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SEVEN DEADLY SINS OF SUCCESSION PLANNING: AN OPEN LETTER TO *"FIRST GENERATION"* PARTNERS

Peter A. Giuliani, Partner

The long-term success rate of closely-held businesses, as independent entities, is abysmal. More the seventy percent of family businesses either fail or are sold before the second generation can assume control. Only about ten percent make it to third-generation status.

It is no surprise that most law firms suffer the same fate. Sure, Messrs. Davis, Polk, Wardwell, Sidley, Austin, Allston, Bird, Baker, Hostetler, et. al. all managed to deliver vital and enduring institutions to a whole series of generations. The simple truth is that most law firms never make it to the second or third generations of partners.

In our book, Passing the Torch without Getting Burned (American Bar Association, 2013) we discuss the reasons why law firm founders may be entitled to some form of compensation for surrendering their ownership of an entity that they created and – one hopes – nurtured and grew into a successful business. The first-generation partners of a law firm, however, have to anticipate and prepare for *"passing the torch"* well in advance of the time they actually want to retire.

Lack of preparation and forward thinking can – and often does – doom a good economic succession plan to failure. It is not about the money; it is about human nature, trusting others, developing future leaders, and fostering a climate in which the entity that is the law firm can succeed and prosper into the future. That is precisely the point that first-generation partners often miss, or realize too late to do anything about it.

If you are a first-generation partner around age 60 or slightly younger, you may have a shot at implementing a successful equity transition plan. If you care about the survival of your firm and what it means to your clients, employees and legacy, this article may help you start now to ensure a smooth transition. If you don't care, you can stop reading.

Two Case Studies

Firm A was founded by three lawyers, Manny, Moe and Curley, who broke away from a larger firm because they wanted to do something entrepreneurial – start fresh and do things their way, not repeating what they believed were management mistakes of their predecessor firm. Over the years, their little firm grew to include fifteen lawyers, three of whom were called *"partners"* to the outside world, but were really only employee lawyers who got paid a base salary and small share of profits as a bonus.

The three founders worked hard and served their clients well, and the firm prospered. Sharing profits among themselves equally, the founders ended up earning far more than their counterparts in larger firms that practiced the same kind of law. Internally, they ran their firm with cards held close to the chest. Firm financials were guarded carefully. *"Management"* was the prerogative of the founders, and even the junior *"partners"* had little or no influence in firm matters.

Curley was older than the other two, by about eight years. Naturally, she was the first to consider retirement. With some thought about relative contributions and the economics of the firm, Manny and Moe, devised a plan whereby they would acquire Curley's equity interest over four years, using a deferred premium compensation plan (i.e., they *"overpaid"* her for four years in exchange for her ownership interest). This worked swimmingly well and Curley eased off into retirement, leaving Manny and Moe in sole ownership and control of the firm.

Some years passed and Manny and Moe considered their own retirements. They figured that the plan devised for Curley would work with their three junior partners. They prepared a proposal for the three juniors and shared it with them. Unexpectedly, the juniors balked. They agreed that the founders probably should get something for their ownership interests, but had no basis for evaluating the proposal. Eventually, all three declined the offer, preferring to remain de facto employees. They were just not prepared for the uncertainties that may lie ahead – and, probably, they didn't trust the founders all that much.

Bottom line: The proposal cratered. The juniors gradually found jobs with other firms. As they left, clients became aware that the middle of the firm was eroding and started shifting work to other firms. Eventually, the founders tried to merge the firm with a younger firm, but the younger firm declined, unwilling to take on the unfunded liability associated with buying out the

Firm B's story has a happier ending. Tom and Jerry, law school roommates in the 1960s, pledged that they would eventually join together to form a small boutique firm in their home city. After two years of working in *"big law,"* they returned to their city and opened a small tax and estate planning shop.

Things went well and after five years they had hired on three new lawyers, each of whom had experience with other firms. The firm's reputation for offering value started attracting work for a lot of wealthy entrepreneurs and family businesses. Eventually, the business clients' work encouraged them to add two more lawyers on the corporate/transactional side. Their philosophy was to hire only the best lawyers and to refer out any work that they could not staff appropriately.

While Tom and Jerry were the main attraction, they strongly promoted all of the other lawyers of in the firm to the clients. Tom would often say to a client, *"I could study up a bit and help you with your problem, but I have this really great kid in our firm that knows this stuff way better than I do. Why don't the three of us have lunch so you can meet him?"*

All lawyers in the firm met once a week to go over the business of the firm, schedule assignments and collaborate on solutions to difficult issues. This went on every week for the first ten years of the firm's existence, after which time the firm had grown too large to have an *"all hands"* meeting every Monday morning. Still, they continued to meet as a firm and Tom and Jerry delegated practice management tasks to some of the other lawyers who had been admitted as partners.

Within ten years, the firm had grown to include ten partners (all equity owners) and twenty associates. In addition to estate work, the firm now boasted robust practices in real estate, corporate, income taxation and general business counseling.

After twenty years, the firm more than doubled in size again, and was clearly recognized as a peer firm among the elite firms in the region. After forty years, the firm now has 150 lawyers operating out of four offices.

Up until Tom and Jerry admitted their first non-founder equity partners, the firm operated as a *"handshake"* general partnership. One of the second-generation partners saw that the firm would likely need to admit more partners more quickly to keep up with client demands. She suggested that the partners consider all of the elements of a comprehensive operating agreement and finally commit agreed terms to writing.

In that agreement, the partners established the economic terms governing death, disability, withdrawal and retirement of partners, with full participation by all partners, but with special concern for Tom and Jerry. In the end, when it came time for Tom and Jerry to retire, their transition from equity partner to Of Counsel was seamless. The same held true when the second- generation partners retired.

Bottom line: What started as a two-person firm is now a successful institution with a seamless process for admitting and retiring partners, and it continues to be a strong and enduring force in its marketplace.

What can we learn from these two parables? Succession planning is not an *"exit strategy."* It is a form of very long range planning that focuses on how one builds a lasting institution. Everything that goes into the plan and its execution is intended to create, nurture and grow a law firm that will remain viable for many generations. Further, it is a process that never stops evolving to balance the needs of the present generation of partners against the goal of leaving behind a stronger, better institution than the one inherited by the present generation. In short, a law firm has value only if the present generation is prepared to leave something behind that will enable the next generation to succeed. By doing so, the present generation earns its right to receive compensation for what it has contributed.

According to the philosopher, Georg Hegel, every human construct (i.e., organization or institution) has within itself the seeds of its own destruction. There are at least seven seeds of destruction that, left unattended, can completely derail the orderly succession of a law firm. For this article, we have chosen to call them the *"Seven Deadly Sins of Succession."* They are, as follows:

1. Failure to create a culture of *"legacy,"* as opposed to a culture of *"individualism."*

Tom and Jerry included all of their lawyers in how the firm was run. Of course, they retained a great deal of control over the firm, and that is proper. They did, however, allow others to participate in the discussion and earn a place at the table. The fact that it was a second-generation partner who identified the need for a formal agreement to establish governing principles shows people were thinking about the firm as a growing entity to be inhabited by future generations. Manny and Moe, were more focused on maximizing the value of the firm for themselves.

This is the paradox: By maximizing the value for themselves, Manny and Moe ultimately destroyed the firm. Tom and Jerry, by comparison, thought in terms of maximizing the value of the "institution" that is their firm, for the benefit of future generations. In doing so, not only did they create a viable and enduring firm, they also grew their firm to a point where it could succeed without them.

Cultures based on individuality and short-term thinking – *"Lone Wolf Cultures,"* if you will – cannot succeed and will ultimately sow the seed of decline and destruction. *"Legacy Cultures"* most often lead to multi-generational success. Every major law firm in existence today started out as a small firm, put together by a few founders. They have survived and prospered because of the legacy cultures created by their founders.

2. Failure to create and nurture the next generation of owners.

You can't pass on a law firm to a succeeding generation if you don't build that generation. Think of what would happen in a relay race if the lead runner finishes her lap and the second runner is not in place to receive the baton.

Manny and Moe made that mistake by not investing in their junior partner group. When the time came for them to step up, they were unprepared. The juniors simply did not understand what it means to be an owner of a law firm, behaving more like "time-and-grade" employees.

By contrast, Tom and Jerry invested continually in building their second and third generations. Juniors were involved regularly in the practice management of the firm and were included in weekly meetings. Eventually, second and third generation partners were given leadership roles within the firm, because Tom and Jerry realized they couldn't handle the growth and still maintain their commitment to the highest quality service.

Law firm partners – if their firms are to succeed – must think and act as owners of a business. They need to be involved in the affairs of the firm and committed to building its future. They cannot do this in isolation. The only way they can appreciate the meaning of *"ownership"* is by participation and learning by example from earlier generations of owners. If the early generations don't share their knowledge and experience, there will be no future generations.

3. Failure to address succession issues until it's too late.

Manny and Moe waited too long. By keeping things so close to the vest for so long, there was no time for a reasoned approach to effecting their own succession plan. Even selling the firm through a merger did not work, because the prospective buyer did not see value in a law firm with two superannuated partners and cadre of junior associates.

In the relay race analogy, they ran their lap so slowly that the race was already lost when they finished. Even if they did run a decent lap, the next runners were not of the caliber to win the second lap.

Tom and Jerry were forced to address succession when their firm executed its first operating agreement. They planned for retirement long before they actually considered retirement.

4. Failure to clarify the meaning of "equity."

Historically, the profession has recognized four *"indicia of partnership."* They are 1) having a share in the profits and losses of the firm, 2) contributing to and maintaining capital in the firm, 3) having a say or vote in the affairs of the firm, and 4) having an ownership interest in the net assets of the firm or of the residual estate of the firm if it dissolves. Along with these indicia goes a fiduciary responsibility to protect the firm entity and its tangible and intangible assets.

Too often, *"equity"* is mistakenly understood to only mean sharing in profits and losses. For many young lawyers, the desire for partnership status is really only the hope of gaining a *"piece of the pie."* They are surprised when they are told that becoming an equity partner usually requires a capital contribution. Some think that, since they have labored long hours as associates, they have *"earned"* their ownership interest and are entitled to have a say in the affairs of the firm as a matter of time and grade. Frankly, these are not the kind of people that make reliable future partners.

The seed of destruction lies in the unwillingness or inability of a group of partners to behave like owners of the business. Firms that prepare carefully for succession of generations know that they need to instruct junior lawyers in the privileges and accompanying responsibilities associated with owning a share of the business. If the next generation has not been educated, mentored and prepared to accept the mantle of partnership in the complete sense of the word, succession will fail in the long run.

5. Failure to encourage entrepreneurship.

Successful founders of law firms are successful entrepreneurs. They understand how to take calculated risks and how to build and lead a team. They also understand how to deploy people, physical assets and capital in a way that creates positive economic results. Finally, they understand the principles of good *"business hygiene"* – timely billing and collection, cost control, keeping matters moving through to completion, etc. – to drive profitable, high quality client service.

Manny and Moe's management style hid these drivers of entrepreneurship from the junior partners. When the juniors were offered a chance to become owners, they lacked the entrepreneurial confidence and drive to embrace not only ownership, but the risks associated with ownership. Instead, they preferred to remain employees.

Tom and Jerry were not only entrepreneurs themselves, they were able teachers of entrepreneurship and gave their juniors to tools and free rein to develop into confident leaders who were unafraid to take responsibility for the firm. If juniors couldn't or wouldn't embrace entrepreneurship, they did not become partners.

Here, the seed of destruction will take root if too many lawyers who lack entrepreneurial drive are admitted to partnership. Tom and Jerry started with high standards, invested in implanting those standards, and where the implantation failed they were quick to sever those who didn't measure up.

6. **Failure to *"let go"* and trust others.**

Succession planning should be mostly about passing on existing client relationships to others in the firm, so that those client relationships have a higher chance of enduring, once the lead partner has moved on. Sometimes those relationships are intensely personal. In other cases, the relationships have been guarded by the lead partner for fear that someone my claim origination credit or demand compensation for working on matters for the client(s). In fact, I have had partners tell me that they view their control of client relationships as a way of protecting their compensation, as they wind down

Similar behavior is exhibited when it comes to issues of governance and control. Founders hang onto control because they do not trust presumed successors to treat them fairly. In the worst cases, these situations deteriorate to a point where the founders become impediments to adopting new policies and initiatives that are of vital importance to the firm's future.

It is psychologically difficult, sometimes, for founders to face *"end-of-career"* issues. They say they plan to work forever and not retire, even though their hours decline and their commitment to the firm wanes. This often leads to an erosion of trust between generations of partners.

Manny and Moe operated in *"protection mode,"* controlling client relationships beyond the point at which clients would normally expect some transition plan to emerge. If clients do not know or believe in the next-generation partners, they will drift away, despite historical loyalty to aging lead partners.

Tom and Jerry created a situation in which all clients were exposed to the best minds in the firm. They hired the best lawyers they could fine and trusted them with their client relationships. Decades later, early-stage clients are still using the firm. The firm has grown to support them. They have gone beyond the exclusive-relationship stage and have become institutional clients.

The bad seed, here, is founders acting in *"protection mode,"* fearing what might happen if others were inserted into their client relationships. It is clear evidence of a lack of trust that will eventually torpedo any effort at succession planning.

7. **Failure to educate the next generation about the finances and economic realities of the firm.**

Manny and Moe kept a lot of information to themselves. Maybe they didn't want the juniors to know how much they were taking out in compensation, for fear that they would have to justify why they deserved what they were paid. Maybe they thought that the juniors would start demanding more in compensation to continue to serve clients they didn't originate.

When Manny and Moe finally opened up, they failed to anticipate how the ignorance of the juniors would play out. Of course the lack of trust in the firm exacerbated the situation.

Tom and Jerry ran an *"open shop."* While they probably didn't initially disclose their compensation to succeeding generations, they had done a lot to build trust and good will in the firm by sharing opportunities to do good work for all of the firm's clients. When it came time to offer partnership to the second generation, the junior lawyers already felt grateful to the founders for opening up opportunities.

The weekly meetings also created a sense of shared enterprise and teamwork. Junior lawyers learned about firm economics and business practices by osmosis – just from being in the room and at the table.

Conclusion

It has been said that, beyond the initial physical attraction, it takes three things to make a successful marriage: mutual trust, mutual respect and common goals. So it is with making a successful law firm. Secrecy about basic economic realities erodes trust, shows disrespect for the juniors, and makes formulation of common goals virtually impossible – clearly a seed of destruction.

There are no silver bullets or universal solutions for avoiding the Seven Deadly Sins. That said firm founders and leaders need to recognize that these seeds destruction exist and do whatever possible to avoid them. Ignoring them will eventually imperil the law firm as a durable institution.

Peter A. Giuliani / pgiuliani@smocklawfirmconsultants.com / 203.341.0601