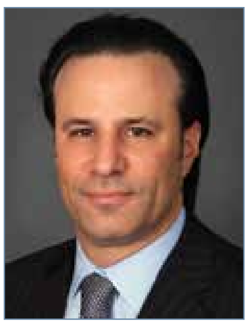
A Small-Cap Conundrum: Purchasing Legal Services Without In-House Counsel

By Adam J. Epstein



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Because so many small-cap companies—particularly those with market capitalizations below $500 million—operate without in-house counsel, and because many officers and directors lack legal backgrounds, there is a constant risk of either hiring the wrong attorneys or paying too much for legal services. And since few small-cap companies can afford either, directors should consider the following insights into common circumstances involving legal services.

Current Environment

The law firm business model is in the midst of a historic transformation. After decades of hypergrowth and profitability, the law industry post-financial crisis is in many cases a shadow of its former self. Put differently, when it comes to purchasing legal services, it's become a buyer's market.

For small-cap companies already saddled with comparatively crippling costs of "being public," the evolution of the marketplace for legal services is unreservedly positive. But even in the face of a buyer's market, many small-cap companies aren't benefitting as much as they should.

For example, one of the most dramatic changes to the law firm model is an inexorable shift away from hourly billing to flat fees. According to *The Wall Street Journal*, the frequency of use of flat fee structures has nearly doubled at large law firms in the last several years. At a high level, this is beneficial to purchasers of legal services, because hourly fee billing can be susceptible to conflicts of interest (i.e., lawyers might be tempted to take more time to complete tasks because they are getting paid by the hour). But just because a company is paying a flat fee for a particular service doesn't necessarily mean the company is getting a better deal. Especially when it comes to clients with less legal acumen, law firms still do their best to construct flat fees that aren't demonstrably different than historic hourly fees when all is said and done. Accordingly, management needs to confirm that any flat fees agreed upon are, in fact, more advantageous to the company and its shareholders.

Notwithstanding the positive developments in the legal services marketplace for small-cap companies, there are three circumstances in particular that are always deserving of added director scrutiny.

Principal Danger Zones

Whether it has an in-house counsel and other lawyers among its ranks or it's at the opposite end of the continuum, small-cap companies tend to have similar challenges when it comes to purchasing legal services. Sometimes it's with respect to which lawyers to hire, sometimes it concerns how much to pay, and other times it involves how to efficiently manage them.

Corporate finance. One of the biggest problems that a small-cap company can create for itself in the legal services realm is to hire the wrong attorneys to represent the company in connection with a financing. Since so many small-cap companies are serial capital raisers, it's a common occurrence, and the damage can be appreciable. That said, there are steps management can take to avoid this pothole.

■ *Company counsel.* While it's understandable that the company's existing outside counsel is often the most logical choice to represent the company in a financing, they are only the right choice if they have *extensive, recent experience representing similarly situated companies, in similar financings*. In other words, current company counsel might be a good choice, but they also might be a terrible choice.

To put things in perspective, the hedge funds that invest in most small-cap financings are represented by lawyers who essentially do nothing else other than represent institutional investors in small-cap financings—full stop. In other words, they have done dozens, if not hundreds, of financings. Accordingly, the fact that outside counsel is a trusted advisor and knows the company well is helpful on the one hand, but useless on the other hand if they aren't similarly expert in small-cap financings. The point here for directors is that management shouldn't select existing company counsel to represent the company in a financing out of allegiance or laziness; company counsel is only the right choice if they are the most qualified.

■ *Large law firms.* Management often assumes that it can't possibly go wrong selecting a large, international corporate law firm to represent the company in a financing. The mistake lies in the assumption. That is, many of the largest law firms in the world predominantly represent large private and public companies. As it pertains to corporate finance, the lawyers in those firms may well have experience navigating some of the most complex finance transactions ever undertaken. But if they don't have material amounts of experience representing small-cap companies in private placements and public offerings, then their other experience may be largely inapplicable.

■ *Actual attorney.* Irrespective of the size and type of law firm, it's critical for management to confirm that the actual attorney who is going to represent the company has *extensive, recent experience representing similarly situated companies, in similar financings.* In other words, it's not sufficient if the firm has such experience, or an attorney's partner. Rather, the actual attorney representing the company is the person who needs to have the highly relevant experience. As is the case with all professional service providers, the firm is only as good as the person who is doing the lion's share of the company's work.

1934 Act reporting fees. Given the dearth of cash and cash equivalents on the balance sheets of myriad small-cap companies, there is little margin for overpaying professional service providers. That said, scores of small-cap companies still pay law firms more than necessary for basic 1934 Act reporting—the core legal work for small-cap companies.

■ *Flat fee.* In light of the changes in the legal services marketplace, small-cap companies should strongly consider negotiating flat fees for basic 1934 Act reporting in lieu of hourly fees. In addition, when soliciting bids for this work, management should try to build in ancillary items like reviewing related press releases, and perhaps even attendance at a fixed number of board meetings.

■ *Billable work.* When it comes to documents that are still commonly billed to small-cap companies on an hourly basis (e.g., corporate governance policies, stock purchase agreements, registration statements, definitive merger agreements, etc.), it often ends up being cheaper to let outside attorneys draft these documents from start to finish for the company's review unless the company has a highly competent in-house corporate attorney. Put differently, companies with insufficient legal acumen often end up spending more money on legal fees by trying to draft these documents internally for counsel's review.

■ *Location.* Given the advent of e-mail and web conferencing, the location of company counsel has become less important. Notwithstanding the same, too many small-cap companies still unwittingly pay a premium in order to have counsel located proximate to the company. Officers and directors should be aware that both flat and hourly fees (and expenses) are often demonstrably less at branch offices of large law firms that are located outside of major markets.

Litigation. Though there are countless helpful resources regarding litigation theory, strategy, and management, many of them omit or underemphasize an important reality: the costs and outcomes of litigation often pose material enterprise risk for small-cap companies. Consequently, management should be focused on some common high-level litigation mistakes that are easiest to avoid.

■ *Litigation consultant.* For small-cap companies with no in-house counsel and minimal litigation experience, management should strongly consider hiring a seasoned litigation attorney as a consultant to assist with, among other things, selecting attorneys, negotiating fees, reviewing strategy, and managing the process, etc. Far too many small-cap companies are penny wise and pound foolish in this regard. In the vast majority of circumstances, the cost of the consultant will be paid for several times over with the resulting savings. The point here for directors is that management's attempt to preside over all aspects of litigation with no or limited prior litigation experience is an unnecessarily risky proposition.

■ *Alternative fee structures.* Where the company is the plaintiff, the company should consider negotiating either a contingent fee or a blended contingent fee agreement with counsel instead of paying straight hourly fees. Previously only the province of small, specialty plaintiff law firms, much larger law firms now regularly take cases utilizing alternative fee structures.

Ultimately, the majority of small-cap companies cannot afford to either hire the wrong attorneys or pay too much for legal services. While such risks might not be company-threatening at larger public companies, they certainly can be for the vast majority of public companies with market capitalizations below $500 million—especially those with minimal in-house legal acumen. These risks are incrementally exacerbated when directors themselves lack legal experience and don't know the right questions to ask. D