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BANKRUPTCY UPDATE

When Law Firms Go Bankrupt — What Secured Lenders Can Learn From the Dewey Bankruptcy

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When law firm Dewey & LeBoeuf filed for Chapter 11 protection, it was obligated to its secured creditors, among many others, led by JP Morgan on a $75 million line of credit facility. Jeffrey Wurst explains what led to Dewey's collapse and offers advice regarding key indicators of a potential creditor's fiscal irresponsibility.

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Victims of bankruptcy come in many forms. They include the debtors themselves, as well as their secured and unsecured creditors. When law firms fall into bankruptcy, the secured lenders are often among the hardest hit. Typically, these secured lenders take security interests in all assets of the law firm when funding operations. The assets with the most value tend to be the cash and cash equivalents and the accounts receivable. The problem with many recent law firm bankruptcies is that cash on hand is minimal and the collectability of accounts receivable tends to be uncertain, making the secured lender's recovery difficult.

During the past four years alone, a mere sampling of the law firms declaring bankruptcy includes Howrey LLP, Heller Ehrman LLP, Dreier LLP and Brobeck, Phleger & Harrison LLP. The most recent to file for Chapter 11 protection, and the largest in the history of law firm bankruptcies, is Dewey & LeBoeuf LLP.

After more than half of its partners defected and after failed attempts at a merger, on May 29, 2012, Dewey filed for bankruptcy in the U.S. Bankruptcy Court for the Southern District of New York. Many theories abound as to the causes of Dewey's collapse, but, essentially, the crux appears to be that Dewey guaranteed an unsustainable amount of compensation to both newly acquired and longstanding partners. Hoping to generate enormous fees off these highly compensated partners, Dewey subsequently took on debt to fund the failing business. However, the economic impact of the recession forced Dewey to consolidate its debt. Further exacerbating Dewey's collapse was an enormous divide in salary between senior and junior lawyers, with the ratio of salaries being reported at between 12:1 and 15:1. Then, as Dewey's façade showed cracks, partner defections (along with their clients) resulted in even less revenue for the firm.

Dewey & LeBoeuf was the product of a 2007 merger between firms Dewey Ballantine and LeBoeuf, Lamb, Greene & MacRae. Legacy Dewey was struggling at the time, with its net income plummeting by $80 million in one year. In that same time, legacy LeBoeuf's net income rose by over $100 million. Still, legacy Dewey offered its prestigious name, and both firms believed that a larger firm was required to compete in the legal market. What legacy LeBoeuf did not know, apparently, was that legacy Dewey had not just been losing profits, but was in debt.

Almost immediately, Dewey & LeBoeuf poached lawyers from other firms, offering guaranteed long-term contracts at high salaries. Several partners were even given packages of more than $5 million annu-

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ally in guaranteed compensation. In the fall of 2011, Steven Davis, Dewey's former chairman, revealed that Dewey gave almost 100 lawyers guarantees. However, incoming revenue was not enough to satisfy the exorbitant salaries. In fact, since creation, Dewey & LeBoeuf partner distributions far exceeded net income. Furthermore, contributions to pension plans were deferred to future years creating a severely underfunded pension and huge pension liability.

In March 2010, Dewey raised $125 million in a private bond offering — an extremely rare course of action for a law firm. However, the offering contained no "risk factors," which in hindsight, should have served as a red flag. In fact, it turns out that Dewey failed to disclose the guarantees to partners in its offering.

Dewey's books were not much better. Dewey reported to *American Lawyer Media* its annual revenue by totaling the year's cash receipts and its outstanding accounts receivable at the year end. The next year, collection of the accounts receivable was then attributed to the cash receipts, thus double-counting these amounts and violating basic accounting principles.

When approximately 20% of the firm's equity partners left the firm between January 2012 and March 2012, Dewey scrambled to find a solution. Even after this mass exodus, Dewey obtained more financing. On April 16, 2012, Dewey consolidated its bank debt by issuing $150 million in secured notes — another unprecedented law firm transaction. In a series of amendments to its agreements with secured lenders, Dewey pledged more assets as security on top of its existing line of credit facility of $75 million. These secured lenders, led by JP Morgan, have the first priority in everything from cash receipts, promissory notes, expense compensation, insurance payments and equity in affiliates.

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The case of Dreier LLP had several similarities with Dewey. Dreier, like Dewey, enticed lawyers with lavish compensation packages. Some attorneys were paid more than $25,000 per week. Furthermore, despite expanding, Dreier still operated at a net loss of about $1 million *per month*. Unlike Dewey, however, Dreier had only one equity partner who conducted all financial and administrative functions. As a result, Dreier's books were more opaque than those of Dewey.

When Dreier filed for bankruptcy in 2008, the firm's schedules showed $30 million owed to creditors with secured claims. Over the years, Wachovia (now Wells Fargo) funded Dreier's operations in exchange for security interests in the firm's property. Wachovia's funding included a letter of credit for Dreier's lease on its office space, a line of credit to fund operations and various loans. Despite all the warning signs, Wachovia still extended credit to the firm. Unlike Dewey, Dreier LLP's property consisted of lavish artwork, a large motor yacht and valuable real estate as well as the standard cash on hand and accounts receivable.

The trend in law firm bankruptcies is that secured creditors receive the proverbial "short end of the stick." For instance, in Dreier, Wachovia's claims amounted of approximately $30 million resulted in a recovery of merely of $9 million. Furthermore, in cases such as Thelen, Coudert Brothers and Heller Ehrman, the secured creditors are still mired in litigation and fighting to recover assets. In each of these costly bankruptcy proceedings, the secured parties have been forced to stand back and watch as the debtors used cash collateral to fund these costly proceedings. However, as discussed above, in the Dewey case, the court recently approved a $71.5 million settlement to be contributed by formers partner for the benefit of the creditors. Even with this infusion, it does not appear likely that the secured creditors will be made whole.

The settlement in Dewey was influenced by *Jewel v. Boxer*, where a California appellate court ruled that fees paid to former partners for cases in progress prior to the liquidation of their law firm should be allocated between the former partners and the liquidating law firm according to their respective right to fees during the partnership. Thus, a portion of the fees earned for "unfinished business" performed by the new law firm are assets of the bankrupt estate. One case in the District Court for the Southern District of New York (*Development Specialists v. Akin Gump*) followed this rule while another (*Geron v. Robinson & Cole LLP*) ruled otherwise. These conflicting opinions set the stage for the settlement in Dewey. This settlement — one of the first of its kind in a law firm bankruptcy — evidences a significant departure from the prior trend in law firm bankruptcies. It appears that the secured creditors may have claimed a victory with this settlement; however, there is still a long road ahead to for them to recover all of what is owed to them.

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It goes without saying that secured lenders should avoid dealing with law firms that exhibit red flags for an imminent bankruptcy. However, a secured lender's due diligence should not stop after credit is extended — instead, the lender should continually pay attention to the warning signs of a failing law firm. If Dewey's bankruptcy has taught us anything, it is that there are certain indicators of fiscal irresponsibility. Watch for:

1.) deferred returns of capital to partners;
2.) reallocation of income in the company;
3.) unusually high lines of credit;
4.) wide disparities in pay amongst the professionals;
5.) deferred contributions to pension plans; and
6.) any attempts to creatively define net income.

Of course, it is difficult to predict whether a law firm will go bankrupt, but careful attention to the warning signs prior to extending credit may save lenders in the end. Exercising sound credit judgment prior to extending credit is key to managing the risks associated with a failure of the firm. abfj

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