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FIRM GUIDANCE

The Keys to Handling BigLaw Firm Tenants

By Edwin B. Reeser

A partner considering a departure from his or her law firm previously had to be concerned about the consequences to the firm that the departure would create. Now, in an LLP structure, all a partner needs to do is weigh the cost of the loss of his or her capital invested in the firm against the reward for leaving, and additional direct obligations undertaken, such as limited lease guarantee amounts, if any. If the calculation militates in favor of departure — poof — they can be gone. There may be some entity bankruptcy and other issues that complicate this picture and they cannot be ignored, but the bottom line is that the considerable monetary hardship or unquantifiable amounts of risk caused by a BigLaw firm's demise are no longer present, or at least not to the extent they used to be.

Thus, the change in the profile of liability associated with being a partner, and the increased mobility both in and out of law firms has impacted a critical part of the foundation to the stability of the law firm enterprise, and destabilized it, perhaps greatly. Some confusion over where liabilities rest may also have been created with the "de-equitization" of partners to income or salaried class partner employees. Those people may still be liable on their lease guarantees irrespective of the status of their partnership and absence of a vote, notwithstanding an essentially involuntary conversion of their partner position.

Regardless of whether one subscribes to the premise that greater personal liability motivates greater commitment from partners, or that if it does that it is a "good thing" for the enterprise and/or the partners, it is virtually assured that landlords are going to be of the view that some measure of personal partner recourse is not only a good thing for them, but an essential requirement of granting a lease of expensive space to a law firm tenant.

That simple requirement is going to call the question on whether a lot of the people who have been the "leaders" under one set of liability rules are going to be the people a lawyer is willing to accept as "leaders" under different (and potentially more draconian) liability assumptions. It is one thing to be at risk for a couple of hundred thousand dollars, and another to be at risk for everything you have worked your entire life to own, invest and save. You have a 15-year generation of partners who are accustomed to operating in an environment of limited or no personal liability on leases. And in BigLaw, that means not just for the office you occupy, but potentially the dozen or more scattered around the United States and abroad, many of which you have never even visited. Many such offices have been added to the roster of locations under the umbrella of the LLP. If you are a partner with less than seven or eight years to practice at the firm, what will your perception of signing new lease liabilities likely be? Unless there is very strong trust and confidence in the integrity and business capability of the firm leadership, the answer is usully going to be "no" as the firms return to testing the mutual commitment to each other that they used to perform when, as partners, they discussed leasing decisions.

> If you are an investor in the ownership of a property of this type with BigLaw firm tenants, you better step up your supervision of the asset and the risk parameters you will allow your agents to operate within when making their lease deals.

This might leave one scratching his head over how could there be so many smart people from coast to coast working on these leases to BigLaw firms (actually all firms using the LLP entity) and yet this could happen. Was everybody just sleeping?

Perhaps there were a lot of assumptions about the underlying viability of creditworthiness of BigLaw tenants that were not re-tested. But I don't think that is the explanation.

There are two points of intersection/responsibility for dealing with the law firm tenant.

The first point of intersection is the management company/leasing representative for the building. They handle all the firms in the building and the prospective tenants. They have their building form of lease. It is typically prepared for tenants generically, and it then becomes the skeletal structure within which a heavily negotiated and custom business transaction is created. They have the protocol for checking financials and creditworthiness. But they have no idea of how a law firm really works financially. (What other business are you aware of that may generate a half billion dollars in revenue per year, but zeros out its entire net operating income every year end?) In fact, if you look at the fiscal year income statement and the balance sheet for a modified cash basis taxpayer — which is what a law firm often is — you will see for a firm of that size a partnership income figure that is probably on the order of $175 million net operating income annually, and a cash in bank balance on Dec. 31 of $50 million or more, with a working line of capital at a zero balance, though a $100 million credit allowance.

What one doesn't necessary grasp is that on Jan. 15, the date that the fourth quarter estimated tax filings for partners with their payments are due, the firm will have distributed at least $45 million of that cash to the partners, and that is not "profit" in the ordinary sense, but rather income earned by the partners from their labor that as of Dec. 31 had yet to be distributed, and as such is a pass-through to each equity partner proportional with their shares of ownership or as otherwise allocated under the partnership agreement. And that by June 30, the firm may be drawn down on the credit line by $75 million.

The BigLaw firm is a monster of a cash engine, but it is a paper tiger as a capitalized business enterprise.

The manager/leasing representative, whether in house or an outside specialist, is not necessarily attuned to this because, over the history of law firms, they were general partnerships and everybody was on the liability hook. When the conversion to LLP form started, they jumped to the quick and obvious interpretation that it was like a corporation. No more pass through liability. So all they needed to do was to protect against their exposure if the firm went bust early in the lease term (very unlikely) for the front-loaded, out-of-pocket advances that landlords gave as incentives to get the deals, such as high tenant improvements, free rent and other concessions. They were focused on the wrong issues.

The second point of intersection is the outside lawyer representing the landlord in the lease negotiation. Surely, being lawyers, and many of them at BigLaw firms themselves, they would understand this issue. Wrong!

There was nothing in their experience or education to alert them to the risk. They are real estate lawyers with leasing specialization, and while they may have an excellent understanding of the theoretical working of various legal entities, they are not (and nobody is) experts in understanding how there would transpire a gradual evolution in the way in which firms managed themselves, and the relationships among partners would change such as to create this altered risk profile gradually. Indeed, most lawyers in BigLaw firms to this day have no clue about the economics, or the dynamics, of how the business of BigLaw really works, even within their own firms. Because it has not been communicated to them by the leadership of the law firms.

As a result of these factors and the current economic cycle downturn, landlords nationwide suddenly find themselves in a position where the dynamic elements that used to combine to hold a firm's partners together and previously made a law firm an incredibly stable and desirable tenant, now have eroded those elements andt combined to tear law firms apart, without meaningful recourse to the landlord to protect itself.

This is going to become relevant on a broad scale, as the underwriting of the value of buildings by lenders, and especially prospective lenders or those asked to renew or extend loans to these big office towers must change. If you are a lender with a loan on a million square foot office tower, and you have 400,000 square feet leased in the aggregate to large law firms (or other professional LLPs), you have to examine the financial statements and dissect and understand the working dynamic of the partnership agreements of those firms with a new forensic focus to understand what those leases are really worth as income streams.

This is going to require some new skill sets and risk evaluation models. If you are a leasing manager for a building, you must change the approach to leasing to these types of entities to properly reflect the real risks involved. If you are an investor in the ownership of a property of this type with BigLaw firm tenants, you better step up your supervision of the asset and the risk parameters you will allow your agents to operate within when making their lease deals. The question has been called.

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 a office managing partner of firms ranging from 25 to over 800 lawyers in size.