'Fire sale' mergers: Why turkeys vote for Thanksgiving

By Edwin B. Reeser

Failures of large law firms and the consequences to all parties are closely followed and well chronicled. The pain inflicted financially and emotionally upon all parties is severe, especially in bankruptcy. Unlike many business failures, law firm collapses seem to occur rapidly, and catch many parties, including equity partners, genuinely by surprise.

One reason for this surprise, besides lack of information and disclosure from management, is the widely held belief that capable lawyers with substantial books of business don't need to worry. The perception is partners can avoid involvement in firm management, work hard, and with enough business they can go anywhere, even when leaders mismanage the firm into bankruptcy. That assumption has now been demonstrated to be untrue in many circumstances.

First, as an "insider," the equity partner is subject to disgorging "constructively fraudulent" distributions received for a period of up to two years under federal bankruptcy law, and perhaps four years or more under some state laws. Two years of draws and year-end distributions for partners is a lot of "clawback" money.

Second, ongoing client matters don't belong to partners with the client relationship, they are assets of the firm. Consider Mary, an equity partner moving to a new firm: Under currently applicable interpretation of statutory and case law on fiduciary duty of a partner to her partnership, Mary must disgorge all profits from the "unfinished business" she takes to her new law firm. That is a lot of "clawforward" money for Mary and her new firm.

Law firms pursuing growth through lateral hiring have awakened to their direct liability exposure to Mary's old firm for profits earned on her unfinished business, which may take years to complete. How much should they pay Mary for that business? If Mary has a $10 million annual business inventory, where 100 percent of the profit is disgorged to the prior failed firm, the answer is "not much." That remains the answer whether Mary's business is $2 million or $20 million per year.

There are plenty of open arguments still to be heard. What is "profit?" Should equity partners in the new firm receive compensation for services rendered on Mary's unfinished business cases? Should Mary receive compensation for her services on those cases? While those issues are worked out, in the meantime, what happens to law firms that want to, or in many instances need to, hire lateral talent from law firms that have failed, are failing or at risk of failing within the next several years (assuming one could even forecast this). Conversely, how does talent such as Mary free herself of that risk, which can damage if not destroy her portability? For both law firms and partners, the horrendous cost of bankruptcy, and being tied up for years in litigation with uncertain outcomes, is not a practical option.

Since both suitor law firms and Mary are motivated to find a solution, they will find one, unless and until the conundrum of "unfinished business" is resolved to eliminate it.

That solution is the "fire sale" merger. Mary's firm, at the urging of Mary and her similarly situated partners, agrees to be "acquired" by a new and typically much larger law firm. This transaction will be more like a packaged "orderly dissolution and liquidation" effected over a couple of years. The new firm takes on the revolving debt of the failing law firm and pays it down with collection of the failing firm's accounts receivable. Unlike bankruptcy scenarios where accounts receivable are collected at deep discounts, continuing businesses collect accounts at realization rates near historical experience. This can be a difference of many millions of extra dollars otherwise lost in the bankruptcy route, now available to pay creditor claims of Mary's firm.

The new firm will also take on staff, associates, and contract partners in numbers sufficient to avoid triggering WARN Act liabilities, a "springing" liability in many law firm bankruptcies that can amount to millions of dollars. They will then be let go gradually, retaining only the most profitable.

Furnishings, fixtures and equipment are practically worthless in a dissolution, but they do have value in a combination as they come to the transaction "free."

> The costs associated with the failure in a bankruptcy are either not incurred, or born heavily by the lower end of the spectrum of staff, associates, contract partners, and those equity partners that the new firm doesn't retain.

Malpractice claims in bankruptcy, especially as a defense to collection actions by trustees, rise dramatically in law firm failures. But in mergers, malpractice claims don't spike, saving large amounts of money.

Leases of surplus space are disposed of in an orderly fashion. Even though it may be necessary to dispose of excess space at a loss, given time it can be done reasonably, and "merger" terms can place the bulk of that cost upon the failed firm's partners.

The costs associated with the failure in a bankruptcy are either not incurred, or born heavily by the lower end of the spectrum of staff, associates, contract partners, and those equity partners that the new firm doesn't retain. Mary doesn't even have to take responsibility for having made it happen. She didn't fire them, she just arranged for somebody else to do it. She keeps her income level, avoids both clawback and clawforward liabilities, and her new firm gets gross revenue and profits gains.

A good deal for every one? Certainly people that lose their jobs might disagree. But for the acquiring firm and the acquired partners who were willing to sacrifice their staff and attorneys to protect their own interests, a significantly better deal than bankruptcy.

So, is there a catch? How do partners in the acquired firm feel about going to a new enterprise that is comfortable accommodating large scale culling of attorneys and staff? Do you want to be their partner? What assurance is there that you will not be on the menu soon? Should you expect to be treated any differently? If you are the acquiring firm, are you excited about bringing in new partners prepared to sacrifice so many of their own? Perhaps the answer is they all fully understand and are prepared to do it.

Knowing all this, how does one get partners to vote for a deal where it is clear that significant numbers will be sacrificed? How do you get turkeys to vote for Thanksgiving?

One way is to not tell the partners in Mary's firm everything. Thanksgiving is described as a future with compatible cultures, expanded platforms with breadth of service capabilities for clients, and new opportunities. The picture is carefully painted to show decorations, table settings, plates and crystal, potatoes, beans, corn, yams, stuffing, wine and cranberry...but not the turkey platter. Contrasted with the bankruptcy scenario, and omitting who gets to be the main course, it could lead to a solid majority vote for the "merger."

A second way is for Mary's firm to make it clear that everyone is in line for the chopping block through a bankruptcy proceeding. The approach is to use the new firm as a refuge while partners find a place they want, without the damage from a bankruptcy of their old firm. Turkeys vote for Thanksgiving when they plan to get off the farm before the holiday. The new firm will be left with little of Mary's firm in a few short years, other than sunk costs in trying to do an opportunistic acquisition of key talents.

Both types of arrangements have taken place in recent years.

The middle and lower tier equity partners, even if they are converted to nonequity status, reduced in income shares, or counseled out of the firm altogether, are better off in the fire sale merger than in bankruptcy. They avoid the clawbacks and clawforwards just as Mary does. They will likely forfeit all or some portion of their capital, but that was likely to happen in bankruptcy anyway. What is difficult for their class is that they will be obligated to forfeit capital in the old firm, and then lose their job anyway.

Thus in a very real economic sense, about one-third of the equity partners in Mary's firm are trading off the equity of two-third of the partners in number and the WARN Act benefits of others, to work the fire sale merger that preserves their job and income status. Most of the middle and lower tier partners have had little or no involvement in the decision-making of the firm that brought it to failure, but they will pay for it. Now they wake up to the significant difference between being invited to "have skin in the game" and "the game of being skinned" as an equity partner. Pass the cranberry, and let's have a show of hands for all in favor of Thanksgiving.

Edwin B. Reeser *is a business lawyer in Pasadena specializing in structuring, negotiating and documenting complex real estate and business transactions for international and domestic corporations and individuals. He has served on the executive committees, and as an office-managing partner of firms ranging from 25 to over 800 lawyers in size.*

On the Move

Holder appoints US attorney to committee

Attorney General Eric Holder appointed Laura E. Duffy of the Southern District of California to serve a two-year term on the attorney general's advisory committee. President Barack Obama appointed Duffy as U.S. attorney in June 2010. Prior to that, she was assistant U.S. attorney in the district as deputy chief of the general crimes section.

Reed Smith adds partner

Reed Smith LLP added Steven S. Baik as partner in Palo Alto. He focuses on patent litigation and has counseled in patent portfolio development and offensive and defensive licensing and litigation. Baik comes to the firm from Freitas, Tseng, Baik & Kaufman, which he formed with three other former partners from Orrick, Herrington & Sutcliffe LLP.

Munger Tolles adds of counsel

Munger, Tolles & Olson LLP added Dan B. Levin as of counsel in Los Angeles. He will join the firm's litigation and appellate practice effective Jan. 3. Levin comes to the firm from the U.S. attorney's office in the Central District, where he was deputy chief of the criminal appeals section.

Best, Best & Krieger adds of counsel

Best, Best & Krieger LLP added Steven E. Lake as of counsel in San Diego. He focuses on representing public educational agencies in compliance matters involving Individuals with Disabilities Education Act, section 504 of the Rehabilitation Act and the Americans with Disabilities Act. Lake returns to the firm after serving as senior counsel for academics and disability for the school district of Palm Beach County. He had previously worked with Best, Best & Krieger from 2006 to 2007.

Shearman & Sterling promotes one

Shearman & Sterling LLP promoted Dana C. F. Kromm to partner in San Francisco. She focuses on public and private mergers and acquisitions and related corporate governance matters. Kromm joined the firm in 2008 from O'Melveny & Myers LLP.

Wilson Sonsini promotes seven

Wilson Sonsini Goodrich & Rosati promoted Samir Elamrani, Tung-On Kong, James P. McCann, Scott K. Murano, Rachel B. Proffitt, Lisa Stimmell and Michelle Wallin as partners. Elamrani is based in San Diego and focuses on intellectual property. Kong specializes in patent litigation in San Francisco. McCann focuses on real estate and environmental, and Wallin focuses on employee benefits and compensation, both in Palo Alto. Also in Palo Alto are Murano, Proffitt and Stimmell, all of whom specialize in corporate and securities matters.

Wendel Rosen promotes one

Oakland-based Wendel, Rosen, Black & Dean LLP promoted Gregory K. Jung to partner, effective Jan. 1. He focuses on commercial litigation involving real estate, construction, insurance and intellectual property disputes. Jung joined the firm in 2006 from DLA Piper in San Francisco.

— Connie Lopez

otm@dailyjournal.com

BRIEFLY

Several telemarketers pleaded guilty Friday to federal felony charges involving taking more than $11 million from underwater homeowners seeking loan modifications and failing to perform the service. Defendants Gary Bobel, Scott Thomas Spencer, Mark Andrew Spencer and Travis Iverson pleaded guilty to conspiracy charges relating to wire fraud, money laundering and tax evasion, and Bobel also pleaded guilty to a separate tax evasion charge. Prosecutors said the men, while working for an Oceanside company called 1st American Law Center, used high-pressure sales tactics and lies to convince more than 4,000 struggling homeowners across the U.S. to pay between $1,995 and $4,495 for loan modification services that were never furnished. A fifth defendant in the scheme, Roger Jones, pleaded guilty to conspiracy last year and was sentenced to nearly two years in prison. Bobel, Scott Spencer and Mark Spencer and Iverson face up to five years in prison on the conspiracy charge, and Bobel faces an additional five years behind bars on the tax evasion charge. Sentencing is set for March 9.

Minimum vehicle liability insurance limits must be raised

Continued from page 1

These 1929 amendments required the suspension of the operator's license and registration of any motorist who failed to satisfy a traffic accident judgment in excess of $100 for property damage or for damage in any amount on account of bodily injury or death. The suspension could not be set aside unless and until the judgment debtor paid the judgment up to certain amounts set forth in the statute and gave proof of financial ability to pay any future claims based upon the negligent operation of a motor vehicle.

From 1929 to 1967, the Legislature occasionally tinkered with the motor vehicle financial responsibility laws, especially in 1947 and 1959. In 1947, the Legislature enacted a law that required a negligent driver who caused personal injury or death or property damage in excess of $100 to show that he or she had security or was exempt. If the negligent driver could not produce such proof, the Department of Motor Vehicles would suspend his or her license, and reinstate it only after he or she satisfied the judgment and provided proof of financial ability to pay any future claims based upon the negligent operation of a motor vehicle.

In 1959, the Legislature passed a bill requiring drivers of motor vehicles to have insurance in the form of money or its equivalent in amounts not more than $10,000 (for bodily injury to or death per person in any one accident), subject to an aggregate sum of $20,000 (for bodily injury to or death of two or more persons in any one accident). Additionally, a limit of not more than $5,000 was applied if there was injury or destruction to property of others.

Then in 1967, the Legislature revised the laws to require motorists to have compulsory liability insurance (or other specified means of security) of at least $15,000 for bodily injury to or death of each person as a result of any one accident, to a total of $30,000 for any one accident, regardless of how many people were injured and killed. Additionally, the law provided that the motorist must have insurance of at least $5,000 for damage to or destruction of property of others as a result of any one accident. These laws became operative on July 1, 1968 and have been the law ever since.

This means that the minimum compulsory financial responsibility requirements have not changed in nearly 45 years despite inflation, the rise in the Consumer Price Index (CPI), and the diminished buying power of the dollar. Using the CPI inflation calculator (available at http://data/bls.gov/cgi-bin/cpicalc.pl), to equal $15,000 in 1968 (when this limit was first enacted), the equivalent amount in 2011 would be $97,595.26. The $30,000 maximum set in 1968 and still in force for everyone who suffers personal injury or death in the same accident, has the same buying power as $195,190.52 today. And for property damage or destruction, it would take $32,531.75 in 2011 to equal $5,000 in 1968.

> This means that the minimum compulsory financial responsibility requirements have not changed in nearly 45 years despite inflation, the rise in the Consumer Price Index, and the diminished buying power of the dollar.

While the financial responsibility limits have not budged since July 1, 1968, the cost of everything else has risen dramatically. Medical health care costs have soared; wages are considerably more than they were in 1968; advances in psychology and pain management can now accurately measure the amount of mental distress and pain and suffering a victim experiences; and car prices have increased tremendously, while repair costs have risen ten-fold.

The primary purpose of requiring liability insurance is to protect other drivers and their passengers, bicyclists, pedestrians, and those on or near the road from a driver's careless or drunken driving, and to provide some modicum of damages to the family or heirs of the person who is killed due to the negligence of another driver. The money is to compensate the victim for medical bills, lost wages, pain and suffering, and other tort damages to save them from financial hardship or even complete ruin. The secondary purpose of the mandatory liability insurance law is to protect the careless driver from financial ruin due to his or her inattentiveness or vehicular negligence.

Unfortunately, all too often the drivers operating motor vehicles who have minimum limits generally do not have sufficient assets to satisfy a judgment or pay for injuries or wrongful deaths out of their pockets. That is why it is so vital that the automobile operator have sufficient limits to cover the people injured or killed in his or her own vehicle, even though the driver was not at fault.

Uninsured and underinsured coverage in amounts of at least $100,000 per person and $300,000 per accident are vital to protecting drivers and their passenger against those who have no or only minimum insurance coverage. At a minimum, mandatory financial responsibility laws should be set at $50,000 per person, with a total of $125,000, and $25,000 property damage per accident.

An interesting factoid: In 1897, Travelers Insurance Co. sold the first automobile liability insurance to Gordon J. Loomis for $1,000. The policy protected Loomis if his car killed or injured someone or damaged another's property.

The author thanks Dean C. Rowan Esq., head reference law librarian at UC Berkeley Law School, for his assistance in this article.

SUBMIT A COLUMN
The Daily Journal accepts opinion pieces, practice pieces, book reviews and excerpts and personal essays. These articles typically should run about 1,000 words but can run longer if the content warrants it. For guidelines, e-mail legal editor Sharon Liang at sharon_liang@dailyjournal.com.

WRITE TO US
The Daily Journal welcomes your feedback on news articles, commentaries and other issues. Please submit letters to the editor by e-mail to sharon_liang@dailyjournal.com. Letters should be no more than 500 words and, if referencing a particular article, should include the date of the article and its headline. Letters may not reference a previous letter to the editor.

NON-JUDICIAL FORECLOSURES
FREE ATTORNEY TO ATTORNEY CONSULTATION

Richard G. Witkin
Attorney at Law
WITKIN & EISINGER, LLC
'Your Trust Deed Foreclosure Specialists'
We continue to specialize in the non-judicial foreclosure of obligations secured by real property or real and personal property (mixed collateral).
When your client needs a foreclosure done professionally and at the lowest possible cost, give Witkin & Eisinger a call.
NATIONWIDE TOLL-FREE: 800-950-6522

Now available
2010 Economic Interest Statements
for California Supreme Court justices
Judicial Profiles—including the latest economic interest statements—available at $40/profile to Daily Journal subscribers on www.dailyjournal.com