ARNOLD & PORTER LLP

Law Firm Economics 101

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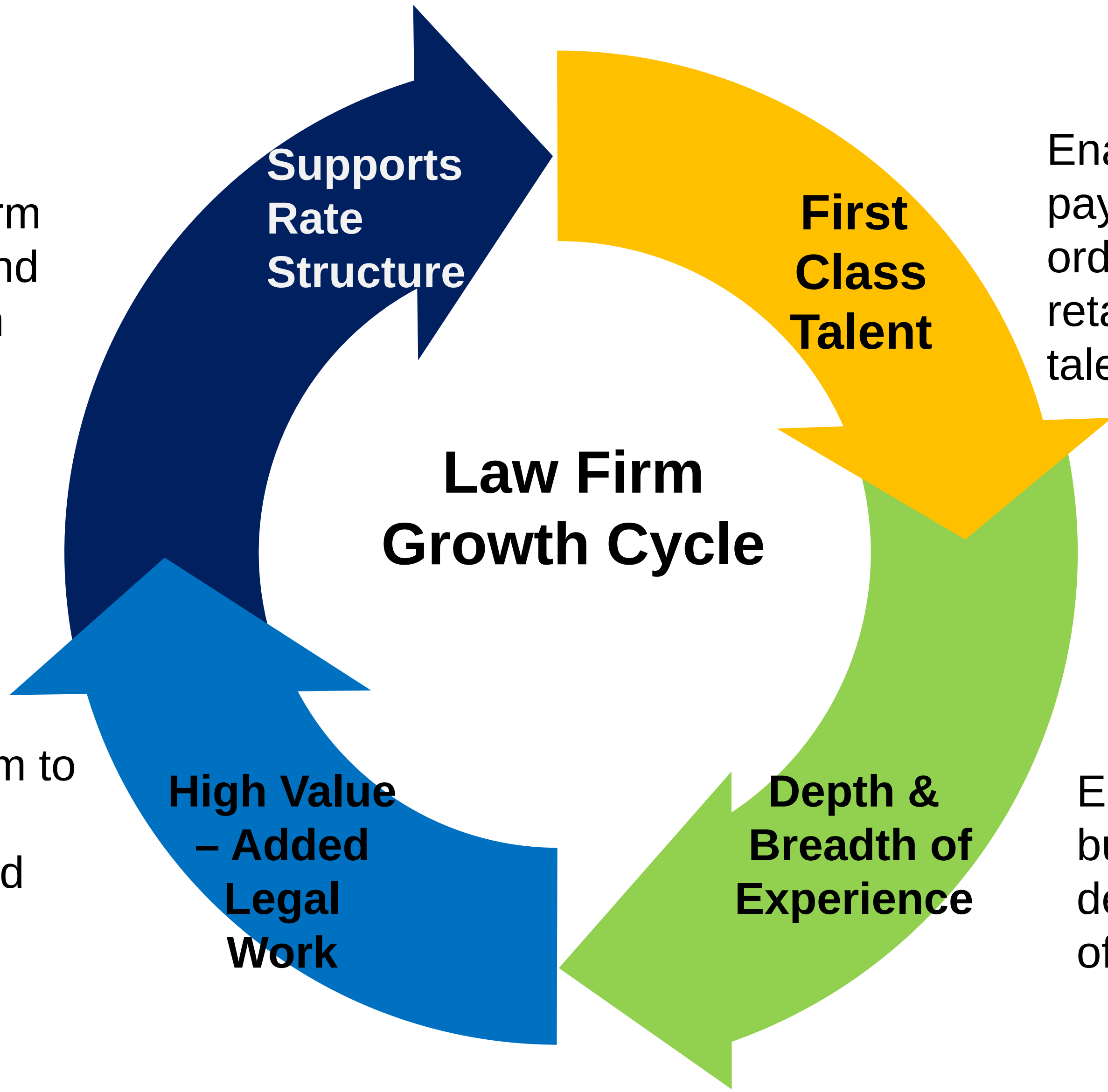
Good Economics Enables Law Firms

Enables firm to command a premium

Enables firm to pay top dollar in order to attract and retain first class talent



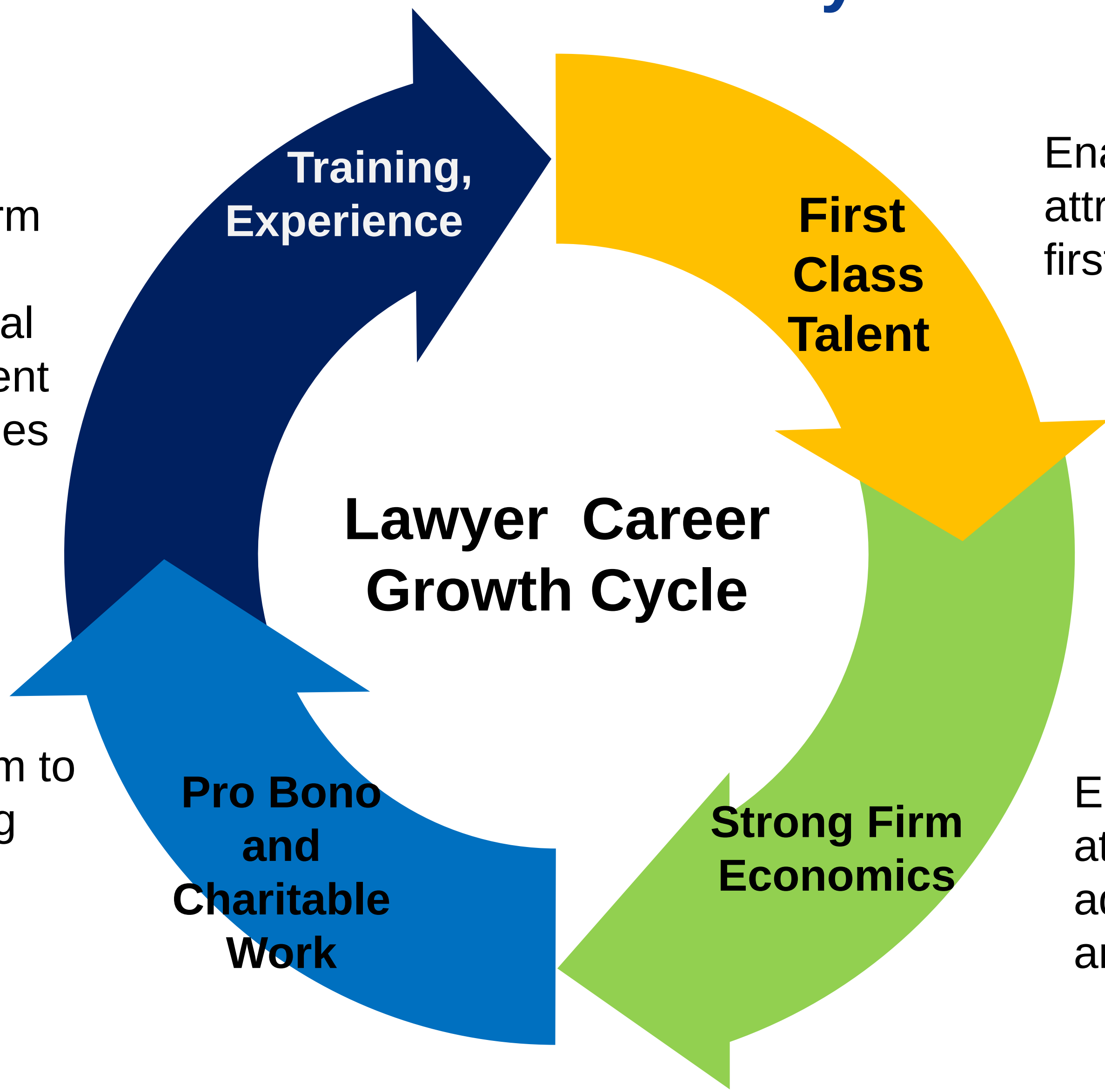
Enables firm to attract high value-added legal work

Enables firm to build and maintain depth and breadth of experience

Good Economics Enables Lawyers' Careers

Enables firm to attract and retain first class talent

Enables firm to provide professional development opportunities



Enables firm to play leading role in community

Enables firm to attract high value-added legal work and clientele

Topics

- How Firms Make Money
- Equity/Non-Equity Partners
- The Economics of Associates
- Risk Factors
- Trends
- Discussion

How Firms Make Money: Revenue

Revenue = Hours Billed

x Effective Rate After Discounts

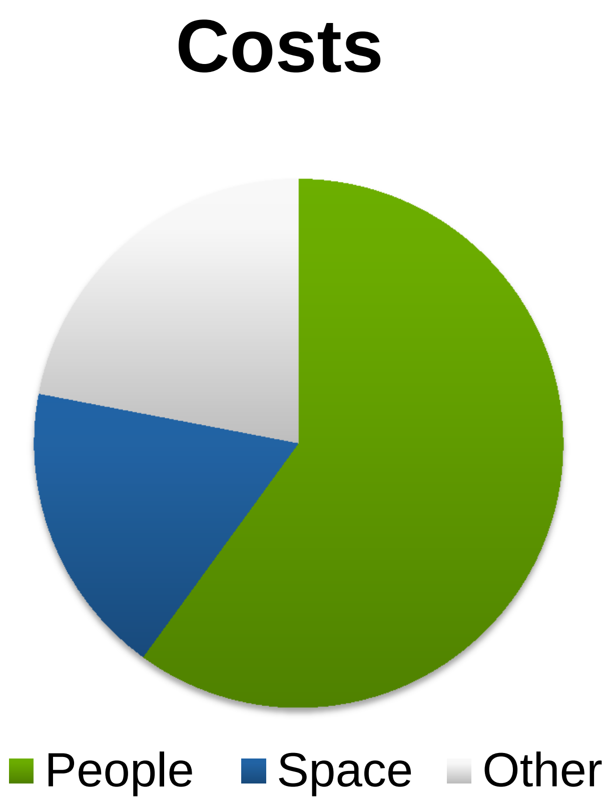
- Write-Offs

- Uncollectible Amounts

- **Alternative Billing is Growing Rapidly**
  - **Fixed fees (transactions, large portfolio of cases, retainers)**
  - **Blended rates for associates and partners**
  - **Contingency/ success fees/ attorney fee awards**

*****Usually measured against hourly rates x hours billed*****

How Firms Make Money: Costs



Real Estate (5-10 year horizon)

Technology (2 years)

Associate Comp (9-24 months)

Staff Comp (3-6 months)

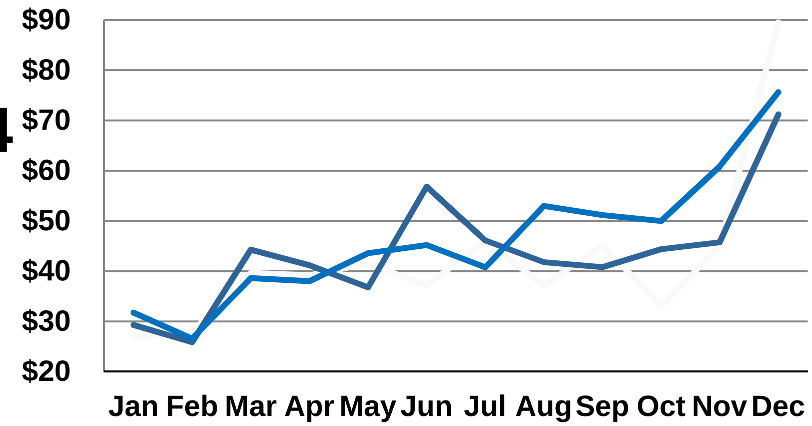
Debt service (1-20 years)

Marketing, Recruiting, Training, Charity, Bar Dues, Retreats, Library (immediate)

How Firms Make Money: Debt

- **Cash Flow is uneven**
  - **Lowest in Q1; highest in Q4**
  - **Attention to A/R is critical**
  - **Time saves clients money**
  - **While firm pays fixed costs**

The Collections Cycle



- **Capital obtained from equity partners**
- **Long-term debt**
  - **Usually for office expansions, IT, or real estate**
- **Revolving debt**
  - **For ups and downs in cash-flow**

Equity/Non-Equity Partners

- **AmLaw: Not about ownership**
  - **Equity Partner has >50% income variable**
  - **Non-Equity Partner has <50% income variable**
- **PPP = Profits/Equity Partner**
  - **Firms can "adjust" the number of equity partners to improve PPP**
- **Revenue per Lawyer (RPL)**
- **Profitability: PPP/RPL**

The Economics of Junior Associates

Expense:

Salary	$160,000**	Recruiting	$25,000
Benefits	52,800	Computers	5,000
Sec'y	30,000	Space	15,000
Training	40,000	**TOTAL:**	**$327,800**

Revenue: $325/hr x 80% realization = $260/hr

x 1200 hrs = $312,000

x 1500 hrs = $390,000

x 1800 hrs = $468,000

*** "BigLaw" Scale: $160K/ $170K/ $185K/ $210K/ $230K/ $265K*

Realization

- Billing Realization % = billable value of work (billable hours x *billed* rate) divided by standard value of work (billable hours x *standard* rate)

Example:

100 hours @ $500/hour	**$50,000**
Less:	
5% negotiated discount	**(2,500)**
5 hours written off (before billing)	**(2,500)**
Amount Billed	**$ 45,000**
Less:	
Client Disputes Bill	**(2,000)**
Amount Collected	**$ 43,000**

Billing Realization % = 45,000/50,000 or 90%

Collection Realization % = 43,000/45,000 or 96%

Overall Realization % = 43,000/50,000 or 86%

Risk Factors

- **Rainmaker departures**
  - Not always bad – depends on who is leaving and why
  - Larger firms usually can better withstand departures
  - Departing rainmakers leave money behind (A/R)
  - Can reach a tipping point
- **Failure to adjust**
  - Market changes, for example:
    - SF litigation firms used to get East Coast referrals
    - Employment counseling done in-house
  - Succession planning
    - Management/rainmakers aging
    - Clients merge; client contacts change

Risk Factors (continued)

- **Over-concentration of clients**
  - Percent of revenue from top 1, 2, 5, or 10 clients
  - Exposure to market/industry fluctuations
    - Tech bust of 2001
    - Capital markets bust of 2008
- **Mergers**
  - Can be distracting, sometimes forced
  - Can greatly strengthen firms
  - Some disruption from departures (desired vs. regretted)
- **Expansion**
  - High fixed costs -- hard to adjust quickly

Trends: Looking Backward

- **Law as a Business**
- **Billing rate increases**
- **Consolidation/mega-mergers**
- **International expansion**
- **Segmentation of firms**
  - **Geography**
  - **Billing rates**
- **Specialization of practice areas**
- **In-house legal departments**
  - **Concentrated number of firms (“convergence”)**
- **Increased spread in partner compensation**

Trends: Looking Forward

- **Billing rate pressures**
- **Alternative billing**
- **Outsourcing/contract lawyers**
- **Virtual firms**
- **Further specialization**
- **More senior lawyers not on partner track**
- **Decoupling associate compensation from seniority**
- **Less hiring; more retention**
- **Accounting firm/consulting firm models**
- **Associate involvement in business development**

Discussion