

Free agency and lateral partner moves

By Edwin B. Reeser

Lateral partner moves in the legal industry, especially the ones involving prestige practices, have often been compared to the free agency feature in professional sports. Many of us who wear suits and ties to work and spend endless hours behind a desk like to think of ourselves in the more fanciful and heroic perspective of star athlete than we do the image of law practice painted by Herman Melville in his 1853 short story "Bartleby, the Scrivener: A Story of Wall Street."

Why should the economics of free agency worry owners for law firms? To follow the free agency example, it would be because in an increasing number of cases they lead to bidding wars and special deals. Those deals include signing bonuses, guaranteed minimum incomes, special perks and allowances, often for several years. This alienates and embitters long term loyal partners, reduces income for existing partners and potentially constricts ascension to partnership from the internal ranks.

The sports industry response, to put limits upon true free agency, is interesting as a comparison because under the rules of professional ethics for U.S. lawyers, restraints on competition are unenforceable. Only in the event of a lawyer retiring or selling their practice will a restraint against competition be permitted.

A second observation, but an incorrect one as we shall see later, is that in law firms it is the "players" that also own the teams. An obvious financial self-interest by the community of partners as owners in each firm should work to dampen enthusiasm for the patently uneconomic guarantees and other compensation structures that redirect income received by the law firm to the partners.

So the question then becomes why do U.S. firms do it. The partners at the top receiving the high incomes should be the ones most averse to the idea. The answer is because the "players" are not "owners" in the modern law firm model. As the partner screams of "heresy," "blas-

phemy" and perhaps "fool" subside, let us see why it is the case.

Equity partners in U.S. firms, beginning over 40 years ago subscribed to partnership agreements in which they waived all claim to any of the assets of the firm, and disclaimed "goodwill." Rather, they converted their very flexible partnership agreements to a commitment to make a capital contribution to the firm, which was the *only* sum they would ever receive upon their death, disability, retirement or withdrawal (DDRW) from the firm. Usually that base capital earns no interest or accrual in value. Why did law firms do this? Several reasons, but two of the more important were:

One, every time a partner would join or leave the partnership, or internally there was an adjustment of earnings shares, there would be a matching "buy-sell" associated with the transfer that could affect *every* equity holder in the firm. There would be taxable gains and losses, and typically no income to distribute on these capital transactions for partners, as the firm grew — creating a nightmare both for record keeping and the method for determining valuation.

Two, the threat of trustees for the estates of deceased partners, conservators for disabled partners, and angry spouses of divorcing partners suing the firm for premium valuation over book value of the assets, going concern multiples, goodwill, etc. In a large law firm, it would be reasonable to expect that every partner in the firm would be a named party in at least half a dozen lawsuits continuously throughout their entire careers! (Remember, they were general partners at that time, and technically still are even in an LLP.) The managing partner and CFO would likely spend half their time in depositions and on the witness stand, or dealing with these cases, and all it would take is one instance of an adverse decision to damage the firm and every partner's interest. So the answer was for everyone to waive off any direct ownership interest in the assets of the firm, and that was done by the vast majority.



Shutterstock

If you step back and think about this for over 10 seconds, you see that several business outcomes are inevitable from this "adjustment" to the growth impact upon a professional service partnership.

The first consequence is that your only compensation is what you take out, so there becomes a big motivation in taking everything possible out of the firm currently.

The second is you have no financial interest in the viability of the entity as a sustainable going concern once you have left. Argue all you want against that, but that is what happens and it is more than apparent in the market place even if it is not widely discussed. This puts the partners in power and who decide in a serious conflict. They have the power to decide who gets

paid how much, and they have a shorter period of time to participate in distributions. The overwhelming pressure and self-interest is to favor themselves over the remainder of the partnership. You have seen it at work in many law firms, even though it is usually only exposed publicly in the ones that fail.

A third consequence is that the "capital" contribution has the label of equity and is reported on the lower right side of the balance sheet as equity, but it doesn't operate as equity. It is *debt*, a non-interest bearing loan by a shareholder, member or partner to the firm, which is an obligation of the firm to repay on DDRW. It should be on the liabilities section at the top of the right side of the balance sheet.

Yet a fourth consequence is the

number for partner capital you see on the balance sheet is "hooyey." The money is not in some account securely stashed away. It's gone — converted into paying the cost of creating accounts receivable, buying equipment, paying expenses, and in some cases actually funding distributions back to the partners — some in guarantees.

Thus, *there is no owner* to counter the free agent player negotiation power. Instead, the firm is simply eviscerated financially.

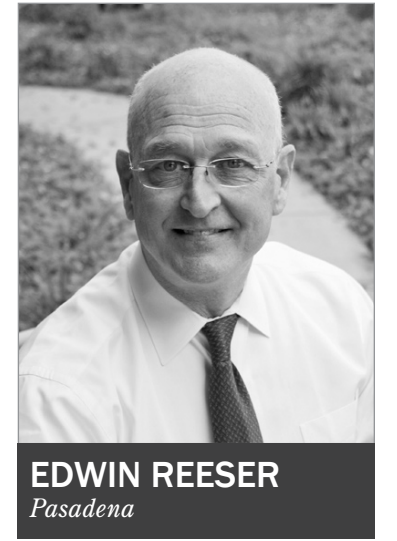
Wonderment has been expressed about how it can be in the face of such pressures for change to improve client service and the "value proposition," and to work many other logical business changes, that law firms have not done it. How could they "not get it"? The answer is

those asking that question don't "get it." They are assuming attributes of the business model exist where and when they do not.

Reset assumptions to the above, and the behavior is entirely logical. Why work to effect difficult change, and take current pay cuts for future returns, when those incurring the largest share of the cost will not be in the firm when future returns will flow? The sure win is to concentrate on perpetuating the struggling model and resort to internal income re-allocations through the vast array of accounting and structural techniques over which the inner circle has absolute control, pushing the financial burden of inefficiencies and cost changes down, and the ability to do it quietly if not invisibly.

This is not cynical. It is just to be expected and is rational, if not enlightened, from the perspective of those that decide. It may be "sport," but it cannot be perceived as "heroic" by any measure. If you don't like it, change the rules of the game, or reply as Bartleby did, "I would prefer not to."

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.



EDWIN REESER
Pasadena

Ukrainian voters rejoice after booting Communist Party

By Robert C. O'Brien

On Sunday night, I sat in a chilly school gym while election officials in the city of Lviv went through the tedious process of counting and reconciling paper ballots for Ukraine's parliamentary election. Millions of Ukrainians went to the polls on Sunday to elect a new Parliament, less than a year after former president and Putin puppet Viktor Yanukovich was ousted in the Maidan protests. There was no heat, because most of the gas that powers Ukraine comes from Russia and is too expensive to use this early in the season. Despite the conditions, however, I will not forget the Ukrainian people I met while observing their election.

There was the kindly grandmother, running a rural polling station, who was so proud to have a foreign observer, especially an American, visit her village. She told me that the little hamlet, aptly named Velyka Volya ("Great Freedom"), was the place where a group of Ukrainian resistance fighters, in a 1946 version of Masada, committed suicide rather than surrender to the encircling Soviet troops.

An elderly man at a downtown



Ballot boxes in Lviv, Ukraine.

Photo courtesy of Robert C. O'Brien

polling station shared his story. As a medical student following the Second World War, he joined the resistance and fought the Soviets until his capture in 1951. He was shipped to a Russian gulag and survived for six years before being released, but authorities prevented him from going home. He never returned to medical school. He was so happy to be serving as a precinct secretary in a democratic election in his native land. He pleaded with me for America to send arms and Kevlar so Ukraine's young men would have a fighting chance against Russian regulars.

A young mother arrived at a suburban precinct. In tow was her 3-year-old daughter, dressed in a white snow suit that matched her own. The little girl clutched and waved Ukraine's blue and yellow flag and smiled the whole time that her mom underwent the formalities of casting her vote. The election was about the

child. Her mom envisioned for her a future of freedom and the rule of law in the sunlit uplands of the West, not of despotism in the wintry East.

The precincts were manned by fresh-faced kids. Of the 17 precinct election committees my team visited, most had a majority of 20-something members. Some were made up entirely of young people. The Maidan protests that claimed the lives of 100 of their contemporaries inspired them to get involved to stop the apparatchiks from stealing another election. These young people are taking their country back and corrupt, one-party rule has no part in their plans.

One of these young post-Maidan activists is Hanna Hopko. She is a 32-year-old mom and committed Christian with a Ph.D in communications. Hopko has already established herself as a reformer who undertook on big tobacco in her effort to rid Ukraine's bars and restaurants of

second-hand smoke — no easy feat in a country where cigarettes are still sold everywhere.

Hopko was the number one candidate on the Samopomich Party list. Until Sunday, Samopomich had never contested a parliamentary election. What it lacked in national election experience, it made up for with a pro-European, free-men and free-markets platform. While President Petro Poroshenko's bloc will win a narrow victory, the International Republican Institute exit poll shows Samopomich taking an unexpectedly strong third-place position. Dozens of its "outsider" candidates, led by Hopko, will now demand reform from inside Ukraine's Parliament.

Finally, for the first time since the Soviets occupied Ukraine in 1918, there will be no Communist Party representation in Ukraine's legislative assembly. When the exit polls were released just after 8 p.m., show-

ing that the Communists were well below the 5 percent threshold for proportional representation, several Ukrainian voters pumped their fists and smiled. For them, this election was a welcome end to Communist influence over their lives.

Notwithstanding the war and the punishing economic circumstances Russia's invasion and occupation have inflicted on them, Ukrainians are happy today. They showed the world they remain unbowed in the face of aggression and are committed to a future in the democratic West.

Robert C. O'Brien is the California managing partner of Arent Fox LLP. He served as a U.S. representative to the United Nations. He was a member of the International Republican Institute delegation that monitored Ukraine's parliamentary elections on Sunday. He also advised Republican presidential candidate Gov. Mitt Romney on foreign policy matters. Robert's website is www.robertcobrien.com. You can follow him on Twitter @robertcobrien.

Daily Journal

Charles T. Munger
Chairman of the Board
J.P. Guerin
Vice Chairman of the Board

Gerald L. Salzman
Publisher / Editor-in-Chief
Robert E. Work
Publisher (1950-1986)

David Houston
Editor

Ben Armistead
Legal Editor

Jill Redhage Patton
San Francisco Editor

Jason Armstrong
Associate Editor
Los Angeles

Yean Jung
Associate Editor
Los Angeles

Craig Anderson
Associate Editor
San Francisco

Katharine Malone
Associate Legal Editor
San Francisco

Los Angeles Staff Writers

Kibkabe Araya, Matthew Blake, Melanie Brisbon, Brian Cardile, Matthew Hamilton, Henry Meier, Jason Pafundi, Kylie Reynolds

San Francisco Staff Writers

Emily Green, Laura Hautala, Hadley Robinson, John Roemer, Joshua Sebold, Fiona Smith, Saul Sugaman

Bureau Staff Writers

Dominic Fracassa, Alison Frost, Kevin Lee, Alex Shively, Palo Alto
Vik Jolly, Riverside
Don J. DeBenedictis, Alexandra Schwappach, Santa Ana
Paul Jones, Sacramento

Designers

Ari Goldstein, Sepideh Nia

Rei Estrada, Video Editor

John Michael, Editorial Assistant

Rulings Service

Seena Nikravan, Rulings Editor
Connie Lopez, Verdicts & Settlements Editor
Luke Delgado, Karen Natividad, Legal Writers

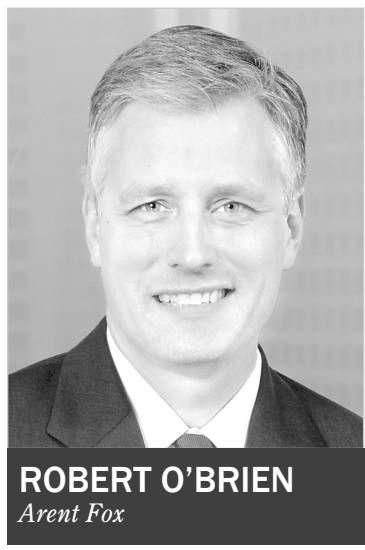
Advertising

Audrey L. Miller, Corporate Display Advertising Director
Monica Smith, Los Angeles Account Manager
Len Auletto, Michelle Kenyon, San Francisco Account Managers
Kari Santos, Display Advertising Coordinator

Art Department

Kathy Cullen, Art Director

The Daily Journal is a member of the Newspaper Association of America, California Newspaper Publishers Association, National Newspaper Association and Associated Press



ROBERT O'BRIEN
Arent Fox