

# Insolvency of Professional Services Firms

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## Professional Firm Insolvencies



### Potential Claims Asserted by Trustee or Creditors' Committee Against Partners

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Absent settlement, a bankruptcy trustee or official committee of creditors will seek to recover from Partners under the following theories:

#### Contract Claims

#### Avoidance Claims

(Fraudulent Conveyances and Preferential Transfers)

One can also anticipate that the trustee will seek to subordinate Partners' claims against the estate to those of unsecured creditors.

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## Contract Claims

### Generally

Trustee holds rights to Contract Claims, *i.e.* claims under Partnership Agreements.

- “*Breach of Contract*” – Trustee will assert claims for breach of contract to the extent Partners are over-distributed.
- *Turnover* – 11 U.S.C. §542 provides Trustee right to turnover of property of the firm’s estate. 11 U.S.C. §541 incorporates rights under Contract Claims as property of the estate.
- *Unjust enrichment* – Trustee will assert that Partners were unjustly enriched by the firm on account of their receipt of advances against profits that did not exist.

Contract Claims seek recovery of:

1. Distributions received by Partners in excess of equity entitlements under Partnership Agreement.
2. Unpaid Capital Contributions in accordance with the firm Capital Policy.
3. Unpaid Personal Account obligations due the firm.

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## Contract Claims

### Risk Assessment

#### Trustee

- Liability for Contract Claims is clear.
- Claims based on resolving credits/debits between Partners and the firm.
- No statute of limitations.
- Trustee may additionally be entitled to prejudgment interest on Contract Claims. Generally calculated at 9% in New York.

#### Partners

- Methodology for calculation of Contract Claims is an area of potential dispute.
  - Date of assessment of Point Value
  - Characterization of Capital Policy
- Setoff/Offset (11 U.S.C. §553)
  - Setoff only valid to the extent Partner is a creditor of the firm.

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## Recent Holdings

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*In re Thelen, LLP 520 B.R. 388 (Bankr. S.D. N.Y. 2014)*

- The Court held that former partners had no right to keep advances which they received against anticipated net income that was never earned, as such, they had an implied contractual obligation to repay these unearned draws.
- If a partner of the dissolving firm was given an advance against his anticipated income prior to the insolvency date, the partner would need to repay that “over draft” or face a claw back action from the Trustee.

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## Avoidance Claims

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*Generally*

Certain sections of the Bankruptcy Code empower the Trustee to avoid, or unwind, certain transfers.

Two Relevant Types of Avoidance Claims:

1. Fraudulent Conveyances
  - a. Constructive Fraudulent Conveyance
  - b. Actual Fraudulent Conveyance
2. Preferential Transfers

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## Avoidance Claims

### *Constructive Fraudulent Conveyance*

Federal Constructive Fraudulent Conveyance 11 U.S.C. §548(a)(1)(B)   11 U.S.C. §548(b)	State Constructive Fraudulent Conveyance N.Y. D.C.L. §273-277
<ul style="list-style-type: none"> <li>• Look back period: two (2) years</li> <li>• The Trustee may recover distributions made by the firm to Partners, where the firm received less than reasonably equivalent value, when the firm was either insolvent, had unreasonably small capital, was rendered insolvent by the transfer, or the Partner believed that the firm would incur debts beyond its ability to pay as they became due. (11 U.S.C. §548(a)(1)(B))</li> <li>• Strict liability for any transfers received while the firm was insolvent or that rendered the firm insolvent. (11 U.S.C. §548(b))</li> </ul>	<ul style="list-style-type: none"> <li>• Look back period: Six (6) years in New York</li> </ul> <p>New York</p> <ul style="list-style-type: none"> <li>• Liability for distributions that fit Section 548(a)(1)(B).</li> <li>• Strict liability for Partners when the firm was insolvent or was rendered insolvent as a result of the conveyance.</li> </ul>

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## Recent Holdings

### *In re Dewey & LeBoeuf 518 B.R. 766 (Bankr. S.D.N.Y. 2014)*

- Judge Glenn held that a Trustee has the right to pursue recovery of all partner distributions made while the partnership was insolvent.
- Second, the Judge held that the partners' legal and business generation activities cannot be considered "reasonably equivalent value" for the purposes of Bankruptcy Code § 548. This deprives the partners of one of their best defenses against a fraudulent conveyance claim.

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# Avoidance Claims

## Fraudulent Conveyance

Litigation of Fraudulent Conveyance Claims require two intensive analyses:

### Date of Insolvency

**Insolvency Defined:** *When the sum of the partnership's debts are greater than the aggregate of all the partnership's property (exclusive of property transferred with actual intent to defraud) plus each general partner's non-partnership property (exclusive of actual fraudulent transfers and exempted property) at fair valuation.*

**Expert Testimony Required:** Commonly, expert testimony is required to demonstrate solvency, as the consideration:

- Requires inclusion of contingent assets and liabilities in any calculations.
- May involve reference to audited financial statements and bank loan documents.
- Requires consideration of all facts and circumstances surrounding the Debtor's collapse.
- Requires a market analysis as to the "fairness" of the Debtor's valuation.

### Reasonably Equivalent Value

Determining whether Partners provided reasonably equivalent value in return for distributions made, both the Trustee and the Partners will engage in investigations as to the proper valuation of:

- Billing accrued by Partners.
- Collections accrued by Partners.
- Origination credits accrued by Partners.

**Expert Testimony Required:** Determining the amount of value provided by Partners would likely require comparison of the above categories to market valuations of the same, expert testimony may be required.

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# Avoidance Claims

## Actual Fraudulent Conveyance

### Federal Actual Fraudulent Conveyance 11 U.S.C. §548(a)(1)(A)

- Look back period: two (2) years
- The Trustee may recover distributions made by the firm to Partners, where the transfer was made with actual intent to hinder, delay, or defraud any entity to which the firm was or became indebted. (11 U.S.C. §548(a)(1)(A))
- Trustee may argue that, by and through its management, the firm possessed the actual intent to hinder, delay, or defraud its creditors when it made payments to Partners after the date of insolvency.

### State Actual Fraudulent Conveyance N.Y. D.C.L. §5275

Look back period: Six (6) years in New York

#### New York

- Conveyance made with actual intent to hinder, delay, or defraud either present or future creditors.

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## Avoidance Claims

### *Fraudulent Conveyance*

#### Defense to Claims for Fraudulent Conveyance

A distribution may be shielded from avoidance if the Partner, in good faith, gave value for the transfer.

11 U.S.C. §548(c).

#### Caveats:

- Applies to Section 548(a) claims, has also been applied to Section 548(b).
- Does not apply to transfers that are deemed preferential under Section 547.
- Provision of "value" by Partner requires a fact-specific inquiry.

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## Avoidance Claims

### *Preferential Transfers*

- Authorized by 11 U.S.C. §547(b).
- Partners are considered insiders under the Bankruptcy Code. *See* 11 U.S.C. §101 (31)(C).
- Trustee may recover insider transfers by the firm to or for the benefit of Partners on account of an antecedent debt made within 1 year (for insiders, as opposed to 90 days) before the Petition Date.

#### STATUTORY DEFENSES AVAILABLE TO PARTNERS

Defense	Defined	Application
Contemporaneous New Value 11 U.S.C. §547(c)(1)	Protects preferential transfers made in exchange for value provided by the Partner <i>contemporaneously</i> .	Defense only applies to extent Partner was paid concurrently with work performed. Valuation comparison of work performed to amount distributed requires extensive (costly) investigation.
Ordinary Course of Business 11 U.S.C. §547(c)(2)	Protects distributions made to Partners in the ordinary course of the firm's business or made according to ordinary business terms.	Consecutive monthly draws of amounts required by the Partnership Agreement are likely protected. However, any distribution above such amount will invalidate use of the defense for that transfer.
New Value (Subsequent) 11 U.S.C. §547(c)(4)	Protects preferential transfers to the extent the Partner produced new value to the Debtor after the date of the preferential transfer.	In N.Y., subsequent new value must have been and still be <u>uncompensated</u> to offset preferential transfer amounts.

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## Avoidance Claims

### *Risk Assessment*

#### Trustee

- Trustee will attack all distributions as insider preferential transfers for the year prior to the Petition Date.
- Trustee will attack under theories of both actual and constructive fraud.
- Absent settlement, Trustee is incentivized to look as far back as possible for the firm's date of insolvency.
- Trustee can cite non-balance sheet indicia of insolvency (*i.e.* lease terminations, etc.) to reach back as far as possible.
- Trustee will engage in expensive and time-consuming investigations into solvency as well as to any asserted defenses of value provided by Partners.

#### Partners

- Any defenses held by Partners retain likely applicable caveats.
- Defense and presentation of counter-arguments (*i.e.* insolvency and extent of value provided) require intense, and likely costly, factual investigations.

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## The Unfinished Business Rule

### *Jewel v. Boxer*, 156 Cal. App. 3d 171 (1984)

- In 1984, The First District of the California Court of Appeals held that in the absence of a partnership agreements, the Uniform Partnership Act requires that attorney's fees received on cases in progress upon dissolution of a law partnership are to be shared by the former partners according to their right to fees in the former partnership, regardless of which former partner provides legal services in the case after dissolution.
- This case essentially holds that absent an agreement to the contrary profits earned on matters that former partners of a failed law firm take with them to their new employers are property of the prior firm.
- Based on this case Trustees and other representatives of failed law firms have argued that upon bankruptcy filing, all work pending at the time of the dissolution and the profits therefrom are part of the failed firm's estate.

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## The Fall of The Unfinished Business Rule?

*In re Thelen, LLP* 24 N.Y. 3d. 16 ( N.Y. Ct. App. 2014)

- NY Court of Appeals held that “unfinished business waiver” included in the partnership agreement for the Chapter 7 debtor law firm, insofar as it allowed former members of the firm, upon the firm’s dissolution, to take hourly fee matters with them for no consideration, did not effect a transfer of any “interest of the debtor in property.”
- NY’s highest Court rules that the “unfinished” business of a dissolving firm was not a part of that firm’s estate. Based on this, the dissolving firm was only entitled to be compensated for the “unfinished” matter’s work that was completed prior to the firm’s dissolution.

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## The Fall of The Unfinished Business Rule?

*Heller Ehrman LLP v. Davis, Wright, Tremain LLP*, 527 B.R. 24 (N.D. Cal. June 11, 2014)

- District Court held that the law firm which had been dissolved had no property interest in the hourly fee matters pending at the time of its dissolution, for which the law firm’s former partners had any duty to account.
- The Court held that the profits the Trustee asserts a claim to are not those of the former Heller shareholders themselves, but rather those of the new, third-party firms. Essentially, the new firms are entitled to the fees for the work they performed on the case, after the case was brought over to their firm.

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## Who's in financial control?

### Issues facing professional firms:

- Failure to submit billable time;
- Who is managing the finances?
  - Mismanagement of Accounts Receivables (collections and write-offs);
  - Cash management;
- Financial reporting – how is information distributed and to whom?
- Lack of transparency
  - Open vs. closed compensation system;
  - Guaranteed compensation;
  - Only certain partners in the know on decisions and circumstances that impact the entire firm;
  - Failure of partners to truly understand the firm and its finances.

## Common Issues in Professional Firm Insolvencies

- Legal structure of the firm – LLP vs. GP; why does it matter?
- What are the valuable assets of the firm and how do you monetize them?
- Individual partners may own or control certain assets –
  - Real estate may be owned by some partners and leased to the firm;
  - Personal guarantees on such real estate? Unfinished business rule – certainty in NY (no liability) and CA (liability) but what about other states
- How should firms deal with this issue both at putative insolvent firms and at firms joined by partners from a failed firm?
- Conflicts of interest;
- Fiduciary duty.

## Other Issues

- Alternatives faced by failing professional firms
  - Restructuring, but how?
  - Merger/Acquisition;
  - Liquidation.
- Sources of recovery for creditors
  - Accounts receivable;
  - Partner personal liability;
  - Partner avoidance actions;
  - Insurance;
  - Real Estate;
  - Other assets.