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This is a good time for law firms to grow, But they probably won't do it right

Commentary by Joseph J. Luzinski

With Florida growing faster than the national average for the second year in a row, law firms are enjoying the best environment for expansion in more than decade. The math says that a merger between firms can increase revenues 20 percent and cut backroom costs 15 percent. Reality says that finances, culture and unrealistic expectations will likely get in the way.

Partnership, Shareholder or LLC agreements are premised on a detailed baseline understanding of the ground rules; they can't leave matters to interpretation later on. That may lead to disagreements or differences that create angst and cause the firm to atrophy or collapse as attorneys leave.

The most important issues are liquidity and financing. Firms should be prudent, operating in a limited debt environment with a line of credit only for those times when cash flow is tight.

Significant debt plus an unforeseen change in the business will likely cause problems. Consider Dewey & LeBoeuf. The global firm, which grew to 1,400 attorneys, went into bankruptcy in 2012 due in part to partner defections, but also to a whopping $225 million in bank debt.

Prudent firms pay attorneys reasonable compensation or draws, and they set aside money for initiatives such as hiring more staff or expanding offices. They also avoid the practices of Dewey, which offered multiyear guarantees to attract talent and used its credit line to meet those obligations.

In retrospect, that seems irresponsible. But the truth is that many law firm partners, like many business managers, too often rely on their gut instincts and cultural norms to leverage the business with debt not equity. If revenues rise 10 percent this year, they assume they will go up the same percentage or more the next year and not only budget accordingly, but spend as if the higher revenue amounts will be realized.

Partners must look closely at the numbers. They may find that gains in one year resulted from one big case. Minus that one-time event, next year's budget should be cut and investments in equipment and people deferred. Budget projection errors lead to cash flow volatility and greater reliance on debt. They stress a law firm because a lender will likely ask the key partners for personal guarantees.

Even when a merger or new practice area bears fruit, there can be financial tensions. The parties involved need to have clear understanding on how to slice a growing pie. Who gets what based on what criteria and what reserves, if any, should be put away for a rainy day?

There's no one way to calibrate success, which is a polite way of saying financial aspects. In the law firm business, measurement concepts abound: equity percentages, point systems, objective criteria such as origination of client matters, the hours put in by those generating the revenue and of course cash collections. Who gets credit for signing a big client? For a big win in court? Should the partners receive bigger checks or should the money be invested in associates so that they don't depart with their clients?

Beyond that, consider the intangibles such as firm culture, work environment, work-life balance, which can be more important to a firm's future. Commenting in 2012 on Dewey's demise, Indiana University law professor William Henderson said, "Money is a weak glue."

Partners and associates must make sure that they are in sync or at least have reasonable expectations to work through issues as they crop up. Part of the culture is tolerance for risk and a tendency to spend. A firm that bets and spends big can quickly collapse if business drops off.

Smart firms must also even out risks endemic to their practices. Real estate is notoriously cyclical, generating substantially increasing billings until that market comes to a halt. Ups and down can be balanced by more steady practices such as corporate, employment, and trusts and estates.

The last consideration is strategic. Over the years, dozens of large Northeastern law firms have planted a flag in Florida because that's where they wanted to be, only to pull out five to seven years later. Why? They thought their reputations in their home markets would translate geographically. Successful arrivals to the Sunshine State, and firms expanding within the state, hire local people to represent their brands and build later through lateral transfers.

Law firms looking for that next opportunity should heed the words of Frank Church, chairman emeritus of DLA Piper, who took that firm global. Talking to the New York Times about Dewey's collapse, he said, "Growth isn't the strategy; it's a consequence of the strategy."

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