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Requiem for a Law Firm

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The financial effects of the death of a law firm on its partners

This week, as we mourn the loss of Howrey, we look at the typical death rattles of a law firm suffering a fatal condition and the individual ramifications to law firm partners upon the dissolution of a law firm. While the demise of Howrey seemed quite inevitable a year ago, it could have been and should have been avoided.

This post is sorrowfully grim reading and a précis of lessons we learned over twenty years in advising law firms and partners of law firms that have escaped implosion as well as some that have imploded, largely because of a failure of leadership and management. I would hope that a reading of this requiem will provide a mighty incentive for law firms to recognize warning bells and avoid early on implosion and dissolution. On the brighter side, we have successfully worked with law firms when the first signs of distress appeared and we succeeded in avoiding the painful consequences described below. And we have successfully charted safe passage for many partners through the minefields described below.

In recent years, we have watched the unfortunate demises of too many fine and venerable law firms, including, among others, Thacher Proffitt, Heller Ehrmann, Thelen Reid, Wolf Block and Coudert. It is not unlikely that before this year is out, others may follow.

The syndrome leading to law firm implosions are all too common. The malady begins with diminished profitability, caused by general business slowdowns, a burst economic bubble (dot.coms, S&L's, securitizations, real estate, to name just a few), and the defection of a major client or a partner who is a major producer of business. As profitability slides, partners producing significant business begin to quietly seek alternatives for themselves as their own compensation suffers. A slow trickle often escalates.

Management too often initially reacts to these phenomena by severe cost cutting including laying off partners not deemed sufficiently productive. Too often, management of failing firms do not adequately grasp the gravity of the firm's condition and address the onset of distress signs in a series of whack-a-mole activities. Managers are loathe to acknowledge the gravity of a declining situation. As the firm's condition continues to decline, partners begin to lose confidence in management. And, thus, the rush to the exit doors begin.

When the trickle of defecting partners starts to turn in to a torrent, and there are insufficient fingers to plug the holes in the dike, management then reluctantly begins pursuing a merger partner. The ability to consummate such a merger is almost nil as partners' resumes flood the streets and the blogosphere creates a cascade of rumors and innuendo, often given legitimacy by traditional media. And, when partners learn that a merger candidate is being sought, they are even more incentivized to seek personal alternatives in order to maximize their own options.

The first "code red" sirens and lights often occurs when the firm finds itself in violation of covenants with its lenders regarding items such as reduction in the number of partners or timekeepers, loss of revenue or failure to abide by a revolving credit facility's annual thirty day cleanup period. Lenders, almost always secured by an assignment of all accounts receivable, are no longer charitable in granting waivers, nor are they keen to restructure loans. Demands for personal guaranties are often made, which often hastens the retreat of partners.

The foregoing is an exceedingly brief synopsis of the course leading to an implosion. But, what are some of the consequences as the firm shutters?

Most often, law firms endeavor to dissolve through a dissolution group without judicial intervention. Some of these arrangements have worked relatively well, although for a voluntary dissolution to succeed, the dissolution committee needs to gain the confidence of the firm's creditors. Law firm landlords are most frequently the major players here. These landlords have leaned, as have law firm lenders, through too many experiences that the value of accounts receivable upon a law firm's dissolution are worth a small fraction of their sated value. Accordingly, in the absence of a compelling argument, creditors, often led by the landlords, file an involuntary petition for bankruptcy under Chapter 7 of the Bankruptcy Code. Most often, the only available response by the law firm is the filing of a voluntary petition for reorganization under Chapter 11, which inevitably leads to the appointment of a receiver, who is statutorily mandated to marshal all assets available. As discussed below, this often leads to a receiver dipping in to individual partner's pockets to pay for any shortfalls.

We have often seen potential suitors of decline to make a full acquisition and instead, cherry pick some significant number of lawyers. In many instances, these law firms are charged with either successor liability or with inducing partners to breach their fiduciary obligations to their law firms.

Salaried employees of a suddenly shuttered law firm most frequently avail themselves of claims under the WARN Act : WARN offers protection to workers, their families and communities by requiring employers to provide notice 60 days in advance of covered plant closings and covered mass layoffs. These claims are asserted against the dissolution committee, if it exists, the law firm's bankrupt estate and firms who are claimed to have successor liability.

In addition, a line of cases in California beginning with *Jewel v Boxer* state that the law "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. The fact that the client substitutes one of the former partners as attorney of record in place of the former partnership does not affect this result." In short, *Boxer* holds that fees received by a partner and his or her firm in connection with a case which was started at the now dissolved law firm belongs to the former firm. The *Boxer* case and its progeny have been heavily criticized and are not followed in many jurisdictions, but they do provide mighty weapons to a receiver or a dissolution committee.

The impact of a law firm dissolution is exceedingly financially severe to individual partners.

Virtually all law firms require partners to maintain capital accounts, which as far as partners are concerned is very real money: it is money borrowed from banks by individual partners or deductions from profit distributions. In the former instance, the debt is not discharged by the firm's dissolution or bankruptcy; in the latter, the partner paid income tax on such deductions. Most partners view their capital accounts as a retirement benefit which will be paid out as a partner withdraws or retires. Insofar as the law firm is concerned, these capital accounts are not segregated funds; they are simply accounting entries.

As the law firm goes in to dissolution mode, these capital accounts are reduced to negative numbers, often substantial six figure amounts. Upon the conclusion of the dissolution, these negative capital accounts are "zeroed out." Under applicable federal tax law, the effect of zeroing out a capital account is that the amount of the negative account is deemed to be income (actually, phantom income) and is taxable. A simple example: if at the time of the dissolution a partner’s account is deemed to be (-$100,000), that negative $100,000 is deemed taxable income. And, as an added whammy, the money actually invested in the capital account simply disappears, as far as the partner is concerned. That retirement nest egg is as good a having been invested with Bernie Madoff. It’s gone forever.

To the extent that individual partners have personal liability as a result of a personal guarantee provided to a lender or a landlord and a portion of that indebtedness is compromised or otherwise discharged in connection with the law firm’s final plan of liquidation, the forgiveness of that debt is considered income (this form of phantom income is commonly called “cancellation of debt” or “COD”) for tax purposes. For example, if an individual partner’s several personal liability on an outstanding bank loan is $100,000 and the loan is compromised at fifty cents on the dollar, the partner must recognize as *income* the $50,000 cancellation of debt and is taxed on that amount.

In addition, since partners are not salaried employees but instead receive instead profits, in the form of draws and distributions, they are subject to clawbacks for any payment they may have previously received from that point in time when the law firm is deemed insolvent, from a bankruptcy point of view. Thus, compensation received by partners during the period of insolvency (again, from a bankruptcy law point of view) are subject to being recouped by a receiver.

Breach of fiduciary duty claims are also regularly made against those in management who defect prior to dissolution, with these new partners’ law firms made co-defendants for inducing such breaches.

A particular thorny issue always arises in connection with the collection of accounts receivable. Clients often perceptively see that their outstanding obligations to a law firm in dissolution are going to be heavily discounted. Receivers often seek to impose fiduciary obligations on former partners in collecting accounts receivable and partners are simultaneously often conflicted in connection with their relationships with existing clients. Moreover, aggressive collection tactics by a receiver are often reflexively met with malpractice claims.

Other areas of potential liability arise in connection with recruiting associates to join defecting partners, defending against malpractice claims, complying with partnership agreements particularly in regard to notice of withdrawal requirements, retention of client files where the firm may have a retaining lien on account of fees owed and occasionally restrictive covenants.

Law firms and certainly partners of law firms finding themselves in these circumstances need to be guided carefully through these treacherous shoals by an independent adviser.