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Comment

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The question in the title may seem to answer itself. But it does not; indeed, the question has been framed to explain my difficulty with Professor Schwarcz's position on third-party opinions. Frankly, Steven Schwarcz has taken a bold, tough position. Addressing what he sees as issues of "first impression," he asks "what it means for lawyers to issue legal opinions that create negative externalities,"[1] and "[i]f lawyers issuing legal opinions owe a duty to the public as well as to the opinion recipient."[2] These are large, possibly even imponderable questions, but he answers them crisply and succinctly in the manner of a classic legal positivist: So long as "the lawyers neither know nor should know that their opinions will be used to facilitate an accounting fraud,"[3] they may deliver legally accurate opinions, even if they will thereby mislead investors. In short, lawyers may wear blinders, but they must stop and end their assistance the moment they recognize a fraud is afoot. In the wake of Enron and much evidence of the abuse of "special purpose entities" and off-balance-sheet accounting, asserting this minimalist position requires some courage and conviction. But Professor Schwarcz thinks much is at stake, including the "very viability of the entire structured-finance industry."[4]

Although I agree with much that he says about the insufficiency of a negative externalities standard, we part company essentially over whether the attorney delivering a third-party opinion has any affirmative obligation to inquire into the transaction's legitimacy. Professor Schwarcz has essentially made the case—cogently and incisively—for letting lawyers employ a tunnel vision. In his view, only if they are alerted by red flags or warning signals does a duty commencc. In contrast, I believe that the attorney's role in this special context of third-party opinions is fundamentally that of a gatekeeper—a role that is midway between that of the attorney as advocate and that of the auditor. Unlike an attorney who is simply representing a client, an attorney acting as a gatekeeper becomes a reputational intermediary on whom third parties may reasonably rely, and hence more can be expected of such an attorney.

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1. Steven L. Schwarcz, *The Limits of Lawyering: Legal Opinions in Structured Finance*, 84 TEXAS L. REV. 1, 7 (2005).

2. *Id.*

3. *Id.* at 6 n.26.

4. *Id.* at 8.

But how much more is not an easy question. This brief comment focuses not on the normal relationship between attorney and client, but on the very different relationship between an attorney who is retained by a client to give an opinion to third parties who will forseeably rely upon it. In my judgment, the existing system for delivering third-party opinions underperformed and became dysfunctional in the 1990s—for reasons that were entirely predictable. Although the principal reasons for this breakdown are not attributable to attorneys, an attorney wearing the blinders that Professor Schwarcz would permit is an impediment to capital market efficiency because the attorney's conduct will predictably produce investor confusion and capital market mispricing. To explain my concerns, I need to begin by supplementing the very useful description of the legal landscape that Professor Schwarcz has supplied. Other key actors need to be identified and their interactions with attorneys understood.

I. A Scorecard of the Players

Professor Schwarcz models the opinion-giving process in terms of three participants: (1) the attorney; (2) the client; and (3) the third-party recipient. But the system is more complex, and it depends upon protocols that were developed by other actors.

A. The Law Firm

In structured-finance transactions (and in many other forms of finance), attorneys act not simply as experts, but as gatekeepers. By this latter term I mean that the law firm issuing a third-party opinion is a reputational intermediary that is credible precisely because the law firm is pledging reputational capital that the law firm has developed over much time and many clients.[5] By placing this capital at risk, the law firm implicitly assures the recipient of its opinion that it would be irrational for the law firm to deceive the recipient because the law firm would lose more in reputational capital than it could possibly gain in client fees from a single transaction. This is a specific application of a strategy that Oliver Williamson has described as "hostage taking";[6] one's statements are made credible if and to the extent that one has placed at risk of forfeiture assets having greater value than the revenue expected from one's client.

Third-party opinions are but one example of gatckeeper intermediary services that the capital markets use to assure investors and thus reduce the

5. For a fuller definition of the concept of gatekeeper and a review of the relevant literature, see John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U. L. REV. 301, 308–09 (2004).

6. *Cf.* Oliver E. Williamson, *Credible Commitments: Using Hostages to Support Exchanges*, 73 AM. ECON. REV. 519, 519–20 (1983). Although Williamson is focused largely on "transaction specific" assets, reputational capital has some similar characteristics in that it is useful only to the practicing professional.

cost of capital. Auditors, securities analysts, investment banks, credit rating agencies—these are the best known other examples of gatekeepers providing certification and verification services to investors. Yet, precisely for this reason, the solo attorney cannot play the role of gatekeeper and cannot give an opinion that will be accepted by sophisticated third parties. Why not? Because the individual attorney has little reputational capital and thus can seldom pledge anything of greater value than this attorney stands to gain from the transaction. Basically, only to the extent that a law firm hired by a client stands to lose more than it can gain from the transaction by deceiving investors can investors trust them.

Thus, whereas Professor Schwarcz focuses on the attorney, I will focus on the law firm. To be sure, legal ethics (and ethicists) have characteristically focused on the individual attorney,[7] but this is an artificial convention that obscures the actual dynamics of most transactions and enables the bar to duck the nastier questions of collective knowledge. Third-party opinions are given by a collective entity—the law firm. My preference for using the law firm as the basic unit of analysis stems in part from the fact that law firms often possess collective knowledge vastly exceeding that of the individual attorney. This collective knowledge can supply a basis for criticizing the law firm's performance, even if the individual attorney has behaved with complete innocence of that knowledge.

Prevailing law does subject the opinion-giving attorney to liability to the third party for negligent misrepresentation,[8] but law firms face a relatively low risk of liability under Rule 10b-5 for statements made in their opinions.[9] In general, the morc that attorneys qualify their opinions, the less that they face liability on either basis. As a result, for at least the largest firms, the

7. Some ethicists have recognized the need for codes that apply to the firm as a whole. *See, e.g.*, Richard W. Painter, *Rules Lawyers Play By*, 76 N.Y.U. L. REV. 665, 732 (2001).

8. The cases recognizing that the law firm can be held liable to a nonclient for negligent misrepresentation are relativcly recent—all within the last twenty years. *See, e.g.*, Greycas, Inc. v. Proud, 826 F.2d 1560, 1565 (7th Cir. 1987); Prudential Ins. Co. v. Dewey, Ballantine, Bushby, Palmer & Wood, 605 N.E.2d 318, 322 (N.Y. 1992). As discussed *infra* subpart I(E), structured-finance legal opinions are typically so qualified that the recipient cannot reasonably seek to hold the attorney liable in malpractice because of the occurrence of legal consequences to which the attorney clearly adverted in the opinion.

9. *See, e.g.*, Eisenberg v. Gagnon, 766 F.2d 770, 776, 779–84 (3d Cir. 1985) (requiring that the plaintiff show that the opinion was given "with a lack of a 'genuine belief that the information disclosed was accurate and complete in all material respects'"); Kline v. First W. Gov't Sec. Inc., 794 F. Supp. 542, 550–51 (E.D. Pa. 1992), *aff'd in part and rev'd in part*, 24 F.3d 480, 492 (3d Cir. 1994) (holding that the plaintiffs stated a Rule 10b-5 claim against the law firm based on statements in an opinion letter); Stevens v. Equidyne Extractive Indus., 694 F. Supp. 1057, 1064 (S.D.N.Y. 1988) (same). Because liability under Rule 10b-5 requires proof of scienter, which must be well-pleaded with particularity at the outset of the action and must raise a "strong inference of fraud" in order for the action to survive a motion to dismiss under Section 21D(b)(2) of the Securities Exchange Act of 1934, the securities laws do not provide a remedy against the attorney who is only negligent—unless that negligence rises to the level of subjective awareness of and indifference to the risks, at which point the attorney may be called "reckless."

reputational injury may be of greater concern than the prospect of civil liability.[10]

B. Bar Associations

The conventions applicable to third-party opinions are relatively new (as Professor Schwarcz recognizes).[11] But at each step in the development of these conventions, the bar associations have acted to minimize the attorney's obligations and the burdens that should be placed on the attorney. Thus, the TriBar Committees have downsized the attorney's opinion and declared it to be "merely a lawyer's informed judgment as to a specific question of law."[12] Similarly, the TriBar Committees have sought to protect attorneys by ruling some issues off-limits and declaring it "inappropriate to seek to require an unqualified opinion on an uncertain or disputed legal principle."[13] At first glance, this regulatory edict may seem surprising because presumably sophisticated parties could bargain over the degree of assurance and certainty that the attorney is to express.

The bar associations' efforts to insulate attorneys should not be surprising; after all, their constituency is attorneys, not clients. By analogy, letting bar associations prescribe the rules for opinions is equivalent to allowing the American Medical Association to specify the tort law principles applicable to medical malpractice actions. Functionally, bar associations operate much like cartels. That is, just as the medieval guild screened out the worst performers of its profession, but suppressed competition among its

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10. A distinction needs to be drawn here between the liability of the corporation's principal outside counsel and that of counsel for a specific transaction only. The liability of the former may be substantially greater than that of a special counsel who is addressing only the context of structured finance. The Enron litigation suggests this, and it represents the current high water mark of professional liability, because Judge Harmon's decision effectively resurrected "aiding and abetting" liability under a new name. *See In re* Enron Corp. Sec., Derivative & ERISA Litig., 235 F. Supp. 2d 549, 591 (S.D. Tex. 2002) (citing Cooper v. Pickett, 137 F.3d 616, 624 (9th Cir. 1997)) (noting that, although a plaintiff could not bring an aiding and abetting claim against secondary actors such as lawyers under § 10(b) of the Securities Exchange Act of 1934, this did not preclude a finding of liability against secondary actors where such secondary actors "acted together to violate the securities laws, as long as each defendant committed a manipulative or deceptive act in furtherance of the scheme"). Even if this case were followed by other courts, counsel acting exclusively as structured-finance counsel do not face the same prospect of liability under it as do Enron's prineipal outside counsel. This is shown by the fact that Judge Harmon dismissed the Enron complaint against Kirkland & Ellis, which did not serve as Enron's counsel, but rather represented Enron's special purpose entities. *See id.* at 705–06.

11. The first significant writing on legal opinions dates back only a little over thirty years. *See* James J. Fuld, *Legal Opinions in Business Transactions—An Attempt to Bring Order Out of Chaos*, 28 BUS. LAW. 914 (1973). Only this year did a new ABA Committee—the Committee on Legal Opinions, ABA Section of Business Law—publish its first "annual review" of this field. *See* Committee on Legal Opinions, ABA Section of Business Law, *Annual Review of the Law on Legal Opinions*, 60 BUS. LAW. 1057 (2005) [hereinafter *Annual Review of the Law on Legal Opinions*].

12. Special Committee on Legal Opinions in Commercial Transactions, New York County Lawyers' Association et al., *Legal Opinions to Third Parties: An Easier Path*, 34 BUS. LAW. 1891, 1896 (1979).

13. *Id.* at 1895.

remaining members, so too does the contemporary bar association seek to protect its members from both liability and competition by ruling it "inappropriate" to ask for certain forms of opinions.[14]

Viewed in this light, it was predictable that bar associations would work diligently (as they have) to simplify the process of opinion-giving, making it more streamlined and routinized. Yet, by protecting their members, the bar associations could potentially cause legal opinions to say so little of substance as to provide little informational value to their recipients. But here, the real irony surfaces: the principal recipients, as next discussed, often want and need legal opinions, not for the information they communicate, but for the insurance policy they provide. Even if the opinion is so highly qualified as to be of limited value, it still may help to justify conclusions that the opinion recipient needs to reach for ulterior reasons and to protect them from liability.

C. The Ratings Agencies

Structured finance is ratings driven. Absent a rating, the debt of a special purpose entity (SPE) is unmarketable. In any issuance of asset-backed securities, ratings agencies must know both that there has been a "true sale" of the assets (usually receivables) and that the financing vehicle cannot be consolidated with the parent on the latter's bankruptcy.[15] But the ratings agencies constitute an oligopoly: Moody's and Standard & Poor's dominate the U.S. market, with Fitch a weak third.[16] Moreover, because long-established conventions require an issuer to secure two ratings (in order to restrict opinion shopping by issuers for the least demanding rater), there is little need for the two dominant firms to compete with each other.

Although the rating agencies do not truly compete, they might still represent demanding consumers of legal opinions (because they are sophisticated repeat players) if they faced a significant risk of liability for their ratings. But they do not. The simple truth is that ratings agencies have

14. For a relevant example, discussed further *infra* at notes 19–20, see ABA Task Force on Securities Law Opinions, *Negative Assurance on Securities Offerings*, 59 BUS. LAW. 1513 (2004). That ABA report has sought to limit the occasions on which "negative assurances" can be requested from counsel, concluding that "[a] request for negative assurance is appropriate only when it is requested for that purpose. . . ."—i.e., "to assist the opinion recipient in establishing a due diligence or similar defense." *Id.* at 1513–14. In short, in other contexts, the bar, acting very much like a classic cartel, is decreeing that its members should not be asked for negative assurances. This makes life easier for lawyers, but may deprive investors in a host of similar contexts (*e.g.*, mergers and acquisitions) of valuable information.

15. *See* Richard E. Mendales, *Looking Under the Rock: Disclosure of Bankruptcy Issues Under the Securities Laws*, 57 OHIO ST. L.J. 731, 774–75 (1996) (stating that rating agencies require an opinion from the issuer's counsel regarding the sale of the assets and the potential for consolidation of the SPE upon bankruptcy of the parent prior to issuing investment-grade ratings).

16. For an overview of this industry, see Claire A. Hill, *Regulating the Rating Agencies*, 82 WASH. U. L.Q. 43 (2004), and Claire A. Hill, *Rating Agencies Behaving Badly: The Case of Enron*, 35 CONN. L. REV. 1145, 1146–47 (2003). For a special focus on why the ratings system ignores important information, see Mendales, *supra* note 15, at 752–53.

not yet been held liable (either under the federal securities laws or at common law) by third parties who rely on their ratings.[17] Indeed, the ratings agencies claim that their monosyllabic ratings constitute First Amendment protected speech.[18] Thus, facing limited competition and even less liability, they are free to enjoy the quiet life and need not engage in much due diligence. In turn, this means that they need not question or closely review the law firm giving them an opinion in the structured-finance context. For them, even if the legal opinion expresses little information of substantive value because of its extensive qualifications, its timely receipt should still be sufficient to relieve them of any potential liability for negligence.

In this respect, the ratings agencies contrast sharply with underwriters in the equity offering context, who do face real liability under the federal securities laws and real competition. Because of these real risks that underwriters face, they are normally demanding consumers of third-party opinions, at least in the initial public offering context.[19] To illustrate, in a public offering, the underwriter will insist that the issuer's counsel give it a Rule 10b-5 opinion.[20] This opinion is in truth less a legal opinion than a representation. It certifies that the law firm is not aware of any material misrepresentation or omission by its client in the registration statement. Such a negative assurance may sound strange, but it is a sensible way of reducing information asymmetries. Counsel is assuring the recipient of the

17. For a review of the case law, see Gregory Husisian, Note, *What Standard of Care Should Govern the World's Shortest Editorials?: An Analysis of Bond Rating Agency Liability*, 75 CORNELL L. REV. 411 (1996); *see also* Mendales, *supra* note 15, at 753 (noting that, although the rating agencies' practice of collecting fees from issuers could subject them to liability, opposition from the courts and from Congress likely will shield the agencies from legal pressure to perform complete and accurate work); Frank Partnoy, *The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit-Rating Agencies*, 77 WASH. U. L.Q. 619, 641 n.97 (2001) (discussing the case law regarding lawsuits filed against rating agencies for failure to anticipate defaults or other credit problems). United States District Judge Melinda Harmon recently dismissed a variety of actions brought against the credit ratings agencies that rated Enron. Newby v. Enron Corp., No. H-01-3624, 2005 U.S. Dist. LEXIS 4494, at *252 (S.D. Tex. May 24, 2005).

18. *See* Jefferson County School Dist. No. R-1 v. Moody's Investor Servs., Inc., 988 F. Supp. 1341, 1348 (D. Colo. 1997) (holding that a rating agency's unsolicited opinion on the credit worthiness of bonds is protected by the First Amendment), *aff'd*, 175 F.3d 848 (10th Cir. 1999).

19. This is the context in which the "negative assurance" opinion developed. Underwriters are demanding consumers in this context, largely because they face presumptive liability under § 11 of the Securities Act of 1933. Also, in an IPO, the underwriter enjoys an extended relationship with the issuer that effectively prevents the issuer from replacing the underwriter once the offering process has begun. In contrast, the underwriter in a registered structured-finance transaction can be replaced (at least in the next transaction) and thus has less leverage over the client.

20. For descriptions of this standard opinion, see ABA Task Force on Securities Law Opinions, *supra* note 14; Richard R. Howe, *The Duties and Liabilities of Attorneys in Rendering Legal Opinions*, 1989 COLUM. BUS. L. REV. 283, 287; and Richard W. Painter, *Toward a Market for Lawyer Disclosure Services: In Search of Optimal Whistleblowing Rules*, 63 GEO. WASH. L. REV. 221, 226–27 n.19 (1995). *Cf.* Ronald J. Gilson, *Value Creation by Business Lawyers: Legal Skills and Asset Pricing*, 94 YALE L.J. 239, 275 (1984) (explaining that any significant acquisition agreement requires, as a condition to the buyer's obligation to complete the transaction, that the buyer receive an opinion of the seller's counsel with respect to a substantial number of items).

opinion that it is aware of no material information that has been withheld or misstated by its client, and given counsel's status as a reputational intermediary, its assurance is worth more than its client's assurance.

D. The Accountants

Accounting firms are the other major player relying on third-party opinions in structured-finance transactions. But accountants are not residual risk bearers; rather, to them, the attorney's opinion represents a form of insurance that enables them to give their client the accounting treatment that it desires. Receiving such an opinion may protect them even if it is wrong, and hence they too are undemanding consumers. Equally important, accountants hear a different message than the opinion-giving law firm truly expresses. The law firm opines, for example, that a transaction is a "true sale," but the accountant hears that no debt associated with the transferred assets need be shown on the originator's financial statements. A basic disconnect exists here between what the law firm opines and what the accountants conclude from the law firm's opinion, but the relationship is nonetheless a direct cause-and-effect one.

Unlike opinions to the underwriter in the equity public offering context (where the opinion provides a due-diligence protection for the underwriters), the attorney's opinion to the originator's accountants in a structured-finance transaction supplies the principal rationale for the desired accounting treatment that motivates the corporation to enter the structured-finance transaction. Enron showed clearly that the originator's desire to "clean up" its financial statements by moving significant liabilities off its balance sheet can be the motive for a structured-finance transaction, not a lower cost of debt.[21] Thus, more reason exists for the attorney to inquire into the transaction's legitimacy before delivering so sensitive an opinion. Also, a law firm handling many transactions for the same originator may be well aware of this and of the overall impact on the originator's financial statements.

E. The Opinion Itself

As Professor Schwarcz acknowledges, the opinions given in structured-finance transactions are uniquely long and heavily qualified. As he observes, a typical opinion "resembles . . . a mini-treatise, comprising 40–60 single-spaced pages."[22] If a corporate borrower were to try and deliver such a qualified opinion to a bank in a standard loan transaction with regard

21. In *In re* Enron Corp. Sec., Derivative & ERISA Litig., 235 F. Supp. 2d 549, 610 (S.D. Tex. 2002), Judge Harmon found that allegations that Enron created special purpose entities in order to shift its debt from itself to these entities for the purpose of hiding its liabilities were adequate to plead scienter and state a Rule 10b-5 violation. Nor does the Enron case stand alone; Dynergy, Inc. has had a similar experience. *See infra* note 45 and accompanying text.

22. *See* Schwarcz, *supra* note 1, at 6 n.28.

to the enforceability of the loan agreement's provisions, the bank would likely not accept it and would refuse to close. Instead, the bank would demand a simple, unequivocal conclusion that the loan agreement was enforceable against the borrower according to its terms.

Why are the characteristic opinions so different in the structured-finance context? First, bankruptcy law has real uncertainties, and therefore some equivocation in "true sale" opinions may be necessary.[23]

But this is not the entire explanation. Second, the context of structured finance does not have the same adversarial bargaining as a loan transaction because often the negotiating parties are not truly at arm's length. This permits law firms, uniquely in this context, to deliver heavily qualified opinions that drone on endlessly like second-rate law review articles. Both sides get what they truly want. The law firm anticipates that its extensive qualifications will protect it from liability. Correspondingly, the accountants and rating agencies perceive themselves as receiving a substantial degree of protection from the attorney's opinion; in effect, they are obtaining not information, but insurance. But the ultimate party relying on the attorney as gatekeeper—the investor—gains little.

F. Summary

Why do the ratings agencies and accounting firms not ask for negative certifications similar to those that the underwriters demand in the standard Rule 10b-5 opinion? This omission seems as striking as Sherlock Holmes's dog that did not bark in the night.[24] Several answers suggest themselves. First, as just noted, ratings agencies face little competitive pressure or liability, and hence, require only a pro forma opinion to assure that they can escape liability. Second, the bar associations—acting like the classic cartel—have tried to preclude requests for such a negative assurance in any context other than the registered public offering (where it is too well established to be abolished).[25] Third, the accountants are under great pressure from their clients to accept off-balance-sheet treatment and the attorney's opinion helps them to reach a conclusion that they independently desire to justify.

The above example of the Rule 10b-5 "negative assurance" opinion (and its limited use) suggests that there is more that could reasonably be asked of the law firm. For example, not only could the law firm be asked to certify the absence of any material misrepresentation or omission, it could be asked to give its affirmative assurance that in its judgment the transaction has

23. Indeed, Professor Mendales points out that the U.C.C. draws no "clear line between a true sale and a transfer for security" (i.e., a secured loan). Mendales, *supra* note 15, at 782. But precisely for this reason the intent behind the transaction may be critical.

24. ARTHUR CONAN DOYLE, *Silver Blaze*, *in* THE COMPLETE SHERLOCK HOLMES 336, 347 (Doubleday 1930) (1894).

25. *See* ABA Task Force on Securities Law Opinions, *supra* note 14, at 1513–14.

a legitimate business purpose (i.e., one other than the suppression of liabilities from the originator's balance sheet).

But how much can sensibly be asked of the law firm? At what point do burdens become excessive? Now it is time to turn from the other parties to the responsibilities of the attorney and the law firm.

II. What Responsibilities Should the Attorney Face?

Professor Schwarcz gets to the heart of the matter when he writes:

> Lawyers issuing structured-finance opinions . . . are neither acting as securities lawyers nor expressing opinions on securities law. They are, nevertheless, opining on matters that may impact, albeit indirectly, disclosure to investors of corporate information. Should these lawyers be responsible to the public for the ultimate use that is made of their opinions, *even if their opinions are neither incorrect nor misleading on their face*?[26]

He answers that lawyers should not be held responsible for any negative externalities so caused.[27] I agree that structured-finance counsel has no duty to lecture the corporation about its overall level of law compliance or to investigate matters unrelated to the specific transaction, but this still leaves open the legitimacy of the very transaction on which counsel is opining. Here, let me subdivide my response into three parts: (a) what liabilities does the attorney now face? (b) why is a "legitimate business justification" relevant? and (c) what responsibilities—ethical or otherwise—should the attorney recognize?

A. The Duty Not to Mislead

To an uncertain extent, Congress may have already answered Professor Schwarcz's question as to the public duties of the attorney and given an answer different than his. Although Professor Schwarcz gives some attention to § 303(a) of the Sarbanes–Oxley Act ("Improper Influence on Conduct of Audits"), his analysis of it is largely skeptical. As he recognizes, this provision could subject attorneys who advise auditors to liability to the SEC, if their advice is "misleading." Specifically, § 303(a) states:

> It shall be unlawful, in contravention of such rules or regulations as the Commission shall prescribe as necessary and appropriate in the public interest or for the protection of investors, for any officer or director of an issuer, or *any other person acting under the direction thereof*, to take any action to fraudulently influence, coerce, manipulate, or *mislead* any independent public or certified accountant

26. Schwarcz, *supra* note 1, at 16–17.

27. *Id.* at 54 ("Because lawyers should have the right to issue third-party business law opinions that help facilitate transactions that arc not unlawful at the time the opinion is issued, this opinion should not be subject to criticism and the lawyer issuing it should not be subject to liability.").

> engaged in the performance of an audit of the financial statements of that issuer for the purpose of rendering such financial statements materially misleading.[28]

Clearly, this language covers an attorney or law firm hired by the issuer to give a true sale, nonconsolidation, or similar bankruptcy opinion if it is relied upon by the auditor of the originator in deciding not to include the liabilities of the special purpose entity on its parent's balance sheet.[29] Although the word "fraudulently" in the above quotation would seem to require an intent to defraud before the attorncy could be held liable, the SEC apparently reads "fraudulently" to modify only the word "influence." The SEC has adopted Rule 13b2-2 to implement § 303(a),[30] and in the adopting release, the Commission interpreted § 303 to apply to any person's action or conduct "if that person knew or should have known that such action, if successful, could result in rendering the financial statement materially misleading."[31] This is essentially a negligence standard, and it may require the exercise of due care by the law firm to make certain that it does not mislead.

The paradigmatic case in which § 303 will clearly be violated arises, for example, when a litigation partner of a law firm is asked by the corporate client to talk to the client's auditor about pending litigation. What the corporate client wants is for the litigator to assure the auditor that the action is meritless so that no reserve (or only a modest reserve) need be created by the corporate client. Assume next that the attorney does so, downplaying the plaintiff's prospect for success in casual, off-the-cuff, oral comments; as a result, no reserve is required by the auditor. Eventually, plaintiffs win a $500 million recovery. On these facts, the SEC (but only the SEC) could find the attorney to have violated § 303.[32]

If this is true, how different is it from this fact pattern when an attorney, opining on a transfer of assets to an SPV, gives a true sale opinion, knowing that the auditor will rely on this opinion in permitting the originator to remove liabilities associated with the transferred assets from its balance sheet? To be sure, distinctions can be drawn, as the attorney's opinion in this example does not misstate any facts (while the litigator's oral advice in the preceding example may havc). Nor is the auditor necessarily misled, even if public investors will be. But, arguably, the attorney's opinion will still

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28. 15 U.S.C. § 7242(a) (2005) (emphasis added).

29. *See* Improper Influence on Conduct of Audits, Exchange Act Release No. 34-47890, § I (June 26, 2003), http://www.sec.gov/rules/final/34-47890.htm.

30. 17 C.F.R. § 240.13b2-2 (2005).

31. Improper Influence on Conduct of Audits, *supra* note 29, § II.

32. The SEC has "exclusive authority to enforce" § 303 under § 303(b). 15 U.S.C. § 7242(b).

"mislead" the auditor in the sense of causing him forseeably to reach an erroneous result.[33]

Of course, the Commission might also seek to impose liability on a law firm on the ground that it "aided and abetted" a securities law violation. But now it will have to show that the attorney "knowingly provided substantial assistance" to the primary violator.[34] Both Professor Schwarcz and I reach the same conclusions when there is knowing assistance, but § 303 may contemplate a negligence standard that in turn creates an affirmative duty to investigate.

The common law may independently create a duty to investigate the legitimacy of a transaction. Case law generally recognizes that the recipient of a third-party opinion can sue the opinion writer for negligent misrepresentation. At least one recent decision has found liability for failure to discover an ongoing fraud investigation of a corporation where the law firm gave an opinion that the corporation was not the subject of any litigation or investigations and other lawyers at the law firm had worked to a limited degree on defending the litigation.[35] Clearly, the attorney has a duty to investigate the facts before the attorney delivers an opinion to the third party. The bottom-line issue thus becomes: what must be investigated?

B. *The Relevance of "Legitimate Business Purpose"*

Professor Schwarcz takes essentially a "just the facts, ma'am" approach to opinion giving. Giving an opinion is a cut-and-dried affair: the client tells the attorney the facts, and the attorney applies the law to those facts and expresses a conclusion. In most contexts, this is, more or less, the process, and moral lectures from the attorney are not appropriate. But the bankruptcy context is distinctive. The goal of the transaction planners is to isolate and insulate the special purpose entity and its collateral so that on a bankruptcy of the parent or "originator" entity (1) their assets and liabilities cannot be pooled, and (2) the parent or originator will not be seen as having any interest in the collateral held by the special purpose entity. Thus, counsel is asked to opine on both these questions. But the law is slippery on both. First, the U.C.C. does not draw any distinction between a true sale and a transfer for

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33. This possibility that a disclosure can be technically accurate but still incomplete and misleading seems to be the core idea underlying *United States v. Simon*, 425 F.2d 796 (2d Cir. 1969), a decision written by Judge Henry Friendly in which the Second Circuit upheld the criminal conviction of two auditors who had certified financial statements as complying with GAAP. The Second Circuit appeared to indieate in *Simon* that compliance with GAAP was not the requisite standard, and that financial statements complying with them could still be materially misleading in violation of Rule 10b-5. Note, however, that § 303 focuses only on misleading the auditor, not investors.

34. *See* § 20(e) of the Securities Exchange Act of 1934, 15 U.S.C. § 78t(c).

35. *See* Dean Foods Co. v. Pappathanasi, No. 01-2595 BLS, 2004 Mass. Super. LEXIS 571 (Super. Ct. Mass. Dec. 3, 2004). This case is discussed in *Annual Review of the Law on Legal Opinions*, *supra* note 11, at 1061.

security where the assets transferred consist of accounts or chattel paper, categories that include the income-producing properties that underlie most structured-finance transactions.[36] In fact, the same steps are taken under the U.C.C. to effect a sale of such instruments as to perfect a secured loan transaction. This uncertainty forces counsel to look outside the four corners of the documents (which is, in part, why these opinions are so lengthy).

But if counsel must consider more and cannot rely on any bright-line test under the U.C.C., the transaction's purpose seems very relevant. If the transaction were intended simply to improve the originator's cosmetic financial appearance, there is not the same indicia of an absolute and irrevocable transfer of the property. Indeed, the transaction might be unwound if circumstances changed. A similar point can be made about the uncertainty surrounding the bankruptcy law on nonconsolidation. Courts consolidate the parcnt and the special purpose entity bascd on equitable factors,[37] and the purpose of the transaction seems particularly relevant from this perspective.

Ultimately, the attorney knows that the third-party recipients of the attorney's opinion care greatly about the risk of consolidation. If a transaction's lack of a legitimate business purpose increases this risk, then third-party recipicnts who are injured by a consolidation may have the right under existing law to hold a law firm liable for negligent misrepresentation if the law firm failed to investigate this question adequately. Professor Schwarcz would probably respond that the attorney made no misrepresentation; rather, investors simply misinterpreted what the attorney actually said. This is arguable, but the attorney either knew, or should have known, that the attorney's opinion would mislead. From an ethical perspective, this should be sufficient to find a violation. Given these risks, the attorney seeking to inquire into the transaction's purpose is not an intrusive busybody, but a professional seeking to fulfill the attorney's duty of due care.

C. *Aspirational Duties*

Professor Schwarcz is clearly correct when he states that the attorney cannot be required to withhold an opinion simply because the attorney

36. The term "chattel paper" includes a set of writings evidencing a monetary obligation and a supporting security interest in, or lease of, specific personal property. *See* U.C.C. § 9-102(a)(11) (2004). Thus, a pool of receivables on car loans (a paradigmatic structured-finance transaction) falls within this definition. This results in uncertainty because U.C.C. § 9-102(a)(28) then defines the term "debtor" to include not only a person who owes payment on an obligation secured by accounts receivable or chattel paper, but also a seller of such accounts or chattel paper. *See* Mendales, *supra* note 15, at 782 n.209.

37. *See, e.g.*, Fed. Deposit Ins. Corp. v. Colonial Realty Co., 966 F.2d 57, 58 (2d Cir. 1992) (holding that because there is no prohibition explicit in the Bankruptcy Code, nor in the principles of equity, a bankruptcy court may direct the substantive consolidation of the bankruptcy estates of defendant debtors); Mendales, *supra* note 15, at 780–81 ("Substantive consolidation is a form of nonstatutory equitable relief that courts impose on a case-by-case basis . . . .").

realizes that the client's conduct will result in negative externalities. Nor is it efficient for the opining law firm to trace every step and research due incorporation and corporate authority. Here, outside counsel can rely on the general counsel or others.

But Professor Schwarcz's rationale for absolving the attorney from any duty to make affirmative inquiry seems overbroad. Lawyers should not be constrained from providing opinions to facilitate "lawful business transactions," he argues, because they should not substitute their judgments for those of their clients, in part because their "clients generally have more and better information about the consequences of transactions, other than the transaction's legality."[38] For the most part, I would agree. But he leaves something important out here: the client's management is not only better informed, it is also more self-interested. Given these conflicts, the tradeoff between the attorney's judgment and that of the client is less certain than he suggests, because of the likelihood of agency costs. This is why legal ethics (and not just § 307 of Sarbanes–Oxley in the case of securities attorneys) requires the lawyer to go up the corporate ladder and report misconduct by the corporation's agents to the board.[39] Thus, if the attorney is aware that a structured-finance transaction will result in a material misstatement of the originator's financial statements, the attorney has a fairly clear-cut obligation to protest to the board, both under generally prevailing standards and especially under § 307.

But, if no warning signals are evident, should the attorney still be under an obligation to inquire into the transaction's purpose or legitimacy? For the reasons earlier discussed, sheer professionalism may require the attorney to inquire into the purpose of the transaction in structured-finance offerings because no clear line separates "true sales" from secured loans—and hence motive is relevant. But this is a narrow and technical response. Even outside this narrow context, legal ethics should mandate a minimal inquiry—not into the corporation's conduct in general, but into the legitimacy of the specific transaction. Why? Because on a cost–benefit basis, such an inquiry is simple, and its absence invites the misuse of the attorney's services. Thus, I believe Professor Schwarcz's position falls short in two respects.

First, under his approach, the attorney may not proceed in the face of warning signals and red flags but has no affirmative duty of inquiry. Of

38. Schwarcz, *supra* note 1, at 28.

39. In August 2003, the American Bar Association revised Model Rule 1.13 (Organization as Client) of its Model Rules of Professional Conduct to eliminate possible ambiguity in this regard. As revised, Model Rule 1.13(b) now instructs the attorney who learns facts "from which a reasonable lawyer . . . would conclude that an officer, employee or other person associated with the organization . . . intends to act . . . in a manner related to the representation that is a violation of a legal obligation to the organization" that it is the attorney's duty to "proceed as is reasonably necessary in thc best interests of the organization." *See Report of the American Bar Association Task Force on Corporate Responsibility*, 59 BUS. LAW. 145, 168 (2003). The commentary to this rule then indicates that "up the ladder" reporting is presumptively required.

course, I agree with Professor Schwarcz that an attorney may not proceed in the face of red flags. But the concept of "warning signals" or "red flags" is not easy to define. A clearer, bright-line standard is preferable because it gives the attorney fairer notice on an ex ante basis. From this perspective, a better rule would require the attorney not only to halt in the face of red flags, but also to ascertain that the transaction has a legitimate business purpose. This spares everyone the costs of an ex post determination as to whether the attorney culpably missed or ignored warning signals. "Legitimate business purpose" would include any lawful purpose, other than the cosmetic manipulation of the originator's financial statements. Reducing the cost of capital is the quintessential legitimate business purpose (here, we agree), but "achieving an accounting treatment permitted by GAAP"[40] is not. To see why not, it is only necessary to return to Judge Friendly's decision in *United States v. Simon*.[41] As *Simon* held, it is possible to comply with GAAP while still falling well short of the full and fair disclosure standard mandated by the federal securities laws.[42] Determining that there is such a legitimate purpose places very little burden on the structured-finance specialist. Indeed, if the corporation's general counsel cannot help the attorney to see such a purpose quickly, this may be itself a warning signal. The failure to take such a simple step could also be seen as negligent conduct that had the consequence of misleading the auditor in violation of § 303.

Second, the attorney should be under an obligation to take reasonable affirmative steps to integrate all the knowledge possessed by the attorncy's law firm.[43] It is, after all, the law firm that gives the opinion, not the individual attorney. Sometimes, the law firm acts as counsel to the corporation and possesses additional knowledge that may give rise to warning signals. Other times, even without acting as counsel to the corporation, the law firm may have advised on earlier transactions and thus may realize that the instant transaction is part of a pattern of continuing transactions that are masking material liabilities. For example, if the law firm has acted as counsel for multiple structured-finance transactions by the same originator and has given such opinions on multiple transactions that collectively removed $10 billion in debt from the originator's balance sheet (or, let's say, 50% of its total consolidated liabilities), then the attorney knows much more (and also has a likely § 307 problem) than if this were the first transaction in which the law firm acted as counsel retained by, or on behalf of, the originator.

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40. Schwarcz, *supra* note 1, at 34.

41. 425 F.2d 796 (2d Cir. 1969) (upholding the criminal conviction of accountants even though the financial statements apparently complied with GAAP).

42. *Id.* at 805–06.

43. Indeed, the civil law already seems to impose this obligation. Thus, an attorney who had no knowledge of a tax investigation of his corporate client was held liable for negligent misrepresentation bccause other lawyers in his firm were so aware. *See* Dean Foods Co. v. Pappathanasi, 18 Mass. L. Rptr. 598 (Mass. Super. Ct. 2004).

III. Conclusion

Professor Schwarcz and I share much common ground. We both agree that clients want champions, not chaperones. But the position of the law firm giving a third-party opinion is very different from that of the attorney advising his or her own client. In imposing higher duties in this context, we are not paternalistically interfering with an actual attorney–client relationship, but we are protecting third parties who have reasonably relied and may have had no opportunity to bargain over the opinion's terms and scope.

As a practical matter, it must be recognized that accounting irregularities are likely to be an enduring feature of the landscape of the corporate world. Once securities fraud is uncovered, the odds become high that the SEC (or a court) will recharacterize the entire transaction and find either the transaction not to be a true sale or not to consolidate the various entities.[44] As a result, the counsel delivering the third-party opinion cannot reasonably ignore this nontrivial risk as to whether the transaction has a legitimate business purpose. The corporate client's desire to cosmetically alter its financial statements is a fact of life that requires no special notice to put the prudent attorney on guard. As the post-Enron cases accumulate, it is also becoming clearer that when a transaction is tainted with fraud, the future solvency of all the participants is threatened.[45]

Against this backdrop, the standard here proposed that the opining law firm must determine that the instant transaction has a legitimate business purpose (other than the accounting impact) is not just a prudential rule of ethics. It may be a rule of self-preservation.

Finally, this essay has observed that bar associations sometimes (and maybe often) behave as cartels seeking to protect their members' interests. But the irony is that these efforts may backfire over the long run and cause the loss of the bar's own reputational capital. A clearer normative principle than the traditional "hired gun" rules of the advocate should guide the bar with regard to those contexts where the attorney is acting as a gatekeeper and inviting investors to rely on it. That principle should recognize that, to the extent the attorney has invited reliance (as the attorney certainly does in the third-party opinion context where public investors are the recipients), legal ethics should seek to protect the opinion-recipient from being reasonably

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44. This result could also be justified on the grounds that the transaction was a fraudulent conveyance. Assuming that the originator later files for reorganization, the transaetion could be avoided as fraudulent if the originator received less than reasonably equivalent fair value for the exchange and the transfer left it without adequate capital for its business. *See* 11 U.S.C. § 548(a)(2) (2004).

45. For a recent example, see *Court Approves $474 Million Settlement in UC-Led Class Action Against Dynegy Inc.*, 6 Class Action Litig. Rep. (BNA) 510 (July 22, 2005) (reporting approval of a class action settlement by the United States District Court for the Southern District of Texas). This settlement related to Dynegy's "Project Alpha," which the SEC had criticized in an earlier enforcement proceeding. According to the SEC, Dynegy had used special purpose entities to report as cash flow from operations what "was in actuality nothing more than a loan." *Id.*

misled (even by a technically accurate opinion).[46] The rationale for such a principle is that only under such an ethical regime can the attorney resist client pressure and protect the reputational capital of the bar. For decades, the bar associations have sought to protect attorneys from the users of their opinions. It is time today for the bar to protect attorneys instead from clients demanding misleading (but technically accurate) opinions.

46. I do not mean that the opinion must be comprehensible to the dumbest recipient who will rely on it; reasonable reliance should focus, as always, on the hypothetieal reasonable investor.