COURTING THE SUICIDE KING

Closing Opinions and Lawyer Liability

By Donald W. Glazer and Jonathan C. Lipson

What are you willing to risk when you represent a client in a major transaction? Your law practice? Your firm? When you deliver a closing opinion to the party on the other side, are you—unwittingly—courting the Suicide King (read on)?

Third-party legal opinions (opinions to be relied on by non-clients) date back to the late nineteenth century. At that time, underwriters of railroad bonds hired prominent lawyers to give opinions, printed on the bonds, confirming that the bonds had been duly authorized. In those days, the opinion givers were putting their reputations on the line—but little else. Lawyers were professionals, and professional courtesy, as well as legal concepts such as privity, made suits by third parties against opinion givers rare, if not unthinkable.

Today, lawyers, prominent and otherwise, routinely deliver closing opinions to non-clients in financial transactions. Unlike in the past, however, the prospect of being sued is no longer a theoretical possibility. Lawyers today too often are seen as deep pockets when a deal goes bad and the acrid aroma of financial fraud fills the air.

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To be sure, cases against opinion givers are still rare. And cases that go to trial and result in an award of damages are even rarer. But that does not mean that lawyers can blithely ignore the risk of giving opinions to non-clients. Although any particular opinion is unlikely to give rise to litigation, small risks run often enough cease being small, and during the last few years cases such as *CFS*, *Enron*, and *Dean Foods* have demonstrated all too clearly the willingness of investors, lenders, and acquirers, including major financial institutions, to sue the law firms that gave them opinions for amounts (up to $1 billion) that threatened those firms' very existence. Major floods may be rare, but every year, somewhere, a one-hundred-year flood wreaks havoc.

Apart from the usual bromides about avoiding unworthy clients, not giving opinions when red flags are flying and taking care to exercise customary diligence in preparing opinions, little has been written about what opinion givers might do to protect themselves in the brave new world of today's opinion practice. In this article we will describe how the current situation developed and explore ways to address the problem.

Cost-Benefit Analysis

When lawyers discuss whether an opinion should be given, they usually consider the cost to their client and the benefit to the recipient. (*See, e.g., 2004 Report on the Remedies Opinion by the Section of Business Law of the State Bar of California.*) The cost to their client includes the legal expense of preparing an opinion and performing the customary diligence to support it. The benefit to the recipient is the assurance that legal issues of concern to it have been satisfactorily addressed. An opinion on a stock offering, for example, provides an investor comfort that the stock it is acquiring has been duly authorized and validly issued by the company.

A cost-benefit analysis can help weed out opinions that are overly expensive to prepare or of little value to recipients. But a client's perspective is not the only one that should count from a cost-benefit standpoint. To be complete and accurate, the cost side of the equation must take into account the potential cost to an opinion giver of being sued. And, as discussed in the next section of this article, increasing litigation risks make that cost difficult to quantify.

Inability to Quantify the Risk

In an era when opinion givers had no practical exposure to liability, the cost-benefit equation could ignore litigation costs because the likelihood those costs would ever be incurred was essentially nil. That era, however, has passed. Today, the risk of being sued on an opinion is real, and litigation-related costs (including not only the

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expenses of defending an action but also the possibility of having to settle or pay damages) must be considered if the equation is to have any value.

Despite the need to take litigation costs into account, an effort to state those costs in dollar terms faces serious obstacles. These include:

- The absence of reliable statistics because of the paucity of reported judicial decisions involving third-party opinions;
- The lack of public information about settlements and defense costs (although we understand anecdotally that settlements can be in the high eight figures or even more);
- The inability to translate into dollar terms the impact a suit can have on a firm's practice and the productivity of the lawyers who worked on the challenged opinion; and
- Most importantly, the inability to place a value on the continuing existence of a law firm as an institution when a suit jeopardizes its future.

If litigation costs to opinion givers cannot be quantified, a cost-benefit analysis in and of itself cannot identify the circumstances when the true cost of giving an opinion exceeds the benefit. Nor can it be helpful in determining how much extra, over and above a law firm's standard hourly rates, an opinion giver would have to charge to balance the equation.

The Dilemma

The knowledge that someone is struck by lightning every year does not keep golfers off the golf course. Although the consequences are dire, the perceived risk is too small. Similarly, the knowledge that lawyers are now sued on opinions and that the damages sought can be catastrophic has not kept lawyers who work on financial transactions from giving third-party legal opinions. Lawyers see the risk to their careers of not giving opinions as large and the risk that they might be held liable for a substantial amount as small. Thus, they accept the risk of liability as going with the territory. Like golfers setting out on a rainy day, however, lawyers would do well to take what measures they can to protect themselves from the elements when they are proceeding, as they are now, under increasingly threatening skies.

Before proposing a solution, we want to make clear that we do not blame the current situation on the legal rules for establishing liability (as set forth, for example, in the *Restatement of the Law Governing Lawyers*). Lawyers are no different than anyone else who has a duty to exercise care, and lawyers who are negligent (or worse) should not get a pass on liability. The sine qua non for an opinion giver is to exercise care in preparing opinions. Unfortunately, however, for an opinion giver, exercising care is not the whole story.

One of the challenges opinion givers face when sued is winning a motion to dismiss. Actions against opinion givers are fact specific, and judges generally have been unwilling to dismiss a complaint before giving an opinion recipient an opportunity to develop the facts. The consequence has been to expose opinion givers to defense costs of potentially tens of millions of dollars and damages claims that far exceed what they can afford to lose. When a firm faces the possibility of a catastrophic loss at trial, the pressures to settle are intense.

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Some Alternatives

As with any question of loss allocation, the exposure of opinion givers to firm-threatening claims can be addressed in two ways: through regulation or through markets. As a practical matter the prospects for a regulatory solution appear remote. Moreover, even if adopted, a regulatory solution would be less likely than a market solution to allocate costs to those who benefit from them.

A standard market solution for addressing risk is insurance. Law firms maintain general liability insurance and, if an excess coverage policy specifically addressing their liability for closing opinions were available on financially reasonable terms, they could then seek to pass the premium on to their clients as a transaction cost. At least to our knowledge, however, no such insurance is currently available. Moreover, if it were, one cannot help but wonder whether clients would balk at paying what could be a substantial premium.

Another alternative is procedural. An opinion giver might seek to establish a mechanism for dispute resolution similar to the mechanism investment bankers include in their engagement letters. Thus, a recipient that sees arbitration as a quicker, private and more efficient way to resolve a dispute might agree that, if it were to bring an action relating to the opinion, it would do so before an expert or a panel of experts on opinion giving. Arbitration would reduce the pressure on a law firm to settle when it is comfortable that it exercised due care but concerned about having that question decided by a jury. However, even a procedure in which disputes are resolved by experts will not protect an opinion giver from having to pay potentially ruinous damages if it did make a mistake and, in fact, was negligent.

Today, many law firms routinely give opinions on transactions involving hundreds of millions and even billions of dollars. In doing so, for a fee that is only a small fraction of the dollars involved, they expose themselves to potential liability to third parties for an amount (i.e., the full amount of the transaction) that is well in excess of what even the largest law firms can afford. The magnitude of the exposure, we believe, is the crux of the problem. Even the criminal law does not exact the ultimate penalty for negligent homicide.

The solution we propose addresses the disproportionality of lawyers' expo-

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sure head on. It is for opinion givers to negotiate a cap on the dollar amount of the damages the recipient can recover for the opinion and to include that cap in the agreement between the parties and the opinion letter itself. The cap we envision would be large enough to assure that the opinion giver takes its responsibilities seriously (and would not apply to recklessness or willful misconduct). It would not be so large, however, as to put a firm's future into jeopardy. We would expect the cap to vary depending on the firm and the transaction. We also would expect it to vary depending on the opinions being given. Some opinions—for example "negative assurance" (which technically is not even an opinion)—have spawned more litigation than others. When giving those opinions. lawyers might press harder for inclusion of a cap than they do for less risky opinions.

We are well aware that ethical rules generally prohibit lawyers from limiting their liability to clients. Our proposal, however, is to limit opinion givers' liability to non-client opinion recipients, and we are aware of no ethical rule that prohibits a lawyer from asking a non-client, represented by its own counsel, to agree, as a condition to receiving an opinion, to limit the amount it can seek as damages.

When a privately held company is sold, the acquisition agreement normally subjects the selling shareholders to an indemnification claim for only a portion of the purchase price, thus allowing them to keep much of the consideration paid to them notwithstanding misrepresentations in the agreement. Moreover, the obligation to indemnify normally expires after a stated period of time, often a year or two. In the current environment in which opinion givers have potential liability for the entire purchase price, a law firm receiving a legal fee for giving an opinion on behalf of selling shareholders has greater exposure to liability than its clients, and for a longer time. A cap would help remedy that inequity.

Although the benefit to an opinion recipient of agreeing to a cap may not be obvious at first glance, opinion recipients, like everyone else involved in the opinion process, have a stake in its smooth functioning. Transactions involving opinions are not one-off events, and over the long run forcing law firms to risk their futures each time they give an opinion is in nobody's interest. Moreover, as a practical matter, putting a firm's back to the wall if something goes wrong may prolong litigation and even lead to a scorched-earth policy under which a firm exhausts its financial resources on defense costs rather than settle for an amount that exceeds its insurance coverage. Thus, we are hopeful that clients will support the efforts of their counsel to manage the liability counsel takes on when giving third-party opinions on their behalf. In addition, we are hopeful that institutions, which often receive third-party opinions from the same firms they rely on for representation in other transactions, will take a longer-range view of what is in their self interest and not dismiss a proposed cap out of hand.

At least three major law firms have been targets of potentially catastrophic suits in the last few years.

An Epilogue—The Suicide King

We invite you, the readers of this article, to join us in a simple card game. We'll call it the Suicide King game after the King of Hearts, the card in which the King holds a sword to his head, apparently poised to do himself in. The game will begin with your placing your initial stake, let's say your life savings of $5 million, on the table in front of you. You then will shuffle a deck of cards and draw one card from the deck. If the card you draw is not the Suicide King, you will win and we will pay you cash in an amount equal to 5 percent of your $5 million. From that 5 percent (initially $250,000) you will pay yourself 40 percent (initially $100,000) as a salary for playing the game and add the balance (initially $150,000) to what you have on the table. If you draw the Suicide King, we will win and you will give us your $5 million.

The game will continue on the first day of each subsequent calendar quarter, with your drawing one card from a new deck. If you win, we will pay you 5 percent of your initial stake and accumulated profits; you will pay yourself 40 percent as salary and add the remainder to your stake on the table. If we win, you will turn over to us what you then have in front of you.

After the first year, assuming, as is likely, that you do not draw the Suicide King (the odds are about one in 13), you will have made over $600,000 and paid yourself a salary of over $400,000. You will be feeling rich and happy. If, as is still likely, you do not draw the Suicide King in the second year, you will be richer still, and may even start to brag to your friends about your financial acumen. And so it may go for many years. But no matter how many years pass, no matter how large your salary and the pile of cash in front of you, we know one thing for sure: at some point you will lose. And when you do, you will lose your life savings and all your profits. You will lose everything.

Now, we readily concede that lawyers are professionals, not gamblers. When they deliver closing opinions, they do not—and should not—regard themselves as playing a game of chance. But no matter how professional they may have been in preparing their opinions, at least three major law firms have been targets of potentially catastrophic suits in the last few years. And that should give everyone pause. We, therefore, end with the question we asked at the outset of this article. The question is whether, in light of your practice, the opinions you give, and the procedures you have in place, you have fully considered the risks you have been running when delivering third-party opinions. The question is whether—unwittingly—you have been playing the Suicide King game.

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