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SECURITIES LAWYERS IN PUBLIC OFFERINGS – CAN LEGAL OPINIONS BECOME DISCLOSURE DOCUMENTS?

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I hereby declare that I have read and understood the regulations governing the submission of LLM dissertations, including those relating to length and plagiarism, as contained in the LLM Manual and that this dissertation conforms to those regulations.

1. INTRODUCTION

Lawyers hold a key role in a public offering process and legal opinions are one of the most important transactional documents in most securities transactions. Different from the auditors' certification, legal opinions do not form part of the disclosure documents. And lawyers are subject to a lower level of liabilities than that of the auditors. However, like the auditors, securities lawyers have been blamed for contributing to Enron's collapse and other corporate scandals in early 2000s. As a response to the securities lawyers' failure, "up the ladder" rule was introduced. Some scholars, particularly Professor John Coffee, however want to go further by imposing public gatekeeper liabilities on securities lawyers who will give certification and verification on non-financial part in the registration statements. This proposal has raised various pro and con opinions.

This research looks at the above proposal in more details by putting it in a broader context of a public offering process.[1] Part 2 and Part 3 of this research look at the jobs of securities lawyers and role of legal opinions in public offering processes respectively. Part 4 discusses what when wrong at Enron, what was wrong with their lawyers and what responses were made to such failures. In Part 5, I will examine the reasons for such failures, and whether the responses to such failures by both regulators and scholars are adequate. In particular, I would argue that making lawyers public gatekeepers and incorporating a legal opinion like in the registration statement would not resolve the failures. Finally, in Part 5, I also propose an alternative approach to the issues raised in this research.

2. ROLE OF SECURITIES LAWYERS IN PUBLIC OFFERINGS[2]

In this part, I will discuss (1) the works generally done by securities lawyers, (2) legal

[1] This research will mainly concern with US laws and US corporations because US securities laws are more developed and most notable corporate scandals occurred in the US.

[2] By public offering, I mean an offering of shares of common stock that meets the following conditions: (1) it is a large scale sale of shares to the public; (2) it is subject to the Securities Act of 1933; and (3) it aims to create or there already exists a public market for the securities (e.g. in a stock exchange).

opinions and (3) the reasons why securities lawyers and their opinions are needed.

2.1. Securities lawyers – What do they do?

Together with the accountants, investment bank underwriters,[3] securities lawyers[4] play an important role in public offering processes.[5] Securities lawyers are regarded as "*the field marshall who coordinates the activities of others engaged in the registration process*".[6] The works of a securities lawyer can be generally described as follows.[7]

First, securities lawyers prepare the registration statement to be filed with and approved by the SEC.[8] Typically, securities lawyers start preparing the registration statement by conducting a due diligence investigation regarding the issuer.[9] Based on the information collected, the securities lawyers will draft the registration statement. The drafting process will involve drafting, circulating drafts to other team members (especially the accountant and the underwriter's counsel, if the draft is prepared by the issuer's counsels, or the issuer's counsels, if the draft is prepared by the underwriter's counsels) for review and comment, and revising.[10] The drafting and revising period may last from five to seven weeks.[11]

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[3] An underwriter is a person who purchases securities from an issuer, or offers or sells securities for an issuer, in connection with the distribution of securities 15 U.S.C. § 77b(11) (1982).

[4] Securities lawyers in a public offering may include outside counsel to the issuer, the issuer's in-house counsel and the underwriter's counsel.

[5] See a general description of a public offering process in Appendix 1.

[6] See AA Sommer, Jr "The Emerging Responsibilities of the Securities Lawyer, Address to the Banking, Corporation, and Business Law Section, N.Y. State Bar Association (24 January 1974)". Bernard Black also considered competent securities lawyers are one element of strong capital market (See Black, "The legal and institutional preconditions for strong securities markets", 48 UCLA L. Rev. 781 2000-2001).

[7] See generally Carl Schneider, Joseph Manko, Robert Kant, "Going Public: Practice, Procedure and Consequences", 27 Villanova Law Review 1 (1981-1982). The Association of the Bar of the City of New York, Report by Special Committee on Lawyers' Role in Securities Transactions, 32 Bus. Law . 1891-1898 (1977).

[8] See generally Regulation S-K, 17 C.F.R. s 229.10-.915 (1994); Regulation S-X, 17 C.F.R. s 210 (1994).

[9] Ibid. There may be two due diligences conducted separately by the issuer's counsel and the underwriter's counsel (William K. Sjostrom, Jr, "The Due Diligence Defence Under Section 11 Of The Securities Act Of 1933", 44 Brandeis L.J. 549, 556-561). In a due diligence, the lawyers will collect information about the issuer by reviewing documents or interviewing with officers or the accountant of the issuers, verifying and evaluating the information. Such information includes, for example, the issuer's articles of incorporation, bylaws, board minutes, stock records, material contracts, real estate titles, and underlying information.

[10] William K. Sjostrom, Jr, "The Due Diligence Defense", 556-561.

Once the draft is completed and signed by the issuer, it will be filed with the SEC for review and approval. Normally, the issuer's counsel will handle the filing and closely follow up with the SEC until the registration is approved.[12]

Together with the preparation of the registration statement, if the offering is underwritten, the issuer and underwriter and their respective counsels will need to agree on the underwriting agreement. The underwriting agreement will often require the issuer to make extensive representations and warranties concerning the issuer and its business. The issuer's counsel would need to advise whether the issuer can make such representations and warranties. The agreement will inevitably also require the issuer's counsel to issue a legal opinion and the issuer's auditors to issue a comfort letter on various figures contained in the registration statement. In practice, no underwriter would affect a public offering without receipt of these two documents.[13]

2.2. Why securities lawyers?

Perhaps, the best place to start explaining the role of securities lawyers is from Professor Gilson's seminal article "Value creation by Business lawyers:[14] Legal Skills and Assets Pricing".[15] In this article, Professor Gilson examines in details why business lawyers are hired by businesses.

First, Professor Gilson observes that business lawyers help to redistribute bargaining power between businesses.[16] That is, if one party to a transaction can employ a more skilful business lawyer then it may earn a larger share of benefits from that transaction relatively than that of

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[11] Ibid.

[12] Carl Schneider et. al, "Going Public", 19-22. In addition, regarding initial public offerings, based on the due diligence's result, securities lawyers may advise and assist the issuer to do some preliminary preparation works to make the issuer's stocks more floatable. This may include reorganisation, recapitalisation, and adjusting stock options, employment retirement plan (Carl Schneider et. al, "Going Public", 25-26).

[13] William K. Sjostrom, Jr, "The Due Diligence Defense", 556-561.

[14] One can obviously see that a securities lawyer is at first a business lawyer.

[15] Ronald Gilson, "Value creation by Business lawyers: Legal skills and Assets pricing", 94 Yale L.J. 239.

[16] Gilson, "Value creation", 244-246.

the other party. However, according to Professor Gilson, the redistributive bargaining function of business lawyers does not increase the total value of a transaction. And all parties to the transaction can be better off by not employing business lawyers and thereby do not have to pay his fees, which accordingly makes the total benefits available to both parties larger. Therefore, the redistributive function does not make business lawyers so attractive to business communities as a whole.

This view is probably true in a public offering context whereby the shares are offered to a large number of investors who (other than large institutional investors) normally do not have chance to negotiate with the issuer. Therefore, if business lawyers are viewed as having redistributive bargaining function only then investors will tend to discount the stock prices on the assumption that the issuer with the support of highly-skilled securities lawyers will get a better share of benefits in the public offerings.

Professor Gilson's second observation about business lawyers is their role in handling regulatory issues. Although Professor Gilson does not view the regulatory handling function of business lawyers as their main marketing power generally, in the field of securities, such function does play an important role. A public offering involves a lot of regulatory issues (e.g. the registration and approval of the registration statements) and potential liability (e.g. for making misleading statement in the registration statements).[17] Therefore, issuers and underwriters inevitably need to employ securities lawyers to assist them to handle regulatory issues in public offering processes. Indeed, the hiring of securities lawyers is one key element to the "due diligence" defence of an underwriter, should the latter face a claim regarding a

[17] E.g. Section 11 of the Securities Act. Professor Black in "Legal and institutional preconditions" views that it is necessary to maintain a high level of liability against the issuer and the underwriter in order to make them employing securities lawyers (Black, "Legal and institutional preconditions", 795). ABA, "Lawyers' Role in Securities Transactions", 1884.

securities fraud.[18] Additionally, as securities lawyers can evaluate legal risks better than other professionals do, securities lawyers tend to have a more central role in public offering processes.[19]

Professor Gilson's main argument concerning business lawyers is that they are transaction cost engineers who function to reduce the differences between (1) the value that a capital asset would obtain in a perfect market[20] and (2) the price actually agreed-to in the imperfect world that businesses occupy.[21] In the context of Acquisition Agreements, Professor Gilson gives various examples of how a business lawyer can add value to an acquisition agreement. These examples include the use of earn-out period provisions in case there are differences between parties about earning forecasts,[22] the use of representations and warranties to reduce information asymmetry between buyers and sellers,[23] and notably the use of legal opinion as a

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[18] Sjostrom, Jr, "The Due Diligence Defense", 586-588, American Bar Association, "Report Third-Party Legal Opinion Report, Including The Legal Opinion Accord", 47 Bus. Law. 167, 228. Under Section 11(a) of the Securities Act, various persons involving in the public offering process may be subject to liability, if any part of the registration statement contains an untrue statement of fact or omits to state a fact which is required to be stated or which is necessary to make the statement not misleading. Section 11(b) however confer a "due diligence" defence for non-issuer defendant. According to Section 11(b), a non-issuer defendant may escape Section 11(a) liability if after reasonable investigation, he reasonably believed that the registration statement did not contain untrue statement or omitted to disclose material fact which is required or necessary to make the statement not misleading.

[19] Gilson, "Value creation", 296-300.

[20] Such value is evaluated according to Capital Asset Pricing Model (CAPM). CAPM is discussed in Gilson & Mnookin, "Sharing Among the Human Capitalists: An Economic Inquiry into the Corporate Law Firm and How Partners Split Profit", 37 Stan. L. Rev. Under the CAPM, a capital asset is subject to unsystematic risks (i.e. risks that are attached particularly to that asset only) and systematic risks (i.e. risks that are attached to all assets in the market). Unsystematic risks can be diversified away by portfolio investors. Therefore, in a perfect market, where information is costlessly available and unsystematic risks are diversified, the price of a security should only reflect the systematic risks attached to the market as a whole.

[21] Gilson, "Value creation", 255.

[22] Gilson, "Value creation", 262- 264. Note that the CAPM assumes that all investors have the same earning forecasts regarding a capital asset.

[23] Ibid, 267-272. Information asymmetry is inherent in most business acquisitions as the seller often has better information as to the business in question than the buyer does. In an acquisition agreement, there are normally various the seller's representations and warranties about his business to the buyer. By doing so in the contract, the seller in fact provides the necessary information (guaranteed by misrepresentation liabilities) to the buyer in the least cost manner.

lower cost means of verifying the information provided by the sellers.[24] Professor Gilson maintains that this is one method used by business lawyers as transactional engineers to reduce transaction costs.[25]

Applying Professor Gilson's analysis in the context of a public offering, one can see the transactional value of securities lawyers. Taking an underwriting transaction, for example, the role of securities lawyers in such an agreement would be similar to that of a lawyer to an acquisition transaction.[26] The issuer's representations and warranties in an underwriting agreement are similar to those of the seller in an acquisition agreement. And finally, legal opinions issued by issuer's counsels help to reduce the costs for verifying information by the underwriter. So together with the regulatory-handling role, the transactional cost engineering function makes securities lawyers the leading role in public offering process.

Going one step further than Gilson's, according to Utset,[27] in a public offering, securities lawyers hold a key role because they are the cheapest information producer. According to Utset, sale of shares in a public offering involves the sale of (1) the shares themselves with dividend, voting and other rights and (2) the information bundle regarding the shares and the issuer, which allows investors to evaluate share price more accurately.[28] The information will need to be in a language that is acceptable to the market[29] and meet all regulatory

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[24] Id. 288- 293. This is because the seller's counsel with his familiarity with the seller's business is more likely to produce the information with lower costs. More discussion about legal opinion is at section 3.

[25] Professor Gilson also notes that business lawyers when issuing third party legal opinions serve as reputational intermediaries.

[26] This is because the role of a underwriter in a public offering is similar to a buyer in an acquisition agreement. The underwriter often undertakes to purchase the shares to be issued should they are not all bought by the public.

[27] Manuel A. Utset, "Producing Information: Initial Public Offerings, Production Costs, and The Producing Lawyer", 74 Or. L. Rev. 275.

[28] I.d. 280-281. Utset notes that in a public offering process, there are two separate phases. The first phase is the valuation of the shares, preparation of the information bundle and the second phase is the offering after regulatory approval is obtained. This is different from an acquisition transaction whereby the two phases tend to happen simultaneously.

[29] i.e. the shares will not be discounted by the market for failure to understand the information transferred.

constraints.[30]

Utset argues that securities lawyers are the cheapest "mimicker" of the "IPO machine" to produce the shares and the information bundle.[31] This is because familiarity with securities regulations allows securities lawyers to have the ability to "translate" the "language" of other players (e.g. underwriters, accountants) into one common language with the lowest costs. In addition, the issue-spotting skill, which lawyers are equipped in law schools, allows them to have competitive advantage over other professions in taking the leading role in producing the information bundle.[32]

In my view, there may be two other reasons for securities lawyers to take a leading role in public offering process, that is, (1) they have better access to information than others do and (2) they are subject to a lesser level of liability under securities laws. Regarding the first point, attorney-client information is protected by law[33] and lawyers are not obliged to disclose such information. In addition, attorneys are generally prohibited from acting for two clients whose interests are conflict.[34] An issuer will therefore feel more comfortable to disclose as much information including sensitive one as possible to its lawyers. With such an informational advantage, the advice and opinion given by securities lawyers will attract greater weight. Similar observation has been made with regard to the credit rating given by credit rating agencies.[35] Regarding my second point, as securities lawyers are subject to lesser liability

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[30] Utset, "Producing information", 297.

[31] I.d., 305-310.

[32] I.d.

[33] Of course, this attorney-client privilege is subject to certain limits. See Douglas R. Richmond, "The Attorney-Client Privilege And Associated Confidentiality Concerns In The Post-Enron Era", 110 Penn St. L. Rev. 381.

[34] See Charles Hollander Q.C. and Simon Salzedo, Conflict of Interest and Chinese Wall, 2nd edition, Sweet & Maxwell 2004.

[35] Joe Lieberman, "Rating the Raters: Enron and the Credit Rating Agencies", Report of Committee on Governmental Affairs on 20 March 2002. The ratings given by credit rating agencies enjoy significant credibility because the rater is allowed to access to inside information without being obliged to disclose. Similar to lawyers, this provides the credit rating agencies with an informational advantage over other professionals.

than that of underwriters, and auditors,[36] they appear to be the best place for other gatekeepers to shift their legal risks to.[37] In addition, with lesser level of liability, securities lawyers may be more innovative or even "aggressive" in assisting their clients.

3. LEGAL OPINIONS IN PUBLIC OFFERINGS

3.1. Definition and usage

Black's Law Dictionary[38] generally defines *a legal opinion letter* as a "document, usually prepared at a client's request, containing a lawyer's understanding of the law that applies to a particular case". A more detailed definition can be found in the "TriBar 1998 Report".[39] According to the "TriBar 1998 Report", a legal opinion regarding a legal issue[40] provides the opinion recipient with the "*opinion giver's professional judgement about how the highest court ... would appropriately resolve the issue on the date of the opinion letter.*"[41]

In an underwritten public offering process, normally three legal opinions are required.[42] First, the Securities Act requires a legal opinion confirming the "*legality*" of the registered securities.[43] This opinion will be given by the issuer's counsel, addressed to the issuer and attached to the registration statement as an exhibit. Second, as a condition precedent for

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[36] Jill E. Fisch, and Kenneth M. Rosen, "Is There a Role for Lawyers in Preventing Future Enrons?" 48, 4 Villanova Law Review, 1097, 1104-1107.

[37] For example, see John Coffee, "Can lawyers wear blinders? Gatekeepers and Third-party opinions", 84 Tex. L. Rev. 59, 62-66.

[38] Black's Law Dictionary 7th ed. 1999 at 1120.

[39] Tribar Opinion Committee "Third-party "Closing" Opinions: A report of the Tribar Opinion Committee", 53 Business Lawyer, 591 (1998).

[40] Depending on each transaction, there will be different issues. However, there are certain basic issues such as authority of the subject of the opinion to engage in the transaction, the enforceability of the transaction contracts, and assurance that the transaction does not violate any applicable law or contract (Jonathan Lipson, "Price, Path and Pride: Third-party Closing Opinion Practice Among US Lawyers", 3 Berkeley Bus. L.J. 59, 61).

[41] An opinion can be an "unqualified" opinion i.e. the lawyer giving the opinion can reach a clear legal conclusion from the law and the relevant facts. A "qualified" opinion is an opinion that the lawyer can only render subject to certain limitations, exceptions or assumptions due to uncertainties in laws or in facts. (John Sterba, *Legal Opinion Letters – A Comprehensive Guide to Opinion Letter Practice*, Aspen Publishers 2005 Supplement, 1-11).

[42] This paragraph is a brief summary of Chapter 6 of Sterba, "Legal opinions".

[43] Item 29 of Schedule A of the Securities Act, 15 U.S.C. 77aa. A form of that opinion can be found at Appendix 2.

closing, the underwriter will require a legal opinion from the issuer's counsel addressed to the underwriter covering various issues regarding the issuer and the securities. Usually, the underwriting agreement contains a detailed form of the opinion of the issuer's counsel.[44] Thirdly, also as a condition precedent for closing, the underwriter normally requires a legal opinion from its own counsel regarding the issuer and the securities.[45] However, the form of the opinion of the underwriter's counsel is not often pre-specified.

In addition to opinions concerning the *offering* of securities, there are other opinions which are important in *creating* the securities. These are opinions often issued by the issuer's counsel on which the rating agencies or the auditors base to give their views on the issuer's financial performance. One typical opinion of this type is "true sale" opinions in securitization transactions. It can be said that without a true sale opinion, there will be no "securitised assets" and accordingly no securities over such assets can be offered.[46] Another example may be the lawyer's letter addressed to auditors. Lawyer's letters addressed to auditors express the lawyers' view on the likelihood and materiality of issuers' contingent liabilities. These views are very important for the auditors to decide how to present such contingent liabilities in the issuers' financial statements.[47]

3.2. What do these legal opinions say?

As per the legality opinion, the SEC has interpreted "legality" to mean that the securities are "validly issued,[48] fully paid,[49] and non-assessable[50]". If the securities are debt instruments

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[44] See a sample opinion given to the underwriter in Appendix 3.

[45] Richard Howe, "The duties and liabilities of attorneys in rendering legal opinions", 1989 Colum. Bus. L. Rev 283, 286-288.

[46] For a more detailed discussion on true sale opinion see 4.2. Steven Schwarcz, "The limits of lawyering: Legal opinions in structured finance", 84 Tex. L. Rev. 1.

[47] Sterba, "Legal opinions", 8-3 – 8-5.

[48] "Validly issued" means that the issuer has issued the securities in compliance with the relevant corporation law, the company's charter and bylaws and that the issuer has not done anything to derive the securities from their "validly issued" status (Donald Glazer, Scott FitzGibbon and Steven Weise, "Glazer and Fitzgibbon on Legal Opinions Drafting, Interpreting and Supporting Closing Opinions in Business Transactions", 2nd ed. Aspen

then the instruments must impose a binding obligation on the applicant.[51] Because the "legality" opinion must be given when the registration statement is filed and before it becomes effective, the counsel must effectively opine on a future event.[52]

The opinions given by the issuer's counsels to the underwriters cover a broader range of issues. At first, it will address general issues of the issuer such as due incorporation, valid existence, and good standing of the issuer, and the corporate power of the issuer to do business as described in the registration statement.[53] The issuer's counsel will also have to opine on the equity capital of the issuer[54] and the validity of the securities to be offered.[55] The underwriters would also require the issuer's counsel to confirm the "due authorisation, execution, and delivery of the underwriting agreement"[56] and a confirmation that the performance of the underwriting agreement will not violate other agreements or laws which are binding on the issuer.[57]

Regarding the registration statement, the issuer's counsel is usually required to opine that the registration statement has become effective.[58] Second, the underwriter often asks for an opinion that the registration statement "fairly summarises" the laws and regulatory framework

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Publishers 2001, 350-364).

[49] "Fully paid" means that the issuer has received all the considerations called for by the resolution approving the issuance of the stock and the consideration meets the requirements set out by relevant corporation law, the issuer's charter and bylaws (Glazer and Fitzgibbon, "Legal opinion", 365-373).

[50] "Non-assessable" means regarding shares, under the relevant corporation law, the issuer is not entitled to require shareholders who have fully paid their shares to pay the issuer any additional amounts on a per share basis as a result of their share ownership ((Glazer and Fitzgibbon, "Legal opinion", 374).

[51] Sterba, "Legal opinion", 6-25.

[52] For example, the opinion may state "[t]he shares of common stock, when issued and sold as contemplated in the underwriting agreement, *will* be duly authorized, validly issued, fully paid and non-assessable."

[53] Sterba, "Legal opinions", 6-5. This opinion basically means that the issuer have obtained all licences and contractual rights to conduct its business.

[54] This covers the number and type of securities that the issuer has authorized, issued, and remain outstanding.

[55] Sterba, "Legal opinions", 6-6. This opinion is similar to the "legality" opinion requested by the SEC.

[56] Sterba, "Legal opinions", 6-10. Given that there exists uncertainty as to the binding nature of the indemnification in an underwriting agreement, usually, the underwriter does not require opinions as to the validity and binding nature of the underwriting agreement.

[57] Sterba, "Legal opinions", 6-11.

[58] Sterba, "Legal opinions", 6-12. In practice, the issuer's counsel keeps a close contact with the SEC and is normally the first person who is informed by the SEC that the registration becomes effective.

applicable to the issuer, the issuer's material agreements and organisational documents.[59] Third, an opinion that the registration statement and the prospectus "comply as to form" with the requirements of the Securities Act is also often requested.[60] Finally, the issuer's counsel is often required to give a so-called "10b-5" opinion which "informs" that during and from the course of preparing the registration statement, the counsel is not aware of any untrue statement of fact or any omission of any fact in the registration statement which make the registration statement misleading.[61] The name and wording of a "10b-5" opinion follows Rule 10b-5 under the Exchange Act.[62] Indeed, a 10b-5 opinion is more concerned with factual knowledge than legal issues.[63]

As per the opinion of the underwriter's counsel, although it is not explicitly specified in the underwriting agreement,[64] it is often similar to the issuer's opinion[65] with reduced scope.

3.3. Why legal opinions are required?

In rendering a legal opinion, a securities lawyer appears to do what he usually does albeit in a more formal manner.[66] That is applying the law to a particular set of facts in order to reach a legal conclusion. However, in a public offering process, much importance is attached to legal opinions especially third-party legal opinions.[67] There are a number of reasons for that.[68]

First, the use of securities lawyers and request for legal opinions from the issuer's counsel and

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[59] Sterba, "Legal opinions", 6-13 – 6-15. Note that the counsel is not required to opine on the financial statements of the registration which is covered by the auditor.

[60] The exact meaning of "compliance as to form" is not clear (Sterba, "Legal opinions", 6-16).

[61] See sample wording of 10b-5 opinion in Appendix 3 and Sterba, "Legal opinions", 6-17.

[62] 17 C.F.R. 240.10b-5 (2001).

[63] In practice, to emphasize that it is a factual opinion rather than "legal", some law firms put the 10b-5 wording at the end of the opinion and does not number it (Sterba, "Legal opinions", 6-17).

[64] The underwriting agreement often generally provides that the opinion of the underwriter's counsel is in form and substance satisfactory to the underwriter.

[65] E.g. a 10b-5 opinion is also normally required (Howe, "Duties and liabilities", 286-288).

[66] A legal opinion is often printed in a law firm's letterhead paper and signed by a partner of such law firm while legal advice can be given orally or in a less formal manner.

[67] They are often treated as conditions precedent to the closing of a public offering.

[68] For critics against legal opinions, see Thomas L. Ambro, and J. Truman Bidwell, Jr., "Some Thoughts On The Economics Of Legal Opinions", 1989 Colum. Bus. L. Rev. 307.

the underwriter's counsel would demonstrate a due diligence obligation by the underwriter.[69] Second, a third-party legal opinion helps to reduce the information asymmetry in a public offering.[70] In addition to regulatory measure (e.g. mandatory disclosure), third-party legal opinions serve as a private measure to reduce the information asymmetry between the issuers and investors. By requesting the issuer's counsel to opine on various aspects of the issuer, the underwriter effectively forces the issuer's counsel to produce and verify information concerning the issuer with professional skills and diligence.[71] The use of issuer's counsel would also avoid duplication of costs because the issuer can simply use its counsel or its opinions for future deals and with future underwriters without reinventing the wheel.[72] In addition, other players in the public offering may also rely on opinions of the issuer's counsel. From a different perspective, a legal opinion can also give signal to issuer's counter-parties about the issuer's performance. The inability of the issuer's counsel to issue a legal opinion of market standard would suggest the existence of certain defects on the part of the issuer.[73]

Third, securities lawyers when issuing a legal opinion serve as reputational intermediaries to increase the credibility of the information concerning the issuers. Based on (again) Professor

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[69] Sterba, "Legal opinions", 6-4. See also footnote 18.

[70] See Black, "Legal and institutional preconditions", 786-787. Securities are intangible assets whose prices depend on the future performance of the issuers. To predict the future of the issuer, investors would need to rely on current and past information of the issuer. Since the issuer knows more about itself than investors do, there is imbalance of information or, in other words, information asymmetry between the issuer and the investors. Severe information asymmetry can make investors discount share prices heavily, which in turn discourages high-quality issuers to go to the market for capital. Eventually, only low-quality issuers remain in the capital market. This phenomenon is called "market for lemons" (George Akerlof, The Market for "Lemons": Quality Uncertainty and the Market Mechanism, 84 Q.J. Econ. 488 (1970))

[71] Lipson, "Price, Path and Prize", 63. During the preparation of the legal opinion, the issuer's counsel may spot certain issues or obstacles to the transaction and may advise the issuer to correct these issues or otherwise change the opinions (e.g. addition qualification and limitations) (Glazer and FitzGibbon, "Legal opinions", 10).

[72] Consistent with Professor Gilson's "transaction cost engineer" theory, because issuer's lawyers have the lowest cost in producing and verifying the issuer's information, it is logical that they are requested to give opinions on the issuers (Gilson, "Value creation", 273-275). However, third-party legal opinions will inherently create a conflict of interest between the issuer and the issuer's counsel which may affect the integrity of the opinions (see 5.1).

[73] Lipson, "Price, Path and Price", 81- 83. Steven Schwarcz, "The limits of lawyering: Legal opinions in structured finance", 84 Tex. L. Rev. 1, 10-12.

Gilson's analysis,[74] the argument can run as follows. When making investment decisions, investors or underwriters must rely on the information provided by the issuer regarding the issuer's performance. To induce this reliance, the issuer may offer some means of verification to provide investors or underwriters with some comfort in the face of the issuer's obvious incentive to cheat. Such means include direct verification (e.g. through representation and warranties) or third-party verification. However, as per direct verification, investors or underwriter will always be faced with the risk that the seller will cheat on its promise not to cheat. This creates a role for third parties to offer its reputation as a bond that the issuer's information is accurate.[75] The delivery of legal opinion to the underwriter can be regarded as a law firm's offering its reputation as a bond for the issuer's information. The opinion-giving law firms would have the incentive to give a correct opinion as they are repeat players and are subject to liability should they fail to exercise due diligence. Their income would also depend on their level of reputation. The above argument receives empirical support from the research of Karl S. Okamoto.[76]

Fourth, in terms of market efficiency, in accordance with the Efficient Capital Market Hypothesis (ECMH),[77] an accurate legal opinion would help to increase market efficiency in

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[74] Gilson, "Value creation", 280- 293.

[75] It should however be noted that legal opinions are expressions of professional judgments not guarantees that the court will reach the same conclusion as the opinion-giving lawyers (ABA Legal Opinions Principles I.D).

[76] Karl S. Okamoto, "Reputation And The Value Of Lawyers", 74 Or. L. Rev. 15. In this article, the author examines various empirical data and find that (1) reputable or elite law firms account for large number of securities transactions which require reputation of such law firms, (2) elite law firms do not want to take on jobs with high-risk issuers to avoid losing their investment in reputation, and (3) for jobs which do not require much reputation, in-house counsels are often used.

[77] Efficient Capital Market Hypothesis (ECMH) is developed and discussed in various articles notably Eugene Fama, Efficient Capital Markets: A Review of Theory and Empirical Work, 25 J. Fin. 283. (1970); Ronald J. Gilson and Reinier Kraakman, The Mechanisms of Market Efficiency, 70 Va. L. Rev. 549, 1984; John Coffee, Market Failure and the Economic Case for Mandatory Disclosure System, 70 Va. L. Rev. 717 1984; and Ronald J. Gilson and Reinier Kraakman, The Mechanisms of Market Efficiency Twenty Years Later: The Hindsight Bias, available at Social Science Research Network http://ssrn.com/abstract=462786. According to ECMH, securities price will reflect all information available in the market even if information is not immediately and costlessly available to all participants. For heavily traded securities in a well-functioning market, the price will reflect quickly (informational efficiency) and correctly (fundamental or allocative efficiency) information in the

capital markets. This is because legal opinions add credibility to the issuer's information, which, according to ECMH, will be incorporated in the securities price. In fact, without a backing legal opinion (e.g. a "true sale" opinion or a lawyer's letter concerning the issuer's contingent liabilities), the auditor or the underwriter would not be able to rely or "incorporate" the information supported by such opinion when evaluate the securities price.

Finally, third-party opinions of the issuer's counsel can serve as a *practical*[78] estoppel should the issuer in future changes its view about what stated in the opinions. Opinions of the issuer's counsel would ensure that at least the underwriter has reached agreement with the issuer not only on the commercial aspects of the transaction but also its legal aspects. The "practical" estoppel appears to serve as the main reasoning for a lender seeking the opinion that the loan documents are enforceable against the borrower from borrower's counsel while in practice, it is usually the lender's counsel who draft the loan documents.[79]

4. THE FAILURE OF ENRON AND ITS LAWYERS

Before Enron and other corporate scandals at the turn of the 21st century, the established practice of securities lawyers and other institutions involving in public offerings and capital markets seem to be in a good working order. However, these corporate scandals have proved

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market. There are three levels of efficiency depending on the publicity of the information i.e. weak form (share price reflects past information), semi-strong (share price reflects public information), and strong form (share price reflects non-public information). It appears that securities markets are semi-strong efficient even though most investors do not study all the information. This is because all-known information is incorporated rapidly by universally trading by all traders. Public but less-known information is incorporated "almost rapidly" by professional trading by professional traders who collect and research public information. Inside information is incorporate "slowly" by derivatively trading by insiders (derivatively informed trading). Unknown information is incorporated by uninformed trading by numerous market participants. It will therefore be difficult for any investors to beat the market by trying to find undervalued or overvalued shares. ECMH has served as the background theories for many securities regulations. However, the arrival of behaviour finance and the occurrence of Enron and other corporate scandal have raised serious challenge to the model.

[78] This means that legally, the issuer is not bound by what stated in the opinion should the issuers changes its view latter on and is entitled to challenge the opinion. However, in practice, if the issuer wants to challenge a legal opinion issued by its counsel, it would face various difficulties e.g. finding a different counsel (Glazer and FitzGibbon, "Legal opinions", 10-12).

[79] Lipson, "Price, Path and Pride", 88- 93.

serious flaws in the system. This part begins with a brief description about Enron[80] and its collapse, which serves as a background to examine the failure of Enron's lawyers.

4.1. Enron

First, we start with Enron's underlying businesses. Enron started as a gas pipeline company at the time when natural gas prices were regulated.[81] By mid-1980s, when natural gas prices were deregulated and deregulation resulted in more volatile gas prices for both producers and consumers, Enron has created and sole products (e.g. forward gas sale contracts, commodity derivatives), which allows its counter-parties to hedge the risks of gas prices changes. By doing so, Enron turned itself to an energy trading company.[82] Enron was successful at the beginning with this model of business. The changes in business model also turned Enron from a stable energy manufacturing company with capital intensive assets to something like a giant commodity hedge fund[83] with light assets.[84] However, as other competitors adopted similar business model, Enron's competitive advantages in energy trading were reduced. To maintain its market leading position, Enron's management had to expand its trading model to other markets.[85] It was in these markets Enron suffered losses because of, among other things, initial investments in infrastructure and the lack of liquidity in these markets.[86]

When its underlying businesses were in trouble, Enron's hedge fund nature provided it with two important accounting tools[87] to keep it afloat on paper. The first is mark-to-market

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[80] We discuss Enron only as this is the typical example of corporate and securities fraud during that period.

[81] Milton C. Regan, "Teaching Enron", 74 Fordham L. Rev. 1139, 1143- 1154.

[82] (Id.).

[83] Marianne M. Jennings, A Primer On Enron: Lessons From A Perfect Storm Of Financial Reporting, Corporate Governance And Ethical Culture Failures, 2003 California Western Law Review, 163, 173. Jonathan R. Macey, A Pox On Both Your Houses: Enron, Sarbanes-Oxley And The Debate Concerning The Relative Efficacy Of Mandatory Versus Enabling Rules, Washington University Law Quarterly, 329, 339.

[84] Although it adopted light assets strategy, Enron did frequently need to invest in capital intensive assets when it wanted to get into a new market.

[85] Enron has conducted business in broadband internet, timber, pulp, etc.

[86] William Bratton, "Enron The Dark Side of Shareholder Value", 76 Tu. L. Rev 1275, 1299-1300.

[87] Jennings, "A Primer on Enron", 175 – 197.

accounting.[88] Utilising the ability to book revenues immediately (rather than gradually overtime) from long-term contracts, Enron recorded huge but "unrealised" profit in its financial statement.[89] The downside of this accounting approach, however, was that it forced Enron to have new long-term contracts in every new reporting period in order to book new profit. In addition, should the performance under the underlying long-term contracts are terminated then Enron would have to restate its earning.

The second accounting tool is disclosure rules applicable to special purposed entities (SPEs). Usually, a reporting entity needs to consolidate its financial statements with those of its affiliates in order to provide an overall picture of the real performance of the entire group. Through consolidation, all transactions between the reporting company and its affiliates will be cancelled out. The GAAP however allows non-consolidation of financial statements between the reporting company and an affiliated SPE, if the affiliated SPE, among other things, have at least 3% outside equity and retain the right to control the SPE. Accordingly, by entering into structured financing transactions[90] with various 3% outside equity affiliates, Enron was able to transfer debts from its books to its affiliated SPEs or avoid consolidate its

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[88] Under traditional accounting methods, a company must record historical costs of the assets not their market value in their book. The company cannot recognise gain from appreciation in value of its assets until such assets are actually sold. However, investment banks or entities with assets consisting of financial instrument are allowed to record their assets according to market value which are determined according certain approved methods. In 1992, Enron was allowed to apply mark-to-market accounting (Regan, "Teaching Enron").

[89] For example, Enron's unrealised profit for 2000 was about 50 percent of the total $1.41 billion profit originally reported (Jennings, "A Primer On Enron", 177).

[90] Schwarcz, "The limits of lawyering", 3-6; and Regan, "Teaching Enron", 1157-1166. In a typical structured finance transaction, a company (the "originator") sells income-generating assets to an affiliated SPE in return for a payment from the SPE. The SPE then issues bonds or some other form of security to third-party investors either through public offerings or private placement. The issuing SPE uses the proceeds from such offering to pay the originator the purchase price of the asset. The income from the asset that the issuer owns is used to repay third-party investors. Structured finance may be called as securitization or off-balance sheet financing. Structured finance, if properly structured, is a legitimate way to reduce the cost of borrowing. For example, the originator may have a low credit rating because it already has outstanding debt. The SPE on the other hand can have a higher credit rating as it does not have outstanding debt and the loans advanced to it are secured by the SPE's assets. The originator therefore can obtain funds in form of purchase price of the assets more cheaply than if it had borrowed directly. In addition, proceeds from the sale can be recorded as cash flow from operating activities while proceeds from a loan must be reported as cash flow from financing activities, which investors regard less favorably.

SPEs' debt into Enron's financial statements,[91] book profits from such transactions with its affiliated SPE, and improve its cash flows.

In sum, the two accounting tools and structured finance techniques helped Enron to (1) book income and earnings on its income statement immediately, (2) remove or separate debts from its balance sheet, and (3) book cash flow from operations on its statement of cash flows. These measures result in favourable financial ratios in Enron's book that were important to keep its stock price high.

So why did Enron collapse? It was because Enron did not actually "sell" the assets to the SPEs. In fact, Enron retained all the control, benefits, and risks associated with the assets. This was done by Enron, among other things, (1) providing guarantees for third-party investors in the SPEs should the SPE failed to repay its debts, and (2) setting up the SPEs with its own employees who played the role of 3% equity outside investors.[92] Enron often guaranteed the SPE's obligations by Enron's own shares. The guarantee would be effective as long as Enron's share price remains high. However, when the SPEs defaulted,[93] Enron's earnings were restated and the related-party transactions were disclosed, investors lose confident in Enron and its share prices plummeted, which in turn triggered the shares-based guarantees issued by Enron. All of these made Enron the largest bankruptcy in the United State's history.[94]

4.2. Enron's lawyers

Consistent with the role of securities lawyers,[95] Enron's lawyers[96] were present in various

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[91] Although Enron did put some footnotes in its financial statement about its contingent liabilities in such transactions.

[92] Jennings, "A Primer On Enron", 183. Regan, "Teaching Enron", 1159.

[93] Due to the investment made by SPE eventually turned out to be a loss.

[94] Jennings, "A Primer On Enron", Regan, "Teaching Enron", and Bratton, "Enron The Dark Side".

[95] See 2.

[96] Enron's main outside counsel is the law firm of Vinson & Elkin (V&E). However, Enron has also spread its legal works to many other law firms including Andrews & Kurth (See Nancy Dunne, *Enron Lawyers:'We Proceeded in Good Faith'*, Fin. Times, Mar. 15, 2002, at 7 (V&E partner Dilg describing V&E as "only one of

transactions that lead to Enron's debacle. Particularly, Enron's attorneys involved in, among others, (1) issuing legal opinions on Enron's structured finance transactions on which Enron's auditor, Arthur Andersen LLP, based to approve Enron's financial statement, (2) assisting Enron to prepare disclosure documents which, at least with hindsight, were probably misleading, and (3) conducting an internal investigation which can be viewed as whitewash.[97]

As described in 4.1, a structured finance transaction in economic substance is very similar to a loan secured by receivable accounts. Therefore, structured finance transactions are always subject to recharacterisation risks by the court.[98] Given the recharacterisation risk, to approve the accounting treatment of a structured finance transaction and to allow the originator to book the proceeds of the transactions as proceeds from sale of assets, the auditor and the credit rating agencies often require a so-called "true sale" opinion from the lawyers of the originator which provide assurance that the transaction is a sale and the assets is bankruptcy remote.[99] In Enron's case, V&E and A&K have given "true sale" and "true issuance" opinions in order for Andersen to approve the hiding of debt in Enron's books, while in fact these transactions did not clearly qualify as true sales.[100]

Regarding the disclosure issues, in various transactions between Enron and its affiliated SPEs which were controlled by Enron's managers, Enron paid millions of dollars as compensation to its managers.[101] SEC rules require the payment of compensation to Enron's interested

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hundreds of law firms" used by Enron)). Finally, Enron had its own in-house counsel and an impressive legal department with experienced business lawyers (Regan, "Teaching Enron", 1154).

[97] Jill E. Fisch, and Kenneth M. Rosen, "Is There a Role for Lawyers in Preventing Future Enrons?" 48, 4 Villanova Law Review, 1097, 1109-1111. Robert W. Gordon, "A New Role For Lawyers?: The Corporate Counselor After Enron", 35 Conn. L. Rev. 1185, 1186-1190.

[98] Alan Berg, "Recharacterisation After Enron", JBL 2003, May, 205-238. That is the court may hold that the transactions are loans but not sale of receivables and accordingly, the financial statements of the originator must record the proceeds of sale as proceeds of loans and the assets of the SPEs will be consolidated to those of the originator in case of the latter's bankruptcy.

[99] Regan, "Teaching Enron", 1157. John Coffee, "Can lawyers wear blinders? Gatekeepers and Third-party opinions", 84 Tex. L. Rev. 59, 63-65.

[100] Regan, "Teaching Enron", 1158- 1161.

[101] Gordon, "A New Role", 1186.

parties to be disclosed “where practicable”. Under the pressure of Enron’s managers to avoid disclosure, using technical reasoning, V&E advised that Enron did not have to disclose the compensation to its managers. In their SEC filings, V&E also asserted, as required by law, that these “related-party” transactions were negotiated at "arm's-length" and on “comparable terms” to deals with independent third parties, but did not look for any factual support for these assertions.[102]

Finally, following the internal memorandum of an Enron’s officer about the alleged wrongful accounting practices, Enron requested V&E to conduct an internal investigation to determine whether further investigation by an independent law firm is required. V&E accepted to conduct the investigation and concluded that no further investigation was required.[103] V&E’s conduct of the investigation was criticised that it should have not accepted the instruction at the first place due to its own conflict-of-interest and the limited scope of instructions that hindered the finding of wrongful misconduct.[104]

4.3. The responses

Regulatory response - Up the ladder and minimum standards of conduct rules

The involvement of lawyers in Enron and other corporate scandal did not escape the attention, first, of scholars[105] and, second, legislators.[106] In 2002, the Sarbanes-Oxley Act (SOX)[107] was adopted as a major regulatory response to Enron and other corporate scandals. The SOX was claimed as the “most far reaching reforms of American business practices since the time of

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[102] Gordon, “A New Role”, 1186-1187.

[103] V&E nevertheless warned that the “bad cosmetic” of Enron’s SPEs transactions could give rise to serious litigation and bad publicity.

[104] Fisch and Rosen, “Is there a Role”, 1110-1111. Roger C. Cramton, “Enron And The Corporate Lawyer: A Primer On Legal And Ethical Issues”, 58 Bus. Law. 143, 162-168. V&E accepted to conduct the investigation without looking at accounting issues which were in Andersen’s domain and did not interview enough Enron’s employees.

[105] Following reports about the role of Enron's lawyers, Professor Richard Painter, joined by forty other law professors, asked the SEC to adopt a rule requiring corporate lawyers who are aware of client misconduct to report that misconduct to the board of directors (“up the ladder” rule) (Fisch and Rosen, “Is there a role”, 1108).

[106] Fisch and Rosen, “Is there a role”, 1108.

[107] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002).

Franklin Roosevelt".[108]

Concerning securities lawyers, Section 307 of the SOX provides for two important rules. The first rule is the "up the ladder" rule which (1) requires an attorney to report evidence of a material violation of securities law or breach of fiduciary duty or similar violation by the company or any agent thereof, to the chief legal counsel or the chief executive officer of the company (or the equivalent thereof); and (2) if the counsel or officer does not appropriately respond to the evidence (adopting, as necessary, appropriate remedial measures or sanctions with respect to the violation), requires the attorney to report the evidence to the audit committee of the board of directors of the issuer or to another committee of the board of directors comprised solely of directors not employed directly or indirectly by the issuer, or to the board of directors. Second, the SEC is authorised to issue rules regulating the minimum standards of professional conducts including "up the ladder" rule for attorneys "appearing and practicing before" the Commission. In January 2003, the final rules were adopted by the SEC[109] containing detailed provisions of the up the ladder rule. In addition, the rules also encourage issuers to set up Qualified Legal Compliance Committees (QLCC), which, among other things, must consist at least one member of the audit committee and two or more independent members of the board of directors.[110]

In regulatory pipeline – Noisy withdrawal rule

In implementing the Congress's mandate, in November 2002, the SEC released a proposal of the standards of professional conducts including the up-the-ladder rule. The SEC even went on further by imposing a noisy withdrawal rule, which requires the reporting attorney to withdraw from services to the issuer and notify the SEC of such withdrawal if no appropriate

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[108] The SOX regulates, among others, auditor independence, enhanced financial disclosures, analyst conflicts of interest, criminal enforcement and corporate accountability. Samantha Ahuja, "What Do I Do Now? A Lawyer's Duty Post-Sarbanes-Oxley", 38 Val. U. L. Rev. 1263.

[109] Implementation of Standards of Professional Conduct for Attorneys, 17 C.F.R. pt. 205 (2003).

[110] I.d.

response is received. The proposed "noisy withdrawal" rule however received strong objection from the bar associations.[111] The main objection is that such a noisy withdrawal rule would chill the flow of information from the issuers to their lawyers and affect the attorney-client relationship, which may ultimately harm investors rather than protect them. In addition, the noisy withdrawal rule may be in conflict with the confidential privileges of attorney-client communication.[112] In the end, the noisy withdrawal was not adopted in the final rules and was granted additional time for future comment.[113]

Proposed rules - lawyers as gatekeepers and legal opinion as disclosure document

In a more radical approach, Professor Coffee proposes to impose "public"[114] gatekeeper liabilities explicitly on securities lawyers and requires the relevant lawyers to give a negative assurance certification in the SEC's filing which tracks the wording of a 10b-5 opinion customarily delivered to the underwriters.[115] According to Professor Coffee, (1) securities attorneys have long had gatekeeper-like obligations, and (2) in securities transactions, there are not much difference between attorneys and auditors.[116] It is therefore possible to impose public gatekeeper obligations[117] on lawyers.

As with the case of noisy withdrawal,[118] the arguments against Coffee's proposition are mainly that a public gatekeeper role conflicts with the traditional obligations of loyalty that attorneys owe to their clients, or imposing gatekeeping obligations on attorneys will chill

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[111] I.d.

[112] I.d. 1318-1321. For argument supporting noisy withdrawal rules see Susan P. Koniak, "When The Hurlyburly's Done: The Bar's Struggle With The Sec", 103 Colum. L. Rev. 1236.

[113] Implementation of Standards of Professional Conduct for Attorneys, 17 C.F.R. pt. 205 (2003)

[114] I am using the term "public" gatekeeper as lawyers already play the role of private gatekeeper (see more discussion at 5.2).

[115] Coffee, "Gatekeeper Failure and Reform", 496-502. John Coffee, "The Attorney As Gatekeeper: An Agenda For The SEC", 103 Colum. L. Rev. 1293.

[116] Coffee, "Attorneys as Gatekeeper", 1296.

[117] Such obligations as proposed by professor Coffee include (1) a due diligence obligation similar to that of the auditor, (2) a negative assurance certification and (3) being independent (Coffee, "Attorney as Gatekeeper", 1310-1314).

[118] This is by no means coincident. Noisy withdrawal is one key measure to maintain gatekeeper's independence (Coffee, "Gatekeeper Failure", 320-322).

attorney-client communications that also serve to promote law compliance.[119] In addition, in defending the use of structured finance opinions, professor Schwarcz has argued that imposing lawyers with obligations to take active investigations against the issuer in the absence of any warning sign of fraud would exceed their professional ability, incur substantial costs, and result in little success.[120]

5. EXAMINING THE FAILURES AND THE RESPONSES

5.1. The failures

As with any regulatory intervention, any new measure to regulate lawyers in securities transactions must be justified by certain market failures.[121] Below are some market failures with respect to the market for securities lawyers.

Conflict of interests

Normally, an attorney will act for the benefits of his own clients. If after giving advice on a transaction, or drafting transactional documents, the attorney renders a legal opinion addressed to his own client, then the attorney just does one aspect of his counselling role. There is no conflict of interest between the counsel and the client. Nevertheless, in rendering a third-party legal opinion, the issuer's counsel acts for the benefit of the issuer's counter party (e.g. the underwriter) while remains being paid by the issuer. In this case, there arise potential conflicts of interest between the counsel and the issuer.[122]

In a transaction, the underwriter's purpose in requesting a legal opinion is to obtain some sort of assurance about the issuer's information while the issuer's purpose is to meet the condition

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[119] Evan A. Davis, "The Meaning Of Professional Independence", 103 Colum. L. Rev. 1281, and Fisch and Rosen, "Is there a role".

[120] Schwarcz, "The limits of lawyering". For a critic of Professor Schwarcz's view, see also John Coffee, "Can lawyers wear blinders? Gatekeepers and third-party opinions", 84 Tex. L. Rev. 59, and Steven Schwarcz, "We are all saying much the same thing: A rejoinder to the comments of Professor Coffee, Macey, and Simon", 84 Texas. L. Rev. 93.

[121] Ogus, "*Regulation: Legal form and theory*", Hart Publishing, 2004, 29-30.

[122] See Amy Shapiro, "Who Pays The Auditor Calls The Tune?: Auditing Regulation And Clients' Incentives", 35 Seton Hall L. Rev. 1029, 1034-1038 for a similar discussion on the inherent conflict of interest between the issuer and its auditor.

and to close the deal. If the issuer's lawyer is unable to deliver a requisite opinion, the transaction may not be consummated which may cause significant economic losses to the issuer, the lawyer would then inevitably face enormous pressure from the issuer who pays him for issuance of such opinion.[123] While reputation and professional liability might prevent the attorney from giving wrongful opinion under the pressure of the issuer,[124] the ability of lawyers to resist the pressure from the issuer is subject to serious limitations.

First, it is opinion shopping practice by issuers. When an issuer gets an unfavorable legal opinion from its current lawyer, it might dismiss the current lawyer and find another lawyer. The new lawyer upon learning of its former colleague's destiny and with the hope for future mandate may be more agreeable to issue a favorable opinion.[125] Opinion shopping therefore allows the issuer to have substantial leverage against a lawyer and facilitate[126] the production of misleading information. Different from the auditors, lawyers are not subject to noisy withdrawal rules, which can prevent adverse opinion shopping.[127] In addition, the market structure for legal services makes it more difficult for lawyers to withstand loss of a single client than the auditors or the credit rating agents.[128] This is because audit market and rating market are highly concentrated with only Big Four auditors[129] and three big rating agents[130]

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[123] Regan, "Teaching Enron", 1162- 1166, describing Enron's uneasiness when V&K drew Andersen's attention about the correct form of opinion required for a securitization transaction.

[124] John C. Coffee, "The Acquiescent Gatekeeper: Reputational Intermediaries, Auditor Independence the Governance of Accounting", available at www.ssrn.com id. 270944, 7-9.

[125] See a similar discussion in the case of accountants at David M. Martin, "An Effort To Deter Opinion Shopping", 14 J. Corp. L. 419. Enron seems to have adopted the opinion shopping strategy when V&E raised certain objection to Enron's transactions (see Regan, "Teaching Enron").

[126] Note that opinion shopping only "facilitate" but not produce misleading information.

[127] Coffee, "Gatekeeper Failure", 472-473.

[128] Geoffrey Miller, "From Club To Market: The Evolving Role Of Business Lawyers", 74 Fordham L. Rev. 1105 describing how the changing nature of legal market affect the professional independence of lawyers. Enron for example accounted for 7% of V&E's annual revenue (being the biggest client) while it only accounted for less than 1% Arthur Andersen's annual revenue.

[129] Accordingly, the issuer has much less chance for audit opinion shopping. Big auditors also have sufficiently large client base to withhold the loss of a single client.

[130] For credit rating agents, some underwriters even condition their commitment on the ratings of all three major rating agents (Moody, Standard and Poor, and Fitch) to make opinion shopping impossible (Coffee, "Can

respectively while the legal market is much less concentrated and more competitive.

Second, unlike the auditors who are a typical public gatekeeper,[131] securities attorneys have different roles or, in other words, liabilities in a securities transaction.[132] First, in the traditional role of an advocate (or the "hired gun"), securities attorneys have the liability to assist their clients to achieve their goals to the fullest extent permitted by law.[133] The auditors' job on the other hand is not to assist their clients to achieve their goals but to protect investors by examining the issuers' financial disclosures in an unbiased manner.[134] Second, a securities lawyer also acts as a transaction cost engineer to reduce the transaction costs in securities transactions (see 2.1). And finally, a securities lawyer also has gatekeeper-like obligation.[135] This is because securities lawyers when giving a third party legal opinion and preparing disclosure documents can exercise constrains on their clients' misconduct by, for example, not rendering the necessary opinion, and not allowing the issuers to associate their names with the lawyers' names.[136] In addition, when giving a third party legal opinion, lawyers are exposed themselves to the third party's potential claims. They therefore would likely act more scepticism toward their clients. In sum, within the attorney-client relationship in securities transactions, there exists a potential conflict between the advocate role and the gatekeeper role of the attorney. This conflict might provide incentive for lawyers to assist their clients' fraud. For example, when facing the issuer's pressure to give a favourable legal opinion, securities lawyers are more likely to give in as they may later on using their advocate roles as an eligible excuse.

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lawyers wear", 63).

[131] See a discussion on gatekeeper's definition at 5.2.

[132] Firsch and Rosen, "Is there a role", 1102-1104.

[133] i.d.

[134] Mark A. Sargent, "Lawyers In The Perfect Storm", 43 Washburn L.J. 1, 17-19.

[135] See A.A. Sommer, Jr., The Emerging Responsibilities of the Securities Lawyer, Address to the Banking, Corporation & Business Law Section, N.Y. State Bar Association (Jan. 24, 1974), reprinted in Larry D. Soderquist & Theresa A. Gabaldon, Securities Regulation 617-619 (4th ed. 1999).

[136] Mark A. Sargent, "Lawyers In The Perfect Storm", 43 Washburn L.J. 1, 17-19.

A third potential conflict of interest for securities lawyers is the change in partner remuneration system in law firms. Nowadays, most law firms have paid their partners according to "eat-what-you-kill" principle rather than using a "lockstep" system, which remunerates a partner according to his/her seniority.[137] By tying a partner's remuneration with his/her client's payment to the firm, law firms have created incentive for the partner to put his/her benefits over that of the law firm. This means that the partner is more likely to take clients' satisfaction over the firm's reputation.[138] The conflict between a partner and his/her law firm is made more severe as partner's mobility is increasing.[139] Although a quality control system may control opportunistic individuals, such a system is still underdeveloped in law firms.[140] On a more positive side, unlike audit practice, in legal practice, it may be more difficult for a partner in a law firm to control entirely the firm's relation with a single client. This is because in a securities transaction, one not only needs securities lawyers but also lawyers in other fields (e.g. environment, intellectual property) to prepare the disclosure documents or to carry out the necessary due diligence. And a securities law partner may not have total professional control over the works of other lawyers.

Finally, a law firm can suffer conflict of interest when its lawyers are captured by their clients. Having close contact with a client for a long time, a lawyer may be more reluctant to discipline the client as he/she may not want to affect the chance of moving in-house with such a client.[141] In addition, although securities lawyers are required to act for the benefits of their

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[137] Geoffrey Miller, "From Club To Market", 1118-1119. Ronald J.Gilson and Robert H.Mnookin, "Sharing Among the Human Capitalists: An Economic Inquiry into the Corporate Law Firm and How Partners Split Profits", 37 Stan. L. Rev. 313.

[138] Miller, "From Club to Market", 1118-1119.

[139] Nowadays, it is not unusual for a partner to change law firm (Miller, "From Club to Market").

[140] John Coffee, "Understanding Enron: "It's About the Gatekeepers, Stupid"", 57 The Business Lawyers 1403, 1418.

[141] For a similar discussion regarding regulators, see G Beatson, Regulating Financial Markets, AEI Press, 1999, 76-77. In Enron's case, for example, Enron's Chief Legal Counsel is a former V&E's partner and more than twenty V&E's lawyers have joined Enron's in-house counsel team (J. Curtis Greene, New Regulations For Lawyers: The Sec's Final Rule For Professional Conduct In The Wake Of Sarbanes-Oxley: Challenges For

clients who are usually institutional issuers, they often interact with managers of the issuers not with their board. The managers also usually have the power to hire or fire lawyers. Therefore, when the managers' benefits are in conflict with those of the issuers,[142] securities lawyers may be under pressure to act for the managers' benefit not for the issuers.

Information asymmetry

Securities lawyers are employed to control the information asymmetry in securities market. However, the market for securities law services itself is also limited by information asymmetry.[143] This means that it is more difficult the users of legal services in securities transactions to evaluate the quality of the services, which can be viewed as experience goods.[144] Legal opinions for examples are not easy to read and to understand.[145] There may be therefore an "expectation" gap between the opinion-giving attorney and the opinion recipient.[146] Without the ability to verify the service quality, users of legal services may rely on reputation of a law firm. However, reputation may have public goods like nature. If a law firm has good reputation, such reputation may spill over to other firms. Accordingly, investors may not investigate diligently about the competence of a law firm who claims that it has

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Foreign Attorneys, 14 Ind. Int'l & Comp. L. Rev. 807, 818).

[142] E.g. The tendency of paying managers by stock option has created incentives for managers to manipulate stock price for their own benefits ignoring the long term benefits of the issuers Coffee, "Gatekeeper Failure", 327-328.

[143] Black, "Legal and institutional preconditions", 787-788. Ronald Gilson, "The Devolution Of The Legal Profession: A Demand Side Perspective", 49 Md. L. Rev**.** 869**,** 889-890 discussing the prospect of lawyers acting as gatekeepers against frivolous claims by their clients**.** According to Professor Gilson, the market for legal services is subject to information asymmetry in three aspects. First, a client may not know what he/she wants from the lawyers. Second, it is difficult for a client to determine quality of legal services ex ante. Third, it is even difficult to determine quality of legal services even after they are used.

[144] Experience goods is the goods the quality of which can only be known after the services are consumed (Alan C. Page, R. B. Ferguson, Investor Protection,Weidenfeld & Nicolson, 1992, 36-37). In the case of legal services, the quality of the services may only be even known if there is a dispute afterwards which may or may not happen.

[145] Glazer and FitzGibbon, "Legal opinions", 13-18.

[146] The opinion recipient may view a legal opinion is an insurance policy on the legality of the transaction while the opinion giver views a legal opinion as a professional judgment only.

strong reputation.[147]

Bounded rationality

Securities lawyers are assumed to be rational in order to process the information they receive from the issuer. However, in practice, they do not appear so. At first, securities lawyers are increasingly required to make judgment about non-legal issues including factual and accounting issues.[148] There has been concern regarding the lack of accounting knowledge of securities lawyers.[149] Facing with bounded rationality, lawyers in turn may rely on the reputation of their clients and the auditors rather than on their own professional judgment and skills.[150]

Externalities

If a securities fraud was facilitated by a legal opinion or otherwise services of the issuer's lawyers then such legal opinions or services might have caused negative externalities.[151] This means that the issuance of such a legal opinions or provisions of such legal services caused harms to third parties (i.e. public investors) who do not have chance to negotiate with the relevant lawyers. The existence of externalities however does not give rise to regulatory intervention automatically. Regulatory intervention is only justified when private arrangement to internalise the externalities cannot be made with reasonable costs.

Reduced liabilities

As discussed above, for a lawyer to withhold from the issuer's pressure and to maintain the

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[147] Black, "Legal and institutional preconditions", 787 – 788.

[148] The 10b-5 opinion and the lawyer's letter to the auditor about issuer's contingencies are good examples.

[149] Lawrence A. Cunningham, "Sharing Accounting's Burden: Business Lawyers In Enron's Dark Shadows", 57 Bus. Law. 1421. V&E's confusion about Andersen's request for "true issuance" opinions rather than "true sale" opinions is an example of lawyers' bounded rationality (Regan, "Teaching Enron", 1162-1166).

[150] In defending its position in Enron's debacle, V&E's lawyers have consistently claimed that they relied on Andersen's judgement or reputation regarding accounting issues (Regan, "Teaching Enron"). When Enron was regarded as the most innovative company, absence of clear evidence to the contrary, Enron's lawyers might have viewed Enron's fraudulent transactions as innovative and been reluctant to stop such "innovative" transactions.

[151] Negative externalities are something which is harmful to a non-contractual party who does not have chance to negotiate the contract. The typical example of negative externalities is pollution caused by a manufacturing factory to its neighborhood (Ogus, "Regulation", 35, Schwarcz, "Limits of lawyering", 27.).

integrity of his job, it is necessary to impose certain liabilities to the lawyers.[152] Securities lawyers however have been generally subject to a low level of liabilities regarding their legal opinions in securities transactions.[153] With lower level of liabilities and deterrence, lawyers may be more willing to risk their reputation.

5.2. The responses – Lawyers as gatekeepers

What is a gatekeeper and what do they do?

Gatekeeping is an important third party enforcement method.[154] As defined by Professor Kraakaman, gatekeeper is a private party who is able to prevent misconduct by withholding their cooperation from wrongdoers.[155] In the context of securities law, Professor Coffee proposes a narrower definition. According to Professor Coffee, a gatekeeper is a reputational intermediary, who provides verification or certification services to investors.[156]

It may be more useful to divide the concept of gatekeepers into "market" gatekeepers and "public" gatekeepers as proposed by Professor Kraakaman and Professor Gilson.[157] Public gatekeepers are those whose incentives to act as gatekeepers come from compulsory regulatory requirements. In other words, the gate kept by public gatekeepers is erected by the State. Public accountants are a typical example of public gatekeepers as audited financial statements are compulsory by law. On the other hand, market gatekeepers are those whose incentives to act as gatekeepers come from market forces.

Gatekeeping is employed when, among other conditions, direct enforcement against the

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[152] Lipson, "Price, path and pride", 102.

[153] Fisch and Rosen, "Is there a role", 1105-1107. Unlike the auditors, securities lawyers are not viewed as "experts" for the purpose of Section 11(b) of the Securities Act and accordingly are subject to a lesser degree of liabilites (Sterba, "Legal Opinions", 6-18, 6-19).

[154] The other method is whistle blowing whereby the law imposes an affirmative duty on a third party to "blow the whistle" (to report to the regulator) should such party discover any wrongdoing of the regulated subject. (Reinier Kraakaman, "Gatekeepers: The Anatomy of Third party Enforcement", 2 J. L. Econ. & Org. 53, 58.).

[155] Kraakaman, "Gatekeepers", 53-54. E.g. Doctors and pharmacists are able to prevent abuse of drug by not providing the necessary prescription. The auditors are able to prevent securities fraud by not providing an unqualified audit opinion.

[156] Coffee, "Gatekeeper Failure", 460.

[157] Kraakaman, "Gatekeepers", 61-62; and Gilson, "The Devolution", footnote 28.

regulated subject is costly[158] or impossible.[159] In that case, if the regulated subject is required to acquire a particular service from a third party gatekeeper, it may be easier to deter the gatekeeper who has little to gain than the regulated subject who has a significant stake in a fraudulent transaction. This approach is based on two key assumptions.[160] First, the third-party or gatekeeper may be subject to legal liability greater than the benefits, which it may gain from the fraudulent transaction of the regulated subject. Second, the gatekeeper in providing the verification and certification effectively pledges its reputation on the line or in other words, it provides a reputational bond. In order to establish its reputation, the gatekeeper must have made substantial investment through time and services provided to numerous clients. Therefore, it is not willing to risk their reputational investment for a single client.[161]

On a general note, Professor Gilson proposes three broad conditions for a gatekeeping model to work. First, there must be a gate, which the would-be wrongdoer must go through and there must be a gatekeeper who can "close" the gate against the wrongdoer (by declining to provide the necessary services). Second, the gatekeeper must be able to determine with precision when wrongdoing is committed. And finally, both sides of the gate must be willing to cooperate, in other words, the gatekeeper must be willing to keep the gate and the regulatory subjects must be willing to go through that gate.[162]

On the supply side, Professor Coffee has proposed the following conditions for a gatekeeper to function effectively: (1) the verification and certification must be made mandatory by law or practice, (2) the accuracy of the certification by the gatekeeper must be observable by public, (3) gatekeeper must be a repeat player, and (4) a gatekeeper must receive only nominal

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[158] Because, for example, it is difficult to verify a wrongdoing ex post due to its complicatedness.

[159] Because, for example, the regulated subject is "judgment proof" (i.e. it does not have the ability to perform the penalty imposed on it). Kraakaman, "Gatekeepers", 56-57.

[160] Coffee, "Gatekeeper Failure".

[161] Coffee, "Gatekeeper failure", 460-461.

[162] Gilson, "The Devolution", 882-884.

fees from any individual client.[163]

Although Professor Coffee does not mention expressly, a right level of gatekeeper liability is essential for making the model function. The subject of gatekeeper liability has been examined and debated extensively elsewhere.[164] Here, it is enough to highlight some brief observations about gatekeeper liability. First, a gatekeeper liability regime includes many elements including (1) the persons who can enforce the liability (e.g. SEC, investors or gatekeeper's clients), (2) the level of proof (e.g. strict liability or negligence based), (3) the defences available for the gatekeepers (e.g. due diligence defence or knowledge based defence), and (4) the method of enforcement (e.g. private litigation, class action or SEC action).[165] Second, increased liability may not be the optimal course of action as in some cases, it may be more effective to require gatekeepers to take specified courses of action ex ante rather than increasing liability ex post.[166]

The discussion about gatekeepers just far is concerned with the anti-fraud function of gatekeepers. In capital market, gatekeepers might also contribute to increase market efficiency. By verifying and providing certification, gatekeepers help to increase the credibility and accuracy of the information concerning the issuer and the securities to be offered, which, according to ECMH, would increase market efficiency.[167] In addition, gatekeeping services allow production and standardisation of information. In addition, such information are often paid by the issuers. Therefore, using gatekeepers would lower the costs

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[163] Coffee, "The Acquiescent Gatekeeper", 8-10.

[164] Kraakman, "Gatekeepers"; Assaf Hamdani, Gatekeeper Liability, 77 S. Cal. L. Rev. 53; Stephen Choi, Market Lessons For Gatekeepers, 92 Nw. U. L. Rev. 916; Frank Partnoy, Barbarians At The Gatekeepers? A Proposal For A Modified Strict Liability Regime, (2001) 79 Washington University Law Quarterly 91.

[165] Kraakaman, "Gatekeepers"; and Hamdani, "Gatekeeper Liability".

[166] Kraakaman, "Gatekeepers"; and Hamdani, "Gatekeeper Liability".

[167] For a description of the flow of information among issuers, underwriters, auditors, lawyers and investors, see Richard W. Painter, "Convergence And Competition In Rules Governing Lawyers And Auditors", 29 J. Corp. L. 397, 401.

of obtaining information for investors or investment analysis.[168]

The use of gatekeeper however gives rise to certain costs and is subject to its own limitation, which must be taken into account in any policy decision.[169] According to Professor Kraakaman, the costs of gatekeeping include (1) administrative costs for monitoring the gatekeepers, (2) private costs for the burden which the regulatory subjects have to bear due to gatekeeping requirements,[170] and (3) tertiary costs which third parties (other than the gatekeepers and regulatory subjects) have to bear.[171] The most serious limitation on gatekeeping strategy is conflict of interest. The conflict is inherent from the fact that gatekeepers are doing their gatekeeping function for profit, which in turn comes from their regulatory subjects. Various types of conflict of interest exist in gatekeeping model.[172] In addition, the model assumes that gatekeepers will act rationally while in fact they may not do so at all times.[173]

Can lawyers act as a public gatekeeper?

In capital markets, securities lawyers have long played the role of a market gatekeeper acting for the benefits of a limited number of players in the market including the issuers, the underwriters, the accountants or the credit rating agencies.[174] The question now is given the failure of securities lawyers in various corporate scandals, should the State impose a public gatekeeper role on them.[175] This would mean, as proposed by Professor Coffee,[176] that

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[168] John Coffee, "Market Failure and the Economic Case for a Mandatory Disclosure System", 70 Va. L. Rev. 717.

[169] Kraakaman, "Gatekeepers", 75-87.

[170] These include the costs for performing the mandatory gatekeeping function and for minimizing residual legal risks applicable to the gatekeepers.

[171] Kraakaman, "Gatekeepers", 75-78.

[172] See generally Coffee, "It's about gatekeepers stupid"; Patricia A. McCoy, "Realigning Auditors' Incentives", 35 Conn. L. Rev. 989, 989-993 and 5.1 – *Conflict of Interest*.

[173] Robert Prentice, "Enron: A Brief Behavioral Autopsy", 40 Am. Bus. L.J. 417.

[174] See 4.3 – Proposed Rules, 5.1 – Conflict of interest, and Coffee, "Can lawyers wear blinders", 60-67.

[175] This situation is similar to the case of the accountant before and after the Securities Act 1934. Before the act, public accountant acted as market gatekeepers. But after various securities frauds in late 1920s, the Securities Act decided to impose the role of public gatekeeper on the accountants. (See George J. Benston, "The

lawyers would need to provide their certification and verification over the issuer's information to the public investors via the prospectus. Goes together with this, lawyers would be subject to increased liability. That is, they might then be viewed as an "expert" for the purpose of Section 11 of the Securities Act and be sued by any investors acquiring the securities covered by their certification.[177]

Using the criteria for a successful gatekeeping model and a gatekeeper (see page 29 above), at the first brush, lawyers look like a strong candidate for a pubic gatekeeper. First, lawyers have one important condition for acting as gatekeeper that is without their services or legal opinions securities frauds are much more difficult to happen. So there is already a gate. Second, lawyers who (1) are close to the issuers or underwriters, and (2) have professional skills should be able to detect securities fraud ex ante more precisely than others do. Third, legal business is heavily dependent on the reputation of the lawyers and their law firms. Accordingly, one can rationally assume that lawyers are not willing to risk their reputation[178] for supporting a single client's fraud. Therefore, it can be said that on the supply side, lawyers have the incentive to act as gatekeepers. Fourth, issuers and underwriters are willing to have lawyers to do the job because the use of reputation lawyers would help to reduce the information asymmetry concerning the relevant securities. In other words, the reputational lawyers lend their reputation to the less well-known issuers.[179]

However, I would argue that forcing lawyers to go public and having one more public gatekeeper is not the right solution.[180] This is because the ability of lawyers to detect

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Regulation Of Accountants And Public Accounting Before And After Enron", 52 Emory L.J. 1325)

[176] See 4.3.

[177] Previously, regarding a legal opinion, usually only the addressees of the legal opinions can sue the opinion giving lawyer (Sterba, "Legal Opinions", 2-4, 2-5, 12-12 – 12-28).

[178] For example, according to Glazer and FitzGibbson (Legal Opinions, 5), "when delivering a legal opinion, the lawyers put their reputation on the line".

[179] Karl S. Okamoto, "Reputation And The Value Of Lawyers", 74 Or. L. Rev. 15.

[180] For critics of Sarbanes-Oxley Act and proposed rules about lawyers as gatekeepers, see Larry E. Ribstein, "Market vs. Regulatory Response To Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002", 28 J.

securities fraud with credible precision is limited. Second, making lawyers public gatekeepers would not only not address the failures of lawyers as market gatekeepers[181] but also make them facing the same problems which the public accountants have faced in Enron while the effectiveness of the solutions[182] to such problems is still subject to debate. Third, lawyers acting as gatekeeper can cause negative externalities to their other roles (advocates and transactional engineers). Fourth, there may be substantial increase in transaction costs for the market which is already much higher after Sarbanes Oxley Act.[183] In the following paragraphs, I will go through each of these points.

First

As discussed above, one important condition for effective gatekeeping is that the gatekeeper must be able to detect wrongdoing with certain precision and any failure of the gatekeeper to detect wrongdoing must be observable by public. To do so, at first, one would need a clear set of standards to make wrong- and right- doing distinguishable. Unfortunately, one cannot say that business law is always "clear".[184] Comparing with the GAAP, business laws are much less codified and have more uncertainties. For example, as the law on the "true sale" issue is not clear, a "true sale" opinion is always reasoned opinions[185] ranging from "twenty to fifty" pages in length.[186] If one takes international perspective of business law as a further example,

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Corp. L 1 2002-2003, and Fisch and Rosen, "Is there any role".

[181] See 5.1

[182] Set out by the Sarbanes-Oxley and other post Enron regulations of the SEC.

[183] "Sarbanes-Oxley A price worth paying?", The Economist, May 19th 2005 http://www.economist.com/business/displayStory.cfm?story_id=3984019 (last visited July 2006); Nathan Wilda, David Pays For Goliath's Mistakes: The Costly Effect Sarbanes-Oxley Has On Small Companies, 38 J. Marshall L. Rev. 671; and Ribstein, "Market vs. Regulatory Responses", 35-45.

[184] As Fisher puts it "Rarely are business lawyers engaged nowadays to give advice where there are black and white, clear-cut answers. … As the global regulatory environment in which businesses operate becomes ever more complex, the distinctions between and among various shades of gray have grown correspondingly more numerous and more subtle. More often than not, businesses and business lawyers must operate in a zone of uncertainty." (Keith R. Fisher, The Higher Calling: Regulation Of Lawyers Post-Enron, 37 U. Mich. J.L. Reform 1017, 1033-1034.)

[185] ***VU TO ADD DEFINITION OF REASONED OPINIONS***

[186] Schwartz, "The limits of lawyering", 16. Coffee, "Can lawyers wear blinders", 65-66 (While Professor Coffee

then we can have numerous standards setters[187] while there are only two main international accounting standards setters (FASB for GAAP and IASB for IFRS) and there is only one main divergence between the two sets of standards developed by them.[188]

Second, as business laws are increasingly specialised, one lawyer or even one law firm may only be in charge of one aspect of a complex transaction. In addition, legal treatment of a transaction may have significant effect on the accounting treatment of such transaction. To determine securities fraud with precision, a lawyer may need to know not only the big picture of the transaction but also its legal and accounting effect.[189] I am afraid that there are not enough business lawyers, who have such qualifications to act as gatekeepers at reasonable costs.[190]

Unlike the auditors who theoretically are able to examine all accounting aspects of any transaction in the financial reports of the issuer, sometimes securities lawyers may not able to examine all legal aspects of all transactions in the financial reports.[191] Instead, the securities lawyers need to rely on the works of other lawyers in other specialised fields. This reliance

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acknowledges that the uncertainty of bankruptcy law is the reason for a lengthy opinion, he posits that it is the structure of a securitization transaction allows lawyers to add lengthy qualifications to the true sale opinions. Although Professor Coffee's argument has some weight, I do not entirely agree with him. Because, the outside investors (who usually are investment banks as well) of the SPEs in any securitisation transaction would have the same incentives to scrutinise the true sale opinion given by the issuer's counsel as the lending bank in loan transaction have regarding the enforceability opinion.(Schwartz, "We are all saying")).

[187] Usually each jurisdiction has its own standards setter for its business law.

[188] "The EC, International Financial Reporting Standards, and the International Accounting Standards Board" attached to "Capital Market Seminar 5" - handout delivered to LLM students in the University of Nottingham in 2005.

[189] Cunningham, "Sharing Accounting's Burden".

[190] See Gilson & Mnookin, "Sharing Among the Human Capitalists", last section, discussing the limits of legal training in law schools and the importance of "on the job" training. Of course, in any transaction, there are always some lead lawyers who have some or all of the necessary qualifications and capacity in order to run and close the deal. However, it is difficult for such lawyers to act as public gatekeeper as they already act as advocates or transactional engineers. Therefore, such "lead" lawyers usually lack the independent appearance to act as gatekeeper given their close proximity with the issuers.

[191] The same can be said regarding geographical coverage. The Big Four auditors have extensive geographical coverage to provide audit services to multinational issuers. However, there is no international law firm which can have such an extensive geographical coverage. The gatekeeping law firm therefore would need to rely to the work of other local law firms. This is not to mention that in other jurisdictions lawyers may not be able to act as gatekeepers while the auditors have been accepted worldwide as a public gatekeeper.

will increase the chance of having mistakes. In fact Professor Coffee also recognises the difficulties a gatekeeping lawyer faces by stating that lawyers cannot logistically conduct an audit.[192]

Second

Now, I am turning to my second point about making lawyers public gatekeepers. Doing so will create a conflict of interest similar to the conflict between audit and non-audit services in the case of pre-Enron public accountants.[193] This is because when a lawyer becomes a public gatekeeper, he will provide both public gatekeeping services (e.g. providing the necessary legal certification or verification) and non-gatekeeping services (e.g. structuring, drafting, and counselling) to the issuer. Again his independence for acting as public gatekeeper will be compromised by the influence of the issuer on non-gatekeeping services. That is, the issuer may threaten terminate the non-gatekeeping services to pressure the gatekeeping lawyers to issue favourable certification. If history is a good indicator then after making lawyers public gatekeeper, we might probably need to forbid them from providing non-gatekeeping legal services to their clients.[194]

Professor Coffee also recognises this point.[195] He suggests that "*the corporation could use one law firm to plan and structure a merger and another to handle all disclosure responsibilities pertaining to the merger*" to cure this conflict of interest. The point however is that to have effective disclosure, the second law firm in Professor Coffee's example must be barred from providing all non-gatekeeping services to the issuers in all other transactions (not just the merger transaction in question). I doubt if there is any law firm who is willing to abandon all other practice areas and only specialise in the gatekeeping services. If they do so then it is likely that the costs of gatekeeping services will be substantially increased to make

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[192] Coffee, "Gatekeeper Failures", 498; and Coffee, "Lawyers as Gatekeepers", 1312.
[193] Coffee, "Gatekeeper Failures".
[194] This what SOX does with respect to the auditors.
[195] Coffee, "Lawyers as Gatekeeper", 1305.

up for the losses of other services.

In addition, in a securities transaction, normally there are already more than one lawyer involved. In addition to the lawyers to the issuers, we also have lawyers of the underwriters or the financing banks. The underwriter's lawyers will usually double check the work of the lawyers to the issuers including negotiating the content of the legal opinion to be issued by the issuer's counsel.[196] Therefore, the proposal to use a third lawyer gatekeeper will not only increase the costs[197] for the issuer but also appear to be redundant.

Opinion shopping is a usual strategy of issuers to deal with public gatekeepers who do not approve the issuers' disclosure. "Noisy withdrawal" is an important regulatory measure against opinion shopping. If lawyers are made public gatekeepers, we would need to equip him with noisy withdrawal.[198] Here, we have again the debate[199] whether or not noisy withdrawal would affect the attorney-client communication, which would probably in turn affect legitimate rights of public investors.[200] Professor Coffee argues that making lawyers public gatekeepers would probably affect ex-post communication about unlawful conducts which already occurred while it would facilitate ex-ante communication about future conducts.[201] However, this argument is based on the assumption that the managers would be able to distinguish between unlawful and lawful transactions. Given that business laws are increasingly complicated and there are usually no clear cut answers, in practice, it would be difficult for managers to distinguish between unlawful and lawful transactions without the help of lawyers. Managers fearing that the information they gave to the lawyers today may be

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[196] Sjostrom, Jr, "The Due Diligence Defence".

[197] As discussed above, it would be expensive to have a lead lawyer who is in the position to spot problem in a complex transaction.

[198] Given that the legal market is much less concentrated than the audit market, law firms are likely to be more prone to opinion shopping than audit firms are.

[199] See page 19.

[200] The attorney-client communication is traditionally protected on the belief that such protection would allow the attorney to represent his clients' interest best (Richmond, "The Attorney-Client Privilege", 385-390).

[201] Coffee, "Gatekeeper Failures", 361-363.

used against them in future would likely withhold all information from the gatekeeping lawyers. As Professor Painter puts it, regulating gatekeepers is a balancing act between ensuring the gatekeepers to receive sufficient information necessary to evaluate the issuer's risks and ensuring that the gatekeepers would take proper response upon detecting a risk.[202] Without the necessary information from the managers, the gatekeeping lawyers may not have chance to take any action at all.

The point of Professor Coffee about facilitating ex-ante communication may be true in a "real-time" disclosure regime whereby the gatekeepers will constantly monitor the issuers and give continuous signal to the public. However, the prevailing disclosure regime is primarily about ex-post conducts. Therefore, the gatekeeper lawyers may not always be present when the managers need them. For example, the auditors only monitor the issuers periodically by reviewing and certifying their quarterly or annual financial reports after a bunch of transactions during the reporting period have been finished but not when such transactions were being carried out. Therefore, before conducting a transaction, the issuer is more likely to seek advice from their consultants rather than their gatekeepers. Similarly, in the merger example given by Professor Coffee (see page 35), the second lawyer acting as a gatekeeper would not come into play until the first lawyer acting as a transactional engineer finishes his job.

Third

In order to act as an advocate or a transactional engineer, lawyers need information. As discussed above, increasing gatekeeper liabilities would likely reduce the information flow to the lawyers and accordingly adversely affect the works of the advocate or transactional engineer lawyers.

Fourth

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[202] Painter, "EU-US Convergence", 415-416.

Imposing public gatekeeping obligations on lawyers would likely to raise substantial costs. First, with increased liability, the gatekeeper lawyers would inevitably raise its fees.[203] Second, to avoid conflict of interest, issuers may need to hire an additional lawyer to act as gatekeeper so there would be costs for additional lawyers. Third, the lawyers with ability to act as gatekeepers are likely to be expensive ones due to higher qualifications requirement. And finally, increased liabilities and costs would raise the costs for market entry for both regulated subjects and gatekeeping service providers[204] and therefore have anti-competitive effects on the market.[205]

5.3. The responses – Legal opinions as disclosure documents

To give signal to the public, a gatekeeper needs to provide written certification and verification in a public document (e.g. the prospectus). Consistent with this logic, if a lawyer is imposed with public gatekeeper obligations then he would need to give some kinds of certification to the public. Professor Coffee proposes that the gatekeeper lawyer is required to give a negative assurance certification that such lawyer "*(1) believes the statements made in the document or report to be true and correct in all material respects, and (2) that such attorney is not aware of any additional material information whose disclosure is necessary in order to make the statements made … not misleading*".[206]

The benefits of having a lawyer certification, if any, are those of increased disclosure.

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[203] Coffee, "Gatekeepers Failure", and Hamdani, "Gatekeepers Liability", 63-80.

[204] As gatekeeping services require strong reputation, it is quite difficult for new gatekeeping service providers to start up.

[205] Beatson, "Regulating Financial Markets", 82-83.

[206] Professor Coffee argues that the wording proposed simply tracks the wording of a 10b-5 opinion given by the issuer's counsel. If this is the case then the wording proposed should include the usual heavy qualifications of a 10b-5 opinion. Such qualifications are as follows "*Such counsel shall also state that such counsel has participated in conferences with officers and other representatives of the Company, representatives of the independent registered accounting firm for the Company and representatives of the Underwriters and their counsel at which the contents of the Registration Statement, Disclosure Package and the Prospectus were discussed and, although such counsel not indepedently verified and is not passing upon and does not assume any responsibility for the accuracy, completeness or fairness of the statements contained in the Registration Statement, the Disclosure Package or the Prospectus (other than section 11 [about legal issues]), …*."

Disclosure is thought to bring about the following benefit (1) increased market efficiency, (2) investors protection, and (3) fixing market failure particularly information asymmetry.[207] The first benefit, according to ECMH, comes from any new information that a lawyer certification may feed into stocks price.[208] The second benefit comes from the logic that lawyer certification will increase the liability[209] applicable to a lawyer which probably will make them more responsible and due diligent in their works. Regarding the last benefit, a lawyer certification will help to reduce the information asymmetry between the issuer and public investors concerning the issuer's securities.[210]

However, I doubt that a lawyer certification would bring such benefits at substantial levels. First, regarding market efficiency benefit, one should note that the certification is similar to that of a 10b-5 opinion which already exists in practice. Therefore, there is likely that no new information is provided in the certification.[211] In addition, according to ECMH, the information contained in 10b-5 opinion should have been added to stock prices through the trading of the underwriters to whom to the 10b-5 opinion is given.

The difference, if any, is that the coverage of a public certification addressed to public investors is much broader than that of a 10b-5 opinion addressed to only limited players. A broader coverage may make the information contained in the certification being fed into market price quicker. However because not all people understand the limits and the qualification of a lawyer certification,[212] a broad coverage will also increase the chance that

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[207] See generally the articles cited at footnote 77

[208] i.d.

[209] This would come from the possiblity of both SEC's enforcement acts and private litigations from public investors. In addition, a lawyer certification attached to the registration statement may make them become an "expert" under the Securities Act which reduces the defences available to them in case of private litigation.

[210] This is similar to the role of legal opinion in reducing information asymmetry between the issuer and the underwriter in a public offering (see page 12)

[211] In fact, in my opinion, the 10b-5 opinion itself after being heavily qualified has very little informational value (see footnote 206). Rather, its main purpose appears to provide a due diligence defence for the underwriter.

[212] This is similar to the fact that the language of a legal opinion is not for non-professionals to read (Glazer and FitzGibbon, Legal Opinions, 15).

investors may overestimate of the informational value of that certification.[213] They may then create noise trading which even distorts market efficiency.

In addition, in drafting a 10b-5 opinion, the issuer's counsel often need to negotiate and work with the underwriter's counsel. The latter counsel will monitor the former's work. Because they are both lawyers, the underwriter's counsel is probably in best position to evaluate the value of the 10b-5 opinion issued by the issuer's counsel. The role of the underwriter's counsel however may be reduced if the gatekeeper lawyer certification is introduced. As in that case when the liabilities is directly imposed on the issuer's counsel and accordingly the liabilities imposed on the underwriter may be reduced, the underwriter will have less incentive to monitor the issuer's counsel.

Regarding the benefit of increased investors protection, Professor Coffee argues that because financial information is certified by the public accountant, logically, non-financial information should be certified by another gatekeeper for which the lawyer is the best candidate. We, however, need to remember that increased liability for a gatekeeper will work only if the gatekeeper can effectively prevent wrongdoing or in other words, the gatekeeper may provide its certification with certain credibility.[214] The non-financial part of a registration statement contains a broad scope of non-legal information (e.g. business overview, management discussion and analysis, and risks factor). Lawyers' ability to certify such non-legal information with certain credibility is obviously limited. This is evidenced by the qualifications put in a 10b-5 opinion by the issuer's counsel.[215] Therefore, the protection brought about to investors by a lawyer certification may be limited. In addition, the costs for increasing gatekeeper liability however may be substantial including increased gatekeeper

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[213] In other words, there is an expectation gap between what a lawyer certification actually provides and what investors believe that it provides.

[214] Assaf Hamdani, Gatekeeper Liability, 102-109.

[215] See footnote 206

fees, and distorting market entry decision of the issuers.[216] More ineffective investor protection may also increase moral hazard on the part of the investors.[217]

Regarding the last benefit, given the limited informational value of a lawyer certification and the bounded rationality of public investors, it is unlikely a lawyer certification will effectively reduce information asymmetry between the issuer and the investors.

5.4. The response – another proposal

Lawyers in Enron are blamed for issuing legal opinions which provide support for the auditors to produce misleading financial reports. This could happen because the auditor is allowed to rely on the legal judgment of the issuer's counsels. Effectively, auditors can pass the risks of making legal judgment which is necessary for them to make accounting judgment to a separate entity. Although lawyers are supposed to make legal judgment, they are not aware of the accounting affects of their legal judgments. Coupled with the fact that they are subject to lesser liability, lawyers are more likely to be prepared to issue legal opinions which although may be technically correct have misleading accounting affects. For example, in Enron's securitization transactions, instead of a "true sale" opinion, V&E was required by Andersen to issue a "true issuance" opinion.[218] V&E raised its concerns about this approach to Enron and Andersen. But it was assured that a "true issuance" was enough. Concluding that it was not in the position to make accounting judgment about what was necessary for Andersen to apply non-consolidation rule under GAAP, V&E issued true issuance opinion on the assumption that the "sale was true".[219]

To fix this problem, there are two possible measures (1) to increase the lawyers' liability to make them more responsible for their legal judgments as currently proposed by Professor Coffee, or (2) to prevent the auditor shifting the burden judgment to the issuer's counsel. In

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[216] Hamdani, Gatekeeper Liability, 102-106.
[217] I.d.
[218] Reagan, "Teaching Enron", 1162-1166.
[219] V&E also made it clear to Enron that it could not delete the assumption.

sections 5.2 above and 5.3 above, I have examined the merits of the first measure i.e. having lawyers as an additional public gatekeeper and converting a 10b-5 opinion into a lawyer certification in the registration statement. The discussion above shows that although these proposals have some merits, they are subject to serious limitations and may result in substantial costs. In addition, there will arise the conflict of interest issues in the lawyer-gatekeeper structure which have emerged from Enron and other corporate scandals regarding the auditors.

Given problems of the first approach, my proposal follows the second approach whereby auditors will not be allowed to rely on the issuer's counsel to make legal judgment and will be required to use their own counsels (either in-house or outside) to determine the legal nature of the transactions on which they are reporting in the financial statements. For example, in a securitization transaction, the auditor will need to have their lawyers to determine whether there is a true sale transaction. Expansion of the auditor's scope of work to non-financial information is logical as the border between financial and non-financial information has been blurred.

In expanding the auditor's scope of work, we can also avoid the inherent conflict of interest between the issuer's counsel and the issuer when the former is required to issue third party legal opinions. Accordingly, we will not have the conflict between (1) the advocate or transactional engineer role and (2) the gatekeeping role of the issuer's counsel which has been discussed above. In addition, as the auditor is now in charge of both legal and audit judgment, there will not be the case where the lawyers are not aware of (and probably do not care) the accounting affect of a transaction and the auditors are not aware of (and probably do not care) the legal nature of the transaction necessary for them to make an auditing judgment.

As the auditor's independence has been strengthened by various measures in SOX, the auditor's counsel will be protected from influence of the issuer more effectively than the issuer's counsel. For example, as the auditors are already equipped with noisy withdrawal,

their counsels would not be influenced by opinion shopping practice by the issuers. Rules on prohibitions of provision on non-audit services, audit partner rotation, and "cooling off" period would also strengthen the auditor's lawyer status.

Of course, there are issues arising from this auditor-lawyer approach. At first, it is the costs of an additional lawyer who acts for the auditor. However, this is not a new issue as the gatekeeper-lawyer approach also requires additional lawyers to act as gatekeeper. Further, the costs of an additional lawyer for the auditor is likely less than that for an additional lawyer acting as gatekeeper due to narrower scope of work.[220] Second, other gatekeepers (e.g. the credit rating agencies) may not be able to rely on the works of the auditor's counsel to do their jobs. However, we can expect that the relevant gatekeeper may seek a confirmation from the auditor on the accounting treatment of the transaction. For example, there already exists market practice for the auditor's cold comfort letter in merger transactions.[221] The last possible issue is that auditor's counsels may not resolve the problem of misleading disclosure made by the issuer's counsel (e.g. the non-disclosure of payment to Enron's executives).

6. CONCLUSIONS

Lawyers and legal opinions play key roles in public offering processes because they help to reduce information asymmetry, reduce transaction costs, and increase market efficiency. Such key roles are due to, among other things, (1) lawyers having better access to information hold by the issuers, (2) lawyers being the best persons to deal with regulatory and legal risks during the public offering processes, and (3) lawyers being the information with lower costs and subject to lesser liabilities than other players. However, lawyers also provide the crucial supports for Enron and its auditors to provide misleading disclosure and financial reports. This is because the current structure inevitably put the issuer's lawyers in various conflicts of

[220] The auditor's counsel only needs to examine transactions which have accounting affect while the gatekeeping-counsel will in theory need to examine all transactions.

[221] See 2.1.

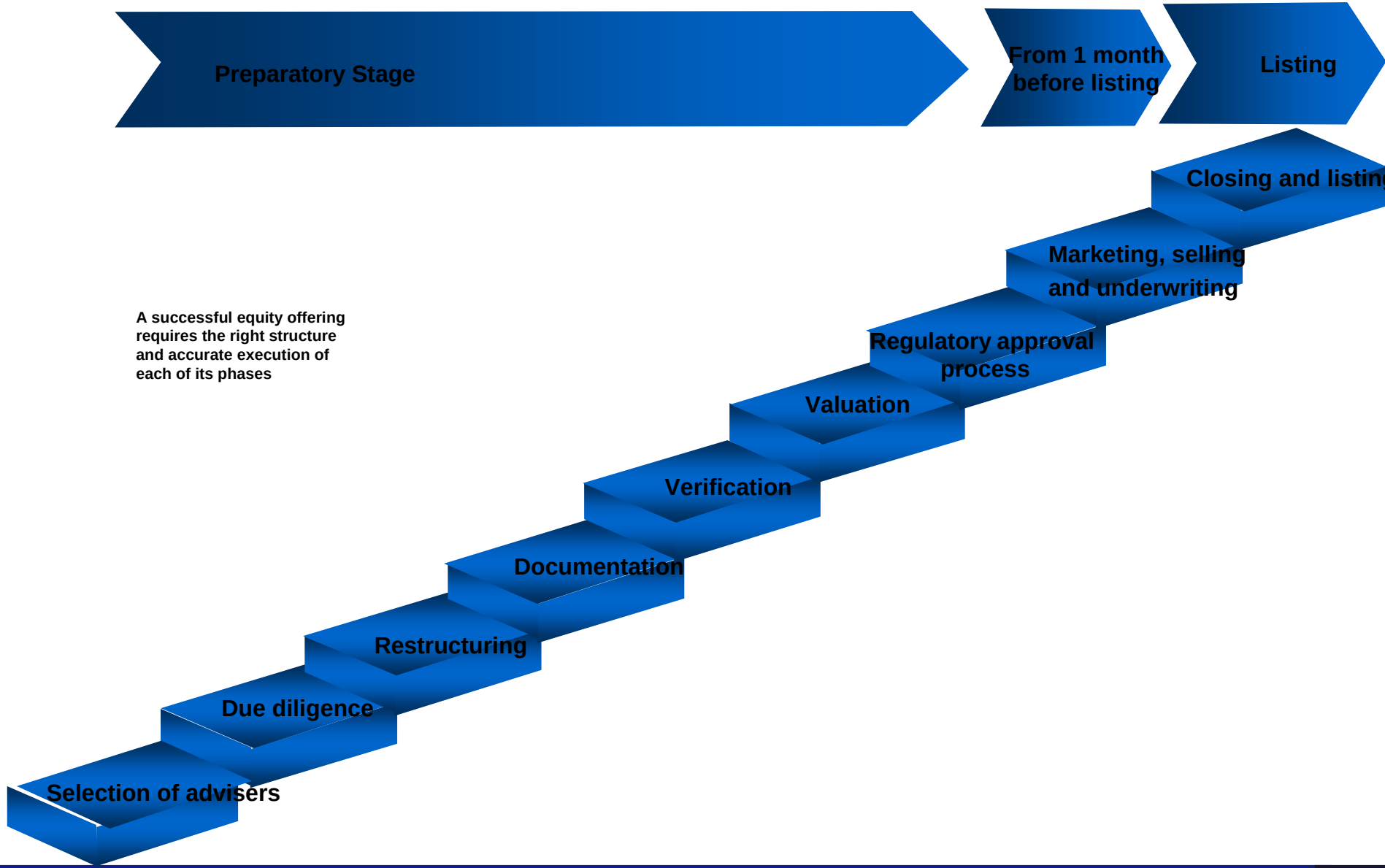
interest. In particular, it is the conflict between the fact that the issuer's lawyers act for the benefits of third parties (e.g. underwriters or auditors) while still being paid by the issuer. Therefore, making lawyers public gatekeepers and increasing their liabilities will not resolve the conflict and accordingly may not stop securities frauds. An alternative approach may be that the auditors are required to make their own legal judgement on their works. Of course, this proposal obviously needs to be implemented with demand side measures which aim to increase the ability and capacity of investors to understand and digest information[222] disclosed by issuers and their counsel (e.g. investor education and reduction of moral hazard), and improving standards setting qualities.

[222] See Steven L. Schwarcz, Rethinking The Disclosure Paradigm In A World Of Complexity, 2004 U. Ill. L. Rev. 1

APPENDIX 1

Overview of Public Offering Process

The IPO Process



A successful equity offering requires the right structure and accurate execution of each of its phases

APPENDIX 2

Sample Opinion Concerning Shares' Validity Filed with The SEC

EX-5.1 3 file3.htm OPINION OF SKADDEN, ARPS, SLATE, MEAGHER & FLOM Table of Contents

Exhibit 5.1

July 10, 2006

Brookdale Senior Living Inc.
330 North Wabash Avenue, Suite 1400
Chicago, Illinois 60611

Re: Brookdale Senior Living Inc.
Registration Statement on Form S-1
(File No. 333-135030)

Ladies and Gentlemen:

We have acted as special counsel to Brookdale Senior Living Inc., a Delaware corporation (the ‘‘Company’’), in connection with the public offering by the Company of 15,350,000 shares (the ‘‘Primary Shares’’), the sale by Health Partners (the ‘‘Selling Stockholder’’) of 1,865,000 shares (the ‘‘Secondary Shares’’) of the Company's common stock, par value $0.01 per share (the ‘‘Common Stock’’), and up to an additional 2,582,250 shares of Common Stock (the ‘‘Option Shares’’) at the option of the Underwriters (as defined below). The Primary Shares, Secondary Shares and the Option Shares are collectively referred to herein as the ‘‘Securities.’’

This opinion is being furnished in accordance with the requirements of Item 601(b)(5) of Regulation S-K under the Securities Act of 1933, as amended (the ‘‘Act’’).

In rendering the opinions set forth herein, we have examined and relied on originals or copies of the following: (i) the Registration Statement on Form S-1 (File No. 333-135030) as filed by the Company with the Securities and Exchange Commission (the ‘‘Commission’’) on June 14, 2006 under the Act, and Amendment No. 1 thereto filed on the date hereof, including information deemed to be part of the registration statement at the time of effectiveness pursuant to Rule 430A of the General Rules and Regulations under the Act (such registration statement, as so amended, being hereinafter referred to as the ‘‘Registration Statement’’); (ii) the form of Underwriting Agreement (the ‘‘Underwriting Agreement’’) proposed to be entered into by and among the Company, as issuer, the Selling Stockholder, and Goldman, Sachs & Co. and Lehman Brothers Inc., as representatives of the several underwriters named therein (the ‘‘Underwriters’’), filed as an exhibit to the Registration Statement; (iii) a specimen certificate evidencing the Primary Shares; (iv) copies of the stock certificates representing the Secondary Shares and the Option Shares; (v) the Amended and Restated Certificate of Incorporation of the Company, as certified by the Secretary of State of the State of Delaware (the ‘‘Amended and Restated Certificate of Incorporation’’); (vi) the Amended and Restated By-Laws of the Company, as certified by Deborah C. Paskin, Secretary of the Company; (vii) certain resolutions of the Board of Directors of the Company, relating to the issuance and sale of the Primary Shares and related matters, including with respect to the formation of a Pricing Committee of the Board of Directors of the Company; (viii) certain resolutions of the Board of Directors of the Company, relating to the original issuance and sale to the Selling Stockholder of the Secondary Shares and the Option Shares and related matters; (ix) certain resolutions of the stockholders of the Company relating to the Amended and Restated Certificate of Incorporation and the Amended and Restated By-Laws; and (x) the Conveyance Agreement, dated September 30, 2005, by and among Brookdale Senior Living Inc., Brookdale Living Communities, Inc., BSL Brookdale Merger Inc., BSL CCRC Merger Inc., BSL FEBC Merger Inc., Emeritus Corporation, FEBC-ALT Investors LLC, FIT-ALT Investor LLC, Fortress Brookdale Acquisition LLC, Fortress CCRC Acquisition LLC, Fortress Investment Trust II, Fortress Registered Investment Trust, Health Partners and NW Select LLC (the ‘‘Conveyance Agreement’’) and certain resolutions of the Board of Directors of the Company related thereto. We have also examined originals or copies, certified or otherwise identified to our satisfaction, of such records of the Company and such agreements, certificates and receipts of public officials, certificates of officers or other representatives of the Company and others, and such other documents as we have deemed necessary or appropriate as a basis for the opinions set forth below.

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In our examination, we have assumed the legal capacity of all natural persons, the genuineness of all signatures, the authenticity of all documents submitted to us as originals, the conformity to original documents of all documents submitted to us as facsimile, electronic, certified or photostatic copies, and the authenticity of the originals of such copies. In making our examination of executed documents or documents to be executed, we

have assumed that the parties thereto, other than the Company, had or will have the power, corporate or other, to enter into and perform all obligations thereunder and have also assumed the due authorization by all requisite action, corporate or other, and the execution and delivery by such parties of such documents and the validity and binding effect thereof on such parties. As to any facts material to the opinions expressed herein that we did not independently establish or verify, we have relied upon statements and representations of officers and other representatives of the Company and others and of public officials.

In rendering the opinions set forth in paragraph 2 below, we have assumed that the Company received the entire amount of the consideration contemplated by the Conveyance Agreement.

Members of our firm are admitted to the bar in the State of New York, and we do not express any opinion as to the laws of any jurisdiction other than the corporate laws of the State of Delaware, and we do not express any opinion as to the effect of any other laws on the opinions stated herein.

Based upon and subject to the foregoing, we are of the opinion that:

1. When (i) the Registration Statement becomes effective under the Act; (ii) the Pricing Committee appointed by the Board of Directors of the Company determines the pricing of the offering of the Primary Shares as contemplated by the resolutions of the Board of Directors referred to above, (iii) the Underwriting Agreement has been duly executed and delivered; and (iv) certificates representing the Primary Shares in the form of the specimen certificate examined by us have been manually signed by an authorized officer of the transfer agent and registrar for the Common Stock and registered by such transfer agent and registrar, and have been delivered to and paid for by the Underwriters at a price per share not less than the per share par value of the Common Stock as contemplated by the Underwriting Agreement, the issuance and sale of the Primary Shares will have been duly authorized, and the Primary Shares will be validly issued, fully paid and nonassessable.

2. The Secondary Shares and the Option Shares have been duly authorized and validly issued and are fully paid and nonassessable.

We hereby consent to the filing of this opinion with the Commission as an exhibit to the Registration Statement. We also consent to the reference to our firm under the caption ‘‘Legal Matters’’ in the Registration Statement. In giving this consent, we do not thereby admit that we are included in the category of persons whose consent is required under Section 7 of the Act or the rules and regulations of the Commission.

Very truly yours,
/s/ Skadden, Arps, Slate, Meagher & Flom LLP

APPENDIX 3

Sample Legal Opinion Given to The Underwriter.

EXHIBIT B-1

Form of Opinion of Andrews Kurth LLP, Counsel for the Company

Opinion of Andrews Kurth LLP, counsel for the Company to be delivered pursuant to Section 5(d) of the Underwriting Agreement.

References to the Prospectus in this Exhibit B include any supplements thereto at the Closing Date.

1. The Company has been duly incorporated and is validly existing as a corporation in good standing under the Delaware General Corporation Law (the "DGCL").

2. The Company has the corporate power and authority to own, lease and operate its properties and to conduct its business as described in the Disclosure Package and the Prospectus under the DGCL and to enter into and perform its obligations under the Underwriting Agreement.

3. The Company is duly qualified to transact business and is in good standing in the State of Texas.

4. Each Subsidiary has been organized and is validly existing in good standing under the laws of the jurisdiction of its organization, has the power and authority to own, or lease, as the case may be, and to operate its properties and to conduct its business as described in the Disclosure Package and the Prospectus and is duly qualified to transact business and is in good standing in each jurisdiction listed on Schedule I hereto.

5. All of the issued and outstanding equity interests of each Subsidiary have been duly authorized and validly issued and are fully paid and non-assessable (except to the extent that such non-assessability may be affected by Section 17-607 of the Delaware Revised Uniform Limited Partnership Act (the "DLPA") or Section 18-607 of the Delaware Limited Liability Company Act (the "DLLCA")).

6. The authorized, issued and outstanding capital stock of the Company conforms in all material respects to the descriptions thereof set forth under the caption "Description of Capital Stock" in the Preliminary Prospectus and the Prospectus. All of the outstanding shares of Common Stock (including the shares of Common Stock owned by Selling Stockholders) have been duly authorized and validly issued and are fully paid and non-assessable.

7. No stockholder of the Company or any other person has any preemptive right, right of first refusal or other similar right to subscribe for or purchase Common Stock of the Company arising by operation of the certificate of incorporation or bylaws of the Company or the DGCL.

8. The Underwriting Agreement has been duly authorized, executed and delivered by the Company.

9. The Shares to be purchased by the Underwriters from the Company have been duly authorized for issuance and sale pursuant to the Underwriting Agreement and, when issued and delivered by the Company pursuant to the terms of the Underwriting Agreement against payment of the consideration set forth therein, will be validly issued, fully paid and non-assessable.

10. The Registration Statement, the Preliminary Prospectus, the Prospectus and each amendment or supplement to the Registration Statement, the Preliminary Prospectus and the Prospectus, as of their respective effective or issue dates (other than the financial statements and the notes and supporting schedules, and other financial and related statistical and accounting data, included therein or excluded therefrom or the exhibits to the Registration Statement, as to which no opinion is rendered) appear on their face to be appropriately responsive in all material respects with the applicable requirements of the Securities Act and the Rules and Regulations, except that in each case no opinion is expressed as to Regulation S-T.

11. The statements in the Preliminary Prospectus and the Prospectus under the captions "U.S. Federal Tax Consequences to Non-U.S. Holders of Common Stock", "Business—Governmental Regulation", "Management —Long-Term Incentive Plan", "Management—401(k) Plan", "Management—Employment Agreements", "Management—Indemnification Agreements", "Description of Capital Stock", "Certain Relationships and Related Party Transactions—The Contribution Agreement and Related Transactions", "Certain Relationships and Related Party Transactions—Registration Rights Agreement" and "Certain Relationships and Related Party Transactions—Equity Appreciation Rights" insofar as such statements constitute matters of law, summaries of legal matters, legal proceedings, legal documents or legal conclusions, have been reviewed by us as described above and fairly summarize, in all material respects, the matters referred to therein, subject to the qualifications and assumptions stated therein.

12. No Governmental Approval is required for the Company's execution, delivery and performance of the Underwriting Agreement and consummation of the issuance and sale of the Shares pursuant to the Underwriting Agreement, except (A) as have been obtained or made or (B) would not have a Material Adverse Effect if not obtained or made. As used in this paragraph, "Governmental Approval" means any consent, approval, license, authorization or validation of, or filing, recording or registration with, any executive, legislative, judicial, administrative or regulatory body of the State of Texas, the United States of America or the State of Delaware, pursuant to (i) applicable laws of the State of Texas, (ii) applicable laws of the United States of America, (iii) the DGCL, (iv) the DLPA or (v) the DLLCA.

13. The execution and delivery of the Underwriting Agreement by the Company and the performance by the Company of its obligations thereunder (other than performance by the Company of its obligations under the indemnification section of the Underwriting Agreement, as to which no opinion is rendered) and the consummation of the transactions contemplated thereby (including the Reorganization) (i) have been duly authorized by all necessary corporate action on the part of the Company; (ii) will not result in any violation of the provisions of any Organizational Documents; (iii) will not constitute a breach of,

or Default or a Debt Repayment Event under, any agreement filed as an exhibit to the Registration Statement; or (iv) will not result in any violation of any applicable law, excluding in the cases of classes (ii) and (iii), (A) any such breaches, Defaults or Debt Repayment Events that would not have a Material Adverse Effect and (B) any Default or Debt Repayment Triggering Event under the Term Loan arising from the distribution to the partners of WRCLP contemplated under the caption "Certain Relationships and Related Party Transactions –The Contribution Agreement and Related Transactions" in the Prospectus.

14. The Company is not, and after giving effect to the offering and sale of the Shares and the application of the proceeds thereof as described in the Prospectus will not be, required to register as an "investment company" as such term is defined in the Investment Company Act of 1940, as amended and the rules and regulations of the SEC thereunder.

In addition, such counsel shall state that such counsel has been orally advised by the staff of the SEC that the Registration Statement was declared effective under the Securities Act on January [___], 2006, and that no stop order suspending the effectiveness of the Registration Statement has been issued. Such counsel shall state that to such counsel's knowledge, based solely upon such oral communications with the SEC, no proceedings for that purpose have been instituted or are pending or threatened by the SEC. Furthermore, such counsel shall state that the Prospectus was filed with the SEC pursuant to Rule 424(b)(4) of the Rules and Regulations on January [___], 2006 and that the Shares were approved for listing on the NYSE, subject to official notice of issuance.

Such counsel shall also state that such counsel has participated in conferences with officers and other representatives of the Company, representatives of the independent registered public accounting firm for the Company and representatives of the Underwriters and their counsel at which the contents of the Registration Statement, the Disclosure Package and the Prospectus and related matters were discussed and, although such counsel has not independently verified and is not passing upon and does not assume any responsibility for the accuracy, completeness or fairness of the statements contained in the Registration Statement, the Disclosure Package or the Prospectus (other than as specified in paragraph 11 above), on the basis of the foregoing (relying with respect to factual matters to the extent such counsel deems appropriate upon statements by officers and other representatives of the Company), no facts have come to such counsel's attention which would lead such counsel to believe that (i) the Registration Statement, at the time the Registration Statement became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary in order to make the statements therein not misleading; (ii) the Prospectus, as of its date or as of the date hereof, contained or contains an untrue statement of a material fact or omitted or omits to state a material fact necessary in order to make the statements therein, in the light of the circumstances under which they were made, not misleading; or (iii) as of [___] (which the Underwriters have informed such counsel is a time at or prior to the time of the first sale of Shares by any Underwriter), the Disclosure Package contained an untrue statement of a material fact or omitted to state a material fact necessary in order to make the statements therein, in the light of the circumstances under which they were made, not misleading (other than the financial statements and the notes and supporting schedules, and other financial and related statistical and accounting data derived therefrom, included in or excluded from the

Registration Statement, the Prospectus or the Disclosure Package, as to which no belief need be rendered).

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