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The Tragic Circle

Europe's elite law firms have grown exponentially over the last few years. So what does the future hold for them?

By Partha Bose
The American Lawyer
November 1, 2005

Britain's \$18 billion legal market might seem miniscule compared to the \$180 billion U.S. market. But numbers can be deceiving. Take a look at any global survey of law firms. Four British firms make the top ten in revenues, and another six land in the top 50. British law firms have historically been the leaders in creating top-tier international practices, and in every major economy in the world, a clutch of British law firms are offering services. Indeed, in several European countries, the local operations of British firms dominate the domestic legal markets. Given that dominance, the fate of British firms, in many ways, represents the fate of Europe's law firms.

Legal markets in Europe and many parts of Asia where the British law firms have reigned are stagnating-and even contracting. Five market forces are slowing their growth:

The largest and most lucrative mergers and acquisitions deals in Europe are increasingly being cherry-picked by U.S. firms. Almost all of the deals have huge U.S. law components, and although some European law firms have shored up their U.S. law expertise, many of them have not aggressively sold this capability to their domestic clients.

Legal work on new equity and debt issues has become highly commoditized, putting increased pressure on pricing.

U.S.-style litigation has not taken off in Europe, and many commercial disputes are now settled through mediation and other informal processes, where settlements are generally confidential, costs are substantially lower than in litigation, and delays imposed by courts can be avoided.

Europe has not witnessed the volume of U.S.-style corporate meltdowns (though many corporate governance experts agree the problems of Parmalat Finanziaria S.p.A. and several Dutch near-meltdowns are just the tip of the iceberg). There won't be, as long as Europe's regulatory agencies-such as the U.K. Financial Services Authority, Europe's most important regulator-are burdened with regulating everything but the kitchen sink.

Finally, clients increasingly prefer to use U.S.-style legal structures and documentation with certain types of financial instruments, such as high-yield bonds. This move is especially damaging for English-law practitioners, since their rise has been fueled by the preference by many companies for English law in structuring international commercial arrangements.

If past outcomes in other industries in Europe such as British merchant banking and European life insurance are any guide, then British (and consequently European) law firms face an uncertain-if not outright

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grim-future. We could witness the demise of as many as half of them within the next five to ten years.

Some weak players may be forced into mergers, which may stave off their collapse in the short term. Ultimately, however, the mergers will lead to collapse, because that's what happens when defensive mergers occur between weak players in any industry. The eminently more influential U.S. firms may acquire some of the stronger European firms, selectively cherry-pick practices with a profitable future, and shut down unprofitable ones. Many of the more cost-efficient midsize firms will merge with similar midsize firms in the United States.

There is one other "out-of-the-box" possibility of survival: Considering that it is mainly the large U.S.- and some European-financial services companies that have powered the growth of Europe's law firms in the past decade, some specialist practices, or even entire firms, might be acquired by them. They would bolt these on to their already large in-house legal departments and get rid of the deadweight.

Many, however, will just wither away. Of the firms that remain, five broad categories will describe them.

Simply the best Firms like Bredin Prat in France, Hengeler Mueller Partnerschaft von Rechtsanwälten in Germany, Gianni, Origoni, Grippo & Partners in Italy, De Brauw Blackstone Westbroek in the Netherlands, Uría & Menéndez in Spain, Slaughter and May in the United Kingdom (equivalents of a Cravath, Swaine & Moore or a Davis Polk & Wardwell in the United States) will be around if they keep attracting the best talent and the clients with the knottiest problems; and continue managing their leverage to ensure exceptional development and coaching of their associates.

Focused firms Although diversification is an alluring strategy, as long as firms like Herbert Smith keep defraying that temptation and continue to focus-in Herbert Smith's case, on litigation-they will win. Clients will always be attracted to them because of the efficiencies and effectiveness derived from their specialized services.

Low-cost providers Europe is blessed with several firms that provide excellent service at a relatively low cost. In the U.K., for example, firms like Wragge & Co. and Eversheds operate from bases outside of London, which allows them to keep costs down. Others, like Nabarro Nathanson, keep a tight lid on their operations to achieve a similar cost base from within London. Almost all of today's transaction-oriented firms will be forced to model their cost base along the lines of the low-cost providers.

Distinctive firms Achieving a distinctive and clearly identifiable positioning that clients value and are willing to pay for is the holy grail of competitive success in any industry. Distinctiveness is exactly what firms will have to achieve if they wish to continue with the premiums they have been used to charging. Distinctive firms don't do everything, nor do they aspire to, nor are they everywhere. But whatever they do, they do it in a fashion that very few can imitate.

Rule breakers That's what The Motley Fool, the personal finance Web site, calls companies like eBay Inc., Google Inc., and FedEx Corporation-companies that created entire industries by setting the terms of competition in a way that benefit them. Wachtell, Lipton, Rosen & Katz invented the "poison pill" provision and created an entirely new market for itself. No firm in Europe is a rule breaker, though one may evolve from the ashes of inevitable consolidation.

Either Europe's law firms transform themselves into one of these five categories, or they will be shortly extinct. Extinction for the staid, stodgy, and undefined is inevitable in any industry with structural overcapacity, lack of organic growth, lack of customer loyalty, and a growing preference for substitute service providers (either low-cost or U.S. firms).

While European law firms benefit from already having an international base, most of them are saddled with bureaucratic, stolid management structures and practices. They are highly vulnerable to firms in the United States that have started to put more modern management systems in place and that have awakened to the fact that business opportunities don't begin and end with the U.S. economy.

The coming industry consolidation is of critical importance to clients because their ability to identify-and ameliorate-legal and reputational risk could be affected as the industry undergoes massive structural shifts. Currently law firm management falls largely in the hands of senior-and frequently the best-lawyers, many of whom continue to serve clients. Since few-if any-firms have put in place the kind of management talent required to deal with an industry consolidation, it is absolutely certain that these senior lawyers will not have access to the skills, capabilities, and experience they will need to deal with the consolidation. They will also remain distracted by the day-to-day operational and client demands on their time. Consequently, clients will inherit-and be forced to deal with-their law firms' management problems.

These structural shifts will happen and happen now-first to British firms, and then to Europe's firms. One reason is a lack of innovation. European, and in particular British, law firms have not been at the vanguard of offering innovations in either securities law or corporate M&A. Their ability to create them in the future will be further hampered by regulatory and tax harmonization processes currently under way in Europe.

The firms are also facing boom-and-bust growth cycles. Revenue growth of 8-15 percent is what most professional services firms consider to be the level required for long-term sustainability. Grow faster than 15 percent, and you cannot pay adequate attention to clients, quality of work, or associate coaching and

development. Grow slower than 8 percent, and you cannot invest in new products or practices, training and development programs for associates, critical infrastructure building, knowledge-oriented systems and processes, management processes, and, crucially, brand building.

Law firm revenue figures from 1998 to 2005 reveal that the major U.S. law firms have continued to grow at a steady pace-with a compound annual growth rate of anywhere from 7 percent for Davis Polk to 19 percent for Kirkland & Ellis. Over the same period, the large European firms, all U.K.-headquartered, grew from 9.6 percent a year for Slaughter and May to a high of almost 19 percent for Freshfields Bruckhaus Deringer. At first glance the numbers look extremely promising. But they mask a more troubling reality. From 1998 through 2001, the upswing (especially in the two years, 2000 and 2001) experienced by several U.K.-headquartered law firms was a result of mergers, not organic growth. From 2002 onward, these firms either experienced a leveling off of revenues or even declines in their revenues-clear evidence that they could not build the foundations to turn the growth that they achieved through mergers and acquisitions into organic growth.

Admittedly, from 1998 through 2001, these firms had astonishingly high growth rates-anywhere from 11.4 percent for Simmons & Simmons to 33.6 percent for Freshfields. These firms could obviously do no wrong, and the largest five even earned the sobriquet "The Magic Circle." The three years from 2002 through 2005 have been less kind to them, however, and if U.K. law firms aren't careful, they might well earn a new sobriquet: "The Tragic Circle," as they try to hold on to growth by the skin of their teeth.

Any student of corporate growth will notice that most of the major London firms have had unsustainable growth. Some would even suggest a classic boom-and-bust cycle at work, which has led to rapid and searing consolidation in every industry where such a cycle has happened. Anyone who believes that the legal industry is fundamentally different ought to take a look at the much smoother growth rates achieved by the major U.S. law firms in the same period before lulling themselves into a state of misplaced somnolence. U.S. firms showed a much steadier growth rate-a relatively straight, upward line that stands in sharp contrast to the more turbulent revenue performance of U.K.-based firms.

And don't be fooled by the mergers that have driven European firm growth. There's a big difference between the mergers conducted in Europe and the consolidation that has occurred in the United States and other parts of the world. U.K. firms have added size, but not necessarily efficiency. When U.K. firms have merged with their German, Dutch, French, and Italian counterparts, they have frequently failed to eliminate duplicative overhead costs-such as human resources, IT, or marketing. In the U.S., most firm mergers have been accompanied by a round of cuts aimed at trimming overhead.

So why haven't European firms already gone bust or faced a more radical round of consolidation? There are three insidious reasons. First, in the U.S., if a law firm doesn't invest in them, associates leave for firms that do, or for careers in investment banks and management consultancies. But in Europe there is much less mobility between law firms, and from firms into investment banks and consultancies. Many associates are forced to just stick it out till opportunities arise or firms are forced to take on "fill-the-looms" work (work that inevitably takes the franchise down market).

Second, few partners desire a change of firm ownership unless as a last gasp for survival. Partner incentives are designed to maximize "period income," those ten to 15 years that one is a partner. Compensation is some form of lockstep, and firm leaders-who are generally at the top of a lockstep scale-have even less incentive to do anything that could jeopardize their earning ability.

Third, because partners in the U.K. retire relatively earlier than those on the Continent or in the U.S., long-term growth issues are often viewed as "someone else's problem." Most partnerships have dealt with their unsustainably slow growth in recent years by classic short-term measures: suffocating investments, laying off staff, and limiting the size of the partnership-especially (and ignominiously) cutting back on new partner elections, and thereby choking off long-term prospects for the firm.

U.K. and European firms are also facing a greater threat from their U.S. counterparts. Across Europe, U.S. firms are expanding their share of the market-especially high-margin, big-ticket M&A and finance deals. According to numbers in U.K. legal publications, 6 percent of the U.K.'s overall legal market and 13 percent of the legal spending on commercial matters has now been commandeered by U.S. firms. In a year or two, those figures are expected to shoot past 10 percent and 25 percent, respectively.

While most of the big British firms have failed to grow in the past three years, U.S. firms have targeted the most profitable ends of key practices and stolen market share in Europe. Their lead in certain practice areas is so strong that it's difficult for any client in Europe planning, for example, a stock sale, including an IPO, to ignore the expertise of Cleary Gottlieb Steen & Hamilton, Shearman & Sterling, Simpson Thacher & Bartlett, and Davis Polk, who now command the top spots as legal advisers on the largest global stock deals. Other U.S. firms like Wachtell; Sullivan & Cromwell; Skadden, Arps, Slate, Meagher & Flom; Cravath; and Dewey Ballantine have muscled in on the largest M&A deals acting for the bidder, target, or seller.

But it's not just the famed New York firms that are stealing share. Firms like Kirkland & Ellis, Los Angeles's Gibson, Dunn & Crutcher, and Washington, D.C.'s Hogan & Hartson and Covington & Burling are increasing their slice of the pie-a pie that's not itself growing. Many are coming in on the back of the deep relationships and credibility they already enjoy at home with many U.S. and international (especially financial) clients. Others represent differentiated skills and capabilities-Kirkland & Ellis and Gibson, Dunn

representing not just practice skills but also, in the case of Kirkland, access to the U.S. Midwest, home to a quarter of the Fortune 500 companies; Gibson, to the California market. Hogan & Hartson and Covington, not surprisingly, bring extensive expertise in competition law, international arbitration, and securities litigation. Others, like Sidley Austin Brown & Wood in securitization, Pillsbury Winthrop Shaw Pittman in outsourcing, and Milbank, Tweed, Hadley & McCloy in project finance, are leveraging their well-grooved and highly recognized U.S. expertise to cherry-pick work in Europe that plays to their specific strengths.

U.S. firms will continue to increase their footprint in Europe for three other significant reasons. First has to do with the largely transaction-oriented structure of European law firms, especially those focused on banking and finance. While many general counsel must rely on their outside counsel to serve as watchdogs and flag anything that might be of concern to them, for transactional lawyers with the voluminous number of transactions they've worked on, and their intense focus on specific deals, it becomes very difficult to comprehend how the specific deal they are working on relates to (or takes away from) other deals and initiatives under way at the client or the client's broader business objectives. Not surprisingly, few European transactional lawyers can articulate what their clients are trying to achieve either geographically or strategically. (Indeed, some GCs are taking the extreme step of even quizzing their service providers on their basic knowledge about their organizations.)

Second, U.S. law is beginning to replace English law as the basis for many financial transactions. This goes to the very heart of what made British law firms successful so far: English law was the dominant legal system for non-U.S., international financial transactions.

Finally, the much higher level of associate and partner compensation will continue to make U.S. law firms highly attractive to the best talent in Europe. U.S. partners have longer longevity and can earn 50 percent or 100 percent more than the average partner at a U.K. firm. That makes for a compelling argument for U.S. firms, and we are already witnessing the migration of some top names to them.

There is a myth propounded in Europe about U.S. law firms "hiring and firing" their lawyers and running an "eat what you kill" compensation system. Even a cursory look at the declining fee-earner numbers in the U.K. and the number of partners being deequitized will reveal that this isn't exactly the "warm and fuzzy" culture it's made out to be. Indeed, as far as culture is concerned, some of the major U.S. firms have been in Europe for a long time: Cleary for more than 50 years; Shearman and White & Case for more than 40. They are about just as European as anyone could be.

European firms, on the other hand, have found the U.S. market a tough nut to crack. The U.S. ambitions of most European law firms have gone from scaldingly hot to icy cold within the past three years. If it's any consolation to them, few other non-U.S. professional services firms have cracked the market either. One of the exceptions is UBS AG. UBS adopted a counterintuitive strategy of having a base in New York but going after the investment banking market in the Midwest. It also handed out multiyear, guaranteed packages to investment bankers in the 2000 market crash when other investment banks were handing out pink slips.

It would almost be heresy to suggest to many European law firms that they focus their energies outside of New York, in, dare we say, Washington, D.C., Los Angeles, Chicago, or San Francisco-the world's third-, fourth-, fifth-, and sixth-largest legal markets after New York and London. Even Boston, a stone's throw from New York and home of many of the world's largest financial services and private equity firms, doesn't register a bleep on the radar screens of most European law firms.

European firms haven't grasped one other reality. For many U.S. lawyers, joining a European firm generally does not enhance their street cred. In the United States, most of these firms have little, if any, brand value; don't get the most exciting (and complicated) work; don't attract the best talent; can't place their lawyers into high-profile roles at, say, the Securities and Exchange Commission or the U.S. Department of Justice; and aren't as profitable as many top U.S. firms.

The essence of any professional services firm is its intangible assets-its reputation and brand, quality of work and people, experience and expertise, quality of client relationships, and ability to attract top talent and retain them through exceptional training, coaching, mentoring, and client and internal opportunities. There's almost a tightrope walk that thoughtful managers of professional services firms are forced to make between their operating decisions-such as capacity utilization rates, leverage ratios, and target pricing and hiring rates-and the intangible assets.

Yet the key operating metric for many of Europe's law firms remains capacity utilization. But maintaining high utilization rates has secondary costs, including price discounting to fill the looms with work; short-changing associate training and development (and thereby accelerating attrition rates-which, in some practices in Europe, are running as high as 25-30 percent); cutting back on product and service innovations; and engendering an environment where everyone keeps their heads down and no one is willing to speak up. Unfortunately, these are exactly the environments, management studies have found, that are ripe for ethical violations like bill padding.

While declining utilization is a real problem for any law firm, many European firms operate almost on a seat-of-the-pants management approach of measuring utilization numbers week by week. Practice leaders unable to meet those numbers are encouraged to cut staff, slash spending, and figure out ways to bill more. Professional services firms that adopt such an approach deal with flagging morale, high turnover, shoddy work and ultimately disappear.

In addition, too many of Europe's largest firms, hungry to get in on deals, have taken the route of easy discounts, which fuels an insatiable appetite for clients for further discounts. Firms will often agree to 20-30 percent discounts (depending on the practice and the jurisdiction) on rates to get in on panels, and, once on the panel, will agree to further discounts to get the work over one of the other panel firms (they will finally agree to shave a few more percentages to get their bills paid). This trend is driven by law firms' lack of understanding of what clients want, what value clients put on the work, what competitors might be willing to charge for it, and what clients may be willing to pay. Because they understand the costs, they are willing to go for the simplistic "cost plus margin" pricing formula rather than billing clients for what that work is worth.

Not only do general counsel want discounts, but soon they will start asking more questions about utilization rates. It ought to be every client's prerogative to find out whether their outside counsel focus on short-term utilization metrics, because ultimately they are the ones who bear the brunt of a law firm's internal disgruntlement.

Most European law firms hold on to an organizational model of immense simplicity. Most have a simple, unified model, wherein everyone, no matter their practice or location, all fall under the same organizational construct. It's the equivalent of Henry Ford's famous dictum: "You can have it in any color as long as it's black."

Simply put, not even Ford makes a Model T anymore. Fundamentally, a group of lawyers doing highly commoditized securitization work at low-fee, high-volume, high-leverage, and high-utilization rates cannot be evaluated on the identical performance metrics as M&A lawyers working at high-fee, low-volume, low-leverage, and frequently low-utilization rates.

Europe's lawyers and law firms are in the midst of a structural shift that will make many of their products and services obsolete. This is not a market correction or a temporary dip. The downturn in Europe's legal markets has been going on for a while, and it will get significantly worse. In any industry with structural over capacity, market forces collude to eliminate all those firms with obsolete approaches and inefficient structures. Europe's law firms won't be spared the coming consolidation. This consolidation will also create significant opportunities for the nimble and the highly differentiated-including many from outside of Europe.

Partha Bose is the chairman and chief executive of Partha Bose & Company, LLC, a differentiation-focused strategy consulting firm based in Boston and London. He can be contacted at parthabose@parthabose.com. This article is an excerpt from a longer white paper.

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