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# Dewey Partner Clawback Ruling May Hurt New York Law Firms

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Law360, New York (November 18, 2014, 1:14 PM ET) -- If you are a partner of a New York law firm and unbeknownst to you, your firm is insolvent, then you are working for free. And your unwitting gratuitous service may continue for years before you find out and a bankruptcy trustee shows up at your door asking you to return to the firm every penny you were paid over several years. Had you been working for a California firm, or a firm in a majority of U.S. jurisdictions, you would be entitled to keep the reasonable value of your services over those years. But, at least according to a recent ruling in the Dewey & LeBoeuf LLP bankruptcy case, partners of New York firms must pay back every penny.

The ruling by Judge Martin Glenn, on Oct. 29, 2014, could spell trouble for New York law firms and their partners. Should this ruling stand on appeal, members of New York partnerships will bear greater risk if their firms fail than will members of many similarly structured non-New York partnerships. In this article, we describe the potential implications of the ruling.

**Background**

After months of struggling to meet the borrowing conditions under its credit facilities, deferring partnership distributions, laying off employees, and enduring mass attorney defections, in early 2012 Dewey filed for Chapter 11 protection in the U.S. Bankruptcy Court for the Southern District of New York. The firm's liquidation plan, as confirmed in early 2013, included a settlement with approximately 400 of its former partners.

In exchange for releases and waiver of their claims against Dewey, these former partners contributed $70.4 million to a liquidation trust to resolve the trustee's "clawback" claims seeking disgorgement of prepetition distributions made to them while the firm was allegedly insolvent. Subsequently, other former partners entered into individual "clawback" settlements with the liquidation trustee, but some chose to litigate.

The court partially consolidated the trustee's adversary proceedings with the holdouts, and both sides moved for summary judgment. On Oct. 29, 2014, Judge Martin Glenn issued an opinion granting summary judgment in favor of the trustee on two critical issues.

First, he held that New York Debtor and Creditor Law (NYDCL) Section 277(a) applies to the partners of a New York limited liability partnership, establishing the 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 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).

**The NYDCL §277(a) Ruling: Strict Liability for Limited Liability Partners**

NYDCL §277(a)[1] was adopted by the New York Legislature in 1925, before the advent of limited liability partnerships and the evolution of modern law firms. It 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 former partners argued that the less draconian Section 277(b) should apply, because the term "partners" as used in Section 277(a) was not intended to apply to partners of LLPs, which are more closely analogous to limited liability companies or corporations than general partnerships.[2] The trustee countered that because Section 277(a) utilizes the generic term "partners," it was intended to apply to partners of all types of partnerships.

The court agreed with the trustee, holding that the term "partner" in Section 277(a) includes all types of partners, including LLP partners, and thus Section 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, Judge Glenn looked to the legislative history of the NYDCL, and noted that because many of the provisions dealing with "partners" contained a "carveout" for LLP partners, the lack of such a carveout in Section 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 Section 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.[3]

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.

At least some of the remaining UFCA states, such as Maryland, have achieved the same result by affirmatively amending its version of Section 277(a) to allow partners to prove "fair consideration," instead of by eliminating their UFCA equivalent of Section 277(a). Similarly, Bankruptcy Code § 548(b) imposes strict liability on partners in partnership debtor cases similar to that of NYDCL §277(a), but unlike the New York statute, Section 548(b) applies only to a general partner of a debtor partnership.

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," as discussed below.

**The "Reasonably Equivalent Value" Ruling: No Defense Under New York Law**

After ruling that Section 277(a) imposes strict liability upon partners, the Dewey court next considered whether the distributions to former 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 partners argued that the trustee was not entitled to summary judgment under Section 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.

Moreover, the former partners argued that even if they provided less than reasonably equivalent value, they were entitled to a partial credit under Section 548(c) to the extent their services did provide some value to the estate. The trustee countered, and the court agreed, that New York's "no compensation rule" precluded the former 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."

Here again, New York is in the minority and, according to Judge 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. Unfortunately, the UPA is still in effect in New York and some other states that are home to large numbers of law firms. In contrast, most states have enacted the mid-1990s RUPA, which eliminated the "no compensation rule" and replaced it with the "reasonable compensation rule."

Judge 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. 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, the partner is not entitled to any distributions, regardless of any individual's contribution to the good and welfare of the partnership business.

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. But ordinary partnership distributions are not so protected in Judge Glenn's view, for he applied the "no compensation rule" strictly, and as a matter of law, so the partner defendants have been wholly denied any opportunity to demonstrate the value of their services. 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 Judge Glenn, must pay it all back.

The significance of Judge 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. Inc., 232 F.3d 293 (2d Cir. 2000). His ruling thus appears to be at odds with New York precedents.

**Conclusion**

As Judge Glenn pointed out in his ruling, 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,[4] 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.

Unless the ruling is overturned on appeal or the New York Legislature addresses both of these issues by amending the New York fraudulent transfer and partnership laws, partners of New York firms will continue to bear greater risk in a failure of their firm than the partners of a firm organized under the laws of many other jurisdictions. This risk factor might even affect decisions by prospective lateral partners about which firms to join. Absent reversal on appeal or legislative action, New York law firms may consider reforming their partnerships under the laws of another jurisdiction that has adopted the UFTA and RUPA.

[1] Section 277 provides that:

> Every conveyance of partnership property and every partnership obligation incurred when the partnership is or will be thereby rendered insolvent, is fraudulent as to partnership creditors, if the conveyance is made or obligation is incurred,
>
> a) To a partner, whether with or without a promise by him to pay partnership debts, or
> b) To a person not a partner without fair consideration to the partnership as distinguished from consideration to the individual partners.

N.Y. Debt. & Cred. Law § 277.

[2] In fact, Bankruptcy Code §109(9)(a)(ii) treats nonrecourse LLPs as corporations.

[3] See, e.g., Del. Code tit. 6, § 1304(a)(2) ("A transfer made or obligation incurred by a debtor is fraudulent as to a creditor, whether the creditor's claim arose before or after the transfer was made or the obligation was incurred, if the debtor made the transfer or incurred the obligation: [w]ithout receiving a reasonably equivalent value in exchange for the transfer or obligation ..." and the debtor was left with unreasonably small remaining assets or incurred debts beyond its ability to pay as they became due).

[4] The oft-cited Jewel v. Boxer California appellate decision was decided under California's version of UPA, pursuant to which the "no compensation" rule has been applied. California subsequently adopted RUPA and the "reasonable compensation" rule.

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