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The Big Law Firm Demise . . .

It Happens Like This

Heller, Thelen, PoGo, Thacher. Before them, Brobeck, Coudert, Graham & James, Altheimer, and on and on. A fistful more to come, like an Eastwood spaghetti western: *For a Fistful of Law Firms* or *For a Few Law Firms More*. The bodies stack up like cordwood, the corpses of businesses that truly were paragons of success and prestige.

There seems to be some puzzlement over how it happened and how it could happen.

To extend the movie metaphor, it is not unlike the scene in *Three Days of the Condor* when Max von Sydow explains to young Robert Redford how his own demise will unfold in the shadowy world of espionage. He says, portentously, "It will happen like this . . . ." For law firms, here are the telltale signs.

1. The firm hires a significant number of new lateral partners over a relatively short period of two to three years. There might be a number of new offices as well, as the firm reaches hard to find new talent. But there is little net growth in the number of partners.
2. The real out-of-pocket cost, such as headhunter fees and three months of partner draws paid out to the new additions while they ramp up productivity and contribution to net cash flow, is masked by capitalizing those costs rather than by expensing them in the year of the addition, with a multiyear amortization of the cost that future periods will have to bear. This out-of-pocket capital cost is, in a growth period, effectively funded by the capital contributions of the new lawyers. However, in a stagnant situation, it is simply consumed, all or in part by payouts of return of capital to departing or de-equitized partners. Now a dark cloud hovers on the financial horizon and neither existing nor newly arrived partners may be aware of it. Look for "financial engineering" to alter how costs in this and other areas are characterized.
3. The firm shows a significant number of new de-equitized partners to boost apparent, but not real, profits per equity partner (PPEP). These lawyers can be called counsel, senior counsel, special counsel, salary or income partner, or non-equity partner; the list is endless. The bottom line is that they are just another category of worker bees with varying rights and privileges. They are not, however, true stakeholders and participants in enterprise profit.
4. There is little transparency related to decision-making and strategic objectives. Decisions that were previously the subject of wide discussion become increasingly reserved for a smaller coterie of decision-makers without notice or even disclosure to the partnership at large. Essentially, the nature and role of the equity partner becomes more like an employee at will and less like a shareholder.
5. The culture of the firm becomes more a matter of historical lore than current truth. When the stories get so old as to refer to prior-generation heroes of the firm, less than half of whom the current partners ever had the chance to even meet, let alone interact with, it is really time to worry.
6. More than half of the core management team comprises partners who have been with the firm less than 10 years.
7. The firm equity partner compensation scale becomes skewed. There are many ways to measure the deviance, assuming that one can have access to the data. Fundamentally, the skew becomes a matter of concern when the reported arithmetic average of PPEP is more than 25 percent to 30 percent higher than the mean or midpoint of partner compensation. To simplify, if the PPEP figure fed to AmLaw is $900,000 and half the partners are making $600,000 or less, there is a transfer

of enterprise profit to the upper class that is potentially destabilizing, as it can reflect an exploitation of the lower class and middle class equity partners.
8. Moves to maintain profit levels include short-term, non-sustainable cost-savings measures that may cost more to reverse and restore next year than the benefits generated this year. Certain types of staff reductions are but one example.
9. A material reduction in the draw schedule for equity partners is imposed for next year, notwithstanding only a neutral to modestly reduced income projection. Here law firms can get really cute, if not sinister, depending on one's point of view. The change is typically precipitated by the primary bank relationship that provides the working line of capital to the firm.

The working line serves two purposes in a law firm. One is to provide monies to pay bills on time when cash flows are irregular, which happens on an irregular basis to all business, but especially to law firms. However, law firms really are such monster cash engines that, if one were to totally remove draws to partners from the equation, there is little or no need for a working line. The second, and arguably real reason, for a working line is to pay partners a draw or income to smooth out the distributions so that they can pay their home mortgages, car payments, and private school tuitions, along with quarterly federal and state tax payments. But with the economic crisis having an impact on firm revenues, exacerbated by the high-cost/inefficiency of operations at most badly managed big law firms, the banks are understandably nervous about their exposures with a limited liability entity that has a $50 million to $100 million working line. Their bankers are telling these law firms that they will not have the same deal in 2009 that they may have enjoyed in years past.

Bottom Line Impact

Specifically, loan rates will be higher, possibly a lot higher, and draws will have to come from operating surplus. *They will not be financed by the bank,* or at best they will be significantly capped or collared, probably to match historical collections performance. But what is "historical collections performance" in the law industry? Typically, due to vigorous year-end collections efforts, the allocation of collections through the year, rather than being a level 25 percent per quarter, is more like 15 percent, 20 percent, 25 percent, 40 percent.

What does all this mean for equity partner draws? It means that, whatever a partner used to receive, if one follows the literal restriction now imposed by the bank, will be cut by 40 percent in the first quarter and 20 percent in the second quarter. That does not sound half bad if one is making $900,000.

As we have noted, however, half of the equity partners are actually making less than $600,000. The even harder reality is that their draw is in the range of 50 percent to 60 percent of their actual annual gross. Using a 50 percent model, that means that their first quarter income is actually cut to 30 percent of their projected annual income, which also means that, if they spend 100 percent of what they are allotted based on quarterly estimated tax installments with nothing set aside for food, gas, insurance, clothing, mortgage, cars, or school, they are still under-withheld on taxes.

Such is the context in which they are now likely to be asked to contribute more capital. Remember, too, unlike a corporate position, there are no benefits. Everything is paid for by the partner. Health insurance, parking, and disability insurance are deducted monthly off the top. Then there is the contribution to the pension plan, all of which is individually contributed.

There's real fuel here for a revolutionary uprising from the ranks.

Class Struggle

The pressure is on the upper tier or inner circle partners as well. While they may have the big books of business, they need the lower and middle tiers of equity partners to hang in there, or there is no group to generate enterprise operating surplus income to transfer up to them. The lower tier of equity partners has, by definition, smaller books of business and a quasi-service partner role. They are the ones with low lateral mobility and have essentially already been stripped of much of the financial benefit of being a stakeholder in the enterprise.

They have little to nothing to give at a time like this, but they also have nowhere to go with their practice profiles. Squeezing them further actually makes them willing and, in fact, eager to convert to being salaried income partners just to get their capital back (and exempt themselves from joint and several liability). So watch for this tier to face less draw reduction, while contributing less new capital to the equity pot. Alas, they are ensuring their own role as sheep ready for shearing.

Focus instead on the middle tier and what happens to them. These are the partners with $2 million to $4 million in business in many firms. They are eminently portable, targeted aggressively by headhunters and other firms, and they are the ones with the most enterprise income share to be shipped upstream to the upper tier. How do we handle the potentially deadly dynamic between what these partners have and what the upper tier wants? How does the firm's leadership slake the thirst for money among the upper-tier partners without destroying the firm's engine room, which keeps the firm in motion on a day-to-day basis and may even spawn its future stars?

The not-uncommon superficial solution (*i.e.*, no solution at all) is to defer facing reality by cutting middle-tier draws by very little, or not at all, and to disproportionately impose the cuts on the upper tier. They have the most income, which is not cut in the budget but just deferred. Partners with $3 million to $5 million incomes should not have burn rates so high that they cannot afford to reduce their annual draws from $1.5 million to $1 million for a few months. Besides, as the collections kick into gear by mid-year, they will get a disproportionately larger recovery to bring them back into parity, so it's all just a partial year sacrifice at worst.

The perceived added benefit to this approach is that it holds the upper-tier partners a bit more hostage because, at most firms, if a lawyer departs during the course of the year, all deferred income distributions are forfeit. By the time it becomes clear that 2009 is not going to as good or better, they are in very deep and looking at seven-figure forfeitures if they leave the firm.

This short-term strategy attempts to assure the middle-tier partners that they are not going to have to suffer, that their draws will be maintained or only very slightly reduced, and that their incomes will stay comparable. The message is that the upper tier partners are shouldering the burden. Meanwhile, the upper-tier partners are told that they get to keep their high-income allocations and suffer just a temporary cash flow reduction, which, since they control large books, can be ameliorated through their own efforts to improve current billing and collection practices. You cannot have it both ways.

The reality is that the operating inefficiencies and internal management challenges are not being addressed at all. Firms are just moving pieces around the game board. As the reality sinks in that the problems are not resolved, there will be another wave of law firm collapses as partners at every level feel manipulated, not pacified.

Last Rites

The beginning of the end is when the middle tier gets sick of all the smoke and mirrors and starts migrating to other firms that suck less of their share upstream. But if their draws are being temporarily protected at the expense of the upper tier, what is it that specifically catalyzes the collective discontent?

Start with missed budgets and forecasts, where expectations of distributable income confront realities inflated by 10 to 15 percent. When those middle-tier partners take a closer look at what has gone on, it undermines their confidence in all unspecific and unsupported forecasts of what the future holds.

There has been a lot of discussion over the past year or so in the Big Law community about layoffs and cutbacks and expense discipline. The reality is that the top line is falling faster than operations costs can be trimmed. The compression on profits is going to be severe. Clients have been slow in paying. It should be no shock that there will be many firms in the AmLaw 250 suffering drops in distributable equity partner income by 10 percent and probably a good number that will get hammered for 25 percent or more.

In most cases, the partners will be taken by surprise, having expected maybe a 5 percent falloff. As a result, many of the partners who

confront a 25 percent or so reduction will have to pay substantially all their remaining income from year end's distribution to their pension and retirement plans, with the rest applied to the annual installment loan payback to the bank for their capital loan. Then there is the next capital contribution at the end of that month, with no money to pay taxes.

Tapping the home equity line to pay Uncle Sam while working 3,000 hours a year is kind of a bummer.

What of the leadership's accountability for the annual results? There will be essentially none, which is where law firms are fundamentally distinguished from real business. If you are the CEO of a public company that earns a quarter-billion or more in income per year, and you miss your revenue budget by 20 percent per year for a couple of years, losing your job is a distant secondary concern; it is the risk of going to PRISON that should be more on the CEO's mind these days.

In law, on the other hand, it is just sort of par for the course, because most of those in charge of running the operation have the acumen of a potted plant. (Louis Black had an apropos rant about the lack of accountability among TV weathermen. He observed that, when Al Roker forecast 10 inches of snow, and they got 36 inches instead, there was no accountability; whereas a roofer who had missed by more than two feet would still be in prison!)

You don't need closely guarded inside information to identify the firms teetering on the brink. Look for AmLaw firms that lose eight to 15 of these middle-tier partners in a three- to six-month period (and not necessarily in groups, but in ones and twos as well) to their competitors. Those firms face a cash flow erosion to the tune of $6 million to $12 million *net* distributable just in terms of the revenue that walked out the door. In normal business times, that sets off perhaps a two-year fuse. In these times, it is more like six to 12 months.

As both the upper-tier and middle-tier partners find homes elsewhere, the lower tier will be left behind or culled out along with many income partners and associates. It is now strictly a game of numbers. That is the fate of an industry characterized not by a foundation in sound business practice and actual management but by structural and policy processes that simply shift more benefit to fewer people. Meanwhile, bloated overhead and operational inefficiencies grab bigger portions of the pie as client tolerance for higher fees rapidly erodes.

The squeeze on net operating income precipitated by the downturn exacerbates the existing problem. The crisis in Big Law has been with us for many years. It is only now being revealed in somewhat the same fashion as Mr. Madoff's scheme, which might have continued for a few years as long as he could add more subscribers to his portfolio. A closer look at the growth of law firms is likely to show that there are some distressing similarities in generating growth of income through additions, but not in net operations.

They're called Ponzi schemes. ■

—Ed Reeser

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