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GUEST COLUMN

The tax when partners withdraw

By Edwin B. Reeser

The method for truing up the distributions made to a withdrawing partner and the obligation to repay over-distributions create a narrow window for partners to minimize "departure tax" — that is, the financial penalty applied to partners who voluntarily withdraw, which can be a rude awakening for partners who didn't read the partnership agreement.

Here's a generic provision found in partnership agreements regarding voluntarily withdrawing equity partners (not lifted from any particular firm's agreement):

"Any payments due to a withdrawing Partner shall be adjusted by that Partner's share of Net Income/Loss in the current Fiscal Year as of the last day of the month preceding their Termination Date. Within 60 days of the Termination Date the Firm or the withdrawing Partner, as the case may be, shall pay the full amount owing. In the event the withdrawing Partner does not make payment in full to the Firm as herein required, the Firm may offset amounts due the Firm from any amounts due to the withdrawing Partner."

Seems pretty benign. Let's see how it works. Set the stage with a 120-equity partner firm that pays 50 percent of forecast income in level draws twice monthly, pays the balance 30 percent on January 15 and 20 percent on March 15 of the following year. Firm annual gross revenue is $480 million, and operating margin is 30 percent. The withdrawal notice is 30 days.

Many law firms run an operating deficit in January and February, with low collections until March of their new calendar/fiscal year. The year-end collections push in Q4 contributes to an anemic cash flow start every year, with liquidity at the lowest levels in January-February. There are no Q1 profits to pay partners, so draws must come from cash reserves or borrowing.

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Associated Press

California Department of Fish and Game fisheries biologist Mark Hampton describes the operation of a weir, which forces salmon past a video camera so they can be counted, in 2004 on the Shasta River outside Yreka.

Farmers fight state water rules in court

By Fiona Smith
Daily Journal Staff Writer

Farmers around the state are desperate to hold onto to every drop of water in the worsening drought, and part of that struggle is playing out in a court case in which they accuse the state's wildlife agency of upending California's water rights regime in the name of protecting imperiled fish.

In a case pending at the 3rd District Court of Appeal, the Siskiyou County Farm Bureau hopes to stop the California Department of Fish and Wildlife, or DFW, from requiring irrigators to notify the agency when they divert substantial amounts of water from a river or stream. The court is set to hear oral argument in the case April 27. *Siskiyou County Farm Bureau v. Dept. of Fish and Wildlife*, C073735.

Once notified, the department can review the health of critically endangered salmon and other fish in the waterway and possibly order irrigators to cut use. But the farm bureau argues that such a move tramples on people's water rights, which are determined by the State Water Resources Control Board, not the DFW.

The wildlife agency and its supporters are "playing a dangerous game," wrote David M. Ivester, a partner with Briscoe, Ivester & Bazel LLP, in a brief on behalf of the farm bureau.

"They are attempting to extract a radical change in the law, with potentially devastating consequences for California, from a single word — 'divert'— in a 50-year-old criminal statute that, until recently, had not been read to have what they now allege is its unambiguous meaning. The effect of this change would be to criminalize ordinary farmers for doing nothing more than exercising their surface water rights, and to give the department an effective veto over those rights."

The wildlife agency has long had the power to require farmers to report when they plan to install irrigation systems that will impact a streambed and to have them take steps to protect fish. But in recent years, the farm bureau argues the agency has used the law in a way it was never intended — requiring reporting from anyone in the region who is diverting substantial amounts of water, whether or not that diversion directly harms a streambed.

The DFW counters that the wording of the law, known as Section 1602 of the fish and game code, clearly applies to anyone who substantially diverts water. The agency is being backed by groups including the State Water Resources Control Board, California Trout, the Karuk Tribe and a group of water law professors, all of whom have filed amicus briefs in the case.

The Pacific Legal Foundation, California Cattlemen's Association, and the Northern California Water Association, have filed briefs in support of the farm bureau.

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Marijuana is Schedule I drug: ruling

US judge's decision is the first on the issue in decades, comes after new laws relaxed enforcement

By L.J. Williamson
Daily Journal Staff Writer

A Sacramento federal judge ruled Wednesday that marijuana should retain its position alongside heroin and LSD on the Drug Enforcement Administration's list of most dangerous drugs.

U.S. District Judge Kimberly Mueller said in an oral ruling that the herb belongs on the DEA's list of Schedule I substances, which are defined as having no accepted medical utility, a high potential for abuse, and a lack of accepted safety for use under medical supervision. No prescriptions may be written for these substances.

The case was significant because it was the first time the question of marijuana's scheduling was given judicial consideration in decades. Mueller held a five-day hearing on the matter last year as part of a motion to dismiss charges against six Trinity County pot farmers by defense attorney Zenia Gilg. *U.S. v. Schweder*, CR11-449 (E.D. Cal., filed Oct. 20, 2011).

The decision comes at a time when prosecutors have loosened their enforcement of marijuana laws.

However, just a day earlier, a 9th U.S. Circuit Court of Appeals panel denied a request by the owner of a Morro Bay medical marijuana dispensary for the court to issue "an order directing the Department of Justice to cease spending funds defending, cross-appealing, and otherwise prosecuting" his case, citing a provision of the 2015 Appropriations bill Congress passed which prohibited the use of federal funds to prosecute individuals involved in a medical marijuana business operating legally under state law.

Responding to the verdict, defense attorney William Bonham said: "Highly disappointed would be an understatement."

"The judge found that the motion had merit, she found that the expert witnesses that we produced were credible, but she found that there was a rational basis for the scheduling, that was passed by Congress 45 years ago, irrespective of the fact that she also stated there has been considerable change in the landscape of marijuana laws, and she felt that the court had to remain on the objective level in reviewing congressional action," he said.

Bonham was baffled, he said, by Mueller's statement that "this is not the time."

"When will it ever be the time?" Bonham asked.

Douglas A. Berman, a professor at Ohio State University Moritz College of Law, said he felt constitutional litigation would be an unlikely route to making significant changes in federal marijuana laws. In addition, Berman said, "It's not clear to me at all that there's a link between scheduling and how we can prosecute defendants."

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DAILY APPELLATE REPORT

CIVIL LAW

Civil Rights: District court exceeds authority in imposing injunction provisions that do not address Sheriff Office's constitutional violations related to racial profiling in Arizona. *Melendres v. Arpaio*, U.S.C.A. 9th, DAR p. 4164

Contracts: Indemnity clause specifying award of attorney fees is not reciprocal and is not triggered by buyer's breach of contract claim against escrow company. *Rideau v. Stewart Title of California*, C.A. 4th/1, DAR p. 4157

Municipal Law: Restaurant owner is liable for public nuisance because his poorly- and neglectfully-maintained restaurant is a hub for criminal activities. *Benetatos v. City of Los Angeles*, C.A. 2nd/5, DAR p. 4149

Law school graduates are doing a bit better on the job market

By Don J. DeBenedictis
Daily Journal Staff Writer

Recent graduates from California law schools have done better landing jobs as lawyers this year than last, according to new reports from the schools.

Overall, just under 54 percent of the class of 2014 had found full-time, long-term lawyer employment by early this year compared to 49 percent of 2013 graduates at about the same time.

Law school deans are cautiously optimistic about what they're hoping is a trend. "Law jobs in California are coming back," said Tom Campbell, dean of Chapman University Fowler School of Law. An economist who formerly was dean of UC Berkeley's business school, Campbell cautioned his prediction is as much hunch as science.

The data comes from the reports law schools accredited by the American Bar Association must file annually with the ABA. According to an analysis of those reports, about three-fourths of California schools saw an uptick in the percentage of May 2014 graduates with full-time, long-term jobs requiring passing the bar exam as of March 15 over the year before.

But a few law schools did worse, including those at Pepperdine University, Santa Clara University, the University of San Diego and Western State.

Schools showing the greatest increase in the percent of graduates hired include those at California Western, Chapman, the University of La Verne, Loyola and USC, among others.

Deans and career services officials at the schools point to a variety of factors lying behind both the ups and the downs.

Michael Hom, the assistant dean of career development at Pepperdine University School of Law, said he traces his school's decline in lawyer employment to the nationwide drop in the number of people passing the July 2014 bar exam. A graduate can't get what the ABA classifies as a "bar passage required" job if he or she didn't pass the bar exam, he said.

Pepperdine's bar pass rate for the exam fell about 5 percent, about the same as its graduate employment rate, according to Hom. "It's hard to tell, but it certainly was a contributing factor," he said.

He also noted that a few of his graduates had accepted lawyer jobs with deferred starts, which put their employment beyond the ABA's March 15 cutoff, meaning they counted as unemployed.

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Litigation

Early Riser
Los Angeles County Judge Frederick Shaller tackles his busy docket with a vigorous work ethic.
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Patent case fee awards up sharply
Two U.S. Supreme Court rulings resulted in a wave of successful attorney fee awards for defendants in patent cases, according to a report.
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Home Court
John Keenan oversees the legal department of AEG, owner of the Staples Center and other arenas.
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Dealmakers
Cox, Castle & Nicholson LLP counseled Bixby Land Co. in its $44.25 million acquisition of the Irvine corporate headquarters of Kawasaki Motors Corp. USA.
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Perspective

Evolving policy interpretation
State Courts of Appeal and even the state Supreme Court itself in various opinions are inconsistent in their approach to policy interpretation. By Rex Heeseman
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Pirating live sports
Proposed bipartisan legislative solutions would give additional tools to the DOJ to help deter piracy of live sports broadcasts. By Makan Delrahim
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New source for policy interpretation

By Rex Heeseman

Since 1990, insurance policy interpretation has focused upon three guideposts in seriatum. An excellent example is *Minkler v. Safeco Ins. Co. of America*, 49 Cal. 4th 315 (2010), where the state Supreme Court unanimously declared:

"'If contractual language is clear and explicit, it governs.' If the terms are ambiguous [i.e., susceptible of more than one reasonable construction], we interpret them to protect 'the objectively reasonable expectations of the insured.' Only if these rules do not resolve a claimed ambiguity do we resort to the rule that ambiguities are to be resolved against the insurer."

While this quote seems straightforward, there has been "overlap" even in even decisions by the Supreme Court. Some decisions have initially emphasized "reasonable expectations," the second guidepost. See, e.g., *MacKinnon v. Truck Ins. Exch.*, 31 Cal. 4th 635 (2003). Other decisions combine the first two guideposts. See, e.g., *Powerine Oil Co. Inc. v. Superior Court*, 37 Cal. 4th 377 (2005) (Powerine II) ("literal language of the policies controls as does the objectively reasonable expectations of Powerine the insured").

Setting aside these arguable inconsistencies, appellate courts have considered various sources in interpreting an insurance policy. A notable example is the use of dictionaries. See, e.g., *Stamm Theatres Inc. v. Hartford Cas. Ins. Co.*, 93 Cal. App. 4th 531, 543 (2001). But a dictionary's definition is not always controlling. *MacKinnon*, 31 Cal. 4th at 649; *TRB Investments Inc. v. Fireman's Fund Ins. Co.*, 40 Cal. 4th 19, 29 (2006).

Another source is the Civil Code, which may flesh out a term's meaning. For instance, because "damages" was not defined in the policy, *AIU Ins. Co. v. Sup. Ct. (FM Corp.)*, 51 Cal. 3d 807, 825, 828 (1990), looked to Civ. Code Section 3281. The meaning of a term may also be illuminated by Internet searches. *MacKinnon*, 31 Cal. 4th at 651-52.

A judge may look to common knowledge or common sense. For example, in applying the exclusion for "wet or dry rot" caused by a fungus infestation, the court reasoned a layperson would normally consider "dry rot" as one such cause. *Jordan v. Allstate Ins. Co.*, 116 Cal .App. 4th 1206, 1214 (2004). On the other hand, a strained description or interpretation should not succeed. See, e.g., *Bank of the West v. Sup. Ct. (Industrial Indem. Co.)*, 2 Cal. 4th 1254, 1276 (1992) ("advertising injury" not encompass activity unrelated to advertising).

Rules of grammar and punctuation may be helpful. For instance, according to the "last antecedent rule," words of limitation at the end of a phrase are generally construed to apply to "the words or phrases immediately preceding" and not to "others more remote." *State Farm Gen. Ins. Co. v. JT's Frames Inc.*, 181 Cal. App. 4th 429, 447 (2010). However, this rule is "not immutable," and should not override the clear intent of the language. *Mt. Hawley Ins. C. v. Lopez*, 215 Cal. App. 4th 1385 (2013).

A recent decision has added a practical angle: the manner in which the vehicle was utilized. *American States Ins. Co. v. Travelers Property Cas. Co. of America*, 223 Cal. App. 4th 495 (2014), review denied S217036. There, the insured rented out food trucks and leased one to Mr. Gomez. The food truck had two seats, with cooking equipment installed elsewhere.

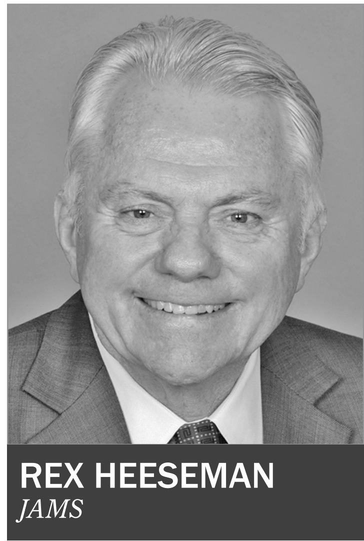
When driving the food truck, Gomez swerved, splashing hot oil on his wife, a passenger. The Gomezes sued the insured, which tendered to its automobile insurer and its commercial general liability insurer. The former defended, but the CGL insurer declined. The CGL policy had an automobile exclusion, with a "mobile equipment" exception (i.e., putting such equipment back into the insuring clause).

In the ensuing litigation between those two insurers, the automobile insurer moved for summary judgment, asserting as the food truck constituted "mobile equipment," the automobile exclusion did not bar coverage under the CGL policy. The trial judge rejected that assertion, entering summary judgment in the CGL insurer's favor.

The Court of Appeal reversed. The "mobile equipment" exception applied because the truck's primary purpose was to serve as a mobile kitchen selling food, not to transport people or cargo. The court observed that, during much of the day, the food truck was immobile or made frequent stops to serve food. Moreover, the food truck had only two seats, one for a driver and one for a cook. As the CGL policy covered this products liability claim, the trial judge therefore erred in finding no duty to defend.

Why is *American States* interesting for policy interpretation purposes? Because of that court's focus upon the manner in which the food truck was used for food sales, not transportation — a use contrary to a truck's typical activity. In other words, the "mobile equipment" exception had to mean something.

So, the next time the issue of policy interpretation is encountered, consider various sources in analyzing the existence of coverage. And, sometimes, a practical approach may carry the day.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Expanded coverage of contamination fund a policy win

By Jordan W. Carlson

In California, underground petroleum storage tanks are subject to the Barry Keene Underground Storage Tank Cleanup Trust Fund Act of 1989. Under the act, every owner of an underground petroleum storage tank must pay a storage fee for each gallon of petroleum in the tank. These fees are deposited by the state into the Underground Storage Tank Cleanup Fund.

The law authorizes the State Water Resources Control Board to make payments from the fund to aid the owners of underground storage tanks when they are required to take a corrective action to investigate and clean up contamination resulting from unauthorized releases from those tanks. Currently, $1 million is available to owners for each corrective action undertaken by the board, a regional water quality board, or a local agency.

Until recently, the fund has been used to pay for remediation only when an underground storage tank is the source of an unauthorized discharge. However, Senate Bill 445, signed into law last year, may change broaden the fund's application. Health and Safety Code Section 25299.50.6 establishes a Site Cleanup Subaccount allowing for investigation and cleanup of contaminated properties for the broad purpose of remediating "the harm or threat of harm to human health, safety, and the environment caused by existing or threatened surface or groundwater contamination" where the responsible party has either been ordered to investigate or conduct a cleanup or it is determined "infeasible for an order to be issued before initiation of remediation."

This is significant because SB 445 omits any mention of the source of contamination covered by the subaccount and does not limit fund coverage to petroleum-related products. In other words, SB 445 does not appear to require a hazardous release from an underground storage tank and allows fund coverage for hazardous releases of compounds that are not petroleum based.

Section 25299.50.6 will allow for a broad application of the fund through the Site Cleanup Subaccount to sites contaminated from sources other than petroleum underground storage tanks — this might include, for instance, contamination from dry-cleaning solvents and other industrial solvents used by manufacturers.

Tetrachloroethylene, or PCE, is the predominant chemical solvent used in dry cleaning. Compared to other volatile organic compounds, including petroleum, PCE contamination is very mobile and recalcitrant. Natural attenuation has been more prevalent at fuel-impacted sites when compared to natural attenuation at PCE- affected sites. A 1999 nationwide study of approximately 250 sites contaminated with solvents found that much less natural attenuation had occurred when compared with petroleum contaminated sites. This study concluded that solvent plumes averaged about 1,600 feet — much larger than the typical 130 foot fuel plume — and that sites contaminated with chlorinated solvents like PCE typically require source reduction and enhanced attenuation to achieve a stable or retreating chlorinated solvent plume.

Fuel- and PCE- affected sites differ mainly due to differences in chemical properties and toxicity. Unlike fuel, which is less dense than water, PCE is very dense and sinks downward in groundwater. PCE is also classified as a probable human carcinogen and has relatively low solubility. The water quality advisories for a 1-in-a-million incremental cancer risk estimate is 0.8 parts per billion (ppb). The state Department of Health Services' maximum contaminant level for PCE is five ppb.

Currently, there are roughly 22,300 active dry-cleaning businesses in the nation. The State Coalition for Remediation of Drycleaners and the Environmental Protection Agency agree that nearly 75 percent of all dry cleaners have some level of contamination present. While many of these dry cleaners are not contaminated to the point of requiring active environmental remediation, contamination is present in some form at these sites and, sometimes, will require major environmental remediation. Cleanup and remediation of sites contaminated with PCE can range from tens of thousands of dollars to several million dollars, averaging about $500,000 per cleanup.

The broadening of the fund to cover sites contaminated by dry cleaners and other polluters is a favorable policy shift for California because of the amount of contamination that necessarily results from dry cleaning and that such contamination is typically quite expensive to investigate and clean up when compared to petroleum contamination. Likewise, huge costs have been incurred to investigate and remediate sites where such chemicals as trichloroethylene (TCE) have been used to degrease and clean parts for many types of manufacturing.

The addition of the Site Cleanup Subaccount is significant for property owners who have come into ownership of a property where contamination is discovered. It is also significant for current and past operators of dry cleaning facilities who may be held liable for contaminating properties where PCE was used as a dry cleaning solvent or where TCE was used in metal plating or in various types of manufacturing operations. This legislative addition could yield untold benefits for the state because it provides much needed financial coverage for sites contaminated by sources other than underground storage tanks and it taps a source of funding already available.

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Quite possibly the best lateral move you never made

Continued from page 1

The First Threshold: Operating Breakeven

Assuming the firm collects 15-20 percent of its annualized revenue in Q1, the partner withdrawing in Q1 must return 100 percent of draws received plus an amount equal to that partner's proportional share of operating losses of the firm. The fixed date for performing that calculation is the last day of the calendar month preceding the withdrawing partner's last day at the firm. For example, if a withdrawing partner gives notice on February 25, but does not leave until March 27, then the February 28 closing of the month will apply. If the firm accelerates the departure to February 27, as many agreements permit, then January 31 would apply.

If the withdrawing partner gives notice immediately after receiving the final March 15 distribution for the prior year, it will be tied to the February 28 month end — probably the highest net negative financial position of the year, creating a high disgorgement figure. Using level annualized operating costs of $24 million per month, and gross revenue in January/February of $40 million, the operating deficit is $8 million. With annual forecast profits of $144 million and profits per equity partner of $1.2 million, that's approximately a $67,000 net loss to each partner.

If the withdrawing partner gives notice January 1, the reference date for the computation is December 31, but if they give the notice January 3, the firm could make the date February 2 using the full 30 days in the notice. Note the final distributions from the prior year, normally due January 15 and March 15, are now in jeopardy of being held for 60 days while a variety of administrative computations are made to square up the accounts. The partner's estimated tax payments are due January 15. The next capital loan principle payment is also due in January. The withdrawing partner would be disqualified from being eligible from a variety of discretionary bonus payments determined in the first weeks of Q1. Providing for this cash flow interruption would be critical to the timing decision.

The Second Threshold: Draws Breakeven

Once the partner gets past the operating breakeven, there is still a disgorgement factor until draws received exceed "profits." Draws commonly outpace profits growth for a few months, perhaps until the second full quarter. Realistically, partner incomes heavily depend on the last three months of the year. When 40 percent of the annual firm revenue is not actually received until Q4, almost all partner profit in excess of 50 percent draws during the year is derived in Q4.

When does this firm reach the "draws breakeven" point? Assuming December is roughly a double collections month — the case for many firms — that is $80 million in revenue, or $56 million in "profit." That is about 78 percent of the $72million holdback. "Draws breakeven" is reached sometime in November for this firm. If a partner gives notice in December, *they will effectively forgo close to half of that year's income* because the computation will be rolled back to November 30.

What about a mid-year withdrawal, after "operating breakeven"? If notice is given in July, June 30 is the applicable end date, and partners could have a whopping disgorgement of draws. If there is zero profit in Q1, and only $24 million in Q2, that would support $12 million in partner draws for the first six months, or $100,000 per partner, but profits allocable were $200,000. Level draws would be $300,000, and average compensation partner would be overdrawn relative to June 30 profit by $100,000. The reason this occurs is the "profit" received by the firm are the last dollars in the door, after all current and prior costs have been paid.

Here is another consideration. You are the above $1.2 million partner with a 35 percent capital requirement, or $420,000. You have a loan balance of $168,000 with a bank, due in two sequential January 15 installments of $84,000, with the balance of $252,500 paid in. Your monthly draw is $50,000. You give notice on August 16 after having received 15 draws ($375,000) that you are leaving and the firm uses July 31 as the reference date. As of July 31, your allocated share of firm net income is $0 for Q1, $200,000 in Q2, $133,000 for Q3, and you received $25,000 on August 15, but are not entitled to any profits allocations for that "advance."

You are overdrawn relative to firm profit by $150,000 in Q1 (there was none). In Q2, firm profits were $8 million per month and your share was $200,000, while distributions were again $150,000. Your year-to-date distributions aggregating $300,000 as of June 30 relative to profits of $200,000 leave you with a reduced repayment obligation of $100,000. With draws at 50 percent of scheduled annual profits, you can see that Q2 profits were more than needed to pay current draws, and reduced the amount of over-distribution from Q1 by $50,000. In Q3, profits are roughly $16 million per month, so with the 50 percent draw you have $350,000 in total distributions through July 31 against $333,000 in profits share. That leaves you negative $17,000 as of July 31, to which you add the August 15 distribution because you don't participate in profits that month, and the repayment obligation totals $42,000.

The bank has a standard three-party agreement with you and the firm that first returns of capital are directed to the bank, and once the loan is paid off the remaining payments go to you. But with the "offset," the firm keeps $42,000 of your paid in cash balance, reducing that to $210,500, and you owe the bank another $168,000, which they can immediately accelerate the due date for. Depending how the partnership agreement treats return of partner capital, the withdrawing partner could face an installment or even deferred return of capital over several years, holding the $210,500 interest free. First distributions, when made, go to the bank — unless the bank already collected it directly from you.

If you leave early in the year, you disgorge large amounts. If you leave late in the year, you forfeit large amounts. How benign does the clause seem now?

Know exactly what your new firm's partnership agreement provides before you leave a firm that treats its partners fairly for something akin to what is presented above. It could be the best lateral move you never made.

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