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Heller and Thelen: Lessons Learned

by Richard Gary

Within the past six weeks, two of San Francisco's oldest, most venerable firms, Heller Ehrman LLP and Thelen LLP, announced that they will dissolve. As a former Thelen partner who chaired that firm from 1992 to 2003, I have a strong personal interest in understanding the circumstances that led to its demise. As a management consultant to almost 40 law firms since I left Thelen in 2003, I have a strong professional interest in examining the dissolution of both firms to determine whether there are lessons that other firms might utilize in order to avoid a similar fate.

There are striking similarities in the circumstances that led to the Heller and Thelen dissolutions.

- **Partner defections**. Partner defections were the immediate cause of each firm's demise. Each firm lost significant numbers of lawyers, including many partners, over the course of the past two years.

- **Failed merger talks**. Rather than addressing its problems internally, each firm engaged in merger discussions, looking to outside sources for solutions.

- **Debt**. When the merger talks failed, partner defections accelerated, and the firms' lenders utilized the contractual remedies available to them to shut down the firms. While details of each firm's debt obligations have not been publicly disclosed, it seems clear that each firm owed the banks so much money that the banks either could not or would not look the other way, especially in the context of the current global economic crisis.

- **Leadership selection process**. The leadership selection process at each firm was flawed. In Thelen's case, the system was entirely democratic and open—and, as a result, highly politicized. In Heller's case, the firm imposed strict term limits on its leaders. I would argue that neither system was designed to identify the leader most qualified to manage a business that generated hundreds of millions of dollars in annual revenues.

Examined closely, these factors suggest strategies to avert the catastrophic outcomes at Thelen and Heller.

Partner Defections

Heller Ehrman LLP was founded in 1890 in San Francisco and was a mainstay in the Bay Area legal community for more than a century. But in the past few years, efforts to make the firm more competitive appeared to adversely affect the collegial and intellectual culture that made Heller unique for so many years. Heller's workforce began to shrink noticeably in 2004, especially in offices outside San Francisco. The contraction accelerated in the two years preceding the firm's dissolution, with Heller losing almost 150 lawyers, or about 20% of its professional workforce.

Thelen LLP was founded in 1924. Like Heller, it was a long-standing pillar in the Bay Area legal community. In 1998, Thelen merged with New York-based Reid & Priest in what was the largest bicoastal law firm combination to that time. The merged firm performed well for a number of years, but lingering cultural issues precipitated a dramatic 60-lawyer (about 45%) decline in the number of attorneys in the firm's New York office in 2005 and 2006. Thelen rebuilt by merging with Manhattan-based Brown Raysman Millstein Felder & Steiner in December 2006, creating a new, 617-lawyer firm, but the honeymoon was short-lived, with cultural and economic issues dividing the firm. More than 200 lawyers (or almost one-third of its workforce) left Thelen in the 12 months ended September 30, 2008, including Brown Raysman name partners Peter Brown, Richard Raysman, and Jeffrey Steiner.

When firms lose people, they lose revenue, but they can't always cut costs quickly enough to offset the loss of revenue. Profits decline, and a downward spiral begins. Defections also erode confidence among remaining lawyers. At Thelen, the August 2008 departure of a key project finance group to Orrick was especially troubling; Heller's loss of 15 IP lawyers to Covington & Burling in September 2008 seems to have sealed that firm's fate.

Partners defect for a variety of reasons—money, cultural issues, a perceived lack of support for one's practice, or a loss of confidence in the firm's future. And there are some people who simply need a change of scenery every few years. But whatever the cause, once the defections accelerate, it can be very difficult to stanch the outflow of people. Strong, decisive action is required.

Failed Merger Talks

Each firm made a conscious decision to seek an external solution to the problems created by partner defections. As Heller's troubles multiplied, it was reported to be in merger discussions with numerous firms, including Goodwin Procter, Winston & Strawn, Proskauer Rose, Baker & McKenzie, and Mayer Brown. Talks with Mayer Brown, Heller's final suitor, ended in mid-September. Thelen pursued a similar strategy, announcing to attorneys and staff in mid-July that it was seeking a merger partner. Discussions with Nixon Peabody terminated in late September.

The quest for an external solution started each firm down a dangerous path, reflecting each firm's view that it was no longer able to overcome challenges on its own. I believe this approach diverted firm management from the task at hand and was an unnecessary, and ultimately fatal, distraction that encouraged partners and others to avoid making the hard decisions that would have corrected the issues confronting each firm.

Indebtedness

While details of Heller's final days are not public, it seems clear that the continuing stream of partner defections in 2007 and 2008 led to a default under Heller's bank credit agreement and that the banks forced the firm to shut down after the Mayer Brown merger talks failed. In Thelen's case, the cascade of partner defections over the past two years created a similar event of default, leading the firm's lenders to close the firm's doors following termination of the Nixon Peabody merger discussions. Details of each firm's debt obligations have not been reported, but it is reasonable to conclude that each firm owed the banks so much money that the banks either could not or would not negotiate a work-out.

Leadership Selection

AmLaw 200 firms have professional administrators, but few, if any, have professional CEO's, although some law firm leaders—Ralph Baxter of Orrick comes to mind—certainly qualify as professional executives. No one goes to law school or enters private practice with the intention of chairing a law firm. And very few firms train leaders for the future. The result is that most firms are led by well-meaning people who may or may not have the skills required to lead a large business. These skills include:

- A vision for the future
- An aptitude for planning and accountability
- An understanding of the financial underpinnings of a business that generates hundreds of millions of dollars in revenue per year
- The ability to manage people, including the ability to communicate honestly and effectively with a wide range of constituencies (both large groups and one-on-one)

In other words, the leader of a large law firm must be able to keep hundreds of highly skilled, highly motivated, highly analytical people both highly productive and relatively happy—all at the same time. This task is anything but simple.

With management playing such a crucial role, it is important that firms select the best possible leaders. And yet, as indicated above, there were critical flaws in the leadership selection process at both Heller and Thelen. Heller's term limits reflected the philosophy that leadership was temporary and should not be held by one person for more than six years; while this view is understandable in the context of a law firm partnership, it ignores the importance of professional leadership and management skills. And Thelen's *laissez-faire* system, which allowed any partner to seek the leadership position, led to election contests that were both politicized and divisive.

The Thelen experience is especially instructive. In 2003, my successor as Thelen's chair was elected by a single-vote margin. As a consequence, he had no mandate to lead, and the partner who lost the election was so alienated that he left the firm shortly thereafter. The process was entirely open, with any partner free to campaign openly for the position. As a result of that experience, I now advocate governance systems that involve a thoughtful nomination process. By that, I mean a procedure in which either an elected management or policy committee or an independent nominating committee of respected partners considers candidates' qualifications in light of the firm's current position and future direction, agrees on a recommended candidate, and then presents that candidate to partners for approval by vote or written consent. Many firms with such a process require that, in order to be elected, a candidate must receive the votes of at least a majority of the partners entitled to vote, thus assuring that the successful candidate has broad partnership support.

Terms limits and forced leadership rotation are bad ideas in the highly competitive legal services industry. So are free elections. They may work well in the world of politics and government, but no corporate enterprise chooses its chief executive this way. I believe it is only a matter of time before large firms employ professional chief executives.

Would a different leadership selection system at each firm have produced different leaders? We'll never know. What we do know is that the systems at Heller and Thelen produced leaders who could not hold their firms together.

Lessons Learned

In my view, there are three principal take-aways for other large firms concerned about the Heller and Thelen dissolutions:

- **Internal focus**. In times of crisis, look inward for answers, not outward. The merger discussions encouraged the constituencies at Heller and Thelen to expect help from outside. When that help did not materialize, it was too late to pursue other strategies to save either firm.

- **Debt levels**. In a faltering economy, be wary of debt and reduce your reliance on it if you can. Do not take unnecessary risks. Heller and Thelen failed, in large part, because debt levels made them vulnerable to adverse events. In the end, neither firm was in control of its own destiny.

- **Leadership and governance**. Re-examine your governance system. Make sure it is designed to select the best-qualified person to lead your firm and that it contributes to firm stability while minimizing firm politics.

No firm has to fail if partners are determined to work together to address the issues that placed the firm in jeopardy in the first instance. At Heller and Thelen, that determination became lost somewhere along the way.

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