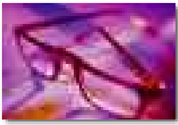

Financial Penalties for Departing May Be OK

We all should be familiar with the basic rules that apply when lawyers leave law firms, including the ethical rules concerning which clients the lawyer takes with her and how fees should be divided when those cases are concluded.[1]

It is a good practice to have employment agreements that provide with some specificity for what happens when a lawyer departs.

A recent Arizona case[2] points out another ethical issue that sometimes arises when lawyers leave their employment—whether and when the lawyer's firm can charge a lawyer, or withhold from what the firm would otherwise owe the departing lawyer, an amount of money solely because the lawyer is leaving to compete with the firm in the legal marketplace. In *Fearnow*, the Arizona Supreme Court held that the forfeiture of a lawyer's "buy-in" as a shareholder did not constitute a *per se* unlawful restriction on his right to practice law but required an evaluation under a reasonableness standard to determine whether it was enforceable.[3]

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The ethical rule applicable in *Fearnow*, ER 5.6(a) of the Arizona Rules of Professional Conduct,[4] prohibits a lawyer from entering into an agreement that restricts the right of the lawyer to practice after termination of a professional relationship. In *Fearnow*, the departing lawyer had previously entered into a shareholder agreement requiring him to tender his stock in the professional corporation back to the law firm. The agreement also provided that he was to get nothing in return for the stock, for which he originally paid more than $33,000, if he thereafter competed with the firm in the practice of law.

The departing lawyer left and sued for the return of his money. The firm defended, pointing out the provision in the agreement. The trial court refused to enforce the provision, finding it violated ER 5.6(a); the Court of Appeals agreed. On appeal, the Arizona Supreme Court found the issue to be one of first impression in Arizona.

The Court initially had no problem distinguishing between an agreement that restricts a lawyer's right to practice or compete and an agreement that imposes a financial disincentive for doing so. The Court cited cases that held both ways in regard to agreements providing financial disincentives. It found persuasive California cases allowing such provisions, particularly where the remaining partners are able to preserve the stability of the firm by making available the departing lawyer's share of capital or accounts receivable to replace the loss occasioned by the lawyer's departure.

Factors that can be examined under the reasonableness standard include whether the firm undertook capital expenditures or hired associates based on the presence of the former partner, whether the departure of the lawyer imposed costs in changing the firm name and related marketing materials, and whether the same financial penalty is imposed on withdrawing lawyers who do not compete in the same geographic or practice areas.[5] Any financial disincentive for leaving should be reasonable and have an easily articulated and justifiable basis, grounded in the facts of each situation.[6]

Fearnow is another example of why it is a good practice to have employment agreements that provide with some specificity for what happens when a lawyer departs. The agreement would cover how fees should be divided for work pending when the lawyer leaves, especially concerning those cases that the lawyer takes with her, and whether and to what extent the value of her interest in the firm is returned to her.

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endnotes

1. *See* previous columns: *Clients Come First When Lawyers Leave Firms,* April 2002, at 12; *Post-Departure Fee Splitting Agreements,* April 2007, at 6. *See also* Lynda Shely, *Law Firm Changes: The Ethical Obligations When Lawyers Switch Firms,* PROF. LAW. (2006 Symposium Issue), at 69.
2. *Fearnow v. Ridenour, Swenson, Cleere & Evans, PC,* 138 P.3d 723 (Ariz. 2006).
3. *Id.* at ¶ 21.
4. Rule 42, ARIZ.R.S.CT.
5. *Fearnow*, 138 P.3d 723, at ¶ 24, nn. 10 & 11.
6. *But see* Justice Bales' lengthy dissenting opinion, arguing that a restriction on the right to practice based on a financial disincentive is still a restriction and is prohibited in some jurisdictions and under the Restatement. RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 13 (2000). Thus, there may be more litigation on this point in the future.