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FIRM GUIDANCE

A Culture of Unaccountability

By Edwin B. Reeser

As I noted last week, half the equity partners in a large law firm reporting profits per partner of $900,000 are likely making less than $600,000. And now the even harder reality: Their draw is in the range of 50 percent to 60 percent of their actual annual gross. Using a 50 percent current draw or distribution model, that means that their first-quarter income is actually cut to 30 percent of their projected annual income.

And that means that if they spend 100 percent of their distribution on their quarterly estimated tax installments — and nothing for food, gas, insurance, clothing, mortgage, cars or school — they still are under-withheld on taxes.

Against this scenario, they are likely to be asked to contribute more capital to the firm. And do not forget, unlike corporate executives, they receive no benefits. Everything is paid for by the individual partners. Health insurance, parking and disability insurance are deducted monthly off the top. Then there are their contributions to the pension plan, all of which are individually contributed.

In some instances, though collected from the attorneys, pension contributions will yet to have been actually deposited with the pension plan because the firm's tax returns are on extension (which extends the date by which the contributions must be deposited) and the firm has used the partners' pension monies for operations, hoping to make it back before the time to file the final return expires. This is fuel for an uprising from the ranks if it was not disclosed and approved.

Now, the "upper tier," or inner circle of equity partners, has a real problem confronting it. While those partners 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 the top tier.

The lower tier of equity partners have, by definition, lower books of business and a quasi-service partner role. They are the ones with low lateral mobility who essentially are already being stripped of much of the financial benefit of being a stakeholder in the enterprise. They have little more to give and no place to go with their practice profiles. Squeezing them further actually makes them anxious to be converted to salaried partners just to get their capital back.

Therefore, expect this tier to be reduced in draw less, and to contribute new capital less, to preserve their position as sheep for shearing.

Instead, focus 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 the ones with the most enterprise income share to be stripped upstream to the upper tier.

What to do? How does the leadership of the firm slake the upper-tier partners' thirst for money without chasing away the "engine room" of the firm, those middle-tier partners who in many respects are the evolving fatter sheep, oops, future stars? With another short term, unsustainable financial engineering move, of course.

The technique most likely to provide a superficial solution, which is no solution at all, is to defer recognition of reality. Do that by cutting the draws of the middle tier little to not at all and applying the draw cuts disproportionately to the upper tier.

Those upper-tier partners have the most income, which won't be cut in the budget, merely deferred. Partners with $3 million to $5 million incomes should not have burn rates so high that they cannot afford to cut their annual draws from $1.5 million to $1 million for a few months. Besides, as the collections kick into gear by midyear, they will get a disproportionately larger recovery, or make-up, to bring them back into parity, so this is intended to be only a partial-year sacrifice.

> What about accountability of the leadership for the year's results? There will be essentially none. And this is what really distinguishes law firms from real business.

It also serves the added purpose of holding those upper-tier partners a bit more hostage: In most firms, if a partner departs during the course of the year, all of his or her deferred income distributions are forfeit. By the time it becomes clear that 2009 is not going to be the same or better, the top partners will be in very deep and looking at a seven-figure forfeiture if they leave the firm.

So in the short term, this technique tells the middle tier that they are not going to have to suffer, their draws will be maintained or only very slightly reduced, and their incomes will stay comparable. The message is that the burden is being shouldered by the upper tier.

The upper-tier partners are told they get to keep their high income allocations and just have a temporary cash flow reduction — which frankly, since they control large books, they can ameliorate through their own improved efforts at billing and collection.

But the reality is that the operating inefficiencies and challenges are not being addressed at all. Pieces are just being moved around the game board. As the reality sinks in that problems are not being resolved, there will be another wave of law firm collapses.

The trigger? When the middle tier gets sick of the situation and begins to relocate to other firms that suck less of their share upstream. Once that flow of talent starts, the end of the firm comes quickly.

What causes the middle tier to notice the situation? Missed budgets and forecasts, where the reality of distributable income are more than 10-15 percent below expectations. Closer looks at what has gone on undermine confidence in management's unspecific and unsupported forecasts of what the future holds.

There has been a lot of discussion over the last six months in the Big Law community over layoffs, cutbacks and expense discipline. But the reality is that Big Law's top line has been falling faster than operational 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 that experience drops in distributable equity partner income by 10 percent, and probably a good number that get hammered for 25 percent or more. In most cases, the partners will be taken by surprise, having expected maybe 5 percent.

Many partners smacked with a 25 percent reduction will end up paying substantially all of their remaining income from the January distribution to their pension and retirement plans. The rest will need to be applied to their annual installment loan payback to the bank for their capital loan — which will leave the next capital contribution request at the end of the month to come out of pocket.

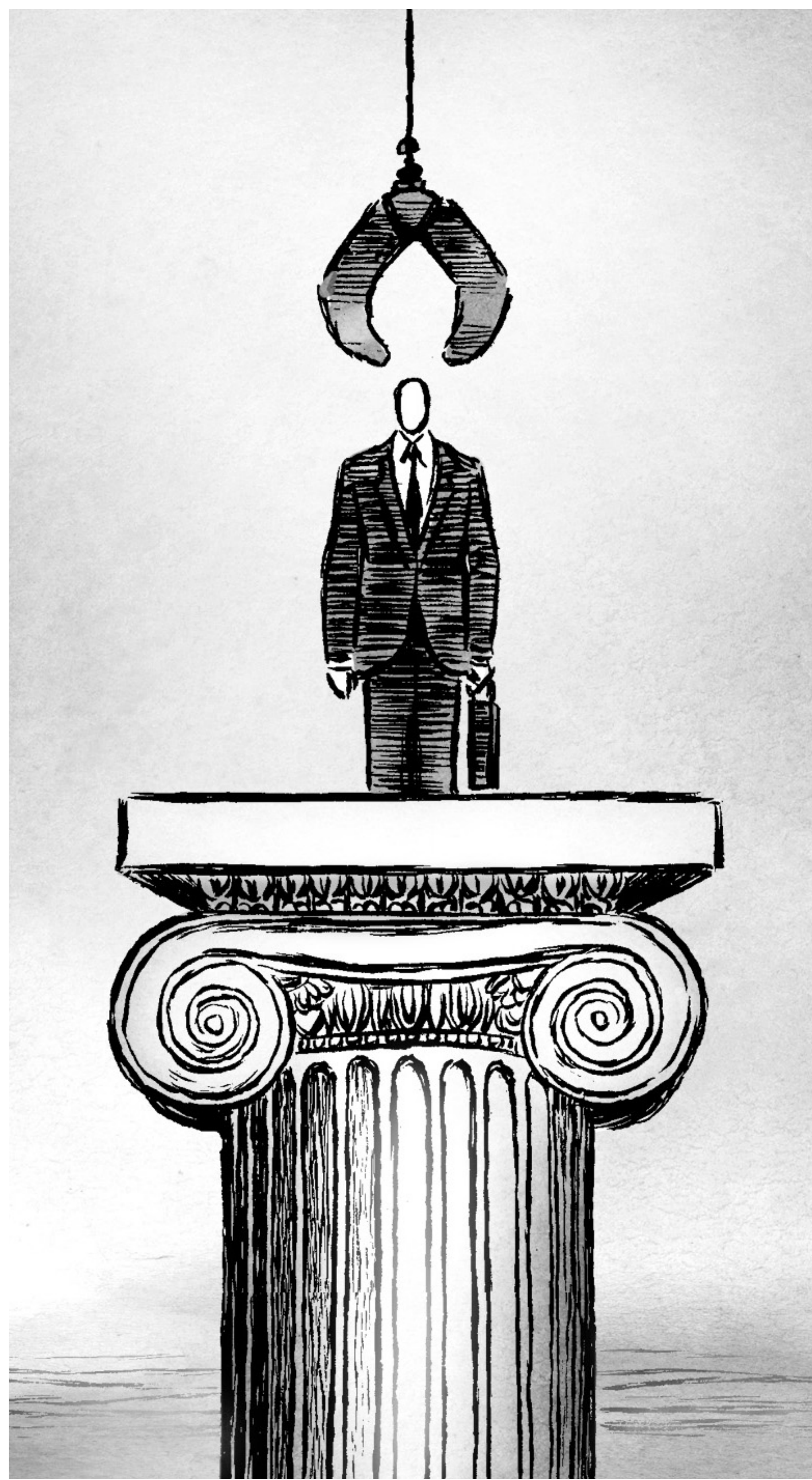
And no money to pay taxes. Tapping the home equity line to pay Uncle Sam is a mood spoiler.

What about accountability of the leadership for the year's results? There will be essentially none. And this is what really distinguishes law firms 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 incarceration that will be at the front of the CEO's mind, because that kind of incompetence in business is beyond breathtaking.

But in law, it is sort of par for the course, because most of those in charge of running big law firms have the business acumen of a houseplant.

The signal that things are not sustainable? 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 ones and twos. Those departures will erode cash flow to the tune of $6 million to $12 million dollars net distributable all by themselves. In normal business times, without replacement, that sets perhaps a two-year fuse on the firm's end. In these times, it will be more like six to 12 months. Plugging the hole caused by the loss of "A" players with "B" players is another warning flag to heed.



The upper-tier partners will find homes someplace else. They always do. The solid middle-tier partners with business will as well. The lower tier will be left behind or culled out, as well as many of the income partners and associates. It becomes a game of numbers.

That is what evolution in the business of law has led us to. Big law now is an industry characterized not by a foundation in sound business practices and actual management, but simple structural and policy processes that shift more of the benefit to fewer people as the bloated overhead and operational inefficiencies grab more of the operating income and as client tolerance for higher fees erodes. The squeeze against net operating income that is precipitated by a downturn in the economy exacerbates the already existing problem.

The crisis in Big Law has been with us for many years. It is only now being revealed, in the same fashion that Bernie Madoff's scheme probably would have continued for several more years, as long as he could continue to add subscribers to his management 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. When the recession ends, this problem will still be with us.

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Firms That Adapt to Clients' Changing Needs Will Weather the Storm

By Vadim Alden

It is often said that crisis brings both danger and opportunity. The same can equally be said about the impact of the current economic recession on law firms. Most firms have been impacted, many negatively. But there are certain firms that are weathering the storm better than others, and some are even expanding while others contract. How are these firms able to turn prevailing conditions into opportunity? And what can your firm do to achieve positive results?

The answer depends on two essential elements of the firm practice: cost and service. When applied to law firms, these terms seem timeless and obvious, but they are the core factors in ensuring a firm's survival and growth even in this troubled climate. Firms that adapt to this economy and the fiscal impact of the recession on their clients are in a more favorable position to weather the storm and maybe even profit from it.

It is impossible to discuss cost and service in the current economy without mentioning BigLaw. Large firms seemingly thrived during the brief economic boom in 2004-2006. Rates increased, salaries went up, as did lawyers' bonuses, perks and firms' commitment to "lifestyle." As large firms increased salaries, midsize and smaller firms followed suit to attract and retain talent, and to remain somewhat competitive with emerging clients who benefited from an apparently robust economy. Today, a quick survey of large firms paints a very different picture. The news is rife with stories of salary cuts, pay freezes, cancelled summer associate programs, deferred start dates for first-year associates, and what some refer to as "stealth" attorney and staff layoffs. Firms are struggling to keep clients who have suddenly become concerned with their legal costs and who are asking, "What am I getting for my money?" more than ever. For those attorneys who survived the layoffs, the workload has increased, and job security has been replaced by the overwhelming pressure to stay put. The blogosphere is filled with horror stories of laid off BigLaw associates who have been jobless for months, and the thick air of uncertainty clouds over both partners and associates alike.

> Many midsize and smaller firms are actually employing methods to deliver more than before, partly due to being sensitive to their clients' needs in both cost and service.

But not all law firms are faring poorly. In fact, many midsize and smaller firms are actually employing methods to deliver more than before, partly due to being sensitive to their clients' needs in both cost and service. The National Law Journal recently featured 20 midsize firms that have found ways to stay competitive in the current volatile market in its " Hot List." Featured firms used various techniques, such as specializing in specific areas of the law, supplementing associate training programs to train and retain talent, and revisiting fee arrangements with their existing clients to accommodate client needs and hardships.

This is the natural cycle of a firm's ability to adapt to changing times, which is undoubtedly easier for smaller firms as opposed to their larger counterparts. As demonstrated by these firms, reconciling the economic environment is a crucial aspect of staying viable in trying times.

To adjust to the changing legal market, many midsize firms are re-evaluating the way they do business altogether. One aspect most successful midsize firms have in common is the tendency to abandon the "one-size-fits all" model of charging high rates, while moving toward alternative fee arrangements with their clients. This includes charging fixed fees in certain cases, and accommodating the client's specific needs on a case-by-case basis. Smaller firms have an advantage here because they already have rates that are significantly lower than those of larger firms. By being flexible and sympathetic with their clients, these firms ingratiated themselves with their existing clients as well as positioned themselves in a favorable spot to poach clients that traditionally looked to bigger law firms for representation. It is logical for a company that is undergoing significant financial pressure to look to cut costs not only in its own operations, but also in how the company pays for legal and other services.

Firms that are more flexible with cost arrangements also engender goodwill with new and existing clients. When the economy begins to recover, many companies that currently cannot afford certain legal services, will slowly move back into the market, and will undoubtedly be more selective in choosing a firm that gives them the most value for the work.

Those firms that were most flexible will reap the rewards and gain new clients. Goodwill travels, and many well-treated clients will share praises for those firms that were most accommodating.

Flexibility with cost arrangements is just one factor that can help a firm attract more business in a slow time. Equally important is the quality of service the law firm can provide to a client in a time of need. For a firm to remain competitive today, it is crucial that attorneys at all levels re-examine the way they do business and focus on providing high-quality results now more than ever before.

Successful firms are mindful not only about their rates and quality of their work product, but also about their clients' individual needs and priorities. As the economy has weakened, clients are looking to get the most for their money. Companies are looking for ways to cut costs across the board, including legal costs. In-house legal departments are being asked by management to cut costs by putting pressure on outside counsel to cut rates, decrease hours and stick to tighter budgets. Many legal departments are also cutting costs by doing more work in-house and relying less on outside counsel.

> Lawyers have to go extra mile to satisfy the client's needs without jeopardizing quality. Those firms that can react to constantly shifting client expectations will undoubtedly be more successful than their less adaptive counterparts.

While the diminished supply of clients certainly makes it tougher for firms to compete for business, it should also encourage them to work harder to achieve positive results. The tight market fosters competition among the firms, which is good for attorneys because it keeps them efficient and focused on their work.

It is no longer good enough to simply perform a service when there are other firms of all shapes and sizes on the sidelines who are ready to compete for your client's business. Lawyers have to go extra mile to satisfy the client's needs without jeopardizing quality. Those firms that can react to constantly shifting client expectations will undoubtedly be more successful than their less adaptive counterparts.

As proven by the recent layoffs and firm closures, it is no longer enough to simply sit tight and hope to sail through the recession until the next boom in the legal market. The current economic crisis has affected everyone, but those that choose to remain active and adapt to the existing conditions will be able to weather it and come out on top.

Firms must re-evaluate their cost structures, pay more attention to quality and satisfy their clients' changing expectations. In a time of crisis, when the opportunity knocks, firms that meet the challenge and react the fastest to these demands will thrive.

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