Size Matters Not Much

For a law firm that is already large, do incumbent partners benefit from further growth? That question is on the minds of the managers of any sizeable, well-run law firm. There are, of course, benefits from growth apart from incumbent partners' income gains – diversification, stability and the expansion of connections to new interests, practice areas and clients. Nevertheless, the importance of equity partner income is not to be denied so it is per-equity-partner profits on which we now focus.

Stories

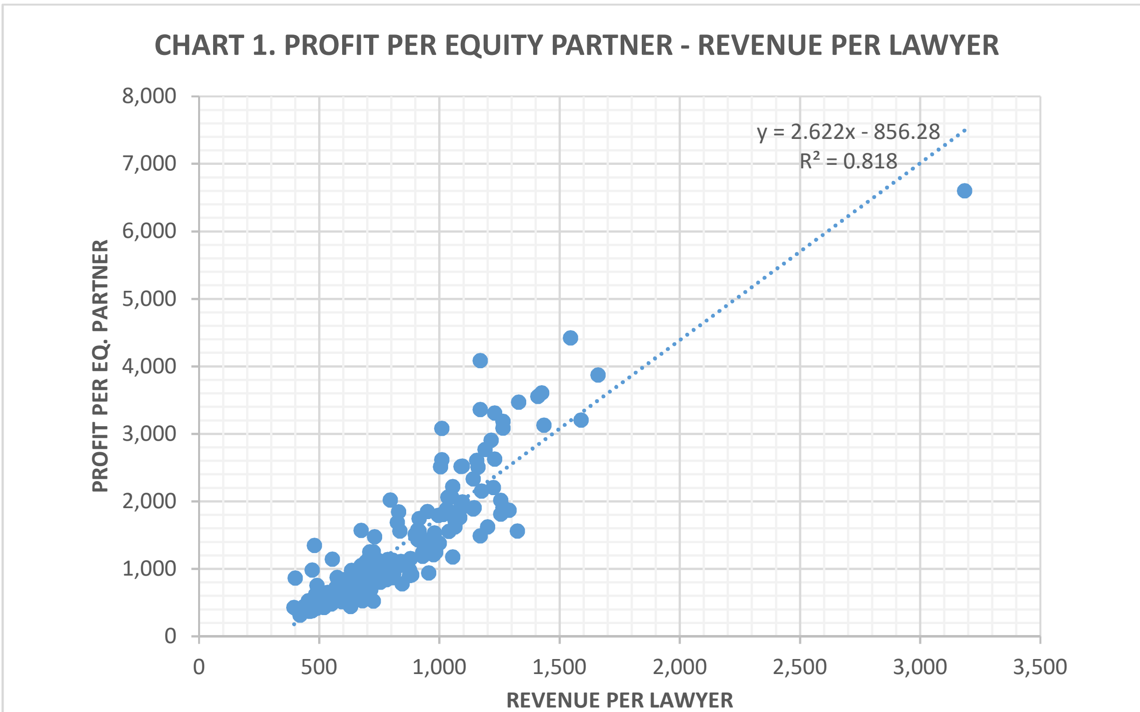
Mere mental models-- basically story-telling--offer no real insights. Incumbent partner incomes go up when the profit pool gets bigger and incumbents get to share in it. But when growth calls for investment out of incumbent partners' pockets and when the extra profits (when they come) go largely to new partners, lateral or otherwise, there is little left over for incumbents. None of this helps much.

Facts

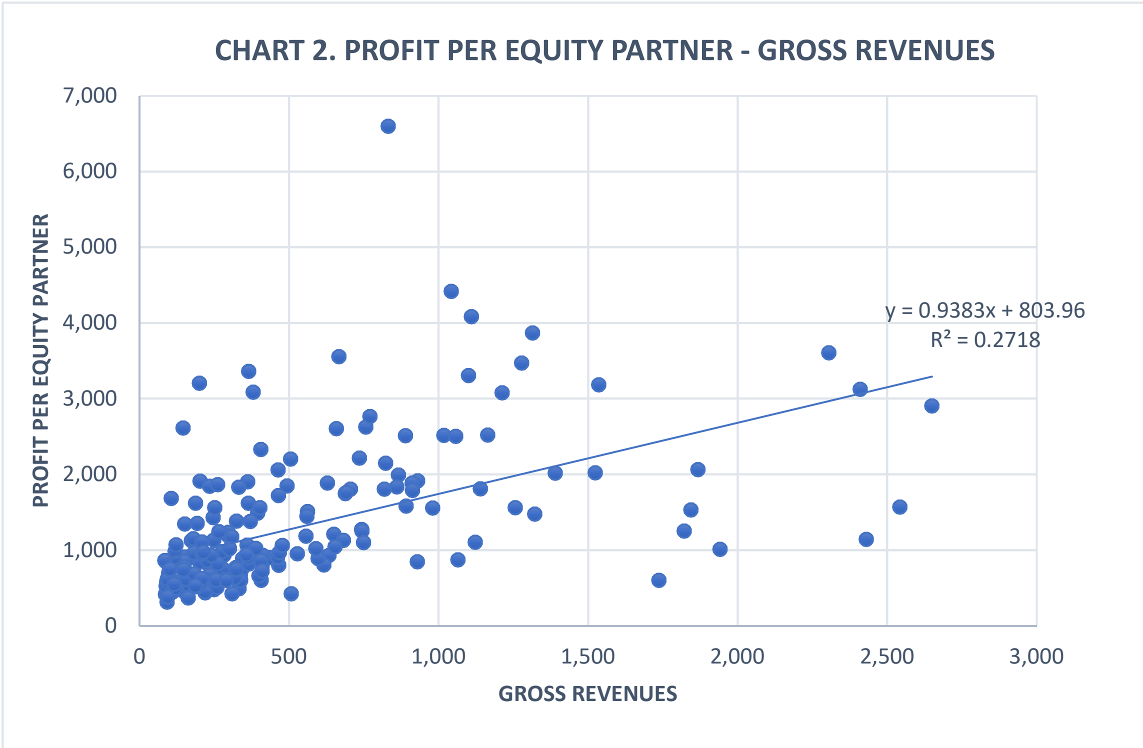
So much for mental models. What do we actually know?

For a factual examination of the question, we turn to the American Lawyer 100 and 200 data sets which reports measures of law firm size and profitability, including per-lawyer and per-partner averages by individual firm. Since we are examining only the 200 largest U.S.-based firms, no inference drawn from these numbers can be applied to smaller firms outside this group. Studying the biggest firms may contribute to the intuition of smaller firms' managers but only indirectly. Every statement that follows should be prefaced by the phrase: "For firms in the top 200," since what is true for them may not hold true for smaller firms.

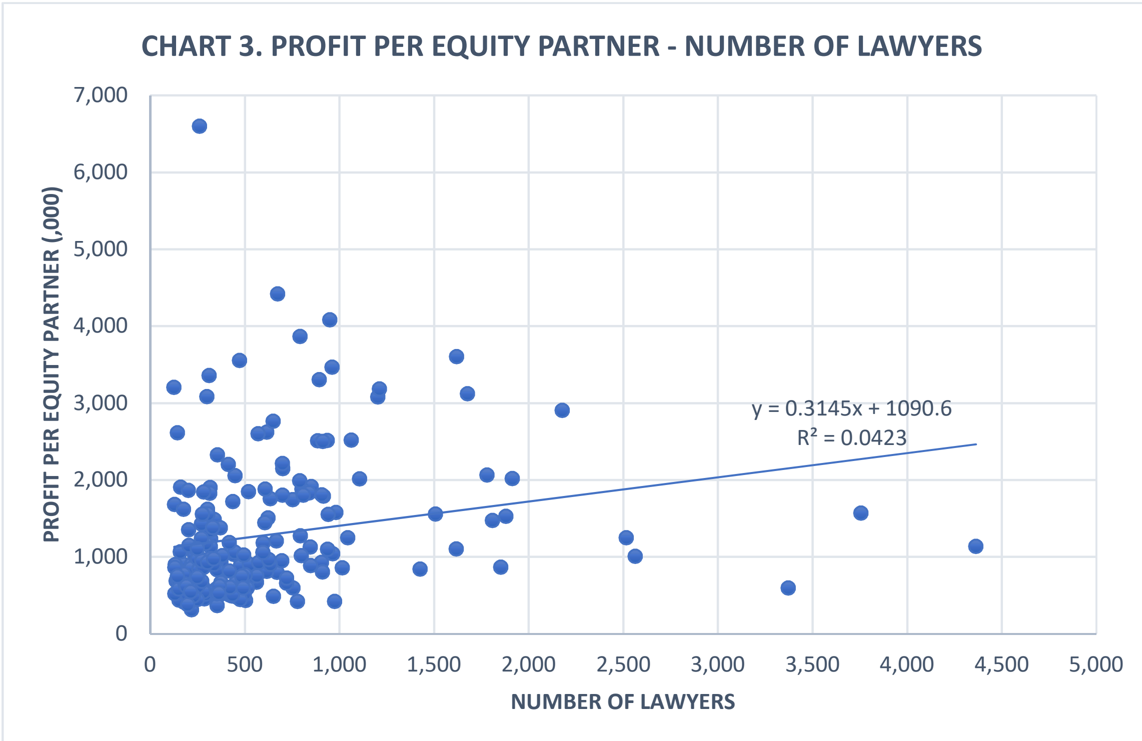
Here are the charts that tell the story:



1. Turning to firm averages that reflect the profit yield to individual partners at the top 200 firms, we observe a strong relationship between profit per equity partner and revenue per lawyer, as expected. The more that each lawyer of every category earns for the firm, the higher the incomes of the owners—the equity partners.
   Note the two-way relationship between these measures: Higher utilization and billing rates create more income for partners while partners who bring in and oversee profitable business for the firm create the demand that supports higher rates and more hours per lawyer. There is no generalizing across firms about which direction of causality dominates.
   Revenue per lawyer is unrelated to firm size. There are firms of every size within the ALM 200 which enjoy high demand, high billing rates and so high revenue per lawyer and there are firms of every size which do not.



2. Chart 2 goes to the heart of the matter. It shows a positive but weak relationship between average profit yield to equity partners and firm size measured by gross revenue. Note though that most of the largest firms (those over $1.5 billion revenues) yield below-predicted profit for their partners. Of these largest firms, several are multinationals and vereins in which very wide geographic differences in profitability may explain their relatively low profit yield relative to firm size. A large fraction of the smallest of the top 200 also are less profitable per partner than the overall average (see the concentration of firms of less than $500 million in revenues whose per-partner profits are less than $1 million).



3. The third chart tells us that there is almost no connection at all between profit per partner and firm size measured by the number of lawyers. The scatter of observations is very wide and the very biggest firms exhibit lower-than-average profit per partner.

Conclusion

There are several reasons why already-large law firms' partners and managers might wish to see their firms grow. But when an incumbent partner contemplates an investment in growth and asks "Will this put more money in my pocket?" the answer cannot be supported by any broad statement about firm size among the American Lawyer Top 200. Indeed, the very wide distribution of profit per partner at all levels of firm size among the Top 200 is a caution against generalization.

Two factors connect firm-wide growth to incumbent partner pay outcomes. The first is whether expansion makes a firm more excellent in the eyes of clients and recruits. Excellence, however hard to define, generates demand, creates competitive advantage, justifies higher billing rates and attracts better candidates in the market for legal talent. Second, the payoff to incumbent partners for investment in growth depends importantly upon the way partner profits are distributed. "Shared fate" pay programs in which partner compensation is determined less by individual partner accomplishment and more by "the size of the pie" will yield benefits to incumbents as long as new partners do not claim a highly disproportionate share of their incremental contribution to the firm's profit. By contrast, incumbent partners in firms whose pay plan predominantly rewards individual contribution cannot expect much spillover into their pockets from firm growth not directly connected to them.

Two points are worth reiterating:

1. There are reasons why growth is healthy for a firm even when it does not put more money in incumbent partners' pockets.
2. Among the top 200, the statistics show that when it comes to equity partner income, firm size matters hardly at all.