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ARE WE SELLING RESULTS OR RÉSUMÉS?: THE
UNDEREXPLORED LINKAGE BETWEEN HUMAN
RESOURCE STRATEGIES AND FIRM-SPECIFIC CAPITAL

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Abstract

Over the last several decades, virtually every large law firm has adopted some variant of the “Cravath system,” which builds human capital by hiring the best students from the best schools and providing them with the best training. At the end of a multi-year “tournament”, the best associates are promoted to partner. In theory, this system delivers superior services to clients, thus creating firm-specific capital that generates higher profits. In recent years, however, the surge in demand for corporate legal services has outstripped the supply of one key input—elite law school graduates. The ensuing salary wars have significantly increased the cost structure of large corporate law firms and undercut clients’ willingness to pay for associate training. These trends are unsustainable. More significantly, clients are unhappy and searching for ways to control costs.

This essay draws upon the findings of an innovative study of engineers at the renowned Bell Laboratories to sketch out a plausible alternative law firm model that could profit from client discontent. In an exhaustive study that was designed to identify the various traits of star performers (so Bell Labs could recruit more of them), researchers found no relationship between performance and various social, psychological, and cognitive abilities, such as I.Q. Two years of observational fieldwork subsequently revealed that higher productivity among knowledge workers was attributable to several distinctive work strategies that were teachable. Further, controlled experiments showed large and persistent productivity gains for engineers who completed the training program, with women and minority workers posting the largest increases. I discuss whether these insights could be applied to law firms (the answer is yes) and why law firms nonetheless would resist despite the potential for higher profits. I then outline how the concept could be put to a market test.

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William D. Henderson[†]

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INTRODUCTION

Large corporate law firms are in the business of selling legal services, typically by the hour. To increase profits, virtually all firms look for ways to justify premium fees. The range of strategies is relatively diverse and includes unique geographic platforms or specialization by industry or substantive law. Yet, in terms of the recruitment and development of human capital, virtually all law firms have converged on the same standard formula: Hire the best graduates from the best law schools; provide them with the best training; and at the end of an six to ten year apprenticeship, promote the best associates to partner.¹ This model is often referred as the “Cravath system” because of its creation and refinement at the New York law firm of Cravath, Swaine, & Moore during the early 20th century.² The emphasis on educational

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¹ See Lawrence J. Fox, *The End of Partnership*, 33 *FORDHAM URB. L. J.* 245, 245 (2005) (law firm partner discussing how all large firms claim to interview only at “the very best schools and seek to recruit the very best law students”).

² See MARC GALANTER & THOMAS PALAY, *TOURNAMENT OF LAWYERS: THE TRANSFORMATION OF THE BIG LAW FIRM* 9-10 (1991) (discussing creation and influence of the “Cravath system”); MILTON C. REGAN, JR., *EAT-WHAT-YOU-KILL* 20-23 (2004) 20-23

credentials was initially an attempt to establish a distinctive brand of legal services that could differentiate the firm from other Wall Street competitors.³ Now, ironically, it has become a uniform industry practice utilized by every large law firm that claims to provide first-rate legal services.

Yet, the pervasiveness of the Cravath system, in combination with the dramatic growth in the volume of corporate legal work, has resulted in some peculiar market dynamics that suggest the need, if not the inevitability, of a new model for recruiting and developing human capital. Specifically, the surge in corporate legal services has increased much faster than the number of top law school graduates. In 2005, the nation's 250 largest firms (NLJ 250) hired 5,376 first year associates; in 2007, the total number increased 33% to 7,131.⁴ Of the 1755 additional entry level jobs, 936 (53.3%) went to students from the top 20 feeder schools in 2005, which suggests that most firms dug deeper into the class at elite schools in order to meet their hiring needs.⁵ To entice more elite young lawyers into corporate practice, the prevailing entry level salary in major cities increased from \$125,000 in 2005 to \$160,000 in 2007. Virtually all large law firms moved to this level of compensation to avoid signaling to the marketplace that the firm had become "second rate."⁶

There are two significant problems with these dynamics: (1) as firms have attempted to pass these costs along to clients, many have responded by requesting that no junior associates be assigned to their matters;⁷ and (2) because of a widening stratification of profits within the corporate bar, a large

(discussing origins and influence of the Cravath firm, which "provided a structure whose influence persists to this day").

³ Regan, *supra* note 2, at 22 (discussing how various features of the Cravath system "served to set the Cravath firm apart from its potential competitors").

⁴ Author's calculations from ALM data.

⁵ *Id.*

⁶ Bruce A. Green, *Professional Challenges in Large Firm Practice*, 33 FORDHAM URB. L.J. 7, 22 (2005) (quoting Stephen Crane, partner at Proskauer Rose LLP and past president of the New York State Bar Association, on why firms need to match market leaders in salary wars).

⁷ See, e.g., Leigh Jones, *Pay Hikes are Leaving Clients Cold*, NAT'L L. J., Aug. 8, 2007, at 8 (reporting likelihood that higher rates from salary wars will cause many clients to refuse to pay for associates to work on their matters); Kellie Schmitt, *In Salary Twist, Firm Pays Both More and Less*, THE RECORDER, Sept. 25, 2007, at 1 (reporting comments of head recruiter at Major, Lindsay & Africa that "clients increasingly don't want to pay for first-years to work on their matters"); Joel Rose, *Creative Strategies for Coping with Higher Associate Compensation*, LEG. INTELLIGENCER, July 6, 2006, at 7 (law firm consultant opining that "today's higher associate-compensation levels have exceeded possible hourly rate increases that may be passed on to clients"); Attila Berry, *Closing in on \$200K*, LEG. TIMES, Dec. 24, 2007, at 1 (reporting comments of Susan Hackett, senior vice president and general counsel of the Association of Corporate Counsel, that "many clients see the salary war as having reached an insane level and feel that the value-to-cost ratio of new associates is edging on untenable").

proportion of firms who play in the salary wars lack the financial wherewithal to absorb pay raises that cannot be passed along to clients.⁸

Within this environment of spiraling salaries, unhappy clients, and undertrained associates, something has to give. In this essay, I argue that there are enormous financial rewards to the law firm that abandons the Cravath system in favor of a business model that focuses on long-ignored client demands. Foremost on the general counsels' list of is the availability of predictable, high quality legal services for which the law firm assumes, or at least shares, the risk of cost overruns. Under this business model, law firm profits are a function of controlling costs rather than billing more hours at higher hourly rates. Although corporate clientele are unlikely to price shop on high profile, bet-the-company matters—primarily because the general counsel does not want to be second-guessed in the event of a bad outcome⁹—a large amount of legal work does not fit into this category. Further, these sophisticated but lower stakes legal matters cannot be cost-effectively performed in-house because of lack of economies of scale or scope. For this large basket of legal services, which comprise a substantial proportion of the Am Law 200's annual billings, a general counsel is likely to be concerned less with résumés and more with high-quality, cost-effective results.

There are four reasons why the “high quality/fixed costs” model has an enormous financial upside: (1) there is empirical evidence that within a certain range, differences in cognitive ability, such as I.Q.,¹⁰ are uncorrelated with contributions to organizational productivity, which suggests the price premium for elite law school graduates is excessive;¹¹ (2) among knowledge workers, organizational productivity is primarily a function of work strategies that are teachable and trainable;¹² (3) there is a large supply of young lawyers with

⁸ See Marc Galanter & William D. Henderson, *The Elastic Tournament: The Second Transformation of the Big Law Firm*, forthcoming 60 STAN. L. REV. _ fig. 8 (2008) (reviewing uniformity of starting salaries but wide variations of profits per partner (PPP) within the Am Law 200 and noting the ratio of starting associate salary is 4:1 for the 25th percentile of firm profitability and 13.9:1 for the 95th percentile). See also Aric Press, *The New Reality*, AM. LAW., Aug. 2007, at 91 (“There is a price point [for associate salaries] that not all Am Law 200 firms will be willing to match. We’re confident that that number begins with a 2.”).

⁹ Cf. Nat Slavin, *Fear and Anxiety Cloud Counsel’s Judgment*, CORP. LEG. TIMES, July 2003, at 4 (“There are three simple paths to job security for in-house counsel: Don’t rock the boat, protect the CEO and cover your ass with the best outside counsel your budget can buy.”).

¹⁰ The LSAT measures verbal reasoning ability, which is a key element of general intelligence or I.Q. See William D. Henderson, *The LSAT, Test-Taking Speed, and Meritocracy: The Surprising and Undertheorized Role of Test-Taking Speed*, 82 TEX. L. REV. 975, 979 nn. 16-17 (collecting citations on LSAT and construct of reasoning ability).

¹¹ See Robert Kelley & Janet Caplan, *How Bell Labs Creates Star Performers*, HARV. BUS. REV., July-Aug. 1993, at 128.

¹² *Id.*

slightly less elite credentials who are willing to work very hard for substantially less than \$160,000 per year, particularly if they are developing as lawyers; and (4) a heavy emphasis on knowledge management, business processes, lawyer training, and teamwork can produce “firm-specific” capital—i.e., an asset whose value is unique to the firm because it cannot be removed by departing partners, nor easily duplicated by competitors.¹³

This essay proceeds in two parts. In Part I, I present evidence that the high quality/fixed costs model would be enormously attractive to the many general counsel who are charged with lowering legal costs as a percentage of company revenues. I also review data on the separating dynamic within the Am Law 200, which shows that the most lucrative practice specialties are gradually migrating to the largest and most profitable law firms. Thus, for many large firms, the formulation of new business models will be a matter of survival rather than choice.

In Part II, I illustrate the potential gains of human resource strategies by reviewing Robert Kelley’s and Janet Caplan’s famous study of engineers at Bell Laboratories and 3M in the late 1980s and early 1990s. The core insight of Kelley’s and Caplan’s work is that, within a certain range, cognitive abilities and various key measures of knowledge workers personalities and social attributes are uncorrelated with contributions to organizational productivity. Rather, exceptional performance is a function of work strategies that are teachable, with minority and female knowledge workers often posting the largest gains.¹⁴ If this research can be applied to sophisticated legal work—and Kelley and Caplan assume that it does—the ability to circumvent the persistent associate salary wars, and the excessive cost structure they generate, offer an enormous competitive advantage for a legal services innovator. If general counsels are buying cost-effective results rather than résumés, law firms built on organizational productivity rather than the Cravath system could be the wave of the future.

The primary obstacles to this new law firm structure are (a) lack of access to patient capital, and (b) ingrained intellectual snobbery, particularly

¹³ The concept of firm-specific capital was originally developed by Gilson and Mnookin. See 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, 353-71 (1985) (discussing attributes and advantages of firm-specific capital and delineating its various sources). According to Gilson & Mnookin, the paradigmatic example of firm-specific capital is IBM’s relationship with Cravath, Swaine, & Moore, which transcended any loyalties to individual Cravath lawyers. See *id.* at 354.

¹⁴ See Kelley & Caplan, *supra* note 11. Robert Kelley, who teaches at Carnegie Mellon University, also elaborated his findings with Bell Laboratories, and other companies, in a best-selling book published a few years later. See ROBERT E. KELLEY, *HOW TO BE A STAR AT WORK* (Random House 1998) [hereafter *STAR AT WORK*].

among law firm partners. (I concede that law professors' snobbery is much worse, but in this context, we are not impeding innovation.) Thus, I conclude with some remarks on how non-lawyer ownership in law firms, currently barred by the ethics rules,¹⁵ would dramatically accelerate the transition to more cost-effective delivery of corporate legal services.

I. STRESSORS ON THE CURRENT MODEL

There are three reasons why the uniform structure of human capital development in corporate law firms is destined to change in the near future: unhappy clients, overpaid associates, and the migration of the most lucrative practice areas to a subset of the corporate bar. In Part I, I address each item in order.

A. *Unhappy Clients.*

In a January 2007 speech that was widely discussed in the blogosphere, Mark Chandler, Senior Vice President and General Counsel of Cisco Corporation, gave voice to the large number of in-house lawyers who are frustrated with their outside counsel.¹⁶ One of Chandler's most pointed observations was the fact that law firms are either oblivious, or indifferent to, the cost pressures that increasingly apply to corporate legal departments. As a result, their standard business practices provide few if any incentives for cost savings, innovation, or productivity gains. After summarizing a few key numbers reflecting Cisco's financial position, such as annual revenues of \$32.8 billion per year (#60 in the 2006 Fortune 500), operating expenses of "35% of revenue and falling," and a robust 25% profit margin, Chandler described how he and other general counsel are evaluated by company management:

I offer these data points from the perspective of a general counsel who is required to run his department just as other corporate departments are run. This is more and more the case in American industry. The legal department in Cisco is as metrics-driven as manufacturing, HR or sales. I've got 4.7 employees in my

¹⁵ See, e.g., ABA MODEL RULES OF PROFESSIONAL CONDUCT, Rule 5.4 (setting forth general prohibition on lawyers and nonlawyers entering into a partnership or co-ownership arrangement in which the practice of law is one of the purposes of the business).

¹⁶ The occasion was a luncheon speech at the Northwestern School of Law's 34th Annual Conference of the Securities Regulation Institute, available online at (http://blogs.cisco.com/news/2007/01/cisco_general_counsel_on_state.html). The speech subsequently became the topic of commentary at several well-trafficked legal blogs. See, e.g., Bruce MacEwen, "New Delivery Mechanisms That Will Be Highly Disruptive--Clayton Christensen Is Talking To You," ADAM SMITH, ESQ., online at http://www.bmacewen.com/blog/archives/2007/02/new_delivery_mechanisms_t.html; Peter Lattman, "The Last Vestige of the Medieval Guild System," WSJ LAW BLOG, online at <http://blogs.wsj.com/law/2007/01/29/ciscos-gc-on-law-firms-the-last-vestige-of-the-medieval-guild-system/>.

department per billion of revenue, total legal spending is about .38 percent of company revenue, and non litigation spending is about .16 percent. I spend \$38 M internally, and about \$80 million per year with outside counsel. I know just where I stand on these metrics vs. my peers, because we share the data. My numbers are pretty good, but I still don't know how to be as efficient as Larry Tu at Dell.¹⁷

These costs pressures inevitably affect how in-house lawyers perceive their outside counsel. Chandler thus continues:

The bottom line is that I'm driven by the same need for productivity improvements as is the rest of the company. It's simple. As Cisco gets bigger, the share of revenue devoted to legal expense needs to get smaller. Letters from law firms telling me how much billing rates are going up next year are therefore totally irrelevant to me, or as we say in Silicon Valley, orthogonal to my concerns. ... [F]rom my perspective, I don't care what billing rates are. I care about productivity and outputs.¹⁸

Many general counsel share Chandler's concerns. According to a recent survey of Chief Legal Officers, 59 percent of Chief Legal Officers had fired, or were considering firing, at least one of their outside law firms during the current calendar year, with "cost management issues" topping their list of grievances.¹⁹ The cost pressures are coming from the executive suite. In a 2005 survey conducted by the *Corporate Legal Times*, corporate CEOs were asked what was the "most important thing their GCs could do to improve their legal departments."²⁰ In response, 16% stated "Reduce costs" followed by 14% for "Manage outside counsel better."²¹ Overall, 32% stated that their GCs spend too much on outside counsel.²² Thus, in a dramatic rise from the previous year's survey, 23% of CEOs acknowledge that cost was now a primary factor in the selection of outside counsel.²³

¹⁷ Chandler, *supra* note 16, at 1-2.

¹⁸ *Id.*

¹⁹ See Daniel J. DiLucchio, *The Chief Legal Officers Speak and the Answers Are: Costs and Compliance*, METRO. CORP. COUNSEL, May 2004, at 54 (citing and quoting Fourth Annual Chief Legal Officer Survey (Oct. 2003), conducted by Altman Weil, Inc., and the Association of Corporate Counsel (ACC)). Similar results have been reported in the more recent surveys, which are collected online at: <http://www.acc.com/php/cms/index.php?id=222>.

²⁰ Corporate Legal Times/Dickstein Shapiro Morin & Oshinsky, *The Bottom Line*, CORP. LEG. TIMES, Oct. 2005, at __.

²¹ *Id.*

²² *Id.*

²³ Julie Miller, *CEOs Get Their Say in Outside Counsel*, CORP. LEG. TIMES, Oct. 2005, at __.

In most cases, the hourly rate is not the contentious issue. Rather, the firms want to obtain some predictability to their legal budgets by shifting some of the risk of legal matters—e.g., total cost until resolution, favorable versus unfavorable outcome—back onto the law firms, thus providing incentives to control costs.²⁴ As noted by a former senior counsel for legal operations at General Electric, firms increasingly need to justify why their firm provides the best value: “Quality will be required, but not at any price.”²⁵

Now, it is important here that I do not overstate my point. From the perspective of a partner, the relevant question is not whether there are unhappy corporate clients in the world, but whether *my* clients are unhappy. The perspective of firm management is only slightly different: Are the bread-and-butter clients of the firm unhappy to the point that they are considering firing the firm? If the answer is no, these busy and talented lawyers can attend to other emergencies. In any given year, only a handful of corporate law firms are truly on the bubble. Most firms reasonably believe they can forestall any serious problems through prudent strategy or, if advantageous, a merger. So not much changes.²⁶ But my broader point is hard to deny: There is a large and ready market for any law firm than can figure out a way to deliver the same, or better, legal services using a cost structure that is not pegged to spiraling associate salaries.

B. *Overpaid Associates.*

In this discussion of overpaid associates, my “overpaid” characterization is based upon market evidence rather than a personal or moral valuation. I am a law professor—I want my students to make a comfortable living. But over the long term, large firm lawyers have to develop professionally—i.e., acquiring and developing professional skills and judgment—in order to earn their keep. And because of rapidly escalating associate salaries, clients are increasingly unwilling to pay for entry level lawyers to climb the learning

²⁴ See Adele Nicholas, *GCs Share Advice on Becoming a Trusted Advisor*, CORP. LEG. TIMES, Jan. 2005, at 16 (describing importance of controlling costs to a GC’s career and thus the key objectives of alternative fee arrangements with outside counsel)

²⁵ Special Section, *Managing to Better Results*, CORP. LEG. TIMES, June 2005, at 34.

²⁶ Consultant Dan DiLucchio nicely summarizes the calculus of outside counsel:

From the law firm perspective, general counsel may talk about AFAs [alternative fee arrangements], but send mixed messages about their appetite for these arrangements.

...

Creating alternate billing structures that work for both law department and law firms takes creativity, time, effort and work. Without significant pressure from a client, devising an AFA is not a priority for the law firm. When billable hours are readily available, busy lawyers will spend their time billing the hours.

Daniel J. DiLucchio, *Hourly Billing: It’s Business as Usual*, LEG. INTELLIGENCER, Sept. 12, 2007, at 34.

curve.²⁷ The numbers speak for themselves. Among the law firms that pay entry level salaries of \$160,000 (in at least some markets), the average “low” billing rate for an associate is \$220 per hour. For firms headquartered in New York, Washington, D.C., Chicago, Los Angeles, or San Francisco, the rate is \$255.²⁸

High associate salaries set in motion several harmful incentives. First, many partners prosper economically when entry level associates perform month after month of document review, which requires relatively little supervision. If these redundant tasks, however, are not interspersed with additional assignments that augment a young lawyer’s skill set, the internal labor market for an associate’s services can dry up as rapidly as one’s billing rate rises with seniority.²⁹ So, ironically, a \$160,000 per year position can become a dead-end job as early as the second year at the firm. Second, these practices make it harder for firms to make the case that an engagement with the firm includes the expense of training the next generation of partners to service that client’s needs. If there is no substantive training, no future benefit will materialize.³⁰ In turn, we move closer to a pure transaction-based lawyer-client relationship in which tasks like document review are given to contract attorneys and the client refuses to pay for any legal work from first or second year associates.³¹ Third, although individual partners trying to protect their book of business can survive in this environment, it makes it much more difficult for firm managers to build firm-specific capital.³² As a result, they

²⁷ See note 7, *supra* (sources discussing client unwillingness to pay for time of entry level lawyers).

²⁸ Calculations by author from data provided by the Law Firms Working Group. Among firms in the NLJ 250, 31 firms with starting salaries of \$160,000 or more also provided “low” associate billing rates.

²⁹ Cf. Christine White, *Improving Associate Retention Through Professional Development*, LAW FIRMS PARTNERSHIP & BENEFITS REP., Feb. 1999, at 1 (noting that one of the worst scenarios for a new associate is “get[ting] stuck on huge cases, with little opportunity for skills enhancement, that impede their ability to progress toward partnership”).

³⁰ See Jerry Crimmins, *Corporate Counsel Dig In on Law Firm Fees*, CHI. DAILY L. BUL., Nov. 8, 2007, at 1 (reporting belief among some general counsel that associates “trained on the client’s dollar” leave the firm and thus provide zero return on their investment).

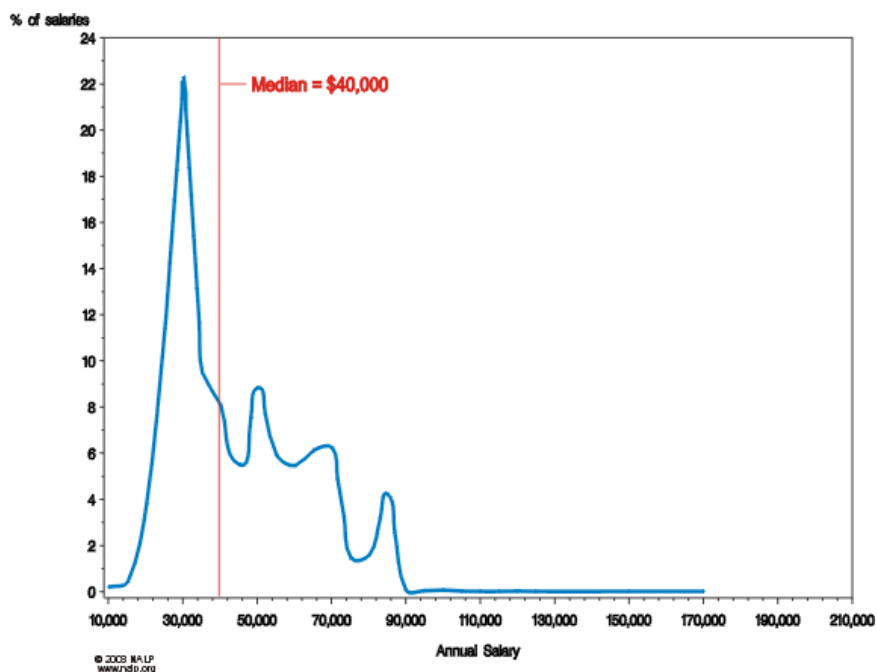
³¹ See, e.g., Thomas Sager, *Corporations Not Going to Take It Anymore*, CONN. L. TRIB., Dec. 3, 2007, at 14 (chief legal counsel for Du Pont Corp. listing ways for clients to “mitigate the impact of the increases” from higher associate salaries, including restricting use of first- and second-year associates, requiring minimum associate experience, or mandating use of temporary legal staff for repetitive and routine work); Joel A. Rose, *What Firms are Doing Now to Rein in Costs?*, COMP. & BENEFITS FOR LAW OFFICES, Dec. 2006, at 4 (consultant reporting that higher salaries have resulted in an “unwillingness [among] clients to pay associates’ high hourly rates” and that firms are responding by hiring more lateral lawyers who are already trained and more temporary lawyers to staff document-intensive demands).

³² For the definition of firm-specific capital, see note 13 and accompanying text.

are hostage to powerful partners who may or may not have strong loyalties to the firm.

The historical data on entry level lawyer salary reveal that large law firms have entered new and completely uncharted waters. For example, drawing upon data from the National Association of Law Placement (NALP),³³ Figure 1 shows the distribution of starting salary for lawyers who graduated from law school in 1991.

Figure 1. Starting Salaries, All Law School Graduates, Class of 1991



Although Figure 1 is not a normal “bell-shaped” curve, it bears some resemblance to one. There is a clustering in the \$30,000 to \$40,000 range (approximately 40% of all entry-level lawyers), and just 6% of salaries at \$70,000, which was the median salary for large law firms at the time.³⁴ In 2000, when the salary was inspired by the Internet economy took the starting salary to \$125,000, the distribution began to take on a “bi-modal” distribution, with a clustering of 48% of new hires in the \$30,000 to \$50,000 range (the first mode),³⁵ and a sharp spike at \$125,000 containing 14% of entry level lawyers (the second mode). According to the NALP, “never before had a

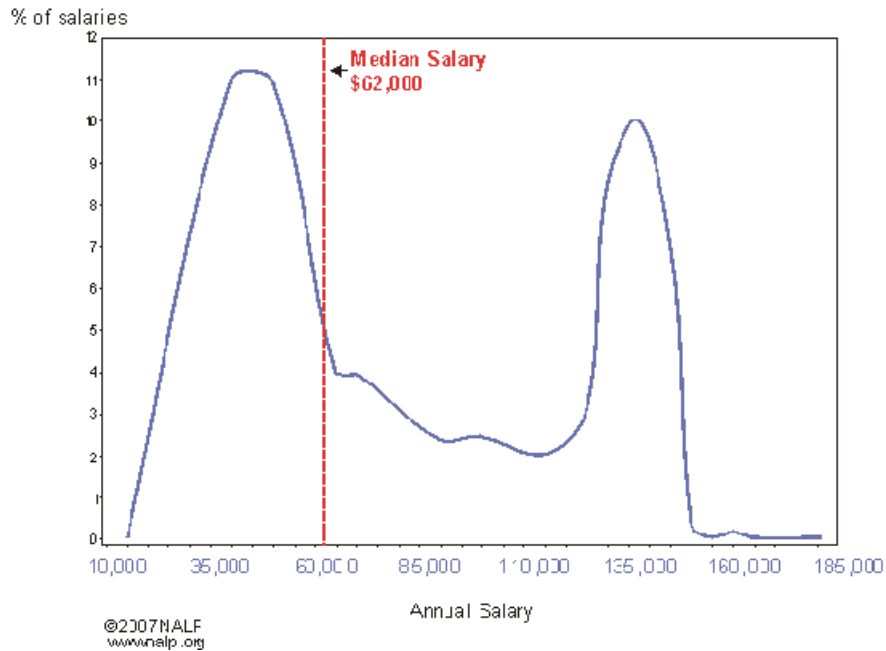
³³ See *Salaries for New Lawyers: How Did We Get Here?*, NALP BULLETIN, Jan. 2008.

³⁴ See *id.*

³⁵ In statistics, the “mode” is the most frequently occurring value within a sample. In a normal distribution, the mode, the median (i.e., the 50th percentile or midpoint), and the average are all very close or identical in value.

single salary so dominated the landscape.”³⁶ Figure 2 shows the distribution for the class of 2006, which reflects an obvious and dramatic stratification of the market for new lawyers. The first mode (between \$40,000 and \$60,000) contained 44% of lawyers, but the second mode (between \$135,000 and \$145,000) now encompassed 17% of the new lawyer population.³⁷

Figure 2. Starting Salaries, All Law School Graduates, Class of 2006



With the recent wave of salary wars, which took large firm starting pay to \$160,000 in virtually all the largest markets, the second mode undoubtedly will move further to the right.³⁸ One of the core claims of this essay is that this radical skew of salary is due an extremely conservative institution—the large corporate law firm—clinging to the traditional Cravath system business model in the face of an ever-expanding demand for corporate legal services. Since these firms all claim to hire the best lawyers from the best schools, their salaries need to be at the top of the market. Yet, collectively, these firms (the Am Law 200 / NLJ 250) now hire approximately 20% of the entry level market. Obviously, these trends are completely unsustainable. But the more difficult question is how the most vulnerable firms can gracefully remake themselves into something that can be sold to clients or, even more formidable, the partnership.

³⁶ See NALP Bulletin, *supra* note 33.

³⁷ See *id.*

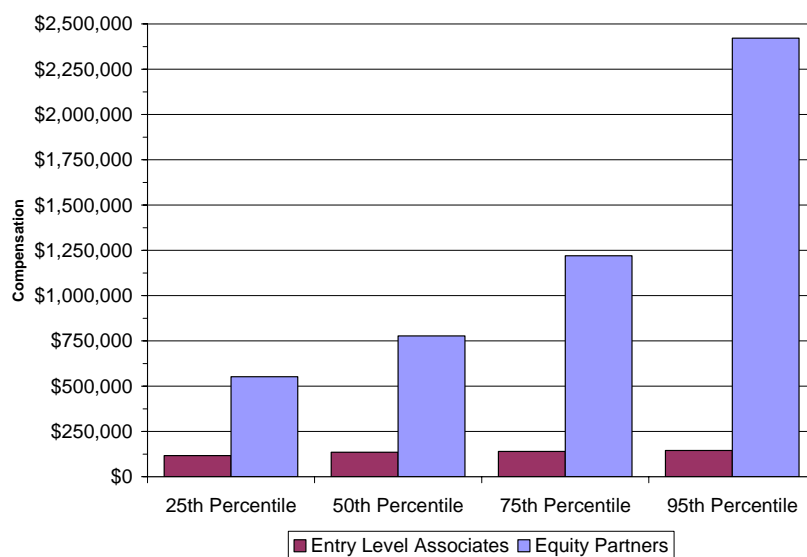
³⁸ See *id.*

C. Segmentation by Practice Areas

A careful review of market data, including lateral partner movement and firm profitability, suggests that large corporate law firms are gradually being separated into two groups based on relative position in different practice specialties. Specifically, partners in marquee practice areas are disproportionately moving to larger and more profitable law firms; conversely, partners in specialties that are less likely to bind lucrative clients to the firm are disproportionately moving to less profitable firms.³⁹ As these trends continue to play out, a large number of firms without an optimal mix of high margin legal work will no longer be able to compete in the salary ways.

These claims are based on two market trends. First, as shown in Figure 3, which summarizes Am Law 200 data for fiscal year 2006, there is striking uniformity of salaries for entry level associates yet an enormous gap in relative firm profitability.

Figure 3. Compensation by Partner, Entry-Level Associate, Am Law 200 (FY 2006)



For fiscal year 2006, the ratio of 25th percentile average partner profits to starting associate salary is 4.7 to 1. At the 75th percentile, the ratio increases to 8.7. At the 95th percentile, the figure jumps to 16.7. Since 1998, the ratio of partner profits to associate salaries has increased for the vast majority of Am Law 200 firms.⁴⁰ But the rates of increase vary dramatically by relative

³⁹ These claims are developed in a forthcoming study in the *Stanford Law Review*, which I co-authored with Marc Galanter. See *The Elastic Tournament*, *supra* note 8, at 133-41.

⁴⁰ This trend is attributable, at least in part, to higher leverage. Between 1998 and 2006, leverage (i.e., total number of lawyers divided by the total number of equity partners)

position in the Am Law 200 hierarchy: 10.4% at the 25th percentile; 20.7% at the 50th percentile; 36.0% at the 75th percentile; and 52.9% at the 95th percentile.

The disproportionate gains for partners at the most profitable firms are explained, at least in part, by the second market trend: the upstream migration of partners in the most lucrative practice areas. Drawing upon a unique dataset of partner mobility (primarily the Am Law 200) between 2000 and 2005, compiled by ALM Research, Inc., it is possible to examine movement patterns by practice specialty and firm profitability, including the difference between the firm left and firm joined.⁴¹ These patterns are summarized in Table 1.

Table 1. Partner Mobility within Am Law 200 by Practice Area, 2000-2005

PRACTICE AREA	FIRM LEFT	FIRM JOINED	DIFFERENCE	N	% OF TOTAL
White Collar & Securities Enforc.*	\$721,837	\$1,009,490	\$287,653	49	1.2%
M&A, Private Equity, Venture Cap.*	\$804,980	\$919,644	\$114,664	253	6.2%
Intellectual Property*	\$693,272	\$781,620	\$88,348	460	11.3%
Antitrust	\$857,089	\$944,114	\$87,025	79	1.9%
Labor & Employment	\$610,426	\$665,019	\$54,593	270	6.7%
Bankruptcy	\$717,895	\$734,386	\$16,491	114	2.8%
Corporate Securities	\$750,831	\$766,159	\$15,328	686	16.9%
Litigation	\$735,033	\$738,620	\$3,587	598	14.7%
Other	\$733,510	\$736,464	\$2,953	386	9.5%
Business Law	\$836,592	\$801,757	-\$34,835	515	12.7%
Regulatory*	\$700,583	\$657,222	-\$43,361	360	8.9%
Real Estate, Public & Project Finance*	\$764,480	\$708,100	-\$56,380	250	6.2%
Trusts & Estates*	\$766,806	\$608,889	-\$157,917	36	0.9%
Group Total	\$742,563	\$759,257	\$16,694	4056	100%

* Statistically Different from Group Mean at $p < .01$

Based upon an inspection of mean differences between firm left and firm joined, it appears that partners in certain practice areas are more likely to move to a firm with higher profits per partner. The average gains for partners in white collar crime & securities enforcement, mergers & acquisitions (including private equity), and intellectual property were all higher than the group average at statistically significant levels. Many of these practice areas, obviously, are the most price-insensitive; general counsel are not going to be very cost-conscious in matters involving criminal investigations of top company officials, a major merger, or patent litigation affecting the key bet-

increased throughout the Am Law 200: 25th percentile, 14.9%; 50th percentile, 18.6%; 75th percentile, 26.7%.

⁴¹ For a full description of this dataset, see Galanter & Henderson, *supra* note 8, at 133-41.

the-company technology.⁴² Conversely, the average declines for partners in regulatory law (e.g., environmental, energy oil & gas, FDA law), real estate law, and trust & estates were all lower than the group average at statistically significant levels. Arguably, these practice areas are more price sensitive and may be spurring downward movement as some partners attempt to hang on to longtime clients by moving to firms that will permit lower billing rates.⁴³

More refined statistical methods further corroborate a separation dynamic. In a multivariate regression model, which controlled for profitability differences based on large markets (New York, Washington, Chicago, L.A., and San Francisco) and fiscal year, white collar & securities enforcement, M&A-private equity, intellectual property, and antitrust were all associated (at statistically significant levels) with joining a higher profits-per-partner firm. Conversely, regulatory law, real estate, trust & estates, and labor & employment were associated (also at statistically significant levels) with joining a lower profits-per-partner firm. Only bankruptcy and corporate securities were not associated with upward or downward movement. The full regression results are included as an appendix to this essay.

This separating dynamic is now playing itself out in the salary wars. Profits are going up at large law firms because of strong demand for corporate legal services.⁴⁴ As note in section B, because these firms all utilize some variant of the Cravath system—i.e., hiring the best graduates from the best schools and giving them the best training to attract and retain the best clients—a larger proportion of entry level graduates are being paid at the top of the market. In 2007, as the top of the market has moved to \$160,000, many brand name large firms have managed to meet the market by upping their starting salary to \$160,000 but changing other aspects of their business model, such as abandoning associate lockstep,⁴⁵ creating different pay scales based on

⁴² Cf. DiLucchio, *supra* note 26, at 7 (“[T]here may be an inverse relationship between the likelihood of negotiating an [alternative fee agreement] and the seriousness of the legal matter facing the company”).

⁴³ See Kimberly Kirkland, *Ethics in Large Law Firms: The Principle of Pragmatism*, 35 U. MEM. L. REV. 631, 675 (2005) (reporting that when rates exceed what a partner’s clients are willing to pay, “[t]his partner must either find new clients or resign and take his existing clients to a firm that charges lower rates”).

⁴⁴ See JOHN P. HEINZ ET AL., URBAN LAWYERS: THE NEW STRUCTURE OF THE BAR 287 (2005) (attributing growth of large firms to greater corporate demand); John P. Heinz, Robert L. Nelson & Edward O. Laumann, *The Scales of Justice: Observations on the Transformation of Urban Law Practice*, 27 ANNU. REV. SOCIOLOGY 337, 342 (2001) (same); Randall S. Thomas, Stewart J. Schwab & Robert G. Hansen, *Megafirms*, 80 N.C. L. REV. 115, 136-52 (2001) (same).

⁴⁵ See Zusha Elinson, *Howrey to Ditch Lockstep Compensation for Merit Based Model*, THE RECORDER, June 29, 2007 (discussing Howrey’s move to merit-based associate pay).

practice group,⁴⁶ creating a new tier of non-partnership track associates,⁴⁷ or allowing associates to opt for lower pay in exchange for a lower billable hours requirement.⁴⁸ Yet, when clients won't absorb these higher costs, they have to be borne by the partnership.⁴⁹ Thus, each wave of associate increases provide more reason for the firm's most profitable partners to consider moving to a firm with more market clout.⁵⁰

How to gracefully bow out of the salary wars—i.e., without signaling to the market that the firm has become “second rate”⁵¹—is an immensely difficult problem. Only twenty or thirty years ago, virtually all firms that later became part of the Am Law 200 were elite firms within regional markets.⁵² Indeed, some of the best corporate law opportunities were in states with heavy industry. The history and self-image of these firms is one of “white shoe” establishment and eliteness. Unlike corporations that routinely adapt to changing economics conditions, many large firm partners have a deep-seated psychological aversion to alternative business models that are not grounded in elite pedigree. Thus, most large firms are banking on their long-term ability to compete or merge their way into sufficient quantities of premium, price-insensitive work. Conversely, corporate clients are clamoring to buy an array of legal services that established law firms are unwilling to provide, particularly those that provide greater predictability of cost.⁵³ When upstart

⁴⁶ See David Lat, *Skaddenfreude: Dechert DC's FSG Favoritism?* ABOVE THE LAW, Feb. 12, 2007 (discussing Dechert's decision to create a separate payscale for associates in its prestigious financial services group).

⁴⁷ See Kellie Schmidt, *McDermott Will to Add Lower-Paid Associates*, THE RECORDER, Nov. 2, 2007 (reporting that McDermott Will & Emery recently created a second tier of attorneys that will have “good pedigrees” but will work less, be paid less, bill out at a lower rate, and not be on track for partnership).

⁴⁸ See Zusha Elinson, *Thelen Reid Responds to Associate Raises with a Two-Tier Pay Scale*, THE RECORDER, June 25, 2007 (conditioning \$160,000 pay scale on an associate opting in to a 2000 hour per year billable requirement); Lynne Marek, *Chicago Firm Asks Associates to Choose Between Pay Levels*, NAT'L L.J., Oct. 12, 2007, at ___ (reporting that Chapman & Cutler matched \$160,000 scale but permits associates to opt in to a lower pay scale after the first year).

⁴⁹ See Rose, *supra* note 31, at 4 (reporting that because of need to keep up with the salary wars, “an increasing portion of the associate compensation levels is now absorbed by the firm and reflected as lower profits for the partners”).

⁵⁰ See, e.g., Lynn Marek, *Sidley Lures Private Equity Group from Schiff Hardin*, NAT'L L.J., Mar. 21, 2008 (reporting movement of six private equity attorneys from Schiff Hardin, a smaller Am Law 200 firm in Chicago, because of “breadth of the platform” at Sidley).

⁵¹ See note 6, *supra*, and accompanying text.

⁵² See Galanter & Henderson, *supra* note 8, at 123-25 & tbl. 1 (presenting data on the large shift from regional to national competition among large U.S. law firms).

⁵³ See Gillian Hadfield, *Legal Barriers to Innovation: The Growing Economic Cost of Professional Control Over Corporate Legal Markets*, 60 STAN. L. REV. ___ (2008) (attributing high costs and lack of innovation in legal services to heavy regulation that precludes

legal services providers make a fortune vanquishing the inefficiencies and perverse incentives of the billable hour⁵⁴ and eat-what-you-kill compensation systems,⁵⁵ the value of pedigree is going to plummet.

II. ORGANIZATIONAL PRODUCTIVITY

In Part I, I presented evidence of unhappy clients, overpaid and undertrained associates, and a segmentation of the market for legal services that will make it difficult for many large law firms to maintain their current business model. In Part II, I review a large-scale study of human resource strategies at the renowned Bell Laboratories in the late '80s and early '90s and ask whether its provocative research findings can be applied to market for corporate legal services.

A. *The Bell Labs Study*

In 1984, the DOJ's antitrust litigation against AT&T resulted in a consent decree that mandated the divestiture of Ma Bell and the creation of what later became known as seven Baby Bells. For executives at Bell Laboratories, the consent decree meant that its corporate parent would no longer have monopoly profits to finance the next generation of computer or telecommunications breakthroughs. Although its scientists had managed to win several Nobel Prizes since its inception in the 1925,⁵⁶ there was no guarantee that Bell Labs could succeed in a competitive marketplace.

One strategy advanced by company executives was the development of a human resource system that would identify the predictable markers for the organization's most successful engineers. Although all Bell Labs workers had similar, excellent paper credentials, there remained large differences in total

competition from nonlawyers seeking profit-making opportunities and concluding that there are no significant costs to complete deregulation of market for corporate legal services).

⁵⁴ For a provocative recent indictment of the billable hour, see Scott Turow, *The Billable Hour Must Die*, ABA JOURNAL, Aug. 2007, at __ (20-year big firm lawyer concluding that the billable hour "is bad for the lives of lawyers ... worse for clients, bad for the attorney-client relationship, and bad for the image of our profession").

⁵⁵ See Edward H. Bernstein, *Structural Conflicts of Interest: How a Law Firm's Compensation System Affects Its Ability to Serve Clients*, 2003 U. ILL. L. REV. 1261, 1274 (arguing that these incentives are so "powerful and ubiquitous" in firms that utilize an "eat-what-you-kill" compensation system that ABA ethical rules should be amended to require disclosure to clients "as a matter of course"); see also Jason McLure, *Beyond Boggs*, LEG. TIMES, Sept. 26, 2005, at 1 ("Former partners at Patton Boggs say that the system can push lawyers into making skewed decisions, such as choosing a younger partner with less leverage to negotiate for attribution share ... or avoiding giving high-level work to other partners at all.").

⁵⁶ For historical information on Bell Labs, see www.alcaltel-lucent.com.

productivity.⁵⁷ If only they could hire more “ten- or twenty-for-ners,” Bell Labs’ long-term prospects would be secure.⁵⁸ Bell Labs subsequently hired a group of PhD researchers to assist with this project. The study was led by Robert Kelley, whose prior work specialized in productivity assessments in the emerging “gold collar” sector.

Shortly after commencing their work, Kelley’s research team encountered their first conceptual obstacle. To determine the star performers, they asked managers and engineers (and eventually customers) to identify workers who greatly outperformed their peers, especially those who achieved those results using methods the peers had come to admire.⁵⁹ Surprisingly, while there was relative consensus on star performers within each group, the choices of managers and engineers only overlapped approximately 50 percent of the time.⁶⁰ Apparently, each respective group saw strengths and weaknesses that were less observable to from the vantage point of the other group. Thus, to be designated as a star performer, a Bell Labs worker had to be selected by both managers and his or her peer engineers.

Next, Kelley’s research team polled company executives, middle-managers, and various brain-powered Bell Labs workers on what attributes made the top performers so special. They generated forty-five different constructs that fell into one of three categories: “(1) cognitive abilities, such as higher I.Q.s, logic, reasoning, and creativity; (2) personality factors such as self-confidence, ambition, risk taking, and a feeling of control over one’s destiny; and (3) social factors, such as interpersonal skills and leadership.”⁶¹ Kelley’s team also identified several “environmental” factors, such as work history, job satisfaction, and relationship with bosses. In general, both managers and engineers believed that the stars’ superior performances were traceable to fundamental, immutable traits that permanently separated them from their average peers. To test the theories, two hundred stars and average

⁵⁷ Compare Kelley & Caplan, *supra* note 11, at 130 (reporting the Bell Lab executive had learned that “academic talent was not a good predictor of on-the-job productivity”), with Elizabeth Goldberg, *Is This Anyway to Recruit Associates*, AM LAW., Aug. 2007, at 93 (reporting on study by Kansas City, Missouri-based Blackwell Sanders Peper Martin that examined the relationship between each “associate’s grades, class rank, and school rank to their evaluations and accomplishments at the firm” and finding that nothing could predict “who would become a standout lawyer”).

⁵⁸ See STAR AT WORK, *supra* note 11, at 3-5.

⁵⁹ *Id.* at 6.

⁶⁰ *Id.* at 295-96 (appendix discussing methodology of study). Kelley’s team eventually concluded that the engineers tended to have a more accurate assessment of a worker’s contribution because they observed on a more regular basis who originated a new idea or who can be counted on to help someone out of a jam. See *id.*

⁶¹ *Id.* at 7.

performers were subjected to a two-day battery of tests that measured the forty-five alleged attributes of success.

The results of Kelley's two-year study surprised everyone: there was no appreciable relationship between status as a star performer and any of the cognitive, psychological, social, or environmental factors. How could this be? Attempts to reanalyze the data were equally fruitless. Yet, although Kelley's team was unable to validate any of their proposed explanations of worker success, one finding was unmistakable: no one at Bell Labs, including the star workers, their managers, or their average peers could explain what attributes were responsible for high productivity or star performance. Indeed, overconfidence in one's own powers of assessment was the only recurring theme that emerged from the findings.⁶²

Fortunately, rather than throw in the towel, Bell Labs extended the study so that Kelley's research team could generate new theories of star productivity that could be empirically validated. Thus, for the next two years, Kelley and his researchers examined the work habits and strategies of Bell Lab engineers—as Kelley recalled, this excruciating task often amounted to little more than watching knowledge workers think.⁶³ At the end of this process, Kelley's research team identified nine work strategies that distinguished star performers from the middle-of-the-road engineers. In relative order of importance, they included:

- (1) *Taking Initiative*. Top performers took responsibility above and beyond their stated jobs, volunteering for new activities and promoting new ideas;
- (2) *Networking*. Top performers were deft at tapping into coworkers' expertise and shared their own knowledge with those that needed it;
- (3) *Self-Management*. Top performers were very good at regulating their own work commitments, time, performance level, and career growth;

⁶² See *id.* at 8. This finding is reminiscent of *Moneyball*, where baseball scouts, the game's supposed talent experts, systematically over or undervalued talent based upon an established baseball folk wisdom. Eventually, the statistical skills of Wall Street financiers were brought to bear to identify arbitrage opportunities. See MICHAEL LEWIS, *MONEYBALL: THE ART OF WINNING AN UNFAIR GAME* (2003); see also Paul L. Caron & Rafael Gely, *What Law Schools Can Learn from Billy Beane and the Oakland Athletics*, 82 TEX. L. REV. 1483, 1491–99 (2004) (book review) (summarizing how Billy Beane developed his statistics-driven management philosophy).

⁶³ See *STAR AT WORK*, *supra* note 14, at 299 (“[M]y personal definition of hell is being forced to watch [brainpowered workers] do their jobs day-in-day-out, in minute detail, for all eternity. I based that on the nearly two years we spent up close and personal with the Bell Labs stars.”).

- (4) *Perspective*. Top performers understood their jobs within the larger context of the organization and could analyze problems from the viewpoint of customers, managers and team members;
- (5) *Followership*. Although perceived by others as leaders, top performers excelled at setting aside their own agendas and using their talents to help other leaders accomplish the organization's goals;
- (6) *Teamwork*. Top performers were more willing to assume joint "ownership" of goal setting, group commitments, work activities, schedules, and defusing conflict among group members;
- (7) *Leadership*. Top performers had the ability to formulate, state, and build consensus on common goals and then work to accomplish them;
- (8) *Organizational Savvy*. Top performers recognized and thus could navigate competing interests within the organization;
- (9) *Show-and-tell*. Top performers typically had the ability to present their ideas persuasively in written or oral form.⁶⁴

One of the most striking features of Kelley's research was the propensity of average workers to draw erroneous lessons from the success of top performers. For example, average performers tended to invert the order of priority and thus focus on organizational savvy and show-and-tell, which they surmised was the key—based on the success of the stars—to impressing management.⁶⁵ Similarly, middle performers tended to view initiative (the most important work strategy) as doing tasks that will get noticed by superiors, whereas top performers viewed it as action and follow-through that helped coworkers or the organization succeed.⁶⁶ Likewise, middle performers viewed networking as staying "in the loop" on office gossip and getting to know people who could help their careers. Top performers, in contrast, viewed networking as a bartering system in which the cost of admission was technical expertise, and staying in required a sincere commitment to be reciprocal over the long term. As Kelley noted, star performers consistently got their phone call returned faster than their middle-performing peers.⁶⁷

⁶⁴ See Kelley & Caplan, *supra* note 11, at 131 (summarizing nine work strategies); STAR AT WORK, *supra* note 14, at 31-34 (listing and elaborating on nine work strategies).

⁶⁵ See Kelley & Caplan, *supra* note 11, at 131.

⁶⁶ STAR AT WORK, *supra* note 14, at 31 (noting that initiative "involves some risk taking and is not just window dressing").

⁶⁷ *Id.* at 32 (discussing attitudes of average and top performers regarding networking). Similar themes are echoed in the recent management literature. See, e.g., Rob Cross, Thomas H. Davenport & Susan Cantrell, *The Social Side of Performance*, MIT SLOAN MGMT. REV., Fall 2003, at 20 (reporting that the most effective networks are "rarely motivated by explicit political or career-driven motives. ... By simply getting their work done at a superior level, the

Finally, there are two additional reasons why Kelley's Bell Labs study warrants the attention of law firm partners and managers who are searching for a viable competitive advantage. First, Kelley's team empirically validated their findings. Specifically, the nine work strategies became the basis for a training program (one day a week for several weeks) that was designed and taught by Bell Labs top performers. The training was then given as a controlled experiment in which a treatment group received the training program and a control group received nothing. Remarkably, on every dimension of performance over the next year, the Bell Labs engineers in the treatment group received significantly higher average productivity gains than their control group counterparts.⁶⁸

The second noteworthy result was the performance of women and minority workers. Although all groups—including star performers—posted higher average group gains in the months following the training,⁶⁹ the gains tended to be dramatically larger for women and minority participants.⁷⁰ Conversely, while the productivity of nonparticipants as a group trended up over time (though not as fast as workers who had received the training), the performance of women and minority nonparticipants actually deteriorated on some dimensions.⁷¹ Kelley attributed the successful female and minority outcomes to several of the nine work strategies, including (a) proactive measures to break into knowledge networks that were based on expertise rather than gender or race; and (b) self-management of time and commitments to deal with the many requests from coworkers, albeit many to showcase the company's diversity rather than tapping into a developed skill set.⁷²

B. *Application to Law Firms*

In this section, I posit the following thesis: The organizational principles that improved productivity for world class engineers at Bell Labs could serve as the basis for a new model of law firm focused on the efficient provision of

most successful knowledge workers develop reputations and networks that bring opportunities and resources to them as needed.”).

⁶⁸ See Kelley & Caplan, *supra* note 11, at 135 (showing gains in average productivity for control and participant groups on seven criteria: “spots problems”, “does high-quality work on time”; “keeps boss informed”; “pleases customers”; “works across organizational boundaries”; “focuses on competition”; “understands management decisions”).

⁶⁹ See STAR AT WORK, *supra* note 14, at 18-19.

⁷⁰ See *id.* at 19-20 (reporting gains that were on average four times as large as their white male counterparts).

⁷¹ See *id.* at 258-61 & fig. 4-6.

⁷² See *id.* at 267-71. The instrumental use of minority workers is also a serious problem in law firms. See, e.g., JANET E. GANS EPNER, *VISIBLE INVISIBILITY: WOMEN OF COLOR IN LAW FIRMS* 20 (ABA Comm. on Women in the Profession 2006) (discussing focus group in which women of color “reported being treated like ‘show horses,’ brought into meetings to impress clients but without having a substantive role”).

high quality legal services. Such a firm's primary competitive advantage would be cost effective results rather than elite educational credentials. Although it is possible to make various arguments that the Bell Lab findings cannot be extended to lawyers—that, in effect, lawyers are a special category of knowledge workers—why confine ourselves to academic debate? The mounting pressures on the Cravath system suggest that a market test of an alternative model is definitely worth a try.

The Achilles Heal of the traditional law firm model is the high costs associated with elite academic credentials, primarily due to stagnant supply in the face of perennially higher demand for corporate legal services.⁷³ Yet, one of the key insights learned at Bell Labs was that “academic talent was not a good predictor of on-the-job productivity”, nor were standardized measures of I.Q. or other measures of cognitive ability.⁷⁴ In other words, within a certain range of ability, higher gradations do not necessarily warrant a price premium. Granted, market demand is driven by perceptions rather than findings of empirical studies. If general counsels are impressed by elite credentials, then firms can charge more when they hire associates and lateral partners from highly ranked law schools. Certainly, for bet-the-company matters, general counsels are not going to price shop.⁷⁵ But on a wide array of other matters, in-house lawyers are looking for effective cost-containment strategies.⁷⁶

The separating dynamic discussed in Part I arguably reflects a gradual rationalization of the market in which price-insensitive practice areas are migrating to elite national firms while others are moving downstream because clients are refusing to pay ever higher billing rates.⁷⁷ Certainly, collegial relations are easier to maintain when deliberations over profit-sharing and overhead do not occur among partners with widely different earning capacities. For firms in the more price-sensitive practice areas, where the fate of the client does not hang in the balance but the client lacks either the economies of scale or scope to perform the work in-house, elite educational credentials are less likely to command a large premium. Yet, the psychological vestiges of the Cravath system require that these firms stretch to pay the market rate.

Because of the peculiarities of the market for corporate legal services in the early 21st century, an alternative law firm model based on the insights of

⁷³ See Crimmins, *supra* note 30, at 1 (discussing spiraling associate salaries and quoting legal consultant, “The problem is ... there aren't enough of these people to go around from the top law schools”).

⁷⁴ Kelley & Caplan, *supra* note 11, at 129-30.

⁷⁵ See, e.g., Bruce MacEwen, *Nobody Ever Got Fired for Hiring Skadden*, Apr. 24, 2004, at http://www.bmacewen.com/blog/archives/2004/04/nobody_ever_got_fired_for_hiring_skadden.html.

⁷⁶ See notes 17-25, *supra*, and accompanying text.

⁷⁷ See note 43, *supra*, and accompanying text.

the Bell Labs study requires a two-fold analysis: (1) what are the competitive strengths of the new model vis-à-vis existing competitors?; and (2) why are existing competitors so reluctant to exploit this market opportunity?

Regarding competitive strengths, the key features of the proposed approach, which I dubbed the high-quality/fixed cost model, are high quality and cost predictability. Specifically, the law firm (a) guarantees the quality of the legal services, (b) assumes the financial risk of unpredictable legal fees, and (c) where possible, shares in the financial benefits of a favorable outcome. This alternative fee arrangement draws upon the repeat player status of the law firm, which is the institution with the best information to estimate the time and expense to achieve a desired result. When a firm assumes this risk, like any other service business, it will have strong incentives to eliminate all waste and redundancies that do not optimize the probability of better results for its client base.

Drawing upon the Bell Labs study, one area of waste or redundancy vis-à-vis competitors is excessive pay for associates. As discussed earlier, the market for entry level lawyers currently has a bi-modal distribution in which approximately 17% of law school graduates are clustered at uniformly high starting salaries.⁷⁸ Yet, because of the cliff-like quality for jobs below the right mode (\$135,000 to \$145,000 in 2006), large numbers of law students who barely missed the on-campus interview (OCI) grade cut-offs struggle to find jobs in major markets that pay even 50% of the large firm going rate. These students are either drastically undervalued or their large firm counterparts are grossly overpaid—regardless, it is an arbitrage opportunity. Assuming such a firm sets up shop in Chicago, large numbers of graduates with strong academic records from Indiana, Illinois, Wisconsin, Iowa, and Wash. U. would happily begin their careers there in exchange for \$85,000 per year, training (that could be underwritten by a client), interesting work, sensible hours, and the chance to grow as a young professional.

Once again drawing upon the Bell Labs study, a second source of competitive advantage would be a human resource system that emphasizes and rewards organizational productivity. At the top of the hierarchy are expert lawyers and managers that understand the client's objective and have the expertise to evaluate work quality. But the goal of lawyers at all levels would be to deliver high quality legal services in the most cost-effective way possible, thus improving financial performance and bonding important clients to the firm. In many respects, the ethos of the firm would be remarkably similar to one embodied in the original Cravath system in which "all business

⁷⁸ See Figure 1, *supra*, and accompanying text.

in the office must be firm business.”⁷⁹ Writing in 1948, Robert Swaine, the name partner who authored the firm’s famous history, characterized the outlook of Cravath, Swaine, & Moore as follows:

Every partner is expected to cooperate with every other in the firm’s business, through whichever partner originating, and to contribute to all the work of the firm to the maximum of his ability. The formation of partners of cliques practicing independently of each other, which developed under [a prior partner], would not be allowed today.⁸⁰

It is ironic that sixty years after these words were written, the success of Cravath, Swaine, and Moore is widely perceived to be the elite pedigree of its lawyers rather than an ethos of cooperation and selflessness. Similar to Cravath in the early 20th Century, the goal of the high quality/fixed cost model would be the creation of firm-specific capital that would draw clients to the firm. Moreover, the model has an inherent cost advantage--because of the absurdities of the bi-modal distribution, such firms would have cost structures that permit on-the-job training for associates on the client’s dime.

Yet, the primary source of competitive advantage would be the development of business processes and knowledge management (KM) systems⁸¹ that eliminate or streamline aspects of a legal matter or transaction that were not novel or unique. Because the firm increases its profit margins by driving down costs, processes that economize on lawyers’ time (worth \$200 to \$500 per hour) are extremely valuable. The high quality/fixed cost model provides the firm with the right incentives to design and build capital-intensive knowledge management systems.

Returning now to the peculiarities of the market for corporate legal services in the 21st century, the final mystery to resolve is why the alleged market opportunity identified by the Essay would exist in the first place. The answer to this question turns on three factors.

First, institutional incentives at virtually every large law firm reward partners for either hours billed or fees originated. When you are making

⁷⁹ See REGAN, *supra* note 2, at 22 (quoting ROBERT T. SWAINE, *THE CRAVATH FIRM AND ITS PREDECESSORS, 1819-1948* (1948)).

⁸⁰ REGAN, *supra* note 2, at 22 (quoting SWAINE, *HISTORY OF THE CRAVATH FIRM*). See also Paul C. Saunders, *When Compensation Creates Culture*, 19 *GEO. J. LEGAL ETHICS* 295, 296-97 (2006) (Cravath partner discussing cultural benefits of firm’s lockstep compensation system and opining that eat-what-you-kill undermines “collegiality and partnership” and may even create an unethical culture).

⁸¹ For a useful primer on knowledge management for law firms, see Bruce MacEwen, *Knowledge Management Yesterday and Today*, ADAM SMITH ESQ., Sept. 6, 2007, at http://www.bmacewen.com/blog/archives/2007/09/knowledge_management_yest.html.

\$600,000 per year selling your time or the time of junior partners and associates, it is far from intuitive that you could make \$900,000 by negotiating fixed fees with the clients and investing in lawyer training and knowledge management.

Second, constructing the high-quality/fixed cost model requires a fairly substantial amount of patient capital. Expert lawyers with high opportunity costs need to join the firm and contribute their time. In addition, the firm needs to maintain high quality legal work while simultaneously learning how to price work on a fixed-fee basis and identifying and creating work strategies and KM solutions that will improve productivity and efficiency over the long term. For some start-up period (two to four years is a guess), investors should expect to lose money. Although lawyers are rich in relative terms, few lawyers in their individual capacity have the capital, expertise, or inclination to underwrite this venture. And, of course, the best source of patient capital—nonlawyers—are precluded from investing by the profession's ethic rules.⁸²

The third reason this market niche has been ignored is that virtually all large law firms want to increase their profits by obtaining more high-end, price-insensitive legal work. Although it may be possible to make more money by taking a sophisticated approach to the broad middle market, this transition would come at the expense of something very fragile: the firm's image as an elite institution. The payoff, however, would be firm-specific capital—i.e., knowledge management, work organization, proprietary business processes, and expertise in pricing legal matters that bind clients to the firm. This advantage would be very expensive and time-consuming for rivals to duplicate.

Perhaps the best historical parallel to this clash of financial opportunity and cultural norms is the refusal of elite New York firms in the 1960s and '70s to represent clients in proxy battles and hostile takeovers. Because these matters were viewed as unseemly, large institutional clients were referred to several upstart Jewish law firms that began to specialize in this work.⁸³ By the late 1970s, the M&A practice niche was the most lucrative on Wall Street,

⁸² See, e.g., MODEL RULES OF PROFESSIONAL RESPONSIBILITY Rule 5.4(a) (2004) ("A lawyer or law firm shall not share legal fees with a nonlawyer except [under several enumerated, narrow exceptions]."); see also Larry E. Ribstein, *Ethical Rules, Agency Costs, and Law Firm Structure*, 84 VA. L. REV. 1707, 1721-25 (1998) (discussing and critiquing ban and theorizing that the prevalence of the promotion to partnership system can be partially explained by the liquidity constraints imposed by the ban); Edward S. Adams & John H. Matheson, *Law Firms on the Big Board?: A Proposal for Nonlawyer Investment in Law Firms*, 86 CAL. L. REV. 1, 3 (1998) (noting that every state in the union has adopted some rule against nonlawyer investment in law firms).

⁸³ See generally Eli Wald, *The Rise and Fall of the WASP and Jewish Law Firms*, 60 STAN. L. REV. ___ (2008) (chronicling the demise of the barriers against Jewish lawyers within the elite corporate bar).

and the upstart firms were leveraging this advantage to get more work from establishment's most coveted clients. In 1979, the headline of issue one, volume one of *The American Lawyer* read, "Flom Firm Takes over as Top Money Maker in '78."⁸⁴ The story chronicled the enormous profits of two Jewish firms, Skadden Arps and Wachtell Lipton, that prospered from work that the established firms had turned away. Indeed, with the annual publication of "league tables" for firm profits, cultural norms of eliteness are now anchored less in identity of elite clientele (e.g., commercial and investment banks) than annual profits,⁸⁵ including monies earned from (gasp) contingency arrangements.⁸⁶ Once a firm makes a fortune by focusing on an underserved middle market, it too will redefine our perceptions of eliteness.

CONCLUSION

This Essay is about change—admittedly, a strange and unfamiliar topic for most of us in the legal profession. I document the inevitability of change by focusing on three unsustainable trends: unhappy clients, overpaid and undertrained associates, and a separating dynamic that is dividing the large law firm monolith into two or more segments based on relative mix of practice areas. After introducing readers to the intriguing findings of the Bell Labs study, which suggested that, among knowledge workers, academic success and I.Q. are uncorrelated with star productivity, I raised the possibility that the pervasiveness of the Cravath system had produced a systematic overvaluing of lawyer credentials. Moreover, I argued that the three troubling trends set forth in Part I may represent an arbitrage opportunity of epic proportions—akin to Joe Flom and Marty Lipton toppling the established Wall Street firms in the '70s and '80s.

Yet, will any of the large U.S. law firms embrace the path of change? After much reflection, I believe the most plausible way to test the high-quality/fixed cost model is for a large and established firm to target a price-sensitive practice area. In turn, the firm would create an affiliate law firm (in a separate office space) controlled by key partners who lateral over from the established firm. These partners would bring over a solid base of clients interested in the fixed-fee approach. The new affiliated firm, which would be data-driven from its inception, would be free to develop its own hiring and promotion policies, including the scuttling of the promotion-to-partnership

⁸⁴ See LINCOLN CAPLAN, *SKADDEN: POWER, MONEY, AND THE RISE OF A LEGAL EMPIRE* 80 (1993) (showing photo of cover-page and discussing impact of article within the New York bar).

⁸⁵ See generally Galanter & Henderson, *supra* note 8.

⁸⁶ See Vivia Chen, *Success on a Smaller Scale*, *AM. LAW.*, Aug. 2005, at 79 (reporting that some of the highest profits per partner in the Am Law 200 came from entrepreneurial firms that took large cases on a contingent fee basis).

tournament in favor of a corporate model of employee profit-sharing.⁸⁷ The owners of the affiliate, of course, would be the established law firm, which would agree to (a) refer work to the affiliated firm, and (b) underwrite losses in the range of \$10 million per year for a period of three to five years. If the high quality/fixed cost model is successful, the established firm could gradually apply the same principles to other practice areas with a similar cost profile.

An alternative approach, which I favor, is the amendment of ethics rules to permit nonlawyers to have an equity interest in a law firm.⁸⁸ Here, the formula is very simple: A private equity firm forms a partnership with an established mid-sized firm operating in a commodity market space. Assuming the mid-size firm has lawyer/owners who are excellent legal technicians, the private equity firm underwrites a value-proposition that general counsels like Mark Chandler are anxious to explore. If the concept works—i.e., it is possible to do the same quality of legal work and make larger profits by eliminating or streamlining all inefficiencies and redundancies spawned by the billable hour—the private equity firm will get a nice return. More significantly, the market for corporate legal services will be permanently transformed.

⁸⁷ See Galanter & Henderson, *supra* note 8, at ___ (discussing advantages of abandoning the tournament model).

⁸⁸ See note 82, *supra*. See also Hadfield, *supra* note 53, at _ (arguing the monopoly over legal services by lawyers has dramatically stifled innovation and raised costs); Milton Regan, Larry Ribstein, & Bruce MacEwen, *Law Firms, Ethics, and Equity Capital: A Conversation*, 21 *Geo. J. Leg. Ethics* ___ (2007) (discussing issues surrounding nonlawyer ownership of law firms including listing of ownership share on a stock exchange), available at <http://ssrn.com/abstract=985351>.

APPENDIX

Ordinary Least Square of Natural Log PPP (firm joined)

VARIABLE	B	STD. ERROR	P-VALUE
(Constant)	-106.968	8.356	0.000
Natural Log of PPP, firm left	0.256	0.015	0.000
Fiscal Year	0.058	0.004	0.000
Joined DC Firm	0.047	0.017	0.005
Joined NYC Firm	0.138	0.016	0.000
Joined Chicago Firm	-0.016	0.023	0.484
Joined San Francisco Firm	0.191	0.023	0.000
Joined LA Firm	0.132	0.024	0.000
Regulatory	-0.113	0.022	0.000
Antitrust	0.131	0.042	0.002
M&A, Private Equity, Venture Capital	0.166	0.026	0.000
Intellectual Property	0.053	0.019	0.005
Labor & Employment	-0.083	0.024	0.001
Real Estate, Public & Project Finance	-0.071	0.025	0.004
White Collar & Securities Enforcement	0.267	0.051	0.000
Trusts & Estates	-0.153	0.064	0.017
Corporate Securities	0.026	0.017	0.139
Bankruptcy	-0.014	0.035	0.701
N	3,553		
ADJUSTED R ²	26.6%		

Notes: Natural log of profits per partner used for both the dependent variable (firm joined) and the independent variable (firm left) to correct for nonrandom variation of errors (heteroskedasticity). To provide a reference group that is present in virtually every firm, litigation and general business were omitted from the model.