

## I. Law Firm Implosions Why Law Firms Implode (The Inherent Risks of Law Partnerships and the Ethical Rules That Limit Their Rescue)

### A. Characteristics of Law Firm Failures

1. Law firms don't merely go bankrupt- they implode spectacularly in a brief span of time.
2. Conventional wisdom associates business failure with diminishing profits or poor management decisions.
3. Fragility of ownership structures is a significant contributor to law firm implosions.

### B. Notable Recent Implosions

1. Dewey & LeBoeuf's failure is considered among the most notable law firm implosions. a. The firm declared bankruptcy in 2012. In its prime, it had over 1,100 lawyers across 15 countries and ranked 22nd largest globally by American Lawyer. b. At the time of filing, over 300 partners had departed, taking many of their clients to new firms.
2. Brobeck, Phleger & Harrison, based in San Francisco, filed for bankruptcy in 2003. a. The firm experienced rapid growth in the 1990s, representing well-known tech companies and startups in Silicon Valley. At its peak, the firm comprised over 1,000 lawyers. b. The firm faced major setbacks when the dot-com bubble burst, resulting in mass departure of partners and associates. c. After a failed merger with Morgan Lewis & Bockius, the firm dissolved.

### C. General Pattern of Implosion

1. Firm profits might decline, prompting management to employ strategies to raise cash to maintain high partner compensation and retain partners.
2. Despite these measures, influential partners often leave when their compensation drops, taking associates and clients along with them.
3. As partners depart, they retract their capital contributions.
4. The firm may breach a clause in its loan or lease agreements, leading partners to assume personal liability for loans.
5. Firms often attempt mergers to survive. Success means survival; failure coupled with continuing partner departures leads to collapse.

## II. Partnership Structure and Liability A. Ownership Structure of Law Firms

- A. Contrary to most businesses owned by investors, law firms are partner-owned, making them particularly susceptible to partner departures.

1. Nonlawyers may not own law firms. a. The ABA Model Rule of Professional Conduct 5.4(b) prohibits forming a partnership with a nonlawyer if any activities consist of the practice of law. b. Rule 5.4(d) also restricts practicing in a corporation or association authorized to practice law for a profit, where a nonlawyer holds any interest (Appendix A).
2. These rules aim to preserve lawyers' professional independence.

B. Rules on Lawyers' Mobility and Solicitation

1. Model Rule of Professional Conduct 5.6(a) allows a lawyer to leave her firm at any time. This rule is interpreted broadly to prevent firms from restricting lawyers' mobility between firms (Appendix B).
2. This Rule's purpose is to give clients the freedom to choose their lawyers.
3. Rule 7.3 governs solicitation, prohibiting lawyers from soliciting professional employment primarily for pecuniary gain, unless there is a family, close personal, or prior professional relationship with the client (Appendix C).

C. Partner Compensation

1. Lockstep: In this system, partner compensation is based on seniority alone. The longer a partner stays with the firm, the more they are compensated.
2. "Eat what you kill" compensation: Each partner's compensation is directly tied to the revenues they generate.

D. Partner Liability

1. Fraudulent Transfer Liability: Under the Bankruptcy Code § 548, any transfer up to two years prior to filing can be clawed back. This encourages early exit when a law firm faces trouble, as partners who exit early avoid the clawback, while those who leave later are at risk.
2. Capital Contributions and Preferential Transfers:
  - a) *A capital contribution is an asset payment a partner makes to the law firm when they become a partner.*
  - b) *A partner can withdraw their capital contribution when they leave a firm, but not if the firm files for bankruptcy. This incentivizes early departure.*
  - c) *Under 11 U.S.C. § 547, repayments during dissolution are voidable as preferential treatments if certain conditions are met.*
3. Unfinished Business Liability:
  - a) *According to Jewel v. Boxer, matters pending at the time of dissolution are considered the "unfinished business" of the partnership and are therefore a partnership asset.*

b) *Partners remaining with the firm during dissolution must share any proceeds from work performed after dissolution on matters that belonged to the firm with the firm.*

E. Partner Run: This phenomenon is typically triggered by a senior rainmaker leaving the firm, leading to a domino effect of partner departures.

### III. Solutions / More Stable Partnerships

A. A. Management Solutions:

1. Cut overall costs.
2. Discourage partner runs by amending the partnership agreement to waive liability for unfinished business claims.
3. Delay payouts of capital to departing partners.
4. Foster client loyalty to the firm over individual partners.
5. Strengthen firm culture to cultivate partner loyalty.

B. Policy Solutions:

1. To discourage partner runs, allow some restrictions on partner withdrawals, such as non-compete agreements or requirements for partners to forfeit their capital contributions upon departure.
2. Permit some investor ownership of law firms and lift the prohibition on nonlawyer ownership.

### IV. Appendix A.

- A. ABA Model Rule of Professional Conduct 5.4(d)
- B. ABA Model Rule of Professional Conduct 5.6

## Rule 5.4: Professional Independence of a Lawyer

### *Law Firms And Associations*

- (a) A lawyer or law firm shall not share legal fees with a nonlawyer, except that:
- (1) an agreement by a lawyer with the lawyer's firm, partner, or associate may provide for the payment of money, over a reasonable period of time after the lawyer's death, to the lawyer's estate or to one or more specified persons;
  - (2) a lawyer who purchases the practice of a deceased, disabled, or disappeared lawyer may, pursuant to the provisions of Rule 1.17, pay to the estate or other representative of that lawyer the agreed-upon purchase price;
  - (3) a lawyer or law firm may include nonlawyer employees in a compensation or retirement plan, even though the plan is based in whole or in part on a profit-sharing arrangement; and
  - (4) a lawyer may share court-awarded legal fees with a nonprofit organization that employed, retained or recommended employment of the lawyer in the matter.
- (b) A lawyer shall not form a partnership with a nonlawyer if any of the activities of the partnership consist of the practice of law.
- (c) A lawyer shall not permit a person who recommends, employs, or pays the lawyer to render legal services for another to direct or regulate the lawyer's professional judgment in rendering such legal services.
- (d) A lawyer shall not practice with or in the form of a professional corporation or association authorized to practice law for a profit, if:
- (1) a nonlawyer owns any interest therein, except that a fiduciary representative of the estate of a lawyer may hold the stock or interest of the lawyer for a reasonable time during administration;
  - (2) a nonlawyer is a corporate director or officer thereof or occupies the position of similar responsibility in any form of association other than a corporation ; or
  - (3) a nonlawyer has the right to direct or control the professional judgment of a lawyer.

## **Rule 5.6: Restrictions on Rights to Practice**

### ***Law Firms And Associations***

A lawyer shall not participate in offering or making:

(a) a partnership, shareholders, operating, employment, or other similar type of agreement that restricts the right of a lawyer to practice after termination of the relationship, except an agreement concerning benefits upon retirement; or

(b) an agreement in which a restriction on the lawyer's right to practice is part of the settlement of a client controversy.