LEGAL AND ETHICAL ISSUES ARISING IN LAW FIRM BANKRUPTCY CASES

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"Clawbacks of Partnership and LLC Distributions:
Lessons from Large Law Firm Bankruptcies"

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I. Introduction and Overview

Two types of litigation dominate law firm bankruptcies and dissolutions – claims against former partners (colloquially referred to as "Clawback Claims") and unfinished business claims against the former partners and their new firms (also known as "*Jewel*" claims). These written materials only address issues germane to Clawback Claims, with one caveat: because the largest and most recent law firm dissolutions are proceeding in bankruptcy courts in New York (Dewey & LeBoeuf LLP, Coudert Brothers LLP, and Thelen LLP) and California (Brobeck LLP, Heller Ehrman LLP, and Howrey LLP), these written materials analyze the issues primarily under Second Circuit and Ninth Circuit law, with references to Fifth Circuit law where available and appropriate. Because of these courts' experience in overseeing law firm dissolutions, issues raised in (and decisions from) Second Circuit and Ninth Circuit courts provide an extensive blueprint for the legal arguments – pro and con – regarding Clawback Claims.

Clawback Claims can be divided into two types – claims for breach of contract under the law firm's partnership agreement or other contractual relationship with the former partners ("Breach of Contract Claims") and claims for preferences or fraudulent transfers under the Bankruptcy Code or state fraudulent transfer laws (the "Fraudulent Transfer Claims"). Part II of this paper discusses the Breach of Contract Claims – the trustee or plan administrator's basis for asserting them, whether the claims may be subject to arbitration, and the partners' defenses to the Breach of Contract Claims. Part III analyzes the Fraudulent Transfer Claims – including the complicated question of whether partners gave reasonably equivalent value for the distributions received from their failing law firm. Part IV summarizes potential tax issues that partners may face even after their law firm fails – including the dreaded phantom income that may result from the repayment of

the failed law firm's revolving line of credit. Finally, Part V identifies unique issues related to pursuing Clawback Claims against foreign partners – partners who reside in the law firm's overseas offices, are not likely to be U.S. citizens, and may not have a direct relationship with the bankrupt law firm whose estate is being administered in the U.S.

II. Breach of Contract Claims

The first category of claims against former partners is state-law Breach of Contract claims. Law firms may have multiple contracts with their partners, including the partnership agreement. The partnership agreement itself typically governs the allocation of profits to partners, the payment of draws, capital contributions, payment and reimbursement of tax advances, etc. Additional agreements may arise from personal loans (including those for capital contributions) and special agreements setting forth the terms of payments or guarantees. Trustees or liquidators of dissolved law firms are charged with pursuing for the benefit of creditors those claims against partners that may arise under the partnership agreement or other agreements with partners.

The most significant Breach of Contract Claims are for the recovery or recoupment of excess draws paid to equity partners. Most law firm partnership agreements provide that payments to equity partners during the year are effectively advances against the distribution of profits for that year. When actual profits for the year are finally determined, each partner is entitled to additional distributions based on the difference between each partner's allocable share of profits and draws (or other payments) received during the year. However, if payment to any partner exceeds that partner's allocable share of profits, that partner is required to repay the excess to the firm.

The obligation to return excess distributions may be substantial. The failure of a firm typically results in large losses resulting from the writedown of accounts receivable and fixed assets. Moreover, a law firm's failure may accelerate certain liabilities, such as lease liabilities, causing them to be charged as expenses to the current year. As a result, a law firm may have little or no profits allocable to the year immediately prior to its failure; at least, profits will be far less than anticipated at the time draws were paid. If a law firm fails at the end of the year, or early in the following year, partners may be required to return all compensation paid during that year. These Breach of Contract Claims against partners are particularly significant because they arise under contract and therefore the trustee does not have to prove any of the elements of fraudulent transfer (such as insolvency or lack of reasonably equivalent value) to have a recovery.

A second type of Breach of Contract Claim against partners is a claim for unpaid capital. There is considerable variability in the manner in which law firms determine the amount that each partner is required to pay or contribute in exchange for his or her partnership interest. In some cases, capital contributions are adjusted on an ongoing basis along with partner compensation, so that even long-time partners can owe capital to the firm. When a law firm fails, unpaid capital contributions are treated as binding and are typically called by the firm or its trustee.

Similar to draws, many law firm partnership agreements provide that the firms will make tax payments on behalf of partners, which payments will be repaid by the partners to the firms. Law firms are "pass-through" entities for tax purposes and such provisions allow firms to pay partners' allocable shares of Federal and state income tax as well as taxes paid abroad on earnings generated by non-U.S. practices. Typically, these tax advances are simply treated as adjustments to partner

compensation and deducted from distributions. However, when a law firm fails, tax advances for the prior year generally are unreimbursed, giving rise to additional Breach of Contract Claims against partners.

Finally, law firms may have made loans to their partners that are separate from the firm's partnership agreement whether to fund capital contributions or otherwise. When the law firm dissolves, these loans remain outstanding and the firm or its trustee will pursue repayment

To a former partner, each of the Breach of Contract Claims can equal hundreds of thousands of dollars in liability. Partners, of course, may be expected to assert defenses. Three of these defenses – demand for arbitration, prior material breach, and fraud in the inducement – are addressed here.

First, if the law firm partnership agreement contains an arbitration clause, the partners can demand arbitration. Arbitration benefits the partners by removing the dispute from the bankruptcy court: from the partners' perspective, arguing their case in front of a fact-finder who likely is not favorably disposed to bankruptcy creditors could be a better forum. Arbitration is still difficult for the former partners, however – difficult to pay for, and difficult to obtain. Financially, the partnership agreement may require the partners to share in the cost of arbitration, which increases the cost to the partners who are now paying their own counsel, half of the arbitrator's fees, and continuing to be distracted from their new law practice.

Practically, the partners will have a difficult time removing the state-law Breach of Contract Claims to arbitration because fracturing the core fraudulent transfer claim from the non-core, state-law Breach of Contract Claims would undermine the efficient administration of the bankruptcy estate. In the Ninth Circuit, bankruptcy courts may refuse to compel arbitration where non-core claims are inextricably intertwined with core claims and separating the two will result in piecemeal litigation. *See, e.g., Continental Ins. Co. v. Thorpe Insulation Co.* (*In re Thorpe Insulation Co.*), 671 F.3d 1011, 1021-23 (9th Cir. 2012); *Ackerman v. Eber* (*In re Eber*), 687 F.3d 1123, 1131-32 (9th Cir. 2012) (affirming bankruptcy court's denial of arbitration where court considered "the Bankruptcy Code's objectives, including centralization of disputes concerning a debtor's legal obligations, and protection of debtors and creditors from piecemeal litigation").

Similarly, the Second Circuit permits bankruptcy courts to exercise their discretion to deny the arbitration of non-core claims if arbitrating the non-core claims would interfere with the purposes of the Bankruptcy Code, such as the centralization of the debtor's disputes in bankruptcy court. *See, e.g., MBNA Am. Bank., N.A. v. Hill*, 436 F.3d 104, 108 (2d Cir. 2006); *In re US Lines, Inc.*, 197 F.3d 631, 640-41 (2d Cir. 1999); *In re Winimo Realty Corp.*, 270 B.R. 108, 118 (S.D.N.Y. 2001).

Under the law of both circuits, the liquidator has a strong argument that non-core, state-law Breach of Contract Claims are inextricably intertwined with core Fraudulent Transfer Claims (especially where the monies sought by the trustee are sought under both claims) and therefore the purposes of the Bankruptcy Code would be frustrated by splitting the claim between bankruptcy court and arbitration. Indeed, even if a partner prevailed that the trustee's Breach of Contract Claims should be arbitrated, the bankruptcy court could stay the arbitration until the Fraudulent Transfer Claim has been adjudicated so as to avoid any risk of inconsistent findings. *See, e.g., In re S.W. Bach &*

Co., 425 B.R. 78, 104 (Bankr. S.D.N.Y. 2010). And, of course, arbitrating the Breach of Contract Claims doesn't guarantee the partners victory – it only changes the forum, and the arbitration panel's decision to impose liability is subject to fewer appellate options than a final judgment in bankruptcy court or district court. For these reasons, partners should not view arbitration as a strong defense to a trustee's Breach of Contract Claims.

Second, partners can argue that they have their own claims against the firm arising from the partnership agreement or otherwise, and that such claims reduce or offset any contractual obligations they have to the firm. Most commonly, partners assert that they have claims for unpaid prior year compensation, for the return of capital or even for retirement benefits. However, partnership agreements generally have provisions subordinating those claims to those of general creditors. In any event, such claims are effectively claims for payment on account of equity interests and may be subordinated under §510(b) of the Bankruptcy Code. They have not been accorded weight in prior settlements of partnership obligations.

Partners may assert more individual claims as offsets to their contract liabilities. Any such claims are fact-specific would require the partners to identify the particular provisions of the partnership agreement or other contract giving rise to the claim or specific acts in question. For example, a partner may assert that he or she received a contractual "guaranty" of a minimum annual compensation that was breached. The partner may even argue that breach of such agreement released them from any further performance or obligations under the partnership agreement. In such case, however the trustee would be expected to argue that a "guaranty" of payment may have been enforceable as against other partners with respect to an allocation of partnership profits, but would be subordinated to creditor claims under §510(b) and is therefore not available for set-off.

Even if a partner did hold separate and cognizable claims, such claims would not excuse or discharge that partner's liabilities to the partnership. One party's material breach only excuses future obligations to perform and does not discharge obligations the other party assumed prior to the alleged material breach. For example, Section 237 of the Restatement of Contracts makes clear that "[a] claim for damages that has already arisen as a result of a claim for partial breach is not discharged under the rule stated in this Section." RESTATEMENT (SECOND) OF CONTRACTS § 237 (1981). Both Second Circuit and Ninth Circuit courts have adopted Section 237 of the Restatement. *See, e.g.*, *In re Lavigne*, 114 F.3d 379, 387 (2d Cir. 1997); *Pfizer, Inc. v. Stryker Corp.*, 348 F. Supp. 2d 131, 147 (S.D.N.Y. 2004); *First Interstate Bank of Idaho v. SBA*, 868 F.2d 340, 344 (9th Cir. 1989); *Imprimis Int'l, Inc. v. Fraidenburgh*, 2007 WL 1576356, at *9 (E.D. Cal. May 31, 2007). As with the arbitration defense, the partners face a difficult road ahead: even if specific contract provisions and breaching acts are identified, the breaches may not be sufficiently material or early enough in time to excuse the partners' repayment obligations.

Third, some partners – particularly lateral partners who joined the firm near its demise – may assert fraudulent inducement claims. Presumably, the partners would argue that firm management misrepresented the firm's financial health in order to induce them to join the firm. These fraud claims are difficult. As an initial matter, FED. R. CIV. P. 9(b) requires the partners to identify a specific misrepresentation – including when it was made, who made it, why the statement was false, and strong evidence of fraudulent intent. *See, e.g.*, *Mills v. Polar Molecular Corp.*, 12 F.3d 1170, 1175 (2d Cir. 1993); *First Capital Asset Mgmt., Inc. v. Satinwood, Inc.*, 385 F.3d 159, 179

(2d Cir. 2004); *Vess v. Ciba-Geigy Corp. USA*, 317 F.3d 1097, 1102 (9th Cir. 2003); *Cooper v. Pickett*, 137 F.3d 616, 627 (9th Cir. 1997).

And even if the partners can survive FED. R. CIV. P. 9(b), it is difficult to prove reliance: arguing that the partners would have taken different actions (*i.e.*, refusing to join the firm or departing sooner) had the partners known of the firm's true financial health is too speculative to constitute justifiable reliance. *See, e.g.*, *Naartex Consulting Corp. v. Watt*, 722 F.2d 779, 793 n.22 (D.C. Cir. 1983) ("It is elementary that speculative damage will not support an action for common law fraud.").

In sum, liquidators are likely to have very strong Breach of Contract Claims against a dissolved law firm's former partners, and the partners are unlikely to have successful defenses or counter-claims.

III. Fraudulent Transfer Claims

In addition to Breach of Contract Claims, trustees may seek clawback payments made to partners as constructive fraudulent transfers. Fraudulent Transfer Claims provide a separate basis to claw back payments from partners that is unrelated to the partnership agreement. Such claims may substantially exceed Breach of Contract Claims when the firm is asserted to have been insolvent more than a year prior to its dissolution. Moreover, Fraudulent Transfer Claims are not subject to counterclaims by partners because §502(d) of the Bankruptcy Code provides that claims asserted by recipients of avoidable fraudulent transfers are disallowed until such transfers are repaid in full.

Fraudulent Transfer Claims asserted against partners of failed law firms generally revolve around two important issues: (1) whether the partner gave reasonably equivalent value for the payments he or she received; and (2) whether the law firm was insolvent when the payment was made. Each issue is addressed below.

A. Reasonably Equivalent Value¶

1. Equity Partners

The reasonably equivalent value analysis depends on whether the partner is an equity partner in the law firm or a so-called contract partner.

Partners in law firms that are limited liability partnerships present interesting issues when determining whether or not the law firm received reasonably equivalent value for draws or other payments received by partners. Trustees will argue that, as a matter of law, distributions to limited partners are not for value. Partners will argue that, as a matter of fact, it is possible for a partner's contributions to the firm to have provided value equal to (or even more than) the payments received.

The trustees' argument is based upon cases interpreting the meaning of "equity security" under the Bankruptcy Code. The Bankruptcy Code defines an "interest of a limited partner in a limited partnership" as an "equity security." *See* 11 U.S.C. § 101(16)(b). Payments made to equity – including distributions to limited partners – are "not for value" because they are "made . . . on account of the partnership

interests, and not on account of debt or property transferred to the partnership in exchange for the distribution." *See Hayes v. Palm Seedlings Partners-A* (*In re Agric. Research & Tech. Group, Inc.*), 916 F.2d 528, 540 (9th Cir. 1990); *accord In re AFI Holding Inc.*, 2006 WL 6810954, at *4 (B.A.P. 9th Cir. Oct. 16, 2006) (affirming that the Ninth Circuit "held that the [limited] partnership distributions were not for value . . . ."); *see also Le Cafe Creme, Ltd. v. Le Roux (In re Le Cafe Creme, Ltd.),* 244 B.R. 221, 239–240 (Bankr.S.D.N.Y.2000) (conversion of equity to debt by insiders of debtor was not for value when debtor was insolvent); *see also Harbour v. Harbour*, 643 N.Y.S.2d 969, 971-72 (1996) (payment on account of capital is not for value); *see also In re Woodmere Investors Ltd. P'ship*, 178 B.R. 346, 363 (Bankr. S.D.N.Y. 1995). The Ninth and Second Circuits' application of this rule is not unique: it is generally accepted that distributions to limited partners or other equity securities are not for value.[1] They are treated the same as dividends made to shareholders of owners of any business.

Trustees may also argue that partners are "insiders" who can never take in good faith for value and therefore can never assert they have provided "reasonably equivalent value." This is because the definition of a "corporation" under Bankruptcy Code §101(9)(A)(ii) includes limited liability partnerships and because an "insider" of a corporation includes a general partner of the debtor under Bankruptcy Code §101(31)(B)(v). Trustees may also argue that §548(b) of the Bankruptcy Code allows the avoidance of any transfer made to a general partner while the firm was insolvent, regardless of value given and received. The questions of whether the partner of a limited liability partnership is a "general partner" for these purposes remains a matter of dispute.

Law partners will argue that case law holding distributions to limited partners are not for value assumes passive investment vehicles – not a law firm where partners are working diligently to generate new business, work matters for clients, and collect firm receivables. It is this work, law partners argue, that provides value for the payments the law firm made to its equity holders. In effect, partners argue that their ownership represents a sort of "hybrid" interest – part owner, part employee.

Trustees will argue this is a distinction without a difference: none of the case law discussed above argues that a limited partner provides value for compensation simply by working for the debtor-partnership. In fact, in at least two of the cases cited above, the court permitted the recovery of equity payments from working owners. *See, e.g.*, *In re Brentwood Lexford Partners, LLC*, 292 B.R. at 267; *Boyer*

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[1] *See, e.g.*, *Buncher Co. v. Official Comm. of Genfarm Limited Partnership IV*, 229 F.3d 245, 252 (3d Cir. 2000) ("[T]he Bankruptcy Court correctly treated the interest of a limited partnership as an equity security."); *In re Thunderdome Houston Ltd. P'ship*, 2000 WL 889846, at *9 (Bankr. N.D. Ill. 2000) (same); *U.S. v. Rocky Mountain Holdings, Inc.*, 782 F. Supp. 2d 106, 122-23 (E.D. Pa. 2011) (same); *Boyer v. Crown Stock Distrib., Inc.*, 2009 WL 418275, at *15 (N.D. Ind. Feb. 17, 2009), *rev'd on other grounds*, 587 F.3d 787 (7th Cir. 2009) (same, as applied to corporation); *Fisher v. Hamilton* (*In re Teknek, LLC*), 343 B.R. 850, 861 (Bankr. N.D. Ill. 2006) (same, as applied to LLC); *In re Brentwood Lexford Partners, LLC*, 292 B.R. 255, 267 (Bankr. N.D. Tex. 2003) (same); *In re Tri-Star Techs. Co., Inc.*, 260 B.R. 319, 326-27 (Bankr. D. Mass. 2001) (collecting cases from 1st, 2nd, 3rd, 5th, and 9th Circuits supporting rule).

v. Crown Stock Distrib, Inc., 587 F.3d 787, 796 (7th Cir. 2009). In *Brentwood*, for example, the trustee of a management company sued the debtor's three executives to recover money each was paid – alleging that, according to the documents governing the company, the cash paid to management was a profit-sharing distribution and, as a matter of law, not for value. *See In re Brentwood Lexford Partners, LLC*, 292 B.R. at 262-66. The executives countered that the payments were for services performed for running the management company. *See id.* at 267. After a trial, the court held that because the executives did not have contracts requiring the debtor to pay them for running the company, the payments were instead "distributions . . . made to equity holders of BLP . . . [and] amounted to dividends." *Id.* As a result, the debtor did not receive reasonably equivalent value for the distributions. *See id.* Here, the law firm's partnership agreement is again of critical importance – if the agreement holds that payments to the partners are draws or other advances against profits, the court could easily reach the same result as in *Brentwood.*

Partners will counter, however, that there is a case on-point related to reasonably equivalent value provided by working lawyers of a dissolving law firm. Partners cite *Annod Corp. v. Hamilton & Samuels*, 100 Cal. App. 4th 1286 (2002), for the proposition that a law firm partner provides reasonably equivalent value for distributions to the extent he or she generates receivables that exceed draws paid by the firm.

In *Annod*, the plaintiff was a commercial landlord who sued the former partners of a defunct law firm for the firm's failure to pay its rent. *See id.* at 1291. The landlord's theory was constructive fraudulent transfer: that the partners paid themselves draws instead of paying the firm's rent, and "the partners should not have received any draws" when the firm couldn't pay its rent. *Id.* The partners moved for summary judgment, claiming that the draws they took were not excessive compared to the value generated for the firm. *See id.* at 1292. The trial court granted the partners' motions, and the appeals court affirmed, after examining the facts relied upon by the trial court. *Id.*

Based upon *Annod*, partners will claim that if their revenue generated (either through originations or billings) to the law firm was substantially equal to (or exceeded) payments he or she received, the trustee cannot prove the lack of reasonably equivalent value element of a constructive fraudulent transfer.

To defeat *Annod*, trustees will argue that the case both misstates federal bankruptcy law and is inapposite to the facts of a particular law firm's dissolution. Legally, *Annod* appears inconsistent with federal bankruptcy law because it treats draws to partners as payments on an antecedent debt, which is inconsistent with a finding that payments to limited partners are on account of their equity security interest. *Compare* Annod *Corp.*, 100 Cal. App. 4th at 1297 ("In this case, money was transferred in satisfaction of the antecedent debts of Hamilton & Samuels, i.e., the overdue partnership draws.") *with In re Agric. Research & Tech. Group, Inc.*, 916 F.2d at 540 (holding that distributions to limited partners are "not on account of

debt or property transferred to the partnership in exchange for the distribution") *and In re Riverside-Linden Inv. Co.*, 925 F.2d 320, 323 (9th Cir. 1991) ("An ownership interest is not a debt of the partnership. Partners own the partnership subject to the profits or losses.") (internal citations and quotations omitted).

Factually, trustees will distinguish *Annod*, arguing it "does not stand for the proposition that a transfer made to enable an enterprise to stay in business cannot constitute a fraudulent transaction." *Aptix Corp. v. Quickturn Design Sys., Inc.*, 148 Fed. Appx. 924, 930 (Fed. Cir. 2005). Instead, the trustees will focus the court on whether – like *Annod* – there is "extensive additional evidence" that, when operating the firm for the benefit of creditors, "that the partners acted in good faith" by acting in compliance with the firm's partnership agreement, reducing partner draws, and leaving a substantial amount of cash in the dissolving firm. *See id.* The "extensive additional evidence" present in *Annod*, however, is typically absent from major law firm dissolutions.[2]

Key facts to consider are: (1) the language of the law firm's partnership agreement; (2) whether the partners voluntarily reduced their draws; and (3) whether the partners left substantial cash in the partnership for distribution to creditors. First, the language of the law firm's partnership agreement will be a critical fact to distinguish *Annod*. The plaintiff in *Annod* could not cite to any provisions in the law firm's partnership agreement that "show[ed] what monies the partners . . . were entitled to receive." *See Annod*, 100 Cal. App. 4th at 1301. If the law firms' partnership agreement provided, however, that partners were only entitled to draws or other profit-sharing payments, the trustees will have a stronger argument that the payments are, as a matter of law, not for value.

Second, as the law firm in *Annod* approached failure, the firm's partners only took sporadic and reduced draws. Indeed, draws were cut so significantly "that at times Hamilton & Samuel employees, including some of the secretaries, were being paid more than the partners." *See Annod*, 100 Cal. App. 4th at 1296. But at many dissolved law firms, payments to equity partners are not reduced as the firms near dissolution – indeed, many take on debt, borrowing money from their lenders in order to pay partner draws.

Third, in addition to reduced draws, the *Annod* law partners also left "substantial assets, including cash income, in the firm which were then able to satisfy the claims of its creditors." *See Annod*, 100 Cal. App. 4th at 1296. In contrast, dissolved law

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[2] In addition to whether evidence of good faith is present, certain case law also limits *Annod* to the particular liability – commercial lease liability – for which the plaintiff sought to recover. In *Annod*, the creditor was a commercial landlord who had signed a mutual release where the landlord would not pursue the tenant's partners and vice versa. *See Annod*, 100 Cal. App. 4th at 1300. The court found permitting the landlord to demand the partners prioritize paying the rent over paying themselves would "rewrite the lease to delete the nonrecourse provision." *See id.* If the trustee can argue that the imposition of fraudulent transfer liability would not rewrite any contracts with the partners, *Annod's* applicability may be limited. *See, e.g., Dollar Tree Stores, Inc. v. Toyama Partners LLC*, 2011 WL 3295420, at *6 (N.D. Cal. Aug. 1, 2011) (rejecting *Annod*, in part, because the fraudulent transfer claim did not seek to rewrite a contract).

firms usually leave little cash in the partnership – and all or nearly all of it is subject to the secured lenders' liens.

Despite all of these legal and factual arguments, no major law firm bankruptcy has resulted in a controlling decision on how to evaluate whether a partner provided reasonably equivalent value for the payments he or she received. Partners have asserted they provided reasonably equivalent value in various ways, including hourly billings, generating new business, overseeing matters as billing partner and assisting in firm management and administration. These issues will be critical in ongoing law firm dissolutions and bankruptcies, as well as any those that arise in the future.

2. Contract Partners

Since Dewey's demise, much has been made of so-called contract partners – partners who may not truly be "partners" in the classical, legal sense. For example, is their compensation subject to the normal ups and downs of a law firm? Can a partner's contractual guarantee transform an attorney from partner to some form of contract employee? Does it matter whether a partner receives an income allocation or receives a K-1 or W-2 tax form? Has the contract partner acted consistent with her post-dissolution interpretation of their partnership status? Because the nature of partner contracts varies among both different firms and partners at the same firms, a thorough analysis of each type of partner contract is beyond the scope of these written materials.

If a partner were held to be subject to the terms of a separate contract, and not to the partnership agreement, it would presumably be easier to defend against a trustee's Fraudulent Transfer Claims. This is because a contract partner receiving negotiated compensation would seek treatment as any other provider of contracted services. However, Fraudulent Transfer Claims still apply. A contract partner may still be called upon to disgorge if the agreement itself constitutes a fraudulent conveyance because the firm agreed to pay excessive compensation or the partner received excessive "bonuses." The partner may still be called upon to defend on the grounds that she received payments in "good faith" for "reasonably equivalent value." *See* 11 U.S.C. § 548(c).

Trustees may argue that "contract" partners actually received profit distributions from the law firm – even if those distributions were subject to the terms of a written agreement. Although partners are not normally entitled to compensation for services (rather, they share in the partnership's profits), a partnership may contractually obligate itself to pay a salary to a partner. *See* Callison & Sullivan, PARTNERSHIP LAW AND PRACTICE: GENERAL AND LIMITED PARTNERSHIPS § 10:7; *Friedman v. Golden Arrow Films, Inc.*, 442 F.2d 1099, 1106 (2d Cir. 1971). The nexus question, then, is whether the partnership contractually obligated itself to pay salary to a partner or whether the partner's right to profit distributions was memorialized in a written document. If the payments received qualify as a distribution of profits, "that is not compensation or salary for services rendered and

is not a transfer in exchange for reasonably equivalent value." *In re Teknek, LLC*, 343 B.R. 850, 861 (Bankr. N.D. Ill. 2006); *see also Faulkner v. Komman (In re The Heritage Organization, L.L.C.)*, 413 B.R. 438, 473 (Bankr. N.D. Tex. 2009). This is because the partnership did not "owe" the partners the profits, so when the partnership paid the profits, it did not discharge an antecedent debt under the contract.

For example, in the Howrey case, a former Howrey partner moved to dismiss the trustee's fraudulent transfer claim to recover a return of capital the partner received while Howrey allegedly was insolvent. The former partner's theory was that, under the terms of both Howrey's partnership agreement and his separation agreement, the obligation to repay his capital was contractual; thus, because the payment of a contractual obligation is for value (*i.e.*, the payment reduces the amount of the obligation), the partner claimed the fraudulent transfer claim must be dismissed as a matter of law. Judge Montali disagreed, noting in a hearing transcript that a partner's status as equity holder does not change merely by his or her withdrawing from the firm, and that monies paid on account on that equity interest – even if pursuant to contract – are still recoverable as fraudulent transfers.

Issues surrounding contract partners have troubling consequences for those who deal with law firms. To what extent can a partner reduce or avoid Clawback Claims simply by entering into a new agreement with the firm providing that he or she is no longer an equity partner, but is now a "contract partner" or "of counsel" whose relationship with the firm is defined by an agreement other than the partnership agreement? What if the partner in question has been and remains one of the highest paid partners of the firm and continues to run his or her department or practice group? What is she can receive "bonuses" that feel a lot like profit distributions? What if the partner was a member of the management committee and still sits in an *ex-officio* capacity? Is the partner deliberately avoiding liability or simply availing himself or herself of the right to privately contract? What if all or even a substantial portion of the partners of a firm elect to take such status? These questions are not simple and may be very fact-specific. The extent to which individual contracts between a law firm and its partners do, in fact, transform the partner relationship is likely to be a central feature of future law firm partnership litigation.

B. Insolvency

To recover a transfer of a debtor's property that was not for reasonably equivalent value, a trustee need only prove that the bankrupt law firm suffered from one of three financial conditions – balance sheet insolvency, inability to pay debts as they come due, or unreasonably small capital. If the trustee prevails on one of these tests, distributions to partners may be recovered as fraudulent transfers, assuming other elements are met. *See, e.g.*, *In re Vadnais Lumber Supply, Inc.*, 100 B.R. 127, 137 (Bankr. D. Mass. 1989).

A law firm's insolvency is far easier to prove at or near dissolution than in the months preceding its collapse. Thus, these materials addresses the applicable financial condition tests in reverse chronological order – balance sheet and inability to pay debts as they come

due (both which apply best at or near dissolution) and inadequate capitalization (which typically plague law firms for months or even years before their demise).

1. Balance Sheet Insolvency

In conducting a balance sheet analysis of a law firm's solvency, the first question to be addressed is whether the firm's assets and liabilities must be judged at liquidation value. A business should no longer be valued as a going concern when it has reached its "point of peril . . . when the firm's ability to continue . . . is in doubt because its expected costs are greater than its expected revenues." *See In re Taxman Clothing Co., Inc.*, 905 F.2d 166, 169 (7th Cir. 1990). When a law firm has reached this point is a fact-intensive inquiry; however, it is safe to assume that by the time the firm is unable to pay its debts as they come due, it has likely passed its point of peril.

Applying a liquidation value to law firms will greatly reduce the value of the firm's assets. While cash will not be discounted, it is unlikely the firm will have any significant cash reserves at or near the time of its dissolution. A liquidation value will then reduce the value of the firm's assets – its furniture, fixtures, and equipment, for example, will be of little to no value (and perhaps even a liability). The firm's A/R will decline in value as well, because clients will either not pay a bankrupt firm, or will pay the firm far less than the stated value of its invoices. A firm's unpaid capital contributions may be considered an asset of the firm, but problems collecting that capital will greatly reduce its value once the firm is no longer a going concern.

Applying a liquidation value will also increase the size of the firm's liabilities. For example, a key part of a law firm's ongoing liabilities are rent obligations. And one law firm bankruptcy case, *In re Labrum & Doak, LLP*, 227 B.R. 383 (Bankr. E.D. Pa. 1998), allowed the debtor to count future rent obligations in determining insolvency, even if that amount is limited. *Id.* at 389. The plaintiff in *Labrum* sought to include more than $14 million of future rent obligations as "present liabilities" of the debtor. But *Labrum* was hesitant to include the "entire amount" of these future obligations and explained that "it is logical not to include all of the future rents as liabilities because this calculation miscategorizes the future rent liability as an obligation presently due in full, while, if the Debtor remained a going concern, would have consisted of making installment payments in the future during the tenancy . . ." *Id.* (emphasis supplied). With that, the *Labrum* court seemingly approved valuations done by the debtor's accountant that measured lease obligations "due for a period of one year." *Id.* at 386. This approach is consistent with other bankruptcy courts that have approved an expert's valuation of future lease obligations for insolvency purposes where it "does not include all future lease payments, but limits the amount to the present value of the short-term cost of space not necessary for [debtor's] then-existing servicing operations" and assumed, among other things, the early termination provision of the lease. *In re Commercial Fin. Servs., Inc.*, 350 B.R. 520, 539 n.16 (Bankr. N.D. Okla. 2005) (emphasis supplied).

Other liabilities may come into consideration once a law firm is no longer a going concern. For example, a firm may owe capital to recently departed partners. That obligation may be subordinated to other creditors for distribution and setoff purposes, but may count as an unaccrued liability for solvency purposes. The same may be true of the firm's obligations to retired partners, which are generally not accrued on a firm's books and records. Finally, in determining a law firm's liabilities one also has to consider malpractice claims. Failed law firms have historically been subject to very considerable claims asserted by former clients.

Once a law firm ceases to be going a concern for purposes of a balance sheet insolvency test, the law firm will have precious little assets to weigh against ever-increasing liabilities, and it is likely the firm will be insolvent under this test.

2. Inability to Pay Debts as They Come Due. ¶

In the *Heller* litigation, the parties are litigating the meaning of the intent or belief test set forth in Bankruptcy Code Section 548(a)(1)(B)(ii)(III). They take opposite positions on whether a debtor's ability to pay debts as they come due is a "backward-looking" or "forward-looking" test. The estate's representative argued that the test looks at the debtor's ability to pay its existing debts as well as additional debts that it might take on. Under the estate representative's theory, the dispositive question for whether a law firm is paying its debts as they come due is straightforward: are the law firm's creditors being paid? If not, the law firm is unable to pay its debts as they come due.

Defendants argued that the trustee bears the burden to prove that the debtor intended to incur, believed that it would incur, or reasonably should have believed that it would incur, debts beyond its ability to pay as such *future debts* became due. 11 U.S.C. §548(a)(1)(B)(ii)(III). Defendants' argument was that the "intent or belief" test requires a prospective cash flow analysis starting with the time of the alleged transfer at issue in this case, and that it measures whether the debtor reasonably believed that it could pay its debts *going forward*, not whether the debtor could pay debts that were incurred *prior to* the alleged transfer. *See, e.g., Hall v. Quigley (In re Hall)*, 131 B.R. 213, 216 (N.D. Fla. 1991) (holding under an earlier, but identical, version of Section 548(a)(1)(B)(ii)(III), that the court disregards debts the debtor *had already incurred* at the time of the transfer because they were "not debts that he intended to incur after the transfer"). "This part of the statute protects *future* creditors from a debtor who transfers assets with the intent to hide them or impair the debtor's ability to pay debts as they arise or with the belief that inability to pay debts would likely result." *WRT Creditors Liquidation Trust v. WRT Bankr. Litig. Master File Defendants (In re WRT Energy Corp.)*, 282 B.R. 343, 414-15 (Bankr. W.D. La. 2001) (emphasis added); *see also In re Hall*, 131 B.R. at 218 (same). The test "can be met if it can be shown that the debtor made the transfer or incurred an obligation contemporaneous with an intent or belief that *subsequent* creditors likely would not be paid as their claims matured." 5 *Collier on Bankruptcy* ¶548.05[3][c] (emphasis added); *see also WRT*, 282 B.R. at 415 (same).¶ Under the defendants' theory, it is not dispositive that the law firm

currently is failing to pay its debts as they come due, so long as firm management projects that all creditors will be paid *eventually*.

In the recent *Heller MSJ* opinion, Judge Montali segregated a debtor's inability to pay debts as they came due into two tests: (1) a subjective test, applied under 11 U.S.C. § 548(a)(1)(B)(ii)(III), which focuses on whether the debtor believed it could pay its debts as they came due, or (2) an objective test, applied under state law, which concerns whether the debtor reasonably should have believed it would incur debts beyond its ability to pay them. *See, e.g., Heller MSJ*, 2013 WL 951706, at *10. Judge Montali concluded that a plaintiff satisfies both tests if he proves the debtor is not paying existing debt:

> "Intending to pay or paying future debt in full while making no or partial payments on existing debt ***is*** incurring debt beyond the debtor's ability to pay, whether a subjective or objective test of intent or belief is applied." *Heller MSJ*, 2013 WL 951706, at *11 (emphasis in original).

In *Heller MSJ*, Judge Montali found this element proven as a matter of law where Heller owed over $40 million to its lender, "had no ability or authority to pay various debts," and creditors went unpaid as a result. *See id.* These facts tend to be present as most law firms near dissolution: the firms have massive secured debt, coupled with little to no ability or authority to pay its unsecured debts, which results in millions of dollars in unpaid trade debt or other obligations to creditors. Once a firm reaches this point, it may be found insolvent as a matter of law because of its inability to pay its debts as they come due.

3. Unreasonably Small Capital.

The unreasonably small capital or inadequate capitalization test is the financial condition test most appropriate for discerning whether fraudulent transfers from months or even years before a law firm's bankruptcy can be recovered from a law firm's former partners. The Bankruptcy Code does not define "unreasonably small capital," but a company is generally considered to have "unreasonably small capital" if it is unlikely to be able "to generate enough cash from operations and sales of assets to pay its debts and remain financially stable after a transfer." *Dahar v. Jackson (In re Jackson)*, 459 F.3d 117, 124 (1st Cir. 2006). Unreasonably small capital is therefore a test short of traditional insolvency – *i.e.*, the balance sheet test or inability to pay debts as they come due. Instead, the question is whether the company's financial difficulties are likely to lead to insolvency in the future. *See, e.g., In re Vadnais Lumber Supply, Inc.*, 100 B.R. 127, 137 (Bankr. D. Mass. 1989). This test is particuarly applicable to law firms because they are traditionally illiquid – their main assets, their partners, leave in the elevator each evening. Moreover, firms tend to distribute so much cash to their partners that they lack the financial reserves to cope with difficult economic environments. *See, e.g.*, Hildebrandt Consulting, WHITE PAPER: THE ANATOMY OF LAW FIRM FAILURES (Nov. 19, 2008)

(finding many law firms are thinly capitalized as a matter of "philosophical principle.").

Capital includes funds that can be generated through operations, converting assets to cash, or infusions such as debt or capital contributions. *See, e.g.*, *Moody v. Sec. Pac. Bus. Credit, Inc.*, 917 F.2d 1056, 1073 (3d Cir. 1992). So when judging whether a law firm has unreasonably small capital, a trustee or estate representative should look towards: (1) how much cash or net working capital the law firm has on hand, and whether the amount comports with what a comparably-sized law firm or professional services firm should retain; (2) what revenue the firm can expect to generate from new billings and collections of A/R; and (3) the law firm's access to financing, which is typically a revolving line of credit with a major bank.

To assess the first metric, trustees will look to published financial data or other available information that compares the cash and net working capital for law firms and professional services relative to their size. For example, a law firm with $100 million in annual revenue – and all the attendant overhead costs that come with an operation of that size – will need more cash and net working capital than a law firm with $20 million in annual revenue. Determination of whether a law firm has adequate cash or net working capital will therefore involve analysis of cash and working capital on the date of transfer and comparison to applicable credit metrics.

Partners will defend their firm's capitalization, however, by arguing that the firm's historical track record of generating revenue is evidence of the firm's continued ability to convert WIP and receivables to cash. This argument requires the partners to rely upon management's projections of future income. But management's projections "tend to be optimistic," so the critical question is whether the financial projections were *objectively* reasonable in the light of the facts and evidence available at the time. *See, e.g.*, *Peltz v. Hatten*, 279 B.R. 710, 744 (D. Del. 2002). Trustees will argue that management's projections were objectively unreasonable in light of the firm's immediate past history in failing to generate sufficient income to cover its costs. In fact, any projection of the amount of cash and working capital needed by a firm needs to take into account the possibility that the firm may underperform its projections.

Finally, the partners will claim the firm had adequate access to capital because of its ability to fund operations through its lines of credit or other loans. The validity of this argument will require examining the firm's relationship with its lender(s), the bank's credit files, why the bank extended credit to the firm, and what might stop that credit from continuing to be extended. This may require a fact-intensive inquiry with significant third-party discovery. Partners may also assert they had the ability at all times to raise significant additional equity capital through partner capital calls; this could involve a similar inquiry as to the facts and circumstances, both disclosed and non-disclosed, at the time in question.

Because firms are philosophically opposed to retaining cash, the trustee's best opportunity for proving that a firm's financial condition justifies recovering

payments made to former partners will be by demonstrating that the firm's significant overhead rested on a shaky base of little cash reserves, great dependence on continued generation of new matters, and little access to credit when WIP and A/R dwindled. In such a scenario, a firm may be inadequately capitalized for months or even years before its collapse, which would permit the trustee to recover significant sums from the firm's former partners.

IV. Potential Tax Issues

The Internal Revenue Code of 1986, as amended (the "Code"), defines "partnership" very inclusively: "the term 'partnership' includes a syndicate, group, pool, joint venture or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a corporation or a trust or estate." In determining whether parties have carried on a business or venture in such a manner as to constitute a partnership for federal income tax purposes, the Tax Court has distilled prior case law into the following list of factors:

> The agreement of the parties and their conduct in executing its terms; the contributions, if any, which each party has made to the venture; the parties' control over income and capital and the right of each to make withdrawals; whether each party was a principal and coproprietor, sharing a mutual proprietary interest in the net profits and having an obligation to share losses, or whether one party was the agent or employee of the other, receiving for his services contingent compensation in the form of a percentage of income; whether business was conducted in the joint names of the parties; whether the parties filed Federal partnership returns or otherwise represented to respondent or to persons with whom they dealt that they were joint venturers; whether separate books of account were maintained for the venture; and whether the parties exercised mutual control over and assumed mutual responsibilities for the enterprise.

Luna v. Commissioner, 42 T.C. 1067, 1077-78 (1964).[3]

Courts have refused to permit taxpayers who file tax returns as partners while it is advantageous to them to disavow their status as partners when it becomes disadvantageous. For example, the Ninth Circuit has held that when an Oregon partnership "filed tax returns as a partnership....[the partner] gained a tax benefit by not including his share of the taxable gains of the partnership in his return for 1946. [The partner] now seeks to disclaim the partnership's validity for those years. This he cannot do." *Maletis v. United States*, 200 F.2d 97, 98 (9th Cir. 1952).

Thus, even defunct law firms still file partnership tax returns – and former partners in these law firms continue to receive K-1's. The range of tax issues for these partners is far beyond the scope

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[3] The Tax Court continues to apply the *Luna* factors to determine whether parties have operated as a partnership for federal income tax purposes. *See, e.g., WB Acquisition, Inc. v. Commissioner*, T.C. Memo 2011-36.

of these materials (and the expertise of its authors). But two issues have been significant in prior law firm bankruptcies.

First, the law firm partners tend to receive large losses in the years for which their law firms collapsed (and potentially in subsequent years as new deductions are taken). These losses often have immediate financial benefit for the partners – for example, the losses may be so great that the partners have no tax liability for a particular year, and therefore allow the partners to use income that might otherwise go to the government to minimize the financial impact of their law firm's bankruptcy (*i.e.*, augment annual income, repay capital loans, etc.). However, these losses may only be available once and, once used, will not be available for the partners in the event of future partnership income.

Second, the partners may have so-called "phantom" income or cancellation of debt income ("CODI") that results from the law firm paying off its secured creditor through income that otherwise would have gone to the partners. CODI is the worst of all possible worlds: the partners owe taxes on money they never received. If possible, the partners may wish to carry forward their losses in order to offset any future CODI income. But if their law firm collapses with significant secured debt (as nearly all of them do), the partners should consult their tax professionals about the liability to expect if future income is received by the partnership.

V. Enforcing U.S. Bankruptcy Judgments Against Foreign Partners

If a dissolved law firm had offices abroad, the choice of law analysis for a trustee or liquidator's clawback claims against the foreign partners in those offices becomes more complex. But even if the plaintiff succeeded in applying the law he or she desired, the trustee or liquidator may have additional difficulty enforcing a bankruptcy court judgment abroad.

Enforcing a U.S. judgment abroad is difficult because the U.S. is not a party to any international treaty or convention governing the recognition and enforcement of foreign judgments. *See DaPuzzo v. Globalvest Mgmt. Co., L.P.*, 263 F. Supp. 2d 714, 743 & n.19 (S.D.N.Y. 2003). Generally, international law counsels a foreign state to enforce a U.S. judgment upon examination of four factors: (1) if the court had subject matter and personal jurisdiction; (2) whether the defendant was properly served; (3) if the proceedings were vitiated by fraud; and (4) whether to the judgment is contrary to the public policy of the foreign country. *See* Ronald A. Brand, *Recognition and Enforcement of Foreign Judgments*, FEDERAL JUDICIAL CENTER INTERNATIONAL LITIGATION GUIDE at 20-24 (2012). But whether a foreign court would enforce a judgment issued by a U.S. court depends not only on the foreign country's domestic laws, but also principles of comity, reciprocity, and res judicata. *See, e.g., Anwar v. Fairfield Greenwich Ltd.*, 289 F.R.D. 105, 115-16 (S.D.N.Y. 2013). Additionally, several foreign countries mandate a showing of reciprocity that the U.S. Court would enforce judgments of a similar nature from their courts.[4]

A global survey of the enforcement of bankruptcy court judgments is obviously beyond the scope of these materials. However, many global law firms have United Kingdom offices, and two recent

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4 *See, e.g., In re Vivendi Universal, S.A.*, 242 F.R.D. 76, 104 (S.D.N.Y. 2007) (analyzing German procedural law to determine whether a foreign judgment would be recognized in Germany, including whether "if reciprocity is guaranteed, *i.e.* if the foreign court would recognize a corresponding German judgment").

decisions from the United Kingdom Supreme Court are instructive to the issues (if not hurdles) a trustee or liquidator may face in pursuing a law firm's foreign partners.

In October 2012, the United Kingdom Supreme Court issued a decision in two appeals regarding the enforcement of foreign bankruptcy rulings in England in *Rubin v. Eurofinance SA* and *New Cap Reinsurance Corp. v. Grant*, [2012] UKSC 46. The two main principles from *Rubin* (a U.S. judgment) and *New Cap* (an Australian judgment) are that the enforcement of insolvency proceedings will be treated the same way as other foreign judgments, and that participating in foreign insolvency proceedings (*i.e.*, submitting a proof of claim) is likely to be sufficient for the U.K. court to find that a party has submitted to the jurisdiction of the foreign court.

The first decision, *Rubin*, involved a U.S. bankruptcy court that issued a default judgment of approximately $10 million on fraudulent transfer claims against a U.K. resident involved in a sales promotion scam. The defendants were residents of England and took no part in the U.S. litigation against them. Although the appellate court allowed the judgment to be enforced against them, the U.K. Supreme Court reversed that decision[5] and reaffirmed the traditional four bases of common law jurisdiction principles to enforce foreign insolvency orders in England – the person against whom the judgment was obtained must have done one of the following: (1) be "present in the foreign country" when proceedings commenced; (2) filed claims or counterclaims in proceedings in foreign court; (3) submitted to the foreign jurisdiction by "voluntarily appearing" in them; or (4) agreed to submit to the jurisdiction of the foreign court. Because the defendants were residents of England and did not participate in the U.S. bankruptcy litigation, the *Rubin* court refused to enforce the foreign judgment.[6]

The U.K. Supreme Court in *New Cap*, a case involving an Australian reinsurance company that went into insolvency liquidation in Australia, applied the same traditional common law principles of jurisdiction but reached the opposite conclusion as that reached in *Rubin*. The *New Cap* liquidator in Australia obtained a judgment against a Lloyds syndicate that received large payments before the company's liquidation. The U.K. Supreme Court decided that the Australian judgment against the Lloyds syndicate was enforceable because it had filed a proof of claim (or "proofs of debt") in the Australian bankruptcy and participated in the process by voting at a meeting of creditors. Specifically, the *New Cap* decision reasoned that the Lloyds syndicate "should not be allowed to benefit from the insolvency proceedings without the burdens of complying with the orders made in that proceeding."

If a trustee or liquidator proceeded against a foreign partner in the U.K., the first question might be whether the partner filed a proof of claim. But more significant than this technical detail is what the trustee or liquidator must do to preserve and pursue the claim in the U.S., while analyzing

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5 In so doing, the United Kingdom Supreme Court also reversed what had been since 2007 a major exception to the traditional principles of enforcement of foreign judgments in the U.K. in relation to cross-border insolvency proceedings created by the Privy Council (Lord Hoffman) in *Cambridge Gas Transport* [2007] 1 AC 508.

6 The United Kingdom Supreme Court also had received submissions from Bernard Madoff's SIPA Trustee as an intervenor in the proceedings. Based on the Privy Council rulings in *Cambridge Gas* (see *supra* at fn 6), the Madoff Trustee was seeking to enforce in the courts of Gibraltar default judgments he had obtained in the United States bankruptcy court against a BVI and Cayman company totaling $247 million relating to certain alleged preferential payments. Neither the BVI company nor the Cayman company had taken any part in the United States proceedings.

contemporaneously whether the risk that a U.S. judgment may not be enforced militates towards proceeding against the partner in his or her home country.[7]

[7] It should be noted that while Ireland and England now continue to apply the traditional settled principles of jurisdiction to enforce foreign judgments (presence, participation, submission and agreement), Canada, on the other hand, has adopted a dramatically different approach, permitting enforcement of at least certain foreign judgments on the basis of a "close and real connection." (see decision by Supreme Court of Canada in *Beals v. Saldanha* [2003] 3 SCR 416 adopting a "real and substantial connection" test).

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LAW FIRM INSOLVENCIES AND BANKRUPTCIES

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I. Introduction

There is no shortage of reports about the challenges today's lawyers face and predictions are abundant about the difficult legal landscape of the future. These challenges have had a direct impact on lawyers and their law firms, causing discomfort for a profession that traditionally has been an enclave of opportunity.

The disruption law firms and lawyers confront today did not happen overnight. Although law firm failure has been around for generations,[1] pressures on law firms have grown steadily, converting what once was a seller's market into something entirely different. It is unimportant to fix the exact inflection point when this regression started (although some analysts peg it to the technological revolution of the 1980's). Regardless of when it began, however, it is clear that the challenges faced by law firms and lawyers hastened with the financial crisis of 2007. And these challenges have not abated.

The Great Recession saw the acceleration of a paradigm shift away from traditional uses of law firms by sophisticated legal services consumers. Businesses are shifting to different sources of legal services. Non-legacy firms, with lower rates, are being used more and more.[2] Non-traditional legal vendors are enjoying significant increases in market share while traditional firms' profits remain uncertain.[3] And, many corporations are now bringing significant amounts

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The statements contained in this paper are intended to provide the reader with a survey of issues, views, and precedents that are situationally relevant when law firm insolvencies or bankruptcies arise or are filed. Nothing in this paper, nor any views espoused, should be attributed in any manner to any particular author in connection with any pending or future court proceeding, business circumstance or other matter involving a law firm or law firms, and the authors hereby expressly disavow any attribution of a general or particular statement or position set forth in this paper in any pending or future court proceeding, business circumstance or other matter involving a law firm or law firms.

[1] *See* David J. Parnell, THE FAILING LAW FIRM at 261-296 (2014).

[2] CENTER FOR THE STUDY OF THE LEGAL PROFESSION AT THE GEORGETOWN UNIVERSITY LAW CENTER, 2014 REPORT ON THE STATE OF THE LEGAL MARKET at 8 (2014), peermonitor.thomsonreuters.com/wp-content/uploads/2014/01/2014_PM_GT_Report.pdf ("In a recent survey … general counsel at 88 major companies were asked about their willingness to move high stakes …work away from "pedigreed firms" … to non-pedigreed firms, assuming a 30 percent difference in overall cost. Of the respondents, 74 percent indicated they would be inclined to use the less pedigreed firm, with only 13 percent saying they would not.") (footnotes omitted).

[3] Rachel Zahorsky & William Henders, *Who's Eating Law Firm's Lunch?*, ABA JOURNAL (Oct. 1, 2013), www.abajournal.com/magazine/article/whos_eating_law_firms_lunch/ ("2012 revenue for the top 100 U.S. firms totaled more than $70 billion[.] Since the recession hit the legal profession in 2007, these firms have grown in headcount, often through mergers and the absorption of lawyers from several law firm failures. But on a per-lawyer basis, revenue has been essentially flat. [A]s […] other legal vendors snatch millions of dollars in work typically done by traditional law firms, the growth of the Am Law 100 could disappear completely.").

of work in-house and away from firms.[4] As with all too many aspects of American society, the size of the pie for outside counsel is no longer growing, and concern seems to be rising.

This paper begins by discussing the financial fragility of the typical law firm model and some of the business practices that commonly drive the decline and fall of firms. It then goes from bad to worse, by discussing insider risk in cases of law firm collapse. The paper concludes on a more positive note by discussing how an ailing law firm can develop a plan to avoid collapse and begin the process of rehabilitation.

II. The Fragility of the Typical Law Firm Model

A. Lack of Ownership/Control of Key "Assets"

Client relationships are the key "assets" of a law firm. However, firms cannot control these relationships. Clients have all-but-absolute discretion in hiring and firing counsel. "A law firm does not own a client or an engagement," courts have recognized.[5] Firms therefore have little meaningful ability to maintain client relationships on anything but a voluntary basis. The going-concern value of any firm therefore may be fleeting since this value rests primarily on client goodwill.

This all-important client goodwill may be vested in individual lawyers instead of their law firms. "Clients hire lawyers, not law firms" is a common refrain.[6] Thus, if key lawyers leave, their former firms may be unable to convince the clients to stay with the firms and abandon their preferred key counsel. Indeed, that "fact of life" contributes to the attorney movement between firms and the existence of a robust lateral hiring market.[7]

Many lawyers in turn try to "silo" their clients to ensure ready portability, further preventing the accumulation of firm-specific client goodwill. Along with reducing the law firm's ability to control client relationships, this practice also prevents firms from making the most of these client relationships since partners who silo work are less willing to cross-sell their colleagues' services in different markets or areas to clients within their silo. Other lawyers, having worked hard to develop key client relationships, are loathe to cross-sell deeply for fear of having another firm attorney perform substandard work (thus damaging the relationship) or

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[4] Jennifer Smith, *Companies Curb Use of Outside Law Firms*, WALL STREET JOURNAL (Sept. 14, 2014) ("This year corporations are shifting an estimated $1.1 billion that they used to spend on outside lawyers to their own internal legal budgets, according to a new data analysis. That migration cements a trend that took off during the recession, when general counsels were under pressure to rein in costs, and spiked in 2012, when companies redirected $5.8 billion in legal spending in-house.").

[5] *Geron v. Seyfarth Shaw LLP (In re Thelen LLP)*, --- N.E.3d ---, 2014 WL 2931526, at *1 (N.Y. July 1, 2014).

[6] *See, e.g.*, Tom Kane, *Clients Still Hire Lawyers Not Law Firms, So Get Off Your Duff!*, LEXISNEXIS LEGAL NEWSROOM (July 8, 2011), www.lexisnexis.com/legalnewsroom/legal-business/b/marketing/archive/2011/07/08/clients-still-hire-lawyers-not-law-firms-so-get-off-your-duff.aspx.

[7] *See, e.g*, Harrison Barnes, *The Importance of Portable Business*, THE LATERAL ATTORNEY REPORT (May 2009), www.lateralattorneyreport.com/2009/05/the-importance-of-portable-business/ ("A partner with significant portable business can usually move to any region of the country or any law firm of his/her choice. He/She is a commodity.").

excelling (thus making inroads into the relationship). This can significantly diminish the advantages of synergy and economies of scale that larger firms seek to exploit.[8]

Firms in turn can do little to prevent their own members from moving to different firms and taking/poaching clients. Disciplinary rules may prevent lawyers from entering into agreements that restrict the right of a lawyer to practice after the termination of the employment or partnership relationship.[9] The law firm model works mostly on carrots instead of sticks—firms have limited options for retaining lawyers or their clients when those lawyers or clients wish to leave.[10] Additional compensation, or at least sustained compensation, may be the only way to retain key rainmakers. And of course when a firm starts to struggle, it may be unable to compensate the lawyers it most needs to retain. The loss of incentive to stay with the firm can weaken a firm and in extreme cases, lead to its demise.[11]

B. Short-Term Cash Management

A common practice among many law firms is that little, if any, net earnings are retained at fiscal year end. Firms instead typically distribute almost all of their profits to their partners or members at the end of each fiscal year. This leaves firms without a rainy day fund (or "equity cushion," to use bankruptcy-speak). Moreover, firms that suffer from a cash flow shortage or liquidity crisis may have difficulty finding third-party financing due to the lack of owner equity and the concern about meaningful going-concern value given the potential ephemeral nature of the firm's client relationship and revenue stream.

The yearly cash-out model also increases volatility in yearly partner distributions and makes partner distributions more vulnerable to sharp declines during difficult times. Without retained earnings, yearly distributions depend on yearly profits instead of long-term performance. In a year in which earnings are down, the year-end distributions can compare unfavorably to prior years, creating concern among the firm's most productive attorneys. In such cases, the risk of attorney departure increases which in turn further exacerbates the risk for the firm.

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[8] Erin Fuchs, *America's Lawyers Are Screwing Over Their Own Colleagues To Get Ahead*, BUSINESS INSIDER (July 22, 2013), www.businessinsider.com/how-profits-per-partner-hurts-biglaw-2013-7 ("What you have is people looking out for themselves and no one else. That is extremely damaging to the firm.") (quoting Patricia K. Gillette, Orrick, Herrington & Sutcliffe LLP).

[9] *See, e.g.,* Tex. Disciplinary R. Prof'l Conduct 5.06 (prohibiting a "partnership or employment agreement that restricts the rights of a lawyer to practice after termination of the relationship, except an agreement concerning benefits upon retirement"). *But see Fearnow v. Ridenour, Swenson, Cleere & Evans, P.C.*, 138 P.3d 723 (Ariz. 2006); *Howard v. Babcock*, 863 P.2d 150 (Cal. 1993); *Capozzi v. Latsha & Capozzi, P.C.*, 797 A.2d 314 (Pa. Super. Ct. 2002) (holding that reasonable liquidated damages provisions deterring partner departures may be enforceable).

[10] Some firms' constituent documents provide for the return of capital to a departing partner at a slow pace, thus potentially creating a disincentive to leave. While such features typically will be upheld as enforceable, the "slow pay" feature may be ineffective in stemming the flow of departures in certain market conditions. Many lawyers that are resolute about leaving a firm negotiate their new compensation package at a new firm in a way that offsets, to a degree, some of the negative impact of the installment payout of capital from their old firm.

[11] Jordan Weismann, *Why Law Firms Are Rigged to Fail*, THE ATLANTIC MONTHLY (May 31, 2012), www.theatlantic.com/business/archive/2012/05/why-law-firms-are-rigged-to-fail/257843 ("When profits drop, partners almost inevitably split, or at least start shopping for better prospects.").

The downward spiral of a struggling firm can cause other cash flow problems as well. Collecting on accounts receivable and realizing the value of work-in-progress can be much more difficult when a client has left the firm. Indeed, evidence indicates that some efforts to retain clients—such as discounting rates—may in fact be counterproductive by sending the message that bills do not need to be paid.[12]

C. Long-Term Liabilities

Many law firms seek to present an image of success and prestige—class-A offices with nice furniture and large conference rooms and good views, impressive libraries, cutting-edge technology, extensive charitable donations and civic involvement, etc. Whether simply symbols of success or important to the delivery of legal services, these assets come with fixed costs that can be expensive and may involve incurring significant long-term liabilities and commitments. In times of transition and reduced gross revenues, these long-term liabilities and costs can undermine firm stability by making it difficult to realize sufficient net revenues through a right-sizing of expenses.

In many instances, law firms sign multi-year office leases that anticipate some level of growth over the term of the lease. Such growth projections can be difficult to meet, either due to unanticipated departures, lack of lateral hiring success, lack of business growth, or the perverse effect of declining revenue due to increasing operating efficiency.

Today, more firms are beginning to wake up to the burden of these liabilities.[13] Some have begun to right-size their overhead expenses and long-term liabilities. Leases signed by several major law firms in recent years have purposely sought to reduce the square footage leased.[14] "The national average law firm spends 6.2 percent of gross revenue on real estate expenses," which is "two or three percentage points less than the share spent about 10 years ago."[15] Further, many law firms are targeting office space of 600 feet per lawyer—considerably lower than the current average of 823 square feet—and some firms are also considering

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[12] Frank Strong, *Law Firms that Discount Have More Past Due Clients*, LEXISNEXIS BUSINESS OF LAW BLOG (Sept. 2, 2014), businessoflawblog.com/2014/09/law-firms-discount/ ("Law firms that discount or write off legal fees prior to invoicing clients, also tend to also have more past due clients.").

[13] Although an unproven concept on a large scale, more attention is being given to the idea of operating a "virtual law firm." *See, e.g.,* Chad E. Burton, *How Real are Virtual Law Firms?*, ABA GPSOLO (Sept./Oct. 2012), www.americanbar.org/publications/gp_solo/2012/september_october/how_real_are_virtual_law_firms.html. The advances in technology experienced in recent years makes this discussion more plausible than ever. Even for firms that cannot convert to a virtual platform, the techniques and systems virtual law firms employ may be something they can adopt in order to streamline operations and reduce expenses.

[14] Jennifer Smith, *Weil Gotshal Hops on the (Real Estate) Downsizing Bandwagon*, THE WALL STREET JOURNAL LAW BLOG (Sept. 30, 2014), blogs.wsj.com/law/2014/09/30/weil-gotshal-hops-on-the-real-estate-downsizing-bandwagon/.

[15] M.P. McQueen, *Real Estate Roundup: Big Firms Move to Smaller Spaces*, THE AM LAW DAILY (Aug. 25, 2014), www.americanlawyer.com/id=1202668019958/Real-Estate-Roundup-Big-Firms-Move-to-Smaller-Spaces (quoting Sherry Cushman, Cushman & Wakefield, Inc.).

equalizing office space, which can increase efficiency (and remove a potential source of inter-partner conflict).[16]

For the firms facing an upcoming lease expiration, the opportunity to right size its real estate is presented. But for other firms whose leases have a significant remaining term, the drag of excess office space can become an issue. In today's strong leasing market (in some areas), it may be possible to negotiate with a landlord for a return of unused lease space that otherwise acts as a burden on the firm. Firms that cannot rationalize lease-related liabilities may be at a competitive disadvantage to firms that can, causing further risk.

In addition to offices—overly expensive or not—modern law firms also need sophisticated information technology to competitively serve their clients. Obtaining (or leasing) this equipment and paying for its maintenance and continual modernization can be costly. And recently, ever-growing concerns about security among lawyers and their clients indicate that the costs of maintaining an adequate IT infrastructure will increase.[17]

Ironically, the increases in employee productivity from information technology may lower law firm revenues instead of increase them. For many firms, revenues traditionally depended on hours worked by its timekeepers. Technology advances have increased attorney and employee efficiency to the point where a productive timekeeper may bill fewer hours which can cause revenues to decrease or stagnate. For instance, electronic resources can dramatically expedite legal research or document review, thereby lowering the revenues the law firms traditionally obtained from those activities (especially considering that these activities are mostly done by relatively low-cost associates).[18] Other traditional firm profit centers such as paralegals can also be diminished by use of technology. Increasing costs and decreasing revenues tends to make technology improvements a threat to older firms.[19] At the same time, however, clients

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[16] *Id.*; *see also* Martha Neil, *Baker Botts Joins Open Office Trend, Moves Junior Associates to Interior Area*, ABA JOURNAL (Sept. 18, 2014), www.abajournal.com/news/article/baker_botts_joins_open_office_trend_moves_junior_associates_to_interior_are/ ("A growing open office trend [...] often results in fewer offices, smaller individual work spaces and cost savings for the employer[.]").

[17] Matthew Goldstein, *Law Firms Are Pressed on Security for Data*, NEW YORK TIMES DEALBOOK (Mar. 26, 2014) ("A growing number of big corporate clients are demanding that their law firms take more steps to guard against online intrusions that could compromise sensitive information as global concerns about hacker threats mount.").

[18] *Charging More, Getting Less*, THE ECONOMIST (Jan. 18, 2014), www.economist.com/node/21594317/print ("[T]he easy profits once earned in litigation departments have also dried up: the tedious task of reviewing mountains of documents, which law firms used to farm out to battalions of newly qualified associates, can increasingly be done by computers.").

[19] Rachel Zahorsky & William Henders, *Who's Eating Law Firm's Lunch?*, ABA JOURNAL (Oct. 1, 2013), www.abajournal.com/magazine/article/whos_eating_law_firms_lunch/ ("All of the lawyers in my area of practice observed the same relentless pattern of businesses gaining enormous efficiencies through technology and globalization; albeit the collateral effects were often massive employment dislocation. Once you thought about it, there was no principled reason why this pattern was going to exempt BigLaw.") (quoting Kevin Colangelo, Pangea3, LLC).

increasingly expect to enjoy the fruits of modern technology, meaning that those older firms must evolve.[20]

D. Individual Client Dependence

Dependence on a small number of key clients can be a problem for small and large firms, although smaller firms tend to confront this issue more frequently. Smaller firms may be more harshly affected by rough times since their practices and client lists tend to be smaller and less diverse. Such firms may become even more subject to the mercy of a few clients upon which those firms depend. Clients who know that they are vital to a firm can leverage that power to benefit at the expense of the firm by extracting lower rates.[21]

Individual client dependence can be particularly difficult to avoid due to the competitive nature of lawyers and the business of law. Most lawyers readily pursue the opportunity to gain more business regardless of source, even if the new business obtained unduly weights the firm's client mix in favor of one client. Rare is a firm that establishes a limitation on the volume of a client's work as a percentage of all clients' work. One firm that has the discipline (or ability) to do so is Wachtell Lipton Rosen & Katz, which limits particular client dependence to ensure long-term stability. "No clients account for more than 3, 4, 5, 10% of revenues, so we don't have to worry about pissing any clients off," a Wachtell partner explained.[22] "I think there is very little question that the firm will survive the retirements of Wachtell, Lipton, and Rosen."[23] Needless to say, other firms may not have the luxury of avoiding the perils of depending on a small number of clients.

E. The "Type A" Personality Matrix

Much has been written about lawyer personalities. Most of these observations negative—lawyers are often characterized as narcissistic workaholics, perhaps with a fundamentally "weak sense of self."[24] Whether this gross overgeneralization is scientifically supportable is beyond the scope of this paper, but at a minimum it presents a point of view that exists.

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[20] Jennifer Smith, *Companies Curb Use of Outside Law Firms*, WALL STREET JOURNAL (Sept. 14, 2014) ("Many of the largest law firms have pivoted away from so-called commodity practices in recent years to concentrate on more specialized areas: white-collar defense work and government investigations, for example, or sophisticated, cross-border transactions and global regulatory issues. Such expertise is harder to duplicate in-house, and typically fetches higher prices.").

[21] *Charging More, Getting Less*, THE ECONOMIST (Jan. 18, 2014), www.economist.com/node/21594317/print ("[T]he general counsels of large businesses are increasingly finding that they can ignore these extravagant rates, and insist on big discounts.").

[22] WILLIAM STARBUCK, THE STRATEGIC MANAGEMENT OF INTELLECTUAL CAPITAL & ORGANIZATIONAL KNOWLEDGE at 371-401 (Oxford Univ. Press 2002), available at pages.stern.nyu.edu/~wstarbuc/mob/wachtell.html.

[23] *Id.*

[24] Erin G. Smith, *Scientifically Proven: Lawyer = Workaholic = Narcissist*, BUSINESS INSIDER (Mar. 22, 2010), www.businessinsider.com/scientifically-proven-lawyer--workaholic--narccisist-2010-3 (citing Timothy A. Pychyl, *The Personality of the Workaholic and the Issue of "Self"*, PSYCHOLOGY TODAY (Mar. 20, 2010) (citing M.A. Clark, A.M. Lelchook, & M.L. Taylor, *Beyond The Big Five: How Narcissism, Perfectionism, and Dispositional Affect Relate To Workaholism*, 48 PERSONALITY & INDIVIDUAL DIFFERENCES at 786-791 (2010))).

Still, there might be some truth in stating that, on occasion, certain personality traits common among very successful lawyers are not entirely conducive to building a strong, lasting law firm. Characteristics of strong team builders—collegial, selfless, and humble—may not be among the first adjectives used to describe lawyers with self-starting and aggressive personalities. Instead, many lawyers are independent and confident, some would say to the point of being stubborn and arrogant. The advocacy skills that lawyers develop may be counterproductive when lawyers use those skills in law firm politics—the proverb "he who represents himself has a fool for a client" may apply here.[25]

Moreover, lawyers in private practice may be prone to the unfortunate habit of basing their self-esteems on their compensation. For these lawyers, reductions in income are taken personally and they may be less willing to remain calm during bad times even if their personal finances and well-being are not significantly impacted by an off year.[26]

The "bad apple" effect also may exacerbate these personality-driven problems.[27] Negative behavior among some members of a group can cause the behavior of other members of a group to deteriorate, further damaging the firm as a whole.[28] Members who may have once been team players may be encouraged to build silos, hoard work, and promote their own interests ahead of the firm, causing further harm to the group.

F. Fear of Being the Last (Wo)man Standing: The Domino Danger

All of these factors exacerbate the fragility of law firms. Lawyers are aware of how fast firms can become undone, based on numerous recent examples. For instance, despite having over eighty years of history (albeit the history of two firms), "[i]t took just six weeks for Dewey & LeBoeuf to disintegrate."[29]

This awareness or perception of fragility in turn may increase an attorney's motivation to be prepared for a move and to make that move as early as possible. "When a firm starts to lose good people it can quickly devolve into a crisis of confidence."[30] Lawyers at a struggling firm

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[25] For an excellent (and somewhat R-rated) inside look at self-destructive infighting at a struggling firm, see James Stewart, *The Collapse: How a Top Legal Firm Destroyed Itself*, THE NEW YORKER (Oct. 14, 2013), www.newyorker.com/magazine/2013/10/14/the-collapse-2.

[26] Of course, it may be only natural to have such a reaction. As Gyp Rosetti once noted "Everyone's a person, though, right? So how else could they take it?" *Boardwalk Empire: Bone for Tuna* (HBO television broadcast Sept. 30, 2012).

[27] *See, e.g.*, LARRY MC MURTRY, LONESOME DOVE at 91 (Pocket Books 1986) ("Uva uvam vivendo varia fit.") (paraphrasing Juvenal, Satires 2.81 ("In the fields the scab of one sheep, or the mange of one pig, destroys an entire herd; just as one bunch of grapes takes on its sickly color from the aspect of its neighbor.") (G.G. Ramsay, trans.)).

[28] David Pincus, *One Bad Apple Spoils the Bunch*, PSYCHOLOGY TODAY (Aug. 11, 2008), www.psychologytoday.com/blog/the-chaotic-life/200808/one-bad-apple-spoils-the-bunch ("'Bad apples' are people who are internally conflicted. These internal conflicts tend to spread up to the level of the group, decreasing the groups' complexity, flexibility, and their ability to grow and adapt.").

[29] *Id.*

[30] Jennifer Smith, *The Downside of Luring Lateral Partners*, THE WALL STREET JOURNAL LAW BLOG (Oct. 20, 2014), blogs.wsj.com/law/2014/10/20/the-downsides-of-luring-lateral-partners/ (quoting William Brennan).

understandably do not want to wait until it is too late to make a successful move. A successful move can take months of planning, and after a point in time these plans cannot be undone even if the firm's performance improves.

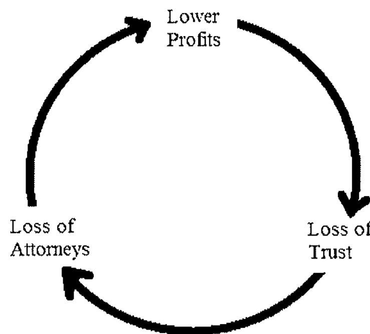
Clients as well can be aware of law firm fragility and fearful of the chaos threatened by the collapse of their counsels' firms. Clients may wish to avoid the risks posed by such chaos and assign work to other firms or actively encourage their preferred lawyers to move to more solid ground. This pressure can also increase the likelihood of failure for vulnerable firms and accelerate the timeframe for collapse.

This downward-spiral dynamic has even been recognized in one recent court case. In rejecting the Unfinished Business Doctrine in *In re Thelen LLP*, the New York Court of Appeals recently noted the dynamics that encourages

> partners to get out the door, with clients in tow, before it is too late, rather than remain and work to bolster the firm's prospects. Obviously, this run-on-the-bank mentality makes the turnaround of a struggling firm less likely. And attorneys who wait too long are placed in a very difficult position.[31]

Ironically, even the overall weakening of the Unfinished Business Doctrine by decisions such as *In re Thelen*—discussed in much more detail below—may in fact encourage departures by reducing risks for lawyers who depart a failing firm.

In any event, fears of law firm collapse can clearly become self-fulfilling—fears of lawyer departure can cause bad behavior and lawyer departures, thereby ensuring further losses of revenue and more lawyer departures, and ultimately causing the demise of the law firm. When partners "smell trouble they pack up and take the client files with them."[32] A vicious downward spiral can emerge and grow beyond control within a matter of months at many law firms:



[31] *Geron v. Seyfarth Shaw LLP (In re Thelen LLP)*,--- N.E.3d ----, 2014 WL 2931526, at *8 (N.Y. July 1, 2014).

[32] David Parnell, *Joff Mitchell Of Zolfo Cooper: 'My Advice To Law Firms Is To Get Your House In Order'*, FORBES (Aug. 6, 2014), www.forbes.com/sites/davidparnell/2014/08/06/joff-mitchell-of-zolfo-cooper-my-advice-to-law-firms-is-to-get-your-house-in-order/.

III. Too Much or Too Little Can Spell Trouble: Common Drivers of Disaster

A. Overpaying for Talent

In the rush to increase profits by luring lateral hires and their clients, firms increasingly began offering large guaranteed salaries to the rainmakers they woo. Indeed, this may have become a standard practice as dictated by the market for high-end laterals with good, portable business.

The problem with guaranteed salaries for apparent rainmakers is two-fold. First, even though the firm guarantees the salaries paid to laterals, laterals do not guarantee the revenues they will generate for the firm. This can reduce the profitability of the firm *and* remove the profits-based incentives for those laterals to bring their clients over and develop business for their new firm. An empirical study recently found that "for most law firms there is no statistically significant relationship between more lateral partner hiring and higher profits."[33]

Second, these potentially unmerited hand-outs to unproven laterals can cause discontent among other partners, perhaps encouraging those attorneys to wonder whether they could get a similar windfall through a lateral move.[34] Unfair guaranteed salaries for certain partners have been at the center of several recent law firm crises.[35]

> In an environment like we are in today, where legal revenues are under real pressure, you need to structure your firm so that you can maximize the compensation to those who are performing and contributing. And if you have to dilute their compensation by paying it to people who are not contributing, at the least it creates resentment. The worst case scenario is that you lose those people and they go to firms that are willing to pay them for what they generate.[36]

Overpaying for non-productive lateral "talent" has contributed to the downfall or severe undermining of many firms.[37]

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[33] William Henderson & Christopher Zorn, *Is Reliance on Lateral Hiring Destabilizing Firms?*, THE AMERICAN LAWYER (Feb. 3, 2014).

[34] Brian Baxter, *At Bingham, Big Guarantees Raise More Questions*, THE AM LAW DAILY (July 29, 2014) , www.americanlawyer.com/id=1202665178239/At-Bingham-Big-Guarantees-Raise-More-Questions, ("[T]he size and scope of the [lateral partner] guarantees led to internal fissures … that caused at least some partners to leave the firm over the past few years[.]").

[35] *Id.*; *see also* James Stewart, *The Collapse: How a Top Legal Firm Destroyed Itself*, THE NEW YORKER (Oct. 14, 2013), available at www.newyorker.com/magazine/2013/10/14/the-collapse-2 ("Inevitably, word spread among the other partners that [one partner] had renegotiated his guarantee on astonishingly favorable terms, even as the partnership continued to struggle. […] Now other partners, and, in some instances, entire practice groups, came to [management] with new demands.").

[36] David Parnell, *Joff Mitchell Of Zolfo Cooper: 'My Advice To Law Firms Is To Get Your House In Order'*, FORBES (Aug. 6, 2014), www.forbes.com/sites/davidparnell/2014/08/06/joff-mitchell-of-zolfo-cooper-my-advice-to-law-firms-is-to-get-your-house-in-order/.

[37] A corollary to the problem created by overpaying for lateral talent is the inattention at many firms to the task of integrating a lateral attorney once hired. A recent analysis of the problems faced by Bingham McCuthen, itself a

B. Benevolent Employment Practices & Expansion for Expansion Sake

On the other side of the coin, some observers point out that *targeted* lateral acquisitions can actually be very beneficial to firms, and that it is expansion for expansion's sake—be it through indiscriminate office openings, or ill-advised partnership promotions—that can be more damaging to law firms. This point of view certainly has merit. Many law firms have had trouble adjusting to new realities precisely because they were able to enjoy decades of successful expansion and free-spending without exercising caution or judgment.

To some observers, hiring successful laterals at market rates is far less of a problem than promoting unproductive attorneys to partners. While letting go of associates is never easy, the consequences of bad promotions to partnership are worse:

> In the six years prior to the recession, many firms admitted far too many partners—some into equity partnership, many into income partnership. A driving factor in the number of partners in the lateral marketplace is that firms are coming to grips with the mistakes of the past. Lax admissions standards have been a far greater issue than mistakes made on laterals.[38]

While this problem continued into the past decade, it has roots that may be decades old.[39] This hang-over from past excesses may continue to harm firms for years to come by driving off newer talent and preventing firms from adapting to the additional economic changes that seem likely in the future.

Indeed, while promotions of associates to partner have declined since the Great Recession, growth-for-the-sake-of-growth may continue as a meme among law firm management. A recent report stated that many firm leaders still

> believe that growth (in terms of lawyer headcount) is required for their firms' continued success. Indeed 55.7 percent of those surveyed responded affirmatively to that question, with only 35.7 percent responding negatively. This is surely puzzling in the wake of five years of tepid demand growth and stagnant productivity and with little prospects of a quick turnaround in either of those conditions. One possible explanation is that law firm leaders feel constrained to articulate some kind of strategic vision to help their firms weather the current storm, and the message that we need to "build a bigger boat" is more politically

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proponent of mergers and lateral acquisitions, attributes some of its ills to its failure to give sufficient attention to integrating the new lawyers into the firm and its culture. David Lat, *The Rise and Fall of Bingham McCutchen*, ABOVE THE LAW (Oct. 3, 2014), http://abovethelaw.com/2014/10/the-rise-and-fall-of-bingham-mccutchen/.

[38] Brad Hildebrandt, *What Critics of Lateral Hiring Get Wrong*, THE AM LAW DAILY (April 2, 2014), www.americanlawyer.com/id=1202649440768/What-Critics-of-Lateral-Hiring-Get-Wrong.

[39] Steven Harper, *Dangerous Advice for the Leaders of Large Law Firms*, THE AM LAW DAILY (May 23, 2014) ("The real problem of the 1980s was the lax admission standards of associates of all firms to partnerships. The way to fix that now is to make it harder to become a partner. The associate track is longer and more difficult.").

> palatable than a message that we need to fundamentally change the way we do our work.[40]

Many law firm leaders would likely say that they expand for "strategic purposes" and that their mergers provide "a lot of client opportunities that really give us a much larger upside than just becoming a bigger law firm."[41] Nevertheless, ill-advised expansion has caused law firm failures in the past. Plenty of firms may still face their day of reckoning for such mistakes, and missteps in growth will continue to threaten law firms in the future.

Along with overly-optimistic expansion to new offices and practice areas and excessively generous promotions to partners, many firms also face the consequences of promising too much to former members. "[M]any law firms are burdened—and their ongoing viability threatened—by past promises to provide retired partners with substantial incomes after retirement, sometimes for life."[42]

> These promises were made back in the "old days" when firms were smaller, partner incomes were lower, and "for life" didn't contemplate current actuarial projections of retiree longevity. Typically the promises were made without funding, causing the income streams of earning partners to become increasingly burdened by annuity-like cash flow obligations to retired partners.[43]

For some firms, "unfunded retirement/buy-out plans represent a clear competitive disadvantage in the marketplace."[44]

Ideally, law firms would be able to promote all associates to partner, expand to absorb any firms or groups that want to come on board, and promise all retired lawyers and staff generous pensions. Reality dictates otherwise, however, and firms that do not proactively acknowledge and adapt to this reality may harm the firm the firm's current and former members and employees.

C. The Expectation of Everything

Students of history are familiar with what has been called the "hubris of success" by experts in organizational management. For instance, Robert Graves coined the "Punic Curse," by which ancient Rome, after its victory against Carthage and ascendancy over the known world,

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[40] CENTER FOR THE STUDY OF THE LEGAL PROFESSION AT THE GEORGETOWN UNIVERSITY LAW CENTER, 2014 REPORT ON THE STATE OF THE LEGAL MARKET at 13, peermonitor.thomsonreuters.com/wp-content/uploads/2014/01/2014_PM_GT_Report.pdf. (citing Thomas S. Clay, *2013 Law Firms in Transition: An Altman Weil Flash Survey* at 13 (May 2013)).

[41] Sara Randazzo, *Study: Law Firms Shouldn't Chase Growth Just to Grow*, THE AMERICAN LAWYER (Jan. 6, 2014).

[42] Ann MacNaughton and Barton Bradshaw, *Promises to Keep: Solving the Dilemma of Unfunded Deferred Compensation Plans*, LAW PRACTICE (January/February 2007), www.americanbar.org/publications/law_practice_home/law_practice_archive/lpm_magazine_articles_v33_is1_an5.html.

[43] *Id.*

[44] James Cotterman, *Retirement Basics for Law Firms*, LAW PRACTICE TODAY (July 2004), apps.americanbar.org/lpm/lpt/articles/fin07041.html.

was "strangle[d] in the strings of purse" and "must sicken worse" before "she mends." Nearly thirty years ago, the unheeded Paul Kennedy spoke of America's "need to 'manage' affairs so that the relative erosion of the United States' position takes place slowly and smoothly, and is not accelerated by policies which bring merely short-term advantage but longer-term disadvantage."[45]

Successful law firms are no different than other successful institutions. They benefit from success but then must struggle with the consequences of that success. This cycle of the rise-and-fall of human institutions, which can at times seem almost inevitable due to basic human nature, looks like this for law firms:

1. An initial struggle for footing.
2. Some success doing what it does well.
3. The prospect of climbing new mountains becomes increasingly attractive (this comes in the form of new client types, new practice disciplines, new industries served or a new geographic presence).
4. Significant resources of time and money are redirected to the "something new."
5. The "something new" doesn't work near as well as envisioned.
6. The source of original success slips; momentum is lost; future success and stability are threatened.[46]

If not acknowledged and addressed, this expectation of everything can hasten the decline and fall of a successful firm. "In order to avoid decline, effective law firm executives direct the majority of firm resources to improving the value proposition that brought about the original success of the firm."[47]

D. Playing in the Danger Zone

Some lawyers and firms, when confronted with hard times and stagnating growth, and the feeling of being left out, have wildcatted into high-risk yet lucrative practice areas in search of pay dirt. "Even the most sophisticated law and lobbying firms are willing to gamble with their reputations and balance sheets in the face of stiffening competition."[48]

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[45] PAUL KENNEDY, THE RISE AND FALL OF GREAT POWERS at 534 (Vintage Books 1987).

[46] Roger Hayse, *Overconfidence a Cause of Law Firm Decline*, MANAGING LAW FIRM TRANSITION (May 27, 2014), www.managinglawfirmtransition.com/2014/05/overconfidence-a-cause-of-law-firm-decline/.

[47] *Id.*

[48] Paul M. Barrett, *The Fall of the House of Boggs*, POLITICO MAGAZINE (Sept. 15, 2014), http://www.politico.com/magazine/story/2014/09/the-fall-of-the-house-of-boggs-110989.html.

However, some fly too close to the sun. Risky areas such as class-action contingency fee work or aggressive tax shelters have caused firms to fail.[49] Further, just as stagnating or declining profits can encourage firms to engage in high-risk practice areas, pressures on individual lawyers can entice them to dabble in areas in which they personally lack expertise.[50] This increases the risks of malpractice claims (and resulting reputation-loss) both for these particular lawyers and for their firms.

E. Lack of Transparency, Leadership Vacuums, and Lack of Succession Planning

Being a leader of a large law firm in the current legal market is difficult, and for some, may not be an enviable task. Many in the rank-and-file are restless, competition is fierce, and growth may be a zero-sum game, where every victory comes at a price to someone else. As famous Texan Sam Rayburn was fond of saying, "any jackass can kick down a barn but it takes a good carpenter to build one." Like a good carpenter, strong law firm leadership hopefully uses its skills to build towards success.

Unfortunately, fundamental skills sometimes are lacking in some law firm leaders. One area in which leadership can be deficient is in clearly and consistently communicating with law firm owners and employees. When this lack of communication is motivated by a desire to "play cards close to the vest," a lack of transparency exists and the firm can suffer. On a case-by-case basis, limiting the "people in the know" may be appropriate, but consistently being too restrictive in keeping people informed can weaken a firm and a lack of trust can develop. As one writer has noted, a lack of open communication feeds the rumor mill, which often produces worse anxiety and instability than the truth.[51] Transparency builds a firm's fundamental integrity and trust. Opacity tempts failure.

Law firm leaders must also confront and embrace change in today's rapidly changing technological and legal environments. Leaders prepared to do so proactively adapt instead of reactively catching-up. Resistance to change and the cognitive bias towards business-as-usual are only human, and a problem for all lawyers and not just their leaders.[52] However, law firm

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[49] *Id.*; *see also* Nathan Koppel, *How a Bid to Boost Profits Led to a Law Firm's Demise*, WALL STREET JOURNAL (May 17, 2007), online.wsj.com/articles/SB117936836588605815.

[50] Dan Pinnington, *Malpractice Claims Are Very Real - And Easily Preventable: The Key Is Improving Lawyer/Client Communications*, LAW PRACTICE TODAY (Nov. 2005), apps.americanbar.org/lpm/lpt/articles/mgt04052.html ("Lawyers who dabble in practice areas outside their usual area of expertise are significantly more claims-prone[.]").

[51] Margaret Lockhart, *Transparency In Troubled Times: Communication for Law-Firm Leaders*, WOMAN ADVOCATE (Summer 2009), apps.americanbar.org/litigation/litigationnews/practice_areas/womanadvocate-communication-leaders.html ("If firm leaders are not talking to people, attorneys and staff are certainly talking to each other. In this environment, it doesn't take long for potentially destructive rumors to spread.").

[52] Neil Cameron, *The Wake Up Call – Why Law Firms Can No Longer Ignore the Need to Embrace New Ways of Working*, LEGAL WEEK (September 5, 2014), www.legalweek.com/legal-week/analysis/2363360/the-wake-up-call-why-law-firms-can-no-longer-ignore-the-need-to-embrace-new-ways-of-working ("[I]t still suits many lawyers to believe that it is the world of other lawyers in other law firms that is changing and that they won't be affected. This is a perfect example of cognitive bias.").

leaders, many conservative by nature, may be more resistant to change and less willing to adapt to current trends in the legal environment. The lack of innovators in leadership, or persons willing to consider new ideas, can hobble a firm and risk its demise.

Law firm leaders must also confront their own mortality (at least in a leadership sense), distasteful as that may be. Succession planning is key for retaining a firm's future leaders and major clients.

> Clients want to know who will be in charge of their legal matters. If they see little underway for a transition, they may seek to reduce their risk by bringing in alternate counsel. Younger partners want to know that leadership and management succession have been considered and that individuals from their ranks are being groomed for these important roles. [53]

Nevertheless,

> [s]uccession planning is a difficult task for law firms. Do you want to be the one to tell the fiery warhorse in the corner office it's time to put away the briefcase? Law is often a reactionary practice. Firms are hesitant to expand practices or bring in new attorneys until they are certain there is requisite demand. No two firms are completely alike and many are expert succession planners, but many also fall into a "complacency trap," meaning the senior leadership is seen as bringing in enough revenue to not disrupt a good thing (*i.e.*, wait and see until the last minute to find a suitable replacement), especially if a partner can help make a smooth transition of personal client relationships maintained over decades.[54]

Economic and demographic forces may exacerbate this problem of succession planning—baby boomers are working longer and less willing to transition clients, while the ongoing drop in associate promotions and displacement of younger lawyers may be creating a looming gap in manpower and leadership that will negatively affect larger, baby-boomer-controlled firms in the coming decades. Without a well-understood succession plan in place, taking into account that the demographics are different today than 10 to 20 years ago, leadership succession at law firms may be far more chaotic and disruptive for firms than in prior years.

IV. Total Collapse and the Risk of Creditor Claw-Back Efforts

Given all of the above-described dynamics and factors that can spell trouble for a law firm, what if the unthinkable happens and there is a total collapse of the firm? As we have recently seen in the press (and as some of us have even experienced personally), often the downward spiral can accelerate so rapidly that the firm reaches the point of no return within a mere months, if not weeks, of the first drop of a major domino. Should a total collapse occur leading to the dissolution or even bankruptcy of the law firm, it is important to understand the

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[53] James Cotterman, *Retirement Basics for Law Firms*, LAW PRACTICE TODAY (July 2004), apps.americanbar.org/lpm/lpt/articles/fin07041.html.

[54] Michael Allen, *Mandatory Law Firm Retirement, Succession Planning, and You*, ABOVE THE LAW (July 24, 2014), abovethelaw.com/2014/07/mandatory-law-firm-retirement-succession-planning-and-you/.

potential exposure that former partners or shareholders of the firm may face, particularly if the firm was insolvent for a significant amount of time leading up to the collapse. This section of the paper provides an overview of certain of the types of claims that may surface.

A. Partnership/Stockholder Agreement Claims

First, former partners/shareholders may face contract-based claims under applicable state law for obligations imposed under the governing partnership/stockholder agreement, or under other financial agreements entered into with the firm. In the partnership setting, a partnership agreement typically governs the allocation of profits to partners, the timing and payment of partner draws, the payment and reimbursement of tax advances, the obligation to make capital contributions, and similar matters. In the professional corporation setting, a stockholder agreement (or the bylaws) typically governs the timing and payment of equity shareholder compensation/distributions and the obligation to make capital contributions. Often these agreements or related ancillary agreements provide for the temporary advancement of profits or compensation/distributions pending year-end results, as well as the advancement of funds to cover partner/shareholder obligations. While typically these advances are simply netted against year-end profits/surpluses, ultimately the partners/shareholders are obligated to repay such advances under the terms of such agreements. In the event of the firm's dissolution or bankruptcy, the individual tasked with winding up the firm's remaining affairs, whether a liquidator or trustee, will be charged with the responsibility of enforcing such repayment obligations for the benefit of creditors.

Thus, naturally, one type of contract claim that may be pursued is for the recovery or recoupment of excess draws or compensation/distributions paid to partners/shareholders. Most law firm partnership agreements provide that payments to equity partners during the year are effectively advances against the distribution of profits for that year. Similarly, many shareholder agreements effectively treat some portion of the "budgeted" compensation of equity shareholders during the year as an advance against the year-end surplus (profits) budgeted for the year. In good times, when actual year-end profits are finally determined, each partner/shareholder is entitled to additional distributions based upon the difference between each partner's/shareholder's allocable share of profits and the draws/compensation (or other payments) received during the year. However, if the prior "advance" payments to any partner/shareholder exceeds that partner's/shareholder's allocable share of profits, then that partner/shareholder is required to repay the excess to the firm.

The drop off in profits can often be quite material in the event of a firm's collapse because the failure of a firm typically leads to large losses from the write-off of accounts receivable and the write-down of work in process and fixed assets. Plus, a law firm's failure may accelerate certain long-term liabilities, such as loans and lease obligations, causing them to be charged as expenses to the current year. This, in turn, can result in the firm having little to no profits to allocate to the partners/shareholders. Thus, depending upon the timing of the failure, partners/shareholders may be required to return a substantial portion of the draws/compensation they received during that year.

Another danger area involves contract claims for unpaid capital. There is considerable variability in the manner in which law firms determine the amount that each partner/shareholder

is required to pay or contribute in exchange for his or her partnership interest or stock. In some cases, capital contributions are adjusted on an ongoing basis along with partner/shareholder compensation, so that even long-time partners/shareholders may owe capital to the firm. When a law firm fails, the obligation to fund unpaid capital contributions is typically binding, resulting in the firm's liquidator/trustee calling on such capital obligations. And if capital was paid to partners prior to the firm's insolvency, whether to departing former partners or otherwise, such capital will be the subject of claw-back actions for the complete return of all such capital distributions.

Separately, in the case of law firm partnerships, many partnership agreements provide for the firm to make tax payments on behalf of partners, which are then subject to repayment to the firm by the partners. In this regard, while partnerships are "pass-through" entities for tax purposes (in that the partnership's gains and losses are passed through to the partners themselves), a partnership agreement will typically allow the firm to pay the partners' allocable shares of federal and state income tax as well as taxes paid abroad on earnings generated by non-U.S. practices. Typically, these tax advances are simply treated as adjustments to partner compensation and deducted from distributions. However, when a law firm fails, tax advances for the prior year often go unreimbursed, giving rise to additional claims against the partners.

Finally, if a personal loan has been extended to a partner/shareholder (*e.g.*, to finance the payment of capital contributions), then the liquidator/trustee will no doubt pursue repayment of the outstanding balance of the loan.

To former partners/shareholders, any one or more of these contract claims may rise to the level of hundreds of thousands, if not millions, of dollars in exposure. Depending upon the circumstances, however, they may also have their own claims against the firm that may nullify or at least minimize such exposure.

For example, if a partner/shareholder was a recent lateral hire who was misled about the firm's financial health during the recruitment process, then he or she may have a viable fraudulent inducement counterclaim. But fraud-based claims can be difficult to establish. At the pleading stage, such a claim will need to be pled with particularity, reciting the who, what, when, where and how particulars of the misrepresentation(s) made.[55] And even if the partner/shareholder successfully survives an initial dismissal attack, it is often difficult to prove reliance (*i.e.* that the partner/shareholder would have taken a different course of action had he or she known of the firm's true financial health). Depending upon the type of financial information that was shared during the recruitment process, such financial information may be too speculative to support a finding of "justifiable" reliance.[56]

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[55] *See* Fed. R. Civ. P. 9(b) ("In alleging fraud ..., a party must state with particularity the circumstances constituting fraud...."); *see also First Capital Asset Mgmt., Inc. v. Satinwood, Inc.*, 385 F.3d 159, 179 (2nd Cir. 2004); *Benchmark Electronics, Inc. v. J.M. Huber Corp.*, 343 F.3d 719, 724 (5th Cir.), *modified on other grounds on denial of reh'g*, 355 F.3d 356 (5th Cir. 2003); *Vess v. Ciba-Geigy Corp. USA*, 317 F.3d 1097, 1002 (9th Cir. 2003).

[56] *See, e.g., Naartex Consulting Corp. v. Watt*, 722 F.2d 779, 793 n.22 (D.C. Cir. 1983) ("It is elementary that speculative damage will not support an action for common law fraud"), *cert. denied*, 467 U.S. 1210 (1984).

Separately, the partner/shareholder may also hold claims against the firm for amounts owed under the partnership/shareholder agreement or otherwise. Such claims may reduce or offset any contractual obligations owed to the firm. In this regard, partners/shareholders commonly assert that they have claims for unpaid prior year compensation, for the return of capital, or even for retirement benefits. While at first blush this may seem helpful, in many instances the partnership/shareholder agreement may include provisions that subordinate those claims to the claims of general creditors. Moreover, in the case of a bankruptcy, claims on account of equity ownership may be subordinated under section 510(b) of the Bankruptcy Code.[57] Plus, the mere existence of such claims will not ordinarily excuse the partner's/shareholder's obligation to perform his or her own contractual obligations or otherwise discharge his or her liabilities to the firm. In this regard, while one party's material breach under an agreement may excuse the other party's future performance obligations, it does not discharge the other party's obligations that came due or were assumed prior to the material breach.[58]

B. Fraudulent Transfer Claims

In addition to contract-based claims, partners/shareholders may face avoidance litigation commenced by creditors, or the trustee in the event of the firm's bankruptcy, seeking to claw-back various payments as allegedly fraudulent transfers.[59] There are a number of different approaches that a creditor/trustee may take in pursuing fraudulent transfer claims.[60] And if a former partner/shareholder is owed significant sums by the firm and the firm is in bankruptcy, avoidance claims can be particularly problematic given the Bankruptcy Code's provision for the disallowance of claims held by those who have received and refused to return an avoidable transfer.[61]

1. Constructive Fraud

First, under both the Uniform Fraudulent Transfer Act ("**UFTA**") and the Bankruptcy Code, a law firm's payment or other transfer to a partner/shareholder may be avoided as constructively fraudulent if the firm made the payment/transfer in exchange for less than reasonably equivalent value while insolvent (or insolvent equivalent).[62] Disputes relating to

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[57] *See* 11 U.S.C. § 510(b).

[58] *See, e.g.,* Restatement (Second) of Contracts § 237 (1981) ("A claim for damages that has already arisen as a result of a claim for partial breach is not discharged" by the rule providing for relief from the obligation to perform in the event of the other party's material breach); *see also In re Lavigne*, 114 F.3d 379, 387 (2nd Cir. 1997); *First Interstate Bank of Idaho v. SBA*, 868 F.2d 340, 344 (9th Cir. 1989); *Pfizer, Inc. v. Stryker Corp.*, 348 F. Supp.2d 131, 147 (S.D.N.Y. 2004).

[59] *See* Uniform Fraudulent Transfer Act (1984) ["**UFTA**"]; 11 U.S.C. § 548; *see also* 11 U.S.C. § 544(b)(1) (enabling trustee to pursue any fraudulent transfer claims that a creditor could have pursued under applicable nonbankruptcy law).

[60] One approach that is not discussed herein is the pursuit of a fraudulent transfer claim predicated upon the debtor's actual fraud (*i.e.* the intent to hinder, delay or defraud creditors). *See* UFTA § 4(a)(1); 11 U.S.C. § 548(a)(1)(A). Instead, the discussion herein is focused on litigation risks assuming the debtor had no intent to deceive its creditors.

[61] *See* 11 U.S.C. § 502(d).

[62] *See* UFTA §§ 4(a)(2), 5(a); 11 U.S.C. § 548(a)(1)(B).

constructive fraud claims often revolve around two issues: (1) whether the law firm was insolvent (or insolvent equivalent) when each particular payment was made; and (2) whether the partner/shareholder gave reasonably equivalent value for the payments.

a. Insolvency or Insolvent Equivalence

First, to avoid a transfer as constructively fraudulent, a creditor/trustee must, in general terms, prove that at the time of the transfer, or as a result of the transfer, the law firm was balance sheet insolvent, unable to pay its debts as they come due, or left with unreasonably small capital. The establishment of any one of these tests is sufficient.[63]

Balance Sheet Insolvency. In conducting a balance sheet analysis of a law firm's solvency,[64] the first question to address is whether the firm's assets and liabilities should be valued on a going concern or liquidation basis. In this regard, at least one court has opined that a business should no longer be valued on a going concern basis when it has reached its "point of peril ... when the firm's ability to continue ... is in doubt because its expected costs are greater than its expected revenues."[65] While application of such an analysis is necessarily fact-intensive, it is reasonable to assume that by the time the firm has reached the point of being unable to pay its debts are they are coming due, it has likely passed its "point of peril."

Application of a liquidation valuation to a law firm is likely to greatly reduce the value of the firm's key assets. Not only will the value of the firm's fixed assets (such as furniture, fixtures and equipment) likely be nominal at best, but the value of the firm's outstanding accounts receivable will no doubt be significantly impaired given the propensity of clients to withhold payment or bargain for deep discounts in dealing with a defunct firm. Additionally, any unpaid capital contribution commitments that may be outstanding at the time of the failure are likely to be of more questionable value, including as a result of the defensive and/or offsetting claims that may exist, as noted above.

A liquidation valuation also impacts the assessment of liabilities. One of the key long-term liabilities of a firm, for example, is its office lease rental obligations. In the event of a default, or impending default, the financial impact of the default will need to be considered under the terms of the lease(s). And while it may not be reasonable to include the entire stream of rental payments that would come due under the lease over an extended period of time in the valuation of liabilities, some portion of the future rental stream is likely to be included in valuing liabilities.[66] Another type of liability that can be difficult to evaluate once a firm is no longer

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[63] *See, e.g., In re Vadnais Lumber Supply, Inc.*, 100 B.R. 127, 137 (Bankr. D. Mass. 1989).

[64] *See* UFTA § 2 (defining "insolvency"); 11 U.S.C. § 101(32) (definition of "insolvent").

[65] *In re Taxman Clothing Co., Inc.*, 905 F.2d 166, 169 (7th Cir. 1990).

[66] *See, e.g., In re Commercial Fin. Servs., Inc.*, 350 B.R. 520, 539 n.16 (Bankr. N.D. Okla. 2005) (approving, in conjunction with the assumed application of the lease's early termination provisions, a valuation that "does not include all future lease payments, but limits the amount to the present value of the short-term cost of space not necessary for [the debtor's] then-existing servicing operations"); *Official Committee of Unsecured Creditors v. Brennan (In re Labrum & Doak, LLP)*, 227 B.R. 383, 386-89 (Bankr. E.D. Pa. 1998) (seemingly approving valuation of lease obligations that limited the liability to those obligations that would come due for a period of one year).

operating as a going concern is the firm's liability for capital repayment obligations to recently departed partners/shareholders. As noted above, such obligations may be subordinated to other creditors for distribution purposes and/or may be subject to setoff to the extent of amounts owed by a particular partner/shareholder to the firm. Thus, for solvency analysis purposes, such obligations may be treated as unaccrued liabilities. Finally, the analysis will also have to take into consideration any pending or threatened malpractice claims against the firm. Failed law firms have historically been subject to claims asserted by former clients, often quite sizeable in amount.

Inability to Pay Debts as They Come Due. Under the UFTA, a debtor who is generally not paying its debts as they become due is presumed to be insolvent.[67] The Bankruptcy Code does not have an identical analogue to this rule. However, both the Bankruptcy Code and the UFTA include an insolvent equivalency test that focuses on the debtor's ability to pay debts as they come due. Under the Bankruptcy Code, the test requires proof that the debtor "intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured."[68] The UFTA is similar, but adds a subjective "reasonably should have believed" possibility.[69] In each case, the test is a forward looking one that ostensibly makes the debtor's current untimeliness in paying debt irrelevant.[70] At least one court, however, has indicated that the untimeliness in the payment of existing debt effectively establishes the forward-looking test.[71]

Unreasonably Small Capital. Finally, both the UFTA and the Bankruptcy Code include a remaining capital test,[72] a test that enables avoidance to reach back well before the actual point of insolvency or the failure to pay debts as they come due. While neither the UFTA nor the Bankruptcy Code specifies what constitutes unreasonably small capital, a company is generally considered to have unreasonably small capital if it is unlikely to be able "to generate enough cash from operations and sales of assets to pay its debts and remain financially stable after a transfer."[73] The question is effectively whether the company's financial difficulties are so extreme or pervasive that they are likely to lead to insolvency in the future.[74] This test is

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[67] UFTA § 2(b).

[68] 11 U.S.C. § 548(a)(1)(B)(ii)(III).

[69] *See* UFTA § 4(a)(2)(ii).

[70] *See, e.g., WRT Creditors Liquidation Trust v. WRT Bankr. Litig. Master File Defendants (In re WRT Energy Corp.)*, 282 B.R. 343, 414-15 (Bankr. W.D. La. 2001) ("This part of the statute protects *future* creditors of a debtor who transfers assets with the intent to hide them or impair the debtor's ability to pay debts as they arise or with the belief that inability to pay debts would likely result") (emphasis added); *see also Hall v. Quigley (In re Hall)*, 131 B.R. 213, 218 (Bankr. N.D. Fla. 1991).

[71] *See Heller Ehrman LLP v. Jones Day (In re Heller Ehrman LLP)*, Adv. No. 10-3221DM, 2013 WL 951706, at *11 (Bankr. N.D. Cal. Mar. 11, 2013) [hereinafter referred to as "**Heller II**"] ("Intending to pay or paying future debt in full while making no or partial payments on existing debt ***is*** incurring debt beyond the debtor's ability to pay") (emphasis in original), *determined otherwise on other grounds on de novo review*, 2014 WL 2609743 (N.D. Cal. June 11, 2014).

[72] *See* UFTA § 4(a)(2)(i); 11 U.S.C. § 548(a)(1)(B)(ii)(II).

[73] *Dahar v. Jackson (In re Jackson)*, 459 F.3d 117, 124 (1st Cir. 2006).

[74] *See, e.g., In re Vadnais Lumber Supply, Inc.*, 100 B.R. 127, 137 (Bankr. D. Mass. 1989).

particularly relevant to law firms given that a law firm's most valuable "assets" (its clients and attorneys) are neither permanent nor capable of valuation. Moreover, from a cash standpoint, law firms typically distribute substantially all of their year-end cash to partners/shareholders, leaving no meaningful cash reserves to address future practice area slowdowns or legal industry disruption.[75]

In considering the level of capital remaining after a transfer, in addition to existing cash and cash equivalents, capital includes funds that can be generated through operations, the conversion of assets to cash, and infusions from credit and capital contributions.[76] Thus, when evaluating whether a law firm has unreasonably small capital, the matters to consider are: (i) how much cash or net working capital the firm has on hand, and whether the amount comports with that of a comparably-sized law firm or other professional services firm; (ii) what revenue the firm can expect to generate from new billings and the collection of accounts receivable; and (iii) the law firm's access to financing and capital contributions. And because firms are philosophically opposed to retaining cash, a creditor's/trustee's best opportunity to prove that a firm's financial condition justifies recovering payments made to former partners/shareholders will be to demonstrate that the firm's significant overhead rested on a shaky base of little cash reserves, a heavy dependence on the continued generation of new legal engagements, and little access to credit in the face of dwindling AR and WIP.

b. Reasonably Equivalent Value

Turning to reasonably equivalent value, often key to the analysis is the nature of the ownership interest that a partner/shareholder had in the firm at the time of the payments at issue. For example, a creditor/trustee is likely to argue that, as a matter of law, distributions made to partners, and even on some level to the shareholders of a professional corporation, were on account of their existing equity ownership in the firm (*i.e.* not in exchange for any value given to the debtor). Partners/shareholders, on the other hand, are likely to argue that, as a matter of fact, it is possible for a partner's/shareholder's contributions to the firm (both monetarily and in the form of generating new business) to have provided value equal to (if not more than) the payments received.

From the creditor's/trustee's perspective, distributions made to partners – including limited partners in a limited liability partnership[77] – are not "for value" because they are "made ... on account of the partnership interests, and not on account of debt or property transferred to the partnership in exchange for the distribution."[78] The same concept has been applied in the

[75] *See* HILDEBRANDT CONSULTING, WHITE PAPER: THE ANATOMY OF LAW FIRM FAILURES (Nov. 19, 2008) (finding that many law firms are thinly capitalized as a matter of "philosophical principle").

[76] *See, e.g., Moody v. Sec. Pac. Bus. Credit, Inc.*, 971 F.2d 1056, 1073 (3rd Cir. 1992).

[77] *See, e.g.*, 11 U.S.C. § 101(16)(B) ("equity security" defined as including an interest of a limited partner in a limited partnership).

[78] *Hayes v. Palm Seedlings Partners-A (In re Agric. Research & Tech. Group, Inc.)*, 916 F.2d 528, 540 (9th Cir. 1990); *accord In re AFI Holding Inc.*, 2006 WL 6810954, at *4 (B.A.P. 9th Cir. Oct. 16, 2006).

context of corporations and limited liability companies.[79] Partners/shareholders, on the other hand, will argue that this general principle is only relevant in the context of passive investments, not a law firm where partners/shareholders are working diligently to generate new business, are working matters for clients, and collecting firm receivables. It is this work, they will argue, that provided value for the payments the law firm made (or at least some portion of them).[80] In other words, partners will argue that they hold, what amounts to, a hybrid role with the firm – part owner; part employee. But these types of customary "services" in furtherance of the business of the partnership are not ordinarily compensable under applicable state partnership law.[81] The "no compensation rule" applicable to partnerships is predicated on the "general principle of partnership law that partners are expected to devote their efforts to the partnership business, not to individual endeavors."[82] Thus, absent an express "special compensation" agreement for services to be rendered to the partnership, such an argument is likely to have little chance of success.[83] In the professional corporation context, on the other hand, the argument may be more compelling because shareholders are typically treated as employees for accounting and tax withholding purposes.

In the case of the return of capital contributions, partners/shareholders may also argue that the payment was on account of an *antecedent debt* (as opposed to equity ownership) and, thus, was for reasonably equivalent value.[84] However, even where the partnership/stockholder

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[79] *See Boyer v. Crown Stock Distrib., Inc.*, 2009 WL 418275, at *15 (N.D. Ind. Feb. 17, 2009) (distributions to equity holders in corporation not for value*), aff'd in part and rev'd in part on other grounds*, 587 F.3d 787 (7th Cir. 2009); *Fisher v. Hamilton (In re Teknek, LLC)*, 343 B.R. 850, 861 (Bankr. N.D. Ill. 2006) (same, as applied to LLC); *In re Brentwood Lexford Partners, LLC*, 292 B.R. 255, 267 (Bankr. N.D. Tex. 2003) (same); *see also In re Tri-Star Techs. Co., Inc.*, 260 B.R. 319, 326-27 (Bankr. D. Mass. 2001) (collecting cases from multiple Circuits supporting rule).

[80] *See generally Pryor v. Tiffin (In re TC Liquidations LLC)*, 463 B.R. 257, 268 (Bankr. E.D.N.Y. 2001) (services rendered by employees on behalf of company found to constitute "value" for purposes of considering whether "reasonably equivalent value" was provided); *Balaber-Strauss v. Sixty-Five Brokers (In re Churchill Mortg. Inv. Corp.)*, 256 B.R. 664, 679-80 (Bankr. S.D.N.Y. 2000) (services rendered by third parties for a debtor found to provide "reasonably equivalent value").

[81] *See, e.g.*, N.Y. P'SHIP LAW § 40(6) ("No partner is entitled for remuneration for acting in the partnership business [subject to an inapplicable exception]).

[82] *Jacobs v. Altorelli (In re Dewey & Leboeuf LLP)*, Adv. Proc. Nos. 14-01015 (MG), 14-01797 (MG), 13-01772 (MG), 14-01818 (MG), 14-01795 (MG), 14-01794 (MG), 14-01817 (MG), at p.30 (Bankr. S.D.N.Y. Oct. 29, 2014) [hereinafter referred to as "**Dewey & Leboeuf**"] (quoting *Development Specialists, Inc. v. Akin Gump Strauss Hauer & Feld LLP*, 480 B.R. 145, 159 (S.D.N.Y. 2012*), rev'd in part & vacated and remanded in part on other grounds*, 574 Fed. Appx. 15 (2nd Cir. 2014)).

[83] *See Dewey & Leboeuf*, at pp.31-33 (absent a "special compensation" agreement, the "no compensation" default provisions of New York partnership law bar, as a matter of law, a partner's "value" argument predicated on services rendered by the partner on behalf of the partnership); *see also Friedman v. Golden Arrow Films, Inc.*, 442 F.2d 1099, 1106 (2nd Cir. 1971) ("A concomitant rule [to the 'no compensation rule'] provides that a partner is entitled to special compensation if the parties did, in fact, agree that such compensation would be allowed").

[84] *See, e.g., Pereira v. Dow Chem. Co. (In re Trace Int'l Holdings, Inc.)*, 301 B.R. 801, 805 (Bankr. S.D.N.Y. 2003) ("Past consideration is good consideration" and "the payment of existing liability is not fraudulent"); *Annod Corp. v. Hamilton & Samuels*, 100 Cal. App.4th 1286, 1297 (Cal. Ct. App. 2002) ("In this case, money was transferred in satisfaction of the antecedent debts of [the partnership], i.e., the overdue partnership draws"). *But see Dollar Tree Stores, Inc. v. Toyama Partners LLC*, 2011 WL 3295420, at *6 (N.D. Cal. Aug. 1, 2011) (calling into question *Annod*, or at least distinguishing the opinion based upon the particular facts at issue in the case).

agreement makes the firm "liable" for the return of a partner's/shareholder's capital upon departure from the firm, the fact remains that "the return of the capital contribution still arises out of the original capital contribution which was made in connection with obtaining an equity interest" in the firm.[85] And "[e]quity distributions are not ordinarily considered transfers made on account of an antecedent debt, and in turn, are not considered to be made in exchange for 'reasonably equivalent value.'"[86] As one judge put it:

> There's a principle in the world of insolvency called once a shareholder always a shareholder. And if we translate that to the law firm, I don't see how you take something called a capital contribution [and characterize it as a creditor payment], recognizing as I do from the record, that at the time you were repaid you were no longer a partner[;] it was still a return of a capital contribution.[87]

Ultimately, key facts to consider in evaluating the nature payments made to a partner/shareholder will include: (i) the language of the law firm's partnership/shareholder agreement (*e.g.*, the agreement's terms with respect to partner/shareholder obligations to the firm, distribution rights on account of equity ownership, and if applicable "special compensation" provisions); (ii) whether the firm entered into a free-standing "special compensation" agreement with the partner/shareholder for services to be rendered to the firm;[88] (iii) whether the partner/shareholder voluntarily reduced his or her draws/distributions (*i.e.* provided value in the form of the reduction); and (iv) whether the partner/shareholder left cash in the firm for distribution to creditors (*i.e.* similarly, provided value in the form of foregoing distribution rights).

2. General Partner Exposure

Separately, in the case of a law firm partnership bankruptcy, former partners face additional fraudulent transfer litigation risk under section 548(b) of the Bankruptcy Code. Section 548(b) enables a trustee of a partnership debtor to avoid any payments or other transfers

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[85] *Dewey & Leboeuf*, at p.35.

[86] *Id.* at p.34 (citing *Geron v. Fontana (In re Thelen LLP)*, Adv. Proc. Nos. 11-02648, 11-02674, 11-02690, 13-01444, 2014 WL 2178156, at *6 (Bankr. S.D.N.Y. May 23, 2014)); *see also Harbour v. Harbour*, 643 N.Y.S.2d 969, 971-72, 227 A.D.2d 882 (N.Y. App. Div. 1996) (payment on account of capital is not for value); *cf. Le Café Crème, Ltd. v. Le Roux (In re Café Crème, Ltd.)*, 244 B.R. 221, 239-40 (Bankr. S.D.N.Y. 2000) (conversion of equity to debt by insiders of debtor was not for value when debtor insolvent).

[87] *Diamond v. Gabler (In re Howrey LLP)*, Adv. Proc. No. 13-03211 (Bankr. N.D. Cal. Dec. 23, 2013).

[88] *See* CALLISON & SULLIVAN, PARTNERSHIP LAW AND PRACTICE: GENERAL AND LIMITED PARTNERSHIPS § 10:7 (while partners are not ordinarily entitled to compensation for their services, a partnership may contractually obligate itself to pay a salary to a partner); *see also Friedman v. Golden Arrow Films, Inc.*, 442 F.2d 1099, 1106 (2nd Cir. 1971); *In re Brentwood Lexford Partners, LLC*, 292 B.R. at 267 (payments to executives who were entitled to profit-sharing distributions under the company's governing documents, but who did *not* have separate compensation agreements for running the company, construed as the equivalent of dividends negating reasonably equivalent value arguments). In this regard, framing the argument can be quite pivotal. Claiming that the payment resulted in the partner/shareholder agreeing to stick it out and continue to work for the firm is likely to be too amorphous to immunize the payment from attack. *See, e.g., Aptix Corp. v. Quickturn Design Sys., Inc.*, 148 Fed. Appx. 924, 930 (Fed. Cir.) (explaining that the fact that a transfer enables an enterprise to stay in business does not immunize the transfer from attack as a fraudulent transaction), *cert. denied*, 546 U.S. 1040 (2005).

made by the debtor to a general partner if the debtor was insolvent at the time of the payment/transfer or became insolvent as a result of the payment/transfer.[89] In other words, at least as to the trustee's prima facie case, whether or not the former general partner provided reasonably equivalent value to the debtor in exchange for the payment/transfer may be irrelevant – the Bankruptcy Code could effectively provide for strict liability in the event of insolvency.[90]

One of the issues that has arisen in recent cases, however, is whether a particular law firm partnership constitutes a "general partnership," such that the partners of the firm constitute "general partners" for purposes of Section 548(b). In this regard, none of the following terms is defined within the Bankruptcy Code: "partnership," "general partnership," or "general partner."[91] Curiously, however, "corporation" is defined as including a "partnership association organized under a law that makes only the capital subscribed responsible for the debts of such association"[92] but excluding a "limited partnership."[93] So where, for example, does a limited liability partnership and its partners fit into this matrix? Even Congress has seemed to be somewhat perplexed by this question.[94]

Recently this very question was presented to the Bankruptcy Court for the Southern District of New York in connection with the *Dewey & LeBoeuf* bankruptcy case.[95] Given the absence of a clear directive from the Bankruptcy Code's definitions, the court determined that it was necessary to look to applicable state law to determine whether a limited liability partnership constitutes a "partnership" or "corporation" for purposes of § 548(b) (utilizing the Bankruptcy Code's definition of "corporation").[96] Applying New York partnership law, the trustee argued that Dewey & LeBoeuf did not qualify for "corporation" treatment because, among other things, a partner of a New York LLP is "liable and accountable for any negligent or wrongful act or misconduct committed by him or her … while rendering professional services on behalf of such registered limited liability partnership;" thus, it cannot be said that "only the capital subscribed

[89] *See* 11 U.S.C. § 548(b).

[90] *See Dewey & Leboeuf*, at p.12 n.4 ("A trustee seeking to avoid a transfer by an insolvent partnership to a general partner does not need to show that the transferor did not receive reasonably equivalent value") (citing 5 COLLIER ON BANKRUPTCY ¶ 548.06[2] (Alan N. Resnick & Henry J. Sommers eds., 16th ed. 2014); *Brennan*, 227 B.R. at 387 (stating that section 548(b) "suggests … that the value given and good faith of the partner-transferee is irrelevant").

[91] *See generally* 11 U.S.C. § 101.

[92] *Id.* § 101(9)(A)(ii).

[93] *Id.* § 101(9)(B).

[94] *See* 140 Cong. Rec. H10752-01 (1994) (stating in connection with § 723, which addresses the personal liability of general partners for the debts of the partnership, that it is "unclear how [a partnership-specific provision] would be construed to apply with regard to registered limited liability partnerships which have been authorized by a number of States….").

[95] *See Dewey & Leboeuf*, at pp.12-16.

[96] *Id.* at pp.13-14 ("Courts look to state law to determine whether a LLP-debtor is a 'partnership' for purposes of the Code" and, specifically, "[t]he Court must examine the potential liability to which the partners of the LLP are exposed under applicable state law to determine to determine whether that state's version of a LLP constitutes a 'partnership' or 'corporation' under the Code") (citations omitted); *see also In re Beltway Law Grp., LLP*, No. 14-00380, 2014 WL 3882424, at *1-3 (Bankr. D.D.C. Aug. 7, 2014) and *In re Rambo Imaging, LLP*, No. 07-11190-FRM, 2008 WL 2778846, at *6-7 (Bankr. W.D. Tex. Jul. 15, 2008)).

[is] responsible for the debts of such association."[97] The court rejected this argument, however, finding that this carve-out to the limited liability provisions of New York LLP law only makes partners "personally," as opposed to jointly or severally, liable for any misconduct directly attributable to them. In other words, it does not add the personal assets off the offending partner to the pool of partnership assets to be used to pay off the partnership's debts.[98] Therefore, under New York partnership law, the court determined that a registered limited liability partnership constitutes a "corporation" for purposes of the Bankruptcy Code, resulting in the inapplicability of § 548(b) to the firm's partners.[99]

While instructive as to the partners of LLPs under New York law, the *Dewey & LeBoeuf* holding does not answer the question of how the partners of LLPs under other state law might be treated, nor for that matter how the partners of limited partnerships (which are excluded from the definition of "corporation" under the Bankruptcy Code) might be treated. The clear take-away from *Dewey & LeBoeuf*, however, is that it is necessary to consider the level of liability protection afforded to the partners of an LLP or LP under applicable state law to assess whether the partners of the firm constitute "general partners" for purposes of Bankruptcy Code § 548(b).

Should a partner be construed as a "general partner" for purposes of § 548(b), the trustee is likely not required to establish that the debtor failed to receive reasonably equivalent value in exchange for the payment/transfer as part of the trustee's prima facie case, as explained above. That said, the targeted former partner may raise the exchange of reasonably equivalent value as a *defense* to the trustee's prima facie claim under section 548(c) of the Bankruptcy Code.[100] Significantly, however, the defense also requires a showing of good faith on the part of the former partner.[101] And the "good faith" requirement may be quite daunting to establish if the former partner had knowledge of the firm's financial distress at the time of the payment/transfer or access to financial data that would have enabled the former partner to obtain such knowledge.[102]

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[97] *See Dewey & Leboeuf*, at p.14 (referencing N.Y. P'SHIP LAW § 26(c)).

[98] *See id.* at p.15.

[99] *Id.* at p.16.

[100] *See id.* at p.12 n.4 ("But even though a trustee does not need to prove a lack of reasonably equivalent value as part of the claim, the defendant retains a 'value' defense") (citing 5 COLLIER ON BANKRUPTCY ¶ 548.06[4] (Alan N. Resnick & Henry J. Sommers eds., 16th ed. 2014); *Brennan*, 227 B.R. at 387 (agreeing that "satisfaction of the conditions of § 548(c) does provide a defense to a § 548(b) transfer").

[101] Specifically, provided the former partner received the payment/transfer for value and in good faith, and provided the payment/transfer is not also avoidable under sections 544, 545, or 547 of the Bankruptcy Code, the former partner is entitled to retain the payment/transfer to the extent the former partner gave value to the firm in exchange for the payment/transfer. *See* 11 U.S.C. § 548(c).

[102] *See, e.g., O'Cheskey v. Horton (In re American Housing Found.)*, Adv. No. 10-2018, 2011 WL 4625349, at *23 (Bankr. N.D. Tex. Sept. 30, 2011) (explaining that "good faith" is to be evaluated using "an objective standard, examining what the defendant, as a reasonably prudent person, should have known instead of what they actual knew relating to the fraudulent transaction"), *aff'd*, 2012 WL 11851620 (N.D. Tex. 2012), *aff'd*, 544 Fed. Appx. 516 (5th Cir. 2013); *Heller II*, 2013 WL 951706, at *15.

C. The Unfinished Business Doctrine

Another type of claim that has dominated headlines of late is a claim for the recovery of profits generated from the law firm's pending client engagements as of the time of dissolution (*i.e.* the firm's "unfinished business"). Until recently, the claim seemed to have a lot of teeth. But the tide now appears to be turning. Nevertheless, because the Unfinished Business Doctrine has yet to be universally rejected, it is important to have a basic understanding of its history and operation and the risks that it presents to former partners/shareholders and their new firms.

1. Origins of the Claim: The Uniform Partnership Act and *Jewel*

At its core, the Unfinished Business Doctrine finds its roots in partnership law. Generally speaking, the partners of a partnership may enter into an agreement, on whatever terms they deem fit, to govern their respective rights and obligations to one another and the partnership, including in the event of the dissolution of the partnership. Often, however, partners fail to do so, or do so in an incomplete fashion. To fill the gap, the Uniform Partnership Act (the "**UPA**") was first adopted in 1914 to provide backstop, default rules. Among other things, the UPA provides that:

- No partner is entitled to remuneration for acting in the partnership business (with one inapplicable exception). UPA § 18(f).
- On dissolution the partnership is not terminated, but continues until the winding up of partnership affairs is completed. UPA § 30.
- Every partner, as a fiduciary, must account to the partnership for any benefit, and hold as trustee for it any profits derived without the consent of the other partners from any transaction connected with the conduct ***or liquidation*** of the partnership or from any use of its property. UPA § 21(1).

With these provisions in mind, in 1984 a California appellate court held in *Jewel v. Boxer*[103] that "in the absence of a partnership agreement, the Uniform Partnership Act requires that attorneys' fees received on cases in progress upon dissolution of a law partnership are to be shared by the former partners according to their right to fees in the former partnership, regardless of which former partner provides legal services in the case after the dissolution."[104]

To put the *Jewel* ruling in context, all four partners of a law firm partnership had mutually agreed to dissolve the partnership, thereafter splitting into two new firms.[105] Each of the new firms took over certain of the cases that had been in progress at the old firm at the time of its dissolution.[106] Curiously, the new firms never entered into new engagement agreements with the clients; instead, the new representations proceeded under the terms of the agreements

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[103] 156 Cal. App.3d 171 (Cal. Ct. App. 1984).

[104] *Id.* at 174.

[105] *Id.* at 174-75.

[106] *See id.* at 175.

the clients had entered into with the old firm.[107] Later, two of the former partners filed suit against the other former partners for an accounting of the fees that had been earned on the cases that the other partners took over, claiming that the fees constituted assets of the former firm subject to division among all of the former partners.[108] In response, the defending partners argued, among other things, that the clients had signed substitution of counsel notices that were filed in the pending cases, thereby discharging the old firm and substituting their new firm. Thus, they argued that the post-dissolution fees paid by the clients did not relate to the old firm engagements and correspondingly did not constitute assets of the old firm.[109] The court rejected these arguments, explaining that courts "must look to the circumstances existing on the date of dissolution of a partnership, not events occurring thereafter, to determine whether [the] business [at issue] is [the] unfinished business of the dissolved partnership."[110] To hold otherwise, according to the court, "would permit a former partner of a dissolved partnership to breach the fiduciary duty not to take any action with respect to unfinished partnership business for personal gain."[111]

From a policy perspective, the *Jewel* court also reasoned that compelling the division of fees earned on "unfinished business" would serve to (a) prevent partners from competing for the most remunerative cases during the life of the partnership in anticipation of retaining those cases upon a dissolution of the partnership, and (b) discourage former partners from scrambling to take physical possession of files and seeking personal gain by soliciting existing clients upon the dissolution.[112] The defending partners countered with their own policy argument – that the clients, themselves, have an absolute right to the attorney of their choice and the attorneys have no right to dictate that decision.[113] But the court found that to be irrelevant to the specific question at issue:

> [T]he right of a client to the attorney of one's choice and the rights and duties as between partners with respect to income from unfinished business are distinct and do not offend one another. Once the client's fee is paid to an attorney, it is of no concern to the client how that fee is allocated among the attorney and his or her former partners.[114]

The court also found unpersuasive the former partners' argument that an adverse ruling would effectively discourage a former partner's continuing representation of a dissolved firm client. The court reasoned that each of the former partners of a dissolved firm continues to have a fiduciary duty to wind up and complete the unfinished business of the dissolved partnership, and

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[107] *See id.*

[108] *See id.*

[109] *See id.* at 178.

[110] *Id.*

[111] *Id.* at 178-79.

[112] *See id.* at 179.

[113] *See id.* at 177.

[114] *Id.* at 178.

this duty acts to prevent a former partner from refusing to furnish any work or attempting to impose the obligation totally on the other former partners.[115]

In conjunction with its ruling, the *Jewel* court also considered the amount of the post-dissolution fees to be allocated to the old firm. The trial court had allocated such fees to the old and new firms on a *quantum meruit* basis. The *Jewel* court found such allocation to have been in error under the provisions of the UPA, instructing the trial court, on remand, to allocate the fees to the former partners in accordance with their respective percentage interests in the former firm, subject only to the right of the former partners who actually handled the post-dissolution work to be reimbursed for the reasonable and necessary overhead expenses attributable to the production of the income (excluding, however, partner salaries).[116]

2. Initial Clarification/Expansion of the Unfinished Business Doctrine

Following the *Jewel* decision, various other courts issued opinions clarifying and expanding the Unfinished Business Doctrine. Among the topics addressed were the following:

Contingent Fee v. Hourly Fee Matters. Whereas courts have long recognized that a firm engaged under a contingency agreement has a continuing interest in any recoveries that may be realized after the matter is moved to a new firm,[117] the *Jewel* court did not consider whether a distinction is to be drawn between matters handled on a contingent fee basis and matters handled on an hourly fee basis for purposes of the Unfinished Business Doctrine. In 1997, however, the District Court for the District of Columbia found no difference between the two, ruling that the UPA "requires that former partners share *all* profits earned from completing client matters that were pending at the time of dissolution .... [H]ow the firm's clients were billed, either at an hourly rate or on a contingency fee basis, does not change the status of their work as partnership property."[118] Several other courts have taken the same position.[119] As further explained below, however, the trend has recently moved in the opposite direction.[120]

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[115] *See id.* at 179.

[116] *See id.* at 180; *see also Official Committee of Unsecured Creditors v. Ashdale (In re Labrum & Doak, LLP)*, 227 B.R. 391, 420 (Bankr. E.D. Pa. 1998) [hereinafter referred to as "**Labrum & Doak**"].

[117] *See, e.g., Geron v. Robinson & Cole LLP*, 476 B.R. 732, 739 (S.D.N.Y. 2012), *aff'd*, 762 F.3d 157 (2nd Cir. 2014); *Santalucia v. Sebright Transp., Inc.*, 232 F.3d 293, 298, 300-01 (2nd Cir. 2000).

[118] *Robinson v. Nussbaum*, 11 F. Supp.2d 1, 5 (D.D.C. 1997) (emphasis in original); *see also Young v. Delaney*, 647 A.2d 784, 792 (D.C. 1994).

[119] *See, e.g., Labrum & Doak,*, 227 B.R. at 396, 411; *Greenspan v. Orrick, Herrington & Sutcliffe LLP (In re Brobeck, Phleger & Harrison LLP)*, 408 B.R. 318, 333 (Bankr. N.D. Cal. 2009) [hereinafter referred to as "**Brobeck**"]; *Diamond v. Pillsbury Winthrop Shaw Pittman, LLP (In re Howrey LLP)*, 2014 WL 507511, at *10 (Bankr. N.D. Cal. Feb. 7, 2014) (applying D.C. law); *Diamond v. Jones Day LLP (In re Howrey LLP)*, 2014 WL 4435982, at *2-3 (Bankr. N.D. Cal. Sept. 9, 2014) (applying D.C. law).

[120] In this regard, the following opinions which found the Unfinished Business Doctrine to apply with equal force to hourly fee matters have since been reversed on appeal or determined otherwise on *de novo* review at the district court level. *See Development Specialists, Inc. v. Akin Gump Strauss Hauer & Feld LLP*, 480 B.R. 145, 159 (S.D.N.Y. 2012), *rev'd in part & vacated and remanded in part*, 574 Fed. Appx. 15 (2nd Cir. 2014) (involving the bankruptcy case of Coudert Brothers LLP) [hereinafter referred to as "**Coudert**"]; *Heller II*, 2013 WL 951706 (involving the bankruptcy case of Heller Ehrman LLP).

Partnerships v. Professional Corporations. Inasmuch as the ruling in *Jewel* was predicated on provisions of the UPA, it would seem rational to conclude that the doctrine must only be relevant to partnership law firms, and possibly only to those organized as general partnerships (as opposed to limited liability partnerships). But those courts that have considered the scope of the doctrine, or at least its underlying principles, in the context of law firm dissolutions have reasoned that the form of the organization is not controlling; rather it's the special fiduciary relationship that exists between the attorney-owners of the law firm. As explained by the Second Circuit: "It is beyond cavil in New York that a member of a law firm owes a fiduciary duty to the other members of the firm."[121] Thus, according to the Second Circuit, the fiduciary duty principles of partnerships apply equally to professional corporations of lawyers.[122] These same fiduciary principles were applied by a California bankruptcy court in analyzing the obligations of lawyers who had organized their law firm as a California limited liability partnership owned by the lawyers' respective professional corporations (which had separately been organized under the laws of a variety of jurisdictions) who separately employed them.[123] Thus, the obligation to account for and share post-dissolution client fees has been found to apply with equal force to both professional corporations and limited liability partnerships.[124]

Agreements to Waive Unfinished Business Obligations ("Jewel Waivers"). Another question considered post-*Jewel* was whether the partners of a law firm may enter into a valid agreement whereby the partners and the law firm waive the right to an accounting in relation to the firm's unfinished business upon dissolution, thereby facilitating a transfer of the business to whichever of the partners may continue the work thereafter unencumbered by the Unfinished Business Doctrine (commonly referred to as a "**Jewel Waiver**"). To put this question in context, *Jewel* and many of the post-*Jewel* cases had discredited the various protests raised by defending former partners based upon the fact that the former partners could have avoided the dissolution provisions of the UPA by simply entering into an agreement providing otherwise.[125] Based upon

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[121] *Santalucia*, 232 F.3d at 297; *see also DSI I*, 480 B.R. at 157 (explaining that the UPA is not the source of the duty of former partners to account to one another; rather the source of the duty is the fiduciary relationship of trust and confidence that partners have time immemorial shared with one another); *Graubard Mollen Dannett & Harowitz v. Maskovits*, 86 N.Y.2d 112, 118, 653 N.E.2d 1179 (N.Y. 1995) ("[L]aw partners, no less than any other business or professional partners, are bound by a fiduciary duty requiring 'the punctilio of an honor the most sensitive'") (quoting *Meinhard v. Salmon*, 249 N.Y. 458, 464, 164 N.E. 545 (N.Y. 1928)).

[122] *Santalucia*, 232 F.3d at 299.

[123] *See Heller Ehrman LLP v. Arnold & Porter LLP (In re Heller Ehrman LLP)*, Adv. No. 10-3203DM, 2011 WL 1539796, at *2-3 (Bankr. N.D. Cal. Apr. 22, 2011) [hereinafter referred to as "**Heller I**"] (opining that, irrespective of form, the attorneys themselves are governed by a set of rules that bind themselves together: "Those are the rules of trust, confidence and loyalty, rules that apply to attorneys representing clients together, fiduciary ones to be sure").

[124] *Santalucia,* 232 F.3d at 300-01; *Geron v. Robinson & Cole LLP*, 476 B.R. 732, 744 (S.D.N.Y. 2012) (under California law, *Jewel* applies with equal force to registered limited liability partnerships), *aff'd*, 762 F.2d 157 (2nd Cir. 2014); *Heller I*, 2011 WL 1539796, at *3-4 (principles of *Jewel* to apply with equal force to attorneys who organize within a professional corporation) (citing *Fox v. Abrams*, 163 Cal. App.3d 610 (Cal. Ct. App. 1985)).

[125] *See, e.g., Robinson*, 11 F. Supp.2d at 6 ("partners are free (indeed encouraged) to execute written partnership agreements which provide for an exact disposition of profits from hourly rate matters after dissolution"); *Labrum & Doak*, 227 B.R. at 412 ("In the case at bar, we have held that the Debtor's [partnership agreement] was silent as to the allocation of attorneys' fees at the time of dissolution. As a result, the former partners must bear the

these admonitions, law firms have in fact often entered into Jewel Waivers (albeit often very late in the game). In 2009, the Bankruptcy Court for the Northern District of California was confronted with the validity of such a Jewel Waiver in the *Brobeck* case. In finding the waiver to be valid, the court explained that "the Brobeck partners were free, indeed encouraged [by the admonitions of the prior cases], to enter into a contrary agreement on how they wished to handle Brobeck's Unfinished Business. The Brobeck partners took the clear message from *Jewel* – an agreement that immediately disposes of unfinished business and minimizes the disruptive impact of a dissolution is appropriate, and the court will not fault them for complying with this aspect of California law."[126] Since that time, no serious challenges have been made to the validity of Jewel Waivers.

3. The Revised Uniform Partnership Act

In 1997, the Revised Uniform Partnership Act (the "**RUPA**") was adopted. The RUPA modified the UPA in at least two material ways having relevance to the Unfinished Business Doctrine.[127]

<u>Scope of Permissible Partnership Agreement Provisions</u>. First, the RUPA more clearly delineated the scope of the partners' authority to enter into a partnership agreement having terms contrary to the provision of the RUPA. In this regard, the RUPA starts with the premise that, except as otherwise provided in RUPA § 103(b), "relations among the partners and between the partners and the partnership are governed by the partnership agreement" (with the RUPA to only govern those matters that are not addressed in the agreement).[128] The § 103(b) carve-out, however, provides that the partnership agreement may not "eliminate the duty of loyalty under Section 404(b) [which includes the duty to account] but: (i) the partnership agreement may identify specific types or categories of activities that do not violate the duty of loyalty, if not manifestly unreasonable; or (ii) all of the partners or a number or percentage specified in the partnership agreement may authorize or ratify, after full disclosure of all material facts, a specified act or transaction that otherwise would violate the duty of loyalty."[129]

As noted above, in *Brobeck* a California bankruptcy court was tasked with deciding whether the Jewel Waiver at issue in the case was valid. Among the arguments presented by the trustee was that the waiver was invalid under the RUPA because it eliminated the duty of loyalty in contravention of § 103(b), failing to satisfy either of the exceptions provided in § 103(b).[130] The court disagreed, finding the waiver to be valid under both of the exceptions. First, focusing

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consequences of their failure to provide for allocation of fees in their agreement"); *Jewel*, 156 Cal. App.3d at 180 ("The former partners must bear the consequences of their failure to provide for dissolution in a partnership agreement").

[126] *Brobeck*, 408 B.R. at 334.

[127] Most states have passed legislation to enact the RUPA. New York is among the small number of states that have not yet done so.

[128] *See* RUPA § 103(a).

[129] *Id.* § 103(b)(3).

[130] *See Brobeck*, 408 B.R. at 334-35.

on the manifestly unreasonable exception, the court reasoned that the modification to the duty of loyalty had been reasonably tailored because it only affected the duty to account (one aspect of the duty to loyalty) and did not purport to outright eliminate the duty of loyalty.[131] Second, focusing on the ratification after full disclosure exception, the court found persuasive the fact that, not only were the details of the firm's unfinished business explicitly disclosed in documents circulated to the partners, but there were numerous discussions among the partners regarding the agreement that included the Jewel Waiver and its provisions before the partners approved it.[132] Additionally, the court found that the trustee, who was also asserting fraudulent transfer claims in relation to the Jewel Waiver, had the ability to address any damage caused to creditors by the firm's execution of the Jewel Waiver while insolvent.[133]

Wind-Up Compensation of Partners. Next, while arguably the RUPA did not change the rules regarding a partner's duty to account for unfinished business,[134] it did open the door for former partners to be "reasonably" compensated for completing the unfinished business of the dissolved partnership (whereas the UPA did not allow for any compensation). Specifically, RUPA § 401(h) provides that "[a] partner is not entitled to remuneration for services performed for the partnership, *except for reasonable compensation for services rendered in winding up the business of the partnership*."[135] That said, the RUPA fails to provide any guidance as to the meaning of "reasonable compensation" or how it is to be computed.

While the matter continues to be one of much dispute, the Bankruptcy Court for the Northern District of California has provided the following guidance. First, "[r]easonable compensation *to the partners* is not the same as reasonable compensation *for completion of the Unfinished Business*;" thus, "the particular compensation ... of any [former partner at his or her new firm] who previously was at [the dissolved firm], is of no relevance."[136] Second, "reasonable compensation" and deductible overhead expenses incurred in completing the unfinished business do not include such things as legal recruiter fees, marketing expenses, training, or any other expenses that have no true bearing on the completion of the business.[137]

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[131] *See id.* at 336.

[132] *Id.* at 335.

[133] *See id.* at 336.

[134] *See* RUPA § 404(b)(1) ("A partner's duty of loyalty to the partnership and the other partners [includes the duty] to account to the partnership and hold as trustee for it any ... profit, or benefit derived by the partner *in the conduct of winding up of the partnership business* or derived from a use by the partner of partnership property, including the appropriation of a partnership opportunity") (emphasis added). *But see id.* § 404(b)(3) (a partner's duty of loyalty includes the duty "to refrain from competing with the partnership in the conduct of the partnership business *before the dissolution of the partnership*") (emphasis added); *Heller Ehrman LLP v. Davis, Wright, Tremaine, LLP*, 2014 WL 2609743, at *4 (N.D. Cal. June 11, 2014) (relying upon RUPA § 404(b)(3) and the official comments thereto in finding that nothing within the RUPA gives a dissolved firm the right to demand an accounting for profits earned by a former partner under a new retainer agreement with a client).

[135] RUPA § 401(h) (emphasis added).

[136] *Heller Ehrman LLP v. Jones Day (In re Heller Ehrman LLP)*, Adv. No. 10-3221DM, 2014 WL 323068, at *6 (Bankr. N.D. Cal. Jan. 28, 2014) (emphasis added) [hereinafter referred to as "**Heller III**"].

[137] *See id.* at *7.

4. Avoidability of Transfers Effectuated by Jewell Waivers; Exposure of Subsequent Transferee Firms

Starting with the premise from above that a Jewel Waiver may be valid under applicable law, the next question to consider is whether such a waiver may be avoided as a fraudulent transfer.

The first step in answering this question is to determine whether a Jewel Waiver effectuates a "transfer" at all. Under both the UFTA and the Bankruptcy Code, the term "transfer" includes every mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with property or an interest in property.[138] And while it may seem odd for a "waiver" to be considered a transfer, if the waiver affects an interest in property, then it may qualify as a transfer under both the UFTA and Bankruptcy Code.[139] Thus, in the context of a Jewel Waiver, the *Brobeck* court explained:

> Undisputedly, Brobeck (through the execution of the Jewel Waiver by its partners), waived its interest in its Unfinished Business profits, thereby changing its rights with respect to those profits. The Jewel Waiver legitimately and effectively gave what was otherwise property of Brobeck to the Brobeck partners.[140]

Thus, with the initial question answered, the next question to consider is from whom the unfinished business transferred pursuant to a Jewel Waiver or, as most trustees have pled the claim, the value of such transfer – being the profits realized on the unfinished business – may be recovered. Under Section 550 of the Bankruptcy Code, for example, recovery may be sought from both the initial transferee[141] or any immediate or mediate transferee of such initial transferee.[142] In the latter case, however, the trustee may not recover from such subsequent transferee if the subsequent transferee took the interest in property for value in good faith, and without knowledge of the voidability of the transfer.[143]

With the foregoing in mind, a former partner/shareholder who takes an engagement that was pending at the time of the former firm's dissolution would seem to be a natural target, as the

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[138] *See* UFTA § 1(12); 11 U.S.C. § 101(54)(D).

[139] *See, e.g., Kapila v. United States (In re Taylor)*, 386 B.R. 361, 369 (Bankr. S.D. Fla.) (debtor's waiver of NOL carryback constitutes a transfer), *aff'd*, 402 B.R. 56 (S.D. Fla. 2008); *see also Towers v. United States (In re Feiler)*, 218 B.R. 957 (Bankr. N.D. Cal. 1998) (hallmark of a "transfer" is a change in the rights of the transferor with respect to the property after the transaction), *aff'd*, 230 B.R. 164 (B.A.P. 9th Cir. 1999), *aff'd*, 218 F.3d 948 (9th Cir. 2000).

[140] *Brobeck*, 408 B.R. at 338; *see also Heller I*, 2011 WL 1539796, at *4-5 (while waiver included in debtor's pre-petition plan of dissolution did not specifically refer to "unfinished business," it waived the debtor's right to profits from unfinished business and, thus, effectuated a transfer of the debtor's property).

[141] 11 U.S.C. § 550(a)(1).

[142] *Id.* § 550(a)(2).

[143] *See id.* § 550(b)(1); *see also* UFTA § 8(b)(2) (providing protection to a subsequent good faith transferee who took for value).

initial transferee of such unfinished business. However, it is the former partner's/shareholder's *new firm* who typically enters into an agreement with the client to complete the engagement and who receives the fees in relation thereto. Thus, it is likewise these *new firms*, as the subsequent transferees of the former partner/shareholder, who often find themselves in the crosshairs of fraudulent transfer litigation.[144] As explained by one court:

> [The Defendant law firms] were not the initial transferees of the benefits of the Jewel Waiver – the Shareholders were. Moreover, the Jewel Waiver was executed for the benefit of the Shareholders. The Defendants were at most subsequent transferees of the benefits of the Jewel Waiver. Certainly, Defendants benefited from the waiver, but that benefit was secondary to that received by the Shareholders.[145]

As indicated above, however, a trustee may not recover from a subsequent transferee if the subsequent transferee can successfully establish that it took the transfer for value in good faith, and without knowledge of the voidability of the transfer.[146] But each of the prongs of this defense can be quite daunting to establish.

First, in the case of value, the bar would appear to be pretty low, in that "[t]he 'value' required to be paid by the subsequent transferee is merely consideration sufficient to support a simple contract....There is no requirement [of] ... a reasonable or fair equivalent."[147] But key to the analysis is whether the new firm gave any value *to the former firm*. For example, the new firm's compensation of, and provision of benefits to, a former partner/shareholder, or any other personnel of the dissolved firm for that matter, does not constitute such value.[148] Moreover, the new firm's agreement to perform services for the client that the dissolved firm can no longer perform does not constitute value given in exchange for the business because, with the Jewel Waiver avoided, the former partner/shareholder was already obligated to perform those

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[144] *See, e.g., Heller II*, 2013 WL 951706, at *5 ("The critical transfer ... is that which occurs when the [former partner/shareholder], having been the immediate transferee of the Jewel Waiver, joins the Defendant law firm and brings along the unfinished business free of the duty to account").

[145] *Id.* at *12.

[146] *See* 11 U.S.C. § 550(b)(1).

[147] *Heller II*, 2013 WL 951706, at *13 (quoting *Enron Corp. v. Avenue Special Situations Fund II, LP (In re Enron Corp.)*, 333 B.R. 205, 236 (S.D.N.Y. 2005)).

[148] *See id.* (agreeing to provide benefits to a former partner/shareholder and any other former personnel of the dissolved firm does not constitute value because they would have been provided such benefits irrespective of the Jewel Waiver).

services.[149] Instead, there must have been some independent value given to the dissolved firm in order for the defense to apply.[150]

Second, in the case of the good faith/without knowledge prong, often the new firm will already have knowledge of the former firm's demise if widely reported in the press. And even if not widely reported, as part of the lateral interview process the new firm is likely to have learned something about the former firm's dissolution or financial challenges, putting it on inquiry notice in relation to any business that the lateral candidate is promising to bring with him or her.[151] Indeed, paradoxically, in the process of agreeing to provide something of value to the dissolved firm, the new firm would almost undoubtedly obtain knowledge of the dissolved firm's financial condition.

Finally, courts have also considered the level of damages recoverable from the successful prosecution of a Jewel Waiver fraudulent transfer claim. In this regard, as a general proposition, the measure of damages awardable in a fraudulent transfer case is the measure that would "restore the estate to the financial condition it would have enjoyed if the transfer had not occurred."[152] Thus, in the context of avoidance of a Jewel Waiver, the "only way to determine the value of the fraudulently transferred rights [to the unfinished business of the dissolved firm] is to determine the amount of [the] net profits [realized from the unfinished business]."[153] This, in turn, draws into the analysis many of the same highly contested issues about allocable overhead and former partner/shareholder compensation (in RUPA jurisdictions) discussed above.[154]

5. The Modern Trend: Unfinished Business Doctrine Nearly Finished

More recent opinions have been largely unfriendly to the Unfinished Business Doctrine, at least as applied to hourly fee matters. Not only has the doctrine, in such context, been rejected under New York law, it has recently been substantially limited in application under California law. That said, at least for the moment, it continues to retain viability under the laws of the

[149] *See id.* at *7 (provision of services that the dissolved firm can no longer provide did not constitute value because former partners/shareholders are already obligated to perform such services in connection with the wind-up of the dissolved firm's business); *see also Coudert*, 480 B.R. at 156 (while a former partner of a firm generally does not owe any continuing fiduciary duties to his or her former partners or the firm, an exception exists in the case of disassociation upon dissolution of the firm, in that all existing partners of a firm at the time of the firm's dissolution have a continuing duty to each other and the firm in relation to the wind-up of the firm's affairs, including the wind-up of unfinished business).

[150] *See, e.g., Heller II*, 2013 WL 951706, at *7-9 (suggesting that a new firm's agreement with the dissolved firm to take certain actions enabling the dissolved firm to minimize its liabilities, such as an agreement to hire certain personnel to minimize the dissolved firm's WARN Act liability, may suffice).

[151] *See, e.g., id.* at *15; *see also American Housing Found.*, 2011 WL 4625349, at *23 (explaining that "good faith" is to evaluated using "an objective standard, examining what the defendant, as a reasonably prudent person, should have known instead of what they actual knew relating to the fraudulent transaction").

[152] *Heller III*, 2014 WL 323068, at *3 (quoting *USAA Fed. Savings Bank v. Thack (In re Taylor)*, 599 F.3d 880, 890 (9th Cir. 2010)).

[153] *Id.*

[154] See discussion in IV(C)(3) above.

District of Columbia, and in most other jurisdictions the doctrine has yet to be directly tested. Even so, clearly the momentum has shifted towards universal rejection of the doctrine.

The first significant blow to the doctrine came in 2012 from a New York federal district court in connection with the bankruptcy case of Thelen LLP. In *Geron v. Robinson & Cole LLP*,[155] the District Court for the Southern District of New York, applying New York law, was asked to consider the doctrine's applicability to hourly fee matters that were pending at the time of Thelen's dissolution. Acknowledging that the New York Court of Appeals had yet to definitively address the issue, the court concluded that the New York Court of Appeals would reject the doctrine as to hourly fee matters for multiple reasons. First, unlike in the contingency fee context, the court reasoned that application of the doctrine to hourly fee matters would result in an unjust windfall to the dissolved partnership estate, inasmuch as it would shift compensation away from the attorneys who actually perform the work to the dissolved partnership that did not.[156] Second, the court believed that the treatment of a pending hourly fee matter as an interest in property could create absurd results in the context of bankruptcy. For example, arguably it would enable a trustee to sell the interest under section 363 of the Bankruptcy Code. And, while clients have the right to the counsel of their own choosing, arguably the validity of a client's discharge of a bankrupt firm might be called into question under the automatic stay provisions of section 362 of the Bankruptcy Code.[157] Taken in combination, the court reasoned that application of the doctrine to hourly fee matters would conflict with New York's strong public policy in favor of client autonomy[158] and attorney mobility[159] and clash with New York's rules of professional conduct governing fee-splitting.[160] Thus, the court concluded that a dissolved law firm's pending hourly fee matters do not constitute partnership assets under New York law.[161]

Interestingly, just a few months prior to issuance of the *Geron* opinion, another judge of the District Court for the Southern District of New York had ruled in the complete opposite direction in connection with the *Coudert* bankruptcy case, determining that *all* client matters pending on the date of the firm's dissolution constituted assets of the firm regardless of how the firm was to be compensated.[162] Ultimately, both the *Geron* ruling and the *Coudert* ruling were further appealed to the Second Circuit. Having the ability to certify questions of unresolved New

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[155] 476 B.R. 732 (S.D.N.Y. 2012), *aff'd*, 762 F.3d 157 (2nd Cir. 2014).

[156] *See id.* at 740-41.

[157] *See id.* at 741.

[158] *See id.* at 741-43 (reasoning that a "pending client matter is not an ordinary article of commerce," and that the recognition of an hourly fee matter post-dissolution would infringe upon a client's right to terminate an attorney at will).

[159] *See id.* at 745 (distinguishing the *Jewel* line of cases on the basis of New York's stronger commitment to attorney mobility than California).

[160] *See id.* at 740.

[161] *Id.* at 743.

[162] *See Coudert*, 480 B.R. at 159.

York law to the New York Court of Appeals, the Second Circuit decided to seek the guidance of the New York Court of Appeals on the matter.[163]

This led to the second significant blow to the doctrine's viability when, on July 1, 2014, the New York Court of Appeals responded to the certified questions presented by the Second Circuit to it.[164] First, the court clarified that partnership laws (such as the UPA) do not define property. Instead, the nature and scope of property interests are to be determined under other applicable state law, with the partnership laws merely supplying default rules for how partnership property, as determined by such other applicable law, is to be divided upon dissolution.[165] Next, focusing on property law, the court explained that the mere "expectation" of future business is too speculative to constitute a cognizable interest in property:

> *[E]xpectation of any continued or future business is too contingent in nature and speculative to create a present or future property interest.* Although property is often described as a 'bundle of rights,' or 'sticks,' with relational aspects … *the ability to terminate the relationship at any time without penalty [ ] cannot support a finding that a transferrable property right existed.*[166]

With this principle in mind, the court then considered the nature of an hourly fee engagement. In this regard, the court explained that under New York law clients have always maintained the unqualified right to terminate the attorney-client relationship at any time without any obligation, save and except the obligation to compensate the terminated attorney for the fair and reasonable value of the services "completed."[167] Thus, based upon both sets of principles, the court ruled that "no law firm has a property interest in future hourly legal fees because they are 'too contingent in nature and speculative to create a present or future property interest' given the client's unfettered right to hire and fire counsel."[168]

The court further concluded that its ruling was supported by public policy. Specifically, the court found the following public policy considerations to be pivotal:

(a) The treatment of hourly fee matters as partnership property would result in the type of "unjust windfall" to the dissolved firm described in *Geron*;[169]

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[163] *Geron v. Seyfarth Shaw LLP (In re Thelen LLP)*, 736 F.3d 213 (2nd Cir. 2013), *conformed after certified questions answered*, 762 F.3d 157 (2nd Cir. 2014).

[164] *Geron v. Seyfarth Shaw LLP (In re Thelen LLP)*, --- N.E.3d ---, 2014 WL 2931526 (N.Y. Jul. 1, 2014) (emphasis in original) [hereinafter referred to as "**Thelen**"].

[165] *See id.* at *4.

[166] *Id.* at *4-5 (emphasis in original) (quoting *Verizon New England, Inc. v. Transcom Enhanced Servs., Inc.*, 21 N.Y.3d 66, 72, 990 N.E.2d 121 (N.Y. 2013)).

[167] *Id.* at *5 (further explaining that, even in the context of contingency fee engagements, the only thing that a terminated lawyer is entitled to receive is compensation for the value of the contingency interest as of the date of termination).

[168] *Id.*

[169] *See id.* at *7.

(b) Application of the Unfinished Business Doctrine to only those partners who are present at the time of dissolution (as opposed to partners who had departed prior to dissolution who ostensibly had no continuing fiduciary duties to the partnership or other partners under the UPA) "would encourage partners to get out the door, with clients in tow, before it is too late, rather than remain and work to bolster the firm's prospects" – a "run-on-the-bank mentality [that] makes the turnaround of a struggling firm less likely;"[170]

(c) Partners who remain until the time of dissolution may have to advise their clients that they can no longer afford to represent them, thus creating a practical restriction on a client's right to choose counsel;[171]

(d) Partners who remain until the time of dissolution may have difficulty securing a position with a new firm, thus creating a practical restriction in attorney mobility;[172] and

(e) For those partners who successfully land a position at a new firm with pending matters in tow, clients may have concern that their hourly fee matters will not obtain the level of attention that they would otherwise obtain in the absence of application of the Unfinished Business Doctrine.[173]

Based upon the New York Court of Appeals' ruling, the Second Circuit affirmed the ruling in *Geron*[174] and reversed the ruling in *Coudert.*[175]

The third blow to the doctrine came in June 2014 when the District Court for the Northern District of California, upon *de novo* review of rulings entered in several *Heller* bankruptcy adversary proceedings, considered the doctrine's continuing viability to hourly fee matters under California law.[176] In this regard, initially the court found the circumstances involved in the Heller adversary proceedings to be distinguishable from the circumstances that were involved in the *Jewel* case. Among the differences noted by the court were the following:[177]

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[170] *Id.*

[171] *See id.* at *8 ("Clients are not merchandise. Lawyers are not tradesman. They have nothing to sell but personal service. An attempt, therefore, to barter in clients, would appear to be inconsistent with the best concepts of [lawyers'] professional status") (quoting a 1943 opinion of the New York County Lawyers' Association).

[172] *See id.*

[173] *Id.*

[174] *Geron v. Seyfarth Shaw LLP (In re Thelen LLP)*, 762 F.3d 157 (2nd Cir. 2014).

[175] *Development Specialists, Inc. v. Akin Gump Strauss Hauer & Feld LLP (In re Coudert Bros. LLP)*, 574 Fed. Appx. 15 (2nd Cir. 2014) (remanding, however, for further consideration of other potential claims that had been dismissed as "duplicative and unnecessary" of the unfinished business claims).

[176] *See Heller Ehrman LLP v. Davis, Wright, Tremaine, LLP*, 2014 WL 2609743 (N.D. Cal. June 11, 2014) [hereinafter referred to as "**Heller IV**"].

[177] *See id.* at *4.

Jewel	Heller
Voluntary dissolution of firm by partners	Dissolution effectively forced by firm's creditors
Partners could have, but chose not to, finish representing clients as or on behalf of the dissolved firm.	Heller lacked the financial ability to continue to provide legal services, leaving clients with no choice but to seek new counsel and shareholders with no choice but to seek new employment.
Clients represented at new firms under fee agreements that had been entered into with the dissolved firm.	Clients signed new retainer agreements with new firms.
New firms comprised entirely of partners from the dissolved firm.	New firm was pre-existing third-party firm that provided services well beyond the capacity of the dissolved firm and its former shareholders.
Former partner defendants continued to owe fiduciary duties to the other former partners and the dissolved firm.	New firms never owed any duties to the dissolved firm.
Decided under UPA	RUPA applicable, which permits competition and provides for "reasonable competition" of former partners who wind-up partnership business.

Moreover, the court noted that *Jewel* was an intermediate-level appellate decision, and that the California Supreme Court had yet to definitively address the viability of the doctrine. Turning to the merits, the court explained that, inasmuch as a law firm never owns its client matters – rather, the clients own such matters – at best a law firm has only an "expectation" of future business.[178] And in relation to such expectation, even if considered to be part of a firm's "good will," any interest in property represented by such "good will" disappears as soon as either (a) the client removes the business, which it can do at will, or (b) the law firm ceases to be able to perform the work that would generate any such "expected" future profits.[179] Thus, based upon the foregoing, the court ruled that where a law firm has been dissolved by virtue of creditors terminating their financial support, thus rendering it impossible to continue to provide legal services in ongoing matters, "neither law, equity, nor policy recognizes a law firm's property interest in hourly fee matters."[180]

Notwithstanding the strong language and reasoning of these opinions, they only addressed the state of play under New York law and California law. Indeed, in the *Howrey* bankruptcy case, the Bankruptcy Court for the Northern District of California recently distinguished the litigation pending before it from the *Thelen* and *Heller IV* opinions on that very basis, finding its unfinished business issues to be governed by DC law.[181] Upon consideration of

[178] *See id.* at *5.

[179] *See id.* at *6.

[180] *Id.* at *1.

[181] *See Diamond v. Jones Day LLP (In re Howrey LLP)*, Adv. No. 13-3093 DM, 2014 WL 4435982, at *2-3 (Bankr. N.D. Cal. Sept. 9, 2014).

DC law, the court ruled that not only have DC courts found the Unfinished Business Doctrine to be applicable to both contingency and hourly fee engagements, they have rejected the type of policy arguments discussed in *Heller IV*.[182] Thus, at least for those law firms that are governed by DC law, the Unfinished Business Doctrine continues to remain viable.

As a side note, the *Howrey* court also considered the viability of a fraudulent transfer claim relating to unfinished business taken by a former partner who has departed prior to execution of the Jewel Waiver. In this regard, among the claims pursued by the Howrey trustee were fraudulent transfer claims against firms who had obtained Howrey unfinished business from partners who left Howrey before execution of the Jewel Waiver. While finding such claims to be non-actionable, inasmuch as the transfer effectuated by the Jewel Waiver did not apply such partners,[183] the court nevertheless allowed the trustee to proceed on the alternative theory of unjust enrichment.[184] In this regard, the court reasoned that because the former partners who left Howrey pre-dissolution had abrogated their responsibilities under DC law to account for profits realized on business arising before the partners' disassociation, and because the new firms did not have any greater legal or equitable claim to the profits the pre-dissolution partners brought with them, then the new firms may have been unjustly enriched by their receipt and retention of such profits.[185] According to the court, the questions to be considered upon further factual development are (a) whether and to what extent it would be "just" or "unjust" for the new firms to retain the profits, and (b) whether the recovery of profits should be limited to profits attributed to the departing partners or to all profits realized from the unfinished business.[186] Stay tuned…

V. Executing the Early Turnaround to Avoid Such Grief

Given the magnitude of the grief and distraction that partners/shareholders are likely to experience in the event of a complete firm meltdown, the best way to avoid such grief and distraction is to effect an early turnaround of the firm. But clearly ready-to-wear, one-size-fits-all blueprints for effective law firm turnarounds do not exist. Each unhappy law firm is unhappy in its own way. The proper plan for each firm must take into account subjective, firm-specific issues. Careful consideration must be paid to the clients, lawyers, and markets at hand. However, at least one universal maxim for effective turnarounds does exist—hope is not a plan.

To be successful, not only must the firm's management be committed to proactively addressing the firm's difficulties before matters spiral out of control, but they must also have the proverbial gastric fortitude to implement the tough changes dictated by the turnaround plan. To be sure, turnaround plans should be capable of evolving to take advantage of changing circumstances. But simply continuing with the status quo and conducting business as usual is not a good option for law firms in decline. Action must be taken. The remainder of this paper hopefully provides a general plan-of-action for developing an effective blueprint for rehabilitating a struggling law firm. As with most challenges in life, understanding the "Five

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[182] *See id.*

[183] *See id.* at *3.

[184] *See id.* at *4-6.

[185] *See id.* at *5-6.

[186] *See id.*

Ws" is essential—a turnaround plan must address *why* the plan is needed and *what* is needed; the *when* and *where* (how) the plan will be implemented; and *who* will do all of this.

A. Determination of the Problems, Their Actual and Perceived Magnitude, and Viable Solutions

The first thing for the turnaround team to accomplish is the identification of problems affecting the firm's performance and long-term financial viability. Thus, the process begins with a broad soul-searching aimed at answering the questions of why a plan is needed and what changes should be made. Developing a plan to address the problems of a law firm requires accurate recognition of those problems both in reality and as perceived by key constituents. While "money" tends to be an over-arching driver, revenues alone are not necessarily the end-all and be-all of a looming crisis. Conflicts over values—such as personal preferences for stability versus opportunity, equality versus incentive, tradition versus innovation, and sacrifice versus salary—are often the true sources of law firm troubles.

Mismatches between expectations and reality, or between perception and reality, often fuel these conflicts. After all, one would not expect trouble in a firm where every lawyer knows his or her true financial value and both expects and receives fair compensation based on that true value. For true long-term stability, a firm must address and fix unrealistic or mismatched expectations because no increase in revenue will ever be sufficient to satisfy attorneys who expect to consume more than they produce. This applies from rainmakers on down the line.

Along with achieving a sustainable culture based on shared values—no easy task—most firms have room for improvement in terms of maximizing revenue and business development opportunities. Identifying these problems and their solutions often begins with a post-mortem or de-briefing. Every failure, such a departing client, departing partner, or unsuccessful pitch, should be examined to identify mistakes or room for improvement. Lessons from successful pitches and satisfied clients can be equally important. Objective assessment from uninvolved members and even from opposing counsel and their clients can be invaluable. Situation-specific problems and solutions related to issues such as pricing, staffing, experience, quality of representation, or communication should be identified.

This information should be collected systemically across the firm to avoid relying on anecdotal evidence for long-term decisions—for instance, the loss of one pitch due to issues with rates, office location, or conflicts must be weighed against other situations in which those factors did not impair an opportunity. A noisy, dissatisfied partner with one good anecdote should not be permitted to foist ill-advised change upon a satisfied but silent majority. On the other hand, the silent majority should not be permitted to drive the firm down the path to failure through complacency, waiving the status quo banner based on historical success alone. These issues must be evaluated in a rational, fact-based manner.

Accurately gauging the perceived magnitude of problems and the impact of potential solutions is also critical because perception is almost as important as objective reality. Most firms purport to operate in a democratic fashion. Thus, the electorate must be well-informed and heeded. And, even questionable perceptions likely have some validity, particularly where the data intended to discredit such perceptions is, itself, subject to reasonable dispute or different

interpretations. Identifying objective truth based on the shadows on the cave walls has always been tricky. Valid or not, perceptions among law firm members must be addressed. A turnaround plan that will not have requisite support is a non-starter. A turnaround plan that addresses the concerns of constituents to their reasonable satisfaction is far more likely to succeed, even if some of the changes to be implemented are relatively ineffective compromises designed to garner broader support.

Gaining a sustainable consensus requires effectively listening to and communicating with constituents. Information must be shared on a reciprocal basis—people should be free to honestly discuss their views and disagreements, and the assessment of issues should be addressed directly with solid data. This information should be empirical and objective to the greatest possible extent. Differing perceptions should be acknowledged, understood, addressed, and potentially even accepted. Priorities must be set. Compromise will be necessary. Constituents should be reminded that the collective first-rate intelligence of a law firm can hold two opposing ideas at the same time and still retain the ability to function. This maxim tends to only break down where there are truly irreconcilable cultural values at stake.

B. Development of an Achievable Plan to Address the Problems

Along with identifying and prioritizing problems that must be addressed based on the actual and perceived magnitude of those problems, a law firm must also develop a plan for solving those problems. This second aspect—the *when* and *where* (*i.e.* the how) side of a plan—is almost as important as the *why* and *what* part of the discussion, especially since things tend to fall apart during the conversion of ideas into reality. All of the discussion above emphasizing the need for transparent, open, and reciprocal communication about the nature of the problems equally applies to the solutions to these problems. Implementation of a turnaround plan must have constituent support.

The best turnaround plans prioritize problems to be addressed and the solutions to those problems. Problems and solutions should be triaged into short-, medium-, and long-term priorities. This achieves balance by preventing quick and easy but relatively minor improvements from being missed while also keeping focus on the long-term, overarching goals of the turnaround campaign. In the case of overcapacity, for example, a smaller and simpler goal may be to broadly educate members of the firm about individual and section capabilities and foster a certain number of cross-selling opportunities to introduce existing clients to other attorneys and practice groups within a finite period of time, a relatively painless and achievable short-term objective. Yet, an easy preliminary step like this will rarely be sufficient. Thus, short-term, easily-achievable goals must be complemented by higher long-term expectations as well.

For instance, while a short-term goal of increasing profitability may be to reduce the level of overhead per attorney by some fraction within one year, longer-term objectives may require a right-sizing of salaries and leasehold space. Or perhaps the maintenance of an historically high revenue producing client has forced the firm to reconfigure the engagement to an alternative lower revenue producing flat monthly fee arrangement that is unprofitable to the firm. Step one, in such scenario, may be to re-evaluate the manner in which such matters are being staffed to eliminate inefficiency. Step two may be reconfigure the cost structure associated with the

practice, such as by making adjustments to compensation. Should that fail to suffice, the final objective may be to consider phasing out the client or practice area. Ultimately, firms must establish measurable objectives to evaluate progress, and must correspondingly establish defined time lines for achieving those objectives.

While turnaround plans should have concrete goals to measure progress, flexibility does not necessarily need to be sacrificed—metrics can be varied or flexible. However, a lack of schedules and goals leads to a lack of urgency or even a lack of implementation. As many of us know, deadlines and other specific goals provide significant assistance in achieving objectives.[187]

C. Identification of the Critical Keepers and Solicitation of Buy-In and Commitment

The "who" of any turnaround plan is especially critical. Responsibility for achieving goals must be allocated for those goals to be achieved. A plan formed in a vacuum, without adequate support and input, is doomed to fail. However, a piecemeal plan formed by a committee of the whole, without any coherent vision or guidance, may be unlikely to effectuate meaningful change. More importantly, in all but the smallest firms, reaching agreement on a turnaround plan by broad referendum will likely take far too long for that option to be feasible.

As any politicians worth their salt know, key constituents should be canvassed at the beginning of any campaign. Without support from crucial colleagues, turnaround plans may be dead-on-arrival or even backfire by causing defections among key partners who feel left out. On the other hand, the success of the plan may depend on the support and cooperation of these key personnel. This support may come at a cost, and adequately gauging and weighing those costs is critical to success. Adequate incentives should be provided to persuade the personnel needed for a plan's success to "buy in" to that plan. And, if it becomes apparent that certain key personnel cannot be reasonably appeased, then the plan must be designed to succeed without them.

Thus, while the need for building a broad consensus and having adequate, open, and broad communication with all constituents is crucial for a turnaround plan, the process of gathering that support must begin somewhere, and should start with the people whose support matters the most. The fact of life is that some law firm partners are more "equal" than others. While accepting or addressing this imbalance may be a necessary long-term goal for law firm turnaround, in the short-term this reality cannot be ignored or denied, and planning a law firm turnaround must begin with the key constituents needed to effectuate such a turnaround.

One important point here is that clients should also be considered in the "who" phase of turnaround plan development, as with the why, what, when, where, and how phases. The attorneys who are key to the firm's relationship with its clients will likely know what their clients want, but that should not be presumed. Critical keepers should consult with their critical clients. This both optimizes the plan itself and reassures the clients that their interests are being considered and that they will benefit from the changes.

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[187] *See, e.g.*, Phyllis Korkki, *Need Motivation? Declare a Deadline*, NEW YORK TIMES (April 20, 2013), www.nytimes.com/2013/04/21/jobs/deadline-pressure-the-great-motivator.html ("This column — inferior though it is to what I had imagined — is done, and it's done because I had a deadline.").

D. Messaging to the Masses

Unfortunately there may be a narrow window between reaching out to key constituents to form a plan and then successfully communicating with the broader base of support needed for the plan's ultimate success. Law firm members may pass along information to their friends, or simply gossip. Leadership should presume that the rumor-mill will start immediately and that leaks will be unavoidable.

Transparency and open two-way communication are the best antidote for rumor and gossip. Firm management should disclose strategic planning efforts. This planning effort need not be cast in a negative light even if it is motivated by disappointing performance. Effective organizations have strategic plans that are being constantly improved, and morale should be improved by knowing that something is being done to protect the collective good of the firm.

Many plans, when finalized, will have bad news for law firm personnel. Ideally, pre-destined layoffs and salary cuts may, at least in part, be replaced with defined, achievable objectives under the plan against which future performance can be evaluated to determine who will be affected. This reduces the need for secrecy and helps preserve morale by providing everyone with the opportunity to succeed.

However, if a plan must include layoffs, salary cuts, or other adverse actions on day one, then the bad news should be delivered as soon as possible after the decision is made. Rumors about who will be fired are very damaging to morale, and firms should do their best to give affected employees the earliest possible warning once a decisions is made. In this day and age, the labor market for legal industry employees is tough, and firms should attempt to avoid the perception of being "heartless" by laying employees off without giving reasonably advanced notice and the best possible opportunity to find a new job.

Communication about turnaround plans should also not be a one-way street. Listening to all constituents is crucial, as discussed above. Their opinions do matter, and also their opinions likely have some level of validity. While plan-building needs to start somewhere, and should start at the top, the process should not be entirely top-down. The plan should not be presented as a fait accompli. Comments should be broadly solicited and meetings and planning sessions including all constituents may be a good way to make the process as painless as possible.

Finally, as with the other phases of implementing a turnaround plan, a law firm must not exclude its clients from this process. Gossip about a major change at a firm will spread outside of the firm. Key clients of the firm who were not advised of impending changes during the early stages of turnaround planning should be contacted upon broad internal announcement of the plan and provided with reassurance and a positive message.

E. Execution

Last, but certainly not least, the turnaround plan must be executed. As in forming a plan, execution requires the support of key personnel and adequate communication. Responsibility for overseeing a plan's implementation and tracking progress toward the achievement of plan objectives should be delegated to a specific individual(s) or committee. Transparency is needed here as well. Progress updates should be circulated as broadly as possible, and constituents

should also be able to provide input on the implementation process. A turnaround is a team effort and must be both planned and accomplished as a team.

In addition, an appropriate level of flexibility must be maintained. The best laid plans of managing partners can falter if too rigidly implemented. Adjustments to certain goals or specified objectives, benchmarks or timelines may be appropriate. Additional goals may be recognized, and achieving smaller objectives may become less important if larger objectives are being satisfied. Other metrics may prove more useful for gauging performance or measuring success. As with the initial planning process, transparency and proactivity are important in modifying a plan. If certain goals are to be relaxed or changed, then those changes should be made as early as practicable, and those changes should be communicated as broadly as possible to minimize any negative perceptions of failure or favoritism or unfair treatment.

VI. Conclusion

The failure of a law firm is tragic, from the loss of jobs and looming litigation to the loss of once-shared hopes and loyalties. Each of these tragedies is caused by human decisions—how much to give, take, and leave; whether to change; and how to change. One thing is certain: for members of a faltering firm, change of some sort will be inevitable. And crisis can often breed success by impelling positive change. The current challenges facing firms do create opportunities for some. As Bob Dylan once aptly put it, "for the loser now will be later to win, for the times they are a-changin.'"