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Comparing Recent **Clawback Rulings** In 'Dewey' and 'Thelen'

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BIGSTOCK

Let's get the easy part out of the way. If you're a law firm partner at a failing firm, you want your firm to avoid bankruptcy. That is a no-brainer. The list of reasons is long, and for many law firm partners, their own financial well-being is not at the top of the list. They worry about associates, support staff, clients, disruption in their professional lives, reputational damage and a million other things. But at some point, these partners must also confront the potential threat to their own financial condition. It has become standard operating procedure in law firm bankruptcies that trustees will pursue some variety of "clawback" claims against the partners, which seek recovery of amounts already paid to partners. The claims may seek to reach back months, or even years, and may seek some or all of what the partners have been paid.

So, what determines how sharp these claws are? We can draw some conclusions from comparing the recent partner clawback decisions in the bankruptcy cases of Dewey & LeBoeuf LLP and Thelen LLP. In *Dewey*, the court relied on unique features of New York insolvency and debtor-creditor law to allow the Dewey Trustee to proceed in his clawback suit to recover *all* of what former partners were paid by Dewey dating back more than three years. By contrast, in *Thelen*, the court interpreted the partnership agreement and relied on California contract law principles to permit the Thelen Trustee to seek recovery of *some* of the amounts the former partners were paid by Thelen, but only in its last year of operation. While both decisions are tough for law firm partners, the decision in *Dewey* and its reliance on uniquely harsh New York state law exposes partners to much greater risks than the decision in *Thelen*.

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Dewey & LeBoeuf

Prior to its bankruptcy filing, Dewey was a law firm registered as a New York limited liability partnership. In May 2012, after months of struggling to meet the borrowing conditions under its credit facilities, deferring partnership distributions, laying off employees, and enduring mass attorney defections, Dewey filed for Chapter 11 protection in the U.S. Bankruptcy Court for the Southern District of New York (Judge Martin Glenn). The firm's liquidation plan, as confirmed in early 2013, included a settlement with approximately 400 of its former partners, resolving the Dewey Trustee's clawback claims seeking disgorgement of prepetition distributions

made to the former Dewey partners while the firm was allegedly insolvent. Subsequently, other former partners entered into individual clawback settlements with the Dewey Trustee, while some holdouts chose to litigate.

Thelen

Prior to its bankruptcy filing, Thelen was a registered limited liability partnership governed by California law. In October 2008, after mass attorney defections that triggered a breach of Thelen's loan agreement, its partners voted to dissolve the partnership and entered into a dissolution agreement, pursuant to which the firm effectuated a dissolution in November 2008. Nearly one year later, in September 2009, Thelen filed for chapter 11 protection in the U.S. Bankruptcy Court for the Southern District of New York (Judge Allan L. Gropper). The Thelen Trustee settled clawback claims against more than 130 former Thelen partners, while, like in *Dewey*, some holdouts chose to litigate.

The Opinion in 'Dewey'

As described in more detail in our recent article,[1] on Oct. 29, 2014 Glenn granted summary judgment in favor of the Dewey Trustee on two critical issues. First, he held that New York Debtor and Creditor Law (NYDCL) §277(a) applies to the partners of a New York limited liability partnership, establishing the Dewey Trustee's right to pursue recovery of *all* partner distributions made while the partnership was insolvent, allegedly dating back to January 2009. Second, he overruled the former Dewey partners' principal defense, holding that the partners' legal and business generation services cannot qualify as "reasonably equivalent value" for purposes of Bankruptcy Code §548(a)(1)(B)(i) to offset that recovery, because the partners already owed the duty to contribute those services to the partnership. See 2014 WL 5463302 (Bankr. S.D.N.Y. Oct. 29, 2014).

NYDCL §277(a) states that every transfer made by an insolvent partnership to its partners is subject to avoidance, without exception. NYDCL §277(b), on the other hand, deals with transfers made by an insolvent partnership to entities *other than* partners, and provides that such transfers are not subject to avoidance as long as the partnership received "fair consideration" from the transferee. The court in *Dewey* held that the term "partner" in §277(a) includes all types of partners, including LLP partners, and thus §277(a)'s strict liability standard applied to all transfers made to Dewey's former partners after the firm became insolvent without allowing any offset for their services to the partnership. In so holding, Glenn looked to the legislative history of the NYDCL, and noted that because many of the provisions dealing with "partners" contained a "carve-out" for LLP partners, the lack of such a carve-out in §277(a) indicated an intent to include the LLP partners in that provision.

New York is in the minority of states that still has in effect the Uniform Fraudulent Conveyance Act, from which NYDCL §277 derives. Most states have adopted the more "modern" Uniform Fraudulent Transfer Act. Unlike the UFCA, the UFTA does not contain a special provision like §277(a) that specifically covers transfers made by a partnership to its partners. Rather, the UFTA contains a single provision applicable to all types of transferees (including partners) that provides that transfers made by an insolvent transferor are avoidable only if the transferor did not receive "reasonably equivalent value" in exchange for the property transferred. Thus, in a UFTA jurisdiction, a transfer made by an insolvent partnership to any party, including a partner, may not be avoided if the transferee provided value to the transferor that was reasonably equivalent to the value of the property received by the transferee.

> While both decisions are tough for law firm partners, the decision in **'Dewey'** and its reliance on uniquely harsh New York state law **cut much deeper** than the decision in 'Thelen'.

The UFTA itself does not, however, determine whether a former partner's services may qualify as reasonably equivalent value. Rather, the answer to that question depends on whether the state has adopted the Uniform Partnership Act (UPA), with its New York-style "no compensation rule," or the Revised Uniform Partnership Act (RUPA) with its "reasonable compensation rule."

After ruling that §277(a) imposes strict liability upon partners, the court in *Dewey* next considered whether the distributions to former Dewey partners could be avoidable under the constructive fraudulent transfer provisions of Bankruptcy Code §548(a)(1)(B). Like the constructive fraudulent transfer provisions in the UFTA, Bankruptcy Code §548(a)(1)(B)(i) provides that a transfer by an insolvent entity is only avoidable if the transferor received consideration of less than reasonably equivalent value in exchange for the transferred property.

The former Dewey partners argued that the Dewey Trustee was not entitled to summary judgment under §548(a)(1)(B)(i) because the former partners were entitled to a factual hearing on the question of whether their services as partners (measured by billable hours, business generated, fees collected, marketing, and client and practice development) constituted reasonably equivalent value provided to Dewey.[2] The court in *Dewey* disagreed, holding instead that New York's "no compensation rule" precluded the former Dewey partners from establishing a reasonably equivalent value defense. Embodied in New York Partnership Law §40(6), this rule states that "[n]o partner is entitled to remuneration for acting in the partnership business, except that a surviving partner is entitled to reasonable compensation for his services in winding up the partnership affairs."

Glenn ruled as a matter of law that New York's "no compensation rule" trumped the usual inquiry into whether a transferee provided reasonably equivalent value. This is true even though limited liability partnerships are treated like corporations under the Bankruptcy Code.[3] Under the UPA, absent an agreement to the contrary, a partner ordinarily is entitled only to his or her share of the profits. Of course, in an insolvent firm, there are none. Thus, Glenn applied the "no compensation rule" strictly, and held as a matter of law that the former partners were not entitled to any distributions, regardless of any individual's contribution to the good and welfare of the partnership business.[4] Even if the partners were paid less than their market value, or generated millions more than they were paid in collections for the firm and its creditors, the partners, according to Glenn, must pay it all back.[5]

Here again, New York is in the minority and, according to Glenn's ruling, harsher than other jurisdictions in its treatment of law firm partners. The "no compensation rule" is part of the old pre-World War I era UPA. In contrast, most states have enacted the mid-1990s RUPA, which eliminated the "no compensation rule" and replaced it with the "reasonable compensation rule."

The Opinions in 'Thelen'

In 2014, Gropper issued two separate opinions in *Thelen* based on a legal analysis and reasoning quite different from the opinion in *Dewey*. The results in *Thelen* are also tough on law firm partners, though not as harsh as in *Dewey*. In the first opinion, issued on May 23, 2014, Gropper ruled in favor of the former Thelen partners, denying the Thelen Trustee's motion for partial summary judgment. At issue before the court in *Thelen* was whether certain draws received in 2008 by the former Thelen partners as advances against their entitlement to their allocable share of net income (ASNI), constituted overpayments and were avoidable under the constructive fraudulent transfer provisions of Bankruptcy Code §548(a)(1)(B)(i). See 2014 WL 2178156 (Bankr. S.D.N.Y. May 23, 2014).

At oral argument, the parties in *Thelen* informed Gropper that they had agreed that the fraudulent transfer issues should be decided first, and the contract issues later. The Thelen Trustee then moved for partial summary judgment with

respect to the fraudulent transfer claims, arguing that the governing partnership agreements were determinative as to the issue of the "reasonably equivalent value" of each former partner's services. Specifically, the Trustee stated the reasonably equivalent value of the former partners' services was set forth in the partnership agreements as the final ASNI, and this bargained-for exchange constituted the market value of their services. Thus, Thelen received no value in exchange for the excess amounts received by the former partners over and above the compensation set forth in the partnership agreements, that is, the final ASNI. The former Thelen partners, on the other hand, argued that they were entitled to an evidentiary hearing to present evidence to show that they had provided reasonably equivalent value. Some went on to argue that they had provided additional services to Thelen because of its precarious position, staying until the "bitter end" and ultimately providing a benefit to other partners, employees, and creditors.

Gropper ruled in favor of the former Thelen partners in the first opinion, holding that they should not be bound by the partnership agreements for purposes of determining "reasonably equivalent value," particularly where the contract was never fully performed and the partners were performing under extraordinary circumstances. Of particular note is Gropper's decision to reconsider the parties' agreement to proceed first with the fraudulent transfer issues and then the contract issues, because he perceived that it was clear that the contract issues predominated (evidenced by the fact that the Thelen Trustee had framed the contract issues as determinative of the fraudulent transfer issues).

On Nov. 20, 2014, Gropper issued a second opinion in *Thelen*, holding for the Thelen Trustee, which may have come as a surprise to the parties, given his holding for the former Thelen partners in the first opinion. At issue in the second opinion was whether the former Thelen partners' draws and other advances that, because of the dissolution of the firm or for other reasons, exceeded the final ASNI for 2008, must be repaid to the Thelen estate. Relying on California contract law, Gropper denied the former Thelen partners summary judgment, holding that they could not keep the advances they were paid against anticipated net income that was never received. See 2014 WL 2178156 (Bankr. S.D.N.Y. Nov. 20, 2014).

Under California contract law, Gropper found that the former Thelen partners' final ASNI was subject to the contingency that profits would be realized sufficient to justify the amounts advanced, a contingency that never occurred. The former partners had assumed the risk that Thelen would not be able to cover their advances, and had impliedly agreed to repay such advances in the event that the firm could not do so. Moreover, the partnership agreements themselves supported the notion that the former Thelen partners were obligated to repay the advances in excess of the final ASNI.

Exploring 'Dewey' and 'Thelen'

Both the *Dewey* and *Thelen* opinions produce harsh results for law firm partners. However, the reasoning in each case differs to a significant degree.

As Glenn pointed out in *Dewey*, New York fraudulent transfer and partnership laws are much harsher on law firm partners than the laws of many other states. This is due to the interplay of the New York version of the old UFCA, without modification of the strict liability standard for transfers made by a partnership to its partners, and the New York version of the old UPA, without modification of the "no compensation rule." Most states have ameliorated the harsh result imposed in *Dewey* by adopting the UFTA, thereby eliminating strict liability for partners, and by adopting the RUPA, expressly providing entitlement to reasonable compensation for partners. If Dewey had, for example, been organized under the current laws of California, the Trustee would not have prevailed on summary judgment, and the litigation would have turned to determining the reasonable compensation to be offset against each former partner's distributions during the period of insolvency.

Of course, Thelen *was* organized under the current laws of California, but the result of the opinions in *Thelen* was also harsh for law firm partners. Gropper did not apply California fraudulent transfer and partnership law, but rather, he analyzed the Thelen Trustee's claims under contract law instead, focusing on California contract law and the partnership agreements themselves. Because of the way the Thelen partnership agreements operated, the final ASNI for partners was calculated at the end of each calendar year, and so the payments at issue in *Thelen* spanned only one year (2008). Thus, each former Thelen partner was only at risk of avoidance of his or her draws and advances made in 2008, rather than the more than three-year span of the payments at issue in *Dewey*.[6]

In addition, former partners of law firms organized under the current laws of California or another state that does not have the "no compensation rule" face another potential issue. In addition to bringing a clawback claim, to the extent that a former partner was not paid prior to the law firm filing for bankruptcy and that partner asserts a claim against the estate in respect of unpaid compensation after a final accounting has been made, the trustee could seek to equitably subordinate the partner's claim under Bankruptcy Code §510(c). That section provides that a bankruptcy court may "subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim." However, this argument can be analogized to similar cases in which trustees have sought to equitably subordinate "equity redemption claims." Equity redemption claims are founded on notes issued in connection with the redemption of equity interests, generally where a departing employee is entitled to repayment of his or her capital, and is instead given a note, and subsequently the company files for bankruptcy and the note remains unpaid. Although there is some risk of equitable subordination, at least one Circuit Court has held that such a determination is not automatic and these claims should not be subject to equitable subordination absent evidence of misconduct on the part of the claimant.[7]

Conclusion

The lessons from *Dewey* and *Thelen* for partners facing clawback claims in the future are that trustees have multiple claws and some are sharper than others. Partners of law firms organized under the laws of New York face the prospect of having to pay back all amounts they previously were paid by the firm, for as much as six years potentially, depending on the date of insolvency. Partners also must consider the possibility that their partnership agreement will give rise to clawback claims. Trustees may yet develop other arguments as well. It's a dangerous world out there. And there are many partners out there with the scars to prove it.

1. Evan C. Hollander, Lisa Hill Fenning, Jonathan W. Hughes and Dana Yankowitz Elliott, "Dewey Partner Clawback Ruling May Hurt New York Law Firms," Law360, Nov. 18, 2014. The analysis herein builds on the November 18th article.
2. Moreover, the former partners argued that even if they provided less than reasonably equivalent value, they were entitled to a partial credit under §548(c) to the extent their services did provide some value to the estate.
3. See 11 U.S.C. §101(9)(A)(ii).
4. The court noted that the Dewey partnership agreement did allow for "special compensation" arrangements that might qualify as such an "agreement to the contrary," but those arrangements were deemed to be outside the scope of the matters before the court on summary judgment.
5. The significance of Glenn's ruling is partially undermined by his failure to address the case law in New York that has softened the "no compensation rule" under the *Kirsch* rule by allowing partners to retain the value of their "efforts, skill and diligence." See, e.g., *Kirsch v. Leventhal*, 586 N.Y.S.2d 330 (N.Y. App. Div. 1992); *Santalucia v. Sebright Transp.*, 232 F.3d 293 (2d Cir. 2000). His ruling thus appears to be at odds with New York precedents.
6. The clawback period in *Dewey* was limited to a little over three years because the Dewey Trustee established an insolvency date of January 2009. However, because New York Civil Practice Law and Rules §213 has a six-year look-back period, it is possible that a member of a New York partnership could be at risk of avoidance for up to six years of distributions.
7. See, e.g., *In re Merrimac Paper*, 420 F.3d 53 (1st Cir. 2005) (refusing to equitably subordinate a debtor's former employee's claim that was based on a stock redemption note, because the debtor had shown no evidence of any misconduct on the part of the former employee noteholder).