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Legal Opinions in SEC Filings

*Special Report of the Task Force on Securities Law Opinions, ABA Section of Business Law**

INTRODUCTION

Section 7(a) of the Securities Act of 1933 (the "Securities Act") requires a registration statement to contain the information specified in Schedule A to the Act.¹ Paragraph 29 of Schedule A requires the filing of "a copy of the opinion or opinions of counsel in respect to the legality of the issue."² The Securities and Exchange Commission (SEC) has addressed that requirement in Item 601 of Regulation S-K.³ Under paragraph (b)(5) of Item 601, a registration statement must include as an exhibit "[a]n opinion of counsel as to the legality of the securities being registered, indicating whether they will, when sold, be legally issued, fully paid and non-assessable, and, if debt securities, whether they will be binding obligations of the registrant."⁴ The opinion on legality appears as Exhibit 5 to a registration statement and is thus often referred to as an "Exhibit 5 opinion." This Report examines Exhibit 5 opinions.

PRELIMINARY MATTERS

Neither the statute nor the SEC rules indicate to whom an Exhibit 5 opinion should be addressed. Customary practice is for the opinion to be addressed to the issuer. Counsel to the issuer—either inside counsel or outside counsel—renders the opinion.

An Exhibit 5 opinion need not be included as an exhibit to a registration statement as initially filed. The only requirement is that it be filed as an exhibit before the registration statement is declared effective. Thus, the opinion often is filed with an amendment to the registration statement.

The fact that the opinion must be filed before—and in the case of shelf registrations, often long before—the securities are actually sold gives rise to issues

*The Task Force is a joint effort of the Committee on Legal Opinions and the Subcommittee on Securities Law Opinions of the Committee on Federal Regulation of Securities of the American Bar Association, Section of Business Law. Keith F. Higgins served as reporter for this Report.

1. 15 U.S.C. § 77g(a) (2000).

2. *Id.* § 77aa(29).

3. 17 C.F.R. § 229.601 (2003). A similar requirement for small business issuers appears in Regulation S-B, and references in this Report to Item 601 of Regulation S-K also refer to the comparable provision of Regulation S-B. *Id.* § 228.601.

4. *Id.* § 229.601(b)(5).

about the appropriateness of assumptions that are included in the opinion. These assumptions are discussed below.

Rule 436 under the Securities Act requires that a written consent of counsel be filed as an exhibit to a registration statement, “[i]f any portion of the . . . opinion of . . . counsel is quoted or summarized as such in the registration statement or in a prospectus. . . .”⁵ This requirement has led to speculation whether counsel rendering an Exhibit 5 opinion, whose name is included in the prospectus as having passed on the legality of the securities, is considered an expert for purposes of section 7 of the Securities Act. The statute itself refers to:

any accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him [who] is named as having prepared or certified any part of the registration statement, or is named as having prepared or certified a report or valuation for use in connection with the registration statement. . . .”⁶

The statute does not specifically refer to lawyers, an omission that may explain why Rule 436 refers to the consent of “an expert *or* counsel.”⁷ In any event, Rule 436 requires that a consent of counsel “be filed as an exhibit to the registration statement.”⁸ That consent is both to the filing of the opinion as an exhibit to the registration statement, and to the reference to counsel in the related prospectus. As a drafting matter, most lawyers include the consent in the opinion. Some also add a statement to the effect that the filing of the consent shall not be deemed an admission that counsel is an expert within the meaning of section 7 of the Securities Act. The SEC staff has not objected to “no admission” language. The SEC staff has objected, however, to language affirmatively denying that counsel is an expert within the meaning of the Securities Act. Whether counsel includes the “no admission” language or not should have no bearing on whether counsel is or is not an expert under section 7.

Rule 436(f) under the Securities Act specifies that, if an opinion filed as an exhibit relies on an opinion of another counsel, the consent of that other counsel need not be provided.⁹ The SEC staff has taken the position, however, that a signed copy of the opinion relied on must be included as an exhibit to the registration statement.

Third party closing opinions often expressly limit their use. If an Exhibit 5 opinion were to state that it may be relied on only by the issuer, the SEC staff would almost certainly object, viewing such a limitation as being inconsistent with the purpose of paragraph 29 of Schedule A to the Securities Act.

5. *Id.* § 230.436(a).

6. 15 U.S.C. § 77g(a) (2000).

7. 17 C.F.R. § 230.436(a) (emphasis added).

8. *Id.*

9. *Id.* § 230.436(f).

PARTICULAR CLASSES OF SECURITIES

EQUITY SECURITIES

Substantive Requirements

Item 601 of Regulation S-K requires that the opinion state that the securities, when sold, will be:

- Legally issued
- Fully paid, and
- Non-assessable.¹⁰

The phrase “legally issued,” although taken directly from the language of the Securities Act, is not the language lawyers customarily use when rendering a third party closing opinion on equity securities. Thus, in Exhibit 5 opinions, many lawyers use the more customary formulation that the securities have been “duly authorized and, [when sold in accordance with the provisions of the applicable purchase agreement], will be validly issued, fully paid and nonassessable.”¹¹

The SEC staff does not insist on the “legally issued” language and many opinion givers use “duly authorized” and “validly issued” instead.¹² This is the language normally used in third party closing opinions, and its meaning (as well as the meaning of “fully paid and non-assessable”) is the subject of numerous bar association reports.¹³

Because the Exhibit 5 opinion is delivered before the securities are sold, opinion givers often cast the opinion in the future tense, stating that the securities will be validly issued, fully paid, and non-assessable upon their sale in accordance with the applicable purchase agreement or governing document. Opinion givers also sometimes condition the opinion on further action by the board or a board committee. Opinion givers should be careful about the breadth of any such assumptions. Although an opinion giver may appropriately assume that the pricing committee of the board has taken the action necessary to set the sale price,¹⁴ the SEC staff may object to an assumption that the board, or a pricing committee, has taken all required action prior to the issuance and sale of the securities. In general, assumptions should be limited to matters that structurally cannot be completed before effectiveness of the registration statement.

10. *Id.* § 229.601(b)(5).

11. DONALD W. GLAZER ET AL., *GLAZER AND FITZGIBBON ON LEGAL OPINIONS: DRAFTING, INTERPRETING AND SUPPORTING CLOSING OPINIONS IN BUSINESS TRANSACTIONS* § 10.1, at 331–32 n.3 (2d ed. 2001) (indicating that counsel for the company normally renders an opinion that shares “have been duly authorized and validly issued and are fully paid and nonassessable.”).

12. Due authorization is subsumed in validly issued even if not stated separately. *Id.* § 10.5. Thus, “validly issued” should be sufficient.

13. *See, e.g.*, TriBar Opinion Committee, *Third-Party “Closing” Opinions: A Report of the TriBar Opinion Committee*, 53 BUS. LAW. 591, 648–50 (1998) [hereinafter TriBar 1998 Report] (discussing third party closing opinions). Many of the bar association reports describe opinion practice in particular states. By following the approach taken for third party closing opinions, opinion givers should be able to rely on the substantial body of literature describing customary practice regarding those opinions.

14. For example, this practice is usually followed when, in reliance on Rule 430A, the registration statement is declared effective before pricing occurs. *See* 17 C.F.R. § 230.430A(a) (2003) (indicating that a registration statement that omits the public offering price may be declared effective).

Opinions on Delaware Corporations by Counsel Not Admitted to Practice in Delaware

Counsel not admitted to practice in Delaware often render Exhibit 5 opinions on stock issued by Delaware corporations. Usually, they include in their opinions a so-called coverage limitation, limiting the scope of the opinions to the Delaware General Corporation Law. In the late 1990s, a question arose over the scope of the law covered by legality opinions on stock issued by Delaware corporations. In the registration review process, the SEC staff frequently commented that this limitation unacceptably limited the scope of the opinion because, on its face, it seemed to focus only on the Delaware corporation statute and not on the Delaware Constitution and judicial interpretations. That controversy has been largely resolved.

Representatives of the ABA Section of Business Law met with the staff and explained that the reference to the "Delaware General Corporation Law" was an opinion drafting convention, and that the practicing bar understood this phrase to cover the Delaware General Corporation Law, the applicable provisions of the Delaware Constitution, and reported judicial decisions interpreting these laws. Based on these discussions, the staff revised its procedures. These new procedures, which are described in the SEC Division of Corporation Finance's November 2000 *Current Issues and Rulemaking Projects* outline, are as follows:

- [The staff] will issue a comment asking counsel to confirm . . . in writing that it concurs with [the staff's] understanding that the reference and limitation to "Delaware General Corporate [sic] Law" includes the statutory provisions and also all applicable provisions of the Delaware Constitution and reported judicial decisions interpreting these laws. As part of this standard comment, [the staff] will ask that counsel file this written confirmation as correspondence on the EDGAR system. As such, it will be part of the Commission's official file regarding the related registration statement.
- Once [the staff has received] this written confirmation from counsel, [the staff] will not comment further on the inclusion of this language in the opinion for that registration statement.¹⁵

The revised procedure satisfies SEC staff concerns, although it creates what many view as the unnecessary step of having to confirm in writing to the SEC the customary meaning of opinion language. Many lawyers now include the required confirmation directly in their Exhibit 5 opinions.

DEBT SECURITIES

Binding Obligations

For debt securities, Item 601 of Regulation S-K requires the filing of an opinion that the securities will be "binding obligations of the registrant."¹⁶ In practice, this

15. SEC Division of Corporate Finance, *Current Issues and Rulemaking Projects*, at 58 (Nov. 14, 2000), available at <http://www.sec.gov/pdf/cfcr112k.pdf> (last visited July 10, 2004).

16. 17 C.F.R. § 229.601(b)(5) (2003).

opinion, often referred to as the “remedies” or “enforceability” opinion, is stated in various ways. Perhaps the most common formulation is that the debt securities constitute valid and binding obligations of the issuer, enforceable against the issuer in accordance with their terms “except as may be limited by bankruptcy, insolvency or other similar laws affecting the rights and remedies of creditors generally and general principles of equity.”¹⁷ Minor differences in wording do not change the meaning of the opinion.¹⁸

Exhibit 5 opinions on debt securities typically refer to the debt instruments themselves rather than the indenture under which they are issued. An enforceability opinion on the debt securities covers those portions of the indenture that relate to the terms of the securities, including any terms in the indenture that further define terms in the securities, such as the terms for conversion.

Governing Law

Unlike the law governing the validity of equity securities (which is the entity law of the jurisdiction in which the issuer is organized), the law governing the enforceability of debt securities is generally the law chosen in the instrument under which the securities are issued. Often New York law is chosen to govern the obligations of the issuer in a registered debt offering. When counsel for the issuer is not in a position to render an opinion on New York contract law, underwriters may be willing to accept an opinion on the enforceability of the debt as if the law of counsel’s home jurisdiction applied.¹⁹ That practice is not acceptable to the SEC staff. The Securities Act requires an opinion on the legality of the issue, and the SEC staff takes the position that anything short of an opinion on the law that governs the enforceability of the debt securities will not suffice.²⁰

Non-Standard Exceptions

Sometimes counsel includes exceptions, in addition to the standard bankruptcy exception and equitable principles limitation, to identify issues that affect the enforceability of particular provisions of the securities being registered. When including additional exceptions, counsel should consider whether they relate to issues requiring disclosure in the prospectus. In addition, counsel should be prepared for possible SEC staff comments.²¹ If the exceptions simply make explicit what is understood as a matter of customary practice to be implicit or otherwise are not material, additional exceptions should not require prospectus disclosure.

17. TriBar 1998 Report, *supra* note 13, at 622–23 (noting the bankruptcy exception and equitable principles limitation to an “enforceability” opinion). The bankruptcy exception and equitable principles limitation are standard exceptions that are understood to apply even when not stated expressly. These exceptions do not require disclosure, and the SEC staff does not normally comment on them.

18. *Id.* at 619–20.

19. *Id.* at 635 n.98.

20. See *Current Issues and Rulemaking Projects*, *supra* note 15, at 58.

21. Counsel should keep in mind that “boilerplate” exceptions that do not relate to the securities being offered are likely to be questioned by the SEC staff.

OPTIONS, WARRANTS, AND RIGHTS

Rights to acquire securities, either equity or debt, are contractual rights. In that respect they are more like debt securities than equity securities.²² In the case of warrants, for example, an opinion that a warrant is validly issued, fully paid, and non-assessable would be inapt because these concepts relate to stock—not contractual obligations.

An Exhibit 5 opinion on warrants should address their enforceability under the law chosen to govern the warrants. Typically, the offer and sale of the warrants and the securities underlying the warrants are registered at the same time. In that case, the Exhibit 5 opinion should state not only that the warrants are enforceable, but also that the underlying securities have been duly authorized and, upon delivery in accordance with the terms of the warrants, will be validly issued, fully paid, and non-assessable.

PARTICULAR TYPES OF OFFERINGS

Opinion practice varies, depending not only on the type of securities being offered, but also on the type of offering. The Exhibit 5 opinion—not simply the form of opinion—must be on file when the registration statement is declared effective. When a significant period elapses between effectiveness and the sale of the securities, special issues may arise.

SHELF OFFERINGS

Shelf offerings under Rule 415 permit issuers to offer and sell securities long after a registration statement becomes effective.²³ Moreover, in the case of universal shelf registrations, the class or classes of securities to be offered and sold may not be known on the effective date. Exhibit 5 opinion practice has adjusted to accommodate shelf offerings.

Shelf Registrations for Specific Securities

When an issuer registers common stock to be issued from time to time in the future, the opinion should state that the shares have been duly authorized. The remainder of the opinion, however, often requires assumptions that various actions will be taken before the securities are issued. In addition to the assumptions that apply whenever shares are being issued in the future, such as the issuer's receipt of the required consideration, the opinion giver may need to assume expressly, among other matters, that:

- The board of directors adopts resolutions approving the issuance and sale of the common stock at a specified price or pursuant to a specified pricing mechanism.

22. This is the case even though an option, warrant, or right fits the definition of "equity security" in Rule 405 under the Securities Act. 17 C.F.R. § 230.405 (2003).

23. *Id.* § 230.415.

- If the issuer is in a regulated industry and requires regulatory approval pursuant to the law under which it was incorporated or a similar statute, it has obtained any necessary regulatory approvals.

These assumptions are perfectly appropriate, and the SEC staff has not objected to them before the shelf registration statement is declared effective.²⁴

Most issuers filing a shelf registration statement for common stock register a specific number of shares rather than an aggregate dollar amount.²⁵ If the issuer decides to register an aggregate dollar amount of common stock, the opinion giver should assume that no more than a specified number of shares, based on the then current market price, will be issued and sold under the registration statement. That number should be available under the issuer's currently authorized common stock in its charter. If the issuer ultimately wishes to sell more shares than were covered by the original opinion, a new opinion should be filed, at the time of the takedown, covering the shares being issued.

Universal Shelf Registrations

Universal shelf registrations permit issuers to register an aggregate dollar amount of securities, designating by class the various types of securities (e.g., common stock, debt securities, convertible debt securities, preferred stock, and warrants) that may subsequently be issued, but not allocating the dollar amount among those classes of securities. A universal shelf registration statement thus requires more assumptions than even a shelf registration for a particular class of security. The board of directors will not have approved the terms of the debt securities or preferred stock at the time of effectiveness of the shelf registration statement. In the case of common stock, the issuer may not have sufficient authorized shares to permit an opinion that, were the issuer to elect to sell the entire aggregate dollar amount of securities registered as common stock at current market prices, the stock to be sold has been duly authorized.²⁶ Assumptions, therefore, are necessary, and the SEC staff has not objected to opinions that include reasonable assumptions.

Filing Updated Opinions

Shelf registration was not contemplated at the time Congress enacted the legality opinion requirement. Permitting assumptions in these opinions is necessary for the shelf registration process to work. Although the SEC has not adopted a rule that requires the filing of an updated opinion at the time of a shelf takedown,

24. *But see* the discussion *infra* entitled "Filing Updated Opinions."

25. Although an aggregate dollar amount of securities can be registered under Rule 457(o), 17 C.F.R. § 230.457(o) (2003), choosing that option would result in the issuer's being able to sell fewer shares if the price of the common stock increases from the price used to determine the registration fee.

26. This problem can be solved by assuming that, after the sale of shares of common stock under the registration statement, the total issued shares will not exceed the number authorized in the issuer's charter.

it has expressed the view that such an updated opinion is required. In note 47 of Release 33-6714, the SEC stated:

Although certain qualified legality opinions may be filed as an exhibit to such a registration statement that is declared effective, after pricing and prior to sales an unqualified opinion (and consent) must be filed on Form 8-K [17 CFR 249.308] and thus incorporated by reference into the registration statement or must be contained in a post-effective amendment.²⁷

The Division of Corporation Finance has affirmed this position in its *Manual of Publicly Available Telephone Interpretations*, in which it states that it will accept a "qualified opinion" at the time of effectiveness, "subject to the understanding that an unqualified opinion will be filed [before] any sales are made under the registration statement."²⁸

In filing an updated opinion, an issuer can make an exhibit-only filing pursuant to Rule 462(d), which provides for the immediate effectiveness of post-effective amendments filed solely to include exhibits.²⁹ Alternatively, for shelf offerings conducted by an issuer under Rule 415(a)(1)(x), which must be registered under Forms S-3 or F-3, the opinion may be incorporated by reference into the registration statement through a Form 8-K or 6-K filing.³⁰

ACQUISITIONS AND EXCHANGE OFFERS

Acquisitions and exchange offers that involve the offer and sale of securities are registered on Form S-4. These registration statements require an Exhibit 5 opinion on the securities being issued in the acquisition. Often the issuance of the securities being registered requires the approval of shareholders. Such is the case in many stock-for-stock mergers, whether as a requirement of state corporation law or a securities exchange. Because an opinion must be on file before the registration statement is declared effective, as with shelf registrations, these opinions may be based on the express assumption that the required shareholder approval has been received.³¹ The SEC staff does not require a new opinion following shareholder approval.

27. Elimination of Certain Pricing Amendments and Revision of Prospectus Filing Procedures, 52 Fed. Reg. 21,252, 21,255 n.47 (June 5, 1987).

28. SEC Division of Corporation Finance, *Manual of Publicly Available Telephone Interpretations*, at D.11 (1997), available at <http://www.sec.gov/interps/telephone/1997manual.txt> (last visited July 10, 2004).

29. 17 C.F.R. § 230.462(d) (2003).

30. *Id.* § 230.415(a)(1)(x).

31. An assumption may not be necessary, however, where the shareholder approval is obtained solely to satisfy listing requirements. Shares would still be validly issued even if a listing rule is violated.