The plights of targets and acquirers

By Edwin B. Reeser

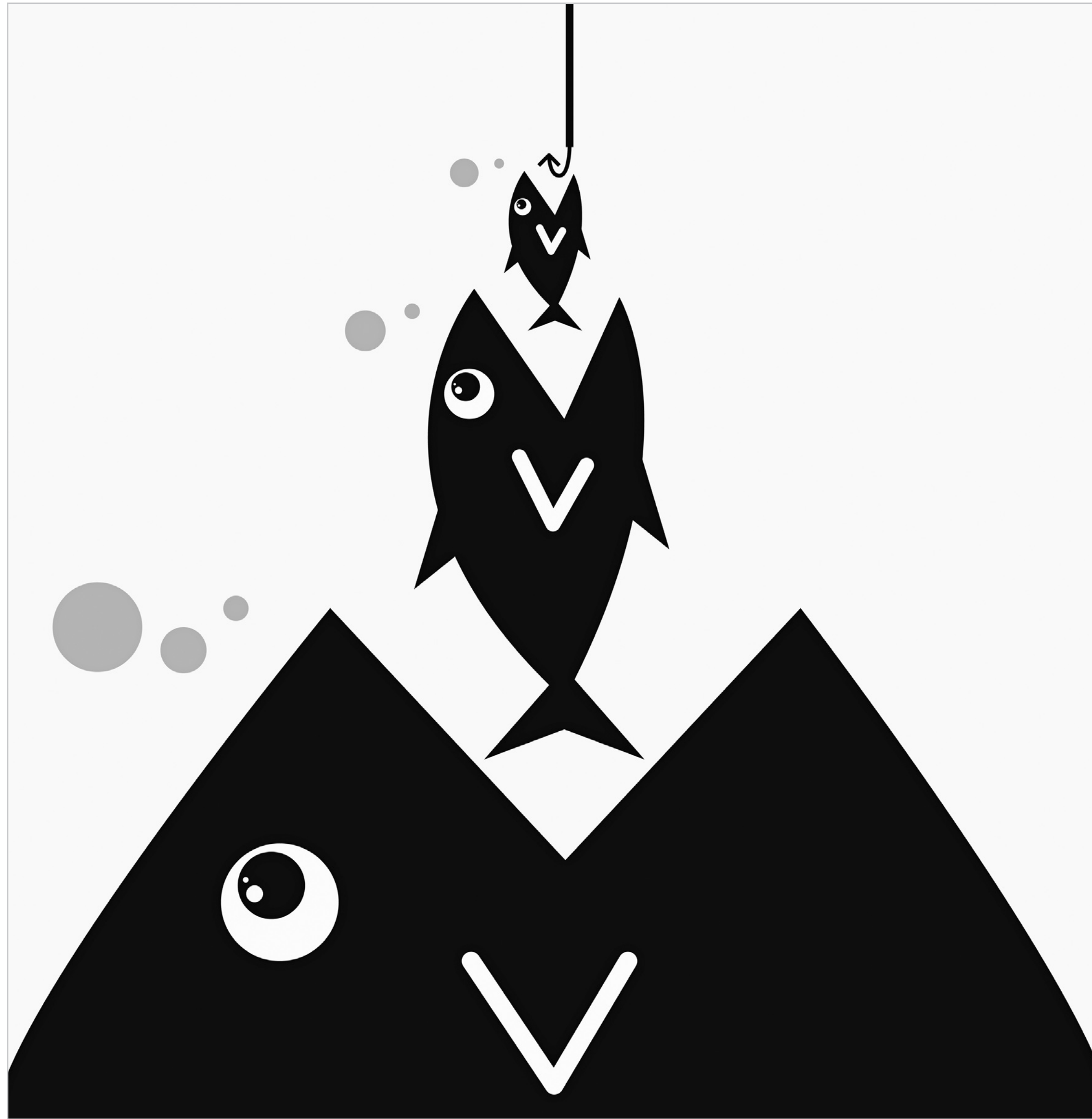
With the recent announcement of discussions between Locke Lord LLP and Edwards Wildman Palmer LLP, an overview of law firm combinations may be warranted. The odds are always extremely low that a deal to fully combine giant firms will succeed because of conflicts, difficulty getting offices and practice groups to stay — especially when there's overlap — and friction over power, politics, money and ego.

The economic due diligence period of such deals is relatively straight forward. The back room dealing, however, takes immense time and effort. That means investing time and money in an unlikely outcome. You need to have something more to justify pursuing such an adventure.

The smart, sometimes brutal play is for the acquirer to have a two-prong approach. The first, seldom-used prong is the acquisition of the target in its entirety, or at least the overwhelming majority. The second prong is used when merger talks break down, but after the acquirer firm has built a rapport with the best target firm lawyers. If and when the target collapses (not an unlikely scenario), the acquirer has a head start over competition to scoop up talent. This is not to suggest using a bait-and-switch strategy; it's simply a logical fallback.

This dynamic opens a "retrade" opportunity if the only key issue is what the acquirer firm has to pay. That is, how much cost to deal with target firm issues can be loaded onto target partners? The key is not what the target partners get by making the deal, but what liabilities they avoid. Loss mitigation will drive this discussion if the target partners believe there's no time to find a better suitor.

Then the question of why take on the liabilities, costs, risks and administrative effort of a merger becomes the focus of the acquirer. When you can strip out the filet and leave the rest behind, why take the rest? A few dozen of the best equity partners and related support staff — that deal's a breeze. Of course, the acquirer can't cause the target to fail, and there' likely a no poaching covenant in the letter of intent, so the opportunity must present itself.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If the target firm is coming off a challenging year and facing yet another, the very prospect of consummating a deal may be the only thing keeping the target partners together. Remember, many big firms that have failed had outstanding lawyers and outstanding clients. A shortage of either of those two elements is almost never why a firm fails, and why the lateral market goes wild when one does. The availability of such talent in such quantity is a rare opportunity. Plus it's a relatively risk-free pick up.

Obviously, if the target firm can operate without a merger, they will be OK. The acquirer firm will know the answer to that question well before they have to decide what to do. The target firm knows going in.

Indeed, Howrey LLP ran out of resources and talent before they could make a deal. It seems unlikely that Dewey & LeBoeuf LLP could have made a deal given all we've learned since their demise. Patton Boggs LLP might have closed a deal with Locke Lord but for the timing of an acceptable resolution of certain long-running litigation matters. Perhaps Locke Lord enabled the Patton Boggs-Squire Sanders combination — by shining a light on economic realities — and was just unlucky by being a few months too early. And while Patton Boggs was able to make that deal, if they had not it's possible there would not have been enough "glue" to carry on solo. And don't forget the myriad other famously talented and successful firms that explored combinations before collapse (e.g., Brobeck Phleger & Harrison LLP, Heller Ehrman LLP, and numerous others).

Generally speaking, "liquidating" combinations have better financial outcomes for the target partners — as well as those further down the food chain — than bankruptcies do. So, as tough as the terms can be, you should root for a successful combination for the target firm.

So we can see why combinations often make sense for target firms, but it's much harder to grasp why a combination makes sense for the acquirers months or even years later. It's almost impossible in advance to know why they really want or feel compelled to do it. The real story is thus not about the target, but about the acquirer. Why the urgency to take on such risk?

And it *is* risky since the talent that the acquirer "buys" is free to leave, take clients and compete shortly after closing the combination. The bigger, stronger acquirer may be able to work a "good deal," only to be rewarded with the departure of target partners once they have avoided the fallout of their former firm's collapse. This loss mitigation strategy has another barb: Once that cost is fixed in the mind of the target partner as one he or she must bear as the better outcome to bankruptcy failure, the second decision becomes whether the marriage to the acquirer is with "Ms. Right and Forever," or rather, "Ms. Right Now." The price has already been paid, so what's to keep them from looking for the best firm for their practice — aside from the unlikely event that it happens to be the acquirer? Combinations necessarily involve "tag along" talent seeking to avoid loss, which typically is not present in direct lateral talent buys.

For the acquirer law firm, what does that new fully combined firm look like and how will it have an advantage in the market place? "Big and mediocre and in more places to represent the middle market" doesn't sound like an inspired strategy. Upgrading the gene pool with some of the best lawyers and most profitable work from the target firm is a winning move for any law firm, and the natural default approach if the bigger deal doesn't happen. And it further illustrates that growth for the sake of growth *is not a strategy at all*. If an explanation of what's compelling the acquirer firm cannot be made convincingly, the first prong — a full combination — should not occur.

Here are a dozen questions to ask to test what the nature of the transaction will be, and who is more likely to be the "acquirer" versus the "acquired." And remember, always keep clear the distinction between "participation" and *control*.

1. Who will be the chair of the combined firm?
2. Who will be the key executive committee members and practice group leaders of the combined firm?
3. Who will have the voting control of the combined firm — especially when it comes to the power to set compensation?
4. Which firm's compensation methodology will be adopted?
5. Whose partners have their equity position maintained, and whose partners lose all or part of their equity in their old firm? And whose partners "contribute" additional capital into the combined firm and in what amounts?
6. Whose partners may be subject to golden handcuffs or disgorgements on distributions or bonuses if they depart either firm before the combination, or the combined firm within a certain period of time?
7. Which firm may have to deliver a certain percentage of partners by the closing date?
8. Are there liabilities that one of the firms must take care of only with the assets of their firm and not the combined firm?
9. Which partners are going to have to leave to clear conflicts problems?
10. Will there be any guarantees given to key partners and on what terms?
11. If the combination does not happen, will both firms proceed independently, and if not, which firm is more likely at risk of not being able to survive?
12. If one firm may be at survival risk should the deal not proceed, what is it that makes the other firm strongly motivated to want to do that deal in the first instance?

Finally, the leaders at every target firm are just as aware of these dynamics as the leaders at the acquirer firm. The couple of months after signing the letter of intent are always intense; give the players room and privacy to concentrate and get it right.

That is just my opinion of the general landscape of these things. I might be wrong.

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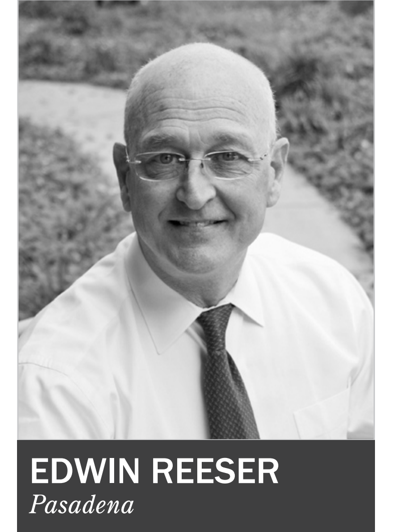
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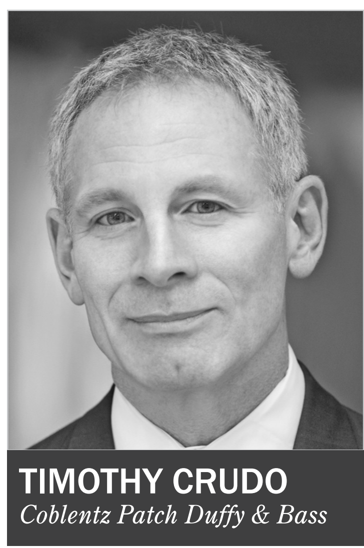
Could 3 little words expand reach of securities laws?

By Timothy P. Crudo

Several recent cases have focused attention on the extraterritorial reach of the federal securities law. In 2010, the U.S. Supreme Court found that Securities Exchange Act's antifraud provision does not apply extraterritorially in *Morrison v. Nat'l. Austl. Bank Ltd*, 561 U.S. 247 (2010). Last month, the 2nd U.S. Circuit Court of Appeals found that the anti-retaliation provision in Dodd-Frank don't apply extraterritorially either. *Meng-Lin v. Siemens AG*, 13-4385 (2d Cir. Aug. 14, 2014). Little discussed, however, is the reach of California's securities statutes.

Part 5 of California's Corporate Securities Law of 1968 covers fraudulent and prohibited practices. See Corp. Code Sections 25400-25404. As initially enacted, these provisions prohibited a number of different practices, but only if they were carried out "in this state." For example, Section 25400 prohibits any person "in this state" from engaging in certain acts or misrepresentations to induce purchase or sale of security or to manipulate price. Similarly, Section 25402 prohibits insider trading "in this state." Section 25401 likewise outlawed the offer, sale or purchase of a security "in this state" by means of a false or misleading statement. See, e.g., *McFarland v. Memorex Corp.*, 96 F.R.D. 357, 364 (N.D. Cal. 1982). Section 2508 even defined what constituted an offer, sale or purchase of a security "in this state."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In 2013, Section 25401 was amended to "expand the basis for unlawful activity" and bring the statute in line with its federal counterpart. As expanded, this section lifts verbatim the language from federal Rule 10b-5, the omnibus antifraud provision promulgated by the U.S. Securities and Exchange Commission under Section 10(b) of the 1934 Securities Exchange Act. In addition to prohibiting false or misleading statements, Section 25401 now also forbids a "devise, scheme or artifice to defraud" as well as an "act, practice or course of business" that operates as a "fraud or deceit." However, in amending this section the Legislature also deleted the requirement that the offending offer, sale or purchase occur "in this state." No other provision in this part of the statutory scheme that included an "in this state" requirement was so revised. Does this mean that California's antifraud protections are now available to investors — as well as California regulators and prosecutors — regardless of the transactional nexus with California?

The issue, as the U.S. Supreme Court discussed on the federal level in *Morrison*, is initially one of statutory construction: "[U]nless there is the affirmative intention of the Congress clearly expressed to give a statute extraterritorial effect, we must presume it is primarily concerned with domestic conditions.... When a statute gives no clear indication of an extraterritorial application, it has none." California similarly recognizes that "[h]owever far the Legislature's power may theoretically extend, we presume the Legislature did not intend a statute to be operative with respect to occurrences outside the state unless such intention is clearly expressed or reasonably to be inferred from the language of the act or from its purpose, subject matter or history." *Sullivan v. Oracle Corp.*, 51 Cal. 4th 1191 (2011). So what about Section 25401? The statute says nothing expressly about extraterritorial application. Was the removal of the "in this state" limitation an oversight, or does it signal the Legislature's intent for a broader reach? See *People v. Anaya*, 158 Cal. App. 4th 608, 612 (2007) ("It is ordinarily to be presumed that the Legislature by deleting an express provision of a statute intended a substantive change in the law."). The legislative history is silent on this point, nor has any case analyzed this change.

Does it matter? Maybe. Given the hurdles facing plaintiffs in federal cases, "the reach of the California Corporate Securities Law is increasingly important to shareholders, corporations, and the judicial system." *Diamond Multimedia Systems Inc. v. Superior Court*, 19 Cal. 4th 1036, 1046 (1999). And violation of Section 25401 can result in significant state regulatory and criminal penalties, so any extension of the law should give pause to those who are attempting to comply with it (Section 25401 violations can be punished by imprisonment up to five years and fines up to $25 million).

That said, at least for now the omission of these three little words from Section 25401 appears unlikely to have much practical effect. The presumption of nonextraterritoriality does not apply where the alleged unlawful acts or omissions take place in California, and in any event Section 25400(d) already broadly prohibits anyone buying, selling or offering a security from doing so by means of false or misleading statements, at least those made in California, regardless of where the purchase, sale or offer took place. Plaintiffs attempting to bring cases under Section 25401 where there is no nexus to California either in the buying/selling/offering or in the underlying wrongful conduct may well face personal jurisdiction, choice of law and venue problems regardless of the language of that statute. At the same time, Section 25541, which provides for criminal penalties, has long prohibited any "device, scheme, or artifice to defraud" or act that operates as a fraud or deceit in connection with the offer, purchase or sale of a security without requiring that any particular conduct be carried out in this state, and no concern has been raised that this statute has cast too broad a net. Subject to the future efforts of creative plaintiffs' lawyers or aggressive prosecutors turning them into something more meaningful, these three little words may not be missed.

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