

## **Leadership & Accountability**

**by:**

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When Dewey & LeBoeuf filed for bankruptcy in May, the firm's collapse marked not only the largest law firm failure in U.S. history, but also the latest instance of a once powerful firm following the sorrowful path "blazed" by other notable firms, including:

Finley Kumble – (dissolved in) 1987

Gaston & Snow – 1991

Shea and Gould – 1994

Mudge Rose – 1995

Bogle & Gates – 1999

Arter & Hadden – 2003

Brobeck – 2003

Heller Ehrman – 2008

Thelen - 2008

Howrey – 2011

Dewey's collapse should have served as a wake-up call to leaders of large law firms - a "call" that has been delivered many times before. Every time a major firm collapses, industry observers and partners in other firms dissect the failed firm's corpse and declare its shortcomings. Too often, the next step is to move on, rather than learn lessons from the failure. While I assume no law firm leader has firm dissolution as a goal, the number of large firms that have collapsed over the years, the recent spike in firm failures and the apparent weakness of other firms makes me wonder why some firm leaders ignore the warning signs in their firms and fail to resolve issues in their firms that mirror problems in firms that have failed.

Having been hired to oversee the wind down of many law firms, I know firsthand that law firm dissolutions are always unsettling and frequently quite miserable for all of the key parties – partners and staff, clients and creditors. Will Dewey’s collapse finally serve as the needed wake-up call or will law firm leaders resume their slumber the way so many have in the past?

### **What Kills Firms?**

By and large, the law firms listed above had two positive characteristics – a large number of high quality lawyers and an enviable client base. Together, these would seem to be important keys to success. In reality, they simply masked temporarily a whole host of issues that ultimately doomed the firms. While each failed firm had its own unique issues, many also had a number of troubling commonalities, including:

1. A muddled business plan - usually one that ignores the importance of differentiation in a competitive market;
2. Ignorance of (or unwillingness to accept) market realities – no firm that is best known for its skill in handling routine legal matters can hope to transform into a “bet the company” firm in a short timeframe, yet the strategic plans of many firms reflect this “path” – they are setting themselves up to fail;
3. Lack of client and/or practice diversification (or, the flip side, extreme diversification);
4. Excessive hiring of lateral partners during the five years prior to dissolution - firms repeatedly lower their partnership criteria and end up hiring marginal performers who somehow command compensation in excess of what they deserve;
5. Overexpansion, including speculating on real estate while assuming a “build it and they will come” attitude toward both clients and talent;
6. Poor financial hygiene, typically reflected in excessive use of debt, weak client intake policies and cash flow (mis)management;

7. Inaccurate or misleading financial statements (frequently coupled with the fabrication of financial information for public consumption);
8. A whole raft of compensation issues – undisclosed side deals; systems that emphasize individual interests rather than institutional interests, partners holding the firm hostage with their compensation demands; lack of trust or the appearance of favoritism; and
9. All too often, the development of a culture of secrecy – usually the final, fatal step before a firm enters its death throes.

### **Role of Management**

Whenever a business fails, blame for its failure must be laid at the feet of the business's leaders. Law firms are no different. The action (or, at times, inaction) of law firm leaders causes firms to fail. As law firms have expanded domestically and, for many, globally, the firms have centralized management and invested leaders with more power and authority.

To be clear, I have always advocated that firms need strong, centralized management that has the ability and authority to take on reasonable risk on behalf of the firm's partners. Unfortunately, in too many firms, centralization has gotten out of hand and firms have become less partnership and more oligarchy. Law firm leaders have grown out of touch with their partners and are not being held accountable for their actions. Quite simply, the benefits of consolidating management have not been accompanied by reasonable business controls that enhance accountability of leaders.

As we have seen time and again, the absence or failure of business controls can doom an otherwise healthy organization (e.g., MF Global, Arthur Andersen, Lehman Brothers, WaMu, and the list goes on). Again, in this regard, law firms are no different.

### A Way Forward?

In my role as a trustee and chairman of the audit, compliance and ethics committee of the country's largest non-profit academic medical center, I have insight into how that organization (and, generally, the medical field) operates, which allows me to compare and contrast between it and the law firms around the world with whom I consult. While the medical profession may be a more complicated business model (and certainly subject to a wider range of federal and state oversight), there are many similarities in how the businesses are structured and how they should operate.

In light of the Dewey failure (and before the next big firm failure makes headlines), now is a good time to consider whether mechanisms employed in another industry can help inform better decisions in the legal industry.

Leadership & Tenure – Law firms need to clarify the roles, responsibilities and authorities of their leaders.

While I do not favor forced rotation at the highest levels of management, I do believe law firm leaders should have a fixed term (3 years or 4 years) after which the partnership has an opportunity to review the performance and renew the mandate of the leader, if desired. From a leadership development standpoint and because I think there is some value to getting “new blood” onto an Executive/Management Committee, I do believe there should be term limits for those serving on these committees. [Note: Whenever a law firm leader or leadership committee member tells the firm's partners – by action or otherwise – that no one else could possibly handle the role, look for a new leader ... or a new firm.]

Audit & Compliance – Today, most large law firms employ a number of staff members (and some partners) who possess sophisticated financial skills and ensure the firm's finances are kept in order. What I think is missing in most firms is a serious (though possibly not full-time) audit function or audit committee staffed with trained auditors authorized to perform unannounced audits of firms operations in order to test

accuracy, controls and identify issues long before they become problematic. To simply have a committee of partners who review the financial statements is not enough.

In the medical center, we do not employ medical professionals to audit the organization's operations. We rely on trained auditors. Similarly, a law firm should not rely on legal professionals to serve the audit role either. Ideally, the auditors should report to the firm's general counsel and directly to the firm's Executive Committee.

Given the size and scope of law firms today, it is inconceivable that an audit and compliance function is not in place in every firm. As I have witnessed first-hand in every dissolution I have been called on to manage, the lack of operational controls and good financial hygiene crippled the firm long before the vote to close the firm. While there may be policies and procedures in place that govern the firm's operations, all too often the "placement" was on a shelf rather than in hand. An audit and compliance function can ensure the firm's actions match its policies and procedures.

So, what should the audit function review? Here are some areas to consider:

- Financial statement accuracy and budget compliance;
- Compensation arrangements, particularly "special deals" or guarantees;
- Expense reporting, particularly for law firm leaders, including practice heads;
- Vendor contracts and procurement arrangements;
- Office lease agreements;
- Office operations, in general
- International office operations, particularly those offices operating in developing economies and those where bribery is commonplace;
- Compliance with the firms other procedures and adherence to regulatory obligations.

Disclosure & Certification – At the medical center, we require the CEO, COO, CFO and deans of every school to sign a statement certifying that, to the best of their knowledge, the financial and performance data of the institution and of the various departments (in the law firm, similar to departments or practice groups) are accurate. Why can't the same be done in law firms?

Outside Interests – Similar to the disclosure statement, we also require every professional to sign a statement disclosing all outside business interests (e.g., board membership, non-affiliated business ownership, etc.).

Code of Conduct – Every law firm should have a formal code of conduct, but I suspect where they exist few people ever think about them after they sign them as a new employee (or when revisions are made). In addition to general policy statements, firms should have formal policies covering things such as insider trading, use of confidential information, and the like. All employees should sign these documents each year.

While such controls may not prevent a law firm failure, the absence of such controls undoubtedly limits a firm's ability to identify issues early on and take preventative action before a minor problem becomes a major headache. The controls also protect leadership and provide some comfort to partners regarding the firm's leaders, finance and operations.

The question that remains – Will Dewey & LeBoeuf's failure actually serve as a wake-up call to firm leaders or will they simply hit the snooze button, hoping that the next time a firm fails, their firm will somehow escape once again? Time will tell.