FIRM GUIDANCE

A New Lease on Life?

By Edwin B. Reeser

The owner of the premier office tower where Heller Ehrman LLP formerly had its headquarters is throwing the keys to the lender.

Beautifully designed, engineered and constructed, 333 S. Bush is one of the finest office towers in the United States; a fitting, proper abode for one of its oldest and finest law firms. Until the firm imploded, seemingly overnight, last September.

The collateral damage of a single BigLaw firm triggering losses approaching high eight and perhaps nine figures to the owners, and probable additional losses to the lender, mandates serious rethinking of the approach that all building owners, and lenders to building owners, apply to making future lease deals with BigLaw firms.

It may make BigLaw firms and their equity partners more financially at risk.

BigLaw firms have long been sought after as tenants for premier buildings, and rarely had failures that worked severe consequences on landlords. What are the factors that will make a new approach recommended for owners and landlords in their dealings with BigLaw?

One is the change in the legal entity nature of the tenant. More specifically, the change in the strength of the commitment of partners to one another within a law partnership that influences the stability of the business enterprise. Until about 15 years ago, most BigLaw firms were general partnerships, and all equity partners were individually, jointly and severally liable for the obligations of the partnership. Typically, a partner who withdrew did not sever liability under the lease effective the day of withdrawal. Thus, if a 15-year lease was executed while you were an equity partner, and you left sometime during the first lease year, absent a specific release from the landlord and the consent of the remaining partners (which neither will likely give absent consideration and pre-negotiation at the inception of the lease agreement), you would be liable for the remainder of the lease term. Departing partners had a strong interest in the continuing health and financial viability of the firm they left. The "we are all in this together" mantra had real economic underpinnings that moderated behavior and enhanced cooperation among partners.

Every managing partner and leasing lawyer who represented law firms in major leasing transactions 15 or more years ago can attest that one of the watershed events in the lifespan of all law partnerships was the renewal of the partners' collective commitment to stay together as a team upon the execution of a new lease. On occasion, the process of negotiating a major new lease and undertaking its long-term financial commitments precipitated the decision among partners to dissolve or break into parts rather than sign up together for another 10 or 15 years, or reconfigure (sometimes significantly) their methods of operating the business, governing themselves and allocating their profits as a precondition to staying together. That "refreshment of joint undertaking and communal direction" was perhaps painful, but very important. With the advent of the LLP, it became basically unnecessary to go through that process, as there no longer was enough at risk financially to warrant each individual partner's suffering through the process. It also became easier for firm leadership to obtain the partner support required to open new offices in aggressive expansion plans. It may now become difficult to hang on to some of those growth offices when and if the whole firm partnership, on individual partner terms, is asked to guarantee even a portion of a long-term lease for an unpopular office that is not perceived as carrying its share of the performance burden. Indeed, when partners do reflect on the recourse of a landlord in a remote outpost to the capital worth of the entire firm for rent, and what that means financially to themselves individually, that alone could trigger some new and energized discourse within the firm.

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Some BigLaw firms operating as general partnerships did negotiate limitations to partner recourse liability on leases, such as caps to the amounts of such liability, sometimes with partner limits based on ownership share in the enterprise with a factor (eg. 125 percent of proportional share) to be allocated to the liability, often with amortization schedules reducing the amount of liabilities over all or a part of the lease term. Some involved letters of credit to protect landlords against losses from large tenant improvement allowances and free rent in the early years of the lease term. There were negotiated provisions to permit the release of limited numbers of withdrawing or retiring partners, subject to tests of eligibility, usually related to financial health and stability of the firm. Some law firms used multiple entities in their own structure to capture and hold risk within lesser included "buckets," usually on a geographic basis, to insulate the firm at large from regional liabilities. With many tens of millions of dollars of equity partner capital accounts at risk, that alone could be an unacceptable risk to the business even without direct partner recourse. With the supply-side surplus of space that emerged in many city centers and the intense competition for tenants starting in the early 1990s, law firms were able to extract many favorable lease concessions from landlords, and minimizing risk of partner recourse on leases was among them.

During this period, there was the advent of the limited liability partnership, essentially a general partnership but without partner liability for its debts, other than those derived from malpractice, and even then only to the partner who failed in the performance of his or her professional duty (although all of the capital of the partnership would be at risk). Any obligation of the partnership at the time of conversion from GP to LLP would continue to be administered as a GP obligation, so converting the status could not wipe away the exposure that existed at the time the deal was made. But all new contract obligations would be governed by the LLP status of limited liability to partners. Over the ensuing 15 years, virtually all of the obligations of the law firm LLPs were transmuted to nonrecourse status. Today the great majority of BigLaw firms have leases that were entered into after their adoption of the LLP.

Interestingly, many of these new lease deals did not attempt to seek recourse liability on the single greatest fixed overhead obligation of the partnerships, thus giving up significant leverage to assure performance, and which also provided internal incentives to keep partnerships together. The bargaining posture reversed from law firm tenants seeking limitations to recourse, to landlords seeking specific penetrations of the liability shield. Those leases that did require limited recourse frequently did not require all new, incoming partners after the lease was initially executed to execute the limited guarantees, or if they required such signatures, it was often not followed administratively so as to capture all of them. Absent those direct contractual obligations between landlord and "late arriving" partners, over time there can evolve a significant class of equity partners in the partnership without the personal liability exposure of their fellow partners. Not surprisingly, some of these partners were sought after and brought into their new firm because of their significant books of business. Causing the new partner to sign onto the lease guarantees might be an unacceptable requirement, a "deal killer" and thus a "detail" never raised or disclosed, or never consummated. Whether an omission through sloppiness and inattention, or deliberation, the departures of this class of "post lease" partners who did not sign on to proportional and other recourse liability for the lease could cause significant adverse consequences to the partnership — consequences they might not share with their other partners as it related to lease obligations guaranteed only by some — when they subsequently depart with their clients.

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