The Entity Choice for Ozymandias-Limited Liability Partnerships.

By Edwin Reeser

The legal profession has been exposed to difficult times since the world wide “bubble” economy in 1990 popped. Economic distress brought theretofore unheard of responses by law firms. The first and perhaps most dramatic of these more ”business-like” actions survives to this day as the descriptor of a purely economic decision to maintain partner profits at the expense of young associate careers: to be “Lathamed.” The mass layoff technique has been widely embraced by the legal industry, and used repeatedly by numerous firms. Being first at something dramatic can come with a brand that lasts a long time, even after becoming industry standard.

The size of firms, and complexity and risk of the matters they handle, began to increase substantially in the 1970s and has continued to this day. Law firms were typically general partnerships, with unlimited joint and several liability for all partners. You assumed this liability if you wanted to be partner in a large law firm. Active involvement in firm management, associate training and mentoring, and partner selection was standard. Much attention was paid to who was doing what, who became partner and what types of work the firm engaged in. Associate letters and enclosed work product were commonly reviewed and approved by a supervising partner, with their initials on the file copy. However, governance methods, operating procedures and protocol that worked when firms had 20, 50, even 70 partners, became increasingly difficult to administer with 100 or more partners.

The LLP form arose and was widely adopted in the middle 1990s, partially in response to the liability shock from the professional accounting and law firm failures that transpired in the late 1980s. An election for qualifying professional partnerships, the firms are still governed by the Uniform Partnership Act.

There has been a significant change in the way partners approached partnership since the advent of LLPs. The new approach became, "I don't have to care as much about what the partner in the office next to me, down the hall, downstairs, in another city or in another country is doing because I won't be liable for the loss anymore. No more unlimited joint and several liability exposure. I am limited to my capital investment in the firm as the measure of liability. With many clients, strong skill sets and a good reputation, I can start over anywhere. I can concentrate on my work, avoid politics and the nonsense of firm governance. It matters not that control of the firm is delegated to others, or what their decisions might mean to the survival of the enterprise." That flawed assumption for many helped facilitate significant changes not only in the discipline of practice, but in law firm governance and participation of partners in the operation of their own firms. The transition to “law as a business” also promoted “more corporate like” leadership and control in the hands of fewer and fewer people. Lateral mobility began to pick up in this era as well, as barriers to entry were lowered. Growth through mergers and opening of new offices became much easier to accomplish. Transparency in financial reporting and compensation in many firms disappeared.

The economy on its knees in 1992 from financial industry ills (remember savings and loans?), recovered by 1995-96, and profits for law firms increased dramatically. Firms dramatically expanded the number and breadth of their practices and grew in size, interrupted briefly by the dot-com crash in 2001, followed by the terrorist attack in New York and D.C. on Sept. 11, 2001. The economy regained momentum well into 2007, though there were clear warning signs by early 2006 that the cycle was turning down. That boom growth period from 1995 through 2007 masked with strong profits and cash flows some difficult problems firms were building into their business models. Leadership in many firms did not drive success as much as they rode it. When the Great Recession of 2008 fell upon the world, again from serious ills in the financial industry, (remember Bear Stearns and Lehman Brothers?) the structural and operational weaknesses of the business model of many law firms were revealed.

Much of what partners thought about their personal risk of loss in a failed firm turned out to be incorrect. While it was correct that the LLP limits individual partner investment risk to amounts committed to the enterprise, it was incorrect to assume that was the limit of partners' liability, because of the bankruptcy laws.

When LLP elections were being made the broad perception was that big law firms did not go bankrupt, even when they went out of business, the 1987 failure of Finley, Kumble, Wagner, Heine, Underberg, Manley, Myerson & Casey being one notable, but easily distinguishable exception. While there were large law firms, the aggregate population of lawyers in the 100 largest law firms in 1992 was a fraction of what it is today. Law firms also didn't tend to have much debt. There were not compelling reasons to chase after individuals for disgorgements, and bankruptcy wasn't an attractive proposition for creditors.

Today the situation is different.

The vastly greater size of many firms, use of bank debt, and number and amount of claims involved make appointment of a trustee and the pursuit of individual stakeholders for disgorgement of their draws for periods prior to the collapse a viable economic exercise in more cases.

This is especially so for clawbacks of distributions made during the pre-bankruptcy filing period when the law firm was insolvent. The [*Jewel v. Boxer*] "unfinished business" clawforwards have also garnered recent attention. See 156 Cal. App. 3d 171 (1984). Irrespective of how the "unfinished business" issue is resolved, it is an element that in recent law firm failures amounts to a small fraction of the clawback liabilities. In Dewey & Leboeuf LLP's case, estimates of disgorgement exposure to partners is in excess of $400 million, while Jewel claims were estimated, perhaps optimistically by counsel for the estate, at $60 million. Constructively fraudulent distributions to partners as insiders during a period when the firm may be determined insolvent are not under reconsideration by the courts.

The scope of liability exposure hit hard with the 2003 Brobeck, Phleger & Harrison LLP failure. Though firms across the country had the opportunity to closely observe what was happening and why, most did not adjust their methods. Rather, firms distanced themselves from Brobeck's fate by quickly concluding they were sufficiently different that it couldn't happen to them. Bankruptcy disaster for law partners is now in full swing with Thelen LLP, Heller Ehrman LLP, Coudert Brothers LLP, and soon Howrey LLP. It isn't over with Brobeck after nine years. Dewey avoids the worst outcome as the plan of settlement was Court approved though the decision will undoubtedly prove controversial. (See, "Do Partners Really Want to Save Their Law Firms?" Managing Partner, August, 2009.)

We have experienced more than two decades of structural, operational and firm governance evolution for the entities that practice law, much of it premised upon a central assumption of partner liability exposure that was incorrect.

We have seen that improving the value proposition for clients doesn't have enough power to overcome the operational inefficiencies inherent in current practice.

We have seen that decrying the loss of “culture” in law firms has fallen on deaf ears.

We have seen that money as a motivator and management tool doesn't work in law business any more than it does in other business, and yet we gravitate more towards it.

We have seen that with the lack of transparency the typical equity partner in a large law firm has no idea of the risk of the true financial condition of their own firm, the potential for its failure, or the scope of their own personal liability.

So what is a compelling reason to confront, embrace and resolve the challenge?

How about change what you are doing with the structure, operation and governance of your practice as a business, or virtually assure the extreme risk of losing all that you have worked for your entire professional career?

If you don't, it isn't because your firm is "different" or you are “different” and this doesn't apply to you or your firm. It is because you are the same and you haven't the courage to face up to it. I didn't like the answer either. But it is the one that is correct. Do it together if you can, and if together you cannot, then do what you must on your own.

But don’t be caught posing for the next sculpture of Ozymandias.

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