LAW FIRM PARTNERSHIP & BENEFITS Report®

Does Your Partnership Agreement Violate the Rules of Professional Conduct?

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In many industries, non-competition provisions are a typical feature of employment contracts and partnership agreements. Courts will usually enforce such provisions if they protect a legitimate interest of employer and are reasonable in scope, time and geographic area. Non-competition agreements among lawyers, however, have long been condemned as unethical. Such agreements were prohibited by DR 2-108 of the Model Code of Professional Responsibility adopted by the American Bar Association in 1969, and by Rule 5.6(a) of the ABA's Model Rules of Professional Conduct promulgated in 1983. In its current form, Rule 5.6(a) provides:

A lawyer shall not participate in offering or making:

(a) a partnership, shareholders, operating, employment, or other similar type of agreement that restricts the right of a lawyer to practice after termination of the relationship, except an agreement concerning benefits upon retirement.

Prohibitions similar to DR 2-108 and Rule 5.6(a) have been adopted in virtually every American jurisdiction.

In their core application, these rules are reasonably clear. They prohibit the typical non-compete provision that restricts a departing lawyer from practicing law in a particular area for a specified period of time. They also prohibit "anti-poaching" agreements that prevent a departed lawyer from soliciting business from clients of his former firm. *See, e.g., Dwyer v. Jung*, 133 N.J. Super. 343, 336 A.2d 498 (1975).

What the States Say

The outer limits of these rules, however, have been harder to pin down. Questions about the scope of the rules began with the decision of the New York Court of Appeals in *Cohen v. Lord, Day & Lord*, 75 N.Y.2d 95, 550 N.E.2d 410 (1989). In *Cohen*, the court invalidated a partnership provision that did not expressly prohibit competition by a withdrawing partner, but that substantially reduced the post-departure payments to which the partner was entitled if the partner joined a rival firm. Because the agreement imposed a significant monetary penalty on competition, the court concluded that it was the functional equivalent of a covenant not to compete, and hence prohibited by the DR 2-108. Cohen is now "the strong majority rule in this country." *Pettingell v. Morrison, Mahoney & Miller*, 426 Mass. 253, 256-57, 687 N.E.2d 1237, 1239 (1997). Only California and Arizona have declined to follow *Cohen's* lead. *Howard v. Babcock*, 6 Cal.4th 409, 863 P.2d 150 (1994); *Fearnow v. Ridenour, Swenson, Cleere & Evans, P.C.*, 213 Ariz. 24, 138 P.3d 723 (2006).

New Jersey cases have taken *Cohen's* forfeiture analysis a step further, suggesting that partnership agreements that denied benefits to all or virtually all withdrawing partners violated Rule 5.6(a). *Katchen v. Wolff & Samson, P.C.*, 258 N.J. Super. 474, 610 A.2d 415 (App. Div. 1992); *Weiss v. Carpenter, Bennett & Morrissey*, 143 N.J. 420, 672 A.2d 1132 (1996). In the New Jersey cases, the agreements at issue did not expressly discriminate between partners who left to compete and those who left to engage in other pursuits. The concern of the New Jersey courts seemed to be that the loss of financial benefits discouraged all lawyers from leaving the firm and thereby deterred those lawyers who might want to leave in order to compete with their former firm. The agreements were thus "anticompetitive in the broadest sense." *Katchen*, 258 N.J. Super. at 481, 610 A.2d at 419. The New Jersey decisions lead to the peculiar result that a partnership agreement requiring forfeiture of benefits might be unenforceable against a lawyer who left to join a rival firm, but not against a lawyer who left "to bicycle around the world." *Katchen*, 258 N.J.Super. at 481, 610 A.2d at 419.

The APICs Saga

Uncertainty about the outer limits of DR 2-108 and Rule 5.6(a) has produced a small cottage industry of challenges to law firm partnership and employment agreements on the grounds that they are anti-competitive and hence unethical and unenforceable. Departing lawyers have, for example, invoked Rule 5.6(a) to attack partnership provisions that required them to remain liable for a portion of the firm's rent and employment agreements that required them to share any fees generated by contingent fees cases

that they removed from the firm. An unreported Massachusetts trial court decision involving an employee loan reflects the imaginative uses to which Rule 5.6(a) has sometimes been put. In that case, the firm lent an employee funds to pay for law school tuition, on the understanding that, if the employee returned to the firm after passing the bar, the loan would be forgiven over time. If the employee left the firm before the loan was fully written off, he was obliged to repay the balance remaining. The employee passed the bar but left the firm before serving the required length of time. When the firm sued for the balance, the newly minted lawyer claimed that the loan terms were anti-competitive and violated Rule 5.6(a). The trial judge sensibly rejected the employee's argument.

Against this background of uncertainty, the recent decision of the Massachusetts Supreme Judicial Court in *Pierce v. Morrison Mahoney LLP*, 452 Mass. 718, 897 N.E.2d 562 (2008) provides valuable guidance concerning what Rule 5.6(a) does and does not prohibit. Pierce was the second chapter in a long-running dispute about a type of financial benefit referred to in the firm's partnership agreement as "Annual Partnership Interest Credits" ("APICs"). APICs represented the annual net income or loss of the firm calculated on an accrual basis and allocated among the partners. As originally drafted, the partnership agreement provided that APICs were payable over time to partners who had reached age 60 or served for 20 years as a partner and who retired from the practice of law. The agreement also provided for APICs payments to partners who voluntarily withdrew from the firm before becoming eligible for retirement benefits. If, however, the withdrawing partners thereafter engaged in competition with the firm, they forfeited the right to receive APICs.

In the first chapter of the APICs saga, two partners who voluntarily withdrew to form a rival law firm sued to obtain their APICs payments. The Massachusetts court, following *Cohen*, held that the forfeiture for competition provisions of the partnership agreement, as applied to withdrawing partners, violated DR 2-108. *Pettingell v. Morrison, Mahoney & Miller*, 426 Mass. at 255, 687 N.E.2d at 1238.

While the first case was pending, the partners voted to amend the partnership agreement to eliminate the payment of APICs to voluntarily withdrawing partners who left before reaching age 60 or serving as a partner for 20 years. Under the amended agreement, all withdrawing partners were treated alike, regardless of whether they left to join a rival firm or to paint sunsets in Tahiti.

In chapter two of the APICs dispute, several partners who withdrew to join

rival law firms and who had not reached age 60 or been partners for 20 years sued to obtain their APICs benefits, claiming that the amended partnership agreement still violated the prohibition against non-competition agreements. In *Pierce v. Morrison Mahoney LLP*, the court rejected their challenge. The starting point of the court's analysis was the purpose served by Rule 5.6(a). The rule existed, in the court's view, to protect the ability of clients to select counsel of their choice, not to protect lawyers. 452 Mass. at 724-25. The partnership agreement at issue in the *Pettingell* required partners who had withdrawn from the firm to choose between representing clients in competition with the firm, thereby forfeiting their APICs, or refraining from competition and continuing to receive APICs. This financial disincentive limited client choice by discouraging former partners from accepting clients who might jeopardize their APICs payments, thereby "shrinking the pool of qualified attorneys " available to clients. By contrast, the amended partnership agreement, which treated all withdrawing partners alike, did not require departed partners to choose between accepting clients and receiving financial benefits. It therefore did not limit client choice in violation of Rule 5.6(a). 452 Mass. at 725.

In reaching this decision, the court tacitly rejected the reasoning of the New Jersey decisions invalidating agreements that were "anticompetitive in the broadest sense." Rule 5.6(a), the court said, was not intended to protect lawyer mobility. Under the amended partnership agreement, partners who hoped to receive APICs payments might be reluctant to leave the firm until they reached age 60 or had served as partners for 20 years, but that disincentive to departure did not violate the Rule. "There is nothing inherently violative of public policy," the court said, "in partners agreeing to such disincentives in the interests of the long-term financial and professional health of their enterprises." 452 Mass. at 726.

Limits of Rule 5.6(a)

The *Pierce* decision makes it clear that Rule 5.6(a) is not the universal solvent of partnership and employment obligations that some disgruntled lawyers have tried to make it. The Rule prohibits agreements that expressly prohibit competition and financial disincentives that discourage lawyers from engaging in competition after they leave the firm because both types of provisions restrict the pool of available lawyers and limit client choice. The Rule does not, however, prohibit agreements that treat all departing lawyers alike and it does not prevent firms from adopting financial incentives to encourage attorneys to remain with the firm.

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