Another city may declare bankruptcy

But at least some experts say cases don't signal statewide municipal emergency

By Ben Adlin
Daily Journal Staff Writer

The Central Valley city of Atwater could soon become the fourth California municipality to declare bankruptcy in less than a year.

Citing "a severe and chronic fiscal crisis that jeopardizes the delivery of essential public services," the City Council on Wednesday declared a fiscal emergency and made clear that all options — including an eventual Chapter 9 filing — are on the table.

"The economic downturn that the nation experienced four years ago has critically reduced the General Fund and other revenues," said a staff report in support of the declaration. "Though it was anticipated that the economy would recover by now, the recovery has not materialized."

A call to the city manager's office on Thursday was not immediately returned.

Like many California municipalities, Atwater is struggling under sagging home prices, high unemployment and friction with government workers over how to cut costs. The staff report, published last month, cited a 40 percent decline in median home values over the past five years and an unemployment rate of 21 percent.

'You're still talking about fewer than half a dozen cities" of nearly 500 in the state. You could argue it's surprising there haven't been more, but bankruptcy's a pretty big step.'

— *Raphael J. Sonenshein*

All told, the city of roughly 28,000 residents faces a projected $3.3 million general fund deficit for the current fiscal year.

But while the factors pushing Atwater toward insolvency may sound familiar to a litany of other California cities, experts cautioned against a conclusion that the state's municipal sky is falling.

"I still wouldn't say it's a wave," said Michael A. Sweet, a bankruptcy lawyer at Fox Rothschild LLP. "There are characteristics of each filing that we've seen recently that are unique."

Three cities — Stockton, San Bernardino and Mammoth Lakes — already declared bankruptcy this year.

"Stockton is the kind of city where people who are out there talking about a wave might be looking," Sweet said, but he added that the other two were triggered — at least in part — by particular circumstances.

Mammoth Lakes was hammered with a $43 million court judgment after being sued by a developer. San Bernardino has been accused of questionable accounting methods, in addition to having weathered a bad economy, Sweet said.

Even Atwater represents one of the worst-case scenarios, said Raphael J. Sonenshein, executive director of the Edmund G. "Pat" Brown Institute of Public Affairs at California State University Los Angeles.

"Those that are in areas of high poverty, high unemployment and huge declines in housing prices are the ones that are most at risk," he said, noting that Atwater faces "severe" conditions in each category.

"You're still talking about fewer than half a dozen cities" of nearly 500 in the state, Sonenshein said. "You could argue it's surprising there haven't been more, but bankruptcy's a pretty big step."

Sonenshein added that federal support has been largely absent during the current fiscal slump.

"Usually the states and cities would get what's called countercyclical aid" meant to carry local economies in tough times, he said. "They've been left on their own."

And for cash-strapped cities, that makes the choices ahead difficult.

"You have to do something," Sonenshein said. "Raise taxes, cut services or go bankrupt. The choices aren't great."

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AOC and Alliance clash over records

Continued from page 1

emails, written letters couldn't be tampered with after the fact.

He denied the Alliance's claim that Alliance judges were singled out and said "no other judges except declared Alliance judges are making these [type of] requests."

Hull also said that while he believes some Alliance requests are reasonable, others are "more intended to be intimidating and to provide make-work for AOC employees."

According to Hull and Finke, the Judicial Council has created a group that's studying ways the branch can handle policy requests and more complex questions. Proposals for such a process may be presented to the council by its December meeting.

Alliance spokeswoman, Sacramento County Superior Court Judge Maryanne G. Gilliard, said the Alliance's requests, although numerous, are largely straightforward and factual, and therefore don't have to be handled by Hull.

Regarding the volume of the Alliance's requests, Gilliard said the AOC and the Judicial Council have long avoided a culture of transparency and accountability, noting that the substance of such Alliance criticisms were reflected in a report commissioned by Cantil-Sakauye last spring on branch administration and the Council's oversight of it.

"[They] have never had their actions or decisions questioned and we understand they feel put upon and even a little stressed that judges are asking these questions," Gilliard said, "but they are spending public dollars, and they need to be accountable."

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True costs of lateral partner buy-ins

By Edwin Reeser

Recruiters are standing by to take your call.

What happens when the firm comes in 12 to 14 percent below targeted compensation for the equity partners? Does the firm "discount" the amount of equity required? Do they give every partner a return of capital? That is doubtful. So now our hypothetical partner with the $100k raise winds up collecting $688k and not $800k. But the partner had to put up $42k ($84k pretax), so the take home is now $604k (oh, let us not forget they have to pay tax on that too). And she keeps paying in the additional 5 percent until the 60 percent is reached. These are numbers that speak for themselves.

LAST IN A TWO PART SERIES

Part one appeared on Oct. 4. The series is collected at www.dailyjournal.com.

How much would you pay to be in this firm? Don't Answer!

What happens when the firm comes in 10 percent above targeted compensation for the equity partners? (I told you, this was a hypothetical.) Does the firm not treat the surplus as a de facto "raise" for the year past and out of the distribution withhold 30 percent as the true up? Probably, because unless the firm sets a budget that calls for lower compensation the following year, that is going to be the baseline against which partners will be asked to contribute additional base capital anyway! Easier for the firm to just take it before it hits your pocket.

But wait, there is more!

What about the possibility that the firm might be "aspirational" on the budget, so as to grab a bit more of that cash? The dynamic helps the firm to maximize capital and reduce net distributions. But how that money once it is in the firm is distributed, that can still be manipulated in a "black box" compensation system. (Such as "bonuses" that are not part of "targeted compensation" and thus not required by the recipients to be supported by capital contributions or half a dozen other approaches. For example, holding back 5 percent of net distributable profits firmwide for discretionary bonuses, which routinely find their way into the pockets of the inner circle of management who vote it for themselves. That can be done "offgrid" through a Verein holding company so that the partners in the subpartnerships never find out. Or it can be done in a single firm because, well, they can. Five percent of say $200 million takes care of a lot of "friends.")

Oh, and perhaps the firm could be generous on "raises"? That is good for some more capital to get that precious cash in hand. The "raises" are balanced by the aspirational budget, so it all ties out neatly.

For new laterals, or even existing partners, if they do not hit the target that is agreed to, or unilaterally heaped upon them, for hours-billings-higher rate settings, they can be "cut" on their compensation or equity partner share at the discretion of the leadership. Those cuts are not necessarily evenly applied to all persons, giving substantial leverage under the color of fairness while actually being quite subjective. Remember that 5 percent rolling annual contribution every year keeps being applied as long as any balance is due on the 60 percent requirement.

How much would you pay to be in this firm? Don't answer!

The firm may adjust the baseline requirement for a demoted or compensation reduced partner, as most firms do, rather than when it is function of overly high "aspirational" budgets and unrealistic "raises," but even then there is a "gotcha."

For example, the lateral has a $700k target comp, but misses target performance in the first year and is "reset" to $600k comp. Baseline capital is set at 30 percent or $180k. But the "requirement" is 60 percent. The installment pay-in is just an accommodation, so she doesn't get a "refund" for being over contributed. Her contractual capital requirement is still 60 percent or $360k on the $600k target compensation. She has $210k in initially on the $700k, so she still owes $150k. Her January 5 percent is reduced to $30k from the $35k it would have been at the higher salary, so that knocks the balance down to $120k and she keeps paying in at 5 percent each year until she is fully capitalized. It just is treated as an earlier pay down!

But wait! There is more!

The "more" is when the partner leaves the firm and the partnership agreement doesn't provide an immediate 100 percent return of partner paid in capital. To the extent there are capital payment returns made, any bank borrowings get paid first. The partner could face a call from the bank to pay the entire balance of the loan outstanding, while the firm pays little or nothing for a year or more, and installments are spread over three years, five years, and possibly even longer, and interest free of course.

Is there more?

You bet. Ready? Little of this has anything to do with making the firm stronger. The problem of whether the lateral recruiting costs versus the net production of the laterals present a "winning" financial proposition are not addressed. The problem of redirecting cash internally from equity capital as contrasted with debt — much of which has been pushed down to individual partners rather than sourced from revolving lines at the firm level — is not addressed. Dewey used debt to do what it did to its partners, but it wasn't restricted to only using debt — it could have used heavy capital contributions instead, or in a blend. The classic challenge of overdistribution as contrasted with undercapitalization is not protected against just because a firm uses all equity for its capital needs. With a large performing receivables base, not much capital is actually needed to operate the business, assuming distributions are reasonably restricted to net cash on hand less operating reserves.

For new laterals ... if they do not hit the target that is agreed to, or unilaterally heaped upon them, for hours-billings-higher rate settings, they can be "cut" on their compensation or equity partner share at the discretion of the leadership.

With the Ginsu knife you got a lifetime 100 percent satisfaction guarantee or your money back, no questions asked. So the Ginsu offering from that perspective was actually a better deal than partnership in a law firm.

And now time for the "closer."

If the firm that pursues a heavy rolling capital contribution commitment is well managed, and compared to a firm with balanced use of debt and equity responsibly used capital at 35 percent of targeted compensation, isn't the average PPP partner in this firm investing $300k more of their after tax savings in this firm, with no interest or capital appreciation in its growth, to "buy" their $1.2 million compensation package? Compensation that a firm across the street would also offer in a competitive market for the same performance?

And if the firm is not well managed and goes bankrupt anyway, the unfunded portion of her heavy capital contribution is going to be an estate claim that the creditors and trustee will demand her to satisfy with the unrelenting focus of The Terminator. The bank loans she may have taken out to make capital contributions will remain as personal liabilities to satisfy as well!

Pick up the phone and pledge your equity now. Managing Partners are standing by.

It is up to you to ask the questions you need to know the answers to. How much capital does a firm really need to have, whether debt or equity, and what is that capital being used for exactly, before you ask yourself:

"Now, how much would I pay to be in this firm?"

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.*

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DEAL MAKERS

MERGERS & ACQUISITIONS

O'Melveny, Wilson Sonsini represent in market intelligence company merger

San Francisco-based market intelligence company Cleantech Group LLC and New York-based business advising company LRN Corp. announced Tuesday an agreement to merge Cleantech and former LRN subsidiary GreenOrder LLC. Terms of the merger weren't disclosed. O'Melveny & Myers LLP represented LRN with a team led by Silicon Valley partner Jennifer DePalma that included Silicon Valley and New York partner Sam Zucker. Wilson Sonsini Goodrich & Rosati PC represented Cleantech with a team led by San Francisco partner Robert G. O'Connor that included San Francisco associates Jonathan Axelrad, David R. Goldman, Vinnie Buehler and Wendra Liang.

O'Melveny, Morgan Lewis counsel on Foster City-based digital printing company buy

Foster City-based digital printing company Electronics For Imaging (EFI) Inc. is purchasing Dublin-based competitor Online Print Solutions for an undisclosed amount, EFI announced Monday. O'Melveny & Myers LLP represented EFI with a team that included San Francisco partner C. Brophy Christensen and Los Angeles counsel Andrew H. Ellis and associate Reid A. Jason. Morgan Lewis & Bockius LLP represented Online Print Solutions with a team led by San Francisco partner Scott D. Karchmer that included Palo Alto of counsel Matthew K. Miller and San Francisco associates Scott M. Berning and Heather C. Brookfield.

Stradling assists with 3M's $860 million acquisition of ceramics solutions company

St. Paul, Minn.-based technology giant 3M Co. announced Monday plans to purchase Costa Mesa-based ceramics solutions company Ceradyne Inc. for approximately $860 million. Stradling Yocca Carlson & Rauth PC represented Ceradyne with a Newport Beach team led by shareholder Robert Rich that included shareholders Marc G. Alcser and Shahzad A. Malik and associates Ryan D. Chavez, Anthony Consoli and Ryan Charles Gaglio. Cleary Gottlieb Steen & Hamilton LLP represented 3M.

Hill Farrer helps with sale of Anaheim-based pest control company to UK competitor

UK-based pest control company Rentokil Initial Plc acquired Anaheim-based competitor Western Exterminator Co. for $99.6 million, with a deferred consideration of up to $15 million more within 18 months, Rentokil announced last week. Los Angeles-located Hill Farrer & Burrill LLP represented Western Exterminator with leadership from managing partner Michael J. DiBiase, partner Thomas F. Reed and associate William A. Meyers. The Hill Farrer team also included partners Stacey A. Sullivan, Ian M. Green, Jesse Molina, Arthur B. Cook and James A. Bowles and associates Whitney B. Kringel and Grant K. Peto. Greenberg Traurig LLP represented Rentokil.

FINANCINGS

Gunderson Dettmer represents social radio company in $9 million financing round

San Mateo-based social radio company Jelli Inc. announced Tuesday it has raised $9 million in funding led by its newest investors, Intel Capital, a Santa Clara-based venture capital and private equity division of Intel Corp., and Toronto-based venture capital firm Relay Ventures. Gunderson Dettmer Stough Villeneuve Franklin & Hachigian LLP represented Jelli with a team that included Redwood City partner Louis D. Soto.

Cooley assists with Regulus Therapeutics' revised initial public offering filing

Regulus Therapeutics Inc., a San Diego-based microRNA therapeutics company, announced Thursday revised plans for its upcoming initial public offering. Regulus had planned to offer 4,545,454 shares at between $10 and $12 per share, but said Thursday it now plans a $45 million offering of 11,250,000 shares at $4 per share. Cooley LLP represented Regulus with a team that included San Diego partners Thomas A. Coll, Charles S. Kim and Kenneth J. Rollins, San Francisco partner Susan Cooper Philpot and San Diego associates Megan Arthur, Karen E. Deschaine, Asa M. Henin, James C. Pennington and Jessica Wade. Attorneys from the Boston office of Goodwin Procter LLP represented underwriter Lazard Capital Markets LLC.

— Andrew McIntyre

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