Law Firm Salaries

City and US Law firm fundamentals, their impact on the recruitment market and why "real" assistant level compensation should not rise in 2012.

April 2012

Introduction

As recruiters of lawyers, ultimately paid on a percentage of the salary we place them on, we have a vested interest in lawyers being paid well. However, we also have a vested interest in the sustainability of the law firm recruitment model and if law firms, as they have in the past, overpay their assistants when the fundamentals of their business do not support this, then the resultant redundancies and ensuing lack of confidence in the market can make the job of the recruiter a lot more difficult.

At the time of writing (April 2012) most of the larger UK and US commercial law firms in London will be finalising their new assistant level compensations and, like all capitalist business, they will be keen to pay as little to their employees as the market will bear. No firm wants to be first to announce its compensation ahead of its peers as it risks having to make an ignominious backtrack (*à la* Freshfields in 2010) to avoid being seen as paying less than its rivals, should they fail to follow suit. This year Allen & Overy has been the first major UK law firm to take the plunge with its announcement last week of pay freezes for its senior lawyers and "pay rises" significantly below inflation for its junior assistants.

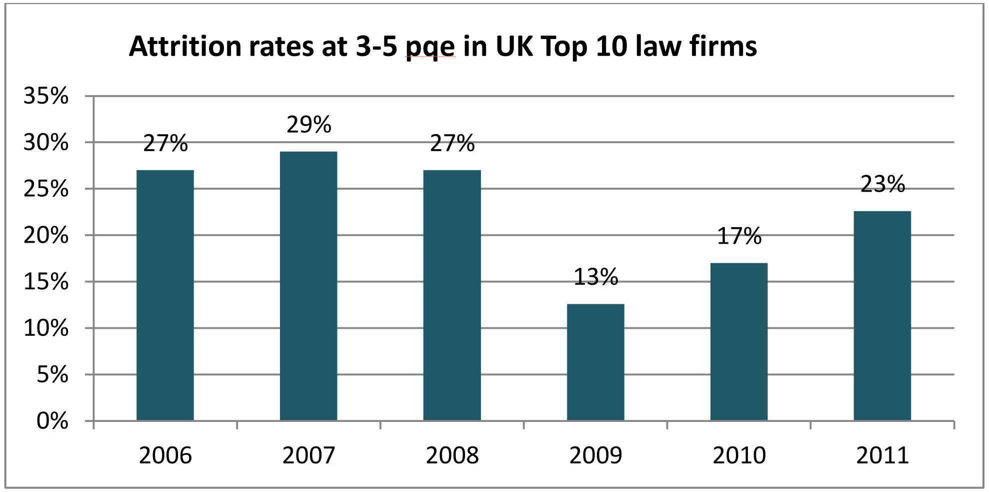
An improved recruitment market

In the financial year 2010/11 the market for legal services seemed to show significant signs of improvement for the first time in two years. Across the Top 100 UK headquartered law firms revenue rose 13% with the odd spectacular performance from firms like Mishcon De Reya and Norton Rose. Profits per equity partner (PEP) also jumped by a similar amount and the improvement in confidence lead to a sharp increase in assistant recruitment activity.

From mid-2010 onwards, firms which had made deep cuts in their associate base (8-10% on average during the downturn) appeared to commence restocking their assistant base in earnest. For many it was a chance to up-skill by nabbing lawyers from law firms further up the food chain and replacing positions previously held by often more senior assistants whom they had made redundant or performance-managed out in the preceding two years. The return to confidence also spurred the lateral partner market which itself generated demand for assistants to service expected work flows.

As a result, the first half of 2011 saw across-the-board hiring of assistants at the 2-6 post qualification experience (pqe) level at most law firms. This continued, albeit at a slightly less frenetic pace, into the second half of 2011 and, perhaps surprisingly in view of the increasing possibility of a deep recession arising from a potential Euro currency collapse, into the first quarter of 2012. In particular law firms have had a seemingly insatiable appetite for all things energy or mining, however, they have also continued to re-stock on traditional City staples such as banking, corporate and litigation as well as some newly fashionable niches such as white collar crime. Perhaps most telling of all has been the return of demand for professional support lawyers (PSL's) – a non-fee earning "luxury" which was dispensed with when law firms were in crisis mode but which has returned with a vengeance as confidence levels have improved.

Evidence of this surge in the recruitment market can be found in elevated attrition rates at the 3-5 pqe level at Top 10 firms:



Source: PricewaterhouseCoopers Law Firms' Survey

2011 – another year of "real" base salary falls

In spite of a clear increase in demand for lawyers in 2010 and 2011, base salary levels for assistants at given pqe levels only increased by about 2% in 2011. With the Office for National Statistics (ONS) quoting a CPI inflation figure of just under 4.5% for 2011, this was a real term reduction in salary of nearly 2.5%. This real base salary cut was also in evidence in the USA with New York law firms freezing salaries in January 2012 – a trend followed by New York Rate paying firms in London (although masked in some instances by artificially favourable US$/£ exchange rate fixes).

Below inflation pay increases have been the norm on both sides of the Atlantic since 2008 and it is true to say that in all types of commercial law firm, City lawyers of equivalent class level are earning less in real terms than they were in 2008. With New York Rate paying firms this is easy to demonstrate, thanks to the almost universal preservation of assistant level lockstep (where an individual lawyer's compensation increases each year they matriculate up a class (pqe) year). The widespread adoption of "merit based pay" by City firms makes this assertion a little harder to prove mathematically but does not make it any less correct – indeed most firms using merit based pay admit that it has enabled significant wage savings. Indisputable evidence of real - and in some instances absolute - pay reductions can be shown by comparing newly qualified (NQ) lawyer salaries in 2008 with those in 2011 (or 2012 for New York Rate paying firms):

Typical London Salaries	**Magic Circle Rates**	**City Rates**	**West End Rates**	**Mid-Atlantic Rates**	**New York Rates**
NQ 2008	£65,000	£62,000	£49,000	£78,000	£94,000
NQ 2011	£61,500	£57,000	£49,000	£75,000	£94,000
Change	-5.4%	-8.1%	±0%	-3.8%	±0%
Change in real terms*	-13.5%	-15.9%	-8.5%	-12.1%	-8.5%

**Adjusted for inflation using CPI*

Bonus payments were also flat or down in 2011

Bonus payments (which are by no means universal) generally fell in Top 100 UK law firms in 2011.

Top 10 UK firms

	2010	2011
>5 pqe	21%	17%
3-5 pqe	17%	15%
1-2 pqe	10%	13%
NQ	8%	6%

Top 11-25 UK firms

	2010	2011
>5 pqe	9%	8%
3-5 pqe	10%	10%
1-2 pqe	9%	9%
NQ	6%	8%

Top 26-50 UK firms

	2010	2011
>5 pqe	8%	8%
3-5 pqe	7%	6%
1-2 pqe	7%	6%
NQ	5%	5%

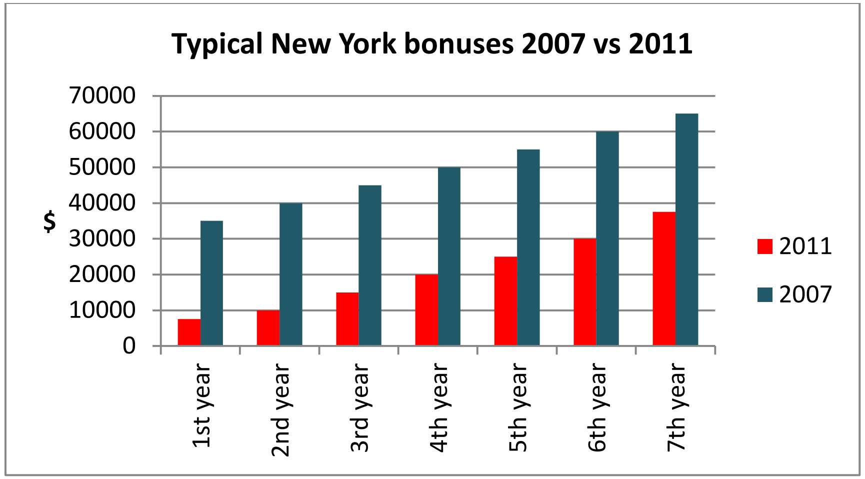
Top 51-100 UK firms

	2010	2011
>5 pqe	12%	7%
3-5 pqe	8%	6%
1-2 pqe	9%	6%
NQ	1%	5%

Source: PricewaterhouseCoopers Law Firms' Survey

Annual bonus payments in New York firms, announced in December 2011, also remained frozen on 2010 (although the picture was slightly confused by an additional one-off "spring bonus" paid around April 2011 by some New York Rate paying firms).

Bonus payments to assistants in US law firms in New York tend to be much more structured by class year than in UK City firms where there is generally far greater flexibility in differentially rewarding individuals at a given pqe level. A consequence is that long-term bonus levels at New York law firms are much easier to compare – it is noteworthy that December 2011 bonuses remained dramatically lower than those paid in December 2007:



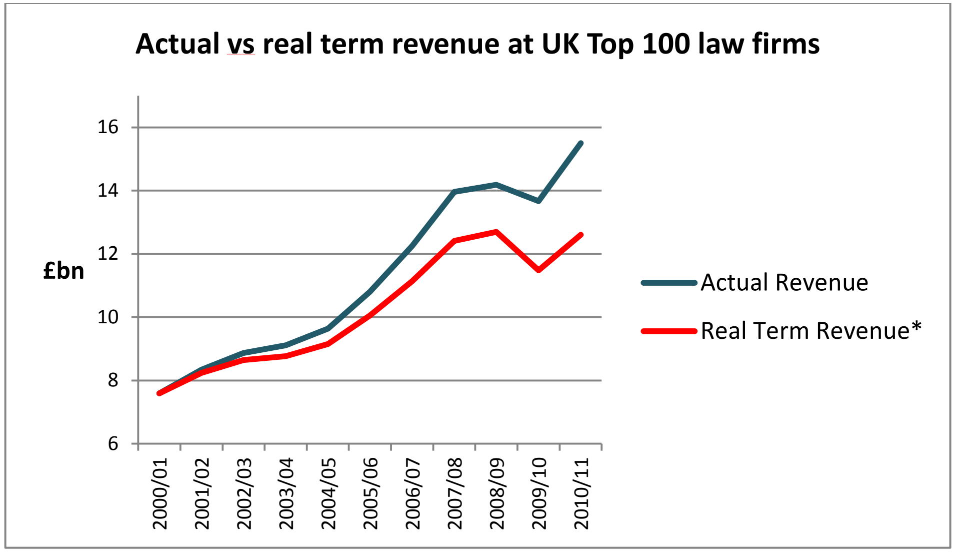
Why supply and demand dynamics have not increased assistant level compensation

At first glance, on a strictly supply and demand basis, it may appear puzzling that law firm compensation continued to fall in real terms in 2011. After all, real revenue and profits were up significantly on the previous year and, from late 2010, it was clear that law firms were, once more, starting to find it hard to recruit from a finite pool of suitably qualified lawyers – particularly at the 2-6 pqe level.

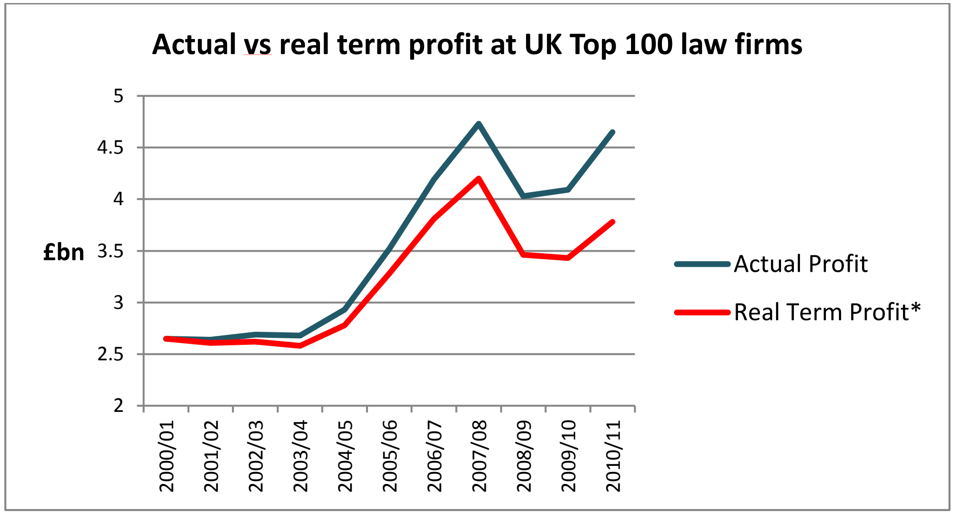
The reasons that real compensation has not risen, and in our view will be unlikely to rise in 2012, are the following:

(i) *Law firms are in a much weaker financial position than they were in 2008*

Although 2010/11 did see sharp real revenue rises across the Top 100 UK headquartered law firms, an inflation adjusted examination of their longer term performance indicates revenue to be 0.8% less than in 2008/9. In relation to gross profits, the situation is even worse with Top 100 law firms profits in 2010/11 down more than 10% on 2008/09.



**Adjusted for inflation using CPI*
Source: Legal Business September 2011 & Edwards Gibson



**Adjusted for inflation using CPI*
Source: Legal Business September 2011 & Edwards Gibson

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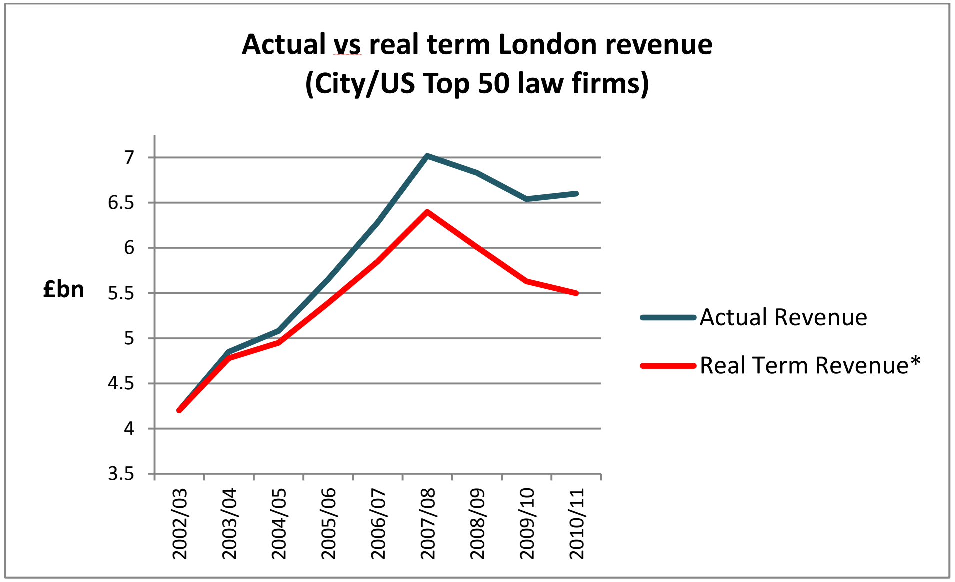
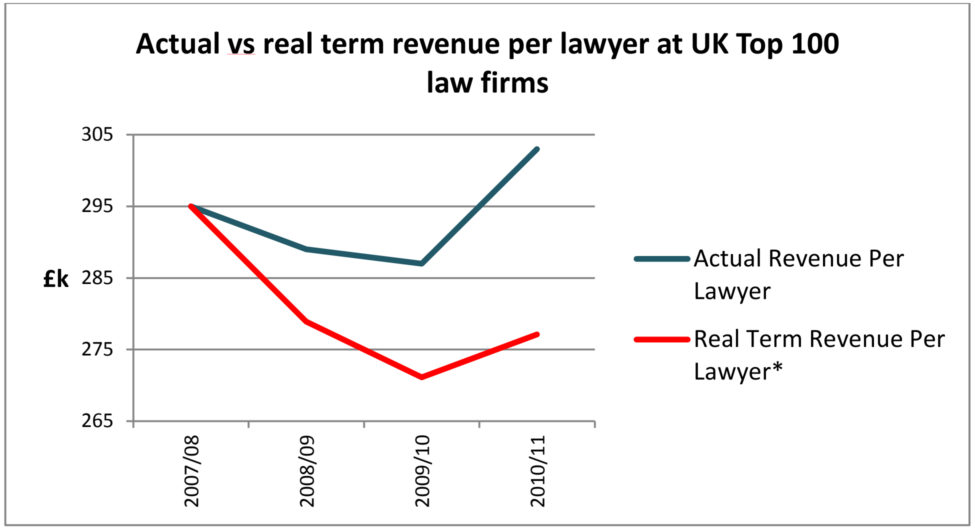
The global strength of English law means that a relatively high proportion of the Top 100 UK firm's revenue is generated by overseas offices. When London office revenue alone is examined, the figures are even more negative. Although the largest UK and US firms in the City reported a nominal 1% rise in revenue for 2010/11, this was a 2.3% fall when deflated using the CPI. Worse, revenue at these firms indicates a 14% inflation adjusted fall since 2008/09.



**Adjusted for inflation using CPI*
Source: Legal Business September 2011 & Edwards Gibson

Of course even if the overall financial health of law firms was poorer in 2010/11 than 2008/09 there would still be scope for increased compensation for individual lawyers if those lawyers had increased productivity. However, across the Top 100 UK firms inflation adjusted revenue per lawyer and profit per lawyer was down 6% and 17% respectively (see below). The low revenue per lawyer figures are in spite of there being fewer fee earners at Top 25 firms *(*The PwC Law firms' survey 2011 found that, in comparison with 2007, the percentage of fee earners at Top 10 and Top 11-25 UK law firms was down 10% and 3% respectively).



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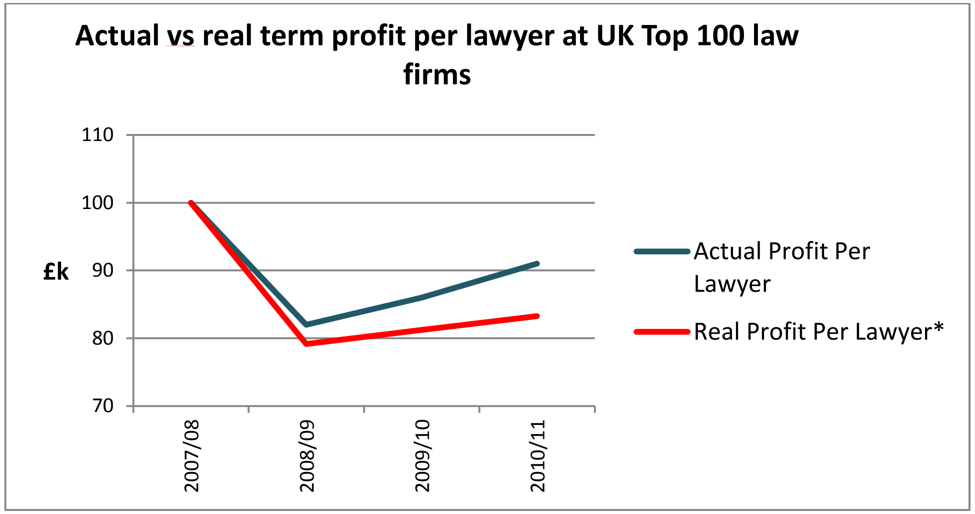

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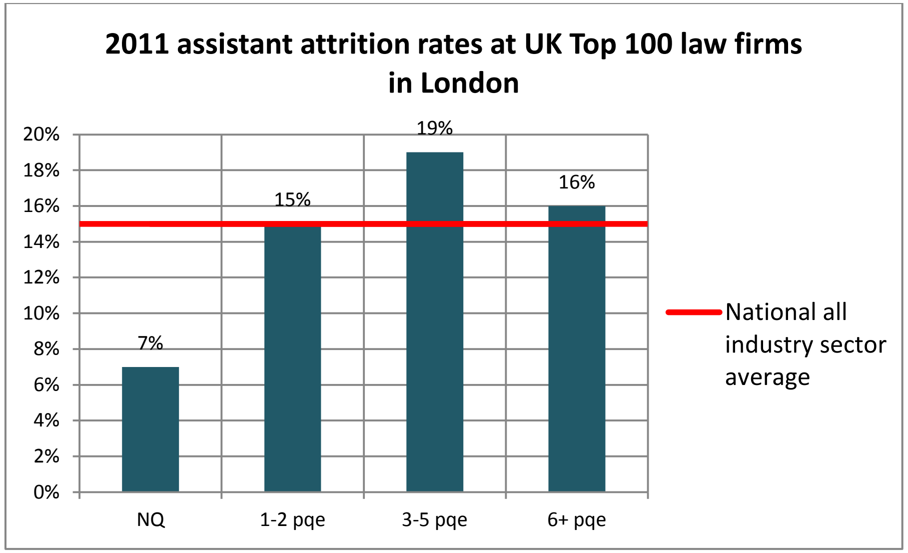
Source: Legal Business September 2011 & Edwards Gibson

(ii) *Actual law firm demand for assistant level lawyers is far lower than pre-recession levels*

Much tighter hiring criteria, along with smaller HR recruitment teams to facilitate recruitment has at times given the impression that assistant level recruitment has returned to pre-recession levels. However, although demand for assistants in the first quarter of 2012 was well over a thousand per cent higher than during the same period at the height of the recession in 2009, actual levels of demand are still more than a third lower than at the peak of the market in 2007. Further, the supply of candidates has been comparatively good (although, for the reasons above, this may not always have seemed apparent to law firms). Indeed far from law firms needing to increase headcount to service increased work flows, a report published by Royal Bank of Scotland (RBS) in March 2012 stated that, as a result of "*permanent structural change in market forces in the UK*", there was significant scope for law firms to reduce fee earner headcount by a further 5%.

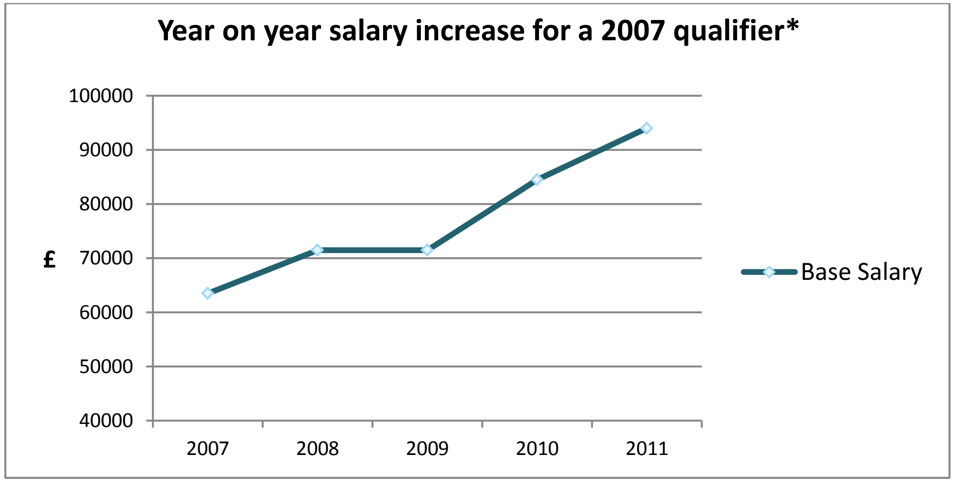
This relative soft demand is evidenced by London law firm attrition rates which are in many instances the same or lower than the 15% average across all UK industry and, in any event, significantly below law firm historic highs:



Source: PricewaterhouseCoopers Law Firms' Survey

(iii) *"In demand" assistants are well paid relative to the rest of the UK workforce*

Although some individuals will always be unhappy with their pay, most lawyers who managed to retain their jobs during the downturn, are on some visceral level aware that they have been very well taken care of in comparison to other UK workers and professionals. In spite of law firms increasing pay for each pqe class year at levels below inflation every year since 2008, many individual lawyers have continued to enjoy annual salary increases of 6-10% (the only exception to this being 2009). The reason for these relatively high increases is assistant level lockstep which remained broadly intact at top City and US firms up to 5 pqe. Even at those firms which purport to have moved to merit based pay, the hangover of assistant lockstep has resulted in similar rises for many thousands of individual lawyers – not a bad result for lawyers when the ONS quoted median gross annual earnings for full time employees increased by only 1.4% in 2011.



**At a typical Magic Circle Rate paying law firm*

(iv) *Sophisticated use of bonus payments by law firms*

There is a natural assumption that the level of bonus payments is directly proportional to the financial performance of law firms. Whilst this argument appears to hold true for law firms based in the US, this does not necessarily seem to be the case for UK law firms. Indeed, in spite of financial years 2008/09 and 2009/10 being considered poor, according to PwC's annual law firms' survey, bonus payments, as a percentage of associate salaries, actually went up in both years. In contrast improved headline revenue and profitability at UK law firms in 2010/11 resulted in bonuses falling. The criteria for obtaining bonus payments varies significantly between firms, however, "average" figures based on pqe, bely a huge range. Even at the 3-5 pqe level Top 10 bonuses payments for individual lawyers vary from less than 7% to more than 25%. Beyond 5 pqe the range is significantly greater. Although bonus potential is rarely quoted to recruiters as a primary factor for candidates in determining whether or not to join a given law firm, there is no doubt that the increasingly adroit use of these payments insulates law firms from losing more of their star performers to rivals paying higher base salaries.

(v) *The main competition for legal talent is from in-house which continues to pay less than law firms*

By far the greatest competition for assistant level lawyers is from in-house commercial legal departments. In the period between 2007-2010, when most law firms reduced net headcount, the number of lawyers in-house grew by 27% (*source: Law Society*). With fewer than 3% of commercial lawyers training in-house, virtually all of the shortfall was sourced from law firms. Few lawyers in-house benefit from the hangover of associate lockstep, so pay rises for individuals tend to be significantly lower than in law firms – in 2010/11 they averaged 2.8% (*source: IDS Executive Compensation Review*).

The attractions of in-house revolve around lifestyle and proximity to the business rather than pay and most lawyers moving in-house are aware that, over time, they will take a 10-20% pay cut to achieve this. The only significant in-house sector where lawyers, below partner level, have not had to take medium term pay cuts when moving in-house has been investment banking (although this too appears to be changing).

The prognosis for the 2012 pay round

The increases in profit per partner for the financial year end 2010/11 where in significant part due to cost savings over the preceding three years. These included: partnership restructurings, outsourcings and swinging reductions in PA support. Equally as important were fee earner headcount reductions and real salary falls for UK assistant level lawyers. It remains to be seen if the financial year ending April 2012 will see any real increases in **UK generated** revenue of City firms but, even if there are, these will have to be truly significant to make up for the underperformance of the preceding three years and justify significant across-the-board salary hikes. The available evidence is that any increases will not be significant – in January 2012 New York Rate paying firms in London froze salaries (although they continued to matriculate assistants up their lockstep).

From a cold hard business perspective the **only** basis for raising assistant base salaries in the absence of high attrition rates should be evidence of sustainable increases in UK revenue and revenue/profit per lawyer. From the available evidence at the time of writing there is nothing to say UK firms have seen this and for this reason we believe that they should not raise real base salaries in 2012 – to do otherwise would be the fastest way to erode the nascent return to improved profitability.

Of course we say "should not" rather than "will not" – since 2000, law firms have twice increased assistant level compensation, when we have felt they should not, and on both occasions widespread redundancies were the result. Indeed, unless UK generated revenue has increased above inflation, there is a strong pecuniary argument that there should be another absolute pay freeze across all pqe levels as occurred in 2009. Nevertheless, the assistant level recruitment market is vastly stronger than 2009, so we suspect this is highly unlikely. In our view a sensible headline rise for City firms might be 2% of base salary for all levels above newly qualified – enough to make lawyers feel valued but below current inflation levels (and well below the nearly 4.5% CPI for 2011). Even on that basis the continuance of the assistant lockstep track will mean that many individual lawyers will still see pay rises of more than 6% and law firms will continue to be able to make real salary savings.