Comment

The Limits of Legal Analysis: Using Externalities to Explain Legal Opinions in Structured Finance

Jonathan Macey*

I. Introduction

Sometimes a little bit of economics goes a long way in aiding our understanding of perplexing practices and conventions within the legal profession. The study of third-party legal opinions is one such occasion.

A third-party legal opinion is simply a legal opinion provided for the benefit of some third party who is not the client of the lawyers who write the opinion. Of course, there is no legal requirement that third-party legal opinions be issued to support particular transactions. The market for such opinions exists because the issuance of such an opinion makes the transaction worth more to the third party, and therefore to the client, and hence there are gains from trade (because the deal is worth more) from organizing a transaction such that the client's counter-party receives a third-party legal opinion.

Simple economic analysis helps us understand why a market for third-party legal opinions exists, and it also helps us better understand whether this market should be regulated, and if so to what extent. Steven Schwarcz's article, *The Limits of Lawyering: Legal Opinions in Structured Finance*,[1] contains a wealth of institutional detail and greatly advances our understanding of the nature of third-party legal opinions in general and their role in structured finance in particular. Professor Schwarcz's excellent article reflects a great depth of experience and learning as well as an appreciation for the practical environment in which the law operates. His article will be an important touchstone for lawyers now and for the foreseeable future.

Third-party opinions often occur in the context of structured finance transactions. Such opinions frequently are adduced in order to generate guidance for legal issues that are quite narrow and often specific to a particular transaction. Analysis of the issues generated by third-party legal opinions is, by necessity, complicated stuff, and not for those adverse to legalese and other sorts of technical jargon, such as accounting-speak and finance-speak.

For example, from Professor Schwarcz we learn that

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* Sam Harris Professor of Corporate Law, Corporate Finance and Securities Law, Yale Law School.

1. 84 TEXAS L. REV. 1 (2005).

> true sale and nonconsolidation opinions—the legal opinions most commonly associated with off-balance-sheet financing—are frequently issued by most major law firms. These opinions (hereinafter "structured-finance opinions") address only bankruptcy law issues and make no accounting analysis. Indeed, their primary as well as historical purpose is to assure investors and rating agencies that the structure of the SPV transaction is "bankruptcy remote." Furthermore, these opinions typically are . . . and, for purposes of the following discussion, initially will be assumed to be . . . technically correct as to the legal matters they purport to cover.[2]

II. The Market for Third-Party Legal Opinions

As suggested above, it seems safe to conclude that the reason we observe third-party legal opinions is because they are efficient. They are efficient because, even though they are costly to the clients who pay for them, they increase the overall value of the transactions to which they pertain by some amount greater than the cost to the parties.

Of course, the market response to the demand for a legal opinion does not automatically generate a *third-party* legal opinion. There must be some reason why the third party prefers to have a legal opinion generated by its counter-parties' lawyer, rather than by its own lawyer. And here it is interesting to note that sometimes the third parties receiving legal opinions do, in fact, have their own counsel, and the lawyers issuing a third-party opinion "often have to negotiate their opinion with counsel for the opinion recipient."[3] This, of course, brings into sharp focus the question of why third parties want a legal opinion from their counter-parties' lawyers rather than from their own attorneys.

It seems to me that the answer to this question is simple. Clients direct their lawyers to generate legal opinions for third parties such as investors or credit providers in a wide range of business and financial undertakings because their lawyers can do so more *efficiently* than the lawyers for the third parties. This is because the lawyers generating the opinions enjoy certain economies of scope when they combine the legal work they do for their clients with the legal work that they do for the third parties. The performance of due diligence for the recipient is a prime example of this phenomenon: the issuance of a third-party legal opinion obviates the need for the recipient's lawyers to duplicate such work already done by a client's lawyers.[4]

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2. *Id.* at 5 (internal citations omitted).

3. *Id.* at 25; *see also* Leslie L. Gardner, Note, *Attorney Liability to Third Parties for Corporate Opinion Letters*, 64 B.U. L. REV. 415, 419 n.34 (1984) (stating that "the general content of the legal opinion is usually negotiated prior to its issuance").

4. *See* Schwarcz, *supra* note 1, at 10–11 n.55 (explaining that third-party legal opinions can be used by their recipients to establish due diligence).

This efficiency explanation for third-party legal opinions conflicts with some of Profcssor Schwarcz's arguments, but not with others. Professor Schwarcz makes what appear to me to be two inconsistent arguments related to this point. On the one hand, Professor Schwarcz argues that the existence of "information asymmetries" explains the market for third-party legal opinions.[5] On this view, the market for third-party legal opinions exists because they "operate to effectively reduce information asymmetry between parties to a transaction."[6] At another point in his article, Professor Schwarcz suggests that no such information asymmetry actually exists. Specifically, Professor Schwarcz observes that "recipients of such opinions often have the same factual information that opining counsel has."[7] This assertion is flatly inconsistent with Professor Schwarcz's informational asymmetry argument because there can be no information asymmetry if the two sides already have the same information.

Professor Schwarcz also argues, incorrectly in my view, that the market for third-party legal opinions exists even where the parties have the same information because "opining counsel assesses certain legal consequences of that information for the opinion recipients."[8] The problem with this argument is that it does not explain why the opining counsel is better able to assess "certain legal consequences" of information better (more cheaply or more reliably) than the recipient's actual counsel. In fact, this assertion appears quite implausible. Recipient's counsel is likely to have the same ability to apply the law to facts as opining counsel.

Therefore, among these rival explanations, I am drawn to the efficiency explanation of third-party opinions. There is a market for third-party legal opinions because there are economies of scale in doing the original legal work for a client, and then using that information to generate a legal opinion for the recipient. It's not that the opining counsel has better analytical powers or is better able to assess legal consequences of information than recipient's counsel. Rather, the market is driven by the fact that the costs of using the client's lawyer are lower than the costs of using the recipient's lawyer.

My efficiency theory is consistent with and strongly supported by Professor Schwarcz's interesting observation that third-party legal opinions are not typically requested on legal issues whose analysis would be independent of the transaction's fact pattern.[9] In other words, third-party

5. *See id.* at 9–10 (noting that third-party opinions are usually required as a condition precedent for closing transactions).

6. *Id.* at 10; *see also* Ronald J. Gilson, *Value Creation by Business Lawyers: Legal Skills and Asset Pricing*, 94 YALE L.J. 239, 312 (1984) (describing lawyers as "transaction cost engineers," and describing how legal opinions of all sorts can reduce the costs associated with information asymmetry between parties).

7. Schwarcz, *supra* note 1, at 10 n.54.

8. *Id.*

9. *Id.* at 10 n.53.

legal opinions are only used when there are "legal issues whose underlying facts are transaction-specific."[10]

Thus, I agree with Professor Schwarcz's observation that an information asymmetry exists between those demanding and those supplying third-party legal opinions. To the extent that Professor Schwarcz asserts that the parties have "the same factual information,"[11] I disagree with his analysis. Furthermore, it seems to me that the existence of an information asymmetry is only the start of the economic analysis. For two reasons, the existence of such an information asymmetry is a necessary, but not a sufficient, condition for the emergence of a market for third-party legal opinions.

The first reason is that, outside of the structured-finance context in which Professor Schwarcz is writing, we observe many transactions in which there are information asymmetries without the existence of a third-party legal opinion. In any simple transaction between a buyer and a seller for the exchange of assets for cash, there is probably an acute information asymmetry because the owner of the assets is likely to know a lot more about those assets than the prospective buyer. As explained in more detail below, disclosure is the usual way of dealing with this problem. But there are myriad other ways as well. For example, sellers and buyers can solve (or at least mitigate) the problems posed by asymmetrical information by using guarantees, or warranties, or through insurance or other sorts of assurances or representations that pass from sellers to buyers where asymmetrical information exists. Third-party legal opinions emerge where such opinions represent the most efficient way to deal with the asymmetrical information problem between a law firm's clients and the recipients of such letters. This, in turn, is likely to be the case where the law firm can use legal analysis already done to generate the opinion letter.

The second reason why the existence of an information asymmetry is a necessary, but not a sufficient, condition for the emergence of a market for third-party legal opinions is that the issuance of a third-party legal opinion is not the only way to deal with the existence of an information asymmetry. Simple disclosure is another way. Disclosure of the transaction-specific facts would eradicate the information asymmetry. So it must be the case that the preparation of a third-party legal opinion is more efficient than alternative methods, such as disclosure, for dealing with the information asymmetry. It is not immediately apparent why this is so, and Professor Schwarcz does not consider the issue. One likely explanation is that there are economies of scale between legal work that the law firm issuing the third-party legal opinion does for its client, and the legal work involved in preparing the third-party legal opinion. Another plausible explanation of why third-party legal opinions may be more efficient than simple disclosure is credibility.

10. *Id.*

11. *Id.* at 10 n.54.

Disclosures by the issuer may not be as credible when they are made outside of the context of an actual opinion letter. A third possibility is that the client would prefer to keep the information necessary to write the third-party opinion letter confidential, and the third-party opinion letter serves as a superior substitute to disclosure because it satisfies the recipient's need for information without disclosure that the client views as costly. All of these alternatives are consistent with my efficiency explanation.

With this point clarified, we are prepared to confront the most interesting part of Professor Schwarcz's article, his arguments about externalities.

III. Externalities

An externality occurs when private activities have an effect on third parties who receive no compensation for the effects generated by these private activities. Pollution creates negative externalities. An agreement between two people to rob and kill a third person creates a negative externality, at least for the third person. A contract between a customer and a supplier presumably creates benefits for the customer and the supplier and may well impose costs on third parties, such as competitors of the customer and the supplier. But there is a critical difference between the first two examples of externalities and the third. In the first two examples, the externality infringes certain *rights* of the affected third party: the right to clean air, the right to life and property. In the third example, by contrast, the externality is what is known among economists as a mere "pecuniary" externality: it imposes a cost on a third party but does not interfere with any legal or moral right that the third party is thought to enjoy.[12] This is because there is no "right" to be free from the effects of competition.

Professor Schwarcz argues that "the principal basis for governmental imposition of constraints on structured-finance opinions . . . appears to be protection against externalities."[13] Unfortunately, the article does not distinguish among various types of externalities. This is unfortunate since every sort of economic activity—from innovation, to commercial contracts and agreements, to transactions in markets—generates an externality, when "externality" is defined as having an effect on third parties. Professor Schwarcz attempts to finesse this problem by asserting that there exists a distinction between "lawful externalities" and "unlawful externalities."[14] But this reasoning is circular: if a lawful externality is an externality that has been made permissible by the government, then the existence of an externality cannot be used to justify government intervention. In other words, if lawful

12. For a discussion of externalities, including the difference between true externalities and mere pecuniary externalities, particularly in the context of takeovers, see David D. Haddock et al., *Property Rights in Assets and Resistance to Tender Offers*, 73 VA. L. REV. 701 (1987).

13. Schwarcz, *supra* note 1, at 23.

14. *Id.* at 26.

externalities are permissible, then any conduct permitted by law, however detrimental to the economy, is permissible, while if unlawful externalities are impermissible, then any conduct not permitted by law, however beneficial to the economy, is impermissible. Of course, if this is the test, then there is no need to introduce the concept of externalities into the discussion since the real issue has nothing to do with externalities but rather with whether the conduct is legal or not.

This is not to say that I necessarily disagree with Professor Schwarcz's policy conclusions. In fact, I think his observations may well be sound. I mean only to say that his analysis is not particularly helpful in forming opinions about the nature and limits of third-party legal opinions.

For one thing, it is not entirely clear what sort of externalities Professor Schwarcz refers to because sometimes he appears to be talking about externalities created by a lawyer's third-party legal opinion, while at other times he appears to be talking about externalities associated with the underlying transactions themselves. For example, Professor Schwarcz talks about "externalities caused by structured-finance opinions" that "affect the public,"[15] while then in the very next paragraph he observes that "[a]ll transactions, including structured-finance transactions, create externalities."[16]

A more serious concern regarding Professor Schwarcz's externality argument is his idea that third-party legal opinions should not "create externalities that society defines as unlawful."[17] In fact, externalities have nothing to do with his argument. Rather, Professor Schwarcz argues that, regardless of the presence or absence of externalities, a transaction and its concomitant third-party legal opinion can go forward as long as a transaction is technically legal. After all, as Professor Schwarcz observes, "[I]f lawyers were constrained from providing opinions to effectuate bargained-for lawful business transactions that nonetheless may cause externalities, they would bc forced to substitute their judgment about externalities for that of their clients."[18] This, in turn, would be bad because "clients generally have more and better information about the consequences of a transaction, other than the transaction's legality."[19]

This is not quite a complete argument for two reasons. First, just because clients generally have more and better information about the consequcnces of transactions, that does not mean that such clients have more and better *incentives* to refrain from going forward with transactions whose social harms outweigh their social benefits. In fact, clients are likely to have very perverse incentives since it is the *clients* who receive all of the *benefits* from any negative externalities they impose on others.

15. *Id.* at 26.
16. *Id.* at 27.
17. *Id.*
18. *Id.* at 28.
19. *Id.*

Thus, the option of having clients decide the externality issue, as Professor Schwarcz suggests, is not very satisfying. Alternatively, it may be the case that Professor Schwarcz is saying that the legislature is, in effect, making this decision, since it is Congress and, via delegation from Congress, federal administrative agencies like the SEC that are deciding what is legal and what is not. But if this is the case, then neither lawyers writing third-party legal opinions nor the companies engaged in the transactions that require the generation of such opinions should be expected to engage in any review of the externalities associated with any transaction in which they are engaged, as distinct from their review of the basic legality of the transaction.

IV. Conclusion

I agree with Professor Schwarcz's assertion that lawyers face information costs that make them unattractive candidates for serving as gatekeepers for society regarding the transactions for which they issue third-party legal opinions. While lawyers are unattractive candidates for the position of gatekeeper because of the information costs they face, companies are even more unattractive candidates for this position because they lack the *incentives* to serve as gatekeepers.

This in turn raises the thorny question of whether there is any professional well-situated to serve as gatekeeper for complex structured-finance transactions. Professor Schwarcz scrupulously avoids this question. He makes the argument that lawyers should, absent extraordinary circumstances, be able to examine only the portion of any transaction relevant to their opinions, at least as long as they have no warning that the underlying transaction itself is illegal.[20]

That may be a fine strategy, in theory, but it's very risky in practice these days. For example, quite recently, the accounting firm KPMG and a number of its former professionals have gotten into serious trouble over the sale of tax shelters. The defendants' argument in these cases is the same as Professor Schwarcz's. Specifically, the tax shelters sold by KPMG were devised by KPMG to help wealthy individuals avoid billions of dollars in taxes while staying within the strict letter of the law. As Robert S. Fink, the lawyer for one of the eight KPMG partners indicted by the Department of Justice observed:

> [B]y bringing these indictments, the government is attempting to criminalize the type of tax planning that tax professionals engage in on a daily basis. If the government wants to put an end to these types of transactions, the proper response is for Congress to change the law, not to scare professionals away with indictments.[21]

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20. *Id.* at 32–33.

21. Jennifer Bayot, *8 Shelter Experts Indicted*, CHATTANOOGA TIMES FREE PRESS, Aug. 30, 2005, at C1 ("In 2003, a Senate subcommittee report on four KPMG shelters found that people who

So we are left with the now well-accepted "asymmetry of information" theory of third-party legal opinions.[22] Such opinions are efficient where the benefits outweigh the costs. The costs are a byproduct of the fact that the lawyers issuing such opinions face an acute conflict of interest, since these lawyers' paying clients are negotiating against the parties on whose behalf the opinion is being offered. The benefits come from the fact that the lawyers issuing the third-party legal opinion can do so more cheaply than other lawyers, since they are already involved in the transaction and thus enjoy economies of scope when performing two sets of legal services associated with the deal.

A final issue to confront in the area of third-party legal opinions is the issue of what is special about them. Should there be any difference in the rights and responsibilities afforded by lawyers to their ordinary, plain-vanilla clients and the rights and responsibilities that extend to recipients of third-party legal opinions? I think not. Like any other client, the recipient of a third-party legal opinion who does not trust or like the opinion generated by the lawyers hired to issue the opinion has several options, including: (a) hiring its own professionals to render legal advice; (b) refusing to proceed with the transaction; or (c) renegotiating the transaction's price or other terms to offset any perceived increase in risk associated with the opinion. These options are the same options that counterparties normally have when they are concerned about the advice they have received in connection with a transaction they are thinking of pursuing. In other words, what we learn is that third-party legal opinions are not, in any discernible respect, different from other sorts of legal opinions, either in terms of the risks and problems for lawyers, or in terms of the risks and problems for clients and third parties. The only difference is that there are *always* third parties involved when third-party legal opinions are offered, and this is often, but not always, the case when other sorts of legal advice are rendered.

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bought the shelters avoided at least $1.4 billion in taxes from 1996 to 2002."); *see also* Jonathan D. Glater, *8 Former Partners of KPMG Are Indicted*, N.Y. TIMES, Aug. 30, 2005, at C1.

22. *See* Bryn Vaaler, *Bridging the Gap: Legal Opinions as an Introduction to Business Lawyering*, 61 UMKC L. REV. 23, 38 (1992) (discussing Professor Ronald Gilson's theory of "transaction cost engineering" and its relation the role of third-party legal opinions in diminishing information asymmetry between transacting parties).