Law Firms Penalizing Departing Partners? – That Goes Straight to the Penalty Box!

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MANY SOPHISTICATED lawyers in the throes of infatuation with a law firm they are joining barely consider the partnership agreements that describe their financial arrangements. While these same lawyers would never advise their clients to enter into an important financial arrangement without becoming familiar with the intricate details of that agreement, they themselves often do not do so. A key provision of a partnership agreement that these new partners often overlook governs what happens if the partner leaves or is pushed out of the partnership. The financial consequences can be significant—as or more significant than the financial consequences of a divorce. Yet, many partners enter into a law firm partnership without thinking about the financial consequences if the relationship does not work out.

The Rules of Professional Conduct address the move of a lawyer from one law firm to another, where the old law firm tries to penalize the departing lawyer for competing at the new law firm, including by taking clients to the new law firm. In this three-way contest among lawyers, law firms, and clients, the majority of the courts and state bar opinions have consistently recognized that it is the clients' interests—the clients' free choice of counsel—that must come out on top, *not* the former law firm's interests.

RULE 5.6(a) AND FINANCIAL PENALTIES • Rule 5.6(a) of the Model Rules of Professional Conduct provides that "a lawyer shall not participate in offering or making: a partnership, shareholders, operating, employment, 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." Comment 1 to this Rule explains its rationale: such agreements "not only limits their [lawyers'] professional autonomy but also limits the freedom of clients to choose a lawyer." Rule 5.6 is very similar to its predecessor, Disciplinary Rule 2-108(A), which was in effect in some jurisdictions until recently.

There is little controversy that Rule 5.6(a) flatly prohibits law firms from requiring lawyers to enter into covenants not to compete. In contrast, some other professionals (*e.g.*, physicians, accountants, and executives) can be bound by such covenants if they are reasonable in geographical, temporal, and subject matter scope. However, law firms have improperly attempted to do an end-run around this blanket prohibition by trying to come up with other ways to penalize departing partners, particularly those who take clients with them, and work at competing law firms.

RULE 8.5 AND THE CHOICE OF LAW • A threshold issue is the choice of law to be applied to a departing partner, which can be problematic for law firms that have offices in multiple states. For example, a partnership agreement might state that the law of New York applies to all disputes arising under the agreement. But, if a partner in the Illinois office of that law firm, who is not barred in New York, has a dispute that requires interpretation of Rule 5.6, then that partner and the law firm will need to look to Rule 5.6 as it has been interpreted by the courts and bar ethics opinions in Illinois (which are binding on the Illinois partner and the Illinois office), not the law in New York.

ABA Model Rule 8.5(b)(2), the choice of law provision, provides that for issues that are not in connection with matter pending before a specific court or tribunal, the rules to be applied are "the rules of the jurisdiction in which the lawyer's conduct occurred, or, if the predominant effect of the conduct is in a different jurisdiction, the rules of that jurisdiction shall be applied to the conduct." Under this rule, if the managing partner in the New York headquarters made the decision to penalize a departing attorney in the Illinois office, then the rules to be applied would be those of Illinois, since the predominant effect of the New York partner's conduct was in Illinois. Thus, a partnership agreement's choice of law provision can be trumped by Rule 8.5(b)(2). Since the Rules of Professional Conduct themselves differ from one state to another, and the state courts and bar ethics opinions have reached different results for comparable factual scenarios, it is necessary to determine the law to be applied.

THE MAJORITY RULE: FINANCIAL PENALTIES ARE *PER SE* VIOLATIONS OF RULE 5.6(a) • The majority rule among the courts and ethics opinions is that these financial penalties, even if couched as golden handcuffs, are *per se* violations of Rule 5.6(a). Most courts have followed the seminal decision of the New York Court of Appeals, in *Cohen v. Lord, Day & Lord*, 550 N.E.2d 410, 411 (N.Y. 1989), which held that the ethics prohibition on covenants not to compete extended to financial penalties on withdrawing partners, because those 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." The New York Court of Appeals recognized that the law firm's economic interests were trumped by the client's interests:

"While a law firm has a legitimate interest in its own survival and economic well-being and in maintaining its clients, it cannot protect those interests by contracting for the forfeiture of earned revenues during the withdrawing partner's active tenure and participation and by, in effect, restricting the choices of the clients to retain and continue the withdrawing member as counsel." *Id.* at 413.

Other state appellate courts have taken the same approach as did the New York Court of Appeals. The Supreme Court of New Jersey, in *Jacob v. Norris, McLaughlin & Marcus*, 607 A.2d 142, 148 (N.J. 1992), held that a law firm could not penalize departing partners "by selectively withholding compensation," since these "indirect restrictions on the practice of law, such as the financial-disincentives at issue in this case, likewise violate both the language and the spirit of [N.J. Rule of Professional Conduct] 5.6." Further, "By forcing lawyers to choose between compensation and continued service to their clients, financial disincentive provisions may encourage lawyers to give up their clients, thereby interfering with the lawyer-client relationship and, more importantly, with clients' free choice of counsel." *Id.*

The Illinois Appellate Court, in *Stevens v. Rooks Pitts & Poust*, 682 N.E.2d 1125, 1130 (Ill. App. Ct. 1997), similarly recognized that the majority of jurisdictions that have addressed this issue, including Iowa, New Jersey, and New York, "have overwhelmingly refused to enforce provisions in partnership agreements which restrict the practice of law through financial disincentives to the withdrawing attorney." Thus, the court invalidated a partnership agreement provision that "require[ed] the departing partner to give up certain compensation due to him if he competes with the firm in a certain geographic area within one year after his departure, [because] this financial disincentive provision hinders both the departing lawyer's ability to take on clients and the clients' choice of counsel." *Id.* at 1132.

The Court of Appeals of Texas similarly struck down a partnership agreement provision that allowed a law firm to value a departing partner's stock at "book value" (here, only $3,947.35), instead of the actual goodwill value (here, estimated at in excess of $112,000), because that partner moved to a competing law firm. *Whiteside v. Griffis & Griffis, P.C.*, 902 S.W.2d 739, 741 (Tex. Ct. App. 1995). The Court of Appeals recognized that the majority of states to have addressed this issue – except for California – "almost universally hold that financial disincentives … are void and unenforceable restrictions on the practice of law." *Id.* at 743-44. Hence, the Court of Appeals "align[ed] ourselves with the majority of jurisdictions that have rejected financial disincentives . . . we believe the strong public-policy concerns surrounding client choice warrant prohibition of lawyer restrictions." *Id.* at 744.

More than five decades ago, the ABA issued an ethics decision that similarly recognized that any desire to protect law firms had to give way: "Clients are not merchandise. Lawyers are not tradesmen. They have nothing to sell but personal service. An attempt, therefore, to barter in clients, would appear to be inconsistent with the best concepts of our professional status." ABA Comm'n on Professional Ethics, Formal Op. 300 (1961).

THE MINORITY RULE: SOME FINANCIAL PENALTIES ARE ACCEPTABLE • In contrast, the Supreme Court of California took the minority approach in *Howard v. Babcock*, 863 P.2d 150 (Cal. 1993). The court reasoned that there should be "no legal justification for treating partners in law firms differently in this respect from partners in other businesses and professions," *id.* at 157, a view rejected by the vast majority of courts to have considered that analogy. Even then, the court limited the penalties to those that could be imposed to "an amount that … is reasonably calculated to compensate the firm for losses that may be caused by the withdrawing partner's competition with the firm," in other words, actual or consequential damages as opposed to liquidated damages. *Id.* at 160. Justice Kennard's dissenting opinion recognized that while "law firms may be economically injured by the loss of clients,"