

The End of Innocence

“Dewey jettisoned traditional notions of a law firm partnership. Instead, Mr. Davis promoted a star system where top-producing partners had guaranteed contracts paying them millions of dollars a year. Some partners, the so-called rainmakers who brought in the business, made more than ten times Dewey’s lowest-ranking ones, the service partners who earned a salary of about \$300,000 drafting legal briefs and proofreading merger agreements.”

Peter Lattman—The New York Times

BigLaw’s Tipping Point

Merriam-Webster defines competition as the effort of two or more parties acting independently to secure the business of a third party by offering the most favorable terms.¹ This sounds harmless enough, does it not? Competition is fun, invigorating, and timeless. And being that it is the foundation of our economy, it is vital to our personal and professional lives. In fact, the absence of competition can breed ugly things like laziness and mediocrity, and when left completely unchecked, catastrophes such as Communism or even extinction.

Where am I going with this? Well, when we are speaking of competition at the highest levels (e.g., professional sports, the Fortune 500, BigLaw) to say that it is intense is an understatement. Sometimes, it can become so driven

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and so intense that it tests the integrity of the infrastructure that supports it. This testing of mettle is precisely what is happening in major law firms and the environments in which they function, today. The intense drive for law firm expansion and the lateral tournament that feeds it have grown so intense over the past three decades that cracks in the legal infrastructure have been literally exposed, and in some cases they have splintered and firms have fallen. How did it get to such a critical point? To answer that question, let’s go to the history books.

Coming of Age

If you ask some of the retired legal veterans, undoubtedly they will tell you that, rather than being driven by profits, the practice of law was (primarily) driven by passion and personal interests. Sure, attorneys were paid for their services, but law was a profession, not a business per se. And while attorneys of old got by, they didn’t get rich solely from the practice of law. In fact, with average attorney incomes actually declining in the 1940s and ’50s (when adjusted for inflation), the legal profession was

(relatively) financially unattractive.² As you might imagine, a side effect of these falling wages was fewer graduates going to law school, which reduced the legal ranks in the years to come—who wants to get into a dying profession? More about that shortly.

At the time, though, most firms had negative leverage ratios, did not keep time like they do today, organized themselves as general partnerships, and financed obligations *exclusively* from their own capital base. With a modest economy, these lawyers were absent the myriad goliath transactions and litigation cases that are common today. But it didn't matter. They liked what they did, and that's why they did it. Stoic, loyal, and dedicated to both the profession and the collective, these partners defined the era of the traditional professional partnership (P²) model, which was governed by the unlimited liability of the structure and held together by a powerful partnership ethos.

The start of the 1960's (postwar) era, however, brought with it a number of developments that changed the legal landscape forever. The economy

strengthened considerably, spawning a huge need for legal services vis-à-vis corporate America's massive expansion. Accompanying this growth was the expansion of in-house law departments, a relaxation of marketing restrictions, an increased usage of the billable hour, significant technological developments, and two major liability reductions in the form of professional liability insurance in the 1960s, and eventually, the introduction of the limited liability partnership in the 1990s.

Do you remember the decline of interest toward the legal profession we just mentioned? Well that came around full circle, too. Fewer attorneys and a surplus of legal work increased, exponentially, a lust for client acquisition and ever-higher bill rates. For the very first time in its existence, legal services became a true financial windfall, and as history has shown us, money changes everything. And while, on its face, the alignment of these stars seem to be reason enough for firms to want more money, there were also less obvious, and a bit more insidious, forces at play.

Of consequence, too, were the legal community's attempts to mirror the ever-evolving and maturing strategy and marketing methodologies of corporate America. In a 1952 article written for *The Journal of Finance*, the economist Harry Markowitz (recipient of the John von Neumann Theory Prize and the Nobel Memorial Prize in Economic Sciences) introduced the market changing notion of Modern Portfolio Theory (MPT), which regards the attempt to (i) maximize a portfolio's expected return for a given amount of risk, or (ii) equivalently minimize risk for a given level of expected return, by carefully choosing the proportions of various assets.³

In other words, this was the formal introduction of profit maximization through economies of scale, and reduction of risk through diversification. Though modern behavioral economics has challenged the validity of this, at the time it was bleeding edge, terribly convincing, and ran through cor

- porate America like a laxative.

To further validate MPT, senior managers at GE started a nineteen-year initiative known as the Profit Impact of Market Strategy (PIMS) study in the early 1960s, which was deployed to establish best practices as they pertain to strategic approaches to the market, and in particular, the gaining of market share.⁴ By the 1970s, the majority of the strategic management research focused on size, growth, and MPT. At the time, the conclusions

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arising from this study were quite clear: due to advantages gained through the experience curve and economies of scale, the greater an organization's share of the market, the greater their rate of profit.⁵

These (perceived) benefits created a demand for, and interest in, growth strategies such as horizontal and vertical integration, diversification, mergers, acquisitions, joint ventures, and other simpler forms of organic growth. As you might imagine, marketers and strategic managers transitioned this knowledge to their existing portfolio strategies, creating increasingly finite lines of business (LOBs) or specialized service business units (SBUs), turning them into semi-independent profit centers. In layman's terms, they further specialized their products or services.

In response to these major market shifts, prevailing market theories, and market segmentation, law firms sought to develop their own portfolio of services to not only better service their ever diversifying and expanding clients, but to also satisfy their own conservative, risk averse nature and more effectively increase their profits. Law firms began, for the first time, to truly take note of what their clients were doing so as to mimic their corporate growth. The question quickly became not whether the firms should chase the market, but how? A question that is easier asked than answered.

Challenges to Growth

At this point in legal history, the rate of lateral mobility was anorexic at best. Professionally speaking, moving to other firms was unacceptable; a legal ethos kept lateral growth strategies out of the war room.⁶ Growth in the form of direct client acquisition is terribly expensive—there are entire marketing departments, materials, technological overhead, expense accounts (for client courtship) and more to account for. The time expenditure is huge, too. Aside from the massive outlay of hours just to get started on a marketing campaign, managing and closing a marketing funnel consumes even more. Add to that the high hourly rate of the primary marketer—i.e., the rainmaker—and you have a time- and capital-intensive endeavor. Even if things go exceedingly well, and a firm is able to get a new client in the door, the business is often piecemeal and discounted and may or may not

gain enough critical mass to ultimately turn the consumer into a house cli-

ent. We haven't even factored in the reality that many attorneys don't have the applicable skills to effectively market and sell their services, anyway, which is certainly evidenced by the relatively small rainmaking population.

If that's not enough, the very nature of legal services is a wrench in the machine, too. You see, a massive portion of available legal work comes from established, historied institutions. This means that statistically speaking, the majority of "new" business that comes into a firm must be appropriated from another firm—a feat not easily achieved because of the credence nature of legal services. A credence good is one which possesses qualities that cannot be observed by the (relatively) less savvy consumer after the purchase, rendering it quite difficult to assess the good's true utility. Experience goods, on the other hand, can be more directly measured, thereby making their utility much easier to ascertain.⁷ This reality leaves much of the legal consumer population in the proverbial dark when it comes to effectively valuing the services they are paying for. Did they get the best service? Did they get the right service? Were they charged fairly for those services? These questions and more create a huge informational asymmetry between the attorney and their client(s), resulting in massive value being placed on the client/attorney relationship by the clients; they need and covet a strong bond and trust between themselves and the attorneys that service them. This relationship is the sole remedy (in most cases) to the dissonance that surrounds legal consumption. So, the very nature of the industry results in (i) established relationships that are incredibly difficult to sever, and (ii) a client lifetime value (CLV) that is very high, and therefore very attractive, well serviced, and fiercely protected.

In a market where partner-specific relationships were, and generally speaking, continue to be, the single most powerful binding mechanism between a client and a law firm, direct client acquisition initiatives were (and in most cases, still are) outrageously expensive, generally ineffective, and statistically speaking, unsuccessful.

Leverage and Destabilization

So, with lateral acquisitions being taboo and direct client acquisition being terribly costly and almost impossible to achieve, how is a firm supposed to aggressively grow? Without the ability to easily acquire new books or billers, they were forced to work (far) harder if they were to capitalize on any potential surplus from their existing client list. With this notion sounding unappealing—because it was/is—other means were sought out; enter the phenomenon of leverage. Firms found that by adding new associates, they could send work to lower levels and bill it out at lower, but still profitable rates to make more money! Genius. So genius, in fact, that this continues to be the very heartbeat of any large-scale professional

service firm—especially law firms. Every rose, however, has its thorns.

Marc Galanter and Thomas Palay wrote a book you may have heard of—*Tournament of Lawyers*—which basically describes the Cravath System of promotion and its various advantages and disadvantages. In short, the associate-to-partner path was seen as an apprenticeship whereby the firms hired the highest caliber associates available and pitted them against each other for eight years. In the end, the best made partner while the rest went their separate ways. This was, and still is, the basis of new hires and leveraging methodologies, though to a lesser degree as it has been replaced by a more “elastic” tournament.⁸

Despite its successes and effectiveness, this pledging process, if you will, is not without its challenges. While leverage generated significant revenue and profits, it also swelled the partner ranks in later years. You see, because of the perceived impact to a firm’s prestige factor—a primary reputational signal used to lure in first year associates—more traditional notions of “up-or-out” were a bit more “up” and a bit less “out” than they are today.⁹ And though this assumption of reputational impact has subsided to a degree, even today’s law firm management finds the actual firing of associates to be a major blow to their prestige, and is therefore a last resort.

Combining all of these factors increased the rate of associate hiring, which eventually resulted in many more partners, who needed to hire even more associates in order to maintain the same leverage ratios, and therefore, profits. Hey, their predecessors were making \$350K a year, it was only fair

that they did too. This cycle ultimately resulted in an abrupt expansion that generated a number of unexpected outcomes, including (i) a massive spike in associate salaries for recruiting and retention purposes, (ii) newer technologies to increase firm efficiency and efficacy, (iii) an increase in the use of the billable hour, and (iv) the invention of new classes of legal employment such as non-equity partner, counsel, senior associate, clerk, etc.—the elastic tournament—so as to protect the firm’s reputation and retain attorneys that were not partner-worthy, but were still quality (and expensively cultivated) talent. When we cut through the fluff, these four events were means by which to facilitate the further leveraging of associates, which resulted in superior levels of compensation, whetting and forever changing the fiscal appetites of the average law firm partner.

In the evolutionary timeline of large law firms, the era of leverage marked the beginning of the end of the professionally governed, white-shoe law firms of old that practiced law for law’s sake. The profession shot into a profit driven supernova that spiraled aggressively, gaining enough momentum to eventually drive itself. Ordinarily, lawyers making more money wouldn’t (and shouldn’t) be such a bad thing. Assuming that you (the reader) are an attorney, you provide a terribly useful, and in many instances, vital service. Expansion is a natural process in any viable industry, and in most industries, poses no real threat. With that being said, legal expansion didn’t become a structural issue until the mid-80s, when fluid lateral movement reared its head. To better understand, we will visit a

great American pastime—baseball.

The Fundamentals of Free Agency

At \$6B a year, Major League Baseball (MLB) is the second highest grossing professional sport in America. Actually, it is one of the higher-grossing institutions in America in general. Not too shabby for a game whose roots trace back to a simple 19th century pastime.¹⁰

The origin of modern baseball is usually considered [to be] the for-

mal organization of the New York Knickerbocker Base Ball Club in 1842. The rules they played by evolved into the rules of the organized leagues surviving today. . . . The first admission fee (50 cents) was charged that year for an All Star game between the Brooklyn and

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New York clubs. The association formalized playing rules and created an administrative structure. The original association had 22 teams, and was decidedly amateur in theory, if not practice, banning direct financial compensation for players. In reality of course, the ban was freely and wantonly ignored by teams paying players under the table, and players regularly jumping from one club to another for better.¹¹

And so the story goes, after having been exposed to the lights and glitter of the media and stardom, what was once just a game played out of passion is now a major commercial enterprise that is spinning out of control. Average salaries in 1972 were \$146,026; in 1982, they were \$456,250; in

1992, \$1,296,907; in 2012, a whopping \$3,440,000.¹² We're talking average salaries! These guys are making huge money, which means that the teams are *paying* huge salaries, which requires huge revenue, which requires that consumers purchase expensive goods and services. The average price of a MLB ticket in the 2011 season was \$26.91;¹³ a beer at a Phillies game was

\$7.25, while a hot dog at a Dodgers game was \$5 even.¹⁴ As for the cost of jerseys, hats, and other memorabilia, let's not even go there. And while most would say that the players make this kind of money because, quite simply, their game play sells these things, it isn't the whole story.

There are two pieces of the puzzle that often fly below radar when discussing MLB salaries. First, free agency in MLB surfaced (officially) back in 1975.¹⁵ Make no bones about it, baseball salaries were on the rise before bona fide free agency hit. But when it was ultimately unleashed and began greasing lateral movement between teams, salaries skyrocketed. Players loved playing—and still do, I'm sure—but why not make more money in the process? Second, and even more important, the blood that free agency spilled into the water brought sports agents from far and wide. Consistent and easy movement meant there was huge money to be had!

Agents and salaries have their obvious associations: hard bargains, intense negotiations, and flagrant tactics to leverage team management and owners. But a less obvious and more insidious dynamic is the aggregation, dissemi-

- nation, and eventual leveraging of market- level *information*. Consider Scott Boras, for instance. Having represented guys like Barry Soto (\$126M contract), Jonny Damon (\$52M contract), Daisuke Matsuzaka (\$52M contract)

and Alex “ A- Rod” Rodriguez (a cool \$250M contract), he is arguably one of the most prolific sports agents in the world. One of his not- so-secret weapons is a staff of forty people that crunch numbers with a multimillion dollar database that the teams “ just don’ t have.”¹⁶ Why is this so important to explaining sky- high MLB salaries? Well, aside from providing leverage in the negotiations, they set the expectations of the players involved—this is where things get complicated.

Let’ s take a different tack to better explain this. Hypothetically speaking, if A- Rod couldn’ t get \$250M because the market just wouldn’ t pay it, do you think that he’ d play ball for \$220M? How about \$200M? How about \$150M? Actually, let’ s just get down to brass tacks. A- Rod doesn’ t have a college- level education, and to the best of my knowledge, does not have another highly- marketable skillset aside from playing baseball.¹⁷ With this being the case, I am willing to bet that if he were making some nominal wage at a less than desirable job and had no idea how much MLB could or would pay, he’ d play baseball professionally for just his nominal wage. Shoot, maybe he would do it for even for less. The hard reality is that, aside from testing supply and demand concerns to see what revenue the market will bear, the reason that these athletes are paid so much is because they *know what the teams can and will pay*.

Now, I realize that this is a bit of a “ duh” moment. Of course they know. But it wasn’ t always so, and even though the market’ s demand pushed salaries upward, it was—and still is—the aggregation and leveraging of that information that is the real spark to the rocket’ s fuse. How does this translate to you, the reader? Enter *The American Lawyer*.

The Entrance of *American Lawyer*—The Honeymoon’s Over

“ In February 1979 the first issue of the *American Lawyer* featured [Steven] Brill’ s article on Joseph Flom, who had led Skadden Arps Slate Meagher & Flom into the ranks of the most prosperous U.S. law firms and also served as chairman of the board of editors of *The National Law Journal’s*. In this article Brill emphasized law firm finances, a topic usually not discussed by most lawyers.” Fundinguniverse.com’ s article goes on to say “ Brill soon

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National Law Journal's rankings by number of attorneys, Brill ranked firms by their annual revenues. Although some initially considered *The American Lawyer* no more than a gossipy lightweight magazine, in the 1980s some law firms sought to be included in Brill's publication. Former U.S. Supreme Court Chief Justice Warren Berger said in the August 12, 1991 New York that, *The American Lawyer* routinely revealed information - revenues, part-ners' salaries, and fees- that had always been closely guarded by firms. Brill also looked at the business ethics of individual firms, and how they treated young associates, which turned his magazine into a bible among law- school graduates.¹⁸

Prior to the 1980s, lateral movement was (largely) only legally accept-able. Partners could and sometimes did lateral to other firms, but it was an ethical and professional faux pas.¹⁹ Like an imaginary line of demarcation that keeps warring armies at bay, professional etiquette may have been intangible, but was more than enough to keep the infrastructure of BigLaw intact. This unspoken dogma received its first blow, however, in 1986, when *The American Lawyer* published their profits per partner (PPP) list. The profits cat was officially out of the bag, and the combination of temptation, resentment and below- market incomes turned into a tidal wave of laterals that a professional ethos could no longer hold back. So as the late ' 80s and ' 90s rang in, along with being legally acceptable, lateral movement became so commonplace that it was ethically *and* professionally acceptable, too.

Advertised PPP resulted in massive lateral movement as attorneys chased the bigger buck, and the rest is history. With a newfound knowledge of what the market could bear, no longer were law firms billing their clients based on the cost of time and value; they were seeking the best way to increase their profits—which exploded, by the way. And as we have already learned from our lesson in the economics of Major League Baseball, where more money is available, players and attorneys abound.

For the first time there was reliable information about the earnings of partners in the largest firms, and every partner in every major business practice firm knew what the competition was able to generate from their law practices. Many partners realize that they could earn a good

deal more in a different law firm or in a different law firm environ-ment, and this stimulated their interest in ' reforming' their own firms or moving to more profitable ones. The age of innocence in the legal profession had come to an end and nothing has been the same since.²⁰

Author Michael Trotter—quoted above—couldn't be more correct. The average PPP of the Am Law Top 50 was \$309K in 1985, \$568K in 1990, and \$550K in 1995—aggregate inflation adjustment resulted in the

drop. It wasn't until 2000 that the market really gained traction, with average PPP climbing to \$967K. 2005 saw an average of \$1.385M;²¹ 2010 saw an average of \$1.386M;²² and 2012, the latest ranking as of the writing of this book, saw an average of \$2.112M;²³ not too bad when you consider that the legal field is still clawing its way out of the worst bloodbath it has ever seen.²⁴

As a result of this leap in profitability, the expansion of BigLaw's footprint has been massive, too. *The National Law Journal* ("NLJ") reported in 2008 that, "In 1978, the average NLJ 250 firm had 2.5 offices, including its headquarters location. Sixty-seven firms had a single office. In 2008, the average NLJ 250 firm had 10.2 offices; only seven firms had a single office. Thirty years ago, NLJ 250 firms had a total of 84 offices and 567 lawyers in foreign locations. Today the figures have increased to 562 offices and 14,198 lawyers abroad.

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In their report, *An Empirical Analysis of Lateral Lawyer Trends from 2000 to 2007*, William D. Henderson & Leonard Bierman state that, while approximately 11,000 partners left Am Law 200 firms, approximately 15,500 joined Am Law 200 firms. Likewise, between 2000 and 2012, the nation's average partner-level lateral movement has been in force at 2,436 partners per year. With approximately 48K partners in the NLJ200, this represents approximately 5 percent of that partner population—every year—moving to another firm.²⁶ This isn't slowing down, either. *The American Lawyer's* 2011 survey of managing partners, chairs, and other firm leaders of the Am Law 200 firms found that 82 percent planned to add lateral litigation partners in 2012, 74 percent planned to add lateral corporate partners, and 57 percent planned to add IP partners.²⁷ These numbers have certainly played out, and as far as mergers go, do I really need to list them?

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Law firms are aggressively growing through lateralization and mergers, period.²⁸ Already keystones to large-firm strategy, growth and expansion are not only much easier today, but are also much more volatile and have sent the average BigLaw firm into the deeper water.

Treading Water—Competition in the Pool

"Two little mice fell in a bucket of cream. The first mouse quickly gave up and drowned. The second mouse, wouldn't quit. He struggled so hard that eventually he churned that cream into butter and crawled out. Gentlemen, as of this moment, I am that second mouse."

Frank Abagnale, *Catch Me If You Can*

The antidote to law firm stability—guaranteed and unrestricted free agency—was once kept at bay by a romance between professional courtesy and ignorance. But *The American Lawyer* ended the marriage and left in its place equally fragile binding agents like culture, common goals, compensation models, and reputational capital, among other things, which conspire to ravenously consume and at the same time produce *profits*.

tion of the glue that binds partnerships together has placed management in a quandary: where they once were pursuing profits to thrive, many are now pursuing profits to survive. Law firms have been turned upon by their own creation. Let me explain.

While law firms are quite profitable, they are also terribly expensive to maintain. With an average profit margin of 37.5% (in 2011),²⁹ on paper the Am Law 200 looks lucrative and stable, and by and large it is. But, with high and fixed overhead, even a minor drop in revenue can significantly impact net profits and spell disaster, because when the firm's middle-tier catches wind of falling profits, it is very prone to lateral movement. In light of their central role in generating firm revenue, management wants to avoid spooking them with financial dips, which can leave them in a bit of a pickle.

Revenue from new client acquisition is difficult, slow, and costly to acquire. Patenting and owning rights to new, unique, and otherwise valuable legal "products" is close to impossible. Technological advances can

be a double-edged sword in that, along with increased efficiency, they can result in commoditization. Outside capital that might be used to stabilize operations is close to impossible to acquire. Legal products and services can actually educate the legal consumer, further depreciating the perceived value of firms over time. Add to all of this the increasing segmentation of the competitive landscape into various inexpensive, nonlegal service providers and you have an almost impossible-to-survive situation. To even remain afloat, much less prosper, modern firms need to (at least) maintain consistent revenue and profits to not only pay their bills, but to keep the skittish rainmaker in his office.

How can they do that, you ask? They need clients, and inherently the partners that "own" them; to keep those partners, they need to pay them well; to pay them well, they need competitive PPP; to maintain competitive PPP, they need the partners' books. In other words, they need a partner's money in order to pay them and keep them around—a feat not so easily accomplished when even the slightest suspicion can cause the relatively uninformed, but super important middle-tier to run. This dilemma, if you will, pushes the average law firm into deeper pools, where it treads water, exhaustingly.

You see, generally speaking the first partners to leave a failing firm are often closest to the firm's finances, future projections, strategies, and/or management—they are the ones "in the know." And any outward-bound partners sign the standard nondisparagement agreement that prevents them from publicizing what their motivations were. This keeps the bulk of the partnership in the dark during difficult times. Also, regardless of a firm's management's transparency, it is (generally) culturally unacceptable for a suspicious partner to request firm financials. Much like asking your spouse to review their bank statements or cell phone records, should a partner do so, they become suspects themselves,

to be placed under a microscope. Along with being removed from management duties in general, these factors conspire to keep the average partner ignorant of financial concerns, whether they are interested or not.

And while many firms knowingly support such an environment, paradoxically, financial opacity can be a risky path to tread. Where it may be stabilizing to prevent the general population from knowing all of the firm's

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financial issues, it can also become destabilizing when misinformation or misinterpretations spread/s. So, when a partner does become suspicious and is laterally mobile—those with \$2M+ books, for example—they are caught in a prisoner's dilemma that makes it too risky to "sit tight and see what happens." Influential partners leave, the herd instinct is invoked, and a sizeable chunk of the partnership follows, quickly collapsing the firm's infrastructure.

The pressure exerted on law firms in this financialized legal market is taking its toll. New technology, new classes of professional services, and even new types of legal services (Axiom for instance) have entered, and further complicated, the already competitive financialized landscape.³⁰ The continually rising billable hour and the necessity to feed this profit-driven machine has also forced legal consumers to evolve—becoming more sophisticated, smarter, and savvier—further leveling the informational asymmetry, devaluing the professional-consumer relationships, and impacting client loyalty. Large law firms can't rest for even a moment, lest their meal be stolen; profits actually *must* be kept up, or the free agents will leave, and profits, along with the firm's walls, will collapse. To better understand this, let's look at the life cycle of a failing firm.