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When Partners Part: Mitigating The Effects of Damaging Departures

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This is the second of three articles on the ethical problems that arise when a partner leaves afinn and competes for clients. This article deals with agreements and other dçuices used by law firms to protcct against the financial inroads of a partner's withdrawal. The third article in the series will appear in the November issue.

The ability of law firms to protect themselves against the financial repercussions of a partner's withdrawal and entry into a competing practice has been addressed by the Court of Appeals in a trilogy of opinions issued between 1989 and 199& Through its benchmark decisions in *Cohen v. Lord, Day & Lord,* 75 N.Y.2d 95 (1989); *Denbeirg v. Parker Chapin Flattau & Klimpl,* 82 N.Y.2d 375 (1993); and *Hackett v. Milbank, Tweed, Hadley & McCloy, 86* N.Y.2d 146 (1995), the Court has told New York law firms unequivocally that courts will in most cases invalidate agreements that penalize lawyers for continuing to practice law after their withdrawal, even if the post-withdrawal practice is in direct competition with the firm, and even if valid justifications exist for the agreement other than the prevention of competition.

The principal reason for invalidating these agreements is DR 2-108(A), which provides: "A lawyer shall not be a party to or participate in a partnership or employment agreement with another lawyer that restricts the right of a lawyer to practice law after the termination of a relationship created by the agreement, except as a condition to payment of retirement benefits." The majority view is that an agreement among lawyers purporting to proscribe competition following its termination — that is, a traditional covenant not to compete — is unethical and will not be enforced because it adversely affects the client's right to choose counsel freely (and, secondarily, the lawyer's right to engage in her profession), and thus is contrary to public policy. *E.g., Matter of Silverberg,* 75 A.D.2d 817 (2d Dep't 1980); *Dwyer v. Jung,* 336 A.2d 498 (N.J Super.), remanded, 343 A.2d 464 (NJ.), *aff'd* 348 A.2d 208 (N.J Super. 1975). Similarly, provisions requiring a lawyer to pay over a percentage of the fees earned on post-departure work performed for clients of the former firm have universally been condemned. *See, e.g.*, DC Ethics Opinion 65 (1979); Illinois Ethics Opinion 628 (1978); Pennsylvania Ethics Opinions 86-17 (1986), 87-105 (1987) and 88-249 (1988).

Financial Disincentives

More controversial are agreements that do not directly prohibit the practice of law or demand fee splitting after departure, but that instead establish so called "financial disincentives" to starting a competing practice. In *Cohen*, the Court of Appeals tipped the balance firmly toward the departing Iawyer. The partnership agreement at issue in *Cohen* afforded a withdrawing partner, in addition to his capital account and the balance of his partnership share for the year of withdrawal, a payment equal to 1/3 of his partnership share in each of the three years after withdrawal (ostensibly in consideration of unpaid fees, and fees for services performed but not billed as of the time of departure), unless he withdrew from the firm and, "without the prior written consent of the Executive Committee continue[d]

to practice law in any state or other jurisdiction in which the Partnership maintains an office or any contiguous jurisdiction, either as a lawyer in private practice or as a counsel employed by a business firm (*Cohen*, p.95.)

The Court of Appeals invalidated the provision. It observed that "while the provision in question does not expressly or completely prohibit a withdrawing partner from engaging in the practice of law, the significant monetary penalty it exacts, if the withdrawing partner practices competitively with the former firm, constitutes an impermissible restriction on the practice of law." (*Cohen*, p98.) Judge Bellacosa's majority opinion continued: "The forfeiture for competition provision would functionally and realistically discourage and foreclose a withdrawing partner from serving clients who might wish to continue to he represented by the withdrawing lawyer and would thus interfere with the client's choice of counsel."

Effect Of Restriction Controls

Four years later, in *Denburg*, the Court of Appeals was presented with a partnership agreement provision that reduced payments otherwise due to a partner who withdrew from the firm during a defined five year period by the greater of 1/8 of the profits that partner generated from former firm clients during the two years following withdrawal or 1/8 of the firm's profits allocated to the partner over the preceding two years. The firm argued that the provision was a reasonably limited short-term arrangement for the recoupment of partnership liabilities relating to a lease for new office space that vastly increased the firm's rent obligations. The Court of Appeals, in a 6-1 majority opinion written by Chief Judge Kaye, invalidated the provision as a financial disincentive to post-departure competition. In so doing, the Court left no doubt that the reasons underlying the adoption of the provision were immaterial: the "focus should essentially he not on the intent of the clause but on its effect." (*Denburg*, p.381.) The Court therefore rejected the firm's argument that the provision "had the legitimate purpose of assuring some restitution to the firm by partners who abandoned the enterprise just as the firm undertook extraordinary relocation expenses," and looked instead to the facts that the provision applied only to lawyers continuing in private practice and that the required payment "bears little relation to the purported compensatory purpose of the clause and instead exacts an amount directly proportional to the success of a departing partner's competitive efforts."

The Court stopped short, however, of announcing a rule that would ban any provision that had the effect of a disincentive to practice law following withdrawal. it agreed instead that a law firm has "a legitimate interest in its own survival and economic well-being." (*Denburg*, p.355.) The majority opinion expressly disavowed any suggestion that agreements involving financial disincentives are per se illegal, and emphasized that the enforceability of such agreements depends on "the particular terms and circumstances."

Denburg Case Narrows Options

Denburg substantially narrowed the field of options available to firms seeking to mitigate the effects of partner withdrawals. Unlike the partnership agreement at issue in Cohen, which left little doubt that its intention and effect was to erect a barrier to competition, the *Denburg* agreement arose out of a specific and extraordinary lease obligation undertaken by the firm and the desire of the partners to exact a mutual commitment either to remain with the firm for five years or to share in some other way in the fiscal burdens of the new lease. The way in which the firm chose to calculate the share of the partner who did

not remain with the firm, however, was to require payment of a sum that approximated the financial detriment suffered by the firm as a consequence of the departure of the partner, measured either by the extent to which the partner diverted firm clients to a new firm or by the extent to which the partner's efforts had contributed to the firm in preceding years. The principal problem with the *Denburg* provision was that it was keyed too closely to competition for former firm clients — the provision would disproportionately impact any partner who diverted substantial business from the firm — and thus violated the principles underlying DR 2-108(A).

Hackett Reopens Door

The door seemingly slammed shut on law firms in *Denhurg* was reopened a crack in *Hackett*, in which the Court of Appeals upheld a partnership agreement provision that entitled a withdrawing partner to receive a percentage of his average past compensation, subject to a dollar for dollar reduction to the extent that the former partner earned more than $100,000 from the new employment. Importantly, the provision did not affect any payments otherwise due for earned but un-distributed sums. Writing for a unanimous Court, Judge Simons reasoned that the provision at issue "is not inevitably anticompetitive on its face" because it does not "disciminat[e] between partners departing for private practice and those, for example, entering academia or government service," as did the provision at issue in *Denburg*. (*Hackett*, p.l56.) The Hackett provision "applies equally to all withdrawing partners and no financial disincentive specifically devolves on partners withdrawing to compete with Milbank, Tweed in contrast to all other withdrawing partners."

Possible Options

in light of the framework established by the *Cohen-Denburg-Hackett* trilogy, New York courts can be expected to evaluate provisions relating to withdrawal on the basis of their structure and effect, and not their intent or purpose. Thus, law firms seeking to limit the negative impact of a partner's departure must be careful not to create a system that is directly linked to the ability of a withdrawn partner, or the willingness of a partner considering withdrawal, to continue to practice law. Here are some suggestions of partnership agreement provisions that stand a reasonable chance of surviving a challenge under DR 2-108(A) as interpreted by the New York Court of Appeals:

Allocating Financial Outlays

- A firm embarking upon a major financial commitment based in part upon certain assumptions regarding continuity of partnership and reliability of income stream might consider assessing penalties against individual departing partners. If, for example, the firm acquired space specifically for a new or enlarged department or practice area, acquired computers and software designed for a segment of practice, or hired associates for a particular partner or practice area, it would make sound economic sense to place the burden of those costs on the partners for whose principal benefit and accommodation they were incurred, *Denkurg*, however, teaches that any such provision must be lied to the nature and amount of the particular obligation, so that a provision requiring the departing lawyer to pay the expense, in whole or in part, could well be sustained; but approximations based on past performance or business diverted by the partner, such as in the *Denburg* agreement, will not survive judicial scrutiny.

Using Going Concern Value

- Another, more general alternative may be to compensate a withdrawing partner based on a percentage of the going concern value of the firm, taking into account the effects of her departure on future earnings.

This option was suggested by the New Jersey Supreme Court in *Jacob v. Norris, McLaughlin & Marcus,* 607 A.2d 142 (N.J. 1992), which stated: "In computing a withdrawing partner's equity interest in the former firm, accounting for the effect of the partner's departure on the firm's value is not unreasonable. Although the departing attorneys always have a right to receive the value of their capital accounts, in computing the value of any additional interest they have in the firm, the value they contributed can be offset by the decrease in the firm's value their departure causes." (p. 152.) Such a provision has the virtue of treating all partners equally, regardless of what they d0 after withdrawal and whether or not they compete with the former firm, as was arguably the case in Hackett. While the process of valuing the partnership every time a partner leaves may he impossibly cumbersome and expensive for a large firm, it may be effective for the small firm in which the effects of a single departure may be quite substantial and such an evaluation can be more readily accomplished. (A model partnership agreement provision embodying this concept will be published in Part Ill of this article.)

Determination By Special Committee

▪ Alternatively, a provision that commits the computation of post-termination compensation to the sole discretion of an executive committee, a special compensation committee or similar body may withstand scrutiny under DR 2-108(A). After all, because the rule applies only to agreements that impinge upon the right of a lawyer to practice, a facially neutral agreement relating to post-termination compensation should not pose a problem. Thus, in *Seyfarth, Shaw, Fairweather & Geraldson v. Goldberg,* N.Y.L.J., Nov. 15, 1990, at 21 (Sup. Ct. N.Y. Co.), the court upheld a partnership agreement that provided that compensation to a withdrawn partner would be determined by the executive committee on the basis of its evaluation of the partner's "productivity, experience and contribution to the continued success of the firm." The evaluation, under the agreement, was to be "made impartially and thoughtfully" by the committee. Finding that "no [restrictive covenant] is to be found in the Agreement," the court rejected the argument that the provision violated DR2-108(A).

Curbs on Current Solicitation

▪ Finally, a firm may decide to approach the problem of diversion of clients not through financial mechanisms, but by including a provision in a partnership agreement that restricts the manner in which solicitations can be made by departing lawyers to firm clients. While this concept is untested in the courts, one prominent ethics committee has endorsed a provision in an associate's employment contract limiting post-departure solicitation to the mailing of a printed announcement (under penalty of liquidated damages), on the theory that the clients are not restricted from following the attorney and the attorney is not restricted from accepting employment from the clients. "In the view of the Committee, if the right to send announcements is preserved, the firm may ethically enter into an employment agreement with an associate which limits direct solicitation by the associate after termination of his employment." DC Ethics Opinion 97 (1980); also DC Ethics Opinions 241 (1993), 221 (1991), and 77(1979). Alternatively or in addition, the firm could require dissemination of a joint pre-departure announcement by the firm and the departing lawyers to inform the firm's clients of the separation and to present to the clients their option of staying with the firm or leaving with the departing lawyers. (Benefits of a joint announcement were alluded to by the Massachusetts Supreme judicial Court in *Meehan v. Shaughnessy,* 535 N.F.2d 1255 (Mass. 1989).) Among other things, a joint announcement affords the firm a measure of control over the content of communications with firm clients and helps control, if not equalize, whatever competition may erupt between departing partner and firm for existing clients.

Conclusion

In its 1993 decision in *Howard v. Babcock,* 6 Cal. 4th 409 (1993), the California Supreme Court was presented with a provision of a partnership agreement that directly penalized any partners who withdrew from the firm to engage in a competing practice. Such partners, the agreement provided, "shall be subject, at the sole discretion of the remaining non-withdrawing partners, to forfeiture of all of their rights to withdrawal benefits other than capital…" Unquestionably, this provision would have been struck down in New York. California, however, upheld it on the ground that it was a reasonable non-competition clause, of the kind that businesses of all varieties — including law firms — are statutorily free to adopt. The court explained: "[No longer can it be said that law is a profession apart, untouched by the marketplace. Not only has law firm culture changed but, as in other businesses, lawyers now may advertise their services and may even communicate by letter with persons unknown to them, suggesting the possibility of employment. Thus the general rules and habits of commerce have permeated the legal profession."

New York, in contrast, has chosen not to relax [he rules governing attorney conduct and does not hold lawyers only to the ethics of the marketplace. New York courts continue to require lawyers to adhere to higher standards, commensurate with their status as a learned profession, a philosophy perhaps most evident in the realm of restrictive covenants in partnership agreements. Stodginesss and anachronistic notions of professionalism are not at the root of this ideology but rather a desire to ensure that legal services are available to clients. Clients must have the right to choose between the lawyers who are leaving and the lawyers who are staying, based on fair and open competition among those vying for their continued business. Likewise, lawyers cannot enter into agreements among themselves that may, directly or indirectly, render them unavailable to perform legal services some time in the future. We can expect that the law of New York will continue to evolve in a manner consistent with this populist viewpoint, in terms of the duties of the departing partner to the former firm, the duties of the former firm to the departing partner, and the duties of both to their clients.

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