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Beware the partner trap

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For most lawyers, attaining partnership is an achievement, a moment of happiness and relief. However, recent events may be increasing awareness that what seems like a reason to celebrate may actually be the start of a nightmare.

How is this possible?

In addition to receiving recognition and the opportunity to share in a firm's profits, becoming a partner — or at least an equity partner — involves assuming three types of increased risk. First, a new partner may be expected to contribute capital, to pay money into the firm or leave money in the firm for it to use — or lose. Second, a new partner may assume greater responsibility for the firm's debts and liabilities. Third, a new partner may relinquish predictability in compensation. Partners often receive a comparatively smaller monthly payment or draw, and may not learn or receive their full annual compensation until profits and losses are determined at the end of the firm's fiscal year.

In addition to these risks, unscrupulous or opportunistic firms may take advantage of potential partners by:

· Adding new partners to raise capital or cover expenses instead of asking existing partners to pay more.

• Misleading a potential partner to join the firm with the intention that existing partners can usurp the new partner's revenues or practice.

• And adding partners to project confidence, despite knowing the firm may face a potential devastating event — such as a major malpractice claim — that may decimate the firm.

Such problems may arise in firms of all sizes. For example, a solo practitioner client of mine was asked to join a small local firm. These negotiations failed only shortly before the firm itself dissolved, leaving numerous unhappy creditors. Another example involves failed Dewey & LeBoeuf and Steven Otillar, a former partner hired shortly before the global law firm collapsed. Otillar alleges in court pleadings that Dewey and its bank induced him to join the firm as part of a scheme to keep Dewey afloat with funds from newly hired partners.

How can a potential partner avoid such a partner trap? Here are five suggestions:

• 1. Be mindful of the risks. A potential partner should be mindful of the risks as well as the rewards involved in becoming a law firm partner and owner.

• 2. *Review governance documents.* The potential partner should review the firm's governance documents, such as a partnership agreement, to learn what commitments the firm is making and expecting before signing such documents. A potential partner should also review other documents he or she may be expected to sign, such as lease, line of credit or employment agreements.

• 3. Obtain assurances from the firm. A potential partner should also conduct due diligence about the firm to make sure it's an entity he or she wants to own. Topics for investigation include expectations for new partners, including how much revenue they should generate, how they will be compensated and whether they will work with firm clients or only their own clients. A potential partner should also investigate how the firm is performing financially, including its liabilities, debts and use of credit; whether the firm is losing major clients or partners; whether the firm faces substantial civil or criminal claims; and whether firm lawyers

are under criminal, disciplinary or other investigation. Also of significance is the firm's culture, including anticipated work hours and working conditions, as well as how partners and staff are treated.

Due diligence should include communications with firm managers, as well as people likely to be more forthcoming about the firm's situation, such as former classmates or friends. Sometimes the due diligence can be accomplished by obtaining verbal information or a written statement from the firm. The level of information required will vary based upon the potential partner's prior knowledge of and relationship to the firm. A long-time associate, for example, may require less due diligence than a new lateral.

When a potential partner does not already have a sense of a firm's financial situation, three types of documents can yield substantial information: the firm's most recent financial statements, its tax returns and a professional liability insurance application. If a firm will share these documents and they are reasonably accurate, they should provide substantial information about the firm's status.

• 4. Obtain third-party information and evaluations. A potential partner should also discuss the firm, its reputation and culture, and its operations with knowledgeable outsiders. In particular, a potential partner should try to speak with former partners of the firm. These former partners may overstate their grievances, but they will also likely provide accurate information about potential problems a partner may encounter.

A potential partner should also research the firm online. Media reports and press releases can disclose major developments and indicate whether the firm is expanding or shrinking. Although sometimes a positive indicator, fast growth generally causes substantial financial and operational strain. Substantial firm departures, meanwhile, may reveal a firm has cultural or financial problems.

A potential partner may also want to review recent court filings involving the firm to determine whether it may be facing major claims from clients or creditors.

• 5. Join with care. Having conducted this due diligence, a potential partner should proceed with caution when assuming an ownership position at a firm. He or she may even want to consider initially accepting a more protected role, such as a nonequity position or an of counsel relationship, that may provide some advantages of partnership without all the associated risks.

In sum, obtaining partnership can be a significant achievement and offer a lawyer substantial rewards, but it may also involve substantial risks. Due care should be exercised to ensure a proffered partnership position is indeed a prize, not a trap.

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