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Protecting a Law Firm's Crown Jewels

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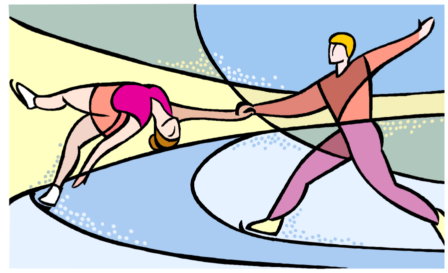
The problem with the law firm business model, we are told repeatedly, is that its principal assets, namely, its productive partners, go down the elevator every night and may not return the next day. The issue arises out of our arrival to an era of law firm partners as free agents and a lack of institutional loyalty, a subject about which there is much railing.

But, those partners who take the elevator down and out and don't return the next day are taking with them valuable assets that are the property of the law firm and which law firms as well their lenders and landlords need now consider preserving and protecting. I refer to unfinished business that law firm partners take with them to new law firms. The simple fact is that the profits derived from unfinished business of a client of law firm partnership is the partnership's asset, just as are the outstanding accounts receivable, work in process, furniture, artwork and equipment. And, I'm not just referring to law firms in dissolution. These are recoverable assets of healthy thriving law firms.

One of the results of the recent spate of law firm bankruptcies was to alert lawyers that upon the dissolution of a law firm, profits from unfinished business can be clawed back under the doctrine now known as *Jewel v Boxer*. Judge Colleen McMahon of the United States District Court for the Southern District of New York, in a much publicized well reasoned and articulate opinion in the *Coudert* case explained the basis of the unfinished business doctrine. The essence of her ruling is that "A departing partner is not free to walk out of his firm's office carrying a Jackson Pollack painting he ripped off the wall of the reception area." Profits from unfinished business are akin to the Pollack painting and departing partners are statutorily obligated to return both the painting removed from the wall and profits from unfinished business. This has been the law in New York for a century.

Under the Uniform Partnership Act, absent an agreement to the contrary, a partnership goes into dissolution upon the death or withdrawal of a partner. Thus, all modern partnership agreements typically provide for the continuation of the business of the partnership upon the death or withdrawal of a partner and these agreements go on to describe the rights, entitlements and obligations of the partnership and the partner on a going forward basis. The overwhelming majority of law firm partnership agreements are completely silent on the issue of unfinished business that follows a partner that withdraws from a law firm. But it is completely within the fabric of the partnership fiduciary relationship, as articulated in *Meinhard v Salmon*, and further expounded upon by Judge McMahon, for law firms to require departing partners to account to the partnership for profits from unfinished business *even absent a dissolution of the partnership*. Moreover, the agreement can further obligate a withdrawing partner to inform his or her new law firm that profits from unfinished business belong to his or her former law firm. Fancy that. I know this is probably a shocker to most readers, but it's clearly the law.

Intuitively, most lawyers will simply shudder when reading this. Their reaction, when I have previously spoken of this, is to instinctively say that this can't be so; it constitutes an impermissible restriction on a lawyer's ability to practice law, unbridled by covenants not to compete. The *Jewel v Boxer* line of cases, as well as the long parade of authority cited by Judge McMahon makes clear that the unfinished business doctrine does not trample on that issue, even in New York which is completely restrictive on the prohibition barring any form of covenants not to compete and certainly not in states like [California which does permit some restrictions in limited circumstances].



We certainly now know from *Coudert* and Dewey & LeBoeuf that principal assets of a law firm are unfinished business (although, in fairness, these claims were pursued in a host of other major law firm bankruptcies, with a tad less fanfare). For the first time of which I am aware, in Dewey, the firm's secured creditors have actually purported to take a security interest in the proceeds of unfinished business claims.

Thus, the question now emerges: Why shouldn't law firms include in their partnership agreements provisions requiring withdrawing partners to account to the firm for unfinished business even absent dissolution? The ancillary question is why wouldn't lenders and law firm landlords mandate such provisions as a condition of borrowing or tenancy? The short answer is that in due course, these provisions are likely to be standard fare.

Let's turn to the likely effects on lateral partner recruiting.

It is a standard practice in lateral partner recruiting for a law firm to prepare a pro forma analysis of income and expenses derived from a lateral candidate. In analyzing this pro forma, law firms make informed decisions as to the likely profitability of any candidate. With the recent unfortunate spate of law firm failures and the increased recourse to *Jewel v Boxer* recoveries, I have regularly counseled every law firm client to include in its pro forma examination a projection of any possible unfinished business remittances and to pay particular heed to this analysis when there is evidence that the candidate is from a law firm suspected to be in difficult financial circumstances. In doing so, it must be remembered that *Jewel v Boxer* remittances are only for the *profits* derived from the unfinished business. Even the former partner can bill for his time in a unique metric, as Judge McMahon noted, based not on standard hourly rates, but based on his or her "efforts, skill, and diligence." Thus, neither the former partner nor his or her new firm is forced into indentured servitude. They are simply barred from deriving a profit for any of the particular matters the new partner brings along with him or her.

This last point require some emphasis: it is only the particular discrete matters that fall into the rubric of unfinished business. As Judge McMahon said:

> "' Unfinished business" must be distinguished from "finished business" – business that has been completed prior to dissolution (the merger done and documented; the lawsuit tried to verdict or settled). If a firm has finished a piece of business but has not collected its fee, in whole or in part, the resulting receivable is, obviously, an asset of the firm. If the firm liquidates, the fee has to be collected for the benefit of the members of the firm

in liquidation. Jackson v. Hunt, Hill & Betts, 7 N.Y.2d 180, 183 (1959). 23 "New business" is an entirely new contract or engagement to do a piece of work. New business that is contracted for and undertaken only after a partnership dissolves – even business from a client of the dissolved firm – is not an asset of the dissolved firm, because a partnership has no more than an expectation of obtaining future business from a client. For that reason, the attorney who conducts the business and collects the resulting fee owes no duty to his former partners to account for any profit he may earn. Stem, 227 N.Y. at 550; see also Conolly v Thuillez, 26 A.D.3d 720, 723 (3d Dep't 2006); In re Brobeck, Phleger & Harrison LLP, 408 B.R. 318, 333 (Bnkr. N.D. Cal. 2009) (applying California law). Retainers from former clients on new matters – even matters, like appeals, that are related to finished representations – have been treated as "new" business and are not subject to the duty to account. See, e.g., Talley, 100 N.Y.S.2d at 117-18 (no duty to account for fees earned on appeals from matters originally handled as partnership business).5

Between "finished business" and "new business" lies unfinished business: executory contracts to perform services, begun but not fully performed by the partnership on the date of its dissolution. Unfinished business is presumptively treated as a partnership asset subject to distribution."

Thus, the new firm must make an informed decision as to whether it is prepared to make an investment in the new partner and his or her clients until it can start earning a profit on those

clients coming along. The cost of the investment is largely an opportunity cost; namely, the lost opportunity to bill profitable time on different clients and matters.

Will this dampen the lateral partner market? Quite likely, but, frankly, not in a material way, I suspect and certainly not long term as such contractual provisions begin to metastasize, at the instance of lenders and landlords, as well as law firm leadership, separately incentivized to dampen the enthusiasm of profitable and productive partners to seek a higher bidder. In due course, there will likely develop an open market in which firms will both be remitting and collecting unfinished business remittances. And, I am sure, the market will ultimately require law firms to simply arrive at negotiated deals early on as valuable free agents rise to their highest level and less productive partners eased out the door.

These results are all inevitable. Well informed lawyers will counsel lenders and landlords on these issues and these clients, who have bargaining leverage will require unfinished business recoveries as a staple of law firm partnership agreements. Law firms will being compelled to pay unfinished business remittances will in turn take steps to keep its assets corralled by requiring the same of its partners.

In coming months, law firm leaders will be sitting across the table from lenders and landlords requiring law firms to include unfinished recoveries in their partnership agreements. Partners will be presented with proposed amendments to their partnership agreements containing these provisions.

Now is the time to begin considering your bargaining position.

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