The Lawyers' Lawyer Newsletter

Recent Developments in Risk Management

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The 'Unfinished Business' Rule – Fraudulent Transfers – Risks in Hiring Attorneys From Failing Law Firms

***In re Heller Ehrman LLP*, Bankruptcy Case No. 08-32514DM; *Heller Ehrman LLP, Liquidating Debtor, v. Jones Day, et al.*, Chapter 11 Adversary Proceeding No. 10-3221DM, Memorandum Decision on Motions and Cross-Motions for Summary Judgment (Bankr. N.D. Cal. Mar. 11, 2013)**

Risk Management Issues: What are the special financial risks potentially faced by firms seeking to hire lawyers laterally from firms that dissolve? What is the meaning and scope of the "unfinished business" rule - at least under California law as viewed by the Bankruptcy Court for the Northern District of California? What can hiring firms do to mange the risks of the application of the rule in connection with lawyers whom they hire – and what can firms generally do to prevent the issue from arising? What are the implications of this case in the light of the two opposite decisions from the US District Court for the Southern District of New York (discussed in the November 2012 issue of the Lawyers' Lawyer) on the future of the unfinished business rule – and how should firms deal with the risks while the uncertainty continues?

The Case: In 2008, after a global law firm defaulted on its loans, its partners voted to dissolve the partnership pursuant to a written dissolution plan. The dissolution plan included a provision commonly referred to as a "*Jewel* waiver." The term refers to a California appellate decision, *Jewel v. Boxer*, 156 Cal. App. 3d 171 (1994), in which the court held that when a lawyer moves from a failing firm to a new firm, the new firm and the lawyer must pay the failed firm any profits on unfinished business taken to the new firm. The law firm's "*Jewel* waiver" provision waived the firm's rights and claims to seek payment of legal fees generated after the departure date of any lawyer or group of lawyers with respect to unfinished firm business. After the dissolved law firm filed for Chapter 11 bankruptcy, its plan administrator sued various law firms, to which former partners of the dissolved law firm transferred, to recover profits those firms earned while completing former the dissolved-law-firm client matters that were pending, but unfinished on the date of the dissolved law firm's dissolution.

The dissolved law firm's plan administrator moved for summary judgment against all defendants, arguing that the *Jewel* waiver constituted a fraudulent transfer to the defendant law firms under both federal and California law. U.S. Bankruptcy Judge Dennis Montali first concluded that "unfinished business" meant "any business covered by retainer agreements between the firm and its clients for the performance of partnership services that existed at the time of dissolution," and that such unfinished business was the dissolved law firm's property absent the disputed *Jewel* waiver.

Judge Montali next concluded that the partners who left the dissolved law firm and joined defendant law firms did not provide "reasonably equivalent value" to the dissolved law firm in exchange for the *Jewel* waiver. Judge Montali reasoned that there was no evidence that any partner would have refused to execute the dissolution agreement absent the *Jewel* waiver. Thus, the *Jewel* waiver was not given to the departing partners in exchange for anything. Based on these conclusions and his finding that the dissolved law firm, at the time of the *Jewel* waiver, was incurring debts that were beyond its ability to pay, Judge Montali ruled that, notwithstanding the *Jewel* waiver, the transfer of the dissolved-law-firm matters to defendant law firms constituted a fraudulent transfer.

The 'Unfinished Business' Rule, continued on page 2

Judge Montali then looked to whether defendant law firms had any affirmative defenses to the fraudulent transfer claim. He determined that those law firms were "subsequent transferees" of the fraudulent transfers, in that the departing partners transferred to them unfinished business "free of any burden to account for profits." Under federal and California law, a subsequent transferee may be protected from recovery by the plaintiff, but only where the transferee "gave value" for the transferred property "in good faith." Judge Montali found that while defendant law firms bestowed many benefits on the former partners of the dissolved law firm, such as office space, staff and compensation, none were in exchange for the *Jewel* waiver, as defendant law firms all provided evidence that they did not hire the partners based on their unencumbered unfinished business. Because the benefits provided to the incoming partners would have been provided even without the *Jewel* waiver, defendant law firms could not take advantage of this affirmative defense.

Based upon the existence of a fraudulent transfer and the lack of any affirmative defense by defendant law firms, Judge Montali granted the dissolved law firm's motions for summary judgment and ordered a trial to determine amount of money earned by defendant law firms as profit on the unfinished business from the dissolved law firm.

Comment: This case is the latest in the series of recent decisions involving the "unfinished business" rule. See prior issues of the *Lawyers' Lawyer* newsletter: Volume 17, Issue 3, September 2012, discussing *Development Specialists, Inc. v. Akin Gump Strauss Hauer & Feld, LLP, et al.*; and Volume 17, Issue 5, November 2012, discussing *Geron v. Robinson & Cole LLP, et al.*, 2012.

Risk Management Solution: Even if the *Geron* case is very clearly upheld on appeal, and the *Development Specialists* case is rejected as to New York law, and the unfinished business rule is abrogated as to hourly fee cases in New York, the rule will remain a problem as to cases where California law governs, as demonstrated by this decision. Accordingly, hiring firms' due diligence efforts continue to be significantly complicated. Confidentiality obligations generally prevent a potential lateral from revealing the contents of his or her current firm's partnership agreement, but educating a lateral on the issues that the rule presents — both for the lawyer and the hiring firm — and seeking assurances regarding those risks (e.g., that the lateral's current firm is not about to dissolve, and whether or not the current firm's partnership agreement contains an anti-Jewel provision) is reasonable and prudent for hiring firms. Once a lateral lawyer has given notice to his or her solvent former firm and clients have responded to joint notification letters, it may be worth considering whether there is an opportunity to negotiate a fee division with the former firm to avoid the potentially devastating effects of a Jewel claim years later. The opposite, of course, is true when a prior firm is insolvent because agreements that divert assets from an organization on the verge of bankruptcy are risks arguably not worth taking.

Other due diligence procedures may also be worthwhile, if more uncertain, to avoid or at least limit the possibility of these claims. For instance, careful research of publicly available information about the firm which the lateral prospect wishes to leave may produce useful intelligence about the firm's long-term prospects. Similarly, even firms that resist using "headhunters" to identify potential recruits may wish to consider engaging one or more of these professionals to act as consultants — extra eyes and ears to the market place — to identify firms where there are signs of incipient problems, such as a rash of resumes on the marketplace. Finally, whenever there is the slightest perceived risk that the rule will be applied to work being brought by the lateral to the hiring firm, the financial terms offered to laterally moving lawyers are likely to be significantly circumscribed.

Additionally, law firms generally may seriously consider adopting so-called anti-Jewel provisions, while they are still going concerns, in order to avoid the problems posed to both partners who leave the firm and the firms to which they seek to move, if the prior firm subsequently dissolves. An example of such a provision might be:

The [partners/shareholders/principals] each acknowledge the duty to complete work undertaken for clients while with the firm. However, all [partners/shareholders/principals] and [name of entity/firm] waive any and all rights to receive payment of legal fees generated from unfinished business after dissolution or fees generated by any departing lawyer or group of lawyers following their departure in connection with matters that were in-progress at the time of departure. Following dissolution, each lawyer or group of lawyers shall be solely entitled to the post-dissolution fees they generate from the winding up of [entity/firm name's] unfinished business.

Statute of Limitations – Termination of Representation – Continuing Representation – The Need for Closing Letters

***Perkins v. American Transit Insurance Company*, 2013 WL 174426 (Jan. 15, 2013 S.D.N.Y.)**

Risk Management Issue: What can lawyers do to avoid the risk that they will be found to have engaged in continuous representation that prevents the assertion of a statute of limitations defense against a client who later sues for malpractice?

The Case: This case involved a dispute between a policyholder's bankruptcy estate and the insurer and the lawyers engaged to represent the policyholder, after a judgment was entered against the policyholder in excess of the policy limits. The underlying case was a lawsuit arising out of an automobile accident.

The insurer engaged the first law firm to represent the policyholder in the underlying lawsuit in 2003. That lawsuit proceeded through discovery toward trial, and in July 2005 the insurer decided to hire a second law firm to try the case. A substitution of counsel was filed on behalf of the policyholder, and the second law firm replaced the first law firm as counsel of record in the underlying case. According to the policyholder, this substitution of counsel took place without his knowledge. In October 2005, the matter was tried, and a jury entered a verdict in favor of the plaintiff for $1.5 million, well in excess of the policy limits.

The plaintiffs exhausted the policyholder's insurance and then proceeded against his personal assets. The policyholder filed for bankruptcy, and in July 2010, the bankruptcy trustee sued the first law firm (and others) for legal malpractice on behalf of the bankruptcy estate. The first law firm moved to dismiss, arguing that New York's three-year statute of limitations had expired due to the fact that the lawsuit was filed approximately five years after the attorney-client relationship between the policyholder and the first law firm had terminated.

The bankruptcy trustee responded that there was a question of fact as to whether the first law firm continued to represent the policyholder even after the second law firm was substituted in as new counsel. Under New York law, the statute of limitations can be tolled based upon the "continuous representation" doctrine, if there is ongoing representation connected to a specific matter and clear indicia of an ongoing, continuous, developing and dependent relationship between the attorney and client.

An attorney from the first law firm testified that after the substitution was filed, the first law firm would generally make itself available for "lay of the land" questions from the second law firm. He also admitted that the first law firm reviewed the second law firm's bills to make sure that the amount charged was appropriate and that there was a record of activity in the court which corresponded with charges.

In ruling as a matter of law that these activities did not amount to a continuous representation of the policyholder by the first law firm, the court stated that the attorney-client relationship is marked by an individual communicating with an attorney in his capacity as such, for the purpose of obtaining legal advice. The court also noted that it is common for law firms to have contact with each other for background purposes when a case is being transitioned from one to another. The court determined that this exchange of information between the first law firm and

Hinshaw & Culbertson LLP
222 North LaSalle Street
Suite 300, Chicago, IL 60601
312-704-3000
www.hinshawlaw.com
www.lawyeringlaw.com

Editors:
Anthony E. Davis and
Daniel E. Tranen

Contributors:
Jeffrey McAllister, Katherine G.
Schnake and Daniel E. Tranen

successor counsel did not amount to further representation of the policyholder by the first law firm. The court also found that the bill review was conducted for the benefit of the insurer, not the policyholder, because it was the insurer that was paying the second law firm's bills.

The bankruptcy trustee further argued that because the substitution of counsel took place without the policyholder's knowledge, it was ineffective to terminate the attorney-client relationship between the first law firm and the policyholder. The court rejected this argument based upon the fact that the insurer controlled the defense. The court found that the policyholder impliedly authorized the insurer to act as his agent in obtaining lawyers to defend him, and therefore, impliedly gave the insurer to power to change lawyers for the policyholder without obtaining formal consent.

The court found that there was no genuine issue of material fact as to the date of the first law firm's termination as attorney of record for the policyholder. Because this date was more than three years before the initiation of the lawsuit, the malpractice claim against the first law firm was time-barred.

Risk Management Solution: The first law firm was fortunate to be let out of the lawsuit on summary judgment based upon its statute of limitations defense. This circumstance highlights the importance of utilizing a clear and unequivocal "closing letter" to mark the termination of an attorney-client relationship, even when a firm is replaced on the record during the course of litigation.

Such a letter should be addressed to the client and it should note that the relationship is terminated as of a specific date. The letter should indicate that the firm will cause an orderly transfer of the files to new counsel and will be available to answer any questions necessary to help the new firm take control of the case, but will no longer be providing legal services.

In *Perkins*, such a letter would have avoided any question about when the attorney-client relationship ended, whether the policyholder was aware of the substitution of counsel or whether the first law firm was continuing to provide legal services to the policyholder after the substitution took place, and would likely have avoided the claim and the need to defend it.

Multijurisdiction Practice (MJP) – Compliance With Local Ethics Rules – Contingency Fee Agreements Containing Invalid Provisions

***Forbes v. St. Martin, et al.*, 2013 WL 791847 (Miss. App. 2013)**

Risk Management Issue: What ethics rules apply when lawyers undertake representation of clients in jurisdictions where they are not admitted? Which jurisdictions' ethics rules apply, and what are the effects of failure to comply with the applicable rules?

The Case: Plaintiff client was injured in a gas explosion in Mississippi and was in a coma. A relative of plaintiff contacted a Louisiana attorney (attorney) and asked him to travel to the hospital to visit plaintiff and his wife. Two days later, the attorney met with the client's wife and spoke with her about representing them in a personal-injury lawsuit. The client's wife agreed to hire the attorney and executed a contingency-fee contract that provided, in pertinent part, that the case could not be settled without the attorney's approval and that he could only be fired under certain circumstances. The attorney gave the client's wife $700 in cash for living expenses after she signed the contract. He did not see or speak with the client that day, nor did the client sign the contract.

Multijurisdiction Practice (MJP), continued on page 5

Because the attorney was not a licensed attorney in Mississippi, he associated with a Mississippi attorney as his co-counsel (co-counsel). The attorney and co-counsel agreed to split any fees on a 50/50 basis. Co-counsel drafted a personal-injury complaint and listed the attorney as "of counsel."

Two months after the wife's signing of the contingency fee agreement, the attorney visited the client in the hospital. The client was no longer in a coma. There was disputed evidence as to whether the client ratified the contract at that time. The attorney testified that he asked the client to sign a contract but the client's injuries prevented him from using his hands. The client testified that he did not remember being asked to sign a contract but he knew that his wife had retained the attorney as his attorney and that she had signed a contract under which the attorney would be compensated for his efforts.

The client was eventually discharged from the hospital and he and his wife met with the attorney. Upon the attorney's recommendation, they rejected a $5 million settlement. Additionally, the attorney convinced the client and his wife to execute a second contingency fee contract that changed the attorney's compensation and prohibited his termination. The personal-injury claim was eventually settled for $13.6 million, resulting in attorneys' fees of $4.6 million.

The client thereafter asserted claims for breach of fiduciary duty, professional negligence, fraud and misrepresentation, conversion, rescission, imposition of a constructive trust, *quantum meruit*, attorneys' fees, and actual and punitive damages against the attorney. Essentially, he challenged the validity of the two contingency fee agreements and the attorney's right to recover attorneys' fees and expenses based upon the attorney's improper conduct. After the lower court granted summary judgment in favor of the attorney, the client appealed.

On appeal, the client first argued that the contracts were void because of the attorney's improper solicitation and inducement in the form of cash payments. The attorney admitted that he had given the client and his wife nearly $100,000 during the pendency of the case. The attorney argued that a significant portion of the cash advances were used to pay the client's medical expenses, but he admitted that he made cash advances for a Bahamian vacation, a Caribbean cruise, a car, cell phones, and other personal expenses. The court found that the cash advances were in violation of Miss. R. Prof'l Conduct 1.8(e), which prohibits lawyers from providing financial assistance to a client in connection with pending or contemplated litigation. Although the attorney argued that such actions were permissible in Louisiana, the court found that his co-counsel's knowledge of these payments could render the contract void based upon the violation of the Mississippi Rules.

The client also argued that the cash advances amounted to undue influence and that the contingency-fee contracts were void as a result. He argued that the attorney violated the Mississippi statutes on maintenance and champerty, which prohibits a person, firm, partnership or corporation to promise, give or offer "any other thing of value, or any other assistance as an inducement to any person to commence or to prosecute further, or for the purpose of assisting such person to commence or prosecute further, any proceeding in any court." Miss. Code Ann. § 97-9-11 (Rev. 2006). The court noted that the improper advancement of money to a client is a violation of law and creates a conflict of interest. The policy reason for this rule is that unregulated lending to clients would generate bidding wars for cases among lawyers. For this reason as well, summary judgment in favor of the attorney was overruled.

The client also argued that the contingency fee contracts were void because the attorney engaged in the unauthorized practice of law in Mississippi. Because the issue of whether the unauthorized practice of law voids a contract for legal services was a matter of first impression in Mississippi, the court examined cases from other jurisdictions, which focused on the connection between the domicile of the lawyer and the events of the case. The court noted that there was no connection between the client, his accident, his injuries or his damages and the state of Louisiana. The litigation could only be filed in Mississippi and decided on Mississippi law.

As a result, the appellate court found that the attorney offered to represent the client in a legal matter that he knew he could not handle based on his law license. Moreover, although the attorney did not file an entry of appearance in the client's case or sign any pleadings, co-counsel included the attorney's name as "of counsel" on the complaint and the attorney appeared before the Mississippi courts for at least two months, gave legal advice to the client and attended depositions. Accordingly, the court held that there was a genuine issue of material fact in

Multijurisdiction Practice (MJP), continued on back

dispute as to whether the attorney and his firm were engaged in the unauthorized practice of law and reversed the lower court's granting of the attorney's motion for summary judgment.

The appellate court also held that second contingency fee contract was void. After the client rejected the $5 million settlement offer, the attorney asked them to sign another contingency fee contract. The client testified that when he signed this agreement, he was still under the influence of a considerable amount of medication, including Prozac, Xanax and Risperda. The attorney argued that no written contract was necessary, but once settlement discussion began, he realized that he needed a contract to secure a contingency fee as opposed to an hourly or *quantum meruit* fee.

The attorney and the client had dramatically differing accounts of the circumstances under which it was entered. The court held that the version of events put forward by the client and his wife suggested that the attorney took undue advantage of them, making the transaction presumptively fraudulent. This created a fact question that did not allow for summary judgment in favor of the attorney.

The court further held that the attorney had no right to limit his clients' ability to settle the lawsuit or ability to terminate the attorney as their attorney. The court held that clauses in a contingency fee agreement that included an anti-settlement or anti-termination clause are void and against public policy. *Zerkowisky v. Zerkowsky*, 160 Miss. 278, 286, 131 So. 647, 648 (1931).

The court concluded that the invalid provisions of the contingency fee agreement may render the entire agreement void. Because the client presented sufficient evidence to establish that there was a genuine issue of a material fact in dispute, the lower court erred and the attorney was not entitled to summary judgment. The case was reversed and remanded for further proceedings.

Risk Management Solution: This case is the most recent in a long line that demonstrate the risks of engaging in multijurisdiction practice (MJP) without first researching the applicable ethics rules. In states that have adopted Model Rule 5.5(c)(1), lawyers may provide legal services on a temporary basis by meeting one of several alternative conditions, one of which is associating with a lawyer who is admitted to practice in that jurisdiction and who actively participates in the matter. However, that does not resolve what rules will be applied to govern the foreign lawyer's conduct. Typically in litigation the law and ethics rules of the jurisdiction where the case is pending will apply (See Model Rule 8.5).

Accordingly, even when engaging in MJP in compliance with Rule 5.5, it is critical that lawyers engaging in the practice of law in a foreign jurisdiction to carefully review and conscientiously abide by the local rules of professional conduct. Not only do those rules govern the lawyer's conduct on behalf of the client in the foreign jurisdiction, but they also govern the lawyer's relationship with his or her client. Acceptable practices in the lawyer's home jurisdiction may not be acceptable in the context of MJP.

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