Crazy Like a Fox

Why the increase in nonequity partners (and decrease in associate ranks) makes business sense.

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At first blush, it sounds crazy: firms shedding associates—long regarded as the sweet spot of law firm profitability—while expanding their ranks of better-paid nonequity partners. But even during the recession, that's what happened ["Holy Nonequity Partners," May 2010]. And the bankers have noticed. In an essay about third-quarter financial trends ["New Year, Old Worry," January], Citibank's Dan DiPietro and Gretta Rusanow noted "a discernable decline in the percentage of asso-ciates represented in the leverage composition and a significant growth in the income partner, counsel, and of counsel categories. The result is a much more expensive leverage model, which would be fine if these more expensive lawyers were as productive as equity partners and associates, but they are not. In looking at average annual lawyer productivity from 2001 to 2010, income partners and counsel worked about 150 hours less than equity partners and asso-ciates." In other words, relying on nonequity partners instead of associates makes for a dangerously expensive leverage model.

We disagree. We believe that the growth in nonequity partner ranks is a part of a fundamental shift in the leverage model—call it the New Leverage. Reduced reliance on associates is part of it; so is the deequitization trend of recent years—and it's an aspect of the latter element, not the former, that firms should be worrying about.

First, about those nonequity partners: If firms are crazy to increase their nonequity ranks like this, they're crazy like a fox. In the deleveraging process, nonequity partners are immensely more profitable than associates. Here's why:

• It is not about the hours worked; it is about the hours collected. Realization rates on work by nonequity partners are high, particularly when contrasted with associates, where write-downs are much more common (assuming that clients will pay for associate work in the first place).

This is more complicated than just hours worked. The new leverage model is more of a column than a pyramid, with clients demanding that more senior people work on their cases, and some general counsel forbidding use of first-, second-, and even third-year associates altogether. It has become common for clients to say that they will pay for however many standard-rate hours it will take for nonequity partners to work on their case but will not subsidize on-the-job training of a gaggle of associates.

• The Rollover (or attrition cost) of associates is significant. The average Am Law 200 law firm loses approximately 20 percent of its associates per year, and when one factors in recruitment, summer programs, time write-downs, training, and so forth, it's widely accepted that each lost associate costs a firm $250,000–$300,000. We all know, but quietly ignore, that at many firms, this "impact cost" adds up to millions of dollars every year.

Now contrast that to the rollover rate for nonequity partners. The rate is not only much lower, but even when a firm loses nonequity partners, there is little impact cost, since the firm has recovered the investment in their development and has been earning profits on them—in most cases for years.

The one cost here that is not measurable is client dissatisfaction. Clients continue to complain about the high turnover and disruption they experience whenever they have to confront yet another replacement associate working on their matter. Those clients may instead choose to move their work to more efficient and lower-cost firms. This movement is hard to quantify, but it is happening broadly, and the forecast is for it to accelerate.

• The Marginal Additional Cost per nonequity partner is modest. Admittedly, the salary for a nonequity partner is higher, but that is about it. The per capita allocated cost for overhead for a nonequity partner is about the same as for an associate. Thus the marginal income per hour from a nonequity partner is much more profitable to the firm. Nonequity partners can work fewer hours and produce a bigger net return to the firm, especially because of their higher realization rates.

• Nonequity partner compensation is usually performance-based. Almost by definition, every income partner makes money for the equity partners, while most associate compensation is lockstep-based and not attached to true profit contribution. As a class, associates do not make money for the firm until sometime in the third or even the fourth year and cumulatively do not reach break-even for the firm until even later. With attrition of 80 percent of the class by the end of the fifth year (and thus fewer associates making a profit to counter the early-year losses on great numbers of them), it is a somber economic reality that even in the glory years, associates' profit contribution, relative to the cost to support them, was problematic and is now obviously unsustainable.

• Nonequity partners make a value-added contribution. Contrary to the conventional wisdom, we believe it is logical that nonequity partners work less—or that they appear to. These nonequity partners settle into a manageable, though still hardworking, existence. Many take on nonbillable leadership positions in firm initiatives involving pro bono, diversity, recruiting, training, and professional development.

These practitioners also often possess specialized skill sets that are valuable to the firm at large. They can help with RFP responses and new business pitches and contribute to handling nonbillable administrative duties in ways that most associates never could. In addition, many of them have reasonable books of business and self-sustain their presence, making it a no-brainer to keep them on the team.

Finally, the nonequity category is often home to lawyers interested in flextime work and alternative career paths. Firms can retain some whiz-bang lawyers who have young children they want to spend more time with or who just want to get off the equity partner treadmill.

• Two of the three sources of nonequity partners are virtually risk- and cost-free. Nonequity partners come to a firm in one of three ways. The first involves promoting the best associates from within. They already produce more revenue than they cost, so they are welcomed into the nonequity class, to learn the business development skills needed for advancement to the equity partnership.

The second comes from the deequitization of underperforming equity partners. Again, they are retained at a compensation formula that is a guaranteed win for the law firm. (As we'll discuss below, this is likely to have been the case even when these deequitized partners were in the equity partner ranks. The bulk of equity partners in the modern big-firm economic model are net contributors to the "enterprise profit," which is shared among an ever-shrinking percentage of upper-tier equity partners.)

The third source is the lateral transfer market. This involves high out-of-pocket costs for recruiter fees and the risk that a lateral's promised book of business won't materialize. Increasingly, firms are requiring all but true stars to spend a year or two as nonequity partners to prove themselves. This makes a mistake easier to fix by dispensing with an underperforming lateral as an employee at will and sparing the firm a painful and procedurally sensitive and difficult equity partner expulsion.

All told, we think astute firm management should conclude that a professionally skilled nonequity partner with a modest book of business (say, $700,000) who delivers a reasonable realization (93 percent or so) and a $200,000 contribution to the distributable income pool for the equity partners is a valuable contributor to the bottom line.

The one component of the new leverage model that we believe warrants serious attention is the application of the deequitization strategy to maintain or boost equity partner income levels—and indeed, in some instances, to seriously increase income to some equity partners at the expense of others. This strategy has two parts—one that has become widely recognized, and one that has not.

The talked-about portion is reducing the number of players who share in the pie by either expelling or easing out the "underproductive" members of the equity class, or by converting them into a salaried income, contract, senior, or of counsel status (possibly with a performance bonus component).

But the other portion is the dramatic stretching of the partnership income spread and how it is accomplished, especially at firms with closed compensation systems. While it has been noted that the spread from lowest to highest partner incomes has increased from, say, 3:1 to much higher ratios, such as 10:1 or even 12:1, the breakdown is not analyzed, mostly because it is kept secret from the partners themselves. 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).

In order to pay the higher-compensated partners, there has to be a shift or reallocation of partnership profits "upstream." That money comes from the lower- and middle-tier equity partner ranks. So while there may be reports of maintaining or even increasing PPP, the reality is that almost all of that money has been handed to the high-performing partners, and that the lower- and middle-tier partners have seen no income increases. Indeed, we hear that many of them have seen, in real terms, reductions in their actual compensation, even in situations where they have met or exceeded budgeted targets for client originations, hours worked, and hours billed.

This is an important point and one that has been misunderstood. Whatever the average PPP is, most of the equity partners at most Am Law 200 firms do not collect anywhere near that sum. The arithmetic average—the mean—is much higher than the arithmetic median, the midpoint at which half earn above and half below the reported number. Typically two-thirds of the equity partners earn less, and some only perhaps half, of the average PPP. This increased "tilting" of a firm's basic operating platform is a great destabilizer—and a potential contributor to sudden firm collapse. That, we believe, is where the real danger to law firms lurks.

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