

There Is No Shareholder Value in Large Law Firms Today

By Edwin B. Reeser

The maximization of the short-term result at the expense and destabilization of the entity for the long-term future is an important feature in the current crisis affecting large law firms.

Strong financial cores help to keep a firm flexible in its responses by providing the time necessary to enable positive change. Without adequate time, the right ideas cannot be implemented, even if you come up with them, to save the firm. Time and cash are inextricably intertwined. Law firms do not go out of business because they run out of profits. They go out of business because they run out of cash.

For example, at the end of the year, which for law firms is usually the calendar year, there are two very large variables that impact performance: collections and expenses. We all know about the flogging of clients to pay their bills prior to the end of the year, because we bear personal witness to the flogging of the partners to make it happen. What greater testament to bad management can there be than this? Clients extract concession discounts for year-end payments routinely because their lawyers put themselves in a vulnerable negotiation position. How can there be anything more fundamental than that? So don't do it.

I was once a name partner in a small firm, and was given the duty to be the managing partner. There were only a half dozen partners and about 20 lawyers at the start, but we had a plan. Our mission was to build a firm that was the partners "owned" and that was secure and stable, because it was effectively the source of our salaries, and that was even more important than the amount of the salaries. Frankly, there was no doubt that the enterprise would generate more than sufficient income for all the partners. As long as the source could be secured, then the second priority of maintaining and expanding the amount could be pursued,

but never at the expense of the security of the source. That prioritization was absolutely critical. And it has been lost, amazingly, in the current financial dynamics of many firms.

Here are some of the key tasks we did that are not done by most firms today. We paid attention to a steady collection process throughout the year. A formal review and action response was required every quarter. Remember, we were working under a weighted average of 45 days for receivables, and anything over 60 days needed a pretty good reason. Anything over 90 days was real cause for concern. Early intervention, and cessation of work if possible, were the only real defenses to a problem becoming a bigger problem that could hurt the enterprise. As a result, while end of the year collection effort was important, we never gave year-end discounts just to collect. If Jan. 2 was the day, fine. So long as we collected. Indeed, we would talk to the client about whether making the payment a bit early in December or a bit later in January was better. If they wanted an interim bill through Dec. 15 to pay before Dec. 31, we would accommodate. But we would also accommodate a stretch to January. The important part was getting the commitment that it be paid. Cash in the bank was more important than which day it arrived.

We paid everything in our liabilities bucket current. As modified cash basis taxpayers, we wanted to match up the period in which expenses accrued with the payment. So, in December, we would look at our accounts and I would have every vendor/supplier contacted and tell them: "Send me your bill for December goods and services by Christmas Day, and you will be paid before New Year's Day." Everything was paid, and it was all in accord with applicable tax rules and regulations. The ship launched into the new year fully provisioned. Can you imagine what it meant to us in terms of vendor good will and service response for everybody that worked with us? We might have been a small account, but we were

treated like royalty. And that helped with client service when it really mattered. In the overall budget, it is not a big deal, especially when you are not squeezing for every dollar of PPP. The stories out there right now of big law firms stretching out payments for their vendors are remarkable.

Associate and staff bonus payments were made the week before Christmas. Think that made folks happy? We knew what we were going to be making with some confidence because we did not depend on 30 percent of our annual monies and 50 percent of our net distributable profit coming in December. We could forecast with some reasonable accuracy what would happen. Besides, most of these were fixed amounts, not firm performance dependent.

We paid into the pension plan, or at least set the cash aside before year end, if in fact we had not already made some periodic deposits during the year. We also understood that we did not pay partners with profits. We paid partners with cash.

If the end of the year reportable income was lower than we liked, we paid less income taxes. But, in January, we started the month with no bills. This was nothing like the current condition of many large law firms where gross collections in January are sometimes less than operating expenses, not including payments for staff and associate bonuses. Our cash position by the end of January was huge. We could hold on to the money rather than have it pass through to the taxman in a few days.

There was a working capital line but we almost never used it. We did not borrow money to make partner draws. With a nice slug of money in January (and holding a cash reserve), we could dole it out as we felt comfortable, and every once in awhile make a special or extra distribution to partners during the course of the year.

How much cash did we hold? The equivalent of one month of

gross operating expense, including staff and associate salaries. That was partner money, partner capital. There was a line item on the monthly report to partners that showed "cash reserve" and also a

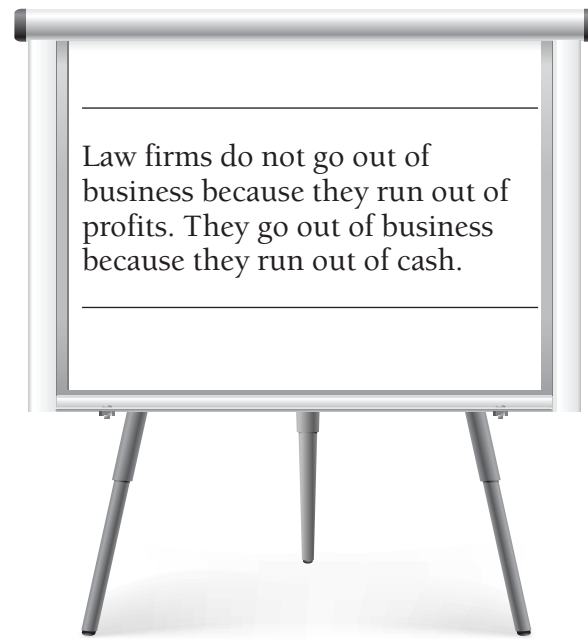
withstand outside pressures that impact them. Reliance on debt is only one of them, though it is a big one. A service business does not have capital assets as a material income-producing element. There-

cash generated this year, sometimes not until the second or even third quarter.

The "capital" that partners have in most law firms these days is really no such thing. The agreements of partnership in large law firms do not typically give partners a right to an ownership share in the business. Rather, they forego such rights and have a contractual agreement to a number for capital and income share that bears no rational relationship to enterprise value. This so-called "capital" is part of a fantasy construct, sometimes with a relationship to a "draw" or allocation of income from operations. But as we know, it is phoney baloney. If a firm today dissolves, there is no capital to pay debts, let alone return to partners.

So, with the structures of capital and ownership in many large law firms not "real," ongoing enterprise and shareholder value are not real either. Why should partners be expected to treat the entities as real either? They have become fungible production units, with little job security. More importantly, why should vendors and creditors treat the entities as real? And, as we see, when the wind blows just hard enough, in just the right direction, like a fleet of sailboats without keels, just the right combination of environmental conditions can cause one or more to flip and sink.

And what happened of the little boat that did so well? The partners agreed to a large law firm acquisition for the "opportunity" that platform would afford. This large law firm no longer exists. A lot of great little decisions were ultimately negated by one rather significant bad one — not unlike the dog in Aesop's fable who gave up the bone he had for the reflection of the "better" one in the water below.

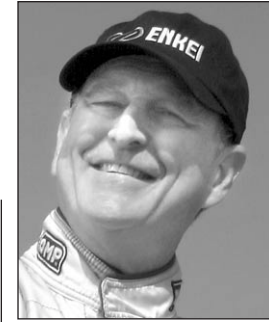


comparison to our past/present/forecast expenses. Current depreciation of capital items provided a way to replenish those reserves in a tax advantaged way as well. If there was a problem that really hurt us, we could manage for several months without being in distress, plenty of time to make adjustments in our largest variable component of cost — people — if that was going to be the answer. It is a lot easier for partners to be confident in management when the source of your income is not in question. The amount can be a subject of debate and discussion, and always is. But it is when the security of the source becomes a question that the ship founders.

The financial engineering games employed and built upon by many law firms over the past two decades have artificially inflated the PPP numbers, and hollowed out the core strengths (financially) of the enterprises, so that in many instances they have become paper tigers. They have no resilience to

fore, there is very little justifiable need for the use of debt whatsoever. Other than to accelerate the distribution of income from future periods to current periods, (which is not a justifiable need), it serves almost no purpose in a law firm. Debt is not just bank borrowing or leases of equipment. Manipulation of the timing of payment of liabilities and recognition of income also play a role. This last "hidden" element is where some real problems presently rest in law firms today.

Today, law firms pull income from future periods into the present, push present expenses into the future, recharacterize expensible items as capital investments that are amortized, and play musical chairs with partner capital accounts. Pension contributions for partners for last year are paid with



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The Unintended Consequences of Impatience

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not take all morning with your infuriating delays and waste the precious time of the lawyers waiting to argue their cases? You think that bringing volumes of transcripts from the trial you deserved to lose will enhance your chances on appeal? Get real."

That is not what I said. That is what I thought. The lawyer grabbed another file and once again approached the podium. As he cleared his throat to begin his argument, and was about to utter his first word, I said, "Your time is up." Many in the courtroom laughed and applauded. But I don't do that anymore. It might be interpreted as a sign of impatience. Now don't get me wrong. Sometimes impatience is warranted. A judge should not lose control of the courtroom for fear he or she might be labeled "impatient." I have learned to control my proclivity for impatience even when it is warranted, because of my greater concern about unintended consequences.

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Let me illustrate with a hypothetical. Sooner or later, we Americans once again will display our irritation with the French, even though the previous week we loved them. Some snooty French cook will claim to have invented "French fries," and we will protest. Movements to ban French toast, and outlaw "French kissing" will gain momentum.

As the protest grows, a small municipality in the Midwest enacts an ordinance requiring that all French Poodles be neutered. The five people who own French Poodles hire the ACLU to challenge the ordinance in court. The town's city attorney thinks the ordinance is silly, and hints he will not enforce it. Owners of German Shepherds, Russian Greyhounds, Mexican Hairlesses, Japanese Akitas, and English Setters throughout the country urge the French Poodle owners to drop their suit. They caution, better to play dead for the moment. But no, the suit is filed



and makes its way to the Supreme Court. In a unanimous decision, the court holds the ordinance is unconstitutional and chides the city council for enacting an idiotic law. The Supreme Court's harsh language reflects "impatience," and offends the populous of the state in which the municipality is located. The people enact a constitutional amendment that prohibits ownership of not just French Poodles, but all dogs of foreign countries. Moral of the story: Let sleeping dogs lie.

Speaking of dogs, a personal experience brought home to me the relationship between impatience and unintended consequences and taught me a lesson. A friend of mine died. His elderly mother, Francine, lived alone in a condominium in the San Fernando Valley. I dropped in on occasion to see how she was doing and to take her out to dinner. She had an elderly Schnauzer, Regina, for whom I had an overwhelming aversion. I love animals, but detest dogs with human names. Regina walked stiff-legged like a wind-up toy. Frequently, and for no apparent reason, she emitted a sound, which I charitably call a bark. Regina's "bark" sounded more like a muffled uh-oo-gha, uh-oo-gha. Sit at her kitchen table drinking a cup of coffee, and you might hear at your feet, "uh-oo-gha, uh-oo-gha." As you shall learn shortly, this unpleasant description of Regina's decrepitude is germane to my story.

It was Thanksgiving, and we invited Francine to our house for an early turkey dinner. It was understood that Regina would not be joining us. I drove out to the Valley to pick up Francine around 2 p.m. This was a typical Southern California Thanksgiving Day, 85 degrees. I rang the doorbell and Francine invited me in. It was hard to see inside because the curtains were drawn. I could hear a weak "uh-oo-gha, uh-oo-gha." As my eyes

became accustomed to the dark, I could make out that Francine was wearing a full-length winter coat. I found this curious, not just because of the warm temperature outside, but because the heat in the condominium was turned on high and blasting out of the vents.

I believe this was the point at which I displayed...impatience. Did I take a moment to ask Francine, who I had no reason to believe was senile, for an explanation? No, not impatient Arthur. "This is crazy," I thundered. "You are wasting energy." I flung open the curtains causing Regina to blink as sunlight flooded the room. I turned the knob on the heating controls to "off." "Shall we go?" I said...impatiently without letting Francine get a word in edgewise. To Regina, I said...impatiently, "Go chew on your rancid rubber bone...if you have any teeth left." It is not easy to admit that I could have been so sarcastic, so...impatient.

Francine and I left and we quickly forgot about my unpleasant outburst. We had a delicious Thanksgiving dinner with family and friends, and Francine had a wonderful time. I drove her home around 9:30 p.m. Unlike the afternoon, the evening in the Valley was particularly cold. Luckily, Francine was wearing her warm winter coat.

We opened the door to the condominium and turned on the light. I sensed something was wrong quite apart from it being freezing inside. No "uh-oo-gha, uh-oo-gha." No Regina. I shivered. There in a cor-

ner of the room I saw stretched out and unmoving, Regina. She was stiff as a board, and appeared to be critically, seriously and terminally dead. It was obvious rigor mortis had set in. But to be doubly sure, I drew upon the knowledge I had acquired in my high school physiology class. I placed two fingers near Regina's nostrils. No breath. Conclusion — Regina is dead, a conclusive presumption.

Francine was standing on the other side of the room, shivering in her winter coat. My mind was racing. What am I going to do with a dead Schnauzer on Thanksgiving evening, and what am I going to do with Francine who had just lost her best friend?

I turned on the heat, which once again came blasting out of the vent with a "whoosh." I embraced Francine and told her how sorry I was that Regina had passed on. Inwardly, I cursed the predicament I was in and I cursed myself for being in that predicament. Meanwhile, the room was heating up. I suggested Francine take off her coat. I glanced across the room at Regina's lifeless body. Wait a second. Did I see a flick of Regina's ear? Can't be. Probably wishful thinking. But just to be sure I walked over to Regina. The room was like an oven. Regina twitched. She opened an eye. She stirred. She got up...slowly, but she got up and stayed up. I replaced my earlier conclusive presumption with a new one. Regina is alive — beyond all doubt — at least for now. Oh joy! Francine is ecstatic. Stiff-legged Regina is hobbling about.

From this upsetting experience, I learned a good lesson about the corrosive effect of impatience. Had I asked earlier in the day why the heat was on and the curtains closed, this upsetting chain of events would never have occurred.

And from that day on, I have made every effort to be a patient and courteous person on and off the bench. But on occasion I wonder whether a law outlawing Schnauzers would pass muster.



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