Illustration by Daniel Liévano

WARNING SIGNS

THREE DECADES OF DATA REVEAL HOW BIG LAW'S GREATEST FAILURES UNFOLDED, AND WHAT WE CAN LEARN FROM THEM.

BY LIZZY MCLELLAN AND GINA PASSARELLA

WHEN LECLAIRRYAN REACHED THE point of no return in August, finally acknowledging its plans to dissolve after months spent bleeding partners, it came into focus that the firm's aggressive expansion had actually contributed to its demise.

The firm had promised partners more than they were worth and signed expensive leases on understaffed offices. It missed budget in 2011 for the first time, but not the last. When new leadership took over in 2016, there was talk of "righting the ship," a former shareholder recalls. Any attempts to do so were too late.

By the time it closed, LeClairRyan had borrowed $15 million from a lender, nearly half of which remained as debt in bankruptcy. It owed more than $8 million to UnitedLex, related to a collaboration that was billed as the firm's savior but ultimately became yet another source of debt. And those debts don't include capital contributions as high as $100,000 per person, collected from as many as 50 ex-partners who now seem unlikely to ever be repaid.

Even as the firm's debt grew, some lawyers were given bonuses to stay, sources have said. A select few partners with guaranteed contracts kept enjoying a high level of compensation while others took pay cuts. Even in its final year, the firm boasted of its plans to change the industry with its new, updated model, dubbed "Law Firm 2.0" by leadership.

The details of LeClairRyan's collapse are unique, but its trajectory is far from it. As recently as Sedgwick in 2017 and as far back as Finley Kumble more than three decades ago, overambitious law firms have ended up in trouble. Nearly all were growing head count and revenue in the years leading up to their demise. But an analysis of 10 years of data leading up to a dozen different firm collapses shows that in most cases, profits per lawyer failed to keep pace with the costs of expansion, leaving firms overburdened by the mounting debt that helped fuel their growth.

As recently as 20 years ago, the major law firm dissolutions could be counted on one hand. But in the wake of the dot-com bubble burst, and then the Great Recession, they began to pile up. Even economic recovery couldn't stem the tide. Growing financial and client pressures forced firms to rethink their strategic vision, and many chose growth. Some followed the wrong path.

Each failure was another chapter in an unfolding story, whether it was a firm dissolution or a firm welcoming absorption by a larger entity as financial pressures grew. Some firms grew head count by hundreds of lawyers in just a few years before they met their end. Others invested in specific practices, looking to become the go-to firm for an industry or legal service niche. And a few ended up under investigation—or worse—for questionable business practices.

But they all had something in common: a strategy developed in the best of times that didn't consider what the worst of times might hold.

Janis Meyer, the former general counsel of Dewey & LeBoeuf, which filed for bankruptcy in 2012, describes the common thread between failed firms simply: "They had expectations that couldn't be fulfilled."

A number of consultants say law firm failures can often be traced back to one or more of three issues: expanding too quickly, failing to manage costs and generally poor leadership.

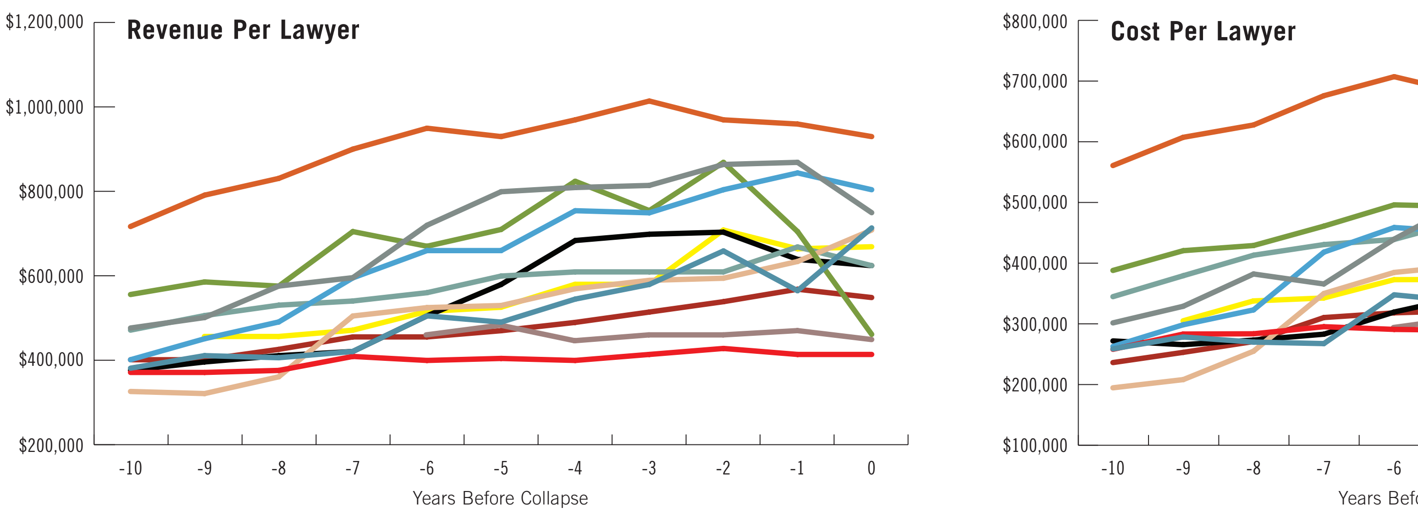
"When the money got tight, those people who had huge practices and portable business left. But had there been stronger leadership, that might not have happened," says Les Corwin, a partner at Eisner whose practice includes law firm bankruptcies and dissolutions. Corwin places much of the blame of law firm failures on a lack of leadership.

External factors, including a recession, can accelerate a firm's demise, but typically are not at the root of its problems. Collapsed firms "had not grown in the right ways," says Mary K Young, a consultant at Zeughauser Group who previously worked in the marketing department of Howrey, which dissolved in 2011.

Failed firms all had something in common, Janis Meyer says: "They had expectations that couldn't be fulfilled."

PRELUDE TO COLLAPSE

In the decade before firms closed their doors, costs often rose at an unsustainable rate, making profits harder to maintain.



Data from ALM Intelligence

Before 2008, Young says, "you could bury a lot of issues." But since the Great Recession, firms have nowhere left to hide them.

GROWING REVENUE, GROWING DEBT

Bill Brandt has worked on a number of law firm dissolutions, including Howrey, Heller Ehrman (2008), Coudert Brothers (2005) and Dewey. He says law firms run into trouble when they lose focus on the fundamentals—the blocking and tackling, as a football coach might say.

"You need to keep getting clients, working for those clients, getting paid by those clients," Brandt says.

Instead, firms that ultimately fail rush to grow rather than using an appropriate level of caution. They open accounts for clients that will never pay, Brandt says. They fail to collect, and their realization rates plummet. Then, he says, they borrow from the bank to make partner distributions, building up debt based on receivables that aren't likely to arrive.

An examination of financial data for 12 now-shuttered law firms in the decade leading up to their collapse shows that gross revenue is not a clear indicator that a firm is approaching failure. The data, available through ALM Intelligence, shows some unsurprising common threads, including a drop-off in head count and profitability in the year or two before a firm's closure. Naturally, mass departures are often the first public sign that a firm is in grave danger.

What may be more surprising is that many of the dozen firms were growing in head count and revenue right up until lawyers began heading for the exits. Several even saw revenue per lawyer climb in those years. On the surface, these firms appeared to be growing and thriving, surpassing peers on the Am Law 200 rankings.

But across these 12 firms, cost per lawyer kept going up, at an average rate higher than the annual growth in profits per lawyer. By the two years preceding collapse, the average failed firm saw profits per lawyer decrease 5.9%, then 25.8%. All the while, costs were still rising—1.3% and 7.1%, respectively, in the two years before collapse, on average.

The biggest leap in head count for the failed firms tended to occur three years out from collapse—an average 12% jump after several years of growth at a more modest 4% average clip. Head count growth fell to 3%, on average, in the year after that sudden increase, then declined 3.5% and, ultimately, 8.2% in the year before firms closed their doors. Revenue per lawyer at the average failed firm fell 2%, then 3%, in the last two years of full operation.

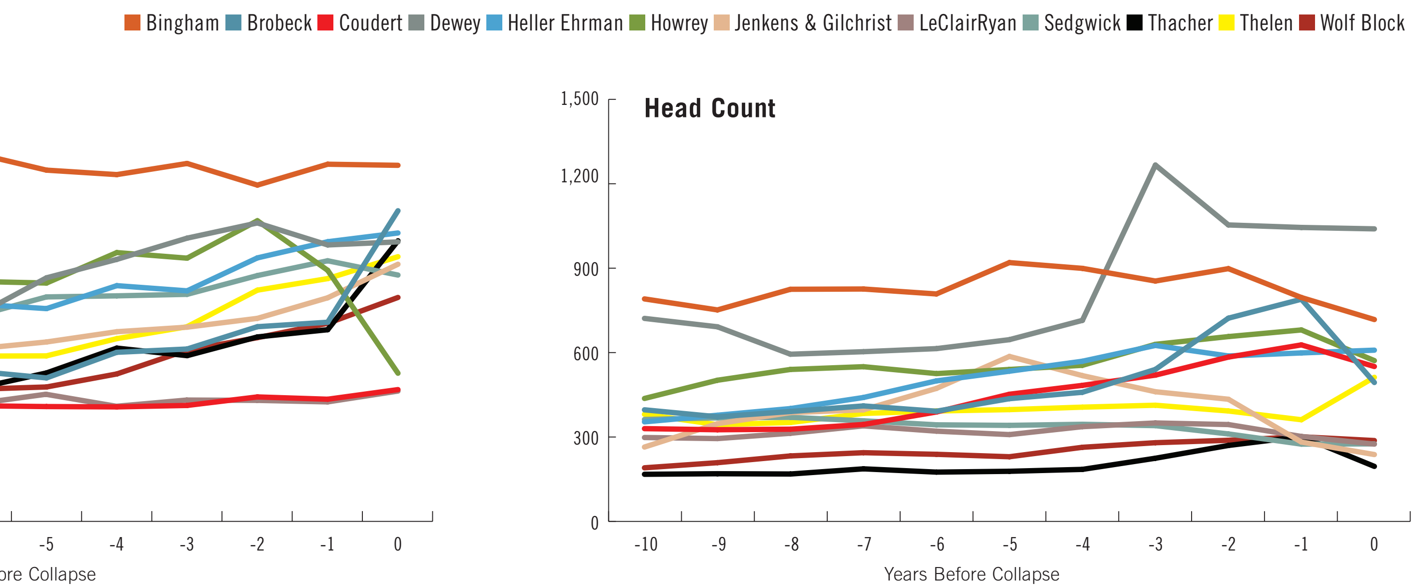
Several of the 12 law firms saw no meaningful growth in profits per lawyer in the decade before their demise—as revenue per lawyer grew, costs per lawyer grew right along with it. This was the case at Coudert Brothers, Wolf Block, Sedgwick and LeClairRyan, according to ALM Intelligence data.

In many cases, trouble was also brewing beyond the publicly reported financial numbers.

LeClairRyan, for instance, reported gross revenue growth for 2013 and 2014. But according to court records, it missed budget each of those years.

At nearly all of the failed firms, major debt was building.

Brobeck Phleger & Harrison had $90 million in debt when it closed in 2003, The American Lawyer affiliate



“It doesn’t take a whole lot of debt to cause turbulence in a firm if the cultural cohesiveness isn’t there.” —Jay Benegal

The Recorder reported at the time, including $40 million it borrowed from Citibank about a year before it dissolved.

When Coudert Brothers closed in 2005, it owed $23 million to its bank creditors, Citigroup and JPMorgan Chase & Co., and after paying that off the firm still listed $18 million in liabilities in bankruptcy, The American Lawyer reported in 2006.

Thelen owed Citibank $60 million when it decided to dissolve in 2008. Heller, which dissolved the same year, had about $72 million in liabilities, about three-quarters of which was owed to Bank of America and Citibank.

Howrey, which closed a few years later, had $25 million outstanding on its credit line from Citibank, and when it became apparent that the firm might not be able to pay that back, the relationship with the bank soured, The American Lawyer reported in 2011.

Dewey had over $245 million in liabilities when it filed for bankruptcy protection, including $76 million in debt to its primary secured creditor, JPMorgan Chase.

Bingham McCutchen, whose merger plans with Morgan, Lewis & Bockius fell apart in 2014 after the departure of more than 100 partners in 18 months, had reportedly accumulated $100 million in debt.

Before the recession, law firms were more willing to borrow money to finance their growth, Sanjay Benegal, a senior vice president and legal industry specialist at Citizens Commercial Banking, says.

“If you look at the golden era of the legal industry, 2001 to 2007, firms were very comfortable borrowing,” he says.

But many firms have since changed their habits—more now rely on capital

contributions from partners and use credit minimally, aiming to pay off debts quickly, Benegal says.

“They boast about the fact that they have credit exposure, but they don’t utilize the credit exposure they have,” he says. “They take pride in the fact that they don’t really need to use it. It may have been an exception pre-financial crisis, but it’s not an exception now.”

But that doesn’t mean firm failures have ceased.

“It doesn’t take a whole lot of debt to cause turbulence in a firm if the cultural cohesiveness isn’t there,” Benegal says.

The problems that plague failing firms often include opacity about firm financials, consultants say. A lack of transparency, especially when it comes to compensation, can have far-reaching effects on a firm’s culture.

Sources describe LeClairRyan’s compensation system as opaque and overly complicated, not to mention the cuts that came in the firm’s later years. Many lawyers at the firm were aware of the guaranteed contracts some colleagues were granted, but their exact terms were a closely held secret, sources say.

When problems become more obvious and partners are caught by surprise, it only hastens a firm’s demise. Legal industry consultant Brad Hildebrandt, who has been the trustee on at least eight law firm dissolutions, including Shea & Gould and Wolf Block, says the issue is made worse by the increasing pace of lateral movement throughout the industry.

Not only do law firms sometimes guarantee money to lateral partners who fail to deliver, but those brought in laterally usually have less loyalty to the firm when conditions worsen and it’s more important than ever to retain productive lawyers.

“There can be warning signs with unhappiness in the partners,” Hildebrandt says. “It’s a lack of confidence that I think develops over time, and then every other little issue exacerbates it.”

WHEN GROWING PAINS BECOME FATAL

At some firms, unhealthy expansion focuses too much on a single practice area or industry. Brobeck, for instance, went all out to develop tech clients and found itself in trouble when the dot-com bubble burst. Wolf Block was heavily reliant on real estate work, which tanked in the Great Recession. Thacher Proffitt & Wood, which collapsed in 2008, focused on mortgage-backed securities work when that practice was at its peak.

These firms may have had a strategic vision behind their niche focus. But in the end, lacking diversification made them "more vulnerable to external forces," Dan DiPietro, chairman of the law firm group at Citi Private Bank, says. After the recession, firms were caught between a rock (the need to diversify) and a hard place (the need to differentiate from peers and excel in a few areas).

"There is a danger to growth that is poorly conceived and poorly implemented," DiPietro says, "but there is also a danger to staying as you are if the world is changing around you."

Still more firms, hungry for growth but without a strategy, find themselves "just throwing things up against the wall and seeing what sticks," Young says. These firms pick up laterals and small groups for the sake of growing, and they fail to identify unsuccessful offices that should be seen as sunk costs.

"Firms expanding geographically will say, 'We go where clients really need us,'" Hildebrandt says, but small offices can create problems due to a disparity in economic performance across a firm's footprint.

Over the past 20 years, law firms have been creating new norms for size. But that doesn't always mean greater profits. Compared with other businesses, law firms don't get large enough to benefit from economies of scale, Young says.

"As they get bigger, they have more revenue and less profits to invest," she says. "Technology and marketing and business development are becoming so important to being successful that they're actually spending more per lawyer" as they grow.

The data bears this out. At each of the 12 firms analyzed, costs per lawyer continued to climb even as revenue per lawyer and head count grew. Brandt says it's possible to grow profits through a well-thought-out expansion strategy. But in the case of Big Law's failed firms, the strategy was lacking.

"They were promised books by people they merged with. Upon further evaluation, some of those books turned out to be a little less than was promised," Brandt says.

Some of the firms with strong practices might have been better off staying compact.

"The overall reputation of those firms suffered even though they retained some of those high-end practices," DiPietro says. "There was a diminishment of the firm's overall reputation by picking up middle-of-the-road practices."

Geographic growth has also traditionally come with real estate expenses. And several firms failed after signing leases for space that would allow for growth before they knew whether those investments would pay off.

"What often causes a bankruptcy is the stretch-out and over-extension of leases," Brandt says. "People enter into these long leases … without looking at the underlying issue of realization rate."

Roger Hayse, a consultant who helped Texas-based Jenkens & Gilchrist with its wind-down in 2007, says that firm's demise could be traced to over-expansion.

"There were a number of factors that came together, all working together against the law firm's long-term health," Hayse says. The factor that stood out from the rest was a Chicago partner being indicted for tax fraud, which resulted in "a tremendous amount of litigation against the law firm."

That partner joined the firm "because of a very, very aggressive growth program," Hayse says. "The Chicago office is such a good example, because the firm had a growth plan, and had never once talked about expanding into Chicago."

BACK FROM THE BRINK

In discussing the causes of LeClairRyan's collapse, numerous sources pointed to decisions made by co-founder Gary LeClair and others in his circle that couldn't be undone by new leaders who took over three years ago. (LeClair has not responded to requests for comment on the firm's dissolution.)

Consultants suggest this is indicative of one of the main reasons behind firms' misguided business decisions.

"A law firm without a strong leader with a clearly defined mandate is on the precipice of disaster," Corwin says.

The same could be said for firms that have a great leader but no plan for passing the reins. For instance, when 250-lawyer Testa Hurwitz & Thibeault closed in 2005, observers pointed to founder and chairman Richard Testa's death in December 2002 as a pivotal moment.

"That was an amazing firm—an institution in Boston, making good money," Corwin says. But it didn't have a succession plan.

Despite the abundance of cautionary tales, consultants say some firms have found a way back from the brink.

Hayse mentions Kaye Scholer as an example. The firm found itself in a bind in the early 1990s, when work for a client led to the federal government

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LAW FIRM COLLAPSES

Over three decades, firms have fallen apart for an assortment of reasons.

1988

FINLEY KUMBLE
The fourth-largest firm in the country before it dissolved and went into bankruptcy.

1994

SHEA & GOULD
Shea & Gould was in merger discussions with Greenberg Traurig before it closed.

1998

DONOVAN, LEISURE, NEWTON & IRVINE
Founded in 1929, it closed after merger talks with Orrick, Herrington & Sutcliffe fell through.

2001

DOT-COM CRASH BEGINS

2003

BROBECK PHLEGER & HARRISON
Brobeck borrowed to pay partners, and merger talks never materialized.

2005

COUDERT BROTHERS
Malpractice claims and debt felled a firm that once had 600 lawyers.

TESTA, HURWITZ & THIBEAULT
The 250-lawyer firm voted to dissolve three years after founder Richard Testa died.

2007

GREAT RECESSION BEGINS

HELLER EHRMAN
Chairman Matthew Larrabee said dissolution was unavoidable.

2007

JENKENS & GILCHRIST
Two lawyers were convicted of fraud, and the firm paid the IRS $76M.

2008

THACHER PROFFITT & WOOD
The firm's structured finance practice was hit hard by the financial crisis.

DREIER
A year after the firm imploded, Marc Drier pleaded guilty to fraud.

THELEN
The firm pointed to economic factors including "recessionary pressures."

2009

WOLF BLOCK
Some said the firm relied too much on real estate work before the recession.

2011

HOWREY
A relationship with Citibank soured and partners voted 149-to-1 to dissolve.

2012

DEWEY & LEBEOUF
Debt led to bankruptcy, and CFO Joel Sanders was later convicted of fraud.

2014

BINGHAM MCCUTCHEN
Morgan Lewis hired 750 lawyers and staff as Bingham closed.

2016

DICKSTEIN SHAPIRO
The firm went from 450 lawyers to 140 before a deal with Blank Rome.

2018

SEDGWICK
Sedgwick's demise could be traced to expansion, infighting and instability.

2019

LECLAIRRYAN
The firm had grown to 21 offices before it dissolved in August.

demanding millions in damages from the firm. A bankruptcy partner who had joined via merger two years prior proposed a plan to reach an agreement with the government. That partner, Michael Crames, later became a firmwide managing partner, and Kaye Scholer continued to operate until it merged with Arnold & Porter in 2017. Crames was not available to comment for this story.

"The firms that are successful in turning things around and getting back on their feet are led by quality leaders," Hayse says. "If you're starting to have financial trouble and the people at the top still are not effective leaders, then your future does not look bright."

So, what does a quality leader look like? Young says firm leaders have to stay in touch with their clients and stakeholders, never losing track of what those people want. They need a vision for where the firm will go next. And they need to be transparent about business decisions that impact those clients and stakeholders—compensation in particular.

"Trust is the glue that holds most organizations together, particularly when there are a bunch of owners," Young says. "If your compensation system isn't transparent and well understood, you don't have the trust."

Hildebrandt says this lack of trust leads to the mass departures that often spell the end of a firm.

"You have to lay a dissolution pretty much at the feet of the people leading the firm," he says. Poor leaders, he says, are worried more about themselves than the firm. They allow the business to incur too much debt and commit to excessive lease holds, and they don't tell partners about the firm's problems. The latter can seriously damage morale when things get bad.

"If the partners want to stay together," Hildebrandt says, "you can save a law firm."

ANOTHER STORM COMING

The jury's still out on when the next recession will hit. But whenever it arrives,

it will shine a bright light on which firms have survived recent years thanks to decent market conditions alone.

"When you see the downturn come, which we think we're on the lip of, I think there's going to be a lot of law firms that are going to be in crisis and they're not going to survive it," Hayse says. "I think you will see more law firm failures in the coming recession than you did in the last one."

Of course, Hayse says, he hopes his prediction is wrong. But productivity and realization rates are still far from pre-recession levels at many firms, and their leaders have not taken the necessary steps to adjust to that reality.

"Unfortunately, law firm partners in general have worked hard and developed high expectations for compensation. At the same time, there are partners whose practices are not as profitable as others," says Meyer, the former Dewey GC.

That puts firms in the difficult position of trying to maintain compensation for highly productive partners while eliminating low-performing practices.

"There is a danger to growth that is poorly conceived and poorly implemented."
—Dan DiPietro

"This becomes particularly troublesome when a firm has a bad year or when there is an economic downturn and simply not enough money to keep everyone happy," Meyer says.

Brandt says the next recession is not likely to be as catastrophic as the 2008 financial crisis for the economy at large, including law firms. But it "may speed up the demise of a couple hangers-on."

The firms that are most likely to fall off, consultants say, are those already struggling with realization, those that have built up significant debt, and those whose expansion has lacked focus. Litigation-heavy firms and those lacking countercyclical practices may suffer, Brandt says. Another red flag: wavering relationships with lenders, Corwin says.

Still, the demise of any such firm has its roots in a legal industry that has changed over the years, witnessing the rise of the in-house legal department and the resulting changes in client demand, Brandt says.

"A recession will exacerbate that somewhat, but it's not a watershed event. The watershed event has been happening on a steady basis for 35 years," he says.

But it's not all doom and gloom. DiPietro notes that the 2008 financial crisis hit everyone. Still, "many firms not only survived, but thrived."

"You have the ability to manage external risk," he says.

With that in mind, he says, firm leaders have some questions to ask themselves: "How strong is your culture, how balanced is your practice mix, and have you made the right decisions?"

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