# Law firm capital: what you see is *not* what you get

By Edwin Reeser

Comedian Lewis Black has a routine in which he describes a stroll through the milk section of the supermarket, calling out the many varied types of available milk products. He then pauses for a moment and identifies "lactose intolerant milk," and observes that if one is lactose intolerant, they cannot drink milk. So what's in the carton?

It has a label that you expect, identify with and readily buy — but it can't be what it says it is. It isn't "milk." Something significant has been done to change the milk, or it is something entirely different and non-dairy, such as soy or almond juice.

Law firm capital calls on partners in some firms may not be far removed from this comedy sketch, but it isn't quite as funny.

All business requires some capital to operate — law firms included. However, many firms tend to set large capital account requirements on partners, but no meaningful net realizable capital value in the law firms actually exists; certainly not a capital value that is in rational balance with the aggregate of paid in capital from the partners.

Let's do a simple, three-step exercise.

*One.* A reasonable and typical capital account balance expected of a big law firm partner is in the range of 35 percent of forecast distributable income. If the aggregate of equity partner annual income in our example is $200 million, the law firm's paid in capital would be about $70 million. If the Profits Per Equity Partner (PPEP) were $1 million, then the average capital contribution would be $350,000 per partner.

*Two.* A reasonable and typical operating margin expected of a big law firm is in the range of 33 percent of annual gross fee revenue. So this law firm should have about $600 million in fees per year. That means the firm is generating average net distributable revenue every month that is roughly 71 percent of the total of invested equity capital. Furthermore, at any point in time this firm could be carrying 90 to 120 days of accounts receivable balances on its books — about $175 million. Even with some scrubbing to adjust for questionable accounts, it's a lot of cash, about 2.5 times total partner capital account investment, and it should be reasonably liquid as an asset class.

*Three.* Recent law firm failures all reflected substantial partner capital contribution accounts. In addition there were outstanding balances drawn on their working lines of credit for working capital (roughly, at the time of collapse, $55 million for Heller, $75 million for Howrey, $75 million for Dewey, plus another $125 million in bonds for Dewey). Thus, all of these firms had between $100 million and $200 million (or slightly more) in capital from their combined equity and debt sources, and receivables in the reported range of $125 to $250 million. Yet all three of them ran out of cash, and then failed.

These capitalization levels are immense for a service business that does not employ "capital" as a material component of income generation. With the exception of Dewey, the working capital debt lines extended by commercial banks were not out of the ordinary, nor did these firms or most other firms historically make much use of debt.

So how did firms with so much capital fail? What was said, and what was happening, were very different things.

What was in the carton wasn't "milk." What was distributed to the partners wasn't "income." What was reported on the balance sheet as capital wasn't "equity." It's true that money had been paid in by partners, but the money wasn't there anymore, even though it showed up on the balance sheet.

Where'd it go? There are no cash or hard assets that come anywhere close to these amounts of partner invested "capital." Add to that the outstanding balance of the working line of debt from the lenders and any term loan balances. That is how much money has been shoved into making the firm stand. Then add the aggregate personal debt partners are carrying to fund their contributions to the firm. How can that massive load evolve and not be noticed as a matter of urgent concern?

Simply stated, partners in many large law firms have been focused on a fictional capital model that has become increasingly divorced from economic reality. There is no direct ownership interest in most large law firms by "equity" partners. Partners only have a contractual relationship which explicitly waives any interest in firm equity. A partner pays in $X, receives a percent of net revenues, and if she leaves, receives a return of $X, probably over a term of years (with or without interest). Thus individual partners don't necessarily pay attention to the fact that the true *value* of a partner share in the firm is nowhere near the capital amount contributed. If they did, partners would realize that most of their paid in capital was gone the moment it was contributed. In many firms, if the firm were liquidated off the balance sheet, most or all of the capital accounts would not be realized by the partners. As we saw with Dewey, the liabilities significantly exceed the assets. What makes this even more uncomfortable is that there can be a lot of "off balance sheet financing" with furnishings and equipment leasing that increase the liabilities by millions, and the real property office leases are typically significant long term obligations aggregating tens of millions more in liabilities.

Most of the "value" is tied into cash and receivables. Specifically, the value resides in the *sustainability* of (a) the ability to generate accounts receivable, and (b) to collect. Like the energy in a spinning gyroscope balanced on a taught string: it has to constantly be refreshed or it will eventually fall off. This is where the "elevator asset" characterization of partners becomes so critical. Where the sustainability aspect of the operation is jeopardized by an adverse jolt to the generation of distributable cash, there is little reason for an individual partner to stay other than liability mitigation. If the upside income potential is perceived as less than elsewhere even if the firm recovers, taking the "hit" and moving on is the rational decision. The more who leave, the more compelling that conclusion becomes.

When the call comes to partners that the firm requires more capital, partners should take a good look into the "milk carton" to make sure they understand what is in it. In the above example it could be more likely to be additional monies to pay for what has already been done to the firm, for distributions made not of income but from partner equity and debt capital, or wasted on poor decisions and costly adventures of bad management, rather than the sales line pitched that it is to prepare for something that may or may not happen in the future. If one is coached to look forward, then they often won't be looking behind to see what brought them to where they are. That doesn't mean one shouldn't make that contribution, just that they should correctly know why they are doing it. For some partners there could be a different response to the call for capital if the vague "we might need it for the future" explanation is recast accurately as "we are dead if we don't get it."

Note that rapid growth, by laterals and group acquisitions or combinations, can generate significant capital without the need for capital calls from the *existing* partners. The financial hole can be growing, but when the existing firm partners haven't been tapped for a new contribution, they aren't paying attention to that dynamic. That only works for so long as there are sufficient numbers of newcomers.

This year more attention was placed upon how seemingly healthy firms failed. The demise of such iconic firms as Coudert, Thelen, Howrey, Brobeck and Heller had some impact, but it was the demise of Dewey that sent shock waves reverberating through the industry. With the benefit now of more disclosure than most of the partners at Dewey were privy to, it is clear that Dewey was in very difficult straits for a considerable number of years prior to its ultimate collapse. Perhaps now there dawns a realization that this is transpiring with other law firms at the end of the year.

The aspects of how a law firm may be different than Dewey are not as critically important as the aspects of how a law firm may be the same as Dewey — an uncomfortable subject which is not likely the focus of as many discussions as it should be. And close to impossible to have if a firm does not make adequate disclosures to its partners of what is going on in their own law firm.

Thus the question asked in response to capital calls at year-end may increasingly be: what is the money really needed for if not the future operation of the business? What other steps have been taken to address the needs of the firm? Is this capital that will essentially be taken from all, but distributed to a few? Has the firm weakened itself without telling the partners by engaging in financial "engineering"? Has the firm covertly shifted income and expense between accounting periods to overstate current year financial performance? And now that those techniques are exhausted, the only way to give you the money promised to you …is to raise it from you!

What really is in that carton? And do you want to drink it?

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# California employers rack up 'wins' in 2012 decisions

By David Ezra

California's legal environment is challenging for employers. But some recent judicial decisions are making the legal environment more manageable. Earlier this year, the state Supreme Court decided *Brinker Restaurant Corp. v. Superior Court*, 53 Cal. 4th 1004 (2012). Employers applauded *Brinker*'s common sense holding that employers who make appropriate meal periods available need not go so far as to ensure that employees actually use the meal opportunities. While *Brinker* received the most attention, it was not the only pro-employer decision that was handed down this year.

**Time clock rounding.**

*See's Candy Shops, Inc. v. Superior Court*, 210 Cal. App. 4th (2012), was an important time clock rounding decision. A class action lawsuit challenged See's time clock rounding policies. See's rounded to the nearest 10th of an hour and it had a stated policy of allowing employees to clock in or out 10 minutes before or after the end of a shift. The class argued that California Labor Code Sections 204 and 510's references to "all wages" and "any work" should be read to forbid virtually any rounding. The appellate court was not impressed, stating: "An employer is entitled to use the nearest-tenth rounding policy if the rounding policy is fair and neutral on its face and it is used in such a manner that it will not result, over a period of time, in failure to compensate the employees properly for all the time they have actually worked."

The court did suggest that statistical evidence showing that the rounding policies generally favored employees could constitute an effective defense. However, if an employer strongly disciplines *de minimus* late starts, such that employees regularly arrive and clock in early and almost never arrive and clock in late, the facially neutral rounding policy could unlawfully result in employees disproportionately working a few minutes off the clock time each day. In *See's* there was no convincing disproportionality evidence. In fact, the evidence reflected the opposite — that most employees benefited from rounding.

**Wrongful termination.**

In *Dutra v. Mercy Medical Center*, 209 Cal. App. 4th 750 (2012), the court terminated a wrongful termination lawsuit. Mercy Medical Center said it terminated Michelle Dutra because she gossiped while on duty, altered a check, and falsified her time card. Dutra, however, claimed she was wrongfully terminated for making a worker's compensation claim.

Dutra argued that Labor Code Section 132a articulated a public policy against employer retaliation in the face of an employee's worker's compensation claim. Section 132a affords a remedy when an employee is fired for making a worker's compensation claim, but that remedy is before the Worker's Compensation Appeals Board — not in superior court. While acknowledging that Section 132a declares that it is the "policy of this state that there should not be discrimination against workers who are injured in the course and scope of their employment," the court did not allow a violation of Section 132a to support a common law action for wrongful termination in violation of a public policy.

The court in *Dutra* distinguished *City of Moorpark v. Superior Court*, 18 Cal. 4th 1143 (1998). *Moorpark* held that Section 132a does not provide an exclusive remedy against disability discrimination. Citing *Moorpark*, the appellate court decided that where a public policy includes substantive limitations on the available remedies, "these limitations also circumscribe the common law wrongful discharge cause of action." The court in *Dutra* concluded that because Section 132a "establishes a specific procedure and forum for addressing a violation," allowing an employee to "pursue a tort cause of action based on a violation of Section 132a would impermissibly give [the employee] broader remedies and procedures than those provided by the statute." Therefore, the trial court had correctly dismissed Dutra's lawsuit.

> Despite the employer's loss, *Kirby*'s holding reduces the incentive for employees (and their attorneys) to pursue recovery of allegedly missed rest breaks.

The state Supreme Court recently indicated that it is extending the time to grant or deny review of *Dutra* through Jan. 24, 2013. But even if review is denied, *Dutra* does not mean that California employers can terminate employees who make worker's compensation claims with impunity. In addition to Section 132a, other common causes of action may be available to an employee who is terminated after an on-the-job injury. As the court explained, Dutra "chose not to amend her complaint. It was [Dutra] that through declining to amend her complaint foreclosed all possible remedies except the [Worker's Compensation Appeal Board]."

**Employment contracts.**

In *Touchstone Television Productions v. Superior Court*, 208 Cal. App. 4th 676 (2012), the court addressed an employer's refusal to extend an employment contract. The plaintiff was a television actress who appeared in the show "Desperate Housewives." She had a one-season agreement, and the show's producers had an exclusive option to renew her contract annually for up to six additional seasons.

The contract had been renewed several times. During the fifth season the actress was allegedly involved in a "battery" incident involving the show's creator, and she complained to the producers — who then decided not to exercise the season six option. The actress subsequently appeared in three additional episodes. Her character was then "killed off" in a fictional car accident.

On a writ petition, the appellate court held that there could be no wrongful termination suit. The trial court "erred when it denied [the producers'] motion for a directed verdict. [The actress] cannot pursue a cause of action for wrongful termination in violation of public policy because, contrary to what she claims, she was not fired, discharged or terminated." Instead, the producers had merely elected not to renew the option.

The court drew a distinction between circumstances where the employee was allowed to finish out the term of the existing contract and circumstances where an employer ends the employment in the middle of the contractual term.

The court did allow the actress to pursue a statutory claim under Labor Code Section 6310 — which generally prohibits employers from discharging employees who complain about unsafe working conditions.

**Rest breaks and fees.**

Finally, even an employer's loss offered good news. In *Kirby v. Immoos Fire Protection, Inc.*, 53 Cal. 4th 1244 (2012), the plaintiff sued numerous defendants, alleging violation of the obligation to provide rest breaks. The plaintiffs settled with some defendants and voluntarily dismissed others with prejudice. Following its dismissal, Immoos moved for (and received) an award of attorney fees.

The state Supreme Court reversed. The court's decision in *Murphy v. Kenneth Cole Productions, Inc.*, 40 Cal. 4th 194 (2007), had identified the "additional hour pay" an employee receives from missed rest breaks as a "wage" for statute of limitations purposes. However, *Kirby* found that the "additional hour pay" was *not* a wage for purposes of assessing attorney fees. The court rejected the employee's argument that attorney fees could only be available under Labor Code Section 1194 (which offers one-way fee shifting) because the "additional hour pay" constitutes a statutory minimum wage. Second, the court concluded that payments made for missed rest breaks would not constitute an "action brought for the nonpayment of wages" under Labor Code Section 218.5's two-way fee shifting provision.

Despite the employer's loss, *Kirby*'s holding reduces the incentive for employees (and their attorneys) to pursue recovery of allegedly missed rest breaks.

2012 was good to California employers, at least in terms of several published judicial opinions. It will be interesting to see if the trend continues in 2013.

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