

This report is not designed to try answer each of the issues posited, but rather, it is intended to raise major issues and to provide a short discussion in an effort to stimulate thinking. Each firm should review each of the items in significant detail when considering a relocation or undertaking a lease renegotiation.

Is there a way to improve productivity in law firm space?

Yes, but it takes work, a vision of the future, a good interiors architect, a cooperative group of shareholders (partners) and maybe even a good real estate advisor.

There are ideas available to law firms today, capable of implementation, which many corporate space users have tried and found successful.

One thing is clear, the paradigm has shifted for other users and is rapidly shifting for the law firm of the 21st Century. The opportunity is yours. There is no one perfect solution but there is most likely, a much better solution. Carpe Diem. It is your firm's opportunity to seize the day.

The often overlooked need for flexibility – a changing business model

The manner in which work is completed in law firms today is dramatically different than it was in the 1990's. Fewer attorneys have their own personal secretary. And, as the senior partners in today's firms who have not learned the desirability of doing their own typing or computer work finally retire, the nature of work will change yet again.

Connectedness of the 2000's will make almost any kind of work possible from anywhere. Increasingly we hear young attorneys in focus groups indicate that size or office and luxurious surroundings are just not important. "Flexibility," "productivity," "high tech platform," "teaming areas" and "amenities" are words much more often used. All of those issues suggest a hard, strategic look at law firm space. Space must be overhauled and new space must have a new look and feel.

And, like all other aspects of business, it will change even more rapidly in the future.

Our crystal ball is cloudy on exactly what will work. But one thing is for sure, regardless of what we decide it will most likely be wrong or too slow to respond, unless... we build in incredible amounts of flexibility.

Can facilities help with billable hours?

With increased pressure on partner (or shareholder) returns and recent increases in salaries of new associates, increasing billable hours is one of the fundamental challenges of a law firm, particularly in areas of the country where young lawyers locate to find their preferred lifestyle.

Facilities can make a difference. The cost of showers is minimal in comparison to providing an opportunity to get some exercise before or after work. A progressive "high tech" environment can make a difference to young attorneys who have lived with modern technology since grade school. Teaming areas can provide interactive spaces that encourage mentoring and cross selling. Standardized office sizes can provide the flexibility for briefcase moves and quicker adaptation by teams. Spending money on technology instead of walnut paneling can have a huge impact on

productivity. Impressing clients with a productive environment instead of ego-driven facilities could make the difference in the next competitive sales opportunity.

An even more conservative view of space

We believe this century will bring an even more conservative view of space. Electronic communication has all but removed the need for clients to visit offices. Profit margins will be tested further, recruiting the best and brightest will continue to be difficult. Although quality work and good service will be the major factor in selecting firms, fees will be negotiated more strenuously and firms will have to be more cautious about the amount of money spent on image. Like American corporations of the 1990's, law firms will find an increasing need to keep overhead low and facilities very flexible.

Law firm image – to whom does it really matter?

Frequently firms address the image issue and the related cost issues to the question “What will our client's think?” That is not necessarily the correct focus.

There are five categories of constituents who need to be considered when determining the firm's image and the amount of money to be spent on space. Those groups are: existing clients, potential clients, attorneys, staff, and potential recruits.

Instead of asking how the firm image affects clients, the issue of how the firm is perceived by its own staff should be the most important image consideration. Every law firm we work with, even the smallest suburban firm, wants to hire the “best and brightest.” A facility that focuses on how new recruits perceive the firm can go a significant distance in helping with the recruiting question.

Projecting law firm growth and controlling real estate needs

Law firm growth has, in the past, been primarily controlled by the amount of business available. As business grew, most matters were accepted and few if any clients declined. Conventional wisdom taught that it was essential for a firm to attempt to be everything to everybody. The examination of profitability of individual matters, let alone individual departments, or individual attorneys was not only not considered, it was discouraged.

Although it has been difficult, as Ross Perot said, “To teach the elephant to dance,” law firms have been forced to consider the profitability of matters, departments and indeed individual attorneys. Compensation plans have been revised and lateral hires have become much more common. Most firms agree that growth for growth's sake is not wise. Law firms, like the rest of American business, will be forced to do more with less. The average size of individual offices will decline, the rate of growth will slow, staff attorneys will be more common and the use of more paralegals will be essential to maintain or improve profitability for the partners or shareholders.

Traditional space standards must be examined and creative planning will be essential. The average square footage of an attorney's office, which grew in the 1980's and remained relatively consistent in the 1990's, will shrink in this century.

Costs to finish space have escalated over the last few years far faster than the official rate of inflation. However, with the economic slowdown of the last year or so constructions costs may actually be decreasing.

How to control operating costs in leases – exercising your right to audit

In our experience, even most of the best negotiated leases do not adequately deal with the issue of operating expenses. Operating expenses are often as much as half of the gross cost of leasing space today. In today's soft markets operating expenses can exceed the net rent. The number of words devoted to operating expense provisions in many major leases is often less than the number used in discussing condemnation. Negotiations should include the gathering of very detailed information on operating expenses and even a pre-audit of the landlord's expenses on the final building candidates. Careful consideration should be given to evaluating future cost saving policies. A voice in building management should be sought for any law firm that represents a substantial share of the building square footage.

Extensive lists of exclusions should be prepared and incorporated in any significant lease. Limits should be placed on management fees, and fees based on either 15% of costs or 3%-5% of gross rents should be consistently challenged.

Routine audits are essential to insuring that the provisions relating to exclusions are implemented. Landlords often bill everyone in a given building the same amount regardless of the lease exclusions. One of Keewaydin's clients (a 400,000 square foot corporate headquarters lease) audited its lease to find more than \$1 per square foot per year at issue.

Avoiding disastrous consequences if a large number of attorneys leave

Many firms do not have partnership or non-compete agreements in place which require individual attorneys to assume a portion of the lease obligations if they decide to leave the firm, nor do they have leases which contemplate dividing up the premises if a group of attorneys elect to leave the firm. In fact, even today, a number of well-established firms with partnership agreements dating back to the 1980's pay attorneys their share of receivables after they leave, regardless of the reason.

No major firm is immune from the danger of a split among its partners or shareholders. Senior partners and executive committees are usually the last to really understand the frustration of young rainmakers, often too late to head off a split. In such instances, the cost of the facilities, whether occupancy costs (rent, operating expenses and taxes), debt payments on above standard leasehold improvements financed by the firm, or debt (or lease payments) on furniture and equipment can bankrupt the firm.

We recommend that firms focus clearly on this issue when considering a relocation. Agreements which require any significant group of attorneys who leave the firm to take on a specific share of the liability may be necessary. Similarly, a lease provision that permits dividing the space and responsibility between two groups, even though they may be hostile to one another, may be required to enable the original firm to survive. The history of law firms is replete stories where extraordinary costs of real estate may not have started the break-up, but those costs inevitably finished off the firm.

Limiting liability to firm assets – protecting partners and shareholders

Today, with the memory of failed firms clear in the minds of many landlords, lenders and REITS, a request for a significant guaranty, letter of credit or other credit enhancement is a virtual certainty. However, most landlords are willing to accept a lease provision that limits the liability of a law partnership or the law corporation to its assets.

Some firms have been required to provide enhancements for above standard tenant improvements if the landlord provides that excess funding at all. Nevertheless, every firm should insist on such an exculpation. While it may not seem a major issue at the time, it could result in a significant problem to individual shareholders in the event of a financial crisis for the firm.

Keep in mind that an exculpation does not solve the problem created when a number of attorneys leave. Careful drafting is essential to insure that any agreement among partners to share the risk of a lease among themselves doesn't become an agreement to which the landlord is a third party beneficiary; obtaining the right to split the responsibility for the lease, may be key.

What is the correct length of lease term?

Flexibility is a key issue. Leases of greater than ten years are unwise unless necessary to complete a desired transaction. They are particularly problematical if a firm views its strategic direction as requiring a merger to keep pace with the legal market in general.

Most landlords today will want to amortize all leasehold improvements over the life of the lease. Thus, the annual rent necessary to amortize \$45 per square foot of improvements only, assuming 9% interest, varies from \$12.57 per square foot in a five year lease to \$5.75 per square foot for a 15 year lease. The cost is \$7.37 for a 10 year lease.

How important are heating, ventilating and A/C systems?

The one item most often stated as a problem with the management or design of buildings by tenants is dissatisfaction with the HVAC system. A study by the Building Owners and Managers Association (BOMA) found that almost 25% of responses to a questionnaire on the worst problem tenants have encountered cited inadequate HVAC systems. Proper planning can usually solve the problem in advance, but few large tenants, even those represented by top brokers or real estate consultants, rarely understand or request the type of equipment, zoning, capacity or fresh air needed for comfortable occupancy.

Interestingly enough, most landlord's leasing agents don't understand HVAC systems either. Well negotiated requirements, particularly those which are incorporated in a request for proposal or a letter of intent at a very early stage, can often result in a commitment from the prospective landlord that will cost that landlord substantially more to construct than he or she may anticipate. The tenant often gets a higher standard for free.

Care must be given however, not to ask for too much. There is a significant cost difference between providing a perfect space and a good space; and, the money must come from somewhere. Consulting engineers are often zealots, anxious to prove they are right, and the law firm or its real estate advisor must have the capacity to evaluate overreaching requests.

Finally, design standards must focus as much on the movement of air and the amount of fresh air as they do on temperatures, to insure a healthy, productive environment.

Like military contractors, landlords often make high profits on extras and changes. Careful definition of overtime HVAC charges and the costs of special installations for 24 hour computer rooms or telephone switches is essential. Don't be fooled into thinking that there is no cost for overtime HVAC just because the landlord doesn't specify an extra charge for it. Such costs are always included in operating expenses. If you are in the building with another 24 hour-a-day user, (anyone with a call center for example) you may be subsidizing its operation.

Will developers or developer's lenders accept options to downsize?

In strong economic conditions, the number of attorneys in large law firms has generally grown from 5% to 10% per year. As firms have grown somewhat rapidly in our burgeoning economy, the possibility of a major recession (even after we come out of the current one) cannot be overlooked. In such an event, downsizing may be essential for survival.

The need for flexibility will be more important in the 2000's. Although mergers and growth are significant business issues today, in the future, we believe that firms will divide up more regularly, smaller firms will merge and create or eliminate whole departments. Options to downsize may not only be desirable but essential to survival.

Getting landlord's approval of any give-back of provisions is not easy, and neither is getting lender approval of such provisions. That type of right undoubtedly affects the potential sale value (although not necessarily the real value) of buildings. Some recommendations for accomplishing such results may include:

- a) Make the give-back option a part of the deal from the very beginning. Include it in your request for proposal and consider refusing to consider proposals which will not accept it.
- b) Be prepared to pay some form of cancellation fee. Agreeing to pay the unamortized value of the improvements at the termination date will be a minimum payment acceptable to landlords, but being willing to do so is better than having no right of cancellation at all. If you consider such a provision, try for a straight line amortization of improvements over the base lease term without interest. However, you may have to agree to interest in the 9%-11% per annum range to get the landlord to agree. Another tack may be to agree to amortize only the "above standard" improvements. Or, attempt to exclude the above ceiling work (HVAC, sprinklers, light fixtures and ceiling tile) from the amortization formula. Persistence and creativity may result in a satisfactory give-back provision although this issue is more market dependent than almost any other topic discussed here. In other words, it is much tougher in a tight market than in a soft one.

Using planning to control costs of leasehold improvements

Law firms regularly spend far more money than is necessary on leasehold improvements. In many of the country's biggest firms, the cost of improvements could be cut by as much as 25% without compromising either the image or the functionality of the facility.

In most cases, poor planning is the reason. Understanding the costs in advance and setting a budget and sticking to it, will often save millions of dollars. Similarly, establishing realistic schedules and putting a team in place that can accomplish the schedule will also help.

However, the failure of the management to require architects and designers to develop various alternatives, and the inability to understand the cost savings available from those alternatives is frequently a major reason for high costs. For example, in most new installations, too much money is spent on obtaining "soundproof" offices, either because the problem could be solved less expensively, or because the level of "soundproofing" requested is higher than necessary.

Similarly, a desire for shorter leases, more flexibility and the need to move more often with mergers, downsizing and other systemic changes suggest that a law firm's image should be portable. Consider a "more plain" reception area and more plain public areas with transportable art as the major image statement. The art can be moved to a new facility at the end of a lease... instead of ending up in a dumpster full of walnut paneling when the next tenant cleans out the space to meet its own particular requirements.

Avoiding the gross lease, porters wage and CPI escalators

Even in New York City, the last bastion of this antiquated idea, the gross lease is rapidly becoming an anachronism. Net leases, with full pass-through of operating expenses and taxes are acceptable to almost all lenders and most developers and owners. Today, gross leases are often the result of brokers looking for a larger base rent for commission calculation purposes. They serve little purpose and seldom give any protection to the tenant.

The same is true with CPI escalators, porters wage escalators and similar items. The real estate business is changing, almost all markets are soft today, and more landlords are becoming realistic about not expecting to make a "profit" on operating costs.

Insist on knowing the brokerage commission

You may be surprised at how large the brokerage commission is in a typical office lease. Brokerage commissions are often negotiable. At a minimum, you should know the exact amount your representative is taking out of the transaction and how large their potential conflict of interest may be. Insist on an agreement establishing and limiting the fee paid to the broker before you agree to have someone represent you. Require the landlord to disclose, in the lease, the entire fee to be paid to all brokers, developers and leasing agents in connection with the transactions.

Do I need a local real estate broker?

Large leases are very complex items today, and the variance between a well negotiated and a poorly negotiated lease may cost a 200 attorney law firm as much as \$500,000 per year.

Large law firms should not be satisfied with market deals in any event. They make their own market. It is far more important to have a high quality representative who understands the business and space, than to have a representative with local knowledge. The experienced tenant representative can obtain all relevant local market knowledge in a few days, but even the best local real estate brokers may never understand the important considerations in evaluating a possible transaction.

If you have any questions relating to this topic or the issues raised herein, contact
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