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The crash of Dewey & LeBoeuf LLP was one of the largest law firm failures in U.S. history.

Law firm failures: looking for the right questions

By Edwin Reeser

The breathtaking speed with which many large law firm failures appear to take place has been noted in several recent large law firm collapses. But we are learning that law firm failures actually don't happen all that quickly, are a long time in the making, and not all of the partners are that surprised. So what enables and promotes some of the rust that corrodes law firm structures to apparent sudden collapse? We will ask a few questions, and make some industry typical answers. Then, we will look at one simple but previously overlooked factor, and revisit those same questions from an altered perspective and different "next level" answers.

Q.1. When does a large law firm generating one quarter of a billion to more than a billion dollars in annual revenue suddenly collapse within a matter of a few weeks?

A.1. When the "tipping point" of partners with portable client business leaves the law firm.

Q.2. What triggers a tipping point of partners with portable client business to leave the law firm?

A.2. When the decision of those partners with portable client business is pursuit of individual self-interest by leaving the firm is superior to staying.

Q.3. What is the reasoning that drives the decision that to leave is better than to stay?

A.3. When future investment required to maintain the entity relative to returns to be obtained is significantly greater than cost incurred in leaving the entity and returns to be obtained.

Q.4. How are partners confronted with the need/opportunity in the same period of time to apply the reasoning that makes so many of them arrive at the same conclusion to leave?

A.4. When there is a simultaneous revelation/discovery of critical information about the financial performance/condition of the law firm that changes their decision.

Q.5. How is the revelation/discovery of that critical information made?

A.5. When the description of the financial performance/condition of the law firm becomes so patently inconsistent with the reality that the real condition can no longer be concealed.

Q.6. How can the inconsistency between reported and actual law firm financial performance/condition of the law firm be concealed from so many partners for so long?

A.6. By the direction of the leadership of the law firm, and the Confidential Partner Withdrawal Agreement.

Never heard of that agreement? Of course not, it's "confidential"! But it has been ubiquitous for years, and whatever its legitimate origins may have been, its current application has morphed into perhaps the single most significant reason why some law firm leaderships are able to perpetuate poorly led and operated firms.

The reason is the interplay of four factors. The first consists of the confidentiality and non-disparagement covenants, the second is the mandatory arbitration of disputes, the third is the waiver and release of claims against the firm, and the fourth is the return of partner capital and exit process cooperation.

Basically, if the withdrawing partner wants their capital back, the distribution of accrued but unpaid profits to the date of departure, the expeditious transfer of client files, the waiver of the 60 day written notice of withdrawal period and a host of other accommodations to facilitate an "amicable" departure, the partner signs that agreement. This requires the partner to strap on a permanent muzzle. Thus the very persons in a position to reveal bad behaviors cannot whisper a word to anyone. Existing partners in the firm cannot have a conversation with them about what they know or why they left, and prospective new partners cannot talk to a former partner to ask about the firm if they are thinking about joining.

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Think back on a few recent large firm failures. Did even one departed partner from the scores who left in the three years preceding collapse surface as a factor in the demise of the firm? Did they reveal anything of consequence to anyone? Not that has been reported. Did they all completely lack knowledge of what was going on? Of course they had knowledge. Did any of the newly arriving partners from the scores who joined in the three years preceding collapse receive material information of the type that when it was revealed led to the demise of the firm? None yet have so acknowledged, and many claim that if they had known they would not have joined the firm. Did all of the partners who remained lack knowledge of what was going on? Definitely not.

Now let's consider the following new and perhaps better answers:

A.1. Law firms do not collapse in the relatively short period of a few weeks. The process has typically been underway for several years. The exodus of the "elevator asset" attorneys is only the final stage.

A.2. Either when (i) insider partners with knowledge of the actual financial condition of the firm decide it is time to get out, or (ii) outsider partners previously without knowledge of the actual financial condition of the firm become privy thereto. This is no longer a trading through self-interest of one platform for a better platform, but simple survival. For most partners it is a capitulation to the revelation that the firm has no future and the rush to the lifeboats is not a drill.

A.3. Either when (i) insider partners determine that the accrual of potential future liabilities outweighs present and near term distributions of rewards, or (ii) outsider partners recognize or perceive an inequitable previously undisclosed distribution of operating profits.

A.4. Revelation of the lack of transparency of actual performance, and the gap between previously represented and current actual knowledge is such as to be not survivable or repairable either practically as an enterprise, or from lack of credibility in leadership of the firm to effect constructive change.

A.5. A little thing that goes wrong. An inflated financial performance number reported to a publication, which is shown to be blatantly false. A statement or explanation of actions from leadership that is so clearly outside the boundaries of rationality that it triggers questions that are not answered, which leads to more questions. The event is typically precipitated from self-inflicted insider actions, not outsider attention to, the law firm. The trickle, then a stream, then a torrent that contributes to the partner departures is the dissemination and analysis of previously unshared information. The departures that follow the same pattern come months later.

A.6. It is not a "surprise" to all partners. It is a direct decision of leadership of the firm not to have transparently shared critically fundamental and basic information. Doing so would lead to addressing and overcoming challenges more directly, or hasten the demise of the leadership and possibly the firm if it could not. By concealing actual performance, the leadership extends the life of the firm for a short time, while guaranteeing that ultimately the firm must collapse and that the scope of the damage will be significantly greater.

Some firms just make a few bad decisions and that does them in. Some firms have bad luck being positioned in a bad place in the market. It happens in all business.

But in law, there appears to be a model that basically guarantees some firms will go out of business. A few partners in this model may reap very big rewards for themselves for awhile. How many participants benefit and how much money becomes unfairly redirected depends on how long the lack of transparency can be perpetuated and how much help can be enlisted in exchange for a share.

The Confidential Partner Withdrawal Agreement is one of the tools that has developed to make it possible to build a bigger hole to drop creditors into, while stuffing pockets of some partners with borrowed money, contributed money, or unevenly distributed earnings that won't have to be paid back or accounted for in a collapse or even bankruptcy — at least not in full, enabled by enforcing silence for "freedom." Significant debt, or heavy capital requirements, manipulation of modified cash basis accounting techniques and lack of crystal clear reporting to partners by leadership also play important roles.

It is what your firm is doing over the term of years preceding today that can be its downfall. It isn't leases and unfunded pension plans . And it isn't a year or two of reduced or disappointing earnings. Not if the partners know the truth. That is business dealing with the good years and pulling through the bad ones. No business is immune from economic cycles or occasional poor performance.

It is not being a partnership while constantly being told it is. It is having an organization where some are partners, and many who just think they are. That is not a revelation one bounces back from.

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