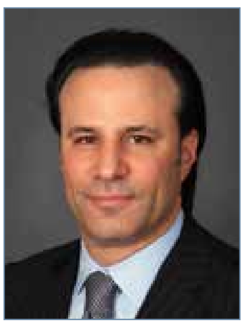
Buy-Side Memo to Small-Cap CEOs: Hire In-House Counsel ASAP

By Adam J. Epstein



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After the 2008 financial crisis, micro- and small-cap companies, to reduce costs, broadly recast in-house counsel as a luxury, and despite the resiliency of the financial markets, many small, public companies never re-hired legal staff.

Savvy institutional investors have taken note and cautiously approach small public companies without in-house counsel because, even under ideal circumstances, they are risky investment propositions. When these companies attempt to navigate a labyrinth of unique commercial, regulatory, and capital markets' legal issues without in-house lawyers, risks can rise beyond the thresholds of many fund managers.

Here are five reasons small, public companies should consider hiring in-house counsel.

Bumper crop. The legal industry is in trouble. Large corporate clients have gotten wise to the billing inefficiencies of big law firms and have increasingly taken legal matters in-house. Large law firms have thinned their ranks dramatically, and put the brakes on hiring new staff. The good news for public companies is that there are an unprecedented number of high-quality attorneys looking for jobs and charging lower rates.

They pay for themselves. Many small-caps without legal staff outsource everything from business development and employment agreements to quarterly and annual securities filings, proxy statements, and financings. Moreover, all of that outsourced work is being purchased by non-lawyers, a fact that benefits law firms a lot more than clients. The reduced fees from doing considerably more of this legal work in-house combined with the savings from having a lawyer purchasing outside legal services can pay for a quality in-house counsel pretty quickly—and then some.

Proactive risk management. These cost savings can pale in comparison to the value small, public companies can derive from avoiding trouble in the first place. No matter how great an outside law firm is, they don't have visibility into day-to-day operations. Every aspect of daily business is replete with legal landmines, not to mention tasks such as reporting and communicating financial results, financings, and mergers and acquisitions. Managing those legal risks without any lawyers in the building is like trying to design a space shuttle without engineers.

Governance. In 2014, nearly 75 percent of shareholder-activism campaigns in the United States were waged against micro- and small-cap companies. Whereas small, public companies might have survived with less fulsome corporate governance in the past, those days are over. When public companies don't have in-house counsel, the corporate secretary role is typically assigned to other Section 16 officers (often the CFO). While some undertake this double duty with aplomb, it's often more advisable for in-house counsel to assume the corporate secretary role given the legal nuances of corporate governance.

Existential threats. For the majority of U.S. public companies, the line separating a going concern from liquidation is thin. Balance sheets at these companies are fragile, and cash flow is variable. Any small-cap institutional investor will tell you that they regularly see non-lawyers hiring the wrong lawyers to negotiate complex financings; non-lawyers trying to preside over sprawling internal investigations; and non-lawyers attempting to manage "bet-the-farm" litigation. Large-cap companies can often easily rebound from a substandard financing, from overpaying for legal services, and from losing lawsuits. Most small-cap companies can't.

For better or worse, life as a small, public company is fraught with complex legal issues. Further, institutional investors know that, without in-house counsel, companies are less likely to spot issues in advance, and when problems arise they will materially overpay for help. Neither is good.