Kowalski&Associates

Read more on our blog by clicking here.

Leverage is Back: The Return of the Pyramid Business Model for Law Firms, with a Twist

Jerome Kowalski

Kowalski & Associates

February, 2012

Yesterday marked the 35th anniversary of my admission to the bar. The day passed quietly, without note or fanfare. But it did cause me to reflect on how things have changed.

In 1976, when I graduated from law school, there were some basic covenants to which all subscribed: If you did well in college, you got in to law school; if you worked hard in law school, you got a job at a good law firm; if you worked very hard as an associate, had the tenacity, appropriate degree of intellectual rigor and good humor, managed not to offend for the term of your clerkship, you were promoted to the partnership and looked forward to lifetime tenure, a sinecure from which you could not be removed and would not dream of leaving until you entered your dotage. Many, if not most, large law firms had a lockstep system of compensation for associates *and* partners. The AmLaw 200 listings, the source of more tall tales than any gathering of fishermen at a tavern, would not surface for a decade. Lateral partner movement was as rare as hen's teeth. If a law firm partner in those days suggested that the firm should de-equitize partners so that the firm's numbers would look better, he would be directed to a psychiatrist for emergency treatment. Partnership had real meaning, it was not an at will employment status and partners would not for a moment think of themselves as free agents, available to the highest bidder. Partners were proud owners of the enterprise. There was genuine *esprit de corps*, mutual respect, pride, loyalty and genuine collaboration.

These ruminations were prompted by the piece recently written by my friend, Professor Steve Harper, entitled "The Lateral Bubble," a must read for anyone toiling away at or near BigLaw. Frankly with all of the buzz in the blogosphere and elsewhere concerning Harper's piece, it seems that all have read it already or pretended to have done so, at the very least.

Professor Harper, no fan of partner free agency, observes that partners are no longer proud owners of the enterprise. Rather, he observes that BigLaw's "currently prevailing business model encourages partners to keep clients in individual silos away from fellow partners, lest they claim a share of billings that determine compensation. Paradoxically, such behavior also maximizes a partner's lateral options and makes exit more likely. In other words, the institutional wounds are self-inflicted."

Harper quotes admiringly another recent article by Ed Reeser and Pat McKenna entitled "Crazy Like a Fox" in which the authors articulately demonstrate in cogent fashion how meaningless the Profits Per Partner metric is (disclosure: Ed Reeser is also a good friend of mine and has been an occasional contributor to these pages; Ed and Steve do not know each other, but I can assure you that they are kindred spirits in every possible respect).

Say Reeser and McKenna:

> "Over the last few years there has been a dramatic change in the balance of compensation, to a large degree undisclosed, in which increasing numbers of partners fall below the firm's reported average profits per equity partner (PPP)…Typically, two-thirds of the equity partners earn less, and some earn only perhaps half, of the average PPP."

In 2010, I wrote about the emergence of a three tiered caste system for associates in BigLaw: Firms now employ "partner track associates", "non-partner track associates" and "staff lawyers". The partner track associates are those from the best schools, with the best grades who toil away the hardest and whose academic credentials are touted to clients and potential lateral partners. Non-partner tracks associates are those who fared a little less well, and who have a fairly short shelf life. The staff lawyers are those who are most akin to day laborers, who float from gig to gig, often paid subsistence wages and receive no benefits.

Well, then, what's good for the sauce for the goose is good for the gander. Partner ranks have now evolved into a new three tiered caste system as well: Highly compensated equity partners, a second tier of less handsomely paid equity partners and a great swathe of contract partners. As Harper, Reeser and McKenna observe, the ratio of compensation from the most highly compensated equity partner to the lowest is staggering; in some firms it's ten or twelve to one. The ratio for most highly compensated equity partner to the lowest level of contract partner is often even greater.

While we may have thought that The Great Recession brought about the demise of the leverage model for law firms and that the new model for the Twenty-first Century Law Firm is an inverted pyramid, the good news, folks, is that leverage is back and the pyramid has similarly returned to its old footings. Except that the pyramid is no longer one with a broad base of associates and partners decreasing in number at each higher level of the edifice. With the devolution of associate ranks to the caste system, the refusal of clients to pay for first and second year associates and clients' not permitting law firms to mark up and sell at a profit the work of temporary staff lawyers, associates no longer make up the base of the pyramid. Rather, it's the ranks of contract partners who lie at the base of the pyramid and support those at its summit. As those at the top need more support for their compensation requirements, some equity partners find themselves cast into supporting roles keeping the rich and famous comfortably enjoying the view from the top. If more financial support is needed, partners are simply de-equitized, move down a notch and then fill out the base of the pyramid. Partners deemed insufficiently productive are asked to leave. The notion that partners are owners of the enterprise is gone.

Ample anecdotal evidence from the field corroborates the return of the leverage model, albeit at the nominal partner level. We have heard from scores of managing partners that those at

the partner at the partner ranks busier than ever, working longer hours and grinding out the work as never before. Equity partner compensation at the pinnacle is at eye popping numbers.

The only issue not yet adequately addressed is the future of the pyramid when those at the top see the lush neighboring pyramid across the expanse with a taller peak, more lavish accommodations emitting a siren call for all those who want even more. Collapse of the structure comes not from erosion at the supporting base, but rather from the loss of the pinnacle.

Keeping the structure erect and enduring simply requires a return to the days of yore when all partners truly felt like they were proud owners of the enterprise, and a return to feelings of genuine *esprit de corps*, mutual respect, pride, loyalty and genuine collaboration.

© Jerome Kowalski, February, 2012. All Rights reserved.

Jerry Kowalski is the founder of Kowalski & Associates, a consulting firm serving the legal profession exclusively. Jerry is a regular contributor to a variety of publications and is a frequent (always engaging and often humorous) speaker to a variety of forums. Jerry can be reached at jkowalski@kowalskiassociates.com or at 212 832 9070, Extension 310.