

The Real Enron Threat: Not that it matters, but the Big Five's exit from the consulting business won't change the MDP landscape.

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1. Does the Enron-Arthur Andersen scandal mean that large law firms can stop worrying about competition from the Big Five's multidisciplinary practices?

Yes, no, and you're missing the point. Yes, because Enron will likely push the Big Five out of consulting. As of this writing, all appear to be ready to divest themselves of their consulting practices. And no, because once they are spun off, those jumbo-size consulting practices will continue to compete with law firms around the world just as they did when they were housed in Big Five firms. Puritanical naysayers at the American Bar Association will bark that the Enron scandal shows that MDPs breed conflicted loyalties, which they do. But Big Five MDPs were created to meet market demand and they grew for the same reason. The hard truth for the puritans is that the separation of auditing and consulting functions into two separately owned entities—whether as a result of regulation, edicts from Paul Volcker, or sensitivity to momentary concerns about auditor independence—will not make client demand or the consulting practice disappear. The consultants will live on and continue to compete with law firms for a greater share of clients' legal dollars.

Law firms never were competing with the auditing units of the Big Five—witness Vinson& Elkins's apt disclaimer that it never did, never should have, and never would have opined on accounting principles or accounting treatment of the transactions it reviewed; For lawyers, though new evidence always delays a verdict, and this will be no exception. Predictably, Enron will further slow the ABA in its efforts to decide whether lawyers should be allowed to practice in MDPs. And that brings me to why the widespread fear of MDPs misses the point: the best law firms already are MDPs. They provide many services for which a law license is not required, not the least of which is a broad swath of business counseling services. Issues involving the structure that law firms will use to compete with the consultants and how broadly law firms will define the turf on which they compete will likely be sorted out long before the ABA pulls its head out of the sand and drops its current definition of legal practice as anything that lawyers do in a law firm. When law

firms choose to compete for consulting work, they will, I hope, learn the lessons of Arthur Anderson's failure with Enron. Surely, as practitioners of a learned profession, lawyers can accomplish at least that much.

2. We are looking for a way to evaluate lateral acquisitions at the practice group and office levels that goes beyond simple revenue growth but doesn't spark a war over cost allocation. Any ideas?

Too many firms have learned the hard way that simply turning practice groups and offices loose after giving them a mandate to increase gross revenue often results in proposals to add laterals whose practices are only marginally profitable. Looking at the impact that a prospective partner's practice will have on the revenue per equity partner of the acquiring practice or office is a better way to focus on the lateral's leverage and contribution to earnings. (Don't use the entire firm's revenue per equity partner for this purpose, since all large firms have a mixed bag of contributors among their practices and offices.)

I am not saying that laterals who would dilute partner's earnings should never be brought on board. But I do say that a lateral must offer a compelling strategic advantage to the acquiring firm. Let's consider an extreme case—that of partner-level lateral who has no book of business, typically a lawyer coming out of government or in-house practice. To be a worthy investment, such a lawyer must offer extraordinary prestige or "door-opening" opportunities that can quickly generate high-profit revenue for the firm's high-margin practices. Compensation for such a lateral should be tied to clearly articulated measurements of financial success. Goals based on those measurements should be established, and the firm's long-term commitment to the lateral should be contingent upon the lateral's progress in meeting them. Only on rare occasions will a "no book" lateral have the market clout needed to command a no-strings offer.

I take an equally tough line on prospective lateral whose books of business underperform the acquirer's revenue per equity lawyer. There are only a few situations in which such a lateral should be acquired. One is when the lateral fills a vital need for an important, highly profitable, existing client—a need that if left unmet could result in the loss of the client. Another circumstance is when the lateral comes from a weak or underperforming firm, and the firm's problems are severe enough to drag down the lateral's performance. Like the no-book laterals, underperformers rarely have the market power to command noncontingent partnership and compensation commitments from acquiring firms and thus should seldom get them.

3. Everyone knows that profitability took a big hit at Silicon Valley firms last year. Are there any signs of life yet?

Ah, the bigger they are, the harder they fall. This year, the difference in the performance of firms will likely depend on a number of factors. Most important will be the ability of their emerging-company lawyers to reinvent themselves as Old Economy corporate practitioners. Leading the charge is Wilson Sonsini Goodrich & Rosati, whose leader, Larry Sonsini, has proven to have big horns as Valley firms butt heads over a shrinking

watering hole. In the first quarter of 2002, Wilson Sonsini was said by its competitors to have more than 10 percent of its lawyers working on the contentious merger of Hewlett-Packard Company and Compaq Computer Corp. Although HP had claimed a preliminary victory after the proxy vote on the combination, the official result wasn't known at press time, and really, it doesn't matter. No matter who wins, the deal will probably continue producing non-price sensitive, bet-the-company legal work for years, including litigation over the contested outcome. Wilson Sonsini lawyers should kneel and face south towards Hewlett-Packard's headquarters across Page Mill Road every afternoon at four, in prayerful thanks to HP chief executive officer, Carleton Fiorina. Other erstwhile dot-com monster firms like Cooley Godward and Brobeck, Phleger & Harrison are pursuing similar strategies and at the same time looking to beef-up what were already very credible big-case litigation practices.

McKinsey & Co. reported last year that the legal profession was entering an era of unprecedented cherry-picking. While this observation from the preeminent consulting firm was not exactly a 9.0 jolt on the Richter scale, the fever has spread to the previously untouchable Valley leaders. All of them are leaking talented lawyers to relative latecomers to the Valley. In what amounts to a revenge on the nerds, Old Economy powerhouses like Davis Polk & Wardwell and Lathan & Watkins are luring some impressive New Economy partners. This will likely accelerate throughout the year, as the recovery in the overall economy proves to be slow and dreary. Several constellations of partners, associates and attendant prestigious clients will likely break off from big Valley players by the end of the year, resulting in a significant reshuffling of the deck among the major players there.

Valley firms will benefit in 2002 from last year's associate layoffs and from their continued ushering of people out the back door, as Wilson Sonsini did last year. Lay-offs, no longer make big news, at least when they come in dribbles—a fact that will encourage further trimming. One big firm insider reports that even people inside those firms are confused about whether the departures are prompted by poor performance or lack of work.

The wild card in this year's numbers is the extent to which some of the big Valley firms cooked 2002's numbers by deferring last year's November and December's receivables into this year and backloading expenses into 2001. Those actions could level out the firm's 2002 performance and, if things go a little better than expected, produce a sharp upturn in profitability in 2002. Do partners mind? Not in the least. Those firms used what everybody knew would be a weak year to generate an unexpected tax break for partners—a silver lining for what was otherwise a cloudy year.