2012 CLIENT ADVISORY

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The Hildebrandt Institute and Citi Private Bank are pleased to present this 2012 Client Advisory highlighting the trends that we perceived in the legal market in 2011, as well as the factors that we believe will impact the market in 2012[1].

[1] The Hildebrandt Institute and Citi Private Bank gratefully acknowledge the participation of the following persons in the preparation of this Client Advisory: James Jones, Senior Fellow at the Center for the Study of the Legal Profession, Georgetown University Law Center; Dan DiPietro, Chairman of the Citi Private Bank Law Firm Group; Gretta Rusanow, Director and Senior Client Advisor of the Citi Private Bank Law Firm Group; and Brad Hildebrandt, Founder, Hildebrandt Consulting.

"Well, it's one foot on the platform and the other on the train . . ."

"The House of the Rising Sun"
American Folk Song

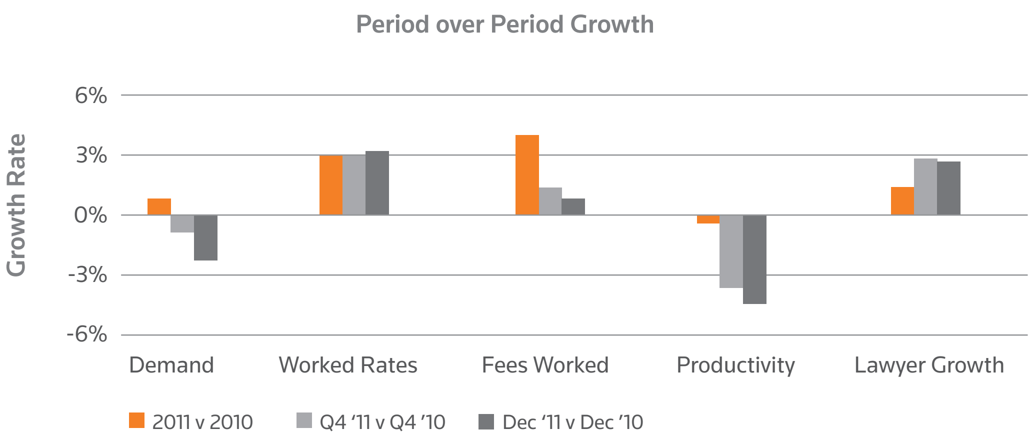
As the legal market continues in its fourth year of the economic malaise that began in mid-2008, it unfortunately remains true that the best way to describe the overall economic prospects of the industry — at least in the near term — is "uncertain." As a result, many law firms find themselves, like the traveler in the folk song, with "one foot on the platform and the other on the train," uncertain about which way to jump to best position themselves for long-term success and unclear about when the train will pull out of the station, at what speed, or on which track. This reality poses significant challenges for law firm leaders as they seek to manage their firms' economic performance and the expectations of their partners.

Where We Are

The legal market ended 2011 with a fairly sluggish overall performance and with mounting pressures on law firm profitability. Although showing signs of recovery during the first half of the year, growth in demand for legal services[2] slowed markedly in the second half of 2011, particularly in corporate and transactional practices. As shown in Chart 1 below, Thomson Reuters Peer Monitor data[3] indicate that the industry ended the year with only modest overall demand growth as compared to 2010, a fact that contributed to slightly negative growth in productivity for the year.

CHART 1

Key Performance Measures: All Firms



Source: Thomson Reuters Peer Monitor

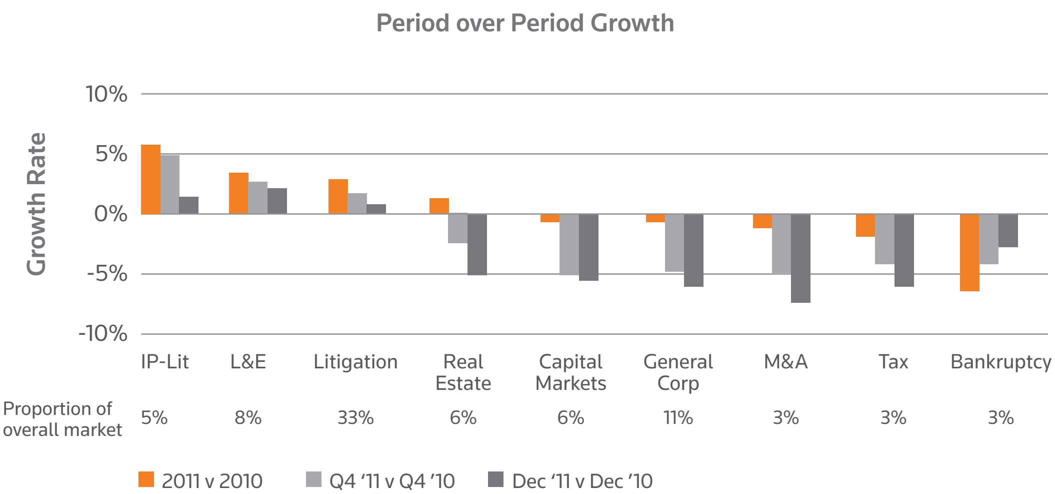
[2] For these purposes, "demand" for legal services is viewed (both in Citi data and Peer Monitor data, as defined below) as equivalent to total billable hours recorded by firms included in a particular data base.

[3] Thomson Reuters Peer Monitor data ("Peer Monitor data") are based on reported results from 116 law firms including 45 Am Law 100 firms, 41 Am Law 2nd 100 firms, and 30 additional firms.

As shown in Chart 2 below, there was essentially flat demand growth in 2011 in M&A and general corporate practices, with sharper declines in demand for capital markets, tax, and bankruptcy work. Only labor and employment, litigation, IP litigation, and (interestingly) real estate practices showed positive demand growth in 2011.

CHART 2

Demand Growth by Practice: All Firms



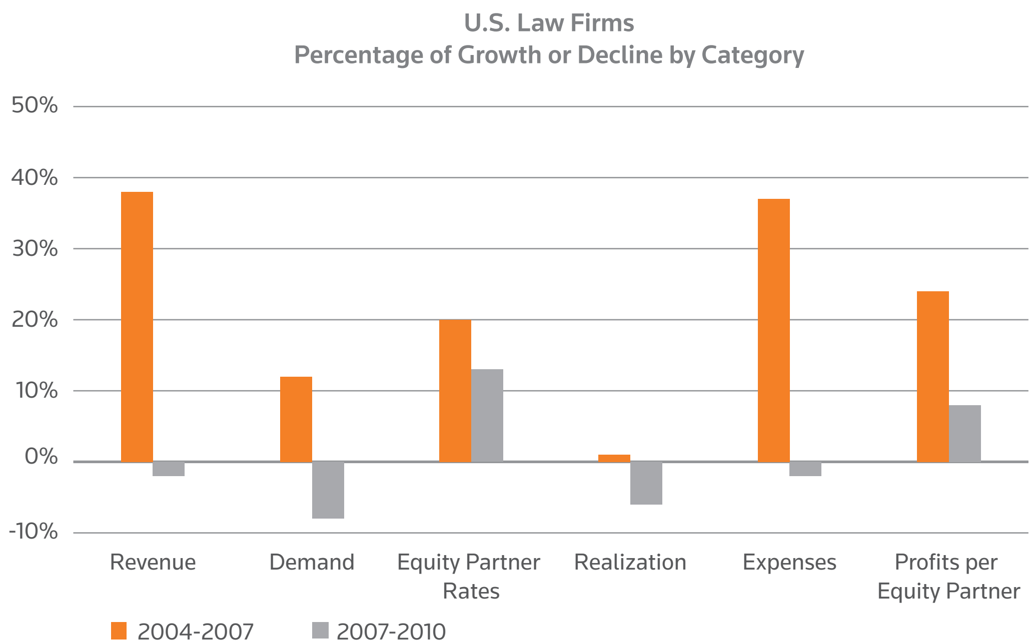
Source: Thomson Reuters Peer Monitor

Unfortunately, the economic performance of the industry in 2011 — with average growth in profits per equity partner ("PPEP") in the low single digits (as predicted in our Client Advisory last year) — was not able to redress the significant declines experienced in all key financial indicators during the first three years of the economic downturn. Those declines are starkly shown in Charts 3 and 4 below, drawn from comparative data assembled by the Citi Private Bank.[4] The charts compare the cumulative performance of the legal market during the three-year period 2004-2007 (*i.e.*, the three years prior to the downturn) with the cumulative performance in the three-year period 2007-2010. As can be seen, performance declined for all key indicators, with particularly stark declines in revenue, demand, and PPEP.

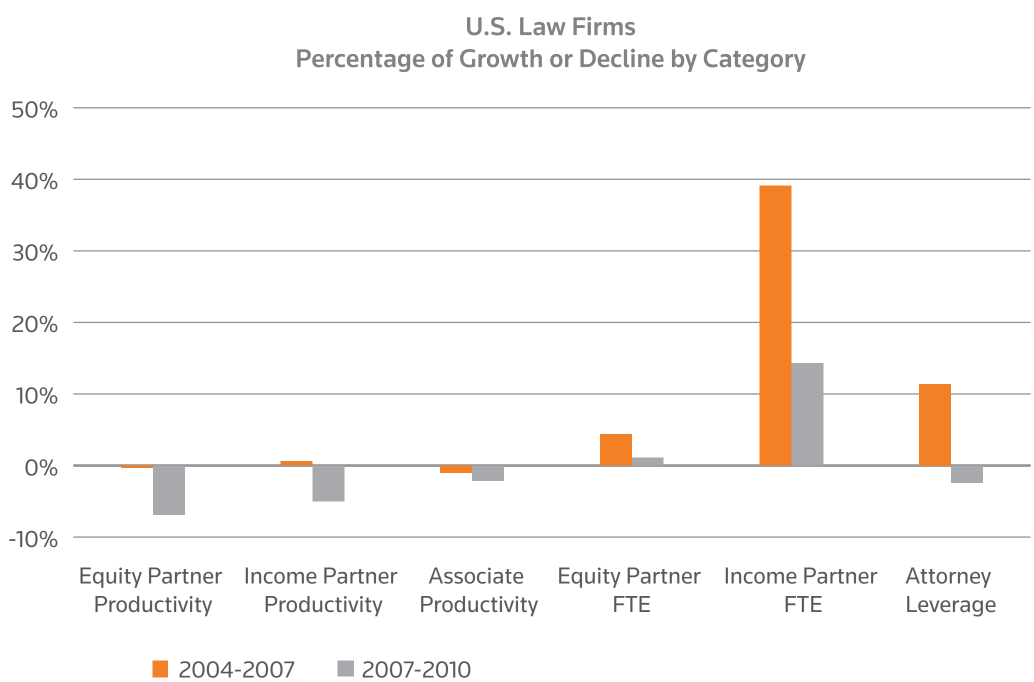
[4] Citi Private Bank Law Firm Group data ("Citi data") are based on reported results from some 205 US headquartered firms. The sample includes 89 Am Law 100 firms, 54 Am Law 2nd 100 firms, and 62 additional firms.

CHARTS 3 AND 4

Impact of the Market Downturn



Source: Citi Private Bank *Law Watch*



Source: Citi Private Bank *Law Watch*

In the fourth quarter of 2010, when the demand growth for legal services turned positive for the first time in seven straight quarters, it appeared that the economic downturn may have run its course and that the industry would begin a steady if gradual recovery. That optimism persisted through the first half of 2011, when demand growth continued across most practices, but was tempered considerably in the second half of the year as demand for corporate and transactional services declined significantly. Despite this latter softening in the market, we did end the year with demand growth still in slightly positive territory (primarily as a result of the strong demand growth in the first half of the year). It seems premature, however, to say that the market has stabilized. Moreover, even if stabilization has occurred, it is still at a significantly lower level than in the pre-recessionary period. Since it is unlikely, based on overall economic conditions, that the demand for legal services will grow robustly for the foreseeable future, the legal industry will be forced to live with uncertainty for some time to come. As described below, that uncertainty will be exacerbated by both constrained growth in revenues and rising expenses. And that, as noted above, will pose significant challenges for many law firm leaders.

Looking Ahead

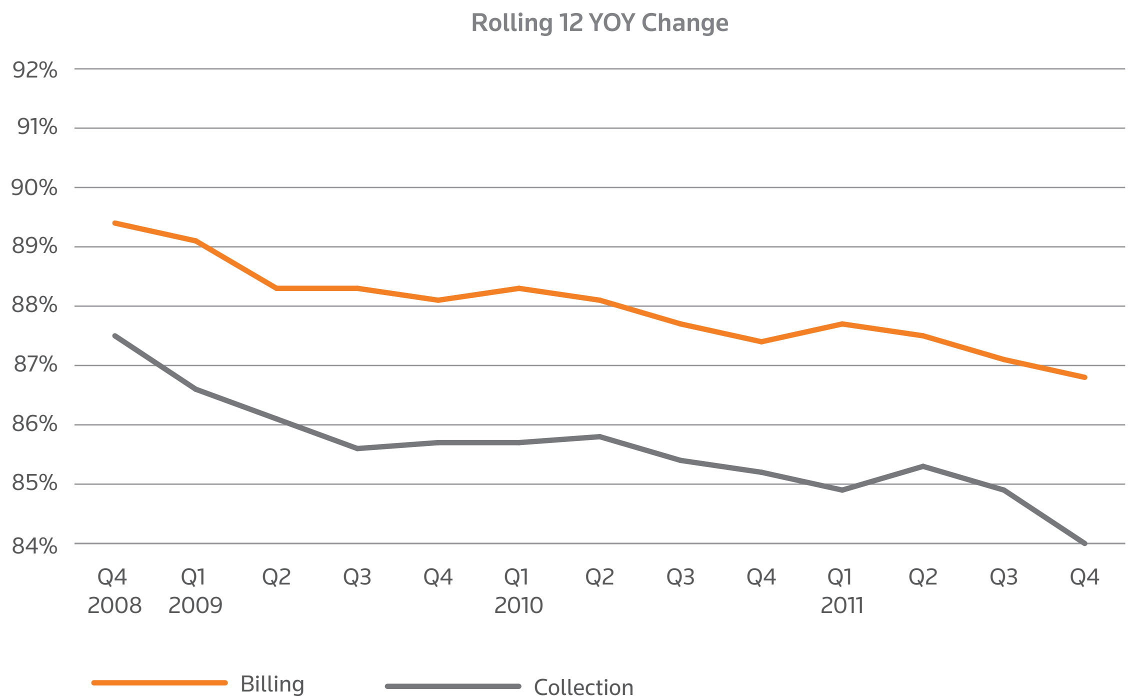
Continued sluggishness in demand growth in much of the world will exacerbate the ongoing struggle in many firms to maintain profitability at acceptable levels.[5] This is particularly true given other economic factors that are also at work in the current market: continuing client resistance to fee increases, growing levels of direct and indirect expenses, and the increasing cost of maintaining leverage.

5 This may be less true in Asia and in emerging markets in other parts of the world, as described in more detail in the section on "Growing Impacts of Globalization" below.

As to fees, while firms have continued to increase rates (albeit at a more modest pace than before the recession), clients have continued to push back strongly with demands for discounts and other forms of concessions. This is reflected in a realization rate that declined sharply at the end of 2008 and again in 2009, stayed relatively flat in 2010 and early 2011, but evidenced further deterioration in the second half of 2011. As shown in Chart 5 below, the average collected realization rate against standard[6] for the firms covered in the Peer Monitor database, has fallen from 89 percent in October 2008 to less than 84 percent at the end of 2011. While there is considerable variation in realization rates among individual firms and while some firms with effective pricing policies have achieved much better results, the industry as a whole is operating well below historic levels in terms of realization.

CHART 5

Collected Realization Rate against Standard: All Firms



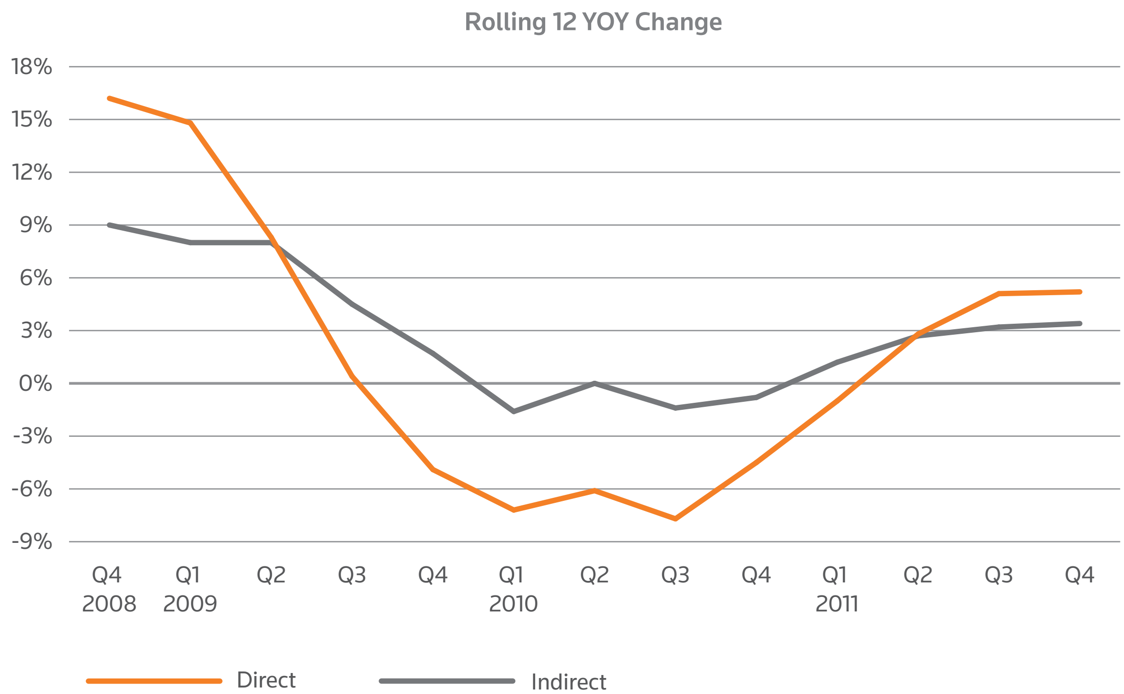
Source: Thomson Reuters Peer Monitor

[6] Collected realization rate against standard refers to that percentage of work performed at a firm's standard rates that is actually billed to and collected from clients.

At the same time that profit margins have been squeezed by client resistance to fee increases, firms have also experienced an increase in expenses. While almost all firms cut expenses dramatically in 2009 and 2010 — in large measure by reducing headcount in both professional and administrative ranks — we have seen expenses creeping up again since mid-2010. This is really not surprising since major layoffs cannot easily be repeated and other expense "cuts" were often deferrals of expenditures rather than eliminations of particular activities. Nonetheless, as shown in Chart 6 below, in the past year expenses — in both direct and indirect categories[7] — have begun to grow.

CHART 6

Expense Growth: All Firms



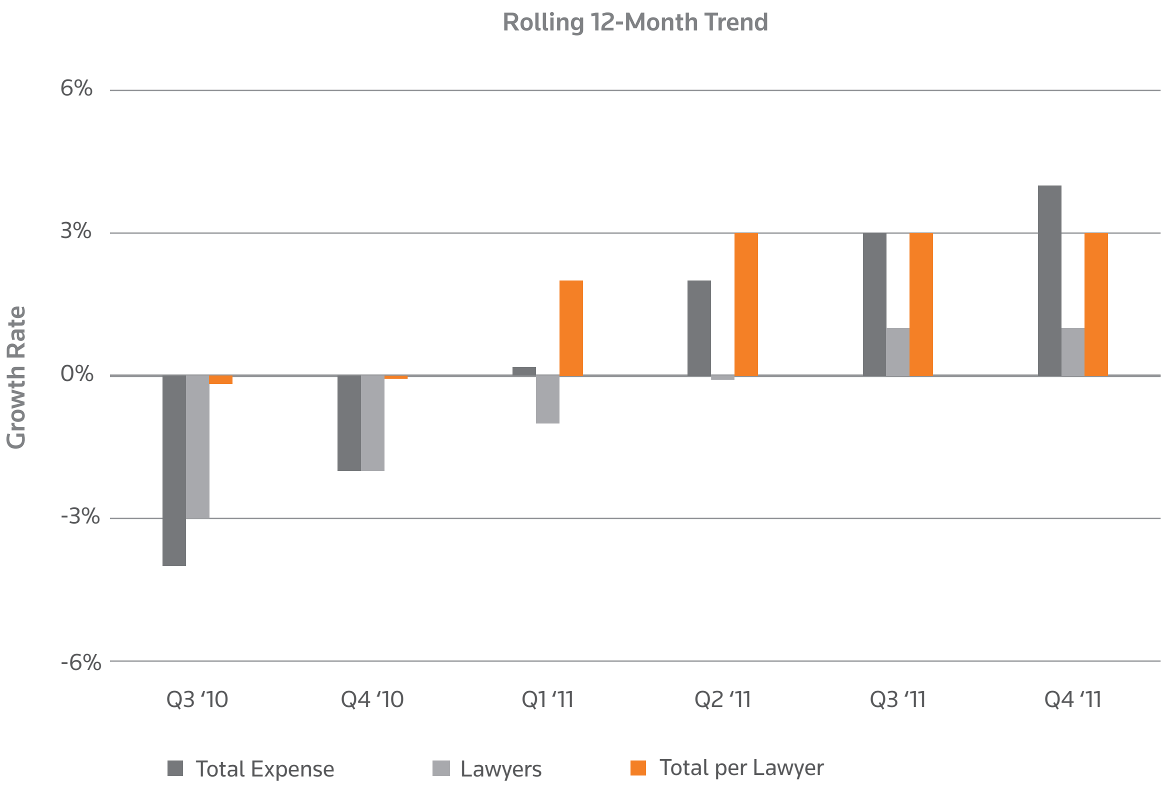
Source: Thomson Reuters Peer Monitor

[7] Direct expenses refer to those expenses related to fee earners (primarily the compensation and benefits costs of lawyers and other timekeepers). Indirect expenses refer to all other expenses of the firm (including occupancy costs, technology, administrative staff, etc.).

Moreover, as reflected in Chart 7 below, expenses have grown not just in relative dollar terms but also on a per-lawyer basis.

CHART 7

Total Expense Growth by Lawyer: All Firms



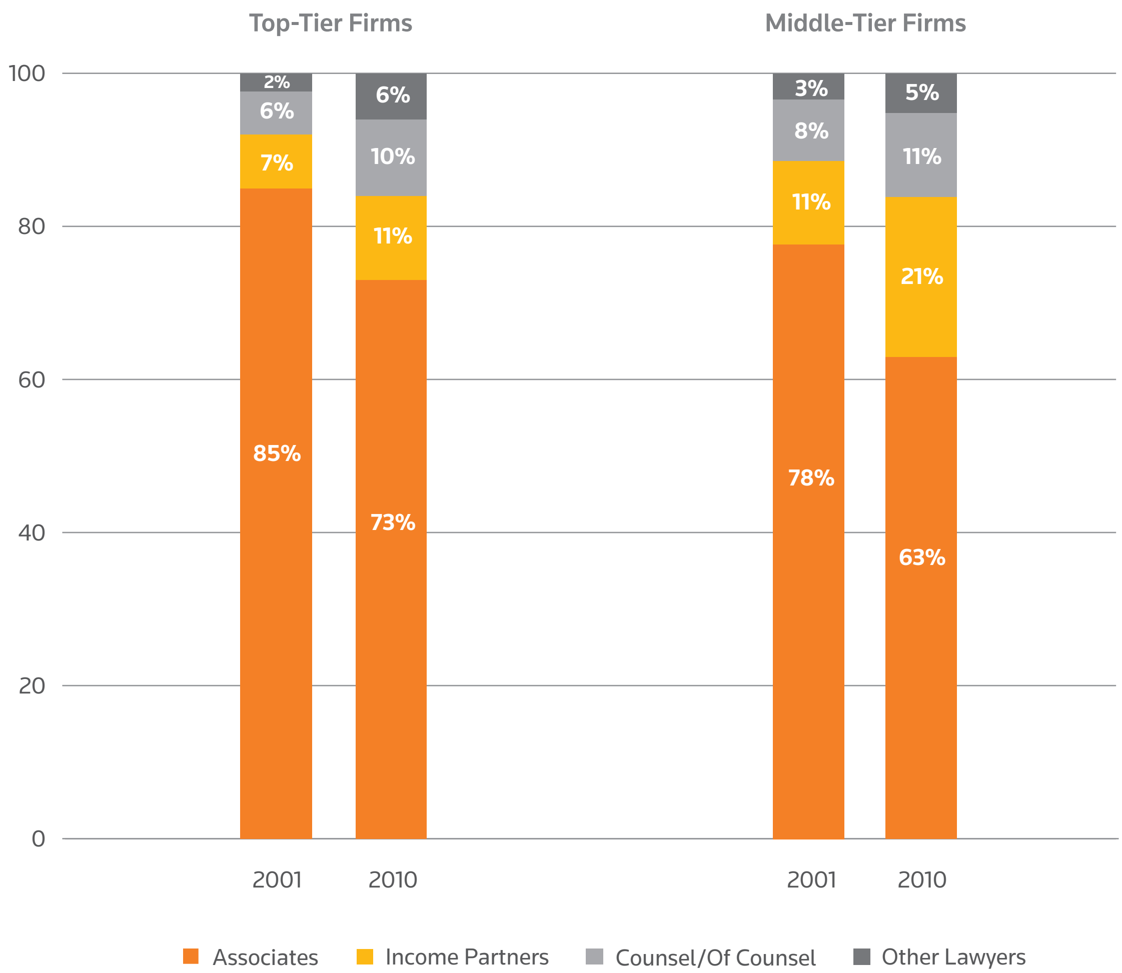
Source: Thomson Reuters Peer Monitor

One factor contributing to the growth in direct expenses has been the increasing unit cost of leverage in many firms. This has been driven in large measure by extensive layoffs of associates in 2008 and 2009 and exacerbated in many firms by increases in the number of income partners (sometimes as a result of so-called "de-equitizations"). As shown in Chart 8 below, the percentage of non-equity partner lawyers in top-tier firms[8] accounted for by associates dropped from 85 percent in 2001 to 73 percent in 2010. Among middle-tier firms, the decline was even more stark — dropping from 78 to 63 percent in the same time period. The increasing percentages of non-equity partner lawyers attributable to generally more senior income partners and counsel/of counsel have resulted in an overall increase in compensation costs to firms across the market.

[8] The Citi Private Bank Top Tier and Middle Tier Law Firm Analysis is an analysis of the most profitable law firms in the Citi Private Bank *Law Watch* database in both 2001 and 2010, categorized as either "top tier firms" (53 firms) or "middle tier firms" (47 firms).

CHART 8

Leverage Composition of Top- and Middle-Tier Firms

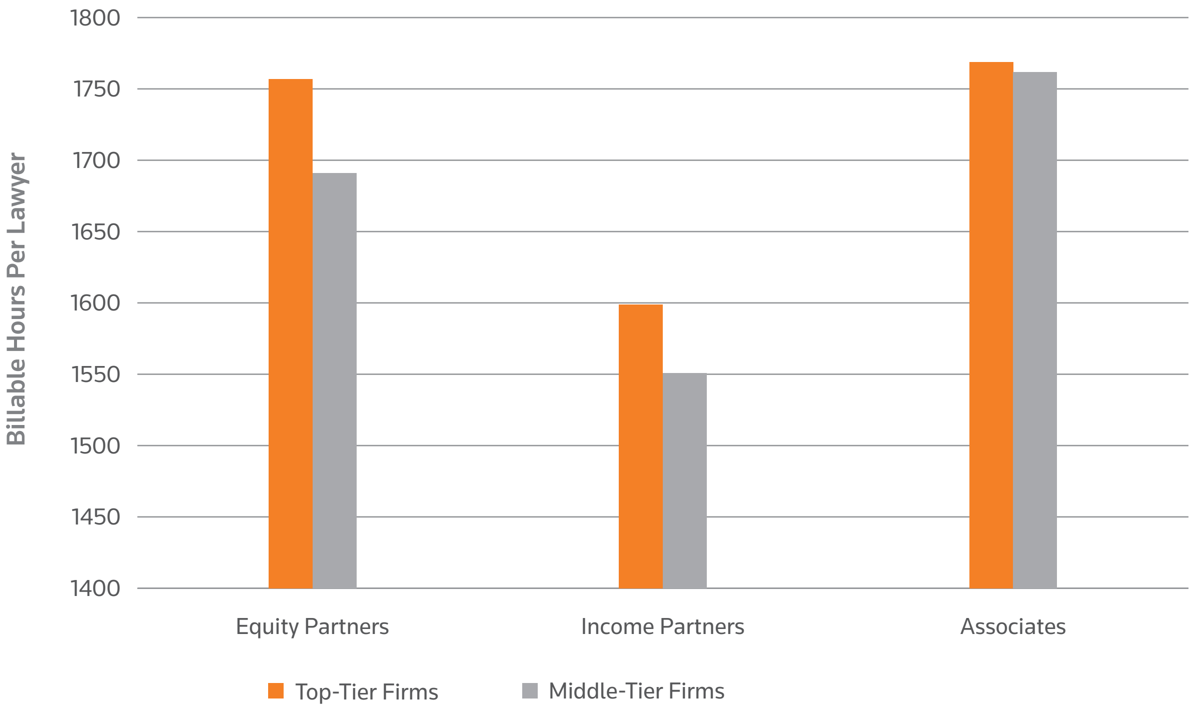


Source: Citi Private Bank Top Tier and Middle Tier Law Firm Analysis

Of course, the costs associated with this more top-heavy leverage would not be particularly detrimental if they were offset by more productivity and greater revenues. Unfortunately, that has not been the case. As shown in Chart 9 below, productivity levels of income partners (the largest category of non-associates in the new leverage models) have consistently been well below that of equity partners and associates for the past decade — indeed, about 150 hours per year below.

CHART 9

Average Annual Productivity by Timekeeper (2001-2010)



Source: Citi Private Bank Top Tier and Middle Tier Law Firm Analysis

All of these factors — combined with the continued slow pace of demand growth — have created an environment in which many firms will need to work harder to maintain profitability at levels that meet the expectations of their partners. Indeed, we expect that 2012 may prove to be even more challenging than 2009 in terms of profitability across the industry, not because revenues will be as depressed as in 2009 but rather because of the combination of slow revenue growth and rising expenses. Overall, we expect that profitability will increase only modestly at low single-digit rates in 2012. There will, of course, be variations depending on locations, practices, and client mix, and clearly certain firms will find ways to continue to grow even in this challenging climate. On the whole, however, we expect that the legal industry will experience only modest gains in the current year.

Trends to Watch

Driven in part by the market forces described above, some firms have begun re-thinking their traditional models for delivering legal services and have launched innovative initiatives to better position themselves in the market both now and in the future. Some of these efforts, as well as other trends that we believe bear watching in the coming year, are set out below.

New Approaches to Expense Management. The pressures on law firm profitability in a slow growth market (including the recent rise in both direct and indirect expenses across the industry) have led a growing number of firms to move parts of their support and other functions to lower cost locations. Following the earlier examples of Orrick (in Wheeling), Clifford Chance (in India), and Baker & McKenzie and White & Case (in Manila), we have seen WilmerHale opening facilities in Dayton, Pillsbury opening in Nashville, and Allen & Overy and Herbert Smith both opening and expanding facilities in Belfast. Typically, these "remote" operations begin as centers for back office administrative and support functions that do not need to be physically located in a firm's main office, but they often quickly grow to include a wide variety of other activities, sometimes including litigation support, basic document drafting, and some legal research. It is interesting that WilmerHale, in announcing its recent move in Dayton, specifically referenced its intent to hire local lawyers to bolster its research capacity in the new location.

We believe that these efforts to control expenses by relocating certain activities to lower cost locations make good sense and that we will see additional firms adopting this strategy in the months and years ahead. We also believe that firms will continue to experiment with outsourcing of various functions, including some traditionally handled only in-house.

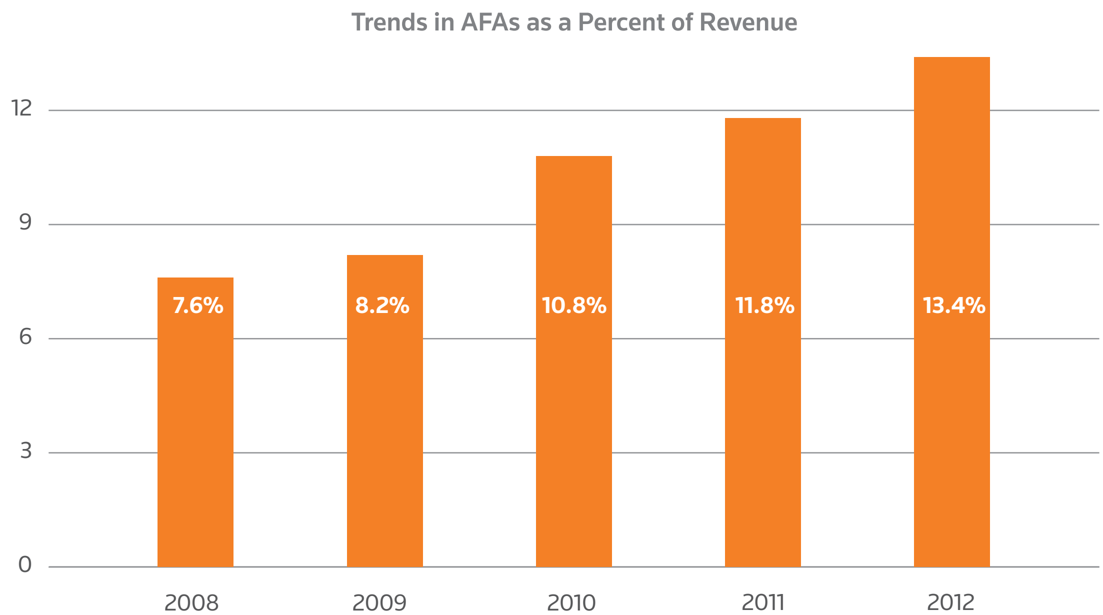
Offshore legal process outsourcing firms ("LPOs") have experienced rapid demand growth in the U.S. market, and several have opened onshore centers in the U.S. to augment their foreign operations. Typical work in such centers include litigation support, review of basic corporate documents, risk management activities, and IP-related research. While in the past, most of the work of LPOs has come directly from corporate clients (effectively bypassing law firms), some firms are now working collaboratively with selected LPOs as a means of improving the firms' overall leverage.

Experiments with New Business Models. Responding to client demands for greater efficiency and cost effectiveness in the delivery of legal services, many firms have continued to experiment with ways of redesigning legal work processes and better managing projects to meet client expectations. A number of firms have instituted project management training for their lawyers and have taken steps to provide their partners with tools necessary to budget and track projects effectively. A few firms have launched efforts to actually redesign work processes by reexamining the mix of professionals — both lawyer and non-lawyer, in-house and outsourced — needed for certain kinds of work and the technology and knowledge tools required to support them. We believe that these kinds of efforts are likely to expand in the future.

Another example of firms experimenting with new business models is the continuing growth in importance of alternative fee arrangements ("AFAs").[9] As shown in Chart 10 below, in a recent Citi Private Bank Survey of managing partners of primarily Am Law 50 firms (the "Citi 2011 Managing Partner Survey"), based on responses to a specific question concerning AFAs from 40 U.S. firms, it appears that the percentage of total firm revenues attributable to AFAs has been rising steadily since 2008 and is projected to hit 13.4 percent in 2012.

CHART 10

Alternative Fee Arrangements in Large Firms



Source: Citi 2011 Managing Partner Survey

While these percentages may seem relatively small, it must be remembered that they represent averages among predominantly Am Law 50 firms, many of which were under almost no pressure to use AFAs prior to the current economic downturn. Moreover, the data shown in Chart 10 exclude information from several non-U.S. based firms that were included in the Citi 2011 Managing Partner Survey. Those firms reported a significantly higher percentage of AFA use than their American counterparts.[10] It should also be noted that the use of AFAs varies widely depending on a firm's mix of clients and practices. In the Citi 2011 Managing Partner Survey, 25 percent of responding firms expected that AFAs would represent 20 percent or more of their 2012 revenues, while an equal number of firms projected that AFAs would be 5 percent or less of their 2012 revenues. We expect that the use of AFAs will continue to expand and could indeed become the norm in certain practices.

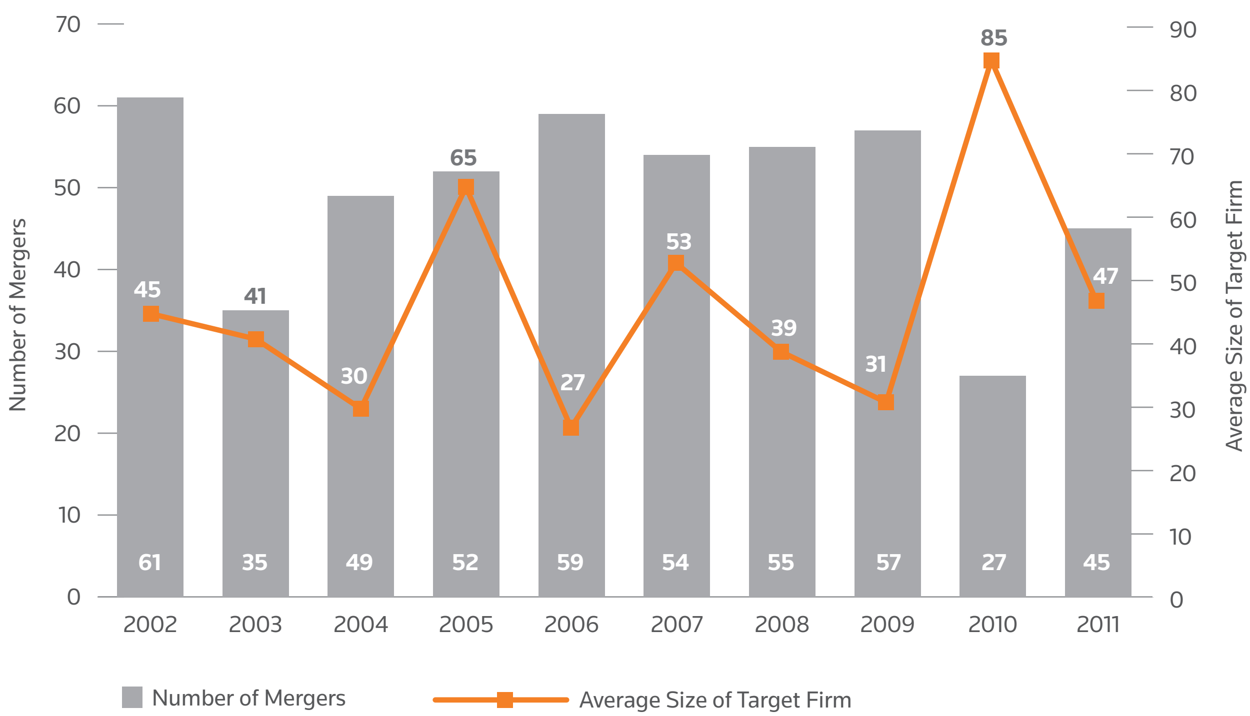
[9] Alternative fee arrangements refer to agreed-upon fees for legal services that are not based on hourly charges. Thus, AFAs would include fixed fees, some types of contingency fees, value or incentive fees, and portfolio pricing (i.e., fixed fees for a series of projects or cases or for projects occurring within a set period of time). They would not, however, include fee discounts if the underlying fees were hourly based.

[10] The Citi 2011 Managing Partner Survey included data from seven firms headquartered outside the U.S. Had data from those firms been included in Chart 10, the average percentage of revenues attributable to AFAs projected for 2012 would rise from 13.4 to 15.7 percent.

Expanding Merger and Lateral Activity. Despite the slow economy (or, in some cases perhaps, because of it), law firm mergers rebounded strongly in 2011. As shown in Chart 11 below, there were 45 completed mergers last year involving U.S. based firms.[11] That represented a 67 percent increase over 2010, a year that saw only 27 mergers. While firms appear to remain somewhat cautious about large combinations — often preferring regional tie-ups — merger activity appears to be heading back towards pre-recessionary levels when we typically saw 55+ mergers per year.

CHART 11

Merger Activity in U.S. Based Firms



Source: Hildebrandt Institute *Merger Watch*

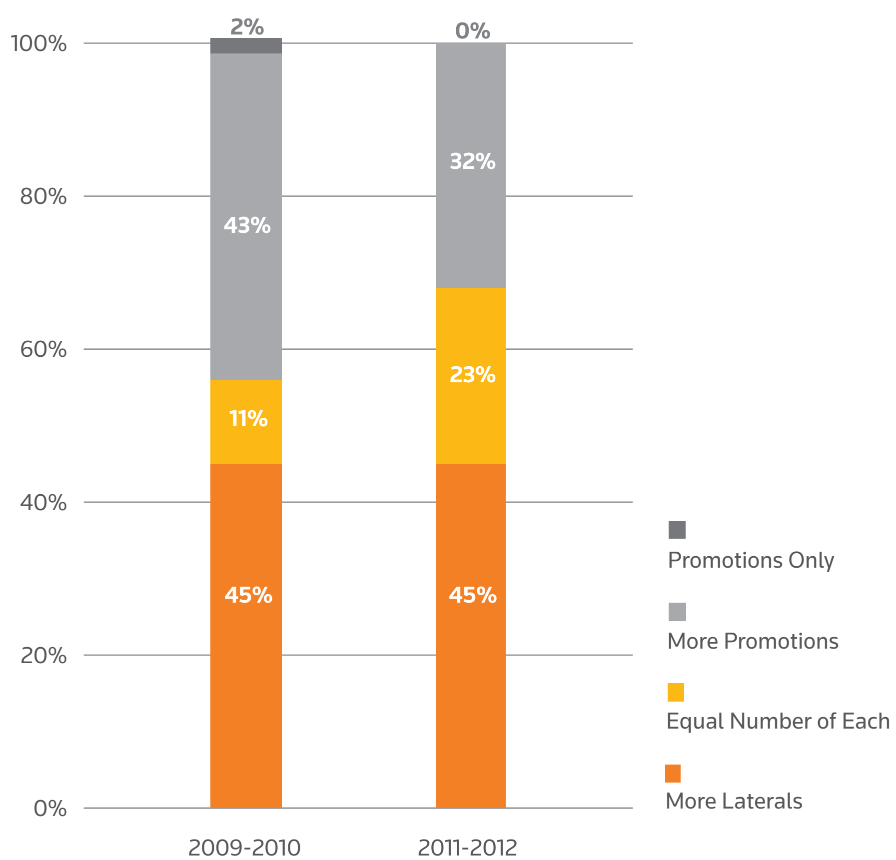
[11] Chart 11 shows all mergers of U.S. firms where the smaller firm had at least five lawyers.

We expect that the pace of mergers in 2012 will at least equal or, perhaps more likely, exceed the pace in 2011. Indeed, there have already been 14 mergers of U.S. firms that have been announced or become effective thus far — double the number at this point a year ago.

At the same time, we have also seen a shift among firms toward lateral acquisitions as a means of expanding their equity partner ranks as opposed to a primary reliance on internal promotions. Chart 12 below shows the partner growth strategies of 47 large law firms as measured by the Citi 2011 Managing Partner Survey. As can be seen, the chart — which compares the percentages of new equity partners attributable to laterals vs. internal promotions in the period 2009/2010 with projections of such percentages in the 2011/2012 period — shows a clear shift toward more reliance on lateral partner candidates.

CHART 12

Large Firm Partner Growth Strategies: Promotions vs. Laterals



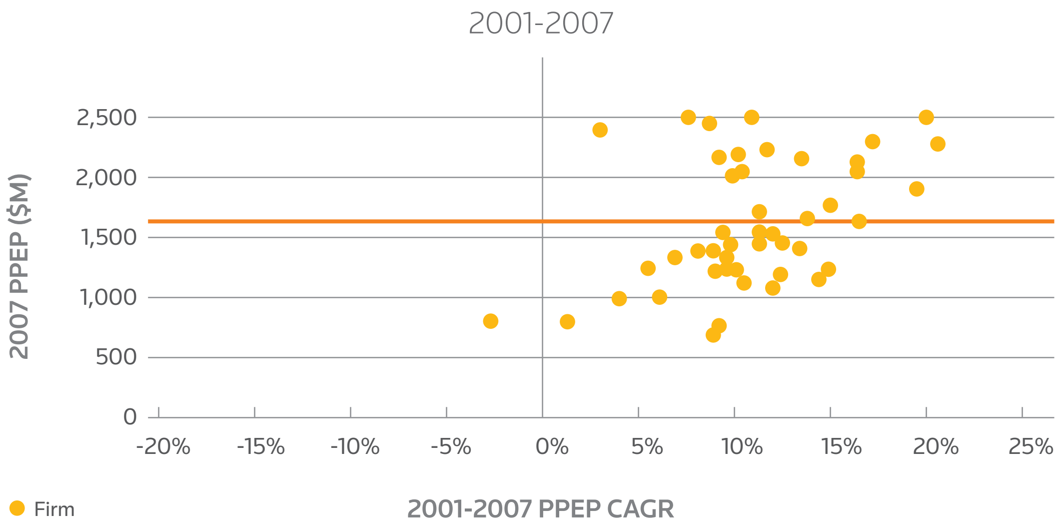
Source: Citi 2011 Managing Partner Survey

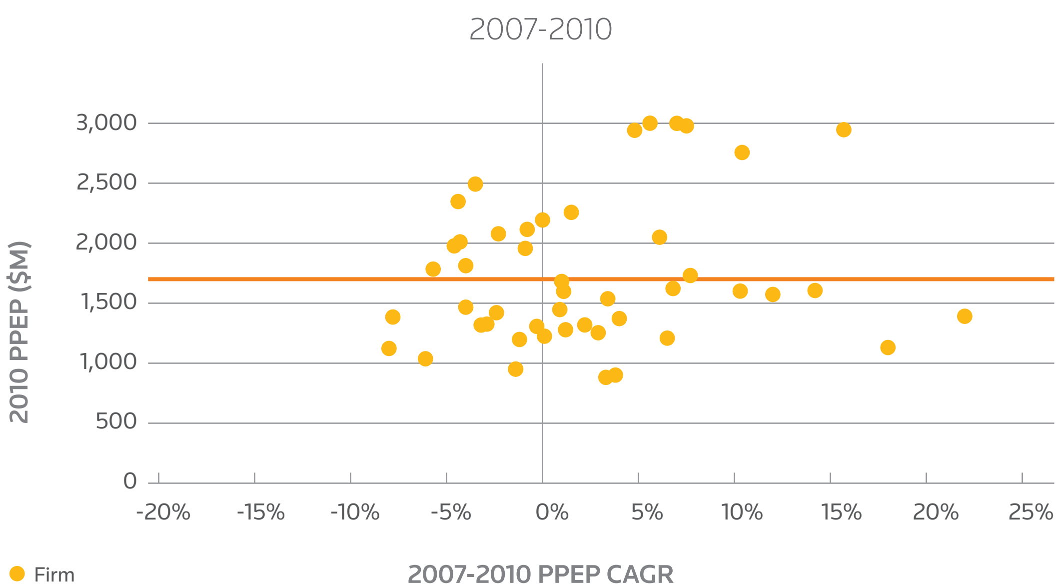
Widening Dispersion of Performance in the Legal Market. Responding to a more highly competitive market (in which demand exceeds supply) and changed client expectations (particularly as regards efficiency and cost effectiveness), firms across the market have become much more strategically focused. That, in turn, has led to increasing segmentation of the legal market as firms have sought to align themselves around specific strategic objectives — e.g., as global full-service firms, global focused firms, national full-service firms, regional mid-market firms, specialty or industry focused firms, etc. This growing segmentation — as enhanced or sometimes undermined by the quality of firm leadership and management discipline — has resulted in a widening dispersion of firm financial performance. Put simply, there have been more definitive winners and losers than in the pre-recession years.

Chart 13 below compares average PPEP as well as the compound average growth rate ("CAGR") in PPEP for 53 top-tier firms during the period 2001-2007 (i.e., during the pre-recession years) with similar profits and growth rates during the 2007-2010 period. As can be seen, during the pre-recessionary period, all but one of these firms enjoyed moderate to strong PPEP growth. Beginning in 2007, however, a handful of firms separated themselves from the market and achieved very strong PPEP growth, while nearly half of the firms reported negative or flat growth.

CHART 13

Profit Performance Dispersion: Top-Tier Firms



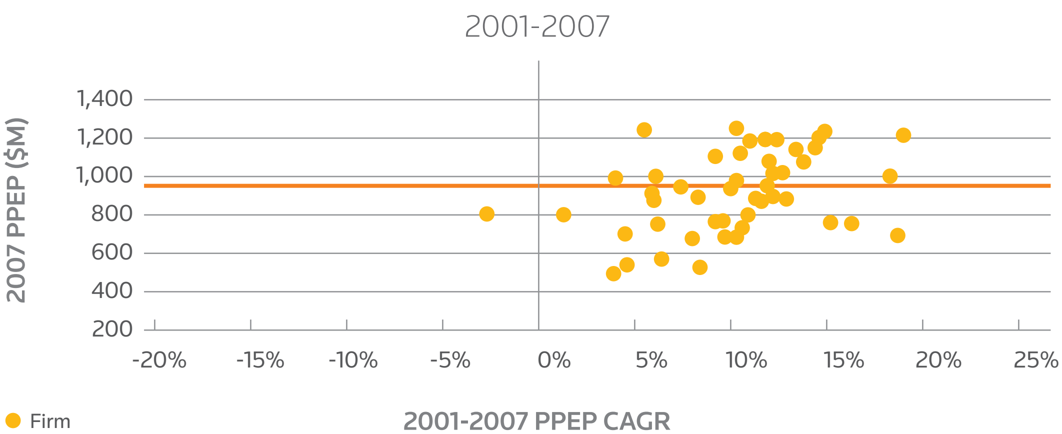


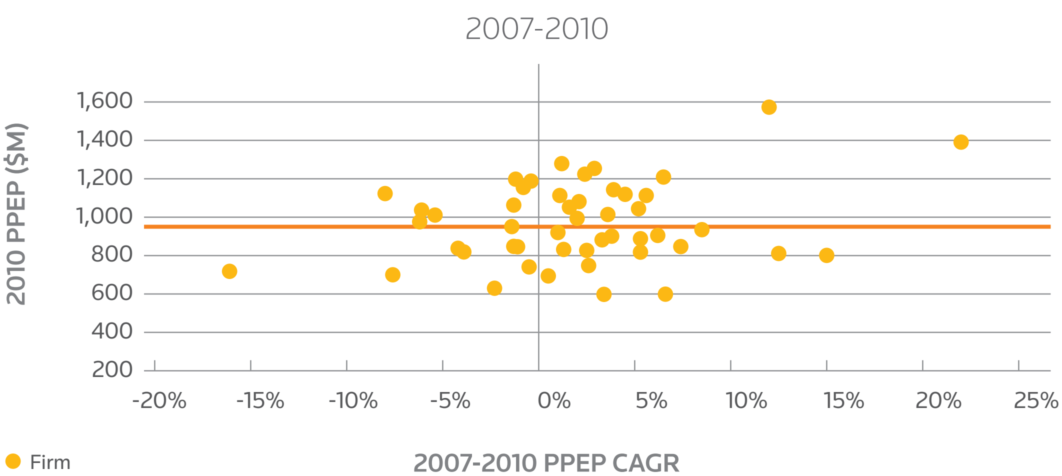
Source: Citi Private Bank Top Tier and Middle Tier Law Firm Analysis

A similar disparity in profit performance was also evident among middle-tier firms, although this segment of the market showed somewhat less volatility than their top-tier counterparts. This can be seen in Chart 14 below.

CHART 14

Profit Performance Dispersion: Middle-Tier Firms





Citi Private Bank Top Tier and Middle Tier Law Firm Analysis

We believe that this kind of performance variance in the legal market (which was much less pronounced in the pre-recession period) will continue for the foreseeable future as some firms manage to navigate the new competitive environment successfully while others fall behind. Indeed, as the "winning" firms in this new competitive environment continue to widen the gaps between themselves and their less successful counterparts, the gaps will tend to harden, making it even more difficult for firms to jump from one performance level to another.

Growing Impacts of Globalization. One of the most intriguing developments of the past year was the explosion of interest in global markets exhibited by firms around the world. This was reflected in the number of law firm mergers outside the U.S., which jumped to 54 in 2011, as compared to 44 and 48 in 2010 and 2009, respectively.[12] Many of these cross-border combinations were quite significant in size — including the 1,275 lawyer combination of Squire Sanders & Dempsey with Hammonds in the U.K.; DLA Piper's combination with Australia's DLA Phillips Fox to form a firm of over 4,000 lawyers; and the decision of Canada's Ogilvy Renault and South Africa's Deneys Reitz to join the Norton Rose Group to create a global practice of 2,500 lawyers.

For 2012, a number of large cross-border mergers have already been announced, with Canada, Australia, and Asia key locations of interest. Effective January 1, the Norton Rose Group combined with Canada's Macleod Dixon to expand its global practice to more than 2,900 lawyers. The U.K.'s Ashurst and Australia's Blake Dawson announced plans to combine their businesses in Asia by March 2012, with a full merger (conditional on a further vote of the partnerships) by 2014. The Australian firm, Freehills ended 2011 by entering into merger discussions with the U.K.'s Herbert Smith. And recently, Australia's Mallesons Stephen Jacques and China's King & Wood announced the combination of their firms to create King & Wood Mallesons with over 1,800 lawyers, effective March 1, 2012. The latter is particularly significant as it represents the first real emergence of a Chinese law firm in the global market.

All of this activity is being driven to a significant extent by demand growth in key emerging markets and business sectors around the globe, which have continued to generate legal work notwithstanding the economic downturns in much of the developed world. This is particularly true, of course, with respect to the so-called "BRIC" countries (Brazil, Russia, India, and China), but it also includes growing industry segments like energy (which accounts for much of the interest in Canada). At a deeper level, the trend also reflects the ongoing shift of world economic activity from the west and north to the east and south.

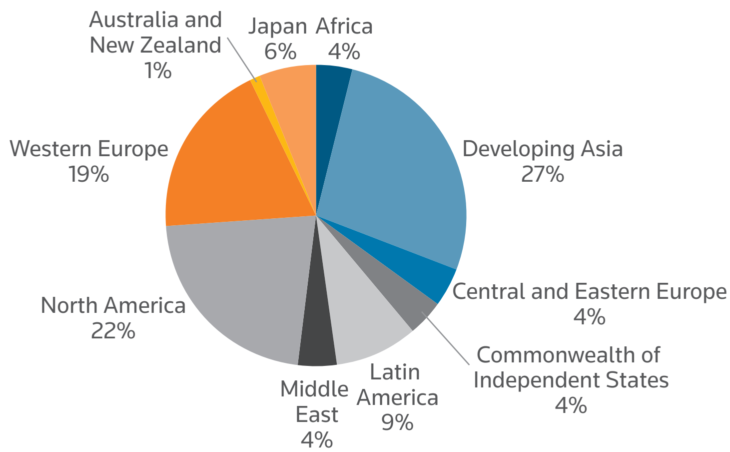
[12] Source: Hildebrandt Institute Merger Watch.

As shown in Chart 15 below, the International Monetary Fund and the Citi Investment Research and Analysis group predict that over the next 40 years, there will be a dramatic shift in world economic activity, with developing countries (particularly in Asia) accounting for an increasing share of world GDP.

CHART 15

Long-Term Shift of World GDP Growth

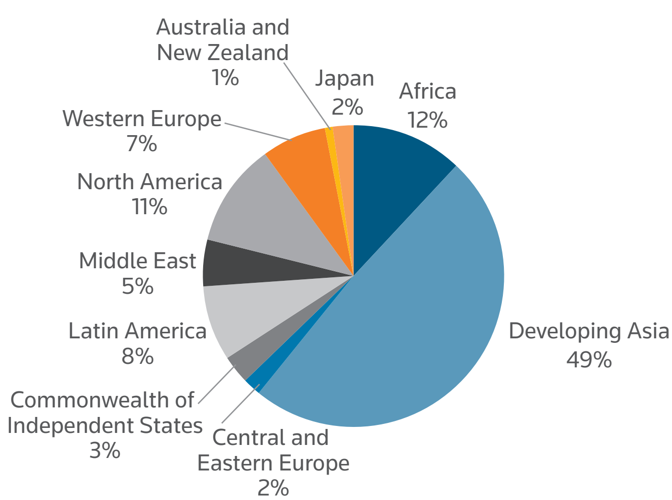
Composition of Real World GDP 2010



Note: GDP based on PPP Valuation of Country GDP (CID).

Source: IMF World Economic Outlook; Citi Investment Research and Analysis

Composition of Real World GDP 2050



Note: GDP levels calculated taking regional GDP (CID) data for 2010 from IMF, then calculating forward to 2050 using regional real growth rated based on Citi forecasts.

Source: IMF World Economic Outlook; Citi Investment Research and Analysis

Given these trends, we believe it inevitable that globalization will continue to be an important force shaping the legal market for the foreseeable future. Indeed, it is interesting that within the past several months a number of top-tier firms that have not had large global footprints — including Davis Polk, Kirkland & Ellis, Milbank, Simpson Thacher, and Sullivan & Cromwell — have been reconsidering their global strategies, partly in recognition of the growth in demand for legal services evident in the emerging markets.

Renewed Focus on Professional Development. One of the most serious side effects of the now almost four-year economic malaise in the legal market is the adverse impact it has had on young lawyers. Apart from the obvious hardships created by the substantial layoffs of associates in 2009 and 2010, the shrinking of equity partner ranks, the increased reliance on lateral hiring, and the growing reluctance of clients to pay for the services of first- or second-year lawyers have all combined to raise anxiety levels even among associates who retained their jobs. And the anxiety is exacerbated, of course, by the heavy debt burdens carried by many young lawyers.[13]

In the Citi 2011 Managing Partner Survey, most managing partners identified the long-term impact of the recession on associates and its implications for growing the next generation of law firm partners as one of the biggest challenges confronting their firms. As a result, a number of firms have launched initiatives to provide more comprehensive training and professional development programs for their mid-level and senior associates — including providing them with project management and other business-related skills. In the past year, for example, both Milbank and Skadden announced programs to put all of their mid-level and senior associates through multi-week training programs developed in partnership with outside academic resources. We expect that these efforts will continue in the coming year as more firms turn to MBA-type executive education programs both to create a competitive advantage in associate recruitment and to improve morale within their associate ranks.

In summary, we anticipate that 2012 will be a year of limited growth for the legal market. While we expect that demand will continue to grow at a modest pace, other economic factors will pose serious challenges as firms struggle to maintain profitability. But the current market will also provide opportunities for firms that are flexible and innovative enough to differentiate themselves from their competitors and to think creatively about how legal services might be delivered more efficiently and cost effectively. That will, of course, require effective leadership, strong management discipline, and clear strategic focus. Firms that are able to combine these ingredients successfully in the current market will enjoy an enormous competitive advantage. As always, we stand ready to assist our clients in meeting the challenges of this evolving market.

[13] In 2010, the average debt burden carried by 85 percent of graduates from ABA-accredited law schools amounted to $98,500, according to U.S. News and World Report. At 29 law schools, the debt burden exceeded $120,000. W. Henderson and R. Zahorsky, "The Law School Bubble," ABA Journal, January 2012, at 30-31.

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