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*Bring Me Another Plate of Leeches . . .*

# Do Partners Really Want to Save Their Law Firms?

Driven by economic pressure, approximately 5,000 attorneys and 8,000 staff have been terminated in BigLaw in the United States since the beginning of 2009, with significant additional redundancies eliminated at UK firms and their foreign offices. Many of the substantial regional law firms have made sweeping cuts as well.

An unknown number of terminations had already been made during calendar year 2008, but it is estimated that, in the aggregate, it was on the order of more than 1,000 attorneys from the AmLaw 250. Firms are implementing salary freezes; rescinding employment offers to graduating law students; delaying start dates for new associates by three to six months; giving stipends to support a year of work in public service for associates who delay those start dates for a year; curtailing or eliminating summer clerk programs; and cutting salaries and eliminating lockstep promotion policy.

There are conversions of equity partners to income partners at some firms; conversion of income partners to equity partners at others; terminations of partners and of counsel elsewhere; and much more. Actual salary cuts have become a fact of life for associate, income partner, and of counsel positions in 2009, as they already are for equity partners.

Cost control focus has gone beyond revocation of visible perks, such as garage parking and client development entertainment allowances, as well as less visible benefits such as deductible increases and coverage decreases for professional insurance or health/vision/dental programs. In fact, the cuts have reached levels as minute as coffee service, cookies at in-house meetings, and library subscriptions. The age of "entitlement" has abruptly ended in the law business.

Reports of profit declines at some of these firms are in the range of 20 percent or more, but for a majority of firms, the reported year-end results actually range from neutral to 3 to 5 percent decreases. Hmmmmm! Does an enterprise of any kind take a chainsaw to its staff and attorneys for a drop of that magnitude? Of course not!

So the magnitude of financial stress is presumably much greater than reported. These management responses in the form of terminations and cost cutting are either proportional to the impact on current or projected income stream or hysterically out of proportion. Now, the managing partners of major law firms are not the kind of people to get hysterical. It should therefore be fair to conclude that the responses are calculated and requisite, not irrational or emotionally over-reactive.

But why now? Once the year-end profits for 2008 were finally in, the distributions of income made to the partners, and once the work flow for the first six weeks of the year completed and tallied, business prospects looked beyond bleak for 2009 with no clear picture of when they might improve. But the slash and burn of the first quarter has not abated, and each month brings a new wave of adjustments that are quickly adopted across the industry, following the lead of the major firms.

The law firm management response is not unlike a medieval physician responding to a patient who is not recovering. Throw on a few more leeches, open a vein, and draw some more blood.

Why is this happening if the reported declines in net revenue are reported to be so marginal? In a few instances, it's because the reported declines are not accurate. More importantly, though, the real driver is a fundamentally flawed business model, which has wreaked havoc for more than a decade and which cannot be effectively changed in a short time. The current actions of management are not directed to a solution, only a deferral of the day of real reckoning.

## Ticking Time Bomb

Let's take a look at where the painful fault lines in the structure predominately lie.

***1. The balance sheets of the firms are hollowed out.*** Working capital has been dissipated in unproductive lateral hires as well as expansions to diversified practice areas and new locales that have been disappointing in their performance. The costs of these expansions and their general lack of contribution to profit have weakened both the culture and the financial stability of the entities.

The amount of partner capital required by firms has been kept too low, which has further roiled lateral movement and made it harder to retain existing partners. Why keep $400k in after-tax savings in a non-interest bearing capital account with the firm to support your $800k compensation package when another law firm that will pay you for your book of business requires that you have only $200k at risk?

In response, firms have increasingly turned to banks that were eager to provide the working capital with easy-to-obtain and cheaply priced revolving credit lines. Such working capital has been used not only to level out the irregularities in cash flow from operations but also to fund equity partner draws in the first part of the fiscal year when net operating cash flows would otherwise be inadequate to do so.

As we pointed out in July's *Of Counsel* ("The Big Law Firm Demise: It Happens Like This"), law firms typically collect their revenues by quarter in the ratio of 15 percent/20 percent/25 percent/40 percent (respectively, for each quarter), so equity partners living off actual net cash available for distributions would receive very little in the way of distributions for the first six months of the year. The cost of credit has risen sharply for many firms and its availability has diminished, as banks are unwilling to take what they perceive as increased lending risks to support such policies at law firms.

Many firms have, whenever possible, made use of their credit lines to capitalize expenditures that would formerly have been expensed in order to increase distributable income. For example, some firms have capitalized headhunter fees for lateral partner acquisitions, including in some instances an initial 90 days of draws to lateral additions while they worked to get their pipeline up to a point where the work could enter the billings and collections stage. Do this for 15 or 20 partners a year for three years, with a three- to five-year amortization of that cost, and the impact to the financials is material.

Yet it is but one example of a wide array of questionable practices that have been employed in the competition for talent driven by reporting profits-per-partner figures that are ever higher but not necessarily "real."

Partners are increasingly hesitant to throw potentially good money after bad in the form of additional capital contributions and reduced monthly draws when such draws do not have to be made up until the end of a year, especially when annual performance outcome is increasingly so uncertain. This holding back especially affects firms where the projections of year-end income by leadership proved to be very significantly below the announced targets a few short weeks before year-end 2008.

***2. Limited liability structures erode true partnership.*** A consequence of the evolution away from general partner, and joint and several liability for the success or failure of the enterprise, is that there is no longer a financial reason beyond their capital invested in the firm for partners to get involved in the management and operation of the business, not as a true partner used to. At the same time, management has become increasingly opaque and uninterested in providing truly transparent and participatory management to the "partners." Amid the bad results for 2008 and likely for 2009, the trust quotient of rank-and-file partners with respect to their leadership is going to be severely tested.

***3. The income statement is difficult to influence.*** Even with heroic efforts, fixed overhead is extremely difficult to reduce to the extent necessary to meaningfully affect the bottom line. No business is going to "save its way to success." Perhaps 50 percent of fixed overhead at a law firm is not subject to adjustment, and the other half is probably not subject to more than a 20 percent cut.

With negotiable fixed costs thus amounting to perhaps one-third of total operating expenses, at best we're talking about only a 3 percent total cost savings. There's lots of action and some results, but finally, it's like beating back the waves of an incoming tide with a baseball bat. Prospects for top-line revenue growth are hard to rely on. All your partners have been out there doing their best to sell more services. But in a business traditionally analyzed as a top-line enterprise, from which everything derives from the gross dollars brought through the door, the impact of a recession is to shock the core economic driver of the business.

That means that the only place left to look for short-term relief is reduction in the very high level of variable cost. That means people.

***4. Law firms have lost touch with their fundamental economic relationship with clients.*** "How do I provide better legal services and products to clients for a lower cost?" That is what clients want in all business. That is what most businesses focus on trying to deliver.

And that is what law firms have ignored at their peril for the better part of the past 15 years.

Nor has the question particularly registered on the consultants' meters for the past decade either. Everything has been about "how do I make more money?" Perhaps a practicum on doing work "better, faster, cheaper" was not something law firms wanted to buy, so consultants could not sell it even if they wanted to. But that is the way it has always worked, hasn't it?

In any event, law firms are out of sync with what their clients are saying they want and need. Since the firms cannot deliver it, clients have so wearied of paying for what they don't want that they're now truly on the verge of not buying at all. The days are gone when you could deliver gravel and sand in the trunk of a Mercedes.

With an overhead structure now completely out of balance with revenue generation, and little time to make changes to effectively serve client demands within the structure of what exists today, the sudden collapse of firms like Heller, Thelen, and Thacher in 2008 presage what is likely to be a series of dissolutions *du jour* in the final months of 2009.

***5. Financial incentives to change the business model are actually disincentives.*** Yes, it's a paradox: Amid all the caterwauling about the crisis that is devastating law firms, there's no real need to save the situation. That may well be the decisive factor that permanently alters the legal landscape.

Dozens of the nation's largest and most prestigious firms are confronted with a financial scenario akin to a coyote on the neck of a kitten. One common scenario is that a few, precious few, partners with significant books of business will at the last moment depart their firms and the rest will be left behind to endure a quick collapse. Those lacking sufficient portable books of business have no place to go, so they stay.

Another scenario is the sudden and (seemingly without warning) law firm collapse. Lacking a culture that will support a partnership through hardship or allow for major do-or-die changes based on consensual action plans—and without an economic foundation to minimize swings in income and risk profile—only slight pressure is needed to topple the tower.

In the meantime, the partners ride the operation to the bitter end. It is more profitable to do so in many instances than to waste time, effort, and money trying to fix the problem. For the partners (including, not surprisingly, many of the firm's "leaders"), the best and most logical business decision is to drive the enterprise right into the wall.

There is at present no perceived third-party liability in doing so. With capital account risk at typically 25 percent of one year's income, every month of extra income represents fully one-third of that capital recovered (excluding issues of income taxes accrued and deductions for capital losses).

Take a look down the hall. Do you know what it is that all those guys have on? That's right: parachutes.

Let's take a closer look at what may be the most important determinant of the future of law firms as we know them.

## Does Anyone Care?

Many of the partners in leadership positions are enjoying income levels that are well above those matched to their business book if they had to relocate. They will not replace their income dollar for dollar when or if they leave for another firm. Partners at any level who leave too early face the real possibility that they are going to lose their equity capital anyway because, at many law firms, that capital is either forfeited or dribbled out over a term of months or years such that, considering the firm's current survival potential, it could evaporate anyway.

It is therefore not an irrational decision for a managing partner and the inner circle of "leaders" to define their best personal self-interest as maintaining the status quo as long as they can, especially when they know that they do not have the business acumen and political support to adjust the entire business model of the firm from the nonfunctional one that they know to something that they have never lived in, but that could work. It's too risky. It's also politically impossible.

After all, if you've been making several million dollars a year for quite some number of years, it's the easiest decision and probably the only one if you have no idea what else to do anyway.

Meanwhile, the working partners outside the circle of management and leadership are best served by preserving their client books rather than spending time trying to pilot the enterprise to safety at this juncture. It matters not whether they work in the current firm or another as long as liability is capped and their clients are portable.

On the other hand, if the firm undertakes a progressive strategy to reconstitute itself with a healthy, viable business model, it would almost certainly require the most productive and portable partners to take a pay reduction as an investment in the new model. Would they be motivated to leave? Could you convince your most productive partners in this environment to do otherwise?

Good luck trying!

## Tricks of the Trade

Significantly, and sadly, many law firm leaders cannot afford a comprehensive and transparent analysis of what they've actually been doing for the past several years, which would be required for a "clean sheet of paper" transformation to a new business model. Alas, there is a gaping divide between what partners have agreed to live by in their written partnership agreements and how the inner circle actually administered the decision-making apparatus. The synapse would shock a number of their partners if they were fully aware.

For example, draw programs may call for 50 percent of a partner's budgeted income to be paid on a current basis, with the rest to come at the end of the year. But leadership may well cut secret or undisclosed deals with certain high-performing partners to provide them with a larger proportional distribution on a current basis. It may be couched in cute ways that nominally do not violate the word or letter of the partnership agreement, such as characterizing the extra advance amounts as noninterest bearing loans to be credited against future draws. When asked if they are making special draws to favored partners, the technical answer is "no." But the question was not asked correctly.

There are other fairly common tricks, such as guaranteed minimum distribution amounts to certain partners. As a result, when the reductions in partner draws have to be applied, and the expectation is that they will be equitably applied, they are not.

There can also be use of the pension contributions made by partners by the end of the first quarter to cover shortfalls in operating cash flow or by delaying the filing of the partnership tax returns (that date being the cutoff for when the contribution actually must be made). The obligation to contribute to the pension plan remains, but the cash was actually spent on salaries and paper clips. The outside date for extension to file for a calendar year taxpayer is September 15th when hopefully the cash flows will have picked up. That gambit does not tend to be broadcast for approval from the full partnership either!

The real burden is born by the lower and middle tiers of the partners to whom the special and more favorable treatment of upper tier and leadership partners is not disclosed. Given the outcome of a full disclosure of these operating procedures to all partners, how can there be a reasonable expectation of any trust in their leadership going forward?

Here too the pressure to maintain the status quo is immense, given the greater economic benefit to the upper tier from its guaranteed draws and multimillion dollar minimum income levels.

Is there really a choice for them? In fact, at this juncture, driving the entity into the wall, knowing that they can walk away from it with very limited liability and moving to another vehicle to practice, is perhaps the best personal risk avoidance strategy available.

There is change ahead, but it is likely to come from the new growth of reconstituted professional practices with new service and product delivery models responsive to client demands. These models will be created from the ground up by the alumni of collapsed and collapsing law firms. You won't see change in the inflexible, stifling economic systems in which too many powerful interests remain so lucratively invested.

The leeches have almost finished their work. Soon it will be time when the only thing left to do with many firms in BigLaw is to go through the pockets of the patient and look for loose change. The good news is that, 20 years from now, the top firms in the business will be those that are just now being created. ■

—Ed Reeser

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