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How Jenkens & Gilchrist lost its way

As law firm dissolves, leaders have no doubt tax scheme to blame

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Four years of lawsuits and federal investigations had worn down the leaders of Jenkens & Gilchrist. Many of their biggest earners were leaving the law firm and taking their prized clients with them. And it had become hard to attract talent, with no end in sight for the firm's problems.

It was time to execute the last-ditch plan: dissolve the firm. Jenkens & Gilchrist couldn't be saved. So the firm's leaders had to try and save the people. "There is a timeline beyond which even the most loyal people say no," said former chairman Tom Cantrill. "It had just taken so long."

Founded 56 years ago and once the largest law firm in Dallas, Jenkens is closing its doors for good this weekend. What drove it to extinction was a combination of issues, including misjudgments tied to rapid growth and an aggressive drive to bring in business.

But above all, a risky tax shelter practice out of its Chicago office brought about the firm's end. The tax scheme, which Jenkens long defended but wound up admitting was fraudulent, left a cloud that would not disperse, according to interviews with nearly three dozen people inside and outside the firm.

Harry Joe, a longtime partner who left for another practice in mid-March, put it bluntly: "Looking back with 20/20 hindsight, I believe it led to the downfall of the firm."

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Small beginnings

The firm got its start in 1951 when Holman Jenkens and William H. Bowen, who had worked for the oil-rich Clint Murchison family, set up an independent firm with two other attorneys. A year later, Henry Gilchrist joined the practice, which changed its name from Jenkens & Bowen to Jenkens & Gilchrist.

The firm started small and expected to stay small, typical of other high-end law firms of that era. Its main client remained the Murchisons, even though it took on other clients. It has sometimes represented *The Dallas Morning News*.

Demand for its services grew as Dallas and the Texas economy boomed. Jenkens expanded, and by 1982 there were 125 lawyers on staff. A year later, a Houston office was added; more were to follow.

But the Texas economy began to tank. Oil prices fell. Energy and energy-services companies failed, and banks and savings and loans folded. Jenkens found itself ensnared in a costly mess, because several partners had represented some of the failed S&Ls.

The firm's partners and insurers paid $18 million to settle a potential Federal Deposit Insurance Corp. lawsuit and a 1987 legal malpractice suit. A federal jury brought in a $5.8 million verdict in a securities lawsuit.

Jenkens may have survived the S&L scandal. But the early '90s economy was lagging. A retrenchment was in order. David Laney, who was elected president and chairman in late 1989, began by cutting about a quarter of the lawyers from the payroll – from as many as 225 lawyers before the cuts to about 165.

The firm had grown too dependent on the Texas economy.

"There was no question that the strategy would have to include growth. But growth by itself made no sense. The focus was on how we were going to grow," Mr. Laney said. "The underlying strategy that we followed for most of that decade was clear: geographic market diversification so all our marbles weren't concentrated in Texas, and industry diversification so all our lawyers weren't practicing in energy, real estate, banking and related litigation."

The growth years

In the '90s, Jenkens added and expanded offices in Austin, Houston, San Antonio, Washington and Los Angeles. In 1998, it took over the top spot in *The News'* annual ranking of law firms by numbers of attorneys in Dallas. It kept that position for five years.

In December 2000, Jenkens announced it was merging with a New York law firm to open up an office in the Big Apple. In 2001, it added a small office in Pasadena, Calif. Jenkens now had more than 600 attorneys on the payroll.

Not every addition was an obvious fit. Some of the offices had a culture that was far different from the close, conservative Dallas headquarters. But it was the 1998 decision to hire Paul M. Daugerdas and open a Chicago office that turned out to be the most portentous.

Mr. Daugerdas, the lead attorney in the Chicago office, was an intriguing person. A certified public accountant as well as a tax lawyer, Mr. Daugerdas had worked previously at Arthur Andersen LLP, long before the accounting firm's involvement in the Enron meltdown, and then a Chicago law firm. His work involved tax shelters.

MILESTONES IN JENKENS & GILCHRIST'S HISTORY

1951: The firm is founded.

1983: A Houston office is added.

1984: An Austin office is added.

1990: David Laney becomes chairman of the law firm.

February 1991: Merges with Shapiro, Edens & Cook, adding 28 lawyers to 13-person Austin staff.

August 1992: A Washington, D.C., office is added.

February 1993: A San Antonio office is added.

June 1997: A Los Angeles office is added.

1998: *National Law Journal* names Jenkens & Gilchrist the nation's fastest-growing law firm.

December 1998: A Chicago office opens. Paul Daugerdas joins the firm.

December 2000: The opening of a New York office through a merger with Parker Chapin is announced.

2001: A Pasadena, Calif., office is added.

December 2002: Jenkens & Gilchrist is sued over tax advice.

In 1998, he pitched his ideas to Jenkens' directors. They realized that bringing him on, along with a few of his associates, could mean a lot of money for the firm. The concept was that clients would be able to shelter their income from taxes through a complicated strategy pushed by Mr. Daugerdas and others.

Those clients would pay a lot of money to Jenkens for opinion letters that said it was "more likely than not" that the tax shelters met the federal tax code. The money sounded good. Still, the proposal to add Mr. Daugerdas and his tax strategies made some Jenkens lawyers uncomfortable.

Part of the reason was Mr. Daugerdas himself. A self-assured man, the Midwesterner with a Mike Ditka-style accent could be divisive – a "bully," some of his former colleagues say. They didn't feel he would fit in well at the firm.

But the greater concern from inside the firm was that the strategy was too risky. Tax lawyers by their nature are conservative. Only a small number of the specialists in the late '90s were embracing aggressive tax shelters.

A group of Jenkens tax specialists debated Mr. Daugerdas' strategy. Some thought he had found a loophole within the boundaries of the tax code. Many others disagreed strenuously.

Few Jenkens attorneys understood the strategy. But when it came time to make a decision, the leadership trusted some well-regarded tax specialists who felt the strategy was legal and could be defended.

David Deary, a Dallas lawyer who sued Jenkens over the tax shelters, said he thinks greed drove the decision to hire the Chicago people. "The revenue that they could generate was so enticing to a few people over there at Jenkens that my impression is they were blinded," he said.

Ultimately, a majority of Jenkens' shareholders voted to add Mr. Daugerdas and his two colleagues and to open up a Chicago office. No one will discuss how close the vote was. But insiders say that it was far from unanimous.

A fatal decision?

Having won his partnership with Jenkens, Mr. Daugerdas went to work finding clients interested in sheltering their taxes and willing to participate in the esoteric strategies he offered.

The tax strategies pitched by Mr. Daugerdas "sounded intriguing," Mr. Laney said. "But the last risk we would have taken was one that might lead to crossing swords with the federal government. We had been there before and would not risk going there again. I envisioned Jenkens becoming a large, diversified national, maybe someday international, firm with a permanent presence."

December 2002: William P. Durbin Jr. becomes chairman of the law firm.

March 2003: David Laney leaves the firm and joins Jackson Walker LLP.

June 2003: The IRS sues Jenkens, demanding that the firm disclose the names of tax shelter clients.

January 2004: Mr. Durbin resigns, a month after being elected to a second one-year term. Tom Cantrill becomes chairman.

2004: Mr. Daugerdas is replaced as managing shareholder in Chicago.

May 2004: A judge approves a $75 million settlement of the lawsuit.

January 2005: The settlement increases to $81.55 million.

April 2005: New York attorneys leave Jenkens to join Troutman Sanders LLC.

January: Patrick Mitchell becomes chairman.

March: The IRS announces that Jenkens has agreed to pay a $76 million penalty for its promotion of abusive and fraudulent tax shelters. Jenkens operates its last day as a law firm. The 100-plus attorneys in Dallas wait for an announcement that they will be invited to join Hunton & Williams.

He wanted to avoid doing anything to jeopardize the firm, particularly as he was one of the practice's leaders who had to negotiate Jenkens' path out of the S&L mess a decade earlier. But he and the other decision-makers trusted the tax attorneys who believed that Mr. Daugerdas' plan was both legal and profitable and should be part of the Jenkens practice.

"Had we not stubbed our toe in Chicago, I don't think we'd be where we are now," said Patrick Mitchell, who took over as Jenkens' chairman in late 2006.

"No doubt about it," agreed Tom Cantrill, Mr. Mitchell's predecessor.

Mr. Daugerdas' spokesman said he "respectfully declined to comment" or answer written questions from the newspaper. Mr. Daugerdas still lives in Chicago.

Mr. Daugerdas alone received $93 million in fees from 1999 through 2003 from the tax letters, according to *The New York Times*, citing people who had seen documents in connection with a lawsuit filed against Jenkens. The news report said the Chicago office generated $267 million from those fees, an extraordinary amount for any law firm.

As Mr. Daugerdas and Chicago prospered, so did the whole law firm. Its profits from Mr. Daugerdas' practice probably meant hundreds of thousands of dollars a year in additional income for some of the more highly compensated partners, according to an insider.

One of the strategies promoted by Mr. Daugerdas and his colleague was called COBRA, for "Currency Options Bring Reward Alternatives." It involved a complicated strategy that used offsetting currency options – one to buy one currency, the other to sell another currency – to create a paper loss for its participants.

Among the buyers of the COBRA strategy were four people who sold an Indiana computer company and had to deal with a capital gain of more than $70 million in 1999. The group, led by Henry N. Camferdam Jr., paid Jenkens more than $2 million for an opinion letter saying that the tax shelter "more likely than not" met the tax code.

In a lawsuit filed in late 2002, Mr. Camferdam and other plaintiffs said Ernst & Young, working with Jenkens, suggested a tax strategy to them that could reduce or eliminate taxes on the capital gains. But, the plaintiffs alleged, the advisers and promoters knew the shelter wasn't legal.

Mr. Camferdam and the others had reason to worry – the Internal Revenue Service had informed them that they were being audited.

Growing storm

With many people making big capital gains in the latter part of the '90s, the IRS and the Justice Department became increasingly concerned about tax strategies designed to create paper losses for taxpayers. The IRS issued a series of notices warning that the strategies had to have a sound business purpose. The purpose couldn't be simply to avoid paying taxes.

In 2002, under pressure from the IRS, Ernst & Young disclosed the names of the tax shelter clients. On Dec. 11, 2002, the IRS told Mr. Camferdam and the others that their tax returns were being audited. (In 2004, Mr. Camferdam was assessed back taxes and interest on his capital gain, plus a 40 percent penalty.)

Upset, the group filed a lawsuit nine days later against Jenkens, Ernst & Young and others. The list of defendants eventually included Deutsche Bank AG; Deutsche Bank Securities Inc., which had executed the currency option trades; several other accounting firms and law firms; and several individuals, including Mr. Daugerdas.

Jenkens balked at giving the IRS a list of its tax-shelter customers, citing attorney-client privilege.

In June 2003, the IRS sued Jenkens in federal district court in Chicago to force the firm to hand over its clients' names. More and more of the tax shelter buyers flocked to the class-action lawsuit – which grew to more than 1,000 plaintiffs. Mr. Deary, the lead lawyer for the plaintiffs, said Jenkens and the others gave tax advice that they should have known was bad.

"From the very beginning, the tax shelters that they peddled were flawed – from the very beginning. I mean, there was no business purpose. There was no economic substance," Mr. Deary said.

He blames Mr. Daugerdas and two Chicago attorneys, Erwin Mayer and Donna Guerin, for putting together the tax strategy. But he doesn't let Jenkens' leaders off the hook.

"Certain people, in my opinion, in the management positions turned a blind eye to what was going on," he said. "The remaining groups in the Dallas and Austin offices, for example, really didn't know what was going on."

Mr. Mayer and Ms. Guerin did not return calls requesting comment.

Mr. Deary said clients usually heard about the shelters from their trusted accountants and financial advisers, who touted the safety as well as the attractiveness of the tax strategies.

"They would say the only downside to this – if there is one – is that if you're audited, you're going to have this great legal opinion from Jenkens & Gilchrist that, No. 1, is going to convince the IRS that this is a great tax strategy and you're going to more than likely prevail with the IRS," Mr. Deary said.

"But if you don't prevail, you're never going to have to pay a penalty, because you have this great opinion letter. You've got insurance, so there is no downside. And look, everybody in your position is doing it," he said, repeating the arguments he turned up in his investigation of the shelters.

In fact, Mr. Deary said, "if you go to most objective professionals that weren't involved in this market, they would tell you that they wouldn't have touched this with a 10-foot pole."

American Lawyer, which wrote about Mr. Daugerdas and the tax shelters in its December 2003 issue, showed two law professors a summary of a COBRA shelter. Both professors said it "lacks economic substances," and the IRS and several former Treasury officials and private practitioners agreed, according to the magazine.

It added: "In truth, say the experts, a COBRA is about nothing but saving taxes."

Marshall Simmons worked as a Jenkens lawyer from 1967 to 1982 and had rejoined the firm in 1995 as its risk manager. He said that when the problems later arose, he asked a partner at the law firm why they had embraced Mr. Daugerdas and the tax strategies.

"I was told there were two major factors. One was that when Paul Daugerdas came and made his presentation, he said no lawyer had ever been sued for 'more likely than not' opinions, which is what we were giving them, 'more likely than not,' " said Mr. Simmons, who retired in 2005.

"No. 2, we believed that while these were aggressive, that they had real value," he said. "We didn't go into this thinking, 'Well, let's hope we don't get caught before we make a lot of money.' We legitimately thought that these opinions were valid."

At Jenkens, though, there was higher drama going on than a little lawsuit filed by some disgruntled clients in a New York court.

There was a palace coup under way.

A new leader

William P. Durbin Jr., a partner who had joined the firm in 1983 after a stint in the Missouri attorney general's office, had recruited Mr. Daugerdas and the Chicago office. He also had helped negotiate the 2000 deal to start a New York office.

Mr. Durbin rallied support from the Chicago and New York offices to challenge Mr. Laney for the chairman's position in the firm's November 2002 election, according to people who were with Jenkens during that period.

Surprised by the opposition, Mr. Laney withdrew his name from consideration. He said in a recent interview that he had been ready to step down as chairman and that he was "tired, really tired" after leading Jenkens for 12 years, and serving six years on the Texas Transportation Commission, five as its chairman.

"But the principal reason was that a campaign for partners' votes so contradicted the culture I envisioned for the firm that, even if I could have mustered the energy to 'run,' I considered it inappropriate and distasteful for the firm's chairman to campaign either 'for' myself or 'against' any partner," Mr. Laney said.

"Just as important a factor was the very troubling prospect of a political campaign splitting the firm that I had worked over a decade to build and unify," he said. "The best thing for the firm, and at the time probably for me, was for me to step quietly to the sideline."

Mr. Durbin's one-year term officially began Jan. 1, 2003, although in truth he took the reins as soon as the election was settled. Mr. Laney was soon gone. He announced late that February that after 25 years at Jenkens, he was moving to another Dallas law firm, Jackson Walker LLP, where he works today as a partner.

The election left Jenkens deeply divided. But with the help of executive director Roger Hayse, Mr. Durbin in 2003 set about revamping the operation. Jenkens hired management consultants Bain & Co. to look at its staffing, as well as other parts of its business.

Mr. Durbin did not respond to several requests for an interview. His wife said he was out of the country.

After news of the IRS investigation broke, Mr. Durbin staunchly defended the validity of the tax advice and Jenkens' stand not to reveal the names of those who received the tax letters.

Even so, Jenkens and other principals in the tax shelters began settlement talks with the plaintiffs' attorneys. In May 2004, defendants and their insurers agreed to pay the plaintiffs $75 million. A day later, the Illinois federal court ordered Jenkens to disclose the names of clients to the IRS.

Trouble arose when more than 100 plaintiffs opted out of the class settlement, choosing instead to battle on. Negotiators came up with a richer, $81.55 million settlement, announced in January 2005. Jenkens was responsible for $5.25 million, with its insurers and other defendants picking up the remainder.

By that time, Mr. Durbin was no longer running the firm. He had won re-election, the only contested race in the firm's history. But his victory upset many inside the firm who felt he emphasized finances rather than people. A large number – the estimates range from 20 to 50 – were preparing to leave.

To head off the defections, one of the firm's leaders went around talking to various attorneys, asking if their minds would be changed if Bill Durbin were no longer in charge. Mr. Cantrill made a Sunday call to Mr. Durbin, who was on vacation, and told him that he needed to resign.

"We thought if we could find a way not to have those losses, that was in the best interest of the firm," Mr. Cantrill said. "We brought that to Bill's attention, and Bill agreed. He knew there was a risk that we could lose some people. I'm sure it wasn't the best day in his life, but he also loves this law firm, always loved this law firm."

The next day, the lawyers readying their exits were asked to hang on, told that the firm was willing to change. On Wednesday, Jan. 14, 2004, Mr. Durbin announced publicly that he had reconsidered his decision to serve a second term and was resigning. Mr. Cantrill, a compromise candidate, replaced Mr. Durbin as chairman, and the group of disgruntled lawyers stayed put.

But the atmosphere had soured. The threat of the tax lawsuits and investigations by the Justice Department and IRS hung ominously over Jenkens. Soon afterward, attorneys upset with the constant upheaval and grim internal politics began to leave. And not enough good people were being hired to replace them.

Jenkens & Gilchrist, named the nation's fastest growing law firm in 1998 by the *National Law Journal*, wasn't growing any longer. It was shrinking.

The lawyer totals dropped – from 253 Dallas office attorneys in the 2002 census to 144 attorneys by 2006. Throughout the firm, the drop was also drastic, from 611 in 2001 to 281 in 2006. Staff members, who had no equity in the firm, also noticed the writing on the wall and began turning in their notices.

Trying to recover

Mr. Cantrill, who led the firm through the S&L problems in the late '80s, tried to stem the losses of lawyers to other firms. He also served as point man on negotiations for the settlements on the lawsuits and the IRS and Justice Department investigations.

With the exodus of good lawyers continuing, a group of veteran Jenkens attorneys, including some from the early 2004 revolt, went to the firm's leaders in early 2006. Something had to change, they said: What was the plan?

Mr. Cantrill and Mr. Mitchell said the first option was to have Jenkens survive on its own, growing lawyer by lawyer or through acquisitions of other firms as it had done in the '90s. Another possibility was for Jenkens to merge with another large firm with a national reach. During 2006, management identified a number of good candidates for a merger.

All those alternatives assumed that Jenkens would be able to wrap up the lawsuits and reach settlements with the IRS and the Justice Department in time to save the firm.

"Business people can deal with known risks," Mr. Cantrill said. "If you know where it stops, if you can put a bow around it and say this is what we got, I think we would have been successful in finding a very attractive partner."

But by the time Jenkens announced a settlement Thursday with the IRS and the U.S. attorney's office in New York, it was too late. The firm was in its last days, its attorneys and staff spreading to other law firms.

In a statement released by the U.S. attorney's office, Jenkens admitted that "certain J&G attorneys" in its Chicago office "developed and marketed fraudulent tax shelters, with fraudulent tax opinions." Firm officials overseeing the Chicago tax practice "placed unwarranted trust in the judgment and integrity of the attorneys principally responsible for that practice," the statement said.

The IRS announced that Jenkens had agreed to pay a $76 million penalty for its "promotion of abusive and fraudulent tax shelters and violation of the tax law concerning tax shelter registration and maintenance and turnover to the IRS of tax shelter investor lists."

The settlements end the investigation of the law firm. But the U.S. attorney's announcement said that the deal didn't end ongoing investigations of Jenkens' people, past or present.

Jenkens operated its last day as a law firm Saturday, its offices elsewhere already closed or with only a handful of attorneys remaining. The 100-plus attorneys in Dallas are waiting for an expected announcement that they will be invited to join Hunton & Williams, a national firm with a local office.

Many key Jenkens players are already gone. Mr. Daugerdas was replaced in 2004 as managing shareholder of the Chicago office, and his title was reduced to "of counsel," meaning he wouldn't share in the firm's profits so much. In December 2005, he and Mr. Mayer were pushed out of Jenkens, firm officials said.

Mr. Durbin in December packed his things after 23 years and departed without any hoopla. Mr. Cantrill said Mr. Durbin had decided not to practice law anymore. "That led to a mutual decision: Well, if you're not going to practice law, you probably shouldn't be part of the law firm," Mr. Cantrill said.

Mr. Mitchell said he hates that the founders' legacy won't continue. "There's no sense of accomplishment if there's no Jenkens & Gilchrist. But ultimately, Henry would be the first one to say [that] Jenkens & Gilchrist is the people. From my standpoint, you've got to focus on what's best for the people of Jenkens & Gilchrist. If that means we all move to other law firms, that's what it means," he said.

In a bit of irony, the class-action settlement, delayed by a partial appeal, will finally be paid to the plaintiffs this week. Mr. Deary said he is happy to have won the case and stopped the use of the tax shelters. But he's sad about the many people at Jenkens affected by the firm's problems.

"I think 99 percent of the lawyers at Jenkens and the staff people there are as much innocent victims of the 'Chicago 3,' as I call them, as our clients are," Mr. Deary said, adding that "99.9 percent of the people at Jenkens are good people and good lawyers. There were three bad apples, and the bad apples upset the applecart in a big way, and you see what happened."