U.S. firms missed critical opportunities that will keep top U.K. firms competitive for the foreseeable future.

By Tony Williams

The Empire Strikes Back

WITH APOLOGIES TO MARK TWAIN, when it comes to the major U.K.–based law firms, reports of their death have been greatly exaggerated. In a piece in the November 2005 issue of The American Lawyer, law firm consultant Partha Bose painted a grim future for some of the most prominent U.K. firms—a group he dubs "The Tragic Circle." Bose argues that these firms will bleed market share and talent because of a grow-ing competition from U.S. firms in Europe and Asia, unsustainable growth, and a downturn in demand in core practice areas.

But, in my view, Bose's conclusions are far too stark. If anything, U.K. firms are well positioned to compete with U.S. players internationally, provided they continue to capitalize on their deep international experience and capability, and their long and deep relationships with investment banks, and they re-evaluate their expectations for the U.S. market.

That is not to object to many of Bose's observations. The United States, as he argues, is a far deeper and stronger market than the United Kingdom. The bottom Am Law 200 firm in 2004—Lathrop & Gage—had annual revenues($86 million) that would make it number 44 in the The Lawyer U.K. 100. Fifty Am Law 200 firms produced profits per equity partner of more than $1 million per year. Only 12 U.K. firms reached that figure.

Much of this should be expected, however. The U.S. has a far larger economy and legal sector. And since 2000, three trends in particular have assisted major U.S. firms: Chapter 11 is a gravy train for lawyers, and the period from 2000 to 2005 saw many of the largest U.S. insolvencies of all time; Sarbanes-Oxley and other regulations have frightened company directors sufficiently that they won't make a move without consulting lawyers; and litigation continues to be the preferred method of settling business disputes in the United States.

In the U.K. and continental Europe, by comparison, there have been very few major corporate insolvencies (the Parmalat affair being the exception that proves the rule). Regulators have been active, but not quite with the witch-hunting vigor we have seen in the U.S. And generally, litigation is seen as a potentially

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expensive distraction that should only be used as a last resort. (The new lord chief justice for England and Wales, Lord Phillips, recently commented that companies should regard the prospect of getting sucked into highly expensive civil litigation with "horror.")

It is dangerous, as Bose attempts to do, to draw longer-term trends from the divergence between the performance of U.S. and U.K. firms over the last few years. The three factors mentioned above count for much of that divergence. In any event, the European market has performed strongly in 2005 and is expected to do extremely well in 2006. It is likely that by the end of 2006 the European firms will be closing the profitability gap with many of the U.S. firms.

It is simply ridiculous to suggest that the size of the U.K. firms will hold back their successful development internationally. In all but very niche-based practices, clients increasingly demand a breadth and depth of service both nationally and internationally that very few firms can consistently provide (hence the wave of law firm consolidation currently taking place across the U.S.). Admittedly, this does require a strong throughput of work and does cause some profitability pressures in a downturn, but the availability of that capacity is crucial as markets recover.

Indeed, as 2005 progressed, it became increasingly obvious that for major M&A transactions and capital markets work in Europe, the Magic Circle U.K. firms have been performing strongly. These large firms now have a depth of both U.K. and U.S. capability that enables them to operate credibly under either choice of law. Interestingly, the rapid expansion of the use of London for international equity offerings in 2005 (both for full listings by large companies and AIM for smaller or younger companies) does seem to suggest that, despite its depth, the U.S. market deters many international companies because of the cost of regulation and the risk of litigation.

U.K. firms are light-years ahead of U.S. firms when it comes to institutionalizing their client base. U.S. partners still speak of "my" clients, whereas U.K. partners refer to "our" clients. This has a major impact on the penetration of the major clients, where, increasingly, focused client teams rather than one or two heavy-hitting client partners are essential for an enduring and profitable relationship.

As the recent downturn across Europe has shown, European firms can be slow to make decisions and traditionally have not been as bottom line–focused as U.S. firms. A careful balance is required here. These firms need to be profitable and to keep improving profitability. However, if you want to encourage effective team work and a collegial approach, there is a need to look to the medium term rather than to rely on one quarter's figures to decide whether a partner stays or goes.

There is evidence that firms are getting more strategic in their approach and hard-nosed in their decision making. In the last three years, at least 100 partners have been asked to leave Magic Circle firms as these firms have ramped up their partner performance criteria. Some practice areas have been reorganized, and some foreign offices closed (Clifford Chance in Berlin and Freshfields Bruckhaus Deringer in Thailand).

But recent performance is not the key difference between the Magic Circle and the major New York firms. The issues are far more deep-seated. The United States is the world's major economic and political power, and New York is the world's largest and deepest domestic market in the world for legal services. Law firms in New York, especially at the top end of the market, can sit back and wait for clients in crisis to come to them. At one level this is an enviable position. The top New York firms are some of the most profitable in the world, so it is hard to criticize their model. But this does produce relatively high barriers to investment elsewhere in the world (and even elsewhere in the United States), because few locations can produce a financial return similar to that available in New York. This encourages a certain arrogance and in the longer term may lead to lost opportunities.

European Legal Advisers

The leading legal advisers, ranked by deal value in billions of euros, on announced European transactions during 2005

RANK	FIRM	VALUE	NUMBER OF DEALS
1	Clifford Chance	€ 314.4	299
2	Freshfields	€ 280.4	271
3	Linklaters	€ 271.1	276
4	Sullivan & Cromwell	€ 194.6	56
5	Allen & Overy	€ 176.0	230
6	Cleary Gottlieb	€ 159.7	88
7	Skadden, Arps	€ 133.6	74
8	Simpson Thacher	€ 103.3	30
9	Baker & McKenzie	€ 99.0	137
10	White & Case	€ 95.0	164

SOURCE: MERGERMARKET

However, this may not worry the existing generation of partners in such firms. I remember being told in 1998, by a very senior partner in a major New York firm, "Everything that is innovative in legal services originates in New York. To operate outside New York is dilutive of quality and profitability. We will not do it." Apart from saying, "Have a nice day," I had no immediate response for him.

I should have pointed out that U.K. firms lead the world in privatization, public sector project finance, and some means of alternative dispute resolution, to name but a few areas. This approach has caused U.S. firms to miss international opportunities. In 1986 the so-called Big Bang in the U.K. transformed its financial markets by abolishing restrictive practices and opening up the financial markets to institutional capital. The U.S. investment banks rode into London (and also into Asia) in the late 1980s. Generally, the major New York law firms wished them well and waved goodbye to them at the airport.

Strategically, this was an error. If American firms had invested in London or Hong Kong at that time, many of the international ambitions of the U.K. firms would have been stillborn. U.K. firms went international by necessity. By the late 1980s, it was clear that if they wanted to grow beyond their domestic market, they needed to capitalize on London's growing position as the center for international transactions. That meant expanding their operations in Europe and Asia. Hong Kong—still British territory then—was an initial stop, and U.K. firms had an obvious advantage there because of the city's colonial ties to Britain. Their strength in Hong Kong has enabled them to dominate work now emerging from China.

The merger in 1987 that created Clifford Chance was another manifestation of this new international approach. Firms such as Freshfields and Clifford Chance also developed strong relationships with U.S. investment banks as they moved into Europe and Asia (even seconding partners to the banks as they set up and grew in London). Investment banks such as Morgan Stanley now generate over half of their revenues outside the U.S. The non–U.S. operations are no longer exotic outposts but an integral part of their business.

It's possible that some U.K. firms that expanded internationally did so in too many marginal locations, but generally they now apply pretty rigorous performance criteria to their international operations. If they do not perform, they are restructured or closed.

However, three things are now clear from this period of expansion by the top U.K. players and the readjustment necessary as a result of the slowdown in 2001, 2002, and 2003: First, most of them now have a credible foothold in the major business and financial centers of the world (with the notable exception, for most, of the United States); second, a new breed of law firm management is addressing the performance of such offices and of individual partners in a much more business like manner (indeed, the de-emphasizing of certain less strategic offices and the removal of non-performing partners has already occurred and is continuing); third, the firms have spent extensively (though not always wisely) on their international operations, and the cost of developing those international offices has now been paid in full. The offices are now producing credible returns and will require little further investment (the exception, of course, being in the U.S.).

Conversely, U.S. law firm development outside of the country has been at best sporadic—even opportunistic—rather than strategic. There are two key exceptions: Cleary Gottlieb Steen & Hamilton has, with relatively small offices in key locations, developed over the last 25 years an enviable position on cross-border equity capital markets transactions. Admittedly, much of this work is actually done in New York, but the firm does have a major presence in the focused area of international equity transactions. The second exception is Shearman & Sterling, which has developed strong operations across Europe. Indeed, its strength in Germany and its role acting for Daimler on the German law aspects of the DaimlerChrysler merger in 1998 was described to me by a senior partner in Bruckhaus, the leading German firm, as the final straw that forced them to accept the need for a merger with an Anglo-Saxon firm.

But even Shearman & Sterling suffered as a result of its international investment. In 2002 and 2003 its profitability was significantly below its New York peer group. It has scaled back on some of its ambitious European expansion plans, and last year its profits per partner figure was $1.15 million, still significantly below its peer group. Another problem for Shearman: Some of its U.S. rivals, most notably Sullivan & Cromwell, have caught up or even overtaken it in the European deal league tables.

Most U.S. firms feel they have nothing to worry about from European competition. Many have rubbed their hands with glee over the relative failure of U.K. firms to establish a significant and profitable presence in New York. Of the Magic Circle, only Clifford Chance has tried a major U.S. merger—with Rogers & Wells in 2000. The strategy was right, but it was poorly executed. From 2000 to 2003, the U.S. operations went into a freefall (it didn't help that the dot-com bubble burst just as Clifford Chance merged in the United States).

In response, the firm installed a new worldwide management team that is intent on addressing issues head-on. This they have done—and are in the process of rebuilding. In spite of the headlines about Clifford Chance's problems in the United States, it's dangerous to gloat. Clifford Chance takes the long view. It may make mistakes, but so does any pioneer. It will learn from them and come back stronger than ever. It is quite likely that its profits per partner will increase to at least $1.4 million this year as the cost-cutting and business-focused management begins to reap the results of the last two years' work. The firm is committed to increasing its profits per partner to $1.75 million. In the first nine months of 2005, Clifford Chance acted on 69 announced transactions in North America, with a total value of just over $50 billion. (The firm was number one in both the volume and number of announced European transactions.) If that is abject failure, the U.S. firms had better hope that they never get it right!

The other Magic Circle firms, possibly chastened by Clifford Chance's experience, have been far more conservative in the U.S. Allen & Overy has 103 lawyers in New York, Freshfields has 61, and Linklaters, 100. It is clear that all would welcome a top-tier New York merger.

But as the New York elite do not want to dance, perhaps it is time for the U.K. firms to turn their attention elsewhere. It is to my eternal regret that when I was managing partner of Clifford Chance, I failed to convince my finance partners to consider the possibility of a merger with, say, Latham & Watkins. My finance partners insisted that any merger had to be with a "real" New York firm.

Yet consolidation has created a tier of top quality U.S. firms of at least 1,000 lawyers. These firms have strength and depth in New York; Washington, D.C.; California; and other major U.S. markets. They will, over time, become potent competitors with even the entrenched New York firms. As these firms develop and integrate their mergers, they will increasingly look internationally for further profitable development.

If you accept the premise that U.K. firms in New York have been faltering, then surely the development of U.S. firms in Europe has been a success story? Well, yes and no. There are about 100 U.S. firms with an "office" in London, ranging from a brass plate to more than 250 lawyers. A few are performing extremely well. But the brutal fact is that many of those firms have no idea why they are in London, what clients they are trying to service, what expertise they wish to offer, and what financial targets they should be meeting. Probably 90 percent of U.S. firms in London are losing money.

Their U.S. partners are probably not aware of the true extent of the losses, as IT, recruitment, training, and central support and management time costs are rarely properly allocated to the London office. Rent-free periods are taken "up front" rather than amortized over the length of the lease, and the costs of partners seconded from the U.S. (even ignoring the opportunity cost of such a partner giving up, say, a $5 million per year home practice) is often lost or incompletely accounted for. It is quite normal for U.S. firms to lose, on a properly accounted basis, $2–5 million in London alone. In 2004 the highest London loss reported to me by a U.S. firm was $18 million. It is very likely that over the last ten years, U.S. firms have made in London a net "investment" (really just a loss) in excess of $1 billion. In very few cases has this resulted in any substantial benefit. Smaller, but still significant, sums have been invested in France, Germany, and Italy.

The losses have occurred for four main reasons. First, many firms have not known why they are coming to London—there has been a "me too" mentality that seems to contradict the argument that U.S. firms are brutally analytical and hard-nosed in their approach.

Second, firms have assumed that if they establish a London outpost, all of their U.S. clients with operations in London will hire them. This is naive. Many U.S. corporations in London have law firm relationships going back 30–50 years with European firms that have real depth and expertise. Why would they transfer this work to a ten-lawyer office that has little or no local knowledge?

Third, U.S. firms have misunderstood the dynamics of a lateral hire in London. Put simply, U.K. firms have invested in institutionalizing their client relationships. When a partner moves, he is unlikely to bring more than, say, 25 percent of his current book of business with him. Indeed, "the better" the firm he comes from, the less current work he is likely to bring. Accordingly, any lateral hire usually requires a two-to-three-year investment before the partner adequately pays his way.

Fourth, the London team is insufficiently integrated with the U.S. operations. There is insufficient relationship-building within the firm. London is left as a silo ("England and America, two countries divided by a common language"). Failure to fully understand these points has had a devastating effect on the progress of U.S. firms in London.

Fortunately, many American firms are learning these lessons and are taking a far more businesslike approach to their London offices. Some will expand very successfully, some will be radically restructured and refocused, and a few will even close. Many U.S. firms have made or are now contemplating U.K. or other European mergers as a way of developing a credible and cost-effective footprint in Europe. Clearly, U.S. firms have been increasing market share in London, but from a very low base.

However, despite Bose's assertion, most of this growth has come at the expense of firms in the two or three tiers immediately below the Magic Circle, rather than the Magic Circle itself. A realistic review of the development of law firms internationally reveals at best a mixed picture. It is far too simplistic to suggest, at this stage, that the U.S. firms will clearly win and the U.K. firms will lose.

It is even unclear what appetite many leading New York firms have for an international fight and whether they will remain primarily based in New York, with small outposts in a few of the world's major financial centers. U.K. firms have increasingly learned from their mistakes as they developed internationally.

As we see in London, U.S. firms still have much to learn about developing profitable international operations. If both sides have made mistakes, then what do the next five to ten years hold? I believe that a number of trends are inevitable:

- The top-tier "boutique" type firms, such as Wachtell, Lipton, Rosen & Katz in New York, Slaughter and May in London, Hengeler Mueller in Germany, and Uría & Menéndez in Spain, will remain independent and highly profitable compared to their markets. If they continue to be attractive to top graduates and are able to differentiate their offerings from the major international firms, they have a bright future. But this route is only available for a very small number of relatively small firms.
- Mid-tier consolidation will continue apace for at least the next two years in the United States, creating firms of more than 1,000 U.S. lawyers with real strength and depth in New York; Washington, D.C.; and California. Profits per partner at these firms will be at least $1 million per year. Such mergers will transform the top 25 Am Law firms over the next few years. These firms, after finishing their own mergers, will look to expand in Europe and Asia. These "new" firms will be increasingly strong competition for top-tier work in the U.S. and internationally.
- There will be some limited consolidation in the U.K. and European upper- and mid-tier market. Some mid-tier firms will become more focused and more profitable; some will fail or face forced mergers. The more dynamic players are likely to embrace a U.S. merger within the next five years, especially with the more dynamic firms being created by the current consolidation in the United States.
- Firms that have a clear market focus, which they single-mindedly develop, will be increasingly successful in their chosen area. Conversely, undifferentiated and unfocused firms will struggle to survive.
- Clifford Chance will continue to reform its U.S. and international operations and will adopt a more ruthless approach to profitability. It may even contemplate another U.S. merger. If it sustains its current drive and increasing profitability, it will clearly be one of the few top-tier international firms in ten years' time.
- For the other Magic Circle firms, the picture is more mixed. Slaughter and May will continue its highly profitable boutique model. The other three, Allen & Overy, Freshfields, and Linklaters, clearly need more U.S. depth. They may get lucky with a top-tier New York bride, but I doubt it. They may be better off looking at the new breed of top tier and very profitable "national" U.S. firms. If hubris prevents them doing this, they face attack if (and it is a big if) the major U.S. firms manage to consistently upgrade the quality and depth of their London and international offerings.
- Many of the most profitable New York firms will be held back on their international development by the success and profitability of their New York offices. This may prevent them developing the depth of the offering that their clients need internationally. Their international operations may be sufficient to ensure that they cherry-pick profitable international work with a U.S. angle and a high New York involvement, but they are unlikely to develop a wider top-tier international practice. The danger here is that the growing depth of non–U.S. capital markets, an aversion to the aggression of U.S. regulators, and a horror of U.S.–style litigation may cause many international corporations to avoid direct access to U.S. investors unless and until they have no alternative.
- The battle to recruit and retain good quality, well-motivated, and internationally minded lawyers will continue. Those that attract and retain the best will enter a virtuous circle of profitable growth and enhanced reputation. Those that fail to attract or lose such talent will enter a vicious circle of steady and inexorable decline.

The battle lines are now drawn. The winners will be the top international law firms for major cross-border and domestic M&A, capital markets, and complex litigation worldwide. Let the battle commence.

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