Law Firms Penalizing Departing Partners? – That Goes Straight to the Penalty Box!

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MANY SOPHISTICATED lawyers in the throes of infatuation with a law firm they are joining barely consider the partnership agreements that describe their financial arrangements. While these same lawyers would never advise their clients to enter into an important financial arrangement without becoming familiar with the intricate details of that agreement, they themselves often do not do so. A key provision of a partnership agreement that these new partners often overlook governs what happens if the partner leaves or is pushed out of the partnership. The financial consequences can be significant—as or more significant than the financial consequences of a divorce. Yet, many partners enter into a law firm partnership without thinking about the financial consequences if the relationship does not work out.

The Rules of Professional Conduct address the move of a lawyer from one law firm to another, where the old law firm tries to penalize the departing lawyer for competing at the new law firm, including by taking clients to the new law firm. In this three-way contest among lawyers, law firms, and clients, the majority of the courts and state bar opinions have consistently recognized that it is the clients' interests—the clients' free choice of counsel—that must come out on top, *not* the former law firm's interests.

RULE 5.6(a) AND FINANCIAL PENALTIES • Rule 5.6(a) of the Model Rules of Professional Conduct provides that "a lawyer shall not participate in offering or

making: 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." Comment 1 to this Rule explains its rationale: such agreements "not only limits their [lawyers'] professional autonomy but also limits the freedom of clients to choose a lawyer." Rule 5.6 is very similar to its predecessor, Disciplinary Rule 2-108(A), which was in effect in some jurisdictions until recently.

There is little controversy that Rule 5.6(a) flatly prohibits law firms from requiring lawyers to enter into covenants not to compete. In contrast, some other professionals (*e.g.*, physicians, accountants, and executives) can be bound by such covenants if they are reasonable in geographical, temporal, and subject matter scope. However, law firms have improperly attempted to do an end-run around this blanket prohibition by trying to come up with other ways to penalize departing partners, particularly those who take clients with them, and work at competing law firms.

RULE 8.5 AND THE CHOICE OF LAW • A threshold issue is the choice of law to be applied to a departing partner, which can be problematic for law firms that have offices in multiple states. For example, a partnership agreement might state that the law of New York applies to all disputes arising under the agreement. But, if a partner in the Illinois office of that law firm, who is not barred in New York, has a dispute that requires interpretation of Rule 5.6, then that partner and the law firm will need to look to Rule 5.6 as it has been interpreted by the courts and bar ethics opinions in Illinois (which are binding on the Illinois partner and the Illinois office), not the law in New York.

ABA Model Rule 8.5(b)(2), the choice of law provision, provides that for issues that are not in connection with matter pending before a specific court or tribunal, the rules to be applied are "the rules of the jurisdiction in which the lawyer's conduct occurred, or, if the predominant effect of the conduct is in a different jurisdiction, the rules of that jurisdiction shall be applied to the conduct." Under this rule, if the managing partner in the New York headquarters made the decision to penalize a departing attorney in the Illinois office, then the rules to be applied would be those of Illinois, since the predominant effect of the New York partner's conduct was in Illinois. Thus, a partnership agreement's choice of law provision can be trumped by Rule 8.5(b)(2). Since the Rules of Professional Conduct themselves differ from one state to another, and the state courts and bar ethics opinions have reached different results for comparable factual scenarios, it is necessary to determine the law to be applied.

THE MAJORITY RULE: FINANCIAL PENALTIES ARE *PER SE* VIOLATIONS OF RULE 5.6(a) • The majority rule among the courts and ethics opinions is that these financial penalties, even if couched as golden handcuffs, are *per se* violations of Rule 5.6(a). Most courts have followed the seminal decision of the New York Court of Appeals, in *Cohen v. Lord, Day & Lord*, 550 N.E.2d 410, 411 (N.Y. 1989), which held that the ethics prohibition on covenants not to compete extended to financial penalties on withdrawing partners, because those penalties "functionally and realistically discourage and foreclose a withdrawing partner from serving clients who might wish to continue to be represented by the withdrawing lawyer and would thus interfere with the client's choice of counsel." The New York Court of Appeals recognized that the law firm's economic interests were trumped by the client's interests:

"While a law firm has a legitimate interest in its own survival and economic well-being and in maintaining its clients, it cannot protect those interests by contracting for the forfeiture of earned revenues

during the withdrawing partner's active tenure and participation and by, in effect, restricting the choices of the clients to retain and continue the withdrawing member as counsel." *Id.* at 413.

Other state appellate courts have taken the same approach as did the New York Court of Appeals. The Supreme Court of New Jersey, in *Jacob v. Norris, McLaughlin & Marcus*, 607 A.2d 142, 148 (N.J. 1992), held that a law firm could not penalize departing partners "by selectively withholding compensation," since these "indirect restrictions on the practice of law, such as the financial-disincentives at issue in this case, likewise violate both the language and the spirit of [N.J. Rule of Professional Conduct] 5.6." Further, "By forcing lawyers to choose between compensation and continued service to their clients, financial disincentive provisions may encourage lawyers to give up their clients, thereby interfering with the lawyer-client relationship and, more importantly, with clients' free choice of counsel." *Id.*

The Illinois Appellate Court, in *Stevens v. Rooks Pitts & Poust*, 682 N.E.2d 1125, 1130 (Ill. App. Ct. 1997), similarly recognized that the majority of jurisdictions that have addressed this issue, including Iowa, New Jersey, and New York, "have overwhelmingly refused to enforce provisions in partnership agreements which restrict the practice of law through financial disincentives to the withdrawing attorney." Thus, the court invalidated a partnership agreement provision that "require[ed] the departing partner to give up certain compensation due to him if he competes with the firm in a certain geographic area within one year after his departure, [because] this financial disincentive provision hinders both the departing lawyer's ability to take on clients and the clients' choice of counsel." *Id.* at 1132.

The Court of Appeals of Texas similarly struck down a partnership agreement provision that allowed a law firm to value a departing partner's stock at "book value" (here, only $3,947.35), instead of the actual goodwill value (here, estimated at in excess of $112,000), because that partner moved to a competing law firm. *Whiteside v. Griffis & Griffis, P.C.*, 902 S.W.2d 739, 741 (Tex. Ct. App. 1995). The Court of Appeals recognized that the majority of states to have addressed this issue – except for California – "almost universally hold that financial disincentives … are void and unenforceable restrictions on the practice of law." *Id.* at 743-44. Hence, the Court of Appeals "align[ed] ourselves with the majority of jurisdictions that have rejected financial disincentives . . . we believe the strong public-policy concerns surrounding client choice warrant prohibition of lawyer restrictions." *Id.* at 744.

More than five decades ago, the ABA issued an ethics decision that similarly recognized that any desire to protect law firms had to give way: "Clients are not merchandise. Lawyers are not tradesmen. They have nothing to sell but personal service. An attempt, therefore, to barter in clients, would appear to be inconsistent with the best concepts of our professional status." ABA Comm'n on Professional Ethics, Formal Op. 300 (1961).

THE MINORITY RULE: SOME FINANCIAL PENALTIES ARE ACCEPTABLE • In contrast, the Supreme Court of California took the minority approach in *Howard v. Babcock*, 863 P.2d 150 (Cal. 1993). The court reasoned that there should be "no legal justification for treating partners in law firms differently in this respect from partners in other businesses and professions," *id.* at 157, a view rejected by the vast majority of courts to have considered that analogy. Even then, the court limited the penalties to those that could be imposed to "an amount that … is reasonably calculated to compensate the firm for losses that may be caused by the withdrawing partner's competition with the firm," in other words, actual or consequential damages as opposed to liquidated damages. *Id.* at 160. Justice Kennard's dissenting opinion recognized that while "law firms may be economically injured by the loss of clients,"

"the purpose of rules of professional ethics is to restrain and guide the conduct of attorneys and to protect the public, not to protect the financial interests of law firms." *Id.* at 165 (Kennard, J., dissenting). She aptly quoted then-Chief Justice Rehnquist on cautioning that economic considerations should not trump ethical considerations:

"As Chief Justice Rehnquist of the United States Supreme Court has observed: 'It is only natural, I suppose, that as the practice of law in large firms has become organized on more and more of a business basis, geared to the maximization of income, this practice should on occasion push towards the margins of ethical propriety. Ethical considerations, after all, are factors which counsel *against* maximization of income in the best Adam Smith tradition, and the stronger the pressure to maximize income the more difficult it is to avoid the ethical margins.' In my view, the increasing pressures to weaken the rules of professional ethics generated by the emphasis on maximizing income require more, not less, vigilance by this court to preserve the practice of law as a profession and to protect the public."

Id. at 166 (Kennard, J., dissenting) (quoting W. Rehnquist, "The Legal Profession Today," 62 Ind. L.J. 151, 154 (1987)). It is interesting that protecting the right of lawyers to move in order to better serve their clients is an issue that does not fall on any traditional judicial divide, since judges across the spectrum recognize the need to protect clients, not law firms.

The Supreme Judicial Court of Massachusetts took both approaches in addressing the partnership agreement of an insurance defense law firm. Originally, that firm's partnership agreement provided that partners who left for a competing law firm would forfeit two categories of benefits: (1) the "cash profits attributable to the partner in the year of withdrawal, determined at the end of the firm's fiscal year and based on the number of full months that the partner was with the firm in that year and on the partner's established share in the firm's profits;" and (2) "the partner's share of the change in the net worth of the firm determined each year on an accrual basis." *Pettingell v. Morrison, Mahoney & Miller*, 687 N.E.2d 1237, 1238 (Mass. 1997). The court readily aligned itself with the majority of states in concluding that this provision violated the ethics rules, since "The concern here is to protect the clients and potential clients of the withdrawing lawyer and the law firm. An enforceable forfeiture-for-competition clause would tend to discourage a lawyer who leaves a firm from competing with it. This in turn would tend to restrict a client or potential client's choice of counsel." *Id.* at 1239.

As a result of this court decision, this law firm amended its partnership agreement so that it now "imposes identical financial consequences on all partners who voluntarily withdraw from the firm, regardless of whether they compete with the firm after withdrawing," with an exception for partners who had reached the firm's (voluntary) retirement age. *Pierce v. Morrison Mahoney LLP*, 897 N.E.2d 562, 565 (Mass. 2008). Five departing partners, whose earned partnership credits (equivalent to ownership interests) ranged from $70,585 to $1,076,855 (for a total of $1,645,550), sued the law firm after it refused to pay these amounts upon their departure for competing law firms. *Id.* at 567 n. 12.

This time, the Supreme Judicial Court of Massachusetts held that the amended partnership agreement did *not* violate Rule 5.6, since it now applied to all departing partners, regardless of whether or not they left for a competing law firm. The court drew a somewhat hypertechnical distinction "between a loss of benefits that is triggered by the decision to compete and one that is triggered by the decision to leave [prior to retirement age], whether or not one later competes," on the grounds that "[o]nly the first limits client choice in violation of the public policy behind Rule 5.6." *Id.* at 569.

We believe that this purported distinction fails to recognize the reality that law firms will apply these penalties against departing partners who take clients with them, while allowing those who go in-house or work for the government to continue to receive their benefits. Indeed, in this case, the firm did precisely that—another withdrawing attorney who "joined the [state] Attorney General's office … continued to receive … payments" from his ownership interests, which the firm justified on the grounds that he had reached the firm's "age or seniority benchmarks" for retirement. *Id.* at 570. Yet, the Supreme Judicial Court refused to consider this favorable treatment of that attorney, in contrast to the firm's refusal to pay the five departing attorneys their $1,645,550 in ownership interests, merely because the former attorney had reached the firm's voluntary retirement age, so that his right to the ownership interest was viewed as a retirement benefit, even though he continued to practice law.

Delays in Return of Capital

One impermissible penalty imposed upon departing partners is to delay the return of their capital account upon their departure, if they go to work at a competing law firm. Normally, when a departing equity partner leaves a law firm, the partnership agreement will have a timetable for the return of capital, in order to avoid the proverbial run on the bank if too many partners depart at the same time. Otherwise, firms may end up like Howrey LLP. In its last year, the capital withdrawals paid to numerous departing partners constituted nearly half its annual revenues (since Howrey was spending its capital accounts), which rendered that firm insolvent and forced it into bankruptcy. However, the reality is that most large law firms are or should be adequately capitalized (since capital accounts should only be held in reserve for long-term capital expenses, not used for day-to-day expenses), so that the departure of one or two equity partners should have a minimal impact on the firm's capital account.

D.C. Bar Ethics Opinion 241 (1993) readily found that a law firm that ordinarily paid out the capital to departing partners over a five-year period, but delayed the commencement of that five-year period for lawyers who went to competing law firms until five years after the date of withdrawal (so that payments would not be completed until ten years had passed), violated Rule 5.6(a). Even though this law firm only delayed the return of capital, and did not reduce or eliminate the payment, the D.C. Bar held that this provision "undoubtedly serves as a deterrent to opening a competing practice" and "thus represents a restriction on the right to practice . . . even as to potential future clients."

Somewhat surprisingly, the Virginia Bar reached a different result in Legal Ethics Opinion 1711 (1997). It held that a Virginia firm could have two tiers for the return of partner capital: five years for a partner who "retires from the practice of law" but ten years for those who continued practicing law.

The Virginia Legal Ethics Opinion reached what we believe is the wrong result, by claiming that the different time periods were merely "an agreement affecting only the termination of the relationship itself, not a restriction on the attorney's right to continue to practice law after the termination of the relationship." Since a significant part of an equity partner's assets may be tied up in the capital account, and an equity partner may have borrowed money in order to make the capital contributions, the firm's retention of the funds for up to ten years strongly inhibits clients and lawyers from moving to a new law firm in order to optimize legal representation of the clients, as the D.C. Bar Ethics Opinion recognized.

Clawback of Bonuses

Another impermissible financial penalty is where a law firm's partnership agreement provides

that the firm may, at its discretion, clawback bonuses that were already paid during the time period immediately prior to when the departing lawyer gave notice of his withdrawal from the partnership. For example, a partnership agreement may provide for this clawback, at the discretion of the firm's management committee or managing partners, if the bonuses were paid during the six-month period prior to receiving notice of the withdrawal. Such a clawback provision might be acceptable if it were applied equally to every departing partner, *i.e.*, there was no discretion in its application.

But what about the firm that maintains discretion to decide which departing partners to penalize? For example, a law firm could penalize only those departing partners who leave for competing law firms, while allowing departing partners who go in-house, or to the government, to retain their bonuses. This unethical approach reflects the belief that the firm should maintain good relationships with former partners who go in-house (a potential client), and those who go to work for the government (who may be regulating the firm's clients in the future), but a firm should be free to penalize those who take clients with them to competing law firms.

This approach also violates Rule 5.6(a), as it penalizes not only the withdrawing lawyers but also their clients, and is generally applied *only* to withdrawing partners who go into competition with their former law firm. In effect, this type of clawback is another type of an impermissible covenant not to compete.

Refusal To Pay Guaranteed Compensation

Yet another impermissible financial penalty on departing partners is a variation on the golden handcuff. At large law firms, an equity partner's guaranteed compensation (equivalent to salary) is usually calculated at the beginning of the calendar year. The typical large firm practice is to pay only part of that compensation through the monthly draws in the twelve months of that year, with a significant portion of the compensation—as much as 50 percent—to be paid (or "trued up") at or after the beginning of the next calendar or fiscal year. Therefore, if a partner wants to earn her full promised compensation for the year, she needs to remain with the firm for the entire year, or even well into the next year. However, as she stays into the next calendar year in order to receive the balance of her compensation for the previous year, she loses at least one-half of her annual compensation for the period she stays in the new year.

Further, many firms require advance notice of withdrawal—two or more months—before a partner can withdraw. These same law firms have full discretion to require the partner to withdraw immediately upon giving notice, so the firm controls the time of withdrawal, which, in turn, allows the firm to penalize partners by forcing them to leave before the "true up" of their compensation for either the current year or the previous year.

That prohibition on liquidated damages applies with equal force to refusing to pay a *pro rata* share of the full compensation to partners who leave before the firm pays out the full compensation for the year. The longer a partner stays in the new year to get a full payment of the past year's compensation, the more he loses in the current year, as he receives only 50 percent or so of his compensation for each month of the current year.

D.C. Bar Ethics Opinion 368 (2015) recently made clear that any attempt to impose liquidated damages on a departing lawyer who subsequently competes with the old law firm is a *per se* violation of Rule 5.6(a). The Ethics Opinion held that "a departing lawyer may not be subject to liquidated damages because she subsequently competes with her former firm," so that the only liability was "for the value of work completed *before* she leaves the firm." The Ethics Opinion surveyed the case law, and noted that California's approach "is distinctly the minority rule, however." Thus, the Ethics Opin-

ion followed the majority approach in holding that partnership agreement provisions penalizing departing lawyers violated Rule 5.6, because of their harmful effect on clients:

"Because they limit a client's freedom in choosing a lawyer and a lawyer's professional autonomy, provisions in partnership, employment, and other agreements that expressly or impliedly restrict a lawyer's practice are prohibited. *Neuman v. Akman*, 715 A.2d 127, 130-31 (D.C. 1998) (citing D.C. Rule 5.6, cmt. [1]); accord *Cohen v. Lord, Day & Lord*, 550 N.E.2d 410, 411 (N.Y. 1989); *Stevens v. Rooks Pitts and Poust*, 682 N.E.2d 1125, 1132 (Ill. App. 1997); D.C. Legal Ethics Op. 325 (2004); D.C. Legal Ethics Op. 241 (1993); D.C. Legal Ethics Op. 122 (1983). **The prohibition extends not only to absolute bars upon competition with the former firm but also, at least in some circumstances, to "[r]estrictions . . . that impose a substantial financial penalty on a lawyer who competes after leaving the firm.'** D.C. Rule 5.6 cmt. [2]; *accord Cohen*, 550 N.E.2d at 411; *Stevens*, 682 N.E.2d 1125; D.C. Legal Ethics Op. 325 (2004); D.C. Legal Ethics Op. 241 (1993); D.C. Legal Ethics Op. 194 (1988); D.C. Legal Ethics Op. 65 (1979)."

See D.C. Bar Ethics Opinion 368 (Feb. 2015) (emphasis added); *see also* E. Stillabower, "A Look at Employment Contracts for Lawyers," *Washington Lawyer*, May 2015, at 14-15. Hence, under this majority rule, firms cannot penalize departing partners by refusing to pay them the *pro rata* share of their earned but unpaid compensation for the portion of the year in which they worked at the firm, or by requiring partners to remain at the firm through the end of the year in order to obtain their full earned compensation for that year.

CONCLUSION • Law firms cannot impose covenants not to compete upon their lawyers. Many large law firms attempt to circumvent this clear ethical proscription through imposing financial penalties upon departing lawyers, particularly those who go to competing law firms. These financial penalties not only interfere with lawyer mobility but also interfere with the fundamental right of clients to their choice of counsel. Therefore, law firms that attempt to penalize departing partners will and should find themselves in the penalty box for interfering with the ability of clients to be represented by counsel of choice, and for their counsel to be able to work at a law firm of their own choosing.

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