Heller Ehrman LLP v Tremaine LLP 3/5/18

Jewel waiver; Revised Uniform Partnership Act (RUPA); Dissolved law firm property interest in unfinished hourly matters

Like "cloud-capp'd towers," "gorgeous palaces," and perhaps someday even "the great globe itself," many arrangements endure for some time but eventually dissolve. (Shakespeare, The Tempest, act IV, scene I, lines 152–154.) So too with certain law partnerships — including firms that are retained, before they dissolve, to handle matters on an hourly basis. The question before the California Supreme Court is whether a dissolved law firm retains a property interest in such legal matters that are in progress — but not completed — at the time of dissolution. The United States Court of Appeals for the Ninth Circuit asks for an answer this question, which implicates both common law principles and statutory rules of partnership law, and has implications for the competing interests of ongoing and dissolved law partnerships, partners and firm employees, creditors and clients.

Petitioner Heller Ehrman (Heller) was a global law partnership with more than 700 attorneys. By August 31, 2008, the firm was in financial distress. Heller's creditors soon declared it in default, and Heller's shareholders — lawyers responsible for running the firm and providing legal services to its clients — voted to dissolve the firm. Heller notified its clients that as of October 31, 2008, it would no longer be able to provide any legal services.

Heller's dissolution plan included a provision known as a *Jewel* waiver. Named after the case of *Jewel v. Boxer* (1984) 156 Cal.App.3d 171, the provision purported to waive any rights and claims Heller may have had "to seek payment of legal fees generated after the departure date of any lawyer or group of lawyers with respect to non-contingency/non-success fee matters only." The waiver was intended as "an inducement to encourage Shareholders to move their clients to other law firms and to move Associates and Staff with them, the effect of which will be to reduce expenses to the Firm-in-Dissolution." By its express terms, the waiver governed only those matters billed on a non-contingency — that is continual, or hourly — basis.

In the following months, Heller's former shareholders joined at least 16 other law firms, including the respondent law firms of Davis Wright Tremaine LLP; Jones Day, Orrick, Herrington & Sutcliffe LLP; and Foley & Lardner LLP. Many of Heller's former clients — and all of those who went to the respondents — signed new retainer agreements.

In the meantime, Heller filed for bankruptcy under chapter 11 of the United States Bankruptcy Code. When Heller's plan of liquidation was approved, the bankruptcy court appointed a plan administrator who became responsible for pursuing claims to recover assets for the benefit of Heller's creditors.

In December 2010, the administrator filed adversary proceedings in bankruptcy court on behalf of Heller against the law firms where Heller's former shareholders had found work. **The administrator sought to set aside the *Jewel* waiver, claiming that under the Bankruptcy Code, the waiver was a fraudulent transfer of Heller's rights to post-dissolution fees to its former shareholders, and from them, to their new firms.** While it was not the administrator's allegation that the shareholders breached any fiduciary duty while working for Heller, the administrator nonetheless sought to recover from the shareholders' new firms the profits generated by the hourly fee matters pending when Heller dissolved and were brought to the new firms.

The respondents vigorously contested the administrator's claim. At summary judgment, the parties filed cross-motions on whether the *Jewel* waiver constituted a transfer of Heller's property to the respondents and whether any such transfer was a fraudulent transfer under the Bankruptcy Code. Relying on one of his earlier decisions, the bankruptcy judge found in favor of Heller on both issues.

The district court reversed. The court rested its ruling on considerations of law, equity, and public policy. In analyzing California law, the court reasoned that the **Revised Uniform Partnership Act (RUPA)** undermined *Jewel*, the legal foundation on which Heller based its claim. Specifically, the court concluded that RUPA contains no provision giving dissolved law firms the right to demand an accounting for profits earned by its former partners under new retainer agreements. The court ultimately held that Heller did not have a property interest in the hourly fee matters pending at dissolution. Moreover, since Heller did not have a property interest in such matters, there was no fraudulent transfer to the new law firms. The court's decision on the property issue thus resolved the case.

Heller appealed to the Ninth Circuit, which asked the California Supreme Court to provide guidance. The Court granted the Ninth Circuit's request that it resolve **the question of what property interest, if any, a dissolved law firm has in the legal matters, and therefore the profits, of cases that are in progress but not completed at the time of dissolution.**

Although this dispute has a direct impact on who controls the profits from ongoing cases involving hourly fees, no doubt for some litigants certain aspects of this case also seem to implicate broader concerns — regarding, for example, the extent of partners' fiduciary obligations to their firm or the efforts partners make to secure business on behalf of their firm. Nonetheless, the question that must ultimately be addressed is about **the scope of a dissolved firm's *property interests*, and whether those interests extend to the profits from ongoing matters billed on an hourly fee basis.**

Because this dispute concerns a dissolved firm of lawyers with fiduciary duties to the firm, the California Supreme Court looked first to the law of partnership and its related fiduciary obligations for its analysis. Justice Cuellar began by noting that neither previous cases nor specific statutory provisions concerning partnerships resolve the question presented.

Only twice previously — in the late 19th century — has the Court addressed the fiduciary duties of a dissolved law firm's former partners regarding the unfinished business at the time of dissolution. In *Osment v. McElrath* (1886) 68 Cal. 466 and *Little v. Caldwell* (1894) 101 Cal. 553, the Court confronted situations in which law firms dissolved with contingency matters pending. In both cases, the Justices held that the fees generated by one partner in completing the matters were to be shared equally with the former partner (or his estate). (*Osment*, at p. 470; *Little*, at p. 561.) The Court rejected the argument that the lawyers who personally completed the matters were entitled to a greater share of the fees than stipulated to in the partnership agreements.

California partnership law was codified in 1929 when the Legislature adopted the Uniform Partnership Act (UPA). The UPA preserved many common-law principles, including the rules elucidated in *Osment* and *Little*. (See *Jacobson v. Wikholm* (1946) 29 Cal.2d 24, 27–28) The First District Court of Appeal then added further gloss when it interpreted the UPA in the case of *Jewel v. Boxer*. In *Jewel*, partners of a dissolved law firm sued their former partners who had been handling "most of the active personal injury and workers' compensation cases." (*Jewel*, at p. 175.) The suing partners sought their shares of the fees from these cases, arguing that they were entitled to the same fees as prevailed during the partnership.

The *Jewel* court ruled in favor of the plaintiffs. It reasoned that the former partners were not entitled "to extra compensation for services rendered in completing unfinished business," where "extra compensation" was compensation "which is greater than would have been received as the former partner's share of the dissolved partnership." (*Jewel*, at p. 176 & fn. 2.) **Accordingly, without an agreement to the contrary, any attorney fees generated from matters pending when the law firm dissolved were "to be shared by the former partners according to their right to fees in the former partnership, regardless of which former partner provides legal services in the case after the dissolution."**

Subsequent Court of Appeal decisions consistently applied *Jewel*'s holding to contingency fee cases. (See, e.g., *Fox v. Abrams* (1985) 163 Cal.App.3d 610, 612–613; *Rosenfeld, Meyer & Susman v. Cohen* (1987) 191 Cal.App.3d 1035, 1063.) Such widespread application of *Jewel* was confined to the contingency fee context, however. **Only in 1993 did a Court of Appeal expressly interpret *Jewel* to encompass matters the dissolved law firm had been handling on an hourly basis. (See *Rothman v. Dolin* (1993) 20 Cal.App.4th 755, 757–759.) To this day, *Rothman* remains the only**

published California opinion to apply *Jewel* to the hourly fee context, and it did so before UPA was revised.

Three years after *Rothman*, the Legislature again revised partnership law by replacing UPA with RUPA. (See Corp. Code, § 16100 et. seq.) RUPA made several changes to the default rules of California partnership law. First, it added an entire section governing the fiduciary duty to account. It replaced former Corporations Code section 15021(1), which had provided that partners had a duty to account for benefits and profits, with section 16404, subdivision (b)(1), which sets forth **a partner's duty "to account to the partnership and hold as trustee for it any property, profit, or benefit derived by the partner in the conduct and winding up of the partnership business or derived from a use by the partner of partnership property or information, including the appropriation of a partnership opportunity."** (Corp. Code, § 16404, subd. (b)(1).)

Second, **RUPA supplied a new provision specifying that one of a partner's fiduciary duties is the duty "to refrain from competing with the partnership in the conduct of the partnership business before the dissolution of the partnership."** (Corp. Code, § 16404, subd. (b)(3).) Notably, the duty to refrain from competing with the partnership only pertains to the period *before* dissolution.

Third, RUPA changed the rule previously in force regarding partners' post dissolution rights to reasonable compensation. It replaced Corporations Code section 15018, subdivision (f), which had provided that only a "surviving partner is entitled to reasonable compensation for his or her services in winding up the partnership affairs," with section 16401, subdivision (h), which provides that all partners are entitled to such compensation. (Corp. Code, § 16401, subd. (h).)

Since the enactment of RUPA, no California court has, in a published opinion, resolved whether there remains a basis for holding that a partnership has a property interest in legal matters pending at a firm's dissolution. More recent is the intermediate appellate decision in *Jewel*, although that, too, was issued before the passage of RUPA and implicated only contingency fee matters. The Court will thus consider with fresh eyes the question posed by the Ninth Circuit.

Heller is a dissolved partnership, and the parties make various arguments associated with partnership law. The analysis of whether hourly fee matters pending at the time of a partnership's dissolution are the partnership's property are placed in context by considering not only the scope of property rights under California law — and the interests of clients relative to those of the attorneys they hire — but also the application of California's partnership law to this case.

Both the common law and provisions of California law codifying the nature of property associate a property interest with a specific bundle of rights to control the use and disposition of a particular asset. By helping to structure expectations that people can reasonably hold in their dealings with each other, conceptions of property facilitate social and economic relationships. Here, the question of whether a sufficiently strong expectation exists in the context of a law firm partnership performing hourly work on legal matters will be addressed.

A property interest grounded in such an expectation requires a legitimate, objectively reasonable assurance rather than a mere unilaterally-held presumption. What Heller claims here is not merely that a firm has a legitimate interest in the hourly matters on which it is working. Rather, Heller claims a legitimate interest in the hourly matters on which it is *not* working — and on which it cannot work, because it is a firm in dissolution that has ceased operations. In doing so, it seeks remuneration for work that someone else now must undertake. Because such a view is unlikely to be shared by either reasonable clients or lawyers seeking to continue working on these legal matters at a client's behest, Heller's expectation is best understood as essentially unilateral.

A client may ordinarily find that it makes little sense to continually change the allocation of work on legal matters billed on an hourly basis to different lawyers or firms, because of the value of the relationships formed in the course of representation, the accumulation of knowledge by the lawyers involved in the case, or simply the cost of identifying and transacting to retain suitable new counsel. Even so, hanging over all agreements involving legal representation — especially those involving work paid on an hourly basis — is the possibility that a client will change the nature of the work requested, the terms on which the work is to be performed, or the lawyer the client prefers. Such uncertainty is rooted not only in the reality that hourly fees are paid in increments, but also in the extent to which the client legitimately retains flexibility to change the terms of the bargain for legal services after a lawyer has been retained.

Of course, to assume that firms routinely acquire business simply through the good offices of a single lawyer belies the reality that firms exist for a reason — no matter how much business that individual appears to generate alone. Partners pool not only physical resources but human capital. They hold out not only themselves but their firm as capable of deploying the necessary resources to handle matters effectively. In doing so, lawyers often leverage the preparatory work and reputation of an entity in which they have a shared stake, and to which they owe a shared fiduciary duty. These realities certainly make it difficult to deny that lawyers in the same firm would ordinarily feel some shared interest in each other's work — indeed, some degree of mutual interest is all but implicit in the very nature of a firm.

But **a shared interest can differ from a property interest**, which under California law must reflect more than a mere contingency or a certain probability that an outcome — such as further hourly fees remitted to the firm — may materialize. While

Heller was a viable, ongoing business, it no doubt hoped to continue working on the unfinished hourly fee matters and expected to receive compensation for its future work. But such hopes were speculative, given the client's right to terminate counsel at any time, with or without cause. As such, they do not amount to a property interest. (Civ. Code, § 700) Dissolution does not change that fact, as dissolving does not place a firm in the position to claim a property interest in work it has not performed — work that would not give rise to a property interest if the firm were still a going concern.

A dissolved law firm therefore has no property interest in the fees or profits associated with unfinished hourly fee matters. The firm never owned such matters, and upon dissolution, cannot claim a property interest in the income streams that they generate. This is true even when it is the dissolved firm's former partners who continue to work on these matters and earn the income — as is consistent with our partnership law.

To find otherwise would trigger or exacerbate a host of difficulties. The more fees a former partnership can claim, the less remain available to compensate the people who actually perform the work. Reduced compensation creates incentives that are perverse to the mobility of lawyers, clients' choice for counsel, and stability of law firms. Former partners of a dissolved firm may face limited mobility in bringing unfinished matters to replacement firms when those unfinished matters are unattractive because the fees they generate must be shared with the dissolved firm. It was for this reason that Heller's shareholders executed the *Jewel* waiver, intending it as "an inducement to encourage Shareholders to move their clients to other law firms and to move Associates and Staff with them." Indeed, partners and their associates and staff are valuable hires to some extent precisely because of the business they bring. That lawyers sometimes have reason to switch firms does not diminish the importance of certain fiduciary duties that facilitate the existence of any firm. (See Corp. Code, § 16404, subd. (a)) Yet neither the scope of those duties nor a reasonable understanding of the scope of property under California law supports the inference that a dissolved firm owns the fees from matters its attorneys once handled on an hourly basis.

Recognizing a property interest even in hourly matters would also risk impinging on the client's right to discharge an attorney at will, a right that has been recognized in both statute and case law. (*Fracasse v. Brent* (1972) 6 Cal.3d 784, 790, citing Code Civ. Proc., § 284) To allow a firm like Heller to share in fees paid by a client who has discharged it (and paid it in full) necessarily reduces the fees available to compensate the client's substituted counsel of choice. In such a situation, clients with pending matters who prefer any of the firms that hired Heller's former shareholders may — in recognition of the fact that these firms will not receive the full fees paid and therefore will not be as incentivized to work on their matters — opt for second-choice counsel. In other words, allocating fees to Heller alters the freedom that clients have in choosing attorneys after Heller stopped representing them. To protect this freedom, the Justices affirm that client matters belong to the clients, not the law firms, and the latter may not assert an ongoing interest in the matters once they have been paid and discharged.

The clients' ability to retain their preferred counsel is a weighty interest, even if counterbalanced by an interest in partnership stability. This weighing of equities is evident in a case like *Howard v. Babcock* (1993) 6 Cal.4th 409, 412, where the Court deemed enforceable a law partnership's non-compete agreement, which imposed a reasonable cost on departing partners who competed with the firm. In doing so, we sought "to achieve a balance between the interest of clients in having the attorney of choice, and the interest of law firms in a stable business environment." Here, however, both interests are served by cutting off the fees going to the dissolved law firm.

Amici make this argument by pointing to the instability that results under a rule that pivots depending on when a partner departs a business. In particular, amici refer to situations where a partner remains with a struggling partnership in an effort to help rescue it, the partnership subsequently dissolves, and that dissolved partnership is understood to have a continued interest in unfinished hourly fee business — but only because the partner remained until dissolution. Anticipating such an outcome, partners would leave the firm and take business with them at the first sign of trouble so as not to risk being around when the partnership dissolves. This ruling will minimize this instability by reducing the incentives for partners to "jump ship" — that is, by limiting the dissolved partnership's continued interest in unfinished hourly fee matters as asserted against partners who stay until dissolution.

Nothing else in RUPA cuts against this holding. Of the three new provisions in RUPA — governing the fiduciary duty to account, the scope of permissible competition, and reasonable compensation for winding up a partnership — the Court has explained how the first two cohere with our conclusion. The third, too, is consistent with our analysis: winding up encompasses a limited number of tasks but the partners who perform those tasks are entitled to "reasonable compensation" for having done them. (Corp. Code, § 16401, subd. (h).) RUPA therefore does not change the Justices understanding of what constitutes property.

Under California partnership law, a dissolved law firm does not have a property interest in legal matters handled on an hourly basis, or in the profits generated by formers partners who continue to work on these hourly fee matters after they are transferred to the partners' new firms. To hold otherwise would risk intruding without justification on clients' choice of counsel, as it would change the value associated with retaining former partners — who must share the clients' fees with their old firm — relative to lawyers unassociated with the firm at its time of dissolution who could capture the entire fee amount for themselves or their current employers. Allowing the dissolved firm to retain control of such matters also risks limiting lawyers' mobility post dissolution, incentivizing partners' departures pre dissolution, and perhaps even increasing the risk of a partnership's dissolution.

The Court concludes that a dissolved law partnership is not entitled to profits derived from its former partners' work on unfinished hourly fee matters. Any expectation the law firm had in continuing the legal matters cannot be deemed sufficiently strong to constitute a property interest allowing it to have an ownership stake in fees earned by its former partners, now situated at new firms, working on what was *formerly* the dissolved firm's cases. Any "property, profit, or benefit" accountable to a dissolved law firm derives only from a narrow range of activities: those associated with transferring the pending legal matters, collecting on work already performed, and liquidating the business.

So, with the exception of fees paid for work fitting the narrow category of winding up activities that a former partner might perform after a firm's dissolution, a dissolved law firm's property interest in hourly fee matters is limited to the right to be paid for the work it performs <u>before dissolution</u>. Consistent with the statutory partnership law, winding up includes only tasks necessary to preserve the hourly fee matters so that they can be transferred to new counsel of the client's choice (or the client itself), to effectuate such a transfer, and to collect on the pretransfer work. Beyond this, the partnership's interest, like the partnership itself, dissolves. The Supreme Court disapproves of *Rothman v. Dolin* (1993) 20 Cal.App.4th 755 to the extent that it conflicts with this analysis.