Law Firm Breakup

What You Need to Know When Dissolving the Entity

by Michael F. Schaff and Peter A. Greenbaum

Law firm 'partnerships,' like other businesses, are similar to a marriage; at some point the parties may decide to part ways and dissolve their partnership. Among the many reasons for the dissolution of a law firm are financial difficulties; the death, disability or retirement of one or more attorneys; or animosity among the partners. There are a number of basic issues that should be addressed upon the dissolution of a law practice to allow for everyone involved to transition into the next stages of their professional lives in as painless a manner as possible. While the dissolution of each law partnership will have its own unique challenges, there are general issues that, if addressed early, will make the process more streamlined and efficient, resulting in fewer complications for each party.

When analyzing the breakup, the practice's organizational/governing documents should be the starting point. It will either be an operating agreement if the practice is a limited liability company, or a stockholders agreement if the practice is a professional corporation. Additional governing agreement(s) may include bylaws, employment agreements and other agreements between the owners. To the extent a breakup or dissolution is addressed in the governing documents, the processes set forth therein should be followed, unless otherwise agreed. Keep in mind that in many cases the organizational documents may only address the topic at a high level (if at all), and often will not detail the minutia of a separation.

Clients

A law firm's clients are typically its most important and most valuable asset. Upon dissolution, it is imperative to address how clients will be serviced post-dissolution. Given the level and frequency of personal interaction, attorneys and clients typically develop strong bonds with one another. Where the attorney and client have a strong bond and the attorney is the sole servicing attorney, it is typically appropriate for him or her to continue to service the client after separation. In many cases, however, multiple attorneys service the same client. In these cases, it may be appropriate that the client be contacted and given the choice of which attorney they would like to continue to represent them.

When the attorneys are not able to 'allocate' the clients between themselves, it may be appropriate that a joint letter from the practice be prepared and sent to all clients, informing them of the practice breakup, and the future plans of the attorneys (at least the partners), and either giving them the choice of which attorney they would like their files to remain with or advising the client which attorney has their files and that they have the right to obtain them from the attorney. This letter may include contact information for each attorney after the separation, as well as other information deemed pertinent. Several common issues associated with the letter sent to a client include determining who will draft the letter, who must approve it before it is sent out, who will mail the letter, and who will pay for the costs associated with it (printing and postage). When sending out the client letter, it may be beneficial to send it to both active and inactive clients, as attorneys typically view contact with inactive clients as a marketing opportunity.

As a natural extension to the allocation of the clients, the clients' files need to be distributed and maintained by the servicing attorney. The authors recommend the servicing attorney grant the former partners access to these records for billing, malpractice, and other pertinent issues. Make sure there is an obligation for the custodian of the clients' records to maintain them for the applicable statutory period before discarding or destroying them. For instance, in New Jersey

attorneys generally must retain client records for a period of seven years after closing their case.[1]

Identification and Division of Assets

The practice's hard assets must be accounted for and divided among the owners upon the dissolution of the practice. These hard assets may include: cash and cash equivalents; accounts receivable; fixtures, furniture, equipment, telephone numbers, websites, and email addresses; property leases; equipment leases; real estate; office supplies; and prepaid expenses (suppliers, utilities, etc.). Unless specifically agreed to in the practice's governing documents, there is no set of rules for the process of how these hard assets are allocated.

Many dissolving law practices try to allocate to each owner assets with an equal aggregate value, or a value close to their ownership percentage. Prior to allocation of the assets, the attorneys can either determine the value of the assets to be distributed themselves (with or without the assistance of their accountant), have a third-party appraiser or independent accountant complete this task, or agree on a methodology for the value to be determined after the dissolution and applied retroactively. Once the assigned values are determined, some practices use a pre-determined asset distribution method, while others will agree on the distribution methodology at such time, which in either case can include a 'draft' system or a flip of a coin to determine who chooses an asset first (with a corresponding value assigned to each asset). Thereafter, the value of all assets chosen by each owner is added up and compared to the other. To the extent that an owner receives more than his or her share of the assets, a cash adjustment is made through a lump sum cash payment, a reduction in the cash otherwise to be received, or in an agreed-upon number of installments.

Other material assets of the practice include the practice's telephone number(s) and website(s). If the owners cannot agree on which owner is to receive exclusive control of the telephone number(s) and/or website(s), they may agree that no one will receive the telephone number(s) or the website(s), and instead each must obtain new telephone numbers and/or websites. In those circumstances, the authors recommend the owners keep the existing telephone number(s) and/or website(s) active for an agreed-upon period of time (at least 12 months). For a phone number, they should implement a third-party telephone intercept service to either forward calls by pressing a number or directing callers to each owner's new practice. For a website, they should implement a webpage that directs the visitor to click through to the appropriate webpage for the specific attorney or the new practice.

If the owners decide to use an intercept service, they should set forth a time period for which the service will be used, and who will pay the costs. Also, they should determine whether one owner is to receive the telephone number and/or website at the conclusion of the intercept period, or whether no one is to receive the number and/or website.

Agreements of the Practice

Another key asset of the practice is the current agreements to which the practice is a party. These current agreements include property leases, equipment leases, employment agreements, service and support agreements and software license agreements, just to name a few. With each of these agreements, there are a number of questions that must be answered prior to their division. Initially, each agreement should be reviewed to determine their material terms, including identifying the financial or service obligations of each party under the agreement, the duration of the relationship and how the agreement can be terminated.

It is important to confirm that the agreements are in the practice's name—often agreements are inappropriately put in the name of one of the owners, rather then the practice. Furthermore, it is important to determine whether any agreements are personally guaranteed by any of the owners (or prior owners). For example, it is not unusual for office leases and equipment leases to be personally guaranteed by the individual owners. If this is the case, and if one of the owners has personally guaranteed an agreement that he or she is not involved with after the dissolution, then he or she will want that guaranty released or terminated as a part of the resolution of the dissolution. It should be noted that any release or termination of a guaranty will require the approval of the other party to the agreement, and that party is generally under no obligation to give the release. Therefore, an alternative would be for the owner receiving the agreement to indemnify the party who will not be responsible going forward.

It should also be determined whether any third-party consents are needed to assign the agreements from the practice. It should be noted that most real estate leases and equipment leases prohibit the assignment without the consent of the landlord, lessor, or other party.

The practice may have a number of agreements that no owner wants to continue or assume after the dissolution. In these circumstances, steps should be taken to determine whether the agreements can be cancelled or terminated without penalty, or otherwise terminated through a negotiated arrangement with the third parties. To the extent one or more agreements cannot be terminated, that agreement becomes a liability of the practice and the post-dissolution costs would be allocated among the owners.

Financial Considerations

As of the time of the dissolution, the practice will likely have cash on hand, accounts receivable to be collected, accounts payable to be paid, and other liabilities to address, such as lines of credit or term loans. These inter-related assets and liabilities must also be allocated and distributed among the partners.

In many cases, a bank or other lender or third party may have a lien on the practice's assets that should be discharged (or otherwise dealt with) before the distribution of the assets, since it might otherwise be a default under the terms of the loan and, if not addressed, the party receiving the asset would still be subject to the lien. Once all accounts payable and other liabilities have been paid or appropriately dealt with, the remaining cash (both on hand at the time of the breakup and collected thereafter) should be distributed to the practice's owners. As with other assets, the owners should agree on the methodology for allocating the cash and liabilities, if applicable.

Since there may be accounts receivable to be collected after the dissolution, the owners should establish a plan that details who will be tasked with collecting the funds, whether that party would be entitled to a collection fee, and how the collected funds will be allocated among the owners. Each of these should have an appropriate level of reporting and transparency. There also might be post-dissolution tax filings and payment liabilities of the practice that should be addressed.

Offices

The practice's offices are valuable assets that are regularly an item in dispute at dissolution. Who leaves and who stays becomes a major issue of contention. In many cases, no one wants to leave the offices and set up a new practice elsewhere. In addition to agreeing on who will remain in the office location, where one or more of the practice owners also own the real estate the practice owners should address whether they will continue to jointly own the real estate or if it will be sold (either to one or more of the owners or to a third party). To the extent the owners will continue to own the office, the fair market rent and occupancy terms must be agreed upon. Similarly, if one or more of the owners sells his or her ownership, the fair market value of their interest must be determined.

Associates and Staff

The practice owners should also determine which employees will work with whom after the dissolution, or alternatively, if employees will be let go. If employment or consulting agreements exist at the time of the dissolution, they should also be appropriately transferred, amended or terminated. Other potential employee issues that should be discussed and allocated between the owners include final contributions to, and termination of, pension plans; pending employee bonuses; deferred compensation, outstanding salaries or reimbursable expenses of the employees or attorneys; as well as unused vacation time.

Management of the Practice Through Dissolution

In many cases, the breakup will not occur immediately, with the owners agreeing that the effective date of the breakup or dissolution will occur at some date in the near future. Accordingly, it is imperative that procedures are agreed upon so the law practice continues to run in an efficient manner until the final dissolution date. As the practice goes through the dissolution process, it will still need to be run and managed, with clients continuing to be serviced. In these instances, the owners should develop a clear and concise plan to address how decisions will be made and how income and expenses will be allocated during this transition period.

Litigation and Insurance

The law practice, like other businesses, may have pending or threatened litigation against the entity or an owner, employee, or other person or group affiliated with the practice. The practice should develop a plan prior to the breakup on how to deal with these issues.

It is also important to analyze the practice's insurance policies, since the general liability, fire, and casualty insurance will usually be terminated. Review all life or disability insurance policies owned by the practice or owners to determine whether they will be cancelled or transferred to the insured owner (with or without consideration). Malpractice insurance policies should also be reviewed, both for the practice and for the individual attorneys. The practice should determine whether existing malpractice policies will be maintained, terminated, or assigned at dissolution. To the extent malpractice insurance is 'claims-made' insurance, the practice must decide whether 'tail insurance' will be obtained, and if so, which party will bear the costs.

Post-Closing Restrictive Covenants

As the practice splits apart, the attorneys will build new legal practices at various competing entities. Should the practice have offices in a state that permits the imposition of post-separation restrictive covenants, they should be considered to ensure their respective employees, clients, and/or referral sources are not being solicited by other attorneys. However, specific state law must be considered in this regard. For instance, Rule 5.6 of the New Jersey Rules of Professional Conduct prohibits a lawyer from offering or making a partnership or employment agreement that restricts the rights of a lawyer to practice

after termination of the relationship.

The Importance of the Team

Often, many outside professionals assist in the dissolution process, including the practice's accountant, the practice's outside corporate attorney and other professional advisors, as well as each individual owner's personal accountant and attorney. A strong team that works as a single, cohesive unit is vital to making the dissolution process efficient and as painless as possible. It is suggested the practice rely on its professionals, each of whom can be of significant help in resolving any issues among the owners.

Organizational Issues

General organizational housekeeping issues should also be addressed. In the event the legal entity will be dissolved (rather than certain owners remaining with the entity post breakup), the state filings governing dissolutions must be effectuated. Alternatively, if after the dissolution of the partnership one or more attorneys remain with the legal entity while others leave, those leaving must formally transfer ownership to the remaining attorneys. In either case, after the dissolution of the partnership, either one or all the prior owners will form new entities to continue practicing law. As is the case with any new business, initial start-up formalities must be followed, including obtaining a new taxpayer identification number, establishing bank accounts and obtaining benefit plans.

Conclusion

The dissolution of a law firm partnership can range from a friendly separation to a heavily litigated dispute, or anything in between. It is important to remember that even the friendliest breakup may encounter some speed bumps. It is suggested that as part of any proposed dissolution of a law practice, the parties attempt to minimize problems and disputes with open lines of communication. To the extent all issues can be discussed in advance, the risk of problems mushrooming into costly and time-consuming litigation can be minimized. ⚖

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ENDNOTE

1. New Jersey Advisory Committee on Professional Ethics Opinion 701.

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