The New Subclass?

Cover Story
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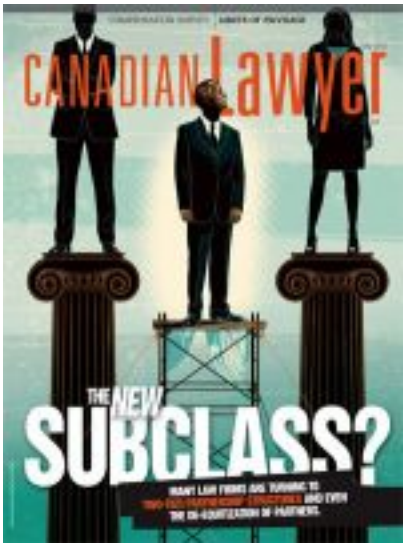

“We. Are. The 99 per cent,” went the refrain echoing around Wall Street and Bay Street at the height of the Occupy movement in late 2011. But the same cries could soon be coming from within the glass towers that line the streets at the world’s financial centres if big law firms face the backlash some analysts are predicting from marginalized lawyers chasing an increasingly elusive seat at the equity partnership table.

“Somebody needs to start Occupy Big Law,” says Steven J. Harper, a retired partner formerly with U.S.-based international giant Kirkland & Ellis LLP. According to Harper, the increasing ranks of non-equity partners chasing the mirage of full partnership, or recovering from de-equitization, risks creating a “permanent subclass” in law firms. Even within equity partnerships, he says the widening gulf between the lowest- and highest-paid members is a recipe for disaster.

At the recently collapsed Dewey & LeBoeuf LLP, some have estimated that spread at between 20: and 30:1. In more conservative Canada, where ratios are firmly in the single digits, and rarely higher than 5:1, it still hurts to be the “one” getting multiples less than your so-called partner, says Harper. “The gap at some of these firms is staggering, in a way that was not true 10 years ago,” he says. “What it means is you wind up with an even smaller group at the top that really controls things, and they can embed themselves there.”

Edmonton-based law firm strategist Patrick McKenna says law firms have moved to shrink their equity partnership ranks because they’ve exhausted all other options to increase, or simply maintain, partner profitability. He says there are four factors that play a role in its calculation: margin (revenue minus expenses), billable hours, rates, and leverage (associate-to-partner ratio).In the 1980s and 1990s, McKenna says law firms basically worked lawyers harder, pushing billable hour targets to their limits. From about 1995 to 2008, firms simply raised rates, which worked just fine until the global economic downturn hit. Since then, margins have shrunk because expenses continue to rise, while revenue has flatlined or fallen thanks to reduced demand for legal services. Leverage, traditionally low in Canada anyway, has not been an option elsewhere as corporate clients balked at high rates for inexperienced and allegedly unproductive associates. “Well, there’s only one other mechanism to increase partner profitability, and that’s to have less partners sharing in pie,” says McKenna.

Pulling up the drawbridge

One way firms reduce the number of equity partners is by delaying entry. In the last couple of decades, young lawyers have found the path to partnership follows a longer and more convoluted route than it did for their predecessors. “I had one lawyer tell me the chances of being hit by lightning are higher than being made an equity partner,” says McKenna.

Last year, a Robert Half Legal survey of lawyers at large Canadian law firms found associates will wait an average of seven years to make partner. “Competition for partner positions has intensified,” said John Ohnjec, division director of Robert Half Legal in Canada, at the time. “In fact, some firms have been thinning the ranks of partners by promoting fewer associates.”

An increasingly common stop on the partnership track is non-equity partnership. According to Harper, firms are attracted to two-tier partnership by the ability to generate an extra couple of years of leverage out of associates who would otherwise have been promoted. For lawyers, they get the prestige of the partner title, and a billing rate to match, which also suits firms. “The underlying driver is non-equity partners are extremely lucrative. You don’t have to pay them anything near what they generate,” points out Harper.

According to Adam Pekarsky, who runs the Pekarsky Stein recruitment firm in Calgary, non-equity partner positions have been a useful tool for some local firms that are reluctant to dilute the profit pool but want to retain talented lawyers. “There’s lots of examples of firms who have gone two, three, four, five years with no new equity partners. The problem is those people you are passing over,” he says. “Non-equity partnership is supposed to be temporary, but the cynic would say that’s only because firms can’t get away with extending it.”

The danger, according to Harper, comes when firms have some success evolving the position from a transitory state to a permanent one, something he notes is happening more frequently. “Once it becomes clear that you’re staying there, these lawyers become second-class citizens. They know it, and everyone at the firm knows it. They’re delegated the work nobody else wants to do, and it gets very demoralizing."

Pekarsky says a generational shift, combined with more exacting requirements from law firms, has made their search for potential equity partners more difficult. If a firm hires 10 articling students, he says they'll do well for one of them to end up as an equity partner a decade later. "Organic, homegrown partners are a rare breed. It's no longer the brass ring for the vast majority of young lawyers entering the profession," he says. "There's so much more pressure on lawyers to do more, that partnership becomes a less appealing prospect. The personal sacrifice is too much for many in a time when both spouses work."

One Bay Street non-equity partner finds himself torn in exactly that way. In a position to apply for equity partnership, he's not so sure it's the right option. "There's always that sense that I'm perhaps not getting as much as I might, but I'm comfortable where I am with the certainty of income. It makes sense so long as they continue to pay me well," he says.

And a six-figure buy-in is not an overly attractive proposition at a time when equity partner draws are limited. "They want you to pony up, and for what exactly? The market is constricting, if anything, and everyone thinks they're [McCarthy Tétrault]," he says. "There's a great deal of risk putting up that amount to ensure firm does well."

Simon Margolis, the managing partner at Bull Housser & Tupper LLP, says there's a five- to seven-year window for income partnership, the non-equity version at his Vancouver firm. He views it very much as a temporary station for equity partner candidates, who have a few years to move up or move on. "The big step to me is entry to income partnership. Some don't develop quite as you expected, but if you're not sure about someone, then they shouldn't become income partners, because the plan is that within a reasonable amount of time they're going to make it to equity," Margolis says. "You don't want to end up with a bunch of people stuck there."

At the London, Ont., office of Lerners LLP, managing partner Ian Dantzer seems aware of the potential underclass described by Harper, bristling at the term "two-tier" to describe the firm's partnership structure. "Two-tier is a tough word because it implies one is better than the other. We have a path to equity partnership," he says. "Non-equity partnership is a testing ground, an intermediate stage between associate and equity partnership. It gives them greater tools and status to go out and market themselves, generate work, and build a practice."

De-equitization

Even lawyers who have finally arrived at the promised land of equity partnership must constantly look over their shoulder to make sure they stay there. "You don't allow partners in unless they have their own book of business, and you kick them out if they can't keep it. We eat our own if they can't sustain themselves and pay for some others," says McKenna.

The most vulnerable to de-equitization are lawyers whose promotions were well timed, gaining admission to the partnership in better economic times, when firms were a little less stringent with entry requirements. “We went through a period in the 1980s and 1990s, where if you put in your six to eight years, it didn’t matter, you were just made a partner. Later on, we assessed those partners, and decided maybe they weren’t the right material for us,” says McKenna. “Some partners have retired on the job, but haven’t informed the firm.”

Ed Wesemann, a consultant at Edge International, says de-equitization is particularly popular in the U.S. and U.K., where law firm finances and partner profitability rates are much more public than in Canada. By shifting an equity partner into the non-equity ranks, law firms are able to give a boost to their profit-per-equity-partner rate, a key indicator of law firm performance. “It’s very hard to fire an equity partner, but it’s a little easier to make them into non-equity partners. The biggest problem with equity partners is when they don’t have their own supply of business. So this is a good place to park them, and you can usually give them a little cut in pay,” he says. “You’ve done something and helped the statistical base. Nobody makes any more money, but the math looks a little better.”

According to an *American Lawyer* report on the top 200 firms in the country released in December, 39 per cent of managing partners said their firms de-equitized partners in 2011, and 38 per cent planned to de-equitize more in 2012. In the U.K., Magic Circle firm Clifford Chance LLP began consulting partners in April on a new termination policy that will allow them to ship out under-performing partners more quickly. That came on the heels of a partnership restructuring by Clifford Chance’s rivals Linklaters, which resulted in the departure of 25 partners and the demotion of 16 more.

De-equitization also comes into play for partners reaching retirement age. In addition to a training ground for lawyers on their way up, Margolis says non-equity partnership is also a “good spot for people to rest in on their way down.” “We have some senior people who are still valuable for us, but not in the position to, or not wanting to, devote themselves in quite the same way as we expect of an equity partner,” he says. “It’s a way of keeping them in the fold, but just compensating them appropriate to their contribution.”

Colin Cameron, the president of Vancouver-based Profits for Partners Management Consulting Inc., says Canadian firms are pushing mandatory retirement ages earlier, with the phase-down process beginning as soon as the partner’s 60th birthday in some shops. “To maintain their profit levels, the business model requires partners to move out of the equity partnership ranks in the 60- to 65-year range. The move down to non-equity status is the most common first step,” he says. “In large Canadian firms especially, they have to be financially as strong and capable as they can to defend themselves against much other bigger, and international players, like Norton Rose. There’s more parties going for a smaller group of clients, who are also pushing for alternative fees, so firms will be pushing retirement as much as they can legally in order to survive.”

The continuing case of Mitch McCormick, the B.C. lawyer who launched a discrimination suit against Fasken Martineau DuMoulin LLP over its mandatory retirement policy, has cast some doubt over just how far law firms can go. The B.C. Court of Appeal heard arguments in April on whether the B.C. Human Rights Tribunal has jurisdiction to hear the merits of the case. The situation is equally unclear south of the border, where law firms were denied a precedent-setting decision when 1,700-lawyer Sidley Austin LLP settled a discrimination case with 32 de-equitized partners in 2007. However, the $27.5-million cost of the settlement is enough for firms there to proceed with caution.

Whether they arrived there by virtue of age or substandard performance, de-equitized partners have boosted the ranks of non-equity partners even further. Edge's Wesemann says the short-term focus on profitability that has driven the increase could spell trouble in the long run. "We've created this monster. They're not real partners, but they bill like partners, and they have no natural predator," he says.

According to Wesemann, the lack of genuine partner-level work at law firms means non-equity partners, particularly long-standing ones, end up doing work that is more appropriate for fourth- or fifth-year associates. "We have a rebellion coming. The recession has given us more empowered clients who are actually reading the bills we send them, and they are saying, 'why on earth are we paying a partner rate for this?'"

He notes the non-equity trend is more fully developed in the U.S., where firms are now taking an axe to their non-equity partner ranks, as well as the equity partnership. A May 2012 report by Altman Weil Inc., "Law Firms in Transition," found that with the exception of support staff, non-equity partners were the most likely position American firms will cut in the next year. Equity partners followed closely behind in third place.

Star power

As Dewey & LeBoeuf stumbles through bankruptcy, Canadian law firms should see the firm — created less than five years ago — as a beacon to the dangers of partnership inequity, advises Harper. Just before the firm imploded, some partners reportedly earned at least 20 times what the lowest-paid partners were drawing from the firm. The problem was exacerbated by guaranteed incomes promised to some lateral stars as part of the big-money deals that brought them to the firm over the last two years. Existing equity partners found their earnings squeezed in order to subsidize guaranteed incomes the firm could not afford, of which there were about 100 such agreements according to bankruptcy filings in Manhattan. "What does partnership actually mean if you have a ratio of 20:1? It's incredibly de-stabilizing," says Harper.

He says the firm bought into a star culture that overvalued rainmaking lawyers, and that compensation packages spiralled out of control. "The notion a top lawyer is worth 10 times more than another partner makes no sense at all. You get into a vicious circle, where you panic about losing somebody and get into a truly irrational bidding war."

While Dewey may be an extreme example, McKenna says partner compensation is increasingly skewed at large American firms towards partners at the top end. Ratios routinely hit 10:1 for partner income at opposite ends of the scale, he says. "You've got partners with a smaller book of business who, if you look at the economics very carefully, are actually supporting the stars. When you get a spread that gets too great, you end up with a partnership within a partnership," says McKenna. "And if people come for money, they leave for money. There's no loyalty."

Guaranteed incomes or joining bonuses are not unusual in Canada where rainmakers are concerned, according to Cameron, who says that most "would be quite hesitant to pass on clients without some sort of guarantees." But in conservative Canada, where partner income ratios rarely top 5:1, the impact is reduced. But Christopher Sweeney, CEO of ZSA Legal Recruitment, says rainmakers have increasing influence at a time when corporate clients are placing their faith in a smaller group of trusted advisers. "Firms like to think clients come to them because of the brand and overall service. That is true, but increasingly, sophisticated corporate clients have specific relationships because of individual lawyers," he says. "That makes it critical that firms adequately reward their top lawyers."

At Bull Housser, Margolis says the spread of equity partner earnings from top to bottom is 3:1, but that he's open to widening the gap. "Three-to-one is where we're currently at, but it doesn't mean it always has to be. We would have the capacity to get bigger than that, and if it's done correctly, I don't think it's a problem. If someone's doing all the right stuff, we all do better by that," he says.

Margolis says the firm tries to avoid fine distinctions between individual partners by creating clear bands of partner pay with distinct entry qualifications, and that the firm's size makes it easier. "We don't have hundreds of partners, so you can get a good feel for what people are doing," he says. "There aren't too many raised eyebrows."

Shekhar Parmar, director of the Calgary office at legal recruiter The Counsel Network, says Canadian firms may be particularly wary of overpaid rainmaking because of this country's own cautionary tale in the 2007 dissolution of Goodman and Carr LLP. "That was a scenario in which some partners were cut pretty large cheques compared to their book size," he says. The firm abandoned its lockstep partner compensation scheme, which rewarded lawyers based on their seniority, in the 1990s, and recruited a clutch of star performers, including some with high-paid special deals outside the equity partnership. "That kind of thinking can work out well, but you're taking a gamble. Sometimes things don't work out and you have to pay the house," says Parmar.

A string of missed budgets and a failed merger sparked an exodus of equity partners at Goodman and Carr, and the firm's management decided closure was the only option.

Parmar says he helps Canadian firms evaluate the risk of bringing on new partners laterally, and he finds that most are thinking longer term since the demise of Goodman and Carr. "We help them work out whether they're bringing real value or if it's more smoke and mirrors," he says.

At Lerners, Dantzer says his firm won't break the bank to land a star performer. "We're very cautious about lateral hires. We won't do it just for the sake of bringing someone on. Any merger is very difficult. I think it's very divisive if you give special treatment to someone new. Unless a significant group recognizes the long-term importance of that practice or person, you're just creating problems for yourself, resentment, and maybe desertions, so you sort of work against yourself."

Dantzer says Lerners will resist the temptation to go after star-free agents, and focus instead on its own prospects. "I think more and more we are becoming convinced we have to build from within and develop a sense of loyalty. It takes much longer to do, but it's much more stable and profitable long term," he says. "The idea of going out like the Toronto Maple Leafs and buying a few stars sounds good in theory, but it doesn't deal with chemistry, long-term cost, and the chance that they could move on again."

But Sweeney says that approach may not work for all Canadian firms if the market sees further incursions from abroad. Norton Rose Group landed in Canada with the wholesale takeover of Ogilvy Renault LLP, before adding Macleod Dixon LLP. Another global giant, Allen & Overy, which has been linked in the past with Canadian law firms, elected for a more organic growth strategy when it entered the Australian market, by poaching leading partners from top firm Clayton Utz to establish a presence in the country. A similar move in Canada could force large Canadian firms to shell out extra cash for their star performers in order to hold on to them and the clients they bring with them. "If a big international firm came in and started building up with just the cream of the crop, that could mean 60- or 70-per-cent increases, which would be a game-changer," says Sweeney. "It's not going to happen with the existing major players."

The last time something similar happened in Canada, says Sweeney, was when Osler Hoskin & Harcourt LLP opened its Montreal office in 2001, recruiting partners by offering them considerably more money. To cover the increased cost of holding on to their stars, firms city-wide bumped rates by around $100 per hour. "There was some flexibility because Montreal was underpriced at the time, so it was able to absorb that shock," he says.

Increased rates are not an option this time around, with corporate clients looking to save, and that means Canadian law firms will have to absorb the shock themselves. "There's always a marketplace for stars, and I foresee their value to law firms climbing. We're almost bordering on free market agency for the top talent in law. These lawyers will spend three to five years at a firm, and if the firm isn't able to increase what they're earning, they'll see what kind of bids are coming in from another team," he says. "Using the one-per-cent analogy from Occupy Wall Street, even in law firms, there will be those rewarded on a different scale from everyone else. That's going to cause internal problems from people, and firms have to deal with that. It's just part of running a law firm in the modern era."