

# Why Law Firms Collapse

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Law firms don't just go bankrupt—they collapse. Like Dewey & LeBoeuf, Heller Ehrman, and Bingham McCutchen, law firms often go from apparent health to liquidation in a matter of months or even days. Almost no large law firm has ever managed to reorganize its debts in bankruptcy and survive. This pattern is puzzling, because it has no parallel among ordinary businesses. Many businesses go through long periods of financial distress and many even file for bankruptcy. But almost none collapse with the extraordinary force and finality of law firms. Why?

I argue that law firms are fragile because they are owned by their partners, rather than by investors. Partner ownership creates the conditions for a spiraling cycle of withdrawals that resembles a run on the bank. As the owners of the business, the partners of a law firm are the ones who suffer declines in profits and who have to disgorge their compensation in the event the firm becomes insolvent. So if one partner leaves and damages the firm, it is the remaining partners who bear the loss. Each partner's departure thus has the potential to worsen conditions for those who remain, meaning that as each partner departs, the others become more likely to leave as well, eventually producing an accelerating race for the exits. This kind of spiraling withdrawal is sometimes thought to be an unavoidable consequence of financial distress. But if law firms were not owned by their partners, this would not happen. Indeed, the only large law firm in the history of the common law world that has ever survived a prolonged insolvency is also one of the only large law firms that has ever been owned by investors. These insights have extensive implications for how we understand law firms and corporate organization more generally.

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## INTRODUCTION

Law firms don't just go bankrupt – they collapse. Dewey & LeBoeuf; Heller Ehrman; Howrey; Brobeck Phleger & Harrison; Thelen. All of these firms and many others have disappeared with extraordinary swiftness and finality. Large law firms often go from apparent health to liquidation in just a few months—sometimes even weeks or days. And no large law firm has ever managed to reorganize its debts in bankruptcy and survive. This pattern of swift and complete collapse is puzzling, because it is strangely out of proportion to law firms' actual financial distress. Many collapsed firms have remained formally profitable up through the days they dissolved.

What explains this sad pattern? The obvious answer is that collapsed law firms have suffered financial problems: their profits have gone down, their practices have dried up, or their managing partners have made bad decisions. But financial distress alone cannot be the whole story, because financial problems are not unique to law firms. Many businesses suffer financial problems and many even go bankrupt. But almost none explode like law firms. Chrysler declared Chapter 11 bankruptcy a few years ago, and Amazon lost money for decades. And yet these companies are still making cars and shipping packages, even though many law firms collapsed into smoking ruins at a time when they remained profitable and current on all of their debts. Law firms, it seems, are not unique because of their tendency to fall off of financial cliffs, but because of the way they shatter when they hit the ground.

Drawing on an informal review of the collapses of 37 large law firms in the last thirty years, I argue that the best way to understand this phenomenon is to look beyond the details of the legal profession to deeper principles in organizational economics. Lessons from economics can show us that law firms collapse because of their peculiar patterns of organization. The reason law firms shatter is that they are made of unusually thin glass.

The problem, in short, is that law firms are owned by their workers. Specifically, a law firm's equity belongs to its partners, who get paid in shares of the profits. This ownership structure makes law firms very different from most large businesses in America, which tend to be owned by investors. This pattern of law firm ownership is required by the Model Rules of Professional Conduct<sup>2</sup> and it may also be a product of deeper forces in economics.<sup>3</sup>

Partner ownership makes a law firm fragile by exposing it to an accelerating spiral of decline that I call a *partner run*. Like a bank run, a partner run operates through a self-reinforcing spiral of withdrawal. When one partner

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<sup>2</sup> MODEL RULES OF PROF'L CONDUCT R. 5.4 (2013). Technically the requirement is only that law firms be owned by lawyers, and not by lawyers who necessarily work for them. As a practical matter, nearly all large law firms tend to be owned by their workers.

<sup>3</sup> *Infra* note 20 and accompanying text.

leaves, she damages the firm. This causes other partners to leave, which further damages the firm, causing still more partners to leave, and so on. Partner ownership is essential to this spiral of departures, because it provides the financial incentives that drive it. Partner ownership exposes every partner to the financial damage done by every other partner's withdrawal, thus encouraging partners to follow each other in successive waves of exit.

To be precise, partner ownership encourages partners to follow each other out the door for two reasons. First, partner ownership requires the partners to be paid in profits, rather than in salaries or bonuses. Hence if one partner's withdrawal damages the firm's profits, the aggregate pay of the firm's remaining partners must necessarily and automatically decline. Naturally, therefore, the remaining partners will begin to leave too. Second, as owners, partners face significant forms of personal liability that do not apply to salaried employees. These forms of liability include fraudulent transfer, preferential transfer, and unfinished business liability. Crucially, these liabilities all punish partners in direct proportion to how long they stay at a declining firm. Partners who leave late suffer more than partners who leave early. Fraudulent transfer liability, for example, allows creditors in bankruptcy to claw back the profits a firm pays to its partners in the months leading up to bankruptcy, meaning that a partner who stays until bankruptcy will lose more months of pay than a partner who leaves a year prior.

The spiral set in motion by partner ownership is able to spin freely because unlike the investors who own conventional businesses, the partners who own a law firm can freely withdraw. Under the Model Rules of Professional Conduct, law firms are generally forbidden from using covenants not to compete and other restrictions to keep their partners from leaving.<sup>4</sup> This rule is unique to the United States—it does not apply to lawyers in the United Kingdom or Australia. And this rule is also unique to law firms—it does not apply to accounting firms and other partner-owned professional services firms in the United States, or to investor-owned firms, which almost always prohibit their owners from unilaterally withdrawing.<sup>5</sup> The right of free withdrawal in law firms thus destabilizes law firms by depriving them of the stability that withdrawal restrictions on owners generate for other businesses.<sup>6</sup>

This ownership-centered theory of law firm collapse gains support from the recent experience of Slater and Gordon, a large law firm based in the United Kingdom and Australia. Beginning in 2017, Slater and Gordon suffered debilitating debts and a prolonged period of insolvency. But eventually, after about two years of negotiations with creditors, the firm restructured its debts and became possibly the only large law firm in the history of the common law world to survive a prolonged insolvency. Slater and Gordon was also, as it turns out, one of the only large law firms in the history of the common law world to have been owned by investors. This was not a coincidence.

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<sup>4</sup> MODEL RULES OF PROF'L CONDUCT R. 5.6 (2013); *see also* MODEL CODE OF PROF'L RESPONSIBILITY D.R. 2-108 (1980) (containing a similar prohibition).

<sup>5</sup> Of course, investors can sell their shares, but they cannot truly withdraw by demanding a return of the money and property that underlies the shares. *See infra*

<sup>6</sup> *See, e.g.,* Margaret M. Blair, *Locking in Capital: What Corporate Law Achieved for Business Organizers in the Nineteenth Century*, 51 UCLA L. REV. 387, 419 (2003); Henry Hansmann, et al., *Law and the Rise of the Firm*, 119 HARV. L. REV. 1333 (2006); Henry Hansmann & Reinier Kraakman, *The Essential Role of Organizational Law*, 110 YALE L.J. 387 (2000).

Slater and Gordon's investor ownership structure was the key factor that differentiated it from other insolvent law firms and allowed it to survive. Slater and Gordon was able to survive insolvency by doing the same things that other insolvent investor-owned businesses do: it continued to pay its employees and restructured its capital commitments. Neither of things would have been possible if Slater and Gordon were worker-owned.

This theory about the significance of partner ownership offers a number of surprising insights. The first is that a law firm can begin to collapse even when collapse makes all of the firm's partners worse off and even when the firm might otherwise remain viable as a going concern if only the partners could commit to stay. This theory also helps us to see why some firms live while others die. Debt, macroeconomic forces, and declines in demand for legal services all turn out to be much less important than we might think. Governance failures and social factors, by contrast, turn out to be much more important.

This theory can also tell us how to stop law firms from going up in flames. The solution is not just for law firms to make more profits and borrow less money. We could also stop law firms from collapsing by changing professional ethics rules to allow firms to be owned by investors or to permit firms to restrict their partners from withdrawing. Still another solution would be for law firms to change their partnership agreements and management strategies in ways that I will explain.

This theory also reveals a deep connection between partner ownership and the values of friendship, loyalty and trust. By undermining the formal bonds of money and creating powerful financial incentives to withdraw in times of decline, partner ownership forces firms to rely on informal forces like friendship and loyalty to hold themselves together. Partner ownership cuts the metal nails of contract and replaces them with leather cords of loyalty. Law firms are thus uniquely reliant on informal forms of bonding capital in place of more formal forms of financial capital. The trouble is that if the leather cords of friendship and loyalty cease to bind – if all partners care about is money – then partner ownership has a hard time creating financial incentives that can hold a law firm together. Indeed, I show for the first time that partner ownership can become the very force that blows a law firm apart.

The phenomenon of law firm collapse warrants our attention for a number of reasons. One is that even if law firm collapses are uncommon, they cast a long shadow over the way law firms do business. In the same way that the fear of bank runs—which are also uncommon—shapes every aspect of the banking industry, the fear of partner runs may very well shape many aspects of large law firm management.

More broadly, law firm collapses are interesting because they offer insight into deep conceptual problems in organizational law. It is these broader problems that I find most interesting about law firms. Whether a business should be owned by workers or investors is an enduring question in organizational law and an issue of profound social and political importance. It was the core ideological conflict of the Cold War. The experience of law firms also implicates deep questions about whether and how to keep the owners of a business committed. A spate of highly influential theoretical articles in law and economics has recently shown that the essential role of organizational law is to

prevent owners from withdrawing.<sup>7</sup> The experience of law firms deepens this understanding by showing for the first time that under certain conditions, withdrawals among owners can spiral into self-reinforcing runs. The risk of spiraling withdrawal has been seen before among depositors in banks. But this article is the first to show its existence or possibility among equity holders of an operating business.

Part I of this article offers a narrative of a typical law firm collapse. Part II explains the theory to make sense of this phenomenon. Part III identifies risk factors that make some firms more vulnerable to partner runs than others. Part IV offers further descriptive observations and Part V offers solutions at the levels of both policy reform and firm management. Part VI concludes.

## I. THE PATTERN AND PUZZLE OF COLLAPSE

Let us begin by describing the pattern of a typical law firm collapse and identifying what makes it unusual. I base this description on a review (admittedly anecdotal) of news and litigation records from 37 major law firm collapse since 1988. A list of these firms appears in the Appendix.

### A. *The Pattern of Collapse*

At the time a typical partner run commences, the firm is still generating a large profit, but profits have diminished relative to a previous high. This decline in profits is significant, but not catastrophic and the firm can still easily remain current on its debts. The firm's management is struggling to hold partner draws steady at the previous high, however. Management has been employing a series of stopgap measures to raise the cash necessary to keep paying the partners the same amount as before. Management may have increased its borrowing from banks and has started running down capital reserves.

The partner run commences with the departure of a senior rainmaker. By virtue of her high status in the firm and membership on the executive committee, this rainmaker may have greater access to information about the firm's finances than most partners. The rainmaker realizes that partner draws will soon have to be reduced. She may attempt to resolve the problem by trying to force a change in the governance of the firm. The immediate impetus for her departure may thus be her defeat in a power struggle. When the rainmaker ultimately leaves, she will take a group of other partners and associates along with her. Crucially, her clients will follow as well.

Within a few months after the senior rainmaker's departure, another, slightly less senior rainmaker will also leave, again with an entourage of partners and associates in tow. This rainmaker's exit will be followed within about a month by still more departures, also in large clumps as whole practice groups decamp for other firms.

As the spiral of departures accelerates, the firm will borrow more and more money to try to keep payments to the partners on a level plane. Senior

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<sup>7</sup> See, e.g., Blair, *supra* note 6; Henry Hansmann, et al., *supra* note 6; Hansmann & Kraakman, *supra* note 6.

partners remaining with the firm will also attempt to renegotiate their compensation. They will make large, sometimes outrageous demands, knowing that the firm's survival may hinge on their willingness to stay.

The partners who leave will follow subtle professional ethics rules in attempting to recruit clients to their new firms. The departing partners will send their clients notices announcing their departures and reminding the clients of their rights to hire the attorneys of their choice.<sup>8</sup> Many of the clients will shift to their lawyers' new firms, reducing the revenue available to the declining firm. The departing partners will also withdraw their capital from the old firm.

At some point in the spiral of departures, the firm will trip a series of covenants in its bank loans and lease agreements. By this point the firm will have substantial borrowings from a single bank – often Citibank. These borrowings will be secured by a general lien on all of the firm's assets. The covenants in the loan and lease agreements will require the firm to maintain a minimum number of partners or to avoid more than a fixed number of partner departures in a fixed period of time. When these covenants have been tripped, the lenders will become concerned and will seek to renegotiate. The lenders may ultimately agree to waive these covenants, because they may believe that their remedies are limited and that their best option is to help facilitate the firm's survival. As a condition for waiving the covenants, however, the lenders may insist on personal guarantees from the partners. By signing these guarantees, the partners will waive limited liability and will enable the lenders to recover their full claims from each partner individually in actions outside of the firm's general bankruptcy.<sup>9</sup>

At some point the firm will begin merger negotiations with a healthier firm. If the negotiations succeed and the merger occurs, the firm will most likely be saved. The partner departures will accelerate briefly upon the announcement of the merger and then stop. If the merger negotiations fail, the firm will declare a cessation of operations and possibly dissolve.

When the end finally comes, it will come swiftly. The management committee will call a meeting of the partners to announce that the game is up. The associates and staff will be stunned. Unlike many of the partners, relatively few of the staff and associates will have left of their own accord prior to the dissolution. Some will have been laid off in the firm's final attempts to shed costs, and some will have left to follow the partners whose clients they served. But few of them will have left independently in search of other jobs.

Strangely, the firm may still be profitable on the day of its dissolution. Although it may have distributed more cash than it actually earned in the months prior to collapse, it will still be earning a significant accounting profit up through the very end and it may even remain current on its debts, leases and other fixed obligations, having defaulted only on the partner maintenance covenants and not on the payment provisions.

After the firm has dissolved, it will form a committee of partners and outside experts to manage the winding up and liquidation. The creditors may soon force the firm into an involuntary bankruptcy proceeding, however. In

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<sup>8</sup> MODEL RULES OF PROF'L CONDUCT R. 5.6 (2013).

<sup>9</sup> See, e.g., Partnership Agreement of Coudert Brothers LLP, art. 3(h)(6)-(7) (Dec. 30, 2004) (on file with author) (providing personal guarantees by the partners to Citibank and J.P. Morgan Chase, accompanied by various limitations on these guarantees.)

bankruptcy, the firm's most important creditor will be the bank, whose priority will be secured by a general lien on all of the firm's assets. The bank will thus control the bankruptcy unless it is fully secured, in which case unsecured creditors may play a role as well. The most important unsecured creditors will be the landlords, who will claim the right to termination fees on their leases. The firm will also face smaller claims from trade creditors, such as office suppliers and external litigation management companies whose bills the firm failed to pay in its dying days. Retired partners with an interest in the firm's pension plan will make claims, as may former associates and staff.

Because the firm will have few physical possessions, the estate's major assets will consist of claims against others. One set of claims will be against clients with unpaid bills. Another set of claims will be against former partners. Although the shield of limited liability will protect the partners from general personal liability to the estate's creditors, this shield will be useless against a variety of indirect claims, which flow directly from partners' status as owners and come out of the laws of fraudulent transfers, preferential transfers, and unfinished business.

The value of all of these claims, if pressed to their fullest extent, would be enough to push almost all of the partners into personal bankruptcy. Fortunately for the partners, however, these claims will be settled for a portion of their value. The creditors will recognize that although the legal merits of their claims may be strong, the obstacles to collection will be profound. The partners will be widely dispersed across multiple states and foreign countries, making litigation extremely expensive. And even if the creditors obtained judgments, collection efforts would yield little, because the partners would be capable of declaring personal bankruptcy and might have sheltered many of their assets in estate planning devices.

Nevertheless, despite these favorable settlements, the partners' fate will not be happy. Most of the partners will have left the old firm not because they expected more money than they made when the old firm was still healthy, but because the spiral of departures left them with no choice but to leave. And although some of the partners may have gained a raise by leaving, much of the value of these raises will have been eaten up by liabilities.

### *B. The Data*

This narrative of collapse derives mostly from interviews and reviews of court and news records, but it is also consistent with available quantitative data. The best such data come from American Lawyer Media's Lateral Partner Moves database, which keeps track every time a partner leaves one large law firm for another.<sup>10</sup> The dataset reaches back to 2000—long enough to cover 16 of the 37 collapsed firms in Table 1. The question this dataset can answer is whether the number of partner departures shoots up in an exponential curve in the months leading up to a law firm's final collapse.

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<sup>10</sup> Specifically, the database tracks movements among National Law Journal (NLJ) 350 and American Lawyer (AmLaw) 200 law firms, which rank the largest firms in the United States.

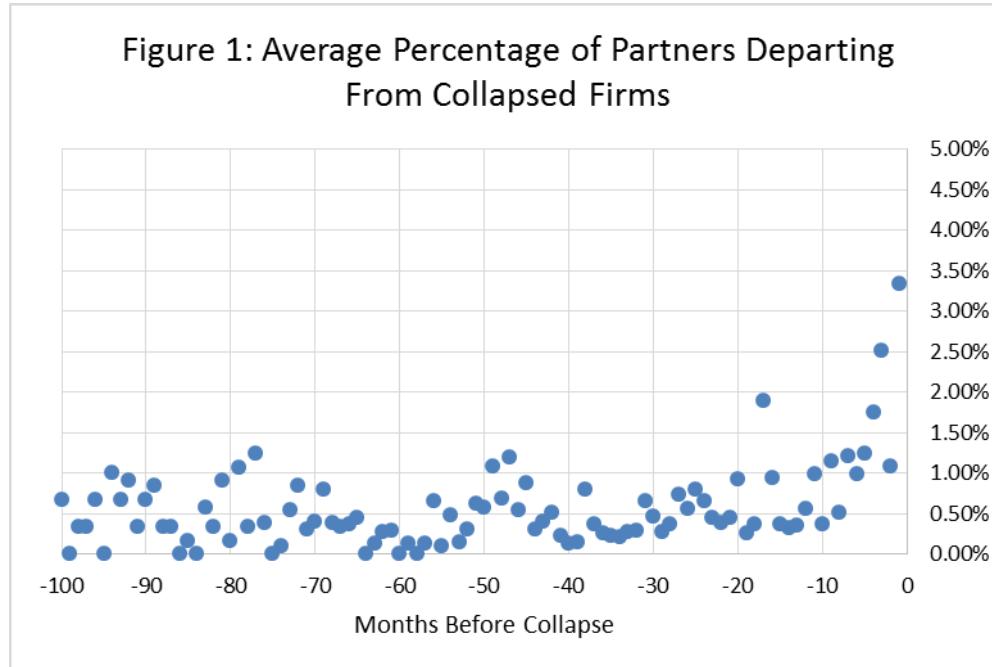


Figure 1 presents the results. The horizontal axis of Figure 1 plots the average percentage of partners departing in the 100 months prior to the month in which a collapsed firm ceased operations. Month 0, on the right edge, represents the month a firm ceased operations and Month -100, on the left edge, represents the month 100 months prior to Month 0. The date of collapse gets closer as we move to the right on the graph. The dots in the graph represent the averages in each month for all of the 16 collapsed firms included in the dataset. Rather than expressing the raw numbers of partners who left a firm, the plots express the number of partners who departed in a given month as a percentage of the total partners who were present on month 0. This percentage-based formulation has the effect of normalizing departures by a firm's size.

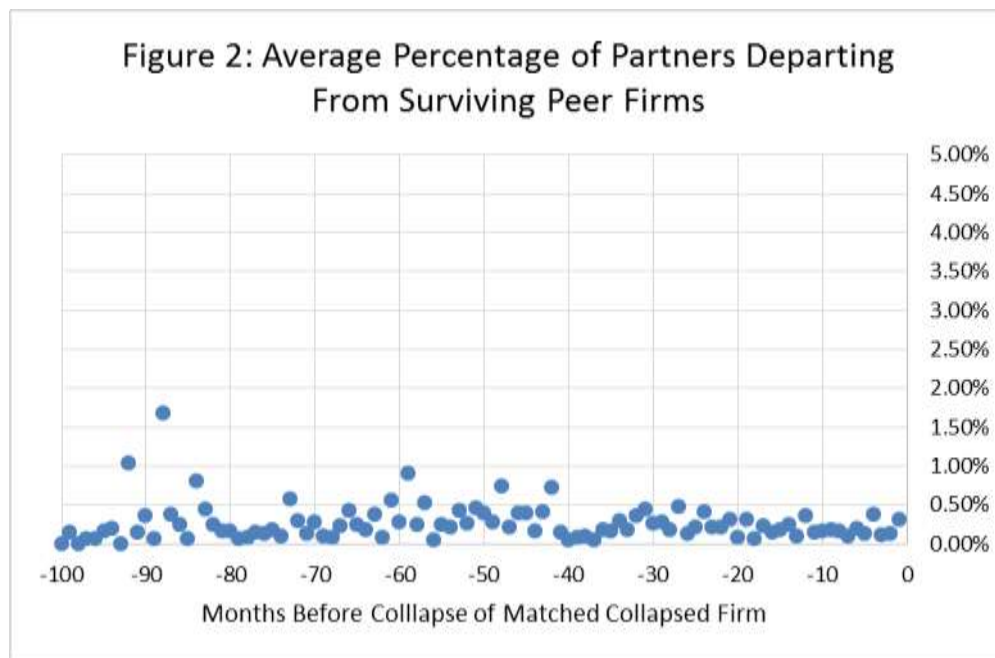
The picture presented by Figure 1 is exactly consistent with the narrative of spiraling partner departures suggested by qualitative evidence. Figure 1 shows that in the six months prior to a firm's cessation of operations, the firm loses, on average, about 11% of its partners. In the twelve months prior to ceasing operations, it loses almost 16%.

Figure 1 is especially striking because it likely understates significantly the magnitude of the increase in partner departures in the final months before collapse. The ALM data only report a partner move at the moment the partner appears at a new firm, rather than at the moment the partner leaves an old firm, with the effect that the data is effectively being reported at a lag. The precise length of this lag is hard to discern, but it surely means that many of the partners who leave in the moments just prior to collapse are not showing up until after the collapse—beyond the scope of this graph. The spike in departures in the final months before collapse is probably also understated because the data are reported only at monthly intervals—not daily or weekly intervals—meaning that if a firm ceased operations on the 15<sup>th</sup> of



a month, any partners who left on the 1<sup>st</sup> through the 14<sup>th</sup> of the month—the literal eve of collapse—are treated as though they left in the month of the collapse and are thus excluded from the final point in the graph. This is important because these departures on the eve of collapse may very well be large in number and crucial to the final outcome.

As a control, Figure 2 plots partner departures at healthy peer firms over the same periods. Figure 2 matches each collapsed firm with the firms ranked one spot above and one spot below the collapsed firm on the Am-Law profits-per-partner rankings in the year before the collapsed firm's demise and then plots the average percentage of partners in these matched healthy firms over the same periods as the collapsed firms. Not surprisingly, Figure 2 shows no pattern of exponentially increasing departures, suggesting that a partner run is a phenomenon unique to a collapsing firm.



### *C. The Puzzles*

The pattern of decline evident in collapsing law firms creates a number of puzzles. First, why *exactly* do the partners leave as firms decline? Many people understand that law firms collapse because their partners depart, but no one has a precise understanding of why. It is often said that law firms collapse “because their assets go down the elevator every night.” But this does not tell us why the assets fail to come back up. The explanation is not obvious, because there are few analogues in regular industry. The employees of ordinary industrial companies can also leave at any time, and yet they almost never leave with the speed and finality of law firm partners. When Chrysler went bankrupt, almost all of its employees—from the unionized factory workers to the non-union executives—stayed put. Indeed, the reason why declining industrial companies so often have to lay off their employees is that the employees refuse to leave on their own.

Second, why can't the partners of a collapsing law firm reach an agreement to save the firm? Put differently, why do law firms never attempt to reorganize their debts in Chapter 11 and continue operating as ordinary companies so often do? Again, law firms are quite unusual in this regard. Financial distress and even bankruptcy are not uncommon among ordinary companies, but ordinary companies quite frequently survive these ordeals. The S&P 500 today is filled with formerly bankrupt companies that are still in operation—Delta Airlines, General Motors, Chrysler, and American Airlines, to name just a few. If these companies can go through bankruptcy and survive, why can't a law firm?

Finally, why is the intensity of law firm implosions so out of proportion to the imploded firms' financial distress? It goes without saying that collapsing law firms suffer a degree of financial distress, but few people realize just how mild this distress actually is. Figures 3 and 4 illustrate the financial distress of collapsed firms, using data from the American Lawyer's annual ranking list. For the 18 collapsed law firms that were large enough to have appeared on the AmLaw 200, Figure 3 charts the average profits per partner in each of the three years prior to collapse. Figure 4 charts the average total revenues.

Figure 3. Profits per Partner

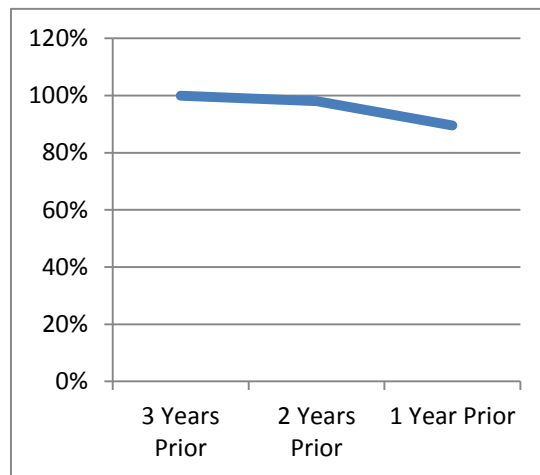
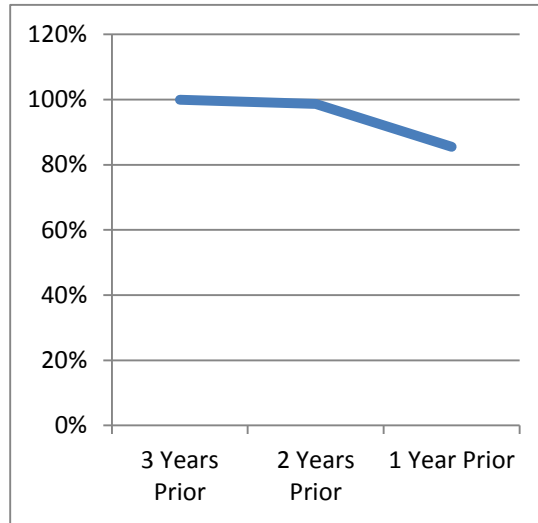


Figure 4. Gross Revenues



The figures show that profits and revenues barely declined in the last year prior to collapse. The trends in the figures are consistent with impressions from news reports and litigation records. Many collapsed firms closed their doors when they were still quite profitable. And many others remained current on their debts—often even making extensive prepayments—all the way up until the moments of their dissolutions.

Even adjusting for the possibility that these numbers have been dressed up to look nicer than they actually are, this is hardly the kind of provocation that would drive an industrial firm into sudden explosion.<sup>11</sup> Uber, for instance, not only fails to earn a profit—it loses billions of dollars every year. And yet Uber is still carrying passengers all over the world. Why can Uber lose money year after year, even as a law firm blows apart at a modest decline in profits?

The tendency of law firms to collapse in the absence of obvious financial distress is especially puzzling because, in theory at least, a law firm's capital structure ought to be more robust than that of an ordinary firm, not less robust. Because law firms are owned by their partners, rather than by investors, a law firm's largest expense – partner compensation – is not technically an expense at all. Partner compensation is paid only in the form of distributions on equity, and distributions on equity are entirely discretionary. They can be withheld for any reason or no reason at all. Just as Apple, the computer maker, can sit on billions of dollars in profits and choose not to distribute them, so too a law firm can choose to hold onto its profits without paying its partners.<sup>12</sup> Law firms thus have enormous free cash flows that they can use for any purpose they wish, including debt repayment. By the standards of industrial companies, law firms are freakishly well capitalized.

<sup>11</sup> The American Lawyer's financial data is self-reported and may not be entirely reliable, but these figures find support in bankruptcy filings. Brobeck, Phleger and Harrison, for example, formally dissolved on February 10, 2003. In 2002, however, Brobeck had net income after all expenses of about \$64 million. In re Brobeck, Phleger & Harrison LLP, Notice of Motion and Motion for Order at 8-10, No. 03-32715 (Bankr. N.D. Cal. filed Mar. 21, 2005).

<sup>12</sup> Fitz Tepper, *Apple's Cash on Hand Decreased for the First Time in Nearly Two Years*, TECH CRUNCH, July 26, 2016.

## II. THE EXPLANATION

How then do we solve these puzzles? The qualitative and quantitative data clearly show a trend of spiraling partner departures in the months before a firm's collapse. But we need a theory to make sense of what could be driving these departures and how, exactly, they might be related to collapse. The answers are not obvious, and financial distress alone is clearly insufficient.

My solution lies in law firms' unusual pattern of worker ownership. To see how worker ownership might drive the partners to depart in a spiraling run, let us begin with a very simple model of a law firm partner's set of choices, which I will call the *leave/stay decision*. Every day, a partner has the option either to remain at her current firm or to move to another firm. The partner will balance two sets of considerations: (1) the costs and benefits of staying at her current firm; and (2) the costs and benefits of moving to a new firm. A partner will put both sets of costs and benefits on a scale and choose the option that tips the scale most favorably. The costs and benefits that go up onto the scale can include personal and social considerations as well as financial considerations. A partner might find it costly to leave, for instance, if leaving would reduce her income, sever her friendships, or entail a longer commute.

The leave/stay decision is a serious one for law firm partners, because professional ethics rules in the United States allow lawyers to leave their firms at any time. Model Rule of Professional Conduct 5.6(a) provides:

A lawyer shall not participate in offering or making: (a) 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.<sup>13</sup>

This rule has been interpreted very broadly to prohibit agreements and devices that might stop lawyers from moving freely between firms. The rule prohibits, among other things, covenants not to compete<sup>14</sup> and the excessively long retention of a partner's capital contribution after she leaves.<sup>15</sup> The express purpose of this rule is to protect the interests of clients by allowing them to hire the lawyers of their choice.<sup>16</sup>

In terms of the leave/stay decision, this rule of free withdrawal has the effect of preventing the imposition of costs on departure. If a partner who withdrew had to give up the practice of law for a year or forfeit the capital contribution she made to her old firm, then leaving would be very costly. But because a firm cannot impose these costs, Rule 5.6(a) ensures that leaving, though costly, is not as costly as it might be otherwise.

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<sup>13</sup> MODEL RULES OF PROF'L CONDUCT R. 5.6(a). For a general exploration of these rules, see Robert W. Hillman, *Client Choice, Contractual Restraints and the Market for Legal Services*, 36 HOFSTRA L. REV. 65 (2008); ROBERT W. HILLMAN, HILLMAN ON LAWYER MOBILITY (1998).

<sup>14</sup> HILLMAN, *supra* note 13; *Cohen v. Lord, Day & Lord*, 75 N.Y.2d 95, 96 (1989)

<sup>15</sup> *Id.*

<sup>16</sup> MODEL RULES OF PROF'L CONDUCT R. 5.6 cmt. 1.

### A. Worker Ownership

The possibility of low-cost withdrawal is thus important to explaining law firm collapse, but it does not provide a full or complete explanation. Even if the low cost of withdrawal helps to explain why one partner might leave, it does not explain why one partner's departure might cause other partners to leave as well.

To answer that question, we must turn to worker ownership. Worker ownership is required by a web of overlapping provisions in the Model Rules of Professional Conduct, the center of which is Rule 5.4(d):

A lawyer shall not practice with or in the form of a professional corporation or association authorized to practice law for a profit, if: (1) a nonlawyer owns any interest therein....<sup>17</sup>

Related rules also prohibit the sharing of fees between lawyers and nonlawyers,<sup>18</sup> the formation of partnerships between lawyers and nonlawyers<sup>19</sup> and the control of lawyers' professional judgment by nonlawyers.<sup>20</sup> The oft-stated purpose of these rules is to maintain lawyers' professional independence by ensuring that they are subject only to the control of other lawyers and not to non-lawyer investors. Lawyers, it is said, are socialized and regulated to behave ethically and serve the broader interests of the judicial system.<sup>21</sup>

Partner ownership may also have an economic logic of its own, independent of this rule. Law firms tended to be partner-owned before the Model Rules of Professional Conduct required it, and the reasons have been debated extensively.<sup>22</sup> The most prominent theory belongs to Henry Hansmann, who argues, among other things, that worker ownership is more efficient in law firms than other types of businesses, because law firm partners are more homogeneous than other types of workers, which renders law firm partners more capable than other kinds of workers of making decisions collectively.<sup>23</sup>

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<sup>17</sup> MODEL RULES OF PROF'L CONDUCT R. 5.4(d). *But see* D.C. RULES OF PROF'L CONDUCT R. 5.4 (2013) (providing a limited exception). WASH. RULES OF PRO'L CONDUCT R. 5.9 (2015) (allowing co-ownership of a law firm by a lawyer and a "limited license legal technician.")

<sup>18</sup> MODEL RULES OF PROF'L CONDUCT R. 5.4(a)

<sup>19</sup> MODEL RULES OF PROF'L CONDUCT R.5.4(b)

<sup>20</sup> MODEL RULES OF PROF'L CONDUCT R.5.4(c).

<sup>21</sup> Rule 5.4 is titled, "Professional Independence of a Lawyer."

<sup>22</sup> HENRY HANSMANN, *THE OWNERSHIP OF ENTERPRISE* (2000); Henry Hansmann, *When Does Worker Ownership Work? ESOPs, Law Firms, Codetermination and Economic Democracy*, 99 *YALE L.J.* 1749 (1990); David Kershaw, *No End in Sight for the History of Corporate Law: The Case of Employee Participation in Corporate Governance*, 2 *J. CORP. L. STUD.* 34 (2002); Jonathan Levin & Steven Tadelis, *Profit Sharing & The Role of Professional Partnerships*, 120 *Q.J. ECON.* 131 (2005); James B. Rebitzer & Lowell J. Taylor, *When Knowledge Is an Asset: Explaining the Organizational Structure of Large Law Firms*, 25 *J. LAB. ECON.* 201 (2007).

<sup>23</sup> HANSMANN, *supra* note 22, and Hansmann, *supra* note 22.

For present purposes, I take no position on the overall efficiency or the ethical or practical merits of partner ownership. Rather, I merely hope to understand some of the previously unknown consequences of partner ownership.<sup>24</sup>

My claim is that partner ownership enables partner runs in two primary ways. First, it makes a law firm's partners into residual risk-bearers. Second, it exposes partners to various forms of personal liability that punish them for staying. Both of these mechanisms link the decisions of one law firm partner to other partners. These mechanisms ensure that if one partner leaves, leaving will become more attractive for the others.

## 1. Residual Risk-Bearing and Sensitivity to Declining Profits

As owners, the partners of a law firm are the firm's residual risk-bearers. That is, they bear the risk – good and bad – of the firm's costs, revenues and profits. This is because partners are paid not in fixed wages or cash bonuses, but in shares of the firm. And the value of the shares fluctuates with overall profits.

### a. Partner Sensitivity to Profits

The partners' status as residual risk-bearers is important, because it intensifies the partners' sensitivity to declines in profits and thus to other partners' departures. For reasons I will explain, a partner's departure often reduces a firm's profits. And once a partner leaves and the profits decline, partner ownership ensures that it is the remaining partners who bear the loss. If the firm has fewer profits, it cannot continue to pay the remaining partners the same.

This, then, is the core of the problem: Every partner's leave/stay decision is linked to every other partner's leave/stay decision. As more partners leave and reduce the firm's profits, the benefits of staying for the remaining partners decline, making the remaining partners more likely to leave as well.

Partners would be less likely to follow each other out the door if they were less sensitive to declines in profits. If a partner's pay could remain fixed as profits declined, then the partner would be indifferent to other partners' departures. Contrast a partner, for example, with an associate who does not own shares in a firm, but instead gets paid entirely in a fixed annual salary. As partners leave and profits decline, this associate's salary may stay the same, and if so, the associate will have no particular incentive to leave. Just as the employees of Delta, Chrysler, Uber and many other money-losing and bankrupt companies have continued to get paid, so could the salaried employee of a law firm.

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<sup>24</sup> Many authors have recently debated the wisdom of partner ownership. *E.g.*, Gillian Hadfield, *The Cost of Law: Promoting Access to Justice Through the (Un)corporate Practice of Law*, 38 INT'L REV. L. & ECON. 43 (2014); Edward Adams, *Rethinking the Law Firm Organizational Form and Capitalization Structure*, 78 MO. L. REV. 777 (2013); Larry Ribstein, *The Death of Big Law*, 2010 WIS. L. REV. 749 (2010); Gillian Hadfield, *Legal Barriers to Innovation: The Growing Economic Cost of Professional Control Over Corporate Legal Markets*, 60 STAN. L. REV. 1689 (2008); Alan Hyde, *In Defense of Employee Ownership*, 67 CHI.-KENT L. REV. 159 (1991).

To formulate the point a little more subtly, a worker's tendency to leave as profits decline will be directly proportional to the worker's sensitivity to the firm's profits. As a worker's exposure to a law firm's profits increases, so too will the worker's tendency to leave in response to the decline in profits wrought by a spiraling cycle of withdrawals.

This subtler way of framing the point allows us to see that the distinction between a partner and other workers is not always as sharp as the example of the associate suggests, because other associates and other workers sometimes have bear sensitivity to profits as well. An associate might get paid in part with a bonus that is based on profits or she might expect her salary to be cut as profits decline. Indeed, if profits decline far enough, the associate might even expect to get laid off. These sensitivities mean that as successive departures of partners dive profits downward, the associate might be tempted to leave too.

Ownership nevertheless drives partners to run even faster and more intensely than other kinds of workers. And the reason is simply that partners are even more sensitive to profits than other kinds of workers. The difference between partners and other workers, in other words, is a matter of degree. Whereas for a profit-based bonus might account for twenty percent of the total compensation of an associate, profits account for a hundred percent of the total compensation of a partner. And although an associate might suffer a bonus cut as a firm's profits decline, the bonus cut is not a necessary or inevitable consequence of declining profits. Associates often get paid their bonuses as well as salaries even as profits decline, just as the employees of other declining businesses do. For partners, however, the linkage between declining profits and declining pay is automatic and unavoidable. As the pie of profits shrinks, simple arithmetic forces at least some partners to accept a smaller slice. Additionally, as we will see in a moment, ownership further heightens partners' sensitivity to a firm's decline by exposing them to liability as a result of declining profits that a salaried employee will never face.

Imagine, for example, two attorneys at a law firm in decline, one an equity partner and the other an associate who gets paid eighty percent in a salary and twenty percent in a profit-based bonus. Imagine that as the firm declines, both attorneys project a fifty percent chance that the firm will collapse one year from now, and that in the event of a collapse, both attorneys will lose their jobs. In the interim, the firm has ceased earning profits, but continues to be able to pay salaries and debts, as collapsing law firms very often do. Now consider: which of these two lawyers will leave the firm first? The answer is the partner, for the simple reason that he will not get paid. Between now and the firm's collapse one year from now, the associate may take a pay cut, but maybe not, and in any event, the associate will continue to receive eighty percent of her total compensation. The partner, by contrast, will receive nothing. Both lawyers will start looking for other jobs, but for the partner, the search will be much more urgent and the opportunity cost of delaying will be much higher. The difference between the partner and the associate will become even more stark once we consider, as we will in a moment, the way that staying with the firm will expose the partner to liability.

#### b. Departures as a Cause of Declining Profits

Partners are thus highly sensitive to declining profits. But a sensitivity to profits by itself is not enough to drive a run. Partner departures will only turn into a run if each partner's departure drives down profits for those partners who remain. But how exactly does this happen?

The answer requires some reflection, because when a partner leaves, she does not just leave the firm with fewer clients; she also leaves it with less compensation and overhead to cover. Even as a firm's revenues decline upon a partner's departure, the firm's costs decline as well. To understand why a partner's departure might hurt a firm, then, we have to ask why revenues might decline *even more* than costs. There are several reasons.

First, many of a firm's costs are fixed and do not decline when a partner leaves. A firm's bank debts, leases, and pension obligations all stay the same even after a partner leaves. Labor costs also remain more or less fixed, since a firm cannot fire associates and staff or cut their salaries willy nilly. Economists might recognize it as a version of the infamous *specific investment* problem.<sup>25</sup> Firms invest in partners, and then cannot always redeploy their investments when the partners end the relationship.

Second, partner withdrawals exhibit a selection bias. In general, the partners who leave first tend to be the ones for whom the leave/stay calculus is most nearly in equipoise. Unfortunately, it just so happens that these partners also tend to be the ones whose departures do the most damage. One reason a partner's leave/stay decision might be in equipoise is that the partner brings in more in revenues than she takes out in costs. The partner, in other words, is a net contributor. When a net contributor leaves, the rest of the partners suffer, because the firm loses more in revenues than it recovers in saved costs. The leave/stay calculus of a net contributor is more likely to be in equipoise for a net contributor than for a partner who is a net taker, because the net contributor's compensation, by definition, is low in comparison to her productivity. This will make the contributor more likely to get a better deal by moving to another firm. Indeed, the cycle of a partner run works by converting successive waves of partners into net contributors: As a firm's profits decline, the compensation of the remaining partners progressively declines until finally even the partners who were originally net takers end up getting paid less than the value of their contributions.

Another reason a partner's departure might cut into profits is that the firm must return the partner's capital contribution when she leaves. Like all businesses, law firms require capital. In law firms, capital covers things like monthly payroll cycles and investments in office space renovations and other physical assets. Law firms cannot raise capital by selling equity shares to investors, so they tend instead to raise it from their partners.<sup>26</sup> In AmLaw 200 law firms, partners' capital can be substantial: it comprises on average around a quarter of a firm's annual earnings.<sup>27</sup>

Model Rule of Professional Conduct 5.6 – the rule that prohibits law firms from locking in their partners – requires a law firm to return capital to a partner when the partner departs. A large number of partner departures can thus

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<sup>25</sup> See, e.g., OLIVER WILLIAMSON, *THE ECONOMIC INSTITUTIONS OF CAPITALISM*, 30-32 (1985).

<sup>26</sup> They also often borrow from banks, which creates a whole different set of problems.

<sup>27</sup> Hildebrandt 2013 Client Advisory, 11 chart 8.



cause a firm to bleed to death. In Howrey LLP's last full year of operation in 2010, the firm paid out more than \$113 million in capital to departed partners even as it took in total revenues of only \$262 million.<sup>28</sup> Few businesses could withstand such punishment. In recent years, firms have learned to blunt the impact of capital repayments by spreading these payments out over several years.<sup>29</sup> The Model Rules apparently permit firms to drag out the repayment of capital for several years after a partner leaves, so long as the firm hands the money back eventually. But like Howrey, many collapsed firms have failed to take advantage of this potential for delay.

A further problem is that once a firm starts to decline, the value of its profits have to be discounted for increasing risk. As a firm declines, it becomes less likely to make good on its promised compensation. Additionally, as I will explain in a moment, once a firm files for bankruptcy, the firm's partners often have to give up large portions of the compensation they received in the months and years leading up to the bankruptcy. A partner who anticipates a collapse will thus have to anticipate returning all the compensation she receives between now and the time of collapse. As a result, in order to keep its partners from leaving, a declining firm has to pay its partners more than its competitors, because the competitors' offers of compensation do not have to be discounted for risk. Two million dollars at a declining firm might be actuarially equivalent to \$1 million at a healthy firm. Thus, as a firm's profits decline in *absolute* terms, they decline even more in *risk-adjusted* terms.

A further problem is a firm's increasing exposure to hold-up threats by the remaining partners.<sup>30</sup> As more and more partners leave, each remaining partner's departure becomes proportionally more destructive, so that by the end, one or two partners might credibly threaten to blow up the entire firm. These partners can then turn the threat of destruction into a chance to extract more pay—especially because the risk discount they have to apply to the declining firm's profits will allow them to credibly demand to be paid even more at the declining firm than they might be getting offered at other firms. The renegotiation of some partners' pay in this way is damaging, because the division of a firm's profits is zero-sum. The partners' percentage interests have to add up to 100%, so as some partners gain, others must inevitably lose. And the losers, of course, become more likely to leave.

Consider, for instance, Dewey & LeBeouf. It has often been said that Dewey & LeBeouf collapsed because it offered guaranteed compensation to

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<sup>28</sup> Complaint by Allan B. Diamond Against Marc Reysen at 10, In re Howrey LLP, No. 11-31376 (Bankr. N.D. Cal. Dec. 13, 2013).

<sup>29</sup> Dewey & LeBeouf repaid capital in installments over 4 1/2 to 5 1/2 years, depending on the timing of a partner's departure, with the first installment not occurring for 1 1/2 to 2 1/2 years after the departure. Partnership Agreement: Dewey LeBeouf LLP § 7.6(a)(1) (Apr. 12, 2010) (on file with author). Coudert Brothers paid installments over three years. Partnership Agreement of Coudert Brothers LLP, art. 11 (Dec. 30, 2004) (on file with author). See also Robert W. Hillman, *Ties That Bind and Restraints on Lawyer Competition: Restrictive Covenants as Conditions to the Payments of Retirement Benefits*, 39 IND. L. REV. 1, 30 (2005) (describing delays in capital distributions).

<sup>30</sup> Oliver Williamson, *Transaction-Cost Economics: The Governance of Contractual Relations*, 22 J.L. ECON. 233 234 (1979); Benjamin Klein, et al., *Vertical Integration, Appropriate Rents, and the Competitive Contracting Process*, 21 J.L. ECON. 297 (1978).

attract partners laterally from other firms. But in fact many of the guaranteed compensation contracts at Dewey went to existing partners who threatened to leave. As the firm's condition worsened, the partners' demands became increasingly outrageous. Morton Pierce famously went from \$5 million in annual compensation to \$8 million and demanded a huge lump sum of \$60 million as a condition for staying.<sup>31</sup>

## 2. Personal Liability

Declining profits is not the only problem a partner faces as a result of the partner's status as an owner. The partner also faces the threat of personal liability. This liability accelerates the spiral of decline, because it rewards partners for leaving early and punishes them for leaving late. These forms of liability are not the general liability faced by general partners under the common law of partnership. They are subtler and much more likely to provoke partners to leave early.

### a. Fraudulent Transfer Liability for Compensation

The first form of liability allows creditors to recover profit distributions under fraudulent transfer law. Section 548 of the bankruptcy code allows a bankruptcy court to recover a transfer that a debtor made without receiving reasonably equivalent value in exchange if the debtor made the transfer while it was insolvent or if the transfer caused the debtor to become insolvent.<sup>32</sup> Section 548 takes back these transfers for up to two years prior to the filing of a bankruptcy petition.<sup>33</sup> Section 544 of the bankruptcy code also authorizes a bankruptcy trustee to employ similar fraudulent transfer provisions in state laws.<sup>34</sup> State laws commonly include specialized provisions in partnership, LLC and professional corporation statutes that prohibit a firm from distributing profits when it is insolvent.<sup>35</sup> Unlike section 548, which reaches back only two years, state statutes often contain much longer time limits or no time limits at all.

A law firm partner's compensation routinely qualifies as a fraudulent transfer, because it takes the form of a profit distribution, rather than wages. Under well-established principles of bankruptcy and state law, a profit distribution is a fraudulent transfer, because a firm has no legal obligation to pay it. Because a firm can choose not to distribute profits for any reason, distributing profits is a transfer that does not involve an exchange for reasonably equivalent value. By contrast, wages are untouched by fraudulent transfer, because a wage is a payment in exchange for labor, and labor and contract law require firms to pay wages regardless.

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<sup>31</sup> James Stewart, *The Collapse: How a Top Legal Firm Destroyed Itself*, THE NEW YORKER, Oct. 14, 2013, at 89-91.

<sup>32</sup> 11 U.S.C. § 548.

<sup>33</sup> Congress changes the recovery period from one year to two years in 2005. See Pub. L. No. 109-8, § 1402(1), 119 Stat. 23 (codified as amended at 11 U.S.C. § 548 (2005)).

<sup>34</sup> 11 U.S.C. § 544.

<sup>35</sup> CAL. CORP. CODE § 16957; N.Y. LTD. LIAB. CO. LAW § 508 (2014).

A partner who stays at a declining law firm thus risks losing all of the pay she receives in the months or years prior to the firm's collapse. This risk encourages a partner to leave early in a law firm's spiral of decline, because the sooner a partner leaves, the less of her pay she will have to give up. Imagine, for instance, that a firm becomes insolvent one year prior to the time it files for bankruptcy. A partner who stayed all the way up through the bankruptcy will have to return an entire year's worth of pay. A partner who leaves ten months prior to the bankruptcy will only have to return two months of pay. A partner who leaves more than one year prior will not have to return any pay at all. The lesson is to get out early.

#### b. Preferential Transfer Liability for Capital Repayments

Another source of personal liability is a partner's capital contribution. Model Rule of Professional Conduct 5.6 has been interpreted to require a law firm to repay a partner's capital contribution when the partner withdraws. When a firm dissolves, this kind of repayment is voidable as a "preferential transfer" under section 547 of the bankruptcy code.<sup>36</sup> Section 547 treats a payment as a preferential transfer if a debtor was insolvent at the time the payment was made, the payment occurred less than one year prior to bankruptcy,<sup>37</sup> and the payment enabled a creditor to receive more than she would have received in bankruptcy. Because a partner would ordinarily receive nothing on her capital contribution in bankruptcy, any repayment of capital to the partner prior to bankruptcy is a voidable preference.<sup>38</sup>

Like the doctrine of fraudulent transfer, the doctrine of preferential transfer encourages a partner to leave early. Section 547 limits the reach of the preferential transfer doctrine to transfers made less than one year prior to bankruptcy. So if a partner leaves and gets her capital repayment more than one year before bankruptcy, she is safe. Moreover, even a capital repayment made less than one year prior to bankruptcy is worth something, because it has settlement value. Although bankruptcy trustees always demand return of these payments, the trustees invariably settle for less than the full value because of the difficulties of collecting. The lesson, once again, is to get out early.

#### c. Unfinished Business Liability

The saddest source of liability is the so-called "unfinished business" or "*Jewel*" doctrine. This doctrine has vague origins in the Uniform Partnership Act (UPA) and the Revised Uniform Partnership Act (RUPA),<sup>39</sup> but it finds

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<sup>36</sup> 11 U.S.C. § 547.

<sup>37</sup> The relevant period is one year, rather than 90 days, because law firm partners are "insiders" of the firms for purposes of the statute. *Id.*

<sup>38</sup> See, e.g., Partnership Agreement: Dewey LeBoeuf LLP § 7.7 (Apr. 12, 2010) (on file with author); Partnership Agreement of Coudert Brothers LLP, art. 3 (Dec. 30, 2004) (on file with author).

<sup>39</sup> UNIF. P'SHIP ACT § 401(h), 802 (1997); UNIF. P'SHIP ACT §§ 18(f), 30 (1914). The doctrine is built on the theory that partners who take unfinished business receive "extra compensation" in violation of these statutes. *Jewel v. Boxer*, 156 Cal. App. 3d 171, 176 (Ct. App.

its clearest foundation (and its colloquial name) in *Jewel v. Boxer*, a 1984 California Court of Appeals opinion involving the breakup of a small law firm.<sup>40</sup> The *Jewel* doctrine says that partners who remain with a firm up through the time of its dissolution must share with the firm the proceeds of any work they perform after dissolution on matters that belonged to the firm at the time of dissolution. *Jewel* liability is not merely an obligation to help a firm collect on billings accrued prior to a partner's departure – it is an obligation to share new billings for work a partner does *after* the firm dissolves.<sup>41</sup> The rule has been applied widely to all types of dissolved law firms. It reaches not only firms organized as general partnerships, but also firms organized as limited liability partnerships, professional corporations and limited liability companies.<sup>42</sup> *Jewel* claims have often been among bankrupt law firms' largest assets and settlements have commonly reached millions of dollars.<sup>43</sup>

The *Jewel* doctrine has just recently become much less important than it used to be. As this article was being written, the California Supreme Court decided a case involving Heller Ehrman and the New York Court of Appeals decided a case involving both Coudert and Thelen. In both decisions, the courts held that *Jewel* applies only to contingent-fee matters and not to matters billed on an hourly basis.<sup>44</sup> The California court's discussion of this result

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1984).

<sup>40</sup> *Jewel v. Boxer*, 156 Cal. App. 3d 171 (Ct. App. 1984).

<sup>41</sup> To be clear, the fees generated on matters outstanding at the time of the old firm's collapse will technically be paid by the partners' new firms, not by the partners themselves, since the fees must be paid to the new firms. Nevertheless, the partners will ultimately bear the burden of these recoveries in the form of decreased compensation and diminished employment prospects.

<sup>42</sup> *Fox v. Abrams*, 210 Cal. Rptr. 260, 265 (Cal. Ct. App. 1985); Douglas R. Richmond, *Migratory Law Partners and the Glue of Unfinished Business*, 39 N. Ky. L. Rev. 359, 381-384 (2012). Heller Ehrman, for example, was organized as a set of professional corporations, but faced *Jewel* liability anyway. See David M. Stern, *Law Firm Bankruptcies*, 37 LITIGATION 8 (2011).

<sup>43</sup> For examples of settlements of unfinished business claims, see Order Granting Motion by Liquidating Debtor for (1) Approval Of Settlement Of Claims Against Covington & Burling LLP & IP Shareholder Defendants Under Bankruptcy Rule 9019; (2) for a Finding of Good Faith Settlement Under California Code of Civil Procedure § 877; and (3) Leave to File Second Amended Complaint, *In re Heller Ehrman LLP*, No. 08-32514 (Bankr. N.D. Cal. Aug. 11, 2011) (approving a \$4,996,213 settlement for unfinished business claims); Order Pursuant to Rule 9019 of the Federal Rules of Bankruptcy Procedure Authorizing & Approving a Settlement Agreement Between the Plan Administrator & Baker & McKenzie LLP, *In re Coudert Brothers LLP*, No. 09-01150 (Bankr. S.D.N.Y. Aug. 20, 2010) (approving a \$6,650,000 settlement for unfinished business claims); Order Approving Settlement Agreement with Morgan, Lewis & Bockius, LLP & Finding that Settlement is in Good Faith at 4, *In re Brobeck, Phleger & Harrison LLP*, No. 03-32715 (Bankr. N.D. Cal. Nov. 10, 2004) (approving a \$10,200,000 settlement for unfinished business claims).

<sup>44</sup> *Heller Ehrman LLP v. Davis Wright Tremaine LLP*, 411 P.3d 548 (Cal. 2018); *In re Thelen LLP*, 2014 WL 2931526 (N.Y. 2014). Prior to these opinions, a majority of courts had extended the *Jewel* rule to matters billed on an hourly basis. See, e.g., *Robinson v. Nussbaum* 11 F. Supp. 2d 1, 4-5 (D.D.C.1997); *Greenspan v. Orrick, Herrington & Sutcliffe LLP (In re Brobeck, Phleger & Harrison LLP)*, 408 B.R. 318, 333 (Bankr. N.D. Cal.2009); *In re Labrum & Doak*, 227 B.R. 391, 409-10 (Bankr. E.D. Pa.1998). *But see Welman v. Parker*, 328 S.W.3d 451, 457 (Mo. Ct. App. 2010) (refusing to apply unfinished business doctrine to hourly fee matters).

expressly relied upon an amicus brief in which I made arguments similar to the arguments I make here.<sup>45</sup>

Notwithstanding its recent diminishment, *Jewel* is worth exploring here, because this diminishment only occurred very recently and so *Jewel* played an important role in almost all of the large law firm collapses included in this study. Additionally, *Jewel*'s death is not yet final—it still applies to firms organized outside of New York and California and even in New York and California, it still applies to matters billed on a contingent (rather than hourly) basis.

The logic of the *Jewel* rule is to protect the partners from each other. The rule functions like the corporate opportunity doctrine, ensuring that partners do not abscond with an opportunity that belongs to a partnership.

This logic makes sense in theory, but in practice it encourages a race to the exits. The problem is that *Jewel* has been interpreted to flip on like a switch at the moment a firm dissolves: it applies to partners who stay until dissolution, but not to partners who leave just prior to dissolution.<sup>46</sup> This creates terrible incentives. A partner who stays until dissolution faces millions of dollars in liability, even as a partner who leaves one day prior to dissolution walks away completely free. The lesson is to get out as fast as you can.

This strange doctrinal result is an unintended historical accident. All of the early precedents in *Jewel* doctrine – including *Jewel* itself – avoided this result, because they involved small law firms that used the Uniform Partnership Act's default rule of partnership dissolution.<sup>47</sup> Under this default rule, a partnership automatically dissolves any time any partner withdraws.<sup>48</sup> In

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<sup>45</sup> *Heller Ehrman LLP v. Davis Wright Tremaine LLP*, 411 P.3d 548, 556 (Cal. 2018) (“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. We 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.”). See Brief of Amicus Curiae Professor John Morley Supporting Respondent, *Heller Ehrman LLP v. Davis Wright Tremaine LLP*, *Heller Ehrman LLP v. Davis Wright Tremaine LLP*, 411 P.3d 548 (2018) (9th Cir. nos. 14-16314, 14-16315, 14-16317, 14-16318).

<sup>46</sup> *In re Thelen LLP*, 2014 WL 2931526 (2014) (“[T]he trustees disclaim any basis for recovery of profits from the pending client matters of a former partner who leaves a troubled law firm before dissolution...”); *In re Howrey LLP*, No. 11-31376, 2014 WL 507511, \*10 (Bankr. N.D. Cal. Feb. 7, 2014 (“[W]hen partners left Debtor prior to dissolution, taking Howrey Unfinished Business with them, that business itself and any future profits to be realized on it was no longer property of Debtor...”)); *In re Heller Ehrman LLP*, 2013 WL 951706 at \*3-4 (Bankr. N.D. Cal. Mar. 11, 2013) (“Heller’s counsel conceded that if a Shareholder had left Heller prior to the dissolution and had taken unfinished business, Heller could not pursue recovery of profits earned by that Shareholder following his or her departure, absent some breach of fiduciary duty.”)

<sup>47</sup> *Jewel*, 156 Cal. App. 3d at 174.

<sup>48</sup> UPA § 31(1)(c) (a partner’s withdrawal causes the partnership to dissolve). This is also the rule under the RUPA. RUPA §§ 101(8), 801(1).

firms with this rule, *Jewel* does not create a race to the exits, because there is no point in trying to withdraw before dissolution: the very act of withdrawal causes a dissolution.<sup>49</sup>

This default rule stands in contrast, however, to the practice of dissolution in large law firms. Large law firms invariably opt out of the default by specifying in their partnership agreements that they only dissolve upon a vote of the partners and not upon each partner's withdrawal. This rule makes sense for technical reasons unrelated to *Jewel*: dissolution creates a host of legal and administrative headaches, and as a firm's partners become more numerous, dissolving on the withdrawal of each departing partner would be administratively impossible. *Jewel's* exemption of partners who leave before dissolution sits awkwardly with this distinction between dissolution and withdrawal, because *Jewel* now creates an opportunity for a partner to avoid liability simply by leaving early.<sup>50</sup>

The story of the California law firm of Dickson, Carlson & Campillo illustrates. When the firm found out in the late 1990s that two of its partners were leaving and taking a big client with them, the firm's remaining partners voted to dissolve the firm – and then organize it again the very next day.<sup>51</sup> By formally dissolving, rather than just letting the departing partners quietly withdraw, the firm triggered the *Jewel* rule and forced the departing partners to share the billings they later earned from the client they took with them.

The distinction between withdrawal and dissolution has made *Jewel* very easy to avoid for those who are savvy enough to know how. All a collapsing firm has to do to avoid the *Jewel* rule is just wait to dissolve. The firm can wind down its operations, liquidate its assets, and even declare bankruptcy, but so long as it waits to dissolve until after all of its partners have left, the partners will be beyond the reach of *Jewel*. This was the strategy wisely taken by Bingham McCutchen. In its dying days in 2014, the firm negotiated an agreement with Morgan Lewis under which the great majority of the firm's remaining partners moved to Morgan Lewis, leaving the Bingham an empty but apparently still undissolved shell.<sup>52</sup> That other firms have not used the

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<sup>49</sup> In this setting, *Jewel* actually helps to hold law firms together, because it discourages partners from leaving. Douglas R. Richmond, *Migratory Law Partners and the Glue of Unfinished Business*, 39 N. KY. L. REV. 359, 371 (2012).

<sup>50</sup> The most serious is that in large law firms, *Jewel* does not actually accomplish its goal of forcing fair sharing among partners. In fact, it does the opposite. By the time a large law firm dissolves, its finances have typically been battered so heavily by a partner run that there is nothing left over for the partners to share. As a consequence, none of the money recovered under *Jewel* gets shared by the partners – it all goes straight to the creditors. Instead of allowing the partners who stayed to share in the profits of those who left, *Jewel* simply becomes a millstone around the necks of the partners who remained loyal and who least deserve it. This is not the case in firms that adopt the default rule of dissolution. Because these firms dissolve immediately upon the departure of the very first partner, they often still have some assets to spread around among the partners. In these settings, the *Jewel* rule genuinely helps the partners who stayed. This is why the typical *Jewel* plaintiffs in small law firm collapses are the partners who remained at the firms, while the *Jewel* plaintiffs in large firm collapses are always the bankruptcy trustees and creditors.

<sup>51</sup> Dickson, Carlson & Campillo v. Pole, 83 Cal. App. 4th 436, 99 Cal. Rptr. 2d 678 (2000); Brenda Sandburg, *Partners Want \$32 Million Payday in Brobeck Case*, THE RECORDER (Nov. 19, 2002).

<sup>52</sup> David Lat, *Bingham to Go Bust in Morgan Lewis Raid*, ABOVE THE LAW (Nov. 17, 2014).

same strategy is a testament to how little has been known about law firm collapses and the unusual mechanics of unfinished business liability.

#### d. General Unlimited Liability Contrasted

The destructive character of these forms of liability is evident if we contrast them with the more familiar concept of general unlimited liability. General unlimited liability is an old doctrine of common law partnership that allows a partnership's creditors to sue all of the partners individually for the partnership's debts. General unlimited liability has mostly disappeared from law firms now that the firms organize themselves as limited liability partnerships and other types of limited liability entities. This old doctrine nevertheless serves as a useful benchmark for comparison.

Unlike the forms of liability discussed above, general unlimited liability is basically neutral with respect to the timing of partner departures. Under the common law and the UPA, a partner becomes personally liable for a debt the partnership incurs at any time the partner was associated with the firm, even if the partner leaves prior to the firm's insolvency and dissolution. A partner's liability is established at the moment a debt is incurred, rather than at the moment the partner leaves or at the moment the partnership dissolves.<sup>53</sup> Withdrawal may exempt a partner from general liabilities that a firm incurs after she leaves, but it will not exempt her from liabilities already on the books. General unlimited liability thus offers no inducement to leave early: at any given moment, a partner who leaves faces the same expected liabilities as a partner who stays.

### B. Comparisons and Contrasts

This theory of law firm collapse gains validation from a comparison between partner-owned law firms and similar enterprises.

#### 1. Slater and Gordon

The most important comparison is to the investor-owned law firm Slater and Gordon. Slater and Gordon was founded in Australia in 1935 with a standard partner ownership structure. In 2007, the firm became the world's first publicly traded law firm when it did an initial public offering of common stock to investors after Australia eliminated its rules requiring partner ownership for law firms.<sup>54</sup> The firm then issued new stock to finance the acquisition of several existing law firms in the UK after 2011, when England and

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For at least a year after the Morgan Lewis transaction, Bingham continued to maintain a web site declaring that the firm still existed, but that all of its partners had left and mostly moved to Morgan Lewis. The web site is now defunct.

<sup>53</sup> UNIFORM P'SHIP ACT §§ 306(b), 703(a) (1997)

<sup>54</sup> Richard Lloyd, *In 2007 Australia's Slater & Gordon Became the First Law Firm in the World to Go Public. Others Have Been Slow to Follow*, THE AMERICAN LAWYER, (Dec. 1, 2008).

Wales also eliminated their restrictions on partner ownership.<sup>55</sup> In both Australia and the UK, the firm did a robust business in personal injury, class action, and other consumer-focused litigation.<sup>56</sup>

Slater and Gordon initially did well with investors, at one point reaching a market capitalization of \$2.25 billion.<sup>57</sup> In 2015, however, the firm ran into trouble. It borrowed hundreds of millions of dollars to acquire the legal services arm of a UK company called Quindell, which offered legal services as part of a bundle of other services to people who had been involved in car accidents.<sup>58</sup> After the acquisition, Slater & Gordon discovered that an accounting fraud had allowed Quindell to overstate its value, meaning that Slater & Gordon had massively overpaid for its purchase and was forced to write down the value of the acquisition by nearly a billion dollars.<sup>59</sup> Around the same time, the government of the UK discontinued cash compensation for minor whiplash claims, cutting into a major component of Slater & Gordon's UK business.<sup>60</sup>

Slater & Gordon thus had \$741 million in debt and no means to pay it off.<sup>61</sup> After lengthy negotiations with creditors, the firm announced an agreement to spin off its UK operations into a separate company<sup>62</sup> and to recapitalize both the Australian and UK businesses by nearly wiping out the firm's shareholders and giving 95% of the equity to a group of hedge funds that had acquired the firm's debts.<sup>63</sup> During the two-year interim between the time Slater & Gordon became insolvent in 2015 and the time it restructured its debts in 2017, the firm defaulted on its loans, but continued to pay its lawyers and other employees their regular salaries and bonuses, just as other insolvent

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<sup>55</sup> The firm completed the expansion by acquiring a series of partner-owned UK firms using proceeds from a follow-on public offering. Jessica Seah, *Slater & Gordon Raising \$64 Million for U.K. Expansion*, THE AMERICAN LAWYER (May 8, 2013); *Alternative Business Structures*, L. SOC'Y (Jul. 22, 2013), <http://www.lawsociety.org.uk/advice/practice-notes/alternative-business-structures/> (noting the legalization in England and Wales in 2011 of "alternative business structures," or "ABSs," which are investor-owned legal services firms).

<sup>56</sup> Neil Rose, *Slater & Gordon Completes Pannone Acquisition and Hints at Yet More to Come*, LEGALFUTURES (Feb. 17, 2014), <http://www.legalfutures.co.uk/latest-news/slater-gordon-completes-pannone-acquisition-hints-yet-come>.

<sup>57</sup> Chris Johnson, *A Tale of Two Law Firm IPOs*, LAW.COM (Sept. 11, 2017), <https://www.law.com/sites/almstaff/2017/09/11/a-tale-of-two-law-firm-ipos/>.

<sup>58</sup> Lucy Battersby, *Slater and Gordon: What Happens When the Ambulance Chasers Crash*, THE SYDNEY MORNING HERALD (Mar. 5, 2016); Neil Rose, *Quindell Targets Huge Staff Growth and Higher Value Cases*, LEGAL FUTURES (June 19, 2014), <http://www.legalfutures.co.uk/latest-news/quindell-targets-huge-staff-growth-higher-value-cases>.

<sup>59</sup> Jonathan Shapiro, *Slater & Gordon Swings to \$958m Interim Loss on UK Write-Down*, FINANCIAL REVIEW (Feb. 29, 2016), <https://www.afr.com/business/slater--gordon-swings-to-958m-interim-loss-on-uk-writedown-20160228-gn5y6w>.

<sup>60</sup> Battersby, *supra* note 58.

<sup>61</sup> Battersby, *supra* note 58.

<sup>62</sup> James Booth, *Slater and Gordon's UK Business to Split From Australian Parent*, LEGAL WEEK (Aug. 31, 2017), <https://www.legalweek.com/sites/legalweek/2017/08/31/slater-and-gordons-uk-business-to-split-from-australian-parent/?slreturn=20180708152713>.

<sup>63</sup> Ben Butler, *Hedge Funds Swoop on Slater & Gordon*, THE AUSTRALIAN (Aug. 31, 2017).



businesses tend to do. The recapitalization succeeded and the Australian and UK branches of the firm continue in operation today.<sup>64</sup>

The result of the recapitalization was that Slater and Gordon became the first large law firm in the world to become insolvent, restructure its debts, and continue in operation. Slater and Gordon had vastly more debt and arguably a much more serious set of financial troubles than any of the collapsed law firms on Table 1. And yet, Slater and Gordon was the only large law firm ever to have gone through insolvency and survived. Why?

The obvious answer is that Slater and Gordon was owned by investors. If the firm had been owned by its lawyers, then it could not have restructured its debts, because the lawyers would have left. They would have started running the moment the troubles in the Quindell acquisition became evident in 2015. If the firm's chairman had stood up and announced to a room of partners that the firm would not have any more profits to distribute for the next ten years, the partners would have walked away, because the alternative would have been to work for free. The two years between the announcement of the Quindell troubles and the restructuring of the firm's debt thus would have ended in the firm's death, rather than its renewal. And if the firm did manage to survive until its debt could be restructured, the restructuring would have killed the firm on its own. The essence of the restructuring was to take the equity and give it to the creditors. But if the equity had initially belonged to the lawyers, there would have been no way to take it away from them, because, once again, they would have just left.

Slater and Gordon did not face these problems, because it was owned by its investors. It kept the loyalty of its lawyers the same way that other bankrupt investor-owned businesses have kept the loyalty of their employees: it continued to pay them. Just like Delta, Chrysler, Amazon and countless other investor-owned companies that have gone bankrupt or lost money, Slater and Gordon took money from its creditors and equity holders and paid the money to its employees as wages for their ongoing work. Investor-owned businesses can do this, because in an investor-owned business, the equity holders are locked in—they cannot take back the money they originally contributed. Once the stockholders of Slater and Gordon handed over their money in the IPO, the money belonged to Slater and Gordon to do with as it wished. And so the firm could take the shareholders' money and give it to other people, including the lawyers and other employees whom the firm needed to survive.

Of course, we have to be careful not to draw too strong an inference from the experience of Slater and Gordon, because the firm's bankruptcy was not a controlled experiment—the firm did not come to investor ownership randomly and, in theory at least, the firm might have had other characteristics

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<sup>64</sup> SLATER & GORDON, <https://www.slatergordon.com.au> (last visited Aug. 8, 2018) (Australia); SLATER & GORDON, <https://www.slatergordon.co.uk> (last visited Aug. 8, 2018) (United Kingdom).

besides its ownership structure that might have accounted for its unprecedented durability. But the coincidence of the firm's extraordinary ownership structure and its extraordinary survival is very difficult to dismiss.

## 2. Accounting Firms

Law firms are not the only worker-owned professional service firms to suffer partner runs. Accounting firms suffer runs, too. Arthur Andersen, the partner-owned accounting firm that audited Enron, collapsed and went into liquidation with astonishing speed after the firm was charged with a crime in connection with the Enron scandal. To be sure, Andersen's doom may have become inevitable once the SEC revoked the firm's authority to audit public companies.<sup>65</sup> But the peculiar speed and finality of Andersen's collapse may be attributable to its ownership structure. The collapse of another large accounting firm, Laventhol & Horwath, provides even stronger evidence of a partner run. At the time of its bankruptcy in 1990, Laventhol & Horwath was the seventh-largest accounting firm in America. But the firm collapsed in a pattern virtually identical to that of many law firms. After a period of rapid expansion, the firm's profits declined and the firm eventually dissolved after about a quarter of its partners fled in a six-month period.<sup>66</sup>

Accounting firms are not quite as vulnerable to runs as law firms, however. An accounting firm can restrict its partners from leaving, and client relationships in the biggest accounting firms tend to be less personal than in the biggest law firms, making it harder for a partner to damage a firm by taking a client with her when she leaves.

### C. Other Explanations

Partner ownership is not the only explanation for law firm collapses. Like any complex phenomenon, the collapse of a law firm has many causes, each of which may be individually necessary but not sufficient. I argue, however, that other explanations by themselves are not complete. Although a law firm's collapse may have many necessary causes, we cannot make sense of it without understanding the significance of partner ownership.

#### 1. Financial Stress

The most obvious alternative explanation is financial stress. Macroeconomic forces, changes in the legal services industry, and various other misfortunes are said to drive firms over the brink.<sup>67</sup> This theory is clearly right

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<sup>65</sup> Gabriel Markoff, *Arthur Andersen and the Myth of the Corporate Death Penalty: Corporation Criminal Convictions in the Twenty-First Century*, 15 U. PA. L. REV. 797 (2013).

<sup>66</sup> Frederic M. Stiner, *Bankruptcy of an Accounting Firm: Causes and Consequences of the Laventhol & Horwath Failure*, 3 ECON. & BUS. J.: INQUIRIES & PERSPECTIVES 1 (2010).

<sup>67</sup> See, e.g., See, e.g., Edward S. Adams & John H. Matheson, *Law Firms on the Big Board? A Proposal for Nonlawyer Investment in Law Firms*, 86 CAL. L. REV. 1 (1998); Bernard A. Burk & David McGowan, *Big but Brittle: Economic Perspectives on the Future of the Law Firm in the New Economy*, 2011 COLUM. BUS. L. REV. 1; Gillian K. Hadfield, *The Cost of Law: Promoting Access to Justice through the (Un)Corporate Practice of Law*, 38 INT'L.

in some sense – declining profits are obviously one of several necessary causes in driving firms to collapse. Financial distress is often what provides the push to start the spiral of withdrawal spinning.

By itself, however, financial stress is not a sufficient explanation, because, as noted above, financial stress is common to all types of businesses, and yet almost no other businesses blow up like law firms. Indeed, financial stress is especially incomplete as an explanation for law firm collapse because of the peculiar robustness of law firm capital structures.

Financial stress and partner ownership, then, are *both* necessary conditions for law firm collapse. Financial stress may be the force that drives the first wave of partners out the door, but partner ownership is what converts the first wave into successive waves.

Again, Slater and Gordon illustrates. When financial stress hit Slater and Gordon, the firm suffered, but it did not blow up. It responded to financial stress the way other investor-owned businesses often do: by continuing in operating and eventually reorganizing its debts. Without partner ownership, financial stress—even very serious financial stress—was not enough to destroy the firm.

A collapsed law firm is a bit like a glass vase that has been pushed off a table. If we want to explain why the vase has shattered, it is not enough to say that someone pushed the vase off the table, because when we push other things off of tables—rubber balls, cardboard boxes, books—they do not shatter like glass vases. We have to account not just for the vase's fall, but also for its peculiar fragility when it hits the ground. So it is with law firms. We cannot simply say that a collapsed law firm has been pushed off a financial table; we have to explain why it shattered when it hit the ground. In the manner of a materials scientist who wants to understand the differences between the molecular bonds in glass and rubber, I want to apply legal and economic science to understand the differences in economic bonds between worker- and investor-owned law firms.

Banks provide another analogy. Banks also collapse because of financial stress. Often, for example, the thing that precipitates a bank run is the failure of assets in the bank's loan portfolio. But financial stress alone is not enough to explain a bank's peculiar fragility. Banks are special not because they alone

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REV. L. & ECON. 43 (2014); Roberta S. Karmel, *Will Law Firms Go Public* (Brooklyn Law School, Legal Studies Paper No. 321, 2013); Jonathan T. Molot, *What's Wrong with Law Firms? A Corporate Finance Solution to Law Firm Short-Termism*, 88 U.S.C. L. REV. 1 (2015). Milton C. Regan, *Corporate Norms and Contemporary Law Firm Practice*, 70 G.W. L. REV. 931 (2002); Milton C. Regan, Jr., *Lawyers, Symbols, and Money: Outside Investment in Law Firms*, 27 PENN ST. INT'L L. REV. 407, 407 (2008); Larry E. Ribstein, *The Death of Big Law*, WISC. L. REV. 749 (2010); Larry E. Ribstein, *Ethics Rules, Agency Costs and Law Firm Structure*, 84 VA. L. REV. 1707 (1998); Nick Robinson, *When Lawyers Don't Get All the Profits: Non-Lawyer Ownership of Legal Services, Access, and Professionalism*, <http://ssrn.com/abstract=2487878>; Milton C. Regan, Jr., *Lawyers, Symbols, and Money: Outside Investment in Law Firms*, 27 PENN ST. INT'L L. REV. 407, 407 (2008). Galanter, Palay and Henderson's work on the changing character of law firms is especially broad and thoughtful. MARC GALANTER & THOMAS PALAY, *TOURNAMENT OF LAWYERS: THE TRANSFORMATION OF THE BIG LAW FIRM* (1991); Marc Galanter & William Henderson, *The Elastic Tournament: A Second Transformation of the Big Law Firm*, 60 STAN. L. REV. 1867 (2008).

suffer financial stress, but because they alone suffer the runs that turn mere financial stress into explosive crises. What makes banks interesting—and what motivates a great deal of their regulation—is not their exposure to financial stress, which is common to all businesses, but the peculiar way in which they respond to it. The same is true of law firms.

## 2. Human Capital

Another theory is that law firms are more reliant on human capital than other businesses. And unlike other forms of capital, human beings can leave. Lawyers often express this theory colloquially by saying that in a law firm, “the assets go down the elevator every night.”

This theory also has obvious merit, but it too is incomplete, because it does not tell us why one human being would follow another out the door. When one partner goes down the elevator, why do the others not come back up? It is not enough to say that a lawyer’s departure damages a firm, because we also have to explain why that damage might discourage other lawyers from returning. Partner ownership provides the explanation by showing why partners are sensitive to each other’s departures. It tells us why the decline in profits caused by one partner’s departure would cause the remaining partners to leave as well.

## 3. The Absence of Hard Assets

A flip side to the human capital explanation is that law firms do not have hard assets, such as factories, buildings and cash, that creditors can seize and lend against. This would seem to make a law firm’s debts difficult to reorganize and refinance and thus make liquidation more attractive.

This theory gets things exactly backward. The dearth of hard assets makes liquidation *less* attractive, not more. If there are no hard assets to sell, then there is little to be gained from selling them. Liquidation is not a very attractive option if there is nothing to liquidate. For creditors, therefore, law firms are almost always worth more together than apart. A law firm lender almost always wants the firm to stay together, because there will be little or nothing left if the partners all leave. The dearth of hard assets only deepens the puzzle of law firm collapse.

## 4. Signaling

A final alternative explanation is that partners try to leave early in the spiral of decline because they want to signal their value to the labor market. Partners who leave early signal strength and partners who stay late signal weakness. The problem with this story is that the signal it imagines is too easy to manipulate. If all a lawyer had to do to get a good job was to leave early, then every lawyer would leave early, and leaving early would cease to differentiate the good from the bad. The signal would cease to signal anything.

### III. RISK FACTORS: WHY SOME FIRMS LIVE WHILE OTHERS DIE

The forces pulling law firms apart are not irresistible. Most firms manage to survive them, because most of the time, the leave/stay decision sits in an equilibrium that favors staying. Just as most bank depositors stayed put in a state of equilibrium most of the time even before the rise of deposit insurance, so too law firm partners tend to stay put until something happens to change the leave/stay calculus.

To completely understand why firms collapse, therefore, we must identify the forces that push firms out of this equilibrium. Although I cannot pretend to list every imaginable force that can start the ball rolling, a clear understanding of the role of partner ownership can point our attention to certain categories of forces. One advantage of my partner ownership-based theory of collapse is that it points our attention to different kinds of forces than other a theory based on simple financial stress. We can see that some forces are more important in pushing law firms out of equilibrium than we might think, even as others are less important.

### A. Bonding Capital

An understanding of partner ownership tells us that law firms have to rely on unconventional forces to hold themselves together. Because the ties of financial capital are so weak in law firms, the firms have to rely instead on informal non-financial ties that we might call *bonding capital*. These ties include forces like friendship, loyalty and trust. Partner ownership forces bonding capital into a position of much greater importance than if a firm were owned by investors.

If partners respect and value their colleagues, then the leave/stay decision will tilt in favor of staying, because the costs of leaving will be high. And if bonding capital is especially strong, then partners may cease to think in terms of costs and benefits at all and might instead prioritize a set of values and personal commitments other than money. Ties of trust can also enable coordination. In May of 2014, the chairman of Patton Boggs slowed down a partner run – and may have saved the firm – by asking each of the firm’s remaining partners to commit to stay.<sup>68</sup> These commitments were never written down and would have been unenforceable if they were, but the partners apparently had enough trust in each other that almost all of them stayed long enough to complete a merger with another firm.<sup>69</sup>

The unusual importance of bonding capital is one of the most interesting consequences of partner ownership. Bonding capital is hard for lawyers and legal scholars to comprehend, because it grows outside the sphere of contracts and other legal obligations. The way bonding capital forms and the ways it balances out financial incentives are worthy of further exploration by sociologists and others with expertise in understanding non-market relationships.

### B. Financial Stress

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<sup>68</sup> About 90% of the partners agreed to stay. Jennifer Smith, *Patton Boggs Hires Advisers to Aid in Financial Overhaul*, WALL STREET JOURNAL, Mar. 3, 2014.

<sup>69</sup> Catherine Ho & Holly Yeager, *Patton Boggs Agrees to Merge with Squire Sanders*, WASHINGTON POST, May 23, 2014.

Financial stress also matters, but in a surprising kind of way. Firms collapse not because their profits decline in *absolute* terms, but because they decline in *relative* terms. What matters most is not a firm's overall profits, but its ability to convince its partners to stay. And this depends on how a firm's pay package compares to those of its competitors—i.e., its *relative* profits.<sup>70</sup>

This suggests – surprisingly – that when macroeconomic or other widespread conditions reduce demand for legal services, few law firms should collapse as a result, because these events affect *absolute* profits more than *relative* profits. If a slowdown in the M&A market hurts every firm in New York equally, then partners at one firm will have no reason to leave for any other, because all of the firms will be equally downtrodden. And even if a slowdown hurt some firms more than others, partners will still have only a weak incentive to move if other firms are at least partially harmed as well. For this reason, an industry-wide decline like the ones afflicting newspapers and recorded music would not necessarily cause law firms to go out of business.

The story of Jenkins & Gilchrist, a Dallas-based national law firm, illustrates. The firm collapsed in 2006 after three partners in the firm's Chicago office were sued for selling fraudulent tax shelters.<sup>71</sup> The liability ultimately became a major financial problem: \$81.55 million in the final settlement. But the firm had so many profits and so much freedom in choosing how to allocate those profits that if only the firm could have hung onto its partners, it could easily have remained solvent in the face of this liability. More deadly than the actual cost of the liability was the way the liability reduced the firm's profits *relative to the firm's competitors*. Because the liability was unique to Jenkins & Gilchrist, the firm's partners could gain a pay raise from moving elsewhere, and the firm spiraled downward in a classic partner run, steadily declining from 600 lawyers when the liabilities first emerged in 2001 to 281 lawyers when the firm finally dissolved five years later.

### C. Expansion

It is very difficult to pinpoint a single event that began the spiral of partner departures in most law firms' collapses. One cause that stands out, however, is expansion. Although elite law firms have generally gotten much bigger in the last 40 years,<sup>72</sup> many of the collapsed firms expanded with unusual speed and aggressiveness. These expansions seem to be directly linked to the firms' collapses.

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<sup>70</sup> More precisely, what matters is the *change* in relative profits. Some law firms will always be more profitable than others. But most firms nevertheless remain stable, because the market for partners usually sits in an equilibrium, in which each lawyer settles at the firm that offers her the best deal. Partner runs commence when the market falls out of this equilibrium because a firm has changed its profitability.

<sup>71</sup> Katie Fairbank and Terry Maxon, *How Jenkins Lost its Way*, DALLAS MORNING NEWS, April 1, 2007, at A1.

<sup>72</sup> Henderson & Bierman, *supra* note 76, at 1396 ("In 1978, the average NLJ 250 firm had 45 partners and 102 attorneys. By 2008, the average was 213 partners (+473%) and 535 attorneys (+525%).")

Brobeck, Phleger and Harrison, a prestigious San Francisco-based firm founded in 1926, is a good example. From 1997 to 2000, Brobeck nearly doubled the number of lawyers in its offices around the country, peaking at around 900 total attorneys and 200 total partners. In May 2001, the firm's charismatic chairman, Tower Snow, Jr., left the firm with 17 other attorneys for Clifford Chance after losing a power struggle for leadership of the firm. Other departures soon followed and the firm dissolved just a few months later, in January 2002. Commentators at the time pinned Brobeck's collapse on the decline of its technology sector practice after the bursting of the dot-com bubble. But it now seems clear that Brobeck's real problem was its explosive growth. The firm invested huge amounts of money in the acquisition and renovation of office space, with the expectation that it would fill this space with high-billing lawyers. Brobeck earned about the same amount of revenue in 1999 and 2002 (it earned more in the years in between), but its occupancy costs ballooned from 6.6% of revenues in 1999 to 15.2% of revenues in 2002.<sup>73</sup> Brobeck collapsed under the weight of these costs in early 2003. Finley Kumble, which in 1988 became the first major law firm to collapse, followed a similar path. It grew from nonexistence to the nation's fourth-largest law firm in just twenty years. The pressure of this growth drove the firm into a classic spiraling decline.

Expansion can trigger a partner run because expansion has a tendency to affect *relative* profits as well as *absolute* profits. The risks posed by expansion are unique to the expanding firms and are not shared by their less aggressive competitors. Expansions are risky along two dimensions: finances and governance. The financial risks involve costly investments in the near-term that promise payoffs only in the long-term. To open a new office, a firm must sign leases requiring fixed payments for several years and must invest money up-front in the renovation and construction of these new spaces. Growth also requires investments in personnel: firms often pay large premiums to dislodge lateral partners from their old firms, often with no guarantee that the new partners will generate enough business to justify themselves. Professional ethics rules and state law fiduciary duties generally prohibit partners from soliciting their existing clients before they actually leave a firm, and so a new firm can never truly know just how much new business a laterally recruited partner will actually bring.<sup>74</sup> This makes lateral partners into very risky investments. All of these financial risks are serious in law firms, because even if the investments are expected to be profitable, partners can lose faith before the payoffs are realized and then withdraw, making the investments impossible to sustain.

In addition to these financial risks, expansions also create social and governance risks. The main risk is that newly recruited lateral partners will not stay committed. After all, they have already demonstrated a willingness to move.

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<sup>73</sup> In re Brobeck, Phleger & Harrison LLP, Notice of Motion and Motion for Order at 7, No. 03-32715 (Bankr. N.D. Cal. filed Mar. 21, 2005).

<sup>74</sup> ABA Comm. on Ethics and Professional Responsibility, Informal Op. 1466 (1981); Robert W. Hillman, *Loyalty in the Firm: A Statement of General Principles on the Duties of Partners Withdrawing from Law Firms*, 55 WASH. & LEE L. REV. 997, 1009-1019 (1998).

#### D. Client Loyalties

The placement of client loyalties is also important. If clients are loyal to *firms*, rather than to *individual partners*, then partners will be less likely to leave and the firms will suffer less damage when they do. The *concentration* of loyalties among individual partners can also be important, though it can cut in either direction. Concentration of clients in the hands of a few partners can make a firm vulnerable to the departure of those partners. Altheimer & Gray, an 88-year-old Chicago firm, spiraled downward with astonishing speed after Gery Chico, the firm's charismatic chairman and principal rain-maker, stepped away from his practice to run for U.S. Senate in 2002.<sup>75</sup> On the other hand, concentration of client loyalties can make a firm less vulnerable by making the firm insensitive to the departures of all but the handful of lawyers who hold the client relationships.

#### E. The Labor Market

A final factor is the overall cost of leaving and the background labor market in which firms operate. This may be the most important factor of all. The social and economic forces that used to constrain lateral movement have eroded. Until about 30 years ago, lateral partner movement among elite firms was rare and costly, but it is now widespread and growing in frequency.<sup>76</sup> The forces driving this phenomenon have been studied extensively.<sup>77</sup> They include changing social norms in law firms and the spread of information through the annual AmLaw 200 profits-per-partner reports. As lateral movement becomes less costly, all law firms will become more vulnerable to collapse.

#### F. The Ambiguous Effect of Size

A final risk factor is the number of partners, as distinct from *growth* in the number of partners over time. The relationship between size and collapse is complicated and ambiguous. Larger size decreases the odds of collapse by reducing the proportional significance of each partner's departure and by diversifying the risks of individual partner withdrawals. In a firm of a thousand partners, the death or departure of one partner does little harm. In a firm of three partners, it is catastrophic.

But in other ways, larger size can increase the odds of collapse. Larger size may erode bonding capital as it weakens a firm's sense of identity and

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<sup>75</sup> Abdon M. Pallasch, *Gery Chico and the Firm that Failed*, CHICAGO SUN-TIMES, Oct. 5, 2003.

<sup>76</sup> GALANTER & PALAY, *supra* note 67; JONATHAN MACEY, THE DEATH OF CORPORATE REPUTATION, 149-162 (2013); George P. Baker & Rachel Parkin, *The Changing Legal Services Industry and the Careers of Lawyers*, 84 N.C. L. REV. 1635 (2006); William D. Henderson & Leonard Bierman, *An Empirical Analysis of Lateral Lawyer Trends from 2000 to 2007: The Emerging Equilibrium for Corporate Law Firms*, 22 GEORGETOWN J. LEGAL ETHICS 1395 (2009); Coates, et al., *Hiring Teams, Firms and Lawyers* (2013), <http://ssrn.com/abstract=1831544>;

<sup>77</sup> GALANTER & PALAY, *supra* note 67; Henderson & Bierman, *supra* note 76.



the ties of personal friendship and trust. Larger size also undermines voting, because it dilutes the significance of individual partners' votes and creates the kind of collective action problems that plagues large public companies. As Albert Hirschman might say, when *voice* is diminished by collective action problems, partners will lean more heavily on *exit*, raising the odds that exits will spiral out of control.<sup>78</sup>

#### IV. DESCRIPTIVE OBSERVATIONS

This theory of law firm collapse offers several descriptive insights into the processes and consequences of collapse. It also offers insights into the theory of organization more generally.

##### A. *The Welfare Consequences of Partner Runs*

First, let us consider whether the collapse of a law firm is a bad thing. From the standpoint of economic efficiency, does a law firm's collapse always leave the world worse off? The simple answer is that it is hard to say. Some law firm collapses are probably efficient and others probably are inefficient, and unfortunately, it is very hard to say which are which. In this respect, law firm partner runs, once again, are like bank runs. And to be clear, the significance of law firm collapse as a matter of scholarly inquiry does not turn primarily on whether collapse is inefficient or not. The pattern of law firm collapse is unusual and it has a dramatic effect on many people's lives. Those factors alone are enough to make the phenomenon worth our time.

As with a bank run, however, the key thing to remember about a law firm partner run is that it has at least the *potential* to be inefficient. Though a law firm partner run could sometimes be efficient, it is theoretically possible – and realistically probable – for a law firm to collapse inefficiently in a way that makes the partners and other constituents worse off, both individually and in the aggregate.

Because the partners fail to internalize the full costs of their departures, they can leave even when the aggregate and individual costs of leaving exceed the benefits. This can happen for three related reasons. First, many of the costs of a partner's departure are borne by other people. When a firm blows up, it sends shrapnel flying not just toward the partners who left, but also toward the partners who stayed, as well as the staff, associates, creditors, clients, and retirees. The departed partners have no obligation to make these people whole.

Second, the costs of collapse are lower for partners who leave early than for partners who leave late. That was the basic point of Part II, which described how staying late exposes partners to declining profits and escalating liabilities. A partner may thus leave early *even when the costs she personally will bear by leaving exceed the benefits*, because she might expect that the balance of costs and benefits will only grow worse if she stays.

Finally, at the time a partner decides whether to leave, she does not fully consider even the portion of the costs that she personally will bear in the event

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<sup>78</sup> ALBERT O. HIRSCHMAN, *EXIT, VOICE & LOYALTY: RESPONSES TO DECLINE IN FIRMS, ORGANIZATIONS, & STATES* (1970).

of collapse. This is because each partner's departure marginally increases the odds of collapse by only a small amount, and it is only the expected value of this small marginal increase – and not the total odds of collapse – that a partner considers in deciding whether to leave or stay. Imagine, for example, that a partner expects her departure to increase the odds of collapse by five percent. In comparing the personal costs of leaving and staying, the partner will count as a cost of leaving only five percent of the fraudulent transfer liability and other liabilities she expects to face. This is because the odds of having to face this liability are only five percent higher if she leaves than if she stays. The partner will not weigh the *total* risk of collapse, because she will have to face most of that risk—all but five percent of it—regardless of whether she leaves or stays. Instead of asking whether survival of the firm would be better than collapse of the firm, therefore, the partner will ask only whether, given a certain probability of collapse, staying or leaving would be better. The only thing that matters to a partner is how her own departure will change the total risk. Employing this logic of small marginal changes, a firm's partners can increase the total odds of collapse a little bit at a time, until finally the odds reach 100% and everyone becomes worse off than if they all had stayed.

Numerous analogies from the commercial world illustrate the potential inefficiency of partner runs. Most obviously, the law and economics of banking and commercial bankruptcy revolve around the recognition that uncoordinated withdrawals can accelerate in inefficient self-reinforcing spirals. For banks, the people who withdraw are depositors, and for bankrupt firms, they are senior creditors executing on their claims. These spirals can force firms to liquidate their assets even when continuing in operation would be more efficient, reducing the total value available in the aggregate.<sup>79</sup> The law recognizes the inefficiency of these spirals by offering deposit insurance and safety and soundness regulations for banks and by offering the automatic stay of execution for commercial bankruptcies. Of course, some bank runs and some bankruptcies might actually be efficient, just as some law firm collapses might be efficient. But this is not always the case, and that is why we have laws to stop the worst forms of inefficiency.

Recognizing, then, that inefficient collapses are theoretically possible, we might now ask where exactly all of these inefficiencies might come from. We cannot say simply that law firms and their assets go to waste, because many of a law firm's assets—most importantly the workers – end up moving to new law firms. In the jargon of bankruptcy, a law firm's assets get *redeployed*.

We might nevertheless find a few sources of inefficiency. First, there are tremendous costs to transitioning assets from one firm to another. The biggest problem is the loss of clients. As a partner moves from a collapsing firm to a new one, many of the partner's clients may choose not to follow and many clients may be unable to follow, because they will have legal conflicts with existing clients of the new firm. Other costs are social, psychological, and logistical. In interviews, many partners from collapsed firms used metaphors like “divorce” and “death of a family member” to describe their moves, and

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<sup>79</sup> This is widely known. See, e.g., Douglas W. Diamond & Philip H. Dybvig, *Bank Runs, Deposit Insurance, and Liquidity*, 91 J. POL. ECON. 401 (1983) (describing the potential inefficiency of bank runs); THOMAS H. JACKSON, *THE LOGIC AND LIMITS OF BANKRUPTCY LAW* 7-19 (1986) (describing the potential inefficiency of creditor executions in bankruptcy).

many described the moves as the worst experiences of their lives. Associates and staff also face months of unemployment as they look for new jobs.

The redeployment of assets may also be inefficient from the standpoint of creditors. When a successful partner moves to a new firm, the new firm's creditors enjoy increased odds of getting paid. But these increases have diminishing marginal value and likely do not offset the catastrophic losses that creditors of collapsed firms actually bear. When the partners of the collapsing law firm Bingham McCutchen abandoned the firm for Morgan Lewis in 2014, the creditors of Morgan Lewis probably gained a slightly increased chance of getting repaid. But this small marginal benefit for the creditors of Morgan Lewis was probably heavily outweighed by the nearly total losses suffered by Bingham's landlords, lenders, and retirees.

Besides the costs involved in transitioning, the redeployment of assets from one firm to another also has the effect of undermining the incentive to commit resources to a law firm *ex ante*. If I am a lender and I am considering making a loan to the law firm Orrick, for instance, the risk that all of Orrick's assets may be "redeployed" to Morgan Lewis in a potential Orrick collapse will tend to discourage me from lending. The same will be true if I am a mid-career lawyer and I am considering whether to continue working for Orrick in expectation of receiving a pension after I retire—a pension that will not be paid if the firm's assets get "redeployed" in a collapse. Interviews with law firm lenders confirm this intuition. They worry constantly about the risk of partner runs, and they claim to charge higher interest rates and lend less often as a result. This is kind of argument about *ex ante* investment incentives is standard in theories of ordinary corporate reorganization and bank runs, which also often involve the redeployment of assets.

### B. *The Difficulty of Bargaining to Prevent Collapse*

If a law firm's collapse is likely to be inefficient, why can't the firm's partners reach a bargain to prevent the collapse? Why can't the partners just decide collectively to stay? Relatedly, why can't they restructure the firm's debts in Chapter 11 bankruptcy? One reason is Model Rule of Professional Conduct 5.6, which prevents partners from committing to stay by prohibiting restrictions on withdrawals. This makes any bargains the partners might reach unenforceable. A second reason is the absolute priority rule of bankruptcy, which requires equity holders to be paid last – after creditors.<sup>80</sup> If applied literally, this rule would deprive partners in a bankrupt firm of their equity, and thus wipe away their motivation for continuing to work.

### C. *The Role of Debt*

I have often heard lawyers say that the key to avoiding law firm collapse is to avoid debt. But the role of debt is subtler and less important than this simple mantra suggests. Law firms have freakishly robust capital structures, and so debt rarely drives a law firm into literal insolvency until a partner run has almost completely run its course. In fact, it is possible to imagine a law firm collapsing even when it has no debts at all. A simple personality dispute,

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<sup>80</sup> Case v. L.A. Lumber Prods. Co., 308 U.S. 106, 116 (1939)

if it triggered a partner run, could drive a firm into oblivion even if the firm had no obligations to creditors.

Debt is thus usually a symptom, rather than a cause of decline. Firms in distress tend to increase their borrowing only after their profits have declined and only because they fear the decline will spark a partner run. In essence, declining firms borrow in order to reduce partners' sensitivity to declining profits by using borrowed money to hold partner compensation constant. Sometimes firms transform their own partners from equity holders into debt holders by giving them guaranteed compensation contracts. Of course, these strategies are not sustainable for very long; they only worsen the condition of the equity holders over time if the firm's real profits fail to recover.

A good example is Finley Kumble, which collapsed in 1988. In its second-to-last full year of operation, the firm borrowed 44% of the cash it used to pay its partner draws.<sup>81</sup> The firm was still generating a hefty profit and remained quite healthy as a matter of financial accounting. But the firm borrowed because its profits were declining and it realized that unless it maintained partner draws at the previous level, its partners would start running. Only at the end of the calendar year, when the partners' tax returns revealed how much of their draws had been funded with debt, did many of the partners realize how serious the firm's problems had become.<sup>82</sup> The experience of Dewey & LeBoeuf is even more instructive. The firm had many debts when it dissolved, but most of those were incurred in the firm's final year of operation.<sup>83</sup> The same was true of most of Dewey's infamous guaranteed compensation contracts, which mostly went to existing partners who threatened to leave in the firm's final year.

#### *D. Mergers*

Another question is why collapsing law firms so often attempt last-ditch mergers with healthier firms. Virtually every collapsed firm has gone to its grave searching desperately for a merger partner. Heller Ehrman, for example, seriously discussed mergers with at least three firms – Baker & McKenzie, Winston & Strawn, and Mayer Brown – and probably approached many more.

It seems unlikely that abstract “synergies” can explain the unusual timing and urgency of these marriages. A better explanation is that when law firms are crumbling, they seek mergers as a way of restoring confidence. When Squire Sanders merged with an ailing Patton Boggs in the spring of 2014, for example, the merger stopped the partner run then happening at Patton Boggs, because it rendered future departures less important. The merged firm had more partners to absorb the damage of departures and could more easily cover its costs. And Squire Sanders' strength reduced the odds of dissolution and personal liability for Patton Boggs partners.

Struggling law firms are similar in this respect to struggling banks. At the height of the financial crisis in 2008 and 2009, almost every struggling bank desperately sought a merger partner. This is how we ended up with the odd

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<sup>81</sup> KIM ISAAC EISLER, SHARK TANK: GREED, POLITICS AND THE COLLAPSE OF FINLEY KUMBLE, ONE OF AMERICA'S LARGEST LAW FIRMS, 203 (1990).

<sup>82</sup> EISLER, *supra* note 81, at 203.

<sup>83</sup> Stewart, *supra* note 31, at 89-91.

combination of Bank of America and Merrill Lynch: Merrill Lynch sought the merger after a run on its short-term financing.

### *E. The Value of Capital Lock-In*

Legal scholars have been busy in recent years developing theories about why locking in investors is a useful thing.<sup>84</sup> The experience of law firms can elaborate and extend this theory. The standard story is that lock-in is valuable, because if shareholders could withdraw unilaterally, the synergies that come from combining a firm's assets together would be unachievable. If a factory requires all of its parts to operate, then it would become worthless if just one or two shareholders withdrew and started pulling of a few pieces.

The theory of law firm collapse extends this theory by explaining just how valuable lock-in truly is. To my knowledge, no one has ever supposed that withdrawals by equity holders could intensify into a self-perpetuating spiral. Although we have long known that an individual withdrawal by an equity holder can be costly, we have always conceived the costs of withdrawals as simply the sum of individual decisions. No one has ever before understood that a withdrawal by one equity holder could metastasize into a run by all of the equity holders.

## V. SOLUTIONS

I propose several solutions to the problem of law firm collapse. They fall into two categories: policy solutions that require changes to law and regulations, and management solutions that law firms can implement on their own. By offering these solutions, I do not mean to insist that policy lawmakers or law firms should definitely implement them. Each of these solutions involves costs as well as benefits, and it is often hard to say when and whether the costs exceed benefits. Nevertheless, I believe it is useful to understand how these solutions might work, so that we can make an informed decision about whether to implement them.

### *A. Policy Solutions*

One solution would be to eliminate the rules requiring partner ownership and allow law firms to be owned by investors. England, Wales, and Australia have already tried this, and in these countries, investor-owned law firms now take a large share of the markets for personal injury litigation and other types of personal legal services.<sup>85</sup> As the experience of Slater and Gordon shows, investor ownership would effectively eliminate the risk of a run.

Again, this is not to say that we should necessarily adopt a rule permitting investor ownership. Law firm ownership structures raise a host of issues, both economic and non-economic, and the risk of collapse is only one of them. We could debate the strengths and weaknesses of investor ownership at great

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<sup>84</sup> E.g., Blair, *supra* note 6; Hansmann, et al., *supra* note 6; Hansmann & Kraakman, *supra* note 6.

<sup>85</sup> Regan, *supra* note 67; Robinson, *supra* note 67.

length, and many others already have.<sup>86</sup> For present purposes, I take no side in this broader debate. My point is simply that if, in theory, law firms could be owned by investors, they would be less likely to collapse. Given the magnitude of interest in investor ownership, this insight about the risk of collapse is, I think, a useful contribution, even if it does not resolve the debate completely.

Another solution to law firm collapse would be to permit restrictions on partner withdrawals. The United Kingdom already allows a firm to restrict its partners from withdrawing, and firms in the United Kingdom frequently use this freedom to demand noncompete agreements, retain partners' capital contributions, force partners to share billings after they withdraw, and so on. Withdrawal restrictions would reduce the odds of runs by raising the cost of leaving. In the leave/stay decision, if leaving becomes more costly, then partners will be more likely to choose to stay even if the value of staying declines.

Of course, restricting withdrawal would create other problems. And again, I do not take a position in this debate. Whether the costs of restricting withdrawal would be worth the benefits are unclear. My point is simply that, if we chose to allow firms to restrict partners from withdrawing, firms would no longer die in spectacular collapses.

### B. Management Solutions

Law firms can also reduce the risks and costs of collapse by acting on their own. Most important, all large law firms should amend their partnership agreements to waive liability for *Jewel*-style unfinished business claims. Courts clearly permit these kinds of waivers and many judicial opinions have endorsed their enforceability.<sup>87</sup> Nevertheless, *none of the firms in my study properly adopted a Jewel waiver*. The only firms that adopted *Jewel* waivers did so after they had already become insolvent. This made the waivers unenforceable in bankruptcy, because it turned the waivers into fraudulent transfers. Many firms—including Brobeck, Thelen, and Heller Ehrman – have learned the hard way that a *Jewel* waiver adopted after insolvency is a gift to partners that creditors can easily set aside.<sup>88</sup>

There is no reason for a large law firm not to adopt a *Jewel* waiver. Before dissolution, *Jewel* does not stop partners from leaving, because it does not apply. And after dissolution, its only practical effect is to force the partners who stayed to hand over money to creditors. The only people who benefit from *Jewel* in large law firms are the creditors, but in practice the creditors tend not to object to *Jewel* waivers, so there is little reason for the partners not to adopt a *Jewel* waiver.

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<sup>86</sup> *Supra* note 67 and accompanying text.

<sup>87</sup> *Jewel v. Boxer*, 203 Cal. Rptr. 13, 19 (Ct. App. 1984) (“[P]artners are free to include in a written partnership agreement provisions for completion of unfinished business that ensure a degree of exactness and certainty unattainable by rules of general application.”); *In re Brobeck, Phleger & Harrison LLP*, 408 B.R. 318, 327 (Bankr. N.D. Cal. 2009) (holding that the RUPA “expressly authorizes” law firm partners to draw up *Jewel* Waivers.)

<sup>88</sup> *Geron v. Robinson & Cole LLP*, 476 B.R. 732, 743 (Bankr. S.D.N.Y. 2012); *In re Heller Ehrman LLP*, No. 08-32514DM, 2011 WL 1539796 (Bankr. N.D. Cal. Apr. 22, 2011); *In re Brobeck, Phleger & Harrison LLP*, 408 B.R. 318 (Bankr. N.D. Cal. 2009).

In the event that a law firm does not adopt a *Jewel* waiver before it becomes insolvent, the next best solution is for the firm to avoid dissolving once it closes shop. If a firm ceases its operations without formally adopting a resolution to withdraw, it will not face *Jewel* liability, since *Jewel* only applies to partners who leave after the firm dissolves.<sup>89</sup>

In addition to waiving *Jewel* liability, law firms should also amend their partnership agreements to delay paying out capital to departing partners. The Model Rules of Professional Conduct apparently permit a firm to delay capital repayments by dribbling them out incrementally over several years.<sup>90</sup> Delaying capital repayments can help prevent a firm from bleeding to death.

A law firm can also change its strategy and management. It can ruthlessly cut costs and lay off unproductive partners and employees to preserve its profitability. It can also avoid or carefully manage the various risk factors discussed above. It can encourage clients to be loyal to firms, rather than to partners. Failing this, it can try to spread client loyalties around among the partners, rather than relying on a few key rainmakers, or else take very good care to ensure that the rainmakers remain loyal. A firm can also try to cultivate its partners' loyalty by building up a sense of mission and identity in the partnership. And a firm can approach growth carefully. Although large size may reduce the odds of collapse, the growth process that leads to large size is often very risky. To be clear, none of these changes is easy to achieve, and some of them are in direct tension with one another. But such is the challenge of modern law firm management.

## VI. CONCLUSION

When we look closely at the swift and violent collapses of law firms like Dewey & Leboeuf and Heller Ehrman, one fact becomes undeniable: this is not normal. Many businesses suffer financial problems, but almost none blow up with the extraordinary force of law firms. Law firms are highly unusual in their utter inability to withstand losses and reorganize debts. If we want to understand why a law firm collapses, therefore, we need to understand not just why it suffered financial problems, but also why it was so fragile in the face of these problems.

My answer is structural. Law firms are fragile because they are owned by their partners and the partners can freely withdraw. Partner ownership weakens a firm by forcing the remaining partners to suffer the damage done by every other partner's withdrawal. Partner ownership ties a firm's partners together, so that one partner who walks out the door can unintentionally drag the rest of the partners along with her.

To be clear, although partner ownership and free withdrawal establish the necessary conditions for a run, a variety of more specific factors can increase or decrease the odds of a run for a particular firm. Financial stress, of course, can damage a firm. But this damage matters primarily because of the way it increases the odds of a run. Because a law firm has an unusually robust capital structure, financial stress, standing alone, generally does not pose the same

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<sup>89</sup> *Supra* note 52 and accompanying text.

<sup>90</sup> *Supra* note 29 and accompanying text.

risk in a law firm as it does in a conventional investor-owned business. What matters is how financial stress feeds into the risk of a run.

Although this theory of law firm collapse focuses on *financial* forces, it paradoxically tells us that *non-financial* forces are also important. Financial and non-financial bonds are substitutes. When a partner's financial ties to her firm are weak, she may still stay committed if her non-financial ties are strong. Informal bonds like friendship, loyalty and trust can hold a firm together even in the face of financial decline. Partner ownership thus relies on non-financial bonds to some degree for its survival.

This theory also opens a window into much broader issues in organizational law. We learn that locking in the owners of a business may be more important than we have previously realized, because under certain conditions, withdrawals by owners can spiral into a run.

Perhaps the biggest question is whether—and how—we should stop law firms from collapsing. One option is to amend the rules of professional ethics to allow firms to restrict their partners from withdrawing. Another option is to allow firms to be owned by investors. Still another option is for firms to amend their partnership agreements and take the various management steps that I have described. Of course, these solutions would bring cost as well as benefits, and the balance may be uncertain. But the ownership-based theory of law firm collapse nevertheless can finally open our eyes to what is really happening in these strange and frightening implosions. If we want to make law firms more robust, we now know how to do it.



## APPENDIX

Table 1 lists every firm I reviewed. For firms that were large enough to be listed in the AmLaw 200 (American Lawyer magazine's annual list of the 200 highest-grossing law firms in America), Table 1 also includes the AmLaw rankings in the year prior to the firm's collapse by gross revenue and profits per partner. I assembled this list through ad hoc searches of online news databases. The criteria for inclusion were rough – I included essentially every law firm collapse that received significant national press coverage. The list includes every Am Law 200 firm that collapsed since 1988, as well as many other large firms and one Canadian firm, Heenan Blaikie, that collapsed in 2014. The list excludes small firms.

Law Firm Name	Year of Collapse	Am Law Ranking in Year Prior to Collapse	
		Gross Revenue	Profits Per Partner
1. Finley Kumble	1988	2	48
2. Isham Lincoln & Beale	1988	N/A	N/A
3. Myerson & Kuhn	1990	N/A	N/A
4. Gaston & Snow	1991	86	82
5. Washington, Perito & Dubuc	1991	N/A	N/A
6. Shea & Gould	1994	79	83
Johnson & Swanson	1994	N/A	N/A
7. Lord, Day & Lord	1994	N/A	N/A
8. Mudge Rose	1995	76	88
9. Pettit & Martin	1995	N/A	N/A
10. Keck, Mahin & Cate	1997	N/A	N/A
11. Dickson, Carlson & Campillo	1998	N/A	N/A
12. Donovan, Leisure, Newton & Irvine	1998	N/A	N/A
13. Bogle & Gates	1999	193	200
14. Graham & James	2000	91	33
15. Hill & Barlow	2002	N/A	N/A
16. Lyon & Lyon	2002	N/A	N/A

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17. Brobeck Phleger & Harrison	2003	43	156
18. Pennie & Edmonds	2003	136	45
19. Altheimer & Gray	2003	145	120
20. Arter & Hadden	2003	151	198
21. Coudert Brothers	2005	83	172
22. Testa, Hurwitz & Thibault	2005	148	102
23. Jenkins & Gilchrist	2007	140	160
24. Heller Ehrman	2008	56	78
25. Thelen	2008	76	104
26. Dreier	2008	N/A	N/A
27. Wolf Block	2009	153	195
28. Thacher Proffitt & Wood	2009	179	200
29. Morgan & Finnegan	2009	N/A	N/A
30. Rothstein Rosenfeldt Adler	2009	N/A	N/A
31. Darby & Darby	2010	N/A	N/A
32. Howrey	2011	108	159
33. Adorno & Yoss	2011	N/A	N/A
34. Clark, Thomas & Winters	2011	N/A	N/A
35. Dewey & LeBoeuf	2012	28	63
36. Bingham McCutchen	2014	37	44
37. Sedgwick LLP	2017	157	156

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