

# Low leverage: A low road to ruin for law firms?

*A truly worrisome trend is spreading from American law firms throughout the world: institutionalized low leverage. Many partners welcome the higher profits and managerial relief this trend produces. But in the longer term, this short-sighted policy threatens serious damage to firms, clients, and partners themselves.*

**By Sean Larkan**

**L**awyers in other countries carefully monitor the U.S. legal market, sometimes regarding it as a trendsetter and even a model. In recent years, however, a U.S.-led trend towards lower average levels of leverage could have serious-long term consequences for that market and any others that follow it. This has implications for the legal profession, for firms, for partners, and importantly, for clients.

## **WHAT IS LEVERAGE AND WHY DOES IT MATTER?**

Leverage (or gearing) means the average ratio between associates (in this context, all non-partner lawyer fee earners) and partners (total partners, including both equity and non-equity). On this basis, associate-to-partner

gearing in the top 200 U.S. firms was just below 1 to 1 in 2010. In other words, on average these firms employed less than one lawyer for every partner. So far in 2011, leverage has “improved” to slightly more than 1.4 to 1 for the top 200 firms. For the nearly 80,000 U.S. law firms outside this elite group, however, leverage drops down to even lower averages (in many cases, as low as 0.5 to 1).

Firms with higher associate-to-partner leverage invariably justify this strategy on the basis that properly managed, it translates to higher equity-partner incomes. This is usually correct, albeit only if the lawyers are high-calibre, productive, well-utilized, well-managed, and kept busy with high-quality work within a framework of good systems and procedures. However, I think this issue goes much further than simple profitability and income.

Associate-partner leverage should never be seen only in quantitative terms. It should be viewed as a qualitative issue, with many variables and components contributing to a successful outcome. Leverage is only one variable affecting financial results and, on its own, does not guarantee success or high profitability. It must be managed strategically and correctly.

### A BRIEF HISTORY OF LOW LEVERAGE

The trend towards lower leverage appears to have its roots in the tough economic conditions leading up to, during, and following the global financial crisis of 2008. During these periods, the market for legal work, particularly the high-level kind, became more competitive.

Firms responded with measures designed primarily to preserve equity partner incomes, including pruning equity partners who did not generate enough work and significantly reducing non-equity lawyer numbers, all to reduce direct legal costs.

Firms responded with measures designed primarily to preserve equity partner incomes, including pruning equity partners who did not generate enough work and significantly reducing non-equity lawyer numbers, all to reduce direct legal costs. Given the high rates established for associate starting salaries in recent years (\$160,000 in some cases), measures like these can obviously result in significant short-term savings.

It is often said that lawyers are like cats, and therefore impossible to herd. Law firms are also like sheep; they tend to follow one another.

Firms that reduced headcount and leverage also justified it on the basis of clients’ complaints about over-lawyered matters. Leverage became a short-term financial tool to regulate profit levels, rather than a strategic structural asset to be carefully managed for the long-term benefit and strength of the firm. It is fair to say that some highly specialized types of practice do not easily lend themselves to high leverage.

It is often said that lawyers are like cats, and therefore impossible to herd. Law firms are also like sheep; they tend to follow one another. If notable firms start doing things that have positive outcomes (especially financial ones), other firms quickly follow suit. Unfortunately, this can happen equally for developments with negative long-term consequences that might not have been obvious at the time. I believe this is what has happened with leverage.

### WHAT DOES LOW LEVERAGE MEAN FOR PARTNERS?

1. There are fewer people to whom work can be delegated and with whom workload can be shared, forcing partners to work longer hours on billable matters and spend less time building long-term business.
2. Fewer prospects come through the system to ensure future partner succession, obliging firms to rely increasingly on lateral hires and creating cultural grooming and fabric issues over time.
3. Partners lose the benefit of having senior associates on the team to train and support more junior lawyers.
4. Partners are forced to do work that would normally be delegated down to the lowest competency level. This may mean higher write-offs, where certain types of work do not justify high rates, and unhappy clients.

### CHALLENGES FOR LAWYERS

1. New graduates, having invested heavily to qualify for the profession, have trouble finding placements within law firms. No doubt this has contributed to many graduates nowadays ending up as contractors or in careers outside the profession.

**2.** Graduates and associates face the prospect of a volatile employer: hiring one day, firing the next, depending on ever-changing market forces and the need to adjust short-term profit figures. Will this type of employer generate trust, respect and engagement?

**3.** Young lawyers lose the benefit of geared professional teams where they can work on matters with colleagues, discuss solutions to matters, and so on. The missing dynamic of learning to work within the social and stimulating dynamic of a team environment cannot be underestimated.

**4.** Senior associates miss the opportunity to manage and lead more junior teams and develop these vital skills.

On the positive side, those few lawyers who do find a position in law firms can reap significant potential benefits, quickly finding themselves fast-tracked into salaried partner positions.

Graduates and associates face the prospect of a volatile employer: hiring one day, firing the next, depending on ever-changing market forces and the need to adjust short-term profit figures. Will this type of employer generate trust, respect and engagement?

#### HOW DO CLIENTS FARE?

**1.** They pay higher rates for work that used to be delegated to the lowest competent level but that is now performed by partners or more senior lawyers, presumably at higher rates.

**2.** They have fewer choices (and sometime none at all) about the lawyers working on their files.

**3.** They become rightly concerned that the firm is not providing for future continuity and succession for partners and their work.

Clients do, of course, have the cold comfort of knowing there is little likelihood their matters will be over-lawyered.

# 11 Steps to Better Leverage

To build a qualitatively leveraged partner-associate team for the long-term health and well-being of your firm involves a wide range of factors:

1. Such a program must be recognized as a challenge and long-term strategic issue for the firm. There are no quick fixes (e.g., hire today, fire tomorrow, re-hire the next day when things change).
2. A strong and positive people-oriented cultural environment is essential.
3. Senior firm leadership and the entire partnership must fully understand the benefits, challenges and implications.
4. The firm must ensure that building a leveraged team is a key performance indicator for partners and give it sufficient weighting. This skill should be a prerequisite for admission to partnership; for existing partners, something critical to progression on a lockstep or towards increased profit share.
5. It is essential to meticulously recruit the right people from the outset.
6. The firm must carefully think through and establish the partners' roles, responsibilities and accountabilities. The author's Responsible Partner® program or similar structures could be utilized.
7. Every lawyer must have someone responsible and accountable for his or her development, progression, and personal and professional well-being.
8. Partners should be encouraged to delegate to the lowest competent level in order to free themselves up to build business, and should receive billable-target relief and financial recognition for doing so.
9. The firm should recognize that adapting to these new paradigms does not come naturally to most partners.
10. To encourage the building of such teams, partners should be recognized not only for production by themselves and by their team, but also for fee work referred to other teams (referred fees) and work done within their team for other teams (managed fees).
11. The firm should recognize that establishing such teams is critical to high levels of engagement and a key measure of the firm's long-term business success and cultural strength.

### IS THERE ANY HOPE FOR CHANGE?

If this trend continues, a fairly dim picture of the profession emerges, particularly given the negative implications for the various stakeholders.

I suspect many partners have silently welcomed these lower leverage trends. Few of them enjoy the extra burden of managing other lawyers and feeding demanding associate mouths with high-quality work from high-quality clients. Lower leverage was an easy trend to latch onto and justify. It reduces short-term expenses and it saves partners from their natural dislike of showing an interest in and managing others.

Certainly, there are counter-arguments to the concerns expressed here. One would be based on the fact that low leverage is producing high income levels for equity partners: why change what appears to be working well? This reasoning is superficially appealing, but I believe it is based on classic short-term thinking.

Realistically, however, this situation is only going to change when influential firms decide to do it differently and achieve profitable results that are published in reputable media.

Realistically, however, this situation is only going to change when influential firms decide to do it differently and achieve profitable results that are published in reputable media. A geared practice requires outstanding people management skills, hard work, and a willingness to pay more attention to the interests of colleagues and clients than to oneself. This does not describe the average equity partner.

There is also the practical issue of expenses. In the past, firms set unrealistically high salary levels for associates, such that gearing up with lawyers may simply not make financial sense (particularly when there is little prospect of achieving short- to medium-term financial returns on these investments). Law firms may consequently find themselves in a vicious circle.

The trend towards lower leverage is widespread and now well-entrenched. I believe it has serious implications for the long-term health of the legal profession in the U.S., and possibly worldwide if this trend is followed in other jurisdictions. I'm not certain the profession can get itself out of this situation.

It is to be hoped that both partners and firms will reconsider, take a longer-term and broader view (even at the cost of short-term adjustments in equity profit levels), and thereby start a counter-trend. I believe that law firms, their clients, partners and lawyers will all benefit if this happens.

But it will require the legal profession to see leverage differently: not as a short-term switch to be turned off and on to adjust profits, but rather as an essential strategic asset of the firm, benefiting all stakeholders equally and providing for long-term stability, proper planning, and a happier culture and work environment for all. •



## Strategy never sleeps

**Sean Larkan** uses his 25 years of direct leadership and consulting experience and a number of unique methodologies to help law firms internationally to develop new or revitalize existing strategy. Sean has a track record of helping firms realize their potential and achieve actual implementation and growth. In whatever he does, his underlying philosophy is always to build a firm's confidence, strength and well-being.

Email: [sean@edge-international.com](mailto:sean@edge-international.com)

Call: +61 2 40 8844 208 or Skype "seanlark"