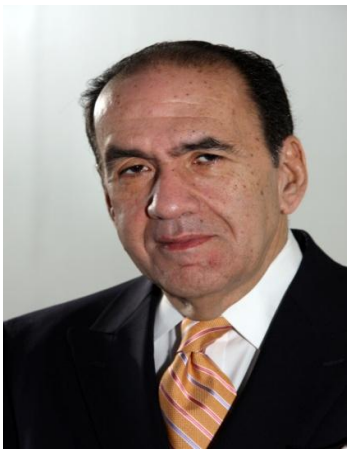
Kowalski&Associates

Read more on our blog by clicking here.



Avoiding Law Firm Implosions by Mandating Firms to Undergo Annual Stress Tests

Jerome Kowalski

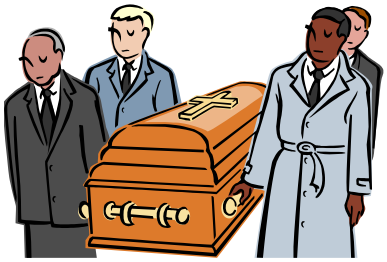
Kowalski & Associates

May, 2012

The horrific death spiral of Dewey & LeBoeuf, which started within the firm in October of 2011 and debuted its public spectacle in March, 2012, continues to evoke gasps and cries from all observers and participants. The latest horrors, not unexpected, are the loss of hundreds of jobs and the disappearance or dramatic reduction of thousands of pensions. To be sure, more ugliness lies ahead: Draconian financial penalties to partners and prosecutorial inquiries of potential criminal liability for some key Dewey players.

The question I pose to you today, dear readers, is whether we are simply voyeurs or whether a sense of professional high mindedness should prevail so that urgent steps are taken to

prevent the next seemingly inevitable law firm implosion? Did we come to the speedway pretending only to be interested in the competition but hoping for carnage or are we among those who seek to promote safety and prevent future crashes?



Dewey & LeBoeuf's Current State of Play

The crescendo of public discourse of the Dewey disaster escalates daily. One of the most recent cogent pieces, sets forth a seemingly well informed and apparently factual exposition of the events leading up to the inevitable denouement. Other well informed pieces analyzes the root causes of the Dewey & Leboeuf debacle. A brief moment of levity was inserted into the mix as an avuncular former Dewey & LeBoeuf partner and department head stared straight faced into a television news camera and calmly explained that the reasons for the firm's implosion was that after Steven Davis, the now ousted chairman of Dewey, sat down with his partners in January and apparently revealed to them for the first time that the firm was functionally insolvent, headhunters had the gall to help partners find new positions, the media had the temerity to report on the facts and the district attorney had the audacity to conduct an investigation of serious allegations of criminal wrongdoing by senior managers at Dewey & LeBoeuf. These *bon mots* brought to mind the tale of the owners of a bus company who were called to task because they had employed an alcoholic bus driver who in his stupor caused a horrendous crash resulting in awful carnage. The owners calmly explained that they were not to blame. The reason so many people were taken to the hospital was because of the fleet of ambulances that descended on the scene and the cause of so many reports of broken limbs was attributable to the zeal of the hospital's ex ray technicians.

The fact is that since the 1988 implosion of Finley Kumble, then the world's second largest law firm, there have been some 43 major law firm bankruptcies. Each major law firm bankruptcy brings disgrace to the profession, disrupts lives, erodes confidence in the profession and creates a cascade of unemployment, poverty, death and disease (the rate of stress related diseases and mortality post law firm bankruptcies, reported only anecdotally, is staggering) and divorce (again, reported only anecdotally).

The blight on the profession is not simply the fact of these law firm failures, but the utter failure of the profession to address these failures and take any steps to prevent them. The appalling nature of this Ostrich like stance is the generally accepted belief that a number of large law firm failures in the coming months seems inevitable.

The problem

The three inch thick annotated American Bar Association's Model Rules of Professional Conduct that sits in every law firm in America is completely silent on the issue of law firm financial reporting, whether it be to the firm's partners, its lenders, vendors or the media. The self reporting through *The American Lawyer* is largely recognized to be unreliable at best, or a large bad commercial joke at worst. Let's simply look at the soft, puffing (and apparently demonstrably false) report that Mr. Davis gave *The American Lawyer* in March, 2012 as a prime example. Neither the firm nor Mr. Davis was called to task for gross overstatements of revenues; *The American Lawyer*, which derives significant revenues from theses annual reports and the hoopla leading up to them did not immediately exercise the requisite journalist imperative of rigorously subjecting Davis to the crucible of informed journalistic inquiry (although it did, to its great credit, after public disclosure of the Dewey deception, take the unprecedented step of unilaterally restating Dewey & LeBoeuf's financial reports).

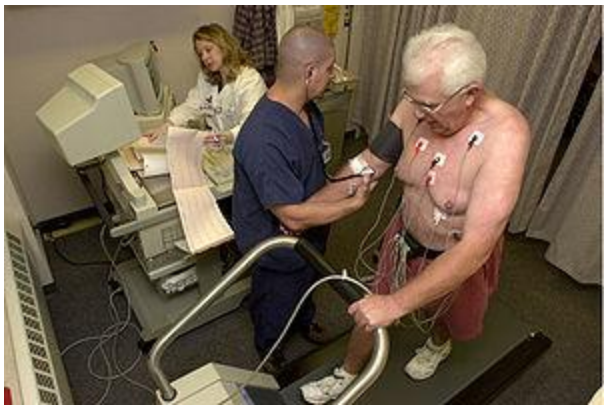
The Model Code is also strangely silent on the issue of law firm governance. Based on what has this far been revealed and now seems indisputable, based on the public record to date, ***the demise of Dewey & LeBoeuf is largely attributable to a complete and abject failure of proper governance.*** The tragic irony is that Dewey still boasts on its web site of its superlative corporate governance practice group. Read it now, while the web site is still up and running. If you missed it, here is a pertinent excerpt:

> "Based on decades of experience in corporate law, governance, restructuring and litigation, Dewey & LeBoeuf has assembled a next generation capability to achieve clients' goals… Our multidisciplinary approach enables us to develop special tools that allow directors and management to avoid 'not knowing.'"

We can apparently now conclude that Dewey did not capitalize on its "generations of experience" in establishing a system for itself of checks and balances, oversight and accountability required of this generation of commercial enterprises. The firm's culture seems to have been built on partners proudly "not knowing." The firm's mascot may well have been an ostrich; the firm seems to be a paradigm of the cobbler's children going barefoot.

Of the four score and some firms that failed over the past three decades, all have seen complete failures of appropriate governance, inaccurate financial reporting and excessive leverage and debt. Some, like Dewey have fallen victim to excessive compensation paid to laterals. More have flawed partner compensation systems.

The Solution



The need to address these issues could not be more urgent. To rely on the sloth of the ABA to urgently address these issues, then followed by fifty-one local bar rule making deliberative bodies, which collectively makes the ABA seem lightening-like, would require the complete suspension of disbelief. To suggest that large law firms could be brought into line fearing disciplinary action by state disciplinary bodies would require the confidence of a naïf. Despite the three inch thick annotated tome that comprises the Model Rules, the overwhelming number of disciplinary actions brought by these bodies only relates to escrow account defalcations and disbarments of convicted felons. Witness the fact that the current public record shows an ongoing criminal investigation of Dewey managers, as well as seemingly clear evidence of deception by some of these lawyers, some rather facially convincing *prima facie* evidence of securities fraud by the firm as an issuer of securities, violations of fiduciary obligations to partners, violations of statutory duties to employees and violations of rights owed to the pension beneficiaries of the firm. Certainly, there may well be complete defenses to each of these matters and I invite my many Dewey readers (or their counsel) to provide them below. But the real point is that while investigations by disciplinary committees are secret, we each can sleep soundly tonight assuming that no such investigation has commenced.

Rather. the solution to this clear and present danger of future large law firm failures must come from BigLaw itself and its stakeholders, including law firm lenders, institutional clients and the academy.

What is required is for law firms to retain independent professionals who would annually conduct a stress test, having full and unfettered access to all of the firm's data and information, and then report to the firm and its partners (equity and non-equity) that (a) the firm has adequate procedures in place to provide adequate oversight of its management group; (b) an appropriate

system of accountable governance is in place; (c) the firm's financial reporting (audited or not) fairly states the firm's financial condition as of the reporting dates; (d) the firm's general counsel is timely provided with all information necessary to discharge his or her duties and that he or she has full and open access to all relevant information as well as the ability to report any concerns to a full governing body; (e) the firm has an appropriate risk assessment and management officer, adequately performing the require objectives of that office; (f) the firm has an appropriate mechanism in place to avoid conflicts of interest and to otherwise insure full compliance with all applicable ethical rules, laws and regulations, (g) the firm maintains adequate insurance coverage; and, finally, (h) no set of facts was discovered that raises any apprehension that the firm is at risk in continuing as a going enterprise. Any failures or suggested improvements in any of these areas should also be described in detail. Similarly, any deficiencies detected in previous reports and the adequacy of any steps taken to ameliorate those deficiencies should be further described. Should management of the law firm elect to discharge the independent professional because of any disagreements in interpretation, the professional should be contractually bound to disclose those facts to the partnership.

There may well be other items that should be included in these reports and suggestions will doubtless appear in the comments section below. If you have a thought, feel free to pony up.

I would further propose that the independent professionals conducting these tests prepare at least two forms of reports: The first being the detailed report described above and the second a summary form which might be made available to clients and prospective clients, lateral candidates and law schools as part of a NALP disclosure. Every one of these stakeholders has a simple right and need to know that the firm will be there next year.

As I suggested, it is extremely unlikely that any regulatory body will timely and efficiently create a mandate for these reports. Rather, a forward looking well managed law firm will certainly see the universal benefit and advantage of having such reports issued to provide comfort and assurances to its stakeholders and to avoid being tarnished by the reputation of a failed law firm. The reports would be potent marketing and recruiting tools. These reports would certainly be most beneficial to top down management style law firms and those that operate in a black box.

I could certainly also see institutional lenders and clients routinely requiring their borrowers and counsel, respectively, requiring these stress tests, particularly as they have been seriously burnt by previous law firm failures and certainly as to lenders, they may correctly feel that what's sauce for the goose is sauce for the gander. It will, I suspect, take only a very small number of lenders and important clients to make these reports a required norm; indeed, mandatory. Similarly, it will take only a handful of the AmLaw 200 to come forward and

proudly offer these reports to make their annual production an industry requirement. The market will require nothing less. The implosion of a law firm casts a pall on the entire profession and creates a blot on every large commercial law firm. Those blots can be avoided by having large law firms don the Teflon that these stress tests should provide.

Jerry Kowalski is the founder of Kowalski & Associates, a consulting firm serving the legal profession exclusively. Jerry is a regular contributor to a variety of publications and is a frequent (always engaging and often humorous) speaker to a variety of forums. Jerry can be reached at jkowalski@kowalskiassociates.com or at 212 832 9070, Extension 310

Related articles

- Dewey Think We Are Watching the Deconstruction of a Venerable Law Firm? (kowalskiandassociatesblog.com)
- Dewey, Sex, Lies and Videotape (kowalskiandassociatesblog.com)
- Dewey & LeBoeuf pension plans seized; faces lawsuit (news.yahoo.com)
- Former Dewey Chair Claims He is Owed $61 Million (jdjournal.com)
- Dewey Need to Take a Pledge? (kowalskiandassociatesblog.com)
- The Dewey chronicles: The rise and fall of a legal titan (news.yahoo.com)
- Dewey Shoot the Lifeboats as Our Partners Seek Safety From Our Law Firm in Stormy Seas? (kowalskiandassociatesblog.com)
- Dewey Partners and Retirees Face Huge Financial Losses (nytimes.com)