CLOSING A FIRM: PROBLEMS THAT MANY DON'T ANTICIPATE

Ellen Freedman, CLM

I've written previously about this topic in an article simply titled "*Closing Your Practice*" which appeared in several county newsletters back in 2001. Since that time I have presented a one hour CLE seminar on the same topic, at least once or twice each year, somewhere in the state. And with all the baby boomers approaching retirement at breakneck speed, it's not a topic which will ebb in importance. In fact, it's more important than ever to think about it. And by that, I mean think about it far in advance.

If you've been following the news, you know that the closing of Wolf Block will continue to reverberate in the legal community for quite some time. Lawsuits are flying back and forth between the firm and former partners, and former partners and the firm. Vendors have entered the fray to safeguard their interests. The dust will not settle any time soon. And this isn't the first, or last time, we'll see such goings on.

The hot line has also been busy with calls from solos who are closing down their firms. In most cases a long and distinguished career is winding down. In addition to solo firms, I also hear from small and mid-size firms. In some cases a firm loses the struggle to remain financially viable. In other cases firms lose the ability to maintain a common vision and goals, and the glue which binds the partners together dissolves along with the firm.

While it's true that some of the challenges of a law firm closing or dissolution cannot be prevented or avoided, there are just as many which can be with some forethought. What follows are, in no particular order, many of the issues I deal with regularly in connection with law firm closings, along with my thoughts on strategies you can implement to avoid them.

Malpractice insurance coverage after the lights go out.

Many of you immediately recognize we're talking about "the tail" or what is otherwise known as an Extended Reporting Period Endorsement. Malpractice insurance policies for lawyers are almost exclusively written on a "claims-made"

basis. This means that if you don't report a claim within your policy period, or an act, error, or omission which you know about which may reasonably give rise to a claim in the future, you will have no coverage if a claim arises after the policy period expires.

In order to protect your assets and estate and ensure future coverage after you retire, you will want an unlimited tail, so that a claim may be reported at any time in the future.

Most policies will provide the retiring attorney with an unlimited tail at no charge if the attorney has been continuously insured for a certain number of years with the carrier. Many practitioners who are winding down toward retirement don't think about this at all. They often switch policies every year or two in order to save on premium, without knowing how many years of consecutive coverage their new carrier requires in order to provide the free tail.

Failure to take note of this policy provision as you approach retirement can be a costly oversight. Typically, the premium for an unlimited tail runs anywhere from 2.5X to 3X the annual premium. Ouch! That quickly consumes any possible premium savings you might have enjoyed for the years preceding retirement.

For firms which dissolve, no matter what size beyond a solo practice, the problem becomes a little dicier. One of the first and most contentious issues which arises is often a disagreement about purchasing the tail at all. Without it, lawyers who move on to other firms can have a gap in insurance if they do not get full prior acts coverage at the new firm. Increasingly, in order to lower premiums, firms forego the additional full prior acts coverage for incoming attorneys. Attorneys who make a lateral move from a dissolving firm sometimes wind up in a risky situation for several years, when the risk of a claim being made is highest.

With a little advance planning, this issue is easily avoided. Simply include in the partnership or shareholder agreement that in the event of dissolution, an unlimited tail will be purchased by the firm. Specify that all partners who were with the firm at any time within the final policy period will be required to pay their prorata share of premium for the tail coverage.

Retention and disposition of remaining client files.

In the March/April 2004 issue of The Pennsylvania Lawyer, I published an article (co-authored by Mason Avrigon, Sr., Esquire) entitled "*Managing the*

Mountain of Paper: Records Management in the Law Firm." It is now part of a comprehensive resource on Records Management in the Law Firm.

This is a complex and problematic area. Just because a law firm closes doesn't mean the firm is relieved of its obligation under Rule 1.15 [Safekeeping Client Property]. The problem for solo attorneys is that often they have retained files for extraordinary lengths of time, and have never adopted any policy regarding client file closing or file retention.

I get calls from attorneys (or their heirs) regarding files which are 50 or more years old, and they can't locate the clients. They have no idea what's in the files. There might be client original documents or valuable papers which the client might find difficult to replace. Although the lawyer is technically under no obligation to provide permanent storage for client files, the lawyer is required to get the written permission of the client before destroying originals and valuable papers. So the reality of the situation often undermines the underlying intent of the Rule.

There comes a point where an attorney must assume that there is little exposure in destroying remaining files for clients who cannot be located. But in the case where a solo attorney is deceased, making this determination often falls on the shoulders of heirs. If they are not an attorney they will be prohibited from reviewing the files to determine whether there are original documents or valuable papers which might require client permission to destroy. They should not even look through the file to attempt to locate a last address for the client. That means that they have to engage another lawyer to assist in this review. Do you really want to leave this mess to your heirs?

At larger firms the problem becomes even more acute. Often attorneys who have departed prior to dissolution have taken most of their active client files — with written permission of the client, of course — but many times leave all the closed files behind. Or perhaps they brought mountains of files from a former firm and subsequently retired, leaving all the files in the safekeeping of the firm. Again, absent the client's written permission and a good purging when the file closes, those who attempt to close the firm in an orderly fashion will be at a loss as to what to do with all the old files.

A few years ago I read about a dissolving New York firm which could not get the partners to agree to pay for a storage facility for all the closed client files. The

debate became heated. No one wanted to pay to store files for former partners, let alone their own former clients. Eventually, the few partners who stayed behind, responsible for winding things down, became sufficiently disgusted and literally threw away all the files. Unfortunately, even the final disposition didn't meet the requirements for shredding or burning in order to safeguard confidentiality. Ultimately, all partners who had left files behind, even those who had departed before the closing of the firm was announced, were disciplined for failure to properly safeguard client property.

On top of these issues, firms must be concerned about discovery and possible accusations of spoliation if client records are dealt with inconsistently. When it is left to individual attorneys to determine what gets saved and what gets destroyed at a given interval, every inconsistency becomes suspect under the bright glare of litigation discovery.

We're fortunate to have PA Formal Opinion 99-120 [Retention of Client Files] and Formal Opinion 2007-100 [Client Files – Rights of Access, Possession and Copying, Along with Retention Considerations] for guidance. Smart firms which wish to avoid the issues mentioned above will develop a written records management policy which encompasses firm records and client records. The firm's engagement agreement will notify clients of the retention policy. The policy will guide the firm to document return of originals and valuable papers when the file is closed. By doing so, the firm may destroy the file in an appropriate manner — fire or shredding — when the retention period has tolled.

A proper review and purging of the file upon closing ensures that heirs are not stuck with files which must be reviewed by an attorney at a later date. It also ensures that originals can be returned to the client while the client can still be located.

I can't count the number of attorneys who contact me asking what they can do with old original Wills and Codicils, when they don't know if the client is alive, and cannot locate the client. Other events may also prevent a firm from being able to dispose of the files. For example, when financial institutions began to merge, the surviving entities would not take responsibility for allowing return or disposal of client files for the prior institutions. Firms which practiced in this area and had not properly purged the files upon closing were left with a thorny problem.

When a firm has multiple partners, the shareholder or partnership

agreement should incorporate responsibility for departing attorneys to contribute to file storage costs if necessary. When clients send in a request to transfer their files to a departed attorney, the firm should consider trying to secure instructions for transfer of all closed files as well. The firm may be better off going to the time and trouble of making copies of documents which might be required to defend a possible malpractice action in the future before turning over the files, rather than risk becoming the permanent caretaker of those files, or be burdened with individual review of the files before future destruction can take place.

Firms should also carefully track what files a lateral partner brings upon joining the firm. If the attorney arrives with closed files of current clients, the shareholder or partnership agreement should incorporate responsibility for the attorney to take the files if he or she moves to another firm in the future.

Future liabilities and audits.

When a firm winds down, unpaid liabilities can rear their ugly head. While not every nuance can be anticipated, you want to make sure that any departed partners remain liable for their share of any back taxes, penalties and interest, defaulted loan payments, unpaid vendor bills, or whatever later arises from a period in which they were a member of the firm. Gone should never mean off the hook for these obligations. Look to your partnership or shareholder agreement to make this obligation clear.

Remaining trust funds unaccounted for.

This is a real problem for solo and small firms. Record keeping frequently tends to be sloppy in this area. Sometimes attorneys will forget to take their remaining fee out of trust.

Sometimes it begins with a conscious decision to leave the money in trust in order to recognize the revenues at a later period when needed, or when tax consequences are more favorable. Of course, this is precisely what the IRS looks for when they audit an attorney trust account. It's a serious no-no.

Sometimes the discrepancy starts innocently enough when the attorney simply fails to instruct the proper staff person to create the bill and pay it from trust. Or fails to instruct the staff person to refund the remaining trust balance to the client.

Regardless of how it occurs, the end result is money left in trust which either cannot be accounted for, or cannot be returned because the client cannot be located. I get frequent hot line calls from attorneys trying to close their practice who are facing one of these two circumstances.

While the attorney may be relatively certain that the funds represent untaken fees rightfully owed the firm, absent proof of that, the firm cannot simply create an invoice and take the money from trust. If the client cannot be located, then the attorney must hold onto the funds for a number of years before turning it over to the State Treasury for safekeeping under the Escheat Rules. Likewise, if the attorney cannot show that the money was untaken fees on a particular matter, then eventually it must also be turned over to the State Treasury.

Every client must have a ledger account kept for funds taken into trust. Each addition to trust, and subtraction from trust, on behalf of that client, should be recorded on the client's ledger. At the end of each month, the firm must reconcile it's bank account statement to the total held in trust. It must **also** reconcile the balance held for each individual client in trust, to the total amount in the trust account. Any discrepancy between the trust account balance and the bank, or the trust account balance and the sum of individual client holdings, should be resolved before the next month end.

A decent time & billing or general ledger program can easily handle this record-keeping requirement. As deposits are made and checks are written, the client's ledger will be updated automatically. It should then be easy to account for remaining balances.

When the matter is closed, the trust balance should be zero. If not, the firm knows that they have either failed to pay themselves, or have failed to return excess funds to the client. In the latter case, the firm will be able to easily locate the client to return the funds, and not be left to keep a bank account open for years after the attorney has retired and closed the firm.

These are not by any means the only loose ends which can trip up the best efforts to close a firm in a timely, organized fashion. But they are certainly those I encounter most frequently.

If you're a solo, you want to start your planning process about 10 years in advance of your anticipated retirement date. Believe me it will take that long to get

your ducks in a row. For firms of two or more attorneys, make sure you have a records retention and destruction policy in place, including good file closing and purging procedures. If you don't have a shareholder or partnership agreement, you need one. If you have one, take a fresh look at it and consider whether you need to incorporate some changes in order to eliminate future problems.