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Citibank's 2011 Mid-Year Survey of Law Firms: Instead of Giving Its Customers New Toasters, Citi is Telling Many of its Law Firm Customers that They May Become Toast If They're Not Careful

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My, my, how things have changed. When I was a kid, banks would induce prospective customers to open a new account by giving away a toaster to new customers. Today, Citibank is warning some of its law firm customers that they may be toast, or at least they may be seriously singed in the current economic climate.



I refer, of course, to the [2011 mid-year report](#) by [Citibank](#) on the economic conditions of the profession. Citibank's law firm lending group, led by Dan DePietro, is uniquely suited to provide an in depth analysis of the financial conditions of the profession, since it serves some 600 law firms and 58000 lawyers in the United States and the UK, by far the leading lender to the profession. We start with the good news: Says Citi "For the first half of 2011, revenue was up 3.7 percent across the

industry. The increase was driven by strong inventory levels coming into 2011, increased rates, a 1.8 percent growth in demand and likely improvement in realization.” The bad news: *Expenses are growing at a faster rate and the rate of increase in expenses is outstripping revenue growth.*

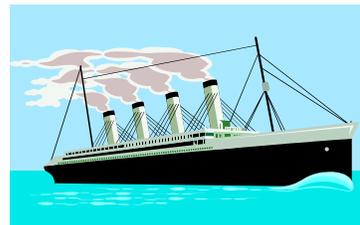


As Citibank noted, one portion of expense growth is attributable to those law firms which engaged in what many see as the silliness of associate “Spring bonuses,” an artifice designed to stem the metastasis of associate attrition. That carcinoma is far better treated by taking less expensive and more productive steps to assure [associate job satisfaction](#) and otherwise [improving the quality of life for associates](#). Not a single lawyer left his or her firm because it wasn’t providing Spring bonuses. Yet scores left within nanoseconds after their Spring bonus check cleared. Simply put, Spring bonuses do not get associates to [stay a little bit longer](#).

Citi also reported that AmLaw 50 firms reported that realizations were beginning to return to pre-recessionary times. Before we toss out the confetti, bear in mind that this refers only to AmLaw 50 firms; moreover, it does not address the real concern about a still stagnant economy, the continued volatility in the capital markets, the continuing fear of a double dip recession and the coming tsunami should the current turmoil in the Euro Zone erupt into utter

chaos. Add to those unknown factors, Citi notes that “headcount was flat,” and expenses continue to increase at a rate of 4.7%, which obviously exceeds the rate of revenue increase. Citi put it to us straight: “the economy appears to be in for a protracted period of slow growth.” Frankly, in light of the light of Citi’s litany of gloomy statistics, even this mild bit of optimism strikes the informed reader as being unwarranted exuberance, unsupportable by economic realities.

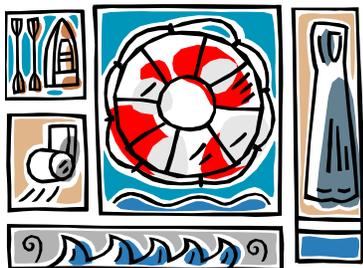
Inexplicably, Citibank viewed it as a positive sign that many firms increased their “inventory” be retaining a larger portion of WIP (that is, for the uninitiated, recorded but unbilled “work in progress”). In reality, stale WIP may be theoretically billable, but rarely collectible.



There are other significant factors in the marketplace, not specifically addressed by Citibank which must further dampen any enthusiasm: First, law firms have too long delayed making needed investments in infrastructure. The need to make these investments is becoming increasingly crucial, indeed vital, [as alternate vendors of legal services continue to gain market share](#). One of the only ways to meet this competition is through acquisition of state of the art technology. [Failure to meet this challenge, these alternate vendors will eat many law firms’ lunch within five years](#).



Citibank also foresees a period of significantly increased lateral movement, as organic growth becomes more difficult to achieve, productive performers will jump ship from underperforming firms, and underperformers will be eased off the gangplanks. I'm afraid Citi is missing part of the boat here in that it does not address the fact that taking on laterals requires substantial investment in ramp up and other expenses, while reduction in headcounts will reduce revenues (although there is always a short term illusory positive blip in ramp down). In essence, Citibank is reporting that we may be in for a period of cannibalism as firms eat each other's flesh.



The Citibank report is silent with respect to one important feature of great interest to law firms; that is, how open will Citibank make its own coffers to law firms in a market it characterizes as one "of protracted slow growth," particularly as Citibank is likely to take a some form of haircut in the Howrey bankruptcy.

My own sense is that Citibank will

undertake a [greater degree of vigilance in reviewing](#) its own existing credits and in extending new credits. And, [as it did in Howrey](#), where Citi loses confidence in the credibility of its borrowers, it will more quickly pull the plug.

Okay, so what's the takeaway?

Here's my views:

1. In many respects Citibank is functioning very much like a typical consultant. By that, I refer to the classical definition of a consultant: Somebody who takes off your watch and then tells you what time it is. There is little that Citibank has told us that we didn't already know, but when somebody smart tells you something that should be obvious, the listener tends to stand up and pay attention.
2. As we approach the fourth quarter, it is imperative for management to start planning for the coming storms and share with the partnership that management has taken a look at the sonar and advise the partnership how the firm proposes to weather the inevitable storms. The cruise ships of old always had two captains: One who appeared in dress whites and instilled confidence in the passengers; the second was a seasoned and wizened sailor who worked tirelessly at the helm to bring the ship to port. Law firm partners need to have the confidence that its ship of state has both on board and the captains need to enjoy the confidence of all

stakeholders.

3. In days of yore, pressure on profits resulted in simply billing existing clients more hours. These days are gone. General counsel, aided by purchasing agents and corporate project managers are more likely than ever to put an early stop to inflated hours. They also have alternate providers of legal services whispering into their ears, "[we can do this better, quicker and cheaper.](#)" Firms need to figure out how to do so as well. This may require the firm to form a strategic partnership with an alternative provider of legal services or [create its own subsidiary or affiliate.](#) In all events, despite some great advances in technology, you still can't produce a product at cost of \$100 and sell it at \$80 and then make up the difference in volume.
4. Firms cannot delay infrastructure investment any longer. That may require biting the bullet and investing firm profits in essential infrastructure and simply swallowing the dubious ignominy of a short term drop in PPP. If you take this route, [issue a press release early on announcing that the firm has such a high degree of confidence in its own future, it is making a substantial investment in its own future.](#) foregoing short term PPP in favor of long term growth and viability. Alternatively, private equity firms are prepared to invest in a state of the art legal

processing law firm affiliate, but will obviously be a significant equity participant in the profits of that venture. The paradox of this essential new technological infrastructure is that it will result in the delivery of legal services at costs lower than currently prevail in BigLaw, but is made essential by the mounting competition of alternative providers of legal services. The ethical rules precluding non lawyer ownership of law firms play no role here. ([Professor Larry Ribstein](#) of the University of Illinois School of Law very recently conducted a compelling [online symposium](#) on the *de facto* and *de jure* deregulation of the practice of law). Indeed, [Clearspire](#), a breathtaking new model law firm is built entirely a new model, owned in essence by non-lawyers. The result is that Clearspire offers an array of quality BigLaw legal services by BigLaw trained lawyers, primarily at fixed fees and bills at a fraction of BigLaw rates. An important warning here: [Do not look to private equity as the safety net that will allow BigLaw to weather the coming storm.](#)

5. We know what many of the unknowns are. Gaze carefully over the horizon and be mindful of oncoming unknown unknowns. As Captain Smith of the Titanic said "We do not care anything for the heaviest storms in these big ships. It is fog that we fear. The big icebergs that drift into warmer water melt much more rapidly under water

than on the surface, and sometimes a sharp, low reef extending two or three hundred feet beneath the sea is formed. If a vessel should run on one of these reefs half her bottom might be torn away.” We may have survived the big storms, but if we permit the fog to cloud our vision, we might sink.

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