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Anatomy of Big Law Firms' Demise: How Did It All Happen?

By Edwin Reeser

Heller, Thelen, PoGo, Thacher, Morgan & Finnegan, Wolf Block in just the past few months. Brobeck, Coudert, Graham & James, Altheimer and others in the last few years. A fistful more to come.

Reminds one of Clint Eastwood's spaghetti westerns: "For a Fistful of Law Firms" and "For a Few Law Firms More." Stacking up the bodies of businesses, which truly were paragons of success and prestige, like cordwood in the back of the wagon.

Yet there seems to be puzzlement over how it happened, how it could happen.

Well, to carry on with the movie image, it's like the scene in "Three Days of the Condor" when Max von Sydow explains to young Robert Redford how his own demise will unfold in the shadowy world of espionage: "It will happen like this …"

In Big Law, it happens like this: A firm adds a significant number of new lateral partners over a relatively short time, say two to three years. Maybe it adds a number of new offices as it searches for hard-to-find talent. But the firm shows little net growth in the number of partners.

The real out of pocket costs of the new partners — headhunter fees and three months of draws paid the newbies while they ramp up their productivity and contribution to net cash flow — is masked by capitalizing them with a multiyear amortization that future periods will have to bear, rather than expensing the costs in the year of the additions.

During a growth period, this out-of-pocket capital cost is effectively funded by the new partners' own capital contributions to the firm. In stagnant times, however, their contributions are simply consumed all or in part by payouts of return of capital to the departing or de-equitized partners, while the capital cost of hiring becomes a dark cloud on the financial horizon — one that neither existing nor newly arriving partners necessarily are aware of.

Look for "financial engineering" to change characterizations of costs in this and other areas.

The firm shows a significant number of de-equitizations of partners to boost apparent, but not real, "profits per equity partner." They might be called counsel, senior counsel, special counsel, salary or income partner or nonequity partner. The list is endless.

The bottom line is they are just another category of worker bees, with varying classes of rights and privileges. They are not true stakeholders and participants in enterprise profit. This shift puts the enterprise reward and risk, and the decisions regarding how to deal with both, in fewer hands.

The former transparency of decision-making and objectives itself begins to disappear. Without notice or even disclosure to the partners at large, participation in decisions that previously were the subject of wide discussion become increasingly removed to the domain of a smaller number of decision-makers. Essentially, the role of the equity partner becomes more like an employee at will and less like a shareholder.

The "culture" of the firm becomes more a matter of historical lore than present truth. It is especially time to worry when the stories that extol the virtues of firm culture come to refer to a prior generation of firm heroes whom few present partners ever had the chance to meet and when it becomes hard to find more current examples,.

Partners who have been with the firm less than 10 years make up more than half of core management.

The compensation scale for equity partners becomes skewed. There are a lot of ways to measure this, assuming access to the data. But generally, the skew would become a matter of concern when the reported arithmetic average or mean of PPEP is more than 25 percent to 30 percent higher than the median or midpoint of partner compensation.

For instance, if the PPEP figure trotted out to AmLaw is $900,000, yet half the partners are making $600,000 or less, there is a transfer of enterprise profit to the "upper class" of equity partners that is potentially destabilizing, as it can reflect an exploitation of the "lower class" and "middle class."

There are undisclosed yet commonly applied modifications to the compensation and draw system. Primarily those would be minimum guarantees to income irrespective of firm performance. Another type would be draws or distributions to selected partners that are higher than the generally accepted formula for all partners.

Moves to maintain profit levels include short-term, unsustainable cost-savings measures that may cost more to undue and restore next year than the benefits they generate this year. Certain types of staff reductions are but one example.

There are additional capital calls at the start of a new year, typically through withholding on distributions from the prior year, notwithstanding a reduced income in the prior year.

A material reduction in the draw schedule for equity partners is imposed for next year, notwithstanding a neutral to modestly reduced projection for income. This one can be especially cute, or sinister, depending on how one chooses to look at it.

It is typically going to be precipitated by the primary bank relationship that provides the firm's working line of capital. The working line serves two purposes in a law firm. One is to provide monies to pay bills timely when cash flows are irregular, which irregularity happens to all business, but especially to law firms. Law firms really are such monster cash engines, however, that if one were to totally end partner draws, there would be little need for a working line.

The second, and arguably real reason, for a working line is to pay draws to smooth out distributions so that the partners can pay their home mortgages, car payments, private school tuitions and quarterly tax payments.

But given the economic crisis and the high costs and operational inefficiencies of many big law firms, banks are understandably nervous about their exposures to these limited liability entities with $50 million to $100 million working lines.

So we are seeing banks telling some firms that they will not get the same deal in 2009 that they enjoyed in years past. New covenants focused on partner departures, especially restrictions on return of capital to departing partners, will be imposed in loan agreements. Or provisions achieving the same result will be inserted into the partnership agreement or adopted as policies.

Loan rates will be higher, possibly a lot higher, and draws will have to come from operating surplus rather than be financed by the bank Draws may be significantly capped or collared, probably to match up with historical collections performance. What is historical collections performance in the law industry? Due to vigorous year-end collections efforts, the allocation of collections through the year, rather than being a level 25 percent per quarter, typically is more like 15 percent to 20 percent.

What does this mean for equity partner draws? It means whatever a partner used to receive, if one follows the literal restriction now often requested by the bank, will be cut by 40 percent in the first quarter, and 20 percent in the second quarter. That doesn't sound too bad if one is making $900,000. What should partners have to complain about?

As we shall see, the answer is plenty.

Edwin B. Reeser is a business lawyer in Pasadena specializing in structuring, negotiating and documenting complex real estate and business transactions for international and domestic corporations and individuals. He has served on the executive committees and as a office managing partner of firms ranging from 25 to over 800 lawyers in size. Reproduced by permission of Aspen Publishers from Of Counsel, July issue is Vol. 28 No. 7.

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