

Skinny Dipping: The Anatomy of Law Firm Demise by Melissa Hogan

Warren Buffet once said, “It’s only when the tide goes out that you learn who’s been swimming naked.” A rough economy tends to reveal those companies and firms that have been trying to “swim naked” and are now getting caught by the receding tide. When you consider the most recent large-scale law firm collapses: Wolf Block (1903-2009), Morgan & Finnegan (1896-2009), Heller Ehrman (1890-2008), Thelen (1924-2008), Dreier (1996-2008), and Thacher Proffitt & Wood (1848-2008), other experts have offered a myriad of explanations for each collapse. Are there common factors? Sure. Do many of the factors already exist at law firms that continue to survive despite the economic downturn? Yes. The question is who’s next?

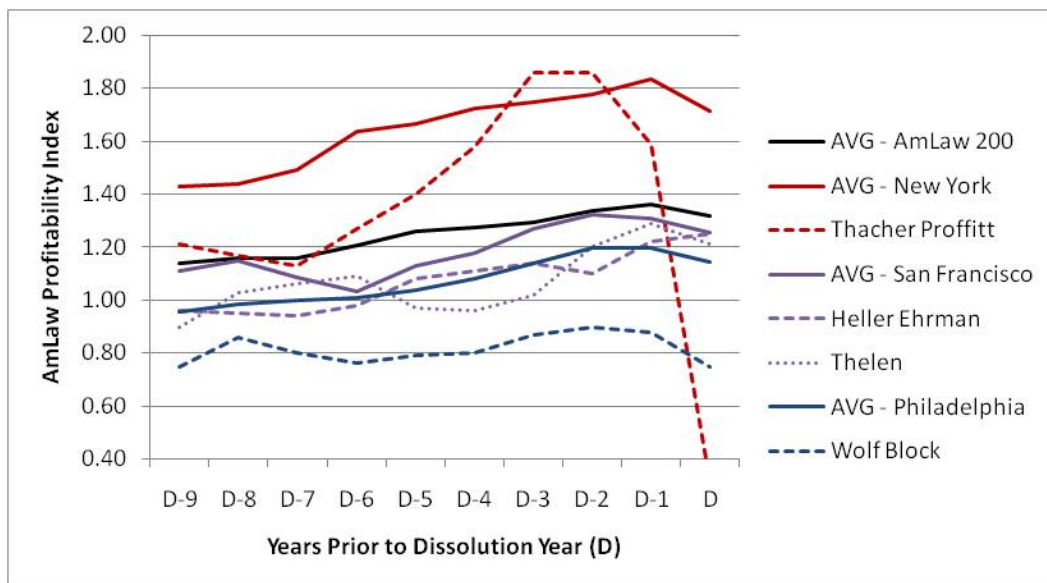
It is not surprising that journalists and commentators are looking for the common threads among this most recent series of law firm dissolutions. Often however, we are too quick to jump on the obvious connections that may only be coincidence rather than true indicators of the eventual demise of a once successful law firm. For example, both Heller and Thelen (and in fact, another notable law firm failure – Brobeck in 2003) were all headquartered in San Francisco. But does that mean all San Francisco law firms should move to more friendly shores? A more objective analysis of some of the real common threads would offer prudent food for thought.

There appear to be several circumstances which contributed to the eventual demise of many of these firms. One might argue that some are inter-related, but nonetheless, they are common to many failed firms. Firms should examine whether they have safeguards against these potentially devastating circumstances:

1. *Do you have a culture, compensation system, and other systemic safeguards to help prevent important partner (or partner group) defections?* Partner defections happen at almost every firm, but the “death spiral” of successive vital partner defections can sometimes trigger a firm’s loan covenants and/or create an inevitability of failure. Heller, Thelen, and another example being Goodman and Carr (Toronto, dissolved in 2007) all suffered over 100 partner defections in the one to two years before dissolution. As such, firms should carefully consider the factors that could prevent such defections. Hindsight after many law firm dissolutions reveals a culture that had degraded into one of distrust, little confidence in management, and self-promotion at the expense of the firm. While one might argue that little can be done to affect the particular culture at any given firm, in reality, culture is an amalgam of many tangible things, including compensation structure of associates and partners, management style, financial strength, strategic direction, collective personality of the firm, values and goals of the firm, etc., which can each be inventoried and addressed if incongruent with the firm’s overall success and strategic direction.

Sometimes, if a firm has a culture that places great importance on the firm’s financial position in the marketplace, if management does not appear to be addressing these issues, it can degrade the firm’s entire culture over time. For example, one might hypothesize that a lagging financial position in the short period prior to the dissolution was a major

factor in the firm's demise. However, if one examines the four dissolved firms' financial data for the 10 years prior to their demise, you can see that sustained below-peer financial performance offers a better description. If one looks at, say, the AmLaw Profitability Index, which measures the ratio of Profits per Partner to Revenue Per Lawyer (i.e., how profitable is a firm on the revenue that it is making and the lawyers it has), one sees that for the most part, these firms lagged behind the average AmLaw 200 firm and/or the average for firms in their city, for a sustained period.



2. *Despite best efforts to prevent partner defections, if they do occur, do you have strategies to address the implications of such defections? At the point of any significant partner defection, firms should examine the (likely multiple) causes of the situation. Was it the compensation structure? Was it a toxic culture? Firms should have a process which allows them to act intelligently, albeit swiftly, to examine the causes and implications of the departure lest the loss of one important partner turn into the loss of over 100 partners in one to two years.*

3. *Have you made strategic decisions to address the current market conditions on practice areas central to your firm? In retrospect, one can examine many dissolutions and point to the decline in a specific practice group or industry that contributed significantly to the overall decline of the firm. Whether it was the dot.com bust or the current decline in real estate, securitization, and corporate transactional activity, firms often relied too heavily on one particular cyclical industry or practice area. The ability to gauge a decline in the firm's pipeline and address it, once again, with intelligent but swift management action, is often vital to the continued success of a firm challenged by a certain market cycle.*

4. *If you are thinking about a potential merger, have you carefully analyzed the possible candidates in an objective manner and created the best business case to bring the merger to fruition? While mergers are often the means by which a firm catapults itself into a new competitive market, both in terms of size, financials, and clients, mergers can also be tricky business. In many cases, including Wolf Block, Thelen, Heller, and Thacher, the*

dissolution followed multiple failed merger talks resulting in the perception, both publicly and internally, of desperation. Each successive series of merger conversations appears inevitably less likely to succeed for one reason or another. Often, the final one or two sets of talks are firms who end up with a large group of lawyers from the dissolving firm, proving true the phrase, “Why buy the cow when you can get the milk for free?” As such, prior to engaging in any serious merger discussions, firms should have a firm grasp on their strategic direction and evaluate potential merger partners against that strategy prior to serious discussions.

In order to address the above risks, a firm has to be prepared to wait out the tide. Some firms are holding their breath, without a lick of swim gear, hoping that the good economy will return to cover them, lest the general partnership, the firm as a whole, or (yikes), the blogosphere discover that they have been skinny dipping. Let this serve as a whistle for everyone to check for their swimsuits.