By Edwin Reeser

In a recent interview, Pittsburgh-based K&L Gates Chairman Peter Kalis hit a number of hot buttons from my financially conservative perspective that a lot of other firm managing partners either do not or cannot confront head on in public, if at all.

"Kalis calls criticisms of the firm's relatively low PPP [profits per partner] and RPL [revenue per lawyer] figures unfair because K&L Gates doesn't enjoy the benefit of having the bulk of its lawyers based in New York, like many of the Wall Street firms." Most of us should agree with Kalis that the comparative PPP and RPL figures are not the metrics that count for everything given the many small markets KLG has a presence in. Conversely, is it a powerful bragging point that occupancy costs are $10k per attorney per year lower? The rent in those smaller markets, as well as the support labor costs, are lower, just as realizable billing rates are lower. The proper question is whether that margin is enough. See "Heading Into Another Term, K&L Gates Chair Kalis Talks Growth, Mergers, and Lateral Moves," AmLaw Daily, Sept. 27.

It is common to have offices in a national/international network which cater to local client bases that are "middle market" deliver a superior operating margin ratio, which makes them formidable if not superior contributors to the profit pool, especially after allocation of partner compensation. One of the dangers of elbowing in to the big "money center" markets like New York or London is that while the rates are high, so are the costs of operation, and so are compensation expectations of partners. If operations in New York or London cannot generate net profits sufficient to sustain the compensation expectations for partners in that office, the firm may need to subsidize compensation with profits taken from other offices. The same concern applies to high-prestige boutique practices, such as certain finance or IP practices, wherever they are located. Many firms bleed large subsidies for the privilege of being in money center markets or boutique markets such as Silicon Valley.

Failure to have discipline with compensation control closely tied to actual net performance can be catastrophic not only financially, but culturally — unless it is concealed from the other partners, of course.

The issue to focus upon is delivery of sustainable net distributable cash through a satisfactory operating margin. Regardless where a firm is based, if the firm model and people inside it cannot generate the essential distributable cash and operating margin, everything else falls apart. A firm can have lower cost operating locations, with lower compensation than New York, but which is still a very attractive value proposition in that market compared to peers. Lawyers in smaller markets understand this, but that doesn't mean they expect their production to be stripped to give to underperforming New York partners.

Then you have the governance issues:

Structure. For example, Verein versus One Firm. See "Swiss Verein — The Cassoulet Pot for Global Law Practice," Daily Journal, Aug. 7, 2011.

Style or approach. For example, open or closed compensation, level of participation in decisions by partners and transparency in performance. I don't think that structure had anything to do with the demise of Dewey & LeBoeuf, but the style and approach did.

Mechanics of compensation. Are there wide spreads among partners in compensation? How are they supported dynamically (sourcing and use of debt/equity capital)? See "Sliced Too Thin," American Lawyer, May 31.

Accounting methodologies. Are recruiting costs being currently expensed or amortized? Is there substantial off balance sheet debt through leasing or other techniques? See "Modified Cash Basis Accounting: Super Fuel for the Profits Per Partner Drag Race," Daily Journal, May 5, 2011.

Lateral "in and out" and the costs. Is the firm building or hemorrhaging through its program? See "Pricing the Purchase of Lateral Talent," Daily Journal, June 18.

Treatment of capital accounts. Is departing partner capital returned right away, or does the firm use it as a source of interest free borrowing? The rolling or installment contribution program at KLG has very significant implications, which we don't need to go into here, but they should be obvious to anyone who considers being a partner there, and as long as partners sign on to the program, then that is their informed decision. See "Adding Up the True Costs of Lateral Partner Buy-Ins", Daily Journal, October 4-5.

Culture. The importance of culture could consume chapters.

And then there are the operational considerations. The list goes on.

KLG reportedly has very narrow (22 percent) operating margins, and equity is held by fewer partners than most firms. That is the only way to sustain larger PPP in a thinner margin environment. It puts the capitalization burden on fewer shoulders, and can result in wider net income swings. Not necessarily a bad thing, as long as the partners understand and are willing to stick out the down swings. However, to get that "glue" there have to be things other than money that hold the firm together. "Culture" is a valuable asset to leadership if properly tended to. See "Low Return," American Lawyer, Nov. 1, 2011.

It is interesting that so many uninformed Dewey partners were willing to "stick it out." What we have all learned subsequent to that collapse is there was nothing to overcome or work through; the leadership had completely sucked dry the financial core of the business to many loyal partners' surprise. It is now recognized that Dewey had no prospects of being saved, even while leadership was touting to the press that the firm was having its best year ever. (That unfortunately puts a serious pall on the credibility of accurate leadership statements from other firms that "we are fine, nothing to worry about here.")

Partners are often loyal and willing to shoulder together through adversity, but the Dewey model appears to have been built upon taking advantage of that very admirable "asset" for the benefit of a few partners. Probably it was not that way initially, but somehow over time it appears to have morphed into that.

Any firm model is capable of falling into that Dewey "perversion." That is the stuff of which notorious failure is born, not whether a firm is a Verein or something else, not whether it is organized on a practice group or a geographic office model, not its comparative PPP figures. If a partner contributes what is expected of her or him, and in exchange is rewarded fairly and in the amounts and types that he or she expects based on that contribution, then the first brick is laid properly. Otherwise, everything built on top is shaky.

So when we look at these contrasts, let us be clear, and fair, about the focus of questions, and the answers. Dewey was a failure. KLG to this point appears to be a success. They could not on the surface appear to be more different. Separating out the image of Dewey, and the reality of Dewey, is what so many have had difficulty coming to grips with. It was not, and in most respects never was, the firm it held itself out to be. KLG is very clear about setting forth what it is, and *why* it is that way.

As with every business enterprise, especially one in highly competitive markets that are undergoing rapid and significant changes, the challenges are significant. When you come to a fight, you fight "with what you brung." The KLG model is sourced in their roots, just like most businesses. It has some advantages, and some disadvantages.

Does it make sense for KLG to be expanding as it is, to be doing what it is doing, the way it is doing it, when it has the rootstock that it does? Why does the firm pursue this growth strategy? Eight mergers in 15 years. Does it bring the prospect of greater profit, greater stability, greater sustainability as an enterprise? Or is this more like the expansions of Ling-Temco-Vought or Gulf+Western? See "Big Law Could Learn Lessons from the Unsuccessful Corporate Conglomerate Business Model," Sept. 16, 2009.

Perhaps it does make sense for a Pittsburgh-based firm, with a lot of small, low cost offices, to be going to Europe, Australia and Asia. Then again, perhaps it is like playing the cello in the high school marching band. It can be done, but why? Is this driven by a need for partners and their practices to have offices overseas? Does the return overcome the additional costs and investments to acquire and sustain those operations, for the collective benefit of the partners in... Harrisburg?

Is having an occupancy cost per lawyer that is $10k lower per year an answer to a question that really indicates something that is outcome determinative for the success or failure of a firm? Nothing in the AmLaw Daily article addressed the bigger questions that matter. But that was probably the point.

Besides, that is for the KLG partners to address internally and collectively if they can, and if they cannot they will most certainly address it individually. That is what usually happens in law partnerships. Let's give them a chance to do it.

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