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COMPETITION AND THE EVOLUTION OF LARGE LAW FIRMS

*Albert Yoon**

The legal profession has generated considerable press in recent years, much of it critical. Stories abound of recent law graduates saddled with crippling educational debt and bleak employment prospects. Applications to U.S. law schools have decreased nearly 40% over the past three years, prompting several law schools to reduce their entering classes. Increasingly, a law degree is no longer viewed as a certain path to an intellectually and economically rewarding career. Commentators point to large law firms as a harbinger of this decline, premised on an ineffective and outdated business model. This Article empirically examines the 100 largest U.S. and global firms from the perspective of revenue and attorney employment for the period 1987 through 2012. Similar to previous economic downturns, the 2008 global recession caused a decline in firm revenue and employment. This time, however, firms appear to have undergone structural change, creating more diversified—and less expensive—tiers of lawyers. These findings suggest a more heavily leveraged model of law firms, benefitting equity partners at the expense of other lawyers within the firm, at the same time creating greater volatility within and across firms.

Introduction

Law schools have experienced a rough few years. Recent law students are graduating with record levels of educational debt[1] and declining employment opportunities.[2] Law school applications have declined for the third straight year, dropping nearly a third since

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* Professor of Law, University of Toronto Faculty of Law. I appreciate helpful comments from Ben Alarie, Firoz Dattu, Marc Galanter, Ed Iacobucci, Stephen Landsman, Anthony Niblett, Andrew Oringer, J.J. Prescott, Andrew Stumpff, Michael Trebilcock, and participants at the 19th Annual Clifford Symposium on Tort Law and Social Policy at DePaul University College of Law. This Article was generously funded in part by the Law School Admissions Council. Lara Guest provided helpful research assistance. All remaining errors are my own.

1. *See Average Amount Borrowed, 2001–2008*, Am. Bar Ass'n, http://www.americanbar.org/content/dam/aba/administrative/legal_education_and_admissions_to_the_bar/statistics/avg_amnt_brwd.authcheckdam.pdf (last visited Sept. 10, 2013). For a discussion of the factors contributing to law school debt, see Brian Z. Tamanaha, Failing Law Schools 107–11 (2012).

2. *See* Ctr. for the Study of the Legal Profession, Georgetown Univ. Law Ctr., 2013 Report on the State of the Legal Market 8–9 (2013).

2010.[3] This decline has prompted many law schools to reduce their class sizes[4] and caused at least one law school to embark on layoffs and buyouts of its faculty.[5]

This disconcerting story about law schools is in large part a story about law firms, specifically large law firms.[6] Two related, unpleasant facts emerged in the aftermath of the economic recession in 2009. First, law firms reduced their hiring of entry-level associates, a pattern they continued even as the economy began to recover.[7] Second, several law schools overstated their post-graduation employment rates and median starting salaries to the *U.S. News & World Report*, statistics that are both driven by hiring by large law firms.[8] Once these figures were more accurately reported, the financial allure of a law degree declined, markedly for some schools. Large law firms are the proverbial tail that wags the dog that is the legal profession—at least our perception of it.

While much has been written about the legal profession from the perspective of large law firms,[9] speculation abounds over their future.

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3. *LSAC Volume Summary*, Law Sch. Admissions Council, http://www.lsac.org/lsacresources/data/lsac-volume-summary (last visited Sept. 10, 2013).

4. *See* Ashby Jones, *Top Law School Cuts Admissions*, Wall St. J. (Mar. 12, 2013), http://online.wsj.com/article/SB10001424127887324281004578354490114584144.html (listing Northwestern University law school); *see also* Martha Neil, *GWU Joins Lengthening List of Law Schools Opting to Reduce Class Size*, A.B.A. J. (May 14, 2012), http://www.abajournal.com/news/article/gwu_joins_lengthening_list_of_law_schools_opting_to_reduce_class_size/ (listing George Washington University, University of California Hastings, and Creighton University).

5. Ethan Bronner, *Law Schools' Applications Fall as Costs Rise and Jobs Are Cut*, N.Y. Times, Jan. 31, 2013, at A1 (describing faculty cutbacks at Vermont Law School).

6. For a particularly unnerving account of large law firm practice (at Mayer Brown), see Noam Scheiber, *The Last Days of Big Law: You Can't Imagine the Terror When the Money Dries Up*, New Republic, Aug. 5, 2013, at 24.

7. Jennifer Smith, *Firms Keep Squeezing Associates*, Wall St. J., Jan. 30, 2012, at B1.

8. Joel F. Murray, *Professional Dishonesty: Do U.S. Law Schools that Report False or Misleading Employment Statistics Violate Consumer Protection Laws?*, 15 J. Consumer & Com. L. 97, 98 (2012).

9. *See generally, e.g.*, Lincoln Caplan, Skadden: Power, Money, and the Rise of a Legal Empire (1993); Marc Galanter & Thomas Palay, Tournament of Lawyers: The Transformation of the Big Law Firm (1991); John P. Heinz & Edward O. Laumann, Chicago Lawyers: The Social Structure of the Bar (rev. ed. 1994); John P. Heinz et al., Urban Lawyers: The New Social Structure of the Bar (2005); Paul Hoffman, Lions in the Street: The Inside Story of the Great Wall Street Law Firms (1973); Robert L. Nelson, Partners with Power: The Social Transformation of the Large Law Firm (1988); Erwin O. Smigel, The Wall Street Lawyer: Professional Organization Man? (1964); Marc Galanter & William Henderson, *The Elastic Tournament: A Second Transformation of the Big Law Firm,* 60 Stan. L. Rev. 1867 (2008); Marc Galanter & Thomas M. Palay, *Why the Big Get Bigger: The Promotion-to-Partner Tournament and the Growth of Large Law Firms*, 76 Va. L. Rev. 747 (1990); Ronald J. Gilson & Robert H. Mnookin, *Sharing Among the Human Capitalists: An Economic Inquiry into the Corporate Law Firm and How Partners Split Profits*, 37 Stan. L. Rev. 313 (1985); William D. Henderson, *The Globalization of*

An optimistic prognosis suggests that the recent economic downturn is merely part of a broader cyclical trend in the legal profession. For example, over the past twenty-five years, one can point to three periods that dramatically changed how law firms operated[10]: the 1990 recession, coinciding with the collapse of the large investment banking firm Drexel Burnham Lambert;[11] the bursting of the dot-com bubble in 2000;[12] and the global financial crisis in 2007–2009,[13] fueled by subprime lending in the housing market. In the first two instances, the legal profession experienced a downturn but rebounded and ultimately thrived. Optimists contend it will do so again, and that a law degree remains a sound investment.[14] A pessimistic forecast contends that this time is different; the global recession, while perhaps precipitating change, merely masks broader structural changes disrupting the legal profession, such as advances in technology reducing the cost of legal work, increased scrutiny of legal fees by clients, and a less egalitarian economic model among law firm management.[15]

This Article empirically analyzes the economics of large law firms, both American and international, to assess whether their response to the most recent economic downturn appears merely cyclical, as the optimists contend, or something more structural, as the pessimists argue. Part II briefly describes the data used in the Article. Part III examines the size of firm revenues, while Part IV explores the division of these revenues, across and within firms. Part V analyzes the relationship between firm size and firm revenue, specifically whether the correlation between the two varies across firms. Part VI explores the labor structure of firms and how the associate-partnership model has

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the Legal Profession, 14 IND. J. GLOBAL LEGAL STUD. 1 (2007); Jayanth K. Krishnan, *Globetrotting Law Firms*, 23 GEO. J. LEGAL ETHICS 57 (2010); David B. Wilkins & G. Mitu Gulati, *Reconceiving the Tournament of Lawyers: Tracking, Seeding, and Information Control in the Internal Labor Markets of Elite Law Firms*, 84 VA. L. REV. 1581 (1998).

10. My thanks to Andrew Orringer for identifying these periods. As part of my research for this essay, I interviewed partners at large law firms, each of whom concurred with the significance of these three events.

11. *See generally* Kurt Eichenwald, *Drexel, Symbol of Wall St. Era, is Dismantling; Bankruptcy Filed*, N.Y. TIMES, Feb. 14, 1990, at A1.

12. *See generally* Virginia Postrel, *Economic Scene: A Vital Economy Is One that Suffers Lucky Fools Gladly*, N.Y. TIMES, Sept. 6, 2001, at C2.

13. *See generally* ALAN S. BLINDER, AFTER THE MUSIC STOPPED: THE FINANCIAL CRISIS, THE RESPONSE, AND THE WORK AHEAD (2013).

14. *See, e.g.*, Michael Simkovic & Frank McIntyre, The Economic Value of a Law Degree (Apr. 13, 2013) (unpublished manuscript), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2250585.

15. *See, e.g.*, Bernard A. Burk & David McGowan, *Big but Brittle: Economic Perspectives on the Future of the Law Firm in the New Economy*, 2011 COLUM. BUS. L. REV. 1; Larry E. Ribstein, *The Death of Big Law*, 2010 WIS. L. REV. 749.

evolved. Part VII discusses the future of law firms from the perspective of both revenue and attorney employment.

II. Data

The data used in this Article come primarily from two sources. The first is the *American Lawyer*, which publishes annually the *Am Law 200*, which lists the top 200 revenue grossing U.S. law firms,[16] and the *Global 100*, which lists the top 100 revenue grossing international firms.[17] The *Am Law 200* dates back to 1985,[18] and the *Global 100* to 1998.[19] The *American Lawyer* provides information on gross revenue, profits per equity partner, revenue per lawyer, and employment figures. To directly compare revenue between U.S. and global firms, I examine the top 100 firms in each category, excluding years where fewer than 100 firms are ranked and U.S. firms ranked outside the top 100. All analysis of economic figures is based on the *American Lawyer*.

The second source of data is the *National Law Journal*, which publishes annually the *NLJ 250*, listing the largest 250 law firms based on number of attorneys, with subtotals for equity partners, nonequity partners, associates, and other attorney categories.[20] The *NLJ 250* figures for some firms vary slightly from the *Am Law 200.* All analysis based on lawyer population within firms is based on the *NLJ 250*.[21]

Information about gross domestic product (GDP), for both the United States and the global economy, comes from the World Bank.[22] All financial figures generated from the World Bank, the *American Lawyer*, and the *National Law Journal* are reported in constant 2012 U.S. dollars unless stated otherwise.[23]

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16. *See, e.g.*, *The Am Law 200*, Am. Law., June 11, 2011, at 70.

17. *See, e.g.*, *The Am Law Global 100: A Wild Ride*, Am. Law. (Sept. 30, 2013), http://www.americanlawyer.com/PubArticleTAL.jsp?id=1202471809600 (subscription to *American Lawyer* required).

18. The *Am Law 200* expanded its list to 200 beginning in 1999; for the period 1987 to 1998, it was the *Am Law 100*, and in 1985 and 1986 it ranked the top 50 and top 75 firms, respectively.

19. The *Global 100* expanded its list to 100 beginning in 2001. It listed 49 firms in 1998 and 50 firms in 1999 and 2000.

20. *See, e.g.*, *Introducing the NLJ 350*, Nat'l L.J., Apr. 2012, *available at* http://www.law.com/jsp/nlj/PubArticleNLJ.jsp?id=1202489565842.

21. In 2012, the NLJ expanded the list of ranked law firms from 250 to 350. *See id*.

22. *See, e.g.*, *Data: GDP (Current US$)*, World Bank, http://data.worldbank.org/indicator/NY.GDP.MKTP.CD (last visited Nov. 26, 2013).

23. All statistical analysis and graphing is based on raw data collected from the sources from 1985–2012. This raw data is on file with the author.

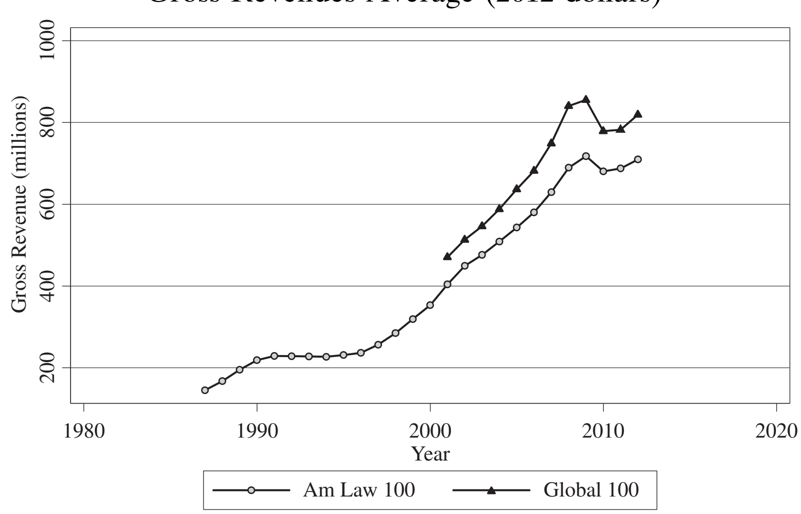
III. The Size of Law Firm Revenues

This Part examines the growth of the largest American and global firms from the perspective of gross revenue, namely how much law firms earn from their clients. Although gross revenues may not tell a complete story about the economic health of firms, they provide useful information about the ability of firms to attract clients and generate legal fees.

A. Gross Revenues

Figure 1 reports the inflation-adjusted average of gross revenues for the *Am Law 100* and *Global 100*. In the United States, gross revenue among these firms remained relatively flat during the early 1990s and then increased beginning in 1995. The positive trend continued until 2009 (totaling nearly $700 million) and then declined in 2010, before increasing modestly in 2011 and 2012. The available data for the *Global 100* firms show a similar trend during the 2000s: a steady increase until 2009 (totaling nearly $850 million) followed by a drop and modest recovery.

Figure 1
Gross Revenues Average (2012 dollars)



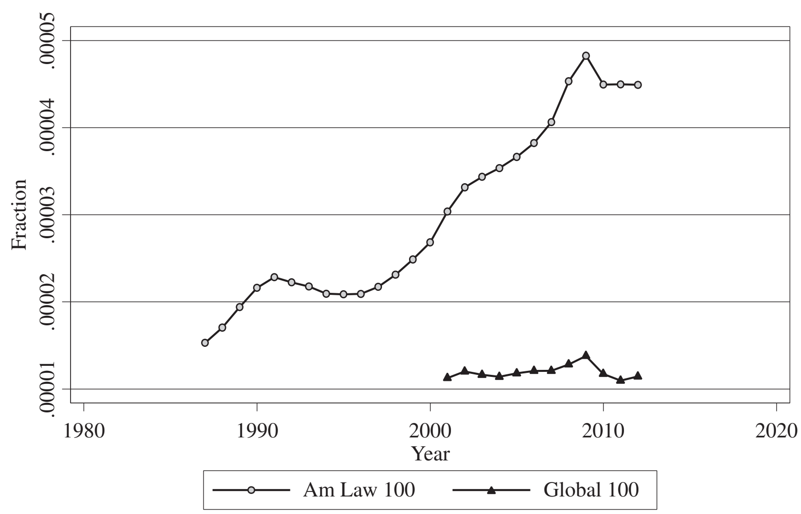
For *Am Law 100* firms, the year-by-year changes are consistent with the story of exogenous shocks by three economic events: the 1990 U.S. recession, the burst of the dot-com bubble in 2001, and the 2007–2009 global recession brought by the subprime crises. Each of these events had a downward effect on the slope of gross revenue for *Am Law 100* firms, the most dramatic being the subprime crises. While the available years of data are limited for the *Global 100* firms, the subprime crises had a similar effect on their gross revenues.

B. Gross Revenues/GDP

Gross revenues alone provide an important but incomplete evaluation of the economic health of law firms. While revealing how firms are faring in real dollars (after adjusting for inflation), they do not provide a context of how the firm is performing relative to the overall economy. Figure 2 reports gross revenues for *Am Law* and *Global 100* firms, divided by their respective GDPs.

For U.S. firms, gross revenue as a fraction of the U.S. GDP actually declined in the aftermath of the 1990 recession, suggesting that these firms experienced not only flat gross revenues, but also economic decline relative to the overall economy. Following the dot-com bubble burst in 2001, firms experienced increasing but more modest growth in gross revenue. Figure 2 also reveals that the 2009 global recession caused a sharp decline, as in Figure 1. For the *Global 100* firms, gross revenues increased modestly as a percentage of global GDP before declining following the 2009 global recession.

FIGURE 2
Gross Revenues/GDP Average (2012 dollars)



Am Law 100 firms relative to U.S. GDP; Global 100 firms relative to Global GDP

Figure 2 also reveals that U.S. law firms comprise a much larger fraction of the American GDP than do their counterpart global firms of the global GDP. American firms at their 2009 peak comprised approximately 0.00005 of U.S. GDP, while global firms at their peak were approximately 0.000015 of global GDP, less than one-third of the U.S. firms' fractional share. This gap is consistent with the view among proponents and critics alike that law firms play a more prominent role in the U.S. economy than they do in the global economy.[24] It may also be the case that Figure 2 understates the true disparity between U.S. and global firms, given that U.S. firms comprise more than half of the *Global 100* firms in most years. A list of the top 100 firms comprised solely of non-U.S. global firms (which *American Lawyer* does not publish) would likely comprise an even smaller fraction of the global, non-U.S., GDP.

IV. The Division of Law Firm Revenues

Collective gross revenues, though important, tell an incomplete picture, even among the highest earning firms. An equally important inquiry is to examine how these revenues are distributed, both within and across firms. In previous generations, the variation in firm revenue and lawyer salaries was smaller.[25] However, recent accounts of law firm governance suggest increased competition and volatility.[26]

A. *Allocation of Revenues Across Firms*

Figure 3 reports separately the gross revenues for the *Am Law 100* and *Global 100* firms, dividing each set of firms into quartiles: firms ranked 1–25; 26–50; 51–75; and 76–100. This disaggregation reveals that each quartile experienced consistent growth during the period 1995–2009, reflecting that as an absolute measure the firms across the range of the top 100 firms, both U.S. and global, shared in the growth in gross revenue.

A closer look at the figures, however, indicates different rates of growth. For each set of rankings, the top quartile began to outpace the other quartiles during the early 2000s. For example, among U.S. firms in 1987 the gross revenue of the top quartile of law firms ($244

24. For a recent discussion of the role—largely deleterious—of the U.S. legal system in the U.S. economy, see J. Mark Ramseyer & Eric B. Rasmusen, *Are Americans More Litigious? Some Quantitative Evidence*, *in* The American Illness: Essays on the Rule of Law (F.H. Buckley ed., 2013) (showing that the U.S. has a higher per capita number of filed suits than Australia, Canada, France, Japan, and England).

25. *See, e.g.*, Nelson, *supra* note 9, at 4 (discussing a law firm partnership as "a company of equals").

26. *See, e.g.*, James B. Stewart, *Dewey's Fall Underscores Law Firms' New Reality*, N.Y. Times, May 5, 2012, at B1 (describing the demise of Dewey & LeBoeuf fueled by competition over compensation guarantees to individual partners).

million) averaged roughly three times the gross revenue of the bottom quartile ($83 million). By 2012, the top quartile of U.S. firms averaged over four times ($1.33 billion) the average gross revenues of the bottom quartile ($325 million). For the *Global 100* firms, the period of available data similarly reflects real, albeit slightly smaller, gains for the top quartile. In 2001, the top quartile firms ($819 million) earned 3.1 times the average gross revenue of the bottom quartile ($266 million); in 2012, the top quartile firms ($1.52 billion) earned 3.7 times the average gross revenue of the bottom quartile ($416 million).

FIGURE 3

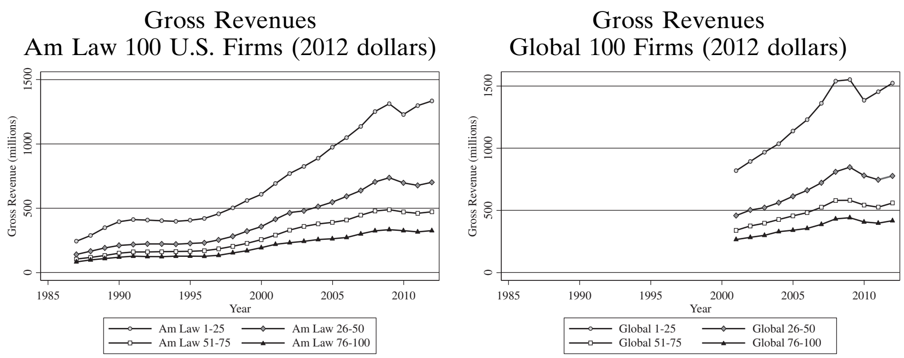
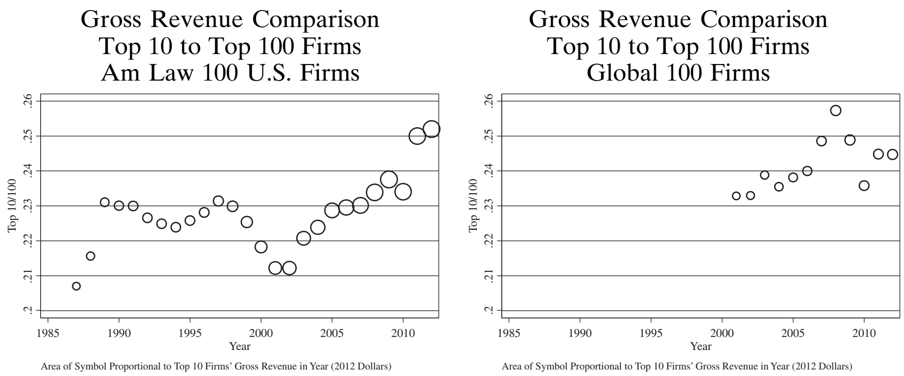


Figure 4 shows that the differential growth is even more pronounced among the top 10 firms in each set. The top 10 U.S. firms earned 5.5 times the gross revenue of the bottom quartile of U.S. firms, while the top 10 global firms earned 4.8 times the gross revenue of the bottom quartile of global firms. The circles represent the relative share of the top 10 firms compared with the total generated by the top 100 firms. Figure 4 illustrates that since 2002, the top 10 U.S. firms have steadily increased their share of the total gross revenue of the top 100 firms, from 21% in 2001 to 25% in 2012. This increase is particularly important given that firms in some years did not increase their gross revenue (as shown in Figure 1). These findings indicate that the legal profession does not follow the "winner-take-all" pattern that emerges in some sectors of the economy.[27] The trends in Figure 2 suggest, however, that when opportunities for legal work grow scarce, the highest ranking firms can respond by taking a larger fraction of the available work generated by the top 100 firms. The comparison

27. For a discussion of the winner-take-all phenomenon, see ROBERT H. FRANK & PHILIP J. COOK, THE WINNER-TAKE-ALL SOCIETY: WHY THE FEW AT THE TOP GET SO MUCH MORE THAN THE REST OF US (1995).

among the *Global 100* firms reveals similar dominance among the top firms, albeit with a greater drop following the 2007–2009 global financial crisis.

FIGURE 4[28]



B. Allocation of Revenue Within Firms

The traditional law firm model is built on the premise of leveraging firm-specific capital, wherein lawyers work several years at the firm as associates for the possibility of partnership and the promise of higher earnings and ownership in the firm.[29] Just as the top quartile (Figure 3) or decile (Figure 4) of firms captured a greater share of the top 100's gross revenues over time, Figure 5 suggests that equity partners have similarly captured a greater fraction of firm revenues relative to other lawyers in the firm. These graphs plot the ratio of profits per equity partner divided by revenue per lawyer for the top 100 U.S. firms and global firms. The higher the ratio, the greater the profits per equity partner relative to the revenue per lawyer.

This ratio for U.S. firms began modestly in 1987 and actually declined during the early 1990s, reaching a low of 1.08 in 1995. It steadily increased for the next thirteen years until dipping momentarily in 2009. Notably, it reached its highest ratio of 1.72 in 2012. The global firms start with a higher ratio for the corresponding year (2001), but follow a similar pattern to the U.S. firms. The ratio reaches 1.85 in 2008 before dropping in 2009, only to record a peak ratio of 1.87 in 2012.

28. Each graph begins with a circle of the same size, irrespective of the underlying ratio. Accordingly, the size of the circles are comparable only across firms contained in the same graph, and should not be compared across graphs.

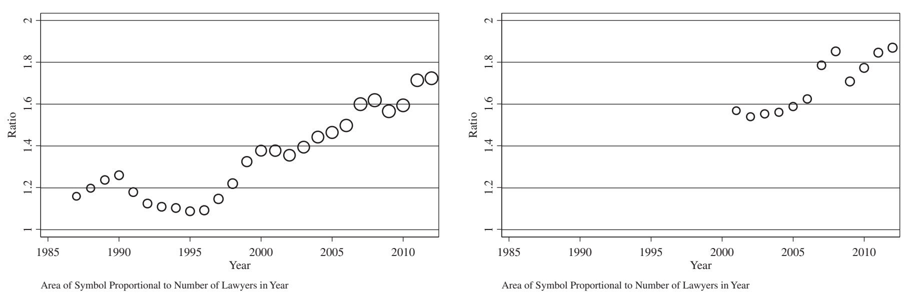
29. For a discussion of the institutional design of large law firms, *see generally* GALANTER & PALAY, *supra* note 9.

This gradual but steady increase in the ratio reflects that equity partners have progressively been able to capture a larger fraction of firm revenue per lawyer. Among U.S. firms, revenue per lawyer increased in real (constant) dollars by 52% ($565,196 in 1987 to $858,250 in 2012); however profits per equity partner increased significantly more, by 226% ($655,490 in 1987 to $1.48 million in 2012). Among global firms, revenue per lawyer grew more modestly at 15% (from $721,470 in 2001 to $830,200 in 2012), while profits per equity partner increased 37% (from $1.13 million in 2001 to $1.55 million in 2012).

FIGURE 5[30]

Profit Per Equity Partner/ Revenue Per Lawyer Am Law 100 U.S. Firms

Profit Per Equity Partner/ Revenue Per Lawyer Global 100 Firms



The circles in each graph in Figure 5 suggest that both U.S. and global firms were able to increase equity partner leverage while adopting different rates of firm growth. The size of circles in each year represents the relative change in the average number of lawyers at the firm. The number of lawyers at U.S. firms grew on average by 280% (averaging 309 lawyers in 1987 to 864 lawyers in 2012), while global firms experienced a more modest growth of 38% (753 lawyers in 2001 to 1044 lawyers in 2012). In the years following the 2007–2009 global financial crisis, equity partner profits have increased without a significant increase in the number of lawyers (denoted by the size of the circles) for both U.S. and global firms. This stability suggests that equity partners are able to increase profits through margin rather than merely volume. That is, equity partners generate higher profits per lawyer rather than higher profits from more lawyers.

30. *See supra* note 28.

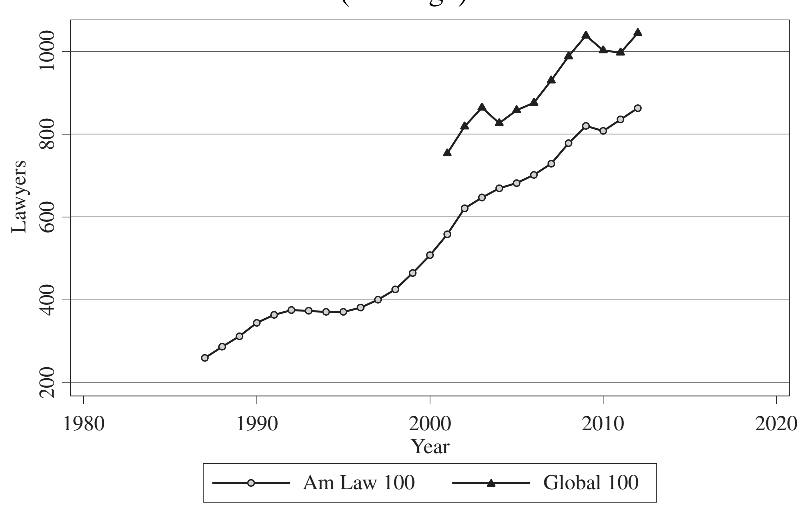
V. The Relationship Between Firm Size and Revenue

The most important component of a law firm is its human capital.[31] All things equal, the greater the number of lawyers working at the firm, the more the firm earns. The two primary rankings for evaluating firms, *Am Law 200* and the *NLJ 250*, rely on the metrics of firm revenue and the number of attorneys, respectively. This Part explores how firms have grown with respect to these dimensions, and the relationship between the two.

A. Law Firm Size

Figure 6 isolates the change in the average number of lawyers over time that was captured in part when looking at trends in the firms' gross revenues (Figure 3). Both U.S. and global firms have followed a pattern of steady expansion as far as the number of lawyers they employ. For most years, the lines for both U.S. and global firms hew closely to the gross revenue lines in Figure 1. Notably, the decline in the total number of U.S. lawyers in 2008 occurs at the early stage of the 2007–2009 global financial crisis (after which gross revenues declined), whereas for the global firms, the decline occurred one year later in 2009.

FIGURE 6
Total Number of Lawyers
(Average)



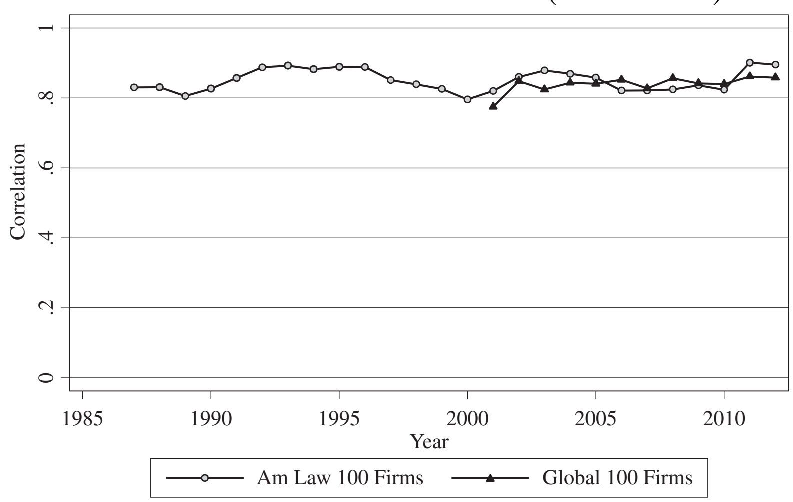
31. Ronald J. Gilson & Robert H. Mnookin, *Coming of Age in a Corporate Law Firm: The Economics of Associate Career Patterns*, 41 Stan. L. Rev. 567, 571 (1989).

This relatively constant increase in lawyer employment comports with most historical accounts of large law firms, which show that increasing revenues and profitability created strong incentives for firms to simply add more lawyers.[32]

B. The Correlation Between Firm Size and Revenue

The traditional law firm model suggests that law firm size is a good predictor of how much the firm generates in revenues. Figure 7 appears to validate this claim, showing the high correlation between a firm's size and its gross revenues. For both U.S. and global firms, the correlations are similar, ranging between 0.80 and 0.90 for U.S. firms and 0.78 and 0.86 for global firms.

FIGURE 7
Correlation Between Firm Size and Revenue
Am Law 100 and Global 100 Firms (2012 dollars)



Upon closer examination, however, the relationship between firm size and gross revenue is more nuanced. Measuring correlation by looking at the entire set of firms collectively masks differences across firms. Figure 8 compares the correlation of the top 50 firms with the firms ranked 51–100. Among U.S. firms, the correlation among the top 50 firms, while lower than the top 100 firms collectively (Figure 6), is still high, ranging between 0.72 and 0.88. For U.S. firms ranked 51–100, the correlation is lower and more volatile from year to year,

32. *See, e.g.*, Burk & McGowan, *supra* note 15, at 11, 13–14 (describing the factors leading to "explosive growth" among large law firms).

ranging from 0.43 to 0.76. For both groupings of U.S. firms, these yearly correlations were statistically significant. Among global firms, the correlation for the top 50 closely approximates the overall correlation in Figure 6, ranging from 0.74 to 0.88, and is statistically significant. By contrast, the firms ranked 51–100 report a markedly lower correlation, ranging from -0.17 to 0.26, with none of the years being statistically significant.

FIGURE 8

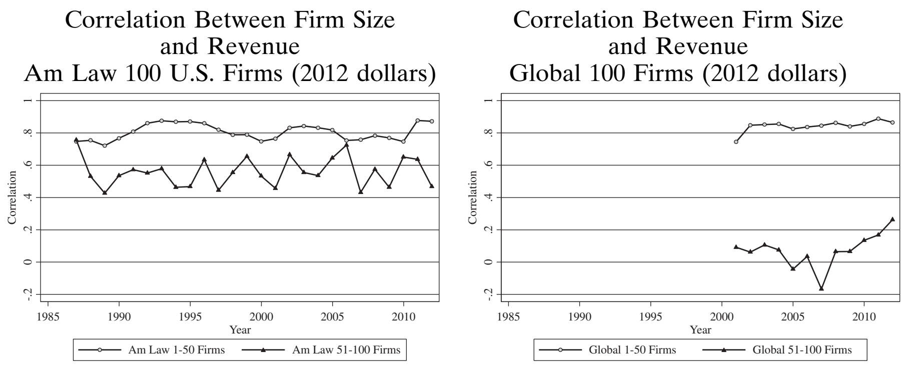


Figure 8 suggests a divergence in the economic model across the top and bottom halves of the top 100 firms. The top 50 revenue-generating firms consistently employ the most lawyers, and firm revenue is much more predictably a function of the number of lawyers they employ. The bottom 50 revenue-generating firms also employ hundreds of lawyers, but these numbers do not generate the same predictable revenue for the firm. This phenomenon is not to suggest that the 51–100 firms are faring poorly. On the contrary, it reflects that some firms with relatively few lawyers nevertheless generate high revenues. For example, in 2012 Wachtell, Lipton, Rosen & Katz was ranked 100th in terms of number of lawyers (245) and 56th in terms of gross revenue ($552 million), but ranked 1st in both revenue per lawyer ($2.25 million) and profit per equity partner ($4.46 million).

VI. FIRM STRUCTURE

The primary asset in the law firm is human capital.[33] Partners have human capital in the form of legal experience and long-term relationships with clients. Associates, as they start their careers, have human capital primarily in the form of formal training through law school.

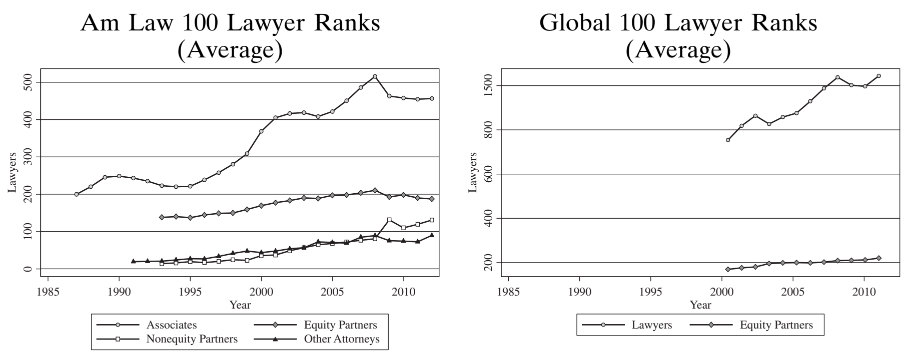
33. *See generally* GALANTER & PALAY, *supra* note 9.

The classic tournament model posits that the possibility of partnership motivates associates to invest in the firm and equity ownership discourages partners from shirking.[34]

A. *The Diversification of Lawyer Ranks*

The steadily increasing ratio between profits per equity partner relative to lawyer revenues suggests that equity partners are able to find ways to leverage profits from the firm. One possible explanation lies in the terms by which firms employ attorneys. Figure 9 reports the different ranks of attorneys at firms. For U.S. firms, the broader growth in the number of associates over time is marked by three periods of stagnation or decline, corresponding to the economic downturns. Although it is too early to say with certainty, the years following 2009 suggest that the firms' decreased employment of associates may be structural rather than cyclical. In addition, the category of associates in recent years has been further subdivided between associates on the partnership track and those who are not, an approach that one firm describes as "our version of outsourcing."[35] The nonpartnership associates earn a lower salary, have more regular hours, and work on more routinized legal matters than their partnership-track peers.[36]

FIGURE 9



The increase in the number of nonequity, or income, partnerships is another notable trend. While the number of equity partners has declined slightly in recent years, the number of nonequity partners has increased. Nonequity partnerships allow firms to create a tiered part-

34. *Id.* at 108.
35. Catherine Rampell, *At Well-Paying Law Firms, a Low-Paid Corner*, N.Y. TIMES, May 24, 2011, at A1.
36. *Id.*

nership structure that is invisible to those outside the firm.[37] Within the firm, nonequity partners are effectively higher-paid associates who still require additional years at the firm before sharing equity in the firm. Outside the firm, the distinction does not exist, as firms typically do not distinguish between these two levels of partnership. In the *Am Law 100* rankings in 2012, 81 firms had nonequity partners, and collectively nonequity partners comprised 40% of all partners. This increase in nonequity partnerships has corresponded with a drop in the number of associates.

The decrease in associates, however, is only partially attributable to the increase in nonequity partners. Over the same period, a higher number of lawyers are working at the firm in the capacity of "other." The *American Lawyer* does not define the role of "other," but recent coverage of law firms suggest that it represents lawyers working on a finite, contract basis.[38] In addition, firms are increasingly relying on legal outsourcing where routine work is performed by large-scale firms, both in the United States and other countries.[39] One of the implications of this movement is that firms may elect to employ fewer associates.[40]

The data for *Global 100* firms is much more limited, as they report only equity partners and total number of lawyers. The number of lawyers began to increase following the 2009 recession—as did the number of equity partners—but these numbers do not reveal the specific ranks of attorneys where this growth is occurring.

The emergence of different ranks of attorneys, at least in the United States, suggests that the traditional law firm model—consisting of just equity partners and associates—has become more diversified. As illustrated in Figure 10, the pyramid now consists of equity partners, nonequity partners, partnership-track associates, non-partnership-track associates, and contract lawyers (which for an increasing number of firms include legal outsourcing[41]).

37. For a discussion of the development of tiered partnerships in law firms, see William D. Henderson, *An Empirical Study of Single-Tier Versus Two-Tier Partnerships in the Am Law 200*, 84 N.C. L. REV. 1691 (2006).

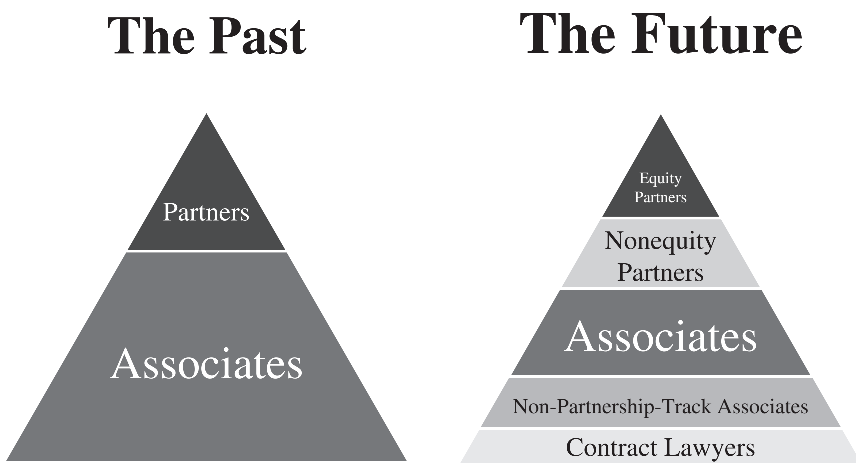
38. *See* Vanessa O'Connell, *Lawyers Settle . . . for Temp Jobs*, WALL ST. J., June 15, 2011, at B1.

39. *See* Cynthia Cotts & Liane Kufchock, *U.S. Firms Outsource Legal Services to India*, N.Y. TIMES (Aug. 21, 2007), http://www.nytimes.com/2007/08/21/business/worldbusiness/21iht-law.4.7199252.html?_r=0.

40. *See, e.g.*, Peter Lattman, *Mass Layoffs at a Top-Flight Law Firm*, N.Y. TIMES, June 25, 2013, at B1 (describing Weil, Gotshal & Manges's decision to reduce its number of associates by 7% and reduce annual compensation for 10% of its 300 partners).

41. Heather Timmons, *Where Lawyers Find Work*, N.Y. TIMES, June 3, 2011, at B1.

FIGURE 10: LAW FIRM PYRAMID



The increased tiers of lawyers may explain the increased ratio of profits per equity partner to lawyer revenue (Figure 5). Nonequity partners, by design, earn less than equity partners. Non-partnership-track associates purportedly earn less than half of what partnership-track associates earn.[42] Contract lawyers, paid by the hour, earn even less, particularly after factoring in overhead and benefits.[43] From a management perspective, these tiers reflect a more efficient pricing for work at the firm. Large firms have been reluctant to reduce starting salaries,[44] but creating these different tiers effectively allows them to lower the internal cost of producing legal work within the firm.

B. Movement Across Firms

In the traditional model, law firms grow internally through the hiring of associates and the promotion of associates to partner.[45] However, in recent years, law firms have sought to grow by acquiring or merging with other firms. Figure 11 reports the number of mergers among U.S. firms since 1994. From 1994 to 1997, mergers were relatively infrequent, but began to steadily increase from 1998 to 2001

42. *See* Rampell, *supra* note 35 (reporting that non-partnership-track attorneys earn between $50,000 and $65,000).

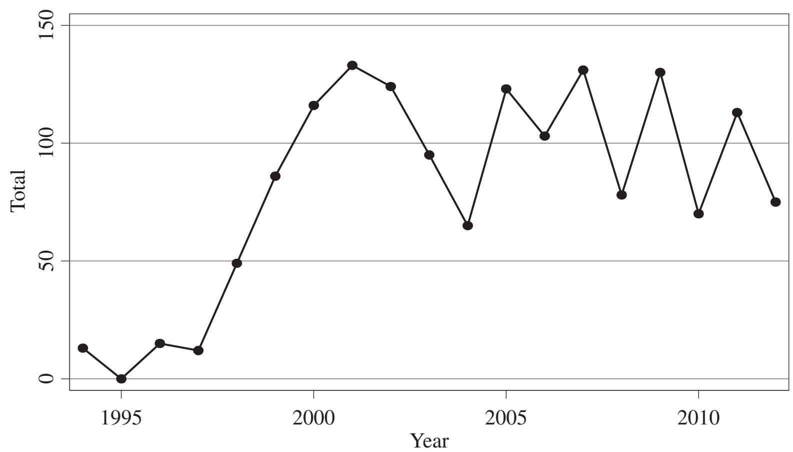
43. *See* O'Connell, *supra* note 38 (describing how contract lawyers earn as little as $15–$33 an hour).

44. For information on NALP Law Firm Associate Data for years 2008–2012, see Press Release, Nat'l Ass'n for Legal Placement, Law School Class of 2012 Finds More Jobs, Starting Salaries Rise—but Large Class Size Hurts Overall Employment Rate (June 20, 2013), *available at* http://www.nalp.org/classof2012_selected_pr.

45. *See generally* GALANTER & PALAY, *supra* note 9.

(peaking at 130 mergers), at which point they began to vary considerably from one year to the next.

FIGURE 11
Mergers and Acquisitions
Am Law 100 U.S. Firms



The effect of these transactions on the firm has been relatively understudied and warrants further examination. Evidence of mergers and acquisitions in the corporate realm tell a mixed story, with notable failures (e.g., AOL-Time Warner[46]) as well as successes (e.g., Disney-Pixar[47]). Figure 12 suggests that law firm mergers and acquisitions are, at best, a weak predictor of future success. The figure looks at each of the 237 firms engaged in a single merger during the 1994–2012 period, and tracks their appearance in the *Am Law 100* in the three years pre- and post-merger.[48] As one would expect, the greatest number of observations occurred at Year 0, the year the merger occurred. What is notable is the precipitous drop in observations before and after the merger. This drop in the years immediately preceding and following the merger indicates that relatively few firms appeared in seven consecutive years among the top 100 *Am Law* firms.

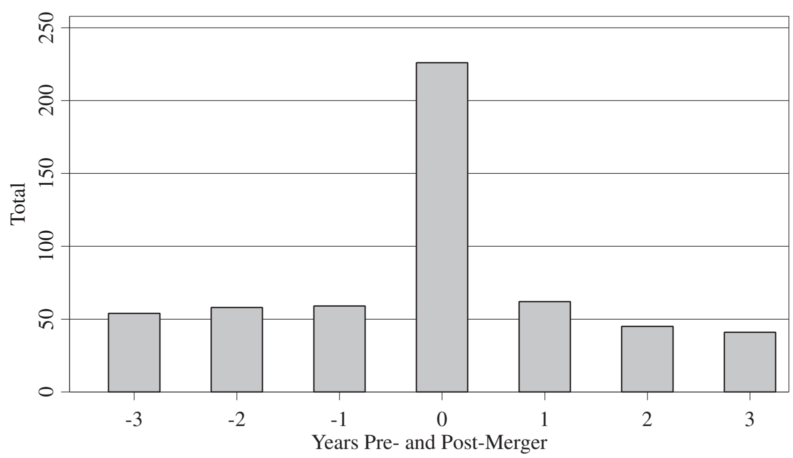
46. *See, e.g.*, Gretchen Morgenson, *What are Mergers Good For?*, N.Y. TIMES, June 5, 2005 (Magazine), at 56, 58 (describing the AOL-Time Warner merger as "the champion of all failed mergers").

47. *See, e.g.*, Brooks Barnes, *Disney and Pixar: The Power of the Prenup*, N.Y. TIMES, June 1, 2008 (Business), at 1 (describing the successful integration of the Disney-Pixar merger).

48. The reason for looking only at single-merger firms is to facilitate a pre- and post-observation. Many of the firms that merged multiple times did so within a few years, making it difficult to evaluate the effect of each merger.

In extreme cases, a merger results not merely in a drop in revenues, but the demise of the firm, as was the case with Dewey & LeBoeuf, LLP in 2012.[49] The majority of firms that appeared in *Am Law* prior to their merger dropped in ranking in subsequent years. Similarly, firms that appeared in *Am Law* the year of their merger often subsequently dropped from the list. These results tell a story similar to corporate mergers: while consistent, high-performing firms may engage in mergers or acquisitions (e.g., Arnold & Porter merging with Howard Rice in 2011,[50] or Baker & McKenzie purchasing Habib Al Mulla in 2013[51]), they are neither a necessary nor sufficient condition for the long-term health of the firm.

FIGURE 12
Mergers and Acquisitions
Am Law 100 U.S. Firms



In contrast to mergers, lateral hiring provides a more informal manner of lawyer movement across firms. Many of these lateral moves are individual in nature, in some cases involving a single partner. In other instances, a group of partners may move, approximating a mini-merger.[52] Figure 13 reports the number of partners departing and

49. Stewart, *supra* note 26.

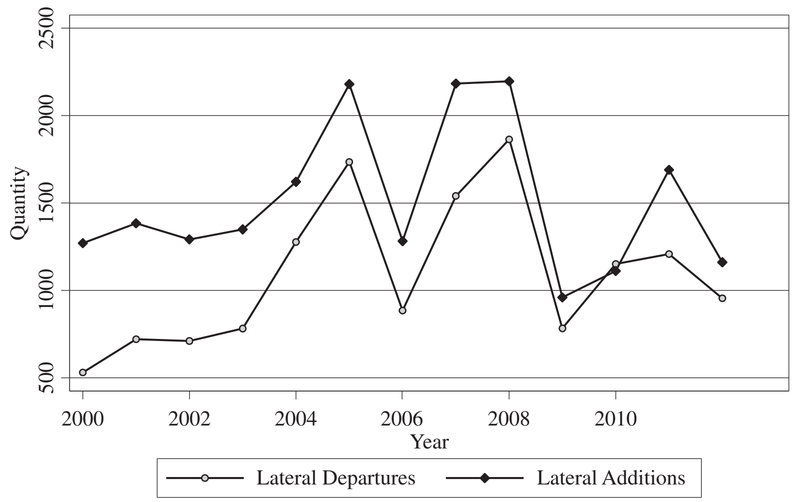
50. *See* Catherine Ho, *Arnold & Porter to Acquire California Law Firm Howard Rice*, WASH. POST (Dec. 6, 2011), http://www.washingtonpost.com/blogs/capital-business/post/arnold-and-porter-to-merge-with-california-law-firm-howard-rice/2011/12/06/gIQAxgTiaO_blog.html.

51. *See* Tom Huddleston Jr., *Baker & McKenzie Expands Mideast Presence with Addition of 40-Lawyer Firm in UAE*, AM. LAW. DAILY (Apr. 18, 2013), http://www.americanlawyer.com/PubArticleTAL.jsp?id=1202596603585&slreturn=20130726124810.

52. *See, e.g.*, Peter Lattman, *11 Partners from Bingham Join Sidley*, N.Y. TIMES, Apr. 2, 2013, at B5.

joining the top 100 *Am Law* firms. The number of departures in most years is comparable to the number of additions, reflecting that much of the lateral movement is self-contained within the top 100 U.S. firms. In every year but 2010, however, the number of additions to the top 100 firms exceeded the departures. This reflects in part that some partners leave for firms outside the top 100 or to work in government, but also that several lateral additions come from government (e.g., elected office, the state or U.S. Attorney's Office, the Securities and Exchange Commission, and the Environmental Protection Agency).

FIGURE 13
Lateral Moves by Partners
Am Law 100 U.S. Firms



Taken together, mergers and acquisitions (Figure 12) and lateral partner movement (Figure 13) reflect increased fluidity of the legal labor market at large firms. This trend is consistent with a less gilded view of large law firms, where compensation hews more closely to individual performance; if lawyers feel a diminished sense of loyalty to the firm, they are more likely to leave.[53] Ironically, firms that employ a lockstep approach to partner compensation, while few in number, may encourage greater loyalty among partners.[54] While the data do not speak directly to the motivations behind partners moving from

53. *See* Robert W. Hillman, *Law Firms and Their Partners: The Law and Ethics of Grabbing and Leaving*, 67 TEX. L. REV. 1, 3–4 (1988).

54. *See* Peter Lattman, *Culture Keeps Firms Together in Trying Times*, N.Y TIMES, Sept. 25, 2012, at F9.

one firm to the next, the data likely reflect the natural consequence of an "eat what you kill" model. The most profitable partners earn more of the business they generate, or leave to another firm that compensates them accordingly, while the less profitable partners remain, or are pushed out of the partnership.[55]

VII. The Future of Large Law Firms

In 1966, William Baumol and William Bowen famously wrote of "the cost disease" that plagued certain labor markets.[56] Industries that depend heavily on human labor become more expensive (in real dollars) over time. As an example, the authors note that a string quartet performance of Beethoven requires the same number of musicians today, performing the same amount of time, as they did when he wrote it 200 years ago.[57] The authors' main point was that the increased costs of these limited activities are offset by technological innovation that reduces the costs of several other activities (e.g., production of most durable goods). The question relevant to this Article concerns the extent to which the cost of legal fees must remain high (like the cost of hiring musicians) or will decrease (like many other services).

Until recently, one could argue that the cost disease aptly described the legal industry. Effective representation of one's client remained a labor-intensive activity. The advent of earlier technological innovations (e.g., typewriter, facsimile machine, word processing, Westlaw and Lexis, e-mail) did not fundamentally change the nature of legal work. Lawyers could now write briefs, conduct legal research, or communicate with the client faster. But these innovations still required the work of lawyers, and because they were available to the profession as a whole, they merely augmented the tools lawyers already had to represent their client, like conducting more detailed research into legal precedent. Thus, these innovations did little, if anything, to reduce the workload of lawyers, and arguably increased them. For example, facsimiles and e-mail facilitated communication between lawyers and their clients, thereby increasing billable time.

Recent technological innovations, however, may fundamentally change the legal profession. Certain legal tasks that formerly required a team of lawyers to complete can now be done with only a few law-

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55. For an interesting case study of the "eat what you kill" model in a large law firm, see Milton C. Regan Jr., Eat What You Kill: The Fall of a Wall Street Lawyer (2004).

56. *See generally* William J. Baumol & William G. Bowen, Performing Arts—The Economic Dilemma (1966).

57. *See id.* at 497.

yers, or in some instances, nonlawyers. The discovery process serves as an example. Until recently, lawyers (typically associates) would literally sit in warehouses and read over documents looking for key terms germane to the case. Today, a computer programmer could write code that could conduct this search in a fraction of the time, and with greater accuracy.[58] The boilerplate nature of other legal work, such as filing for no-contest divorce or drafting of a will, allows prospective clients to seek competitive rates for these services, or to bypass the use of lawyers altogether.

FIGURE 14: DIFFERENT TYPES OF LEGAL WORK

	High Stress	**Low Stress**
High Intellectual Stimulation	Trial Practice Proxy Fight or Hostile Takeover	Legal Academia Legal Research Memo (e.g., issue spotting) Delivering CLE
Low Intellectual Stimulation	M&A Due Diligence Document Production Major Contract Negotiation	Trademark Filing Maintenance Patent Preparation and Prosecution ERISA/Benefits paperwork

Figure 14 is a typology of legal work along the dimensions of stress and intellectual stimulation. Certain legal tasks, such as trial practice, are both stressful and intellectually stimulating. Conversely, other tasks, such as ERISA/Benefits paperwork, are low stress and involve low intellectual stimulation. For some, the most attractive combination is low stress and high intellectual stimulation, found in tasks like legal research memos or legal academia. In contrast, the worst combination is high stress and low intellectual stimulation, found in document production.

The typology of legal work also reflects a third dimension: routinization. While technology, coupled with globalization, will not threaten the existence of the largest law firms, these firms nevertheless will be compelled to respond to it. The market for certain legal work, such as trial practice and appellate brief writing, will remain and become more expensive, consistent with Baumol and Bowen's hypothesis.[59] Routinized work, which all firms encounter, will now be done more cost-effectively, with firms exploiting opportunities to reduce costs by employing cheaper lawyers or hiring outside lawyers on a contract basis.

58. *See* John Markoff, *Armies of Expensive Lawyers, Replaced by Cheaper Software*, N.Y. TIMES, Mar. 5, 2011, at A1 (describing how software programs significantly reduce the duration and costs of discovery).

59. *See generally* BAUMOL & BOWEN, *supra* note 56.

VIII. Conclusion

The purpose of this Article was to examine the effect of the 2007–2009 global recession on law firms, and whether the firms' responses were cyclical or something more structural. While it is too early to make a definitive assessment, it appears that the answer lies in the latter. The economic indicators from recent years, including preliminary data from 2013,[60] suggest that large law firms will continue to be profitable, but there will likely be continued sorting, both across and within firms. If current trends continue, the top firms will incrementally capture a greater share of the overall gross revenue of the top 100 firms, and will increase profits by reducing labor costs through segmentation of the associate ranks.[61] Under this modified framework, the losers of this process will be the nonequity partners, who may find large law firm employment less attainable, less desirable, or both. One set of winners will be clients, large and small, who may find the market for legal services more affordable.[62] As for the equity partners, they will be both winners and losers under this new system. Those who achieve this status will directly benefit from the increased profit margin, but may also be forced to live with the increased volatility of large firm practice, where equity partners compete with one another for a greater share of the firm's profits, or run the risk of being fired.[63] Even large, profitable, and well-established firms may dissolve.[64]

60. Figures from the *Am Law 100* published for 2013 show that the top 100 firms enjoyed a 4.2% increase in average profits per partner in 2012. Fewer firms enjoyed increases in 2012 (66) compared with 2011 (72), but more firms enjoyed double-digit growth in 2012 (19) than in 2011 (15). *See The 2013 Am Law 100*, Am. Law. (Apr. 25, 2013), http://www.americanlawyer.com/PubArticleTAL.jsp?id=1202489912232 (subscription to *American Lawyer* required).

61. *See* Karen Donovan, *Big Law Firms' Profits and Revenues Rise in American Lawyer Survey*, N.Y. Times (Apr. 27, 2011), http://dealbook.nytimes.com/2011/04/27/big-law-firms-profits-and-revenues-rise-in-american-lawyer-survey/.

62. *Cf.* Gillian K. Hadfield, *The Price of Law: How the Market for Lawyers Distorts the Justice System*, 98 Mich. L. Rev. 953 (2000) (describing how the high cost of legal fees by the large law firms have distorted the overall market for legal services).

63. *See* Ed Poll, *Keep Your Eyes Wide Open to De-Equitization: Financial Difficulties Could Portend Partner Cuts*, N.Y. L.J., Feb. 4, 2013, at S10.

64. *See* Stewart, *supra* note 26 (discussing the demise of Dewey & LeBoeuf in 2012).