

The New Model Law Firm

Restructurings at the largest UK law firms have grabbed the attention of the market. But much bigger changes are on the horizon. **RAVINDER CASLEY GERA** reports.

The Times' law columnist Edward Fennell asked in January, "Where were you when you heard that Clifford Chance had announced a 'redundancy programme' for its London offices?" The announcement by email, on January 8th, marked "the end of a pretty much continuous bull run" for the largest UK law firms.

Since then, the scale of the malaise at the leading UK firms has become clear. Clifford Chance's redundancies have been revealed to be part of a wide-ranging review of its 'size and shape'. Linklaters, too, is shrinking – it is in the process of removing around 10% of its lawyers. And Allen & Overy has just completed a review that reportedly removed around 9%.

Such wide-ranging changes at what are still some of the world's largest and most profitable law firms have raised eyebrows. If the likes of Norton Rose can get by without a full-scale redundancy programme, goes the argument, why not the magic circle? Many believe the restructurings to be a cynical money grab by partners desperate to maintain the sky-high profits of the boom years.

In fact, though, the current changes are just the first wave in a period of fundamental change for large firms. A combination of trends – from changing client demands to the increased potential of technology – looks set to force the largest firms to reverse much of their recent growth.

A new model

When the financial crisis is over and the new shape of global business can be discerned, the largest UK law firms will look very different. Partnerships will be smaller. The current rounds of restructuring will be followed by tighter control over equity. Leverage will likely be lower. Firms will focus on the most complex advisory

work, with heavy partner involvement. Simpler matters will be passed on to other firms. Routine aspects of complex work may be standardised, handled by paralegals, or done in dedicated offshore centres.

A combination of forces is pushing firms to shed their remaining lower-margin practices and focus exclusively on the most complex advisory work. "The largest firms still do a fair share of work which involves utilising large volumes of junior lawyers at relatively low margins," argues Chris Bright, a former partner at Clifford Chance and Linklaters, now a consultant at Shearman & Sterling. "That model is eroding, and the value the big firms can get is increasingly focused on using their senior lawyers. That's pushing firms to a slimmer, more profitable model."

A central driver of the change, of course, is the financial crisis. "The magic circle firms grew to their current size largely on the back of the investment banks," says one magic circle partner. "With the reduction in their size and activity, there simply won't be the same demand for those kinds of legal services in future."

James Bateson, head of the financial institutions group at Norton Rose, recently commissioned a survey asking in-house counsel at financial institutions about the future of their industry. It shows 69% believe that 'the financial institutions landscape has fundamentally changed forever.' Says Bateson, "financial institutions in future will be more highly regulated and risk-averse, offering a narrower range of products as a result."

It is not all doom and gloom. With crisis comes opportunity, and other areas of work are set to expand. Restructuring has become the life-line of many firms in the last year – Linklaters in particular has benefited hugely from its work on

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Lehman Brothers – and as the political response to the crisis swings into gear, a new wave of regulation will make regulatory advisory work far more important to companies. But both restructuring and regulatory work, while lucrative, are partner-heavy. “Running teams of six or seven associates to one partner – that model is dead for the foreseeable future,” says one former magic circle partner now at a US firm. “Clients are saying, ‘What I want now is an expert who can give me proper advice.’”

In addition, the financial crisis is accelerating the pre-existing trend for the commoditisation and standardisation of legal matters. As *Client Report* described in the last issue, in our feature “Tougher Than Ever,” clients are demanding reduced rates and more use of fixed fees in a bid to better control their legal spend. This provides a new incentive for firms to standardise simpler matters to reduce the time commitment involved. Standardisation, currently practised in particular areas like syndicated loans or hedge fund formation, is now being considered for the simpler aspects of more complex transactions.

“A new generation of general counsel expects their law firms to deconstruct the work they do to see where savings can be achieved,” says Prof. Stephen Mayson, a consultant on law firm management. “If aspects of a deal are being done on a fixed fee, you’re not being paid to be creative but to be efficient.”

The result will be a shift in the structure of law firms – and perhaps even the structure of the profession. The long-standing ‘pyramid model’, where firms recruit large numbers of trainees and expect many to leave in the first few years of their career, is likely to change to more of a diamond shape, with junior lawyers replaced by paralegal-style staff doing standardised work.

Sarah Hutchison, Director of Business Development at the College of Law, argues that “we should move towards a profession with tiered qualifications: some lawyers will still do a full training contract and work on more complex matters, but others will do a simplified qualification and receive partial rights to work on simpler matters in a standardised way.”

In addition, as has been widely reported, firms are considering moving some simple matters out of their main offices altogether to dedicated offshore centres. Clifford Chance runs a wholly-owned centre in the outskirts of Delhi, employing qualified Indian lawyers on proof-reading, document review and some draft preparation work. The firm currently employs 19 Indian lawyers in the centre and intends to increase that to 30 by the end of this financial year.

Mark Ford, who runs the offshore legal team from London, says clients have responded enthusiastically to the move. “If a client ever expressed concern we’d naturally not use the centre for their work, but so far every client has been very positive about it.”

As the centre grows, Ford hopes to use it for more complex matters. “At the moment the work done is at the basic end of the spectrum. The challenge for the next couple of years is to see whether we can move into offshoring some of the simpler aspects of more complex transactions.”

Of course, this new model – tight, smaller partnerships, low leverage, and a rigorous focus on the most complex advisory work – is not without precedent amongst elite law firms. “The model of the future is the Slaughter and May model,” as Chris Bright puts it. The venerable firm, although far smaller even in London than the other magic circle firms, achieves an aston-



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ishing profit margin of 59% and boasts the highest PEP in Britain. The closest other magic circle firm to this model is Freshfields, which has the next smallest partnership, comparatively low leverage – 1:4.5 – and the next-highest profit margin, 51%, according to the 2007-8 figures published by *The Lawyer*. Freshfields and Slaughter and May are also the only magic circle firms not to be currently undergoing a downsizing.

Managed shrinkage

Despite the current wave of restructurings, it is not yet clear whether the largest firms see a fundamental shift ahead. Linklaters and Clifford Chance have described their restructurings in wide-ranging terms, Linklaters famously giving theirs the hyperbolic soubriquet ‘New World’. Allen & Overy has adopted a more measured tone, referring to a redundancy programme responding to reduced work volume rather than a wide-ranging review in response to future demand.

It will be interesting to see whether these firms are reducing in size enough to adjust to the likely changes in workflow and billing patterns. They may nevertheless have to engage in a further period of ‘controlled shrinkage’ to adjust to a new reality. “It’s possible to shrink a firm gradually without redundancies,” a Freshfields partner argues. Firms will control their equity tightly to prevent partner numbers rising; fewer leavers will be replaced, and more lawyers will be removed through performance reviews. “We’ve had extremely high associate attrition over the last few years, because of high demand for lawyers from the investment banks and in-house, and we haven’t been aggressive in managing people out through the performance review system,”

says the Linklaters partner. “We’ll be much more rigorous in future – we may employ the model many of the investment banks do, of removing the bottom 10% or so each year.”

The easiest long-term way to reduce the size of a law firm, and reduce leverage, is to recruit fewer trainees. Deferrals will reduce trainee intakes for at least the next three years; Allen & Overy reportedly plans to reduce its annual trainee intake 120 to 105 from 2012. Linklaters, Clifford Chance and Freshfields are currently reviewing future trainee requirements. “I suspect we’ll reduce the number we recruit next year (to start work after 2012) a little, but not radically,” says a Freshfields partner. But if standardisation and offshoring become widespread, trainee numbers are likely to reduce significantly.

Difficult transition

The case for a new model may be strong, but it is not yet clear that firms are convinced significant further shrinkage is needed. Right now firms are eager to present the current wave of restructurings as a one-off. “The message from management has been very much that we’re trimming the fat and then carrying on as normal,” says one Allen & Overy associate.

Speaking privately, however, partners at magic circle firms admit a fundamental change to their business models may be on the cards. “There’s been a lot of discussion about the changing nature of our work and the demands of clients,” says a senior Freshfields partner. “Our sense is that in mature markets like London, the smaller, lower-leverage model you’re describing will become the norm for large firms over the next few years.”

But even if managing and senior partners want to pursue a different model, partnership

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politics can provide significant obstacles. Linklaters’ management has considerable power to reshape the firm, and a firm culture that tolerates such change, a legacy of the earlier restructuring under Tony Angel. But for Allen & Overy and – in particular – Clifford Chance, the transition will be more difficult. First, Clifford Chance has the furthest to go: compared with other magic circle firms, it is the least focused on elite work. The largest firm in the magic circle – in mid-2008 it had more than 2,800 lawyers – it is the most highly leveraged, with a ratio of 1:6.2, and still derives a substantial part of its income from standardised areas like syndicated loans. Its profit margin was just 35% in 2008, lower not only than other magic circle firms but also than smaller firms like Ashurst and Nabarro.

Second, even if the firm’s management embarked on a wide-reaching cull of the firms’ less profitable practices, the firm’s heavily democratised governance may prove an obstacle. Unlike the leaders of Linklaters, CC’s management had to obtain temporary special powers to undertake the current restructuring. And, unlike Linklaters, Clifford Chance still chooses its office and practice heads by election. “Their primary allegiance is therefore to the lawyers in their teams, not the firm’s management or the firm as a whole,” points out one consultant close to the firm. “There’s a natural urge to defend them. It has frustrated reform attempts in the past and could again in the future.”

A reckoning delayed

The large law firms are navigating in a storm on a dark night. The timing of any coming economic recovery is still unclear; the regulatory response to the financial crisis, and the future shape of the financial industry, are not yet cer-

tain; and clients’ reactions to the financial crisis are continuing to evolve. Under these circumstances, firms can hardly be blamed if they duck the challenge of predicting future demand in favour of simply shedding their more obvious excess lawyers.

But as the recovery begins, the work that allowed the magic circle firms to grow for two decades will not return in the same form. Clients, happy for years to pay upwards of £200 an hour for junior lawyers at magic circle firms to carry out routine work, will be far stricter. And firms will be forced to choose between size and profitability. There may not be another “where were you?” moment – the transition may be gradual and almost silent – but a slimmer, less highly leveraged future is ahead for the largest UK firms. The ‘global elite’ will survive, but the age of the global giant may be over. ■



Mark Ford, director of Clifford Chance’s offshore Knowledge Centre