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Law Firm Dissolution: Coudert, Dewey and Pandora's Box

BY EDWIN B. REESER

Judge Colleen McMahon released a 54 page opinion from the New York District Court on Thursday, May 24, 2012 denying a motion to dismiss made by ten law firms, and finding that they were accountable for returning to the bankruptcy estate of defunct law firm Coudert Brothers LLP the profits earned on ''unfinished business'' brought to their respective transferee firms.[1]

The rule that was applied for accountability for profits on active cases ported by relocating partners to new law firms from a dissolved/failed law firm originated with a dispute over the dissolution of a four partner law firm in California that found its way to judicial resolution in *Jewel v. Boxer*.[2] That case was of little note, even in California, until the major law firm bankruptcy of Brobeck, Phleger & Harrison LLP in 2003. *Jewel* then came rushing to the forefront in the failures of Coudert LLP in 2006, Heller Ehrman LLP and Thelen LLP in 2008, Howrey LLP in 2011, and now Dewey & LeBoeuf LLP in 2012.

It is interesting that while the Coudert case does not involve partners departing from a healthy law firm to go to another law firm (Coudert's partners voted for a dissolution and subsequently the firm entered bankrupty), a lawyer representing one of the transferee firms expressed the opinion that they believed it is appropriate to certify for appeal Judge McMahon's decision *for its potential application to a situation involving partners departing healthy law firms*. The consequences of doing so could be akin to lighting a match to take a better look into a gas tank. Let's preview why that may be so.

If You Didn't Like *Jewel v. Boxer,* Wait Until You See *Howard v. Babcock*

There are distinctly different issues associated with the scenario of a continuing law firm, prime among them being the *per se* prohibition on non-compete restrictions against departing partners that has been followed for several decades in most states. (There are also present commonly held ethical rules that concern freedom of choice of clients to pick their lawyers, fee splitting, and unconscionable fees.) With no competition possible with a defunct former firm such as in Coudert, that potentially strong public policy argument of the per se prohibition has a less compelling force to be made. It is understandably frustrating to be deprived of a winning argument over such a little ''detail'' of fact. However, in the failed firm scenario it is the primacy of the fiduciary duty of partners to each other and the firm in dissolution/liquidation pursuant to the Uniform Partnership Act or Revised Uniform Partnership Act that prevails as most relevant. Partners must account for assets of the firm they take. Case matters, like much of the furniture and art in the conference rooms and hallways, are assets of the firm, not of the partners.

New York will deal with the issues, should they actually be raised on appeal or otherwise, under its own law and in its own way in due course, as it and every state should. And the decisions will be what they will be. But please take note, *the issues are not unique or new or of ''first impression'' in any way*. California addressed the issue of reasonable restrictions on competition by departing law firm partners almost twenty years ago in *Howard v. Babcock* . . . and not with conclusions the proponents of the ''per se'' prohibition on lawyer noncompetes would prefer.[3] California's Business & Professions Code section 16602 took precedence over Rule 1-500 of the California Rules of Professional Conduct, *and it was held that restrictive covenants are permissible among partners and law firms*. Thus the court found that lawyers were not really all that special or different from doctors, dentists, or architects. (Note that

[1] *In re Coudert Brothers LLP*, 11-cv-05994, U.S. District Court, Southern District of New York (Manhattan)(24 BBLR 755, 6/7/12).

[2] Jewel v. Boxer 156 Cal. App. 3d 171 (1984).

[3] Howard v. Babcock, 6 Cal. 4th 409, 419 (1993).

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California's Rule 1-500 was based on ABA Model Rule 5.6, adopted in many states).

''We are not persuaded that this rule was intended to or should prohibit the type of agreement that is at issue here. An agreement that assesses a reasonable cost against a partner who chooses to compete with his or her former partners does not restrict the practice of law. Rather, it attaches an economic consequence to a departing partner's unrestricted choice to pursue a particular kind of practice.'' (*Howard* at p.419)

The Rule of Reason Could Permit Reasonable Restraints on Competition in the Business of Law

Thus, in California, agreements between partners in restraint of competition that place a reasonable price on competition will be upheld. The common law ''rule of reason'' was applied to ensure that the competing former partner shall pay only fair compensation for the loss that may be sustained by the former partnership as a result of the departing attorney's competition.[4]

This is not to suggest that New York, or any other state, should or will follow the reasoning of the *Howard* decision. But there are more powerful and more numerous economic realities at work today, and not present twenty years ago when *Howard* was decided. Even then the *Howard* court noted the habits of commerce have permeated the legal profession (like attorney advertising).

Thus one should be wary that a comprehensive review that takes into consideration *current economic realities in the profession of law that has become the business of law*, could result in a fundamental reassessment of the per se prohibition against restraints on competition by departing lawyers as being outdated and in need of revision. The legal profession has witnessed stunning changes to the way the profession operates as a business since *Howard v. Babcock* was decided. Running law firms ''more like a business'' could be accepted as a foundational assumption meriting reconsideration of its unique status as a profession distinguishable from all others in per se prohibition states. It does not have to be decided that it is not a profession . . . only that it is enough of a business to turn away from the per se prohibition.

While California has a statutory codification of the ''reasonableness'' standard in non-compete restrictions pursuant to the Business & Professions Code, the statute itself is based on the common law ''rule of reason'' that is operative in virtually every state's case law, so absence of a specific statute such as California's is not an escape from potential application of this line of analysis. The *Howard* court noted that the partners of the surviving law firm remain able to preserve the stability of their law firm by making available the withdrawing partner's share of capital and accounts receivable to replace the loss of the stream of income from the clients taken by the withdrawing partner to support the partnership's debts. What could be more relevant to Dewey than the destabilization caused by partner departures in the first four months of 2012, or to Howrey in the first three months of 2011?

That train of logic is certainly going to be looked at if the matter is raised anew in New York . . . though again, it may not be embraced. Indeed, operationally in California it would still be rare today to see partnership agreements in large law firms with written noncompete restrictions on departing partners even though they are allowed, especially if the firms had offices in states other than California where the *per se* prohibition is still the rule.

In part this may be due to the fact that a departure of a partner or two from a large firm is unlikely to be ''life threatening.'' Yet recent experience with law firm collapses shows that failure transpires rapidly even in large firms, with what is characterized as a ''rush to the doors,'' where a trickle becomes a stream and then a torrent of departures over a matter of a few weeks.

In part it may be that lawyers don't like to write potentially unenforceable provisions as to some of their partners into their own partnership agreements.

In part it is because there are other restraints that are very costly, even though they are not expressly ''noncompetes.'' Let's be very clear: For quite some time we understand partners at Dewey weren't getting distributions of their capital on departure from the firm, or payment of their deferred compensation, and probably little to none of their accrued but undistributed profit shares either. Is the withholding and even forfeiture of their economic interests 'reasonable'? Does it matter if it is a characterization other than a noncompete? Is that meaningful to the affected partner? And that is true of many other law firms other than Dewey today, and for years into the past. But partners bear those costs and leave their law firms anyway, effectively ratifying the logic of the *Howard* court.

Some Immediate Consequences to the Thought Process of Law Firms

Why is this more than tangentially related to the decision by Judge McMahon on Coudert LLP only, and not just an ''academic exercise'' at this time?

Because the collapse of Dewey should have every responsible major law firm partnership in the country mobilized into thinking about and discussing what they should and should not be doing to ensure that what happened to Dewey. . . .and previously to once proud, outstanding law firms like Brobeck, Heller, Thelen, Coudert, Howrey, etc. . . .is not happening to themselves. What should they be thinking about?

The entire approach to the law firm ''free agency'' world of mergers and lateral hires should be reexamined. Pricing for talent should fall where Jewel claims may exist.

The uses of partner capital, its amounts, and the amounts and uses of debt by law firms should be completely re-evaluated. Think about it. If the firm has the assets to pay all of its creditors, surplus distributions are made to partners of the defunct law firm from 'unfinished business' as though the firm had done the work, net of expenses and liabilities. When it gets ''ugly'' is when the defunct law firm does not have the assets to pay the creditors . . . when the firm has too much debt. In a conventional general partnership every

[4] For a review of this subject in more detail, please see Ellen Pansky's article ''California Ethical Rules Governing Restriction on Law Practice'' published with the ABA: http://www.americanbar.org/content/dam/aba/migrated/cpr/pubs/pansky.authcheckdam.pdf.

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partner would be jointly and severally liable for all debts of the law firm in excess of the assets. (A great control on the use of debt!) It appears the expectation that this simple rule, applicable to all general partnerships of whatever business purpose, should conclude otherwise for lawyers through the LLP election has given rise to disappointments.

Is the Adoption of a "Jewel Waiver" a Solution?

The advisability of adoption of "Jewel Waivers" in healthy firms will be debated, but not just by the partners in the law firm. Lenders, landlords and vendors (as well as staff and attorneys other than equity partners who would have WARN Act rights and potential claims against a failed firm) will have a real interest in knowing if the law firm to which they are extending credit has adopted a Jewel Waiver, which would further limit the scope of recovery they could expect to achieve if the law firm failed. This could drive stronger demands for partner recourse liability from firms that do adopt Jewel Waivers in the commercial arrangements they negotiate. There will be no future failures to recognize the importance of this item following the track record of losses to landlords and vendors due to large law firm bankruptcies in recent years.

Has the Per Se Prohibition on Competition Really Mattered?

Putting a "reasonable price" on departing partners who take firm assets (client matters), and whether and to what extent it will be considered an impermissible restraint on their freedom of movement will probably be re-examined. When it does, it could have a significant impact on both the structure and operations on law firms for years to come.

Notwithstanding the per se rule of prohibition on noncompete provisions in law firm partnership agreements, there exists a broad array of other contractual covenants that can and often do levy a significant financial penalty to departing partners. The holy mantra of the per se prohibition against restraints on competition has been the subject of a massive "end run" by law firms for years.[5] With the sudden collapses of Howrey and Dewey, to name only the most recent two, there is pressure to supplement and enhance financial restraints to protect the firms even more. As the courts have not been impressed to date with some of the public policy and ethics rules objections thrown up to deflect the application of Jewel, the clarity of their vision upon the practical world might be expected to continue in that direction if they are asked to look inside the per se prohibition box . . . and become as influenced by *Howard v. Babcock* as they were by *Jewel v. Boxer*.

The Creditors and Landlords Are Watching

There is another issue that has had diminished significance for twenty years, but will now be reborn. One of the serious watershed events in the life of every law firm before LLP elections were available was the time for entering into a new lease of office space. When law firms were simple general partnerships it was clearly understood that every equity partner was going to be jointly and severally liable on that lease. It raised the question for every partner in the firm to "renew their marriage vows." That was tough enough for a partnership redoing its headquarters lease. But when you have a half dozen or more domestic offices the dynamics get very interesting (for that twenty lawyer office in Raleigh to sign off on the 300 lawyer office lease in Manhattan. Or the entire firm to sign off on the 20 lawyer office in Hong Kong or London at extraordinary occupancy rates . . . when that office has not returned a profit in eight years). These moments can precipitate numbers of departures, sometimes threatening the ongoing viability of the firm itself.

The advent of the LLP structure took a considerable amount of that worry away, in the minds of many partners at least, with the simple conclusion that they had no recourse liability exposure. And it may have lulled partners into less concern over the firm taking on debt because they thought they would not be personally responsible for it. It now turns out that was neither a wise nor correct conclusion, with the application of bankruptcy law in some law firm failures resulting in clawbacks of partner distributions . . . an exposure that can be multiples greater than *Jewel* clawforward claim liabilities. Nor was the impression correct that relocation to a new firm with one's clients was a completely effective means of departing a law firm that failed, as the *Jewel* "unfinished business" doctrine is proving.

With the catastrophic consequences brought to owners of major office buildings from law firm failures, including bankruptcy and foreclosure upon the buildings themselves, one should expect that future leasing to law firms may require better credit enhancement, including partner guarantees of some type, and possibly lesser tenant improvement allowances. Secured lenders will almost certainly be re-evaluating their methods of evaluating credit, its pricing, and the amounts extended . . . and it won't be more liberal.

Partners at Greater Risk Should Take Greater Involvement

The bonds of partnership may have always been a bit stronger on the "bad outcomes" side than generally perceived by partners. The need for paying attention to operations, and requiring current resolution of problems along the way is most certainly greater than previously believed. Whatever may have been thought previously, the trend should be for more partner involvement, accountability of leadership, and transparency of financial and operational condition of the law firm. Those firms that cannot or dare not adjust to this pressure because of what they may have done in the past or are doing now . . . are going to be pushed to the front of the risk of failure category as a result of the real world pressures brought to bear on all firms from the dawning realization that none of us as partners in large law firms are different than many of the partners in Coudert, Howrey and now Dewey. Except there may still be time to do something positive about it. That something positive is to make the changes in your firm that will

[5] For a summary of a few commonly applied current techniques that work as penalties in the lateral attorney market, please see "It's So Hard to Say Goodbye": http://www.jdsupra.com/post/documentViewer.aspx?fid=ca942eb2-6eab-4db2-8e56-a8f97f603ed1.

protect you and your partners. If the firm cannot or will not step up to those essential elements of increased partner involvement, accountability of leadership, and transparency of financial and operational condition of the law firm, you can get out before clawbacks and clawforwards become a very real part of your life. The new balance in partner compensation extends beyond getting ''more.'' It now includes preserving your firm so you get to keep it.

Pandora's box is on the table. You just know that somebody is going to open it.

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