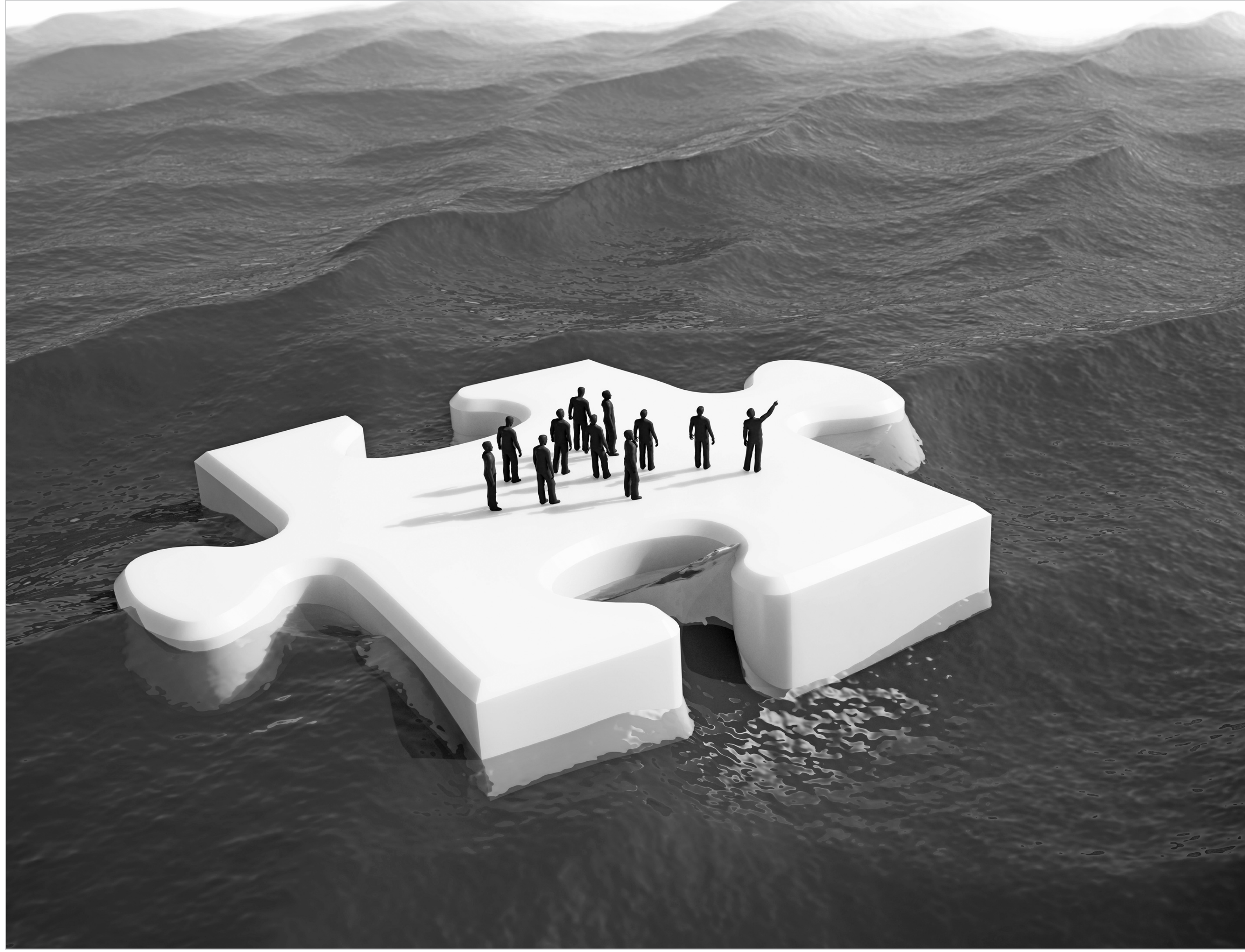
BOUTIQUES:

Know a 'boutique' when you see one

By Edwin B. Reeser



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A "boutique" is defined in the Merriam-Webster Dictionary as "a small store that sells stylish clothing or other usually expensive things."

The application of the term "boutique" to law firms is a bit broader, but for purposes of this article we are going to define it as a law firm which is small in size with a strong focus on one primary practice discipline. Boutique firms are characterized as performing at a high level of professional expertise, with financial rewards to the members that are sometimes higher, indeed significantly higher, than other firms of similar size. In a few instances, they are higher than those of even the largest and most successful law firms with a broad array of practices. In other instances, the practice may not be as lucrative because of the commoditization of the practice that puts hard ceilings on income potential. That type of practice, for our purposes, while both small and specialized, is not high reward, and thus is not a boutique.

The "size" aspect is flexible, but there should be some limits. A national firm with 500 lawyers and 12 offices in one highly focused practice area is a "specialty-focused national law firm" — no more a boutique than a Macy's department store on Carnaby Street in London would be a boutique. That doesn't mean there cannot be more than one office location, but it does mean that there should be the ability to get all the equity stakeholders in a single room (not an auditorium), around a single table, even if it is a big one. Every partner should know every other partner well, and recognize every associate attorney. That's my definition; you can alter it to suit yours.

There are two basic ways these boutique firms come about.

The first is they are built from the ground up by a small number of founding partners over a term of years. This typically was the way boutiques evolved.

The second, which has occurred with increasing frequency over the past two decades, is all or a portion of an elite practice group leaving a large law firm and starting their own law firm. This type of new firm formation increased as firms encouraged some practice groups to leave or undercompensated them relative to their contribution to firm profits. Or the practice group was squeezed with demands for higher rates and hours which would price them out of the competitive market, and with overhead allocations and commitments of the firm that did nothing to help the group, but which the partners had to participate in supporting.

There is an interesting cycle of these boutiques moving into and out of large law firms. Departures can be motivated by a large array of factors. Money, politics, power, rate pressure, hours pressure, freedom from administrative suffocation. The list is long. Reintegration to a large law firm is usually driven by one factor: succession.

If one ever wanted conclusive proof that general counsel will hire the lawyer and not the firm for most of their matters, look to their fondness for the boutique and the value proposition it gives them. Certainly there are firms that thrive on the power of their brand for certain types of expertise, and the headcount to handle them, such as in bet-the-company litigation or very large M&A matters. But in many other sophisticated matters that do not require one or both of the above attributes, "faster, cheaper, just-as-good" wins the day. Ask many large firm partners if they would like to be in a 50-lawyer firm with 14 equity partners earning a million dollars a year or more doing what they do, with billing rates 20 percent to 40 percent lower, with a yearly load of 1,800 hours, and see how many hands reach for the ceiling.

The creation proposition is not difficult for these boutiques when they spin out of a large firm. The clients are all going to come; there isn't anybody left at the old firm to do the work anyway! It is the end-of-life proposition that is hard for the firms.

A departing group is likely to have partners in the 45-55 year age group as the leaders. That means in 10 to perhaps a maximum of 20 years, some of them are going to want to retire. Will the firm survive the departure of the talents that were the core of the practice skill sets that drew the clients in the first instance? Sometimes the answer is "yes," and a succession plan whereby the founding/retiring partners can monetize the buildup in value they have invested in for all those years may be realized. But all too often the realistic answer is "no." What happens then?

Frequently the answer is, join a large law firm. Sometimes it can be the very firm they left many years before. There are two drivers to that decision. The first is that the founders want to take care of their people. If the firm has a material risk of not surviving, they don't want to be putting their people on the street. And the cost and time commitment to liquidate a practice is high. Another is getting something for themselves to help with their retirement.

By joining a large firm with a commitment to working say two or three additional years, the team gets a chance to prove up and be valued members of the larger firm with prospects of advance. The larger firm gets excellent talent, proven clients and work, and a transfer of client confidence over time to their top partner talents, so that the client relationships will be "sticky" and remain with the boutique founders retire. It is a much safer transaction for everyone.

The return to the partners in the boutique is typically that they time it to an expiration of a lease or other major longer term liabilities, and they keep all liabilities in the deal and pay them, with the accounts receivable they also keep. It is not unusual that the small partnership will keep a substantial portion of the accrued accounts receivable balance as collected and distribute it among themselves after paying off the debt. Their starting compensation in the new firm is almost always smaller, because the administrative costs are usually significantly higher. The biggest issue is negotiating the billing rates in the transfer so the clients don't balk. That often is part of the trade off…the lawyers take that transition hit to keep the rates low. But it's ok, they are taking care of everyone and putting some money in their pockets. Not enough to be rich, but enough.

So the lesson is, if you are departing a large law firm, be nice to your old firm, you may be joining them again. And if you are a large law firm, and have a group leaving to form a boutique, be nice to them, because you may get them back when it will pay your firm handsome returns to reacquire them. Unless you jerked them around with returns of capital and file transfers.

Why will a large firm that pressured a boutique practice team out of a firm want the boutique back so many years later?

Because law firms will be firmly embracing contribution to profit compensation systems, not profit blind originations and hours systems. Perhaps this time around they will be able to keep them.

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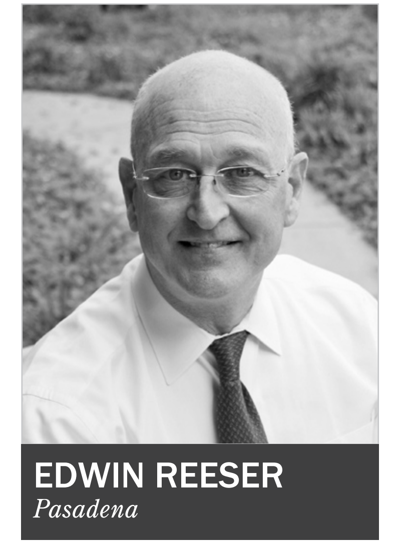

EDWIN REESER
Pasadena

LLCs take a back seat to limited partnerships in 2014

By Bruce Givner and Owen Kaye

Asset protection planning is a concern to many clients and professionals. When discussing asset protection planning we need to distinguish among the three types of creditor issues which we refer to, in client meetings, as Up, Down and Sideways. This is best illustrated by assuming that Joe owns a single member LLC which owns two buildings, which is a relatively common current structure. If someone dies in building one, the judgment creditor will want to pierce through the LLC to get to Joe's personal assets; that is the "Up" type of liability (the traditional "piercing the corporate veil"). If Joe gets in a car crash, the judgment creditor will want to seize his valuable interest in the LLC; that is the "Down" type of liability. Finally, if someone dies in building one, the judgment creditor — frustrated at not being able to "piece the corporate veil" — will want to get the equity in building two; that is the "Sideways" type of liability (sometimes called "collateral").

For the first and third types of liability (Up and Sideways), we have good advice. To make it difficult to "pierce the corporate veil," among other steps, the LLC should be adequately capitalized. Unfortunately, on any given set of facts there is no certainty as to how much capital is enough. All we know is that more cash in the LLC's bank account is better than less. For the "Sideways" (collateral) liability, building number two should be in a different LLC than building one, even if both entities are, in turn, owned by the same master LLC.

The problem is the "Down" type of liability. Twenty years ago, before the Sept. 30, 1994, effective date in California for LLCs, we used limited partnerships for this purpose and benefitted from Corporations Code Section 15907.03, titled "Rights of creditor of partner or transferee" (which is still the law). When a judgment creditor wishes to proceed against a partner's interest in a partnership, the first step is to get a charging order, the procedure for which is described in subsection (a): "On application to a court of competent jurisdiction by any judgment creditor of a partner or transferee, the court may charge the transferable interest of a the judgment debtor with payment of the unsatisfied amount of the judgment with interest." So one possible way to protect the partner is to make the partner's interest non-transferable, which can work in a closely held (family) partnership. However, even in those situations the partnership interest is arguably transferable, e.g., at death.

Therefore, we also rely on subsection (c)(2) which reads, in pertinent part, as follows: "At any time before foreclosure, an interest charged may be redeemed … (2) with property other than limited partnership property, by one or more of the other partners." This is a wonderful provision as it allows the partnership agreement to offer the non-charged partners the opportunity to buy the charged partner's partnership interest for a 30-year, interest only, installment note at an interest rate pegged to prime, with valuations taking into account adjustments for lack of control and lack of marketability. Assume that the partnership's assets are worth $1 million and Joe, the parent, has a 95 percent limited partnership interest, while the trust for Joe's children has a 3 percent limited partnership interest (the LLC, which is the general partner, owned by the children's trust, owns the other 2 percent). What is the value of Joe's limited partnership interest? $1 million *x* 95 percent *x* 80 percent (to allow for a 20 percent lack of marketability adjustment) *x* 80 percent (to allow for a 20 percent lack of control discount) = $608,000. (Of course, the adjustments must be determined by a competent business appraiser.) With this type of provision it was not necessary to have another member, e.g., the children's trust in Joe's case, exercise the option. The mere presence of the option was enough to motivate the creditors to settle in a manner favorable to Joe.

Once LLCs came along in September 1994, we switched from limited partnerships to LLCs since, with an LLC, there is no need to have a separate entity as the general partner. Corporations Code Section 17302(c)(2) for LLCs was modelled on Corporations Code Section 15907.03(c)(2) for limited partnerships, so another member could buy a charged member's interest for terms which would similarly prove unattractive to a creditor.

However, on Jan. 1, 2014, California adopted the Revised Uniform Limited Liability Company Act. Without any discussion, Section 17302(c)(2) was eliminated and replaced with new Section 17705.03(d) which provides: "At any time before foreclosure … a limited liability company or one or more members whose transferable interests are not subject to the charging order may pay to the judgment creditor the *full amount due under the judgment* and thereby succeed to the rights of the judgment creditor, including the charging order" (emphasis added). Therefore, the operating agreement can no longer allow another member to buy a charged member's interest on terms which will motivate a judgment creditor of the charged member to settle on favorable terms.

Given that change many clients who hold their properties in LLCs have transitioned to using the old LLC as the general partner of a new limited partnership. So they have not had to liquidate (federal tax law) and dissolve (state law) the LLC; they still get use of it while benefitting from the new, improved, limited partnership-based structure.

Accordingly, for clients and professionals interested in the highest degree of protection of their valuable interests in entities, the winning choice is a limited partnership rather than a limited liability company. We are, in 2014, returning to 1994.

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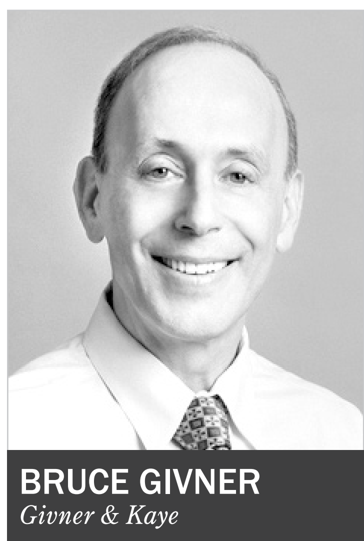

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