beazley

Beazley Brief

Risk management insights for law firms from Beazley

Issue 26 – February 2012

In the May 2009 issue of the Beazley Brief, we reported on the "unprecedented levels" of layoffs that law firms had been experiencing and the large "pool of potential lateral hires" that this attrition created. Noting that lateral hiring wasn't without risk, we reported on four steps that law firms should consider taking both before and after a lateral hire to reduce their risk.

After a brief lull in lateral activity, it appears now that lateral hiring is again on the rise. The February 1, 2012 issue of *The American Lawyer* reported that "2011 was the year that partners jumped back into the lateral market with full force." The article noted a "22% increase" in lateral movement over 2010, and specifically attributed part of that increase to "the dissolution of Howrey." For destination firms, the dissolution of a lateral's former firm adds another layer of risk. Trustees and receivers of dissolving firms have recently relied on the California Court of Appeal's 1984 ruling in the *Jewel v. Boxer* case (available here) to bring claims against the firms where the lateral lawyers have taken their "unfinished business." The specter of these types of claims should be of significant concern to firms seeking to add those lawyers to their ranks.

To address this issue, we sought the insights of a lawyer with significant experience in this area. Kevin S. Rosen is a partner in the Los Angeles office of Gibson, Dunn & Crutcher LLP and chair of the firm's Legal Malpractice Defense Practice Group. Christopher Chorba is a partner in Gibson Dunn's Los Angeles office and Matthew Kahn is a senior associate in the firm's San Francisco office. Kevin, Chris and Matt have substantial experience successfully defending law firms and their partners in high-stakes litigation across the country, including defending law firms that are facing claims based on *Jewel v. Boxer*.

In the following article, Kevin and his team share their thoughts on *Jewel v. Boxer*, on how a law firm can defend against a *Jewel*-based claim, and the steps that a firm can take to try to avoid the problem altogether. We very much appreciate the efforts of Kevin, Chris and Matt and express our gratitude to them for their assistance with this issue of the Beazley Brief.

— **Brant Weidner**
Claims Manager, Lawyers' Professional Liability

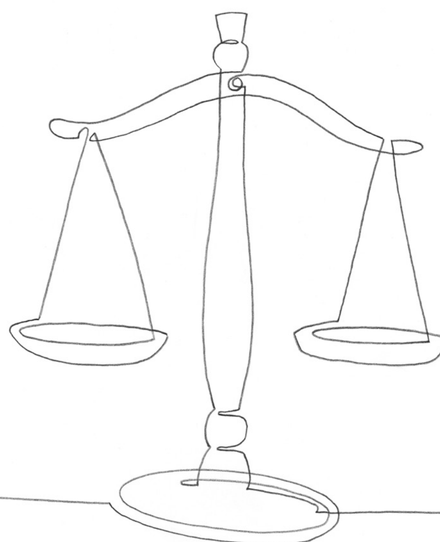
More Than Your Firm Bargained For: The "Unfinished Business" Doctrine of *Jewel v. Boxer*

*By Kevin S. Rosen, Christopher Chorba, and Matthew S. Kahn, Gibson, Dunn & Crutcher LLP**

The recent string of law firm bankruptcies has spawned a new kind of litigation, and other law firms are the target. When law firms dissolve and file for bankruptcy, their former partners sometimes carry the dissolved firms' "unfinished business"—and the profits from it—to their new firms. The trustee or debtor-in-possession of a dissolved firm often will sue to recover those departed profits. Beyond suing the former partners who have left with the unfinished business, trustees also are targeting the "destination" law firms to which the former partners have moved. Trustees have enjoyed some recent success in such litigation, thanks in large part to their reliance on the California Court of Appeal decision in *Jewel v. Boxer*, 156 Cal. App. 3d 171 (1984).

Depending on the volume of ongoing work, this development may create considerable exposure for destination law firms bringing in former partners of dissolved firms. Risk-averse law firms so far have proven largely disinclined to litigate these matters, resulting in dozens of settlements and very little case law to guide other firms' behavior. For example, Morgan Lewis & Bockius LLP agreed to pay $10.2 million to the estate of Brobeck, Phleger & Harrison LLP, and Covington & Burling LLP settled similar claims with the estate of Heller Ehrman LLP for $4 million. With the increased frequency of large law firm bankruptcies, such as that of Howrey LLP, similar litigation seems likely.

**The authors thank Gibson Dunn associate Peter Bach-y-Rita for his assistance in preparing this article.*



How can destination firms minimize exposure stemming from having taken in partners whose large books of business threaten to become large liabilities? And what can healthy firms do now to protect the mobility of their partners if the firm subsequently goes under? This article addresses these questions and others, and proposes potential measures firms can take to protect themselves and their partners.

Jewel v. Boxer

In *Jewel v. Boxer*, two former partners of a dissolved law firm brought an action for an accounting of the post-dissolution profits received by two other former partners for work done on matters that had been ongoing at the time the firm dissolved, *i.e.*, the "unfinished business" of the dissolved firm. 156 Cal. App. 3d at 174-76. The Court of Appeal held that, under California's then-effective Uniform Partnership Act ("UPA"), such profits had to be allocated among all of the former partners according to their respective rights to profits in the former partnership—regardless of which former partner actually performed the work. *Id*. at 176. In other words, when a former partner carries an ongoing matter from a dissolved firm to a new firm, under *Jewel* that new firm is not entitled to the future profits from that matter; rather, such profits must be remitted to the dissolved firm, and then allocated among the former partners.[1] The court stressed, however, that this rule is only a default one, and that law firms are free to contract around it: "*absent a contrary agreement*, income generated through winding up of unfinished business is allocated to the former partners according to their respective interests in the partnership," *id*. (emphasis added), and that "partners are free to include in a written partnership agreement provisions for completion of unfinished business that ensure a degree of exactness and certainty." *Id*. at 179-80.

While *Jewel* was limited to interpreting California law, courts in other states have adopted its reasoning and applied the same rule to dissolved law firms in those jurisdictions. *See, e.g., Hurwitz v. Padden*, 581 N.W.2d 359, 362 (Minn. Ct. App. 1998); *Gull v. Van Epps*, 185 Wis.2d 609, 624-25 (Wis. Ct. App. 1994); *Hammes v. Frank*, 579 N.E. 2d 1348, 1353 (Ind. Ct. App. 1991); *Flynn v. Cohn*, 581 N.E. 2d. 30, 32 (Ill. Ct. App. 1991); *Kirsch v. Leventhal*, 586 N.Y.S.2d 330, 332 (N.Y. App. Div. 1992).

Jewel in Bankruptcy Court: *In re Brobeck, Phleger & Harrison LLP* and *In re Heller Ehrman LLP*

Jewel was decided in 1984, but it has had perhaps its greatest impact in the past several years, as a result of developments related to the bankruptcies of several large international law firms, including Brobeck, Phleger & Harrison LLP and Heller Ehrman LLP. These firms actually heeded the Court of Appeal's suggestion and adopted a *Jewel* waiver—but not until shortly before they filed for bankruptcy. This timing ultimately would prove costly. The sagas of Brobeck's and Heller's respective bankruptcies and related litigation provide a cautionary tale for other law firms and have led to precedential developments that make defending future *Jewel* claims challenging.

Brobeck. In connection with its dissolution in February 2003, Brobeck executed a Final Partnership Agreement that added a *Jewel* waiver. After Brobeck filed for bankruptcy seven months later, the estate's trustee sought to undo that waiver, via adversary proceedings filed against many of the law firms that had hired Brobeck's former partners. The trustee alleged that Brobeck's eve-of-dissolution *Jewel* waiver amounted to a fraudulent transfer of estate assets under both the Bankruptcy Code and California law, and sought to avoid the *Jewel* waiver and recover the profits the destination law firms had earned in winding up Brobeck's unfinished business. Two firms challenged the trustee's claims in a motion for summary judgment. U.S. Bankruptcy Judge Dennis Montali denied the motion in 2009, holding that while Brobeck's *Jewel* waiver was effective as a matter of state law, it also constituted a fraudulent transfer under the Bankruptcy Code; hence the destination law firms could be liable to the estate as subsequent transferees. *In re Brobeck*, 408 B.R. at 336-47. Judge Montali later denied a motion for reconsideration, and the District Court refused to review that ruling. The federal appellate courts have not yet addressed the reasoning in Brobeck, and while the two firms that were the parties to the summary judgment ruling have settled, other adversary proceedings remain ongoing.

Heller. Recently, Judge Montali addressed the same issues in the Heller bankruptcy. Like *Brobeck*, Heller executed a *Jewel* waiver shortly before dissolving and declaring bankruptcy. Like the *Brobeck* trustee, the Heller debtor brought its own series of *Jewel* actions against approximately fifty firms that hired former Heller shareholders. In response to several defendants' motions to dismiss, Judge Montali reaffirmed his *Brobeck* reasoning, permitting the estate to seek to avoid the *Jewel* waiver and recover from the destination law firms the profits they earned in winding up Heller's unfinished business. *In re Heller*, 2011 Bankr. LEXIS 1497, at *17 (Bankr. N.D. Cal. Apr. 22, 2011). Although most of the defendants facing *Jewel* claims have settled with the Heller estate, the litigation continues against a handful of firms.

Defending *Jewel* Claims

The combination of *Jewel* and bankruptcy remedies in *Brobeck* and *Heller* exposes law firms that hire partners from dissolved firms to considerable risk, especially because other bankruptcy courts have begun to follow Judge Montali's reasoning. *See, e.g., In re Coudert Bros. LLP*, 447 B.R. 706, 713 (S.D.N.Y. 2011).

What can a law firm facing a *Jewel*-based fraudulent transfer claim do to defend itself?

Analyze Alleged "Unfinished Business." The first step that any firm must take is to determine whether the partners that joined from a dissolved firm actually brought any unfinished business with them. If not, it should be possible to quickly terminate any *Jewel* claim. If partners have brought unfinished business with them, the next question is whether the matters are contingency-fee or hourly. With respect to contingency-fee matters, the estate is likely to seek a pro rata share of the value of the ultimate settlement or recovery in the case, the estimated present value of the case at the time of the firm's dissolution, or the quantum meruit value of the services rendered by the dissolved firm prior to dissolution. However, in all cases, it appears that the destination law firm is likely to be entitled to retain a portion of the ultimate settlement or recovery attributable to its efforts, and thus the

1 While the UPA was superseded by the Revised Uniform Partnership Act ("RUPA") in 1997, courts have held *Jewel*'s reasoning applicable under the RUPA as well. *See, e.g., In re Brobeck*, 408 B.R. 318, 327 (Bankr. N.D. Cal. 2009).

prospect of turning over profits to the dissolved firm is diminished. *See, e.g., Santalucia v. Sebright Transp., Inc.*, 232 F.3d 293, 300-01 (2d Cir. 2000); *Vowell & Meelheim, P.C. v. Beddow, Erben & Bowen, P.A.*, 679 So. 2d 637, 640 (Ala. 1996). In addition, firms that hired multiple attorneys from a dissolved firm should assess whether any unfinished business that was carried over in fact was brought over by a "non-equity" or "income" partner, or an of counsel, or even an associate. These attorneys, unlike equity partners, may not have the same RUPA duties that give rise to liability under a *Jewel* theory. *See, e.g., In re LaBrum & Doak*, 227 B.R. 391, 407 (Bankr. E.D. Pa. 1998).

Policy considerations also may lead appellate courts to limit expansive application of *Jewel*. Characterizing destination law firms as "subsequent transferees" subject to liability for unfinished business profits threatens the future employment of former partners and staff of dissolved firms.

Defenses to Liability. The decision in *Brobeck* rejected many legal and policy defenses to a broad reading of *Jewel*, including whether the client matters constituted "property" that was "transferred" via the *Jewel* waiver under the Bankruptcy Code, and whether it is appropriate to impose liability under these laws even where the *Jewel* waiver complied with California partnership law. And while other districts have reached similar conclusions (*see, e.g., In re Coudert Bros*., 447 B.R. 706 (Bankr. S.D.N.Y. 2011) ("[T]he Court finds that there is no substantial ground for difference of opinion as to whether the unfinished business doctrine applies to New York partnerships")), these issues have not yet been tested in many other districts or reviewed on appeal.

Even in districts that have rejected the legal and policy arguments, several defenses remain for trial or summary judgment, such as the good faith transferee defense that is available under Bankruptcy Code Section 550(b). Under this defense, if the destination law firm can show that it was a subsequent transferee of the fraudulently transferred profits, then the firm should be able to escape liability to the extent it took the transfer for value, in good faith, and without knowledge of the fraudulent nature of the initial transfer—an argument that most likely would require the destination law firm to show that it did not know about the dissolved law firm's last-minute execution of a *Jewel* waiver.

In addition to such defenses, policy considerations also may lead appellate courts to limit expansive application of *Jewel*. Characterizing destination law firms as "subsequent transferees" subject to liability for unfinished business profits threatens the future employment of former partners and staff of dissolved firms. This result hardly benefits the clients of bankrupt firms and arguably conflicts with a lawyer's ethical duty to protect his clients' interests. Further, post-dissolution accountability for unfinished business profits, while perhaps appropriate in the small-firm setting, arguably is inapplicable to large modern law firms. Where the firm at issue in *Jewel* had only four partners in one office, Brobeck had 900 attorneys, and Heller had over 700 attorneys in offices around the world. While unsuccessful in bankruptcy court, these policy arguments may fare better at the appellate level.

Contesting Damages. At least in those courts that apply the *Brobeck* reasoning, law firms defending *Jewel* claims may have a better chance at the damages phase. Little precedent exists on damages in this context, but Judge Montali suggested in *Brobeck* that recoverable profits for a *Jewel* claim are limited to fees paid for unfinished business minus "overhead costs and reasonable compensation to the partner winding up the unfinished matter." *In re Brobeck*, 408 B.R. at 326 n.4. "For example, if a partner received $50,000 in fees but incurred $40,000 of costs for overhead and the partner's reasonable compensation to generate that $50,000 in fees, the profit for which that partner would have to account is $10,000." *Id*. If a firm can demonstrate that any fees received in winding up unfinished business are substantially offset by these costs, damages can be reduced to a negligible amount—or perhaps even eliminated altogether. In addition, consider whether there were any carryover *pro bono* matters, the costs of which would offset profitable matters.

Courts have not yet resolved many of the questions surrounding deductions from gross income, and it is likely that this area will be the focus of future litigation. One court has held that compensation for non-partner timekeepers and "computer time" all count as reasonable overhead expenses in the context of a *Jewel* claim. *Hammes*, 579 N.E. 2d at 1353. Other courts have addressed overhead more globally, allowing firms to deduct overhead expenses based on a standard expense ratio. For example, one court has applied an overhead percentage of 62.64% to revenue generated from unfinished business. *Flynn*, 581 N.E.2d at 33.

The destination law firm is likely to be entitled to retain a portion of the ultimate settlement or recovery attributable to its efforts, and thus the prospect of turning over profits to the dissolved firm is diminished.

Similarly, many courts have not applied the RUPA's offset for "reasonable compensation." Defendants have a strong argument that "reasonable" means "actual" compensation, because if partners leaving a dissolving law firm did not consider their new firm's compensation package to be "reasonable," then they would take their talents (and "unfinished business") elsewhere. Further, establishing artificial and non-market based rates of compensation may create an unfair windfall for the estate, because the starting point for its damages claim would be actual amounts billed and collected by the new firm for the "unfinished business," but then it would not deduct actual compensation necessary to generate that revenue. For example, suppose a matter went from a dissolving small, four-attorney firm to a thriving international law firm, and that the dissolving firm charged $400 per hour for the services of the lead partner, and the large firm charged $800 per hour for his/her services. Why should the estate of the defunct firm realize the benefit of the $400 per hour marginal increase in net revenue without having to pay the additional compensation necessary to generate that increase in revenue?

Another damages question is whether the estate may recover profits from unfinished business in perpetuity. At least one court has allowed the period for which the dissolved firm must be compensated to be limited to one year only. *In re LaBrum*, 227 B.R. at 396.

Litigating in District Court. For several reasons, defendant firms may prefer to litigate these claims in district court rather than bankruptcy court. The recent Supreme Court decision in *Stern v. Marshall*, 131 S. Ct. 2594 (2011), held that bankruptcy courts lack constitutional authority to enter final judgment on certain "core" bankruptcy claims. Citing *Stern*, several defendant firms have moved to withdraw the reference to the bankruptcy court and thus to have the matter heard in the first instance by the district court. At least one district court has agreed with this argument. *Dev. Specialists Inc. v. Akin Gump Strauss Hauer & Feld*, 2011 U.S. Dist. LEXIS 127898, at *27-38 (S.D.N.Y. Nov. 2, 2011). In the Northern District of California (where the *Brobeck* and *Heller* matters are pending), District Court Judge Charles Breyer agreed that *Stern* precluded the bankruptcy court from entering final judgment on such claims, but he refused to withdraw the reference on the grounds that Judge Montali is well-suited to handle pretrial phases of the case and also to make proposed findings of fact and conclusions of law that may assist the district court when it is asked to enter a final judgment. *In re Heller*, 2011 U.S. Dist. LEXIS 143223, at *3 (N.D. Cal. Dec. 13, 2011).

Proactive Risk Management Against *Jewel* Liability

Law firms fortunate enough not to be dealing with a *Jewel* claim still should have *Jewel* issues on their minds. There are some steps that any law firm can take both to protect its partners in the event of dissolution and to manage exposure to liability from fraudulent transfer claims based on *Jewel*.

***Consider Executing a* Jewel *Waiver*.** Even healthy law firms should consider executing a *Jewel* waiver now, when (hopefully) dissolution and bankruptcy are not even remotely on the horizon. The lesson from the *Brobeck* and *Heller* bankruptcy seems to be that even an RUPA-compliant *Jewel* waiver may trigger liability under the Bankruptcy Code if it is executed too close to the firm's dissolution and bankruptcy. A *Jewel* waiver executed more than two years *before* a firm files for bankruptcy likely should not constitute a fraudulent transfer under the Bankruptcy Code, although state law may provide longer limitations periods. As for firms that may go bankrupt within two years, it still *may* be possible to design an enforceable *Jewel* waiver establishing that the firm has received "reasonably equivalent value" in exchange for the waiver, and provided that the waiver is not designed to defraud creditors. 11 U.S.C. § 548(a)(1)(A)-(B). Of course, there may be political or other considerations at a law firm that counterbalance this strategy.

> A *Jewel* waiver executed more than two years before a firm files for bankruptcy likely should not constitute a fraudulent transfer under the Bankruptcy Code, although state law may provide longer limitations periods.

Caveat Emptor. Law firms hiring lateral partners normally do so with care, but in light of the issues discussed above additional and specific due diligence may be required when making hires from dissolving firms. One important consideration is whether the dissolved law firm has a *Jewel* waiver in place, and if so whether the waiver is subject to attack in bankruptcy court. In either event, firms may need to consider potential *Jewel* liabilities part of the "acquisition price" for lateral attorneys coming from distressed firms.

Careful Recordkeeping at the Destination Firm. It is important when hiring new partners to ensure that proper recordkeeping is maintained to separate "unfinished business" matters from new work. There may be opportunities to terminate older matters in favor of new ones if there is a logical separation in the work, such as "general matters" for transactional attorneys.

As the law of Jewel v. Boxer *and the "unfinished business" doctrine as applied to law firms continues to develop, the* Beazley Brief *will continue to report on this and other important risk management considerations arising out of law firms' lateral hiring practices.*

Contact Information

We welcome your feedback on this issue of the Beazley Brief. Email your comments, observations or future topic requests to brant.weidner@beazley.com.

A library containing all past issues of the Beazley Brief can be accessed any time through Beazley's lawyers' risk management website at www.beazley.com/lawyers.

The information set forth in this communication should not be construed nor relied upon as legal advice and is not intended as a substitute for consultation with counsel.

Beazley Insurance Company, Inc., is located at 30 Batterson Park Road, Farmington, CT 06032.

CBEM052_US/UK_02/12