Professional Perspective

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Trends in Private Company M&A Transactions: Target Counsel Legal Opinions (2021)

Editor's Note: This article is part of an ongoing series analyzing the results of the American Bar Association's (ABA) Private Target M&A Deal Points Studies. For more articles in this series and studies from prior years, see Bloomberg Law's collection of deal points Professional Perspectives authored by experts from Goulston & Storrs.

Contributed by Daniel Avery, Goulston & Storrs

Market Trends: What You Need to Know

One of the most pronounced practice-related trends in private company merger and acquisition transactions is the near-disappearance of target legal opinions as a closing deliverable. Though they were not long ago a common closing condition, target legal opinions have pretty much gone by the board in the private company M&A world.

According to the 2021 ABA study on U.S. private company deal terms, only 1% of the reported deals included the delivery of a target counsel legal opinion as a closing condition. This marks the continuation of a sharp decline in the requirement for target counsel legal opinions evidenced in ABA prior studies—dropping from 73% in 2005. M&A lawyers are generally slow to change their ways, making this decline a striking one when compared to other deal points, many of which are either holding steady, showing fluctuation with no apparent trend, or are trending at a slower pace.

Over this 14 year time period, in the M&A world, the combination of: (1) narrower scope and broader exceptions and carve outs in transactional legal opinions; (2) the expense involved; and (3) more recently, the proliferation of representation and warranty insurance; has yielded a broad consensus that absent special circumstances, target legal opinions no longer satisfy a basic cost-benefit analysis.

This article looks at the common scope of target counsel legal opinions in U.S. private company M&A transactions, as well as related market trends in this area. These trends are reflected in the American Bar Association's Private Target Mergers and Acquisitions Deal Points Studies, which cover U.S. M&A transactions involving privately held targets.

Introduction

In all types of business transactions, the parties rely heavily on their own counsel to negotiate business and legal points, and to draft the transaction documentation to reflect the agreed-upon terms. In addition to relying on due diligence on the representations and warranties contained in the transaction document, one party to a business transaction may require a written legal opinion from counsel to another party as a condition to the closing of the transaction.

Third-party legal opinions are more common in certain types of transactions than others. For example, in financial transactions, such as bank financings, these formal opinions are still quite common. Historically, opinions were similarly required from target company counsel in private company M&A transactions. However, over the past 15 years or so, these legal opinions have decreased in usage, to the point that they are rarely requested, absent unique and special circumstances, in private company M&A. The typical scope of these opinions is discussed below.

Common Scope of Target Counsel Legal Opinions

Third-party legal opinions do not come without significant legal time and resulting expense. Opining lawyers work hard to negotiate a legal opinion with stated limitations to minimize the possibility of a claim against the opining law firm. These limitations may include keeping substantive statements as narrow as possible, relying on certifications and other statements by the client and others, defining and limiting the materials reviewed, and stating exceptions and exclusions broadly. In addition, the opining law firm invests a significant amount of time reviewing all of the materials underlying an opinion, and many firms require multiple-partner or opinion committee review and approval of any written opinion letters.

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Theoretically, a buyer could request that any particular matter be addressed in a target counsel opinion. As a practical matter, however, there are fairly well-established customs and practices for these opinions, including the required topics, specific language used, documents reviewed, and customary qualifiers, exceptions, and assumptions. In recent years, the scope of "customary practice" has been the subject of resources developed by leading practitioners and professional organizations such as the American Bar Association. Further, some of these organizations have developed and published proposed "model" opinions, which have gained varying degrees of acceptance.

In a private M&A transaction, a target counsel legal opinion is most appropriate for legal issues best assessed, or easily verified, by target counsel. For example, because target's counsel is typically involved in preparing the necessary shareholder and director votes and resolutions approving the transaction (and in determining whether related by-law or other provisions regarding quorum, meeting notices, etc., have been followed) that counsel is in the best position to opine that the transaction has been duly authorized. See A.B.A, Model Asset Purchase Agreement (Model APA), Ex. 7.4(a) Opinion of Counsel to Seller (2001).

Apart from these more general transaction-specific matters, a buyer may, depending upon the circumstances, require an opinion to cover additional specific issues, including as to patents, tax, and litigation generally—i.e., beyond claims relating to the transaction itself. Target counsel legal opinions typically do not cover matters that the target's counsel cannot reasonably verify—such as issues impacted by the legal status or actions of the buyer—or purely factual matters or issues.

The buyer may insist on a target counsel legal opinion in an effort to prevent the target from later taking a position inconsistent with the opinion letter or to restrain the opining lawyer from representing the target in any claim at odds with the opinion. However, while the opining lawyer may be unwilling or unable to represent the target in such circumstances, it seems unlikely that the target itself would be prevented from asserting a defense even if inconsistent with the legal opinion.

Some buyers believe that a target counsel opinion can serve as a backstop or insurance for its own diligence lapses or for the target's own representations and warranties as to the matters covered in the opinion. However, using a third-party opinion as a backstop to due diligence may be of limited utility because opinion letters are typically much more narrow in scope than the corresponding target representations and warranties.

Moreover, while lawyers can be held responsible for intentional misconduct, recklessness, or negligence, they usually cannot be held liable "merely for being wrong"—as opposed to a target's liability for breach of representation or warranty, where simply "being wrong" may suffice to generate a claim even if absent intent, recklessness or other misconduct.

Trends in Target Company Legal Opinions

Every other year since 2005, the American Bar Association has released studies examining publicly available purchase agreements of transactions involving private companies. These transactions range in size but are generally considered as within the "middle market" for M&A transactions; the transaction values of the 123 deals within the 2021 study ranged from $30 to $750 million.

According to the 2021 ABA study, only 1% of the agreements included the delivery of a target counsel legal opinion as a closing condition.

This continues a sharp decline in the requirement for target counsel legal opinions evidenced in prior studies—dropping from 73% in 2005. The chart below reflects this significant shift in deal practice with respect to target legal opinions.

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GRAPHIC—Source: ABA Private Target Mergers and Acquisitions Deal Points Studies

Why the Trend?

The ABA studies report how deal points are being resolved in M&A documents, but they do not explain why some deal points may evolve over time. At present, there is no way to extrapolate from the studies the many considerations that go into the decision-making with respect to any given M&A deal point. However, it appears that M&A lawyers and their clients are concluding on an increasing basis that the benefits of a target counsel legal opinion simply do not outweigh the costs, both in time and expense.

The following factors may be influencing the cost-benefit analysis as to target counsel legal opinions:

- A target counsel legal opinion is a poor substitute for thorough due diligence, appropriate representations and warranties, and adequate remedies for claims
- The common use in these opinions of qualifiers—e.g., knowledge qualifiers tied to a small group of named attorneys in the firm giving the opinion), reliance on certificates from the target, and a narrow scope of documents reviewed, makes the opinion less meaningful
- There is a relatively small universe of legal topics that target counsel is in a materially better or more efficient position to determine
- Even if the buyer is requesting an opinion arising under another state's laws when that state's laws control the interpretation of the M&A documentation—e.g., as to enforceability), it is often more advisable for the buyer to seek local counsel to advise on such issues rather than relying on a third-party opinion letter
- Pressure on legal fees has sharpened the focus on the relationship between legal process and actual value to the client, and given the costs of drafting and negotiating a typically narrow third-party legal opinion, that particular document may be making the cut less often. However, this does not explain why in different transactional settings third-party legal opinions are still regularly and consistently required in other types of transactions

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- Representations and warranties insurance (RWI), which has become increasingly common in M&A transactions, provides an alternate means for allocating risks relating to many of the matters historically covered by target legal opinions to a third party—the insurer

This does not mean that third-party legal opinions are always inappropriate or useless. There may be circumstances where such an opinion is warranted and of real benefit to the buyer. For example, if the target has no prior experience in M&A transactions—e.g., a family business being sold by the family members—but has competent, long-standing counsel, the buyer understandably may want the additional comfort that a target counsel legal opinion may offer, recognizing that experienced opining counsel would likely apply a rigorous diligence standard to the statements within his or her opinion.

The same reasoning may apply if the buyer has general concerns as to the overall quality of the target's information produced in response to the buyer's due diligence inquiries. Notwithstanding that target counsel legal opinions are seen less and less in M&A transactions, buyers are certainly not "bound" by market practices and may still see the value in such an opinion as a closing deliverable, whether because of specific facts or diligence concerns, a risk-averse outlook, or otherwise.

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