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LAW FIRM PARTNERSHIP AGREEMENTS: WHO NEEDS 'EM?

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Whatever your reasons for putting off preparing a written partnership agreement, they're probably not good enough.

You and each of your partners[1] have joined the firm because you agree on basic things. You agree about how a law practice should operate. You agree about how compensation should be determined. You have never had a dispute about new hires, office space, firm finances, or anything else. You have all become good friends and will practice together until retirement. Even if someone did choose to leave, the parting would be friendly and you would all remain on the best of terms. Wanna bet?

The hard truth is that law firms are subject to the same changes as every other relationship in our modern society. Marriages break up. Your children grow up, leave home, and strike out on their own. Corporations are dissolved or acquired. Businesses fail or they prosper to the extent that spin-offs become inevitable. Law firms are not immune from change. The chances are very good that in two years your law firm will be very different from what it is today. For some, that prediction may be good news. For others, any change represents trouble in paradise.

Because change is inevitable, a written agreement defining the relationship between you and your partners is important—just as important as the written agreements you help your business clients with every day. This is true whether your firm is organized as a partnership, a professional association, a limited liability corporation, or a professional limited liability partnership. However, it is also necessary to recognize the distinctions between a law firm and a typical business entity. The Rules of Professional Conduct and related case law limit the extent to which a law firm can be operated as a typical business and point up the tension between the traditional notions of the law as a "learned profession" and the new reality that we are engaged in just another business.

There are three aspects of a law practice that are most likely to lead to disputes and conflicts among the partners. First, what are the rules that govern the relationship among partners? This includes issues such as expectations for billable hours, responsibility for client development, and means of determining compensation. Second, how are new partners added to the firm? Third, what happens when one or more of the partners wants to leave or the firm wants them to leave? Each of these areas is a fertile ground from which disputes can and will arise. Each should, therefore, be addressed in some fashion in a written agreement

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among the partners. In addition, because it is impossible to anticipate every possibility, the agreement should include a dispute resolution mechanism.

How Partners Relate To One Another

As a starting point, you should realize that the absence of a written agreement with your partners does not mean that your relationship is completely without rules. Rather, it means that the relationship will be governed by rules created by the Legislature and the courts. (That thought alone should motivate you to begin work on an agreement.) If your firm is organized as a partnership, it will be subject to the statutory guidance provided for partnerships by Minnesota Statutes Chapter 323.[2] Likewise, if your firm is organized as a corporation, a "PA," or one of the new "PLLPs," aside from whatever other formal or informal agreements you make with your partners, the firm must abide by certain statutory rules.[3] In addition, your relationship with your partners will be governed by ethical rules and related case law, and employment law concepts such as "at will" employment.

To a substantial extent, you and your partners can determine your own rules for governing your relationship. The partnership statutes, the corporate statutes, and the PLLP statutes all provide considerable flexibility within the guidelines provided by the Legislature. The only other significant limits on your ability to structure your own relationship are found in the ethical rules.

The Rules of Professional Conduct reflect the traditional view of legal services as a "learned profession" that must be operated somewhat differently than other businesses. Because the practice of law includes a public service aspect, the rules that govern law firms are different from those for other businesses that provide professional services. As a result, there are a some prescribed limits that you cannot change by means of an agreement with your partners.

These rules cannot be altered by contract. For example, your firm's capacity to do work for certain clients may be restricted by the rules concerning conflicts of interest, regardless of whether you and your partners agree to undertake the work.[4] In general, you may not include nonlawyers as partners, even if they are engaged in a service connected with your firm's business, such as government relations representations.[5] As is discussed in more detail below, the rules also restrict the capacity of partners to enter into noncompete agreements and certain arrangements for fee-splitting.

How Are New Partners Added

Who decides if a new partner should be added to the firm? What are the criteria for that decision? Are the criteria different for a lateral hire as compared to the promotion of an associate? To what extent does the new partner become responsible for the existing obligations of the firm? These questions and the importance of carefully considered answers are even more significant in the context of a potential merger—the simultaneous addition of several new lateral hire partners (who may have developed their own ways of relating to each other).

There are no "right" answers to these questions; it is only important that you and your partners answer them. Sooner or later, it is likely that you will be faced with these issues. It will be easier to think about them in a logical, dispassionate way before the new partner

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candidate is standing on your doorstep. By addressing these issues in a written partnership agreement, everyone will know what the rules are when the situation arises and you will have minimized the chances for internal conflict.

Adding a new partner from another firm can also cause a collision between your firm's business objectives and the ethical rules. Rule 1.10(b) of the Rules of Professional Conduct prohibits a firm from representing a client "in the same or a substantially related matter in which that lawyer, *or a firm with which the lawyer was associated*" had previously represented another client with interests adverse to the first client. That means that Rule 1.10, with its principle of "imputed disqualification," may prohibit your firm from representing new clients or even continuing to represent existing clients once you have added a partner (or, for that matter, any lawyer) whose prior firm had a client with interests adverse to your client's. To avoid such problems, you should consider establishing in your agreement or elsewhere a firm policy regarding thorough disclosure and investigation of potential conflicts created by a new hire.

When lawyers are being hired from another firm, you and your partners should also consider what can be expected about the new lawyers' capacity to bring along client fees. The Rules of Professional Conduct generally preclude fee-splitting between firms unless the split is in proportion to services performed, the client consents, *and* the total fee is reasonable.[6] Fee-splitting upon the transfer of a client from one firm to another usually does not cause any problem when the client pays for hourly work.

It is much more difficult with contingent fee work to determine what is a fair proportional division of the fees. Upon transfer of the case, the initial firm may file an attorney's lien for the "reasonable value of the services" it provided.[7] A significant body of case law has developed in Minnesota (and elsewhere) surrounding the question of what is "reasonable value" and the factors used in measuring that value.[8] These issues may affect your decisions about adding a new partner and, as a practical matter, the economics of representing a client whose case may have been primarily worked up by another firm.

What Happens When A Partner Leaves

Like persons in any other relationship, partners leave their law firms in one of two ways—voluntarily or involuntarily. In either case, there are very serious issues for the firm and the remaining partners. These are the issues that most often result in bitter, hard-fought disputes that closely resemble divorces. Why? Because they will involve a struggle over the very core of the law firm's business—its clients. In addition, the fact that clients will be the focus of the struggle means that this area of potential dispute among partners is the one where the rules provide for the least flexibility. That said, a well-drafted written agreement can still go a long ways toward encouraging a peaceful departure.

I. UNDER WHAT CIRCUMSTANCES CAN A PARTNER BE FORCED OUT?

Although you are on the best of terms with your partners now, there may come a time when relations are not so cordial. You may reach the point where you can no longer tolerate your partner's lax work habits, or the seeming remarkable change in personality, or the fact that you believe he or she is stealing from the firm, or any myriad of other problems. Likewise, your partners' perception of how great it is to practice with you may change.

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If there is no written agreement, statutory law and common law concepts like fiduciary duty are going to control whether a partner can be forced out of the firm. On the other hand, with a written agreement, you and your partners can mutually decide now what future behavior is egregious enough to justify termination from the firm. An added advantage is that the offending partner will have already agreed that particular conduct justifies termination. The only question left for resolution will be whether that conduct occurred.

II. HOW AND WHEN WILL CLIENTS BE NOTIFIED OF THE DEPARTURE?

Because the departure of a lawyer, whether voluntary or involuntary, usually involves a struggle over clients, the issue of notice to the clients is often hotly contested. A departing lawyer who gives notice too soon may be accused of breach of fiduciary duty or the duty of loyalty. Either the law firm or the departing lawyer may, intentionally or not, say something to clients that will lead to a defamation or tortuous interference claim. Clients can feel betrayed when they are given very short notice of their need to choose between continued representation by the departing lawyer or the law firm.

All of these issues can be readily addressed in a written agreement among the partners. The agreement should spell out in some detail the notice that the departing lawyer will give to or get from the firm, the information that will be provided to the clients, when that information will be provided and by whom, and how the clients' wishes for future representation will be ascertained and met.

Some significant limits are imposed on what the partners can agree to in this area. A partnership agreement that purports to divide up clients in the event of a lawyer departures will probably be found to violate the important principle of clients' freedom to choose their counsel. Case law has established that a client may terminate its business with a lawyer at any time, for any reason.[9] When a client pulls its business from a law firm, it is viewed as a "termination" of the representation agreement, not a "breach." Also, a body of law has developed attempting to define the point at which a lawyer's efforts to lure a client to a new firm prior to the lawyer's departure from the old firm improperly infringes on the client's proper freedom to choose a lawyer. Solicitation of clients may also be restricted by Rule 7.1 of the Rules of Professional Conduct, which prohibits false or misleading statements about a lawyer or the lawyer's services.

Some law firm break-up cases involving competition for clients have focused on the Rules' prohibition on communication that creates "unjustified expectations," or compares one lawyer's services with those of another when the comparison cannot be substantiated.

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A proposed division of clients or any other restriction on competing for clients after departing the law firm will probably also be unenforceable as a violation of Rule 5.6 of the Rules of Professional Conduct. For most professions, courts will enforce post-employment covenants not to compete if the agreement satisfies a "reasonableness" test that balances the interests of the employer, the employee, and the public. For lawyers, however, another law prevails. Rule 5.6 *prohibits* any agreement that restricts "the right of a lawyer to practice after termination" of a law firm relationship, unless the agreement concerns retirement benefits. Some courts have begun to treat law firms more like other businesses and permit "reasonable" non-compete agreements,[10] but so far the little case law on the topic suggests that Minnesota courts are likely to be skeptical of lawyers' non-compete agreements.[11]

III. HOW WILL THE DEPARTING PARTNER BE COMPENSATED FOR HER OR HIS OWNERSHIP INTEREST IN THE FIRM?

In most instances, the term "partner" indicates, among other things, an ownership interest in the firm. If that is true, then a departing partner has a presumptive right to be compensated for her or his interest in the firm. Once again, the procedure for providing such compensation and its extent can be defined by a written agreement among the partners. And, as in the other areas discussed above, if such an agreement is not reached, the law will dictate how and how much the departing partner gets for the ownership interest.

Regardless of whether the firm is organized as a partnership, a PLLP, or a corporation, the absence of a buy-sell agreement creates uncertainty about how a partner's interest will be valued. Unless there is an agreement to the contrary, the withdrawal of a partner from a partnership results in dissolution of the partnership.[12] Upon dissolution, partners are entitled only to an equal share of any profits or surplus remaining after all creditors and other obligations have been paid, including any capital contributions or advances made by partners.[13] Firms organized as PLLPs are faced with a similar valuation problem if they don't include a valuation formula in their agreements, since PLLPs, are modeled primarily on the limited partnership statutes.[14]

In firms organized as corporations, a departing lawyer faces similar uncertainty when there is no prior agreement between the partners. A shareholder in a law firm corporation, like other owners of closely held corporations, has no easy means to value and sell his or her interest in the corporation. The shareholder has a statutory means to force the corporation to buy the shares and determine their value, but only if the shareholder dissents from a fundamental change in the corporation or is treated unfairly by other shareholders.[15] Otherwise, a departing shareholder may be stuck holding the shares without any right to demand payment for them.

Some of the uncertainty in buying out a departing partner can be avoided by including a buy-sell provision in your agreement. The buy-sell provision should, at a minimum, provide a method for valuing the firm's business and a process for resolving a dispute about how to apply the method. The method often includes a formula that takes into account the firm's receivables and work in progress, as well as the usual business assets and liabilities. Some of the difficulty of valuing a law firm may be alleviated by the new Rule 1.17 of the Rules of Professional Conduct, which now permits the sale of law practice under certain conditions, so long as the practice is sold "as an entirety."

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How Will Future Disputes Be Resolved

Many agreements that we encounter come in contact with daily include dispute resolution mechanisms. These mechanisms typically define the method by which a dispute will be resolved, the place or venue, the person or entity that will be authorized to resolve the dispute, and the rules that will be followed in presenting and resolving the dispute. Why not have such a provision in the written agreement between you and your partners?

One reason to leave it out would be to assure that any dispute is resolved through the courts with the attendant public filings and disclosures. The newspapers love a story about lawyers fighting with each other, especially over seemingly trivial matters. Another reason to leave it out would be to make certain that any dispute will be as costly and time consuming as possible to all concerned. Without an agreed upon dispute resolution mechanism, you can fight first about how, when and where to fight, and avoid getting to and resolving the merits of the dispute for weeks, if not months. Sarcasm aside, for most firms it makes tremendous good sense to agree now (while there is no pending dispute) about a method for resolving disputes if they arise.

The chances are that this article has not told you much that you didn't already know—*if* you took the time to think about it. You probably have given similar advice to people in other types of businesses many times in the past months. The chances are just as good, however, that you have not taken the time to talk with your partners and reach an agreement that addresses the issues discussed in this article. Maybe it's too time consuming. Maybe it's too awkward or embarrassing to raise the possibility of future disagreements about how the firm operates. Whatever the reason, it's not a good one. Your agreement does not have to be long or intricate; it just has to spell out how you and your partners want to govern your relationship. Finally, if you have not made an agreement because you know that you are never going to face any of these problems, please call us when it comes time for you and your partner to square off in court.

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1. The term "partners" is used broadly to refer to partners, shareholders, members, or any lawyer with an ownership interest in a law firm, however defined.

2. See generally Minn. Stat. Ch. 323; Minn. Stat. § 323.17 *(rights and duties of partners determined "subject to any agreement between them," by rules provided in this section).*

3. See Minn. Stat. Ch. 319A and 322B.

4. See Minn. R. Prof. Conduct 1.7-1.10.

5. Minn. R. Prof. Conduct 5.4(b) and (d).

6. Minn. R. Prof. Conduct 1.5(e).

7. See Minn. Stat. § 481.13.

8. See, e.g., Barna, Guzy & Steffen, Ltd. v. Beens, 541 N.W.2d 354 (Minn. App. 1995); *In re* L-Tryptophan Cases, 518 N.W.2d 616 (Minn. App. 1994).

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9. See, e.g., Krippner v. Matz, 205 Minn. 497, 287 N.W. 19 (1939); Trenti, Saxhaug, Berger, Roche, Stephenson, Richards & Aluni, Ltd. v. Nartnik, 439 N.W.2d 418 (Minn. App. 1989).

10. See Howard v. Babcock, 863 P.2d 150 (Cal. 1993).

11. See Barna, Guzy, 541 N.W.2d at 357 (*citing* Jacob v. Norris, McLaughlin & Marcus, 607 A.2d 142 (N.J. 1992)).

12. Minn. Stat. §§ 323.28-30.

13. Minn. Stat. § 323.17.

14. See Minn. Stat. § 322B.80.

15. See Minn. Stat. §§ 302A.471-.473.

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