



All in for the Last Hand

By Edwin B. Reeser

Suddenly, it all begins to make sense. The increase in capital of 5 percent of projected income in 2008 amounts to roughly \$60,000 per partner. The firm has shifted to its partners a personal recourse obligation — a borrowing item that the bank would not permit on its working capital line of credit to handle repayment of departing partner capital. In the aggregate, that was probably enough to generate a one-time \$15 million of increased capital for the firm. The “freezing” of capital commitment to the older “aspirational” budgeted income forecast for 2008 was critical, otherwise the firm would have had to return an average of \$96,000 per partner to bring the balance back to a 40 percent ratio of capital to income. The firm did not have the cash to do that, even after a raise in the capital ratio from 35 percent to 40 percent. The bank was certainly not going to authorize an application in stressed times for return of capital to partners funded by a loan from the bank!

LAST 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.

recognize it right away because of the added bodies. But once a firm starts to shrink, the negative leverage can become overwhelmingly difficult to survive.

The partner capital line item on the firm balance sheet is not matched by tens of millions of dollars in cash in a bank account. It is typically consumed within months, if not immediately. “Expand or die” can become a very real pressure in such circumstances. The growth is because the firm is sick, not because it is successful. Suddenly, new lateral partners, new practice group additions, new locations have a different potential motivator for addition. “Strategic” downsizing is not an option in as many

situations, and has to be carefully reviewed by outsiders when a firm announces it is doing so as a means of improving its financial condition. One reason for the almost obsessive focus of some firm management teams upon reporting increases in profits per partner, especially in the midst of a recession, is when the firm desperately needs partner growth to cover the capital drain from departing partners. This metric of PPP can be portrayed as a symbol of success and stability to attract new laterals, and retain high producers, when in fact the steps taken to achieve it are destructive and destabilizing in themselves.

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It behooves the individual partner as lateral candidate to clearly understand which of the strands to the partnership web are sticky before making a landing. And it behooves the existing partner to understand it when measuring the true cost of staying against the cost of leaving.

Should the firm not follow this creative practice, and instead currently expense all of the recruiter and pipeline costs, the immediate impact to the income statement is a negative \$10 million. Assuming that the newcomers, though fewer in number, are “better” producers, the 28 will have a collective book that is equal to or greater than the 40 departed partners (the 10 de-equitized partners still have their clients in the firm). The income received by the firm from the accounts receivable of the departed partners is hopefully enough as collected to be an income offset to that \$10 million expense, with a net result of zero. And, the firm has not overstated its income and distributed what really is capital, as taxable income. But there still is that issue of deferred capital returns to departing partners. Where has that money gone?

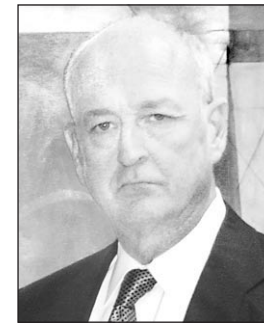
It may be absorbed into the pay down of the revolving line of working capital credit to the bank. If so, then that is potentially a good thing. Borrowing interest free from partners is cheaper than borrowing from the bank. Especially if the firm uses that revolver to advance draws to its partners in the early part of the calendar year when income is less than expense. But it does not take away from the reality that the firm has to come up with millions of after tax dollars to pay back the departed partners.

One critical factor to look at is when does the firm’s revolving line of credit that it has been drawing get reduced to zero? If historically, the date

of repayment is stretching deeper into the year (say from May or June to mid-August or later), or the absolute maximum amount drawn has been increasing, especially in per partner terms, precisely why it is happening may be something to be concerned about. It could be that some of it has been used to pay the deferred returns of capital to departed partners.

There shall be a day of reckoning. Does it make a difference to Mary Doe which method her firm is using to characterize recruitment and pipeline expenses for laterals on its financial statements? Does it make a difference how capital is provided to the firm and how it is repaid if it alters reportable income? Does the historical payback and maximum amount drawn on the working capital line make an important difference in how her evaluation is made of the underlying stability of the firm she is a member of, or might be moving to? These and dozens of other ways of reporting “book” and “tax” income, expense and balance sheet items can be critical to understanding the financial stability of her firm. But only if she knows what all of these cards are, and how they are being dealt around the partnership table. Every partner’s situation is unique, as is their persona, so what motivates their ultimate decision to stay or leave is not possible to determine. What is important is having all of the information to make a fully informed decision. If none of this comes as a surprise or concern to a partner like Mary Doe, then she is clued in to the material elements that allow her to make her decision. If some of these issues do come as a surprise with material weight to Mary, then she needs to find out.

While it is often stated that law partnerships are comprised of volunteers, and not victims, the closed compensation systems and selective disclosure of “techniques of financial reporting” have become increasingly opaque to partners, to the point where they may have taken a seat at the table for a game in which the rules have never been fully explained, and where it is of increasing concern that there may not be any rules at all. Changing the card dealer may not be enough.



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.

SF Prosecutors Drop More Cases in the Wake of Hotel Video Scandal

By Brandon Ortiz
Daily Journal Staff Writer

San Francisco prosecutors dismissed eight additional criminal cases Tuesday in the wake of a growing police scandal involving eight undercover officers accused of conducting warrantless searches and lying on police reports, officials with the public defender’s office said.

The scandal came to light last week after San Francisco Public Defender Jeff Adachi publicly released hotel surveillance videos that allegedly contradict official police accounts of three unrelated drug busts. The claims have reportedly spurred three separate investigations by prosecutors, police and the FBI and could lead to the review of thousands of cases.

It’s also the first test of new District Attorney George Gascon, who is running for election this year and is the city’s former police chief.

Eight cases unrelated to the drug busts were dismissed by prosecutors

on Tuesday, said Tamara Aparton, a spokeswoman for Adachi. Officers who were implicated in the video tapes Adachi released had worked on the cases, including one in which an accused officer had testified at a preliminary hearing, she said. Two

Growing concerns over alleged warrantless searches and false police reports could be the first test of new District Attorney George Gascon, who is running for election this year and is the city’s former police chief.

men whose cases were dismissed were facing prison sentences of 35 and 27 years each for felony drug charges, Aparton said.

Aparton said a total of 13 cases had been dismissed by prosecutors or judges as of Tuesday afternoon, including four directly tied to the video tapes.

Adachi is planning to review every

case the implicated officers have ever investigated or testified in, which could number 2,000 to 3,000, Aparton said. He may seek to reopen the cases to have defendants’ convictions overturned.

A spokeswoman for Gascon did not

immediately return phone calls Tuesday. Last week, Gascon announced that he is investigating the incidents and will review cases the officers had worked on.

On Dec. 23, undercover police arrested a man at the Henry Hotel in the Tenderloin district on accusations he was dealing heroin and crack

cocaine at the hotel. According to a sworn police report signed by Officer Arshad Razzak, police were acting off of a tip from a confidential informant. The officers knocked on a hotel room door and announced themselves. After they didn’t hear a response, they used a master key to partially open the door and told a woman that they were obtaining a search warrant for the room.

Razzak wrote that the woman gave them permission to search the room and that they found heroin and crack on a male occupant.

But Adachi said the hotel’s video surveillance footage tells a different story. He said it shows four officers using a master key to barge into the room without knocking or asking for permission.

Charges against hotel occupants were dropped last week after the public defender’s office showed prosecutors the video footage.

In a separate Jan. 5 drug arrest, Officer Richard Yick swore in a police

report that officers spoke to a woman in a hallway of the Henry Hotel who agreed to open the door to her room. A man who came to the door told police officers that he was on probation, which police confirmed with dispatchers before searching the room, the report stated. Police arrested the man and woman after officers found heroin in the room, according to the report.

But in the security video, Yick allegedly covers the surveillance camera with his hand while three officers barge into the room.

After watching the surveillance video last week, a judge dismissed charges stemming from the Jan. 5 arrest.

In a third video taken on New Year’s Eve, police kicked down a door at Ho-

tel Royan in the Mission District and didn’t confirm the suspect within had a misdemeanor bench warrant until after his arrest, the public defender said.

The officers involved in the arrests have been placed on administrative duty while the department conducts an internal investigation, a police spokesman said.

The scandal grew Monday when Adachi released a video that private defense lawyer Scott Sugarman obtained involving the arrest of another man at the Henry Hotel on Dec. 2. The video involved some of the same officers.

Sugarman and Adachi accused police officers of framing a 29-year-old man on drug charges.

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State High Court Grapples With Defining Pimp

By Paul Elias
Associated Press

SAN FRANCISCO — When is someone a pimp?

The California Supreme Court grappled with that question Tuesday in the case of a man who was convicted of pandering in Los Angeles after he tried to recruit an undercover police officer to work as a prostitute for him.

His lawyer urged the high court

during oral arguments to toss out the conviction, arguing that only pimps who recruit innocent victims — rather than working prostitutes or someone posing as a prostitute — can be guilty of pandering.

The case of Jomo Zambia boils down to defining the phrase in California law that makes it a crime for anyone who “induces, persuades or encourages another person to become a prostitute.”

Zambia was arrested in 2007 and

sentenced to four years in prison. He’s been paroled but wants his conviction erased.

His lawyer Vanessa Place argued that Zambia should have been charged with a lesser crime, such as attempting to pander or solicitation of a prostitute.

She said people can’t be convicted of pandering when they attempt to persuade a working prostitute to change management.

“You can’t become what you al-

ready are,” Place argued.

California Deputy Attorney General Rama Maline countered that the law was meant to imprison any would-be pimp regardless of the target’s status as a prostitute or innocent victim.

The Supreme Court appeared divided on the issue. Justices Marvin Baxter, Ming Chin and Patricia Bamattre-Manoukian seemed ready to side with the state.

Bamattre-Manoukian, an appellate court judge temporarily filling in because of the retirement of Carlos Moreno, said the law could be read as making Zambia’s action illegal because the person was “becoming a prostitute for him for the first time.”

Justice Joyce Kennard, however, said Zambia made a compelling argument.

“When one is already a prostitute, one can’t be encouraged to be a prostitute,” Kennard said. “That seems to be a common-sense interpretation.”

The court will rule within 90 days.

Office Depot to Pay \$4 Million to Settle Overcharges

Associated Press

SAN FRANCISCO — The city has reached a \$4.25 million settlement with Office Depot Inc. over allegations the company overcharged for office supplies, officials said Tuesday.

Mayor Edwin Lee signed a Board of Supervisors resolution authorizing the settlement, which includes a \$3.75 million payment and a \$500,000 purchasing credit.

A 2009 audit by the city controller found that Office Depot deprived the city of an estimated \$5.75 million

in discounts mandated under its five-year, \$18 million contract.

Office Depot initially claimed the overcharges totaled less than \$50,000 and were the result of accounting errors.

The Boca Raton, Fla.-based company strongly disputes the audit’s conclusions but views the settlement as a reasonable compromise, Office Depot spokesman Jason Shockley said.

Last year, the company settled contract disputes with government agencies in Missouri and Florida.

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