International Review of Law and Economics 38 (2014) 150–168

Contents lists available at ScienceDirect

International Review of Law and Economics

Lawyers: Gatekeepers of the sovereign debt market?

Michael Bradley[a], Irving De Lira Salvatierra[b,*], Mitu Gulati[c]

[a] Duke University, Fuqua School of Business & School of Law, United States
[b] Duke University, Economics Department, United States
[c] Duke University, School of Law, United States

ARTICLE INFO

Article history:
Received 13 January 2013
Received in revised form 30 August 2013
Accepted 3 September 2013
Available online 23 September 2013

Keywords:
Lawyers
Gatekeepers
Reputational intermediaries
Sovereign debt

ABSTRACT

The claim that lawyers act as gatekeepers or certifiers in financial transactions is widely discussed in the legal literature. There has, however, been little empirical examination of the claim. We test the hypothesis that law firms have replaced investment banks as the gatekeepers of the market for sovereign debt. Our results suggest that hiring outside law firms sends a *negative* signal to the market regarding the pending issuance; a finding that is inconsistent with the thesis that outside law firms primarily play a certification role in the sovereign debt market.

1. Introduction

The dominant view in legal scholarship is that transactional lawyers add value by serving as *reputational intermediaries*. The notion is that a key function of an elite law firm – like the function of an elite investment bank or accounting firm – is to "*rent*" its reputation to a pending transaction (Gilson, 1984). While this is a widely accepted thesis, the question is *how much* value do they create? No one seriously disputes that lawyers also do a lot of other more traditionally lawyerly things like helping with regulatory compliance, drafting contracts, finding tax loopholes and so on. No one also disputes that other institutions such as investment banks and accounting firms also serve as reputational intermediaries on many of the same transactions. But can we determine, as an empirical matter, whether the role that lawyers play as reputational intermediaries is a central one (as many in the legal literature suggest) or a marginal one (as some skeptics argue)?

The classic work on lawyers as reputational intermediaries is a 1984 paper by Ronald Gilson (Gilson, 1984). Gilson posits that transactional lawyers help reduce transactions costs. He observes that they do things like advise clients about future contingencies, identify differences in valuations among parties and generally help deals get done.[1] The key element of Gilson's thesis regarding the value added by lawyers, however, has to do with information costs. The big law firms that specialize in transactional work (M&A, private equity, debt issuances, public offerings, and so on) play the role of reputational intermediaries or, as it is often referred to, "gatekeepers".

Gilson's reputational intermediary story has generated a significant amount of debate.[2] The basic argument is that most large financial transactions involve significant asymmetric information or verification problems among the various players (investors, issuers, bankers, regulators, etc.). Because the parties involved in these transactions are generally not repeat "transactors", they cannot help solve these problems by credibly asserting that their own reputations are at stake. Counterparties are going to be concerned about the incentives to overstate the value of any transaction.[3] The large, modern law firms, however, are institutions that have built up reputations over decades, whilst serving a wide range of clients. They are repeat transactors, which gives them the ability to help solve information/verification problems by acting as intermediaries and lending their reputation to the transaction.[4]

The puzzle though is that there is nothing lawyerly about this function. Investment bankers and accountants also work in firms that are repeat transactors. Indeed, bankers and accountants often have more money at stake if their reputations are tarnished – witness the case of Arthur Anderson's demise in the wake of the Enron debacle.[5] And these institutions should be, in theory, able to perform at least the same reputational intermediary role being posited

* Corresponding author.
E-mail address: iad4@duke.edu (I. De Lira Salvatierra).

[1] *E.g.*, Gardner (2003) and Gilson and Mnookin (1995).

[2] *E.g.*, Barnett (2008, 2012), Dent (2009), Kim (2010), Carney, Dent, and Gilson (2011), and Wilkins (2010).

[3] *See* Gilson (1984), Okamoto (1995), and Bainbridge (2012).

[4] Ribstein (1998).

[5] E.g., Rauterkus and Song (2004).

0144-8188/$ – see front matter
http://dx.doi.org/10.1016/j.irle.2013.09.001

for law firms. Critics of the Gilson thesis, making this point and others, have questioned the extent to which the reputational bonding role of lawyers is significant.[6]

The theoretical literature has generated at least three unanswered empirical questions. First, how plausible is the reputational intermediary model for lawyers? Second, to the extent that the Gilson model is plausible, can we quantify how much value *lawyers* add in their role as reputational intermediaries? Third, how has the role of lawyers as reputational intermediaries evolved over time? We believe that our empirical analyses shed light on these questions.

The remainder of the paper is organized as follows. Section 2 provides the general context of the sovereign debt market and the related literature to reputational intermediaries. Section 3 describes our database. Section 4 presents our main results about lawyers as reputational intermediaries. Section 5 concludes.

2. Background and context

2.1. The sovereign debt market

We analyze the role of transactional lawyers through the lens of the market for sovereign debt. The basic characteristics of the sovereign debt market suggest that it should be a good area in which to test the lawyers-as-gatekeeper thesis. Sovereign issuers face three key problems. First, there is an asymmetric information problem. The finances of sovereigns tend to be opaque in the best of circumstances – the recent woes of the Euro area provide an illustration of this.[7] In addition, the primary asset of a sovereign is the willingness of its citizens to pay taxes – a difficult matter to predict. Foreign investors are at a particular disadvantage in terms of being able to observe the sovereign's finances or predict the future preferences of its voters.

Second, sovereigns are difficult to sue, and even more difficult to enforce contractual agreements against. Even with explicit waivers of sovereign immunity, finding assets to serve as collateral or repayment is an onerous task.

Third, while sovereigns are, in theory, infinitely lived entities, their agents (politicians and bureaucrats) are not. The primary goal of most politicians is to win elections, which necessarily gives them a short-term focus.

Reputational intermediaries could solve the foregoing problems. But they would have to: (1) demonstrate themselves as having the skill and ability to evaluate the complex and opaque information about the sovereign; and (2) be able to credibly show that they would have much to lose if their representations regarding a sovereign and a pending issue turned out to be incorrect. In theory, both investment banks and law firms that ply their trade in the sovereign debt market have the abilities and incentives described above.

Further, the sovereign debt area is one in which alternate explanations for what transactional lawyers do may be of limited importance – at least in comparison to domestic corporate issuances in the U.S. For example, consider three primary competitors of the reputational intermediary story where lawyers add value in terms of: (1) helping clients negotiate regulatory barriers; (2) performing due diligence in anticipating future contingencies and making sure that the terms of the debt contracts protect against things going wrong; and (3) assisting the client in dealing with legal claims. At first cut, none of these explanations seems to have much promise. First, there are few regulations governing the issuance of sovereign debt. Second, in terms of the effort that might be exerted in drafting and revising contracts, most of the documents are boilerplate. Third, in terms of lawyers providing protection against legal claims, sovereign debtors are relatively immune against lawsuits; after all, they are sovereigns. Given the foregoing, the reputational-intermediary story is a plausible explanation for the functions of lawyers in this market.[8]

We test the implications of this theory using an extensive dataset of sovereign bonds covering almost 200 years. In constructing this database we encountered numerous limitations due in part to the lack of regulatory requirements mandating very much disclosure on the part of issuers. In particular, we do not have information on how much individual law firms were compensated on specific transactions. The absence of information on the price of a product as vague as "reputational intermediary" makes it difficult to evaluate the quality of the product. Consequently, even if we are able to determine that it is likely that law firms are serving as reputational intermediaries in this market, the lack of information on how much they are charging makes it difficult to draw conclusions of how important this role is. Nevertheless, we believe that the empirical analysis that follows takes some steps toward tackling this and related issues.

2.2. Literature

There is a considerable literature examining the effects of intermediaries in providing credibility enhancements for products across a number of markets[9] Intermediaries do sometimes appear to play a role in adding credibility.[10]

Economics and finance scholars studying the reputational intermediary question generally assume that the reputation that underwriters bring to an issue is the primary mechanism for solving the asymmetric information problem.[11] This construct has led to an extensive literature relating the reputation of investment bankers to the cost of capital.[12] The evidence shows that investment banks with high reputations are associated with high quality, low-risk issuances and higher banker fees. The evidence also shows that investors are willing to pay a premium for certification of the quality of an issue, as investors interpret an agreement with a reputable underwriter as a positive signal regarding the quality of the issue.[13] Thus, reputable and larger investment banks appear to be associated with higher quality issues, lower yields and higher fees.[14]

Only a handful of studies have examined the impact of lawyers on the cost of capital and the majority of these studies focus exclusively on corporate issuances. To the extent that lawyer reputation matters in reducing the cost of capital, the relevant reputation is that of the underwriter's counsel.[15] The reputation of the issuer's counsel does not appear to reduce capital costs and may even increase them.[16]

In the context of the sovereign debt market, the most relevant work has been by Marc Flandreau and a series of coauthors

[6] E.g. Schwarcz (2007), Lipshaw (2008), and Ribstein (1998).

[7] The problem of opacity in sovereign finances has received attention recently, thanks to the crisis in the euro area. Academic papers have documented a wide range of accounting devices that have been used by sovereign issuers to try and mislead both regulators and the markets. E.g., Buti, Martins, and Turrini (2007), Dias, Richmond, and Wright (2011), Buchheit and Gulati (2013), and Irwin (2012).

[8] *See also* Buchheit (1995).

[9] Generally, see Klein (1997) and Jin, Kato, and List (2010).

[10] E.g., Gatti, Kleimeier, Megginson, and Steffanoni (2008) and Riley (2001).

[11] *See* Milgrom and Roberts (1982), Shapiro (1983), and Diamond (1989).

[12] *See* Chemmanur and Fulghieri (1994).

[13] *See* Fang (2005).

[14] *See* James (1992), Carter, Dark, and Sing (1998), Fang (2005), and Livingston and Miller (2000).

[15] *See* Barondes, Nyce, and Sanger (2007), Beatty and Welch (1996), and Fang (2005).

[16] *See* Fang (2005).