

HR Breakfast Briefing

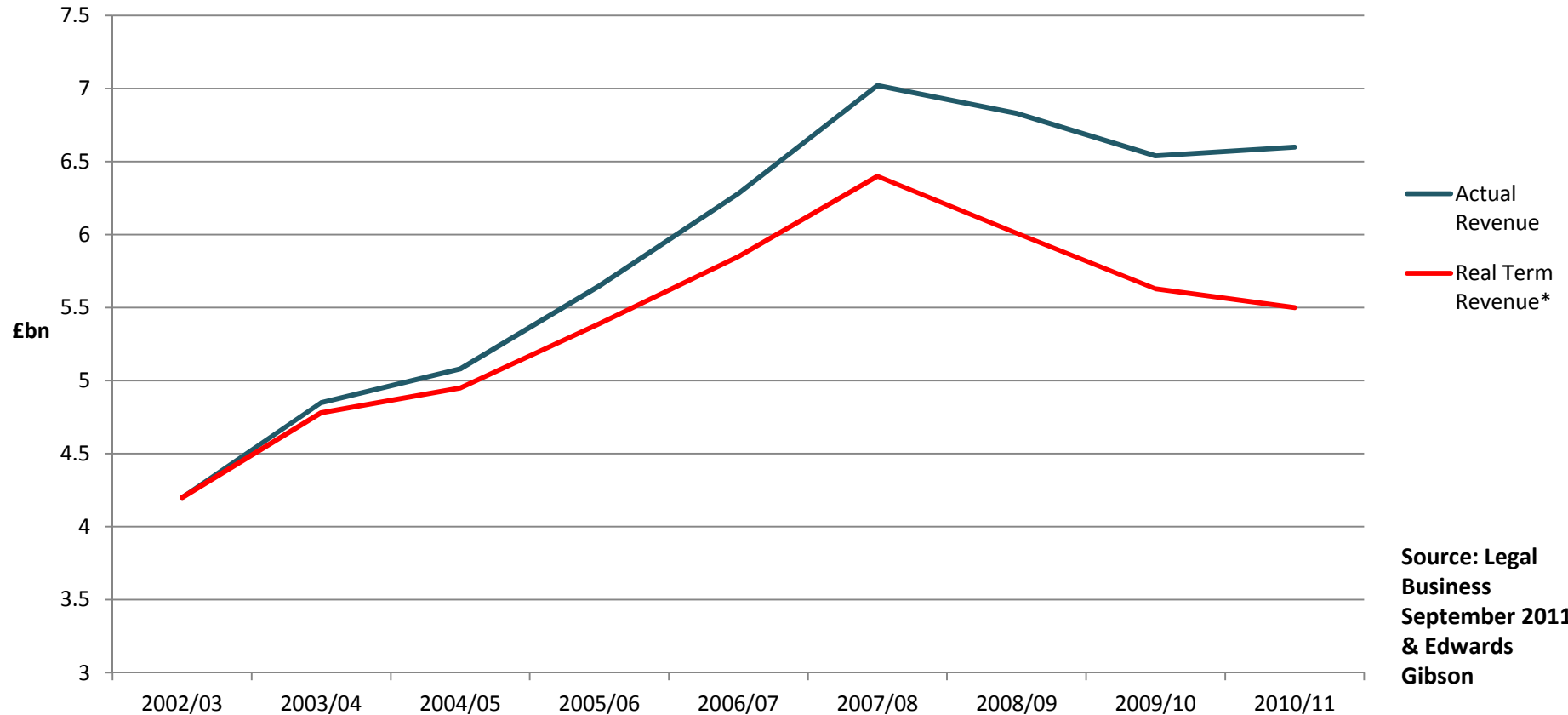
'How high headline salaries and inflexible compensation structures are harming London law firm competitiveness and costing City lawyers jobs'

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Wednesday 20th March 2013

Weak market for law firm legal services in London

Actual vs real term London revenue (City/US Top 50 law firms)



*Adjusted for inflation using CPI

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Reasons

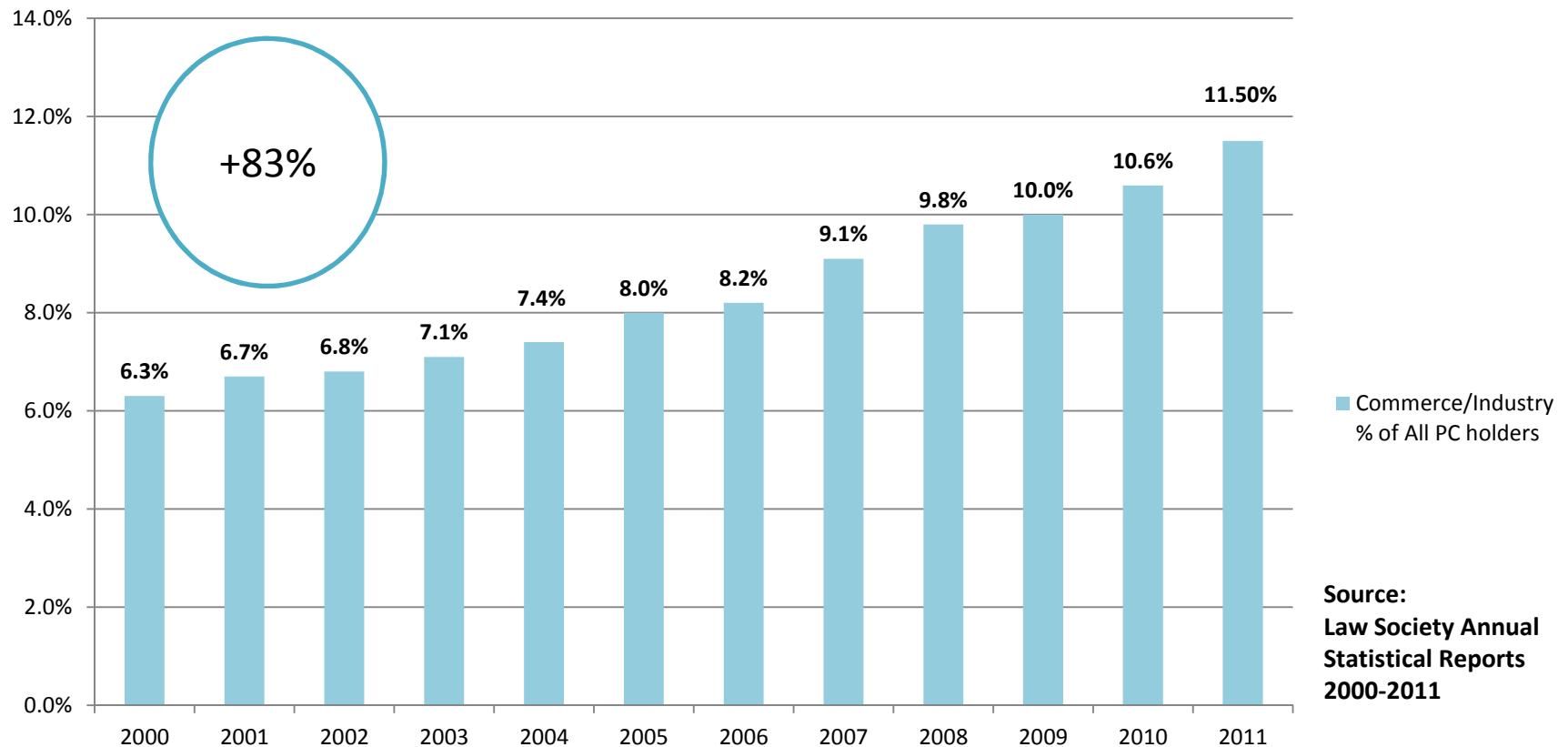
Cyclical

- ◆ Economy

Structural

- ◆ Driven by the rise of in-house legal departments

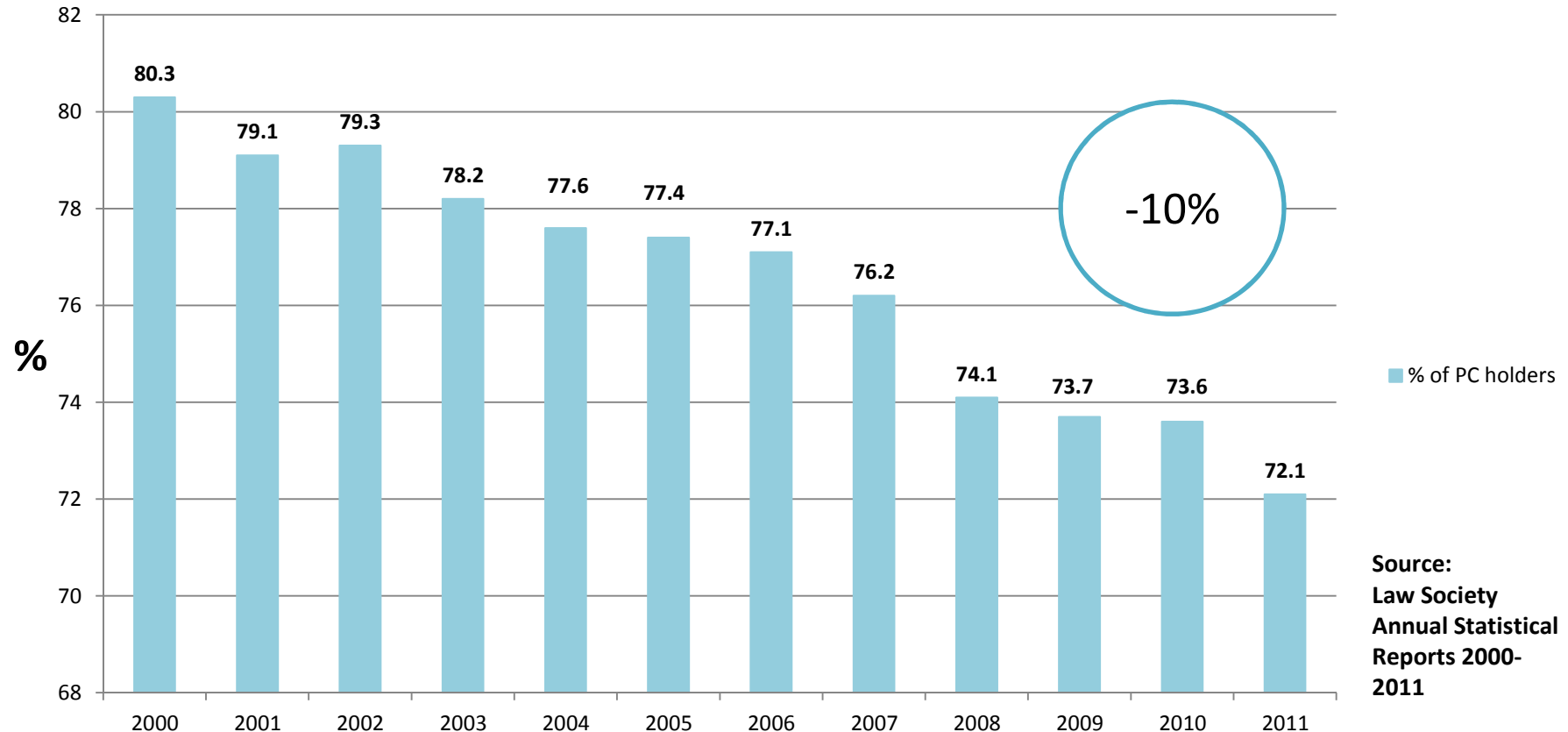
% of solicitors that hold a practising certificate working in commercial roles in-house



- ✦ The **number** of solicitors with practising certificates in commercial roles in-house grew nearly 170% between 2000 and 2011 (on average 9.5% p/a). In 2011 growth was 11.9% (Law Society)
- ✦ The **proportion** of solicitors with practising certificates in commercial roles in-house grew 83% between 2000 and 2011. Now nearly 12% of all solicitors (likely a quarter of all **commercial** solicitors)

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% of solicitors that hold a practising certificate working in Private Practice



- ◆ Conversely, the proportion of lawyers in private practice has fallen more than 10%
- ◆ Virtually all the growth in qualified solicitors in-house has come from lawyers leaving private practice law firms (only 3% of solicitors train in commercial roles in-house)

The growth in the number of fee earners in-house is likely to have been significantly greater

- ◆ The Law Society speculates that of the c. 38,000 solicitors on roll, but without practising certificates, a high proportion of these are in-house

It's not *just* the growth in numbers....

In-house legal departments have grown in expertise

.....and have become increasingly sophisticated users of legal services

The result is less work for individual law firms and downward pressure on recoverable fees – impacting on profit margins and profits per equity partner

Unless law firms

1. Outperform the market

- ✦ Capture market share without dropping rates

2. Focus on work that in-house cannot replicate

- ✦ Premium, bespoke, highly complex “bet the company” or multi-jurisdictional matters
- ✦ Involves dumping/gifting less profitable practice areas with “conflict tails”

3. Reduce Costs

(i) Lawyer redundancies

(ii) Outsource/near-shore commoditised fee earner work

- ◆ Law firms have themselves unbundled lower grade matters and increasingly outsourced/near-shored work to mitigate price differential with in-house

(iii) Hire less expensive/more flexible fee earners

- ◆ Paralegals/career paralegals (evidence is mixed)
- ◆ Contractors (have increased)

All of the productivity and cost savings so far mean continued reduction in full time fee earners at top firms in London

Average number of fee earners in Top 100 law firms 2011/2012

	All Fee Earners incl. ptrns	Assistants & Trainees
	2011-2012	2011-2012
Top 10	-0.2%	-0.2%
Top 11-25	-8.5%	-6.5%
Top 26-50	-18.1%	-21.7%
Top 51-100	-10.6%	-8.0%

Source: PwC

The relatively high growth in average lawyer numbers at smaller US law firms is not statistically significant

(iv) Cut existing lawyers' pay

Partner Compensation

- ◆ Outside the Top 10 firms, non-equity partner compensation is down, with most partners taking home between 7% and 19% less than in 2008 (PwC)

Bonus payments

- Over the past three years bonuses as % of base salary have **fallen** in UK firms

Top 10 UK Firms

PQE	2012	2011	2010
>5	14%	17%	21%
3-5	13%	15%	17%
1-2	9%	13%	10%
NQ	5%	6%	8%

Top 11-25 UK Firms

PQE	2012	2011	2010
>5	8%	8%	9%
3-5	9%	10%	10%
1-2	8%	9%	9%
NQ	5%	8%	6%

Top 26-50 UK Firms

PQE	2012	2011	2010
>5	6%	8%	8%
3-5	5%	6%	7%
1-2	6%	6%	7%
NQ	3%	5%	5%

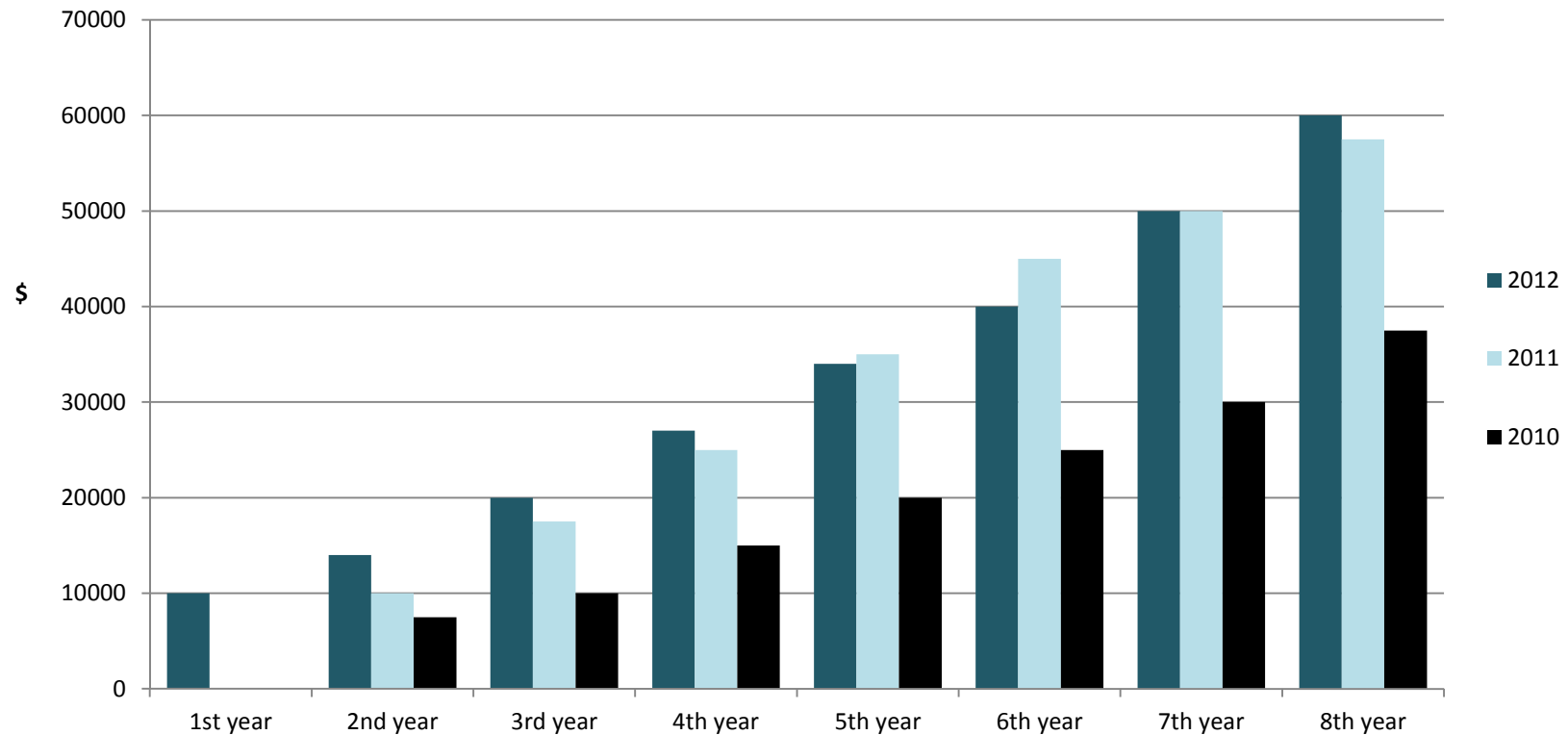
Top 51-100 UK Firms

PQE	2012	2011	2010
>5	6%	7%	12%
3-5	5%	6%	8%
1-2	6%	6%	9%
NQ	5%	5%	1%

Source: PWC

...although bonus payments **rose** over the same period in the US and at most New York Rate paying firms in London

Typical bonus totals comparing 2012, 2011* and 2010 at US law firms paying New York Rates



***Includes spring and end of year bonus**

Assistant Base Salaries

- ◆ Have generally **increased** for each pqe band every year since 2009
- ◆ And *individual* lawyers are still seeing sharp per annum **increases** especially at junior level

Typical per annum rises for a Magic Circle lawyer as they matriculate up the lockstep

	Typical £	% change
NQ	61500	-
1pqe	69000	+12%
2pqe	76000	+10%
3pqe	86000	+13%
4pqe	94500	+10%
5pqe	98500	+4%
6pqe	102000	+3.5%

Why have assistant salaries remained so high?

Is it due to Supply & Demand?

The London Law Firm Escalator 2013

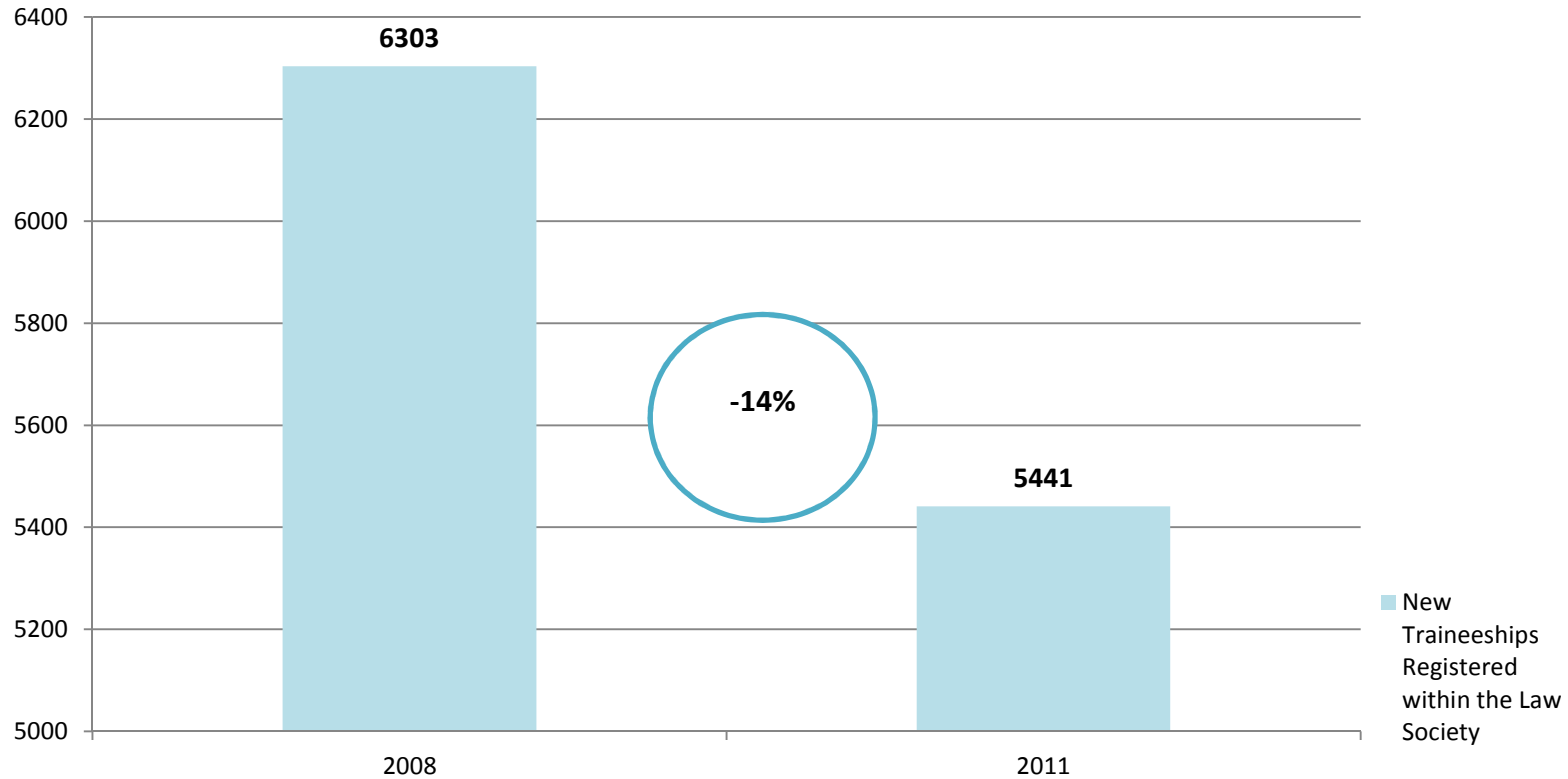


Top law firms are crowded at senior associate level

- ✦ no business case to make partner;
- ✦ limited demand in-house at the 8+ ppe level (fewer than 5%)

And swamped at the junior level

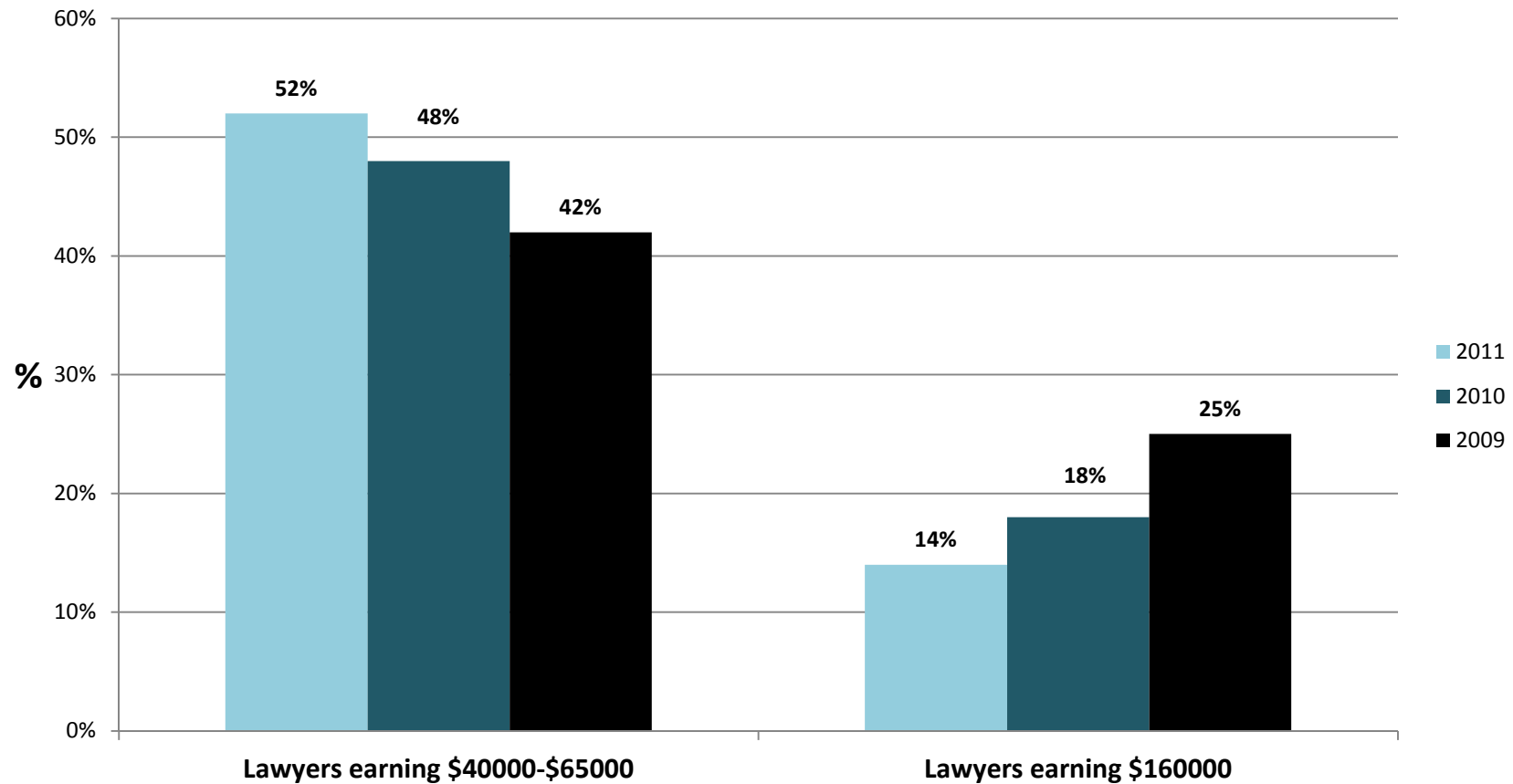
Comparison of Traineeships registered within the Law Society
2008 & 2011



- ◆ Number of traineeships are down sharply
- ◆ Further reductions in trainees in City firms 2013
- ◆ No external newly qualified market 2009-2012

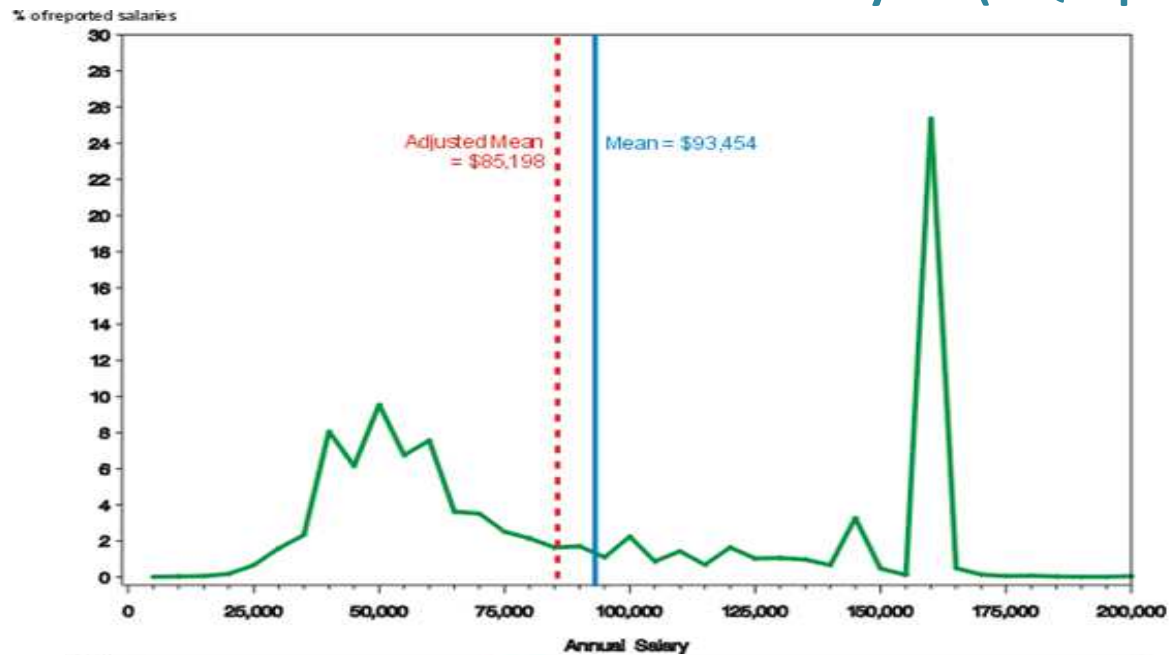
Newly qualified salaries in the US – a dramatic shift in the bimodal distribution curve

Distribution of Salaries for 1st year (NQ equivalent) lawyers in the US
2009-2011



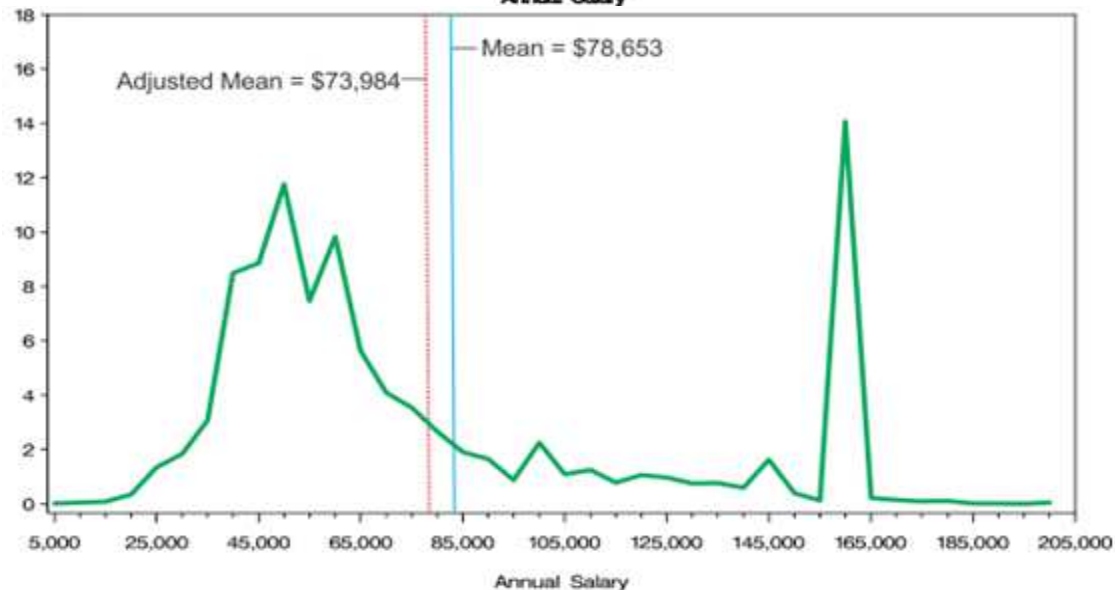
Source: National Association for Legal Career Professionals

Distribution of salaries for first year (NQ equivalent) lawyers in the US



2009

Source: National Association for
Legal Career Professionals 2010



2011

Source: National Association for
Legal Career Professionals 2012

Some supply issues at the mid-level (2-6pqe)

- ◆ Although the demand is still far below 2006/07

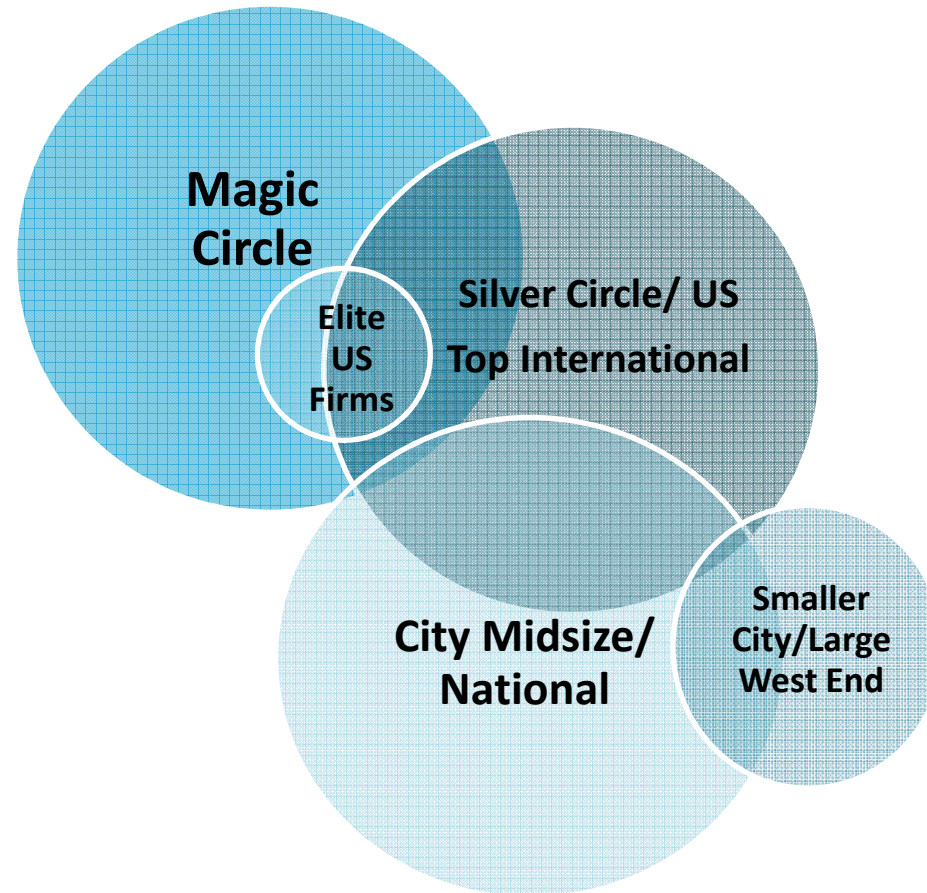
If supply is not an issue why has lawyer compensation remained so high?

Value proposition interconnection of law firms

AND

Preservation of (some form of) assistant lockstep

Law Firm Value Proposition Interconnection



Value proposition interconnection means all commercial firms need some lawyers paid on, or close to, the levels set by more elite law firms with whom they are competing

But most City firms pay their junior lawyers at levels similar to those at Magic Circle firms, even in areas of work in which they are not genuinely competing

Variance of typical newly qualified salaries with Magic Circle

	Typical NQ Salary £	Variance to Magic Circle
Magic Circle	61500	-
Silver Circle	60000	-2.4%
City Mid Size/National	58000	-5.7%
Smaller City/West End	55000	-10.6%
US Mid Atlantic Rates	75000	22.0%
New York Rates	97000	57.7%

Currently all newly qualified City lawyers **within a given firm** are paid the same regardless of the profitability of the practice area into which they have qualified

- ✦ To NQs this seems fair because all lawyers within a given law firm are *prima facie* of the same quality
- ✦ To law firms, egalitarian NQ pay is consistent with notions of partnership collegiality

BUT

‘One size fits all’ compensation does not make economic sense

Different practice areas have different levels of profitability and, over time, lawyers within certain practice areas gain higher intrinsic market value

The ‘mistake’ of non-bespoke NQ compensation is multiplied due to preservation of assistant lockstep

Is replacing assistant lockstep with 'merit-based pay' the solution?

Better than nothing but ...

Cannot remove seniority from the equation

- ✦ more experienced lawyers gain a higher market value over time

Fails to address relative profitability of practice area early enough

The Edwards Gibson Suggestion

- ✦ In the current market, the huge supply and demand imbalance at newly qualified level means there is clear opportunity for the London offices of most UK headquartered law firms to significantly reduce salaries for a large proportion of lawyers.
- ✦ The reductions need not be in all practice areas, for example, where competing in premium areas, lawyers would need to be paid on, or close to, 'market rate' to those in firms higher up the value proposition pyramid.
- ✦ Going forward, the newly qualified lawyers in non-premium practice areas should have re-calibrated salaries at a lower differential to those in premium practice areas.

In the short term this will not happen because:

- ✦ Fear of not getting the best trainees
- ✦ Concern c. £60,000 NQ rate is 'gold standard' for a serious City offering
- ✦ Differential pay risks 'two tier' lawyers and brand pollution
- ✦ Divisive impact on law firm culture at assistant level
- ✦ Fear of impact on the partnership
- ✦ Significant risk of being first mover

Conclusion

The failure to sufficiently differentially compensate lawyers according to *practice area* has resulted in the over compensation of lawyers in non-premium practice areas, making it harder for City law firms to economically compete.

Unless addressed, full-time lawyer jobs will continue to migrate out of City firms to in-house and other legal service providers.

Summary

- ◆ A poor economy since 2009 has meant far less premium work for City firms.
- ◆ The dramatic rise of in-house legal functions over the past decade has resulted in a loss to law firms of hundreds of millions of pounds of non-premium work.
- ◆ Increasing sophistication of in-house departments in a hi-tech and globally competitive world has enabled them to unbundle legal services and project manage tranches of work using a wider range of external legal providers. Less UK fee income has required that law firms reduce full time qualified lawyer personnel cost to maintain profitability.

- ◆ In spite of a strong supply of lawyers at the junior and senior level, the interconnection of law firm value propositions, together with the preservation of assistant lockstep has meant headline salaries at City law firms have remained **disproportionately high**, making it increasingly uneconomic for them to compete with in-house, and other legal service providers, for commoditised work resulting in:
 - An acceleration of non-premium work out of City-based law firms;
 - Fewer roles for full time qualified lawyers in top law firms in London;
 - A (likely) increase in non-permanent contract roles for lawyers.

- ◆ City law firms would be more competitive in relation to other legal service providers if their assistant lawyer compensation structures were amended to differentially compensate their individual lawyers by giving greater weight to practice area over experience and merit.
- ◆ There is currently considerable scope for City firms to reduce pay for newly qualified lawyers and recalibrate lawyer compensation more overtly with practice area but in the short term this will probably not happen.

Thank you for attending

Questions & Discussion