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The Anatomy of Law Firm Failures

The recent failures of Heller Ehrman and Thelen Reid & Priest – coming, as they did, at a time of serious economic downturn for the country and the legal market – have led a number of our clients to ask us about the root causes of law firm failure and whether it is possible to identify early warning signs of firms in distress. In fact, we believe that it is possible to point to certain commonalities in the law firm dissolutions that we have observed over the past several years.

At the outset, we should note that, while the current economic downturn may have exacerbated the distress of Heller, Thelen, and other troubled firms, it would be inaccurate to conclude that the downturn actually *caused* their problems. It is important to remember that Heller and Thelen are only the latest in a series of high profile law firm failures that stretches back at least two decades. The list includes (to name but a few):

- Altheimer & Gray
- Arter & Hadden
- Bogle & Gates
- Brobeck Phleger & Harrison
- Butler & Binion
- Coudert Brothers
- Donovan Leisure Newtown & Irvine
- Hill & Barlow
- Jenkins & Gilchrist
- Johnson & Wortley
- Keck, Mahin & Cate
- Lyon & Lyon
- Pennie & Edmonds
- Shea & Gould
- Testa, Hurwitz & Thibeault
- Troop Steuber Pasich

To a significant extent, law firm dissolutions – as well as the continuing large number of law firm mergers – are the products of a rapidly consolidating and segmenting market place. As competition within the legal market becomes more intense, as clients become more demanding and discriminating in their choice of firms, and as firms become more aggressive in positioning themselves in their selected markets, it is inevitable that there will be winners and losers. As weaker firms become less competitive, their partners will invariably look to relocate their practices to firms that are better positioned for success in their relevant markets. Recognizing that the legal market is continuing to segment, we expect that we will continue to see a steady number of both mergers and dissolutions, even after the recovery from the current economic downturn.



Four years ago, Hildebrandt conducted a study of 80 law firm failures occurring in the United States from 1998 to 2004, in an effort to identify the fundamental causes of the dissolutions. Looking back on that study – and extending it forward to the firms that have dissolved since 2004 – we believe that the conclusions we reached in our earlier study remain valid and offer helpful guidance for today’s law firm leaders.

In our experience, failed firms typically exhibit one or more major fundamental flaws, and the flaws usually fall into three primary categories:

- **Below average financial performance** – often including excessive financial leverage, significant deferred obligations, low productivity, and poor realization;
- **Internal dynamics** – primarily involving leadership issues, partners with incompatible goals, differences over compensation philosophy, and lack of succession planning; and
- **External dynamics** – primarily involving competitive pressures related to the firm’s historical client base, access to new clients and desirable work, and inability to recruit key talent.

All of these issues, of course, can be viewed as involving some sort of strategic failing. And, in fact, in troubled firms there is rarely a well-articulated and implemented strategy.

It is also often the case that a failed firm may exhibit multiple flaws, and this too is really not surprising. A leaderless firm, for example, that is faced with significant competitive pressures will often produce poor economic performance. In many failed firms that we have reviewed, the fundamental flaws were well recognized long before the firm voted to dissolve, but the partners chose not to act on the flaws until it was too late to fix them.

Typically, the underlying problems created by the fundamental flaws in the firms we studied were brought to a head by a triggering event that set in motion a rapid downward slide. Four types of triggering events were the most common: (i) overexpansion that weakened the firm over an extended period of time, (ii) the unexpected rapid or gradual defection of significant partners to one or more other firms, (iii) a breakdown in merger efforts for a firm that was already in serious financial distress and barely surviving, or (iv) the impending expiration/renewal of the firm’s primary office lease. In many cases, there were multiple triggering events – for example, a breakdown in merger discussions followed by the rapid exodus of key partners. While the seeds of collapse are generally sown long in advance of the actual dissolution of a law firm, the downward slide following one or more triggering events can be very rapid – usually a matter of weeks not months.

With these considerations in mind, and recognizing that circumstances will differ from firm to firm, it is possible to identify a number of factors that should be warning signs to law firm leaders. These factors are described below, using the three broad categories identified in our previous dissolution study.



Below Average Financial Performance

At the end of the day, very little makes up for a lack of profitability. During the past several years, however, weak firms had their financial fortunes propped up by strong client demand and an abundance of legal work. That changed abruptly in mid-2007 as the economic slowdown hit and, with the current crisis in the finance and credit markets, strong client demand is not likely to rebound soon. As a consequence, poorly performing firms whose problems were previously masked by thriving economic conditions will now find themselves in a stark new reality.

There are many causes of poor financial performance, but in the present climate the following should be of special concern:

- Economic balance sheet distress. Excessive borrowing is the most obvious aspect of a weak economic balance sheet. Many of the failed firms that we examined borrowed substantial amounts of money to fuel growth as well as to pay partners during periods of cash shortfalls. Many of these firms were thinly capitalized – some almost as a matter of philosophical principle – a condition that drove an increased need for debt financing. High debt levels put these firms at particular risk when external economic conditions turned against them. In some firms, these conditions were exacerbated by unfunded obligations to make deferred compensation payments, typically to retired partners.
- Productivity problems. Most financially troubled firms have experienced chronic productivity problems at all levels, but particularly among partners. Often there is an underlying “cultural” issue as well, a sense that it is more collegial to deal with underperforming partners through compensation reductions or “de-equitizations” than to face the hard reality that some underperformers should simply be asked to leave the firm. Unfortunately, this “more collegial” approach to chronic underperformers hardly ever works, and results instead in a growing sense of frustration among harder working partners that their colleagues do not have a shared sense of real commitment to the organization. If unchecked, this frustration can lead to the departure of strong partners and other lawyers and set off a downward spiral that can ultimately destroy a firm.
- Poor financial hygiene. Many firms, especially during good economic times, pay too little attention to their financial hygiene. Again, often for “cultural” reasons, they have lax controls and give individual partners far too much autonomy to accept questionable clients, discount fees, write off accounts receivable, etc. Not only are these sloppy business practices, but they can also exacerbate a firm’s financial troubles, particularly during periods of economic downturn.

Internal Dynamics

In almost half of the 80 failed firms that we examined in our 2004 report, there were one or more fundamental flaws related to the internal dynamics of the firms themselves. Broadly speaking, these firms suffered from a lack of clear strategies, of clearly articulated and compatible goals among their partners, and of strong leadership to achieve their mutually shared strategic visions.



The lesson is that law firm leaders should pay particular attention to the following kinds of warning signs:

- Problems of strategic focus. Most failed firms that we have seen lacked a realistic strategic focus. Either they had no strategy or, at best, a “paper strategy” that had never been truly accepted by their partners. In a few cases, firms simply committed themselves to completely unrealistic strategies, sometimes pushing uncontrolled growth on the assumption that all firms should be racing to the top of the client ladder without regard to critical issues of capabilities, location, and client base. (As we have sometimes said, some firms seem to be committed to a strategy of being the largest and least profitable firms in their markets!) In a rapidly segmenting legal market, it is absolutely clear that not all firms can play in the top tier, and there are a variety of valid and economically rewarding alternative positions. The key is adopting a strategy that is realistic and achievable and then managing the expectations of a firm’s partners to insure strong commitment to a common vision. As our 2004 study suggested, the absence of a shared sense of strategic vision is one of the most commonly cited reasons that key partners leave their law firms.
- Poor leadership. The lack of strong leaders who can inspire confidence among their partners has been a serious factor in a high percentage of law firm dissolutions. Sometimes this factor is aggravated by the lack of adequate succession planning to transition from one generation of leaders to the next. Successful leadership in a law firm depends heavily on trust, on the willingness of the professionals in the organization to buy into the strategic vision set out by their leaders. When that trust is lost, it can be very difficult to regain it. One frequent symptom of such loss of trust is poor communications between the leadership of a firm and its partners. Many troubled firms that we have seen have been plagued by a steady flow of misinformation and rumors among their partners, a problem that can become toxic very quickly.
- Partner defections. As noted previously, a key triggering event in the downward slide of many failed firms has been the departure of a group of key partners. Sometimes these departures result from poorly conceived compensation systems that over-reward underperforming partners or that emphasize individual behaviors at the expense of collective efforts. In other cases, departing partners have simply lost faith in their firm’s ability to implement an effective strategic vision or to provide the kind of platform that they need to grow their own practices successfully. The tragedy is that, in many cases, partner defections could have been prevented – or at least mitigated – by early intervention. Most firms have the economic wherewithal to respond to these challenges but often lack the will, either for cultural reasons or because of weak leadership. Far too frequently, they wait to take action or to retain outside help until the situation has deteriorated to the point that little can be done. Once significant partner defections begin, it is very difficult to turn that destabilizing situation around.
- Unhealthy culture. Law firms are unique organizations with unique cultures. While they need to operate with sound management structures and business practices, it is sometimes easy to forget that, in important ways, they are unlike other business enterprises. At their core, great law firms – however technically structured – are partnerships of fairly autonomous professionals that must be led more by persuasion and example than by fiat. As such, a healthy culture (or set of core values) that strikes the right balance between common commitment and autonomous action is essential for a successful firm. That balance is almost



always missing in failed firms. Again, this is an issue that can (and should) be addressed before it becomes a real problem, but many firms lack the will or the leadership to tackle it until it is too late.

External Dynamics

In our 2004 study, 45 of the 80 firms we examined split up, at least in part, because of external competitive pressures. These pressures related most often to a firm's inability to service its existing client base, to access new clients and new desirable work, or to recruit new talent. As the legal market continues to segment and as clients become ever more sophisticated in their dealings with outside counsel, these external dynamics will become even more important.

- Failure to understand the market. Many firms get into trouble because they simply fail to understand the markets they serve. They miss trends that may fundamentally alter the business of key clients or industries or assume institutional commitments where they may no longer exist. Consequently, they are surprised when a major client moves its business elsewhere or when a particular line of work winds down "unexpectedly." Failed firms often try belatedly to address these issues through eleventh-hour mergers or rapid expansion, but such actions are a poor substitute for careful strategic planning and action early on.
- Managing partner expectations. A key, and often overlooked, aspect of a successful law firm strategy is genuine partner buy-in to the market positioning that a firm sets for itself. Obviously, not all firms can play at the top tier of the market, and there are perfectly viable and profitable strategies for serving all market sectors. If there is a serious mismatch, however, between a firm's realistic market position or aspirations and the expectations of a significant number of its partners, there is almost always a built-in level of discontent that can deteriorate into a serious problem. In many of the failed firms we have seen, such a disconnect between market reality and partner expectations has been clearly visible.

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The recent failures of Heller Ehrman and Thelen serve as potent reminders that law firms are fragile enterprises that can get caught in downward spirals if not carefully managed and constantly renewed. Based on our review of numerous firms that have failed over the past decade, we believe that most could have avoided dissolution had they acted earlier and more prudently. The seeds of most law firm failures are sown long before the actual dissolutions. In our experience, early diagnosis and action can usually prevent the fundamental flaws identified above from deteriorating into full-blown law firm failures.