Put Up or Shut Up, and Preferably Both

By Edwin B. Reeser

Mary is confronted with a difficult predicament — raise her rates and potentially lose clients, or experience a lower flow of assignments from her clients, which will result directly in compensation reductions for her in the immediate future. Her other option is not to raise her rates to keep her clients, and face compensation reductions in the immediate future, plus the displeasure of management. Worse yet, there are rumblings that anything less than a full raise in rates to the targeted $700 per hour could also result in compensation adjustments, so she could wind up with a partial rate raise, lose clients and have further compensation reduction pressure because she did not raise rates enough.

Management has used the "$2 million" comment as the minimum expectation of client business for the future equity partner. The timing for that being applied as an actual standard for existing equity partners is unclear, but the fundamental message is not. Mary would then be in the potential risk position of being "de-equitized" or even counseled out of the firm, in a weakened position with a smaller book of business. Her market value would be substantially diminished at precisely the time she had to depart.

SECOND IN A FIVE PART SERIES

This series explores some of the current illusions and realities of partner capital and capital accounts treatment in some large law firms. It is intended to be illustrative of issues and does not present the profile of any specific individual firm, past or present.

On top of all of this, Mary is concerned about the loss of culture the firm had been so proud of and which she enthusiastically subscribed to when she joined the firm. Associate and staff reductions have been emotionally wrenching, morale is battered, and confidence in the future of the firm, notwithstanding confident messages from the top, is balanced by the reality that she earned far less than she had been forecast to earn for the past three years. Assurances that the firm would hit certain targets were revised downward once in early summer, again in the fall, and then collections at year-end did not deliver the results notwithstanding heroic efforts by most of the partners. The firm has a closed compensation system so Mary does not know what all the other partners are making, but she has discovered that there are several newly arrived partners that are making more than she is, in some instances between $50,000 to $100,000 thousand more, with lesser books of business.

Mary has an opportunity to go to another peer firm or a boutique law firm with hourly rates about $100 lower and income that is equal to or marginally lower than what she earned last year, though less than what has been forecast for last year. It is a group that is focused on her practice area of expertise, has a good reputation, and several professionals there are very well known and respected by her. Mary likes her firm comrades, but like most partners she never really has interfaced much with the senior management as they are located in another city and she only sees them twice a year when they cycle through the office on a periodic visit, and once more at the annual firm retreat.

Mary's capital account is $364,000. Like most partners she has a loan for a substantial portion of that from the firm's primary lending bank. The terms are simple: prime rate minus 1 percent, payable interest only through the year, and 20 percent of the outstanding balance due by Jan. 31 of each year, right after the final year end distributions. Mary had paid the balance down to about $100,000 by 2006, but with the "raise" her capital requirement increased another $59,500. The loan was recast to another five-year amortization on the balance of $159,500. She paid it down in January 2007 and 2008 by $31,900 each year to $95,700, and then her "raise" in 2008 coupled with the 40 percent capital ratio increased her capital by another $84,000. That was recast to a balance of $179,700, with an annual principal reduction requirement of $35,940. But with the very difficult years of 2008 and 2009, the firm negotiated a forbearance of the principal reduction requirement for its partners on their individual capital loans from the bank, but did not reduce the partner-required capital to match the reduced incomes the partners were being distributed. (Indeed, the firm did not have the cash on hand to return the capital adjustment to all the partners, and the bank was tightening lending terms on the revolver that is used for working capital to the firm.) Her effective capitalization ratio to her projected income is now closer to 48.5 percent.

In 2010, the principal reduction payment was optional for all partners with loan balances of less than $200,000, but in 2011 it was required of all partners, and Mary now has an outstanding loan balance of $143,760. Her capital account is, of course, still $364,000. Basically every time she gets a raise, it takes almost one full year of earnings to pay the additional capital required, plus taxes thereon. She has paid in cash almost $100,000 over the past five years in additional capital, and the balance of her loan is up almost $43,760, while her actual distributable income over the past three years has been below management budget forecasts by about $267,000.

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The firm has a capital return policy for departing partners that has three components. First, should any departing partner owe a capital loan balance to the bank, the firm will first pay 100 percent of all capital return amounts to the bank until the balance of principal and accrued interest is paid in full. This has always been a feature of partner capital loans. Second, the firm has recently adopted a new policy by which it pays departing partners a return of capital in three annual installments, without interest, commencing from the date the departing partner's accounts receivable have been collected by the firm by at least 90 percent. This is announced as a way to protect the firm by incentivizing a departing partner to collect the monies owed the firm. For partners that have been counseled out, the firm has commonly returned all of their capital once the 90 percent threshold has been reached, or if the remaining amounts to be collected are less than a comparatively nominal $50,000 and the history of client payment has been good plus they have a signed departure agreement with a non-disparagement clause in the firm's favor.

But for partners that are departing voluntarily without the firm initiating the move, the three-year rule is being applied quite regularly. For Mary, this means that she will leave with no capital return for the 90 to 120 days that it will take her to collect her accounts receivable to the 90 percent level. Then after the pay-down of one third of her capital balance by $121,333, the $143,760 loan balance to the bank is reduced to $22,427. She will receive no check from the firm and will continue to pay interest on the loan balance for another year. It will be a year after that (so 15 to 16 months after her departure) before she receives the second installment of $121,333, less the $22,427 principal balance, or $98,906. Some partners have taken as long as nine months to reach the 90 percent collection threshold after their departures. And partners with "citizenship" issues, the details of which are not discussed with partners at large and which are "murky" as to what exactly that means, have sometimes had their capital returns tied up for years.

The partnership agreement has a mediation or arbitration clause and confidentiality provisions so that no litigation of disputes is permitted. The non-disparagement clause in her departure agreement will put all capital return at risk in the event of violation by the departing partner. Mary's peer firm has a similar capital contribution requirement, while the boutique firm opportunity has a basic capital contribution requirement of $250,000. If Mary is going to leave, even on the best of terms, she is going to have to go an additional quarter million dollars into debt (if she can get it), and is at risk for the return of her prior firm capital account balance of almost another quarter million dollars over two plus years after the date of her departure. If she cannot get the loan to fund her new partnership capital position, she will either have to negotiate an installment buy in, and perhaps have a reduced draw or compensation package as a result, or come in to the new firm as a contract rather than equity partner at a lower salary (plus perhaps a performance bonus incentive) than she might have otherwise been able to command as an equity partner with a share of profits.

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.

BRIEFLY

The U.S. Senate rejected an amendment that would have weakened the proposed patent reform bill by a wide margin Thursday. Sen. Dianne Feinstein, D-Ca., sponsored the amendment, which would have done away with a proposed change to adopt a first-to-file patent system, instead of the current system that favors the first inventor. But U.S. Sen. Patrick Leahy, D-Vt., said Feinstein's amendment — which she said would help startup companies — would "kill" the overall patent reform bill, and the Senate tabled it by an 87-13 margin. Other amendments were being considered Thursday afternoon, and Leahy said he expects the final bill to be considered next week. If passed, the U.S. House of Representatives would take it up next.

If the Proposition 8 case returns to the trial court for any reason, the judge who struck the same-sex marriage ban down will not be the one to hear any additional proceedings. An appeal of U.S. District Judge Vaughn R. Walker's August ruling is pending at the 9th U.S. Circuit Court of Appeals and the California Supreme Court. Walker retired from the Northern District bench at the end of last month. On Thursday, the case was reassigned to Chief Judge James Ware.

Target Corporation will pay $22.5 million to settle an environmental lawsuit over improperly dumping chemicals at its stores throughout the state. Alameda County Superior Court Judge Steven A. Brick approved a $22.5 million settlement that includes civil penalties, costs and supplemental environmental projects, Santa Clara County District Attorney Jeffrey F. Rosen announced Thursday. Rosen, 19 other district attorneys, the California Attorney General and the Los Angeles and San Diego city attorneys field the suit in 2009 claiming that over a five-year-period the company had improperly handled and disposed of chemicals at more than 240 stores. As a result of the case, the stores have adopted new waste disposal polices including keeping hazardous waste in segregated, labeled containers to prevent customers and employees from being exposed and chemicals from mixing.

A federal grand jury indicted the former mayor of Upland and the mayor's appointee to a municipal board on corruption charges involving an extortion scheme targeting two local businesses. John Victor Pomierski, 56, who resigned as mayor last week, was accused in an 11-count indictment of extorting $45,000 from the business owners in exchange for helping them get permits, among other things. Also charged was John Edward Hennes, 54, a member of Upland's Building Appeals Board, who allegedly communicated Pomierski's demands and collected the money. Pomierski and Hennes were both charged with conspiracy and extortion under color of official right.

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Daily Journal

Lawyer Faces Charges in Separate Case

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U.S. Code Sec. 441f, which says, "No person shall make a contribution in the name of another person."

U.S. District Judge S. James Otero threw out the indictment against O'Donnell in 2009, finding the law does not explicitly bar a person from funneling donations through third parties and that it only applies to the person who made the contribution.

The 9th U.S. Circuit Court of Appeals reinstated the charges last June, saying Otero's interpretation of the law was inconsistent with its purpose.

If convicted of the federal charges, O'Donnell would likely face further State Bar discipline.

O'Donnell is best known for representing clients such as the late writer Art Buchwald in his successful lawsuit against Paramount Pictures over the 1988 Eddie Murphy film "Coming to America."

For the past six years, O'Donnell said his focus has been on public justice litigation. O'Donnell led a team of lawyers seeking compensation from the U.S. government for victims of Hurricane Katrina.

"That focus will continue and intensify once I resume the active practice of law," he said.

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Bratz Judge's Order Deemed Highly Rare by Legal Experts

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schedule conflicts," Zeller said.

Questioning Eckert on the stand this week, Mattel lawyers sought to show that MGA severely harmed the toy company in pirating the Bratz concept by secretly working with a Mattel employee on the idea.

During questioning by Quinn Tuesday, Eckert said Mattel was "highly concerned and anxious" about the huge success of Bratz several years ago, and that the doll forced the company to lay off employees and cut into its bottom line.

Keller tried to punch holes in Eckert's credibility. On questioning by Keller, he said he wasn't sure of the day-to-day responsibilities of Carter Bryant, the toy designer who allegedly created Bratz on Mattel time.

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