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Lessons from Law Firm Bankruptcies and Proposals for Reform

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LESSONS FROM LAW FIRM BANKRUPTCIES 
AND PROPOSALS FOR REFORM

Edward S. Adams*

TABLE OF CONTENTS

Introduction .................................................................... 508
I. History of Law Firm Bankruptcies ........................................ 510
   A. Finley Kumble ................................................ 511
   B. Coudert Brothers ............................................ 514
   C. Thelen ............................................................. 517
   D. Heller Ehrman................................................ 519
   E. Dewey & LeBoeuf ........................................... 521
      1. The Rise and Fall of Dewey .......................... 522
      2. Reasons for Dewey’s Bankruptcy ............. 528
II. Solutions to Law Firm Bankruptcies ...................................... 530
   A. Introduction .................................................... 530
   B. Market-Based Solutions ........................................ 531
      1. Public Investment in Law Firms .................... 531
         a. Increased Capital Advantage ............. 532
         b. SEC Requirements Advantage .......... 532
         c. Public Scrutiny Disadvantage .......... 535
         d. Non-Lawyer Ownership Disadvantage .... 535
         e. Conclusion ........................................... 536
         a. Introduction ......................................... 537
         b. Advantages of Full Disclosure ............. 537
         c. Disadvantages of Full Disclosure ........... 539
         d. Conclusion ........................................... 540
      3. Contractual Restrictions on Departing Partners ........................................ 541
         a. Introduction ........................................... 541
         b. Contractual Restrictions to Prevent

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INTRODUCTION

Dewey & LeBoeuf’s bankruptcy filing on May 28, 2012 shocked the legal community. The latest in an alarming series of bankruptcies, the implosion of one of the profession’s most influential and respected names was “the largest law firm collapse in United States history.” The event carried an ominous immediacy. The fall of a titan cast doubt on the vitality of every law firm—“if Dewey could go down, could we?” The bankruptcy filing was read as a “strong warning for lawyers everywhere: Change or die.” This warning seems severe, but carries with it a hard truth. Dewey & LeBoeuf had its own singular set of circumstances that pushed it into the abyss, but the broad structural characteristics that

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precipitated Dewey’s failure were not unique to the now-defunct firm. Over two years out, however, it appears that the existential portent has been largely ignored.

A combination of factors caused Dewey’s collapse, including: (1) overcompensation and guaranteed pay for rainmakers; (2) increased firm-wide compensation; (3) excessive bonuses paid as a result of the merger between Dewey Ballantine and Leboeuf, Lamb, Greene & MacRae; (4) agreements to pay off $60 million of Dewey Ballantine’s pre-merger debts; (5) uncontrolled national and international expansion with leverage; and (6) the economic downturn following the 2008 financial crisis.

Complex law firm bankruptcies, once quite rare, are now commonplace. The series of events leading to an individual filing Chapter 7 or 13 consumer bankruptcy may be tragic; however, such bankruptcies typically create few far-reaching negative externalities and ideally allow the debtor to emerge from the discharge with the ability to make a fresh financial start. When law firms—especially large ones—file bankruptcy, it almost always signals the end of the firm. Naturally, management partners do not want their firm to fold—they face the prospect of having their equity wiped out. However, bankruptcy is a worrisome prospect not only for those in the inside and at the top of a law firm. When a firm implodes, the fallout can be immense. Offices may be shuttered in multiple states and countries, lawyers and support staff are put out of work, the firm’s creditors face the prospect of getting cents (or nothing) on the dollar, active matters stall indefinitely, and clients are left in the lurch—to name only a few of the more obvious impacts. There is not a net social or private benefit to be gained from a firm bankruptcy. Although the aggregate financial cost of a large firm collapse may exceed that connected to the bankruptcy filing of a smaller firm, the reality is that the risk of bankruptcy touches all firms—large or small, full service or boutique, and everything in between. The fallout from the collapse of a firm is broadly the same in types and form across

firm specializations and sizes—people still lose their livelihood, clients can still be caught flatfooted. Given the massive costs a law firm bankruptcy imposes on a wide array of stakeholders, the fact they are occurring with mounting frequency is a matter of grave concern and one that calls for closer examination.

This Article explores selected major historical law firm bankruptcies as a means of identifying common elements. These similarities indicate that certain broad circumstances and institutional structural deficiencies—including economic turmoil, excessive growth and overcompensation, and toxic firm culture and governance—can act as factors precipitating or hastening the financial collapse of firms. This Article goes on to explore a variety solutions designed to address these conditions and weaknesses and thereby mitigate the risk of law firm bankruptcies. Specifically, this Article recommends (a) a market-based solution allowing the public to invest in law firms—thereby increasing the ability of firms to access capital, creating more financial stability, and triggering public oversight of firm finances; (b) the adoption of a regulatory system whereby all of a firm's finance, oversight, governance, and risk management practices would be disclosed to all firm partners (in both single-tier and two-tier firms) on a specified basis; (c) contractual restrictions governing the departure of rainmaker partners; (d) the legislative enactment of the unfinished business doctrine; and (e) regulatory oversight of law firms by a governmental agency. Explored—but ultimately dismissed—as potential solutions are: (a) changes to the ABA Model Rules of Professional Responsibility; and (b) expansion into new international legal markets. This Article endeavors to analyze the advantages and disadvantages of these solutions designed to mitigate the risk of law firm bankruptcy.

I. HISTORY OF LAW FIRM BANKRUPTCIES

The five largest law firm bankruptcies of the last thirty years involved prestigious firms, all of which employed more than six hundred attorneys. The downfall of Finley Kumble Wagner Heine Underberg Manley Myerson & Casey (“Finley Kumble”), Coudert Brothers (“Coudert”), Thelen Brown Raysman & Steiner (“Thelen”), Heller Ehrman White & McAuliffe (“Heller Ehrman”), and Dewey LeBoeuf (“Dewey”) were not anomalies. This Part will examine the collapses of
these five firms in chronological order, devoting the largest amount of attention to Dewey & LeBoeuf—the most recent and most spectacular of the bankruptcies. Each institution’s path from esteemed, functioning law firm to bankruptcy will be explored in order to demonstrate the shared problems that ultimately resulted in their collapse.

A. Finley Kumble

Finley Kumble departed from the traditional law firm model based on seniority and pioneered a model focused entirely on productivity. In doing so, Finley Kumble became a true meritocracy that adopted a commission-for-fees operation. Despite the firm’s rise to prominence and novel arrangement, it experienced a downfall that has left a lasting impression on the legal field.

Founded in New York in 1968 as Finley Kumble Underberg Persky & Roth, the firm rapidly grew into a legal powerhouse with over seven hundred attorneys. By the late 1980s, the firm—then operating under the name Finley, Kumble, Wagner, Heine, Underberg, Manley, Myerson, & Casey—would become the nation’s fourth-largest. Its architect and leader, Steven J. Kumble, masterminded the transformation. Kumble envisioned his progeny becoming bigger and wealthier than any other firm by adopting a more aggressive, merit-oriented, and business-savvy culture. Most of the attorneys who joined Finley Kumble were drawn by the firm’s unique pay scale. Compensation and bonuses correlated directly with billed hours, collected revenue, and

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10. Id.
11. Brill, supra note 6, at 7.
12. Id.
new client or business retention.  

Marshall Manley, a brash New Yorker, joined the firm in 1978 and built Finley Kumble’s California outpost to over one hundred fifty attorneys.  

By 1979, Finley Kumble’s New York office, managed by Steven Kumble, grew to seventy lawyers.  

By 1984, under the guidance of Robert Washington, Jr., the Washington D.C. office had flourished—attracting over eighty attorneys.  

Other locations, such as Florida, also experienced rapid growth.  

The firm appealed to midsize businesses eager to grow and willing to employ an equally ambitious law firm.  

This rapport worked well for gaining clients and growing business.  

Despite such successful growth, Finley Kumble had significant flaws in their corporate structure. In particular, the firm’s culture revolved around money and greed. With sound judgment clouded by avarice, Finley Kumble found itself facing problems largely of its own creation, namely: (1) financial statements whose usefulness was clouded by misleading accounting practices; (2) declining revenue; (3) excessive debt; and (4) managerial tensions.  

First, Finley Kumble’s financial statements did not reflect its true revenue earnings. To bolster revenue, Finley Kumble “sold” account receivables to a dummy corporation that purchased the receivables with a loan guaranteed by the

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13. Finley’s iconoclastic philosophies left an immediate and lasting impact on the legal profession. “During its relatively short lifespan, Finley Kumble changed almost all the unspoken rules of the profession. In doing so, it reaped massive financial awards and became—simultaneously—the most reviled and envied law firm of its day. . . . [T]he Finley Kumble way is instantly recognizable (even if unspoken) in the strategic plan of every large firm today. . . .” DAVID JARGIELLO & PHYLLIS GARDNER, FREE AGENT DYSFUNCTION: MANAGEMENT REALPOLITIK FOR U.S. LAW FIRMS, JARGIELLO LAW (Aug. 16, 2010), http://www.jargiellolaw.com/site/1850jarg/White_Paper_Series_-_Free_Agent_Dysfunction_-_Print_v3.2_-_COPY.pdf.  


15. Brill, supra note 6, at 7.  

16. Id. at 8.  

17. Id.  

18. Id.  

19. Id.  


21. See Brill, supra note 6.  

22. Id. at 3.
The tactic permitted the firm to borrow money to pay excessive firm debt while at the same time characterizing the money as cash received as opposed to money borrowed. Furthermore, the scheme misleadingly inflated partnership profits, revenue per lawyer, and firm revenue. Reliance on this method became increasingly detrimental over the years prior to the firm’s demise.

Second, revenues declined significantly while Finley Kumble was using these tactics. Rainmakers encountered problems with fee collection and meeting projecting revenue streams, thereby failing to justify their exorbitant pay with concomitant cash inflows. Runaway growth contributed to declining per-lawyer revenue as rainmakers clamored for mounting compensation and as the firm sought expensive, big-name lateral hires that contributed little in bringing new business to the firm in the short-term. Furthermore, expenses drastically increased as Finley Kumble spent extravagantly on remodeled offices, beautiful art collections, pseudo-rainmakers, rent, promotion, insurance, and salaries.

Third, the firm incurred $76 million in debt as a result of their accounting practices, recruiting tactics, and lavish spending. By July 31, 1987, the firm had $53.8 million in outstanding loans—a large portion of which related to the loan guarantees made in exchange for selling accounts receivables. The remainder of the firm’s debt was contingent liabilities in the form of loans guaranteeing partners’ capital contributions.

23. Id. at 4.
24. Id.
25. Id. at 3.
26. Id. at 4. In 1985, $1.8 million in accounts receivables were “sold” to a dummy corporation. In 1986, $10 million was “sold.” Finally, in 1987, $27 million was sold. Id. The temptations and dangers of using self-owned entities as factors would later prove to be an important part of Enron’s undoing. See, e.g., 1 JOINT COMM. ON TAXATION, REP. OF INVESTIGATION OF ENRON CORP. AND RELATED ENTITIES REGARDING FED. TAX AND COMP. ISSUES, AND POLICY RECOMMENDATIONS, 85 (2003).
27. Brill, supra note 6, at 3.
30. Brill, supra note 6, at 3.
31. Id. at 6.
32. Id.
33. Id.
The operation of this grand and complex business enterprise resulted in the clashing of several named partners.34 Marshall Manley, the managing partner of Finley Kumble’s California office, entered into a power struggle with Steven Kumble.35 Later, Harvey Myerson, another named partner and significant rainmaker, joined the fray.36 These disputes led to the firm splintering into two separate factions—supporters of Kumble and the Florida office versus Manley of the California office, Myerson of the New York office, and Robert Washington of the D.C. office.37 The fighting contributed to weakened finances and stood as testament to Finley Kumble’s failure to operate as one cohesive, national law firm driven first and foremost by the interests of their clients.38

In 1987, the United States’ fourth largest law firm filed bankruptcy and dissolved.39 The first truly merit-based law firm attempted to raid, recruit, and compensate high-profile rainmakers to support the firm’s expansion. Ultimately, as the guaranteed compensation promises crumbled under the weight of declining revenues and excessive debt, the firm’s predatory and money-driven culture left the institution with no other values to support its continued existence.40

B. Coudert Brothers

Coudert was a New York-based law firm established in 1853 and recognized as an international firm by 1879.41 At the

34. Id. at 9.
35. Id.
36. Brill, supra note 6, at 10.
40. Brill, supra note 6, at 15.
41. Darrel Wright, The Rise and Fall of Coudert Brothers, ASIALAW PROFILES (Dec. 1, 2005), http://www.asialawprofiles.com/Article/1971491/The-Rise-and-
firm’s peak it had twenty-eight offices in eighteen countries, employed more than eight hundred attorneys, and was one of the largest law firms in the world.42 Despite this widespread influence, Coudert collapsed after more than a century and a half of operations. The primary reasons for its failure include: (1) overreliance on its international practice; (2) excessive financial obligations to partners; (3) abortive merger attempts; and (4) failure to overcome a culture in which clients were viewed more as “property” of individual partners rather than as clients of the firm itself.

For many years, Coudert relied heavily on its international practice.43 While an international practice is a source of prestige—and of potential profits—it is also a source of potential risk. Operating across different economic environments often entails smaller profit margins, and resultant smaller margins for error.44 If a firm stretches itself too thin internationally, its maneuverability in the face of financial pressures can be greatly reduced. Such was the case with Coudert. As the firm expanded, it found itself unable to obtain adequate capital through operations and equity financing and instead borrowed money in order to bring in additional practice groups.45 Ultimately, the combination of internationalization of operations and heavy borrowing reduced Coudert’s financial agility and impugned its ability to compete with its peers on an even footing.46

Further weakening the structure of the firm, Coudert overpaid its partners.47 Although overpayments are not uncommon before law firms reconcile partnership payments with actual profits, Coudert had serious financial concerns at the time the overpayments to partners were made.48 Contrary to expectations, revenue streams sufficient to correct the effects of this over-distribution failed to materialize.49 At the time of bankruptcy, Coudert owed over $8 million in partner

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44. Id.
45. Id.
46. Id.
47. Id.
48. Id.
49. Rosen, supra note 43.
Moreover, overpayments to partners in combination with lateral moves of equity partners forced the firm below the required number of equity partners under its loan provisions with Citibank, N.A. and JPMorgan Chase Bank.\footnote{Ross Todd, Rescues Gone Wrong?, \textit{AM. LAWYER} (Feb. 1, 2011), http://www.americanlawyer.com/id=1202479106564/Rescues-Gone-Wrong.} This exodus ultimately spelled the downfall of Coudert. In a final attempt to salvage the enterprise, Coudert attempted to merge with other firms. After merger talks with Squire, Sanders & Dempsey in 2004 and Baker & McKenzie in early-to mid-2005 failed, Coudert found itself with its back to the wall.\footnote{Wright, \textit{supra} note 41.} Subsequently, the banks refused to extend further credit to Coudert, called in their loans, and forced the firm to dissolve in August 2005.\footnote{Todd, \textit{supra} note 51.}

Coudert filed for bankruptcy on September 22, 2006.\footnote{Patrick Fitzgerald, Coudert Brothers Law Firm Files for Chapter 11 Protection, \textit{WALL ST. J.} (Sept. 22, 2006, 2:49 PM), http://online.wsj.com/articles/SB115895051966871505.} Bankruptcy Judge McMahon made several observations about Coudert’s downfall.\footnote{Dev. Specialists, Inc. v. Akin Gump Strauss Hauer & Feld LLP, 477 B.R. 318, 329–31 (S.D.N.Y. 2012), amended, superseded, 480 B.R. 145 (S.D.N.Y. 2012), rev’d in part, vacated in part sub nom. In re Coudert Bros. LLP, 574 F. App’x 15 (2d Cir. 2014).} He noted that the mega-firm model resulted in divisions among classes of partners, client hoarding, and mercenary lateral hiring.\footnote{Id. at 330; see also Paul R. Hage & Patrick R. Mohan, You Can’t Take Them With You, Coudert Brothers and the Application of the Unfinished-Business Rule to Dissolved Law Firms, 31 AM. BANKR. INST. J., Aug. 2012, at 14, 15–72.} He further stated that many partners no longer saw their book of business as an asset of the firm, but as their personal property.\footnote{Dev. Specialists, \textit{supra} note 51.} Thus, in Judge McMahon’s view, Coudert’s culture and management style undermined the idea that client matters are firm property and greatly diminished the institutional cohesiveness necessary to respond to crises.\footnote{Dev. Specialists, \textit{supra} note 51.} Coudert’s dissolution marked one of the most historic and significant failures of an international law firm.

\begin{footnotes}
\item[50.] Id.\footnote{Ross Todd, Rescues Gone Wrong?, \textit{AM. LAWYER} (Feb. 1, 2011), http://www.americanlawyer.com/id=1202479106564/Rescues-Gone-Wrong.}
\item[51.] Wright, \textit{supra} note 41.
\item[52.] Todd, \textit{supra} note 51.
\item[54.] Id. at 330; see also Paul R. Hage & Patrick R. Mohan, You Can’t Take Them With You, Coudert Brothers and the Application of the Unfinished-Business Rule to Dissolved Law Firms, 31 AM. BANKR. INST. J., Aug. 2012, at 14, 15–72.
\end{footnotes}
C. Thelen

San Francisco-based law firm Thelen, Marrin, Johnson & Bridges was founded in 1924. In June 1998, the firm merged with New York-based Reid and Priest to form Thelen & Priest LLP. In a bid to further increase the firm’s East Coast presence, Thelen & Priest LLP merged with the New York firm of Brown Raysman Millstein Felder & Steiner, LLP (“Brown Raysman”) in 2006.

Thelen Brown Raysman & Steiner LLP, a bicoastal firm of over six hundred attorneys, materialized from the merger. Optimism surrounding the prospects of the new firm would prove premature. Thelen ultimately succumbed to a mix of factors broadly similar to those that proved the undoing of the other firms discussed in this Part: (1) economic recession; (2) defection of partners; (3) failed merger efforts; and (4) incautious financing practices.

A downturn in business left Thelen increasingly vulnerable to the effects of voluntary departures and lateral hiring of partners. Thelen lost around two hundred and thirty attorneys between the 2006 merger and the autumn of 2008, including three named partners from the pre-merger Brown Raysman. The firm attempted to stem this attrition through another merger, but discussions with Nixon Peabody...
LLP and other firms proved unsuccessful. After these deals fell through, Thelen—at that point under the threat of dissolution—attempted to divest itself of certain practice groups. Thelen subsequently shortened its name in August 2008 to Thelen LLP (“Thelen”).

In early September 2009, Thelen was finally pushed into the abyss of bankruptcy. Citigroup, Inc., Thelen’s primary secured creditor, refused to extend additional funds to cover the cost of collection, winding down of operations, or legal expenses associated with Chapter 11 proceedings. On October 28, 2008, Thelen’s partnership council launched a dissolution vote. The vote carried, mere weeks after fellow San Francisco firm Heller Ehrman folded.

According to Thelen, the firm’s estimated realizable assets were insufficient to result in any “meaningful payment to unsecured creditors” in light of the amount owed to Citibank on its secured loan. The estimated remaining assets were accounts receivable of approximately $35 million. However, after considering the liabilities, which amounted to over $18 million, Thelen estimated that it had only $10 million in realizable assets.

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70. See Amanda Royal, Thelen files for bankruptcy, Recorder (Sept. 12, 2009), http://www.ml-sf.com/media/docs/mlg_therecorder_091209.pdf.
73. See generally id.
Interestingly, Thelen was the fourth most highly leveraged American law firm before its demise.\textsuperscript{74} After the dissolution, critics claimed that Brown Raysman carried too much debt and specialized in practice areas that did not match well with Thelen’s premier construction group.\textsuperscript{75} Thelen’s chairman, Stephen O’Neal, attributed the collapse of Thelen to an “economic juxtaposition of circumstances.”\textsuperscript{76} Ultimately, Thelen filed a petition to liquidate under Chapter 7 of the Bankruptcy Code on September 18, 2009.

\textbf{D. Heller Ehrman}

Founded in 1890 by Emanuel S. Heller, what started as a solo practice in San Francisco’s Financial District rapidly expanded, adopting its permanent name of Heller, Ehrman, White, & McAuliffe in 1921.\textsuperscript{77} Heller Ehrman played a significant role in the expansion of the western United States, helping establish Wells Fargo Bank and arranging financing for the Golden Gate Bridge.\textsuperscript{78} Growing at one point to approximately seven hundred attorneys, the firm was a pioneer in providing legal services in business, technology, and complex litigation cases.\textsuperscript{79}

On September 26, 2008, in a shocking turn of events, Heller Ehrman voted to dissolve, ending a legal enterprise that survived the 1906 San Francisco earthquake, the Great Depression, and World Wars I and II.\textsuperscript{80} The consensus on the primary causes of Heller Ehrman’s dissolution implicates: (1) an unusual firm structure insufficiently resilient in the face of financial instability; (2) failure to globalize or specialize the

\begin{footnotesize}
\begin{enumerate}
\item This designation is based on a ratio of all lawyers to equity partners on the American Lawyer Top 100 law firms as of January 1, 2009. Susan Beck, \textit{Past the Tipping Point}, AM. LAWYER (Jun. 1, 2009), http://www.americanlawyer.com/id=1202426909972/Past-the-Tipping-Point.
\item Weiss, supra note 61.
\item Id.
\end{enumerate}
\end{footnotesize}
firm; (3) susceptibility to lawyer raiding; and (4) unsuccessful merger efforts.\(^8\)

First, Heller Ehrman adopted a peculiar business structure different from the vast majority of law firms.\(^2\) Instead of the typical limited liability partnership model, widely used by large firms today, Heller Ehrman was a partnership made up of professional corporations.\(^3\) In order to avoid double taxation of its income, the firm distributed all of its earnings at the end of each fiscal year and used a line of credit to fund operations until the subsequent year’s revenues caught up with its previous year’s expenses.\(^4\) Former Heller Ehrman partner Stephen Ferrulo speculated that this unique method of firm operation was particularly vulnerable to market downturns, and that a decline in business in 2007 “combined with the tight financial climate [to make 2008’s] financial juggle even tougher . . . .”\(^5\)

Second, although the firm prospered as the economy of the western United States surged, San Francisco—the center of the former boom—later underwent a drastic economic change.\(^6\) In particular, the city’s shrinking industrialized base of small to midsized businesses were too few to support the growing number of firms competing for that same business.\(^7\) Heller Ehrman’s failure to globalize or further specialize in additional fields also decreased their ability to maintain revenues.\(^8\) More than sixty percent of its business was from its litigation practice group, and a quarter of its litigation practice disappeared because of a changing San Francisco clientele.\(^9\) By the time Heller Ehrman attempted to

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\(^8\) Poll, supra note 79; Amanda Royal, Lessons Learned From Heller’s Collapse, RECORDER (Sept. 21, 2009), http://www.dailyreportonline.com/id=1202433929059/Lessons-Learned-From-HellersCollapse?slreturn=20141024202755.

\(^2\) Abate & Ross, supra note 80.

\(^3\) Id.

\(^4\) Id.

\(^5\) Id.

\(^6\) Royal, supra note 81.

\(^7\) Id.

\(^8\) Id.

expand globally, it was too far behind other firms. Heller neglected to shore up its core competency while simultaneously failing to adapt to the new paradigm.

Third, similar to many other large law firms, wavering partner loyalty emerged as a significant problem. Like a cheetah singling out a sick gazelle, headhunters and competing law firms saw an opportunity in Heller Ehrman’s structural and expansion problems to poach the firm’s rainmakers. The departure of one partner eventually led to a snowballing exodus of other partners. On September 14, 2008, a large group of Heller Ehrman’s intellectual property lawyers left to another law firm. Without its strongest partners and rainmakers at the helm, Heller became a sinking ship.

Finally, in a last effort to save the firm, Heller Ehrman searched for another firm to absorb its attorneys through a merger. This effort proved fruitless as every merger candidate passed on the opportunity to join the one hundred eighteen year-old firm. One week following the departure of Heller Ehrman’s intellectual property group, the firm’s banks froze its accounts. Several days later, the firm voted to dissolve one of the most historic and long-standing legal establishments in the United States.

E. Dewey & LeBoeuf

February 13, 2012 was the beginning of the end for Dewey. During a meeting called by Chairman Steven Davis, it became obvious Dewey had serious financial issues. Davis informed two dozen of the highest compensated rainmaker partners that Dewey “could not cover the roughly $250 million it owed partners in guaranteed compensation.” Within three months of the merger between LeBoeuf, Lamb, Greene & MacRae (“LeBoeuf Lamb”) and Dewey Ballantine, the firm—once thirteen hundred lawyers strong—became the largest United

91. Poll, supra note 79.
92. Id.
93. Royal, supra note 81.
94. Abate & Ross, supra note 80.
95. Royal, supra note 81.
96. Id.
97. Triedman et al., supra note 4, at 49.
98. Id.
States law firm in history to file Chapter 11 bankruptcy. The events leading up to Dewey’s collapse illustrate the problems that can make even large and prominent law firms prone to bankruptcy.

1. The Rise and Fall of Dewey

Dewey Ballantine and LeBoeuf Lamb merged in 2007 to form Dewey & LeBoeuf—the world’s twenty-third largest law firm by revenue at the time. The merger represented the culmination of several events and trends. Davis, as the sole chairman of LeBoeuf Lamb, employed a strategy of hiring rainmaker partners from other firms. This hiring strategy proved successful for several years. LeBoeuf Lamb doubled its profits per partner between 2000 and 2006 “from $705,000 to $1,450,000.” Even in light of the firm’s expansion to 713 lawyers by 2007, Davis hoped to further expand through a merger with another firm.

Dewey Ballantine, on the other hand, wanted to stabilize its firm following failed merger negotiations with Orrick, Herrington & Sutcliffe in January 2007. The collapse of these merger negotiations devastated Dewey Ballantine and caused a fifth of the partnership, including key mergers and acquisitions partners, to leave the firm. Consequently, Dewey Ballantine sought to diversify its business to prevent overreliance on its M&A practice group.

Over the next few months, Dewey Ballantine and LeBoeuf Lamb engaged in secret merger discussions that resulted in an agreement in August 2007. Following the agreement, Paul, Weiss, Rifkind, Wharton & Garrison conducted due diligence on Dewey Ballantine, McKinsey & Company, Inc., analyzed the benefits of the merger, and Ernst & Young LLP reviewed

99. Id.
101. Id.
102. Triedman et al., supra note 4, at 49.
103. Id.
104. Id.
105. Id.
106. Id.
107. Id.
108. Triedman et al., supra note 4, at 49.
109. Id. at 50–51.
Dewey’s financial information on behalf of LeBoeuf Lamb. However, transparency and caution were in short supply: the new Dewey & LeBoeuf partners received merger agreements that did not contain financial details about either of their prior firms. Allegedly, neither Dewey Ballantine nor LeBoeuf Lamb had outside counsel regarding its merger.

LeBoeuf Lamb partners approved the merger plan, but required concessions to obtain the necessary support. Davis and LeBoeuf Lamb executive director Stephen DiCarmine promised large bonuses for longtime LeBoeuf Lamb partners, executive committee members, and top management conditioned on the merger vote’s passage. In particular, legacy LeBoeuf Lamb executive members would each receive approximately $300,000, and top administrators would receive approximately $1 million. A merger memorandum also noted a special $15 million payment to LeBoeuf Lamb legacy partners. Other key rainmakers were guaranteed large bonuses designed to keep them at the firm—one partner, for example, was promised “$6 million dollars for several years.” DiCarmine stated in early 2009 that any partner bringing in “over $10 million in business got a package, a long-term incentive plan.”

Signs of trouble quickly surfaced. In March 2008, Leboeuf Lamb legacy partners discovered that they were accountable for $60 million in payouts to retired Dewey Ballantine partners pursuant to that firm’s partnership agreement. Nonetheless, Davis—with the consent of the compensation and executive committees—updated partner compensation packages that same month by placing partners in similar tiers at both firms into whichever firm’s compensation band was higher. As a result, partners from both sides saw their compensation increase.

110. Id.
111. Id.
112. Id.
113. Id.
114. Triedman et al., supra note 4, at 50–51.
115. Id. at 51.
116. Id.
117. Id.
118. Id.
119. Id. at 53.
120. Triedman et al., supra note 4, at 53.
121. Id.
Despite increased difficulty meeting a target “profit pool” twenty-five percent greater than the combined profits of the two predecessor firms’ best-netting years, Dewey nonetheless announced compensation increases for its partners on March 13th.\textsuperscript{122} The timing could not have been worse. One day after this announcement, Bear Stearns Companies, Inc. collapsed.\textsuperscript{123} Lehman Brothers Inc. failed six months later, and American International Group, Inc. failed soon thereafter.\textsuperscript{124} “The bottom had fallen out of the capital and credit markets that sustained both the Dewey-side corporate practice and the Leboeuf-side insurance practice.”\textsuperscript{125}

This resulted in Dewey offices closing in Austin, Hartford, Jacksonville, and Charlotte.\textsuperscript{126} The profit pool for 2008 totaled only $278 million—forty percent of projections.\textsuperscript{127} Dewey drew on about $60 million in revenues from the first quarter of 2009 to “cover the shortfall” between expected profits and expenses of the prior year.\textsuperscript{128} These 2009 revenues compensated the most important rainmaker partners, but other partners saw their compensation cut by over forty percent.\textsuperscript{129}

As the economy continued to decline, many Dewey partners did not receive their promised compensation.\textsuperscript{130} In 2009, revenues again slipped by 16% to $809 million and profits fell 13% to $241 million.”\textsuperscript{131} However, Davis continued his policy of rapid growth by hiring additional rainmakers from Cooley LLP.\textsuperscript{132} Dewey subsequently sold $150 million in term notes to refinance firm debt and for general use.\textsuperscript{133} The firm did not alert investors to the firm’s ballooning obligations connected with partner compensation.\textsuperscript{134}

In late 2011, when the legal market began to recover from the 2008 lateral hiring freeze, Davis extended new financial guarantees to at least one hundred partners to prevent

\begin{footnotesize}
\textsuperscript{122} Id.  \\
\textsuperscript{123} Id. at 52.  \\
\textsuperscript{124} Id.  \\
\textsuperscript{125} Id.  \\
\textsuperscript{126} Triedman et al., supra note 4, at 52.  \\
\textsuperscript{127} Id.  \\
\textsuperscript{128} Id.  \\
\textsuperscript{129} Id.  \\
\textsuperscript{130} Id.  \\
\textsuperscript{131} Id. at 54.  \\
\textsuperscript{132} Triedman et al., supra note 4, at 54.  \\
\textsuperscript{133} Id.  \\
\textsuperscript{134} Id. 
\end{footnotesize}
rainmakers from leaving the firm and taking their clients with them.\textsuperscript{135} Davis hid the scope of this practice from the compensation committee.\textsuperscript{136}

Throughout 2011, Dewey expanded into various international markets and appeared to accumulate more business.\textsuperscript{137} However, by late December 2011 and early 2012, more problems began to emerge: rainmakers failed to collect bills (or failed to send them altogether) and clients continued to cut back on legal spending.\textsuperscript{138} Dewey’s partners did not know that the firm’s “obligations for current and deferred compensation exceeded its earnings by at least $250 million.”\textsuperscript{139}

Partners finally learned about Dewey’s dire financial outlook on January 27, 2012, during an “all-partner video conference.”\textsuperscript{140} Davis informed the partners that Dewey had revenues of roughly $780 million in 2011, which generated “only $280 million in profits.”\textsuperscript{141} Because profits generated by the firm had to be used to pay obligations “owed to partners from prior years,” Dewey did not issue any 2011 profit distributions.\textsuperscript{142} Dewey maintained that the partners should not be worried—according to DiCarmine, “the firm had $250 million in accounts receivable less than 180 days old . . . as well as $400 million in older uncollected bills.”\textsuperscript{143} Despite these words of encouragement, “a trickle of partners began to leave.”\textsuperscript{144}

After the February 13th meeting, a group of senior partners (eventually referred to as the operations committee) announced that almost all of the highest-paid partners had “agreed to compensation caps of $2.5 million in 2012.”\textsuperscript{145} This committee subsequently “proposed a long term plan to repay about half the $250 million in deferred compensation owed to partners and write off the rest.”\textsuperscript{146} Pursuant to the plan, “a

\begin{footnotesize}
\begin{enumerate}
\item[135.] \textit{Id.}
\item[136.] \textit{Id.}
\item[137.] \textit{Id. at 55.}
\item[138.] Triedman et al., \textit{supra} note 4, at 55.
\item[139.] \textit{Id.}
\item[140.] \textit{Id.}
\item[141.] \textit{Id.}
\item[142.] \textit{Id.}
\item[143.] \textit{Id.}
\item[144.] \textit{Id. at 55–56.}
\item[145.] \textit{Id. at 55–56.}
\item[146.] \textit{Id. at 56.}
\end{enumerate}
\end{footnotesize}
portion of annual profits” would be allotted “to fund a trust.” \(^{147}\) After two or three years, “the trust would begin paying down deferred compensation over” a period of seven to eight years. \(^{148}\)

This would never reach fruition: on March 17, 2012, Dewey’s insurance transaction group moved to Willkie Farr & Gallagher. \(^{149}\) Following this departure, additional partners began to lateral to other firms. \(^{150}\) Twenty-two partners left in March 2012 alone. \(^{151}\) Some of Dewey’s most senior and highest paid partners attempted to restructure the firm to stabilize the situation, and a five-person “office of the chairman” replaced DiCarmine as the firm’s day-to-day manager. \(^{152}\) Management knew that the hemorrhage of partners was unsustainable, and the office of the chairman had discussions with “about six firms, all of which expressed interest in taking parts of Dewey. Greenberg Traurig was the most serious.” \(^{153}\) By the time Greenberg went public with its interest in “a large-scale deal” for acquiring Dewey, thirty-one additional “partners had announced their departures” from Dewey. \(^{154}\) Greenberg withdrew from its acquisition talks with Dewey after it became public that Davis was the target of a criminal probe for his conduct as Dewey’s chairman. \(^{155}\)

When Greenberg pulled out of merger talks, the firm’s managers told all the remaining partners “that they were free to go elsewhere.” \(^{156}\) Consequently, 214 partners left in May 2012. \(^{157}\) Dewey subsequently filed for Chapter 11 bankruptcy on May 28, 2012, becoming the largest law firm in American history to declare bankruptcy. \(^{158}\)

On February 27, 2013, U.S. Bankruptcy Judge Martin Glenn approved Dewey’s liquidation plan. \(^{159}\) Pursuant to the plan, “former Dewey partners agreed to pay $71.5 million to

\(^{147}\) Id.

\(^{148}\) Id.

\(^{149}\) Id.

\(^{150}\) Id.

\(^{151}\) Id.

\(^{152}\) Id.

\(^{153}\) Id.

\(^{154}\) Id.

\(^{155}\) Id.

\(^{156}\) Id. at 57.

\(^{157}\) Id.

\(^{158}\) Id. at 52.

the firm’s estate in exchange for a release from litigation. The deal required partners to contribute between $5,000 and $3.5 million each.\textsuperscript{160} Overall “[m]ore than 450 Dewey partners opted into the settlement, though a handful . . . declined to participate.”

Secured creditors, such as JPMorgan Chase & Co., had a total of “$262 million in claims against Dewey.”\textsuperscript{161} Under the second amended bankruptcy plan, general unsecured creditors are slated to receive only five to fourteen cents on the dollar for their $300 million in claims.\textsuperscript{162} Totaling the claim classes, the ABA Journal reported that Dewey owed creditors approximately $562 million.\textsuperscript{163} Pursuant to the bankruptcy plan, “secured creditors get 80 percent of what is distributed by the bankruptcy estate, and unsecured creditors get 20 percent.”\textsuperscript{164} In the June 30, 2014 distribution under the plan, holders of general unsecured claims received very slightly more than four cents on the dollar.\textsuperscript{165}

According to court papers, “[t]wo other former Dewey leaders, Chief Financial Officer Joel Sanders and Executive Director Stephen DiCarmine, were not included in the proposed settlement. The trustee reserved the right to pursue non-covered claims against the two men . . . .”\textsuperscript{166} In March of 2014, New York prosecutors filed a 106-count indictment against Davis, DiCarmine, and others alleging that firm leadership had engaged in a criminal scheme to defraud

\begin{footnotesize}
\begin{enumerate}
\item[161.] Sullivan, supra note 159.
\item[163.] Id.
\item[164.] Id.
\item[166.] Sullivan, supra note 160.
\end{enumerate}
\end{footnotesize}
creditors.\textsuperscript{167} Between cut positions, shuttered offices, creditor losses, and the presentation of thorny issues such as the proper disposition of the firm’s old files,\textsuperscript{168} the fallout of the collapse was immense. As of this writing, the Dewey bankruptcy proceedings are ongoing—and are likely to be for some time.

2. \textit{Reasons for Dewey’s Bankruptcy}

Dewey dissolved as a consequence of: (1) overcompensation and guaranteed pay for rainmakers; (2) excessive bonuses paid as a result of the merger between Dewey Ballantine and LeBoeuf Lamb that went unrevealed to most partners until the eleventh hour; (3) agreements to pay off $60 million of Dewey Ballantine’s pre-merger debts; (4) increased firm-wide compensation; (5) uncontrolled, leveraged national and international expansion; and (6) the economic downturn following the 2008 financial crisis.\textsuperscript{169}

First, the partners at Dewey backed themselves into a corner through the implementation of grandiose compensation schemes and guaranteed pay for its partners.\textsuperscript{170} In March 2008, Davis—with the consent of the executive and compensation committees—slotted partners at both Dewey Ballantine and LeBoeuf into whichever legacy firm’s compensation band was higher.\textsuperscript{171} This led to an indiscriminate increase in compensation for all partners.\textsuperscript{172} Such a compensation arrangement is only tenable when there is continually mounting revenue growth, a scenario that did not play out.

Second, Dewey failed to fully disclose to all partners the incentives the firm used to entice rainmakers.\textsuperscript{173} Specifically, as late as the end of 2011 and the beginning of 2012, Dewey’s partners remained unaware that the firm’s “obligations for current and deferred compensation exceeded its earnings by at


169. Triedman, et. al, supra note 4, at 56.

170. \textit{Id.} at 53.

171. \textit{Id.}

172. \textit{Id.}

173. \textit{Id.} at 52.
least $250 million.”174 Dewey’s problems were not revealed to most of its partners until it was too late to effectively head off the firm’s demise.

Third, shortly after the initial merger between Dewey Ballantine and LeBoeuf Lamb, the LeBoeuf-side partners discovered a total of $60 million in obligations.175 Dewey delayed other firm obligations to pay these partner guarantees.176 This “surprise expense” created resentment from the LeBoeuf-side partners.177

Fourth, once the legal market began improving in 2010 and 2011, Davis extended new guarantees to at least one hundred partners to encourage those rainmakers to stay at the firm.178 At a time when the firm needed financial flexibility, Davis instead added millions of dollars more debt with these guarantees.

Fifth, the acquisition of partners from other firms and an expansion into international markets created a false sense of business growth, exposed to Dewey to greater risk, and added more unsustainable debt.179

Lastly, the 2008 recession affected Dewey more than many firms, as it significantly impacted Dewey’s corporate practice and Leboeuf’s insurance practice.180 In the wake of the economic downturn, clients began to realize their increased bargaining power and spent less on legal fees and demanded additional discounts on legal services.181 Compounding this problem, rainmaker partners sent and collected client bills late.182 Ultimately, Dewey lacked the necessary revenues to cover its obligations. Upon discovering this deficiency, rainmaker partners departed the firm along with many of their high-profile clients.183

174. Id. at 55.
175. Id. at 53.
176. Id.
177. Id. at 50.
178. Id. at 54.
179. Id. at 53–54.
180. Id.
181. Id. at 55.
182. Peter Lattman, Dewey & LeBoeuf Said to Encourage Partners to Leave, N.Y. TIMES, Apr. 30, 2012, http://dealbook.nytimes.com/2012/04/30/dewey-leboeuf-said-to-encourage-partners-to-leave/. “The firm had fallen so behind on collecting unpaid legal bills that management sent out an e-mail offering partners free iPads and iPhones if their clients paid them on time.” Id.
183. Triedman et al., supra note 4, at 55–56.
II. SOLUTIONS TO LAW FIRM BANKRUPTCIES

A. Introduction

Each law firm bankruptcy covered in this Article was unique. However, a number of similar causes cut across these collapses. These causes include: (1) overreliance on rainmaker partners, who in times of financial instability tended to lateral out of the troubled firm and take their books of business with them,\(^\text{184}\) (2) the failure of merger negotiations,\(^\text{185}\) (3) the overpayment of partners during or immediately preceding times of economic difficulty,\(^\text{186}\) (4) inability to cope with broader economic downturns,\(^\text{187}\) (5) excessive amounts of firm debt,\(^\text{188}\) and finally (6) a lack of oversight of firm finances by non-rainmaker equity partners.\(^\text{189}\)

This Part will analyze and recommend possible solutions to law firm bankruptcies.\(^\text{190}\) These solutions are designed to confront the structural weaknesses that led to the large firm bankruptcies discussed earlier in the Article. Although these suggestions will directly address the overarching problems presented in these case studies, these propositions also can apply to medium and small law firms. That said, each law firm is different. Consequently, certain proposed solutions will prove more or less effective for a given firm. For example, a small law firm may not be able to employ the market-based public trading solution. However, this same firm may be able to avoid bankruptcy by requiring full disclosure of the firm’s finances to all partners and/or by applying the unfinished business doctrine. Thus, a given proposed solution—or

\(^{184}\) Poll, supra note 79; Stempel et al., supra note 68; Triedman et al., supra note 4, at 55–56; David M. Stern, Law Firm Bankruptcies, 37 LITIG. 8, 13 (2011).

\(^{185}\) Abate & Ross, supra note 80; Poll, supra note 79; Triedman, et al., supra note 4, at 56; Wright, supra note 41; Jones, supra note 61.

\(^{186}\) Rosen, supra note 43; Triedman et al., supra note 4, at 53.

\(^{187}\) Rosen, supra note 43; Stern, supra note 184, at 14; Triedman et al., supra note 4, at 55.

\(^{188}\) Brill, supra note 6, at 1; Triedman et al, supra note 4, at 49.

\(^{189}\) Triedman et al, supra note 4, at 55.

\(^{190}\) This Article assumes that law firms prefer the use of an LLP model and will not return to the General Partnership (“GP”) model. The presumption arises from the legal implications of the GP model. Returning to the GP model would greatly reduce law firm bankruptcies, as the imposition of unlimited liability on partners would theoretically encourage law firm partners to refrain from risky behavior. C.f. Don Rafner, The Advantages of LLP over LLC for a Law Firm, HOUSTON CHRON., http://smallbusiness.chron.com/advantages-llp-over-llc-law-firm-51699.html.
combination of multiple solutions—may or may not be appropriate for a given firm in light of its size and governing structure.

Five possible solutions will be discussed and recommended within two overarching categories: market solutions and regulatory solutions. Proposed market solutions will be analyzed in the following order: (1) creation of a regime in which the public can directly invest in law firms; (2) the establishment of an intra-firm regulatory system whereby all of the firm’s finance, oversight, governance, and risk management practices would be disclosed to all firm partners on a specified basis; and (3) the adoption of contractual restrictions on departing partners. Proposed regulatory solutions will be discussed in the following order: (1) the broad legislative enactment of the unfinished business doctrine, a common law remedy not currently available in all jurisdictions; and (2) regulatory oversight by a governmental agency. Two other solutions—changes to the ABA Model Rules and expansion to international markets—will be discussed but ultimately rejected.

B. Market-Based Solutions

1. Public Investment in Law Firms

This Article’s first market-based proposal designed to stave off law firm bankruptcies is to allow the public to invest in law firms in a manner similar to how it currently invests in publicly traded companies. This potential solution has several advantages and disadvantages. The two primary advantages are that: (1) law firms will have access to more capital to address financial difficulties; and (2) law firms that publicly trade their stock will be required to comply with Securities and Exchange Commission (SEC) rules and regulations. These requirements would obligate the law firm to publicly file certain disclosure documents, such as offering statements and periodic financial disclosures. Failure to comply with SEC requirements—such as not making required disclosures, or making inaccurate disclosures—could expose firms to potential liability. The prospect of running afoul of the SEC would provide heightened accountability by encouraging the timely and accurate release of financial information. The primary disadvantages of this approach include: (1) the prospect that internal law firm governance will be subject to public scrutiny
rather than privately managed by the firm’s lawyers; and (2) the fact that non-lawyers will have an ownership stake in—and hence potential voting membership and control over—the law firm. The prospect of non-lawyer equity holders raises possible ethical problems, as (a) non-lawyers could potentially make decisions that affect a lawyer’s representation of a client; and (b) non-lawyers could potentially accept legal fees as profits. Both (a) and (b) would constitute violations of the Model Rules of Professional Conduct.¹⁹¹ The advantages and disadvantages of this proposed market-based solution will be discussed in further detail below.

a. Increased Capital Advantage

In a solution embracing public investment in law firms, firms availing themselves of such funding will have another capital source on which to draw when faced with financial difficulties. Part II’s case studies starkly illustrate that a shortage of capital at key moments is often a harbinger of bankruptcy. Allowing law firms to sell securities to the public would give them access to a massive funding pool that they can draw on in response to financial difficulties and, ideally, avoid plunging into bankruptcy for want of access to capital.

Oversight would have to be key component of this solution. Public investment divorced of regulation would allow a firm to use investor money without effective accountability—strongly courting financial mismanagement. Unless a publicly traded law firm is exposed to the liabilities that come with public trading, additional capital infusion by outside investors would only exacerbate the likelihood of bankruptcy. Thus, increased access to capital will be part of effective solution only if it comes with oversight.

b. SEC Requirements Advantage

Fortunately, this problem would be at least partially addressed automatically: public issuance of securities by law firms would trigger SEC oversight mandates. Thus, the second advantage of allowing the public to invest in law firms is that firms seeking such investment would be subject to SEC oversight.

¹⁹¹ See Model Rules of Prof’l Conduct R. 5.4(a) (2012) (prohibits a lawyer from sharing legal fees with a non-lawyer); see also Model Rules of Prof’l Conduct R. 5.4(c) (2012) (prohibits non-lawyers from representing clients).
disclosure requirements similar to those that apply to other enterprises that publicly issue stock. Failure to comply with SEC rules and regulations opens the firm—and even individuals in leadership roles—to potentially massive liability. This threat would disincentivize the firm and its leadership from recklessly spending investors’ money.

An extended discussion of the liabilities firms and their principals could face for violations of SEC regulations is beyond the scope of this Article. However, a brief discussion may be helpful. Whether there would be liability and what would be its contours depends on the enabling statute. For example, issuers who conduct a registered deal (that is, a securities issuer who is required to register their deal with the SEC and does so) may be liable under section 11 of the Securities Act. This Part grants an express private right of action to purchasers of securities issued under a registration statement that contains materially misleading information as of the statement’s effective date.\footnote{See 15 U.S.C. § 77k(a) (2011).} Section 11 liability is a serious matter: signatories of the registration statement (in this case, law firm partners) and directors can be held personally liable, and the plaintiff rarely needs to show reliance on the misleading information in the statement—effectively making section 11 violations judged under a strict liability standard.\footnote{Id.} Damages are typically calculated by subtracting the value of the securities at the time of suit from the offering price—with a law firm whose stock value has declined precipitously, this gulf may be immense.\footnote{See 15 U.S.C. § 77k(e).}

Section 12(a)(1) of the Securities Act imposes liability for violations of section 5 of the Securities Act, which would cover the vast majority of law firm security offerings.\footnote{See 15 U.S.C. § 77l(a)(1); 15 U.S.C. § 77e. For further discussion of §§ 5 violations and 12(a)(1) liability, see, e.g., THOMAS LEE HAZEN, FEDERAL SECURITIES LAW 67–69 (3d ed. 2011).} Section 5, broadly speaking, covers SEC disclosure requirements and governs the manner of offering securities.\footnote{See § 77e.} Section 12(a)(1), like section 11, grants a private right of action that implicates an effective strict liability standard.\footnote{See § 77l(a)(1).} A successful section
12(a)(1) action will result in rescission for the purchaser.\textsuperscript{198} Section 12(a)(2) provides another source of liability for public offerings,\textsuperscript{199} again carrying a rescission remedy.\textsuperscript{200}

Section 17 of the Securities Act does not create a private right of action, but grants the SEC a very broad ability to punish instances of both fraud and unknowing unjust enrichment.\textsuperscript{201} Rescission and damages are available under section 17. Additionally, a minority of courts have allowed for punitive damages.\textsuperscript{202} Finally, section 10(b) of the Securities Exchange Act of 1934 grants an expansive private right of action to buyers and sellers of securities in instances of intentional or reckless deception or manipulation by \textit{anyone} who violates SEC regulation in connection with the purchase or sale of a security.\textsuperscript{203} All of this is setting aside the possibility of \textit{criminal} liability for violation of the securities laws.\textsuperscript{204} This Article is not designed to predict what SEC rules may apply to a law firm’s offering of securities in a given situation, nor does it purport to cover every liability situation in the foregoing paragraphs. The salient point is that the SEC and private purchasers have no shortage of tools with which to address both intentional and unintentional violations of the Securities Act.

Consequently, the first and second advantages of the public investment approach may allow a law firm to raise more capital while compelling it to disclose important financial information. Public investment would increase firms’ financial agility while simultaneously incentivizing the wise use of this newfound capital, thanks to the applicability of disclosure


\textsuperscript{199} Section 12(b)(2) is not explicitly restricted to public offerings, but this has been read in as an effective requirement. \textit{See generally} Gustafson v. Alloyd Co., 513 U.S. 561 (1995). An offering can be quite small and still be characterized as “public” for purposes of 12(a)(2) liability. \textit{See generally} Janet E. Kerr, \textit{Ralston Redux: Determining Which Section 3 Offerings Are Public Under Section 12(2) After Gustafson}, 50 SMU L. REV. 175 (1996).


\textsuperscript{201} \textit{See} 15 U.S.C. § 77q.


\textsuperscript{203} \textit{See} 15 U.S.C. § 77j.

requirements and other federal financial regulations. Apart from the threat of liability for regulatory noncompliance, disclosure requirements would allow market forces to act as another source of pressure on firms to use capital strategically and economically. Failure to efficiently maximize productivity and profit would prompt the market to adjust the firm’s value. Disclosures would ensure proper investor awareness of firm performance, and the level of public investment would ultimately respond accordingly.

c. Public Scrutiny Disadvantage

Disclosure, however, can be a double-edged sword. The first disadvantage of allowing public investment in law firms is the possibility of public scrutiny of a firm’s internal governance procedures and financial practices. This aspect of the proposal will likely prove extremely disconcerting to lawyers, as firms have traditionally been managed largely free from outside influence or intervention. Depending on the size and governance structure of a firm, it may be managed exclusively by an Executive Committee or a Managing Partner. Allowing firms to issue securities to the public, however, would require major changes in law firm governance. Although many law firms are likely to balk at the adoption of a management and governance system compliant with applicable statutory and SEC regulatory requirements, the potential benefits of raising capital from the public may outweigh the disadvantages posed by the accompanying public scrutiny.

d. Non-Lawyer Ownership Disadvantage

The second major disadvantage of allowing the public to invest in law firms is that the issuance of equity securities by firms would allow non-lawyers to take an ownership stake in the enterprise. Hence, non-lawyers will have potential voting rights and control over the law firm, and would share in profits with lawyers. This raises possible ethical problems such as (a) the potential that non-lawyers could make decisions influencing a lawyer’s representation of a client; and (b) the possibility of non-lawyers accepting legal fees as profits. Both of these outcomes would be ethical violations of the standing Model Rules of Professional Conduct and under most—if not
These potential aspects of the public investment solution pose serious problems in the first instance, but fortunately these concerns can be easily headed off. First, the prospect of non-lawyers taking control of a law firm such that they could collectively or individually control the legal representation of a client can be avoided. For example, the SEC could require that law firms that publicly issue stock must ensure at least a simple majority of stock remains in the hands of the attorneys. Additionally, the issuance of non-voting stock or other special classes of stock could allow for public investment without public interference in the day-to-day operations of the firm concerning representation of clients. Second, the prospect of having non-lawyers share legal fees could be avoided with the adoption of an internal firm-wide profit sharing arrangement with non-lawyer employees.

e. Conclusion

This Article endorses a market-based, public investment solution to law firm bankruptcies. This proposal could mitigate the financial problems that have driven some of the largest and most prestigious law firms into bankruptcy. In fact, this solution would likely increase access to higher quality legal services due to capital injection and increased financial transparency. These benefits would outweigh the speculative ethical sacrifices, which could be avoided in any case. This Article therefore recommends this market-based solution of permitting law firms to publicly issue stock, thereby allowing them to adjust to new economic realities and decrease the risk of bankruptcy.

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205. See MODEL RULES OF PROF'L CONDUCT R. 5.4(a) (2013) (prohibits a lawyer from sharing legal fees with a non-lawyer); MODEL RULES OF PROF'L CONDUCT R. 5.4(e) (2012) (prohibits non-lawyers from representing clients).

206. The ABA Model Rules generally prohibit a lawyer from sharing “legal fees” with a non-lawyer. MODEL RULES OF PROF'L CONDUCT R. 5.4(a) (2013). That said, the Model Rules allow a “lawyer or law firm [to] include nonlawyer employees in a compensation or retirement plan, even though the plan is based in whole or part on a profit-sharing arrangement . . . .” R. 5.4(a)(3). Generally, where firms run into trouble is where they tie such profit-sharing arrangements to representation in specific matters—general profit-sharing arrangements have typically passed muster without much issue. See, e.g., Thomas Spahn, Paying Non-Lawyer Colleagues: Generosity or Fee-Sharing?, CAROLINA PARALEGAL NEWS (Dec. 6, 2012), http://nclawyersweekly.com/paralegal/2012/12/06/paying-non-lawyer-colleagues-generosity-or-fee-sharing/.

a. Introduction

Second, this Article recommends the adoption of a regulatory system under which all of a firm’s finance, oversight, governance, and risk management practices are disclosed to all firm partners. As Part II demonstrated, prominent law firms that went on to declare bankruptcy often had an internal structure under which many lower-ranking partners had no knowledge that the firm was experiencing financial difficulties until the eleventh hour. Opaque financial disclosure policies—formal and informal—make it very difficult for all partners to grasp the true financial health of their firm. A regulatory system demanding increased internal transparency would improve a firm’s overall financial resiliency by discouraging risky investment, management, and financial behavior, while requiring only minimal interference with a firm’s internal management and governance. However, marginally widening the circle of transparency to include only income partners may not completely prevent poor decision-making. Conversely, involving substantially more people in the decision-making process could bog down management and create internal gridlock. Ultimately, however, the advantages of transparency outweigh its potential downsides. Any pushback on management from newly informed partners will likely lead to increased accountability.

b. Advantages of Full Disclosure

The primary advantages of this type of internal regulatory scheme are in its (1) discouragement of risky investment, management, and financial behavior by top decision-makers; and (2) its minimal interference with a firm’s internal management and governance.

In Dewey’s case, firm leaders made the decision to extend guarantees to rainmakers and incur massive debt without the knowledge of second-tier partners. These decisions, combined with the financial crisis in 2008, led to Dewey’s demise.207 Ultimately, those who made the decisions at Dewey faced few consequences from the ancillary partners, the associates who

207. Triedman et al., supra note 4, at 49.
lost their jobs, and the creditors who received only cents on the dollar as a result of the liquidation plan.208 This two-tiered structure is not unique to Dewey: these types of partnerships have become an increasingly common way to structure law firm equity ownership.209 In many instances this has led to a large equity partner income gap, with equity tier partners earning up to eight to ten times more than non-equity partners.210 Firms with two-tiered partnership models are also more apt to engage in heavy lateral rainmaker hiring: Finley Kumble sought to inflate profits by attracting lateral hires and their clients in exchange for enormous salaries.211 However, this practice increased long-term liabilities, fostered internal discord, and led to the firm’s downfall.212 These types of hiring practices, along with a growing perception of partnership inequality, have the potential to lead to an erosion of partnership values.213

If law firms were required to internally disclose financial statements to every law firm partner—in instead of only a few equity and executive partners—it is unlikely that all partners would support the type of risky management behaviors that have led to the sort of law firm bankruptcies examined in Part II. Full disclosure policies would serve to tether equity partners and non-equity partners together with a common purpose. Furthermore, disclosing financial details to all partners would decrease the possibility that a few individuals at the top would make imprudent “bets” where the downside for the firm is disproportionally large. This increased accountability could act to slow the growth of large firms, but would temper the equity partners’ ability to catalyze short-term but potentially unsustainable expansion by way of lateral hiring. As seen in the cases of Dewey, Finley Kimble, and

208. Sullivan, supra note 159.
211. Brill, supra note 6; Harper, supra note 29.
212. Brill, supra note 6.
Coudert, short-term growth and oversized guarantee of payments have the potential to lead to unsustainable long-term liabilities terminating in bankruptcy.\textsuperscript{214}

Moreover, this proposed solution is reasonable: although it requires internal interference with law firm management and governance, this interference is minimal and less drastic than that required by the public investment solution. Admittedly, widening the circle of transparency can be a difficult change to effectuate. Nevertheless, it is an approach some firms are beginning to independently adopt.\textsuperscript{215} Unlike the first proposed solution to law firm bankruptcies, disclosure to all of a firm’s partners keeps the information in the firm as public disclosures are unnecessary. Moreover, implementation of this scheme would not require any increased exposure to liability under SEC regulations, nor would it raise any direct ethical problems.

c. Disadvantages of Full Disclosure

Disadvantages of applying this type of full disclosure policy include (1) a possible failure to completely prevent poor decision-making; and (2) the involvement of more people in the decision-making process, thereby potentially slowing managerial effectiveness and causing internal gridlock.

Conceptually, the goals of increased transparency are to prevent unsustainable distribution levels to partners and establish wider accountability for firm decision-making. In Thelen’s case, however, a perception of inefficient management and the revelation of poor capital allocation led to attorney attrition rather than a push for better decision-making.\textsuperscript{216} Thus, it is difficult to say with certainty whether increased financial transparency would have saved a firm like Thelen from impending doom. Nevertheless, it is unlikely that a policy of increased disclosure would have negatively affected a firm in Thelen’s position. A clearer view of firm financials could have

\textsuperscript{214} See Brill, supra note 6; Rosen, supra note 43; Triedman et al., supra note 4, at 49; Harper, supra note 29.


\textsuperscript{216} Young, supra note 63.
decreased partner angst, minimized uncertainty, and fostered more constructive problem-solving discussions.

Additionally, making full disclosures to all partners may decrease the overall operational effectiveness of management. In a two-tiered partnership law firm, income partners have different compensation schemes than equity partners.\(^{217}\) Equity partners have a stake in the firm and its furtherance, and thus typically are naturally held more accountable for their decisions in guiding the firm.\(^{218}\) In contrast, income partners are incentivized by a larger paycheck and over the long term are incentivized only by the more removed prospect of ensuring job security. Full financial transparency could create competing interests within both tiers of partners. At the very least, it would not serve to correct this misalignment of incentives. However, this potential for internal conflict should largely be offset by the equity partners’ superior bargaining power, leading non-equity partners to dispute only decisions that could make or break the firm. Importantly, the two tiers of partners are ultimately guided by the shared interest of maintaining the continued existence and profitability of the firm. Although at many points the interests of the two parties may diverge, financial disclosure would ensure a balance of oversight is maintained and the common threads linking the partner classes remain intact.

\(d.\) Conclusion

In sum, this Article recommends the mandatory disclosure of law firm finance, oversight, governance, and risk management practices to all partners. The advantages that this solution presents outweigh the drawbacks. This second solution may be implemented in conjunction with the first public investment solution to more effectively bolster the ability of a firm to ward off bankruptcy. Large law firms may benefit from both public disclosures to the SEC and internal firm disclosures to their partners. For smaller and medium sized firms unable to go public, this solution may be a more promising method to mitigate the possibility of bankruptcy.

\(^{217}\) Henderson, supra note 209, at 1725; Richmond, supra note 209.
\(^{218}\) Id.
3. Contractual Restrictions on Departing Partners

a. Introduction

This Article’s third proposal to combat law firm bankruptcies is to impose contractual restrictions on departing partners. An attorney would enter into these restrictive covenants when joining a firm, and these covenants would restrict the departed partner’s ability to work with current clients of the firm, poach current clients of the firm, or practice in a specific geographic region for a specific period of time. Simply stated, contractual restrictions would act to discourage rainmakers from departing a law firm. Additionally, such restrictions could be implemented flexibly according to market conditions and firm employment negotiations. This solution is not without its challenges, however. Many jurisdictions have a strong presumption against the enforceability of restrictive employment covenants.219 Furthermore, firms implementing such contractual restrictions may risk deterring top talent from joining. In light of its benefits, however, this Article ultimately endorses this third proposal as a conservative solution with little extraneous and unforeseen risk.

b. Contractual Restrictions to Prevent Partner Departure

First, the restrictive covenants this Article endorses will impose at least some burden on the earning capabilities of a departing partner and their ability to practice after leaving the firm. Ideally, this will act to discourage rainmakers from cavalierly leaving firms. Part II presented several examples where law firm bankruptcies have been precipitated or hastened by the departure of rainmaker partners. This strategy would be tailored so as not to categorically prevent a rainmaker from leaving, but would be designed to make it more difficult for a large proportion of rainmakers to leave in a short time span. This solution, however, may have the unintended consequence of discouraging potential rainmakers from initially joining the firm. Accordingly, the exact contours of such restrictions will often vary a case-by-case basis.

The practice of law has shed many prior idiosyncrasies and

has evolved into something more reminiscent of other commercial enterprises. As such, the rationale for treating the legal profession as sacrosanct is significantly weakened, even after considering the enhanced ethical code of the profession.\textsuperscript{220} Reasonable forfeiture clauses on withdrawing partners would not create an absolute restriction on practice.\textsuperscript{221} Rather, a properly drawn agreement would serve to balance the interests of the client, the withdrawing partner, and the law firm.\textsuperscript{222}

If law firms and lawyers did not want to be bound by such agreements, then they would be free not to enter into such contracts. The market would be the ultimate arbiter of whether these contracts are viable options in the legal profession. In a strong economic climate, law firms would have less leverage in negotiating such contractual restrictions. On the other hand, in such a climate attorneys are less apt to search for new job opportunities and the influx of rainmakers would not be as significant. Alternatively, in a down market where attorney laterals are more common, well-positioned firms could include employment restrictions in a reasonable negotiation.

Consequently, as these agreements are only effective to the extent of law firm and attorney participation, this proposal stands as a conservative solution with little extraneous and unforeseen risk.

c. \textit{Presumption Against Enforceability}

There is a strong presumption against the enforceability of such restrictive covenants. Although this is not the case in every jurisdiction, this would pose a roadblock to widespread adoption of this solution. In order to circumvent this barrier, there would need to be national reform either through legislative or judicial action.

In most jurisdictions, ABA Model Rule 5.6 would act to prohibit any attorney from entering into a restrictive covenant. Rule 5.6 prohibits a lawyer from making or offering a partnership or employment agreement that restricts the right of a lawyer to practice after the termination of the

\textsuperscript{221} Id.
\textsuperscript{222} Id.
relationship. This effectively limits the availability of contractual restrictions. Decisions like Cohen v. Lord Day & Lord appear to affirm this limitation in imposing an absolute prohibition of compensation or benefit forfeitures by attorneys in employment contracts. This view has become commonplace among a majority of jurisdictions.

However, some jurisdictions have proven themselves exceptions to this general proposition. California, for example, has upheld restrictive covenants in its courts. In Howard v. Babcock, the California Supreme Court held that a contractual restriction on departing partners in a law practice was enforceable provided it was geographically limited and the cost to the departing partner was reasonable. Specifically, the court stated that partners who practice in competition with the partnership forfeit the right to certain withdrawal benefits. Furthermore, because it was a “reasonable” restriction on the lawyer’s right to practice, the covenant was enforceable. The court sought to balance the interest of a law firm in stable business against the interests of a client in having an attorney of their choice. The restrictions on withdrawing partners were limited to a specified geographical area and imposed a toll on competition similar to liquidated damages. Additionally, the clause providing for damages from breach would only be valid if the calculated damages were the result of a reasonable effort by the parties to estimate any loss potentially sustained. Thus, Howard did not consider the restrictions on practice to be impermissibly against public policy or to interfere with professional conduct rules prohibiting

223. MODEL RULE OF PROF'L CONDUCT R. 5.6(a) (2013).
225. See, e.g., Kerri A. Moerschel, Five Things Every Lawyer Should Know About Agreements that Restrict, or Effectively Restrict, a Lawyer’s Practice After Termination, AMERICAN BAR ASSOCIATION (Mar. 23, 2013), http://www.americanbar.org/content/dam/aba/events/labor_law/2013/03/employment_rights_responsibilitiescommittee/midwintermeeting/37-a.authcheckdam.pdf (“Direct restrictions on a lawyer’s right to practice after the lawyer’s employment ends, or after the partner departs from a firm or partnership, such as agreements not to compete or represent certain clients, are generally prohibited. The source of this prohibition is Rule 5.6 . . . . With limited variations, MRPC 5.6 has been adopted in nearly every State . . . .”).
227. Id. at 412.
228. Id. at 425.
229. Id.
230. Id.
231. Id.
restrictions on practice.232

Likewise, in Haight, Brown & Bonesteel v. Superior Court the California Court of Appeals held that a departing partner could agree to compensate their former law firm if the partner represented clients previously represented by the firm from which they left.233 The court determined that the restrictive covenant—forfeiting any financial interest the departing partner would otherwise have in the firm—did not expressly or fully prohibit the withdrawn partner’s practice of law or representation of any client.234 Only where a restrictive covenant prohibits an attorney from practicing law altogether would the agreement be invalid.235 Thus, the court found that such a financial restriction on the withdrawal of a partner was allowable.236

Similarly, in Fearnow v. Ridenour, Swenson, Cleere & Evans, P.C. the Arizona Supreme Court held that neither Arizona Rule of Professional Conduct Rule 5.6 nor ABA Model Rule 5.6 expressly prohibit imposition of a “financial disincentive” on a departing lawyer.237 The court found the reasoning from Howard compelling, holding that Rule 5.6 only prohibits an agreement that restricts a lawyer’s right to practice after departing a law firm.238 Covenants that impose “disincentives” on withdrawing lawyers without restricting practice would turn on a reasonableness standard.239 Because financial disincentives do not necessarily restrict a lawyer’s right to practice, the court held that restrictive covenants are not categorically void and the validity of the restriction will depend on the reasonableness of the disincentive.240

Applying the reasoning from Howard and Haight would produce a framework that allows firms to restrict partner withdrawal by instituting a contractual penalty or toll. Drawing on the rationale in Howard, the penalty would be tailored to apply only to the practice of law within a specific

234. Id.
235. Id.
236. Id.
238. Id. at 728.
239. Id. at 729.
240. Id.
geographic region. The threat of the toll would provide leverage, allowing law firms to limit withdrawal of partners who would otherwise take clients from them. That said, it would be important to ensure that the toll is part of a reasoned and negotiated process between the law firm and partner.

Similarly, Fearnow’s rationale allows a law firm to enter into restrictive covenants limited to financial disincentives with departing partners. A law firm could make it less lucrative for departing partners to leave the firm, making partners face a financial disincentive without a restriction on practice. This would balance the two public interests involved. The first interest to be vindicated is the allowance of attorneys to withdraw from a law firm, practice at another firm, and accept employment with whichever client desires to retain the withdrawing attorney. This runs to the advantage of both the departing attorney and the prospective client. The second public interest served is allowing the remaining partners to maintain financial stability by keeping the departing partner’s capital share and accounts receivable to replace lost client revenue. The use of financial disincentives in restrictive covenants could therefore alleviate the type of revenue shocks that push firms towards the precipice of bankruptcy.

One potential downside comes in the form of unpredictability: when a court applies the reasonableness standard to the financial disincentives at issue and finds them too burdensome or restrictive, the court could void the covenant as an improper restraint on the practice of law. Though it may be difficult to predict the result of such litigation, especially in the early stages of the implementation of this solution, the outcome would ultimately turn on a factual determination by the court. Thus, provided the law firm uses reasonable financial disincentives, restrictive covenants would represent a viable method of limiting partner departures.

Another barrier to implementing contractual restrictions similar to those upheld in Howard, Haight, and Fearnow is the reality that California and Arizona are in the minority of jurisdictions that allow the imposition of such restrictions. Although many jurisdictions have stopped short of consistently upholding California-style restrictive covenants, some jurisdictions have nonetheless begun to take a more flexible view.241 Ideally, California’s large legal market and Arizona’s

241. See id. at 723 (applying a “rule of reasonableness” used in other
view of financial disincentives will generate the initial momentum required for widespread implementation of such contractual agreements. In any case, while there is not currently pervasive acceptance of this prospective solution, it has the immediate potential to be successfully applied on a limited scale.

d. Conclusion

In sum, this Article recommends that law firms consider the use of contractual restrictions on a case-by-case basis. This solution is very flexible, and carries little risk of driving away talent in light of its ability to be molded to the needs of the contracting parties. Firms within states that share California’s approach to contractual restrictions will be in the best position to implement restrictive covenants on departing rainmakers. Firms outside of such jurisdictions may advocate for changes to the Rules of Professional Responsibility adopted in their respective states. If successful, this would allow restrictive covenants on withdrawing partners similar to the one in *Howard*. This Article’s third proposal represents another market-oriented solution that avoids the sometimes heavy hand of governmental regulation, and may be viewed as preferable to those seeking a means of interdicting law firm bankruptcies that arises largely from the initiative and under the direction of the legal profession. Many in the field would prefer to self-policing, but if the foregoing solutions prove insufficient standing alone they may need to be augmented by regulatory-based approaches.

C. Regulatory-Based Solutions

1. Legislative Enactment of the Unfinished Business Doctrine

   a. Introduction

   This Article advocates the legislative enactment of the “unfinished business doctrine,” originally a common law

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professions, the court found that though geographical restrictions are absolutely prohibited, restrictions involving financial disincentives are not; see generally Pettingell v. Morrison, Mahoney & Miller, 426 Mass. 253 (1997) (finding a significant exception to the absolute prohibition against “forfeiture for competition” clauses, holding then allowable when the forfeiture is necessary to protect the firm’s interest in its own survival).
remedy, as a regulatory-based solution. This proposed solution could inhibit the sort of rainmaker exodus that exacerbates the risk of bankruptcy. The unfinished business doctrine allows a bankruptcy trustee to “sue for profits generated by work that partners started at their old law firms and took to their new positions, such as continuing cases.” As demonstrated earlier in this Article, rainmaker partners departing from financially troubled firms have been a major contributing factor to recent law firm bankruptcies. At present, rainmakers can freely depart their firms as the legal profession views individual clients as loyal and attached to the particular lawyer who represents said clients. Previously, clients were viewed as belonging to a firm rather than a possession of a particular partner.

b. Advantages of the Unfinished Business Doctrine

Pursuant to the unfinished business doctrine, “absent an agreement to the contrary, partners in a dissolved law firm have a duty to account to the dissolved firm and their former partners for all fees generated from work in progress at the time of the firm’s dissolution, in accordance with their percentage interests in the firm.” In sum, “pending matters are uncompleted transactions that require winding up after dissolution, and are therefore partnership assets subject to post-dissolution distribution.”

Thus, adopting the unfinished business doctrine on a state-by-state basis would help prevent law firm bankruptcies because departing partners would have to pay back to their former firm the amount equal to the expenses incurred by the firm pre-dissolution on a given case or controversy. Attorneys typically do not like this doctrine because it “enslaves them to the dissolved firm,” but it would serve as a powerful

244. Harris, supra note 57.
245. Richmond, supra note 42.
incentive to partners to redouble their efforts to avoid the dissolution of their firm.

c. Limitations of the Unfinished Business Doctrine

The unfinished business doctrine, however, is not absolute in its application. First, as the 1984 California Court of Appeal decision in Jewell v. Boxer “makes clear, the unfinished business doctrine is purely a default rule, meaning that partners may contract out of it.”248 These agreements are often know as “Jewell waivers.”249 This type of waiver eliminates financial and legal obligations of departed partners to former firms, freeing them of any continuing duties.250

Second, departing rainmakers will often continue the unfinished business, subject to the unfinished business doctrine restrictions, because these clients “are frequently the best sources of new matters, and those clients would be unlikely to furnish new business if the partner responsible for their existing matters abandoned them.”251 Furthermore, the unfinished business doctrine does not apply to new matters between the departing lawyer and the client the partner took with them from their previous firm.252 These realities may mitigate the strength of the departure disincentive created by the doctrine in individual instances.

Third, when “the dissolved partnership winds up its affairs, the interested parties may reasonably compromise any unfinished business claims” in order to separate ties between the previous firm and the departing partner.253 All in all, the utility of this solution depends on the scope and nature of its implementation—and contracting parties have a wide degree of latitude in that regard.

d. Conclusion

This Article contends that the application of the unfinished business doctrine is a reasonable solution because it can—or at least should—only be applied to expenses that a departing rainmaker incurs on a matter they take with them

248. Id. at 364.
250. Id.
251. Richmond, supra note 42, at 364.
252. Id.
253. Id.
from their old to their new firm when clients follow the partner in their move. This Article does not endorse the capture of income from a rainmaker’s new, future cases deriving from the rainmaker’s book of business that they took with them. Such a proposal would greatly impede a lawyer’s ability to ever leave a firm, out of a concern that the former firm could sue the departing rainmaker at any point in the future—the partner’s revenue stream would ever be in jeopardy. Rather, this Article recommends the unfinished business doctrine be used to cover the damages directly incurred from the departure of these rainmakers. Although calculating damages from such departures may be difficult in some instances, this Article’s proposed framework is clearly preferable to an expansive application of the doctrine that would effectively prevent attorneys from moving between firms—such an inhibiting application would be vigorously resisted by the profession, and would likely not survive legal challenge. The limited version of the unfinished business doctrine that this Article endorses is currently a common law remedy not available in all jurisdictions; thus, in order for the doctrine to be consistently available across states, it would have to be legislatively enacted.

2. Regulatory Oversight by Governmental Agency

a. Introduction

The tension between the formal regulatory powers of quasi-judicial agencies and private, autonomous self-regulation permeates many sectors of the modern American economy—including finance, medicine, manufacturing, oil and gas, education, and others. This Part will explore the possibility of regulatory oversight of the legal industry by a dedicated governmental agency. Ultimately, this Article endorses this approach as another measure to combat the growing prevalence of law firm bankruptcies.

The potential operation and success of a legal oversight agency can be explored by reference to existing governmental oversight agencies. One such regulatory authority, the United States Securities and Exchange Commission (SEC)—formed on June 6, 1934 under the Securities Exchange Act of 1934— is taskted with the enforcement of federal securities laws and

regulation of securities markets and the securities industry generally. In the pursuit of its statutory mandate, the mission of the SEC has come to embody the dual purposes of securities market regulation and the prevention of corporate abuses relating to the issuance, purchase, and sale of securities. The devastating Wall Street Crash of 1929 and the nation’s subsequent slide into the depths of the Great Depression starkly highlighted the need for this quasi-judicial regulatory agency. Although the necessity for oversight in the securities arena was clearly demonstrated, doubt remains concerning the actual effectiveness of SEC regulatory and oversight action in staving off severe market fluctuations and interdicting serious abuses. The agency’s failure to prevent the 2008 financial crisis and associated events such as the bankruptcy of Lehman Brothers and the severe liquidity crisis that nearly wiped out AIG, or to timely detect the Madoff investment scandal or the abuses at Enron, have significantly tarnished the reputation of the organization. That said, the jury is still out on the overall effectiveness of the SEC and whether increased regulatory oversight by the agency would have prevented these financial scandals and market shocks. The SEC did step up its enforcement actions after the 2008 crash, bringing major actions against such market players as Goldman Sachs, Citigroup, J.P. Morgan and Credit Suisse. Uneven track record aside, the SEC at its ideal presents an example of a long-standing government agency with a broad sphere of responsibility in the market and a variety of tools with which to carry out its mandates.

Another example of an oversight body is the Public Company Accounting Oversight Board (“PCAOB”), a non-profit corporation established by Congress to oversee the audits of


259. Id.
The Board’s primary objectives are the protection of investor interests and assurance of accurate, transparent, and independent drafting of audit reports. The PCAOB is not without its critics, who point to some of the same market failures that the SEC failed to prevent as evidence of the accounting oversight body’s questionable effectiveness. In the view of its most fervent detractors, the PCAOB exists mainly as a hurdle slowing the consummation of commercial deals and the achievement of valid business objectives. The Board’s proponents contend that the PCAOB is a necessary reaction to the accounting scandals of the early 2000s and an important component of the broader government effort to protect investors. An extended debate concerning the effectiveness of the PCAOB is not within the scope of this Article. Suffice it to say that the divergence of opinions concerning both the SEC and PCAOB demonstrates the controversy that will attend any attempt by a governmental or quasi-governmental agency to regulate the market behavior of private actors.

Relevantly to the purpose of this Article, the SEC and PCAOB stand as prime exemplars of the general form that a hypothetical governmental Legal Oversight Board (“LOB”) might take. Inspired in part by the SEC’s and PCAOB’s regulation of their respective fields, this Article endorses the creation of a quasi-judicial governmental agency (i.e., the LOB) as an alternative or complementary approach to combat the prevalence of law firm bankruptcies. To act as an effective mechanism in the interdiction of firm bankruptcies, the LOB would require of law firms certain disclosures to the public—financial statements, annual reports, profits per partner ratios, and so forth. Disclosures of these financial and other indices would be required regardless of whether a given firm decided to make a public offering of securities pursuant to this Article’s public investment market-based solution. On the

260. PCAOB Oversees the Auditors of Companies to Protect Investors, PUB. CO. ACCOUNTING OVERSIGHT BD., http://pcaobus.org/Pages/default.aspx (last accessed Nov. 28, 2014).


262. Hilzenrath, supra note 261.
other hand, the issuance of securities triggering SEC oversight and disclosure obligations would render the LOB requirements imposed on an issuing firm largely superfluous—though they certainly would be minimally burdensome when imposed in addition to LOB requirements. In any case, this Article’s fifth proposed solution to law firm bankruptcy has a significantly broader reach than its first recommended approach.

b. Advantages and Disadvantages of Regulatory Oversight

It would be disingenuous to claim that this proposed solution would not encounter strident opposition from the legal profession. The regulatory activities of the LOB would necessarily interfere with the standing internal governance practices of law firm management. Notwithstanding this invasiveness and the backlash it will engender, this Article contends that an LOB could still represent a viable means of reducing the risk of law firm bankruptcies. This contention has several grounds for support.

First, the potential objections of those in the legal industry to the LOB would largely sound as echoes: opponents of the SEC and PCAOB argued that said entities would ruin the securities and financial industries. Clearly, these dire predictions were not vindicated—and no characteristic inherent in the legal profession or necessary to the operation of the hypothetical LOB suggests that similar doomsaying would prove any more cogent. Previously mentioned criticisms of the SEC and PCAOB notwithstanding, most individuals would agree that the two agencies have on balance increased stability, transparency, and accountability in the securities markets and accounting profession. Additionally, it is worth remembering that lawyers are not the only stakeholders with interest implicated in the prevention of law firm bankruptcies. Surely their interests are important, but they do not stand alone.

Second, this proposed solution is proportionate to the harm it seeks to prevent. Admittedly, the creation of an LOB would represent a significant shift in governmental regulation of the legal profession. However, the scale, impact, and mounting frequency of law firm bankruptcies demonstrates that some sort of effective action must be taken—and effective

263. Id.
responses to large systemic deficiencies generally introduce significant change to the system. Law firm bankruptcies—especially those large collapses profiled in Part II—have destabilized the legal market in general and have contributed to the broader economic downturn. Though most evident in the lead-up to and wake of the 2008 financial crisis, a law firm bankruptcy carries with it the potential for significant negative ripple effects. Under this Article’s public investment solution, not all firms will choose to publicly issue securities—effectively taking them outside the ambit of the sort of SEC oversight that would prove helpful in reducing the likelihood of financial ruin. This Article’s regulatory agency approach, however, would ensure that all law firms are comprehensively regulated such that it will be substantially less likely that law firms will go bankrupt and negatively impact the overall economy.

Third, this recommendation presupposes that a hypothetical LOB would be responsive to the concerns of the legal profession. Although the LOB could theoretically be structured in such a way that impermissibly interferes in attorney-client relationships, it is well within the realm of possibility to organize the LOB such that it could regulate the legal profession in a way that would not cause its regulatory power to interfere with a lawyer’s ethical duties to his or her client. The LOB solution is intended to address law firm governance, financial, and management issues that could result in law firm bankruptcies, harm the legal profession, or impede client access to legal services. The LOB is neither intended to be a bureaucracy that micromanages attorney-client relationships nor is it meant to drastically interfere with law firm governance structures. It is worth noting that any LOB would doubtlessly be staffed mostly or wholly by lawyers, who surely would not be completely blind to the concerns of the profession.

c. Conclusion

In sum, this Article recommends the creation of a quasi-judicial agency—such as the hypothetical LOB—whose regulations would require that law firms publicly disclose their financial statements, annual reports, profits per partner ratios, and other relevant metrics.
D. Non-Recommended Solutions

1. Changes to ABA Model Rules

Another potential response designed to mitigate the risk of law firm bankruptcies is the revision of the ABA Model Rules. At least one critic postulates that enacting ABA Model Rules mandating financial reporting by law firms or requiring a certain ethical standard of law firm governance may prove an effective means of combating law firm bankruptcies. This Article will discuss the potential benefits of enacting ABA Model Rules requiring the maintenance of minimum standards of firm operation, such as mandating financial report disclosures or setting threshold levels of incurring debt. Although such revisions are intriguing in concept—and represent a potentially effective solution—this Article ultimately declines to endorse such an approach. The ABA is simply not in a position to impose any of the approaches discussed earlier in this Article, and no effective alternative approach presents itself.

The ABA Model Rules provide general guidance and impose ethical duties on lawyers to behave and act with the utmost respect for the profession. The Model Rules have the potential to act as a vehicle through which the ABA could attempt to head off a future onslaught of law firm bankruptcies. “Attempt” being the key word: the ABA’s limited authority would prove a major deficiency of this approach. The American Bar Association only imposes ethical obligations and guidance. Ultimately the self-governing body can do little to unilaterally impose a market-based solution, statutorily codify an unfinished business doctrine, create a regulatory oversight government agency, or provide some other effective vehicle for interdicting firm bankruptcies.

The current Model Rules would prove hostile to the implementation of an approach imposing contractual

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265. Id. at 6.

266. See generally MODEL RULES OF PROF'L CONDUCT PMBL. AND SCOPE 5 (2013) (noting that the Rules simply provide a framework for the ethical practice of law).

267. Id. (encouraging lawyers to demonstrate respect for the legal profession).
restrictions on departing partners, with Rule 5.6 being directly adverse.\footnote{268} Under this Rule, a lawyer cannot restrict the right of another lawyer to practice after termination of the relationship between the two. In order for an approach embracing contractual restrictions to succeed—or even make the steps towards getting off the ground—the ABA would have to revamp or eliminate the current rule. However, the ABA is unlikely to take such drastic measures,\footnote{269} because employment at-will has long been the rule under the common law.\footnote{270}

The ABA is probably capable of adopting an ethical rule mandating that law firms institute an intra-firm regulatory system. The adoption of an intra-firm regulatory system could allow for the implementation of a variety of procedures and requirements having the ultimate effect of financial stabilization of firms. For example, an ABA Model Rule could require that all of a firm’s finance, oversight, governance, and risk management practices would be disclosed to all firm partners. This would, for the reasons discussed earlier, represent a viable approach towards combating the recurring implosions of law firms.\footnote{271} In another example, the ABA could set threshold levels of firm debt. Part II demonstrated how firms often engage in aggressive lateral expansion maneuvers by incurring excessive debt and promising hefty bonuses and salaries to rainmaker partners. The incurrence of these liabilities can help tip a firm towards collapse, not in the least by significantly reducing its financial maneuverability and ability to effectively respond to changing market conditions. In theory, if an ABA Model Rule created bands or tiers of firm

\footnote{268. Model Rules of Prof'L Conduct R. 5.6(a) (2013) (“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 . . . .”).}

\footnote{269. See 53 Am. Jur. 2d Master and Servant § 43 (1970); Monge v. Beebe Rubber Co., 114 N.H. 130, 132 (1974) (commenting that “the employer has long ruled the workplace with an iron hand by reason of the common-law rule that [a hiring for an indefinite period of time] is presumed to be at will and terminable at will by either party”).}

\footnote{270. William L. Mauk, Wrongful Discharge: The Erosion of 100 Years of Employer Privilege, 21 Idaho L. Rev. 201, 202 (1985) (commenting that the concept of employment-at-will emerged from times of “unbridled, laissez-faire expansionism, social Darwinism, and rugged individualism”).}

\footnote{271. Kowalski supra note 264, at 3 (noting that the Model Rules of Professional Conduct and the Model Code of Professional Conduct are strangely silent on the issue of law firm governance).}
sizes with corresponding debt-incurring limits, firms would be encouraged to maintain more reasonable amounts of debt.\(^{272}\)

The actual implementation of an intra-firm regulatory system through the ABA Model Rules—such as through a Rule requiring financial transparency between partners—could be achieved without overly impinging on the ability of law firm management to make financial decisions in the near term. The ABA could create a new, broadly worded Model Rule 5.8; such a Rule might state some variation of “law firms shall implement a law firm governance system that reveals transparent financial information to partners.”\(^{273}\) This broad language avoids undue operational interference, but it is important not to read its mandatory character too strongly.

Changes to the ABA Model Rules might at best prove influential, pushing law firms to begin taking effective steps towards addressing the systematic weaknesses that have the tendency to magnify financial difficulties into the disastrous and uncontrollable events that suck firms into the abyss. However, such revisions to the Rules are unlikely to present effective solutions in their own right.\(^{274}\) Effective systemic reform will hinge on mandates or powerful incentive/disincentive combinations; a pitched struggle is not often won through suggestion.

The ABA Model Rules do not have the force and effect of statutory law, and do not impose stringent liability when a lawyer fails to comply.\(^{275}\) Instead, every state in the country has a disciplinary authority that governs the investigation and

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272. The approach, undoubtedly, would face numerous practical problems. For example, how can the ABA predict what constitutes a “reasonable debt” given a firm’s size? This seems outside the subject matter expertise of the body. Furthermore, restricting debt would eliminate the entrepreneurship opportunities and growth potential of modern law firms. Lastly, law firm governance seems to be a matter more suitable for micro-management on the firm level rather than macro-management by an entity such as the ABA.

273. \textit{C.f.} MODEL RULES OF PROF'L CONDUCT R. 1.4(a)(3) (2013) (“A lawyer shall . . . keep the client reasonably informed about the status of the matter . . . .”) (emphasis added); \textit{id.} at R. 5.5(a) (“A lawyer shall not practice law in a jurisdiction in violation of the regulation of the legal profession in that jurisdiction, or assist another in doing so.” (emphasis added)).

274. A legislative decree or a regulatory oversight board requirement may be better suited to implement the spirit of the Rule.

275. \textit{See generally id.} at PMBLE AND SCOPE 19–20 (2013) (stating that failure to comply with an obligation or prohibition imposed by a Rule is a basis for invoking the disciplinary process, but that violation of a rule should not itself give rise to a cause of action against a lawyer nor should it create any presumption in such a case that a legal duty as been breached).
discipline of delinquent attorneys pursuant to the state’s own rules of professional conduct. Though probation and suspension sometimes occur, complaint proceedings ending in disbarment or criminal liability are exceedingly rare in proportion to the total number of complaints filed. The ABA does not vigorously engage in broad disciplinary action. Despite the elaborate and widely-encompassing guidance framework created by the Model Rules, the overwhelming number of disciplinary actions brought by the ABA relate primarily to escrow account defalcations and disbarments of convicted felons. For all the possible permutations of ethical quandaries explored by the Multistate Professional Responsibility, the Model Rules in practice merely provide general guidance and impose (often amorphous) ethical duties on lawyers to behave and act with the utmost respect for the profession. Advisory guidelines by their very nature carry no strong coercive mechanism to force compliance—in short, they can be safely ignored by those who choose to reject them. If a Model Rule addressing law firm governance and finance designed to address the concerns leading to firm bankruptcies could be successfully constructed, enforcement remains the ultimate—and perhaps insurmountable—challenge.

The question of enforcement aside, the Model Rules tend not to provide clear guidance in many marginal ethical situations. Absent some clear prohibitions, the Rules are very gray—their language is imprecise, and sometimes appear to present internal inconsistencies. Drafting a Rule consistent with the tenor of the existing Rules—and that avoids running directly counter to standing precepts—presents a challenge that should not be underestimated. In an example of the

276. Typically the disciplinary authority of every state is the State Bar of each state, although some states vary from this model. See, e.g., About Us, MINN. LAWYERS PROF’L RESPONSIBILITY BD. OFFICE OF LAWYERS PROF’L RESPONSIBILITY, http://lprb.mncourts.gov/AboutUs/Pages/default.aspx (last visited Nov. 28, 2014) (stating that the Minnesota disciplinary body consists of twenty-three members appointed by the Minnesota Supreme Court to oversee and administer the state lawyer discipline system).


279. See, e.g., MODEL RULES OF PROF’L CONDUCT PMBL. AND SCOPE 5, 9 (2013).
tensions embodied in the current Model Rules, Rule 5.2 imposes on a subordinate lawyer a continuing duty to abide by ethical standards in executing orders from another lawyer. However, it simultaneously provides that a subordinate lawyer will not violate ethical standards if he acts in accordance with a supervisory lawyer’s “reasonable resolution of an arguable question of professional duty.” The language of Rule 5.2 leaves the associate lawyer at a difficult crossroad in which the lawyer is either left in uncertainty or the Rule itself becomes minimally enforced. The Rules recognize that ethics are not often amenable to precise \textit{ex ante} judgments. The Rules, in the main, embrace a high level of ambiguity; this may very well be one of their strengths. It is not, however, an ideal characteristic of a regime intended to effectively address financial conduct and organizational governance.

Rule 3.2 stands as another example of the tensions in the Model Rules. Under this Rule, an attorney is required to make reasonable efforts to expedite litigation consistent with the client’s interests. The operation of this Rule can place the ethical demands incumbent on attorneys in conflict with the wishes of their clients. Ethically, the attorney must expedite litigation—but should the client’s interests demand prolonged litigation, the attorney arguably does not violate Model Rule 3.2 in the pursuit of such a strategy. The lesson to be taken from this is that broad rules will fail to capture the diversity of factual situations in the real world, and may be at odds with the attorney’s vindication of client interests. For our purposes, if a new ABA Model Rule mandated law firm financial disclosures, the Rule may contradict and directly interfere with a lawyer’s duty to zealously represent their clients or uphold their client’s confidences. An ABA Model Rule aiming to prevent future law firm bankruptcies has the undesirable propensity to place lawyers in this ethical grey zone and not yield significant changes.

Law firm governance is a cultural matter best resolved with a commitment to high standards of sound financial practice. The impact of a new ABA Model Rule would not only be minimal, but such a rule would likely be completely

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disregarded by partners of law firms. As necessary as the Model Rules are to the preservation of the profession’s sanctity, ethical obligations advising broad behaviors cannot compare to the force of an absolute statutory command nor to the resiliency of a commitment to personal accountability. As such, looking to the Model Rules for salvation would ultimately prove entirely naïve.

2. Expansion to International Markets

The Coudert case study starkly demonstrates that aggressive expansion into global markets—at first blush seemingly an opportunity to tap into new and lucrative revenue streams, and a viable method of counteracting existing financial difficulties—may in fact act as a major contributor to a firm’s demise. Global growth can provide new markets and prestige for law firms—but as this subpart will illustrate, it should not be used as a hedge for law firms to stave off bankruptcy. International expansion is an ill-advised solution to financial difficulties, as (1) firms have a disproportionate dependency on future revenue during periods of expansion; (2) global markets have more associated risk; and (3) the interconnectivity of modern markets does not allow for sufficient diversification. Thus, although international expansion may be valuable if prudently employed, it is not recommended as solution to combat potential law firm bankruptcy.

Recent years have seen many large U.S. law firms expand internationally to reap a variety of benefits.281 Entering the global legal market allows firms new opportunities for growth that may not be available domestically.282 However, entering new markets is expensive, time-consuming, and risky.283 Initial capital investments needed to establish steady revenue flows in overseas offices are high, and the process is slow.284

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The alternative, an international merger, can be fraught with risk or unharmonious firm culture. It can take many years after the merger to align a firm’s global priorities, tie up loose legal ends, and engender an environment of collaboration. Indeed, multi-national companies that retain global law firms complain of inconsistent billing and poor communication. Nonetheless, many firms still pursue this type of expansion. In doing so, firms use leverage to finance the high cost of global growth.

As in the case of Coudert, rapidly expanding firms can struggle to obtain the necessary capital infusion for international expansion. This problem often encourages the leveraging of future revenues, which exposes already vulnerable firms to enhanced financial liability. During times of economic instability, it becomes difficult to maintain profitability: clients scrutinize large attorney fees, and indirectly cause anticipated future revenue to shrink. Moreover, international revenue streams often take time to realize and cannot be relied upon for immediate income. Law firms are especially susceptible to these types of economic downturns when clients see legal fees as something to be negotiated or cut, an increasingly common reality in the modern legal market. Thus, in attempts to expand internationally through law firm mergers, it is rare to see both substantial and immediate financial rewards. During this transition period, law firms remain vulnerable. Leverage reduces mobility, and a firm cannot quickly reposition itself in response to changed market conditions.


286. Holding, supra note 284.
287. Id.
Furthermore, law firms necessarily take on increased risk when operating in numerous economic environments. Diversification across borders often results (at least in the medium term) in smaller profits margins and thinner margins of error. Operating in the global legal market carries unavoidable hazards. Firms need to be vigilant of changing market conditions, while simultaneously being wary of incurring too much debt. Simply put, expanding into more markets introduces more and more variables into the equation. Without taking conscious and deliberate effective measures to mitigate the risks inherent in entering into variant economic environments, a law firm seeking international expansion can easily over-extend its resources.

In theory expansion into different legal markets should provide diversification of risks for a law firm, with the effects of an economic slump in one market being offset by the effects of a growing economy in another. However, in the modern world, most countries’ economies are interconnected—although countries may have very different legal regimes, they hardly act as discrete “baskets” for risk hedging purposes. Global economic downturns are no respecters of international borders. Diversification tends to multiply rather than reduce risk.

Although expansion into foreign markets increases a law firm’s prestige, it provides little—if anything—in the way of benefits that would help a law firm stave off a bankruptcy in the near term. Instead of preventing bankruptcy, international expansion may often precipitate it due to shortages of the capital infusion needed to fund growth. Law firms must then seek alternative means such as debt financing, which is far riskier for a firm’s financial health. Expansion internationally may make sense for other commercial reasons, but reducing the risk of bankruptcy is decidedly not one of them.

CONCLUSION

This Article has identified the main causes of law firm bankruptcies through a discussion of historical examples of such collapses. After identifying these root causes, this Article discussed a number of solutions designed to directly address the structural weaknesses leading to law firm financial failure. This Article proposes the following recommendations as specific solutions that can help prevent—or at least mitigate
the effects of—law firm bankruptcies: (1) a market-focused solution allowing the public to invest in law firms; (2) the adoption of an internal law firm regulatory system whereby all of a firm’s finance, oversight, governance, and risk management practices are made transparent to all firm partners; (3) contractual covenants disincentivizing the departure of rainmaker partners; (4) further statutory adoption of the common law unfinished business doctrine; and (5) regulatory oversight by a governmental agency in the form of a legal oversight board.

These proposed solutions are primarily market-oriented. However, this Article does recommend minimal government regulation compelling the disclosure of certain law firm financial information. In sum, this Article endorses the combination of minimal government regulation disclosure requirements with the use of market-based forces to correct the business practices that have led large and prestigious law firms to declare bankruptcy to the surprise and embarrassment of the entire legal profession. This Article's recommended solutions therefore aim to simultaneously correct this market failure and restore confidence in the legal profession's ability to financially manage its institutions.