Where Has The Common Sense Gone in the Industry?

By Michael D. Short on June 18, 2014

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As we watch the hot topics within the legal industry, we are regularly reminded of Will Rogers' wisdom when he said, "common sense ain't common." We find this brilliant observation particularly applicable to two highly questionable current events.

First, let's look at an issue that one of us (Mike Short) wrote about several blogs ago – Section 51 of the Senate Finance Committee Chairman's staff discussion draft bill to reform cost recovery and tax accounting rules to require all law firms (and other personal service businesses) with annual gross receipts over $10 million to maintain their financial records under the accrual method of accounting.

We know that there are many within the legal community who doubt the viability of this seismic industry shift. You doubters rely on common sense to prevail here because the costs and financing of this type of move would be challenging for all impacted law firms and some firms would, in fact, fold under these additional and heavy burdens. Many others, particularly smaller firms with revenue not much above the thresholds, will chose to give up their independence concluding, rightly, that much larger firms will be far better positioned to cope with this new environment. Unfortunately, common sense may not prevail against the $23.6 billion in tax revenues that the government hopes to raise from this law. Furthermore, a community of relatively highly paid lawyers (and accountants and architects and other professionals) who cry "unfair burden" will garner little sympathy in the court of public opinion.

Our sources tell us that a) a tax reform bill is coming within the next few years, and b) some form of this proposal will be embedded deep within the broader bill. If this proposal were removed it would need to be replaced with some other source for $23.6 billion in new taxes, shifting that pain to another industry/profession/community. The real irony here is that the effect of this really isn't new government revenue over the long haul, bur rather a one-time acceleration of some revenue in exchange for a permanent increase in accounting costs.

Assume for a moment that this bill will become law. Conceptually, the better solution for the industry would be to calculate the tax bill for each law firm and lawyer as if we were all moving to accrual-based books, issue those tax bills, and then leave the industry alone and on a cash basis. At least this way, each firm won't have to absorb the additional annual accounting review fees and hire the additional staff needed to maintain accurate (or as accurate as possible) accrual-based books. Amazingly, law firms/lawyers may end up with a large accelerated tax bill AND the additional, recurring costs required to maintain accrual-based books. This makes no sense, but at least the industry can take solace from the fact that it's being imposed from the outside.

Next, let's look at Opinion 642 of the Professional Ethics Committee of the Texas State Bar. This respected body has determined that only a lawyer can have the title of "Officer" in a law firm in their state. Part of the rationale is that "Identifying a person as an 'officer' of or a 'principal' in a law firm when the person does not, in fact, have a controlling or ownership interest in the firm would be a false or misleading communication about the firm."

One of the challenges we consultants face regularly is getting lawyers to think and act like business-people – not lawyers

– when dealing with the business of law. This clearly is not happening here. The job titles in question – Chief Financial Officer; Chief Technology Officer; Chief Marketing Officer; etc. – are broadly recognized and generally accepted within the broader business marketplace. Regardless of the industry, these are specialized and experienced professionals who provide invaluable support to the core functions of any enterprise…including law firms. This decree is the work of lawyers and not business people and, unlike the proposed tax provisions discussed above, this new burden on the industry is self-imposed.

So what are the potential outcomes?

- Lawyers or former lawyers holding all of these key positions? Heaven help that law firm because divine intervention would be required.
- The relocation of key positions (and potentially firm headquarters) to other states (within multi-jurisdictional law firms)? Some will probably go this route.
- A recruiting disadvantage for Texas firms? Possibly.
- The re-titling of invaluable employees to lesser positions in order to satisfy this optical illusion, thus forcing them to explain that they live in Texas whenever talking “shop” with peers and interested parties in other states.

We should also acknowledge another aspect of Opinion 642 – that non-lawyers’ compensation packages cannot be linked or indexed to firm revenue or profitability because these professionals are not owners. Any firm that actually linked the rewards systems for these professionals with measurable contributions – a heretical concept that actually *protects* the firm’s interests – will be re-working those deals.

As the business of law becomes more innovative and reliant upon support from professionals without law degrees, those who look down upon the pejorative “non-lawyer” sub-species and venture to keep them hidden, or at least knocked down a peg, will – in some instances – be putting a law firm in Texas at a competitive disadvantage for much needed talent. This, too, makes no sense.

The changing business of law is facing enough inevitable change right now. We don’t need to layer on needless and useless complexities. The timing of both is quite poor, but the underlying logic of each appears to be completely devoid of invaluable common sense. We urge industry leaders to participate in the debate when bad ideas are imposed from the outside, and stop allowing well-meaning but misguided insiders to make matters worse.