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MARKET INFORMATION AND THE ELITE LAW FIRM

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ABSTRACT

Following the contraction in demand for law firms' services during the Great Recession, "Big Law" was widely diagnosed as suffering from at least five 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 large law firms has been largely misunderstood. As applied to the most elite U.S. firms by practice area, each of these forces either has a limiting principle or, counter-intuitively, serves to reinforce such firms' economic advantage. Even as many firms reduce their fees and contract in size, we should expect certain of them to continue to charge more and grow bigger. The current prescriptions for fixing Big Law are at best misplaced, and at worst harmful, simply because they 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 supposedly excessive fees charged by “Big Law” and the need for law firms to provide more cost-effective services to their clients.¹ The 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.²

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.³ While many lower-ranked law firms continue to struggle, despite having lowered their fees in the downturn, the highest-ranked firms present a picture of financial health and perennially overworked lawyers.⁴ There is a widening chasm between the most elite corporate law firms and the rest of the pack in terms of transaction volume,

¹ 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, 2:55PM), available at: <http://www.forbes.com/sites/quora/2012/03/06/why-are-lawyers-so-expensive-even-with-the-excess-supply-of-lawyers/>.

² See Elizabeth Olson, *Corporations Drive Drop in Law Firms’ Use of Starting Lawyers*, *Study Finds*, N.Y. TIMES, Oct. 10, 2014.

³ 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.”)

⁴ See Eric 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 “100 top-grossing firms in the nation” and noting that unlike their counterparts, the “Super Rich firms - the 20 with PPP [profits per partner] of at least \$2 million and RPL [revenue per lawyer] - outperformed the financial averages by four or five percentage points....”).

billing rates, lawyer compensation, and hiring.⁵

What accounts for this winners-take-all phenomenon 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 transaction acquire private information about the range of plausible deal terms and their current market prices that other service providers cannot replicate. 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 can procure a better economic deal for their clients by virtue of this market knowledge. 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 repeat-player firms.

The argument proceeds as follows. Although many corporate transactions become standardized and even commoditized over time,⁶ others can involve increasingly complex, rapidly changing terms for a sustained period of time. Currently, these heavily negotiated and tailored transactions are largely confined to the areas of mergers and acquisitions, highly-leveraged debt financing, and private investment fund formation, though this need not continue to be the case. These transactions are characterized by the frequent development and dissemination of entirely new deal terms and by rapid changes in the market price of each term.

Such transactions stray from the perfect-market ideal of transparent, uniform pricing. Rather, information about individual deal terms and their pricing remains private (and therefore scarce), and otherwise similar deals may occur at disparate prices. For a given deal, the final set of terms agreed to by the parties will be determined by a combination of market forces and bargaining under incomplete information. The final pricing and contract terms will be heavily affected by the parties’ information in the bargaining stages.

To maximize their surplus from this type of transaction, participants require expert information of two types. First, they require information as to any new terms that arise with respect to the transaction in question. They must be made aware of how far out the bargaining frontier extends, or risk either losing out on a jointly value-increasing term or being exploited by the other party’s superior knowledge. Second, because the pricing of individual

⁵ See Hoffman & Smith, *supra* note 2, 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.”).

⁶ See Susskind, *supra* note 1, at 28-33 (describing the evolution of legal services from bespoke to fully commoditized).

deal terms is opaque for this type of transaction, the parties require information such as the terms of recent comparable deals, the contingencies associated with such deal terms, and the ways in which terms interact with one another. Market information of this type should assist the parties in pricing deal terms in two ways: first, by helping the parties determine their expected payoffs from the various possible deal terms, and second, by informing them of their “outside” options should they decide to break off the negotiations and begin again with another party.

Where do transaction counterparties 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 the most opaque term pricing. Law firms retain a near monopoly over the deal terms for such transactions, because they are repeat players across a range of different clients and, unlike other transaction participants, they negotiate 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,⁷ 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 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.⁸ In practice, this knowledge management exercise may be implemented by firms in various ways, from using sophisticated database software to track precedential transactions, or “gridding” deal terms manually to compare the most relevant transactions for a client, all the way down to the more informal and traditional practice of simply gathering and reviewing recent comparable transaction documents before beginning a negotiation. Unsurprisingly, firms’ knowledge-management practices 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 firm/client relationship. The rules of professional responsibility zealously endorse the confidentiality of attorney-client communications. Yet in practice clients are paying for law firms’ ability to pool information across clients and

⁷ Companies such as Xtract Research, Practical Law, and The Deal provide searchable databases of key terms from corporate transactions.

⁸ 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 database of precedent transactions).

to make use of that information in transaction negotiations. A Fortune 500 company will engage a top-tier law firm for its merger precisely because the firm will know the terms obtained by similar companies in recent mergers. In other words, clients of the top-tier law firms no longer seek bespoke, professional service based on a long-term, confidential relationship.⁹ Rather, they are merely purchasing information from law firms, and law firms are merely engaged in the increasingly ubiquitous practice of knowledge management.¹⁰ Yet this form of knowledge management should continue to generate above-market rents for elite firms, because they have better (and sometimes exclusive) access to the underlying information relative to other service providers and market participants.

Finally, this hypothesis of law-firm value calls for some optimism about the future of elite firms, 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. In-house lawyers are only privy to their company's own transactions, in contrast to law firms' real-time access to a wide range of precedential transactions. In particular, in-house counsel will lag behind firms in learning of innovative deal terms that are newly introduced to the market. The trumpeting of in-house counsel as a solution to spiraling legal costs¹¹ should be more muted: in the most lucrative area of practice, prestigious law firms will continue to dominate the market share.¹²

We can end our inquiry with another puzzle – that of the ever-expanding law firm. Various theories have been advanced to explain the apparition and increasing prevalence of the mega-law firm.¹³ While each of these provides a partial explanation, under this Article's thesis, larger firms simply reflect the

⁹ 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).

¹⁰ *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).

¹¹ 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).

¹² 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).

¹³ 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 (documenting the continued trend toward larger firms and listing the most common explanations for the phenomenon as “(i) the 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.”).

informational advantage derived from greater deal volume.

The Article proceeds as follows. Part I reviews the existing literature on the value, if any, provided by transactional lawyers. In Part II, the puzzles left unsolved by the existing literature yield a new theory of law firm value in the transactional context, focusing on elite firms' use of 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. LITERATURE REVIEW

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.¹⁴ The law firm/client relationship poses the classic agency problem: the principal (in this case, 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.¹⁵ The existing literature's focus on this agency problem puts the cart before the horse, however. Before inquiring how well clients are able to monitor and assess their law firms, we need to clarify just what it is that, in the absence of agency 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. This value question is particularly intriguing in the context of transactional

¹⁴ 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").

¹⁵ 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).

lawyering, which is this Article's focus. Major corporate transactions¹⁶ such as mergers and acquisitions, debt financings, and bankruptcy and restructurings, are known to require large teams of lawyers. But what is it that such lawyers do, and why? Unlike the litigation context, in which the lawyer's role *qua* lawyer is clearly defined 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,¹⁷ 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."¹⁸ He began from the premise that all major corporate transactions involve substantial transaction costs, owing primarily to the information asymmetry between the parties as to the true value of the asset to be transferred between them. Gilson hypothesized that good transactional lawyers minimize transaction costs for the parties, for example by allocating each risk involved in the transaction to the party best able to bear it. By minimizing transaction costs, transactional lawyers can increase the parties' joint surplus (value) from the transaction, making both sides better off.

Gilson's theory has at least two notable merits: first, it comports well with transactional lawyers' own sense of where they devote most of their energy (e.g., negotiating earnout provisions, rather than making regulatory filings); and second, it comforts both lawyers and clients to know that, in hiring transactional lawyers, clients are likely saving themselves money relative to a do-it-yourself deal.¹⁹ Gilson's hypothesis is, by his own admission, theory-based, and to the author's knowledge has not been tested empirically.

A competing paradigm to the transactional law firm as "transaction cost

¹⁶ 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 party or involve significant changes in the capital structure, assets, or organization of the corporation, and are negotiated bilaterally with complex, non-standardized terms.

¹⁷ See Susskind, *supra* note 1, at 5 (noting the phenomenon of "lawyers denying that they are lawyers").

¹⁸ 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).

¹⁹ Interestingly, the debate over whether transactional lawyers add or subtract value remains unresolved. Gilson argues that transactional lawyers *must* add value (rather than simply redistribute it between the parties); otherwise, the parties would agree jointly not to use lawyers. Jeffrey Lipshaw convincingly 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). See *infra* notes 62-68 and accompanying text for a more complete critique of Gilson's position.

engineer” is that of the law firm as “reputational intermediary” or “gatekeeper” in corporate transactions.²⁰ 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 a legally binding one) against fraud or misrepresentation by the company as to its value. In other words, the law firm’s reputation is to some degree standing in for material investment 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.²¹ While the law firm-as-gatekeeper thesis has spawned considerable discussion, the empirical evidence for it is decidedly mixed.²²

Taking instead a bottom-up approach to the question, Steven Schwarcz

²⁰ 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 1, 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).

²¹ Taking a much broader view of the practice 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, financing arrangements, and restructurings.

²² 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).

derived a third paradigm for the value provided by transactional lawyers.²³ Through a large-scale survey project, Schwarcz asked both corporate clients and their outside counsel to describe the role played by lawyers in major corporate transactions. Specifically, Schwarcz elicited his subjects' rankings of the relative importance of various hypotheses as to transactional lawyers' value. Based on the survey findings, he concluded that business lawyers primarily add value (if at all) by acting as regulatory compliance experts.²⁴ More precisely, law firms assist clients with major corporate transactions principally by navigating both client-specific and transaction-specific regulatory concerns.²⁵ While Gilson had dismissed the importance of regulatory issues in corporate transactions, Schwarcz's work puts such concerns back at the center of transactional practice.²⁶

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

Thus, we have three broad paradigms for the role played by lawyers in major corporate transactions: transaction-cost engineer, reputational intermediary, and regulatory expert. Each of these hypotheses resonates as being clearly and intuitively correct,²⁷ and these are not conflicting paradigms 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.²⁸ For such "mega-deals," we can often count on one hand the number of firms that dominate the market for each type of transaction.²⁹

This fact 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

²³ See Steven L. Schwarcz, *Explaining the Value of Transactional Lawyering*, 12 STAN. J.L. BUS. & FIN. 486 (2007).

²⁴ *Id.*

²⁵ *Id.*

²⁶ After concluding that transactional lawyers' principal task was transaction cost engineering, Gilson queried whether lawyers were truly required in corporate transactions – as opposed to, say, investment bankers. See Gilson, *supra* note 17, at 301. Schwarcz's work implicitly answered Gilson's query in the affirmative, no doubt to the relief of many a lawyer and law student.

²⁷ Of course, the degree to which each theory carries explanatory weight in practice depends highly on the particular transactional context.

²⁸ See Hoffman & Smith, *supra* note 2 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).

²⁹ See *id.*

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 hammered out, as Gilson freely acknowledges, 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 firm used over and over again for the same type of transaction, we would instead see the top-tier firm 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.³⁰

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 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 entirely account for this pattern. Continuing with our 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. (To use Schwarcz's terminology, the firm-specific regulatory costs far outweigh the transaction-specific regulatory costs.)³¹ Any competent law firm with a transactional practice could satisfy the

³⁰ 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").

³¹ See Schwarcz, *supra* note 22.

requirements, 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.³² What, then, best explains this pattern of law firm selection? This is the task to which the Article turns in Parts II and III.³³

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

³² See Manns & Anderson, *supra* note 29.

³³ 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. 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).

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 routinely 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.

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 Schwarcz's 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 market terms for that particular transaction. The case for this missing piece of the value puzzle is set forth below, through four fundamental claims relating to certain complex, bilaterally-negotiated³⁴ corporate transactions: (1) the set of deal terms is always expanding; (2) the market price of deal terms is always changing; (3) most deal terms are not publicly available; and (4) law firms have the best access to and expertise in such deal terms.

A. Deal Terms are Always Expanding.

Major corporate transactions involve a key written agreement or set of agreements designed to record the parties' understandings with respect to the transaction and render them legally enforceable. Regardless of the depth and complexity of regulatory overlay, such agreements are predominantly characterized by privately negotiated terms. Corporate deals thus afford the parties a significant degree of contractual freedom, even with respect to contract terms that address regulatory concerns.³⁵

³⁴ 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 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).

³⁵ See Victor Fleischer, *Regulatory Arbitrage*, 89 TEX. L. REV. 227, 239 (2010) (arguing that regulatory constraints provide an opportunity for lawyers to innovate in structuring

What, then, determines the scope of the counterparties' negotiations? What sets the boundary for the set of terms considered subject to negotiation? Here again, the parties are generally free to do as they will. There is no strictly defined set of deal terms for a particular type of transaction: the list is jointly determined by the parties and can be expanded or contracted virtually at will.³⁶ Crucially, the recent thrust has been decidedly toward expansion for certain types of transactions.³⁷ 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, 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.³⁸ It should come as no surprise, then, that the legal manifestations of modern finance in transactional agreements are themselves increasingly complex.³⁹ Securitization transactions, for example, generate an impressive array of lengthy, complex agreements.⁴⁰ Second, regulation is also increasing in complexity, prompting new deal terms and deal structures.⁴¹ Third, as technology has improved, the costs associated with the production and sharing of complex transactional agreements have declined.⁴² The switch from the typewriter to the word processor and from mail to email has significantly increased the pace of

transactions).

³⁶ 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.”).

³⁷ 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).

³⁸ 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).

³⁹ 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).

⁴⁰ 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 (a typical example of a pooling and services agreement for asset-backed securities).

⁴¹ See Fleischer, *supra* note 37, at 239.

⁴² See Brockmeyer, *supra* note 39, at 7 (noting the delays in previous decades associated with typewritten agreements for M&A transactions); Fox, *supra* note 41, at 74, 122 (describing the effect of technological change on the drafting of transactional agreements).

producing large corporate agreements 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 terms. Fourth, as law firms have increased in size, they have proved better able to manage more complex agreements (for example, by involving different regulatory specialists for different provisions) and to innovate more, simply 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 Parts III.C and IV.C.4 below.

The preceding list of explanations for the surge in deal terms is unlikely to be exhaustive. Whatever the causes, the agreements governing certain major corporate transactions appear to comprise an ever-greater set of terms. The remainder of this Part II addresses only these types of transactions and their contractual embodiments.

B. The Market Price of Deal Terms is Always Changing.

Not only is the set of deal terms expanding for major corporate transactions, but the price of each such term can change over time according to market conditions. The notion of a corporate transaction's *overall* price is intuitive. The price of a merger or stock acquisition, for example, is the amount to be paid by the acquirer for the target's stock. The price of debt financing is commonly understood as the interest rate on the debt or, better still, the interest rate and fees to be paid to the holder(s) of the debt. It is also clear that this overall transaction price (referred to hereafter as the "deal price") is subject to change over time, holding all else constant, 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.⁴³

Although we readily acknowledge that deal prices change constantly, we often forget two additional, fundamental points. First, *every* term in a transactional agreement – whether it is a "business" term or "legal" term⁴⁴ – has a "price." This price is best defined as the aggregate value of what the party requesting inclusion of that term in the agreement must trade off in

⁴³ 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).

⁴⁴ The business people involved in corporate transactions commonly distinguish between two types of deal terms: "business" (or "economic") terms and "legal" terms. While no attempt is made to draw a line between the two (and lawyers are forever trying to remind their clients that "all legal terms are business terms"), business terms tend to capture the fundamental economic deal between the parties (and are therefore generally numeric), while legal terms are the remainder of the contractual provisions governing the transaction.

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 the decrease in the interest rate that the lender has to agree to in exchange.⁴⁵

Second, the price of each such deal term can change according to market conditions, at least to some degree.⁴⁶ Let us define the "market price" of a particular transaction term as the *average* price of that term at a given point in time, holding all else constant. Indeed, we should expect at least some dispersion in the pricing of a given transaction term by market participants, rather than a single, "efficient" market price.⁴⁷ Transactional agreements are not commodities, and accumulating evidence suggests that their terms are not perfectly priced.⁴⁸ 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.

C. Most Deal Terms Are Not Public.

Complex corporate transactions 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

⁴⁵ 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 "legal term" for a lender-favorable "legal 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.

⁴⁶ See Albert Choi & George Triantis, *Market Conditions and Contract Design: Variations in Debt Contracting*, 88 NYU L. REV. 101 (2013) (proving that the non-price terms of debt contracts can vary with market conditions).

⁴⁷ MAUREEN O'HARA, MARKET MICROSTRUCTURE THEORY 53 (1995) (summarizing several information-based models of markets under which spreads occur).

⁴⁸ See Manns & Anderson, *supra* note 29 (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).

disclosure to the press or rating agencies, 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 acquisitions, the parties never file the complete set of transaction documents with the SEC, as only the key agreements are required to be disclosed.⁴⁹ 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 “mega-deals” 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, and thus would not require *any* public filings of the transaction documents.⁵⁰ In such cases, the deal terms, which would be of considerable interest to comparable companies seeking financing, remain hidden from the market.

Finally, because novel terms arise frequently in the types of transactions at issue, 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.

D. Repeat-player law firms have the best access to, and experience with, the full package of deal terms.

In the absence of public, commoditized pricing for deal terms, and where such terms are constantly evolving, pricing deal terms for purposes of negotiating a new transaction requires both (a) continuous access to deal terms for recent transactions of the same type and size and (b) sustained experience with such terms, including as to their purpose, plausible interpretations (both by industry custom and by the courts), contingencies, enforceability, probability of being invoked post-closing, and so forth. Repeat-player law

⁴⁹ See 17 C.F.R. § 229.601(a)(4) (mandating disclosure of “material” agreements for companies registered under the Securities Exchange Act of 1934).

⁵⁰ See *id.*

firms are the market participant best suited to fulfilling both requirements across the full range of transaction terms, through the sheer volume of transactions that they handle and, as compared to other service providers, their monopoly over the drafting of transaction agreements.⁵¹ While other market participants such as the transaction counterparties themselves, in-house counsel to the counterparties, investment banks, accounting firms, and third-party information providers that compile and compare deal terms, all have some exposure to and familiarity with deal terms, we should expect law firms to have more.

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 terms (both business and legal) of such transactions.⁵² Transaction parties, by contrast, only have access to deal terms for their own prior transactions. Major transactions are relatively rare in any individual corporation's life, such that the company's management should tend to be 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"⁵³ legal counsel for corporate transactions (i.e., whether to hire in-house counsel or to engage outside counsel), scholars have failed to recognize that in-house counsel is at a decided disadvantage relative to law firms when it comes to current market information. While large companies may have massive teams of in-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 service providers to transaction counterparties 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 highly sophisticated and keenly aware of market movements.⁵⁴ Investment banks in particular specialize in helping clients price transactions such as mergers and

⁵¹ 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").

⁵² See Gilson, *supra* note 17, at 257 (noting that "the business lawyer's role in corporate acquisitions is pervasive").

⁵³ See Schwarcz, *supra* note 11.

⁵⁴ 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).

acquisitions and corporate financings. 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 centered on the "business terms" of a transaction (also referred to as the "price terms" or "economic terms"). In particular, they and other deal advisors lack law firms' complete access to, and experience negotiating every facet of, the deal documentation, and in particular are less able to identify and interpret the "legal" deal terms than law firms. As drafters and keepers of the deal documentation across many clients, high-volume law firms are best positioned to maintain a repository of the range of possible deal terms – both "business" and "legal" – and to aid clients in comparing them. Thus, while we can safely posit that advisors such as investment bankers may have an advantage over transactional lawyers in pricing certain key economic terms, lawyers are the only party with knowledge of and experience with *all* deal terms. If this knowledge is valuable (as I argue it is), then law firms handling a significant volume of complex transactions will always be in high demand.⁵⁵

Finally, a market has recently developed for knowledge-management service providers that sell summary deal term information to investors. Practical Law, Xtract Research, The Deal, and many others, all perform a function similar to the one this Article ascribes to elite transactional law firms, namely aggregating and comparing terms from recent deals. While the proliferation of such service providers confirms how valuable this function is,

⁵⁵ 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 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.

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. CASE STUDY: LEVERAGED LOAN FINANCINGS

How does information about market terms help clients, if at all, in transaction negotiations? Complex corporate transactions are characterized by the parties' incomplete and asymmetric information.⁵⁶ Where new deal terms are constantly arising, where market forces rapidly affect the relative prices of all deal terms, and where information about such terms and their market prices is rarely public, the counterparties are likely to hold inaccurate and divergent beliefs about the market price of each term. They may even be unaware of the existence of certain deal terms that would increase their surplus from the transaction, a point that contracts scholarship has largely overlooked. Negotiations over transactional terms, then, represent a particular instance of bilateral bargaining with incomplete information.⁵⁷

Because such negotiations result in lower aggregate surplus relative to the perfect-information ideal,⁵⁸ there is room for transactional lawyers to add value by providing better information about deal terms and their current pricing.

⁵⁶ See Gilson, *supra* note 17, at 253 (noting that information about capital assets is "one of the most expensive and poorly distributed commodities"). Note, however, that Gilson focuses on information asymmetry concerning the value of the capital asset at issue, such as the target company's assets in an acquisition transaction. Lawyer-crafted provisions such as representations and warranties, for example, enable the parties to minimize the transaction costs associated with the fact that the selling party is more informed about the value of the target company than the buyer. This Article identifies a different information set that also affects the transaction value, namely the range of terms on which the parties can plausibly contract with respect to the capital asset to be transferred and such terms' market pricing. Even assuming that the parties are equally or perfectly informed about the value of the asset to be transferred, they may nonetheless fail to maximize their joint surplus from the transaction, for example if they are simply unaware of new transaction terms that would benefit one or both parties or they lack the market price of any transaction term and therefore fail to correctly trade off one term against another in negotiations. Where lawyers can assist with market-term awareness and pricing, they can increase transaction value in a manner not contemplated by Gilson's transaction-cost-engineering hypothesis.

⁵⁷ See, e.g., Kalyan Chatterjee & William Samuelson, *Bargaining Under Incomplete Information*, 31 OPERATIONS RES. 835 (1983) (providing a model of bilateral bargaining under incomplete information); Roger B. Myerson & Mark A. Satterthwaite, *Efficient Mechanisms for Bilateral Trading*, 29 J. Econ. Theory 265 (1983).

⁵⁸ See Chatterjee & Samuelson, *supra* note 60, at 836 (stating that "[b]argaining under uncertainty will, in general, fail to be Pareto efficient"); William Samuelson, *Bargaining Under Asymmetric Information*, 52 Econometrica 995, 1004 (1984) (concluding that the parties in a bilateral monopoly bargaining game may fail to reach mutually beneficial agreements when information is asymmetrically distributed).

They can do so in three ways: first, by helping their client determine its expected payoff from particular deal terms, many of which may be novel or complex; second, by making their client aware of potentially value-increasing terms; and third, by determining the value of the client's outside options, if the negotiations were to break down and the client sought an alternative transaction on the market. On the other hand, if transactional lawyers use their superior market knowledge to obtain additional legal fees without regard to transaction surplus (by unnecessarily complicating and protracting negotiations, for example), their intervention may instead be value-decreasing.

What does all this look like in practice? This Part III uses a case study of the U.S. leveraged loan market to address how new deal terms arise, why deal terms are difficult for the counterparties to price, and how law firms can assist with pricing. Sub-part A provides background on leveraged loan transactions and documentation. Sub-part B demonstrates that pricing the contractual terms governing leveraged loans is exceptionally difficult, in ways that much of the existing literature fails to recognize. The combination of multi-stage negotiation and pricing, novel deal term generation, and complex deal term interactions make for a strikingly complicated pricing problem. Sub-part C illustrates the pricing problem by providing stylized cases in which a law firm's representation of the borrower in a leveraged-loan transaction may be value-adding or value-decreasing, all with respect to the same transaction term.

A. Leveraged Loans: Background

As a relative newcomer to the U.S. capital markets, the leveraged loan segment has experienced both tremendous growth in volume and liquidity and significant innovation in its legal terms.⁵⁹ Leveraged loans are loans to companies with a high debt-equity ratio, and are intended to be syndicated: they are typically underwritten or arranged by a single investment or commercial bank and ultimately funded by a large syndicate of lenders.⁶⁰ The lender group typically consists of a highly diverse mix of banks and non-bank institutional investors.⁶¹ Post-issuance, many of these loans are subsequently traded on an increasingly liquid secondary market.

Despite heavy secondary trading, leveraged loans are nonetheless deemed

⁵⁹ 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).

⁶⁰ Katerina Simons, *Why Do Banks Syndicate Loans?*, NEW ENG. ECON. REV. 45, 45–46 (Jan.1993), *available at* <http://www.bostonfed.org/economic/neer/neer1993/neer193c.pdf>.

⁶¹ 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.

not to be securities and therefore are not subject to securities regulation.⁶² 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 and are driven primarily by commercial considerations rather than regulation.

B. *Leveraged Loan Pricing: Three Sources of Complexity*

Before delving into loan-term pricing problems, it is worth being explicit about what makes such pricing so difficult. Leveraged loan financings share three characteristics that significantly increase the complexity of pricing their terms.

1. Multi-Stage Negotiations with Sticky Pricing.

A dominant strain of law and economics holds that bargaining power has no effect on the non-price terms of a contract.⁶³ supply and demand produce a single, efficient set of *non-price* terms for a particular contract type, such that differences in the parties' bargaining power only leads to adjustments to the *price* terms. This view implicitly assumes that deal terms are settled simultaneously. In practice, however, many types of corporate transactions – including leveraged loans – are negotiated in stages,⁶⁴ with the price terms settled in the earliest stages and non-price terms negotiated in later stages.⁶⁵ The crucial feature of such multi-stage negotiations is that the price terms

⁶² 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).

⁶³ 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”).

⁶⁴ 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 50, at 2469 (describing the transaction steps for a leveraged-loan financing for a private equity-sponsored acquisition).

⁶⁵ See Choi & Triantis, *supra* note 64, at 1690.

initially negotiated by the parties are sticky:⁶⁶ regardless of how the remaining negotiations ultimately unfold, it is highly unlikely that the parties will adjust the price terms to which they originally agreed.⁶⁷

This timing mismatch in the negotiation of price and non-price terms leaves room for bargaining power to affect the non-price terms.⁶⁸ Further, it significantly increases the difficulty of pricing such terms: as each non-price term is negotiated, the parties must identify other non-price terms of equivalent value to trade for it, given that adjustments can no longer be made through the price term. The parties must therefore know the pricing of *every* term in the agreement. The information required to negotiate this type of transaction is thus significantly greater than for one in which adjustments to the price term are routine.⁶⁹

2. Novel Deal Term Generation.

The tremendous growth in the leveraged loan market was mirrored by tremendous innovation in leveraged-loan credit agreements. Leveraged-loan 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 loan terms and creatively navigate a difficult lending environment. While commentators frequently note the lack of innovation in legal documents,⁷⁰ leveraged-loan transactions provide an impressive counter-example.⁷¹ In the course of less than a decade, dozens of new provisions were

⁶⁶ 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 29, 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”).

⁶⁷ See Choi & Triantis, *supra* note 64, 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).

⁶⁸ See *id.*

⁶⁹ See also 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).

⁷⁰ See, e.g., MITU GULATI & ROBERT E. SCOTT, *THE THREE AND A HALF MINUTE TRANSACTION: BOILERPLATE AND THE LIMITS OF CONTRACT DESIGN* (2013) (identifying a 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).

⁷¹ See Allison A. Taylor & Ruth Yang, *Evolution of the Primary and Secondary Leveraged Loan*

developed that, over time, became standard loan terms. 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.⁷² 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, both in the sense of helping them determine their individual expected payoffs from including the terms in the deal and in determining the value of their outside option (which is simply the “market” price of the deal terms) if they chose to negotiate with a different party.

3. Complex Deal Term Interaction.

The pricing difficulties for leveraged loan terms do not end with frequent innovation: in all complex corporate transactions, a given deal term cannot be considered and priced in isolation. Transaction terms interact with one another in ways that materially affect aggregate pricing. For example, a credit agreement term granting the borrower permission to engage in a certain transaction (such as a merger, asset sale, or refinancing) without requiring lender approval may exacerbate the problems of borrower adverse selection and moral hazard that characterize lending relationships.⁷³ If so, the lenders may need to adjust other terms in the credit agreement to reflect the increased credit risk, such as the events of default. Pricing loan terms thus involves not only an appreciation of the market price of a particular term standing on its own, but an understanding of how that term would affect every other term in the agreement as well as every term that may later be raised in negotiations. The combinatorics involved would terrify any statistician. Yet law firms handling a high volume of leveraged loan transactions can gain an intuitive

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 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.

⁷² For descriptions of these terms, see the Practical Law glossary, <http://us.practicallaw.com/us-glossary>.

⁷³ Albert Choi & George Triantis, *Market Conditions and Contract Design: Variations in Debt Contracting*, 88 NYU L. REV. 101 (2013) (explaining customization of debt contracts as responses to changes in adverse selection and moral hazard effects).

appreciation for such term interactions and thereby price terms significantly better than can their clients.

C. Leveraged Loan Pricing: 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,⁷⁴ and such amendments or waivers are relatively common.⁷⁵ 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.⁷⁶ 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 is a relative newcomer to the U.S. capital markets, and its 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 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.⁷⁷ Such a provision incentivizes lenders overall to vote in favor of loan amendments, and decreases the likelihood that lenders

⁷⁴ 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.

⁷⁵ 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”).

⁷⁶ 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).

⁷⁷ 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).

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. Thus, all else being equal, 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.⁷⁸ 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 three 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 case, the relevant comparison is between the outcome when the client uses a law firm with market knowledge (an "informed law firm") and the outcome when the client uses 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.

⁷⁸ 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.

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 by the sample dollar values in the following table:

	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 is less than \$0.5 million, *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 will be lower with a yank-a-bank provision, 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 lender 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 (which, once again, requires 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.

By assisting the parties with these three complex tasks, all of which 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 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. Thus, to the extent that the borrower’s law firm expends billable hours trying to introduce the term into the negotiations, it will have made both parties worse off. Not only has the law firm reduced the joint surplus from the transaction, taking into account its legal fees, it has 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 (1) such financings involve complex, heavily negotiated terms that are generally private, (2) the timing and nature of negotiations leaves room for the exercise of bargaining power, and (3) 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 decreased demand for law-firm services in the wake of the 2007-2009 financial crisis, elite law firms in the United States continue to thrive and to dominate the market for major 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 the deal terms of major corporate transactions and use this information to identify value-increasing terms and to assist their clients with term pricing. Traditional accounts of financial contracting have failed to recognize the openness of transaction terms and the difficulty of pricing them, due to misconceptions

about the actual practice of transactional negotiations. To the extent that elite law firms increase transaction surplus or shift transaction surplus to their clients using their market knowledge, such firms 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 can help clients price transaction terms in two ways, each reflecting a different source of uncertainty for the transaction parties. First, it can assist clients in determining how particular terms will affect their expected payoff 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 information.⁷⁹

Second, law firms' market knowledge 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 serves a dual role: 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 the latter source of uncertainty. 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. Model set-up.

The parties are described without loss of generality as "borrower" and "lender." The transaction agreement is characterized as follows: the entire set of transaction terms consists of (a) the price term \mathbf{p} , (b) a discrete term that is not common knowledge (such as the yank-a-bank provision described in Part III), and (c) a term consisting of a continuous variable \mathbf{t} that represents a straight dollar transfer between the parties. A positive value of \mathbf{t} represents a transfer from the borrower to the lender: the payoff to the lender has *increased*

⁷⁹ 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.

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.⁸⁰ 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).

Without loss of generality, assume that the discrete term, if included in the transaction agreement, would benefit the borrower at the lender's expense. Assume further that for this type of borrower, the optimal loan agreement would include the discrete term: 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.⁸¹

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 the discrete term and its associated benefits and costs) 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 ϵ ; therefore, they will not be used unless there is a benefit to their client.

Stage 1: Lenders compete 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 loss L . In practice, L might represent breach of contract damages, break-up fees, or the transaction costs associated with beginning the process all over again with another party.

⁸⁰ In practice such a continuous variable may not exist, but could be approximated by aggregating several different terms with small costs and benefits.

⁸¹ 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.

Stage 2: The parties negotiate the remaining transaction terms (that is, all terms other than the price term). Negotiations proceed according to the alternating-offers protocol outlined by Binmore, Rubinstein and Wolinsky.⁸² The outcome of this game is that 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.⁸³ After any offer is rejected, the probability that the negotiations will proceed is δ , where $0 < \delta < 1$ and δ is very close to 1. In other words, after any offer is rejected, there is a very small chance $(1 - \delta)$ that the negotiation will exogenously break down, in which case both parties suffer the loss L and return to the market. In this model, the negotiation at this stage is limited to (i) deciding whether to include the discrete term in the transaction agreement and (ii) setting the continuous variable, t . We assume that there is no difference in negotiating skill between informed and uninformed law firms, in order to focus on the role of information. Given that, they will simply split the surplus equally.

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 that both parties benefit from hiring an informed law firm. By implication, for ε small enough, the unique Nash equilibrium is that both parties 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.⁸⁴ We consider the case in which the non-price

⁸² Ken Binmore, Ariel Rubinstein & Asher Wolinsky, *The Nash Bargaining Solution in Economic Modelling*, 17 RAND J. ECON. 176 (1986).

⁸³ See John Sutton, *Non-Cooperative Bargaining Theory*, 53 REV. ECON. STUD. 709, 715 (1986).

⁸⁴ See Albert Choi & George Triantis, *Market Conditions and Contract Design: Variations in*

terms have gradually 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 π_b and π_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.⁸⁵

1. Scenario A: Both parties uninformed.

In Scenario A, neither party’s law firm is informed, so both parties 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 π_b and π_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 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):

Debt Contracting, 88 NYU L. REV. 101 (2013).

⁸⁵ 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.

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

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. 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 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:

Payoff if a lying party rejected $2n$ offers $<$ 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:

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

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

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

Moving from A to B, the payoff to an informed borrower has increased substantially: it has gone from π_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.