Modified Cash Basis Accounting:
Super Fuel for the Law Firm Drag Race

By Edwin B. Reeser and James B. Hunt

Have you noticed the recurring news of major, respected law firms having difficulties with their bankers, with an announcement days later that management has recommended firm dissolution? Wondering how this happens without clues that the end was near for each firm, catching great numbers of partners by surprise?

This series is a discussion of the "hows" and "whys" law firms "crash on the roadside" with many partners and employees suffering major career setbacks. Skip this series and hope it doesn't happen to your law firm, or read on to learn the tell tale signs of when firms are incented to "cut the accounting corners."

Do not be dissuaded that a discussion of accounting will be boring or require undue effort to understand. The subject of racing tires is superficially the most boring thing in the world, until you are racing along at 175 mph and realize that only four small patches the size of your palm are touching the road. Suddenly, your intimate understanding of the adhesion dynamics of tires is what separates you from life and death, and tires become a subject of intense interest. Similarly, view this discussion as being strapped into a "law firm race car." This should motivate your willingness to understand the accounting techniques that keep you glued to the road of financial stability, and those that can throw you into the ditch of dissolution. Tires "talk" to drivers, and the presence of certain accounting techniques used by your firm will "talk" to you. If you pay attention, there should never be any surprises.

FIRST IN A FOUR PART SERIES

Observation #1: Accounting never "kills" law firms; bad strategic choices by management "kills" law firms. A law firm's failure begins months or years before the decision to dissolve. The tale often begins with one or more of the following occurrences: A major *opportunity* to *invest* lawyer and management team time in a multi-year contingent fee matter (with no payoff in the end); a major *opportunity* to *acquire* a "highly profitable and prestigious" practice of another law firm (it just costs existing partners lots of money to lure them over); a major *opportunity* to *merge* with a "like-minded" firm of lawyers serving new markets and clientele that the firm desires but can't expand into on their own (the typical "make-or-buy" corporate choice).

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This list could go on, but note the pairing of the two italicized terms in each example. Each strategic venture is characterized as an "opportunity" to act. These opportunities are presented in management meetings as growth milestone events for the law firm, or history-making challenges, often with a sense of urgency to act and always in the spirit of "this is our firm's destiny." On closer inspection, was it a challenge for greatness or a challenge to not fail in the endeavor?

The action (to invest, acquire or merge) always calls for funding from the law firm in order for it to seize the opportunity. Successful investing, acquiring, and merging all require the accountants to "prove up the numbers" that the financial result will be good for the partners involved. We are not saying that accounting is a "bad tool"; it can be a "good tool put to a bad purpose," disguising disappointing or frustratingly poor financial results from a law firm's investment, acquisition, or merger. When a decision turns out to be problematic, the accounting department emerges creatively as a "profit center," by working to keep everything on track and buying time until another strategic opportunity to rescue the firm presents itself.

Thus, law firm failures are generally traceable to an earlier event of substantial strategic opportunity and the firm leadership's choice to act on the opportunity, either without the knowledge or appreciation of the potential eventual destructive outcome, or with complete disregard of the danger. The choice of opportunity is by definition substantial because it takes a substantial act to crash and burn a successful law firm. Accounting is often the tool to hide the scope or even existence of the bad outcome until a solution arrives — if it ever does.

Pay attention to discussion of strategic opportunities and calls to act urgently within your own law firm. Examine the proposition critically and ask probative questions about the new venture and the safety measures. Published comments by paid consultants on the "visionary" qualities of your firm's leadership with respect to such opportunities are true warning flags.

Associated Press

NASCAR drivers race off the line during a drag racing exhibition at ZMax Raceway in Concord, N.C., March 29.

Observation #2: All law firms keep two (or more) sets of accounting "books." This shouldn't surprise you. One set of partnership books is required on the "cash basis" method of accounting, and at least one additional set of partnership books is kept on some form of "modified cash basis" method of accounting. This practice presents the opportunity to build accounting illusions, when deemed by leadership as necessary in a failing law firm.

Cash basis books: These books are required of partnerships for income tax compliance for the law firm and its partners. All law firms that are organized as partnerships annually file Form Ks and K-1s (the partnership and each partner's share of taxable income) using the cash basis method of accounting. Fundamentally, the cash basis method results in collected cash for rendering law services during the fiscal year (gross income). Cash payments made by the firm during each fiscal year are separated into two basic categories: operating costs and capital costs.

Operating costs paid during the fiscal year are detailed and deducted from gross income; the result is the partnership's cash basis net income. Examples of operating costs paid during a fiscal year would include: associate, of counsel, contract attorney, non-equity "partner" attorney, paralegal, secretarial and clerical staff compensation, office rent, property taxes, utilities, marketing costs, business taxes, etc.

Capital costs generally are those payments for additions of long term assets owned by the partnership, such as office improvements, furniture, information technology investment, office art collection, computers and copiers, etc. Capital assets are depreciated over their respective estimated useful lives and such depreciation is a tax deduction and expense, included as a calculated operating cost (not resulting directly from any individual cash payment) in determining the partnership's cash basis net income. This is what the cash basis method is in a nutshell.

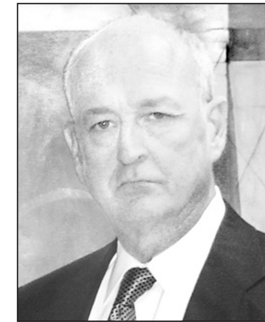
Modified cash basis books: The above description of the cash basis method of accounting is simple; why can't we just stop there?

Cash basis books and reports serve as a poor management tool for running a law firm. Sure, the individual partner's annual taxable net income from the partnership is determined this way, and the numbers do tie to the firm's cash accounts, but that's about all the cash basis method of accounting does.

To monitor law firm performance from a more realistic viewpoint, most law firm management have adopted various accounting methods that more closely "match" billed or earned revenues of the law firm with on-going costs of operations. This "matching" of revenues and costs enables financial report readers of firms to view a more realistic, economics-based financial performance of the law firm. And, for the individual partners, it reports the same for their individual ownership interest in the annual law firm operational results. If the accounting is performed correctly and without "gimmicks," this improved financial reporting is far superior to a cash basis method of accounting for planning and controlling law firms.

So what is the risk of the modified cash basis method of accounting? There is almost limitless "variety" that exists. Footnote disclosures of the various special accounting features and unique accounting reserves and valuations become a critical factor to understanding the financial reports prepared under the modified cash basis method. The law firm management group sets the rules, which can be changed time to time without notice, and which impact comparability from year to year. These are rules that are virtually never disclosed to the partners or anyone else outside of management.

You might ask: "I trust my law firm leadership; why does this inherent flexibility and ease of manipulation cause a problem?" In the next article we shall provide an example of how financial reports, manipulated with non-standard features, can lead to or cover-up law firm operating problems.



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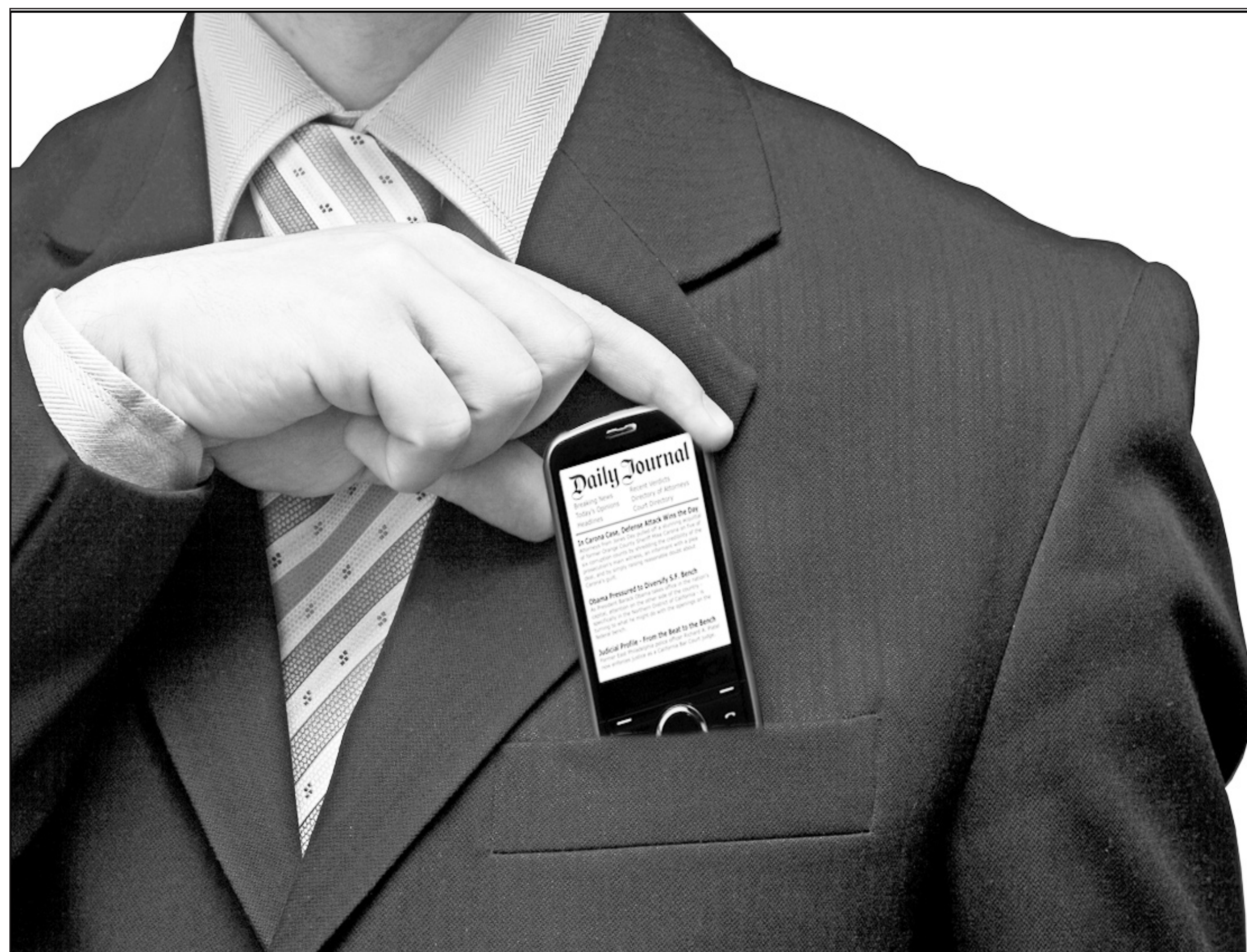

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Manipulating Ledgers With Pencil Strokes: Super Fuel for the Law Firm Drag Race

By Edwin B. Reeser and James B. Hunt

SECOND IN A FOUR PART SERIES

Part one appeared on May 5.

This side of the Atlantic Ocean favors the accrual method of accounting in accordance with U.S. generally accepted accounting standards (U.S. GAAP). These rules are complex and onerous to install and maintain in an accounting department. Most law firms opt for a less-costly solution that produces useful financial reports with reliability near full accrual accounting — the so-called modified cash basis ledgers and reports. Not as carefully measured by accountants, and furnished without audit (only fully measured and reconciled U.S. GAAP financial statements deserve an independent accountant's report of examination) or detailed footnote disclosures, and not consistently applied from one law firm to the next — the modified cash basis of accounting does attempt to accommodate many "big picture" features of full accrual basis accounting. Here are some of the more common features of the modified cash basis method of accounting:

Billed revenues, instead of cash collected revenues. Client billings rendered from the first day to the last day of the accounting period are reported as revenues for the period, irrespective of when the cash is collected from the billed clients. If billings are rendered in a routine, recurring manner, their value represents the "economic" income earned by the law firm while serving its clients. Note, however, that over a period of several months or years, a "flat growth" law firm has the same cash basis income as its modified cash basis income — no change from period to period.

Contingent fee client matters also have no measured income on either basis until the outcome of the matter is known and the collection of an earned contingent fee is measurable and assured. Some law firm managements might be tempted to book a "core value" of revenues (a "conservative 40 percent" of billing value to date for selected matters of "high confidence") for a contingent matter that law firm management is "absolutely convinced" will be collected once the matter is resolved; this measure obviously has risks and is not recommended for modified cash basis accounting.

Unbilled work-in-process reported on the balance sheet. The modified cash basis will often report the billing value of attorney and staff time, and costs incurred on client matters that have not yet been billed by the closing of the accounting period — the work-in-process value. Proper modified cash basis financial reports *do not* include this value in determining net income, principally because the items are not yet authorized or expected to be billed to the client. Such amounts can be substantial, for example bankruptcy proceeding matters where formal fee applications and a court order for payment of fees are required. Contingent fee matters would normally be accounted for as unbilled work-in-process until the outcome of the matter is known and bills can be measured and rendered.

Capital assets. These are office improvements and the like previously discussed in the cash basis method of accounting. The items are usually valued at their acquisition costs and depreciated over their useful lives according to the U.S. income tax regulations for the modified cash basis method. The effect of capital assets and depreciation on net income is normally the same (no difference) for the cash basis and the modified cash basis.

Accounts payable and accrued current liabilities. Recall that the cash basis method measured operating costs according to the amounts paid for such costs. The modified cash basis, on the other hand, accounts for those invoices paid within each accounting period as well as the "incurred, but unpaid" costs (i.e., those bills or costs, which have already been incurred in the law firm operations, but are remaining unpaid). Examples would be the stack of invoices at the end of the month or the year for unpaid goods and services delivered or consumed by that date. Accrued salaries of office staff, insurance and office rent are additional examples. Funds held for payment of partner and employee retirement fund contributions is a key current liability for the modified cash basis method.

> What we have observed in recent law firm failures is that 'financial leverage' can be abused.

Bank loans, lines of credit and other borrowing liabilities; interest expense. You now understand how items of "income," "expenses or costs" can be measured and recorded on the modified cash basis of accounting. The resulting net income really does provide a more realistic and "economic" measurement of law firm financial operations. For many successful law firms, the conversation about the modified cash basis method ends here. Why? Because the next element addresses accounting for bank loans, lines of credit and other borrowing liabilities. Many law firms do not borrow from the bank, opting for conservative financing and growth funding principles. They choose to finance operations with partner capital...period. We are not saying bank loans or lines of credit are "evil." What we have observed in recent law firm failures is that "financial leverage" can be abused. Like pouring a small cup of oil in a corner, it can promote skidding off the road and into the ditch.

The amounts of the bank loan and other borrowing liabilities for the modified cash basis method are reported on the balance sheet of the law firm as liabilities, but they do not carry-over in amounts into net income. Bank loan proceeds are received and cash is deposited into the law firm cash account as the loans are drawn down. When the bank loans are repaid, cash is paid from the law firm cash account. No net income effect; either way. The only net income "effect" is the accrual (and payment) of the periodic interest expense on the loans — interest expense is charged as a cost item on determining net income each period.

Now let's take a look at one example of ledger manipulation that is potentially abusive: Imagine two large law firms serving separate clients located in the same geographical regions of the country. The firms decide to merge into one so that they can continue to serve the separate clients, but remove the obvious redundancies. Law firm management quickly identifies costs saved by consolidation; applying cost savings to achieve instant profits per equity partner gains.

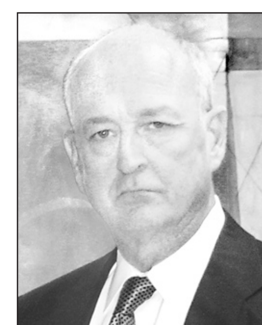
The firms meet in rigorous negotiating sessions, and terms are hammered out. But one detail remains. What will be the proportionate percentage ownership of the two sets of partners brought together? Firms are never exactly equal in value. How to decide the value each group captures for their respective ownership in the new firm? The solution: recent financial results on the modified cash basis.

Accountants will be engaged to make pro forma adjustments that increase the comparability of the accounting methods followed by the respective firms, but one factor cannot be controlled yet is typically present in this situation — each firm has probably been manipulating its accounting ledgers to look more successful, be an attractive merger candidate, and now to get a bigger share of the pie. Such examples include bigger retainer payments classified as revenue, client incentives to pre-pay recurring legal services that are booked as current income, reduced overtime to staff, and setting income "core values" for contingent fee matters. The list can go on and on. The firms are literally "drag racing" each other, using the accounting ledgers of the pre-merger partnerships to gain the competitive upper hand.

Consequently, firm partners are lulled into believing the "race results" and firm leadership can't tell them they have been sneaking rocket fuel into the gas tank. When the "drag racing" is over and ownership has been divided up — reality sets in. Revenues aggressively booked during "race season" are not available to the combined firm for cash needs — those funds were already collected and spent. Typically, post merger operating results fail to meet expectations, and this is one possible reason why.

Costs postponed and reserves "undone" return with a vengeance, to be paid or re-recorded on the ledgers in later periods because they were obligations or necessities for an accurate financial picture. The merged law firm doesn't know its true financial performance. Couple these accounting and cash flow aspects with closing of office space, changes in who is running which departments, plus a myriad of new procedural steps...and you get confusion and disorientation. The business drives smack into the wall at full throttle.

But the firm does not have to be engaged in a merger or acquisition to make use of these techniques. They are fully available to dress up the financial reports of a firm's ongoing operations whenever leadership perceives the need. It has the same effectiveness as expecting that every decal slapped on a race car is guaranteed to produce an additional five horsepower.



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Daily Journal
NEWS BUREAUS

Turning Up the Turbo Boost:

Manipulation of Modified Cash Basis Accounting in Law Firms

By Edwin B. Reeser and James B. Hunt

Consider a firm with 600 lawyers, comprised of 150 equity partners, 150 contract attorneys, 300 associates plus support staff. The firm has budgeted $500 million annual gross receipts, and a 30 percent margin ($150 million) for the equity partners. As at Dec. 28, a $10 million revenue shortfall to $140 million (2 percent) is forecast, a 6.67 percent net partner income shortfall, ($66,700) profits per equity partner (PPEP) to budget. Annual rent is $24 million. Ten lateral equity partners were hired, and 10 equity partners have left. The firm expects $9.6 million in fee receipts the first week of January (1/52 of the annual budget). Now apply these firm facts to the following income distortions:

Hold open the books: At a weekly rate of $9.6 million, or $1.6 million per day, the firm can "plug the gap" on revenue shortfall for last year.

THIRD IN A FOUR PART SERIES

This continues part two, which appeared on Friday.

Evergreen prepaid retainers: Calls are made to clients with ongoing business, but whose fees accrue unevenly. A retainer arrangement is made to level out the expense with quarterly advance retainers, at a 10 percent fee discount rate. Payments are scheduled on the 25th of December, March, June and September. These aggregate $4 million for each quarter.

Defer expenses: The firm has $3 million in operating expenses that it can "hold" and pay in the first week of January.

Partner recruiting fees and "pipeline" expenses: The firm has $2.5 million in recruiter fees and $1.25 million in partner draws for their first 90 days. This $3.75 million is capitalized rather than expensed currently, and written off over a three-year term. Roughly $3.25 million is moved in the first year to the balance sheet rather than expensed.

Equipment and fixtures useful lives: The firm has $4 million in purchases of equipment that may have a typical useful life of three to five years, with a $1 million per year amortization, but is put on the books at 10 years. The reduction in amortization expense is $600,000 dollars.

Let's look at the impact on the reported financial performance of our hypothetical law firm using a small, moderate, and aggressive "drag racing" application of these techniques.

	Small	Moderate	Aggressive
Hold Open Books:	2 days-$3.2 M	4 days-$6.4 M	6 days-$9.6 M
Retainer Program:	$4 M	$4 M	$4 M
Defer Expense:	$1 M	$2 M	$3 M
Capitalize Fees/Useful Life:	0/0	0/0	$3.25 M/600k
Total Impact/Per Partner:	$8.2 M/$55k	$12.4 M/$83	$20.45M/$136k
PPEP to Budget:	($12k or 1.2%)	+ $16k or 1.6%	+$69,667/6.97%

With a light touch of the accounting pen, substantial results emerge to dress up the performance of the firm "just enough" to manage the current need to show "profits" to lateral partner candidates, current partners, creditors or the press. Note that for every $1 million in revenue enhancement, one generates the same amount in net distributable income, as most expenses have been paid. However, most of these techniques once applied, *must be repeated every year* just to stay even. This can build up, over a short period of time, large burdens on reportable profits that must eventually be confronted (just as greater "boost" creates strain and stress to an engine).

While use of these techniques (there are many more) increases the reported, but not actual, income of the firm and its profitability, so does the corrective action to reverse their use decrease the reported, but not actual, income of the firm and its profitability. If a firm scores a contingency win, and applies the income to "unwind" these techniques rather than distribute it all to partners, it may be wise to do so. Continued long enough, the firm can be weakened to the point of sudden collapse. Everything seems to be going great, right up to the point the engine explodes and plants the firm into the wall.

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There are other techniques typically employed by law firms that run contrary to the basic convention of matching income and expense to each other and within the same period. For example, bonuses paid to contract partners, associates and staff are often not paid until the following year. One common excuse is that it is not possible to measure performance to calculate bonus money until books for the year are closed. That is nonsense. Many bonuses are not even subject to variation on how the firm performs. But even for performance based bonuses, there is typically a minimum range that the firm expects to pay and which can be reserved. The firm can "split" the bonus into components paid at year-end, and the following spring to lessen the distortion. Any amount reserved but not paid out prior to year-end only serves to increase PPEP, just not by much. Not reflected in income, but sometimes used, are techniques to enhance cash flow or build up cash by deliberately creating a difference in treatment or timing of handling partner capital.

The firm may require new partners to invest 100 percent of their capital upon admission to the partnership. The capital, however, is repaid to partners over a three-year term, with 25 percent paid within three months and the rest on the annual anniversary of that first payment. If the firm gains 10 new partners and has 10 old partners withdraw, then using that model after three years, with an average capital requirement of 40 percent of projected income or $400,000, there are 30 withdrawn partners with an average of $200,000 owed to them at any point in time. This is only $6 million, while the firm has brought in $12 million.

Obviously a firm in an aggressive growth mode can add many millions of additional dollars of capital to use for operating expenses. Note that the firm continues to collect withdrawn partners' accounts receivable, which are reported as income to the firm, typically without the withdrawn partner having a share. This will generate almost five to seven months of partner gross income, and close to 100 percent of that withdrawn partner's annual take, within 90 days.

Through pension plan funding, the firm can annually hold back from the partners about $6 million in 401(k) contributions. This is partner money, so it is reflected in PPEP even though partners do not receive it and remains in the operating account. The firm does not make the contribution to the plan until May of the following year, using the money for operating expenses and putting the contributions at risk.

Relying upon these techniques for increasing forecast PPEP for the next year, the firm creates a budget for the upcoming year. The forecast sets forth a projection of a healthy increase of 6 percent net distributable income for the partners, about $9 million. Based upon the forecast incomes for the partners, the partners collectively contribute an additional 40 percent of that amount as capital, or $3.6 million, after Jan. 1 but prior to Jan. 31 of the following year. This money is withheld from year-end distributions at roughly $24,000 per partner, but may also be funded by taking out loans from a bank. Assuming that a partner receives a 55 percent draw against forecast income, the partner will have effectively "self funded" almost nine months of the increased forecast income for the year with his or her own capital.

In addition, the partners will have paid quarterly estimated income taxes on such monies; the individual partner will apply most of the additional draw received from the "raise" in "forecast" income to taxes payable on that raise during the calendar year, recovering perhaps $9,000 of the $24,000 additional capital contributed. The partner actually ends the year with a $15,000 worse cash flow after receiving a $60,000 raise! (($24,000 capital + $24,000 taxes) - $33,000 draws = $15,000). With the final distribution of $27,000, assuming the firm meets its budget, the partner will "net" about $12,000 from the $60,000 forecast income raise. But if the firm does not meet budget, or in our example falls short of budget by as little as $1.65 million in revenue (1.1 percent) the partners will net nothing from the "raise."

When considering a lateral transfer to a new firm, responding as a partner to a call for additional capital in your present firm, investigating as management a potential merger or acquisition with another firm, extending credit to a firm as a major supplier, lender or landlord, or examining the question of solvency/insolvency in a law firm collapse, it should be critical to your understanding that you have access to accurate and detailed information on the firm's financial reporting practices. Otherwise you are driving blind.

Application of accounting "super fuel" can deliver good-looking financial reports, but it can also leave the firm on the side of the road, out of the race, with many expensive broken parts.

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State Municipalities, Beware of SEC Administrative Proceedings

Continued from page 1

able "home court advantage" in the adjudication of securities claims.

Given this newfound power, how will administrative law courts, and indeed the SEC's carte blanche authority with respect to security regulation, investigation, and now adjudication, pass constitutional due process scrutiny? Unfortunately, what appears at first blush to be a system of "kangaroo courts" is entirely constitutional.

While courts necessarily have taken the position that the principles of due process apply to administrative adjudications (see *Antoniu v. SEC* (1989) 877 F.2d 721, 724), the application of such due process protection provides minimal assurances to defendants. According to the 9th U.S. Circuit Court of Appeals in *Kennerly v. United States*, "a due process hearing need not take the form of a judicial proceeding." (1983) 721 F.2d 1252, 1256-57. "[A]n administrative hearing with an impartial decision may satisfy due process and the impartial decision maker may come from within the agency against which the claim is made," explained the 9th Circuit

The imbalance of power in favor of the SEC in administrative law courts does not stop there. These courts also have evidentiary shortcomings, and are not burdened with the obligation of *stare decisis* imposed upon state and federal judges alike. An SEC administrative court must uphold the legal conclusions of the SEC unless those conclusions are "arbitrary, capricious, or an abuse of discretion," and must treat the SEC's findings of fact as final if they are supported by evidence in the record. *Korman v. SEC* (2010) 592 F.3d 173, 184.

Nor is the SEC required to follow any mechanistic formula in determining an appropriate sanction. The SEC is not obligated to make its sanctions uniform, and a court will not compare SEC sanctions to those imposed in previous cases. At least one target has referred to this as "Gitmo-Style Wall Street Justice." *Reuters,* April 14, 2011, *Business Law Currents.*

> What is critical for municipalities is that these SEC actions are occurring even in the absence of any default.

It is clear that the SEC is continuing to broaden its efforts to regulate municipal securities issuers, even though precluded from direct regulation by the Tower Amendment. In addition to the behemoth Dodd-Frank Act, in January 2010, the SEC announced that one of the five new specialized units in the Division of Enforcement would be dedicated to municipal securities to further SEC Chairman Mary Shapiro's often stated aims of better disclosures in the municipal market.

What is critical for municipalities is that these SEC actions are occurring even in the absence of any default. In its zeal, the absence of any damages does not appear to hinder an SEC investigation, which by itself can cost the municipality hundreds of thousands of dollars at a time, particularly in California where a local governmental agency can least afford it.

Even though adjudicated in 2006, prior to the financial reform overhaul, the recent SEC action against the city of San Diego is illustrative of the SEC's ever broadening reach. There, the SEC issued a series of sanctions through cease and desist orders against San Diego and individuals working in leadership roles at the city after the SEC determined that San Diego faced severe financial difficulty in funding its future pension and health care obligations and had failed to accurately disclose these future obligations when the city issued a series of bonds from 2001-2003.

Since the SEC had no direct regulatory power over San Diego, it commenced an administrative cease and desist action, forcing the city into a costly settlement that included an overhaul of disclosure requirements and hiring by the city of numerous oversight officials, such as disclosure lawyers and consultants. In addition, four city officials involved in the purported fraud were ordered to personally pay fines of up to $25,000 without the possibility of reimbursement from the city. Under current regulations, the SEC has unilateral authority to fine individuals up to $150,000.

After this case, there is substantial concern that the recent securities legislation changes, the enhanced whistle-blower rewards, and other penalties with respect to costly oversight alterations to municipalities, many municipalities will be regulated without the benefit of promulgated rules. While Shapiro's goals of enhanced disclosures and transparency are lofty, without specific legislation, the local governments are forced to incur hundreds of thousands of dollars in investigation costs for actions that occurred many years prior to the Dodd-Frank Act, without any legislative guidance.

Securities defense litigators often state that if your municipality is under investigation by the SEC, it's already over. No good can result. While the SEC arguably should have the right to regulate securities transactions of state and local governments, and the need for transparency in the municipal securities market is logical given the market size and risk of default, carte blanche investigative and adjudicative power of the SEC is a cause for concern for all participants in the securities markets.

Associated Press

SEC Chairwoman Mary Shapiro testifies before the Senate Banking subcommittee on Securities, Insurance and Investments on March 10, 2011.

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Q&A

Protecting Assets

John L.G. Whittle helps guard Fortinet while it guards customers' networks

John L.G. Whittle comes from a long line of Virginia lawyers. His great-grandfather, Stafford Whittle Sr., once headed the Virginia Supreme Court, and his grandfather, Kennon Caithness Whittle, sat on the same court 50 years later. His mother and uncle also are lawyers.

John Whittle

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Size of Legal Department: 5 Lawyers

Whittle and his wife, Sarah, added two more lawyers to the family when they graduated from Cornell Law School during the technology boom and made their way west — she to Brobeck, Phleger & Harrison LLP in 1996 and he to Wilson Sonsini Goodrich & Rosati PC in 1997.

A few years later, Whittle got the opportunity to be a general counsel. In 2000, at the market's peak, he moved in-house to Corio Inc., an enterprise software company backed by venture capital firm Kleiner Perkins Caufield & Byers that was preparing for its initial public offering. Post-IPO and five years later, the company sold to IBM Corp., and Whittle moved on to the general counsel position at Ingres Corp., an open-source database company. Now he's in charge of the legal department at Sunnyvale-based Fortinet Inc., which makes network security appliances and threat-management systems for information technology departments. The systems include filtering, firewalls, anti-virus software and anti-spam techniques in one offering. Soon after joining the company, he quarterbacked his second IPO as a general counsel and added the duties of overseeing stock administration, global trade compliance and corporate development.

He recently met with Daily Journal staff writer Jill Redhage to talk about why the company's 2009 IPO stood out and how Fortinet is responding to rapid consolidation in the network security sector. Here's an edited transcript of what he had to say:

DJ: Why did Fortinet decide to do an IPO in late 2009?

Whittle: We've been cash-flow positive and haven't needed to raise money, so for us it was more about getting the name out there and having our financials out there. We compete with big, big companies like Cisco Systems and Juniper Networks, and we sell to enterprises and the federal government and all these big customers.

Before, we would say, 'We're doing well. Here are our financials.' But I think it's more credible when you can actually say, 'Hey, go look at SEC.gov, and there are our audited financials. We're a solid company that's not going to go away, and you can trust that. We're a credible alternative to our competitors.'

DJ: So it was more of a marketing device for you guys?

Whittle: For us, it's a marketing device, but also credibility for these customers to [be able to] look at the financials. At the time — November 2009 — we were one of the very few companies going public, so we got a lot of attention. A lot of businesses all around Silicon Valley took note. It was pretty beneficial from that standpoint, just to build credibility for the company.

DJ: Why did you all choose that timing?

Whittle: It was during a little bit of a recovery from the downturn in 2008, so there was an open window at that time.

DJ: How did you know there was a window?

Whittle: It's always unpredictable, but the bankers helped us with that. You just try to get ready for it and do your filings and then there may happen to be a window. You never know what's going to happen with the markets.

DJ: There's been a lot of consolidation in the network and Web security space in the past year. Juniper Networks bought Altor Networks. An investor group purchased SonicWall. McAfee Inc. sold to Intel Corp. Hewlett-Packard Co. bought ArcSight Inc. and Fortify Software. How is the changing face of the competition affecting Fortinet?

Whittle: Network security is a hot market, and we see it as an opportunity. There's a lot of demand out there — the threats are not going away. We feel like [I.T. security] is a very tough problem to solve. We feel like we're in a good situation because we are a relatively big company in that space focused exclusively on solving that problem and instead of just marketing hype, doing it by developing these great products and rolling them out very rapidly.

There are a lot of smaller security companies out there. We see some opportunities to do some acquisitions, given that we have some scale, to help us grasp that opportunity. It may be acquisitions that are designed not to be hugely risky for the company.

DJ: Looking long-term, do you envision Fortinet remaining focused on its current core business, or will it expand into lateral markets?

Whittle: We're focused on I.T. security. For most of our competitors, like Cisco and Juniper, it may not be their bread and butter. Whereas they may say, 'Well, it's not our bread and butter. We'll shift resources away or not give it the focus that [Fortinet] has,' we feel like that's a huge competitive advantage to us, because we just live and breathe it.

DJ: What do you think about defensive patent aggregators such as RPX Corp. as a strategy for protecting companies against patent infringement claims filed by nonpracticing entities?

Whittle: In a way, that model is somewhat similar to a nonpracticing entity. They aggregate patents, and you sign up and pay them money and then get license to their portfolio. If you don't do that, they may spin the patents out to a nonpracticing entity that would then come after you. It's a less threatening approach than some of these nonpracticing entities have, but it's somewhat of a twist on that.

But I think they've got some good companies signed up with them that know what they're doing, and I think it may work for some companies. We're considering it, but we'll see — maybe down the road.

DJ: Some lawyers believe the patent laws in countries such as China and India will over time begin to resemble the patent laws in the U.S. and Europe. How does that theory mesh with your own experience operating abroad?

Whittle: I've heard there's a trend that patents may become more important in China, and there may be more disputes there. I think it's early stages at this point. We're dabbling in filing patents in China and looking elsewhere. But the majority of our portfolio is still based in the U.S.

DJ: Who do you use for outside counsel?

Whittle: Wilson Sonsini is our outside corporate counsel. A little firm in San Francisco named Bernstein Law Group is helping us on some patent matters. [Marc N. Bernstein] is a really good guy who came from Morrison & Foerster, and he's got a six-person law firm. He's very sharp and has a very high-end service for a small firm. We've engaged Baker & McKenzie for a number of things, mainly outside of the U.S., and we've been very happy with those guys. We also use Wilson Sonsini's patent litigation team — Stefani Shanberg and Jim Yoon have been very, very helpful.

DJ: What can other outside lawyers do to get you to consider using them?

Whittle: We're very happy with our team at Wilson. Jon Avina is a really, really good guy. We're very impressed with him and with Carmen Chang, who's our senior partner over there. We've got matters that come up for us every day around the world, so for a new matter that's unique, we would consider what the best firm is for that matter. We may do a little acquisition in Canada that may not be right for Wilson, because it's a $1 million asset purchase or because they don't want to do it, so we may go to them and ask for some referrals and talk to a couple firms up there.

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Keeping the Shiny Side Up: Restraining Modified Cash Basis Accounting Creativity in Law Firms

By Edwin B. Reeser and James B. Hunt

Rigors of financial management and occasional risk-taking by law firm management can lead to wonderful futures or disastrous failures. Law firm accounting can be useful, but can also be put to unworthy use, such as cover-ups and "lily-gilding" of financial performance.

Here is some advice on "early warning" signs that may portend possible law firm troubles ahead, while there still may be time to do something positive and effective about it.

If it sounds too good to be true, it usually isn't true. Read or heard of this one before? Bernie Madoff ring a bell? We are not suggesting that large law firm managements all run Madoff-type "Ponzi" schemes in their law firms. Just be skeptical when you hear the announcement that your law firm is undertaking a substantial new venture, or is expanding into uncharted territories, or taking on an exciting, big contingent fee matter. It will all be sensational. So remain calm.

Ask probative questions about why do it, why do it now, what's in it for all of us, what happens if it's later found to be not worth doing; good, practical inquiries that shouldn't trouble leaders who have done their homework and have the answers and the various "Plan Bs" when Plan A runs into trouble, and "Plan Cs" when Plan B is not enough. If your law firm leadership makes it a practice to grow, expand, or make decisions "on the fly" without careful and considered due diligence and strategy-setting, then maybe it's time to think about another venue to pursue your career. A deal that does not work well going in at the beginning rarely gets better with time. Remember, this is a service business, not the NASA space program. The business of law is not a complicated model, and anything that makes it complex must be suspect. If firm leadership cannot or will not delve into it in detail with the partners, be wary.

Are you furnished an annual reconciliation of your firm's modified cash basis net income to its IRS Form K partnership taxable income (and your Form K-1 share)? No? Well, then ask for one. Your law firm accounting department should find it a relatively easy task to format such a detailed reconciliation — complete with footnotes and maybe even a lawyer's guide to understanding the individual "reconciling items." If you need help understanding the reconciliation, ask a trusted veteran partner or accountant to help you through it. As said earlier, over the long term, the cash basis net income (tax return Form K) should track closely the modified cash basis net income (law firm performance reports), especially if there are no major "ups" or "downs" in firm business levels. The more the two types of reports diverge (your taxable income diverging from your share of the firm's book income), the greater should be your concern about the reliability of the reporting. Ask questions and don't be satisfied with simple explanations that don't add up. If those who ask fundamental questions of this type are punished or chased out of the firm, you need to think about packing your bags. What more do you need to know?

Be concerned when you learn of a new law firm policy that adopts a new, aggressive accounting practice. Aggressive, new policies for "early booking" of all or part of client matter revenues or delays in recording of costs or expenses by your law firm should be evaluated by you against your own standard of: "Is it fair and reliable?" Does it seem to properly "match" revenues and costs within the month or year? Question changes that seem overly aggressive or appear unnecessary. If a firm's chief financial officer or chief operating officer quietly resigns contemporaneously with the accounting change, look even more closely.

Over emphasis on PPEP (profits per equity partner). Be concerned about cash and net operating income that exceeds PPEP. You can have declining profitability and still report increased PPEP. All you need to do is fire partners faster than the net operating income of the firm declines! Where does the firm source its monies? Does it borrow extensively to pay partner draws? When is the line of credit reduced to zero balance — by April or July? When does the pension plan actually get funded, and is the money segregated or commingled with the operating account? What are the operating ratios of the firm, the receivables turnover period, etc.? How efficiently is gross revenue converted to distributable partner income? These are the basic building blocks that reflect more on whether and how the business is being run successfully as a business, and not as a creation of the accounting department.

Law is a people business. The greatest asset of a law firm is its people. It is an asset that leaves the building every night and needs a reason to return the next morning. Any business model for a law firm that points to numbers more than people and culture of the firm, is putting the survival of the enterprise at risk. Numbers are tools, not objectives. You may find that acceptable, and you may not. The management of numbers can be done in a room with one lamp and a pencil and only a vague connection to reality. The management of people is a lot more difficult, and the ultimate reality. If management cannot deliver an environment that compels its greatest assets to grow together and to stay, then either the management has to leave or the best people will leave.

Law firm leaders as celebrities. A number of recent large law firm failures have shared a relatively recent phenomena — the managing partner as a celebrity. Leadership should be about the firm, not the leader. Perks and compensation beyond the requirements of the journeyman job and above what the rank and file partners may receive are a warning that the position may be becoming more about the individual and less about the job done. If there is not tangible accountability for actual results, good and bad, then it becomes more a position of entitlement than of performance. "Dieu et mon droit" (God and my right) may be the banner for British monarchy, but it doesn't have a place on the managing partner's door.

Racing is often referred to as the process by which large sums of money are converted into noise and broken parts. Don't let that analogy apply to your law firm's business because you failed to exercise the collective discipline to "turn down the boost" of modified cash basis accounting creativity. Get a grip on the reality, and keep your firm on the right track, not an imaginary one.

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.

James B. Hunt CPA is a retired partner of PricewaterhouseCoopers LLP USA and PWC's founding partner and former U.S. National Practice Leader of its Forensic Accounting & Investigations unit. He specializes in investigations of white-collar crime, "Ponzi" schemes, and financial reporting frauds, and serves clients worldwide from his private office in Palos Verdes Peninsula.

DEAL MAKERS

Latham Advises Volcom in PPR Acquisition

Latham & Watkins LLP advised sports apparel company Volcom Inc. on its $607.5 million acquisition by French holding company PPR S.A. The French company will pay $24.50 per share of Volcom, a 37 percent premium over the three-month average trading price. Costa Mesa-based Volcom makes surfing, skating and snowboarding apparel. The Latham team was led by Orange County partners Cary K. Hyden and Michael A. Treska and included Los Angeles partners Laurence J. Stein and James D.C. Barrall, Orange County counsel David L. Kuiper, Los Angeles associate Katherine M. Baldwin and Orange County associates David M. Wheeler, Libby Stockstill, Scott M. Akamine, Mathew S. Davis-Ratner, Justin S. Grad, Julie Nudel, John C. Raney and Carol B. Samaan.

Weil Gotshal Guides Getty in Photolibrary Buy

Getty Images Inc. turned to Weil Gotshal & Manges LLP for its bid to buy Australia-based Photolibrary Group Inc. Terms were not disclosed. With the purchase, Seattle-based Getty Images would acquire over 10 million images, footage and audio files, and expand its coverage of Southeast Asia, India and the Middle East. The Weil team included Silicon Valley partner Kyle C. Krpata and associates Andrew W. Nelson and Aubree Corallo.

O'Melveny Steers Warner Bros. in Flixster Grab

O'Melveny & Myers LLP advised Warner Brothers Home Entertainment Group on its acquisition of San Francisco-based Flixster Inc. Flixster operates an online community for movie fans. The company owns popular movie-rating website RottenTomatoes.com. Terms were not disclosed. The O'Melveny team included Newport Beach partners Andy Terner, Jeff Walbridge and Adam Karr, Century City partner Rob Blashek, Century City counsel Justin Bowen, Los Angeles counsel Andrew Ellis, San Francisco counsel Warren Fox, Newport Beach counsel Andy Dolak, and Newport Beach associates Tania Moayedi and Marshall Wigham. Warner Brothers deputy general counsel Mark Easton, a former O'Melveny partner, represented the company. Fenwick & West LLP advised Flixster. The team included Mountain View partners Ted G. Wang and Gregory R. Roussel as well as Mountain View associates Edgar Tirado and Ryan R. Slunaker.

Weil Gotshal Advises Private Equity Firm

Los Angeles private equity firm The Gores Group LLC turned to Weil Gotshal & Manges LLP for its acquisition of Sage Automotive Interiors Inc. from an affiliate of Azalea Capital LLC. South Carolina-based Sage Automotive Interiors makes high-performance specialty fabric for use in automobiles. Terms of the deal were not disclosed. The Weil team included Silicon Valley partners Kyle C. Krpata and Karen N. Ballack and Silicon Valley associates Andrew W. Nelson, Adam B. Rosenblum, Pamela Pao, Kwang-chien B. Ger and Kate Borun.

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