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THE FINANCIAL RIGHTS OF A DEPARTING LAW PARTNER

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Introduction

We recently contributed an article to this newsletter that addressed when and how a law firm can expel a partner. Whether a partner is expelled or (as more commonly happens) withdraws from the partnership more-or-less voluntarily, the question arises, what are the departing partner's financial entitlements with respect to firm assets? We turn to that question in this article.

I. Partnership Agreements and Statutory Provisions.

The starting point for any analysis of a departing partner's financial entitlements is to ascertain whether a partnership agreement addresses the subject. To the extent that it does, it will govern.

Unfortunately, disputes among separating law partners frequently arise when no partnership agreement exists, or when the partnership agreement is silent or unclear on the financial consequences of a partner's departure. In such circumstances, courts typically turn to the Uniform Partnership Act of 1914 ("UPA") or the Revised Uniform Partnership Act of 1994 ("RUPA") for default rules to resolve such disputes. Unless otherwise indicated, the remainder of this article addresses the default framework for

ascertaining a departing partner's financial entitlements in the absence of a controlling provision in a partnership agreement.

Under the UPA, withdrawal of a partner causes the dissolution of the partnership. UPA §§29, 31. The partnership is not terminated immediately, however. It continues for the purposes of winding up business and settling accounts outstanding at the time of dissolution. U.P.A. §30; see also Hamilton Co. v. Hamilton Tire Corp., 197 N.Y.S.2d 384, 386 (Sup. Ct. 1960). The dissolution and winding up of a partnership ordinarily entails an accounting to ascertain the value of each partner's interest in the firm. UPA §22; see also Dawson v. White & Case, 672 N.E.2d 589, 592 (N.Y. 1996); Toeg v. Margolies, 113 N.Y.S.2d 373, 375 (1st Dep't 1952).

Absent any contrary agreement or practice, the core rules under the UPA for determining each partner's financial entitlements are set forth in section 18:

(1) Each partner shall be repaid his or her contributions to the partnership, whether by way of capital or advances, and shall share equally in any profits and surplus remaining after all liabilities, including those to partners, are satisfied; and each partner must contribute towards the losses, whether of capital or otherwise, sustained by the partnership according to his or her share in the profits.

(2) The partnership must indemnify every partner in respect of payments made and personal liabilities reasonably incurred by the partner in the ordinary and proper conduct of its business or for the preservation of its business or property.

(3) A partner who, in aid of the partnership, makes any payment or advance beyond the amount of capital that the partner agreed to contribute shall be paid interest from the date of the payment or advance.

The RUPA adds a wrinkle to the analysis because it provides that partnerships formed for a term can survive the departure of a partner without dissolution. RUPA §§801(1), 801(2). A survey of the case law indicates, however, that law partnerships for a term are rare and that at-will partnerships are the rule. Under the RUPA, in the at-will partnership context, the departure of a partner generally triggers dissolution of the firm, and the analysis of the departing partner's financial entitlements remains substantially the same as under the UPA, unless otherwise noted below.

II. The Firm's Fiduciary Duty To Provide An Accounting And Distribution To The Departing Partner In Good Faith.

Law partners owe one another a fiduciary duty of the utmost good faith and honesty in all matters pertaining to the partnership enterprise. See, e.g., Bohatch v. Butler & Binion, 977 S.W.2d 543, 545 (Tex. 1998); Holman v. Coie, 522 P.2d 515, 523 (Wash. Ct. App. 1974). This duty has implications for the distribution of firm assets upon a partner's departure. First, it includes an obligation on the part of the firm to provide "true and full" disclosure on demand of all matters affecting the partnership, including all information necessary to an accurate accounting of firm assets. UPA §§ 20, 21(1), 22(d); see also Peskin v. Deutsch, 479 N.E.2d 1034, 1038 (Ill. App. Ct. 1985). Second, it demands that the ultimate distribution to the departed partner must be "fair and reasonable." Starr v. Fordham, 648 N.E.2d 1261, 1265 (Mass. 1995).

When an accounting is sought by a departing partner, the burden of proof is on the remaining law partners "to show by clear, convincing, unequivocal and unmistakable evidence that [the remaining partners] had been completely frank and honest with [their] partner, had made full disclosure, and had not dealt secretly behind his back." Peskin,

479 N.E.2d at 1037 (quoting Bakalis v. Bressler, 115 N.E.2d 323 (Ill. 1953)). Further, because the remaining partners stand in a position of potential self-dealing when they determine the departed partner's distribution -- more for the departed partner means less for the remaining partners -- they bear the burden of proving that the distribution was fair and reasonable. See, e.g., Starr, 648 N.E.2d at 1265.

Courts have proven willing to enforce this high fiduciary duty when law firms deal unfairly with departing partners. For example, in Smith v. Brown & Jones, 633 N.Y.S.2d 436 (Sup. Ct. 1995), the court found that the law firm's distribution committee breached its fiduciary duty to a departing partner when it: (1) denied the departing partner a role in the determination of partners' compensation in the year he left, though he had worked eight months of the year; (2) created a new category of "firm" clients and classified the departing partner's largest client as a firm client so as to deprive him of credit for that client's fees; (3) charged the departing partner for a full year of expenses even though he left eight months into his final year with the firm; (4) refused to disclose financial information about the partnership upon request by the departing partner, which he was entitled to review; and (5) refused to attempt to settle in good faith, as was the firm's past custom and practice. See also Starr, 648 N.E.2d at 1265 (Court found that the remaining partners in the firm breached their fiduciary duty to the departing partner by allocating only 6.3% of the firm's profits for the year to him, when he produced more than 15% of total billable dollar amounts among all partners).

Finally, it should be noted that a departing partner's ability to compel an accounting has limits. To avoid undue burden and unfair prejudice to the firm, and to preserve the departing partner's own rights, the departing partner should exercise due

diligence in requesting an accounting as promptly as practicable. In Henderson v. Connolly's Estate, 292 N.W. 543 (Mich. 1940), an attorney sought an accounting against the estate of his deceased law partner. The deceased partner had spent a substantial amount of his time during the partnership working on behalf of a separate corporation as a director, and he retained his earnings from this work separately from the partnership assets. The surviving partner had gone on working in the partnership for many years, knowing of these activities, without seeking an accounting. He did not seek an accounting until approximately ten years after first learning of the outside work, and after the death of his former partner. The court held that the surviving partner's action was barred by laches because he had failed to exercise reasonable diligence. The court admonished that "equity aids the vigilant, and not those who slumber on their rights." Id. at 550 (internal quotations and citation omitted).

Courts have, however, been willing to enforce a request for an accounting by a former law partner even when it was requested long after the departure. In Aurnou v. Greenspan, 555 N.Y.S.2d 356 (1st Dep't 1990), a partner who brought an action for an accounting six years after withdrawing from a law firm in which he had thirteen years of association was entitled to what he would have received upon dissolution and winding up of the partnership at the time of his departure. The Aurnou court did note, however, that the defendants did not assert that the departed partner had abandoned his right to an accounting. Id. at 358.

III. Distribution of Assets.

When the time comes for the distribution of assets, conflicts often arise over what, exactly, gets counted as a firm asset. Such contentions have arisen regarding the proper

treatment in an accounting of (1) the firm's "good will"; (2) fees earned but not yet paid to the firm at the time of the partner's departure; (3) fees received after the partner's departure on cases that were pending when the partner left; and (4) deductions from fees for overhead expenses. These issues will be addressed in turn.

A. Law Firm Good Will.

When a law firm continues in business after a partner departs, the firm's "good will" may properly be included in the accounting to ascertain the partner's interest. See, e.g., Dawson, 672 N.E.2d at 592-93; Burns v. Burns, 643 N.E.2d 80, 82-83 (N.Y. 1994) (suggesting that a law firm's good will is included in a partner's marital estate for purposes of equitable distribution); Harmon v. Harmon, 578 N.Y.S.2d 897, 901-02 (1st Dep't. 1992) (same). When applied to law firms, the concept of good will refers to the "ability to attract clients as [a] result of [the] firm's name, location, or the reputation of its lawyers." Dawson, at 592 (citing Black's Law Dictionary 695 (6th ed.)). Nonetheless, courts will not count a law firm's good will as part of its assets when valuing a departing partner's interest where the partnership agreement provides that good will not be so counted. Id. at 593. Moreover, courts have declined to consider law firm good will in an accounting where the course of dealing between the partners reflected a tacit understanding that there would be no accounting for good will – for example, when new partners never paid for good will, departing partners never received payment for good will, and the firm's financial statement did not list good will as an asset. Id. at 593; see also Siddall v. Keating, 185 N.Y.S.2d 630 (1st Dep't 1959).

B. Outstanding Fees For Completed Work.

When a partner departs from a law firm, outstanding fees are typically due and owing to the partnership. Absent a partnership agreement to the contrary, all money owed to the law partnership for work already completed is a firm asset for purposes of an accounting and the distribution to a departing partner of his or her interest. See, e.g., Jackson v. Hunt, Hill & Betts, 164 N.E.2d 681, 685 (N.Y. 1959) (where partnership agreement provided for partner's entitlement to a share of "net profits," court construed this to include earned but as yet unpaid fees); Aurnou, 555 N.Y.S.2d at 357; Dreier v. Linden, 417 N.Y.S.2d 496, 497-98 (1st Dep't 1979).

C. Work-In-Progress When A Partner Departs.

Cases that are pending at the time of a partner's departure – and the fees they generate *after* departure – are the most frequent subject of contentious litigation between separating partners. Particularly in the context of contingency fee cases, the amount of money at stake can be substantial.

The dissolution of a partnership does *not* relieve the partnership of its obligation to perform under its outstanding contracts to represent clients. Rather, the partnership is obliged to complete representation on all pending matters as if the partnership had never dissolved. Partners who fulfill these continuing contractual obligations to clients are acting as fiduciaries for the benefit of the former partnership. See, e.g., Beckman v. Farmer, 579 A.2d 618, 636 (D.C. 1990); Ellerby v. Speizer, 485 N.E.2d 413, 416 (Ill. App. Ct. 1985); Bader v. Cox, 701 S.W.2d 677 (Tex. App. 1985); Rosenfeld, Meyer & Susman v. Cohen, 194 Cal.Rptr. 180, 189-90 (Ca. Ct. App. 1983); Resnick v. Kaplan, 434 A.2d 582, 587 (Md. Ct. Spec. App. 1981); Platt v. Henderson, 361 P.2d 73, 82 (Or. 1961).

For this reason, the vast majority of courts to address the issue have concluded that cases pending when a partner withdraws constitute “uncompleted transactions requiring winding up after dissolution.” Beckman, 579 A.2d at 636. Such cases are, therefore, partnership assets subject to accounting and post-dissolution distribution. See, e.g., Beckman, 579 A.2d at 636; Ellerby, 485 N.E.2d at 416; Jewel v. Boxer, 203 Cal.Rptr. 13, 18 (Ca. Ct. App. 1984); Rosenfeld, 194 Cal.Rptr. at 189-90; Resnick, 434 A.2d at 587; In re Lester, 403 N.Y.S.2d 33 (1st Dep’t 1978); In re Mondale & Johnson, 437 P.2d 636 (Mont. 1968); Frates v. Nichols, 167 So.2d 77, 81 (Fla. Dist. Ct. App. 1964).

1. No Compensation Rule.

One consequence of these principles is the so-called “no compensation” rule, codified in section 18(f) of the UPA. According to this rule, no partner receives compensation for time spent to complete cases that were pending at the time of dissolution. Instead, all fees earned on such cases are to be shared according to each partner’s distributional interest, regardless of which former partners (e.g., the departed partner or the other partners of the firm) work on the case or how many hours they devote to the file. See, e.g., Beckman, 579 A.2d at 640; Ellerby, 485 N.E.2d at 417; Resnick, 434 A.2d at 587; Jewel, 203 Cal.Rptr. at 17; Frates, 167 So.2d at 81. The rationale behind this apparently odd rule is that, “[o]n balance, the allocation of fees according to each partner’s interest in the former partnership should not work an undue hardship as to any partner where each partner completes work on the partnership’s cases which are active upon dissolution.” Fox v. Abrams, 210 Cal.Rptr. 260, 265 (Ca. Ct. App. 1985). While the rule may have unfair consequences when some partners do significantly more

work than others in winding up the partnership business, one court has noted that, “[i]f there is any disproportionate burden of completing unfinished business here, it results from the parties’ failure to have entered a partnership agreement which could have assured that such a result would not occur.” Jewel, 203 Cal.Rptr. at 19.

Reviewing the facts of a case helps to clarify application of the no compensation rule. In Frates, supra, the departing partner took eight pending contingency fee negligence cases from his old firm to his new practice. The departed partner completed work on these cases over the next several years, and the cases yielded contingent fees of more than \$200,000. When his former partners sought a distributional share of the fees, he contended that the partnership had dissolved upon his departure and the retainer agreements for these cases were therefore terminated. Thus, the departing partner maintained, his former partners were entitled to a share of only the fees earned on the files prior to dissolution. The court rejected the departing partner’s argument, concluding that all fees earned on the cases were assets of the firm and that the departed partner was entitled to receive only his partnership distribution. The court reasoned:

[T]he proposition is universally accepted that a law partner in dissolution owes a duty to his old firm to wind up the old firm's pending business, and that he is not entitled to any extra compensation therefor. . . . The dissolution . . . did not put an immediate end to the partnership, it continued for the purpose of winding up its affairs, and . . . [the departing partner] had a duty to wind up the affairs of the partnership We adopt the rule recognized by our sister states that the retention of a law firm obligates every member thereof to fulfilling that contract, and that upon a dissolution any of the partners is obligated to complete that obligation without extra compensation.

Frates, 167 So.2d at 80-81 (footnotes omitted).

One frequently cited case expressly rejected this rule. In Aurnou v. Greenspan, 555 N.Y.S.2d 356 (1st Dep't 1990), the partners had no distribution agreement, and the departed partner sought to recover from his former partner his distributional share of several contingency fees that were earned after his departure. The court summarily rejected this claim, holding that, "[t]here is no basis to award a withdrawing partner a share of monies earned after his withdrawal, where he has not participated in earning them by his actual service." Id. at 357. The court did permit recovery through quantum meruit for work actually performed on the file by the departed partner before he left the firm. Id. at 358.

Although, New York has adopted the UPA, Aurnou neither mentions the UPA, nor addresses how its holding can be rendered consistent with the no compensation rule of section 18(f). Aurnou has subsequently been criticized for its unexplained departure from both the UPA and the extensive authority elaborating the no compensation rule, and for increasing the potential for battles among separating partners over the most lucrative pending cases. See, e.g., Kirsch v. Leventhal, 586 N.Y.S.2d 330, 332-33 (3rd Dep't 1992).

2. Elimination Of The No Compensation Rule In The RUPA.

The no compensation rule of the UPA was extinguished in the RUPA of 1994, which provides for "reasonable compensation for services rendered in winding up the business of the partnership." RUPA § 401(h). In states that have adopted the RUPA, section 401(h) has potentially far reaching consequences for the distribution of fees during the winding up period. Notably, no published decision has construed or applied section 401(h). This is probably because half of the approximately 26 states to adopt the

RUPA did so only after January 1998, so it remains a relatively new law. Stay tuned for further developments.

3. What Constitutes Unfinished Business?

The foregoing discussion addressed fees earned on cases that were “unfinished business” of the partnership when a partner departed. The question of what constitutes unfinished business can itself be a matter of controversy and litigation.

Courts agree that this determination requires looking to the contractual relations existing on the date of dissolution of the partnership, not to changes in those contractual relations thereafter. See, e.g., Rosenfeld, 194 Cal.Rptr. at 190; Jewel, 203 Cal.Rptr. at 18. “The test of what constitutes ‘unfinished business’ of a partnership upon dissolution . . . is whether there existed, at the time of the dissolution, any contract of employment between the partnership and the clients for performance by the partnership of the services thereafter claimed to be ‘unfinished business.’” Jewel, 203 Cal.Rptr. at 18 (internal quotation and citation omitted).

This issue arises when a former partner enters into a new retainer agreement with a client on a matter that the former firm had been handling for the client. Courts have consistently rejected this tactic to transform unfinished business of the old partnership into new business of a different entity. For example, in Rosenfeld, the court held that the client's retention of two former partners of the dissolved firm to represent him on a matter that the old firm had handled did not turn the unfinished business into new business. The court stated, “It is clear that a partner completing unfinished business cannot cut off the rights of the other partners in the dissolved partnership by the tactic of entering into a

'new' contract to complete such business.” Rosenfeld, 194 Cal.Reptr. at 191. The courts in Jewel and Frates reached the same conclusion. Jewel, 203 Cal.Rptr. at 18; Frates, 167 So.2d at 80-81.

D. Overhead Expenses.

Former partners are entitled to reduce fees owed to a departing partner for reasonable overhead expenses related to producing the income in question and winding up partnership business. This rule applies both to the distribution of fees earned and owing at the time of a partner’s departure and of fees earned following departure on cases pending at the time of departure. See, e.g., Hammes, 579 N.E.2d at 1353; Ellerby, 485 N.E.2d at 417; Dreier, 417 N.Y.S.2d at 497-98.

IV. Constraints On Anti-Competitive Post Departure Financial Agreements.

As stated at the outset, a partnership agreement can set the rules to determine the division of post-withdrawal assets upon the departure of a law partner. This freedom to contract is not absolute, however, and one limitation bears mentioning. Partnership agreements that govern the financial consequences of a partner’s departure commonly provide for some fixed or formula-based payment to the departing partner, without the need for accounting and dissolution. Such provisions sometimes provide that the departed partner will forfeit some or all of the post-departure compensation if, during some specified period after departure, he or she competes with the firm or represents individuals who were clients of the firm at the time of departure. Most courts have held that, when such provisions result in a significant financial disincentive to competition, they violate the public policy that supports an attorney’s right to compete and a client’s

right to select the counsel of its choice. See, e.g., Pettingell v. Morrison, Mahoney & Miller, 687 N.E.2d 1237, 1240 (Mass. 1997); Jacob v. Norris, McLaughlin & Marcus, 607 A.2d 142, 148 (N.J. 1992); Cohen v. Lord, Day & Lord, 550 N.E.2d 410, 411-12 (N.Y. 1989). But see Howard v. Babcock, 863 P.2d 150, 159 n.8 (Cal. 1993) (suggesting that an anticompetitive agreement that would have the effect of compensating departed partners \$5.10 per hour for more than 15,000 hours billed could be enforceable).

Conclusion

The foregoing discussion illustrates the strife, uncertainty, and litigation that can arise from a partner's departure from a firm when no partnership agreement governs the financial consequences for the parties. Obviously, law firms and their partners can avoid or limit such problems by having a partnership agreement that specifically and fully sets forth the legal and financial consequences of a partner's departure.