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Existential Threats to Law Firms

By Ward Bower

Early 19th Century German philosopher Georg Wilhelm Friedrich Hegel observed that human organizations and institutions hold within themselves the seeds of their own destruction. Of late, news of the demise of law firms, including AmLaw 200 firms, seems to confirm Hegel's observation.

In recent years, we have lost several AmLaw firms each year. Some of these firms have dropped out of the AmLaw 200 due to declining revenues, while others have been surpassed in the league tables by firms on the upswing. Some firms have dissolved, and some have been acquired by other AmLaw firms. Think in terms of Dewey LeBeouf, Patton Boggs, Dickstein, McKenna Long. The list goes on.

What causes successful law firms to fail, or to falter so they need to be 'rescued' by an acquirer? There is no one answer, but there are at least two important issues, *economics and demographics*. Let's take a look at some of the issues that can pose existential threats to a law firm.

LONG-TERM BANK DEBT

Long-term bank debt is an internal threat to law firms when such debt exceeds the depreciated value of fixed assets plus cash. Here we are not referring to short-term revolving lines of credit, which firms generally have to zero out each year. Rather, we are referring to longer term loans. To the extent such loans exceed depreciated value of fixed assets plus cash on hand, the firm is borrowing against future partner earnings. This will reduce future incomes thus making the firm vulnerable to poaching or partner departures.

EXPIRING LEASES

As a result of the failure of other law firms and businesses, landlords are more likely to ask for individual partner guarantees in new lease agreements. Partners approaching retirement frequently resist new leases with personal guarantees, and when that happens, firms can fracture.

UNFUNDED RETIREMENT OBLIGATIONS

Unfunded payments to former partners are a time bomb ticking in many partnership agreements. Such payments skim profits from active partners and reduce profits per equity partner. If more than one or two percent of revenues are being paid to former partners who are no longer active in the firm, the firm is entering a danger zone. In today's competitive environment, the reduction of three or four percent of net income is enough to lead some partners to look for greener pastures.

GUARANTEES TO LATERAL PARTNERS

A spate of lateral hiring in recent years has led some firms to provide multi-year minimum income guarantees in order to attract lateral partners. This is a dangerous practice, as Managing Partners of large law firms report that only 50% of lateral hires are deemed successful.

Successful lateral hires will generate sufficient revenues to cover their compensation and benefits, as well as their allocated overhead. Those who do not reach expected levels of productivity will tap into guaranteed payments that effectively subsidize their income at the expense of other partners. This situation is simply unsustainable and threatens the future survival of the firm.

NO LEADERSHIP SUCCESSION PLANS

Many law firms are led by baby boomers, now in their 60s and 70s. Without appropriate preparation, some firms find themselves with a leadership void after boomers retire, die or become disabled. If succession hasn't been carefully planned and new leaders identified, firms can easily lose their direction and begin to hemorrhage partners.

CONCLUSION

If your firm exhibits even one of these existential threats, you may be at risk. Certainly if two or more are present, prompt action is necessary to eliminate the threats. A study of the history of failed law firms leads to no other conclusion.

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