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Minimizing 'Jewel' Risks In Lateral Partner Hiring

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Law360, New York (April 15, 2014, 12:08 PM ET) -- Which law firm is rumored to be failing this week, and which will be next? Such legal industry headlines are catnip for strong firms hoping to bolster their own talent by luring lateral hires away from weak ones. With those opportunities, however, comes the real risk of being sued later by the failed firm's bankruptcy trustee.

Such Jewel litigation has been filed after every major law firm bankruptcy in the past 10 years, including Lyon & Lyon, Brobeck, Coudert, Thelen, Heller and Howrey. These lawsuits have produced years of litigation, with similar suits expected in the Dewey bankruptcy. Under the novel theories advanced by bankruptcy trustees, hiring firms should be required to turn over the profits earned on all matters that clients transferred from the dissolved firm to the new firm.

The origins of the Jewel doctrine lie in partnership law. Most states' version of the Uniform Partnership Act or the Revised Uniform Partnership Act (including California, D.C. and New York) require partners to account back to the dissolved law firm for any profits derived from the winding up of the dissolved firm's "unfinished business," unless the partners agree otherwise.

In the absence of such an agreement, courts in most jurisdictions have applied the partner's duty to account to client matters pending at the time of dissolution, holding that former partners must account back for any profits they earn on those matters after dissolution.

The key case in California is Jewel v. Boxer, 156 Cal. App. 3d 171 (1984), which has served as the springboard for litigation well beyond the scope of the original Jewel suit seeking an accounting for contingency fees paid after dissolution of a four-person firm. Other jurisdictions, including New York and D.C., also have applied a duty to account to law firms.

The law actually encourages partners to enter into agreements about whether they have a duty to account back to each other for profits received when they finish matters that were pending at dissolution (a "Jewel agreement"). Although such agreements generally are lawful and beneficial for many reasons, bankruptcy trustees have asserted that they constitute fraudulent transfers if entered into when the dissolving firm is insolvent.

Much of the recent Jewel-related litigation has been fraudulent transfer actions of this nature, in which trustees have sought to vitiate a Jewel agreement and recover any post-dissolution profits. In an unprecedented move, trustees have expanded these suits to include not just the former partners but also their new firms.

The legitimacy of these claims remains in doubt. One bankruptcy court judge has allowed the trustees' fraudulent transfer claims to proceed, but at least one district court judge has dismissed them. Other legal issues currently being litigated address the scope of the Jewel doctrine. These include:

(1) whether the duty to account applies to the law firms that hire former partners of a dissolved firm;

(2) whether the duty to account applies to partners who leave a firm prior to its dissolution;

(3) whether the duty to account applies to partners resident in non-U.S. offices; and

(4) whether the duty to account applies to nonequity partners.

There is very little legal guidance regarding how to calculate what might be owed back to the estate of the dissolved law firm if liability is found. By statute, only a former partner of the dissolved firm has a duty to account, not the firm that hired the partner.

Thus, the trustees' novel fraudulent transfer theories create many questions about how the accounting would proceed if applied to an entire law firm, including whether a firm would have to account for profit earned by the work of lawyers and staff who were never employed at the dissolved firm and thus owed it no duties.

In addition, the former partner is entitled to deduct reasonable compensation for the work he or she did to complete the matter, as well as overhead costs (including legal and other staff salaries), from the gross revenue the partner received from the unfinished business matters. The resulting profit, if any, is the measure of damages. All of these issues are currently being litigated.

Despite the legal uncertainties surrounding these claims, hiring firms can take steps now to evaluate and minimize their Jewel risk for any lateral hire. Hiring firms should consider the following issues and possible protective measures:

- Is the lateral candidate subject to the duty to account? Relevant information, if available, may include: whether the candidate is a partner in a law firm facing imminent dissolution, whether the dissolving firm has a Jewel agreement in place, whether that agreement occurred before or after the firm's financial difficulties, and whether the candidate is working on one or more matters expected to continue at the hiring firm.

- State law dictates the rules governing whether and when any duty to account is triggered. Generally, the duty to account applies only to client matters that are pending at the law firm at the time it dissolves, and only to partners who remained with the firm at the time of its dissolution or who left it only shortly before, depending on the jurisdiction. It is important to understand the applicable state law, whether and how trustees are pushing the boundaries of those state rules, and whether there are any precautionary steps that can be taken.

- What steps can hiring firms take to minimize risk?

    - Adopt special intake procedures for matters opened by the lateral partner to identify any that were pending at the former firm and might be subject to the rule.

    - Carefully assess the continuing matters and consider declining specific transfers.

    - Approach the candidate's firm to resolve potential disputes before taking on the matter. Although impractical in many situations, hiring firms may consider entering into an explicit agreement with the dissolving firm.

- Hiring firms also must be aware that trustees sometimes assert claims for tortious interference — that is, arguing that a hiring firm somehow contributed to a struggling firm's downfall. Hiring firms may request confirmation that lateral candidates have met and will meet all of their obligations to their former firm, including complying with any departure notice provisions in the partnership agreement or obtaining approval to modify the notice requirement. Hiring firms also may encourage potential laterals to retain separate counsel to advise them regarding their withdrawal from a struggling firm. Such counsel can advise the laterals about many of the issues discussed here, including the timing of the partners' departures and their fiduciary obligations to their existing law firm.

A number of Jewel-related cases are currently pending in courts on both coasts. In California, some of the fraudulent transfer cases in the Heller bankruptcy have just been sent to the district court, which has the right to conduct a de novo review of the bankruptcy court's decisions. The Jewel cases filed in the Howrey bankruptcy remain in the early stages of litigation, but these cases have raised the issue of whether, under D.C. law, the duty to account applies to partners and client matters that leave a firm prior to the firm's dissolution.

In New York, in the Thelen and Coudert cases, the Second Circuit has certified to the New York Court of Appeals state law questions that directly address the issue of whether a law firm has a property interest in post-dissolution profits earned on hourly rate matters. And most recently, the Dewey & LeBoeuf LLP trustee has taken the first steps toward pursuing Jewel claims by seeking revenue information from certain law firms that hired former Dewey personnel.

The legal issues in these cases are complex and unsettled. Hiring firms should take care to assess Jewel risks when hiring laterals from distressed firms and consider ways to minimize those risks before the lawsuits are filed.

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Arnold & Porter currently represents Orrick Herrington & Sutcliffe LLP in the Heller bankruptcy proceedings, and Hogan Lovells US LLP and Reed Smith LLP in the Howrey bankruptcy proceedings. Arnold & Porter is one of many targets of Jewel-related litigation in the Howrey and Dewey bankruptcy proceedings.

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