).

⁶⁹ See Freedman, *supra* note __, at 252; Ambro & Bidwell, *supra* note __, at 308; Freivogel, *supra* note __, at 232 and, with respect to acquisition transactions, Felton, *supra* note __, at 53.

⁷⁰ See Arthur J. Dillon, *Statement of Expectations of Counsel for Institutional Investors*, speech delivered at American College of Investment Counsel Annual Meeting, New York City, Sept. 15, 1988, reprinted in AMERICAN BAR ASSOCIATION, NATIONAL INSTITUTE, THE SILVERADO SUMMIT: THE STANDARDIZATION OF LEGAL OPINIONS – ORDER OUT OF CHAOS (1989).

information provided to it, there is little assurance given that the opinion is not based upon fraudulent or inaccurate information, beyond the important qualification that a lawyer cannot rely on information that he or she knows, or has substantial reason to believe, to be untrue.⁷¹ Second, an opinion's effective scope is limited by language restricting the class of parties entitled to rely on the opinion (normally, the recipient or designated additional reliant parties). These and the other standard qualifications are not empty words. In the relatively small number of judicial decisions involving closing opinions and other legal opinions⁷², courts generally respect the standard qualifications, such as the "equitable principles" exception⁷³, the "bankruptcy and insolvency" limitation⁷⁴, the qualification noting failure to independently verify information provided by the client⁷⁵, the qualification limiting the opinion to the laws of specified jurisdictions⁷⁶ and the audience limitations specified in almost all opinion letters.⁷⁷

⁷¹ See RESTATEMENT LGL §95, Comment *e*; *ABA Legal Opinion Principles*, *supra* note ___, at 192.

⁷² By "other legal opinions", I mean to indicate that the ensuing discussion above 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.

⁷³ See, e.g., *Washington Elec. Coop. Inc. v. Massachusetts Municipal. Wholesale Elec. Co.*, 894 F.Supp. 777 (D. Vt. 1994) (finding that statement in opinion letter that legal obligations were subject to judicial discretion absolved lawyer from any liability for not predicting changes in the law).

⁷⁴ See *TriBar Remedies Opinion*, *supra* note ___.

⁷⁵ For cases upholding such disclaimers, see *Mark Twain Kansas City Bank v. Jackson, Brouillette, Pohl & Kirley, P.C.*, 912 S.W.2d 536 (Mo. Ct. App. 1995) (finding that sophisticated lender represented by counsel could not have justifiably relied on factual statements in opinion letter in light of 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, Winstead, McGuire, Sechrest & Minick*, 961 F.2d 469 (4th Cir. 1992) (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 Secs., Inc.* 24 F.3d 480 (__ Cir. 1994) (finding that statement that opinion based on assumed facts does not bar Rule 10b-5 liability under federal securities laws when lawyer had good reason to know of a material inaccuracy given long close relationship with seller), *cert. denied*, 115 S.Ct. 613 (1994). 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).

⁷⁶ 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

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 typical opinion letter. Historically the common-law privity requirement, which insulated attorneys against claims by non-client third parties, virtually ensured that closing opinions could not give rise to *any* legal exposure.⁷⁸ While these privity barriers have eroded⁷⁹, the legal and insurance trade literature observes, based on the existing case-law record, that opining lawyers' exposure is highly limited: 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.⁸⁰ 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 1970 through 2006, supplemented by a search for additional relevant cases referenced in the relevant 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.⁸¹ These findings,

other states). For additional discussion, see Gruson, *supra* note __, at 366-67; 1998 TRIBAR REPORT, *supra* note __, at 4, 38; *ABA Legal Opinion Principles*, *supra* note __, at 193.

⁷⁷ See Howe, *supra* note __, at 294. For an indicative decision, see *Merkel v. Livestock Breeders Int'l of New Jersey, Inc.*, 1988 WL 66864 (D.N.J. 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).

⁷⁸ See Johnson, *supra* note __, at 326.

⁷⁹ See Langevoort, *Where Were the Lawyers?*, *supra* note __, at 89 [hereinafter Langevoort, *Where Were the Lawyers?*]. This barrier has disappeared with respect to direct recipients of legal opinions, although in certain important jurisdictions such as New York and Texas, it was not definitively settled until 1992 and 1999 respectively that an attorney's duty of reasonable care extends to non-clients in the case of third-party legal opinions. See *Prudential Ins. Co. v. Dewey, Ballantine Bushby, Palmer & Wood*, 590 N.Y.S.2d 831, 605 N.E. 2d 318 (1992); *McCamish, Martin, Brown & Loeffler v. F.E. Appling Interests*, 991 S.W.2d 787 (Tex. Ct. App.) (1999).

⁸⁰ See Freivogel, *supra* note __, at 227 (stating that the number of reported decisions involving third-party legal opinions is "incredibly small").

⁸¹ 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 [].

summarized in the table immediately below for the 20-year period ending 2006⁸², are consistent with the aforementioned view.⁸³

Table 2: Identified Litigation Involving Closing Opinions (1986-2006)

Period	Number of reported decisions	Reported decisions per year	Number and percentage of suits dismissed on summary judgment⁸⁴	Number of suits involving enforceability opinions; percentage dismissed on summary judgment	Suits where opining firm ultimately found liable	Geographic distribution of reported decisions
1986-2002	17	1.06	7 (42%)	7 (71%)	0 (0%)	NY: 5/17 Ct: 1/17 Texas: 1/17 Other: 10/17
2003-06	14	3.5	5 (36%)	8 (50%)	2 (14%)	NY: 5/14 Ct: 2/14 Mass.: 3/14 Texas: 1/14 Other: 3/14
Total (1986 - 2006)	31	1.55	11 (39%)	13 (60%)	2 (.06%)	NY: 10/31 Ct.: 2/31 Mass.: 3/31 Texas: 2/31 Other: 14/31

⁸² Consistent with a conservative approach, the Table omits the period 1970-1985 because virtually no reported decisions involving attorney liability for closing opinions were found for this period (perhaps reflecting enduring privity-related protections), and inclusion of this period would then bias downward the already-low annual frequency of opinion-related litigation.

⁸³ The specific cases are listed in the *Appendix*. 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 acquisition or financing 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 in the *Appendix*. Additionally, note that the list of cases in the *Appendix* includes (and extends substantially beyond) all seven cases identified in the only prior published systematic review of the relevant case-law record through 1998, *see* Freivogel, *supra* note __, at Appendix (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, *see supra* note []). For discussion of the prior study by a leading practitioner commentator on legal opinions, see Arthur N. Field & Jeffrey M. Smith, *Legal Opinions in Business Transactions* (Practicing Law Institute, Nov. 2005), § 3-2.

⁸⁴ 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.

As the table indicates, over the 20-year period from 1986 through 2006, litigated claims relating to closing opinions are infrequent (approximately one decision per year) and dismissed at summary judgment in more than one-third of all such cases. Additionally, in litigations involving the “core” enforceability opinion (almost one-half of all litigation involving closing opinions), summary judgment has been granted to the defendant more than half the time.⁸⁵ Litigation involving a closing opinion is so infrequent that there are no relevant decisions during the past 20 years in such major jurisdictions as California and only two relevant decisions in Texas (these results may be in part a function, respectively, of unusually persistent privity protections in Texas⁸⁶ and a reportedly heavier use of qualifying language in California closing opinion practice⁸⁷). While there has been an 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 climate⁸⁸ and about one-half of such cases are concentrated in the New York, Connecticut and Massachusetts courts. In any case, even these courts have acted consistently with past tendencies. The post-2002 claims have not fared appreciably better as a group on defendants’ summary judgment motions nor yielded

⁸⁵ 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 cases terminated by summary judgment: 7.7% in 2000 and approximately 6% in 1995 and 5% in 1990. See Joe S. Cecil et al., *Trends in Summary Judgment Practice: A Preliminary Analysis*, Div. of Research, Fed. Judicial Center (Nov. 2001).

⁸⁶ See *supra* note [].

⁸⁷ See 2004 CALIFORNIA BAR REPORT, in GLAZER ET AL., *supra* note ___, at App. 9A:88-90.

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 filed December 20, 2002 in [In re Enron Corp. Sec., Derivative and ERISA Litig., 235 F. Supp. 2d 549 \(S.D. Tex. 2002\)](#), Civil Action No. H-03-3624, Consolidated Cases.

any decisions that shift the generally lenient standards of relevant case-law⁸⁹, in which case there is probably little basis to believe that opining firms' legal exposure has increased materially.

Given this case-law history⁹⁰, it is not surprising that 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.⁹¹ Apart from courts' general reluctance to impose liability on opining attorneys⁹², courts have often emphasized that legal opinions, as subjective professional judgments, should be strictly distinguished from (and relied upon to a significantly lesser degree than) objective representations of fact⁹³, which in turn has generated the proposition that an opining attorney's

⁸⁹ See Richard M. Zielinski, *Differences of Opinion*, Law Firm Partnership & Benefits Report (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 “to our knowledge” and “without investigation” qualifiers); Lisa K. Bruno, *Opinion letter pitfalls: Don’t get bitten*, MASS. LAWYERS WEEKLY (Mar. 28, 2005) (same). See also ABA SECTION OF BUSINESS LAW COMMITTEE ON LEGAL OPINIONS, LEGAL OPINION NEWSLETTER, Vol. 4, No. 2 (Mar. 2005) (statement by Arthur Field, leading practitioner commentator, that much-discussed *Dean Foods* decision in Massachusetts “makes no new law, merely confirming established customary practice obligations”).

⁹⁰ Any conclusions derived from the case-law record are subject to the important qualification that a low number of cases in which lawyers have been found liable in connection with closing opinions may not reflect a significantly larger number of instances in which opining lawyers have been sued but then quietly settled such claims rather than litigating them through to a final judicial resolution. While there is inherent uncertainty on this point given available information, relevant practitioner and insurance industry commentary suggests that settled claims concerning closing opinions are infrequent. See Freivogel, *supra* note __, at 230-31; 2004 CALIFORNIA BAR REPORT, in GLAZER ET AL., *supra* note __, at App. 9A:12 n.21. This tentative conclusion is consistent with historically low reported claim rates on the broader category of all legal opinions. For example, 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 AMERICAN BAR ASSOCIATION, STANDING CMTE ON LAWYERS’ PROFESSIONAL LIABILITY, PROFILE OF LEGAL MALPRACTICE CLAIMS 7, tbl. 3 (2003).

⁹¹ See Schwartz, *supra* note __ (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”).

⁹² See Freeman, *supra* note __, at 235 (noting that courts are reluctant to impose liability on lawyers for opinions); Ambro & Bidwell, *supra* note __, at 308 n.3 (same); Freivogel, *supra* note __, at 4 (noting a “benign legal climate” for third-party opinions), *supra* note __.

⁹³ See, e.g., *Washington Electric Cooperative, Inc. v. MMWEC and consolidated cases*, 894 F.Supp. 777, 790 (D. Vt. 1994) (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 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”).

error should not give rise to liability if the opinion reflects an informed judgment.⁹⁴ In an opinion that strikingly illustrates the minimal assurance value that can reasonably be attributed to a closing opinion, 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.⁹⁵ Even in more ambiguous cases, courts generally make efforts to protect opining lawyers who become entangled with their clients' fraudulent behavior, absent compelling evidence of the lawyer having consciously rendered substantial assistance to the client's scheme.⁹⁶ 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 opinion have escaped malpractice liability on the ground that the opinion stated that no responsibility was assumed for the facts upon which the opinion relied.⁹⁷ Cases where a law firm has been sued or held liable for a closing opinion or

⁹⁴ See Beeson, *supra* note __, at 139.

⁹⁵ See *City National Bank v. Rodgers & Morgenstein*, 399 N.W. 2d 505 (Mich. App. 1986). For a similar ruling, see *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).

⁹⁶ For a description of these cases, see Freeman, *supra* note __, at 250-52. See, e.g., *In re Citisource, Inc. Securities Litigation*, 694 F.Supp. 1069 (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 counsel permits a strong inference of recklessness"). See generally Langevoort, *Where Were the Lawyers?*, *supra* note __, at 87 (stating that "when 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").

⁹⁷ See, e.g., *First Interstate Bank of Nevada, N.A. v. Chapman & Cutler*, 837 F.2d 775 (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 Insurance Co.*, 858 F.2d 1104 (5th Cir. 1988) (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).

other legal opinion generally involve either an omission by the opining attorney of such qualifying language⁹⁸, active involvement by the attorney in a client's scheme⁹⁹ or simply representation of a client that happened to be engaged in fraud, which then *incidentally* leads to the attorney being targeted under an aiding and abetting theory.¹⁰⁰ 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 issued¹⁰¹, in which case the opinion probably had little marginal effect on the attorney's legal exposure.

2. *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 (1) the law firm is unlikely to have a rational incentive to risk hard-earned reputational capital by assisting in any individual fraudulent action and (2) no other typical party to a business transaction can

⁹⁸ See Howe, *supra* note __, at 307.

⁹⁹ See Freedman, *supra* note __, at 252.

¹⁰⁰ See Freivogel, *supra* note __, at 230-32.

¹⁰¹ The statement above probably characterizes the well-publicized settlement in the early 1970s with the SEC reached by the White & Case law firm concerning its involvement in the widely followed "National Student Marketing" financial scandal, one of the largest known settlements involving (among other things) issuance of a closing opinion. The issuance of the closing opinion, and the related White & Case letter, represented part of a broader alleged participation by both parties' counsel in facilitating consummation of a sham transaction. Opinion or not, the law firms involved in the transaction would probably still have been in hot water. For descriptions of the episode and related enforcement action, see *Securities & Exchange Comm'n v. National Student Marketing Corporation et al.*, 402 F.Supp. 641 (1975).

¹⁰² See Coffee, *Comment*, *supra* note __, 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 ability to limit legal liability exposure through use of disclaimers).

adequately certify as to its own quality. It therefore follows that a law firm should be highly sensitive to reputational damage for issuing an erroneous opinion, which in turn implies that a closing opinion 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

Closer scrutiny reveals two weaknesses in this common argument: (1) it is not clear that business lawyers generally play any meaningful function as a “reputational intermediary”¹⁰⁴ and (2) even if business lawyers *do* play a meaningful function as a reputational intermediary, it is not clear that issuance of an inaccurate opinion would cause substantial (if any) reputational damage to the opining firm.

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 representation or astute transaction engineering¹⁰⁵ rather than as a bonding mechanism to demonstrate contracting quality.¹⁰⁶ Two historically novel characteristics of the current legal market probably erode the reputational value of an external law firm: (1) larger corporations

¹⁰³ Some would replace “even in” with “precisely because of”. See Arnoud Boot, Stuart Greenbaum, and Anjan Thakor, *Reputation and Discretion in Financial Contracting*, 83 AMER. ECON. REV. 5 (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 __, at 112; George M. Cohen, *When Law and Economics Met Professional Responsibility*, 67 FORDHAM L. REV. 273, 287-89 (2003).

¹⁰⁵ On the business lawyer as “transaction engineer”, see Gilson, *Value Creation*, *supra* note __.

¹⁰⁶ See Langevoort, *Where Were the Lawyers?*, *supra* note __, at 112; Coffee, *Understanding Enron*, *supra* note __, at 1405.

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 client¹⁰⁷; and (2) leading corporate law firms have grown to a size that makes it difficult for any such firm to credibly monitor the actions of all its partners and associates.¹⁰⁸ In sophisticated transactional settings, the marginal reputational value of external counsel may be further limited by two additional facts: (1) potential business partners often have ample capacity and resources to independently perform a rigorous diligence process with respect to any possible counterparty¹⁰⁹ and (2) many business clients are themselves repeat-players in the relevant market and therefore have substantial incentives to safeguard reputational capital. The declining marginal value of law firms’ reputational capital finds further support in the increasing substitution of external counsel by internal counsel in many transactional functions as well as the virtually universal adoption by even the most elite law firms of limited-liability organizational

¹⁰⁷ See COFFEE, *supra* note __, at 194. For a related point, see Ronald J. Gilson, *The Devolution of the Legal Profession*, 49 MD. L. REV. 869, 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 __. 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 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 KLEIN, *supra* note __, at 195-96. 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 __, 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 (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).

forms (in place of the partnership form)¹¹⁰: both phenomena would presumably be less prevalent if clients attributed unique reputational value to outside counsel.¹¹¹

The few empirical efforts to confirm the reputational value of law firms are confined to the securities offering context and find mixed or no support outside of a limited set of elite firms.¹¹² Even these qualified findings may be understated (and possibly already outdated) in light of a 2004 report issued by an ABA “task force” on securities-law opinions, which *expressly rejects* the scholarly proposition that an opining lawyer acts as a “reputational intermediary” with respect to its client.¹¹³ Even if it were 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

¹¹⁰ See Okamoto, *supra* note __, 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 believe any such value is exceeded by the cost-savings by bringing certain legal services “in house” or may “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 __ (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 relevant period outside of a small group of elite firms, which solely represent the most established securities issuers); Beatty & Welch, *supra* note __, 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 __ (surveying general counsels and finding that majority attributes reputational value to outside counsel but only 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 Special Report of the Task Force on Securities Law Opinions, ABA Section of Business Law, *Negative Assurance in Securities Offerings*, [] BUS. LAWYER [] (Aug. 2004).

injury to the law firm. Contrary to the assumptions of the certification thesis, there is no clear empirical evidence that perceived misconduct by a reputational intermediary will result in a swift market penalty (which, working backwards, will then deter any such behavior in the first place).¹¹⁴ 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.¹¹⁵ 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 Appendix); generally, there is little coverage (if any) beyond a one-time description of the relevant decision¹¹⁶ and no mention of any actions taken by the relevant law firm that would normally be indicative of reputational injury in the commercial context (e.g., resignations, changed policies, etc.). To take a particularly dramatic example (albeit a small step outside the opinion context), in 1992 federal regulators froze the assets of the New York law firm of Kaye Scholer for alleged misconduct committed when representing

¹¹⁴ See generally Clive Lennox, *Auditor Size and the Accuracy of Audit Reports: Reputation Theories versus a 'Deep Pockets' Explanation*, avail. at www.ssrn.com (1997) (showing that criticized auditors do not appear to suffer loss of clients or lower fees, and arguing that reputation is not an important factor in determining audit accuracy). But see Michael Firth, *Auditor Reputation: The Impact of Critical Reports Filed by Government Inspectors*, 21 RAND J. Econ. 374 (1990) (finding small economic penalty as a result of UK Dept. of Trade investigations into client resulting in criticism of auditor, based on stock performance of auditor's listed clients and changes in auditor's fees and number of clients).

¹¹⁵ See Lipson, *supra* note __, at 57 (noting that White & Case, Hale & Dorr and Vinson & Elkins have been or are involved in litigation concerning possible liability for negligently issued opinions and are still considered prestigious firms); Langevoort, *supra* note __, at 112 (arguing that law firms likely suffer little reputational damage when found to have been involved in the fraudulent conduct of a client).

¹¹⁶ The sole exception appears to be the recent case of *Banco Popular North America v. Gandi*, a 2004 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. Lawyer, Vol. 13, No. 1 (Jan. 5, 2004).

defendants in the 1980s “S&L Scandal”; nonetheless Kaye Scholer has retained a secure place among the top national law firms.¹¹⁷

This result is not altogether surprising. Even when a law firm is sued for having issued a negligently prepared opinion, the suit may be seen as having little merit, may not be widely publicized or, even if widely publicized, 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 injury to a firm’s reputational capital given the large size of the typical national law firm (thereby limiting its known capacity to limit attorney error) 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 a client is obviously engaged in criminal or fraudulent activities with a client, it is unclear whether a sophisticated market stigmatizes an otherwise reputable firm that “happened”

¹¹⁷ See William H. Simon, *The Kaye Scholer Affair: The Lawyer’s Duty of Candor and the Bar’s Temptations of Evasion and Apology*, 23 L. & S. Inquiry 243 (1998). For further discussion, see COFFEE, *supra* note __, at 214-215.

¹¹⁸ See Kraakman, *supra* note __, at 100 (noting that reputation is a “noisy” signal, which can limit the deterrent effect of reputational penalties on gatekeeper misconduct); Cohen, *supra* note __, 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 its lawyers to a “bad apple” without casting serious aspersions on the firm’s reputation). See generally Choi, *supra* note __, at 10 (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); Coffee, Jr., *The Acquiescent Gatekeeper*, *supra* note __, at 11-12 (noting that ambiguous standards of third-party certification may enable a gatekeeper to remain blind to corporate malfeasance without incurring any financial or reputational penalty).

to issue a closing opinion in connection with the nefarious schemes of a client who had otherwise appeared to be a reputable enterprise.

D. The Opinion Puzzle Emerges. On a theoretical level, the certification thesis puts forward a straightforward account of certain efficiency benefits accruing from, and therefore the widespread use of, closing opinions 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 a potential delay in the closing of a transaction typically having a value in the tens or hundreds of millions of dollars together with diverting attorneys' limited attention from more substantive matters 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 expenditures on the 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 reasonable 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. This discussion has identified two principal factors in particular as eroding an opinion's certification value: (1) profuse (and litigation-tested) qualifications that heavily dilute an opinion's substantive content, and partly as a result, (2) limited legal and reputational exposure for the opining firm. Several additional factors further decrease a typical closing opinion's

informational value. First, 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 material enforceability or other legal issues, the opinion recipient will rationally rely on the non-conflicted advice of its own counsel¹¹⁹ or the counterparty's express representations and warranties in the principal transaction documents, which generally duplicate the content of the standard enforceability, no-conflicts, no-violations and due organization opinions 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 mechanisms.¹²⁰ (In 2001 the Standard & Poor's credit rating agency reached approximately this conclusion, electing no longer to require "security interest opinions" in connection with structured finance transactions, given the standard use of broad qualifications and the ability to seek comfort in the issuer's representations.¹²¹) Second, 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.¹²² Where there *is* a serious enforceability or other related legal

¹¹⁹ See *California Remedies Opinion Report*, *supra* note __, at 915.

¹²⁰ See Mark Suchman & Mia Cahill, *The Hired Gun as Facilitator: Lawyers and the Suppression of Business Disputes in Silicon Valley*, 21 L. & SOC. INQ. 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);

¹²¹ Traditionally, counsel in asset-backed note issuances had delivered an opinion confirming that the assets backing up the notes were subject to a "perfected" security interest in favor of the trustee or security agent acting on behalf of the noteholders, so that the noteholders would be assured of being able to enforce the security interest against the bankruptcy trustee in the event the issuer of the notes became insolvent. See Standard & Poor's, *Credit Ratings: Revised Article 9 of the Uniform Commercial Code: New Standard & Poor's Criteria*, published June 1, 2001, available at <www2.standardandpoors.com/NASApp/cs/ContentServer?pagename=sp/sp_article>.

¹²² See *California Remedies Opinion Report*, *supra* note __, 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); Lipson, *supra* note __, at 4 (noting views of interviewed attorneys that closing opinions often repeat information that "has or should come from a more authoritative source"); Schwarz, *Same Thing*, *supra* note __, at 97-98 (noting that, in loan transactions, it is lender's rather than 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 __, at 64 (making similar point with

issue that would ostensibly be addressed by a closing opinion, the legal and financial advisors to the opinion recipient normally spend considerable time reviewing the counterparty's relevant contractual and other documents.¹²³ Third, at the time of issuance of the opinion, the opining attorney is subject to a heightened 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 stream of further business and possibly alienating other actual and potential clients.

While the certification thesis would presumptively identify the closing opinion as a typically effective proxy for an underlying quality variable, close examination of the closing opinion process as described above shows this assumption to rest on shaky ground. Given the foregoing collateral factors, together with the core factors of minimal substantive content and limited liability exposure, it seems highly unlikely that a sophisticated attorney or business client ever relies on a typically hedged closing opinion to allay any material doubt concerning enforceability, conflicts, violations or the other matters typically addressed in a closing opinion. Any other policy would be imprudent: as noted above, 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.¹²⁴

respect to enforceability opinions generally); 2004 CALIFORNIA BAR REPORT, *supra* note __, in GLAZER ET AL., at App. 9A:40 (same).

¹²³ See generally 2004 CALIFORNIA BAR REPORT, *supra* note __, in GLAZER ET AL., at App. 9A:40 (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”).

¹²⁴ See *supra* note [] and accompanying text.

Even more strikingly, perhaps, a closing opinion probably cannot even estop a counterparty from later contesting the enforceability of the relevant transaction.¹²⁵

At best, a typical closing opinion probably provides its recipient with a positive but minimal level of incremental information with respect to the counterparty's contracting quality. Since an opinion is not substantially more costly for most lower-quality parties to obtain relative to higher-quality parties, it tells the recipient very little about where its potential business partner lies on the contracting quality spectrum. Given the relative ease with which it can be obtained, a closing opinion probably does nothing more than distinguish between extremely low-quality counterparties and the vast remainder. 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 highly unsavory level) can probably obtain the services of a prestigious law firm, assuming only sufficient financial resources. This should not be surprising: law firms could not reasonably be expected to perform any screening function more nuanced than a gross binary categorization since they obviously lack any technology capable of distinguishing between trustworthy and untrustworthy clients and/or the resources to do so.¹²⁶ Any residual certification value declines even further to the extent that the potential opinion recipient is able to rely on other information or proxy instruments in order to identify very low-

¹²⁵ See CALIFORNIA 2004 REMEDIES OPINION REPORT, *supra* note __, in Glazer et al., at App. 9A:44-46 (rejecting notion that receipt of enforceability opinion bars recipient from later contesting enforceability of the relevant agreement, but adding that there may be an informal estoppel benefit insofar as the opinion could limit a counterparty's reasonable latitude in settlement negotiations to contest the enforceability of the relevant agreement); Schwarcz, *Limits of Lawyering*, *supra* note __, at 11 n.55 (same, but recognizing that issuance of an opinion may still hamper the opining attorney's client from later contesting the relevant transaction).

¹²⁶ Stephen Choi has observed that the quality of third-party certification services will depend in part on "screening accuracy" – that is, the ability and cost of distinguishing between high-quality and low-quality clients (which depends in part on the ability of certification intermediaries to earn a return on their services). Thus, a third-party's certification signal may sometimes be compromised to the extent that its client can deceive third-party certifiers as to its true quality level (leading a certifier to "mislabel" a low-quality producer as high-quality). See Choi, *supra* note __, at 924-26. In Choi's terms, we might say that law firms exhibit a low expected screening accuracy.

quality transaction partners. That would seem to be the typical case since the lowest-quality contracting partners presumably bear other marks (e.g., criminal record, disciplinary actions, prior litigation, and market rumors) that should alert all but the least sophisticated parties. It would then seem that the principal condition for obtaining a closing opinion is not primarily contracting quality as the ability to pay the substantial fees charged as part of undertaking the legal work for the relevant transaction (again, barring clients with obvious records of criminal or other distasteful conduct).

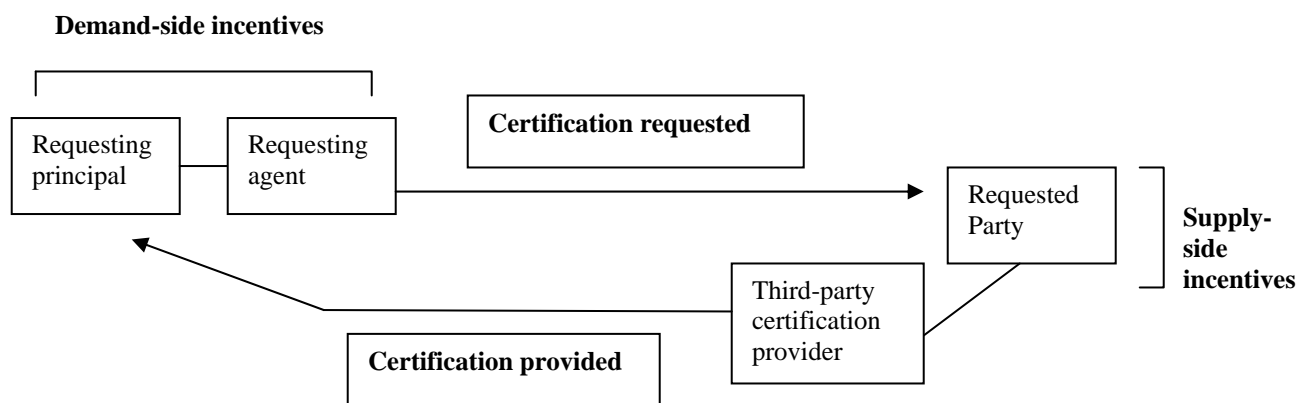
The certification thesis would only offer a *complete* explanation for currently robust levels of closing opinion practice if it were true that (1) closing opinions generally contain meaningful substantive content, (2) law firms take on significant legal and/or reputational exposure in issuing an opinion (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 cost-effective alternative instruments to assess contracting quality. The certification thesis would offer a *partial* explanation for the currently robust 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 highly diluted content of most closing opinions). Given that the first proposition is almost certainly unfounded (that is, it should be uncontroversial that the substantive content of most closing opinions is highly limited) and the second and third propositions are subject to serious doubt (that is, opining lawyers probably do not assume significant legal exposure and most likely do not assume more than limited reputational exposure while opinion recipients usually do have access to more robust diligence alternatives), it is difficult to confidently attribute anything more than minimal certification value to a typically qualified closing opinion.

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 offer significant certification benefits but yet rational economic actors are willing to expend nontrivial resources on obtaining them in many complex business transactions. Again, to simplify slightly: rational actors are paying *something* for what often appears to be *almost nothing* (or almost nothing *new*). In this Part, I address this puzzle by constructing an incentive structure that would induce a requesting party (or, more typically, its agent) to request a closing opinion and a requested party to satisfy any such request, even if these parties, or their agent, believe (as it appears many *do* in fact believe) that the opinion is not cost-justified “generally” (that is, the opinion does not generate value in excess of its total costs). This structure consists of three possible components (of which the first two can be substituted for each other), which I illustrate below through a simple formal model. First, on the demand side, a requesting principal has strong incentives to conform to existing certification practice to the extent that most of the costs of doing so are allocated to the requested party, in which case the principal may elect to conform even when doing so is not cost-justified generally. Second, also on the demand side, where the requesting principal does not act directly (the typical case), a requesting agent has even stronger incentives to conform to existing certification practice in order to mitigate any reputational penalty for perceived incompetence in the event of an adverse business outcome and, given its nominal ownership in the principal, is rationally indifferent to virtually all of the costs of doing so. Third, on the supply side, assuming an opinion is easily available to a broad range of transacting parties and has been accepted by the market as standard practice, requested parties are subject to powerful incentives to satisfy any certification request (through the relevant third-party certification provider) in order to avoid a punitive quality discount for failure to do so. As I

show below, in all three cases, the relevant actor's decision is made independently of its belief as to whether conformity to the relevant certification practice is or is not cost-justified generally.

The Figure below depicts this incentive structure in its most fully intermediated form, the mechanics of which are then discussed in greater detail in the remainder of this Part.

Figure 1: Generic Two-Sided Incentive Structure



A. *Demand-Side Incentives.* The requesting principal faces a straightforward choice: if the anticipated benefits of adhering to the certification convention exceed the anticipated costs, then conform; otherwise deviate. To the extent that it bears only a minority of the total certification costs¹²⁷, a requesting principal may have incentives to conform to a certification convention even when the convention is not cost-justified generally; provided its allocated certification costs are sufficiently small, the principal rationally conforms even though the anticipated informational yield does not exceed anticipated *total* certification costs. As a practical matter, however, the requesting party (at least in the closing-opinion context) almost

¹²⁷ This assumption is relaxed in analysis further below. See *infra* Part III.D.

always acts indirectly through an agent, whether external counsel, internal counsel, a manager or the company board acting on its behalf. Now the incentives to conform are bolstered. The requesting agent has two principal incentives to conform. First, deviating will immediately trigger a reputational penalty to the extent that the relevant “reputation market” (as described further below) believes the attorney, manager or director exhibited incompetence by failing to obtain an opinion from the counterparty’s counsel as per standard practice. Illustrating these reputational pressures, the Business Law Section of the California Bar notes that a leading justification attorneys offer when requesting a specific opinion is simply that the opinion is “market” – that is, that other lawyers are rendering it in similar transactions.¹²⁸ Affirmatively, for an external or in-house attorney, conforming to conventional practice may result in professional benefits insofar as he or she may accrue client goodwill by insisting that the counterparty provide its client with an opinion, thereby demonstrating apparently zealous representation. Second, if the relevant transaction is consummated but ultimately generates an adverse outcome for the agent’s principal and a causal link plausibly exists between the adverse outcome and the agent’s failure to conform to the certification convention, the agent is likely to suffer a substantial penalty for professional incompetence in the relevant reputation market for what is perceived to be an “erroneous” deviation from industry practice (e.g., the manager is perceived to be ignorant or reckless).¹²⁹ In the closing opinion context, these reputation markets

¹²⁸ See *California Remedies Opinion Report*, *supra* note ___, at 912.

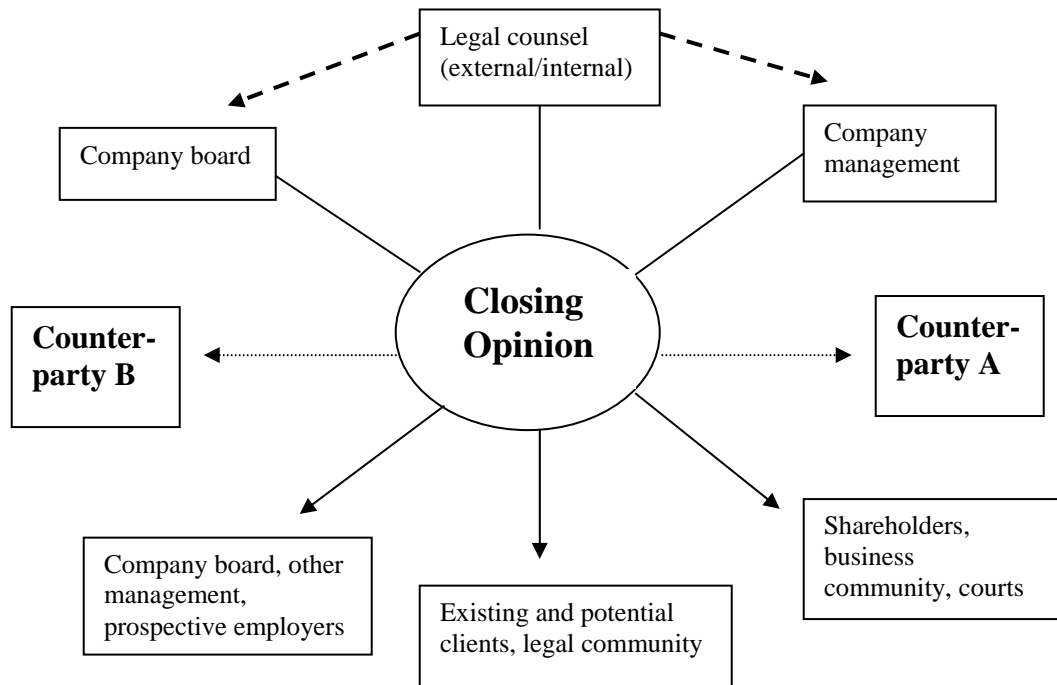
¹²⁹ This rationale is more fully elaborated in a “reputational herding” model developed by David Scharfstein and David Stein in the managerial context. See David S. Scharfstein & David C. Stein, *Herd Behavior and Investment*, 80 AMER. ECON. REV. 465 (1990) (showing that under certain circumstances managers have incentives to preserve and accumulate reputational capital by following the crowd and “looking smart” whatever the ultimate practical result may be of doing so and as a result, some managers may forego actions having positive net expected value if most other managers have declined to take similar actions and therefore, there is a substantial risk of being judged less talented by the labor market in the event the action proves to be erroneous). For a more general model with respect to an agent’s incentives to invest (and sometimes overinvest) in information acquisition, see Todd L. Milbourn et al., *Managerial Career Concerns and Investments in Information*, 32 RAND J. ECON. 334 (2001) (showing that under certain circumstances managers will overinvest in information acquisition about investment

may include (i) other managers, shareholders, directors and prospective employers in the case of a manager, (ii) shareholders and even courts in the case of a director, and (iii) law-firm colleagues and existing and prospective clients in the case of a lawyer. Affirmatively, conforming to the certification convention mitigates any “base” reputational penalty for perceived incompetence that the agent suffers in the relevant market in the event of an adverse business outcome, as the agent can then point to having followed the full set of customary diligence procedures.¹³⁰ As shown in the Figure below, for the requesting agent (whether company board, management or internal or external counsel), independent of any belief as to whether or not the closing opinion yields informational value to its principal net of allocated certification costs, the closing opinion that is ostensibly issued between the transacting parties provides valuable evidence of professional competence that the relevant agent can subsequently use to limit any “base” reputational penalty that would otherwise be assessed against it by the relevant markets in the event of an adverse business outcome. Note that the “reputation channels” depicted in the Figure below can operate simultaneously, generating multiple-order agency-cost distortions (as indicated by the dashed arrows at the top of the Figure): thus, a corporate manager may follow convention and request an opinion in order to limit the reputational downside of an adverse business outcome, 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” to request an opinion, which the law firm itself may have given based in part on the same incentives to limit *its* reputational injury in the event of an adverse business outcome.

opportunities in order to diminish the probability of undesirable outcomes that would trigger adverse reputational implications as to the manager’s abilities).

¹³⁰ See GLAZER ET AL., *supra* note __, at §1.3.2 (noting that “receipt of a closing opinion . . . may help directors and officers of the recipient establish that they have exercised care and acted in good faith if a transaction later turns out badly”).

Figure 2: Reputation Channels



The requesting agent's incentives to conform to the certification convention are bolstered further to the extent that it does not bear the costs of delivering the relevant certification. Even if the principal bears indirect costs relating to the certification process (as is the case in the closing opinion market), so long as there is a typical separation of ownership and control, the agent is rationally uninterested in any cost-saving considerations if it has a less than substantial ownership percentage in the principal¹³¹ (as would typically be the case for a manager or a board member and always be the case for a lawyer). Thus: even if deviating results in substantial cost-savings for the principal, the agent can expect to share in only a nominal portion of any upside in the form of cost-savings but the entire portion of any downside in the form of a reputational penalty. Under these assumptions, a requesting agent probably has almost *no* incentive to

¹³¹ This assumption is relaxed in analysis further below. See *infra* Part III.D.

deviate from an existing certification convention unless it expects to accrue substantial reputational gains from doing so in the event there is a positive business outcome *and* the market views the deviation as a “successful” abandonment of a superfluous or otherwise undesirable transactional procedure (e.g., the agent will be deemed a “creative” thinker or an efficient manager who “cuts through red tape”). Assuming this disproportionate relationship between a low reward for successful deviation and a high penalty for erroneous deviation is satisfied¹³², the agent rationally conforms to a certification convention that is not cost-justified either generally or from the perspective of the principal, whether or not the agent is aware of this fact.¹³³

B. *Supply-Side Incentives.* On the side of the requested party, the incentives to conform to existing certification practice are probably even more powerful. A counterparty whom is being asked to issue an opinion has much to lose, and very little to gain, from deviating, even if it doubts whether the relevant certification instrument has informational value commensurate with its total costs. As argued above, a law firm’s limited screening technologies and minimal liability exposure together imply that a closing opinion is widely available to all but the most

¹³² In subsequent analysis, I study “lead” market actors for whom this assumption is *less* likely to be satisfied. See *infra* Part IV.

¹³³ For excerpts from attorney interviews that echo the discussion above, see Lipson, *supra* note __, at 114-115. For a similar argument with respect to lawyers’ incentives in rendering advice on the legal risks of a particular transaction, see Ribstein, *supra* note __, at 1709-10 (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); Langevoort & Rasmussen, *supra* note __, at 378-79 (noting “an asymmetry in the observability of good and bad advice that leads naturally to an incentive to err on the side of caution”) and 396-97 (arguing that potential reputational penalties for transactions gone awry lead attorneys to overstate legal risks). For a similar argument in the contracting context, see Kahan & Klausner, *Path Dependence*, *supra* note __, at 354-55 (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 __, 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).

unsavory (or cash-poor) parties. While the opinion’s affirmative value as a proxy for contracting quality is therefore limited, it means that the opinion is easily obtainable by parties occupying most (but crucially, not all) of the contracting-quality spectrum and therefore failure to provide it sends a disproportionately negative signal to the requesting agent. Paradoxically, as the informational content of a certification instrument falls to minimal but still positive levels, the market penalty for failing to provide it increases (if the informational content *does* reach zero, then the conformity incentive disappears since failure to honor a certification request would by necessity have no negative quality implication). Precisely because the informational value of the certification instrument is so weak that almost all transacting parties can obtain it but still positive so that it excludes an extreme portion of the universe of potential contracting partners, failure to satisfy a certification request transmits a disproportionately negative quality signal. The penalty for deviating can therefore be severe, ranging from a punitive price discount to failure to consummate the proposed transaction (not unlikely given the difficulties that a counterparty’s agents would encounter in justifying internally a transaction lacking customary certification), in either case risking a loss of tens to hundreds of millions of dollars. Given this contingency, even a highly reputable party may be wary of negotiating for waiver of an opinion requirement, for fear of raising the implication that, appearances to the contrary notwithstanding, its contracting quality lies on the extreme end of the spectrum.¹³⁴ Hence, whether or not the

¹³⁴ This line of argument is broadly consistent with conformity mechanisms identified in other contexts. See, e.g., Donald C. Langevoort, *Organized Illusions: A Behavioral Theory of Why Corporations Mislead*, 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); Walter Kamiat, *Labors and Lemons: Efficient Norms in the Internal Labor Market and the Possible Failures of Individual Contracting*, __ U. PA. L. REV. __ (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); Omri Ben-Shahar, *On the Stickiness of Default Rules*, __ MICH. L. REV. __ (2005) (arguing that parties may not opt out of inefficient default

requested party believes the relevant certification is cost-justified generally, it will usually be willing to incur the costs of providing it if so requested.

C. Distortion Effects. The foregoing discussion provides a set of claims why each of the requesting principal, requesting agent and requested party will rationally elect to conform to the certification convention even if it believes that doing so is not cost-justified generally. In this Section, I present these claims in more formal terms for the purpose both of consolidating these claims into a single analytical framework as well as describing more precisely the conditions under which a sophisticated market will preserve a certification convention that would otherwise be abandoned in an efficient market. The notation set forth below will be used:

Table 3: Definitions

<i>Term</i>	<i>Definition</i>
i	Incremental informational value conveyed by the certification instrument
K	Total certification costs ($= K_1 + K_2$)
K_1	Certification costs allocated to the requesting principal
K_2	Certification costs allocated to the requested party
d	Discount applied by the requesting party to the deal consideration, consequent to failure by the requested party to provide a requested certification
R	Probability-weighted reputational gain for a perceived successful deviation <u>less</u> probability-weighted reputational penalty for a perceived erroneous deviation

rules, even when superior alternative can be identified and formulated at negligible cost, because counterparty will suspect that deviation from norm is indication of “secret” bad intentions).

Each of the requested party, the requesting principal and the requesting agent elects to conform to, or deviate from, the certification convention based on the corresponding decision rules set forth in the Table below, which largely reflects the discussion above.¹³⁵ I also include the hypothetical decision rule that would be costlessly enforced by “society” in order to ensure that transacting parties conform to the relevant certification convention only when doing so is cost-justified generally.

Table 4: Decision Rule Matrix

Actor	Conform if:	Deviate if:
<i>Requested party</i>	$d > K_2$	$d < K_2$
<i>Requesting principal</i>	$i > K_1$	$i < K_1$
<i>Requesting agent</i>	$i > R$	$i < R$
<i>“Society”</i>	$i > K$	$i < K$

If it is assumed that the requested party anticipates a punitive discount for declining to provide an opinion and the certification costs allocated to it are not exorbitant, then it is likely that $d > K_2$, in which case it will elect to conform so long as the requesting agent (or principal) does so previously (i.e., requests an opinion). Following this assumption, the requesting party’s or agent’s election then becomes the determinative factor in whether or not closing opinion practice persists in any particular transaction. Two scenarios can now be identified where the requesting party or agent rationally elects to conform to a certification convention that “should” be abandoned following society’s decision rule (that is, a convention where $i < K$). First, if the

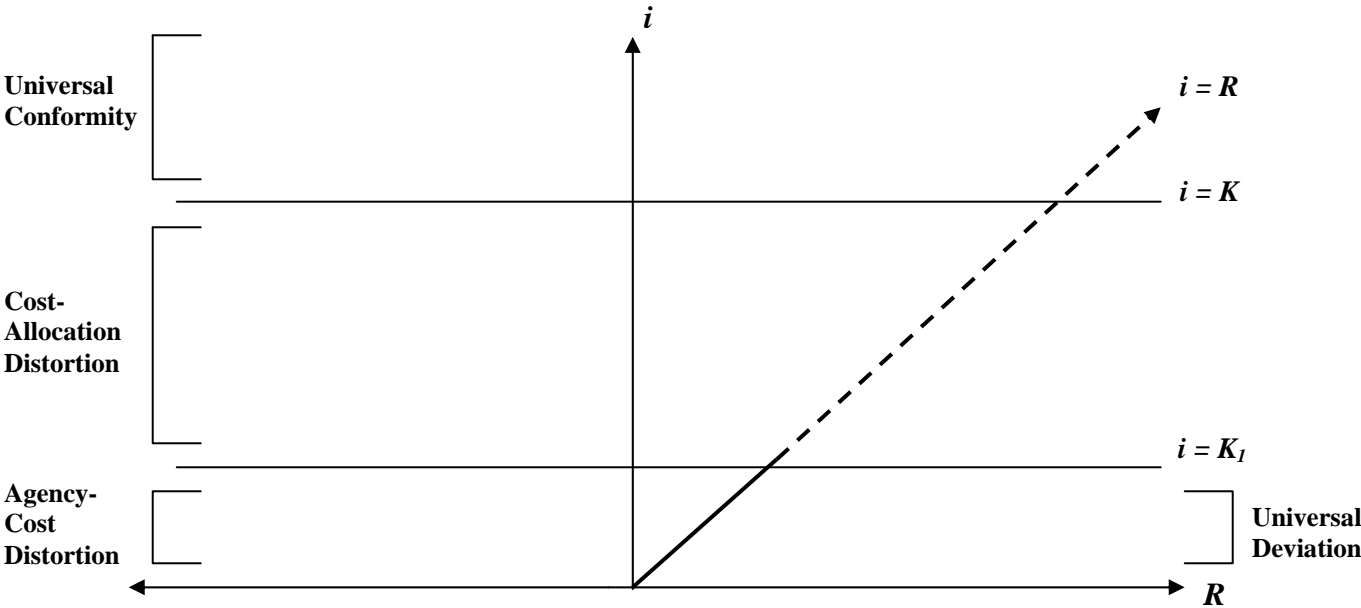
¹³⁵ For purposes of analytical convenience, these decision rules omit two variables discussed above: (i) the requesting agent’s immediate reputational penalty for deviating from convention, and (ii) the requesting agent’s immediate reputational gain for conforming to convention. Including these variables in the analysis would only bolster the conformity result advanced above.

principal acts directly, then, so long as $i > K_1$, the principal will elect to conform (i.e., request an opinion) even if it is also the case that $i < K$, which can arise if K_1 is sufficiently smaller than K_2 . Second, a requesting agent may conform to an entrenched certification practice even if $i < K$ (i.e., the practice is not cost-justified generally) or $i < K_1$ (i.e., the practice is not cost-justified from the principal's perspective). This twice-distorted outcome arises because (1) like the principal (and unlike society), the agent's decision rule disregards K_2 and (2) unlike the principal (and again, unlike society), the agent's decision rule disregards K_1 given its nominal ownership interest in the principal but instead takes into account R , which designates the agent's net reputational payoff (positive or negative) for a contemplated deviation from existing practice. This generates the core incentive structure that sustains a non-cost-justified certification practice in the typical scenario: *the requesting agent will conform whenever $i > R$, even if $i < K_1$ or $i < K$.*

These distortion effects are illustrated in the Figure below using hypothesized values for K and K_1 and assuming that $K_2 > K_1$. The Figure indicates the elections of three actors: society (S); the requesting principal (P); and the requesting agent (A), among a set of two possible actions: *conform*; *deviate*. Note that the Figure reflects two assumptions: (i) for S and P , it is always true that $R = 0$ (meaning that, for these actors, R is an irrelevant variable); and (ii) for A , if $i > K_1$, then $R = 0$.¹³⁶ Three indifference lines are shown: where $i = K$, "society" is indifferent between *conform* or *deviate*; where $i = K_1$, the requesting principal is indifferent; where $i = R$ (which is drawn as a 45° line lying between the i and R axes), the requesting agent is indifferent (except that, based on assumption (ii) noted above, where it is also true that $i > K_1$, the requesting agent therefore still elects *conform*). All actors are assumed to be risk-neutral.

¹³⁶ That is: if the certification is cost-justified from the perspective of the principal, then its agent cannot plausibly expect any positive reputational payoff (e.g., for "getting a deal done" efficiently) by electing *deviate*. This assumption is not critical to the key agency-cost distortion result; it simply excludes implausible scenarios for expositional clarity.

Figure 3: Distortion Effects



<p><u>Distorted Outcomes:</u></p> <p><i>Agency-cost distortion</i> $(K_1 > i > R)$: <i>S</i> deviates; <i>P</i> deviates; <i>A</i> conforms</p> <p><i>Cost-allocation distortion</i> $(K > i > K_1)$: <i>S</i> deviates; <i>P</i> conforms; <i>A</i> conforms</p>	<p><u>Efficient Outcomes:</u></p> <p><i>Universal deviation</i> $(i < R, i < K_1)$: All types deviate</p> <p><i>Universal conformity</i> $(i > K)$: All types conform</p>
<p><u>Assumes:</u> (i) for <i>S</i> and <i>P</i>, $R = 0$; (ii) for <i>A</i>, if $i > K_1$, then $R = 0$.</p>	

Above the “social indifference” line ($i = K$), the preferred action is *conform*, while below the line, the preferred action is *deviate*; thus, any action by the requesting principal or agent below the line other than *deviate* constitutes a socially inefficient outcome attributable to one of two distortion effects. First, in the area where $K > i > K_1$, a “cost-allocation” distortion effect arises with respect to the requesting principal and agent as a result of the fact that neither takes into account K_2 . This area represents transactions where the requesting principal and/or agent

conforms excessively from society's point of view: that is, the certification convention inefficiently persists as a result of the disproportionate allocation of costs to the requested party.¹³⁷ Second, in the area where $K_I > i > R$, an "agency-cost" distortion effect arises as a result of the fact that the requesting agent (but not the principal) expects to accrue informational value in excess of any reputational payoff (negative or positive) from electing *deviate*. This area represents transactions where the requesting agent conforms excessively from society's and the principal's point of view: that is, the certification convention inefficiently persists as a result of the misalignment of incentives between principal and agent.

D. *Refinements*. Each of the distortion effects described above relies on an underlying "discounting" assumption: (1) the cost-allocation distortion relies on the assumption that the requesting principal entirely discounts K_2 , the certification costs allocated to the requested party; and (2) the agency-cost distortion relies on the assumption that the requesting agent almost entirely discounts K_I , the certification costs allocated to the requesting principal.¹³⁸ As a practical matter, these assumptions may not always be fully satisfied. First, the requesting principal may not entirely discount K_2 in transactions where resource expenditures by the requested party operate indirectly to the economic detriment of the requesting principal (e.g., less

¹³⁷ Note that the dashed extensions of the agent's indifference line indicate that these extensions rely on the second assumption noted above in the text (if $i > K_I$, then $R = 0$).

¹³⁸ The agency-cost distortion relies further on the assumption that the requesting agent does *not* discount (or at least does not fully discount) i to reflect its nominal ownership in the principal). This may seem inconsistent with the assumption that the agent fully discounts K_I . This differential treatment relies on the notion that, whereas the agent does not suffer any loss in excess of its nominal ownership percentage as a result of K , the value of i is directly relevant to the agent insofar as it impacts the "base" reputational payoff from electing to proceed with the relevant transaction or not. Note further than any partial discounting assumption would still support the excessive consumption result so long as $i/n > R$, where n is the discount factor. For a similar non-discounting assumption, see Todd L. Milbourn et al., *Managerial Career Concerns and Investments in Information*, 32 RAND J. ECON. 334 (2001).

cash in the borrower's pocket reduces its ability to repay the lender), in which case any cost-allocation distortion will be mitigated (which, however, does *not* mitigate the agency-cost distortion). Second, to the extent that the requesting principal institutes reasonably effective monitoring, compensation or reputational mechanisms, the agent may not *fully* discount K_1 (e.g., an attorney may partially take into account the client's certification costs in order to avoid a reputation for "overlawyering"), in which case any agency-cost distortion would be mitigated.

However, the analysis above also does not take into account that some requesting agents also anticipate incurring "negative" certification costs in the form of fees paid to them for services provided in connection with the certification process. While in the closing opinion context these are not usually material relative to total fees received by the requesting attorney (and therefore, generally is not, in my view, a plausible "sustaining" factor for closing opinion practice), the fees become more substantial, both on an absolute and relative basis, in other certification settings described below.¹³⁹ Where this fee stream *is* substantial, this would *aggravate* any agency-cost distortion in favor of electing to conform, thereby limiting any mitigating effect resulting from less than complete discounting of allocated certification costs as described above.

While these refinements may have limited net effect in some practical contexts, the following general relationships can be observed for predictive purposes: (i) to the extent K_2 , certification costs allocated to the requested party, is a substantial amount and assuming the requesting principal indirectly bears a portion of these costs, the cost-allocation distortion *declines*; (ii) to the extent K_1 , certification costs allocated to the requesting principal, is a substantial amount and assuming there is some robust level of internal monitoring and incentive

¹³⁹ See *infra* Part V.

mechanisms, the agency-cost distortion *declines* and probably disappears above a certain “exorbitant” cost threshold, and (iii) to the extent the requesting agent derives fees or other revenue from the relevant certification practice, the agency-cost distortion *increases*. In the following Part, I test a further assumption, failing which the agency-cost distortion entirely *disappears*.

IV. *Fixing the Opinion Puzzle.* The agency-cost distortion necessarily assumes that the requesting agent does not assign a sufficiently high value to the expected net reputational payoff upon deviating from an entrenched convention. In this Part, I argue that this assumption may not hold true for “lead” requesting agents (or certain other market participants), who, for reasons identified below, may assign a sufficiently high value to any such reputational payoff so that deviation becomes the preferred course of action (i.e., $i < R$).¹⁴⁰ Thus, the same incentive structure that accounts for the preservation of a non-cost-justified certification practice for a substantial period also explains how such a practice may ultimately disappear from the market as lead participants emerge with sufficiently high valuations of the reputational payoff from electing to deviate. If any of these market leaders deviates and in fact realizes its anticipated reputational gain (which implies that the market views the deviation as successful), it may progressively eliminate a degenerate certification practice by reducing the expected reputational penalties incurred by other market participants that similarly elect to deviate, thereby

¹⁴⁰ This argument is consistent with subsequent refinements of the reputational herding model initially developed by Scharfstein and Stein, as described above, *see supra* note ___. Specifically, Jeffrey Zwiebel argues that a manager’s susceptibility to rational 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). *See* Jeffrey Zwiebel, *Corporate Conservatism, Herd Behavior and Relative Compensation*, 103 J. POL. ECON. 1 (1995).

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.¹⁴¹

In this Part, I describe several possible market leaders in the closing opinion market who may rationally assign a sufficiently high value to the reputational payoff upon deviating from an inefficient certification convention. These market leaders appear to have at least the capacity to set new practice conventions as well as a mass of follower participants eager to imitate the prevailing industry convention, in which case it should follow that this market (and perhaps by extension, other degenerate certification markets) should have some reasonable ability to correct itself over time. I identify at least three potential market leaders: (i) elite and “upstart” law firms, (ii) collective organizations (most notably, the bar associations) and (iii) insurance carriers. These are examined in turn (including evidence of modest contractions in closing opinion practice apparently initiated by these market leaders), followed by a discussion of obstacles that may prevent the emergence of these lead participants.

A. *Law Firms.* The law-firm market provides two possible candidates: (i) the relatively small group of elite national law firms and (ii) the new “upstart” firm that contests the older elite’s market share. Both market players are often credited with developing new practices and contractual instruments that are in turn sometimes adopted by the remaining mass of competing firms.¹⁴² Elite firms may have incentives to deviate from convention to the extent they accrue

¹⁴¹ See Antonio Bernardo & Ivo Welch, *On the Evolution of Overconfidence and Entrepreneurs*, __ J. ECON. & MGMT. STRATEGY __ (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 (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).

¹⁴² See M.J. Powell, *Professional innovation: corporate lawyers and private lawmaking*, 18 L. & SOCIAL INQUIRY 423 (1986).

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 most other firms.¹⁴³ An elite law firm may also expect a lower reputational penalty for unsuccessfully deviating from convention to the extent that this penalty is lower where a law firm 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.¹⁴⁴ 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.¹⁴⁵ In the closing opinion context, elite or

¹⁴³ 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 Stickel, *Predicting individual analyst earnings forecasts*, 28 J. ACCOUNTING RESEARCH 409 (1990) (observing that the highest-ranked investment advisors tend to “follow the crowd” less than other advisors) with John R. Graham, *Herding among Investment Newsletters: Theory and Evidence*, 54 J. FIN. 237 (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 (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 payoff from a risky project declines relative to that of a safe project).

¹⁴⁴ See Owen Lamont, *Macroeconomic Forecasts and Microeconomics Forecasters*, J. ECON. BEHAV. & ORG. ___ (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).

¹⁴⁵ On a more general level, Prendergast & Stole have offered a theoretical model in which young or new market participants have a greater incentive than older or more established participants to take more extreme positions (even positions that the participant knows to be objectively unjustified), because (1) younger participants wish to demonstrate having novel information relative to the accumulated pool of historical information represented by existing practices while (2) older participants wish to avoid innovations that would suggest any past beliefs 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 has contracted to a certain extent. Examples include: (i) the virtually complete withdrawal of closing opinions in the public mergers and acquisitions market; (ii) a possible slowdown in the use of closing opinions in the private mergers and acquisitions market¹⁴⁶; and (iii) consistent with recent pronouncements of the Business Law Section of the California Bar¹⁴⁷, the apparently increasing abandonment in recent years by California practitioners of requesting closing opinions in smaller acquisition and financing transactions.¹⁴⁸

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

practices had been in error. *See* C. Prendergast & L. Stole, *Impetuous Youngsters and Jaded Old-Timers: Acquiring a Reputation for Learning*, 104 J. POL. ECON. 1105 (1996).

¹⁴⁶ *See* Schwartz, *supra* note __, at __ (stating that recently “some lawyers have relaxed traditional requirements for closing opinions in connection with mergers and acquisitions”); Lipson, *supra* note __, at 93-94 (noting that some lawyers indicate that enforceability opinions are sometimes waived in asset sales involving parties of equal bargaining power).

¹⁴⁷ In 2004 and 2005, the Business Law Section of the California Bar issued reports including statements to the effect 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” and recommending that opinions concerning certain matters are best foregone when the opinion recipient can rely on appropriate representations and warranties in the underlying agreement and its own diligence investigation. *See* 2004 CALIFORNIA BAR REPORT, *supra* note __, in GLAZER ET AL., at App. 9A:9-10; 2005 CALIFORNIA BAR REPORT, *supra* note __, at 22.

¹⁴⁸ *See* 2004 CALIFORNIA BAR REPORT, *supra* note __, in GLAZER ET AL., at App. 9A:38 n.4 (based on informal survey of California practitioners).

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 theoretically be an effective tool for facilitating abandonment of an obsolete industry standard, something approaching the opposite seems to have been the case until recently in closing opinion practice where the bar associations’ standardization efforts, while probably 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.¹⁴⁹ As noted elsewhere, the California Bar (and, to a certain extent, some other regional bar associations) recently appears to have departed to a certain degree from these historical tendencies, specifically casting doubt on whether it is appropriate to issue enforceability opinions in certain transactions.¹⁵⁰ The driving force behind these and other more discrete contractions in closing opinion practice¹⁵¹ appears to be a creeping recognition by

¹⁴⁹ 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 supra* note __), 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); Deer, *supra* note __; Dillon, *supra* note __. *See also* Arthur Field & Steven Weise, *Remedies Opinions and Exceptions*, printed in AMERICAN BAR ASSOCIATION, NATIONAL INSTITUTE, THE SILVERADO SUMMIT: THE STANDARDIZATION OF LEGAL OPINIONS – ORDER OUT OF CHAOS (1989) (noting that “clean” remedies opinion did not contain until recently any limitation other than an exception for insolvency laws); Bradbury Clark, *supra* note __ (same). 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.

¹⁵⁰ *See supra* notes [] and accompanying text.

¹⁵¹ 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

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”¹⁵², advice that the market followed widely¹⁵³, thereby illustrating the bar’s potentially potent coordinating power to correct inefficient industry practice.

C. *Insurance.* The third candidate is the insurance industry. Not being a requesting agent, the insurance industry is not subject to the agency-cost incentives that might lead a lawyer, manager or board member to rationally adhere to a socially excessive certification practice. To the contrary: the insurance industry 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 phenomenon: the once-entrenched practice of issuing title opinions in real estate transactions in the United States has now been largely displaced by title insurance¹⁵⁴, 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

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 __, at 647.

¹⁵² *See* ABA Guidelines, *supra* note __, at §I.C(i), *cited in* GLAZER ET AL., *supra* note __, at §9.10.2

¹⁵³ *See* GLAZER ET AL., *supra* note __, at §9.10.2.

¹⁵⁴ *See* Benito Arrunada, *A Transaction-Cost View of Title Insurance and its Role in Different Legal Systems*, published in THE GENEVA PAPERS OF RISK & INSURANCE, Vol. 27, No. 4, pp. 582-601 (Oct. 2002) [hereinafter Arrunada, *Title Insurance*].

to indemnify the buyer for title defects.¹⁵⁵ 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.¹⁵⁶ Illustrating this possibility, a California insurer has recently begun marketing to lenders a policy that covers losses based on failure of perfection or priority of a lender's security interests in borrower collateral¹⁵⁷, 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. Where this capacity is limited, some form of regulatory intervention in the relevant certification market may be appropriate (an approach actually undertaken by Rhode Island, which prohibits lenders from requiring that borrower's counsel render an enforceability opinion as a condition to closing¹⁵⁸). 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

¹⁵⁵ See *id.* The title insurance industry is apparently now bringing this practice to Canada and Australia, where it is rendering obsolete similarly inferior title opinion practices or sparking lawyers to defend their traditional role in these transactions by collectively offering a similar insurance-type product.

¹⁵⁶ Title insurance was also once thought to be a novel concept. For an initial "radical" proposal, see Daniel Deviate Gage, Jr., *The Land Title Underwriter*, 14 J. LAND & PUBLIC UTILITY ECON. 56 (1938). More recently, a similar "radical" proposal has been made to replace much of the complex regulatory structure relating to the audit process for publicly traded corporations with a simple requirement to obtain financial statement insurance. See Alex Dontoh, Joshua Ronen & Bharat Sarath, *Financial Statements Insurance* (Aug. 2004), avail. on www.ssrn.com.

¹⁵⁷ See CLARK'S SECURED TRANSACTIONS MONTHLY (2003); <http://www.eagle9.com/faq.html>.

¹⁵⁸ See R.I. GEN. LAWS §19-9-7. Note that the Rhode Island legislation seems to have been motivated in part by legal ethics concerns relating to the conflict of interest between a lawyer's duties to its client and giving an opinion to a non-client having potentially adverse interests.

factors in particular can substantially increase the costs of abandoning conventional practice. First, legal or other institutional requirements that require or strongly encourage use of a particular certification instrument can distort the market’s “natural” abandonment of an obsolete certification practice.¹⁵⁹ In the securities context (and under certain other legal regimes¹⁶⁰), the use of legal opinions is mandated by law, specifically with respect to the “legality opinion” that must be attached to a registration statement for a securities offering.¹⁶¹ Additionally, as a matter of standard practice (which may be supported by “prudential” management requirements under applicable banking regulations¹⁶²), U.S. institutional lenders require as a matter of long-standing policy delivery of a closing opinion from borrower’s counsel in large financing transactions. While presumably intended to screen out fraudulent behavior and address related informational asymmetries, legal requirements or established institutional policies that entrench certification practices may have no such effect while effectively imposing a levy on transacting parties in the event such practices are no longer cost-effective. More perniciously, some certification intermediaries may lobby (and have lobbied¹⁶³) for the introduction or retention of legal requirements that block any future migration by market leaders to a more efficient certification practice. Second, certain forms of cooperative or collusive action among certification intermediaries can similarly increase a market leader’s costs of deviating from industry practice.

¹⁵⁹ Frank Partnoy has argued that “regulatory licenses” are a principal source of the market share of certain gatekeeper entities, which in turn casts doubt on attributing such success to these entities’ incentives to accumulate and maintain reputational capital. *See* Partnoy, *Strict Liability*, *supra* note __, at 509-510.

¹⁶⁰ For a full listing, see 2004 CALIFORNIA BAR REPORT, *supra* note __, in GLAZER ET AL., at App. 9A:42-44.

¹⁶¹ *See supra* note __.

¹⁶² *See California Remedies Opinion Report*, *supra* note __, at 914 n.32.

¹⁶³ This scenario was apparently realized in the title opinion market, where lawyers reacted to the introduction of title insurance—a superior certification practice—by lobbying, successfully in some states, for a legal requirement that a lawyer act as the sole “conveyancer” in real estate transactions (of course in the name of protecting the “fairness” of the real estate transfer process). *See* Arrunada, *Title Insurance*, *supra* note __. For discussion of similar behavior by European notaries, see *infra* note [].

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 have served the uncontroversial purpose of reducing transaction costs, they have also effectively blessed and possibly “frozen” existing forms of closing opinion practice¹⁶⁴, thereby increasing the anticipated reputational penalty for an unsuccessful deviation from industry practice.

V. Preliminary 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, sustained by agency-cost and adverse selection effects, which may in turn also be supported by a one-sided cost-allocation to the detriment of the requested party, has potential application as a diagnostic tool for identifying and accounting for socially excessive consumption of other widely used (but also widely questioned) certification proxies in the financial and other markets. Even where any such certification practice generates relatively low costs on an individual basis, the social losses resulting from the inefficient persistence of any such practice may be substantial in the aggregate by force of multiplication across thousands of transactions annually. As noted earlier, while each closing opinion typically generates out-of-pocket costs of only several thousands of dollars, a rough but artificially conservative estimate of the total annual out-of-pocket expenditures in the U.S. on closing

¹⁶⁴ See generally Coffee, *Comment, supra* note __, 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).

opinions approaches at least several millions of dollars¹⁶⁵, which would represent a net social loss after deducting for any residual incremental informational value. Given the possibility that sophisticated transacting parties may sustain non-value-enhancing certification practices (which may then be exacerbated by legal requirements), it appears that some markets may be afflicted not by the more commonly identified shortage, but rather an *excess*, of certification instruments, which, once entrenched, impose a material “cost of doing business” (and a resulting allocational distortion¹⁶⁶) that does little to alleviate informational asymmetries while being difficult to dislodge given the incentive structure and other factors described above.

Identifying a purportedly degenerate certification market, especially where entry barriers in the relevant certification market are low or nonexistent, market participants have roughly equal sophistication and distorting legal interventions are largely absent (all of which is substantially true in the closing-opinion context), 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. But as a general matter any such market failure is not especially surprising in light of economic models that have always anticipated the theoretical possibility of inefficient signaling outcomes to the extent that, following Spence’s fundamental thesis, the private return from signaling investments exceeds the social return.¹⁶⁷

¹⁶⁵ See *supra* note [] and accompanying text.

¹⁶⁶ The social losses would also include even more serious allocational distortions if certification recipients misappreciated the limited informational value of the relevant certification. Following the model presented above, an overestimate among requesting parties of the informational value of the relevant certification would further boost any “overconsumption” result. In the closing opinion context, given the absence of differential sophistication between opinion issuer and recipient, this contingency is not plausible without reference to an attenuated herding mechanism whereby sophisticated recipients have rational incentives to discount evidence as to an opinion’s limited informational value. For sake of brevity, I do not pursue this argument here.

¹⁶⁷ See A. MICHAEL SPENCE, MARKET SIGNALING: INFORMATIONAL TRANSFER IN HIRING AND RELATED SCREENING PROCESSES (1974); Michael Spence, *Job Market Signaling*, 87 Q. J. Econ. 355 (1973); Michael Spence, *Competition in Salaries, Credentials and Signaling Prerequisites for Jobs*, 90 Q. J. Econ. 51 (1976). These well-known contributions generally advance the thesis that signaling investments are inefficient to the extent that they reallocate a portion of the relevant economic pie to “higher-quality” actors at a positive resource expenditure

Consistent broadly with this more pessimistic (and complex) view of certification intermediaries, this Article’s thesis may potentially account for empirical findings and business press reports suggesting that other certification products widely consumed in the financial markets at nontrivial resource costs may contribute limited incremental informational value. As discussed in part above¹⁶⁸, these potential additions to the “degenerate certification” gallery include: certain legal opinions other than closing opinions¹⁶⁹, certain fairness opinions issued by investment banks¹⁷⁰, and certain bond ratings issued by credit rating agencies.¹⁷¹ The net social value of

without generating any allocational or other countervailing efficiencies that increase the size of the pie. This thesis requires that signaling investments do not at all affect the total social product through either “matching efficiencies” or a “human capital” component that increases productivity (thus, Spence’s model assumed that education investments are entirely unproductive); 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. For more general discussions of excessive consumption and other inefficiencies in certification or “audit” markets, see MICHAEL POWER, *THE AUDIT SOCIETY* (1997); POWER, *supra* note __.

¹⁶⁸ See *supra* Part I.B.

¹⁶⁹ Two prominent candidates are (i) legality opinions issued by counsel in publicly registered offerings, whose added informational value is uncertain, see Partnoy, *Barbarians*, *supra* note __, at 536-37, and (ii) “true sale” and “non-consolidation” opinions issued in structured-finance transactions, which figured in the Enron transactions and have been the subject of increasing criticism as being technically correct but conveying little substantive information, see *supra* Schwarcz, *Limits of Lawyering*, *supra* note __, at __. I note that the substantive content of tax opinions is also often subject to considerable debate, but this is substantially related to the lack of sophistication and legal distortions on the “demand side” of this market.

¹⁷⁰ It has been noted in the academic literature, some judicial statements and an increasing portion of the institutional-investor and regulatory communities, that the informational value of fairness opinions (issued by investment banks to target and acquiror boards in merger and acquisition transactions) is limited in light of conflicts of interest, the inherently subjective and uncertain methodologies available to investment bankers, and the abundant use of disclaimers and qualifying language. See, e.g., Charles M. Elson et al., *Fairness Opinions—Can They Be Made Useful?*, 6 *MERGERS & ACQUISITIONS LAW REPORT* 907 (Dec. 1, 2003); Stephen Glover & David Harris, *Fairness Opinion Practice Comes Under Scrutiny as NASD Considers New Rules*, *WALL ST. LAWYER*, Vol. 8, No. 8 (Jan. 2005); David Henry, *A Fair Deal – But For Whom?*, *Bus. Week* (online), Nov. 24, 2003, avail. at www.businessweek.com/magazine/content/03_47/b3859105_mz020.htm. See also Ann Davis & Monica Langley, *Opinions Labeling Deals ‘Fair’ Can Be Far From Independent*, *Wall St. J.*, Dec. 29, 2004, Page A1 (stating that is an “open secret on Wall Street that fairness opinions can be anything but arm’s-length analyses” given strong conflicts of interest).

¹⁷¹ The academic literature observes that credit ratings have questionable informational value in light of the fact that the rating agencies (i) are subject to limited legal liability in light of regulatory exemptions and court decisions granting First Amendment protections, (ii) rely on accuracy of information provided by issuer management, and (iii) despite the purported disciplining effect of reputational pressures, tend to follow, rather than lead, the market consensus. See, e.g., *RATING THE RATERS: ENRON AND THE CREDIT RATING AGENCIES*, *HEARING BEFORE THE COMMITTEE ON GOVERNMENTAL AFFAIRS, U.S. SENATE*, 107th CONG. 471 (Mar. 20, 2002) (statement of Prof. Jonathan R. Macey) (stating that credit ratings provide no useful information to the market); SEC REPORT

these routine commercial practices is subject to ongoing dispute by academic researchers, sophisticated market participants and some policymakers¹⁷², in light of some of the same factors that cast doubt on the certification value of closing opinions, including: (i) other information and/or diligence instruments already being available to transaction participants, (ii) limited or zero legal liability of the certification provider (especially acute in the credit rating market as a result of a judicially created “First Amendment” exemption¹⁷³), (iii) constrained screening technologies, (iv) conflicts of interest on the part of the certification provider and (v) market concentration among certification providers (again, particularly acute in the credit rating market¹⁷⁴).¹⁷⁵ Subject to further inquiry, the foregoing considerations raise some analytical curiosity as to the persistence of these tentatively questionable practices in sophisticated financial markets, 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 probe these intuitions further, I show below how this Article's two-sided incentive structure can, with minimal customization, account preliminarily for the surprising persistence of two of

ON THE ROLE AND FUNCTION OF CREDIT RATING AGENCIES IN THE OPERATION OF THE SECURITIES MARKETS, Jan. 2003, at p.4 [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); Partnoy, *Credit Rating Agencies*, *supra* note __, at 59-99 (arguing that credit rating agencies contribute little to no new information to the market and their market power is principally derived from regulatory licenses). For a description of available empirical data, *see supra* note [].

¹⁷² Fairness opinions previously had received scrutiny from the New York State Attorney General's office, when led by Elliot Spitzer, and subsequently, the SEC. As a result, the NASD (the National Association of Securities Dealers) proposed rules that would require NASD member firms, among other things, to give greater disclosure of any possible conflicts of interest, including compensation arrangements. *See* NASD Proposed Rule Change to Establish New NASD Rule 2290 Regarding Fairness Opinions, SR-NASD-2005-080 (proposed June 22, 2005); Form 19b-4, filed by NASD with the SEC in June 2005 (available on www.sec.gov).

¹⁷³ *See supra* note [].

¹⁷⁴ Concentration issues are relevant specifically with respect to the credit ratings market, which is dominated by Moody's and Standard & Poor's, whose market power is in turn substantially bolstered by the mandatory use of credit ratings in several regulatory regimes that 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 rating firms. *See* PRIVATE-SECTOR WATCHDOGS, *supra* note __, at 78-80; ROLE AND FUNCTION OF CREDIT RATING AGENCIES, *supra* note __, at 6-10.

¹⁷⁵ *See supra* Part I.B.

these informationally "thin" practices, fairness opinions and credit ratings. Given that these practices involve substantially greater costs than closing opinions (with fees ranging from several hundred thousand dollars)¹⁷⁶, and without taking a definitive position as to whether these substantial costs likely exceed the informational value typically yielded as a result¹⁷⁷, these practices provide potential evidence of both the ability of a degenerate certification practice to persist under a broad range of cost conditions (albeit, for reasons discussed earlier¹⁷⁸, probably with less "ease" as costs climb and ultimately subject to a maximum threshold) and the outside practical magnitude of any resulting social losses in the form of misallocated resources.

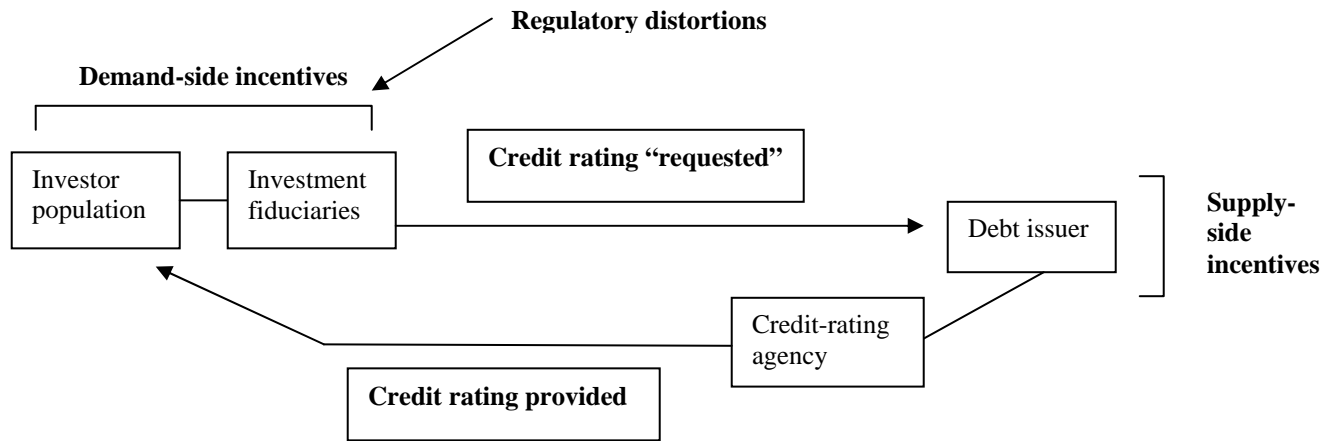
A. *Credit Ratings.* A credit rating can be viewed as a certification instrument that is provided by an issuer (through the third-party rating agency) pursuant to the "standing request" of the investor population (in part represented by agents in the form of money-managers and other investment fiduciaries). Below I provide a graphical illustration of this proposed structure, which applies the two-sided incentive structure developed in the closing-opinion context while incorporating distorting external factors derived principally from state regulation.

¹⁷⁶ Information on these fees is as follows. Rating agency fees range from 3 to 4 "basis points" (i.e., one-hundredths of a percentage point) of the face amount for the rated debt issue up to a maximum of approximately \$300,000 and can be considerably higher for complex structured-finance issues up to a maximum of \$2.4 million. See Frank Partnoy, *How and Why Credit Rating Agencies Are Not Like Other Gatekeepers*, in Fuchita & Litan, *supra* note __, at 60 n.4 and 69. Fairness opinion fees are usually bundled together with the "success fee" on the whole transaction, such that the fairness opinion fee generally represents up to 10% of the sum of the fairness opinion fee plus success fee (amounting to millions of dollars in any substantially sized transaction). See Elson et al., *supra* note __, at 1985, n.14.

¹⁷⁷ In particular, I note that even if credit ratings provide little new information to the market, they may still generate social value as an "information aggregator".

¹⁷⁸ See *supra* Part III.D.

Figure 4: Credit Ratings – Proposed Incentive Structure



As this Figure illustrates, on the demand side, agency-cost pressures are strong insofar as a credit rating provides legal and reputational protection for the “deemed” requesting agent in the event an investment fiduciary (e.g., a mutual fund manager) makes “unsuccessful” investment choices.¹⁷⁹ As noted previously and indicated in the Figure above, these demand-side incentives are then further exacerbated by several regulatory regimes in the securities, banking and insurance industries mandating the use of credit ratings by fiduciaries and other actors for certain investment and regulatory purposes.¹⁸⁰ 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). 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

¹⁷⁹ See COFFEE, *supra* note __, at 287, 294.

¹⁸⁰ See *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985).

the actual or potential harm to the offering price, the issuer typically agreed to fund the agency's rating process and provide it with necessary access to company information.¹⁸¹

Not coincidentally, the credit-ratings market (in common with the closing opinion market) exhibits the critical characteristic that the requesting agent—the investment fiduciary—does not bear directly any of the costs of providing the relevant certification. As argued above, this disproportionate cost-allocation has a crucial effect on sustaining demand-side incentives among requesting parties to continue obtaining a non-value-enhancing certification instrument. The history of the credit-rating market again provides compelling evidence, insofar as it experienced substantially increased growth starting in the 1970s once it moved from a funding model whereby certain institutional investors (the “requesting party” in this case) subscribed to the rating service to an alternative model whereby issuers (the “requested party” in this case) bear the cost of the rating process.¹⁸² As anticipated by this Article's incentive structure, re-allocating certification costs away from the requesting party apparently induced (at least in part) potentially “excessive” consumption of the relevant certification instrument.

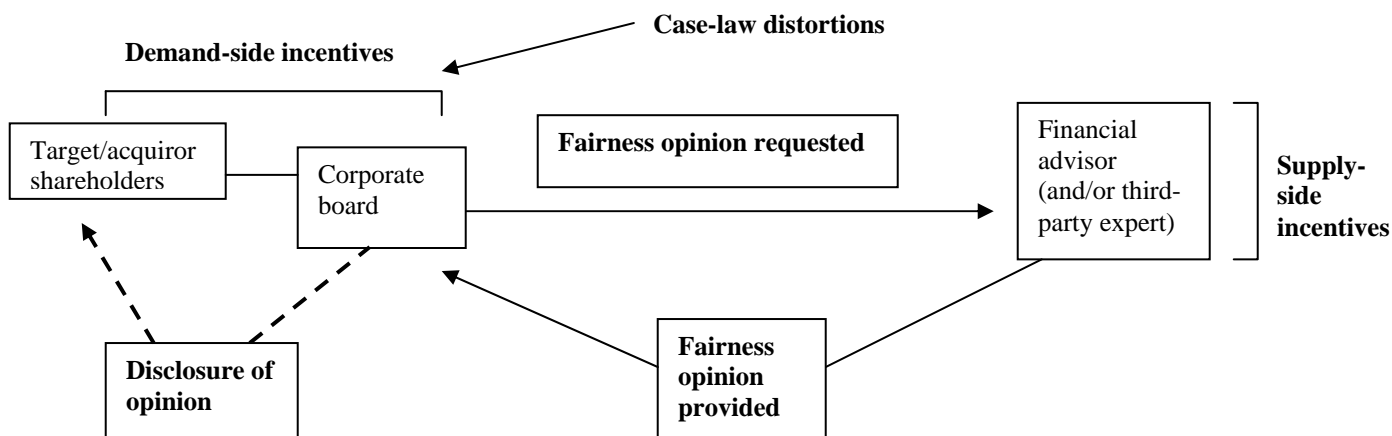
B. *Fairness Opinions.* A fairness opinion can be viewed as a certification that is provided by an investment-bank adviser pursuant to the “standing request” of the corporation's shareholders (represented by their “agents” on the relevant corporate board), with the variation that the opinion is issued solely to the requesting agent (i.e., the board), which (as indicated by the dashed lines below) then typically discloses the favorable conclusion of the opinion to the principal (i.e., the shareholders). As the Figure below illustrates, the same two-sided incentive

¹⁸¹ See *id.*, at 294-96.

¹⁸² See, COFFEE, *supra* note __, at 295-97. Coffee suggests additionally that this growth is due to the simultaneous growth of structured finance transactions, which required the use of special purpose vehicles with a minimum credit rating. Based on this Article's analysis, we would have to say “required”.

structure that may sustain closing opinion practice can be applied with little customization to construct a closely analogous “sustaining” structure for fairness opinions.

Figure 5: Fairness Opinions – Proposed Incentive Structure



On the demand side, agency-cost pressures are strong insofar as a fairness opinion provides legal and reputational protection for the requesting board in the event that it approves an “unsuccessful” merger. On the supply side, adverse selection pressures are strong insofar as failure to deliver a fairness opinion is a near-certain “deal breaker” in most acquisition transactions. As noted previously and indicated in the Figure above, demand-side incentives to seek a fairness opinion are then further exacerbated by legal requirements in the form of 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.¹⁸³ Not coincidentally, the fairness opinion exhibits the critical characteristic (again, in common with the closing opinion market) that the requesting agent—the requesting board (especially, the target’s board members)—does not bear directly any

¹⁸³ See *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985).

of the costs of providing the relevant certification. As argued above, this disproportionate cost-allocation has a crucial effect on sustaining demand-side incentives among requesting parties to continue obtaining a non-value-enhancing certification instrument. The fairness opinion market provides compelling evidence to illustrate this relationship: namely, where the requesting party (at least the principal) *does* bear certification costs (typically, where the acquiror requests an opinion), available data suggest that the fairness opinion *does* tend to have substantial incremental value; where the requesting party does *not* bear the certification costs (typically, where the target requests an opinion, given that it anticipates being acquired, following which any certification costs will be passed on to the new owners), available data suggest that the fairness opinion usually does *not* have substantial incremental value.¹⁸⁴ As anticipated by this Article's incentive structure, where the requesting party bears the certification costs, it apparently elects to "conform" when doing so is cost-justified generally, but where it does not bear these costs, then it apparently consumes the certification instrument even when doing so is not cost-justified.

Conclusion

Certification intermediaries are often presumptively viewed as an effective market-generated mechanism for resolving informational asymmetries that may otherwise frustrate or distort efficient transactions. This happy story makes a cogent logical case and has empirical foundation in several identified market settings. However, this view does not describe an economically important category of transactional settings where these optimistic expectations in theory do not seem to be easily satisfied in practice. Specifically, it fails to account for the

¹⁸⁴ See Kisgen et al., *supra* note __.

mixed and sometimes even contrary results often reached in empirical attempts to confirm the informational value of several certification instruments routinely used in sophisticated financial markets. As I argue, this view also cannot satisfactorily account for the widespread usage of closing opinions in sophisticated business transactions given strong evidence that a typical closing opinion imposes positive resource costs without generating at least commensurate informational value. These observations raise a puzzle: why would a non-cost-justified certification practice persist over a substantial period of time in a competitive market populated by sophisticated participants? This Article’s degenerate certification model provides a potential solution: reciprocal demand-side and supply-side incentives, as supported by a disproportionate cost-allocation to the detriment of the requested party, drive market participants rationally to request and deliver a non-cost-justified certification product.

This incentive structure not only casts doubt on the presumptive efficiency of even widely employed certification instruments in analogous market circumstances but, more practically, may provide guidance in understanding how gross frauds can arise undetected even in sophisticated markets saturated by prestigious (and expensive) intermediaries. Given its obvious importance to the efficient operation of the financial markets and the responsible design of appropriate regulatory interventions (as well as the aggregate resource expenditures typically involved), our understanding of the circumstances under which certification intermediaries actually do and do not remedy (or at least, are or are not likely to remedy) informational asymmetries *at a net social gain* is surprisingly still in its relative infancy.¹⁸⁵ Enron and other contemporary financial scandals have led some legal commentators to revisit the certification or “reputational intermediary” thesis, in the process identifying certain aggravating market-specific

¹⁸⁵ For similar views, see Riley, *supra* note __; Jin et al., *supra* note __.

or regulatory conditions (most notably, conflicts of interest, differential sophistication and market concentration) that may cause certification intermediaries to fail to invest sufficient resources to screen out fraudulent and similar transactional practices.¹⁸⁶ This Article extends this growing taxonomy of “certification pathologies” by providing an alternative model of certification failure that is generically formulated and does not rely on any of these aggravating conditions (and even makes the “generous” assumptions of substantially competitive markets among certification providers and full sophistication among certification recipients), thereby potentially covering a broader range of market settings. Contrary to the happy story that has been widely told to date, some routinely employed certification practices may surprisingly do nothing more on a net social basis than impose a costly transactional burden on the relevant market, in which case even an abundance of prestigious intermediaries provides little to no assistance in mitigating informational asymmetries that may distort efficient transactions.

¹⁸⁶ See *supra* note [] and accompanying text.

APPENDIX¹⁸⁷

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

- Mega Group, Inc. v. Pechenik & Curro, P.C., 32 A.D.3d 584 (N.Y.A.D. 3 Dept., 2006)
- Distinctive Home Builders, LLC v. Copar Const., LLC, 2006 WL 2556138 (Conn. Super. 2006)
- First Massachusetts Bank, N.A. v. Floriam, 825 N.E.2d 115 (Mass. App. Ct. 2005)
- Connecticut Resources Recovery Authority v. Murtha Cullina, LLP, 2005 WL 3291920 (Conn. Super. 2005)
- Banco Popular North America v. Gandi, 876 A.2d 253 (N.J. 2005)
- Keybank Nat'l. Ass'n. v. Reidbord, 2005 WL 3184781 (W.D. Pa. 2005)
- Finova Capital Corp. v. Berger, 18 A.D.3d 256 (N.Y.A.D. 1 Dept., 2005)
- Dean Foods Co., et al. v. Pappathanasi, et al., No. 01-2595 BLS, 2004 WL 3019442 (Mass. Superior Ct., Dec. 3, 2004)
- National Bank of Canada v. Hale & Dorr, 17 Mass. L. Rptr. 681, 2004 WL 1049072 (Mass. Superior Ct., Apr. 28, 2004)
- Marcus v. Frome, 329 F.Supp. 2d 464 (S.D.N.Y. 2004)
- In re Precept Business Services, Inc., 2004 WL 2074169 (Bkrtcy. N.D. Tex. 2004)
- Reich Family LP v. McDermott, Will & Emery, No. 101921-03, 230 N.Y.L.J. 20, 20 col. 1 (N.Y. Sup. Ct., Oct. 29, 2003)
- Republic First Bank v. Abrahams, Lowenstein & Bushman, P.C., 2003 WL 23812027 (Pa. Com. Pl. 2003)
- Goldfine v. DeEsso, 309 A.D.2d 895 (N.Y.A.D. 2003)
- Zimmerman v. Dan Kamphausen Co., 971 P.2d 236 (Colo. App. 1998)
- Mark Twain Kansas City Bank v. Jackson, Brouillette, Pohl & Kirley, P.C., 912 S.W.2d 536 (Mo. App. W.D. 1995)
- Washington Elec. Co-op, Inc. v. Massachusetts Mun. Wholesale Elec. Co., 894 F.Supp. 777 (D.Vt. 1994)

¹⁸⁷ A more detailed appendix summarizing details of claims asserted in each case and final disposition is available from the author upon request. For detailed discussion of case-law trends, see *supra* Part III.C.1.

Resolution Trust Corp. v. Farmer, 836 F.Supp. 1123 (E.D. Pa. 1993)

Scientific Leasing, Inc. v. Windle, 1993 WL 25336 (Tex. App.-Dallas, 1993)

Geaslen v. Berkson, Gorov & Levin, Ltd., 613 N.E.2d 702 (Ill. 1993)

Prudential Ins. Co. v. Dewey, Ballantine, Bushby, Palmer & Wood, 605 N.E.2d 318 (N.Y. App. 1992)

Cambridge Factors v. Sturges & Mathes, Not Reported in A.2d, 1992 WL 174744 (Conn. Super.), 7 Conn. L. Rptr. 110 (1992)

Stock West Corp. v. Taylor, 942 F.2d 655 (9th Cir. 1991)

Terremar, Inc. v. Ginsburg & Ginsburg, 1991 WL 57815 (Conn. Super. 1991)

Gibraltar Savings, State Federal Savings and Loan Association of Lubbock and Gateway Savings Bank v. Commonwealth Land Title Insurance Company v. Popham, Haik, Schnobrich, Kaufman & Doty, Ltd., 907 F.2d 844 (8th Cir. 1990)

United Bank of Kuwait PLC v. Enventure Energy Enhanced Oil Recovery Assoc., Inc., 755 F.Supp. 1195 (S.D.N.Y. 1989)

JST Properties v. First Nat'l Bank, 701 F.Supp. 1443 (D. Minn. 1988)

Crossland Savings FSB v. Rockwood Ins. Co., 692 F.Supp. 1510 (S.D.N.Y. 1988)

Crossland Savings FSB v. Rockwood Ins. Co., 700 F.Supp. 1274 (S.D.N.Y. 1988)

Vereins-Und Westbank v. Carter, 691 F.Supp. 704 (S.D.N.Y. 1988)

City Nat. Bank of Detroit v. Rodgers & Morgenstein, 399 N.W.2d 505 (Mich. App. 1986)