INDIANA UNIVERSITY
MAURER SCHOOL OF LAW
Bloomington

FutureFirm 1.0

Indiana University Maurer School of Law
Bloomington, IN
April 18-19, 2009

Developing a New Strategy for Marbury & Madison LLP[1]

Marbury & Madison LLP (M&M) is a firm with an identity crisis. Although it has been listed in the Am Law 200 since the list was first published in 1999, many corporate lawyers and industry consultants characterize the firm as "mid-sized", which some M&M lawyers find troublesome. There is a palpable feeling within the partnership that the firm enjoys a distinctive culture that produces top quality legal work within a collegial office environment. Notes one member of the Executive Committee (EC), "At M&M, nobody yells. We don't tolerate it." Although the firm now has four offices nationwide, almost all the partners (150 in total) still know each other by name. Further, the firm's annual partnership retreat is still viewed as a warm and welcoming event where accomplishments are celebrated and lawyers have the opportunity to socialize with spouses and significant others.

Yet, consistent industry information suggests that the firm is in the middle of the pack on some dimensions. First, several partners in marquee practice areas recently have moved to cross-town rivals. Most of these firms are larger and are reputed to have higher profits per partner. Second, scores from the Am Law Mid-Level Associate Surveys have been mixed. Although M&M earns relatively high marks for "level of responsibility", "training and guidance", and "attitudes toward pro bono", the firm gets below average marks on "billable hours policy", "family-friendly environment", "communication toward partnership", and "attitudes toward diversity". In discussions with the Executive Committee, M&M's Managing Partner has characterized as a "vise" the tension between profitability (to retain and, if necessary, attract partners) and engendering the trust and loyalty of associates, who are the future of the firm.

Challenges are also brewing with M&M's clients. According to the results of an industry-wide survey, corporate clients often felt disconnected from M&M partners. For example, M&M partners believe they are doing an exemplary job 67% of the time, versus 42% in the eyes of their clients. The only solace that can be drawn from these statistics is that the average Am Law 200 firm did slightly worse.

The future of the firm obviously depends upon its relationship with clients, and its junior lawyers. The M&M Executive Committee fears that it has become out of touch with these

[1] Marbury & Madison LLP is a fictitious firm designed to fit the collaborative environment created for FutureFirm 1.0. The organizers are confident that no real-life firm fits these precise contours; any similarities are completely accidental. We would like to acknowledge Bryant Danner, former Latham & Watkins partner and former GC of Edison International, for providing us with an initial outline. An earlier permutation of Marbury & Madison LLP was created by Bryant for his spring 2009 class, "Law Firms and In-House Law Departments: Decision Points," at University of Southern California School of Law.

constituencies. Thus, the EC created a Task Force of four partners to gather information from the firm's clients and associates. The charge was simple: "Tell us what changes we can make to our business model that will maximize the chance that M&M will survive and thrive over the next 20 years." The EC also stated that the model must have substantial buy-in from clients and associates. "Otherwise, we are just fooling ourselves."

The efforts of the Task Force are taking place in real time – i.e., April of 2009. Profits per equity partner were up 4% last year, but the fiscal year ended in September. For fiscal year 2009, firm revenues and hours-billed are down 10% year-to-date; further, these figures are down 17% overall on the transactional side. M&M's bank, which collects industry data, tells the firm that its peers are experiencing a downturn of similar magnitude (or worse). The firm has laid off 45 staff members (secretaries, paralegals, and other support personnel) and deferred the start dates of the incoming class of associates (35) to January 2010. So far it has resisted associate layoffs or partner de-equitizations,[2] though rumors are circulating that the upcoming mid-year performance evaluations in June will be a vehicle for stealth layoffs. How to allocate a diminution in profits is a daunting prospect for the firm, so the EC wants guidance on how to maintain the size of the profit pie. The difficulty, of course, is separating out short versus medium and long-term effects.

Finally, there is a resignation among the majority of the M&M partnership that temporary retrenchment is not a realistic option. The firm needs a new model that works well for clients, partners and junior lawyers. This may require steps or measures never before taken by an Am Law 200 firm. (Quipped one EC member, "The editors at *Above the Law* are going to have a field day at our expense. But as long as associates and clients understand, so what! I love this firm; it has been a great place for me for 30 years. I am ready for something new that puts us back on top.")

The Partner members of the task force are a select group:

Peyton Smith. Peyton, who is chair of the task force, is based in Chicago. Peyton is chair of the Firm's Litigation Department and a member of the Executive Committee. Peyton is a major rainmaker and has one of the largest shares of points in the firm. Yet Peyton is an institution builder and is thus more interested in building a better future for M&M than maximizing individual or firmwide profits in the short to medium term.

Leslie McNulty. Leslie is an intellectual property lawyer in the San Francisco office. M&M partners probably underestimate how sought after Leslie is by other Bay Area firms. Fortunately, Leslie has intense loyalties to the non-financial values of the firm, including mentoring, training, and doing first-class legal work. Leslie is a product of this system and now wants to retool it for the next generation of M&M lawyers.

John Blackhurst. John, who is a corporate partner in the firm's mid-size market branch office, is highly entrepreneurial and thinks outside the box. He often complains that his DC, Chicago, and San Francisco partners, "live too much in the *Above the Law* fishbowl. For Christ's sake, we need to think for ourselves." John believes in the power of leadership and ideas. "Profit comes from identifying and living sound organizational principles. When money becomes the only thing that matters around here, this firm is toast. But if we focus on our clients and our people, I guarantee that our firm will be immensely profitable."

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[2] Underlined terms are defined in the Glossary at the end of this document. We generated the Glossary for the benefit of student participants.

Marion Stewart. Marion is the youngest partner on the Task Force and got the position because of him/her? outspoken nature. Marion, who is worshiped by clients, is a regulatory lawyer in the firm's DC office. She is also a radical and has suggested numerous times, within earshot of associates, that, "We should scuttle the damn tournament and make everyone an owner. Right now we are bottling up our future." The EC doesn't know what to do with Marion; it is hoped that the Task Force assignment will channel his/her restless energy into something productive for the firm. Marion has concluded that if this effort does not pan out, it may be time to start a new boutique firm with other M&M lawyers; the list of junior partners and associates (and clients!) has already been drafted.

The Task Force has been asked to develop a plan in conjunction with in-house lawyers from the firm's major clients and M&M associates. Participation on the Task Force is going to be time consuming, and many M&M clients and associates are highly skeptical that it will be worth the investment of time. Thus, getting the cooperation of these lawyers requires that the Task Force identify a vision for change—significant enough that the clients and associates conclude that the Task Force might actually make a difference. Drawing upon the facts outlined below, the Task Force is required to develop a business model that touches the three to five most important items from the following list.

- <u>Target markets</u>
- <u>Firm differentiation</u>
- <u>Resourcing and reinvestment in Firm</u>
- <u>Geographic spread</u>
- Areas of practice
- <u>Ownership model</u>
- <u>Remuneration and reward</u>
- <u>Human asset recruitment and development</u>[3]
- Associate/Partner retention/engagement

Below is a summary of the M&M firm.

1. **Origin.** M&M was established in 1925, as a three-man partnership in Chicago, Illinois. It recently became a "limited liability partnership" ("LLP"). It has historically focused on insurance defense/coverage; corporate, labor employment; and regulatory compliance work for <u>"legacy industries"</u> such as steel, automotive, and the airlines. M&M perceives itself as a <u>white-shoe firm</u>, though in recent years, its peers in Chicago have grown much faster.
2. **Geography:** M&M has four offices with 335 lawyers : 175 in Chicago (the Headquarters), 75 in Washington, 50 in San Francisco, and 35 in a middle-size market (e.g., Minneapolis, Indianapolis, Milwaukee, Charlotte, Denver, San Diego, or

[3] Partner teams that attempt to end entry-level hiring, primarily because Clients are reluctant to pay for them, will have a difficult time forming a Student/Graduate alliance, which is a precondition of advancing to Round #2. More fundamentally, the Students/Graduates are the lawyers who must be relied upon to keep the firm going 20 years into the future. When firms collectively conclude that it is better for other firms to supply the training and experience needed to create expert lawyers, the pipeline of talent will eventually run dry.

Miami – the Managing Partner for each team can decide this fact)[4]. For the last five years, a contingent of partners has advocated the opening of an office in either Shanghai or Beijing.

3. **Departments.** As the work flow from the legacy businesses has slowed down, M&M has developed new and relatively strong practices in Real Estate/Project Finance, Environmental Law, and Intellectual Property. It breaks down as follows:
   - Corporate 80
   - Litigation 80
   - Labor & Employment 50
   - Real Estate/Project Finance 25
   - Intellectual Property 25
   - Regulatory Compliance (primarily environmental) 25
   - Unassigned Associates – 50 (Associates are usually "unassigned" for their first 18 months at the firm.)

4. **Rates**. The hourly rate charged for associates range from $185 to $400 (average: $325). The hourly rate charged for partners range from $350 to $750 (average: $485). Corporate and Intellectual Property litigation generally charge the highest rates, but there is substantial downward pressure on all fees, especially Real Estate/Project Finance, Regulatory Compliance, and Labor & Employment.

5. **Firm Structure**. M&M is a low leverage firm: 150 partners, 185 associates with an eight to ten-year partnership track. For the last thirty years the firm has been run by an Executive Committee of twelve lawyers who are elected by their peers every two years. Because voting is weighted by partnership shares, rainmaking partners comprise the majority of the EC. In turn, the EC selects a Managing Partner for a five-year term, whose workload is 50% administrative and 50% practice of law. The Managing Partner role at M&M is that of an administrator rather than leader. The EC also selects Department Chairs who preside over each Practice Group.

   The firm switched to a <u>two-tier partnership structure</u> in 2003, ostensibly to provide a platform for promising lateral hires to prove themselves and for junior partners to cultivate clients. Currently, 15 lawyers (10% of the partnership) comprise the non-equity tier. The firm does not track <u>origination credits</u>, at least not formally. Each year, the EC allocates <u>partnership points</u> (and thus voting power and compensation) on a "rough justice" model in which institutional citizenship—e.g., mentoring, recruitment, exemplary service on committee—is taken into account. Elevation to equity is at the discretion of the EC. In the last five years, five partners have made the jump. Yet, three of five from the first non-equity class remain non-equity partners. Two are women. There is building sentiment among some partners that the firm should revert back to a single-tier system "before it is too late", but the issue has not yet come to a vote.

   In addition to the EC, other Committees include: Recruiting (3 partners, 7 associates); Business Development and Ethics (5 partners, 2 associates); and Office Administration (5 partners, 2 associates)

[4] Expansion into the middle-market city was done to accommodate the expansion of the firm's largest client.

6. **Diversity**. Relative to other firms in the Am Law 200, M&M has made some progress on diversity, yet, from the perspective of some partners, associates, and students during the OCI process, it is not especially impressive. The breakdown is as follows:
   - White Partners (96.7% of all Partners): 120 male (80%); 25 female (16.7%)
   - White Associates (86.5% of all Associates): 90 male (48.7%); 70 female (37.8%)
   - Minority Partners (3.3% of all Partners): 3 Black (two male, 1 female), 2 Asian (both male), no Hispanic
   - Minority Associates (13.5% of all Associates): 15 Black (6 male, 9 female), 8 Asian associates (3 male, 2 female), 2 Hispanic (both male).

   One non-minority woman is a Department Chair and on the Executive Committee. Only two minority Partners hold equity points, albeit both are over 40 years of age and both made partner before the introduction of the two-tier structure.

7. **Salary and Career Progression of Associates**. Associates are eligible for promotion to partner status after 8 years. There are some limited, "early admission" exceptions to this. Required vote is 75% of "points" held by partners. Most (but not all) associates who are not promoted to partner status after 10 years leave the firm. Associate compensation is determined primarily by a lockstep formula, with some downward adjustments for Associates in the (cheaper) middle-market branch office.
   - $160,000 in first year
   - $170,000 in second year
   - $185,000 in third year
   - $210,000 in fourth year
   - $225,000 in fifth year
   - $240,000 in sixth year
   - $255,000 in seventh year
   - $275,000 in eighth year (and beyond)

   It is noteworthy that Income Partners (M&M's term for non-equity) are guaranteed $285,000 per year and are eligible for a discretionary bonus based on performance. This information is generally not shared with Associates.

   Bonus: Eligible for "merit" bonus from second year on. Amount has ranged from $0 – $30,000 for years 2 through 4 ($20,000 average over the last few years); and $0 – $60,000 for years 5 and beyond ($40,000 average over the last few years). Hours billed and collected appear to be the overwhelming determinant of the bonus paid. Several major clients have said, "Your bonus system rewards the wrong type of behavior.", yet, the partners like the straightforward linkage between income generated and bonuses paid.

8. **Expectations re: Hours**. For associates: 1,950 hours, including "billable" time and pro bono hours; but not including time on firm committees. (Associates' actual billable time in recent years has averaged 2,050 hours.) For partners: 1,800 hours, including "billable" time and pro bono hours; allowing some flexibility for Managing Partner, Executive Committee and Department Chairs; those who are major business producers; and partners who are nearing retirement. (Partners' actual billable time in recent years has averaged 1,850 hours.)

9. **Partner Compensation**. Share of firm's net profits: 90% of net profits paid to partners in proportion to the number of "points" that the partner holds. 10% of net profits held in a fund until allocated at the end of the year as merit bonuses to partners. New equity partner usually has about 200 points, increasing (at a non-uniform, discretionary rate, but generally in line with the partners' seniority) to a possible top of 800 points. Initial points and increases (and decreases) determined by the Executive Committee. Some additional features:
   - *Bonus*: Partners eligible to receive merit bonuses, as determined by Executive Committee, based on relative overall contributions to the firm. Recent amounts have ranged from $0 - $750,000.
   - *No guaranteed income*: Monthly "partner draws" of approximately $20,000 to $50,000; proportionate to number of "points" held; subject to repayment if firm's net income is less than estimated for the year.
   - *Range of Profit Distributions*: In keeping with the points and bonus systems, the ratio (high:low) of overall compensation paid to equity partners is about 4.5:1 ($1,500,000 to $335,000). In fiscal years 2007 and 2008, the average Profits per Equity Partner (PPP) have been in the vicinity of $675,000. Because of the relatively small size of the non-equity tier, M&M's average compensation per partner ($600,000 based on equity and income partners) is ranked much higher (#118) than its PPP ($675,000, #138).
   - *Information*: Partners are given full information about the billable and non-billable hours logged by all other partners; details about the business generation results (as a narrative rather than through origination credits) achieved by all other partners; and the compensation paid to all other partners.

10. **Capital Account and Bank Financing**. The M&M partnership has a capital account of approximately $15 million. This is used from time to time to fund asset purchases and other strategic investments. It also serves as a general reserve fund and as an assurance for banks that make loans to the firm. Each equity partner contributes after-tax dollars to the fund (usually from an initial "buy in" or from current income) and has a partnership interest in the fund approximately proportionate to his/her number of points. The capital accounts average about $111,000 per partner, and range from about $40,000 to about $250,000. The firm has a combined $30 million line of credit from two banks, which is used as operating capital for payroll, rent, and other overhead expenses. These funds are secured by the firm's account receivables.

11. **Retirement Program**. This benefit is available to partners (and has not been modified since the implementation of the two-tier system). Partners are eligible after 25 years of practice at the firm and reaching the age of 60. The retirement program is unfunded and paid on each year's current net income, capped at a maximum of 5% of net profits; in recent years, retirement benefits have comprised 3.8% of total firm profits. Benefits to retired partners are determined by a complex formula keyed to points at retirement and are paid out over 15 years.

12. **Ranking on Recent American Lawyer "Lists"**
   - Number of lawyers: 335, which ranks #127 in the Am Law 200.

- Gross Revenue has recently been about $210 million, which ranks #123 in the Am Law 200.
- Profits per partner ($675,000) is #138.
- Mid-level (3-5 years) associates satisfaction rating: 3.85 on a 5.00 scale, which is approximately #90 of the 157 firms ranked in the 2008 Am Law report.

13. **Lateral Entrants.** In the last five years M&M has brought in 15 lateral associates and 8 lateral partners. M&M is quite flexible in integrating laterally-hired associates and partners into the firm's overall structure. For example, some lateral associates with 5 years of experience at another firm have been brought in with "full credit" for those years and have made partner after 3 years at M&M. Also, laterally-hired partners have joined M&M with a number of points higher than the average for comparable seniority M&M partners, and with assurances of certain point progressions and bonus payments for their first few years at the firm.

14. **Attrition and Growth Rate**. About 17% of associates leave the firm each year. Most of this attrition occurs in the first 4 – 5 years. More female than male associates are leaving; minority lawyers are also leaving at a faster rate. About 40% of the associate attrition is prompted by the firm. About 40% is voluntary; and about 20% is "unclear". In the firm's recent history, about 10% of an entering class have ultimately become partner. The non-retirement attrition rate for partners is still low (about 2-3 per year over the last several years). However, this rate seems to be increasing as more partners leave to become partners at other firms or to join in-house law departments. Overall, the firm's growth has been fairly slow for the last several years as the number of new hires and lateral entrants has only slightly exceeded the number of departures.

15. **Paralegals.** The firm has 40 paralegals spread across all departments in about the same proportion as the lawyers. They average about 1,600 billable hours/yr. and are billed out at about $125/hr.

16. **Recruiting and Summer Clerks.** The firm recruits actively at most of the "top 40" law schools and selectively at other law schools. About 40% of the firm's lawyers graduated from the "top 20" law schools. The firm has a substantial summer clerking program. In the three most recent summers, M&M has had a total of about 90 summer clerks. Approximately 75% of the clerks received offers to join the firm as associates. About 60% of these offers were accepted. This produced the current incoming class of 35 for the class of 2009. The size of the entering classes (joining M&M as first year associates) has increased from 27 to 35 over the last five years.

17. **Administrative Staff.** The firm has a large administrative staff, including a Business Manager (who has an MBA) and other full-time professionals to manage the libraries, technology operations, accounting and other essential business functions. The firm also has full-time Managers (and supporting staff) to assist in the firm's recruiting and marketing activities.

Glossary

(for the benefit of student participants)

Business Generation. Law firms need clients. In many law firms, business generation is a key metric of a lawyer's relative success. Lawyers who generate business tend to be the most powerful and highly compensated within the firm.

De-equitization. When a partner is moved from the equity tier (i.e., owner who shares in the profits of the firm) to the non-equity tier (i.e., employee with a guaranteed income and typically limited to no voting rights). *See* Two-Tier Partnership Structure.

Firm Differentiation. How a law firm distinguishes itself from the competition. In other words, what are the unique ways in which a law firm adds value for its clients?

Geographic Spread. The firm's strategy for opening, closing, and staffing branch offices. In general, geographic spread is associated with higher per-lawyer operating costs. Thus, a larger geographic spread should be linked to a coherent strategy to deliver higher value products and services.

Human Asset Recruitment and Development. A law firm's most valuable asset is its people. Thus, a law firm should have a coherent strategy for recruiting and developing human assets for the purpose of producing higher quality and/or more cost-effective legal services.

Ownership Model. In most large U.S. law firms, profits are allocated among lawyers who are equity partners in a general or limited liability partnership or equity shareholders in a professional service corporation. It is possible, however, to provide an equity interest to other lawyers within the firm. However, under virtually all state ethics rules, lawyers are prohibited from sharing firm profits with nonlawyer investors. In addition to profits, the ownership model determines who manages and controls the firm.

Orientation Credits. A system for tracking and allocating business generation activity. In turn, this system is used to determine lawyer compensation. Some firms have a formal numerical system for business generation; others track this important information through a more subjective or holistic method.

Partnership Draw. Periodic disbursement of funds to partners for living expenses in anticipation of their share of firm profits. At the end of the fiscal year, the total draw is typically deducted from a partner's profit distribution.

Partnership Points. Many firms calculate ownership interests through a points system. The higher the number of points held by a partner, the greater his or her ownership interest in the firm. Often a partner's voting interest is determined by the number of points held.

Resourcing and Reinvestment in Firm. The firm's financial commitment to support and improve lawyer productivity, including a possible long-term policy for retaining earnings for reinvestment back into the firm. Reinvestment priorities would likely be based upon an expected return on investment (e.g., increase in revenues and/or a reduction in costs). Examples of resourcing and reinvestment strategies include leveraging of technology, creation and implementation of training programs, and developing standardized products that can be delivered to clients at a very low marginal cost.

Remuneration and Reward. The system of compensation for junior and senior attorneys and support staff. Various methods include uniform pay by level of seniority; tying pay to hours billed or business generated; credits given for committee or pro bono work performed. Remuneration can be in the form of salary, bonus, or share of firm profits (though only lawyers can split profits).

Target Markets. Target markets refer to specific industries, desired clientele (e.g., government, non-profits organizations, small cap public companies, large cap public companies, entrepreneurs, privately held small, privately held large, mature businesses versus high growth potential), specific geographical regions the firm wishes to serve, and/or expansion into multi-disciplinary practice areas that have synergies with the firm's core law practice areas.

Two-Tier Partnership Structure. A partnership in which one group of partners (equity partners) owns and controls the firm and a second group (the non-equity tier) are essentially employees who share the title of partner. In recent years, the two-tier firm has become the dominant model. Over 80% of Am Law 200 firms now utilize a two-tier (or multi-tier) format.

"White Shoe" Firm. A firm with a long history of serving large, prestigious corporate clients. "White shoe" refers to a style of footwear common at elite country clubs during the first half of the twentieth century (think F. Scott Fitzgerald). When virtually all law firms were regional, every large industrial and coastal city had its own "white shoe" corporate law firms. Yet, these firms tended to hire graduates from Ivy League and other national law schools. Today, these firms now comprise a large proportion of the Am Law 200.