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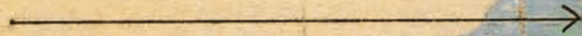


THE AM LAW 100 2007

Is shedding partners the right way to improve profitability?

SOMETIMES.

THE DEPARTED

By Elizabeth Goldberg

Citigroup Private Bank, one of the country's leading law firm lenders, used to pay close attention to a metric that it called "partner defections." Stability in a firm's partnership was considered a hallmark of success, says Danilo DiPietro, client head of the bank's law firm group. High rates of partner departures, he adds, were "an absolute red flag."

That is no longer the case. Partnership in The Am Law 100 has become a fluid concept, with such firms as Cadwalader, Wickersham & Taft; Mayer, Brown, Rowe & Maw; and Sonnenschein Nath & Rosenthal unabashedly pursuing growth strategies that entail orchestrated exits of partners who are deemed to be underperformers. Conventional wisdom has changed so much that almost without exception, legal consultants encourage their clients to prune partners who don't fit the firm's market segment. Firms can make good money doing work at either end of the spectrum, they say, but not at both. And because different kinds of work demand different cost structures and leverage, it doesn't make sense for a firm that bears the expense of high-end capabilities to waste those resources on low-revenue projects. The new paradigm calls for firms to build core practice areas and shed those with low margins; to monitor partner productivity; and to achieve a single rate structure. The inevitable consequence is partner departures—whether firms explicitly ask lawyers to leave or partners simply decide to go where they are more highly valued. Three years ago, Citigroup even changed its terminology. The bank now makes note of "partner departures," not "defections." Says DiPietro: "It [is] still something to track, but it [isn't] immediately seen as a bad thing."

We wondered, in fact, if partner departures could now be considered a good thing. Given that so many firms are actively tailoring their partnerships, is there a direct connection between partner departures and financial success? To find out, we used our database of lateral partner moves to identify 15 firms that lost a particularly high percentage of their partners over the last three years. (The Am Law 100 average between October 2003 and October 2006 was 11 percent; the firms we tracked all lost more than 15 percent. We counted departures of both equity and nonequity partners.) Then we looked at Am Law 100 revenue and profitability figures for those 15 firms between January 2004 and December 2006.

Of the 15, eight increased average compensation for all partners at a rate higher than the Am Law 100 average of 20.1 percent. But only six improved their all-important revenue per lawyer more than the Am Law 100 average of 15.3 percent [see "Losing to Gain?" page 146]. What our sample shows, in other words, is that partner losses can boost profits, but they don't often correlate with an improvement in a firm's overall financial health.

Of course, aggressive management of the partnership ranks is only one factor in a firm's

Illustration by David Lesh

"Laterals are a crapshoot," says consultant Thomas Clay. "If a managing partner is honest, they'll tell you they are lucky if 50 percent [work] out."

economic performance. There could be other explanations for the below-average RPL performance of many of the firms with heavy partner losses. But it is clear that in today's legal marketplace, with partners coming and going with abandon, successful firms have explicit strategies to help them keep the partners they want—and lose those they don't. If firm managers cull partners strategically, and with humanity, they can make their firms more efficient and more unified. If, however, they handle partner departures ineptly, says lawyer and legal consultant Bruce MacEwen, they can "destroy morale and be caustic to the firm's ethos."

In either case, the prevalence of such strategies is more evidence that the law firm business is changing inexorably, as Am Law 100 partners become less like owners of their firms and more like employees who can be dismissed at management's will. Money talks, and right now, that's what the money is saying.

PLAYING THE MARKET

The most common explanation that firms offer for heavy partner losses is market segmentation: They're redefining their partnerships, they say, in a determined push for premium work. For some firms it's a strategy that is already working. Others are still waiting to see the benefits.

Along with Dechert [see "Top Design," page 134], Cadwalader is one of the most financially successful of the firms with heavy partner losses in the last three years. Since 2004, the firm has not increased the size of its partnership. But it has replaced one-quarter of its partners—and has seen profits per partner climb 37 percent.

The firm set its course in 1994, when a group of young partners, including current chairman Robert Link, Jr., seized control of the management committee. The firm had experienced a dip in profits in the early 1990s that some partners feared threatened its future. After Link and his compatriots took over, they began to eliminate low-margin practices and partners who were considered a drag on profitability. "There is a move now for greater accountability," says Link. "We were at the forefront of that effort."

Between 1994 and 2003, roughly 30 Cadwalader partners either were cut or elected to leave as a result of the firm's restructuring. The first big group left in 1994, when the firm closed its 15-lawyer Palm Beach, Florida, office, which had been operating at a loss. Link and his allies also downsized Cadwalader's sleepy maritime group and reformed the trusts and estates practice to focus entirely on wealthy private clients.

The shifts did not immediately raise Cadwalader's revenue ranking relative to its competitors. But they did, Link says, enable the firm to concentrate on its most profitable practice areas—capital markets, global finance, restructuring, corporate M&A, and white-collar and securities litigation—and to attract important laterals in those areas. At the same time, Cadwalader continued to shed partners, including its entire project finance group.

The firm has been well rewarded for that rigorous management. Since 2004, its average compensation for all partners has increased 35.7 percent, and its revenue per lawyer has increased 17 percent. Cadwalader now ranks sixteenth in revenue per lawyer, up five places since 2001; and fourth in profits per equity partner, up from fourteenth five years ago.

Link says that Cadwalader intends to keep vigilant watch over the partners. "We are never going to be finished," he says. "We'll see movement among our partners to stay directed toward certain markets."

Morrison & Foerster has been less aggressive about pruning partners than Cadwalader—"there has been no culling of the herd," insists chair Keith Wetmore—yet still lost almost 20 percent of its 2004 partners. Over those years, MoFo has beaten the Am Law 100 averages in both RPL and average partner compensation growth.

LOSING TO GAIN?

Played right, partner losses can become profitability gains.

FIRM	DEPARTING PARTNERS	PERCENT OF PARTNERSHIP	PERCENT CHANGE IN CAP	PERCENT CHANGE IN RPL
Cadwalader, Wickersham & Taft	23	25%	35.7%	17.0%
Heller Ehrman	48	22%	8.4%	12.7%
Fish & Richardson	31	22%	18.2%	6.8%
Duane Morris	50	21%	7.5%	9.1%
Shearman & Sterling	48	21%	44.7%	25.5%
Alston & Bird	53	21%	-8.3%	9.1%
Wilson Sonsini Goodrich & Rosati	30	20%	30.1%	12.9%
Katten Muchin Rosenman	49	18%	17.1%	9.4%
Orrick, Herrington & Sutcliffe	45	18%	20.6%	9.7%
Dechert	39	18%	49.5%	24.6%
Morrison & Foerster	46	17%	23.7%	22.4%
Dorsey & Whitney	46	17%	2.2%	9.3%
Akin Gump Strauss Hauer & Feld	52	17%	28.6%	12.8%
Hunton & Williams	56	17%	16.2%	15.9%
Baker & McKenzie	96	16%	33.8%	20.7%
AM LAW 100 AVERAGE		**11%**	**20.1%**	**15.3%**

Sources and Explanation: Firms on the chart do not include those that have experienced significant partner losses as the result of mergers since 2004. Departure statistics are from *The American Lawyer*'s laterals database, and reflect equity and nonequity partner losses between October 2003 and October 2006. Financial data is from The Am Law 100. CAP and RPL growth statistics reflect changes between fiscal year 2004 and fiscal year 2006.

MoFo's strategy, nicknamed "Higher, Wider, Deeper" (for higher aspirations, wider market presence, and deeper alliances), has led the firm to focus on building such practices as global capital markets, litigation, and life sciences, and also to be more selective about the work it accepts. Not every partner, Wetmore acknowledges, fits with those new goals. "We are making choices to compete for the very best work for the best clients," says Wetmore, "and sometimes people choose not to make that journey with us."

One point of difference can be billing rates. When firms raise rates, partners whose clients can't afford them sometimes look for a new platform. That's a big reason that former MoFo partner R. Clark Morrison moved to Cox, Castle & Nicholson with five other lawyers in January. Morrison says he had a $5 million real estate and land use practice at MoFo, but that most of his public home-building clients were struggling with his rates even before the housing downturn. When Morrison got notice at the end of 2006 that MoFo would charge another 10–12 percent, he knew it was time to leave. "It wasn't the firm's priority to build the land use practice," says Morrison. "I think MoFo is making the right move for its future, but it just wasn't the right place for me to grow my practice."

Like Cadwalader and MoFo, Akin Gump Strauss Hauer & Feld is in the midst of remaking its partnership—an effort that has contributed to the departure of 52 partners, or 17 percent of the total, over the last three years. In late 2003, after ten years of growth, Akin Gump was bloated. It had more than 800 lawyers scattered in offices across the country, and carried practice groups of every variety and rate. Ranked forty-first in profits per partner, "we were kind of all over the place," says chairman R. Bruce McLean.

So the firm decided to focus on attracting high-end work in six key practice areas, including restructuring, policy and regulations, and private equity. There was consensus in the partnership about the refocusing, McLean says, even though some partners understood that their practices no longer fit. "It was some partners self-selecting to go to a firm that would value the practice they are in," says McLean. In 2004, for instance, the firm lost an 11-member mid-rate health care group to Gardner Carton & Douglas (which merged with Drinker Biddle & Reath last year), as well as several toxic tort specialists.

But Akin Gump's financials have so far been slow to improve. While average partner compensation has risen 28.6 percent and revenue per lawyer has gone up 12.8 percent over the last three years, the growth is largely due to a $58.5 million contingency fee the firm received in 2006 from representing a plaintiff against a South Carolina medical device company. Without that windfall, the firm's average partner compensation would have gone up 11.7 percent and RPL only 5.4 percent.

Nevertheless, McLean is convinced that the strategy is working. He attributes slow RPL growth to hiring a lot of young lawyers, and emphasizes that Akin Gump is landing premier assignments in its target practice areas, such as its representation of creditors committees in four of the ten largest bankruptcies filed in 2005, as well as the creditors committee in the WorldCom, Inc., reorganization. "We are constantly reviewing our performance on where we can do better," says McLean.

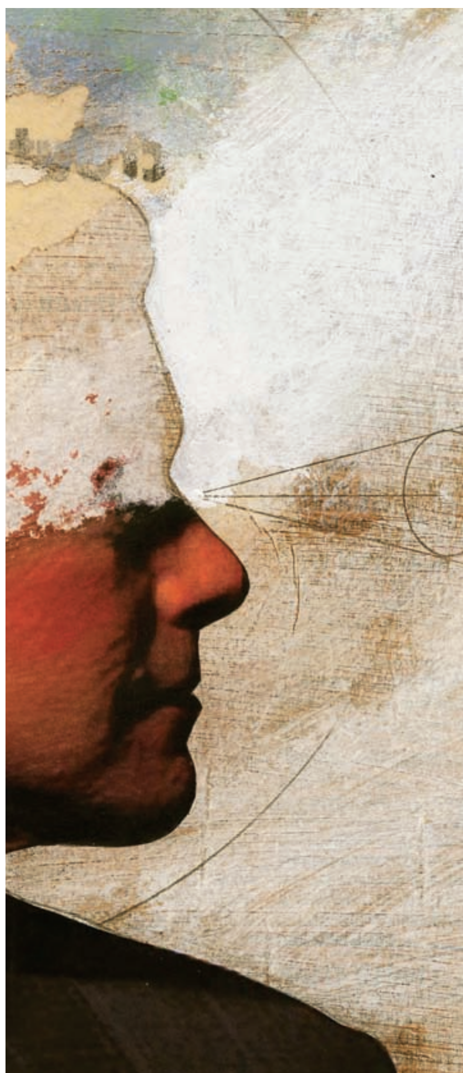
Orrick, Herrington & Sutcliffe is also waiting for RPL to boom. Like Cadwalader, Orrick has pursued a ten-year drive toward high-margin work, with similar partner losses: 18 percent of Orrick's 2004 partners are gone. But in the last three years, Orrick has had less robust success than MoFo and Cadwalader. Although average partner compensation was up 20.6 percent, to $935,000, the firm's RPL has increased only 9.7 percent since 2004—a below-average rate that longtime firm chairman Ralph Baxter, Jr., attributes to rapid head count growth in the associate and nonequity partner ranks. (Aside from equity partners, Orrick's head count is up by 172 lawyers since 2004, raising its ratio of associates and nonequity partners to equity partners from 3.6:1 to 5:1.) Baxter says it takes at least four months for new lawyers to reach full productivity, so he expects RPL to improve over the next year as recent hires ramp up.

Orrick's strategy has not been to eliminate low-margin practices, but to target premium work firmwide: in real estate, complex transactions rather than leases, for example; in labor and employment litigation, class action defense rather than single-plaintiff claims. "What we have done as a firm is [make] sure that everyone is conscious of the changing world and the need to adapt to the changing world," says Baxter. No Orrick partners have been explicitly asked to leave, he says, but "we try to be as good as we can about communicating with partners the firm's perception of how they are doing so they know where they stand."

Lynne Hermle, a partner in the employment group, recalls Baxter explaining the high-value practice concept at a partners meeting about ten years ago. ("High value" is measured at Orrick by how important a matter is to the client.) She knew that her then practice didn't meet the standard, and she considered leaving the firm. But, she remembers thinking, " 'I've always loved it here, so I'll try to make it work.' "

Hermle began to concentrate on defending wage-and-hour class actions and high-profile individuals who were willing to go to trial. The firm helped by providing the necessary manpower as she built her practice; today her Silicon Valley employment group

Mayer, Brown's announcement of a 45-lawyer purge, which once would have seemed cataclysmic, is now merely eyebrow-raising.



Now highly profitable, Cadwalader intends to keep a vigilant watch over its partnership. "We are never going to be finished," says chairman Robert Link.

has three partners and nine associates, and often enlists help from other California-based associates. "I transformed my practice," says Hermle. "One day I was doing Joe versus gas station, and the next day I was doing $40 million class actions."

But not every partner was able to match Hermle's achievement—and not every partner wanted to. Among the 45 partners who have departed Orrick in the last three years, some felt the firm's rapid growth undermined both the partnership's camaraderie and its ability to deliver for clients. Says one partner who left: "It seemed like every Monday we'd get a new memo with a new group of names on it—people you'd never met and [who] a week later became your partners. It's impossible to carefully vet that many."

MOVING RIGHT ALONG

If one side of the profitability equation is figuring out the right work, the other side is getting the right people to do it. Firms cannot support widely varying productivity levels without driving down average compensation numbers, and low-margin groups soak up a disproportionate amount of expensive support services and managerial attention. Top billers are also less willing than they once were to subsidize underperformers, whether they're longtime partners who don't measure up or laterals who don't deliver what they've promised.

Duane Morris has been quick to shed partners in both categories. In 2004 the firm shuttered its low-performing Harrisburg, Pennsylvania, office, releasing 11 partners in the process. It has also said goodbye in the last three years to 25 underperforming laterals—the consequence of a decade of aggressive expansion that transformed a middle-market Philadelphia firm with 242 lawyers into a 20-city firm with twice as many lawyers. Much of that growth came through Duane Morris's acquisition of lateral partners. But some of those hires haven't worked out.

"Laterals are a crapshoot," says Thomas Clay, a consultant at Altman Weil, Inc. "If a managing partner is honest, they'll tell you they are lucky if 50 percent turn out in terms of bringing in the business they said they would."

Duane Morris chairman Sheldon Bonovitz says there is no way for a fast-growing firm to avoid making lateral hiring mistakes, no matter how much due diligence is done. (Duane Morris spends about $7.5 million a year on recruitment.) When his firm makes mistakes, Bonovitz says, it cuts its losses. "If a lateral says, I have a $2 million portable business and after six months, he has none, we are disappointed," says Bonovitz. "We say, 'This isn't the right place, and you can stay with us until you find [another] job.' "

Bonovitz asserts that this type of turnover is healthy because it rewards partners who are hustling. But Duane Morris's financial growth hasn't kept pace with head count expansion. Despite losing more than 50 partners since 2004, the firm's partnership is up by 63 lawyers. That has driven gross revenue up 27.5 percent over the last three years, but average partner compensation has risen 7.5 percent and RPL 9.1 percent—both well below Am Law 100 averages. (Bonovitz says the firm had some nonrecurring expenses in 2006 related to its acquisition of a 64-lawyer California insurance firm.)

Shearman & Sterling is Duane Morris's mirror image: a firm that has lost several partners it would have preferred to keep, yet has seen its average partner compensation skyrocket by 44.7 percent in the last three years. Despite that surge, the firm hasn't caught up with the New York firms it regards as its peers.

In 2000 Shearman had profits per partner of $1.35 million. By the end of 2001, average profits were down 42 percent, to $950,000. Since then the firm's partnership has shrunk dramatically. With 196 partners in 2006, Shearman has 31 fewer equity and 12 fewer nonequity partners than it did in 2004, with the losses including such high-profile defectors as antitrust partner Steven Sunshine, who went to Cadwalader and is now at Skadden, Arps, Slate, Meagher & Flom; and China specialist Carmen Chang, who left for Wilson Sonsini Goodrich & Rosati.

During that time, however, equity partner profits have jumped from $1.15 million in 2004 to $1.65 million in 2006. Rohan Weerasinghe, who took over as Shearman's senior partner in June 2005, would not comment on the firm's strategy for this article, except to say: "I have tried to bring a disciplined business approach to the management of the firm." But in an interview last year with *The New York Law Journal,* a sibling publication of *The American Lawyer,* Weerasinghe said that some of the reduction in Shearman's partner ranks was intentional. The firm was communicating more directly with partners about their productivity, he said, and some individuals had decided to leave as a result. Shearman's 2006 numbers indicate that it has held on to a core of productive partners; despite being 130 lawyers smaller than it was in 2004, Shearman reported revenue growth of 9 percent over those three years, with revenue per lawyer increasing by an above-average 26 percent.

THE ALL-AT-ONCE APPROACH

On March 2 Mayer, Brown, Rowe & Maw announced that it was terminating at least 22 partners and deequitizing at least 22 more—a move that affected almost 10 percent of its total partnership. Such a purge, which once would have seemed cataclysmic, is now merely eyebrow-raising. Mayer, Brown's Chicago rivals, Sidley Austin and Sonnenschein, did

it in 1999, and more recently, Chadbourne & Parke did it in February 2006. The quick fix—improving average profits by slashing the number of partners—is a powerful lure.

Mayer, Brown's incoming chair, James Holzhauer, says the firm had to cut partners in order to raise partner compensation and boost leverage. "We think it is necessary to make sure that [we] maintain a strong market position and even achieve a better profitability," says Holzhauer, adding that the firm targeted partners on the basis of their productivity rather than cutting entire practice areas, which the firm does not intend to do. Mayer, Brown's goal, he says, is to be able to pay as much as its competitors. (In 2005 Mayer, Brown's profits per partner were $955,000, much less than other Chicago firms it regards as peers: McDermott Will & Emery averaged $1.28 million, and Kirkland & Ellis had PPP of $2.12 million.) According to Holzhauer, "Our ability to retain and attract partners depends on profitability."

(Mayer, Brown's March announcement was unrelated to the 81-partner reduction in its equity tier in this year's Am Law 100. CFO Alan Cohen says the firm had previously misunderstood *The American Lawyer*'s definition of equity partnership. That restatement already boosted the firm's PPP by 19 percent to $1.135 million, pushing the firm up six places in the profits per partner rankings.)

Mass demotions like Mayer, Brown's are not without risk. For one thing, consultants caution, manipulating or cutting partner numbers to achieve short-term growth in profits may not serve the firm's long-term health. And even if the firm's cuts are part of a long-term strategy, they can cause backlash that slow attrition does not.

Just ask Cadwalader. Its 1994 decision to dismiss all 15 lawyers in the Palm Beach office landed the firm in court when one of the fired partners, James Beasley, sued the firm, claiming that Cadwalader had violated its partnership agreement. Palm Beach County circuit court judge Jack Cook agreed, and in July 1996 awarded Beasley $2.4 million. "If Beasley had dirt under his fingernails," the judge wrote, "CW&T was up to its elbows in the dung heap."

Sidley Austin is also caught in a protracted legal battle over its 1999 decision to demote 32 partners at the end of 1999. The Equal Employment Opportunity Commission has alleged in a lawsuit in Illinois federal district court that the firm engaged in age discrimination. In court documents, Sidley says its decisions were based on individual partners' performance, not age. The case will turn in part on whether the EEOC can prove that Sidley's partners were actually employees subject to federal discrimination laws.

While Cadwalader and Sidley are extreme examples, strategies that involve partner departures pose cultural challenges for even the most collegial firms. MoFo, for instance, was named one of *Fortune* magazine's 100 b est places to work three times, but slipped off the list in 2007. And Mayer, Brown was roundly criticized after its recent announcement. "The decision was motivated by avarice, insatiable greed for riches, and an inordinate desire to gain and hoard wealth," wrote marketing consultant Larry Bodine. "Mayer, Brown has signaled that its firm culture is a money-hungry, ruthless sweatshop."

NOT BY CUTS ALONE

Since 2004, San Francisco's Heller Ehrman has lost at least 48 partners, or 22 percent of its 2004 partnership. The firm doesn't have a policy of partner pruning, but chairman Matthew Larrabee, like so many other firm managers, says Heller has been increasingly focused on high-margin practices, which in Heller's case include technology, intellectual property, antitrust, and real estate. Performance expectations for partners, he says, have risen firmwide, and departures have followed. While some of the losses have been unintended, such as the ten members of the semiautonomous Venture Law Group who decamped to Orrick in 2005, Larrabee asserts that many who left simply didn't want to compete at a higher level.

But the problem for Heller—and the reason the firm provides a lesson for others shedding partners—is that until recently, Heller wasn't replacing enough of the departed equity partners with strong new performers. The firm's head count declined between 2004 and 2006 from 628 to 601, and the firm's equity partnership shrunk by 18 percent over the same period. Because Heller wasn't replenishing its ranks, the firm's financial performance stagnated. Over the last three years, the firm's RPL rose 12.7 percent, and its average compensation for all partners went up only 8.4 percent—both below Am Law 100 averages. While Larrabee insists that Heller will not pursue growth for growth's sake, the firm picked up the pace of its hiring in the first quarter of 2007,

That's the new reality—partners leave or get pushed out of firms, and firms find laterals to replace them. The partners join new firms, perhaps pushing out a different group of lawyers in the process. Old-fashioned notions of collegial lifetime partnerships are only a memory at many firms. And as firm managers see the benefits of Cadwalader-style tailoring of their partnerships—namely, growth in profitability—traditional ideas of partners as firm owners will further erode.

For partners, it's a return to the long-dead adage about entering law school. Look to the right of you, now look to the left: One of you won't be here next year.

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The law firm business is changing inexorably, as Am Law 100 partners become less like owners of their firms and more like employees who can be dismissed at management's will.