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**“Market Information and the Elite Law Firm”**

**by**

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**Note: It is expected that you will have reviewed the paper in advance of the seminar (though the speaker will be given thirty minutes to summarize it). The attached paper is somewhat longer than usual. You can skip the mathematical appendix. The author also has indicated that it is not essential to read section III, the case study. Without these two parts the paper is less than 24 pages long.**

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## MARKET INFORMATION AND THE ELITE LAW FIRM

*Elisabeth de Fontenay\**

### ABSTRACT

*Following the contraction in demand for law firms' services during the Great Recession, "Big Law" was widely diagnosed as suffering from several maladies that would spell its ultimate demise, including excessive fees, excessive size, increased competition from in-house counsel, the commoditization of legal work, and the decline in demand for "relationship firms." While each of these market pressures is only too real for certain segments of the law-firm population, their threat to the most elite U.S. law firms has been largely misunderstood. Even as many firms reduce their fees and contract in size, we should expect certain firms to continue to charge more and grow bigger. The current prescriptions for fixing Big Law fail to recognize that the top-tier firms within the group serve a unique market function.*

*Focusing on a particular type of legal work – major corporate transactions – this Article proposes a novel theory of the value created by elite law firms: their private information about "market" deal terms, acquired through repeated exposure to the same types of transactions, provides clients with a significant bargaining advantage in deal negotiations. By aggregating expertise in the ever-changing and ever-increasing set of deal terms for certain transactions, law firms help their clients price such terms more accurately and thereby maximize their surplus from the deal. This pricing function – traditionally thought to be limited to investment banks – is one that cannot be replicated or subsumed by in-house counsel, other service providers, or commoditized contracts.*

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## INTRODUCTION

In the age of increasingly sophisticated in-house counsel, what exactly are the benefits that law firms provide to their clients? Among law firms, what does the relative ranking or prestige of a law firm actually reflect? Although these questions are of enormous and urgent practical interest, the scholarship addressing them remains surprisingly limited. We can begin our inquiry with a puzzle. Discussions of the legal profession today devote much attention to the need for “Big Law” to provide more cost-effective services to their clients.<sup>1</sup> The still-recent financial crisis and continuing sluggish economic growth in the United States have only rendered these calls for reform more urgent. Because law firms fail to provide sufficient value in return for their fees, the argument goes, demand for their services has slackened, resulting in painful layoffs for experienced lawyers and a dismal job market for recent law school graduates.<sup>2</sup>

Yet this dire picture ignores a surprising – and, perhaps, dismaying – reality: it is precisely those law firms that charged the highest fees before the downturn for whom demand continues to be greatest and who are best weathering the crisis in the legal profession.<sup>3</sup> While many lower-ranked law firms continue to struggle, the highest-ranked firms present a picture of financial health and perennially overworked lawyers.<sup>4</sup> There is a widening chasm between the most elite corporate law firms and the rest of the pack in

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<sup>1</sup> See Larry E. Ribstein, *The Death of Big Law*, 2010 WIS. L. REV. 749 (2010) (discussing “the forces driving the downsizing of Big Law” and suggesting alternative viable business models for legal services); RICHARD SUSSKIND, *THE END OF LAWYERS? RETHINKING THE NATURE OF LEGAL SERVICES* 1-3 (2008) (predicting a diminished role for lawyers as a result of cost pressures and technological innovation). See also Antone Johnson, *Why Are Lawyers So Expensive Even With The Excess Of Supply of Lawyers?*, FORBES, Mar. 6, 2012, available at <http://www.forbes.com/sites/quora/2012/03/06/why-are-lawyers-so-expensive-even-with-the-excess-supply-of-lawyers/> (arguing that large law firms should decrease their billing rates in response to decreased demand for lawyers).

<sup>2</sup> See Elizabeth Olson, *Corporations Drive Drop in Law Firms’ Use of Starting Lawyers*, *Study Finds*, N.Y. TIMES, Oct. 10, 2014 (describing companies’ increasing reluctance to pay for the services of untrained associates at law firms).

<sup>3</sup> See Liz Hoffman & Jennifer Smith, *Elite Law Firms Reign as Megadeals Blossom*, WALL ST. J., July 14, 2014, at B1; Bernard Burk & David McGowan, *Big But Brittle: Economic Perspectives On The Future Of The Law Firm In The New Economy*, 2011 COLUM. BUS. L. REV. 1, 6 (2011) (disagreeing with Ribstein’s prediction of the “death of Big Law” and arguing instead that the “recession[s] ... economic forces ... do not threaten the viability of the large law firm as such.”)

<sup>4</sup> See Aric Press, *Am Law 100 Analysis: The Super Rich Get Richer*, THE AMERICAN LAWYER, (April 28, 2014), available at <http://www.americanlawyer.com/id=1202651706887/Am-Law-100-Analysis-The-Super-Rich-Get-Richer-?slreturn=20140915093251> (surveying the top 100 U.S. law firms by revenue and noting that, unlike their counterparts, the “Super Rich firms – the 20 with [profits per partner] of at least \$2 million and [revenue per lawyer] of at least \$1 million” – outperformed the financial averages by four or five percentage points....”).

terms of transaction volume, billing rates, lawyer compensation, and hiring.<sup>5</sup>

What accounts for this widening inequality among law firms? The most plausible explanation is that the top-ranked firms provide clients with one or more valuable benefits that lower-ranked firms cannot. Focusing on a particular type of legal practice – major corporate transactions – this Article proposes that law firms that repeatedly engage in the same type of high-stakes transactions acquire private information about the range of plausible deal terms and their current market prices that other players cannot replicate.<sup>6</sup> This expertise in the ever-changing, ever-expanding set of “market” deal terms provides clients with a valuable bargaining advantage in deal negotiations. Law firms that are repeat players with respect to particular types of corporate transactions use their market knowledge to procure better economic deals for their clients. Though this hypothesis by no means rules out other ways in which elite firms add value, it would account for the seemingly self-reinforcing advantage of high-volume firms. The failure to recognize law firms’ informational role in transactions and its effect on bargaining outcomes reflects a widespread misunderstanding, akin to equating the role of an investment bank to that of a commercial bank.

The argument is as follows. Although many corporate transactions become standardized and even commoditized over time,<sup>7</sup> others involve increasingly complex or rapidly changing terms for a sustained period of time. The latter type consists of heavily negotiated, bilateral transactions, characterized by variation in the market price of deal terms, the constant development of new terms, or both.<sup>8</sup> Such transactions stray from the perfect-market ideal of transparent, uniform pricing. Rather, information about individual deal terms and their pricing remains largely private (and therefore scarce). For a given deal, the final set of negotiated terms will be determined by a combination of market forces and bargaining under incomplete information, and will thus be heavily affected by the parties’ respective information in the bargaining stages.

To maximize their gains from this type of transaction, the parties must know the benefit or cost of each deal term to each party, as well as how to

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<sup>5</sup> See Citi Private Bank & Hildebrandt Consulting, *2015 Client Advisory*, <https://www.privatebank.citibank.com/pdf/CitiHildebrandt2015ClientAdvisory.pdf> at 3 (finding the “continued growing separation in the market between the most profitable [law] firms and the rest” with respect to transactional work); Hoffman & Smith, *supra* note 3, at B1 (noting the “growing gulf in the broader legal industry as a handful of the most prominent – and profitable – law firms, pull ahead of the pack.”).

<sup>6</sup> See *infra* Part II.

<sup>7</sup> See Susskind, *supra* note 1, at 28-33 (describing the evolution of legal services from bespoke to fully commoditized).

<sup>8</sup> Transactions falling within each of these three categories currently include mergers and acquisitions, private investment fund agreements, and leveraged debt financings, respectively, though this need not continue to be the case.

trade off terms against one another under current market conditions. A necessary (though by no means sufficient) condition to acquiring that information is real-time access to the terms of a significant volume of recent comparable transactions. Such market information about deal terms assists parties with three tasks that are crucial for transactional bargaining: (1) learning of any new terms that provide value-increasing opportunities; (2) determining their expected payoffs from each deal term; and (3) determining the value of their outside option.<sup>9</sup> Where do parties obtain this expert information? The most obvious source, I argue, is law firms that routinely engage in the type of transaction at issue. By definition, private transactions (or public transactions for which some terms remain private) have opaque term pricing. Law firms retain a near monopoly over the complete deal terms for such transactions, because they are repeat players across a range of different clients and, unlike other transaction participants, they negotiate and draft the full panoply of transaction terms, from signing to closing and potentially beyond (through disputes, renegotiation, and resolution). While third-party data providers have made substantial inroads in aggregating and comparing corporate deal terms,<sup>10</sup> they are largely confined to reviewing publicly available documents *ex post*.

The hypothesis that law firms create value through market knowledge is supported by the changing nature of the transactional work performed at elite law firms. Associates at such firms may now devote much, if not most, of their time to aggregating and comparing their firm's "market precedent" in preparation for a client's potential transaction.<sup>11</sup> Unsurprisingly, firms' practices in this regard should tend to become more sophisticated and routinized as the amount of information to be compiled grows and knowledge-management technology improves.

This reconceiving of the role played by law firms in corporate transactions challenges fundamental and longstanding assumptions about the law

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<sup>9</sup> A party's "outside option" is the payoff that it would obtain if it had to break off negotiations for the current transaction and return to the market for an alternative. In the negotiations literature, the "outside option" is referred to the "best alternative to a negotiated agreement," or BATNA. The outside option is a key determinant of a negotiator's results. *See* ROGER FISHER & WILLIAM URY, *GETTING TO YES: NEGOTIATING AGREEMENT WITHOUT GIVING IN* 99-107 (Bruce Patton ed., 3d ed. 1981).

<sup>10</sup> Companies such as Xtract Research, Practical Law, and The Deal provide searchable databases of key terms from corporate transactions.

<sup>11</sup> *See, e.g.*, Wilson Sonsini Goodrich & Rosati, Knowledge Management Program, *available at* <https://www.wsgr.com/PDFs/professional-development-brochure.pdf> (describing the firm's searchable internal database of precedent transactions). In practice, this knowledge management exercise may be implemented by law firms in various ways, from using sophisticated database software to track all of the terms of precedential transactions, or tabulating recent deal terms manually, to the more informal and traditional practice of simply gathering and reviewing recent comparable transaction documents before beginning a negotiation.

firm/client relationship.<sup>12</sup> The rules of professional responsibility for lawyers zealously endorse the confidentiality of client information. Yet, in practice, clients are paying for law firms' ability to pool information across clients and to make use of that information in transaction negotiations. A Fortune 500 company engages a top-tier law firm for its proposed merger precisely because the firm will know (and use) the terms obtained by similar companies in recent mergers. Such clients do not seek bespoke, professional service based on a long-term, confidential relationship.<sup>13</sup> They are, in effect, merely purchasing information from law firms, which in turn are merely engaged in the increasingly ubiquitous practice of knowledge management.<sup>14</sup> Yet this form of knowledge management should continue to generate above-market rents for elite firms, which have better (and sometimes exclusive) access to the underlying information relative to other market participants.

Finally, this Article calls for some optimism about the future of law firms with elite transactional practices – defined here as those with a significant market share of the very largest transactions by dollar value – while sounding a cautionary note for in-house counsel. Law firms will always retain their private market knowledge as a crucial advantage over their in-house counterparts, however experienced and sophisticated the latter may be. For the most part, in-house lawyers are privy only to their employer's own transactions, in contrast to law firms' real-time access to a wide range of precedential transactions. The trumpeting of in-house counsel as a solution to spiraling legal costs<sup>15</sup> should thus be more muted: for the most lucrative areas of transactional practice, clients will continue to seek the most prestigious law firms.<sup>16</sup>

We can end our inquiry with another puzzle – that of the ever-expanding law firm. Various theories have been advanced to explain the increasing prevalence of the mega-law firm.<sup>17</sup> While each of these provides a partial

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<sup>12</sup> See *infra* Part IV.F.

<sup>13</sup> See Ronald J. Gilson, *The Devolution of the Legal Profession: A Demand Side Perspective*, 49 MD. L. REV. 869 (1990) (describing the decline in relationship lawyering).

<sup>14</sup> *C.f.* CHRISTOPHER D. MCKENNA, *THE WORLD'S NEWEST PROFESSION: MANAGEMENT CONSULTING IN THE TWENTIETH CENTURY* (2006) (arguing that management consultants are richly compensated simply for selling access to their database of information gathered from numerous clients).

<sup>15</sup> See, e.g., Abram Chayes & Antonia H. Chayes, *Corporate Counsel and the Elite Law Firm*, 37 STAN. L. REV. 277 (1985) (noting the increased prominence of in-house counsel and predicting a corresponding contraction in the roles played by outside law firms).

<sup>16</sup> For a detailed discussion of the considerations involved in choosing between in-house and outside counsel, see Steven L. Schwarcz, *To Make or Buy: In-House Lawyering and Value Creation*, 33 J. CORP. L. 497 (2008).

<sup>17</sup> See Georgetown Law Center for the Study of the Legal Profession, 2014 Report on the State of the Legal Market 1, 9, available at [https://peermonitor.thomsonreuters.com/wp-content/uploads/2014/01/2014\\_PM\\_GT\\_Report.pdf](https://peermonitor.thomsonreuters.com/wp-content/uploads/2014/01/2014_PM_GT_Report.pdf) (documenting the continued trend toward larger firms and listing the most common explanations for the phenomenon as “(i) the

explanation, under this Article's thesis larger firms also reflect the self-perpetuating informational advantage derived from greater deal volume.<sup>18</sup>

The Article proceeds as follows. Part I reviews the existing literature on the value, if any, provided by transactional lawyers. In Part II, puzzles left unsolved by the existing literature yield a new theory of law firm value in the transactional context, focusing on elite firms' market knowledge. Part III illustrates the market-knowledge hypothesis with a case study of leveraged financing transactions. Finally, the Appendix provides a game-theoretic model of transaction counterparties' selection of law firms.

## I. A BRIEF REVIEW OF THE LITERATURE

### A. *The Value of Transactional Lawyers: Three Paradigms.*

As with other professional services, the costs of legal services have been increasing faster than inflation in recent decades. For clients, then, the question of what they are getting in return for their legal fees is a pressing one. Yet clients' ability to assess their outside counsel's performance is limited.<sup>19</sup> The law firm/client relationship poses the classic agency problem: the principal (here, the client) lacks complete information about the agent's (the law firm's) performance of its duties, which allows the agent to act to some degree in its own interests at the expense of the principal's.<sup>20</sup> The existing literature's focus on this agency problem puts the cart before the horse, however. Before examining how well clients are able to monitor and assess their law firms, we should clarify just what it is that, in the absence of agency

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desire to achieve 'economies of scale,' (ii) the necessity of creating an 'ever expanding pie' to provide opportunities for younger lawyers ... (iii) the need to diversify to protect a firm against cyclical downturns in specific practices, and (iv) the requirements for a larger market footprint to better serve the needs of clients.'").

<sup>18</sup> This should not be taken to suggest that law firms should seek to expand indefinitely. Other efficiency-related concerns (such as the notorious difficulties and duplication involved in managing large organizations) might suggest a maximum desirable size for a given firm. Further, certain firms may be able to increase their transaction volume without necessarily increasing the number of lawyers, for instance by increasingly delegating or outsourcing the more routine aspects of transactional work. Among elite law firms, New York-based Wachtell, Lipton, Rosen & Katz is well known for adopting this model. See K. William Gibson, *Outsourcing Legal Services Abroad*, 34 LAW PRAC. MAG. 47 (2008) (discussing law firms' practice of outsourcing legal work), available at [http://www.americanbar.org/publications/law\\_practice\\_home/law\\_practice\\_archive/lpm\\_magazine\\_articles\\_v34\\_is5\\_pg47.html](http://www.americanbar.org/publications/law_practice_home/law_practice_archive/lpm_magazine_articles_v34_is5_pg47.html).

<sup>19</sup> See John C. Coates, *Explaining Variation in Takeover Defenses: Blame the Lawyers*, 89 CAL. L. REV. 1301, 1310 (2001) (noting that, as with all agency relationships, "principals (clients) have little information about what their agents are doing").

<sup>20</sup> See *id.* at 1309-10 (describing the law firm/client agency relationship); Susskind, *supra* note 1, at 148-49 (describing the divergent incentives of law firms and their clients).



costs, law firms would ideally accomplish. Simply put, what does it mean to be a good lawyer? When a law firm is hired by a corporate client, what is the value that it is meant to provide? These questions are paramount. The agency-cost analysis only identifies the ways in which law firms and lawyers may *knowingly* depart from their clients' interests, such as by shirking and over-billing. Yet one could easily imagine a law firm working diligently for its client and billing conservatively, while still failing to deliver any value. The agency costs involved in the law firm/client relationship are far from the only, or even the most important, considerations in law firm selection.

Though the agency-cost path is better trodden, scholars have made significant progress in identifying the sources of value provided by lawyers. The value question is particularly intriguing in the context of transactional lawyering, which is this Article's focus. Major corporate transactions<sup>21</sup> such as mergers and acquisitions and financings are known to require large teams of lawyers.<sup>22</sup> But what is it that such lawyers do, and why? Unlike the litigation context, in which the lawyer's role *qua* lawyer is clear in the public imagination, transactional lawyers are often accused of (or congratulated for) not being lawyers at all. Referred to even in firms' own marketing materials as advisers, deal-makers, or business planners,<sup>23</sup> these mysterious figures cost clients a pretty penny in any case.

In his seminal 1984 article, Ronald Gilson dispelled some of the mystery by identifying transactional lawyers as "transaction cost engineers."<sup>24</sup> He began from the premise that, in contrast to the standard perfect-market assumptions, corporate transactions involve substantial transaction costs. Much of these costs stem from the parties' asymmetric information as to the true value of the asset to be transferred between them.<sup>25</sup> In the sale of a company, for example, the seller is always better informed about the company's value than the buyer, making it difficult to reach a deal and to price it accurately. Gilson hypothesized that good transactional lawyers minimize such information costs for the parties, for example by allocating each risk involved in the transaction to the party best able to bear it. For the sale of a

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<sup>21</sup> For purposes of this Article, "major corporate transactions" are defined loosely as corporate transactions that represent all or a significant portion of the enterprise value of at least one party or that involve significant changes in the capital structure, assets, or organization of the corporation.

<sup>22</sup> See Ribstein, *supra* note 1, at 763 (noting large financial transactions require teams of lawyers spanning multiple departments and areas of expertise).

<sup>23</sup> See Susskind, *supra* note 1, at 5 (noting the phenomenon of "lawyers denying that they are lawyers").

<sup>24</sup> Ronald J. Gilson, *Value Creation by Business Lawyers: Legal Skills and Asset Pricing*, 94 YALE L. J. 239 (1984). See also Peter J. Gardner, *A Role for the Business Attorney in the Twenty-First Century: Adding Value to the Client's Enterprise in the Knowledge Economy*, 7 MARQ. INTELL. PROP. L. REV. (2003). Ronald J. Gilson & Robert H. Mnookin, *Foreword: Business Lawyers and Value Creation for Clients*, 74 OR. L. REV. 1 (1995).

<sup>25</sup> Gilson, *supra* note 24, at 269.

company, for example, lawyers craft provisions such as seller representations and warranties, perhaps backed up by the seller's obligation to indemnify the buyer in the event of a breach. Such provisions provide more information and greater assurances to the buyer as to the value of the company, and therefore increase the likelihood that a deal will be reached and correctly priced. Thus, by minimizing transaction costs, transactional lawyers can increase the parties' joint surplus (value) from the transaction, making both sides better off. Among other merits, Gilson's theory is comforting to both lawyers and clients: it entails that, in hiring transactional lawyers, clients are better off relative to a hypothetical lawyer-free deal.<sup>26</sup>

A competing paradigm to the transactional law firm as "transaction cost engineer" is that of the law firm as "reputational intermediary" or "gatekeeper" in corporate transactions.<sup>27</sup> In this view, law firms perform the service of renting their good reputations to clients, thereby enabling them to complete a desired transaction or to obtain better terms for the transaction. Take, for example, a start-up company seeking to secure new funding through an initial public offering (IPO). The dearth of reliable information about the start-up relative to, say, an established public company presents a major obstacle to attracting investors. If the company or its underwriters hires a highly reputable law firm for the IPO, however, this signals to investors that the company has undergone some amount of due diligence and provides some assurance (though not an enforceable one) against fraud or misrepresentation by the company as to its value. In other words, to some degree the law firm's

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<sup>26</sup> Interestingly, the debate over whether transactional lawyers add or subtract value remains unresolved. Gilson's hypothesis is, by his own admission, theory-based, and to the author's knowledge has not been directly tested empirically. Gilson argues that transactional lawyers *must* add value (rather than simply redistribute it between the parties); otherwise, the parties would jointly agree not to use lawyers. See Gilson, *supra* note 24, at 245-46. Jeffrey Lipshaw argues that this assumption of value-creation may be unwarranted. See Jeffrey M. Lipshaw, *Beetles, Frogs, and Lawyers: The Scientific Demarcation Problem in the Gilson Theory of Value Creation*, 46 WILLAMETTE L. REV. 139 (2009) (noting that, if anecdotal evidence is to be believed, many clients feel that their lawyers were a negative-value proposition). For specific types of transactions, some evidence points to elite law firms having a positive impact on transactional value. See, e.g., C. N. V. Krishnan & Ronald W. Masulis, *Law Firm Expertise and Merger and Acquisition Outcomes*, 56 J. L. & ECON. 189 (2013) (finding that top-tier law firms are associated with better outcomes for clients in mergers and acquisitions, but declining to specify the precise mechanism by which this is achieved).

<sup>27</sup> See Karl S. Okamoto, *Reputation and the Value of Lawyers*, 74 OR. L. REV. 15 (1995); Ronald J. Gilson & Robert H. Mnookin, *Disputing Through Agents: Cooperation and Conflict Between Lawyers in Litigation*, 94 COLUM. L. REV. 509, 512-13 (1994); Gilson, *supra* note 24, at 290-93; Reinier H. Kraakman, *Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy*, 2 J.L. ECON. & ORG. 53, n.20 (1986); Larry E. Ribstein, *Ethical Rules, Agency Costs, and Law Firm Structure*, 84 VA. L. REV. 1707, 1739-40 (1998). The concept of a "reputational intermediary" originated in a seminal article by Ronald Gilson and Reinier Kraakman and is not limited to lawyers. See Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 620 (1984).

reputation stands in for material information about the company that investors would otherwise require. In the “reputational intermediary” model, law firms with established reputations provide a certification function for their clients, similar to that of well-reputed auditors.<sup>28</sup> While the law firm-as-gatekeeper thesis has spawned considerable discussion, the empirical evidence for it is decidedly mixed.<sup>29</sup>

Taking instead a bottom-up approach to the question, Steven Schwarcz derived a third paradigm for the value provided by transactional lawyers.<sup>30</sup> Based on a large-scale survey of both corporate clients and their outside counsel, Schwarcz concluded that business lawyers primarily add value (if at all) by acting as regulatory compliance experts.<sup>31</sup> More precisely, law firms assist clients with major corporate transactions principally by navigating both client-specific and transaction-specific regulatory concerns.<sup>32</sup> While Gilson had dismissed the importance of regulatory issues in corporate transactions,<sup>33</sup> Schwarcz’s work puts such concerns back at the center of transactional practice.<sup>34</sup>

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<sup>28</sup> Adopting a much broader definition of transactional law than Gilson, George Dent has proposed that business lawyers act as “enterprise architects” for their corporate clients. See George W. Dent, Jr., *Business Lawyers as Enterprise Architects*, 64 BUS. LAW. 279 (2009). While Gilson’s model rests on the paradigm transaction of the corporate acquisition, Dent’s view encompasses all of business law, and in particular transactions involving long-term business relationships such as joint ventures and venture capital investments. Because these ongoing relationships are characterized by incomplete contracting, Dent argues that lawyers provide a wider range of services than those involved in transaction-cost engineering, including balancing the client’s interests across many transactions and navigating extra-contractual norms of trust and cooperation among the business people. Though this Article’s hypothesis of the value provided by elite law firms reasonably extends to Dent’s broader vision of transactional practice, for ease of discussion the Article’s coverage is limited to Gilson’s narrower scope, consisting of major corporation transactions involving the transfer of a capital asset, such as mergers and acquisitions and financing arrangements. See Gilson, *supra* note 24, at 249 (defining a transaction as the transfer of a capital asset).

<sup>29</sup> See, e.g., Royce de R. Barondes, Charles Nyce & Gary C. Sanger, *Underwriters’ Counsel as Gatekeeper or Turnstile: An Empirical Analysis of Law Firm Prestige and Performance in IPOs*, 2 CAPITAL MARKETS L. J. 164 (2007); Michael Bradley et al., *Lawyers: Gatekeepers of the Sovereign Debt Market?*, 38 Int. Rev. L. & Econ. 150 (2014) (finding evidence that law firms do not act as reputational intermediaries in the sovereign debt markets).

<sup>30</sup> See Steven L. Schwarcz, *Explaining the Value of Transactional Lawyering*, 12 STAN. J.L. BUS. & FIN. 486 (2007).

<sup>31</sup> *Id.*

<sup>32</sup> *Id.*

<sup>33</sup> See Gilson, *supra* note 24, at 247 (noting that business lawyers often operate in areas with minimal or no regulation).

<sup>34</sup> Despite their differing emphases, there is likely to be considerable overlap in the transaction-engineering and regulatory-expertise paradigms in practice, where, for example, lawyers seek to minimize the impact of regulatory concerns on transaction surplus. Gilson’s theory sought a purely private-ordering role for lawyers that creates value; that is, a *raison d’être* for transactional lawyers *in the absence of regulation*. See Gilson, *supra* note 24, at 246-47 (describing his goal as identifying a purely private ordering role for transactional lawyers). Yet

*B. The Value of Transactional Lawyers: What's Missing.*

There are thus three broad paradigms for the role played by lawyers in major corporate transactions: transaction-cost engineer, reputational intermediary, and regulatory expert. Each one resonates as being clearly and intuitively correct,<sup>35</sup> and these are not conflicting hypotheses among which we must choose. Yet the picture that they collectively provide remains incomplete. In particular, they fail to fully account for one of the most salient features of current transactional practice: the overwhelming market share for major corporate transactions held by top-tier law firms.<sup>36</sup> For such “mega-deals,” we can count on one hand the number of firms that dominate the market for each type of transaction.<sup>37</sup>

Table 1. Combined Market Share of Top Five Law Firms By Transaction Type: U.S. Market (2014).<sup>38</sup>

| Transaction Type                     | % Market Share of Top 5 Firms by Deal Volume | % Market Share of Top 5 Firms by Deal Count |
|--------------------------------------|--|---|
|                                      | [Combined Volume USD]                        | [Combined Deal Count]                       |
| US Corporates Issuer Advisers        | 30.4%<br>[\$403 billion]                     | 25.5%<br>[879]                              |
| US Corporates Manager Advisers       | 43.6%<br>[\$602 billion]                     | 37.8%<br>[1003]                             |
| US High Yield Issuer Advisers        | 29.1%<br>[\$98 billion]                      | 22.6%<br>[190]                              |
| US High Yield Manager Advisers       | 63.5%<br>[\$214 billion]                     | 58.2%<br>[411]                              |
| US Syndicated Loans Issuer Advisers  | 37.3%<br>[\$111 billion]                     | 24.4%<br>[107]                              |
| US Syndicated Loans Manager Advisers | 67.1%<br>[\$221 billion]                     | 54.9%<br>[252]                              |
| US M&A Acquirer Advisers             | 24.9%<br>[\$936 billion]                     | 17.9%<br>[695]                              |

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Gilson would readily acknowledge that when lawyers seek to minimize the costs imposed on a transaction by regulatory concerns, they are engaged in a form of transaction-cost engineering.

<sup>35</sup> Of course, the degree to which each theory carries explanatory weight in practice depends highly on the particular transactional context.

<sup>36</sup> See Hoffman & Smith, *supra* note 3 at B1 (noting that, in the first half of 2014, the top five law firms held more than 75% of the U.S. mergers and acquisitions market share by deal dollar value).

<sup>37</sup> See *id.*

<sup>38</sup> Data compiled from the Legal Adviser League Tables on Bloomberg Professional. The figures for M&A advisers were adjusted to correct for double-counting in advisory roles.

| Transaction Type       | % Market Share of Top 5 Firms by Deal Volume | % Market Share of Top 5 Firms by Deal Count |
|------------------------|--|---|
|                        | [Combined Volume USD]                        | [Combined Deal Count]                       |
| US M&A Seller Advisers | 27.7%<br>[\$215 billion]                     | 21.2%<br>[256]                              |
| US M&A Target Advisers | 28.9%<br>[\$808 billion]                     | 16.5%<br>[265]                              |

The market concentration of elite firms aligns poorly with existing theories of corporate value. Take the example of the sale of a large public company. If Gilson's transaction-cost engineering hypothesis were the only plausible source of law firm value, then the seller should hire the most expensive law firm only if the company were faced with a truly novel problem, such as devising a new transaction structure in response to a recent regulatory change. For a transaction such as the sale of a large public company, the mechanisms for allocating risks efficiently between the parties have long since been devised, as Gilson freely acknowledges,<sup>39</sup> through contractual provisions such as representations and warranties, closing conditions, earnouts, termination rights, break-up fees, and so forth. Rather than seeing the same top-tier law firms used over and over again for the same type of transaction, we would instead expect to see the top-tier firms used for the first – or first few – of each type of transaction. For subsequent transactions, the work could safely be relegated to lower-ranked (read: cheaper) firms, no matter how large the transaction. Instead, however, we observe that the size of the transaction correlates closely with the quality/ranking of the law firms used by the party, regardless of the novelty or complexity of the deal.<sup>40</sup>

The reputational-intermediary hypothesis is even less suited to the observed pattern of elite law firm use. Recall that, under this hypothesis, the intermediary's reputation acts as a substitute for information about the company. A law firm's good reputation thus creates value only to the extent that a party to the transaction or third-party beneficiary thereof (such as potential investors in an IPO) lacks reliable, material information about the company at issue. For a merger of equals between two major public companies, however, a law firm's reputation would be of little benefit to the parties, given the relative surfeit of available information about each. For such transactions, the reputational-intermediary hypothesis would predict that the parties would hire lesser law firms. And yet, these are precisely the sorts of

<sup>39</sup> See Gilson, *supra* note 24, at 257 (noting that “the general contents of the [acquisition] agreement have by now become pretty much standardized”).

<sup>40</sup> See Jeffrey Manns & Robert Anderson IV, *The Merger Agreement Myth*, 98 CORNELL L. REV. 1143, 1150, 1155 (2013) (stating that “almost all sizable transactions involve elite law firms” and noting “the almost universal use of a prominent law firm for large-scale transactions”).

transactions for which law firms with the most established reputations are routinely engaged.

The regulatory-expert hypothesis fares the best among the three, as it does not predict the opposite of the observed pattern of law firm usage. And yet it does not fully account for this pattern. Continuing with the example of the sale of a large public company, it is certainly the case that any major corporation today faces a highly complex regulatory environment. Yet if that's so, the corporation would be best served by simply relying on the law firm that is most familiar with it and its specific regulatory concerns (its relationship firm), rather than on the most elite firm, with whom the company may have had little or no prior dealings. Again, the public-company merger is a well-trodden path, and though regulatory hurdles are involved, they are no longer novel or mysterious.<sup>41</sup> Stated differently, the firm-specific regulatory costs likely outweigh the transaction-specific regulatory costs. Any competent law firm with a transactional practice could therefore fit the bill, and one that was intimately familiar with the company's particular regulatory issues would therefore seem best suited to the transaction. Yet this is not what we observe. For a major merger, the company will tend to engage one of the handful of top firms that specialize in that type of transaction, rather than its relationship firm.<sup>42</sup> What, then, best explains this pattern of law firm selection? This is the task to which the Article turns in Part II.<sup>43</sup>

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<sup>41</sup> See Gilson, *supra* note 24, at 247 (claiming that “business lawyers frequently function in a world in which regulation has made few inroads” and where “there is virtually no law to apply”).

<sup>42</sup> See Manns & Anderson, *supra* note 40.

<sup>43</sup> Before proceeding, it is worth dismissing – or, rather, correctly identifying – an alternative hypothesis for why elite law firms are breaking from the pack when it comes to major corporate transactions. The scholarly and practitioner literatures frequently refer to “star” lawyers or teams of lawyers for which clients will pay extraordinary fees. See John C. Coates, Michele M. DeStefano, Ashish Nanda, & David B. Wilkins, *Hiring Teams, Firms and Lawyers: Evidence of the Evolving Relationships in the Corporate Legal Market*, 36 LAW & SOC. INQUIRY 999, 1028 (2011). These legal geniuses are apparently so sought after that they, and therefore the law firms at which they practice, are able to command above-market rents. This story of individual or team talent is simply the legal-services equivalent of the economic principle that the returns to talent have increased dramatically as a result of globalization. See Sherwin Rosen, *The Economics of Superstars*, 71 AM. ECON. REV. 845 (1981) (describing the contemporary phenomenon in certain areas of economic activity of a small number of individuals receiving astonishingly high compensation). The latter has become a standard explanation for the extraordinary compensation paid to top entertainers, athletes, and corporate executives in a globalized economy. The top law firms earn above-market rents, we learn, simply because they are able to identify and hire the most legal stars. Among transactional lawyers, for example, such stars would no doubt include Marty Lipton, the inventor of the “poison pill” antitakeover device, which single-handedly stemmed the tide of the 1980s’ hostile takeover wave and revolutionized the practice of mergers and acquisitions in the U.S. See Michael J. Powell, *Professional Innovation: Corporate Lawyers and Private Lawmaking*, 18 LAW & SOC. INQUIRY 423, 433–41 (1993) (describing the development of the poison pill at Wachtell Lipton and the firms’ efforts to publicize it).

## II. A NEW THEORY OF LAW FIRM VALUE: AGGREGATING MARKET INFORMATION.

Whether implicitly or explicitly, the existing paradigms of transactional lawyer value all reflect the notion that law firms gain a valuable advantage by repeatedly performing the same types of transactions. As high-volume players for a particular transaction, they acquire some skill or characteristic that cannot easily be replicated by firms that are relative novices to the game. The three paradigms simply disagree on what that particular skill or characteristic is. Under Gilson's transaction-cost engineering hypothesis, repeat-player law firms gain a keen understanding of the risk-allocation and information-eliciting devices involved in that type of transaction. Under the reputational-intermediary hypothesis, over time law firms develop a reputation for accurately representing what they know (and don't know) about their client to third parties, including the client's transaction counterparty, potential investors, and regulators. Under the regulatory expertise hypothesis, experience with a given transaction type provides a keen appreciation for the regulatory challenges it presents and how best to manage these.

As this Part II demonstrates, repetition provides law firms with yet another valuable advantage: knowledge of the ever-changing and ever-expanding set of value-increasing terms for that particular transaction, and of their market "price." The case for this missing piece of the value puzzle is set forth below, through three fundamental claims relating to certain complex, bilaterally-negotiated<sup>44</sup> corporate transactions: (1) in order to maximize their surplus from

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As applied to law firms, the star theory is merely a particularly stark instance of either the transaction-cost engineering hypothesis or the regulatory expertise hypothesis, or of both. Star lawyers are described as outstanding problem solvers, yet the problems that they address can, in practice, be classified as minimizing transaction costs, addressing regulatory concerns, or a combination of the two. What still requires elucidation are the precise conditions under which clients require the services of a star lawyer or star team of lawyers. Again, well-established corporate transactions such as routine, public-company mergers and acquisitions seem ill-suited for the services of star lawyers. Thus, despite its intuitive appeal, the star theory – like its parent theories of transaction-cost engineering and regulatory expertise – fails to fully account for elite law firms' dominance in major corporate transactions. The star theory also falters as an account of the current law-firm landscape in that individual lawyers having a dramatic, innovative impact on a particular transaction type or practice area are, in practice, likely to be vanishingly rare.

<sup>44</sup> The remainder of this Part II assumes that the transaction and the agreements through which it is effected are negotiated between two parties, referred to as the counterparties. Though such agreements will be referred to as bilateral, the number of parties bound by the agreement or having rights under the agreement need not be limited to two. In fact, most financing transactions ultimately bind many investors or grant such investors rights as third-party beneficiaries, but in practice are negotiated solely between the company and the large financial institution serving as the lead underwriter or arranger. At the opposite end of the spectrum from the complex, highly negotiated bilateral agreements at issue in this article is the

transactional bargaining, clients require access to market information – that is, access to the full set of terms of recent comparable transactions; (2) such market information is often private; and (3) high-volume law firms have the best access to market information. As will be shown below, certain transactions are characterized by constant innovation in terms or by rapidly changing market prices, including for non-price terms. For such transactions, the parties cannot count on market competition to provide them with the payoff-maximizing set of deal terms; they must instead look to market information to improve their bargain.

*A. The Need for Market Information.*

Over time, certain types of contracts can become commoditized, by operation of the market or even by regulatory fiat. Consumer insurance contracts, for example, may have terms that are substantively identical from one insurer to the next and are never negotiated with the consumer. Uniform terms and the absence of bargaining make the contracting process a simple exercise: the consumer need only look up the going market price and decide whether or not to transact.<sup>45</sup> Whether corporate transactions are becoming or should become commoditized is the subject of much commentary and, among law firms, considerable angst. Every category of corporate transaction already presents some degree of standardization, as reflected in the recurrence of “boilerplate” provisions, for instance.<sup>46</sup>

Yet that is a far cry from commoditization. At any given time, there is some subset of corporate transactions that lies far on the spectrum from commoditized agreements. Such transactions tend to be heavily negotiated on a bilateral basis, in clear contrast to consumer contracts of adhesion. Though there is significant overlap among merger agreements, for example, in the end each agreement presents a unique combination of terms and unique variations in such terms, because they are tailored to some degree to the particular target company and the counterparties and, as we will see, to current market conditions.<sup>47</sup> The parties expend significant resources negotiating the deal

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consumer contract of adhesion (such as a click-through license for a popular software product). The take-it-or-leave-it terms of such contracts are not negotiated at all, and bind a very large, dispersed group of unsophisticated consumers. See Ronald J. Gilson et. al., *Contract and Innovation: The Limited Role of Generalist Courts in the Evolution of Novel Contractual Forms*, 88 N.Y.U. L. REV. 170 (2013) (noting how the number of “traders” affects the contract terms).

<sup>45</sup> This is not to suggest that such contracts are efficient, however. A growing literature identifies conditions under which such contracts of adhesion do not maximize social welfare.

<sup>46</sup> See, e.g., Stephen J. Choi & G. Mitu Gulati, *Contract as Statute*, 104 MICH. L. REV. 1129 (2006).

<sup>47</sup> See Albert Choi & George Triantis, *Market Conditions and Contract Design: Variations in Debt Contracting*, 88 NYU L. REV. 101 (2013) (noting that debt contracts must be tailored to the borrower).



terms, and, for reasons discussed further below, they expect that the final agreement will depend heavily on the outcome of the negotiation process. For the remainder of this Article, references to “corporate transactions” will be to negotiated, bilateral transactions of this type. The need to bargain in such transactions creates strong *ex ante* incentives for the parties to acquire information that will maximize their payoff. As shown below, the combination of novel deal term generation and rapid shifts in the set of “market” terms for certain transactions explains why market information is so valuable to transaction counterparties.

1. Novel Deal Terms: The Ever-Expanding Bargaining Frontier.

Regardless of their degree of regulatory overlay, major bilateral transactions are predominantly characterized by privately negotiated terms.<sup>48</sup> What, then, determines the scope of the parties’ bargain? In most cases, the parties should consider all value-increasing terms, that is, all terms that would increase the parties’ joint surplus from the transaction, regardless of how that surplus is ultimately distributed between them.<sup>49</sup> Yet theoretical accounts of bargaining fail to acknowledge that the set of value-increasing terms may be far from obvious. There is no fixed set of deal terms for the parties to negotiate: the list is jointly determined by the parties and can be expanded or contracted virtually at will.<sup>50</sup>

Crucially, the recent thrust has been decidedly toward expansion for certain types of transactions.<sup>51</sup> Whether or not lawyers are partly to blame, the set of terms considered open to negotiation in these major U.S.-law transactions appears to be growing both continually and at an increasing clip. New terms are constantly being introduced, whether to accommodate regulatory developments, changing market conditions, or party-specific needs,

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<sup>48</sup> See Victor Fleischer, *Regulatory Arbitrage*, 89 TEX. L. REV. 227, 239 (2010) (arguing that even regulatory constraints provide an opportunity for lawyers to innovate in structuring transactions).

<sup>49</sup> Even if a particular term would help one party and harm the other, it is nonetheless value-increasing if it helps the one party more than it harms the other. In this case, the parties should in principle be able to reach a deal that includes the term in question and that makes them both better off, or at least does not make any party worse off: the party that is made better off by the term at issue can simply offer to trade something worth at least as much as the harm suffered by the other party.

<sup>50</sup> See, e.g., *Libeau v. Fox*, 880 A.2d 1049, 1056 (Del. Ch. 2005) *judgment entered*, (Del. Ch. July 9, 2005) *aff’d in part, rev’d in part*, 892 A.2d 1068 (Del. 2006) (“[w]hen parties have ordered their affairs voluntarily through a binding contract, Delaware law is strongly inclined to respect their agreement, and will only interfere upon a strong showing that dishonoring the contract is required to vindicate a public policy interest even stronger than freedom of contract.”).

<sup>51</sup> See Neal H. Brockmeyer, *M&A Practice in the Early Years*, 17 DEAL POINTS 1, 7 (Winter 2012) (noting that “purchase agreements were much shorter” for mergers and acquisitions in previous decades).

and at a faster pace than obsolete terms are discarded. Complex corporate transactions thus commonly result in negotiations over hundreds of terms.

This seemingly exponential growth in deal terms may plausibly be driven by several factors. First, the substantive complexity of financial instruments and transactions has increased dramatically in recent decades.<sup>52</sup> It should come as no surprise, then, that the legal manifestations of modern finance in transactional agreements are themselves increasingly complex.<sup>53</sup> Securitization transactions, for example, result in an impressive array of lengthy, complex agreements.<sup>54</sup> Second, regulation is also increasing in complexity, prompting novel deal terms and deal structures.<sup>55</sup> Third, as technology has improved, the costs associated with the production and sharing of complex transactional agreements have declined.<sup>56</sup> The switch from the typewriter to the word processor and from mail to email has significantly increased the pace at which agreements can be drafted and lowered the costs of negotiating and amending them. It is now cheaper and easier to create and negotiate longer transactional agreements with more specialized or tailored terms. Fourth, as law firms have increased in size, they have proved better able to manage more complex agreements (for example, by involving regulatory specialists to draft or negotiate specific provisions) and to innovate more, if only because they have more resources to devote to these tasks. Discussion of a fifth possibility, that law firms themselves are exogenously (and self-interestedly) responsible for the increase in the number of deal terms, is deferred until Part III below.

The preceding list of explanations for the surge in deal terms is unlikely to be exhaustive. Whatever the causes, the agreements governing certain transactions appear to comprise an ever-greater set of terms. This proliferation of new terms makes it difficult for uninformed parties to determine the bargaining frontier of value-increasing terms. Yet parties who are unaware of new, value-increasing terms are simply leaving money on the table in their negotiations. Further, even if the parties are aware of a new term, if they lack sufficient information to value it correctly, they will achieve less favorable bargaining outcomes. For transactions experiencing rapid

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<sup>52</sup> See Steven L. Schwarcz, *Regulating Complexity in Financial Markets*, 87 WASH. U. L. REV. 211 (2009); Tom C.W. Lin, *The New Investor*, 60 UCLA L. REV. 678 (2013).

<sup>53</sup> See CHARLES M. FOX, WORKING WITH CONTRACTS: WHAT LAW SCHOOL DOESN'T TEACH YOU 74 (2002) (noting that the increased complexity of transactions has led to increasingly complex agreements).

<sup>54</sup> See, e.g., Pooling and Servicing Agreement, dated as of May 1, 2005, for Asset-Backed Pass-Through Certificates Series 2005-R4, available at [http://www.sec.gov/Archives/edgar/data/1328390/000088237705001419/d336334-ex4\\_1.htm](http://www.sec.gov/Archives/edgar/data/1328390/000088237705001419/d336334-ex4_1.htm) (a typical example of a pooling and services agreement for asset-backed securities).

<sup>55</sup> See Fleischer, *supra* note 49, at 239.

<sup>56</sup> See Brockmeyer, *supra* note 52, at 7 (noting the delays in previous decades associated with typewritten agreements for M&A transactions); Fox, *supra* note 54, at 74, 122 (describing the effect of technological change on the drafting of transactional agreements).

innovation, then, access to market information should prove exceptionally valuable.

## 2. Market Shifts in Non-Price Terms.

Other types of transactions, such as mergers and acquisitions, are heavily negotiated despite relatively little innovation in terms.<sup>57</sup> Market information can be crucial even in such cases, because (1) the price of *every* transaction term can vary according to market conditions, yet (2) a party cannot simply assume that it will obtain the “market terms” in its own negotiations, even if the market is competitive. To see why, let us first define the “market price” of a particular transaction term as the average price<sup>58</sup> of that term at a given point in time, holding all else constant, where the “price” of a term is the aggregate value of what one party must trade in order to obtain the other party’s consent to it. (If a lender wants a borrower to accept a particular event of default in the loan agreement, for example, the price of that term might be a decrease in the interest rate.<sup>59</sup>)

The key result is that every term in a transaction agreement – including every *non-price* term<sup>60</sup> – has a market price, and changes in such market prices

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<sup>57</sup> See Gilson, *supra* note 24, at 257 (stating that “the general contents of the [acquisition] agreement have by now become pretty much standardized”).

<sup>58</sup> We need not assume here that terms are priced uniformly and efficiently. Indeed, we should expect at least some dispersion in the pricing of a given transaction term by market participants. See, e.g., MAUREEN O’HARA, MARKET MICROSTRUCTURE THEORY 53 (1995) (summarizing several information-based models of markets under which spreads occur). Transactional agreements are not commodities, and accumulating evidence suggests that their terms are not perfectly priced. See Manns & Anderson, *supra* note 40 (concluding that deal protection provisions in merger agreements are not priced by the market); Stephen J. Choi & G. Mitu Gulati, *From Pigs to Hogs* (May 7, 2014), available at <http://ssrn.com/abstract=2434272> (finding that differences in Greek sovereign bond contracts were priced by the markets at certain times, but not others); Victoria Ivashina & Anna Kovner, *The Private Equity Advantage: Leveraged Buyout Firms and Relationship Banking*, 24 REV. FIN. STUD. 2462, 2463 (2011) (concluding that the view that leveraged loans are commodities is mistaken). Precisely because information about deal terms is scarce for certain complex corporate transactions, we should instead expect the same term to be priced slightly differently in different transactions. Nonetheless, the concept of a market price for any given deal term is a useful one.

<sup>59</sup> Note that in many (if not most) cases, we cannot readily assign a dollar value to the tradeoff (such as where the tradeoff is of one borrower-favorable “non-price term” for a lender-favorable “non-price term”). This is not problematic for the proposed definition, however. Moreover, while some contract terms are binary in nature (i.e., they are either included in the agreement wholesale or not at all), others instead exhibit a discrete or continuous range of values, whether qualitative or quantitative (such as the interest rate, or a covenant that can be made more or less restrictive along a continuum). In all events, to the extent that a particular term affects the parties’ respective expected payoffs from the transaction differentially, including the term in the agreement should result in a reasonably equivalent tradeoff.

<sup>60</sup> Contracts scholars tend to distinguish between “price terms” and “non-price terms” in

should affect the final deal reached by the parties in any particular negotiation.<sup>61</sup> The notion that a transaction's *price* term varies with market conditions is intuitive. The price term in an initial public offering (IPO), for example, is the amount to be paid by the underwriter for the issuer's stock. We readily accept that such price terms are subject to change over time, according to shifts in supply and demand. The IPO market may get very "hot" during some periods and command high prices, but may "dry up" and yield lower valuations in others, for the very same types of issuers.<sup>62</sup> Yet, as shown in recent work, *non-price* transaction terms vary with market conditions as well.<sup>63</sup> Moreover, even in a market with many participants on both sides of the transaction, the parties cannot simply assume that they will end up with the set of all value-increasing terms (even when the set of such terms is known): instead, the outcome of their negotiation will depend in part on their relative bargaining power and their respective information about non-price terms.<sup>64</sup>

How do we explain this seeming paradox that at any point in time there is a set of "market" terms for a particular transaction, yet the parties cannot count on the market to get them a deal on such terms? One explanation is

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agreements. Similarly, business teams involved in corporate transactions commonly distinguish between "business" (or "economic") terms and "legal" terms. While there is no clear principle for distinguishing between the two, price/business terms tend to capture the fundamental economic deal between the parties (and are therefore generally numeric), while non-price/legal terms are the remainder of the contractual provisions governing the transaction.

<sup>61</sup> See Choi & Triantis, *supra* note 48 (demonstrating how the non-price terms of debt contracts can vary with market conditions).

<sup>62</sup> Jean Helwege & Nellie Liang, *Initial Public Offerings in Hot and Cold Markets*, 39 J. FIN. & QUANTITATIVE ANALYSIS 541 (2004) (concluding that hot IPO markets are the result of greater investor optimism, rather than greater firm growth prospects).

<sup>63</sup> See *supra* note 62; LEVERAGED FINANCIAL MARKETS: A COMPREHENSIVE GUIDE TO HIGH-YIELD BONDS, LOANS, AND OTHER INSTRUMENTS (William F. Maxwell and Mark R. Shenkman eds., 2010) (noting that "the concept of 'market' [in a high-yield financing] evolves over time" and depends on several factors); Martin Fridson, Xiaoyi Xu & Yinqiao Yin, *Do Bond Covenants Affect Borrowing Costs?*, 26 J. APPLIED CORP. FIN. 79 (2014) (finding evidence that the strength or weakness of bond covenants does not result in adjustments to bond prices).

<sup>64</sup> A dominant strain of law-and-economics doctrine holds that changes in bargaining power should have no effect on the non-price terms of a contract. On this view, supply and demand in the market produce a single, efficient set of non-price terms for a given transaction type; the parties' relative bargaining power only leads to adjustments to the *price* term. See Albert Choi & George Triantis, *The Effect of Bargaining Power on Contract Design*, 98 VA. L. REV. 1665, n.4 (2012) (compiling several examples of scholarly work in the law and economics vein assuming the absence of bargaining power with respect to non-price contract terms and critiquing this "irrelevance principle"). In contrast to this literature, Choi and Triantis have identified several conditions under which bargaining power *can* affect the non-price terms of various contracts, including the example used here of multi-stage negotiations. *Id.* at 1680-96. See also Manns & Anderson, *supra* note 40, at 1174 (finding that "there is in fact considerable variation in the deal-specific terms [of merger agreements] and that variation largely results from the relative leverage of the two parties").

that many transactions – including mergers and acquisitions and loan transactions – are negotiated in stages,<sup>65</sup> with the price terms settled in the earliest stages (by the principals) and the non-price terms negotiated in later stages (primarily by counsel).<sup>66</sup> The distinguishing feature of such multi-stage negotiations is that the price terms agreed to in the earliest stages are remarkably sticky:<sup>67</sup> regardless of how negotiations over the non-price terms ultimately unfold, it is highly unlikely that the parties will adjust the price terms to which they originally agreed.<sup>68</sup> This timing mismatch in the negotiation of price and non-price terms leaves room for bargaining power imbalances and market shifts to affect not only the price term, but also the non-price terms.<sup>69</sup> The parties will need to bargain over the non-price terms, creating incentives to acquire information that will help them determine (1) the expected payoff to each party of every transaction term<sup>70</sup> and (2) the value of the parties' respective outside options.<sup>71</sup> Market information – that is, information about

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<sup>65</sup> *See id.* at 1690. For leveraged loans, the negotiation stages are as follows. First, the borrowing company solicits bids for financing from various lead arrangers. Such bids typically cover the price terms of the financing, as well as a subset of non-price terms that the parties view as crucial to have agreed upon in advance. The second stage of negotiations begins once the borrower selects the winning lead arranger and signs a commitment letter with respect to the agreed-upon terms. At this point, the borrower and lead arranger negotiate all of the remaining terms of the loan transaction, to be reflected in the final credit agreement. *See* Ivashina & Kovner, *supra* note 59, at 2469 (describing the transaction steps for a leveraged-loan financing for a private equity-sponsored acquisition).

<sup>66</sup> Typically, the “business” teams will initially agree to the price terms – and perhaps a small subset of non-price terms deemed particularly fundamental – in a term sheet or letter of intent, for example). Subsequently, counsel will begin drafting the transaction agreements, leading to several rounds of negotiations over the remaining non-price terms. *See* Choi & Triantis, *supra* note 65, at 1690.

<sup>67</sup> *See id.* (stating that where the deal price is set in the first stage of negotiations, non-price terms “are usually settled without adjustment to price”); Manns & Anderson, *supra* note 40, at 1176 (stating that the price and other economic terms of a merger are agreed upon separately from negotiations over the legal terms, and that “the financial ‘deal’ is typically independent of the legal terms of the agreement”).

<sup>68</sup> *See* Choi & Triantis, *supra* note 65, at 1690-91 (noting that while the parties could theoretically reopen negotiations over the price terms while negotiating the non-price terms, the “nonlegal costs” associated with doing so make it highly unlikely that this will occur).

<sup>69</sup> *Id.* at 1680-96.

<sup>70</sup> A party's payoff from a transaction term is the net dollar-value gain or loss to the party from including the term in the agreement. Where a term's payoff is uncertain, in that there are multiple potential payoffs, the expected payoff is the probability-weighted average of all possible payoffs from the term. In a corporate transaction, it is worth recalling that just as the capital asset to be transferred between the parties (the company to be sold, the amount to be loaned, etc.) has an expected payoff to the parties, so do each of the other deal terms, including “legal” or “non-price” terms such as closing conditions, remedies for breach, choice-of-law clauses, and so forth.

<sup>71</sup> A party's outside option for a given negotiation is its expected payoff from breaking off the current negotiations and returning to the market to negotiate with another party. The parties' respective outside options affect the final deal they will reach (including whether they

all of the terms of recent comparable transactions – fulfills precisely this role.<sup>72</sup>

*B. Market Information About Deal Terms Is Often Private.*

Complex corporate transactions may thus involve an ever-expanding set of potentially negotiable terms, each of which is subject to market conditions. Yet it turns out that information about the pricing, prevalence, and even the existence of various deal terms often is not public, and therefore is not readily accessible to potential counterparties to a transaction.

First, many large corporate deals are private. Transactions that do not involve a public company or otherwise trigger a public disclosure requirement under the securities laws will, absent unintentional leaks or voluntary disclosure, involve deal terms that remain entirely private. Only the counterparties and, to varying degrees, their respective advisors and service providers will know of the final deal reached on all points.

Second, the extent to which the terms of public deals are in fact publicly available is overstated. Consider again the consummate example of a public deal, the acquisition of a public company. Because the acquisition agreement must be filed with the Securities and Exchange Commission (SEC), certainly many deal terms – including the most material economic terms – will be available to the public. Yet even for such transactions, the parties never file the complete set of transaction documents with the SEC, as only the key agreements are required to be disclosed.<sup>73</sup> The documents that are not filed may contain terms that even the parties themselves would view as highly significant, such as those relating to the background tax and regulatory structuring of the deal.

More importantly, even when they involve public companies, many transactions that would clearly be viewed as major transactions by virtue of their dollar amount nonetheless escape filing obligations entirely. For a corporation such as Wal-Mart, a \$500 million bank financing might not exceed the materiality threshold for mandatory disclosure under the securities laws,

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will reach a deal in the first place) because, in most bargaining contexts, how much a party should demand or give up for any particular term depends rationally on the value of its next best alternative. A party with a very good outside option compared to the other party has less incentive to reach a deal, and therefore can demand better terms and try to capture most of the deal surplus from the other party. On the other hand, a party lacking a good outside option will be more eager to reach a deal, even on relatively unfavorable terms. *See supra* note 9.

<sup>72</sup> While the expected payoff to a party from a particular term need not be market-determined – it may be unique to the party – in many cases the market price of the term will be the best available information about the value of that expected payoff, particularly when the term is novel or complex.

<sup>73</sup> *See* 17 C.F.R. § 229.601(a)(4) (mandating disclosure of “material” agreements for companies registered under the Securities Exchange Act of 1934).

and thus would not require any of the transaction documents to be filed.<sup>74</sup> The deal terms, which would be of considerable interest to comparable companies seeking financing, remain hidden from the market in such cases.

Finally, because novel terms arise frequently, there is inevitably some delay in achieving widespread publicity and adoption of these terms. While information about a novel term will eventually trickle into the public sphere (through practitioner articles, public deals, etc.), until that time, counterparties negotiating a transaction may be entirely unaware of it.

*C. High-volume law firms have the best access to the full package of deal terms.*

For many major transactions, then, real-time market information is both a valuable good and, because it is private, an excludable one. As repeat players, high-volume law firms have the best access to the full range of terms for recent transactions, through the sheer volume that they handle and their monopoly over the drafting of transaction agreements.<sup>75</sup> While other market participants such as the transaction parties themselves, the parties' in-house counsel, investment banks, accounting firms, and third-party services that compile and compare deal terms, all have varying exposure to and familiarity with deal terms, we should expect the transactional practices at elite law firms to have the most comprehensive access. Transactional lawyers are, by definition, assigned the task of negotiating the vast majority of deal terms and the exclusive tasks of drafting and maintaining the execution version of all transaction documents. They are *de facto* the deal constituency most intimately familiar with all of the final terms of such transactions.<sup>76</sup>

Transaction parties, by contrast, only have access to deal terms for their own prior transactions. Major transactions are rare in any individual corporation's life, compared to a large law firm's transactional practice. Management should thus tend to be relatively poorly informed as to both the current set of plausible deal terms for any particular transaction and their current pricing in the market. Importantly, the very same critique applies to in-house counsel. In examining companies' decision of whether to "make or buy"<sup>77</sup> legal counsel for corporate transactions (i.e., whether to hire in-house counsel or to engage outside counsel), scholars have yet to note that in-house counsel is at a decided disadvantage relative to law firms when it comes to current market information. While large corporations may have teams of in-

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<sup>74</sup> See *id.*

<sup>75</sup> See John F. Coyle & Joseph M. Green, *Contractual Innovation in Venture Capital*, 66 HASTINGS L.J. 133 (2014) (noting that "attorneys at large law firms will typically have access to a significant number of contracts that may be mined for innovative provisions").

<sup>76</sup> See Gilson, *supra* note 24, at 257 (noting that "the business lawyer's role in corporate acquisitions is pervasive").

<sup>77</sup> See Schwarcz, *supra* note 16.

house lawyers with transactional experience, such lawyers necessarily lack exposure to changing market terms, and this disadvantage grows with the number of years they remain in-house.

Yet law firms are not the only repeat players for major corporate transactions. Various advisers and other service providers to the parties may also have exposure to a high volume of transactions, and of these, some such as investment banks, accounting firms, and credit rating agencies may be both sophisticated and keenly aware of market movements.<sup>78</sup> Investment banks in particular specialize in helping clients price transactions.<sup>79</sup> Of all market participants involved in corporate transactions, they are the best known for their ability to track market movements and even time the markets to get clients the most favorable deal terms. Yet investment banks' knowledge and experience with deal terms is largely centered on the price terms of a transaction (also referred to as the "business terms" or "economic terms"). In particular, they and other deal advisors lack law firms' complete access to the deal documentation, and in particular are less able to identify and interpret the non-price or "legal" deal terms. As drafters and keepers of the deal documentation across many clients, law firms are best positioned to maintain a repository of the full range of possible deal terms – both "business" and "legal." Thus, while we can safely posit that advisors such as investment bankers may have an advantage over transactional lawyers in pricing key economic terms, there is at least some subset of transaction terms for which law firms will have the advantage.<sup>80</sup>

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<sup>78</sup> See Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 620 (1984) (introducing the concept of "reputational intermediary" for market actors that, through repeat business, are able over time to establish reputations for certifying information about other actors).

<sup>79</sup> See Jack Bao & Alex Edmans, *Do Investment Banks Matter for M&A Returns?*, 24 REV. FIN. STUD. 2286, 2312-13 (2011) (finding that a client's choice of investment bank for a merger or acquisition affects its returns from the transaction).

<sup>80</sup> What of clients who are themselves repeat players for particular transactions? Where the investment bank is the client, for example, rather than the advisor, it inevitably relies on its knowledge of recent transactions. On the other side of the negotiating table, various categories of investors, including in particular private equity firms, are also high-volume participants in major corporate transactions such as mergers and acquisitions and leveraged financings. See Elisabeth de Fontenay, *Private Equity Firms as Gatekeepers*, 33 REV. BANKING & FIN. L. 115 (2013). And yet, paradoxically, such investors appear to be the most likely to engage top-tier law firms for their transactions. See Steven M. Davidoff, *The Failure of Private Equity*, 82 S. CAL. L. REV. 481, 535-37 (2009) (demonstrating that the largest private equity firms tend to engage the same small group of elite, repeat-player law firms for their acquisition and financing transactions). Three explanations seem plausible. First, it may be that private equity firms are simply paying for law firms' knowledge of other clients' deal terms. (Even if confidentiality obligations prevent law firms from explicitly revealing one client's deal terms to another, law firms inevitably make use of this information in advising their clients and in negotiating deal terms.) Second, precisely because they are sophisticated repeat players, investment banks and private equity firms are keenly aware of both the value of market



Finally, a market has recently developed for knowledge-management services that sell summary deal-term information.<sup>81</sup> While the proliferation of such products confirms that deal-term aggregation and comparison are valuable functions, the risk that they will eventually usurp law firms' role in this regard is minimal, precisely because law firms have access to, and can make use of, private deals and other private market information.

### III. MARKET INFORMATION IN PRACTICE: A CASE STUDY

Market information about transaction terms is thus both valuable and excludable, and the barriers to entry in acquiring it are high. The law firms that sell market information should therefore expect to be rewarded with persistent rents. This Part III uses a case study of the U.S. leveraged loan market to illustrate how law firms can assist with term pricing. It begins with relevant background on leveraged loan transactions and documentation. The pricing exercise is then illustrated through stylized cases in which a law firm's representation of the borrower may be value-adding, value-shifting, or value-decreasing, all with respect to the very same transaction term.

#### *A. Leveraged Loans: Background.*

As a relative newcomer to the U.S. capital markets, the leveraged-loan market has experienced both tremendous growth in volume and liquidity and significant innovation in its legal terms.<sup>82</sup> Leveraged loans are primarily characterized by two features: (1) they are extended to companies having a relatively high proportion of debt in their capital structure, and (2) they are intended to be syndicated.<sup>83</sup> The lender group (or "syndicate") typically

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knowledge and their specific lacunae in that regard. As discussed above, investment banks and private equity firms have less access to and knowledge of the "legal" terms of transaction agreements than law firms, yet are savvy enough to know that they can benefit from seeking out high-volume law firms for assistance with such terms. Third, private equity firms negotiate against investment banks for most of their acquisition and financing transactions, and will therefore rely on repeat-player law firms precisely to counter investment banks' market knowledge.

<sup>81</sup> Practical Law, Bloomberg Law, Xtract Research, The Deal, and many others, all include products that perform a function similar to the one this Article ascribes to elite transactional law firms, namely aggregating and comparing terms from recent large deals.

<sup>82</sup> For detailed descriptions of leveraged loan financings, *see generally* Sung Eun (Summer) Kim, *Managing Regulatory Blindspots*, 32 YALE J. ON REG. \_\_\_\_ (forthcoming 2015); LEVERAGED FINANCIAL MARKETS: A COMPREHENSIVE GUIDE TO HIGH-YIELD BONDS, LOANS, AND OTHER INSTRUMENTS (William F. Maxwell and Mark R. Shenkman eds., 2010).

<sup>83</sup> Syndicated loans are typically underwritten or arranged by a single investment or commercial bank and ultimately funded by a large syndicate of lenders. *See* Katerina Simons, *Why Do Banks Syndicate Loans?*, NEW ENG. ECON. REV. 45, 45–46 (Jan.1993), *available at*

consists of a highly diverse mix of banks and non-bank institutional investors.<sup>84</sup> Post-issuance, many of these loans are subsequently traded on an increasingly liquid secondary market.

Despite heavy secondary trading, leveraged loans are not treated as securities and therefore are not subject to federal securities regulation.<sup>85</sup> This has two significant implications for our purposes. First, leveraged loans are issued privately, such that, unless the borrower is otherwise subject to securities reporting requirements, the loan documents will not be publicly available. Second, leveraged loan transactions remain to this day very lightly regulated. As such, they are prime examples of complex, heavily negotiated, highly tailored agreements, the terms of which remain largely private. Further, they are negotiated in stages, with the price terms (and certain non-price terms) set before the remainder of the non-price terms are negotiated, increasing the parties' need for market information on the individual non-price terms.<sup>86</sup>

The tremendous growth in the leveraged loan market has been mirrored by tremendous innovation in terms. Leveraged-loan credit agreements saw a surge in novel provisions in the boom period preceding the 2007-2009 financial crisis and again during the crisis itself, when borrowers scrambled to renegotiate their loans and creatively navigate a difficult lending environment. While commentators frequently note the lack of innovation in many legal documents,<sup>87</sup> leveraged-loan transactions provide an impressive counter-example.<sup>88</sup> In the course of less than a decade, dozens of new provisions were

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<http://www.bostonfed.org/economic/neer/neer1993/neer193c.pdf>.

<sup>84</sup> The non-bank institutional investors may include structured asset pools (referred to as collateralized loan obligations) designed to hold syndicated loans, insurance companies, pension funds, mutual funds, private debt funds, and sovereign wealth funds.

<sup>85</sup> See Elisabeth de Fontenay, *Do the Securities Laws Matter? The Rise of the Leveraged Loan Market*, 39 J. CORP. L. 725 (2014) (discussing the differing regulatory treatment of loans and bonds).

<sup>86</sup> See *supra* Part II.B.2.

<sup>87</sup> See, e.g., MITU GULATI & ROBERT E. SCOTT, *THE THREE AND A HALF MINUTE TRANSACTION: BOILERPLATE AND THE LIMITS OF CONTRACT DESIGN* (2013) (identifying lawyers' puzzling failure to update a boilerplate provision in sovereign debt contracts, even in the face of negative court decisions); Marcel Kahan & Michael Klausner, *Standardization and Innovation in Corporate Contracting (Or "The Economics of Boilerplate")*, 83 VA. L. REV. 713, 718-29 (1997) (describing the circumstances in which the use of boilerplate provisions provide economic benefits); Barak D. Richman, *Contracts Meet Henry Ford*, 40 HOFSTRA L. REV. 77 (2011) (characterizing the lack of contractual innovation by law firms as a form of Taylorism). For an overview of competing theories of contractual innovation, see generally Stephen J. Choi et al., *The Dynamics of Contract Evolution*, 88 N.Y.U. L. REV. 1 (2013).

<sup>88</sup> See Allison A. Taylor & Ruth Yang, *Evolution of the Primary and Secondary Leveraged Loan Markets*, in *THE HANDBOOK OF LOAN SYNDICATIONS AND TRADING* 21, 23-24 (Allison Taylor & Alicia Sansone eds., 2007) (describing the origins and growth of the syndicated loan market). While we need not resolve why the leveraged loan market witnessed such a high rate of contractual innovation, plausible contributors include the role of highly sophisticated participants (private equity firms on the borrower side and major investment banks on the

developed that, over time, became standard loan terms.<sup>89</sup> As the drafters and often the originators of such provisions, the select group of law firms handling most leveraged-loan financings were in the best position to price such terms for clients during the period of sustained innovation.

*B. Leveraged Loan Pricing Using Market Information: Application*

As leveraged loan syndicates have increased in size, and the secondary trading of leveraged loans has become routine, borrowers have faced greater obstacles to renegotiating their loan terms after the initial closing. A borrower may seek to renegotiate a loan's terms for any number of reasons,<sup>90</sup> and such requests for amendments or waivers are relatively common.<sup>91</sup> Importantly, the transaction costs involved with renegotiations increase with the size of the lender group and the amount of secondary trading among lenders: collective action problems arise as the number of lenders increases and the duration of their respective loan holdings decreases.<sup>92</sup> Each lender has less incentive and ability to familiarize itself with the borrower and the loan terms, has more incentive to free-ride on the monitoring efforts of other lenders, and has more incentive to hold out against otherwise value-increasing changes to the loan terms in the hopes of extracting a side-payment.

Because the leveraged loan market's surge in size and liquidity occurred so rapidly, this lender collective action problem manifested suddenly. Under the circumstances, a novel loan provision that would facilitate loan renegotiations without dramatically altering the relative leverage of the borrower and the lenders in such renegotiations would prove extremely valuable. This is precisely how the "yank-a-bank" provision was developed and began

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lender side), rapidly changing market conditions and financing structures, the shift in composition of lending syndicates (from traditional commercial banks to structured asset vehicles and other institutional investors), and very light regulation.

<sup>89</sup> Without the assistance of a law firm specializing in leveraged loans, a company seeking financing during this period would almost certainly be entirely unaware of "market flex", the "SunGuard clause," "excess cash flow prepayment step-downs," "equity cure rights," "covenant-lite," "amend-and-extend rights," "loan buyback Dutch auctions," and other novel provisions, and thus risk foregoing significant transaction value. For descriptions of these terms, see the Practical Law glossary, <http://us.practicallaw.com/us-glossary>.

<sup>90</sup> For example, the borrower may be motivated to seek a loan amendment to cure an unintentional and minor breach, to loosen the financial covenants in the credit agreement, to obtain permission to engage in an otherwise prohibited transaction such as a merger or acquisition, to extend the maturity of the loans, and so forth.

<sup>91</sup> See Marcel Kahan & Bruce Tuckman, *Private Versus Public Lending: Evidence From Covenants*, in *THE YEARBOOK OF FIXED INCOME INVESTING* 253, 253-74 (John D. Finnerty & Martin S. Fridson eds., 1995) (noting that "private debt... require[s] more frequent renegotiation than public debt").

<sup>92</sup> Arthur E. Wilmarth, Jr., *The Transformation of the U.S. Financial Services Industry, 1975-2000: Competition, Consolidation, and Increased Risks*, 2002 U. ILL. L. REV. 215, 378 (2002) (noting that syndicated loans have fewer covenants than traditional bank loans).

appearing in credit agreements for private leveraged loan financings. The “yank-a-bank” is a contractual innovation in loan agreements that, among other uses, permits (but does not require) the borrower to replace any lender who votes against a proposed loan amendment simply by repaying that lender’s share of the loan at par.<sup>93</sup> Such a provision incentivizes lenders overall to vote in favor of loan amendments, and decreases the likelihood that lenders can successfully extract hold-up payments from the borrower in exchange for consenting to the amendment.

All else being equal, the yank-a-bank provision increases the borrower’s leverage vis-à-vis lenders in renegotiations. All else being equal, then, under a credit agreement containing a yank-a-bank provision, the borrower should end up paying out less to the lenders in aggregate (either in the form of amendment fees or concessions in the loan agreement) when it renegotiates loan terms, making the borrower better off at the lenders’ expense. At the same time, however, the yank-a-bank provision also provides a benefit to the lenders that may or may not offset this effect. While a loan is outstanding, events occur that are unanticipated by either side and therefore by the loan agreement; in some cases, an amendment to the loan would benefit *both* the borrower and the lenders.<sup>94</sup> Thus, preventing individual lenders from blocking or delaying such loan amendments is in the interest not only of the borrower, but also of the lenders taken as a group.

Ultimately, whether it is in the lenders’ interests to adopt the yank-a-bank provision in a credit agreement – thereby both lowering the transaction costs of loan renegotiations and granting the borrower greater leverage in such renegotiations – depends on contingencies such as the expected size of the lender group, the expected amount of secondary trading in the loan, the likelihood that the loan will have to be renegotiated, and the probability of good behavior by the borrower. Whether including the term proves value-increasing will thus largely depend on whether these contingencies are correctly taken into account when pricing the yank-a-bank provision at the time the credit agreement is negotiated.

The four cases below, all relating to the yank-a-bank provision, illustrate some of the ways in which transactional lawyers’ interventions in deal negotiations could affect the aggregate surplus generated by the deal. In each

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<sup>93</sup> See RICHARD WIGHT ET AL., *THE LTSA’S COMPLETE CREDIT AGREEMENT GUIDE* 575–76 (2009) (describing the use of the yank-a-bank provision to replace lenders who do not consent to credit agreement waivers or amendments).

<sup>94</sup> Assume, for example, that the borrower unintentionally defaults on the loan due to a mere technicality (such as failing to deliver its financial statements to the correct address for the administrative agent), rather than due to deteriorating performance or bad borrower behavior. If the borrower’s credit risk remains fundamentally sound, it is likely to be in the lenders’ interests to waive the borrower’s default, in order to avoid accelerating the loan and triggering the borrower’s bankruptcy, which would likely significantly decrease the value of their loan holdings.

case, the relevant comparison is between the outcome when the client employs a law firm with market knowledge (an “informed law firm”) and when the client employs a law firm or in-house counsel without market knowledge. Finally, the Appendix provides a model showing that, *ex ante*, both parties are in fact incentivized to hire informed law firms, under plausible assumptions about the bargaining process.

1. Case 1: Informed law firm’s intervention is value-increasing by informing the counterparties of a mutually beneficial term.

Assume first a high-quality, well-behaved borrower, such that if the borrower proposes a loan amendment during the life of the loan, the amendment is likely to be value-increasing for the lenders in aggregate. The lenders should thus be happy to grant the borrower additional bargaining leverage *ex ante* in loan renegotiations in order to avoid lender holdout problems that might preclude such an amendment or make it costlier. Assume also that the lender syndicate is expected to be very large, with substantial secondary trading of the loan, such that lender collective action problems would normally be severe.

Under such circumstances, we can safely assume that both the borrower and the lenders would be made unambiguously better off by including a yank-a-bank provision in their credit agreement. More specifically, their respective expected payoffs from the leveraged loan transaction would be higher if the term were included, as reflected in the following sample dollar values:

|          | Gross expected payoff w/o yank-a-bank provision | Gross expected payoff w/yank-a-bank provision | Change in expected payoff from adding term to credit agreement |
|----------|---|---|--|
| Borrower | \$10M   | \$12M   | +\$2M  |
| Lenders  | \$10M   | \$10.5M                                       | +\$0.5M  |

Assume that, in the absence of high-quality financing counsel, the parties would be entirely unaware of the yank-a-bank provision. So long as the additional cost of hiring an informed law firm compared to an uninformed firm does not outweigh the gains, *both* parties are better off – net of legal fees – as a result of including the provision in the credit agreement. By making the parties aware of a novel term, the informed law firm has increased the joint surplus from the transaction.

2. Case 2: Informed law firm's intervention is value-increasing by assisting with the pricing of a term.

Now assume a lower-quality, more opportunistic borrower, facing a smaller lender group (and therefore lower transaction costs of renegotiations). Under these circumstances, giving the borrower more leverage in renegotiations should come at a slight cost to the lenders, all else being equal:

|          | Gross expected payoff w/o yank-a-bank provision | Gross expected payoff w/ yank-a-bank provision | Change in expected payoff from adding term to credit agreement | "Price" range at which parties should agree to add term to credit agreement |
|----------|---|--|--|---|
| Borrower | \$10M   | \$12M  | +\$2M  | \$1M-\$2M in borrower concessions   |
| Lenders  | \$10M   | \$9M   | -\$1M  |   |

Notwithstanding that the lenders' expected payoff from the yank-a-bank provision is negative, they should agree to include the term so long as the borrower makes other concessions in the credit agreement worth at least \$1 million to the lenders. The borrower should agree to include the term so long as the concessions demanded by the lenders do not exceed \$2 million in value. At any "price" within that range (net of legal fees), the parties will achieve a jointly value-increasing deal.

But notice that this requires the parties (1) to be aware of the existence of the yank-a-bank provision, (2) to correctly determine their expected payoffs from including the yank-a-bank provision in the credit agreement (requiring informed predictions as to the borrower's behavior, the likelihood of renegotiation, the size of the lender group, the amount of secondary trading, etc.), and (3) to identify provisions in the credit agreement of equivalent value to the agreed-upon "price" of the yank-a-bank provision. The third step is required given that, as discussed above, the price terms for leveraged loans are typically fixed at the outset of the negotiations, such that negotiations over non-price terms must be effected through adjustments to other non-price terms, rather than to the price terms.

As all three tasks require experience with current market conditions, an informed law firm can bring the parties within the bargaining range of a value-increasing deal for both, net of legal fees.

3. Case 3: Informed law firm's intervention is merely value-shifting.

Assume all of the same facts as in Case 2, except that the parties are already aware of the yank-a-bank provision, and would, using uninformed counsel, have arrived at a value-increasing deal by including the provision in the credit agreement in exchange for concessions by the borrower worth \$2 million to the lenders. Now imagine that the borrower's law firm correctly informs the borrower that, based on its review of recent transactions, the "market" price of the yank-a-bank provision for similar credit facilities is only \$1.5 million – that is, the borrower's outside option is a credit agreement that includes the yank-a-bank provision in exchange for only \$1.5 million in borrower concessions. The borrower will now negotiate harder for this provision, for example by threatening to break off negotiations and exercise its outside option, and might thus successfully bring the price down to \$1.5 million (or lower if the lenders are uninformed as to the true market price).

|          | Gross expected payoff w/o yank-a-bank provision | Gross expected payoff w/ yank-a-bank provision | Change in expected payoff from adding term to credit agreement | "Price" at which parties would agree to add term w/o law firm intervention | "Price" at which parties would agree to add term w/ law firm intervention |
|----------|---|--|--|--|---|
| Borrower | \$10M   | \$12M  | +\$2M  | \$2M in borrower concessions   | \$1.5M in borrower concessions  |
| Lenders  | \$10M   | \$9M   | -\$1M  |  |   |

With a deal at \$1.5 million for the yank-a-provision (compared to \$2 million), the informed law firm's intervention has clearly made the borrower better off. Yet all that has occurred is a shifting of deal surplus from the lenders to the borrower: the total *gross* surplus to the parties remains unchanged relative to the deal that they would have reached on their own. Thus, taking into account legal fees, the informed law firm's intervention has actually reduced *net* social surplus.

4. Case 4: Informed law firm's intervention is value-decreasing for both parties.

Finally, assume a low-quality borrower and a very small lender group, with no secondary trading of the loan post-issuance. Because the transaction costs of renegotiation are low in this case, we can posit that the benefit to the

borrower from a yank-a-bank provision would be low, while the costs to the lenders from ceding negotiating leverage to the borrower would be significant, as reflected in the following figures:

|          | Gross expected payoff w/o yank-a-bank provision | Gross expected payoff w/ yank-a-bank provision | Change in expected payoff from adding term to credit agreement | “Price” range at which parties should agree to add term to credit agreement |
|----------|---|--|--|---|
| Borrower | \$10M   | \$10.5M  | +\$0.5M  | None  |
| Lenders  | \$10M   | \$7M   | -\$3M  |   |

In this case, there is no price at which both parties are made better off by including the provision in the credit agreement; they should not agree to include the term. An informed law firm acting faithfully on behalf of its client would not introduce the term into the negotiation. If the firm wishes to increase its legal fees at its client’s expense, however, it might try to convince the parties to spend time bargaining over the term, making both parties worse off. In that case, the firm will have used its information advantage in such a way that not only reduced the *joint* surplus from the transaction, but also made its *own* client worse off.

To conclude this Part III, leveraged loan financings represent one of several transaction types for which repeat-player law firms can extract significant rents by aggregating and deploying private information about market transaction terms. This opportunity exists because such financings involve complex, heavily negotiated terms that are generally private; multistage negotiations leave room for the exercise of bargaining power; and pricing their terms would be exceptionally difficult for one-off players. Yet a law firm’s experience with market terms is no guarantee that it will add value to the transaction; plausible scenarios exist for value-increasing, value-shifting, and value-decreasing behavior.

### CONCLUSION

Notwithstanding sluggish demand for law-firm services in aggregate, elite law firms in the United States continue to thrive and to dominate the market for the largest corporate transactions. Existing accounts of the value provided by transactional lawyers do not fully explain this state-of-play, because they omit a crucial function performed by repeat-player law firms. Such firms



aggregate private market information about deal terms and use this information to identify value-increasing terms for their clients and to assist with term valuation and pricing. Traditional accounts of financial contracting have failed to recognize the rapidly expanding set of transaction terms and the difficulty of pricing them, due to common misconceptions about the actual practice of transactional negotiations. To the extent that elite law firms can improve their clients' outcomes in major transactions by using market knowledge, they should remain largely immune from competition from in-house counsel, the commoditization of legal work, and client pressure to decrease fees.

## APPENDIX: MODEL OF LAW FIRM SELECTION

Recall that law firms' market knowledge helps clients value and price transaction terms in two ways, each reflecting a different source of uncertainty. First, market information helps the parties determine how particular terms will affect their expected payoffs from the transaction. A client with relatively little transactional experience may lack information to accurately estimate a particular term's costs and benefits for itself and for the counterparty, while a law firm with repeated exposure will quickly acquire that expertise.<sup>95</sup>

Second, law firms' market information can remedy clients' uncertainty or even unawareness as to what exactly the standard or "market" terms of a particular transaction are. While clients often have some visibility into the price term(s) of comparable transactions, they may be unaware of what non-price terms the market will bear at that price, particularly when new terms are constantly being introduced. Information about market terms thus serves a dual role here: it can make the parties aware of potential value-increasing terms to be added to the bargain, and it determines the parties' respective outside options and therefore their ultimate surplus from bargaining.

The model provided in this Appendix is designed to capture uncertainty over the "market" non-price terms.<sup>96</sup> It demonstrates that under plausible bargaining conditions, both transaction parties are incentivized to select law firms with market knowledge (referred to here as "informed" law firms).

*A. Set-up of Basic Model.*

The parties are described without loss of generality as "borrower" and "lender." The transaction agreement to be negotiated is characterized as follows: the entire set of transaction terms consists of (1) the interest rate  $p$  (the "price term"), (2) discrete non-price terms, and (3) a continuous term  $t$  that represents a straight dollar transfer between the parties.<sup>97</sup> A positive value of  $t$  represents a transfer from the borrower to the lender: the payoff to the lender has *increased* by  $t$ , while the payoff to the borrower has *decreased* by  $t$ . Similarly, a negative value of  $t$  represents a transfer from the lender to the borrower. We assume that it is common knowledge that the value of  $t$  is generally negotiated to be  $t = 0$  (it is set to zero without loss of generality).

Assume now that there exists a discrete term  $d$  that is not common

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<sup>95</sup> While the law firm's assistance is unlikely to take the form of explicitly ascribing a dollar value to a particular term, in practice the law firm's role is precisely that: in negotiations, it will ensure that the client trades other terms of equivalent value for that one.

<sup>96</sup> While uncertainty over payoffs is routinely incorporated into bargaining models, the existing literature does not, to the author's knowledge, take into account the possibility that a party may simply be unaware of value-increasing terms.

<sup>97</sup> In practice such a continuous variable may not exist, but could be approximated by aggregating several different terms with small costs and benefits.

knowledge (such as the yank-a-bank provision described in Part III for some period of time after it was first devised). We assume further that, for a borrower of this type, the term would benefit the borrower at the lender's expense, but would be value-increasing overall if included in the transaction agreement: that is, the discrete term would increase the borrower's expected payoff by an amount  $x > 0$  and decrease the lender's expected payoff by a lesser amount  $y > 0$ , where  $x - y > 0$ . Assume that both parties can fully calculate the expected benefits and costs of the discrete term, once they are made aware of it.<sup>98</sup>

The transaction negotiations occur in three stages, reflecting the practice for certain corporate transactions of settling on the price terms before negotiating the non-price terms:

Stage 0: Each party simultaneously chooses whether to hire an informed law firm (defined as a law firm that is aware of (1) the discrete term  $\mathbf{d}$  and its associated benefits and costs and (2) what the current "market" non-price terms are for any borrower) or an uninformed law firm. Because of reputation effects in these markets, assume that it is common knowledge which law firms are informed. Thus each party will know whether the other is informed when they begin negotiating the non-price terms in Stage 2. Informed law firms are more expensive, represented here by an additional fixed cost  $\mathbf{\epsilon} > 0$ ; therefore, they will not be used unless there is an expected benefit to their client.

Stage 1: Lenders compete in an auction to offer the borrower the lowest price term. The price that lenders are willing to offer reflects what they expect to negotiate as non-price terms in Stage 2. This price term is publicly observable, in the sense that all parties are aware of what the likely price term is for a borrower with these characteristics. The borrower selects the lender offering the lowest price term. Once the lender has been selected, the agreed-upon price term may not be changed during subsequent negotiations with the lender. After this Stage 1, if the negotiations break down both parties incur a lump-sum loss  $\mathbf{L}$ . In practice,  $\mathbf{L}$  might represent breach of contract damages, pre-negotiated break-up fees, or the transaction costs associated with beginning the process all over again with another party.

Stage 2: The parties negotiate the remaining transaction terms (that is, all terms other than the price term). In this model, the negotiation at this stage is limited to (i) deciding whether to include the discrete term  $\mathbf{d}$  in the transaction agreement and (ii) setting the transfer payment  $\mathbf{t}$ . Negotiations proceed

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<sup>98</sup> As discussed above, in practice the parties may also be uncertain as to their expected payoff from the discrete term, particularly if it is a relatively novel term. An informed law firm's market knowledge should mitigate this source of uncertainty as well.

according to the alternating-offers protocol outlined by Binmore, Rubinstein and Wolinsky.<sup>99</sup> After any offer is rejected, there is a very small chance  $(1 - \delta)$  that the negotiation will exogenously break down (that is,  $0 < \delta < 1$  and  $\delta$  is very close to 1), in which case both parties suffer the loss  $L$  and return to the market. In this type of game, the parties negotiate over a split of the surplus, where the surplus is the total payoff to agreement minus the payoff to the parties from their outside option.<sup>100</sup> We assume that there is no difference in negotiating skill between informed and uninformed law firms, in which case the equilibrium outcome of the negotiation is that they will simply split the surplus equally.<sup>101</sup>

### B. Result.

The outcomes at Stage 1 and 2 create the payoffs for the following different choices at Stage 0:

|        |                     | Borrower            |                   |
|--------|---------------------|---------------------|-------------------|
|        |                     | Uninformed law firm | Informed law firm |
| Lender | Uninformed law firm | A                   | B                 |
|        | Informed law firm   | C                   | D                 |

We show below that Scenario D is the equilibrium outcome: that is, both parties benefit from hiring an informed law firm. By implication, as long as  $\epsilon$  is small enough, the unique Nash equilibrium is that both parties will hire informed law firms.

### C. Proof.

Over time, the non-price terms of a transaction agreement can shift in favor of one or the other party.<sup>102</sup> We consider the case in which the non-

<sup>99</sup> Ken Binmore, Ariel Rubinstein & Asher Wolinsky, *The Nash Bargaining Solution in Economic Modelling*, 17 RAND J. ECON. 176 (1986).

<sup>100</sup> See John Sutton, *Non-Cooperative Bargaining Theory*, 53 REV. ECON. STUD. 709, 715 (1986).

<sup>101</sup> See *id.*

<sup>102</sup> Choi and Triantis demonstrate that under multi-stage negotiations in which the price term is set first, the parties' relative bargaining power can affect the non-price terms to which they will agree. See Albert Choi & George Triantis, *Market Conditions and Contract Design: Variations in Debt Contracting*, 88 NYU L. REV. 101 (2013). Yet such multi-stage negotiations

price terms have shifted in favor of borrowers in the form of the discrete term. Thus, suppose that if both parties were fully informed, the most likely set of loan terms to be offered a borrower with these specific characteristics by any lender (the “market” terms) would be a price term of  $p$ , the discrete term, and a value of  $t = 0$ .

Define  $\pi_b$  and  $\pi_l$  as the payoffs to the borrower and the lender, respectively, when  $t = 0$  but the discrete term is not included in the transaction agreement. Suppose that all lenders offer a price term near  $p$  at Stage 1. The borrower selects one such lender and we now consider outcomes at Stage 2, in which the non-price terms are negotiated bilaterally.<sup>103</sup>

1. Scenario A: Both parties uninformed.

In Scenario A, neither party’s law firm is informed, so both parties are unaware of the discrete term. They expect that in every other negotiation, parties are agreeing to  $t = 0$  and no additional terms; thus they expect a payoff of  $\pi_b$  and  $\pi_l$  respectively. They consider no additional terms in their agreement; thus they expect to earn  $(\pi_b - t)$  and  $(\pi_l + t)$  respectively, where  $t$  may be negative. The negotiated value of  $t$  represents an equalization of the surplus:

$$\begin{aligned} \text{Borrower's surplus} &= \text{Lender's surplus} \\ (\pi_b - t) - (\pi_b - L) &= (\pi_l + t) - (\pi_l - L) \\ &\rightarrow t = 0 \end{aligned}$$

Thus with evenly matched bargaining skill, the two parties agree to the same package of terms that they (incorrectly) believe is being agreed to in all other negotiations.

2. Scenario C: Informed lender; uninformed borrower.

In Scenario C, the law firm representing the lender is informed, while the borrower is uninformed. The lender would offer to include the discrete term in the agreement, in exchange for an appropriate transfer payment  $t$ , but would not reveal that the parties’ respective outside options would include the

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can also lead to market-wide shifts in non-price terms in favor of one side of the transaction. When the financial crisis first manifested, for example, the largest banks had committed to provide billions of dollars in financing for new leveraged buyout transactions at historically low interest rates. Because the borrower-favorable “price term” had been fixed, the shift in market conditions (the tightening of credit) resulted in highly lender-favorable non-price terms when such terms were eventually negotiated.

<sup>103</sup> The additional cost of using an informed law firm is modeled here as a lump sum; thus, it is sunk at Stage 2 and need not be considered.

discrete term with  $t=0$ . In that case, the bargaining would lead to a transfer payment by the borrower to the lender (since the borrower benefits more from the discrete term):

$$\begin{aligned} \text{Borrower's surplus} &= \text{Lender's surplus} \\ (\pi_b + x - t) - (\pi_b - L) &= (\pi_l - y + t) - (\pi_l - L) \\ x + y &= 2t \\ t &= 0.5(x + y) \end{aligned}$$

3. Scenario D: Both parties informed.

In Scenario D, both law firms are informed: they are aware of the discrete term and aware of the standard terms offered on the market for a borrower with these characteristics. They always find it optimal to negotiate an efficient agreement – that is, one in which the discrete term is included. (Even if the lender had all the bargaining power, it would include the discrete term and ask to be paid an extra  $t = (x - y)$ .) As to the negotiated value of  $t$ , it is determined by the parties' outside options: the losses  $L$  from breaking off negotiations and the payoffs  $(\pi_b + x)$  and  $(\pi_l - y)$ , respectively, that the parties expect to earn if they negotiate with other parties:

$$\begin{aligned} \text{Borrower's surplus} &= \text{Lender's surplus} \\ (\pi_b + x - t) - (\pi_b + x - L) &= (\pi_l - y + t) - (\pi_l - y - L) \\ \rightarrow t &= 0 \end{aligned}$$

Thus, if the lender is informed, the borrower improves its payoff by also becoming informed (moving from Scenario C to Scenario D).

4. Scenario B: Informed borrower; uninformed lender.

In Scenario B, the borrower's law firm is informed but the lender's is not. The borrower's firm asserts that the "market" loan agreement includes the discrete term and has  $t = 0$ . To make this claim credible, the borrower must signal through costly delay in the negotiations.<sup>104</sup> Suppose that the lender will believe the claim after the borrower has rejected  $n$  offers made by the lender, and had  $n$  offers of its own rejected. Thus, after  $2n$  rejections, the parties will agree to the discrete term and  $t = 0$ . What value of  $n$  makes this credible?  $n$  must be sufficiently high that a non-credible party is worse off for having rejected that many offers. We must therefore find a value of  $n$  for which it would be unprofitable to wait  $2n$  periods if the true "market" loan agreement

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<sup>104</sup> See Anat R. Admati & Motty Perry, *Strategic Delay in Bargaining*, 54 REV. ECON. STUD. 345 (2001).

had  $t = 0$  but did not include the discrete term.

Assume first that the true market loan agreement had  $t = 0$  with no discrete term, and the borrower chose not to lie about this. In that case, the parties would negotiate a loan agreement that included the discrete term (since the benefit to the borrower from the term exceeds the cost to the lender) but that set  $t$  to reflect that the borrower's and the lender's respective outside options did not include the discrete term. The resulting deal would be:

$$\begin{aligned} \text{Borrower's surplus} &= \text{Lender's surplus} \\ (\pi_b + x - t) - (\pi_b - L) &= (\pi_l - y + t) - (\pi_l - L) \\ x + y &= 2t \\ t &= 0.5(x + y) \end{aligned}$$

Telling the truth in this case would therefore cost the borrower  $t = 0.5(x + y)$ . This is referred to hereafter as the "Low Outside Option Agreement."

To make it unattractive to lie, then, the payoff to a lying borrower who rejects  $2n$  offers must be less than the payoff if the borrower simply admits that the market terms do not include the discrete term. Thus, to dissuade lying:

$$\text{Payoff if a lying party rejected } 2n \text{ offers} < \text{Payoff to not lying}$$

$$\left( \begin{array}{c} \text{Payoff if} \\ \text{negotiations} \\ \text{don't break down} \end{array} \right) + \left( \begin{array}{c} \text{Payoff if} \\ \text{negotiations} \\ \text{break down} \end{array} \right) < \text{Payoff to not lying}$$

$$\delta^{2n}(\pi_b + x) + (1 - \delta^{2n})(\pi_b - L) < \pi_b + x - 0.5(x + y)$$

$$\delta^{2n}(L + x) < L + 0.5(x - y)$$

$$\delta^{2n} < \frac{(L + 0.5(x - y))}{(L + x)}$$

$$n > \frac{[\ln(L + 0.5(x - y)) - \ln(L + x)]}{2 \ln(\delta)}$$

(The inequality changes direction because  $\ln(\delta)$  is negative).

If we choose  $n$  large enough so that the inequality holds only for lying parties, then it will not hold for the informed party signaling credibly. In that case, if the true state of the world is that the market agreement contains the discrete term with  $t = 0$ , then  $n$  is such that:

$$\left( \begin{array}{c} \text{Payoff if truthful borrower} \\ \text{rejects } 2n \text{ offers} \end{array} \right) > \left( \begin{array}{c} \text{Payoff if truthful borrower} \\ \text{simply accepts} \\ \text{the Low Outside Option} \\ \text{Agreement} \end{array} \right)$$

$$\delta^{2n}(\pi_b + x) + (1 - \delta^{2n})(\pi_b + x - L) > \pi_b + x - 0.5(x + y)$$

$$\delta^{2n}(\pi_b + x) + (1 - \delta^{2n})(\pi_b + x - L) > \pi_b + 0.5(x - y)$$

Moving from A to B, the payoff to an informed borrower has increased substantially: it has gone from  $\pi_b$  to something above  $(\pi_b + 0.5(x - y))$ , which is greater.

The payoff to a lender also increases significantly in moving from B to D. The lender's payoff in B is  $\delta^{2n}(\pi_l - y) + (1 - \delta^{2n})(\pi_l - y - L)$  (or worse, if the parties' negotiations subsequently break down); that is, there is some risk that the negotiations break down during the credible signaling phase. But the lender's payoff in D is  $(\pi_l - y)$ , which is greater. This is because:

$$\begin{aligned} \text{Lender's payoff in B} &= \delta^{2n}(\pi_l - y) + (1 - \delta^{2n})(\pi_l - y - L) \\ &= \pi_l - y - L(1 - \delta^{2n}) \\ &< \pi_l - y \end{aligned}$$

because  $(1 - \delta^{2n}) > 0$ , given that  $0 < \delta < 1$ .

Thus D is the only Nash equilibrium. If the parties were at A, there would be a deviation to B and then to D. If the parties were at C, there would be a deviation to D. Thus, both parties have an incentive to select law firms with market knowledge.

#### D. Extensions

The basic model above posits a temporary shift in market terms in borrowers' favor. The result that both parties benefit in expectation by hiring an informed law firm also holds for a market shift in lenders' favor. The intuition is as follows. If the market terms happen to be *favorable* to one party,



that party benefits from being informed of this, because (1) if the other side is uninformed, the party can achieve a better bargain by sending a credible signal of the market shift, or (2) if the other side is informed, the party can achieve a better bargain without having to send a costly signal. If instead the market terms happen to be *unfavorable* to the party, the most that it stands to lose from being informed is the additional cost  $\epsilon$  of the informed law firm, because: (1) if the other side is uninformed, the party will simply choose not to reveal the unfavorable market shift, and (2) if the other side is informed, the parties can avoid the costly signal from that side. Thus, so long as  $\epsilon$  is small enough, both parties benefit from hiring an informed law firm, regardless of the direction in which the market terms have shifted.

If, however, the market terms are payoff-neutral (that is, they have not shifted in favor of either party [*or there are no value-increasing terms that are not common knowledge?*]), there is no advantage to either party to hiring an informed law firm. Knowing this, each party will thus estimate the probability of each of the three possible outcomes: a favorable market shift, an unfavorable market shift, or neutral terms. So long as the probability of a favorable shift is not too small, and the gains are substantial, the parties will benefit in expectation from hiring an informed law firm. For example, imagine that the borrower anticipates payoff-neutral terms on average (that is, the borrower expects on average to obtain a price term  $p$  with  $t=0$  and no other discrete terms), and assigns a probability  $q$  to that outcome. Then  $(1-q)$  of the time there is a favorable or unfavorable market shift, and the borrower gains from hiring an informed law firm. If  $\epsilon$  is small enough, then, the borrower hires an informed law firm.