Law Firm Penalties On Departing Partners Just Got Riskier

By **Alan Kabat** (February 5, 2021)

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The D.C. Court of Appeals, on Feb. 4, issued an important decision that sharply limits the ability of law firms to penalize departing partners who leave for other law firms and take clients with them.

This decision makes clear that financial penalties violate Rule 5.6(a) of the D.C. Rules of Professional Conduct, since they restrict the lawyer's right to practice, and thus interfere with the client's ability to choose a lawyer.

Even before COVID-19, large law firms were experiencing significant volatility with partners changing firms. COVID-19 has escalated these lateral moves and the resulting economic hit that law firms will suffer.

Fortunately for departing partners, any substantial financial penalty that the law firms may impose will violate Rule 5.6(a) of state bar ethics rules and the American Bar Association's Model Rules of Professional Conduct, which many states follow as guidance.

The D.C. Court of Appeals, in Jacobson Holman PLLC v. Gentner, has now provided a clear road map for the numerous law firms in Washington, D.C., and their equity partners, and confirms that the law is continuing in the direction of prohibiting financial penalties on departing partners.[1]

Historically, law firms had a range of so-called golden handcuffs that they could use to prevent their rainmaking partners from leaving, or to impose financial penalties on them if they did leave. The Model Rules of Professional Conduct and bar ethics opinions have had to respond to new strategies by law firms that violate the rules by interfering with the attorney-client relationship.[2]

Over the past several decades, a majority of the courts and ethics opinions have held that financial penalties imposed upon departing partners violate Rule 5.6(a), which provides that "a lawyer shall not participate in offering or making a partnership … 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."

Comments to the rule state that the rationale of Rule 5.6(a) is that such an agreement "not only limits their [lawyer's] professional autonomy but also limits the freedom of clients to choose a lawyer," and are essentially covenants not to compete.

Thus, many courts and bar ethics opinions have held that delays in returns of capital, or clawbacks of bonuses, or refusal to pay guaranteed compensation are all impermissible liquidated damages or covenants not to compete.[3] This is necessary to protect the free choice of clients to choose their lawyer, instead of clients being tied to a specific law firm.

Jacobson Holman v. Gentner

The most recent decision, from the D.C. Court of Appeals, involved an intellectual property litigation boutique, in which the two name partners informed the other partners in 2013 that they were going to dissolve the firm and do business under a new entity. Marsha Gentner and several other attorneys instead decided to leave the firm, and they demanded their accrued capital be returned to them.[4]

The dissolved firm had several partnership agreements. The first agreement from 1989 stated that the accrued capital would be calculated at the end of the fiscal year immediately preceding the withdrawal, "adjusted" for net profits and losses up to the date of withdrawal.

The second agreement from 1997 had a 50% penalty for departing partners who took clients, and also set forth a different process for calculating any adjustments to the accrued capital, with adjustments limited to those that arose or occurred after the closing date of the last financial statement.[5]

Gentner had an accrued capital balance of $141,569, but the firm tried to offset that with (1) pending member bonuses and allowances; and (2) writeoff of accounts receivable unlikely to be paid, resulting in Gentner now owing $21,762 to the firm. Further, the firm asserted that if a court were to find a positive balance, it should be cut by 50% because clients followed Gentner to her new law firm, Dykema Gossett PLLC.[6]

Gentner filed a breach of contract action in the D.C. Superior Court, which granted summary judgment in her favor, holding that the forfeiture provision of the 1997 agreement violated D.C. Rule 5.6(a), and was thus unenforceable. Jacobson Holman appealed, and the D.C. Court of Appeals affirmed in a strongly written opinion.

Judge Catharine Easterly, joined by Judges Roy McLeese and Eric Washington, held that although the firm's partnership agreement allowed for adjustments to the year-end accrued capital balance, those adjustments could only be based on costs or events arising after the year-end financial statement.

Here, the firm knew all along that it had to budget for bonuses and that it had numerous uncollectible accounts unlikely ever to be paid. The court held that allowing these adjustments would "simply invite the remaining equity members to make unpredictable, self-interested, post hoc changes to the firm's financial statements."[7]

Moreover, the 50% financial penalty for moving to another law firm and taking clients squarely violated Rule 5.6(a), since the comments to that rule state that "restrictions … that impose a substantial financial penalty on a lawyer who competes after leaving the firm may violate paragraph (a)."[8]

The court had no difficulty in holding that the 50% penalty was "substantial," since "[w]hatever the outer limit is for a 'substantial penalty,' we conclude a 50 percent forfeiture of a departing partner's earned equity interest for taking even one client with them falls well within its bounds."[9]

Thus, the law firm could not enforce the financial penalty provision of its partnership agreement against Gentner and other departing partners.

The court emphasized: "We … publish this opinion to ensure that the members of the District of Columbia Bar understand the strictures of Rule 5.6(a)."[10]

Appellate Decisions in Other States

Appellate courts in several states have similarly rejected financial penalties against departing partners.

The key case is Cohen v. Lord Day & Lord, from the New York Court of Appeals, which held in 1989 that financial penalties "functionally and realistically discourage and foreclose a withdrawing partner from serving clients who might wish to continue to be represented by the withdrawing lawyer and would thus interfere with the client's choice of counsel."[11]

The New Jersey Supreme Court, in Jacob v. Norris McLaughlin & Marcus, similarly held in 1992 that "selectively withholding compensation" from departing partners was improper, since they were restrictions on the practice of law, and were "forcing lawyers to choose between compensation and continued service to their clients."[12]

In 1997, the Massachusetts Supreme Judicial Court in Pettingell v. Morrison Mahoney & Miller held that requiring forfeiture of profits and share of the change in net worth was illegal, since those provisions "would tend to discourage a lawyer who leaves a firm from competing with it. This in turn would tend to restrict a client or potential client's choice of counsel."[13]

Also in 1997, the Illinois Appellate Court, First District, in Stevens v. Rooks Pitts & Poust, invalidated a partnership agreement that required a departing partner to forfeit compensation if the partner competed with the firm, since "this financial disincentive provision hinders both the departing lawyer's ability to take on clients and the client's choice of counsel."[14]

Courts in other states, including Texas and Oregon, are in accord.[15]

Notice Requirements and Garden Leave

The ABA has addressed attempts by law firms to use yet other mechanisms to penalize departing partners.

One is the notice requirement that requires the partner to provide several weeks' or even several months' advance notice of departure. Some law firms further require "garden leave," i.e., the departing partner cannot work on client matters during that notice period.

While a short notice period allows for an orderly transition of client matters, longer notice periods handcuff the attorney and the clients to the law firm.

The fundamental ethics problem with these notice requirements and garden leave is that by blocking the partner from working on client matters for one to several months, the law firm is interfering with both the partner's ability to work, and the client's ability to obtain the legal representation of the clients' choice, exactly the same problem with other financial penalties.

In December 2019, the ABA issued Formal Opinion 489, which squarely and decisively concluded that "a firm's imposition of a fixed notice period may be inconsistent with Rule 5.6(a)," absent a showing of "particular circumstances related to the orderly transition of client matters."[16]

Further, "firms cannot prohibit or restrict access to email, voicemail, files, and electronic court filing systems where such systems are necessary for the departing attorney to represent clients competently and diligently during the notice period."[17]

If the client has elected to move with the departing partner, and the files are in good order, and the departing partner has agreed to help the old firm with the final billing, then the old firm cannot impose the full notice period.[18]

While the presumption is that the old firm and the departing partner should cooperate on a joint written communication to the clients, the ABA recognizes that can be stonewalling, in which case "a law firm cannot prohibit the departing lawyer from soliciting firm clients."[19]

Partnership Agreements — Time to Review Them Anew

In light of these court decisions, and the ABA's Formal Opinion 489, it is time for law firms to review their partnership agreements. There needs to be a clear procedure for what happens when an attorney resigns from a law firm for any reason. Here are the land mines, and the ways to avoid them:

1. Law firms must treat all departing partners equally when it comes to their compensation and exit payments — there cannot be any provisions that penalize partners who leave for other, competing law firms, while rewarding those who retire, move in-house or go to work for the government.

2. Law firms must have a clear definition of when and how an equity partner's accrued capital is to be calculated, and a clear, unbiased process for determining whether any changes can be made to that calculation due to events occurring between the time the calculation is made and the time the departing partner gives notice.

3. Law firms can have a reasonable notice requirement for departing partners, but no longer than necessary to allow for the windup and transition of client matters. The notice requirement must have a carveout, allowing it to end sooner if the client decisions have been made and the departing partner has agreed to help the firm with the final billing.

4. Garden leave requirements are verboten; instead, law firms need to allow departing partners to continue to work on client matters during the transition period, which includes continued access to the client materials.

The case law, including the D.C. Court of Appeals' recent decision, and the ABA's Formal Opinion 489 make clear that law firms cannot have restrictive covenants in their partnership agreements that impose financial penalties upon departing partners, since those penalties interfere with the clients' best interests.

Law firms should review their partnership agreements and amend them to avoid these violations of Rule 5.6(a), so that departures can be handled in a way that does not penalize clients or lawyers in violation of professional conduct rules or lead to protracted litigation.

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[1] Jacobson Holman PLLC v. Gentner, No. 19-CV-830, __ A.3d __ (D.C. Feb. 4, 2021).

[2] See Lynne Bernabei & Alan R. Kabat, "Law Firms Penalizing Departing Partners? That

Goes Straight to the Penalty Box!" The Practical Lawyer, October 2015, at 27-33, https://www.bernabeipllc.com/wp-content/uploads/migrations/3116461/Law-Firms-Penalizing-Departing-Partners-That-Goes-Straight-To-The-Penalty-Box-Pdf.pdf.

[3] Id.

[4] Jacobson Holman PLLC, slip op., at 6-7.

[5] Id., slip op., at 3-5.

[6] Id., slip op., at 7-9.

[7] Id., slip op., at 14.

[8] Id., slip op., at 24.

[9] Id., slip op., at 27.

[10] Id., slip op. at 2.

[11] Cohen v. Lord Day & Lord, 550 N.E. 2d 410, 411 (N.Y. 1989).

[12] Jacob v. Norris McLaughlin & Marcus, 607 A.2d 142 148 (N.J. 1992).

[13] Pettingell v. Morrison Mahoney & Miller, 687 N.E.2d 1237, 1239 (Mass. 1997).

[14] Stevens v. Rooks Pitts & Poust, 682 N.E.2d 1125, 1132 (Ill. App. Ct. 1997).

[15] Whiteside v. Griffs & Griffs PC, 902 S.W.2d 739, 743-44 (Tex. Ct. App. 1995); Hagen v. O'Connell Goyak & Ball PC, 683 P.2d 563, 564-65 (Or. Ct. App. 1984).

[16] See ABA, Standing Committee on Ethics and Professional Responsibility, Formal Opinion 489, "Obligations Related to Notice When Lawyers Change Firms," at 7 (Dec. 4, 2019), https://www.americanbar.org/content/dam/aba/administrative/professional_responsibility/aba_formal_opinion_489.pdf.

[17] Id.

[18] Id. at 5.

[19] Id. at 3 (citing ethics opinions from Illinois, Iowa, Michigan, Texas, Virginia and Washington).