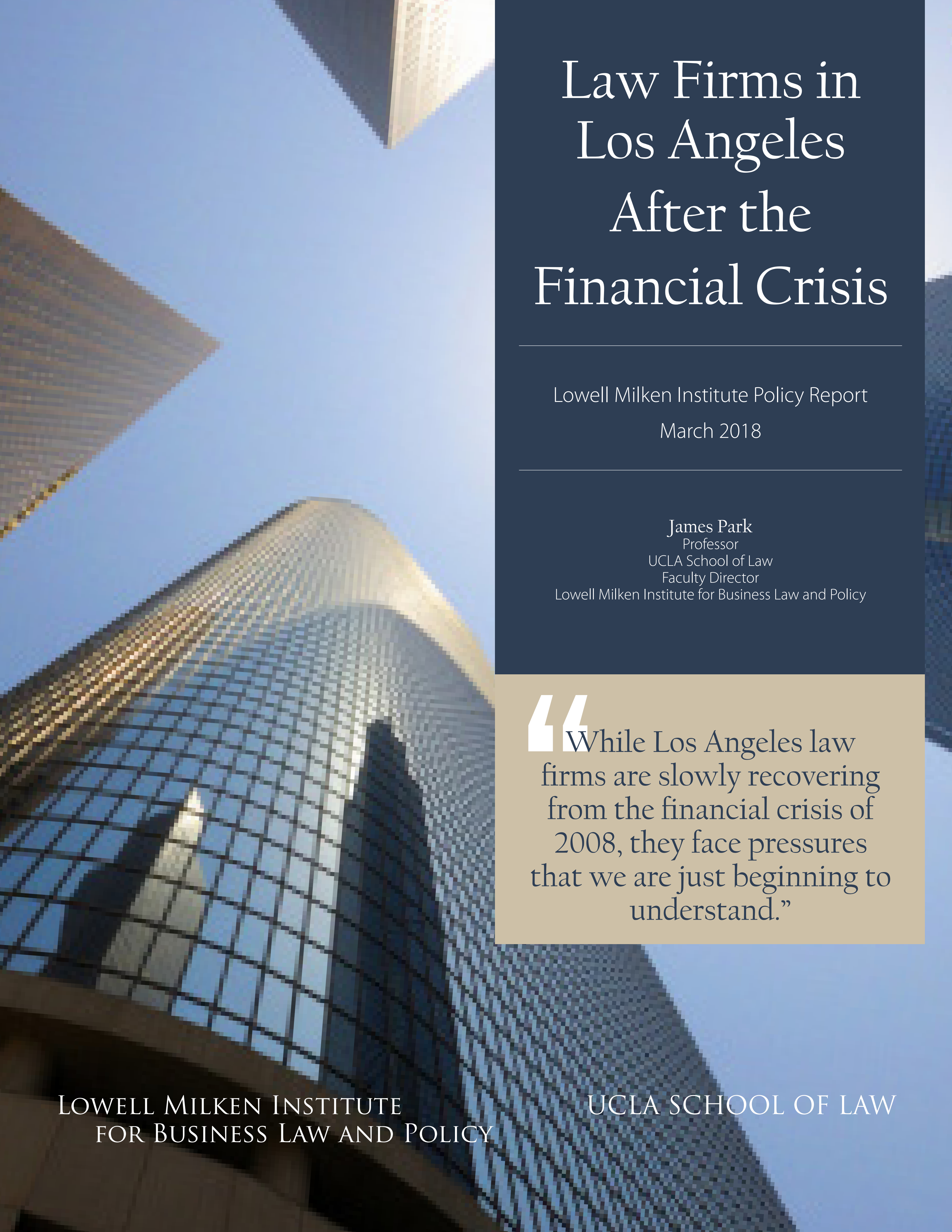

Law Firms in Los Angeles After the Financial Crisis

Lowell Milken Institute Policy Report

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"While Los Angeles law firms are slowly recovering from the financial crisis of 2008, they face pressures that we are just beginning to understand."

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Summary of Findings

- *As of January 2017, large law firms employed about as many attorneys in Los Angeles (about 6,500) as they did prior to the financial crisis of 2008.*
- *The major law firms founded in Los Angeles have reduced their total headcount in Los Angeles by about 20 percent over the last 10 years.*
- *Many law firms have opened and expanded new offices in Los Angeles, adding about 1,000 attorneys over the last 10 years.*
- *The Los Angeles offices of large law firms have gotten significantly smaller, declining from an average of 70 lawyers in 2007 to 50 lawyers in 2017.*
- *Leverage has declined in Los Angeles law firms from an average of 2.0 associates per partner in 2007 to 1.75 associates per partner in 2017.*

Introduction

After the financial crisis of 2008, law firms reduced their headcounts and hired fewer new associates as the economy slowed. Almost a decade later, the national economy is well into a recovery and the legal market is stronger. At the same time, there is a growing sense that the practice of law has changed. Whether it is the rise of technology or efforts by corporations to reduce legal costs, the business model of law firms is increasingly under pressure.

Los Angeles has long been one of the country's largest and most important legal markets. Building on a reputation for excellence in serving their home market, a significant number of firms founded in Los Angeles have built nationwide practices with successful offices in other cities.

Despite the national success of Los Angeles firms, there is a belief that the Los Angeles legal market has declined relative to the markets in other cities. A common theme is that as Fortune 500 corporations have moved their headquarters from Los Angeles, there are fewer clients who can afford the high rates of elite law firms.

This policy report by the Lowell Milken Institute for Business Law and Policy at UCLA School of Law studies the Los Angeles offices of large law firms. Focusing on the period from 2007 to 2017, it examines data for the Los Angeles offices of firms large enough to be listed in the National Law Journal 250 (NLJ 250).[1] Though many studies have looked at this data on a nationwide level, no study has extensively examined the data for Los Angeles.

This study finds that Los Angeles law firms are slowly recovering from the 2008 financial crisis but the recovery has been mixed. While the largest Los Angeles firms have reduced their presence in Los Angeles, an increase in lawyers employed by newer offices opened by non-local firms has offset this decline.

An Overview of the Los Angeles Market

There is a general belief that the Los Angeles legal market has weakened in relation to the markets of other cities such as New York City and Washington, D.C. A number of sources have described Los Angeles as primarily supporting a "middle-market" practice with fewer significant transactions that can generate significant legal fees.[2] One prominent leader of a Los Angeles firm remarked in 2010, "You can't live on Los Angeles . . . The firms that are here that have succeeded have had to branch out to other markets."[3]

More recently, there have been signs of life in the Los Angeles market. A 2017 article in the National Law Journal examined the "five largest legal markets in the U.S." and noted that "Los Angeles [is] surging forward."[4]

The data supports the view that the Los Angeles market is slowly recovering. The number of lawyers working for law firms in Los Angeles declined by about 10 percent after the financial crisis of 2008. The number of lawyers has recovered to 2007 levels, but is still about 5 percent off from the market's 2008 peak.

1 In 2012, the *National Law Journal* began reporting data on the largest 350 firms. For the sake of consistency, we focused only on the firms that were included in the NLJ 250. We generally refer to NLJ 250 firms in this policy paper simply as "law firms."

2 *See, e.g.*, Anna Scott, *L.A. Firms Adjust to City's Waning Power*, Daily J., June 24, 2010 ("The gradual departure of Fortune 500 companies, corporate headquarters and various industries during the past two decades dimmed Los Angeles' cachet as a base for big-ticket legal work. Subsequently, the city's business environment today supports a mostly middle-market legal industry compared to New York and Washington, D.C.")
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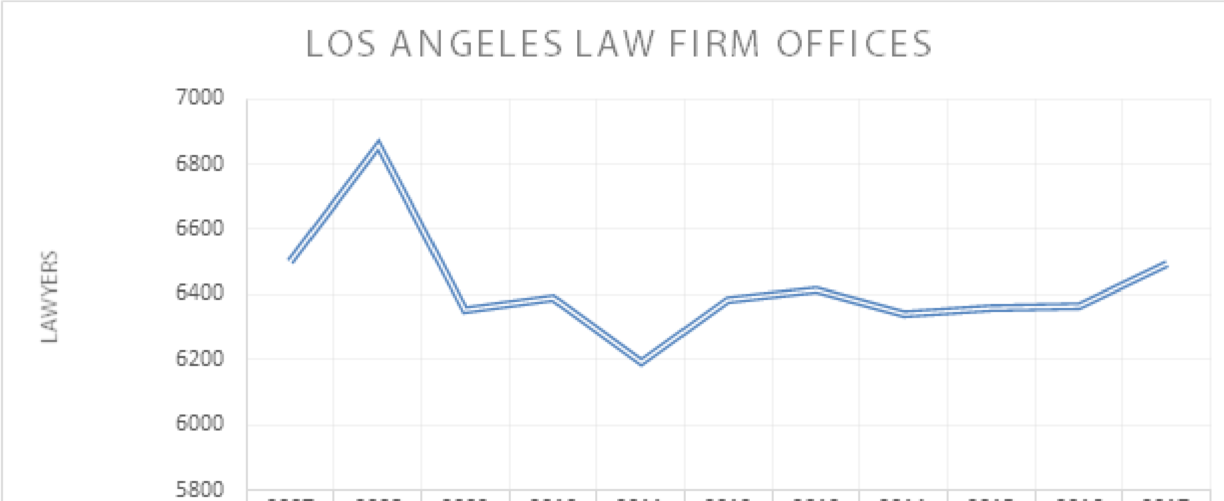
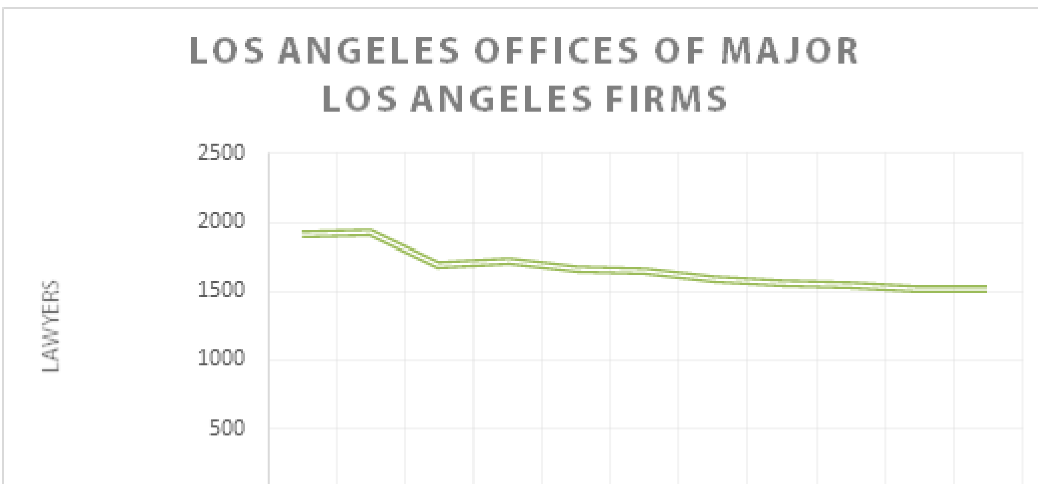
3 *Id*.

4 Katelyn Polantz, *The NLJ 500: Which 5 Cities Have the Most Lawyers?*, Nat'l L. J., June 28, 2017.



	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
LA Law Firms	6503	6859	6352	6391	6191	6386	6412	6343	6359	6365	6493

However, a closer look at the data set shows that the recovery has not been uniform. The number of lawyers working for the largest Los Angeles offices has steadily declined. The figure below summarizes data on the home offices of nine major firms that were founded in Los Angeles ("Major Los Angeles Firms").[5] These firms have all been listed in the Vault 100 ranking of prestigious law firms. Collectively, these firms are about 20% smaller in Los Angeles than they were at the start of 2007.



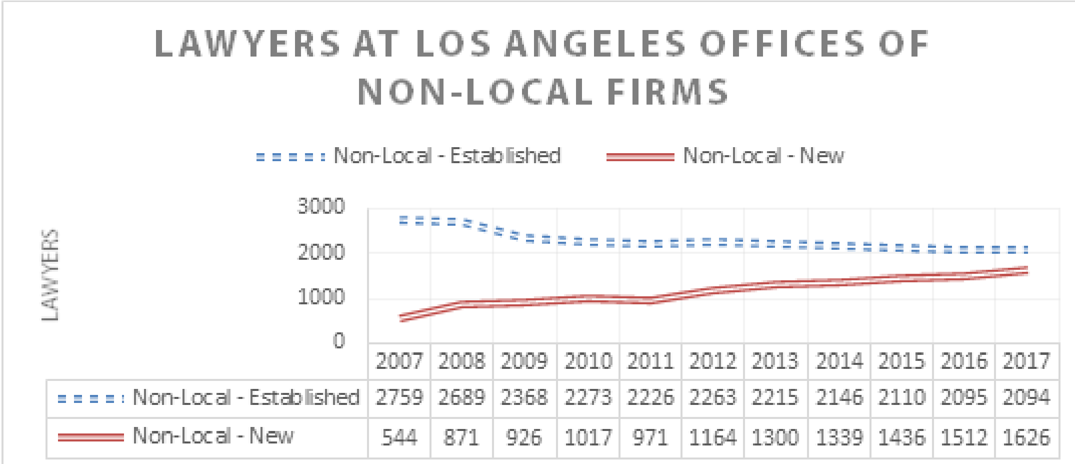
	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
LA Major Firms	1915	1927	1701	1718	1665	1655	1585	1565	1541	1522	1521

This decline likely reflects a number of developments. First, these firms are reducing the size of less profitable practices. Second, they are hiring fewer new associates in Los Angeles to save costs or because there are fewer matters that need significant staffing.

The recovery in the Los Angeles law firm market is explained by growth in the offices of firms that were not founded in Los Angeles (Non-Local Firms). Firms without a significant presence in Los Angeles prior to 2007 have added more than 1,000 lawyers over the last decade. A number of national firms have successfully opened Los Angeles offices that have grown to between 30 and 50 lawyers. This trend has been noted anecdotally,[6] and is documented here for the first time. In contrast, Non-Local Firms with a longer history in Los Angeles have on average declined by about 20%, a similar decline as seen by the Major Los Angeles Firms.

5 We take into account the fact that some firms report separate numbers for offices in Los Angeles and other areas, such as Century City.

6 *See, e.g.*, Kat Greene, *SoCal Firms Boom as PE, Media Fuel Middle-Market Growth*, Law360, Mar. 29, 2016 ("The LA market has been thriving so much in recent years, it's even attracting outsiders looking to compete for business.").



Many of these newer offices are still small in size, with fewer than 50 lawyers. A few of the attorneys we spoke to were pessimistic about whether the new entrants reflect substantial strength in the Los Angeles legal market. At least part of the growth of these firms is from lateral movement of attorneys who were previously practicing at one of the Major Los Angeles Firms. Lawyers may simply be shifting from one group of Los Angeles firms to another. The newer Non-Local Firms may concentrate on areas such as litigation or entertainment rather than the large corporate transactions that often drive large firm profits. Whether or not some of these offices will expand so that they rival some of the more established firms is yet to be seen.

The conventional wisdom is that many law school graduates work for "big" law firms. More and more, firms are only "big" in terms of the total number of lawyers they employ nationally. Law firm offices in Los Angeles are increasingly not "big." In 2007, the average number of lawyers in a Los Angeles law firm office was 70 (the median was 57). In 2017, the average declined to 50 lawyers (the median is 37.5).

It is difficult to interpret what this means for the market for entry-level associates in Los Angeles. On the one hand, smaller offices are less likely than larger offices to hire significant numbers of new associates. On the other hand, if these new offices continue to grow, they will create a demand for more associates. Indeed, many of the Non-Local Firms have already hired entry-level associates.

These trends are evidence that the structure of the legal market in Los Angeles has significantly changed over the last decade. The next section will examine several explanations for the declining size of Los Angeles law firms.

Explaining the Decline

Our sense from speaking to practitioners is that they view local developments as primarily responsible for a weaker Los Angeles market. Legal work is increasingly concentrated in particular cities – technology in San Francisco, finance in New York City, and government in Washington, D.C. The high cost of living has made it less attractive for public corporations to locate their headquarters in the Los Angeles area. As a result, there are fewer local clients to support large firm offices.

While these local factors have contributed, we believe that national trends are a more significant cause of the decline of lawyers working for Major Los Angeles Firms. The most powerful evidence is that the trends we identified in Los Angeles are present in other major legal markets. We looked at the home offices of the largest law firms founded in five other cities. Los Angeles and Chicago have seen similar declines. Even stronger markets such as New York City and Washington, D.C. have seen substantial reductions since 2007.

Table 1: Lawyers at Home Offices of Major Law Firms in Six Cities

	2007	2017	% Change
Los Angeles	1915	1521	(20.6)
San Francisco/Silicon Valley	1735	1583	(8.76%)
Chicago	3562	2866	(19.5%)
Washington, D.C.	2141	1921	(10.3%)
New York City	10,103	8,906	(11.8%)
Atlanta	1385	1045	(24.5)

Our sense is that even in stronger markets, there are winners and losers among firms. For example, in New York City, a market that is perceived as vibrant, there are only four major hometown firms that have increased their head count since 2007. Thirteen major hometown firms have substantially reduced their number of lawyers, and six have stayed about the same size.

Evidence of National Trends

Over the last several years, commentators have extensively debated the future of big law firms in the United States. There is a growing consensus that the decline in business caused by the financial crisis of 2008 accelerated longstanding changes to the practice of business law.

Pressure from clients to cut legal costs has steadily increased and is widely seen as affecting the ability of law firms to generate fees. As Professor William Henderson recently wrote: "Law firm economics are changing because clients are changing how they buy legal services. The biggest change – by a very wide margin – is the growing ranks of in-house lawyers. Over the last 20 years, in-house legal departments have grown 7.5 times faster than lawyers employed in private practice, from less than 35,000 in 1997 to more than 105,000 in 2016."[7]

Nationally, the traditional model of leverage, where law firms generate revenue by utilizing significant numbers of associates to staff large cases and transactions, is under pressure. There is evidence for this trend in Los Angeles.

Because law firms are effectively competing with in-house counsel to provide legal services, they have become more efficient. They delegate or outsource more work to less expensive staff and contract attorneys. They use technology to reduce the cost of organizing and searching documents.

While law firms are maintaining their profits and in many cases growing them, there are questions as to whether they have incentives to decisively respond to changes in the market for legal services. As an article in *The American Lawyer* this past summer observed, "[t]he partnership model is fraying in no small part because of a structure that promotes a short-term, transactional approach and jeopardizes sustainability in a rapidly changing marketplace."[8]

We found evidence of these national trends in Los Angeles.

Evidence of Declining Leverage

Nationally, the traditional model of leverage, where law firms generate revenue by utilizing significant numbers of associates to staff large cases and transactions, is under pressure. There is evidence of this trend in Los Angeles. The number of partners in the Los Angeles offices of the major firms has declined by about 10% since 2007, while the number of associates has declined by more than 25%. Los Angeles firms have never relied heavily on leverage relative to firms in some major markets, such as New York City, and their leverage has declined even more. On average, the leverage ratio of associates to partners in Los Angeles fell from about 2 in 2007 to 1.75 in 2017.

These developments are consistent with the national trends of increasing client pressure and technology. Companies may require firms to staff their matters with smaller teams, making it difficult for firms to profit from leverage. A full understanding of the de-leveraging of Los Angeles firms will require more study. For example, it might be fruitful to study whether firms have reduced leverage in particular practice areas.

Evidence of Pressure to Increase Profits Per Partner

Another factor reducing firm size is the natural tendency of law firms to act as profit-maximizing entities. Even as the market for associates has been weak, the profitability of law firms for their partners has consistently remained healthy since the crisis of 2008. Maintaining or increasing such profits might be achieved by reducing associate hiring, limiting or reducing the size of a partnership, and shedding low-margin practice areas.

It is difficult to obtain numbers that allow us to examine the profitability of particular law firm offices. However, there are a number of major law firms that have their largest office in Los Angeles. The table below averages the reported profits per partner and revenue per lawyer for four of those firms. **Even as the average size of law firms is declining, these firms have maintained their profitability, though profits have not grown substantially and may be just keeping pace with inflation**.

7 William D. Henderson, *The Paradox of the Client-Driven Market*, Law.Com (Oct. 4, 2017), https://www.law.com/sites/almstaff/2017/10/04/the-paradox-of-the-client-driven-market/.

8 Mark A. Cohen, *The Legal Industry is Undergoing More than a 'Dance Around Change'*, Am. Law. (Jul. 10, 2017).

Table 2: Average Profits and Revenue at Los Angeles Major Firms with Largest Office in Los Angeles

	2007	2017	% Change
Average profits per partner	$1,403,000	$1,679,000	19.6
Average revenue per lawyer	$910,000	$1,158,000	27.2

We suspect that a result of law firms' focus on increasing profitability is that lawyers, both partners and associates, are increasingly forming practices with lower billing structures than big law firms. Further study of middle-market practices in Los Angeles might be fruitful.

Fewer Public Companies

One intriguing hypothesis is that with increasing federal regulation of public companies, the number of public companies has declined, reducing the number of potential clients nationally. Corporate law experts have observed that over the last 20 years, the number of public companies traded on a stock exchange has declined from about 8,000 to around 4,000.

The bulk of this decline happened in the years prior to the financial crisis of 2008. At the start of the crisis, there were around 4,600 listed companies. There was a decline to around 4,100 companies, but the number of companies has been around 4,300 for the last few years.[9] Thus, while most of the decline occurred prior to the time period of this study, there has been a modest reduction in the number of potential public company clients, which might be a factor in explaining lower demand nationally for law firm services.

The number of companies going public in the U.S. declined sharply after the financial crisis. Since then, there has been a substantial though uneven increase in IPO transactions. For example, in 2014, 291 companies went public, the highest number since 2000. M&A activity has been increasing, especially with respect to acquisitions of the increasing number of private companies that have been formed.

It is possible that the decline in the number of public companies has reduced the demand for legal services, but we do not have sufficient evidence on whether there is a causal link between these trends.

Developments in the Los Angeles Market

Over the last few decades, the story of the Los Angeles economy is that as large corporations leave the city, they have been replaced by small and mid-size companies. This has not been an entirely negative story, as entrepreneurship can be a significant source of legal work. Moreover, while the move of certain industries from Los Angeles has affected the prospects of its large law firms, much of this outflow predated the financial crisis.

Are Large Companies Leaving Los Angeles?

The declining number of large corporations headquartered in Los Angeles has been noted by a wide number of sources. As the *Los Angeles Business Journal* has noted, "as giant players in aerospace, energy and banking started leaving town, these small- to mid-sized businesses have become the motor driving regional growth." The article remarked that "L.A. is just not a Fortune 500 kind of town – never has been, never will be."[10] This observation, though, was made in 2005, prior to the 2008 financial crisis, and before a significant rise in the number of lawyers employed by Los Angeles law firms in 2006 and 2007.

Since the 2008 financial crisis, there has been an additional reduction in the number of Fortune 500 headquarters located in Los Angeles or Orange County (from 22 to 16). On the other hand, by other metrics, there is still a substantial corporate presence in Los Angeles.

As summarized by Table 3, the number of public companies with a market capitalization of over $1 billion has remained essentially constant. The largest public companies headquartered in Los Angeles have significantly higher average market valuations than in 2007. The number of large private companies in Los Angeles with revenue of over $1 billion has increased significantly. The number and size of Los Angeles private equity firms, which generate corporate work from transactions, has also grown.

9 Ernst & Young, *Looking Behind the Declining Number of Public Companies* (May 2017).

10 Kate Berry, *Why L.A. Companies are Getting Smaller and Smaller and Smaller*, L.A. Bus. J. (July 18, 2005).

Table 3: Los Angeles Companies (2007-2017)[11]

	2007	2017
Fortune 500 Headquarters in Los Angeles and Orange County	22	16
Large Public Company Headquarters (market cap > $1 billion)	64	63
Large Public Company Average Market Cap (largest 10 companies)	$31 billion	$46 billion
Large Private Company Headquarters (revenue > $1 billion)	21	33
Large Private Company Average Revenue (largest 10 companies)	$4.2 billion	$4.9 billion
Large Private Equity Firms (assets > $1 billion)	9	20
Large Private Equity Firms Average Assets (largest 10 firms)	$3 billion	$10.6 billion

It is possible that more subtle shifts in the nature of the corporations headquartered in Los Angeles have impacted its legal market. For example, the collapse and subsequent acquisition of Countrywide, which was a Fortune 500 company, may have had an impact on securitization work. However, **there is not clear evidence of a significant decline in the number of potential corporate clients located in Los Angeles**.

The National Expansion of Los Angeles Firms

For various reasons, the major Los Angeles firms have expanded outside of Los Angeles to a greater extent than firms in some of the other major cities. Many of the elite New York City firms have only one major office and have a fairly small presence in other cities. In contrast, more than half of the nine Major Los Angeles Firms have their largest office outside of Los Angeles.

Even if the economy is fairly healthy in Los Angeles, if average profitability is higher outside of Los Angeles, the partners in Los Angeles will feel pressure to limit their business to a select clientele to keep pace. Of the nine Major Los Angeles Law Firms, five are ranked in the top 20 nationally (as of 2017) in terms of profits per equity partner.

This dynamic has created room for new entrants. Non-Local Firms see opportunity in Los Angeles as the major local firms have reduced their presence here. One attorney we spoke to observed that Los Angeles is attractive for an out-of-state firm that wants to establish a West Coast practice. He noted that much of his practice involves matters outside of Los Angeles in various western states. NLJ 250 law firms in other cities may find that as they face more competition in their home market, they are compelled to find new markets. It is telling that of the firms that have opened major offices here over the last 10 years, none ranks in the top 40 nationally in terms of profits per partner. **For firms with somewhat lower expectations about profitability than the market leaders, Los Angeles remains a strong market**.

New Markets?

Los Angeles has always been known as the entertainment capital of the world. As technology companies that seek access to such content have increasingly established a presence in Los Angeles, a vibrant community of entrepreneurship has grown over the last five years. Though start-up companies are not a stable source of law firm revenue, if some of these companies grow larger and more established, they could generate additional work for law firms. A number of Northern California firms have opened Los Angeles offices in the hope that they can be first movers in this area. **Further study of this market for law and entrepreneurship may provide insight into the future of the practice of corporate law in Los Angeles**.

11 The numbers reported in this chart are summarized from data previously published in *Fortune Magazine* and the *Los Angeles Business Journal*.

Conclusion[12*]

While Los Angeles firms are slowly recovering from the financial crisis of 2008, they face pressures that we are just beginning to understand. Consistent with national trends, many of the Major Los Angeles Firms have reduced their presence in Los Angeles. On the other hand, the increase in new offices opened by Non-Local Firms is evidence of strength in the Los Angeles legal market.

A surprising finding of this study is that the size of home offices in all of the major markets has declined over the past 10 years. The trend towards smaller Los Angeles offices is more likely explained by fundamental changes in the business of law firms rather than considerations unique to Los Angeles. This reality likely explains some of the recent difficulty of law schools in placing law school graduates in entry-level firm jobs. It is important to acknowledge, though, that there could be a silver lining to these trends. Firms with less leverage may be more attractive places for associates to build long-term careers. Moreover, as national firms increasingly focus on the most profitable work, they will create opportunities for firms where profit expectations are not as high.

It is important to note that this report does not reflect developments over the last year. It is possible that the improving economy and stock market has further improved the prospects of Los Angeles firms. This policy report should thus be seen as the start, rather than the end, of a project to study law firms in Los Angeles.

12 * Thank you to Iman Anabtawi, Dan Bussel, Joel Feuer, and Beth Moeller for helpful comments on this paper. Thank you to the many Los Angeles lawyers who spoke to us about this project. Thank you to Jaime Maier for excellent research assistance.