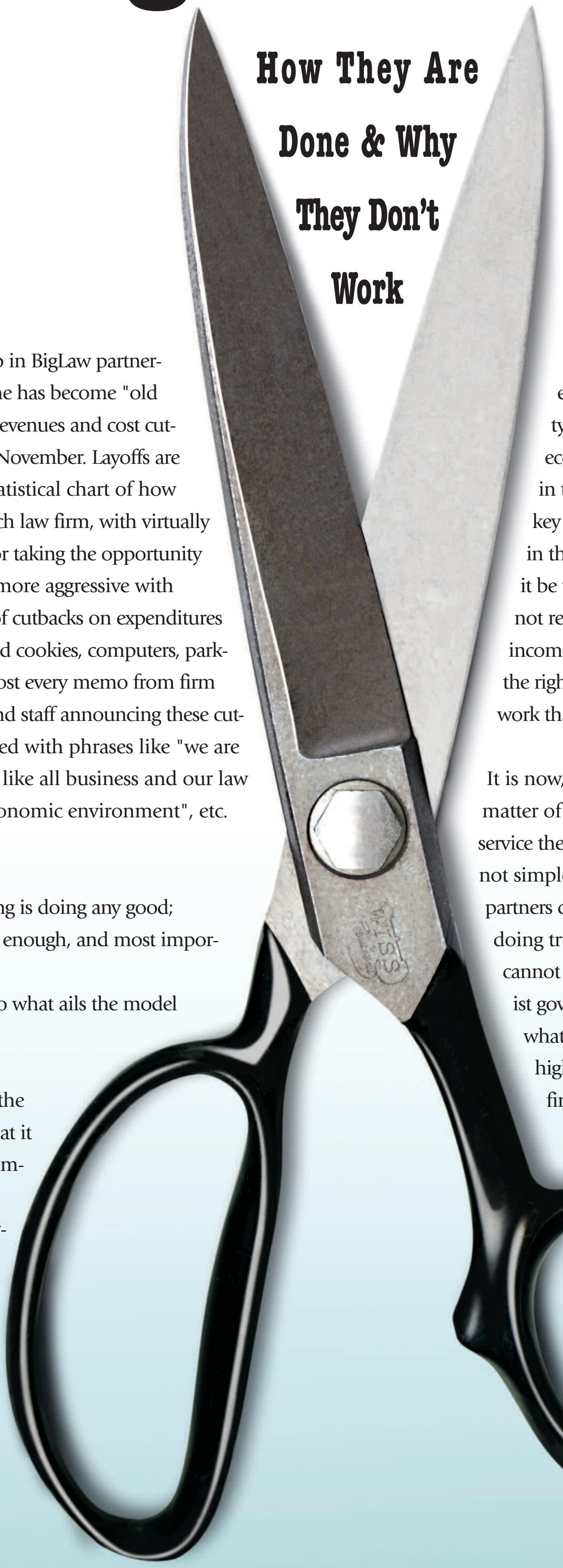
by Edwin B. Reeser

BigLaw Cuts:

How They Are Done & Why They Don't Work



The anticipated severe drop in BigLaw partnership net distributable income has become "old news," from rumors of flat revenues and cost cutting measures reported last November. Layoffs are now relegated more to a statistical chart of how many bodies and from which law firm, with virtually all firms compelled to cut, or taking the opportunity in this environment to be more aggressive with "culling the herd." Stories of cutbacks on expenditures for retreats, bottled water and cookies, computers, parking and perks abound. Almost every memo from firm leadership to the partners and staff announcing these cutbacks and layoffs is peppered with phrases like "we are strong", "we must respond like all business and our law firm competitors to this economic environment", etc.

The real questions are:

1) whether this cost cutting is doing any good;

2) if it is doing good, is it enough, and most importantly;

3) is it really the answer to what ails the model of the business?

Most people familiar with the business of law will agree that it has fundamentally been examined and declared over the years to be a "top line" driven business model; the height of simplicity to understand and plan. In fact, to be involved in firm management as a partner has been a dangerous thing to do, with there being little to no recognition of such service as a meaningful contribution to the enterprise, and thus undervalued. There has typically been little to even no recognition of economic value to the roles of lawyer-managers in the profession, even in big firms. After all, the key to the business is simply that you need to pull in the business and then service it. How hard can it be to manage that? Physical assets and capital are not really a material contributor to the generation of income, as it is a service business. So just match up the right people in skill sets and numbers to do the work that comes in, then bill and collect.

It is now, AND ALWAYS HAS BEEN, a not so simple matter of being "right sized" with the infrastructure to service the business that you have, and plan to have. It is not simple because lawyers are not fungible. Litigation partners cannot, generally speaking, easily switch over to doing trust and estate plans, securities offering teams cannot switch over to doing litigation, and the lobbyist government types really cannot do anything else whatsoever. Practice specializations that command higher rates through greater expertise (whether the firm is operationally focused on practice groups, geographic offices, or otherwise) are further fractionalized. If for example one breaks down real estate, it quickly separates into entitlements, development, construction, finance, securitization, transactional, leasing, and even subcategories by type, such as hotel, retail, office, industrial, farm, and so forth. Expertise is resident in the minds and experience of specific individuals, not from a can of essential qualities that you can buy, drink and absorb . . . so the firm naturally looks for talent that fits a perceived need, will throw off work to other practices (tax, litigation, estate planning, corporate etc), and which may be marketed and sold to existing clients that may have use for that expertise and presently has it serviced at a different firm.

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When you increase the "top line" the analysis has tended to be pretty simplistic. There is a projection of the gross revenue that the new lawyer will generate both through hours worked and hours to be worked by others, a calculation of the fixed and variable overhead that will be required to deliver those hours, and the hourly rates of the hours and their percentage of realization. Cross marketing and other benefits may be examined but rarely are they relied on in the decision to bring a lawyer on board, or to set their compensation. The computation typically leaves a margin to benefit the firm in case things are a bit slower or less robust than expected. Growth is an easier path for management to predict profits because the existing fixed overhead is usually diluted per capita with the addition of a few more bodies. The variable overhead is just that . . . variable. Although with changing the staffing ratios, using fewer people, that can be impacted to the benefit of the firm as well (going to 4 to 1 secretarial ratios from 3 to 1, for example). So growth sounds at first blush like a great idea. Increase your attractiveness to existing and potential clients by being a "one stop shop" for all your global lawyering needs. Take advantage of economies of scale in technology and other resources, which have traditionally been very expensive, with your size. Each addition should add to the net return of the firm and thus growth enhances profitability, as well as stability by having a broader base of work in multiple locations and practice areas. Thus the firm should be better able to withstand the gyrations of the business cycles, which are inevitably to occur several times in the course of an attorney's career, by having cyclical and countercyclical sources of work. What has characterized this business / law cycle as being of a different fashion is that the "counter cyclical" practices have not revved up their activity anywhere close to being able to balance the decline in the "cyclical" practices.

When you have a major reduction in the "top line" then the firm and its partners must by definition take home less money, absent business decisions IMPLEMENTED TIMELY to have an impact. It is this immediacy of a potential reduction in take home distributions that motivates "management" of the law firm to take action, and possibly even more importantly to them to be seen as taking immediate and far reaching action, to preserve net distributable income to the partners. What are the options available to achieve the short-term goal of achieving no reduction in take home pay in a no growth, possibly even shrinking revenue, business environment?

Salaries. Compensation is perhaps 2/3 of the total costs of the enterprise and the balance of operating costs are about 1/3 (including rent!). Obviously the jobs component is therefore one of the first to look at. It is unattractive to cut jobs for a host of public relations reasons, and interpersonal ones as well, which is one reason why law firms have traditionally carried too much non-productive overhead with respect to underproductive timekeepers. Cost savings in the jobs component means firing people, and it is an interesting yet widespread phenomenon that most lawyers are conflict averse with their partners and staff. But the overhead factor for an attorney is significant. Excluding salary and benefits directly associated with the attorney, the cost is likely to be in excess of $100,000 per timekeeper per year in operating expenses. Though some component of this amount is variable with the attorney headcount, a significant amount is either not variable, or only variable with the passage of a significant amount of time (rent, recruiting, communications, books, insurance etc). Therefore, one must carefully consider the host of costing issues and reputational burdens associated with headcount reductions when one is engaged in a long-term enterprise investment. On the other hand, if you are worried about whether you will make it to the end of next year, those considerations may be dispensed with. The variable amount, salary and benefits for the timekeeper, is usually immediately variable when the individual leaves of their own volition. When they are asked or encouraged to leave there is often a severance package or obligation undertaken by the firm that varies depending on status of the individual in the firm and economic conditions, but it is not uncommonly two or three months of salary and benefits and outplacement support….with a reduced expectation of hours and billings so they may aggressively search for a new position. Thus the true economic benefit or relief to a firm from a forced departure on a timekeeper is deferred for several months. To the extent the attorney has been productive, the "tail" of their hours billed and collected during this period ameliorates some of the cost. For example, if a group of five attorneys leaves voluntarily, then their entire A/R inventory will continue to be collected and shared only among the partners who remain. Interestingly, there is in that case a very short term, but significant increase to the remaining partners of their incomes as the variable cost component has been eliminated.

Other steps can include freezing lockstep raises (becoming widespread in the associate ranks), actual cuts in compensation (becoming widespread in the non-equity or income partner ranks), and related to this the "de-equitization" of partners to reduce the size of the income pie to be divided among the remainder. This, however, is not as easy to plan as it might sound, because that partner will still need to be compensated for his/her work on a salaried basis, with benefits etc., as an employee. So the change in status will put more risk of enterprise volatility into the hands of smaller number of equity partners, should the business not be as profitable as budgeted. And with size reduction the allocation of the fixed overhead is now shouldered by a smaller number of timekeepers, and rises per capita.

What are the categories that one can attack to save money and maintain partner distributable NOI other than jobs?

Occupancy. This is about 1/3 of total operating costs (excluding salary and benefits). In some cases modifications may be available, but not usually and not by a lot. Nevertheless, in a crisis no stone is to be left unturned, and careful review of space and its utilization is called for. In some instances leases will have been negotiated with "give back" rights of the tenant. It comes at a price, but those that have them are going to seriously consider using them if the consequences to them in a recovered economy are not adverse. If it is survival time, then making it to next year is more important than worrying about having the best rent deal when you need to expand five years from now.

While one can theoretically suggest a subletting of space in an economic downturn, the reality is that the prospects of subletting space in such a market climate is low, spaces are purpose designed and built and often not readily useable by others without expensive additional modifications, there are security and client file confidentiality issues in having persons not a member of the firm in sublease space, commissions on leasing are relatively high and paid up front, and attainable lease rates are depressingly low, and in most instances well below the cost of the leasehold space to the firm wanting to sublease it. Add to this the fact that the total leasehold space expense is perhaps 5 to 8 % of gross income . . . and you can conclude that while some shedding of space will help, it will not make or break the survival of the firm as a business. It is not "bad leases" that tip firms into unsustainable operating profiles….it is poor handling of the work and attorney balance and management of the people part of the business that results in having too much space. But that puts accountability on leaders so it usually isn't presented that way.

Depreciation. This is a non-cash item. While it may have "optics" attributes in reporting income and loss, it will not likely be much of an issue.

Equipment costs. This tends to be a pretty big item, perhaps around 8% of operating costs (1/4 of the amount of lease expense) encompassing computers and word processors, copy-fax-scanners, leased furnishings, etc. Most firms have gone to leasing agreements on this category because of the speed with which technology outstrips the useful life of the hardware. This stuff cannot be given back without severe penalties, if at all, and thus most firms are relegated to simply deferring the planned date of its replacement or upgrade. Such is a very short-term solution, as technology is an essential element of practice, particularly where it will improve the productivity of staff and attorneys. If you cut 10% of your timekeepers, you get a big storage room full of this stuff that you make lease payments on and don't use.

Supplies. This is not chump change, perhaps 2% of operating costs, so in a big firm it will be a few hundred grand a year. Apart from getting very aggressive about sourcing and haggling over prices, and perhaps trying to avoid wastage, there is not a lot one can do. Every little bit helps, but you have to be careful not to get enraged timekeepers by having stockroom controls that involve filling out forms in triplicate just to get a pencil and pad of paper.

In-house meetings. The cost of these is primarily coffee and goodies to eat or lunches. Tightening down on this is more symbolic than anything else. My experience is that in the real world any surplus goes to the attorney and staff lunchrooms and is consumed before the end of the day. It makes for some good morale actually to have that around, especially for those churning and burning and skipping meals to meet deadlines.

Professional activities. Continuing legal education (outside programs and in-house programs), participation in bar associations and committees. Believe it or not, this is about 9% of operating costs for a law firm. Much of it is associated with in-house CLE courses, which you put on because it is significantly more cost effective than having attorneys going to outside professional programs and dropping $350 to $500 per day for tuition plus travel and lost billing time. Professional dues are not negotiable as far as the State Bar is concerned. Some discipline about how many committees and other professional associations folks are allowed to join at firm expense is prudent, but most firms have addressed this category a long time ago.

Recruiting. This is an interesting one. Summer programs for law clerks, long a sacred cow, may become more endangered. When one computes the costs of attorney time in the recruitment process, the salaries to the clerks, the outings, etc., it is not uncommon for a firm to spend upwards of $250,000 per actual full time hire. With an associate attrition rate in the industry of more than 20% per year, and a break even outcome on hours worked, billed and collected not attained until sometime in the third or even fourth year for many . . . more firms are easing back on the throttle of hiring students right out of law school, and going to the lateral market. While the lateral market for a an attorney does require the payment of a recruitment fee of 20 to 25% of the first year salary and bonus of the candidate – a $40k fee and perhaps $5,000 in attorney interview time is a much better investment return for a third year attorney who is going to make you money, and concluded that yes indeed they really want to be a lawyer.

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Of course, the real action in recruitment is in partners, and groups of partners. Suffice to say that this is very difficult, very active, competitive, expensive, and widely used. Is it working? Lots of lawyers are moving and merging, in perhaps unprecedented numbers. But is it "working?" What is the true cost?

Well, if you assume that the average partner in this category is someone who, to be interesting and eligible for a lateral move, has a base compensation profile of AT LEAST $500,000 . . . the fee element alone per person is perhaps $100,000. That is the threshold, and there are numerous talents that command a fee that is multiples larger. A firm that brings in at least ten lateral partners a year is probably spending on the order of $1.5 to $2.0 million a year. Some firms last year had lateral hires of more than 50 partners. And departures of close to as many as came. The acquisition cost of the talent does not include the "ramp up" or lead time of 90 to 120 days for their working pipeline to begin flowing dollars from billings collected. That is an "investment" in that partner's income distribution that is equal to or greater than the recruitment fee! So whatever the fees to recruiters are, double it for the out of pockets, and don't forget all the attorney time spent interviewing and entertaining not only this candidate, but all the candidates you don't give an offer to or who you are interested in but ultimately determine that they are going to join a different firm. Toss that into a salad and when you dump it on the financial statement, you probably are looking at a base cost of $250-300k, per partner, just to bring them on board. And again, in some instances there will be partners that cost several multiples of that.

This one area overwhelms all the paper clips not purchased or re-used, cookies not digested and even computers not replaced. It is not necessarily well analyzed either. A lot of lateral moves DO NOT WORK OUT. Plenty of partner moves turn out to be disasters for both the firm and the lateral, notwithstanding the best of intentions. Due diligence by both is critical and at least historically tends to be done not very well. Some work out marvelously. But nowhere near as many as anticipated by both sides.

Communications. This is perhaps on the order of 5% of operating costs. You might be able to do some things to bring it down. But you need phones.

Marketing. It may not be very effective. But relax, because in most firms it is not very much money either. Even if you wiped it out entirely it is unlikely to move the needle on cost savings sought. That may be another topic for someone here to talk about.

Travel and Entertainment. Maybe 1.5% of operating costs. Put whatever collars on it you want, it won't make a big difference.

Books and Subscriptions. A lot can be done here, but again, this is perhaps 2% total of operating costs.

Insurance. You gotta have it. Shop it, manage deductibles, tweak coverage and limits. If you haven't been managing this aggressively for the past decade, it would be a surprise, because the way the insurance industry has been managed you have been forced to.

So the bottom line here is that, fundamentally, even if you were to attack the operating expenses with a chainsaw that took a 20% bite, excluding the categories like rent and equipment leases that take up more than 40% of the overall, and add in some that are not adjustable, like taxes, you creep up to almost 50% of your operating expenses as not being short-term "manageable." An overall reduction average on the other categories of 20%, netting a fully allocated reduction of 10% of operating costs, is probably the most heroic outcome you can achieve unless you have been super sloppy and wasteful in running the operations of the business. What would that kind of reduction translate to, in per partner income protection? Maybe $50k per partner. Probably more like $35k. In some firms I could imagine as much as $75k. But materially more than that is hard to deliver.

Partner incomes are falling by $100k to $200k across the country in BigLaw with some frequency, a multiple of many times these savings, and AFTER MOST OF THEM HAVE BEEN IMPLEMENTED. Are the benefits yet to be felt? For the most part the answer is that in 2008 they did as much as they reasonably could. There may be a few tweaks and pushes left, but the incremental improvements in 2009 will be small. If this is so, they are not enough from the operating expense side, clearly, to solve the problem. BigLaw is not going to "save" its way to profitability. Few businesses ever have.

How much savings can a firm achieve by cutting attorneys? Well, if there is no work for them, there really is not much choice but to do it. The savings will be their salary and benefits, and that will for associates be in the range of $200k to $400k per year "fully loaded." For income partners the range is probably more like $300k-$600k.

So it is very clear that if the firm is going to address rapidly declining NOI, as a result of not having work to do, the "right sizing" involving elimination of jobs is the only truly viable option to pursue (and the expansion of income by hiring lateral talent that brings the business with them). Cut astutely and the relief can be in the range of two to four times what can be achieved by sharing wastebaskets and re-using paper plates. Hire astutely and you will have a margin of surplus from the new comer's business book to add to the profits of your team. Desperate competition in the market, however, is making that profitable margin from additions of partners increasingly difficult to do.

So, in answer to the questions initially postulated:

1) whether this cost cutting is doing any good?
Yes it is doing some good, albeit at the price of doing some real "bad" to significant numbers of "good" people.

2) if it is doing good, is it enough?
It is not enough yet, and depending on how the economy responds over the next few years, things are likely to get worse for BigLaw economics before they get better, and that is almost guaranteed for 2009. It is too soon to divine how much longer it will be before things turn around.

3) is it really the answer to what ails the model of the business?
Absolutely not. What we are witnessing is reactive to maintain profits at levels that will allow firms to keep their most valuable talents and to hopefully attract other talents from other firms, but doing RELATIVELY BETTER than the competition. That is not doing a good job. Just better than the next firm that competes for talent with them. This is the quintessential short-term emergency response. It is not "management" of the enterprise.

This law firm response to falling profits is not unlike the story of the two campers who see a grizzly bear headed to their tent, and the first camper immediately shucks his hiking boots, and pulls on his running shoes, as they both head out the tent and down the trail. The second camper is perplexed and says "why did you do that? The grizzly bear (ursus horribilis) is 1,200 pounds and can run 40mph. You cannot outrun it. It will crush your chest with a single blow and begin eating you while you are still alive and breathing. What is the point of putting on sneakers?" To which the first camper replies . . . "I don't have to outrun the grizzly bear. . . I just have to outrun YOU!"

When the panic subsides, which will not be for awhile, people are going to have to turn their attention to the operating model and begin addressing real issues associated with delivering valuable service and legal product at acceptable prices to clients, for a COST OF DELIVERY that is much lower than today so that a reasonable level of compensation may be earned, for a quality of life that is worth living. NOTHING in what is being done now appears to address any aspect of that.

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