

TURNING AROUND THE TROUBLED LAW FIRM RECOGNIZING THE SIGNS AND IDENTIFYING THE PATH TO HEALTH

We've Got Trouble...With A Capital "T"

All law firms go through the same life cycle. Initially partners share an almost blind and intoxicating optimism. As the firm matures, partners dreams and ambitions are realized in increasing measure. But the inevitable occurs when momentum slows and the intoxication of the early days turns to a pessimism-tinged sobriety. Confidence slips, and the future doesn't look as bright. At this point, often months before it ever shows up on the bottom-line, the partnership has officially become a troubled law firm.

But *troubled* is not synonymous with *doomed*. In fact, the difference between strong enduring firms and those that fail is defined by *how quickly and decisively leadership responds*.

The reality is that law firm failures are becoming frighteningly common place. According to a 2004 Hildebrandt study, between 1998 and 2003, 80 firms of 10 or more lawyers simply failed, unable to respond in times of trouble. And if we thought size was an insulator, the last few years have shown the fallacy in that thinking with the demise of giants like Arter & Hadden, Brobeck, Pennie & Edmonds and Altheimer & Grey.

So, in this article we will look at what causes the early stages of trouble for a law firm, and what leadership must do to turn things around.

Underperformance: The Root of All Problems

The truth is that a troubled law firm is, quite simply, a firm that is underperforming. The degree of trouble correlates with two factors: how long the condition has persisted, and the extent of the underperformance.

In the earliest stages, underperformance is manifest in *declining market position*. In this context, a number of things conspire to undermine market position, including how the firm is perceived by its owners, employees, clients, law schools and vendors. A declining market position left uninterrupted ultimately triggers a loss of confidence among clients and partners...which leads to a loss of partners...which leads to the loss of clients...which pressures the economics of the organization, leading to the further loss of partners and clients. This cycle ultimately leads to a loss of confidence among vendors. Creditors begin restricting or even ending lending relationships – the harbinger of an ultimate loss of the organization. When troubles reach this level the most fortunate firms find themselves the target of an acquisition; those less fortunate file for bankruptcy.

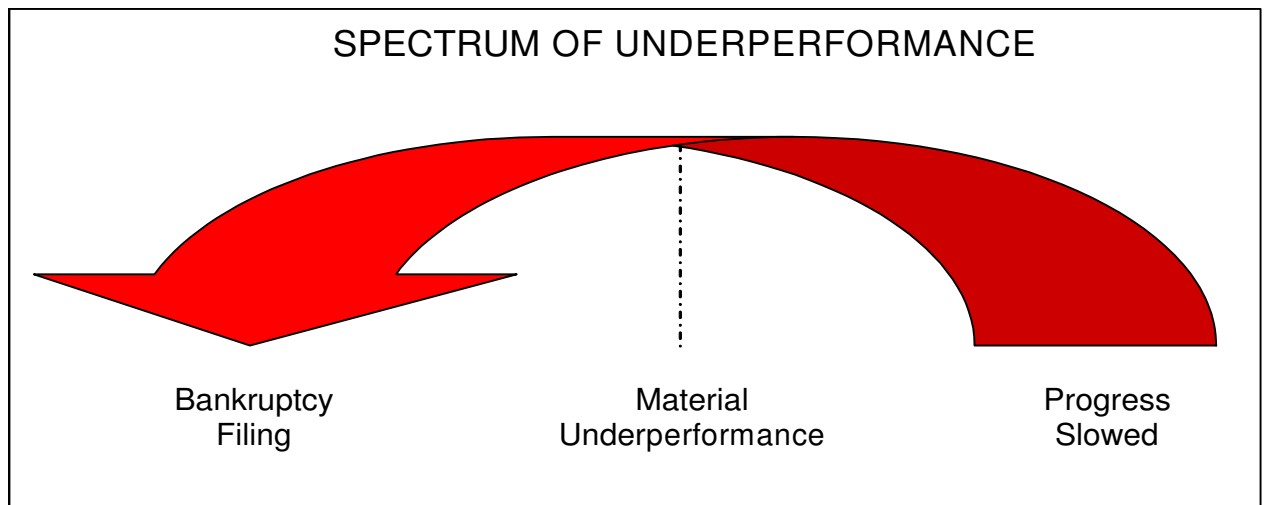
The Early Warning Signs

If a declining market position signals underperformance, leadership needs to recognize the early signs that a firm's position is beginning to slip. The following are eight of the most common of those signs:

1. The unanticipated loss of lawyers
2. The loss of clients or increased difficulty in winning new business
3. Increasing turnover in key positions in the firm
4. Flattening or declining profits
5. Falling revenues
6. A worsening debt position
7. Negative external press
8. Difficulties in hiring lawyers

All well run firms recognize benchmarks and maintain performance data for revenue, profit and turnover. The best also routinely evaluate the firm's performance in all of the areas represented by these eight early warning signs.

Any one of the above signs should set off an alarm; but how does leadership measure how much trouble the firm is in? The graphic below reflects the *Spectrum of Underperformance*. And no matter where you are on the spectrum, a turnaround is in order.



Planning the Turnaround

The first and most important step in turning around any organization is recognizing that a turnaround is necessary. That said, lip service to the trouble will, of course, accomplish nothing positive. No matter how long your firm has been underperforming, and without respect to where the firm sits on the *Spectrum of Underperformance*, an actionable plan is essential. Your plan must address two specific objectives.

1. Drive institutional renewal -- restoring confidence and stability. The Kaye Scholer story exemplifies such a turnaround (see “A Successful Turnaround”). In the event that the restoration of confidence isn’t possible and the organization faces dissolution, objective number two becomes job one.
2. Avoid a bankruptcy filing at any cost short of violating your duty to partners or creditors (discussed below in “Special Issue”). No one wins in a bankruptcy; lawyers and non-lawyers are displaced, clients are inconvenienced, the community and profession suffer and, to my knowledge law firms -- unlike corporate entities -- never survive bankruptcy. The Brobeck story (see “A Failed Turnaround”) demonstrates what can happen if bankruptcy isn’t avoided.

Special Issue

It is worth noting that as a firm moves from right to left on the *Spectrum of Underperformance*, there exists an area defined by the courts as the “zone of insolvency.” Exactly where this zone occurs is the subject of another discussion, but once a firm enters it, developed case law suggest that the duty which leadership had to partners alone now expands to include creditors.

Keys To Executing the Turnaround

Once you’ve decided to right the ship, three steps are critical to the execution of a successful turnaround.

1. Determine whether you need outside professional help. Generally speaking, the further left you are on the *Spectrum of Underperformance*, the greater the need for assistance. If you find your firm on the far left, consider a combination of turnaround consulting support and bankruptcy counsel. If you’re somewhere on the right side of the spectrum, turnaround expertise may be all you need.
2. Identify the cause (or causes) of underperformance. This, needless to say, is easier said than done. Yet, it is essential. You must understand what factors precipitated the troubled condition in order to effectively address change. Although every firm is unique, some likely causes of underperformance include:
 - a. A poor strategy (or none at all)

The unfortunate truth is that most law firms do not have a well thought out strategy. Many have no strategy at all. According to a recent Edge Group survey, only 60% of U.S. law firms have a formal strategy of any type. In the best case, the consequence of no strategy is a lack of institutional alignment, causing waste and a declining competitive position.

b. Growth.

As ironic as it may sound, the realities of growth frequently drive firms from a thriving position to one in which the future is threatened. The legal profession has become so infatuated with growth that most firms seek to add numbers solely for the sake of increased size. Non-strategic growth taxes an organization in at least two ways. First, growth dictates an increased need for leadership and management; yet the typical law firm isn't in a position to deliver those skills. So, a growing firm can often find itself under led and under managed. And second is the issue of resource deprivation. Resources dedicated to any initiative not directly tied to client service will threaten competitive advantage. The only growth that is strategic in nature is growth that is aligned with maintaining (if not increasing) levels of client service.

c. A system with poor accountability.

Lawyers are generally very independent. This autonomous nature has led to an absence of systems of accountability within law firms including those intended to hold individuals accountable for performance. At times the lack of accountability is driven by the absence of articulated standards. At other times it is the result of a failure to maintain a system which monitors *expected-to-actual* performance.

d. Management complacency.

It is a virtual certainty that the longer a firm has been underperforming the greater the degree of complacency. If leadership is attentive to performance and routinely taking steps to address it, the firm is not likely to become a troubled organization.

e. Poor client feedback systems.

To some degree, the root cause for most troubled/underperforming firms is a loss of client focus. When the focus of a law firm shifts from client service to any other target, whether growth, technology, image, or profitability, the effect is underperformance. On the other hand, making a proactive investment to acquire quality feedback from clients can pay off in terms of client satisfaction and loyalty.

f. Poor market feedback systems.

To succeed, a firm must be constantly aware of evolving market demands, and adjust accordingly. There is no better recent example of a firm failing to monitor and adjust to market conditions than Brobeck.

3. Seize control of cash flow. The further you move to the left on the *Spectrum of Underperformance*, the more urgent the need to get a handle on cash flow. In any troubled organization, *cash is king*. In order to gain control, meet with bankers and have a frank discussion about the pressing issues. Deliver one clear message: *that you intend to manage your turnaround in a way that protects your bankers' interests*. Propose a schedule for constant communication designed to keep them apprised of each step in the turnaround process. A good relationship with bankers is a prerequisite to a successful outcome.
4. Develop a detailed turnaround strategy. It is impossible to generalize about the specifics of a turnaround strategy, as each situation is unique. This is where experienced professional assistance may prove invaluable. There are, however, cornerstones for a successful turnaround strategy.
 - a. Develop a means for eliminating the principal drivers of underperformance. This often means eliminating underperforming parts of the firm including space, people and perks.
 - b. Design a communication program. Communication will never be more important than when you are trying to work out a problem. Communicate often, honestly and with confidence and hope.
 - c. Identify the basis for renewal. Every firm has core strengths, identify yours. Investing here is the path to institutional renewal, and the key to building new and meaningful momentum. This often combines identifying what you are going to invest in and what you are going to eliminate.
 - d. Map out an execution plan. Whatever your plan for a turnaround, it has action steps that must be assigned to responsible parties. The leader's role is to determine what the plan is, assign responsibility and hold those individuals accountable.
 - e. Select a leader who can lead the turnaround. Perhaps the most unpopular question in a turnaround is that of leadership. The difficult truth is that law firms, generally, become troubled as a result of how they are led (or more often *not led*). Translation: if the current leadership has led the firm into the current predicament, the question begs, can they be effective in leading the turnaround? On the other hand, if leadership is fairly new to the problems, either because the problems are new or their role is new, then they are more likely to succeed.

Timing

It is rarely too late to turn around an underperforming organization, but remember, there is a direct correlation between how quickly you act and the probability of success. Great leaders identify weakness early and act quickly to eliminate it.

A FAILED TURNAROUND

The Crisis at Brobeck

In late 2000 a sharp decline in the technology sector led to a decrease in demand for sector service providers, chief of which was the high-flying law firm Brobeck, Phleger & Harrison. In the preceding few years the firm had become the darling of the legal industry -- growing rapidly, realizing skyrocketing profits, even advertising on the Super Bowl! They were quite simply the envy of Managing Partners from coast to coast.

In 2001, as a result of rapid expansion, burdensome debt loads and declining revenues Brobeck started losing key partners and tremendous internal dissention developed. The firm's leader during its heyday, Tower Snow, was fired and new leadership stepped in to stop the bleeding and turn the firm around. The turnaround started with an attempt to get capacity and demand back in sync by downsizing the law firm. It ended with a failed attempt to merge the firm into Morgan Lewis & Bockius.

On January 30, 2003, after being in business 77 years, Brobeck announced its decision to close its doors, leaving more than 1,000 lawyers and staff stunned and unemployed. The closing was followed, a month later, by a bankruptcy filing.

If this story wasn't sad enough, the epilogue is even sadder. The former partners of Brobeck, the bankrupt estate, former employees, Clifford Chance (the firm Tower Snow joined after Brobeck) and Morgan Lewis have all been in litigation against each other in an attempt to sort out what has been a tragic mess. The most recent developments include former Brobeck partners agreeing to pay the estate \$23 million in individual payments ranging from \$5,000 to \$500,000, and Clifford Chance agreeing to pay the estate \$5.5 million, resolving allegations that its recruitment of Brobeck partners contributed to the firm's demise.

The clear turnaround lesson of the Brobeck saga is that *you can't afford to wait*. The firm began underperforming at least as early as 2000 and it wasn't until mid-2002 that decisive action was taken. Prior to that a growing number of partners had lost faith in the institution's future many left and many that stayed were disenchanted. Profits per partner had dropped from nearly \$1 million in 2000 to \$245,000 in 2002. By the time a turnaround was attempted it was sadly, too little too late.

A SUCCESSFUL TURNAROUND

The Crisis at Kaye Scholer

In the spring of 1992, Kaye Scholer was in as precarious a position as any law firm has ever been. Because it represented Lincoln Savings & Loan (owned and controlled by the now infamous Charles Keating), the government went after Kaye Scholer like no firm before or since.

Frustrated by a perceived lack of cooperation with their investigation of Lincoln, the Federal Office of Thrift Supervision and the Securities and Exchange Commission decided to turn up the heat. They demanded an immediate payment of \$275 million in damages for misleading the government, and took the unprecedented step of freezing the firm's assets as well as some of the assets of individual partners. The firm couldn't pay rent, payroll or even the light bill – signs of serious trouble.

At this point, nothing short of prompt decisive action could save Kaye Scholer. Fortunately, bankruptcy partner Michael Crammes, a relatively new addition to the firm, stepped forward. Crammes offered an aggressive plan to immediately reach an agreement with the government and the firm's bankers. Crammes led that charge and was successful in not only reaching the necessary agreements, but in convincing his partners to stay the course during the turnaround. For handling the difficulties in such an impressive manner, Crammes was elected the firm's new Managing Partner.

A crisis that would have killed most firms became a successful turnaround. Kaye Scholer not only survived, but since has become very profitable and highly respected, establishing itself as with one of the leading bankruptcy firms in the world. A successful turnaround indeed.