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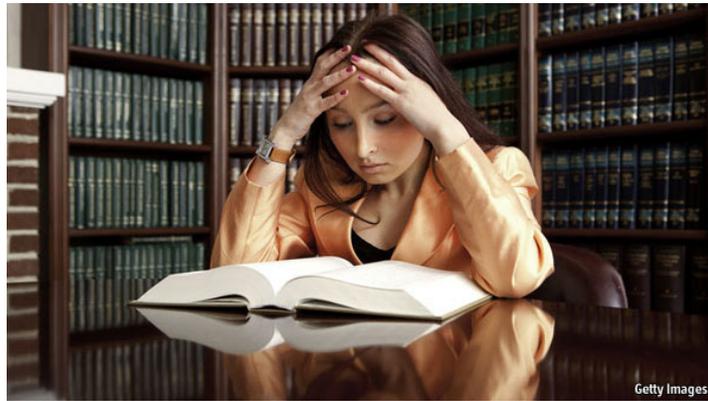
Law firms
A less gilded future

The legal business has undergone not only recession but also structural change. Ever-growing profits are no longer guaranteed. Nor, for some firms, is survival

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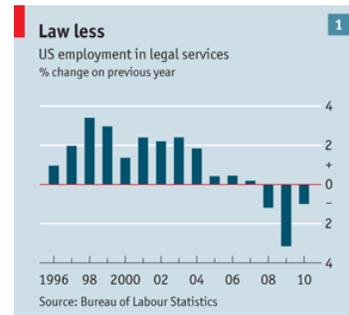
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TWO years ago Howrey was one of the world's 100 biggest law firms by revenue, with nearly 700 lawyers in eight countries. Profits exceeded \$1m per partner. The American firm, which specialised in intellectual-property suits, had had several spectacular years in a row. But in 2009 profits were much less than expected and angry partners began to leave. Defections continued during the recession. After failed merger talks, Howrey shut its doors this March.



Though Howrey was the only big firm to collapse, the forces that destroyed it hit the whole profession hard. Work on mergers and acquisitions (M&A) dried up and nothing similarly profitable took its place (bankruptcy, securities litigation and regulation were rare bright spots). Clients became keener to query their bills—and to demand alternatives to the convention of charging by the hour, such as flat, capped or contingent fees. Small and innovative firms began obliging them, and big firms increasingly felt forced to follow suit.

All this took a toll on the labour market. After a dozen years of growth, employment in America's law industry, the world's biggest, has declined for the past three years (see chart 1). The 250 biggest firms, according to an annual survey by the *National Law Journal*, shed more than 9,500 lawyers in 2009 and 2010, nearly 8% of the total. Many also deferred hiring, leaving new graduates in a glutted market. Legal-process outsourcing firms, which do not advise clients but do routine work such as reviewing documents, put further downward pressure on the demand for their talents. The pain was felt in Britain, easily the biggest legal market after America, and other countries too.



Lawyers would like to believe that the worst is over and that no more of them will suffer Howrey's fate. Work on M&A and initial public offerings has recovered from dismal levels. And according to *American Lawyer*, profit per partner at America's 100 biggest firms rose by 8.4% last year, having fallen by 4.3% in 2008 and gone up by a measly 0.3% in 2009.

But not all the trends that have hit the legal industry are cyclical. Some are here to stay even as

the economy recovers. One is clients' determination to keep their bills down. Feeling that they had overpaid vastly for the work of green trainees, they began refusing to have routine work billed to first- and second-year associates (ie, lawyers who are not yet partners). They see no reason to stand for it again. And alternative fee arrangements continue to grow in importance, albeit slowly: they accounted for 16% of big firms' revenue in 2010.

A second trend is globalisation, which the law is experiencing later than other industries. For lawyers, it holds both promise and peril. Booming emerging markets, especially in Asia, are leading New York and London firms to extend their reach. But the growth of outsourcing to places like India is not lost on money-conscious clients, some of whom are demanding that their lawyers pass certain routine work to cheaper contractors.

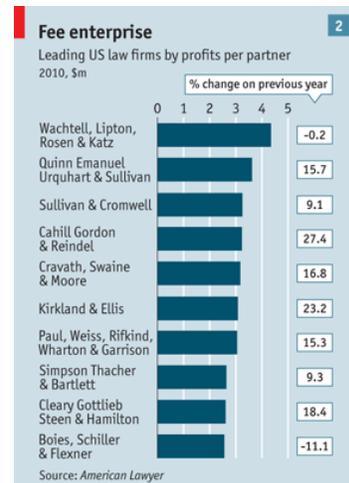
A third trend is the growth of technology in an industry long synonymous with trained human judgment. Software that can perform tasks like "e-discovery", sorting through e-mails and other digital records for evidence, is saving firms money. It has also made it harder to sustain a business model in which partners sit atop a pyramid with a fat base of associates who carry out expensively billed work, some of which is routine and repetitive.

Trends that were not part of the recession will not disappear with the recovery. Some will even strengthen. William Henderson of Indiana University points out just how good and how long a run lawyers had. Spending on legal services grew from 0.4% of America's GDP in 1978 to 1.8% in 2003. The legal business grew four times faster than the economy. Now, Mr Henderson says, a "hundred-year flood" is hitting the profession. Job growth had begun well before 2008, he points out, so that the labour market was already out of balance when recession struck. Not all firms will survive, and those that do will not all prosper equally.

Howrey's boss, Robert Ruyak, blamed two new trends for his firm's demise. Howrey had begun acceding to clients' demands for flat, deferred or contingent fees, causing income to become clumpy and unpredictable. And the rise of specialised e-discovery vendors hollowed out another source of revenue.

What kind of firm is likely to thrive in the environment in which Howrey failed? On one answer, many experts agree: a group of elite New York-based firms that cover a wide spectrum of legal work. These include Davis Polk & Wardwell; Sullivan & Cromwell; Cleary Gottlieb Steen & Hamilton; and Simpson Thacher & Bartlett. Though associated with Wall Street, they have become internationalised, through longish histories in Europe and recent moves into Asia and Latin America. That said, they don't try to be everywhere, covering mainly the leading financial centres. Nor do they try to do everything, but offer the range of services on which their New York businesses were built: M&A, finance, white-collar defence and so forth. Sullivan & Cromwell is one of seven firms in *American Lawyer's* list whose profits per partner top \$3m (see chart 2).

Another bunch likely to do well are tightly focused firms that concentrate on only a few fields. Some ("monolines") specialise in only one. They typically do not try to span the globe, but their work is so good that clients will keep paying handsomely for it. Wachtell Lipton, for example, is a New York firm focused on M&A. It is also the world's most profitable, with profits per partner of \$4.3m last year. Cravath, Swaine & Moore, also known mainly for M&A, joined the \$3m club in 2010 after profit per partner went up by one-sixth. Outside America, this group is represented by Slaughter and May, one of the "magic circle" of five London firms that compete with the leading American outfits. Rather than setting up shop abroad such firms build partnerships with local leaders, such as France's Bredin Prat or Spain's Uría Menéndez, to gain reach without establishing their own offices and hiring staff.



Cravath and Wachtell have boosted profits in the past two years without shedding any lawyers. Many other firms in *American Lawyer's* top 100, lacking their pricing power, maintained profits only by cutting headcount. Even equity partners have not been spared. Firms cut 0.7% of them in 2009 and 0.9% last year.

Anything, anywhere

If revenue is not growing as quickly as it used to, more firms must not only employ fewer lawyers but also compete for market share as never before. With the American market hardly booming, a third class of firms has rushed to expand globally. These are big and well-known, but do not have the glittering reputations of the first two groups. Their promise is that wherever clients want to do business, they will deal with a seamless entity. Jones Day, which began in the American Midwest and is now in 19 countries, exemplifies the type with its slogan, "One Firm, Worldwide". DLA Piper, product of a three-way Anglo-American merger (and technically a "verein", an association of partnerships under Swiss law) aims to offer global clients a complete service while keeping prices down by working out of cheaper cities.

Baker & McKenzie, another verein, has the longest history of globalisation of any big firm. It was in Latin America as long ago as the 1950s and in mainland China in 1993. It is also the world's biggest firm by revenue, pulling in \$2.1 billion in 2010, half of it from clients that use the firm in ten or more places. Baker & McKenzie likes to call itself "global", not "international", meaning it is not a firm that has simply grown out from New York or London. Its new boss, Eduardo Leite, a Brazilian, is the first person from one of the BRIC economies (Brazil, Russia, India, China) to lead such a big firm. But continuity worldwide remains a priority: Mr Leite says that the firm works constantly to co-ordinate its efforts, with regional and national managing partners regularly travelling to audit each other's work for quality, for example.

If groups like Baker & McKenzie and lower-cost DLA Piper are doing well, offering anything, anywhere has pitfalls for more expensive integrated firms with a global spread such as Allen & Overy and Clifford Chance, both based in London. During the recession they had to lay off some partners, cut the equity shares of others and thin their layers of junior lawyers. Some pin Howrey's demise on its rush to spend on foreign offices while betting heavily on antitrust law just as M&A was falling off a cliff. There is money in globalising, but not enough for everyone.

In addition, some countries protect their turf. It is virtually impossible for a foreigner to practise Indian law. Only locals can practise Chinese law. Although flotations and cross-border mergers involving Chinese companies have been good to many firms, the mass rush into China has led to competition on prices. Chinese clients are even more accustomed than American ones to asking for alternatives to the lucrative billable hour. And local firms are becoming more sophisticated. There is no reason to expect they will yield business tamely. Brazil presents similar obstacles to foreign lawyers.



Sound career advice

Ultimately, lawyering is becoming more of a business than a profession. Some lawyers decry this. Others welcome it. Few deny it. Because the American market cannot grow as it used to, firms will have to find new strategies and make use of sophisticated branding to stand out.

Mr Leite suggests one way lawyers can guarantee themselves work: by becoming experts in other industries, not just areas of legal practice. Young lawyers can learn from being seconded to clients. And American law schools are slowly trying to instil some business acumen into future

lawyers, though in Europe and elsewhere law remains distressingly academic.

Another much-discussed solution for teaching lawyers to be businesspeople is the creation of all-in-one professional-service firms, combining lawyers, management consultants and accountants. But this looks unlikely to succeed for many; the three professions are simply too different in their traditions, training and incentives. A liberalisation of the legal market in England and Wales will allow more non-lawyers to own parts of firms or offer certain services, but at first this is likely to affect mainly the cheaper end of the market, not the richest pickings of corporate work.

Many bosses of law firms realise that the profession is changing in ways that will be uncomfortable for some. They are adjusting to this, but Howrey's fall shows just how fragile even a 55-year-old firm can be. Since a firm's only real assets are its partners, when a few departures turn into an exodus, the end can be shockingly quick.

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