"Clawbacks of Partnership and LLC Distributions: Lessons from Large Law Firm Bankruptcies"

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I. Introduction and Overview

Two types of litigation dominate law firm bankruptcies and dissolutions – claims against former partners (colloquially referred to as "Clawback Claims") and unfinished business claims against the former partners and their new firms (also known as "*Jewel*" claims). These written materials only address issues germane to Clawback Claims, with one caveat: because the largest and most recent law firm dissolutions are proceeding in bankruptcy courts in New York (Dewey & LeBoeuf LLP, Coudert Brothers LLP, and Thelen LLP) and California (Brobeck LLP, Heller Ehrman LLP, and Howrey LLP), these written materials analyze the issues primarily under Second Circuit and Ninth Circuit law, with references to Fifth Circuit law where available and appropriate. Because of these courts' experience in overseeing law firm dissolutions, issues raised in (and decisions from) Second Circuit and Ninth Circuit courts provide an extensive blueprint for the legal arguments – pro and con – regarding Clawback Claims.

Clawback Claims can be divided into two types – claims for breach of contract under the law firm's partnership agreement or other contractual relationship with the former partners ("Breach of Contract Claims") and claims for preferences or fraudulent transfers under the Bankruptcy Code or state fraudulent transfer laws (the "Fraudulent Transfer Claims"). Part II of this paper discusses the Breach of Contract Claims – the trustee or plan administrator's basis for asserting them, whether the claims may be subject to arbitration, and the partners' defenses to the Breach of Contract Claims. Part III analyzes the Fraudulent Transfer Claims – including the complicated question of whether partners gave reasonably equivalent value for the distributions received from their failing law firm. Part IV summarizes potential tax issues that partners may face even after their law firm fails – including the dreaded phantom income that may result from the repayment of the failed law firm's revolving line of credit. Finally, Part V identifies unique issues related to pursuing Clawback Claims against foreign partners – partners who reside in the law firm's overseas offices, are not likely to be U.S. citizens, and may not have a direct relationship with the bankrupt law firm whose estate is being administered in the U.S.

II. Breach of Contract Claims

The first category of claims against former partners is state-law Breach of Contract claims. Law firms may have multiple contracts with their partners, including the partnership agreement. The partnership agreement itself typically governs the allocation of profits to partners, the payment of draws, capital contributions, payment and reimbursement of tax advances, etc. Additional agreements may arise from personal loans (including those for capital contributions) and special agreements setting forth the terms of payments or guarantees. Trustees or liquidators of dissolved law firms are charged with pursuing for the benefit of creditors those claims against partners that may arise under the partnership agreement or other agreements with partners.

The most significant Breach of Contract Claims are for the recovery or recoupment of excess draws paid to equity partners. Most law firm partnership agreements provide that payments to equity partners during the year are effectively advances against the distribution of profits for that year. When actual profits for the year are finally determined, each partner is entitled to additional distributions based on the difference between each partner's allocable share of profits and draws (or other payments) received during the year. However, if payment to any partner exceeds that partner's allocable share of profits, that partner is required to repay the excess to the firm.

The obligation to return excess distributions may be substantial. The failure of a firm typically results in large losses resulting from the writedown of accounts receivable and fixed assets. Moreover, a law firm's failure may accelerate certain liabilities, such as lease liabilities, causing them to be charged as expenses to the current year. As a result, a law firm may have little or no profits allocable to the year immediately prior to its failure; at least, profits will be far less than anticipated at the time draws were paid. If a law firm fails at the end of the year, or early in the following year, partners may be required to return all compensation paid during that year. These Breach of Contract Claims against partners are particularly significant because they arise under contract and therefore the trustee does not have to prove any of the elements of fraudulent transfer (such as insolvency or lack of reasonably equivalent value) to have a recovery.

A second type of Breach of Contract Claim against partners is a claim for unpaid capital. There is considerable variability in the manner in which law firms determine the amount that each partner is required to pay or contribute in exchange for his or her partnership interest. In some cases, capital contributions are adjusted on an ongoing basis along with partner compensation, so that even long-time partners can owe capital to the firm. When a law firm fails, unpaid capital contributions are treated as binding and are typically called by the firm or its trustee.

Similar to draws, many law firm partnership agreements provide that the firms will make tax payments on behalf of partners, which payments will be repaid by the partners to the firms. Law firms are "pass-through" entities for tax purposes and such provisions allow firms to pay partners' allocable shares of Federal and state income tax as well as taxes paid abroad on earnings generated by non-U.S. practices. Typically, these tax advances are simply treated as adjustments to partner compensation and deducted from distributions. However, when a law firm fails, tax advances for the prior year generally are unreimbursed, giving rise to additional Breach of Contract Claims against partners.

Finally, law firms may have made loans to their partners that are separate from the firm's partnership agreement whether to fund capital contributions or otherwise. When the law firm dissolves, these loans remain outstanding and the firm or its trustee will pursue repayment

To a former partner, each of the Breach of Contract Claims can equal hundreds of thousands of dollars in liability. Partners, of course, may be expected to assert defenses. Three of these defenses – demand for arbitration, prior material breach, and fraud in the inducement – are addressed here.

<u>First</u>, if the law firm partnership agreement contains an arbitration clause, the partners can demand arbitration. Arbitration benefits the partners by removing the dispute from the bankruptcy court: from the partners' perspective, arguing their case in front of a fact-finder who likely is not favorably disposed to bankruptcy creditors could be a better forum. Arbitration is still difficult for the former partners, however – difficult to pay for, and difficult to obtain. Financially, the partnership agreement may require the partners to share in the cost of arbitration, which increases the cost to the partners who are now paying their own counsel, half of the arbitrator's fees, and continuing to be distracted from their new law practice.

Practically, the partners will have a difficult time removing the state-law Breach of Contract Claims to arbitration because fracturing the core fraudulent transfer claim from the non-core, state-law Breach of Contract Claims would undermine the efficient administration of the bankruptcy estate. In the Ninth Circuit, bankruptcy courts may refuse to compel arbitration where non-core claims are inextricably intertwined with core claims and separating the two will result in piecemeal litigation. *See, e.g.*, *Continental Ins. Co. v. Thorpe Insulation Co.* (*In re Thorpe Insulation Co.*), 671 F.3d 1011, 1021-23 (9th Cir. 2012); *Ackerman v. Eber* (*In re Eber*), 687 F.3d 1123, 1131-32 (9th Cir. 2012) (affirming bankruptcy court's denial of arbitration where court considered "the Bankruptcy Code's objectives, including centralization of disputes concerning a debtor's legal obligations, and protection of debtors and creditors from piecemeal litigation").

Similarly, the Second Circuit permits bankruptcy courts to exercise their discretion to deny the arbitration of non-core claims if arbitrating the non-core claims would interfere with the purposes of the Bankruptcy Code, such as the centralization of the debtor's disputes in bankruptcy court. *See, e.g.*, *MBNA Am. Bank., N.A. v. Hill*, 436 F.3d 104, 108 (2d Cir. 2006); *In re US Lines, Inc.*, 197 F.3d 631, 640-41 (2d Cir. 1999); *In re Winimo Realty Corp.*, 270 B.R. 108, 118 (S.D.N.Y. 2001).

Under the law of both circuits, the liquidator has a strong argument that non-core, state-law Breach of Contract Claims are inextricably intertwined with core Fraudulent Transfer Claims (especially where the monies sought by the trustee are sought under both claims) and therefore the purposes of the Bankruptcy Code would be frustrated by splitting the claim between bankruptcy court and arbitration. Indeed, even if a partner prevailed that the trustee's Breach of Contract Claims should be arbitrated, the bankruptcy court could stay the arbitration until the Fraudulent Transfer Claim has been adjudicated so as to avoid any risk of inconsistent findings. *See, e.g.*, *In re S.W. Bach &*