**Ronald J. Gilson. “Value Creation by Business Lawyers: Legal Skills and Asset Pricing,”**

**94 Yale L.J. 269-280 (1984)**

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1. *Costs of Acquiring Information*

During the negotiation, the buyer and seller will face different costs of information acquisition for two important reasons. First, as a simple result of its prior operation of the business, the seller will already have large amounts of information concerning the business that the buyer does not have, but would like to acquire. Second, there usually will be information that neither party has, but that one or both would like and which one or the other can acquire more cheaply. The question is then how both of these situations are dealt with in the acquisition agreement so as to reduce the informational differences between the parties at the lowest possible cost.

At first, one might wonder why any cooperative effort is necessary. Assuming that the seller did not affirmatively block the buyer’s efforts to acquire the information the buyer wanted (and the seller already had), nothing would prevent the buyer from independently acquiring the desired information. Similarly, assuming both parties had the opportunity to acquire the desired new information, nothing would prevent both parties from independently acquiring it.

Actually, however, it is in the seller’s best interest to make the information that the seller already has available to the buyer as cheaply as possible. Suppose the seller refused to assist the buyer in securing a particular piece of information that the seller already had. If the information could have either a positive or negative value on the buyer’s evaluation of the worth of the business, a rational buyer would infer from the seller’s refusal to cooperate that the information must be unfavorable. Thus, the seller has little incentive to withhold the information.7[[1]](#footnote-1)1 Indeed, the same result would follow even if the information in question would not alter the buyer’s estimate of the value of the business, but only increase the certainty with which that estimate was held.7[[2]](#footnote-2)2 Once we have established that the seller wants the buyer to have the information, the only issue that remains is which party can produce it most cheaply. The total price the buyer will pay for the business is the sum of the amount to be paid to the seller and the transaction costs incurred by the buyer in effecting the transaction. To the extent that the buyer’s information costs are reduced, there simply is more left over for division between the buyer and seller.

Precisely the same analysis holds for information that neither party has yet acquired. The seller could refuse to cooperate with the buyer in its acquisition. To do so, however, would merely increase the information costs associated with the transaction to the detriment of both parties.

There is thus an incentive for the parties to cooperate both to reduce informational asymmetries between them and to reduce the costs of acquiring information either believes necessary for the transaction. As a result, we would expect an acquisition agreement to contain provisions for three kinds of cooperative behavior concerning information acquisition costs. First, the agreement would facilitate the transfer of information the seller already has to the buyer. Second, the agreement would allocate the responsibility of producing information that neither the seller nor the buyer already has to the party who can acquire it most cheaply, thereby both avoiding duplication of costs and minimizing those that must be incurred. Finally, the agreement would try to control overspending on information acquisition by identifying not only the type of information that should be acquired, but also how much should be spent on its acquisition.

a. *Facilitating the Transfer of Information to the Buyer*

In the course of negotiating an acquisition, there is an obvious and important information asymmetry between the buyer and the seller. The buyer will have expended substantial effort in selecting the seller from among the number of potential acquisitions considered at a preliminary stage7[[3]](#footnote-3)3 and, in doing so, may well have gathered all the available public information concerning the seller. Nonetheless, the seller will continue to know substantially more than the buyer about the business. Much detailed information about the business, of interest to a buyer but not, perhaps, to the securities markets generally, will not have been previously disclosed by the seller.7[[4]](#footnote-4)4

It is in the seller’s interest, not just in the buyer’s, to reduce this asymmetry. If the seller’s private information is not otherwise available to the buyer at all, the buyer must assume that the undisclosed information reflects unfavorably on the value of the buyer’s business, an assumption that will be reflected to the seller’s disadvantage in the price the buyer offers. Alternatively, even if the information could be gathered by the buyer (a gambit familiar to business lawyers is the seller’s statement that it will open all its facilities to the buyer, that the buyer is welcome to come out and “kick the tires,” but that there will be no representations and warranties), it will be considerably cheaper for the seller, whose marginal costs of production are very low,7[[5]](#footnote-5)5 to provide the information than for the buyer to produce it alone. From the buyer’s perspective, the cost of acquiring information is part of its overall acquisition cost; amounts spent on information reduce the amount left over for the seller.

This analysis, it seems to me, accounts for the quite detailed picture of the seller‘s business that the standard set of representations and warranties presents. Among other facts, the identity, location and condition of the assets of the business are described;7[[6]](#footnote-6)6 the nature and extent of liabilities are specified;7[[7]](#footnote-7)7 and the character of employee relationships--from senior management to production employees--is described.7[[8]](#footnote-8)8 This is information that the buyer wants and the seller already has; provision by the seller minimizes its acquisition costs to the benefit of both parties.

What remains puzzling, however, it is the apparent failure by both business lawyers and clients to recognize that the negotiation of representations and warranties, at least from the perspective of information acquisition costs, presents the occasion for cooperative rather than distributive bargaining.7[[9]](#footnote-9)9 Reducing the cost of acquiring information needed by either party makes both better off. Yet practitioners report that the negotiation of representations and warranties is the most time-consuming aspect of the transaction,8[[10]](#footnote-10)0 it is termed “a nit-picker’s delight, a forum for expending prodigious amounts of energy in debating the merits of what sometimes seem to be relatively insignificant items.”8[[11]](#footnote-11)1 And it is not merely lawyers who are seduced by the prospect of combat; sellers also express repugnance for a “three pound acquisition agreement”8[[12]](#footnote-12)2 whose weight and density owe much to the detail of the article titled “Representations and Warranties of Seller.” As a result, seller’s lawyers are instructed to negotiate ferociously to keep the document--especially the representations and warranties short. Increased information costs needlessly result. Indeed, a business lawyer’s inability to explain the actual function of these provisions can often cause the buyer incorrectly to attribute the document’s length to its own lawyer’s preference for verbosity and unnecessary complexity. This failure to explain can prevent recognition of value-creating activity even when it occurs.8[[13]](#footnote-13)3

b. *Facilitating the Production of Previously Nonexistent Information*

A similar analysis applies when the buyer needs information that the seller has not already produced. For example, the buyer may desire information about aspects of the seller’s operation that bear on the opportunity for synergy between its own business and that of the seller and that, prior to the negotiation, the seller had no reason to create. Alternatively, the buyer may be interested in the impact of the transaction itself on the seller’s business; whether the seller’s contracts can be assigned or assumed; whether, for example, the transaction would accelerate the seller’s obligations. Like the situation in which the buyer has already produced the information desired by the seller, the only issue here should be to minimize the acquisition cost of the information in question.

While the analysis is similar to the situation in which the seller had previously produced the information, the result of the analysis is somewhat different. Not only will the seller not always be the least-cost information producer, but there will also be a substantial role for third-party information producers. Returning to the synergy example, a determination of the potential for gain from the combination of the two businesses requires information about both. The particular character of the businesses, as well as the skills of their managers, will determine whether such a study is better undertaken by the seller, which knows its own business but will be required to learn about the buyer’s business, or by the buyer, which knows about its own business and is in the process of learning about the seller’s.8[[14]](#footnote-14)4

The more interesting analysis concerns the potential role for third-party information producers. This can be seen most clearly with respect to information concerning the impact of the transaction itself on the seller’s business. As between the buyer and the seller, the seller will usually be the least-cost producer of information concerning the impact of the transaction on, for example, the seller’s existing contracts. Although there is no reason to expect that either party routinely will have an advantage in interpreting the contracts, it is predictable that the seller can more cheaply assemble the facts on which the interpretation will be based. The real issue, however, is not whether the seller is the lower-cost producer out of a group of candidates artificially limited to the seller and buyer. Rather, the group of candidates must be expanded to include third parties.

The impact of including third-party information production in our analysis can be seen by examining the specialized information production role for lawyers in acquisition transactions. Even with respect to the production of information concerning the seller’s assets and liabilities, the area where our prior analysis demonstrated the seller’s prominence as an information producer, there remains a clear need for a specialized third party. Production of certain information concerning the character of the seller’s assets and liabilities simply requires legal analysis. For example, the seller will know whether it has been cited for violation of environmental or health and safety legislation in the past, but it may require legal analysis to determine whether continued operation of the seller’s business likely will result in future prosecution.

The need for third-party assistance is even more apparent with respect to information about the impact of the transaction itself on the seller’s business. Again, however, much of the information requires legal analysis; there exists a specialized information-production role for third parties. For example, it will be important to know whether existing contracts are assignable or assumable: The continued validity of the seller’s leasehold interests will depend on whether a change in the control of the seller operates--as a matter of law or because of the specific terms of the lease--as an assignment of the leasehold;8[[15]](#footnote-15)5 and the status of the seller’s existing liabilities, such as its outstanding debt, will depend on whether the transaction can be undertaken without the creditor’s consent.8[[16]](#footnote-16)6

In both cases, the seller’s lawyer appears to be the lowest-cost producer of such information.8[[17]](#footnote-17)7 As a result, I would expect typical acquisition agreements to assign lawyers this information-production role.8[[18]](#footnote-18)8 And it is from this perspective that important elements of the common requirement of an “Opinion of Counsel for the Seller” are best understood.

Any significant acquisition agreement requires, as a condition to the buyer’s obligation to complete the transaction, that the buyer receive an opinion of seller’s counsel with respect to a substantial number of items.8[[19]](#footnote-19)9 Consistent with my analysis, most of the matters on which legal opinions are required reflect the superiority of the seller’s lawyer as an information producer. For example, determination of the seller’s proper organization and continued good standing under state law, the appropriate authorization of the transaction by seller, the existence of litigation against the seller, the impact of the transaction on the seller’s contracts and commitments, and the extent to which the current operation of the seller’s business violates any law or regulation, represent the production of information which neither the buyer nor the seller previously had, by a third party--the lawyer--who is the least-cost producer.9[[20]](#footnote-20)0

Just as was the case in our examination of the function of representations and warranties, this focus on the information-production role for lawyers’opinions also provides a non-adversarial approach to resolving the conflict over their content. Because reducing the cost of information necessary to the correct pricing of the transaction is beneficial to both buyer and seller, determination of the matters to be covered by the opinion of counsel for seller9[[21]](#footnote-21)1 should be in large measure a cooperative, rather than a competitive, opportunity. Debate over the scope of the opinion, then, should focus explicitly on the cost of producing the information. For example, where a privately owned business is being sold, the seller often retains special counsel to handle the acquisition transaction, either because the company has had no regular counsel prior to the transaction, or because its regular counsel is not experienced in acquisition transactions. In this situation, recognition of the informational basis of the subject matter usually covered by legal opinions not only suggests that a specialized third-party producer is appropriate, but also provides guidance about *whose* third party should actually do the production.

From this perspective, seller’s counsel typically will be the least-cost producer of the information in question. Past experience with the seller will eliminate the need for much factual investigation that would be necessary for someone who lacked a prior professional relation to the seller. Similarly, seller’s counsel may well have been directly involved in some of the matters of concern--such as the issuance of the securities which are the subject of an opinion concerning the seller’s capitalization, or the negotiation of the lease which is the subject of an opinion concerning the impact of the transaction on the seller’s obligations. Where the seller has retained special counsel for the transaction, however, the production-cost advantage in favor of seller’s counsel will be substantially reduced, especially with respect to past matters. In those cases, focus on the cost of information production provides a method for cooperative resolution of the frequently contentious issue of the scope of the opinion.9[[22]](#footnote-22)2

c. *Controls Over What Information to Look for and How Hard to Try*

Emphasis on the information-production role of the seller’s representations and warranties and the opinion of counsel for the seller leads to the conclusion that determination of the least-cost information producer provides a cooperative focus for negotiating the content of those provisions. The same emphasis on information production also raises a related question. The demand for information, as for any other good, is more or less price elastic. Information production is costly even for the most efficient producer, and the higher the cost, the less the parties will choose to produce. Thus, some fine tuning of the assignment of information-production roles would seem to be necessary. We would expect some specific limits on the kind of information required to be produced. And we would also expect some specific limits on how much should be spent even for information whose production is desired.

Examination of an acquisition agreement from this perspective identifies provisions which impose precisely these kinds of controls. Moreover, explicit recognition of the function of these provisions, as with our analysis of representations and warranties and opinions of counsel, can facilitate the negotiation of what have traditionally been quite difficult issues.

Consider first the question of limiting the type of information that must be produced in light of the cost of production. To put the problem in a context, we can focus on the standard representation concerning the seller’s existing contracts. The buyer’s initial draft typically will require the seller to represent than an attached schedule lists “all agreements, contracts, leases, and other commitments to which the seller is a party or by which any of its property is bound.” In fact, it is quite unlikely that the buyer really wants the seller to incur the costs of producing all the information specified. In a business of any significant size, there will be a large number of small contracts--for office plant care, coffee service, addressographs, and the like--the central collection and presentation of which would entail substantial cost. Moreover, to the extent these contracts are all in the normal course of the seller’s business, the information may have little bearing on the pricing of the transaction. As a result, it would be beneficial to both parties to limit the scope of the seller’s search.

It is from this perspective that the function of certain common qualifications of the representations and warranties of the seller are best understood. The expected response of a seller to a representation as to existing contracts of the breadth of those mentioned would be to qualify the scope of the information to be produced: to limit the obligation to only *material* contracts.9[[23]](#footnote-23)3 If the contracts themselves are not important, then there is no reason to incur the cost of producing information about them. Variations on the theme include qualifications based on the dollar value of the contracts,9[[24]](#footnote-24)4 or on the relationship of the contracts to “the ordinary course of business.”9[[25]](#footnote-25)5

A second common form of qualifications--a limit on the information costs to be incurred-- is best understood as an instruction concerning how hard to look for information whose subject matter cannot be excluded as unimportant ahead of time. Here the idea is to qualify not the object of the inquiry, but the diligence of the search.9[[26]](#footnote-26)6 Consider, for example, the common representation concerning the absence of defaults under disclosed contracts.9[[27]](#footnote-27)7 While it might involve little cost to determine whether the seller, as lessee, has defaulted under a lease, it may well be quite expensive to determine whether the lessor is in default. In that situation, the buyer might consider it sufficient to be told everything that the seller had thought appropriate to find out for its own purposes, without regard to the acquisition, but not to require further investigation.

This type of qualification, limiting the representation to information the seller already has and requiring no further search, is the domain of the familiar “knowledge” qualification. In form, the representation concerning the existence of breaches is qualified by the phrase “to seller’s knowledge.” In function, the qualification serves to limit the scope of the seller’s search to information already within its possession; no new information need be sought.9[[28]](#footnote-28)8

Recognizing the function of the knowledge of qualification also raises another question concerning the variation in form that the qualification takes in typical acquisition agreements. In fact, the knowledge qualification--the limit on how hard the seller must search for information--comes in a variety of forms. Often within the same agreement one will see all of the following variations:

“to seller’s knowledge”;

“to the best of seller’s knowledge”;

“to the best of seller’s knowledge and after diligent investigation.”

What seems to be at work, at least implicitly, is the creation of a hierarchy of search effort that must be undertaken with respect to information of different levels of importance.9[[29]](#footnote-29)9

This result is perfectly consistent with a view of the business lawyer as a transaction cost engineer, and with a view of representations and warranties as a means of producing the information necessary to pricing the transaction at the lowest cost. However, it also raises the question of whether implicit recognition of the information-cost function of these qualifications might not facilitate the design of more effective cost reduction techniques. Although this is not the occasion to detail the changes in the form of acquisition agreements that might result from conscious attention to issues of information cost, it seems quite clear that once we understand more precisely what it is we are about, we should be able to do a more effective job.

Consider, for example, the qualifications that we have just discussed concerning how hard the seller must look. Given our understanding of their purpose, the problem of limiting the scope of the seller’s investigation might be better approached explicitly, rather than implicitly through a variety of undefined adjectives. If, for example, the concern is whether the lessor of a real estate lease, under which the seller is lessee, has breached the lease, why not specify the actual investigation the seller should make? Do we want the seller merely to inspect the premises to insure that the lessor’s maintenance obligations have been satisfied? Do we want the seller to go directly to the lessor to secure a statement by the lessor as to the lessor’s satisfaction of its obligations?10[[30]](#footnote-30)0 Different levels of cost obviously are associated with the different inquiries; specificity about the desired level of cost, however, should allow further minimization of information costs. To make the point in a slightly different way, is it possible to say with any assurance which of the forms of qualification listed above imposes an obligation to inspect the premises, but no obligation to inquire directly of the lessor?

1. 71See Grossman*, The Informational Role of Warranties and Private Disclosure About Product Quality*, 24 J.L. & *Econ.* 461, 479 (1981); Grossman & Hart, *Disclosure Laws and Takeover Bids*, 35 *J. Fin*. 323 (1980). The analysis becomes more complicated, however, if disclosure imposes other kinds of costs on the seller -- for example, disclosure of some accounting data might provide to competitors insights into the seller’s future strategy, and disclosure of product information might allow competitors more easily to duplicate the seller’s product. Where there are such proprietary costs to disclosure, the signal conveyed by nondisclosure becomes “noisy”: Non-disclosure may mean that the information kept private is negative; less ominously, it may mean that disclosure of the information would be costly. The result would be an equilibrium amount of non-disclosure. R. Verrecchia, *Discretionary Disclosure*, Working Paper No. 101, Center for Research in Security Prices (August 1983) (unpublished manuscript on file with author). While Verrecchia’s argument has important insights for the issue of voluntary disclosure in the setting of organized securities markets, it seems to me much less relevant in the acquisition setting. There the opportunity for face-to-face bargaining allows the use of techniques such as confidentiality agreements, *see* *Business Acquisitions*, *supra note* 45, at 399-401 (form of confidentiality agreement), that can substantially reduce such proprietary disclosure costs and, as a result, reduce any noise associated with failure to disclose. [↑](#footnote-ref-1)
2. 72In other words, the new information would not alter the mean estimate of value but would reduce the variance associated with the distribution of possible values. [↑](#footnote-ref-2)
3. 73For the purpose of search costs in the acquisition content, see Easterbrook & Fischel, *Auctions and Sunk Costs in Tender Offers*, 35 *Stan. L. Rev.* 1 (1982); Gilson, *Seeking Competitive Bids Versus Pure Passivity in Tender Offer Defense*, 35 *Stan. L. Rev.* 51 (1982). [↑](#footnote-ref-3)
4. 74For example, the potential for synergy between the seller’s business and that of a potential buyer will become of interest to the market only at the point where the possibility of the acquisition comes to the market’s attention. [↑](#footnote-ref-4)
5. 75The costs are still *not* zero. While the information exists, there are still costs associated with finding out where within the seller’s organization the information is located, putting it in a form that is useful to the buyer, and verifying it. As a result, even some information that already exists may not be worthwhile to locate and transmit. *See infra* pp. 278-80 (limitations on for what, and how hard, to look). Additionally, there will be situations where a third party will be able to produce the information even more cheaply than the seller. *See infra* pp. 274-76 (lawyer’s opinions). This qualification, however, does not alter the absence of conflict between the parties. [↑](#footnote-ref-5)
6. 76*See, e.g, Drafting Agreements*, *supra* note 45, at 81-94 (warranties disclosing identity and condition of real property and leases; compliance with zoning; composition, condition, and marketability of inventory; personal property and condition; accounts receivable and collectability; trade names, trademarks, and copyrights; patent and patent rights; trade secrets; insurance policies; and employment contracts). [↑](#footnote-ref-6)
7. 77 *Id.* at 76-81, 94-96, 118 (warranties concerning undisclosed liabilities, tax liabilities, compliance with laws, accuracy of financial statements, and pending or threatened litigation). [↑](#footnote-ref-7)
8. 78*Id.* at 93 (disclosure of all employment, collective bargaining, bonus, profit-sharing, or fringe benefit agreements). [↑](#footnote-ref-8)
9. 79I mean to put off for the moment the question of what happens when one of the seller’s representations and warranties turns out to be incorrect. I will take up the issue of indemnification for breach of warranty in connection with the verification function. *See infra* pp. 281-87. [↑](#footnote-ref-9)
10. 80 *See supra* note 70. [↑](#footnote-ref-10)
11. 81 J. Freund, *supra* note 45, at 229. [↑](#footnote-ref-11)
12. 82 *Id.* at 233. [↑](#footnote-ref-12)
13. 83 Freund, as usual is not guilty of this failure. His explanation for the phenomenon differs from mine, however. *See* J. Freund, *supra* note 45, at 230-34. [↑](#footnote-ref-13)
14. 84 The least-cost producer typically will be the buyer. Although the buyer will already know something about the seller, the seller will have had little reason to learn about the buyer’s business prior to initiation of negotiations. As a result, the amount that still must be learned about the other party’s business in order to evaluate the potential for synergy is likely to be smaller for the buyer than for the seller. This yields a prediction that should be subject to empirical testing. If my hypothesis is correct, I would expect to find few representations and warranties by the seller that could be understood to speak to conditions directly related to the manner in which the two entities could be combined. The *absence* of a representation by the seller, of course, leaves the information-production function with the buyer. [↑](#footnote-ref-14)
15. 85 For example, would a general clause prohibiting assignment of a lease by a corporate tenant prohibit the sale of all the tenant’s stock, or a merger of the tenant, or even the dissolution of the tenant and the succession to the tenancy by the tenant’s shareholders? *See* 1 M. *Friedman, Friedman on Leases* 244-52 (2d ed. 1983).

 [↑](#footnote-ref-15)
16. 86 Loan agreements typically limit a debtor’s freedom to merge or sell its assets without the creditor’s consent. *See* *Commentarie*s, *supra* note 47. From the creditor’s perspective, such protection is critical. The interest rate charged a debtor depends on the risk associated with the debtor’s business. If the business becomes substantially more risky after the credit is extended, the interest rate charged, in effect, is reduced. The consent requirement is designed to prevent a creditor from altering the risk of its business after the fact through acquiring, or being acquired by, a company with a riskier business. *See*  Smith & Warner, *supra* note47, at 126-27. [↑](#footnote-ref-16)
17. 87 The seller’s lawyer will likely have been involved in the original preparation of the documents and, as a result, will have much better information concerning their contents and the context in which they were negotiated.

For present purposes, there is no need to distinguish between outside counsel and lawyers employed full time by the seller. The issue of whether a particular staff function, like legal work, should be handled inside the firm or acquired in market transactions from outside providers can issue of vertical integration that does not bear on the question of whether lawyers--inside or outside--serve a valuable function. The distinction will take on importance, however, with respect to the verification function. *See infra* pp. 289-93. [↑](#footnote-ref-17)
18. 88 The information-production role for lawyers described in the text is not in itself sufficient to respond to my overall question of whether business lawyers can create value. The larger question, it will be recalled, focused on whether business lawyers had the potential to create value even in those situations where there is no traditionally “legal” role. Because the information-production role involves interpreting government regulations and construing the meaning of contracts--functions which are not responsive to the more difficult question with which I am especially concerned--they do not provide an easy way out. [↑](#footnote-ref-18)
19. 89 There is a substantial practical literature.  *See* *A. Jacobs, Opinion Letters in Securities Matters: Text--Clauses-- Law* (1983); Babb, Barnes, Gordon & Kjellenberg, *Legal Opinions to Third Parties in Corporate Transactions*, 32 *Bus. Law* 553 (1977); Bermant, *The Role of the Opinion of Counsel--A Tentative Reevaluation*, 49 *Cal. St.* B.J. 132 (1974); Committee on Corporations of the Business Law Section of the State Bar of California, *Report of the Committee on Corporations Regarding Legal Opinions in Business Transactions* 14 *Pac L.J.* 1001 (1983) [hereinafter cited as *California State Bar Report*]; Committee on Developments in Business Financing, *Legal Opinions Given in Corporate Transactions*, 33 *Bus. Law*. 2389 (1978); Fuld, *Legal Opinions in Business Transactions--An Attempt to Bring Some Order Out of Some Chaos*, 28 *Bus. Law.* 915 (1973); Special Comm. On Legal Opinions on Commercial Transactions, N.Y. County Lawyers’ Association, *Legal Opinions to Third Parties: An Easier Path*, 34. *Bus. Law*. 1891 (1979). [↑](#footnote-ref-19)
20. 90 The opinion of counsel also serves an important verification function. *See infra* pp. 290-93. [↑](#footnote-ref-20)
21. 91 Typically there will be occasions that call for an opinion of buyer’s counsel as well. Consistent with an information-cost analysis, the scope of the opinion of buyer’s counsel increases as information about the buyer becomes important to pricing the transaction. This would be the case, for example, where the two parties are so close in size that the transaction is really a merger, or where the consideration to be given by the seller is the buyer’s stock. In virtually all transactions, the opinion of the buyer’s counsel will be required with respect to the impact of the transaction itself, such as proper authorization of the transaction by the buyer. [↑](#footnote-ref-21)
22. 92 The role of information-producer also may be played by another third-party specialist: the public accountant. The accountant typically also renders an opinion concerning the transaction--the cold comfort letter--and easily can be imagined having an information-production role. The common presence of an internal accounting staff within the seller, however, persuades me that the transactional function of the public accountant is one of verification. *See infra* pp.290-93. Whether or not there is also an information-production role for the public accountant depends on the comparative information-production costs of the public accountant and the seller’s internal accounting staff. [↑](#footnote-ref-22)
23. 93 *See* J. Freund, *supra* note 45, at 272-74. [↑](#footnote-ref-23)
24. 94 *See* 3 *Business Acquisitions*, *supra* note at 45, 96-97 (“Set forth as Schedule G hereto are complete and accurate lists of the following: (i) all arrangements of the Seller, except for purchase and sales orders that involve future payments of less than $250,000 . . . .”). [↑](#footnote-ref-24)
25. 95 *See* Drafting Agreements, *supra note* 45, at 94 (“Neither corporation nor subsidiary is a party to, nor is the property of either bound by . . . any agreement not entered into in the ordinary course of business. . . except the agreements listed in Exhibit . [↑](#footnote-ref-25)
26. 96 This analysis, and that concerning the object of the inquiry, applies as well to the role of third-party information producers. [↑](#footnote-ref-26)
27. 97 *See, e.g.,* *Drafting Agreements*, *supra* note 45, at 94 (“There is no default or event that with notice or lapse of time, or both, would constitute a default by any party to any of these agreements.”) [↑](#footnote-ref-27)
28. 98James Freund identifies another function for representations and warranties that suggests a different role for the knowledge qualification. Freund points out that an unqualified representation serves, in effect, as an insurance policy. Thus, an unqualified representation may be made even though the seller is aware of a possibility that the representation is incorrect, because the parties have determined that the seller should bear that risk and the absolute representation serves to allocate that risk to the seller. *J. Freund*, *supra* note 45, at 247-48. From an information perspective, however, Freund’s point is part of an approach to dealing with the problem of information asymmetry. Suppose both the buyer and the seller are aware that certain of seller’s trade secrets may be subject to a misappropriation claim, and that such a claim, if successful, would reduce the value of the seller’s business by $1,000,000. It would hardly be surprising if the buyer and the seller had different estimates of the probability of a successful misappropriation claim; after all, the seller has vastly more information concerning the circumstances in which the trade secrets were developed than does the buyer. Suppose further that the buyer, based on its information, estimates the probability of liability at .5, and therefore argues that the purchase price should be reduced by $500,000. The seller, however, based on its information, estimates the probability at only .15, which would justify only a $150,000 reduction in the purchase price. The effect of the seller’s making an unqualified warranty concerning ownership of trade secrets is to allocate the risk of liability to the seller, the party with the best information and, therefore, the party best able to price the risk. From the buyer’s perspective, the risk has been eliminated. From the seller’s perspective, $350,000 has been gained: The expected value of the purchase price--total price less expected liability--is $350,000 higher than if the buyer’s estimate was used. Thus, unqualified representations and warranties can serve, as Freund perceptively suggests, as insurance policies. However, the determination of which party should be the insurer turns on the determination of which party has better information and, as a result, is better able to price the risk. [↑](#footnote-ref-28)
29. 99 This proposition--that different forms of qualification reflect the different levels of intended search effort--also may be subject to empirical evaluation. If one of the parties to an acquisition agreement is a reporting company under the Securities Exchange Act, its Form 10K Annual Report typically would contain the agreement as an exhibit. Thus, one could gather a substantial sample of acquisition agreements to analyze whether there was a pattern to the types of information subject to qualification and to the form of qualification used. [↑](#footnote-ref-29)
30. 100 If information is too costly to produce, the issue shifts to who is best able to price and bear the risk, again information-cost issues. [↑](#footnote-ref-30)