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WITH CONSEQUENCES

A CHASM

Despite the recovery, market forces are combining to create unprecedented challenges for Am Law 200 firms.

Get ready to make some tough decisions.

By **ARIC PRESS**

LET'S START WITH ONE FACT: There is now a \$1.1 million gap between the average profits per partner of the top 23 firms on The Am Law 200, as ranked by PPP, and the average of the next 27 firms. In 2001, the gap between them was about half that, or \$590,000. Both grew their profits at roughly the same pace—about 88 percent over the decade—but the gap in absolute dollars became a chasm.

This chasm has consequences. It has put the firms at the very top—let's call them Tier 1 firms—in a position to cherry-pick those just below (Tier 1A) in ways almost unthinkable a decade ago. It has forced the firms in Tier 1A and below to react, to further distort their partnership pay in the hopes of retaining star performers while picking off a few others from tiers below them. And, combined with a developing set of economic and technology factors, it has set the stage for law firms to approach differently the way they work for and relate to their clients. The first two consequences are already being felt. The third? Not so much.

Eighteen firms placed in the top 23 on the profits chart in both 2001 and 2010. These repeat

performers do not follow a single pattern, save one. They're single-office deal or debt powerhouses and multinational, multioffice operations. They run the gamut from extremely low (1:2) to extremely high (1:7) leverage. They boast of single-tier and multitier partnerships, with lockstep and eat-what-you-kill compensation plans. What do they all have in common? Their clients pay more and pay more often.

The five newcomers share that trait plus something else: an uncommon degree of focus. Quinn Emanuel, Irell & Manella, and Boies, Schiller have first-degree litigation pedigrees. Dechert and Paul, Hastings are broader-beamed but no less relentless in their pursuit of upmarket business, rapidly pruning lawyers and slowly building relationships.

Poaching laterals is hardly new. It's the targets that appear different. On americanlawyer.com, The Churn—the twice-weekly account of partner movement—tells the story in its matter-of-fact, head-spinning way. Paul, Weiss takes two partners from Shearman & Sterling and five from O'Melveny; Latham recruits five from Wil-

son Sonsini and four from Vinson & Elkins; Gibson, Dunn takes four from Orrick (as does Dechert) and four from V&E; Kirkland snares three from O'Melveny.

What's happening here? With nary a by-your-leave, the superrich have converted the merely rich into farm teams. As one chair of a poaching firm who asked not to be identified for obvious reasons puts it: "It's the law of the jungle working. We have needs, and we can fill them." Like Tolstoy's unhappy families, every lateral move is different. As the recruiting firms never tire of saying, some lawyers really do move for bigger platforms or new opportunities. But no one is naive here. Seldom is money not part of the equation.

As the climate warms, the poached have reacted. As part of the Am Law 200 survey, we ask firms to report their partner compensation spread. The average from the 118 who responded: 10:1. In fact, the spread can reach 30:1. "We know the market price," says the head of one firm who has adjusted to losing a few partners to higher-bidding firms. "And we're going to meet it. Our [stars] can stay and, just as important, not go someplace else where they'll have a target on their backs." On one level, that's just prudence. On another, though, it can be a cultural challenge: When some partners really are more equal than others, *Animal House* can become *Animal Farm* over the course of a long partnership retreat.

Two caveats. This analysis only describes what's happening. It doesn't imply that the firms who have fallen behind are bound to collapse. These are strong institutions who have lost some ground and a few key players. By most standards they are in enviable shape. But as we'll see below, they face real challenges. Second, this analysis assumes the accuracy of our numbers. We can quibble forever about an outlier here or there and/or the prospect of intentional misleading on the part of some firms. The profits per partner numbers can be, well, manipulated, by how firms categorize their partners—equity or nonequity—or by blatant exaggeration. We are confident that they are directionally

sound and, there is confirmation in the revenue-per-lawyer results [see "Breaking Away," page 65]. The average RPL gap between the top 23 and the next group has also grown over the last decade to about \$260,000, the biggest quartile-over-quartile discrepancy among the Am Law 200 firms.

A SCARCE COMMODITY. As everyone knows, over the past decade Am Law 200 headcount has grown to unprecedented heights. The rush into New York, London, and other client-rich markets has been fueled by the notion that there was substantial unmet demand for top-tier lawyers in all these places. Now it appears that the premise may be wrong: There may be unmet demand, but for the moment at least it doesn't appear to be for unlimited, price-is-not-an-issue billing. But that's what most firms were built to do.

The \$85 billion market served by The Am Law 200 is not a monolith. It varies—from the privileged New York suites where "for services rendered" bills still go out, to provincial capitals where good lawyers help clients solve problems for rates that won't pay for a nine-course dinner at Per Se. After listening to firms describe their work, we've concluded that the market divides into five categories:

- Critical strategic work: a deal of a lifetime, a subpoena to the CEO;
- If you want us, you'll pay our fees: The client needs a law firm's imprimatur;
- Important operations support that the client can't manage in-house;
- Ordinary operations support that the client can't manage in-house; and
- Commodity work that is more efficient to outsource.

Virtually every firm would like to live and work in the first two categories, which, by the way, are no longer immune to price pressures. By our estimates, those premium-priced categories account for about one-third of the market, or \$28 billion. We believe that all Am Law 200 firms get some of this premium work; there are too

many good lawyers with good clients in a splintered market for that not to be true. We also include in the premium category contingency scores.

Based on the financial results we've reviewed, it seems that the best billing work goes disproportionately to the most profitable firms. For this discussion, assume that at the top-earning firms, roughly 60 percent of work falls into this high-billing category. That means that roughly \$11.6 billion is divided among the top 23 firms and the other 177 compete for the remaining \$16.4 billion.

Sound too high? Cut the share of the high-billing work at the most profitable to 50 percent, and that leaves \$18.5 billion for the partners at the other 177 firms. There isn't enough to keep everyone in Beluga: Premium work turns out to be a rather scarce commodity.

If the premium market isn't rapidly growing and there is a slow but steady movement of star players to those who dominate that sector, that still leaves a \$57 billion market of important work to be divided among The Am Law 200. That's the good and bad news. With more law firms competing for this work and more clients resisting routine fee increases and demanding discounts, pricing models have come under increasing pressure. Is that pressure permanent? Or once the national and global economies heat up again, will lawyers' fees return to their comfortable status as rounding errors on gigantic balance sheets?

We don't know the answers to those questions; we are more comfortable reporting the news than predicting its course. But two observations seem appropriate—and safe. First, having grown used to a culture of discounting, it's hard to anticipate clients returning fully to their old habits, even in a time of plenty. Second, what's striking about the behavior of many law firms over the past two years is that they managed their way to profitability by shedding colleagues who did not have enough work, not by examining how the work itself is done.

IT'S NOT ALL ABOUT YOU. Firing or demoting lawyers who do not have enough work to do is an effective tactic to maintain or boost the profits of the surviving partners, but it is all about the firm taking care of itself. Whatever else may be said for lopping off partners who have lost a step, their blood is not being shed so that firms may serve their clients more efficiently.

Indeed, the lexicon seems to be backward, even Lewis Carroll-esque. The best example is a measure of lawyer performance called “productivity.” This turns up regularly as a measure of how busy a lawyer has been. Northwestern adjunct law professor Steven Harper, a former Kirkland litigation partner, pointed out the problem in an Am Law Daily post last April:

Large law firms and their management consultants have redefined a word—productivity—to contradict its true meaning. Recent reports from Hildebrandt [Baker Robbins] and Citibank measure it as average billable hours per attorney. No one questions this definition given the primary goal of large law firms—maximizing partner profits. Billable hours times hourly rates produce gross revenue. More is better, and the misnomer—productivity—persists.

The Business Dictionary defines productivity as the “relative measure of the efficiency of a person [or] system . . . in converting inputs into useful outputs.” The relevant output for an attorney shouldn’t be total hours spent on tasks, but rather useful work product that meets client needs. Total elapsed time without regard to the quality of the result reveals nothing about a worker’s value.

Hardly anyone, least of all us, would deny law firms the pleasure of protecting their interests. But to paraphrase Senator Moynihan, they shouldn’t get to choose their own definitions. It’s hard to walk away from the tortured use of productivity because that would require a generally agreed-upon standard for a lawyer’s “useful output.” Absent an intervening event, such as the rise of really insistent customers or disruptive forces, that could take a while.

ENTER THE POTENTIALLY DISRUPTIVE FORCES.

In the age of smartphones, TelePresence, and the Cornell Law Library on your desktop, it can be difficult to remember that technology and the information revolution have not changed the practice of law nearly as much as, say, Google revolutionized access to in-

formation or the internal combustion engine altered the life and times of a blacksmith. On (widening) margins, that’s beginning to change, though to be fair, this beginning has been very long, slow, and oft-predicted.

Everyone has heard the blandishments about Knowledge Management. Law firms, it was asserted (accurately), were in the business of selling knowledge. Yet they were notoriously inexact about collecting, retaining, and reusing the work they had prepared; also, in a billable-hour world there was conscious or unconscious incentive to reinvent the wheel. Many firms saluted these slogans and invested in various internal and external computerized file cabinets that would order their worlds and promote better work habits. This proved expensive and soul-numbing; updating was essential; only a few had the will and wherewithal to stay with these efforts. KM became yet another false god to die on the altar of reform.

Enter fellows like Kingsley Martin. A British-trained lawyer and veteran law firm tech officer, Martin started a company called KIIAC (Knowledge Information Innovation and Consulting), which offered, among other things, two services. One, it would work internally at a law firm to sort through its deal documents and assemble the standard forms the firm thought it had in place but actually did not. Two, it would work externally, mining publicly available databases, principally the Securities and Exchange Commission’s EDGAR system. The EDGAR work would yield a treasury of documents—essentially all the paper filed in major public deals by the nation’s law firms.

There were two immediate benefits. First, it was now possible for a firm, at a cost far less than it could manage on its own, to assemble the intellectual property of its lawyers. Second, there were no longer any secrets for deal documents. The paper itself, formerly the essence of large firm work, was now a publicly available commodity. Using a proprietary statistical analysis scheme, KIIAC promised complete document sets, including compare-and-contrast clause analysis from the leading firms on

MEET THE ELITE

Eighteen of The Am Law 200’s 23 most profitable firms in 2010—the Tier 1 firms—were also among the 23 most profitable in 2001. (Individual firms are ranked according to their profits per partner in each year.)

2001	2010
Wachtell	Wachtell
Cravath	Quinn Emanuel
Cahill	Sullivan & Cromwell
Davis Polk	Cahill
Simpson Thacher	Cravath
Paul, Weiss	Kirkland
Sullivan & Cromwell	Paul, Weiss
Milbank	Irell & Manella
Skadden	Simpson Thacher
Kirkland	Cleary Gottlieb
Cleary Gottlieb	Boies, Schiller
Willkie Farr	Milbank
Weil, Gotshal	Cadwalader
Cadwalader	Skadden
Debevoise	Gibson, Dunn
Gibson, Dunn	Weil, Gotshal
Dewey Ballantine	Davis Polk
Latham	Willkie Farr
Chadbourne	Debevoise
Crowell & Moring	Schulte Roth
Proskauer	Dechert
Schulte Roth	Latham
Shearman	Paul, Hastings

For an expanded version of this list, go to americanlawyer.com.

BREAKING AWAY

The revenue-per-lawyer gap between Tier 1 firms (numbers 1–23, as ranked by profits per partner) and Tier 1A firms (numbers 24–50, as ranked by PPP) widened over the past decade.

	2001	2010
Average RPL, Tier 1	\$799,565	\$1,140,435
Average RPL, Tier 1A	\$607,037	\$883,333
Difference	\$192,528	\$257,102



the planet. From all this, says Martin, lawyers “can deduce a de facto standard.” This leaves lawyers to compete not on documents but on their knowledge of the market, their ability to negotiate, their alliances with bankers, their ability to deliver a broad range of services from regulatory to foreign-law advice—all things that clients will value but that many law firms have not chosen to emphasize.

It will do something else too: allow lawyers to reduce their costs of production. As Martin enjoys pointing out, firms have tended to increase their profits by raising their prices. That’s harder today. If firms, through new processes, can reduce their internal costs, arguably they can maintain their profit margins just as effectively. He compares this development to the advent of Computer-Aided Design tools for architects. CAD fundamentally changed the nature of the work of architects; it didn’t mark the end of architectural firms. Today, many are bigger, richer, and more influential than ever. They just don’t spend time with graph paper.

Martin’s efforts aim at finding common standards in lawyers’ work product. Ray Bayley’s (Novus Law) efforts aim at finding common tasks in lawyers’ work processes and rendering them more efficient. Bayley plays a leading role in another much-brooded-about trend, the rise of the Legal Process Outsourcing business. Most of the attention about LPOs has focused on the labor cost arbitrage—by shipping work to India or other lower-cost jurisdictions, law firms and their clients can save serious amounts of money. That’s true, and to the degree that exotic-based lawyers can perform work more cheaply, there is a potential disruptive effect.

More dangerous to the existing order is Bayley’s emphasis on the P in LPO. He and his colleagues are seeking to apply the same efficiency techniques that they’ve used in other businesses—notably hospitals, telecommunications, and manufacturing. Their move is to examine work flows, break them into discrete tasks, aggressively train firms’ staffs on the

most efficient ways of performing those tasks, and then monitor them for errors and further efficiencies. Then do it again. As he said in an interview three years ago, if you save a tenth of a second here and a tenth of a second there, pretty soon it adds up to real money.

Like other LPO operators, he started with discovery reviews and then added due diligence and contract management, all tasks that are largely repetitive and susceptible to efficient oversight. Let’s not be blinded here: Are those the only kinds of work that law firms do that fit that description? He’s an interested party, but Bayley guesses that as much as two-thirds of what lawyers do is vulnerable to his organizational schemes.

This process work isn’t for the weak-willed. Bayley says that flying a 747 has 180 unique activities that fall within 18 subprocesses. By contrast, a document review has 864 unique activities in 94 subprocesses. “There’s a move in the market to drive more work into structured, routinized methods,” he says. “This will free up time for lawyers to be lawyers, to focus their elegant minds on content and ideas. There’s always going to be a need for elegant minds.”

A handful of law firms have responded to LPOs with similar efforts of their own: Clifford Chance in India, Allen & Overy and Herbert Smith in Northern Ireland, Orrick in Wheeling, West Virginia, and now Wilmer Cutler Pickering Hale and Dorr in Dayton, Ohio. William Perlstein, the firm’s co-managing partner, says the Dayton branch will be the fourth-largest in the firm’s network. It’s home to 180 staffers and will focus on document review using software and processes developed by Recommend, a leading e-discovery player headquartered in San Francisco. Rather than outsource or bring in waves of contract lawyers, Wilmer will do the work itself.

The firm segregates this work, far from its high-powered, high-style Washington, D.C., offices. But the impact of rethinking how the work gets done may spread internally. Already Perlstein sees

that happening with alternate fee arrangements. Currently the firm does roughly 15 percent of its work on fixed fees, and there is a spillover effect. “If you’re doing a significant matter on a budget and you spend your time talking about costs and benefits, and your next call is with a client on an hourly billing, you’re not going to stop thinking in terms of costs and benefits,” he says.

The client may not let you. Along with KM and LPOs, billing information is getting organized. Last year CT Tymetrix, one of the large e-billing outfits, issued its first Real Rate Report. Based on data collected from some of Tymetrix’s large corporate clients, the RRR began to pull back the curtain on billing habits of law firms. In short, the RRR showed wide variation for similar tasks and that firms were charging different amounts to different clients. It could be that their customers will shrug and get comfortable with the idea that like seats on a long air flight, no two similar matters will get charged alike. But that’s a thin reed on which to build a business plan.

To review then: With surprising speed, the most profitable work and the lawyers who do it are being concentrated in fewer firms. The price pressures on the vast remaining market remain strong and unlikely to fade away. And law firms have responded by tinkering around the edges, culling their herd of their least-busy workers while trying to hold the line on price. For the most part, what they haven’t done is fundamentally rethink their core work processes or come to grips with information that is now flowing into the hands of their clients.

Perhaps it’s time.

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