

Reach versus risk: why big law firms are split on the merits of going global

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In one of the midtown Manhattan high-rises that house the cream of the US legal profession, a combative senior partner seems uncharacteristically unsure when asked about the threat posed by his London-based rivals. While he thinks the British have failed to make the inroads into the New York market they desperately want, he acknowledges that their policy of aggressive international expansion elsewhere might just have a point.

"I am not sure I can tell you today in 2006 whether their [the British firms'] strategy is smarter or ours is," he says. "I can see some serious positives with what they do - but I can also see some serious negatives."

At the end of a year in which a thriving cross-border corporate take-over market has brought in fat fees from their biggest clients, the legal advisers themselves may soon face a moment of international make-or-break. A big strategic gamble is playing out in an industry that has traditionally been less corporate and less multinational than most. The critical question is: who has come up with the best plan to build a global law firm?

The answer matters not just to the lawyers but to the business clients they aim to cater to around the world. Underlying the question is whether companies will ultimately prefer to be served by one-stop-shop multinational law firms or by cherry-picking different legal practices in different countries. Leading US law firms harvest the world's largest legal market at home and plough cautiously elsewhere, while many of the biggest British-based firms have placed a huge bet on building extensive international networks and a global presence.

That comes at a time when the profession is enjoying near-universal commercial success. The strength of the world legal market was highlighted in a survey of the world's 50 biggest firms published in August by *Legal Business*, a London-based magazine, and including figures up to April. Average profits per equity partner, the benchmark figure commonly used for measuring law firm financial performance, rose 17 per cent after a year of heavy cross-border merger and acquisitions work. Anecdotal evidence suggests the market has remained just as good since then.

The rip-tide of profits has loosened tongues in a profession that has preferred to keep its financial affairs much more private than those of the listed companies it serves. It allows both the US and British firms the freedom to claim confidently that they have found the most successful plan to dominate. Any strategic flaws and hubris are hidden by what a partner at one leading US firm describes as a time of bonanza "in a way globally that it has never been before". "If you would like to prove any law firm model is a great model, you could use the last year," he says. "Who is not having a good time?"

Unlike the oligopolous, internationalised and US-dominated auditing industry, the corporate legal market still has a relatively large number of big firms and two distinctive and competing geographic power blocs. According to research published in October by *The Lawyer*, a UK trade journal, 75 of the 100 largest legal firms globally by revenue are from the US, compared with 17 from Britain and just eight from other countries. The US brings better profitability than Britain but the behemoth practices are mostly members of London's "magic circle" - Skadden, Arps, Slate, Meagher & Flom is the only US firm in the top four by revenue.

The British firms have grown by pioneering a controversial and still unproven strategy of international expansion and consolidation. In the 1990s, restless magic-circle firms whose home market was limited in size decided to move beyond their informal relationships with firms in other countries and either put in place formal partnerships or full mergers or opened their own offices. It is a drive that has continued, incorporating new markets as they emerge. Research published last month by PwC, the accounting firm, found that three-quarters of the top 25 British-based firms have at least one wholly-owned office in China, up from one-third in 2004.

Enthusiasts for this model of globalisation say it is the sensible response to British law firms' work becoming increasingly corporatised and cross-border. Reflecting trends long seen in the US, British lawyers have over the past decade taken on many of the roles of investment bankers in the day-to-day management of international takeovers and capital market transactions, while the banks move on to fresh deals. In a small but telling sign of British lawyers' greater prominence in executing transactions, one senior partner recalls how his firm has 50 meeting rooms in its new offices, compared with just two in its old premises. "Ten years ago you would never have a meeting with an investment bank in your own offices," he recalls. "You would spend your life in investment banks' offices."

This commercial evolution has been accompanied by British attempts to overcome potential obstacles to internationalisation, such as the sovereignty and diversity of national legal systems. English lawyers and the Law Society, their professional body, are keen to promote English law as a jurisdiction of choice for international business. In Britain's Commercial Court, eight out of 10 cases involve at least one foreign party, while in half of all cases both sides are from overseas.

At the same time, Britain's government and legal profession have begun an openly aggressive effort to persuade other countries to remove restrictions on how its lawyers can operate. The Department for Constitutional Affairs says it is lobbying 17 countries whose markets are not fully open, focusing particularly on India, China, Brazil, South Korea, South Africa and Malaysia. The results of this political push have so far been mixed and slow to come through. While the Law Society praised South Korea last month for taking steps towards deregulating its legal profession, the UK government complains that China has created a "number of new hurdles" for foreign law firms. These include imposing a long approval period for licences and increasing the number of areas reserved for Chinese lawyers.

Despite this bumpiness, the British firms say their strong financial results for the past year show their international strategy is sound. The biggest four magic-circle firms outperformed even the trend of globally rising profitability last year, according to Legal Business. The four were able to narrow the gap to their US counterparts a little, partly because of a wane in the "restructuring and litigation bonanza" enjoyed by US firms when the mergers and acquisitions market was leaner.

The US firms may continue to enjoy the huge in-built benefit of having many of the largest multinationals on the doorstep, but sceptics in the magic circle and elsewhere say their position may not be as secure as it first appears. One source of concern is that the Sarbanes-Oxley rules on financial disclosure will cause companies to list outside the US and thus buy legal expertise elsewhere. Another is that the cautious expansion strategy of many US firms in emerging markets could damage them if clients decide they want to deal with practices that have a strong presence on the ground.

In reply, leading US firms retort that the British internationalisation - including its aim of making more money through establishing the primacy of English law - is overplayed and outdated. US firms argue that they can keep their profitability high by working their home market, running offices in a few key foreign centres and building links with local firms in countries where they have no presence.

This cuts running costs and insulates US firms from the risk, as one partner puts it, of investing in a busy market only to find that "in six months the business activity drops down to zero and we have got 70 people on the ground with nothing to do". The profession is particularly wary after its experience in Russia, the target of one of its limited international forays: the 1998 financial crisis burnt many US firms that were operating in Moscow.

At a higher strategic level, some US lawyers argue there is no need for firms to follow the accountants' model of moving into all the countries where clients operate. Unlike auditors, lawyers are not compelled to sign off on a multinational's accounts. Some British lawyers agree: the London-based Slaughter and May has remained one of the highest-profile and most

successful firms while mostly shunning international expansion in favour of establishing a network of "best friend" firms in economically significant countries.

Nor do many clients seem particularly bothered about whether or not their firm has operations across the world. A survey of 300 companies published in September by Legal Week, a London-based magazine, found "international capability" was ranked bottom out of 11 features that respondents were looking for in a law firm. Use of information technology, billing transparency and the personal involvement of partners in assignments were all thought more important.

The US firms can also cite evidence that, for British firms, overseas markets still remain significantly less profitable than their domestic work, despite improvements. The PwC research published last month showed that western Europe was easily the most profitable region for the top 25 British-based firms in the past year (30 per cent) - far ahead of Asia (21 per cent), eastern Europe (20 per cent), North America (19 per cent) and South America (13 per cent).

"For the big Wall Street beasts, even China is simply not remunerative enough," says Catrin Griffiths, editor of *The Lawyer*. "They would have to change their entire business model - and go for high returns on relatively short-term investment."

This is one reason why the US itself has become a key battleground. American lawyers say some of the big British firms are on the prowl almost permanently - if mostly fruitlessly - for merger partners that will give them the bigger toehold they want. Contrast that with the partner at one of the biggest US law firms who says of mergers: "That's not our way. We have never merged, we have never acquired and we are never going to." Other US firms are less trenchant - but few combine with anyone except each other.

Senior British lawyers at the big firms acknowledge the difficulties in doing the US deal that some think they need. David Morley, managing partner of Allen & Overy, says his firm has stepped up its contacts with US lawyers as part of a long-standing expansion plan, although it appreciates the pool of willing candidates is small. "We have always had a merger as a possible option," he says. "But at the same time, there aren't that many firms who would be interested in the kind of merger we want."

The London-based firms are moving carefully in part because of the culture-clash difficulties experienced by Clifford Chance after its turbulent 2000 merger with the New York-based Rogers & Wells. A string of big-name R&W partners quit, with many observers saying Clifford Chance had failed to impose a coherent strategy and address complaints. Craig Medwick, the Americas regional managing partner at Clifford Chance, admits the firm made mistakes, such as failing to pay enough attention to compensation and management structures.

But Mr Medwick says the firm has learnt from these errors and is now a real rival to the big US practices. "They are seeing the competition," he says. "They are concerned about it; their clients are intrigued by it."

US firms take a contrary view. No London-based firm has made significant inroads into the New York corporate market, says one senior partner at a US-based firm, adding emphatically: "And they know it." John Madden, co-managing partner of Shearman & Sterling, notes more emolliently that the British firms' aggressive international expansion has had "good and successful" results in some places, but the US has remained "more challenging".

Behind the transatlantic sniping, a fair bit of judicious hedging of positions is being done on each side. Some US firms - such as White & Case, which does a lot of cross-border dispute resolution work - have established significant international networks. On the British side, many have become more cautious and selective about where they maintain overseas offices.

Another area of slow transatlantic convergence is partner compensation, which has been cited as a reason why US firms are more profitable and thus often reluctant to merge with British-based firms. Increasingly, firms on both sides of the Atlantic use hybrids combining the magic

circle's "lockstep" model of rewarding partners according to experience and the "eat what you kill" performance-related pay traditionally favoured by US firms. As a lawyer at one of the most aggressive US firms admits: "Our [reward] system is a lot more static than we make it out to be."

It will probably take a future shock - a downturn in business, a regional economic crisis or even an industry-shaking scandal similar to that suffered by auditing after the collapse of Arthur Andersen - to reveal the impact of law firms' strategic differences. Lawyers are more likely to be exposed in the next round of corporate collapses if - sometimes under contracts that stipulate unlimited liability - they are indeed doing more varied jobs in more places with more people. That, say some, could be the prelude to the profession's first international shake-out.

Top 10 law firms						
By gross revenue	Gross revenue (2006) \$ million	% change on last year	By profits per equity partner		By number of lawyers	
				Profits per equity partner (\$m)	Number of lawyers	Countries in which firm has offices
Clifford Chance International (UK)	1,875	11.9	Wachtell, Lipton, Rosen & Katz (US)	3.79	Baker & McKenzie International (US)	2,975 38
Linklaters International (UK)	1,702	15.4	Cravath, Swaine & Moore (US)	2.60	Clifford Chance International (UK)	2,432 19
Skadden, Arps, Slate, Meagher & Flom (US)	1,610	11.8	Cadwalader, Wickersham & Taft (US)	2.54	Jones Day National (US)	2,178 14
Freshfields Bruckhaus Deringer International (UK)	1,605	12.3	Paul, Weiss, Rifkind, Wharton & Garrison (US)	2.47	Linklaters International (UK)	2,072 23
Latham & Watkins National (US)	1,412	17.1	Sullivan & Cromwell (US)	2.41	Freshfields Bruckhaus Deringer International (UK)	2,013 18
Baker & McKenzie International (US)	1,352	10.1	Simpson Thacher & Bartlett (US)	2.37	White & Case International (US)	1,783 24
Allen & Overy International (UK)	1,340	9.7	Kirkland & Ellis (US)	2.12	Allen & Overy International (UK)	1,760 19
Jones Day National (US)	1,285	8.0	Slaughter and May (UK)	2.04	Skadden, Arps, Slate, Meagher & Flom (US)	1,699 12
Sidley Austin National (US)	1,124	9.2	Mitbank, Tweed, Hadley & McCloy (US)	2.02	Latham & Watkins National (US)	1,668 10
White & Case International (US)	1,046	9.8	Davis Polk & Wardwell (US)	2.00	DLA Piper Europe1* National (UK)	1,573 21

Sources: *The Lawyer*; *The American Lawyer* * DLA Piper and DLA Piper Europe are treated as separate entities
 FT montage: Chris Walker

Fonte: Financial Times, London, dec 14 2006. Comment & Analysis, p. 13.