



OUTSIDE COUNSEL

BY JEFFREY A. JANNUZZO

The De Facto Merger Doctrine and Law Firm Combinations

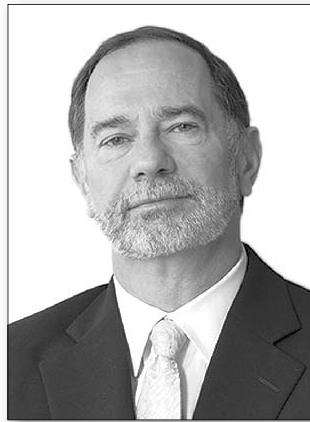
When law firms combine, usually a financially stronger firm takes over a weaker one. And when the law practice of the acquired firm is valuable, it is generally because poor management by its control group has put it in extremis. A merger between unequals gives the acquiring firm plenty of reason to paper the transaction to avoid the debts of the old firm. The old firm having been put in extremis, its current partners' incentive is to bargain for their own futures, with little incentive to look out for former partners who are owed capital, or retired partners who are owed pensions.

The stronger firm can thus get the underlying practice that took years to build, a functioning law office in a city where it wants to establish or expand, and the benefit of an income stream that will go on for years; but avoid pesky liabilities, in particular those to former partners.

In the corporate context, the doctrine of de facto merger has been increasingly used to prevent the avoidance of just debts by the clever papering of business combinations. In the last few years, the de facto merger doctrine has reached law firm combinations. With all the merging going on these days, it will likely be invoked with increasing frequency in the near future. The underlying realities of the transaction will qualify many law firm combinations for "de facto merger" treatment.

De Factor Merger Exception

The normal rule is that a purchaser of assets-only is not obligated for the liabilities of the old firm.¹ However, that rule is subject to four common-law exceptions, the one most pertinent to law firm combinations being the doctrine of de facto merger.² Another exception, called the "mere continuation" rule, sounds like it might



apply, but is actually reserved for situations where the old firm is extinguished.³ If a firm-in-dissolution survives, as often occurs in law firm combinations, the mere continuation rule is not applicable.⁴

The leading recent New York case setting out the requirements for de facto merger is *Fitzgerald v. Fahnestock & Co.*,⁵ which lists four factors:

- continuity of ownership;
- cessation of ordinary business and dissolution of the acquired corporation as soon as possible;
- assumption by the successor of the liabilities ordinarily necessary for the uninterrupted continuation of the business of the acquired corporation; and
- continuity of management, personnel, physical location, assets and general business operation.

Fahnestock also ruled that "[n]ot all of these elements are necessary to find a de facto merger." That principle is by far the most important, and leaves open the question of how much is enough. However, "continuity of ownership" takes first place. In 2003, the Second Circuit construed *Fahnestock* to require the presence of "continuity of ownership," finding that to

be "the essence of a merger." *Cargo Partner AG v. Albatrans, Inc.*⁶

The first reported New York case applying de facto merger to law firms appears to be *Woodson v. American Transit Ins. Co.*, which concerned a malpractice claim.⁷ In a brief decision, the First Department found that a malpractice plaintiff had adequately stated a claim under de facto merger, where the "new" law firm had the same offices, phones, etc., as the old, was substituted in all pending cases, was also "house counsel" for the same insurer, and had the same managing partner, who was at all times an employee of the insurer.

The "new" firm's insistence that the old firm still existed as an entity, even though it no longer practiced law, was unavailing. (If the old firm had actually disappeared, the "mere continuation" doctrine would have applied.) To date, *Woodson* is the only New York appellate decision considering de facto merger of law firms.

Last winter, an unreported Supreme Court decision, *Zito v. Fischbein Badillo Wagner Harding*,⁸ upheld the application of de facto merger, at least so as to allow amendment to add the acquiring firm as successor. The plaintiff alleged that a large number of the old firm's lawyers now were employed at the acquiring firm, including 18 partners, and that the acquiring firm practiced out of the same offices. The acquiring firm's counter-assertions were unavailing, i.e., that it now had its own lease on the offices, that it had not assumed liabilities or bought assets, that the old firm continued to exist and collected receivables, and that its management was different.

In *Zito*, the acquiring firm was allowed to be added as a defendant, subject to discovery on, among other things, "continuity of ownership and management, the transfer of assets, if any, and the continued existence of [the old firm] as a going concern." The plaintiff was a former partner who asserted contract claims, and the decision thus brought de facto merger liability to such claims.

Jeffrey A. Jannuzzo, a solo practitioner, concentrates on partnership disputes.

An Analysis

Analysis of the four factors above suggests that quite a few law firm combinations will be subject to de facto merger treatment.

1. Ownership. The paramount factor of “continuity of ownership” should be easily satisfied in most cases. In the corporate context, just paying the stockholders of the old firm with the stock of the acquiring firm establishes continuity of ownership: “The classic example of a de facto merger is a transaction in which the purchasing corporation pays for the acquired assets with shares of its own stock.”⁹ The doctrine looks to “continuity” of ownership, not “uniformity” of ownership, and disregards matters of form.¹⁰

In a partnership, of course, neither the old firm nor the acquiring firm have stock or stockholders. A partnership is owned by its partners, and the “stock” of a partnership is the partnership interests of the members. In any law firm combination, the gist of the deal is that the partners of the old firm transfer their ownership interest in return for partnerships in the new, since that is the only way the acquiring firm can get its hands on the underlying practice and office which are the reason for the transaction.

Giving partnerships in the acquiring firm to the partners of the old firm is the functional equivalent of giving them stock. It allows the partners to keep their interest in the old firm’s real asset—its client base—through their partnerships in the new firm, and that is the essence of continuity of ownership.¹¹ The paramount factor of “continuity of ownership” should be satisfied in virtually every law firm combination.

2. Cessation. The second factor of “cessation of ordinary business and dissolution” of the old firm is also likely present in virtually every case. The whole point of the transaction is that the old law firm ceases to do business as a law firm, and thereafter engages only in winding up, which is the statutory definition of dissolution.¹²

3. Assumption. The importance of assumption of liabilities necessary to run the business was limited by *New York City Asbestos Litig. v. A.W. Chesterton Co.*,¹³ which held that it and the next factor, continuity of operational aspects, were not by themselves enough to establish de facto merger.

However, this test is likely to be satisfied in every law firm combination where an office is taken over, for the acquiring firm will necessarily have to make arrangements for the lease on that office. In *Zito*, the practical takeover of the office lease was noted, and the “new lease” defense was found unavailing. This was sound. Even if the acquiring firm has made a new lease, it is hard to avoid the

logic that by doing so, it has either in whole or in part relieved the old firm of that critical obligation. Even if the old firm partners remain liable, the practical reality is that the landlord will look to the acquiring firm to make the monthly payments.

Similarly, the acquiring firm will usually have undertaken enough obligations to the rank and file personnel necessary to run the practice to keep them from deserting. At least in some measure therefore, the third factor is likely to be present in most law firm combinations.

4. Operation. The fourth factor considers the continuity of “management, personnel, physical location, assets and general business operation.” In a law firm combination, nearly all of those factors will be present. The point of the deal is to transfer personnel, after all, and most of the rank-and-file employees necessary to operate the law practice will come over. The chiefs of the old firm often bargain for management positions in the new one. Where an out-of-state firm buys into the local market, a major purpose will often be to preserve the physical location, and take advantage of the old firm’s built-out space and long-term lease.

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As to “assets,” the importance of the old firm’s desks and computers pales beside the one true asset that the acquiring firm nearly always hungers for: the law practice of the old firm. There will always be more good lawyers than there are good clients, and the most valuable asset any law firm ever has is its goodwill, i.e., its client base.¹⁴ In virtually every law firm combination, the essence of the deal is the en masse transfer of the old firm’s most important asset, the clients and pending cases, by reason of the partnerships offered to the old firm’s members.

Thus, in virtually every law firm combination, many or all of the four factors for “de facto merger” treatment are likely to be present. The recent cases applying the common-law exception to law firm combinations bode well for the people who are most often hurt when law firms combine: former partners who are owed money by the old firm, and retired partners who performed their services for many years in return for the right to a pension from the firm they helped build.

1. *Schumacher v. Richards Shear Co.*, 59 N.Y.2d 239, 451 N.E.2d 195, 464 N.Y.S.2d 437, 440 (1983).

2. *Cargo Partner AG v. Albatrans, Inc.*, 352 F.3d 41 (2nd Cir. 2003) (under NY law) and *Schumacher v. Richards Shear Co.*, 59 N.Y.2d 239, 451 N.E.2d 195, 464 N.Y.S.2d 437, 440 (1983). The other three common-law exceptions are: (1) that a buyer formally assumed a seller’s debts; and (2) that the new firm is a mere continuation of the old, and (3) that the transactions were undertaken to defraud creditors.

3. *Schumacher v. Richards Shear Co.*, 59 N.Y.2d 239, 451 N.E.2d 195, 464 N.Y.S.2d 437, 440 (1983); *Meadows v. Amsted Industries, Inc.*, 305 A.D.2d 1053, 760 N.Y.S.2d 604 (Fourth Dept. 2003).

4. *Matter of Seventh Judicial District Asbestos Litigation v. Borg-Warner Corp.*, 6 Misc.3d 749, 752, 788 N.Y.S.2d 579, 582 (Sup.Ct. Ontario Co. 2005) (collecting cases) (“In summary, if a ‘predecessor corporation continues to exist after the transaction, in however a gossamer of form, the mere continuation exception is not applicable.’”)

5. *Fitzgerald v. Fahnestock & Co.*, 286 A.D.2d 573, 730 N.Y.S.2d 70 (First Dept. 2001).

6. *Cargo Partner AG v. Albatrans, Inc.*, 352 F.3d 41, 47 (2nd Cir. 2003). See also, *New York City Asbestos Litig. v. A.W. Chesterton Co.*, 15 A.D.3d 254, 256, 789 N.Y.S.2d 484, 486 (First Dept. 2005), and *Washington Mutual Bank, F.A. v. SIB Mortgage Corp.*, 21 A.D.3d 953, 801 N.Y.S.2d 821 (Second Dept. 2005).

7. *Woodson v. American Transit Ins. Co.*, 292 A.D.2d 160, 739 N.Y.S.2d 35 (First Dept. 2002).

8. *Zito v. Fischbein Badillo Wagner Harding*, 11/22/2005 NYLJ 21 (col. 1) (Sup.Ct. N.Y.Co. 2005) (Cahn, J.) (also available in Westlaw library “NYLJ,” and the state court Web site: <https://iapps.courts.state.ny.us/caseTrac/jsp/ecourt.htm>)

9. *Cargo Partner AG v. Albatrans, Inc.*, Id., 352 F.3d at 46.

10. *Lumbard v. Maglia, Inc.*, 621 F.Supp. 1529, 1535 (S.D.N.Y.1985) (“the cases uniformly hold that continuity, not uniformity, is the significant variable.”); *Cargo Partner AG v. Albatrans, Inc.* 207 F.Supp. 86, 104 (S.D.N.Y. 2002) (“The requirement of ownership continuity does not exact form over substance.”).

11. *Cargo Partner AG v. Albatrans, Inc.*, 207 F.Supp. 86, 104 (S.D.N.Y. 2002) (“The fact that the seller’s owners retain their interest in the supposedly sold assets (through their ownership interest in the purchaser) is the ‘substance’ which makes the transaction inequitable.”)

12. Partnership Law Sec. 60: “The dissolution of a partnership is the change in the relation of the partners caused by any partner ceasing to be associated in the carrying on as distinguished from the winding up of the business.”

13. *New York City Asbestos Litig. v. A.W. Chesterton Co.*, 15 A.D.3d 254, 256, 789 N.Y.S.2d 484, 486 (First Dept. 2005).

14. See *Dawson v. White & Case*, 88 N.Y.2d 666, 670, 672 N.E.2d 589, 592, 649 N.Y.S.2d 364, 367 (1996): “When applied to law firms, the term ‘goodwill’ refers to the ‘ability to attract clients as [a] result of [the] firm’s name, location, or the reputation of [its] lawyers’ (Black’s Law Dictionary 695 [6th ed.]).”