North Carolina Law Review

Volume 84
Number 5 *Empirical Studies of the Legal Profession: What Do We Know About Lawyers' Lives?*

Article 13

6-1-2006

An Empirical Study of Single-Tier versus Two-Tier Partnerships in the Am Law 200

William D. Henderson

AN EMPIRICAL STUDY OF SINGLE-TIER VERSUS TWO-TIER PARTNERSHIPS IN THE AM LAW 200

WILLIAM D. HENDERSON*

During the last decade, many of the nation's largest law firms have converted from single-tier to two-tier (or multi-tier) partnerships. A two-tier firm contains separate tracks for "equity" and "nonequity" partners; the equity tier typically controls the firm and enjoys a larger per capita share of the firm's profits. At present, two-tier partnerships make up 79% of the Am Law 200. The conventional explanation for the growth of the two-tier system (or, conversely, the abandonment of the single-tier) is that it produces higher profits per equity partner ("PPP"), thus solidifying the prestige of the law firm and improving its ability to attract the best legal talent. Drawing upon a comprehensive dataset of Am Law 200 firms, this study documents that average PPP are significantly higher in single-tier firms, even after controlling for geographic market segment and firm leverage. The higher profitability of single-tier firms appears to be a function of higher levels of prestige, which enable single-tier firms to (a) attract and retain a more lucrative client base, and (b) run a more rigorous promotion-to-partnership tournament in which associates work longer hours and are less secure in their futures with the firm.

* Associate Professor, Indiana University School of Law—Bloomington. B.A., Case Western Reserve University; J.D., University of Chicago. I would like to thank Bruce MacEwen, author of the Adam Smith, Esq., blog on law firm economics, for countless hours of dialogue on the Am Law 200 marketplace, and Bruce McLean (Akin Gump) and Larry Lederman (Milbank Tweed) for helping me understand the nuances of competition among large law firms and elite lawyers. My methodology and analysis benefited from the IU Law Junior Faculty Workshop, an online workshop hosted by Conglomerate.com, and the Washington, D.C. chapter of the IU Law Society. I also received valuable comments from Scott Baker, Greg Castanias, Daniel Fisher, Michael Guttentag, Robert Hillman, Christine Hurt, Kate Litvak, Karl Lutz, Andrew Morriss, Larry Ribstein, Richard Sander, Jeff Stake, David Van Zandt, David Wilkins, and Joshua Wright. Finally, I want to acknowledge the excellent research assistance of Catherine Matthews, Elizabeth Morgan, Jessica Regan, and Elizabeth Wysong. I am solely responsible for all remaining errors.

Based upon a ten-year longitudinal sample, this study also finds modest statistical evidence that the two-tier structure, after controlling for relative starting position and geographic market, is associated with larger gains in PPP. In light of its uncertain financial benefits, the author theorizes that the two-tier structure is primarily a bonding mechanism used by less prestigious firms to institutionalize a marginal product method of partnership compensation and consolidate managerial control for the benefit of the firm's most powerful partners. Failure to switch to the two-tier structure leaves the firm vulnerable to defections and possible collapse. As a result, the primary economic benefit of the two-tier format may be firm stability rather than higher average PPP. Finally, this study provides some evidence that the appeal of permanent nonequity partnership status, which typically would entail fewer business development demands, may set in motion an adverse selection problem at the associate recruitment level, thus undermining some of the perceived benefits of a two-tier (or multi-tier) format.

INTRODUCTION 1693
I. LITERATURE REVIEW AND BACKGROUND 1699
A. *Gilson and Mnookin* 1699
B. *Samuelson and Jaffe* 1703
C. *Advent of the Two-Tier Structure* 1706
D. *Intended and Unintended Incentives in Two-Tier Firms* 1709
II. SUMMARY OF DATA AND METHODOLOGY 1713
A. *The Base Dataset* 1714
B. *Key Independent Variables* 1717
1. Tier Structure 1718
2. Proportion of NYC/Global Lawyers 1719
3. Firm Leverage 1722
4. Ratio of Nonequity to Equity Partners 1724
5. Prestige Variables 1725
III. RESULTS 1726
A. *Comparison by Tier Structure and Market Segment* 1727
B. *Firms that Switched to Two-Tier Format* 1729
C. *Determinants of Profitability in Single Versus Two-Tier Firms* 1734
D. *Tier Structure and Changes in Profitability over Time* ... 1739
IV. DISCUSSION 1742
A. *A Theory of Single-Tier Versus Two-Tier Law Firms* 1742
B. *Heterogeneous Incentive Structures in Two-Tier Firms* .. 1744

CONCLUSION 1748

INTRODUCTION

During the last thirty years, the typical size of "large" corporate law firms has grown dramatically.[1] During the 1960s, a law firm with seventy-five lawyers was considered large. Only a handful of law firms had more than 100 attorneys. Yet according to data published in 2004 by *The American Lawyer*, the average size (based on gross revenues) of the nation's 200 largest law firms ("Am Law 200") is now 466 attorneys.[2] In 2003, more than 93,000 lawyers worked as partners, associates, of counsel, or staff attorneys in Am Law 200 firms.[3] With average revenues of $272 million,[4] the typical Am Law 200 law firm is comparable in size to companies listed on the NASDAQ or the New York Stock Exchange. However, because every state in the nation has ethics rules that proscribe nonlawyer investment in law firms,[5] Am Law 200 law firms remain privately held businesses owned by the same partners who generate a substantial proportion of the firm's annual revenues.[6]

In theory, the unity of ownership and management should eliminate the substantial agency problems that plague the modern

---

1. *See generally* MARC GALANTER & THOMAS PALAY, TOURNAMENT OF LAWYERS: THE TRANSFORMATION OF THE BIG LAW FIRM (1991) (observing that the rate of growth increased exponentially in the early 1970s).

2. Author's calculations based on data published in the July and August 2004 issues of *The American Lawyer*.

3. *Id.*

4. *Id.*

5. *See, e.g.*, MODEL RULES OF PROF'L CONDUCT R. 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* 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 nation has adopted some rule against nonlawyer investment in law firms); Larry E. Ribstein, *Ethical Rules, Agency Costs, and Law Firm Structure*, 84 VA. L. REV. 1707, 1721–25 (1998) (discussing and critiquing the ban and theorizing that the prevalence of the promotion-to-partnership system can be partially explained by the liquidity constraints imposed by the ban). The District of Columbia recently amended its ethical rules to permit nonlawyers to be partners in law firms. *See* D.C. BAR ASS'N, RULES OF PROF'L CONDUCT R. 5.4(b) & cmt. 7 (2005) (specifying instances where a lawyer and nonlawyer can share a financial stake in a law partnership, including arrangements where a "nonlawyer lobbyist . . . [works] with lawyers who perform legislative services").

6. Some Am Law 200 firms are organized as professional corporations ("P.C."). However, for our present purposes, a "shareholder" in a professional corporation is functionally equivalent to a "partner" in a general or limited liability partnership.

publicly held corporation.[7] Yet if Am Law 200 partners, like corporate shareholders, want to maximize the value of their investment, it remains an open question which type of law firm structure—i.e., system of incentives for associates and partners—produces the best return for the firm on a per-partner basis.

During the 1980s, many large law firms and law firm consultants began focusing on two-tier partnerships as a method of improving law firm profitability.[8] The microeconomic logic was straightforward: Single-tier firms, in which partners share profits (often according to a predetermined schedule of lockstep compensation),[9] provide deleterious cross-subsidies between productive and nonproductive partners. Once admitted to the partnership, a lawyer in a single-tier law firm has little incentive not to shirk. And even if profit shares are allocated—in whole or in part—on the basis of hours billed, some partners can free-ride off the business development talents of others. Because the most valuable partners in a single-tier firm lack the necessary voting power to effect a compensation system that reflects their contribution to the firm, their only recourse was to leave (or threaten to leave) the firm.[10]

In contrast, the two-tier structure purportedly solved these incentive problems by installing rainmakers as equity partners and placing talented legal technicians and specialists in a nonequity tier. Because of the highly selective partnership criteria, it was presumed that equity partners would earn higher incomes in two-tier firms, thus solidifying the firm's prestige and enhancing the firm's ability to

7. The agency costs in large, publicly held corporations arise from the fact that corporate managers, in the face of a widely dispersed ownership (i.e., shareholders), are able to pursue management and investment policies that further their own personal interests rather than those of the corporation. Therefore, the extent of these agency costs is largely a function of the ability and willingness of shareholders to overcome the collective action problem. Monitoring a corporate manager, after all, is a public good. This problem was originally framed by Berle and Means and formally theorized by Jensen and Meckling. *See generally* ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932); Michael C. Jensen & William H. Meckling, *Agency Costs and the Theory of the Firm*, 3 J. FIN. ECON. 305 (1976).

8. For example, the interest in two-tier partnerships in the 1980s resulted in the ABA commissioning a detailed monograph on the subject. *See* BRUCE D. HEINTZ & NANCY MARKHAM-BUGBEE, AM. BAR ASS'N, TWO-TIER PARTNERSHIPS AND OTHER ALTERNATIVES: FIVE APPOACHES 1986.

9. *See, e.g.*, ALTMAN & WEIL, INC., AM. BAR ASS'N, COMPENSATION PLANS FOR LAWYERS AND THEIR STAFFS: SALARIES, BONUSES AND PROFIT-SHARING 16 (1986) (asserting that a lock-step system "is totally lacking in accountability" and "favors the least energetic, least aggressive, and least capable," thus permitting "some partners [to] 'retire' at their desks long before retirement age, yet . . . continue to receive a full share").

10. *See infra* Part I.D.

attract the best legal talent. The two-tier structure could also be utilized to soften the traditional "up or out" rule for talented associates who were not partnership material but nonetheless added value to the firm. With all these advantages, it was presumed that two-tier partnerships would be more profitable for equity partners and less prone to defections that could destabilize the firm.[11]

The powerful economic logic behind two-tier partnerships arguably accounts for its widespread adoption among large corporate law firms. Since 1994, when *The American Lawyer* first began tracking single-tier versus two-tier law firm status,[12] the number of two-tier firms in the Am Law 100 has expanded from forty-four (in 1994) to seventy-seven (in 2003).[13] Of the eighty-nine law firms that appeared on the rankings in both years, twenty-five of forty-nine single-tier firms (51%) switched to the two-tier format by 2003.[14] Similarly, among the fifty-nine single-tier firms that appeared on the Am Law 200 in both 1999 and 2004,[15] twenty-two (36%) switched to the two-tier format during the five-year observation period.[16] At present, 158 Am Law 200 law firms (79%) have a nonequity partnership tier.[17] Further, within this elite cohort, the proportion of nonequity partners is increasing approximately three times faster than the proportion of equity partners.[18]

With a massive migration toward the two-tier structure, the logical inference is that this partnership model, all else equal, offers superior profitability for the lawyers who own and control the firm—the equity partners.[19] However, a careful examination of the Am Law

---

11. *See infra* Part I.D.

12. Under the definition utilized by *The American Lawyer*, a two-tier partnership has a class of lawyers whose income is not primarily determined by the firm's profits. A shorthand for a two-tier partnership is whether less than 100% of the partners receive a Schedule K-1 for tax purposes. *See* Alison Frankel, *Am Law 100: Veil of Tiers*, AM. LAW., July 2004, at 92, 93.

13. Author's calculations based on data published in the July 1995 and July 2004 issues of *The American Lawyer.*

14. *Id.*

15. In 1999, *The American Lawyer* expanded its rankings (based on gross firm revenues) from the top 100 to the top 200. Since that time, the Am Law 100 has been reported in the magazine's July issue and the Am Law 101 to 200 has appeared in the August issue.

16. Author's calculations based on data published in the July and August 1999 and the July and August 2004 issues of *The American Lawyer.*

17. *Id.*

18. Frankel, *supra* note 12, at 92.

19. Among law firms in the Am Law 200, PPP has emerged as the primary measure of a firm's relative performance. *See, e.g.*, Brenda Sandburg, *The New Math*, RECORDER, Apr. 27, 2004, at 1 (noting that "per-partner profits—or PPP—still stand as a sort of shorthand for a law firm's status"). PPP is defined as the firm's net income divided by the

200 marketplace suggests a much more complex and nuanced story. Drawing upon a comprehensive dataset assembled from a variety of published sources, this study presents five significant findings on single-tier versus two-tier partnerships:

(1) Profitability. After controlling for market segment (as defined by the percentage of lawyers working in New York City and major global cities),[20] single-tier partnerships appear to be significantly more profitable than two-tier partnerships.[21]

(2) Leverage. The higher level of profitability of single-tier partnerships cannot be explained by higher leverage.[22] In the four market segments analyzed in this study, single-tier partnerships have, on average, *lower* leverage than two-tier partnerships.[23]

(3) Prestige. The higher profitability of single-tier firms appears to be a function, at least in part, of their superior reputation among high-end corporate lawyers.[24] In a multivariate regression model that controlled for market segment and leverage, law firm prestige is a highly significant predictor of law firm profitability. Further, in a logistic regression model, it appears that highly prestigious law firms are much more likely to utilize the single-tier structure, even after controlling for firm size, profitability, and market segment.[25]

(4) Partnership Tournament. The two-tier structure appears to give rise to a less rigorous "promotion-to-partnership tournament,"[26]

---

number of equity partners within the firm. *See* Frankel, *supra* note 12, at 92–93 (noting that *The American Lawyer* defines an equity partner as a partner who receives more than half of his or her compensation from firm profits or receives a Schedule K-1 for tax purposes).

20. I defined market segment according to the proportion of lawyers working in New York and various global cities because this definition consistently produced the strongest correlation with PPP. *See infra* Part II.B.2.

21. *See infra* Part III.A.

22. This study uses the same definition of leverage as *The American Lawyer*. *See, e.g.*, *Guide to Our Methodology*, AM. LAW., July 2005, at 109 (defining leverage as "the ratio of all lawyers to equity partners"); *Leverage Leaders*, AM. LAW., July 2004, at 93 (defining leverage as "the number of equity partners divided by the firm's total head count"). For an in-depth discussion of why this study employs this definition, see *infra* Part II.B.3.

23. *See infra* Table 6 and accompanying text.

24. The importance of examining a demand-side explanation was originally suggested to me by Professor David Wilkins. Without controlling for prestige, which presumably generates higher and more inelastic demand for a firm's services, a researcher might incorrectly conclude that the single-tier structure (which highly correlates with prestige) is a primary determinant of law firm profitability. I am greatly indebted to Professor Wilkins for this insight.

25. *See infra* Parts III.A–B.

26. The promotion-to-partnership tournament is a concept originally popularized by Professors Galanter and Palay in their famous 1991 study, *Tournament of Lawyers*. *See* GALANTER & PALAY, *supra* note 1, at 100–02.

which could undermine firm profitability. Associates in single-tier firms bill, on average, 1.8 hours more per week than their two-tier counterparts and are less likely to perceive a long-term future with the firm.[27] These differences are corroborated by regression results that suggest that (a) leverage is associated with a larger positive profit gain in single-tier firms, and (b) lower attrition is associated with a significant negative effect on profits per partner ("PPP") in two-tier firms.[28]

(5) Strategy. Based on a ten-year (Am Law 100) longitudinal sample, and controlling for market segment and relative starting position, there is modest statistical evidence that switching to the two-tier format is associated with higher PPP. The expansion of the nonequity track relative to the equity tier is also associated with a slight increase in profitability. The ability to exploit this relationship, however, may be a function of prestige.[29]

Drawing upon these results, this study suggests a relatively simple theory of law firm structure. Specifically, the two-tier partnership structure appears to operate primarily as a competitive strategy utilized by less prestigious law firms that lack a significant base of large, price-insensitive clients. In an environment in which corporate clients are increasingly loyal to individual lawyers rather than firms, rainmaking partners with "portable" business must be compensated at or near their marginal product. Within this market space, a single-tier structure is likely to be too inflexible to apportion profits and management decisions among a single class of partners with widely differing economic contributions to the firm. Hence, in order to retain its most valuable partners, a law firm effectively bonds itself to a marginal product approach by adopting a two-tier or multi-tier structure,[30] which serves to consolidate power in the equity tier. The uneven financial performance of firms that switch to the two-tier format suggests that the primary economic benefit may be firm stability (or survival) rather than higher average profits for the majority of equity partners.

In contrast, single-tier firms in the Am Law 200 generally have higher levels of firm-specific capital,[31] which confers significant benefits in terms of client demand and associate recruitment. As a result, partners at highly profitable single-tier firms lack the incentive,

27. *See infra* Table 11 and accompanying text.
28. *See infra* Part III.C.
29. *See infra* Part III.D.
30. For a discussion of the marginal product approach, see *infra* Part I.A.
31. For a discussion of firm-specific capital, see *infra* Part I.A.

and possibly the ability, to grab their full marginal product by leaving (or threatening to leave) the firm. Further, the high profits and client loyalty of this sharing model can reinforce beneficial intra-firm incentives for efficient, high quality legal work that further solidifies a firm's reputation.[32] The upshot is that the financial benefits of tier-structure, including the type and degree of leverage a firm can employ,[33] vary according to a firm's relative position in the marketplace for high-end corporate legal services.

This study is organized in four parts. Part I reviews the academic and law firm consulting literature on law firm structures to highlight useful conceptual differences between single-tier and two-tier law firms. Part II summarizes the dataset and outlines the theoretical significance of the study's principal independent variables. Part III presents four sets of findings: (1) differences between single-tier versus two-tier firms on the dimensions of profitability, leverage and prestige; (2) logistic regression results showing that firm prestige is the single best predictor of tier structure; (3) linear regression results demonstrating that determinants of profitability, including the promotion to partnership tournament, are significantly different in single-tier versus two-tier firms; and (4) linear regression results suggesting a modest statistical relationship between tier structure and growth in law firm profits. Finally, drawing upon these results, Part IV presents a unified theory of single-tier versus two-tier firms and discusses the implications and limitations of this study, including an important caveat on the heterogeneous nature of two-tier partnerships.

32. For a discussion of the sharing model, see *infra* Part I.A.

33. A firm can increase leverage by either increasing the firm's proportion of associates, nonequity partners, or both. *Cf.* Peter Giuliani, *How and Why To Create a Two-Tier Partnership*, AM. LAW., May 1990, at 28 (law firm consultant noting that "the best compensation system for second-tier partners will enable the firm to *retain the advantages of leverage* but also reward exceptional individual performance" (emphasis added)). However, a less prestigious firm may have to rely disproportionately on nonequity partners because it will be unable to recruit high quality associates if it attempts to run a highly leveraged up-or-out tournament. Fairly liberal promotions to nonequity partner, although relatively expensive, may be an important recruitment and retention tool. *But see* Robert Dolinko, *A Comment on Professor Henderson's Empirical Study of Single-Tier Versus Two-Tier Partnerships in the Am Law 200*, 84 N.C. L. REV. 1753, 1754 (2006) (arguing that the expansion of a nonequity tier is driven by a mixture of economic and noneconomic factors and suggesting that partner-associate ratio is a more telling measure of leverage). For an in-depth discussion of leverage and how it is defined for the purposes of this study, see *infra* Part II.B.3.

I. LITERATURE REVIEW

The literature on law firm partnership structure includes both academic articles and trade publications authored primarily by law firm consultants. Both genres are useful for constructing a conceptual framework of single-tier versus two-tier law firms. Part I has four sections. Section A reviews the important theoretical work of Gilson and Mnookin.[34] Section B summarizes the findings (and limitations) of Samuelson's and Jaffe's empirical work on law firm profitability.[35] Section C provides historical background of the rise of the two-tier model, including terminology commonly used by law firm consultants and managing partners. Finally, Section D discusses the intended, and the potentially unintended, incentives created by a two-tier system.

A. Gilson and Mnookin

In a well-known 1985 article in the *Stanford Law Review*, Professor Gilson and Professor Mnookin utilized portfolio theory to argue that the large law firm was primarily a device for capturing the economic benefits of legal specialization while diversifying away the concomitant risks.[36] Specifically, a lawyer can render more sophisticated and efficient (and hence more lucrative) legal services if she develops a narrow practice area. But the higher expected payoff of specialization also exposes the lawyer's income to fluctuations in the business cycle. Gilson and Mnookin argue that the large general service law firm provides an optimal solution because it facilitates several intra-firm practice areas with offsetting peaks and valleys, such as securities and bankruptcy law.[37]

---

34. *See* Ronald J. Gilson & Robert H. Mnookin, *Coming of Age in a Corporate Law Firm: The Economics of Associate Career Patterns*, 41 STAN. L. REV. 567, 567–68 (1989) [hereinafter *Associate Career Patterns*] (using economic theory to explain variations in the traditional "up or out" partnership decisions among various large corporate law firms); 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 (1985) [hereinafter *Profit Sharing*] (outlining a theory of profit sharing among partners in corporate law firms).

35. *See* S.S. Samuelson & L. J. Jaffe, *A Statistical Analysis of Law Firm Profitability*, 70 B.U. L. REV. 185 (1990) [hereinafter *Law Firm Profitability*]. The results of this study are also reported in Chapter 7 of Professor Samuelson's treatise on law firm management. *See* Susan S. Samuelson & L. J. Jaffe, *Success and Failure* [hereinafter *Success and Failure*], *in* LAW FIRM MANAGEMENT: A BUSINESS APPROACH § 7 (Susan S. Samuelson ed., 1994) [hereinafter LAW FIRM MANAGEMENT].

36. *See Profit Sharing*, *supra* note 34, at 327–29.

37. *Id.* (providing example of how a securities specialist and a bankruptcy specialist can diversify away risks in the business cycle). *But see* ROBERT L. NELSON, PARTNERS

However, as Gilson and Mnookin acknowledge, the lynchpin of this diversification-of-risk model is the partners' agreement ex ante to share profits with one another in good times and in bad. Drawing upon economic agency theory, Gilson and Mnookin caution that the potentially large gains from cooperation can be thwarted by three types of opportunistic behavior: (1) partners "shirking" their duty to be a fully productive member of the firm; (2) partners "grabbing" a higher percentage of firm profits by threatening to depart; and (3) partners "leaving" the firm with their clients and business in tow.[38]

According to Gilson and Mnookin, the division of law firm profits falls on a continuum between a "sharing model" based on partner seniority and a "marginal product model" based on each partner's individual contribution.[39] Although Gilson and Mnookin do not explicitly address the formal structure of law firm partnerships, the economic principles of each model essentially track the division between single-tier and two-tier firms. For example, the authors cited three well-known law firms—Cravath, Swaine & Moore; Covington & Burling; and Wilmer, Cutler & Pickering—as examples of the sharing model because each "remained committed to essentially 'lockstep,' seniority based compensation systems."[40] Realistically, this type of sharing model can only exist in a single-tier law firm; and, not surprisingly, all three firms are (and have been) categorized in the annual *American Lawyer* ranking as single-tier partnerships.[41] In contrast, the adoption of the two-tier structure clearly signals to lawyers within the firm that there are criteria beyond a partner's tenure with the firm (e.g., development and control of lucrative clients) that will be relied upon to allocate profits.[42]

WITH POWER: SOCIAL TRANSFORMATION OF THE LARGE LAW FIRM 64–65 (1988) (noting that extensive interviews with dozens of partners at four large Chicago firms failed to provide any significant support for Gilson and Mnookin's theory that firms had grown to diversify away risks associated with specialization).

38. *See Profit Sharing*, *supra* note 34, at 321, 335–39.

39. *Id.* at 321, 348–49, 352–53, 356.

40. *Id.* at 341. Note that Wilmer, Cutler & Pickering recently merged with another large firm. *See* Lily Henning, *Wilmer Cutler, Hale & Dorr To Merge*, LEGAL INTELLIGENCER, Apr. 20, 2004, at 4. It currently operates as WilmerHale.

41. The tier structure is reported each year in table format in the magazine's annual rankings issues. *See supra* note 15.

42. *Cf.* HEINTZ & MARKHAM-BUGBEE, *supra* note 8, at 5 tbl.2, 25, 50–55 (law firm consultants summarizing five approaches to two-tier partnerships with four of them requiring equity status for partner participation, and the fifth requiring the firm to scuttle profit division principles based on seniority in favor of "income levels consistent with [each partner's] level of contribution").

The parallels between the sharing versus marginal product models and the single-tier versus two-tier structure are also evident in Gilson's and Mnookin's observations of the traditional "up or out" approach to partnership. The authors note that "[t]he values of a sharing model may not allow for a second class of law firm citizen,"[43] whereas "a productivity model, which necessarily contemplates a number of classes of citizens, should find the phenomenon [of retaining associates who are not qualified for partnership] less troublesome."[44]

In evaluating both the sharing and marginal product models, Gilson and Mnookin acknowledge that the sharing approach can deaden incentives and lead to the problem of shirking.[45] Yet, the authors argue convincingly that the marginal product model, because it cannot precisely quantify all dimensions of a lawyer's contribution to the firm, also opens the door for perverse incentives that can undercut a firm's efficiency, service quality, and profitability. For example, if a partner's compensation is pegged to the amount of work her clients provide the firm, he or she may thwart interactions between the client and other partners in the firm—even those with valuable specialized knowledge—in order to block any potential intrusion on his or her business origination credits.[46] Similarly,

---

43. *See Profit Sharing*, *supra* note 34, at 379.

44. *Id.* at 379 n.113. The authors go on to observe that the increasing interest in the productivity model "should lead to renewed interest in the idea of permanent associates," and if the title of partner has any importance independent of profit sharing, "it would be foolish not to call them partners and simply continue to pay them less." *Id.*

45. *Id.* at 340 & n.46 (citing sources reflecting "a growing consensus among consultants and academics that sharing-oriented systems are the worst, and that a partner's share should depend primarily upon his productivity"); *cf.* Berne Rolston, *Improving Techniques of Partner Selection and Compensation*, LEG. ECON., Jan.-Feb. 1988, at 38, 40 ("The day of the 'retired partner in place at age 40' . . . is gone . . . . Every 'owner' therefore must be compensated . . . to a greater extent in proportion to his or her contribution to the business.").

46. *See Profit Sharing*, *supra* note 34, 350–51. A recent article on the law firm of Patton Boggs, which permits partners to negotiate internally over origination credits, offers some insight into how such a system affects internal firm relations and ultimately client service. *See* Jason McLure, *Beyond Boggs*, LEGAL TIMES, Sept. 26, 2005, at 1 (noting that "[f]ormer 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" and quoting the firm's managing partner that "[o]ur system allows people to do the wrong thing"); *see also* Edward A. 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 the ABA ethical rules should be amended to "require[ ] that all law firms disclose their partner compensation systems to clients as a matter of course").

notwithstanding who originated the business, the lawyers who actually perform the work may engender considerable client trust and loyalty. If this contribution is not properly rewarded at its marginal product, the firm is once again vulnerable to grabbing and leaving.[47]

Gilson and Mnookin ultimately conclude that the sharing model can, in theory, be "more productive than a marginal product approach."[48] However, this conclusion was based on the authors' belief that the agency problems of grabbing and leaving could be curtailed by the creation of firm-specific capital—i.e., capital "that a departing lawyer cannot easily take ... with him or duplicate ... outside the firm."[49] They specify two sources of firm-specific capital. The first is the institutional knowledge of the client's business, which is typically developed over a period of years. This situation provides the incumbent firm with an inherent cost advantage and imposes costs on a client who might otherwise be inclined to price shop. The second source of firm-specific capital is the firm's general reputation for quality work, which might be signaled by (a) its existing base of sophisticated and prestigious clients[50] or (b) a large number of firm partners who author law review articles and treatises or participate in professional panels in their areas of expertise.[51]

The primary competitive advantage conferred by firm-specific capital, according to Gilson and Mnookin, is that clients are attracted to the *firm* rather than its individual lawyers. Further, to reduce the attendant uncertainty regarding their most serious legal problems, these clients are willing to pay a premium for access to the firm's lawyers. The upshot is that in a sharing firm with copious amounts of firm-specific capital, partners have less ability to grab and less incentive to leave. This equilibrium would explain the remarkable

---

47. *See Profit Sharing*, *supra* note 34, at 352; *see also Success and Failure*, *supra* note 35, § 7.4.2.2 ("While it is easy to say that [partner] compensation is determined by contribution, it is harder to implement. Even partnerships that use the performance-based approach suffer from defections and breakups.").

48. *See Profit Sharing*, *supra* note 34, at 353.

49. *Id.* at 356.

50. *Id.* at 360–62. This information is now actively aggregated by the legal press. *See, e.g*, *The NLJ Client List—Who Represents Corporate America*, NAT'L L.J., Sept. 12, 2005, at 51 (listing outside counsel to the 250 largest publicly-held corporations in the United States).

51. *See Profit Sharing*, *supra* note 34, at 364. Although this might be an effective strategy for an individual lawyer to build his or her reputation and client base, Gilson and Mnookin suggest that a firm might be willing to make an institutional commitment to these types of activities in order to burnish the *firm's* reputation. *See id.* at 365 n.89 (discussing how client seminars can be used to showcase "the firm's services rather than ... the talents of a particular lawyer").

profitability and stability of lockstep firms such as Cravath, Swaine & Moore. Based on the firm's towering profitability figures as reported in *The American Lawyer*, Gilson and Mnookin express doubt that Cravath's partners could make more money somewhere else. "In other words," the authors note, "there is plenty of firm-specific capital to 'glue' the partnership together."[52] Further, the problem of partner shirking is constrained by a careful and prolonged socialization and vetting process for partner that begins by recruiting only super-achievers from the nation's elite law schools.[53] Of course, as Gilson and Mnookin acknowledge, superior profitability is not an attribute of the sharing model per se. Rather, the firm must begin with a critical mass of firm-specific capital—e.g., large institutional clients and firm prestige—in order to make the model self-sustaining.[54]

For the purposes of this study, Gilson's and Mnookin's work generates two relatively straightforward hypotheses. First, assuming that the single-tier firm is more likely to fit the sharing model, and that two-tier firms more closely track the marginal productivity approach, we would expect to observe a relatively small cohort of single-tier firms with superior profitability. Second, these single-tier firms will most likely have a superior reputation vis-à-vis their two-tier competitors.

B. Samuelson and Jaffe

The only published large-scale empirical study of law firm profitability is a 1990 article in the *Boston University Law Review* by Professor Samuelson and Professor Jaffe.[55] The study drew upon an

---

52. *See id.* at 356.

53. *See id.* at 375–80. Elite single-tier law firms may, in fact, do a better job than most at eliminating the potential of shirking through careful selection. For example, at Cravath, Swaine & Moore, admission to the partnership requires a unanimous vote of the partnership. *See Part I: The Meaning of Partnership in 1996, in* Supplement: Partnership Retreat Notebook, AM. LAW., June 1996, at 8 [hereinafter *Meaning of Partnership*].

54. *See Profit Sharing, supra* note 34, at 381 ("[O]ur analysis suggests a paradox: 'Sharing' enhances the success of successful firms with substantial firm-specific capital while contributing to the instability of less successful firms without much firm-specific capital.").

55. *See Law Firm Profitability, supra* note 35. The results of this study are also reported in Chapter 7 of Professor Samuelson's treatise on law firm management. *See Success and Failure, supra* note 35. Two articles published in *The American Lawyer* during the 1990s reported the results of regression analysis with PPP serving as the dependent variable. *Compare* David H. Maister, *Where the Profits Come From*, AM. LAW., Sept. 1993, at 39 (finding that presence in New York City has a major determinant of law firm profitability in the Am Law 100 and that law firm size is "zero factor"), *with* Kyle Chadwick & Ramsey Hanna, *Predicting Profitability*, AM. LAW., July–Aug. 1994, at

impressive dataset assembled by Price Waterhouse for the purpose of providing consulting services to its law firm clients. The sample, which contained 219 law firms, was based upon a twenty-five-page questionnaire to be completed by "someone in the [law] firm with access to the most confidential information (such as net income figures for each partner and salary information for each associate)."[56] Although some of the firms were relatively small by contemporary standards (e.g., one-third had less than sixty-four lawyers), the authors reported that sixty of the nation's sixty-eight largest law firms were participants in the study.[57] Because participation in the study was voluntary, Samuelson and Jaffe acknowledge that their sample probably contains a self-selection bias in favor of larger, more profitable law firms that could afford the services offered by Price Waterhouse and would generally welcome a comparison with their peers. To increase the response rate, firms were promised confidentiality as a condition of their participation.[58]

The primary research question of the study was to determine what firm characteristics were associated with higher firm profitability. The dataset included several useful variables, such as firm size, the number of hours billed by associates and partners, billing rates, partner compensation (i.e., lockstep versus marginal product basis), location in New York City, and size of non-legal staff.[59] Samuelson and Jaffe also coded for "tall" organizational structures, which included classification for lawyers beyond the traditional partner-associate distinction, such as "non-equity partner," "permanent associate," "junior partner," "senior attorney," and "participating associate."[60] Thus, under their methodology, a two-tier law firm would be coded as "tall." Among other hypotheses,

63 (reporting that law firm size, after controlling for number of branch offices, is correlated with higher firm profit; also finding that, all else equal, profitability is associated with fewer female attorneys and more partners from top-tier schools). In addition, it is likely that law firm consultants have amassed statistical evidence on which types of law firm structures result in higher profitability. However, we would expect such reports to be recycled and sold to numerous clients rather than published in a law journal article—i.e., given away for free.

56. *Law Firm Profitability*, *supra* note 35, at 199.

57. *Id.* at 199.

58. *Id.* at 199–200.

59. *Id.* at 193–98, 201–03. The data, which were collected in 1985 and 1986, also included the number of computer workstations. Although technology is still likely to be a source of competitive advantage, the low cost of PCs and ubiquity of Internet connectivity probably renders this variable irrelevant.

60. *Id.* at 197, 202.

Samuelson and Jaffe theorized that "the new 'tall' model generates more profits than the traditional 'flat' one."[61]

Using multivariate linear regression analysis with PPP as the dependent variable,[62] Samuelson and Jaffe identified several significant relationships. For example, the number of hours billed by associates and partners was a strong determinant of profitability, as was the size of the non-legal staff. Location in New York City was the only geographic variable associated with higher PPP. The number of associates was also associated with higher profitability, while the number of partners had a negative effect. These findings, as the authors noted, suggest that firm size and leverage, as well as admission to partnership, are relevant determinants of firm profitability.[63]

In terms of the single-tier versus two-tier distinction, the study found no significant relationship between tall organizational structures and higher profitability. One of the limitations of the Samuelson-Jaffe study, however, is that it is unclear whether the authors distinguished between equity and nonequity partners when they calculated their dependent variable. Thus, insofar as nonequity partners are functionally the same as senior associates (i.e., their compensation is not primarily a function of firm profits), and total partners were included in the denominator of the PPP calculation, the profitability of two-tier partnerships for the true owners of the firm (i.e., the equity partners) was probably underestimated. Similarly, the study also found that the lockstep compensation system was associated with higher profitability. Yet, because the study had no control variable for reputation or prestige, it remains unclear whether lockstep compensation per se contains incentives that foster long-term profitability, or, as Gilson and Mnookin suggest,[64] whether only highly profitable and prestigious firms have sufficient firm-specific capital (i.e., reputation) to make lockstep compensation a stable and prosperous long-term strategy.

---

61. *Id.*

62. *Id.* at 201 & n.79.

63. *Id.* at 204–09 & tbl.2. Samuelson and Jaffe had independent variables for firm size and partner-associate ratio ("leverage"). However, when included in the same regression as number of partners and number of associates, both variables had no statistical significance. Obviously, firm size and number of associates and partners are highly co-linear with each other. Yet, because the authors' sample contained many smaller firms, which would presumably be disadvantaged by a smaller pool of specialized talent, there appeared to be a reasonable theoretical basis for including all of these variables in the model. The authors note that both firm size and leverage are "subsumed by other measures of size." *Id.* at 204.

64. *See supra* note 54 and accompanying text.

The dataset assembled for this study has strengths and weaknesses compared to the Price Waterhouse dataset utilized by Samuelson and Mnookin. The most significant improvement is that PPP are clearly defined as profits per *equity* partner. In addition, I have included variables for firm prestige.[65] The division between single-tier and two-tier firms roughly tracks the distinction between "flat" and "tall" law firms. However, in my dataset, a tall law firm with one class of partners and multiple classes of nonpartner lawyers (e.g., associate, permanent associate, of counsel) is coded as single-tier. The major advantage of the Price Waterhouse data was the coding for lockstep compensation. Presumably there are some single-tier firms that still utilize this sharing approach based purely on seniority.[66]

C. Advent of the Two-Tier Structure

As noted earlier, a steady number of Am Law 200 law firms continue to make the transition from single-tier to two-tier (or multi-tier) partnerships.[67] At first glance, this longstanding trend might suggest that two-tier partnerships represent a relatively new management innovation that is destined to eventually replace the traditional single-tier model. Although its adoption has varied

---

65. *See infra* Parts II.A. & II.B.5.

66. *See, e.g.*, *Meaning of Partnership*, *supra* note 53, at 13 (reporting detailed 1996 survey of partnership characteristics among Am Law 100 firms and noting that four highly profitable and prestigious firms among the seventy respondents still used the lockstep model).

67. *See* Frankel, *supra* note 12, at 92 (noting that "[j]ust 23 Am Law 100 firms have only one partnership tier, compared to 55 in 1994, the year we first began tracking nonequity partnership"); *see also* Vanessa Blum, *On the Way, but Not There Yet; Firms Are Making Greater Use of Nonequity Positions in Promotions*, LEGAL TIMES, Jan. 17, 2000, at 27 (reporting that in 1999, "62 of the highest grossing U.S. firms reported using some kind of multitier partnership structure—up from just 34 in 1991"); Giuliani, *supra* note 33, at 28 (commenting in 1990 that "[i]n the past decade 21 of 77 of the nation's largest firms surveyed by *The American Lawyer* introduced a second tier; 42 of those 77 firms . . . now have at least two types of partners").

considerably by geographic market,[68] the two-tier partnership has, in fact, been utilized by many law firms for decades.[69]

At least initially, the rationale for two-tier partnerships was relatively consistent. In contrast to Galanter and Palay's paradigmatic "promotion-to-partner tournament," which described a seven- to ten-year process of vetting associates that ended with a single "up-or-out" vote for partnership,[70] the early two-tier partnerships essentially operated as a two-stage tournament.[71] In stage one, which lasted approximately six years, associates who demonstrated sufficient work ethic and technical proficiency were rewarded with nonequity partnership. In stage two, which took two or more years to complete, lawyers were given the opportunity (aided by the title of "partner") to demonstrate their ability to attract clients and legal work to the firm. But similar to single-tier partnerships, the

68. *See, e.g.*, Bradford W. Hildebrandt & Jack Kaufman, *Two-Tier Partnerships: A New Look*, NAT'L L.J., Jan. 8, 1990, at 19 (noting that a "substantial number of firms—particularly in Chicago, Boston, Washington, D.C., and Los Angeles—adopted this [two-tier] system years ago"); Thom Weidlich, *The Legal Field Sees a Glimmer of Recovery*, NAT'L L.J., Sept. 27, 1993, at S2 (quoting the managing partner of Chicago-based Winston & Strawn, "We've had a two-tiered partnership for 20 years. It's the exception, not the rule, on both coasts, but it's reasonably prevalent in Chicago"; quoting the co-chair of Ross & Hardies, "We don't have an up-or-out system [a hallmark of the single-tier model] as many of the New York firms do").

69. For example, in 1983, Hildebrandt, Inc., a renowned specialist in law firm management, reported "many firms throughout the country have had two-tier partnerships for years, though neither the general public nor the legal community seems to be aware of this. The concept is not new, just the publicity." Brad Hildebrandt & Jack Kaufman, *The 'Two-Tier' Partnership: A Solution to the Shrinking Pie?*, NAT'L L. J., Nov. 28, 1983, at 14. As evidence that the legal climate was in a period of change, the authors commented that on "75 percent of our recent consulting assignments we have been asked what we know and think about two-tier partnerships .... Many stress that they are merely curious, and would never use one of these approaches. But they are nevertheless beginning to ask." *Id.*

70. GALANTER & PALAY, *supra* note 1, at 100–02 (discussing how the prestige and profits conferred by partnership entices young associates to engage in a grueling and uncertain battle for promotion). Although Galanter and Palay briefly note the trend toward two-tier partnerships, *see id.* at 58, the bulk of their analysis suggests a single one-stage tournament.

71. As one law firm consultant observed in 1990, the wave of new two-tier partnerships represented a departure from the two-tier model. "In many of the older two-tier partnerships, the income or non-equity partner classification was a step in the progression towards becoming an equity partner. In the new form of two-tier partnership, however, non-equity partner usually becomes a permanent position, and that lawyer is never considered for equity partnership." Robert W. Denney, *A New Two-Tier Idea*, NAT'L L.J., Sept. 24, 1990, at 13.

early two-tier model often culminated in an up-or-out vote for promotion to equity partner.[72]

However, since the mid-1980s, many Am Law 200 law firms have implemented two-tier or multi-tier partnership structures that attempt to optimize their human capital, and therefore their long-term profitability and stability, by stratifying lawyers according to their abilities and workplace expectations. For example, law firm consultant Thomas Clay advises clients that there are five types of partners:

- *Entrepreneurial leader*: Consistently keeps multiple partners, associates and paralegals busy, often in many practice areas. His or her presence drives the firm brand, transitioning relationships to others and creating deeper, broader relations with clients. These partners are very rare [and the most valuable].

- *Business-generating partner*: Capable of staying busy and keeping one to three others busy on a consistent basis with their own business and growing existing client relationships cultivated by others.

- *Self-sufficient partner*: Someone who keeps busy but usually gets a portion of work from others and manages to export a portion of work to others. He or she leverages equally the firm's brand and his or her personal market presence for marketing.

- *Service partner*: Usually a sophisticated lawyer and client manager who can manage a service delivery team but does not generate a significant volume of work on his or her own. This type of partner would not meet the test for self-sufficiency.

- *Technical specialist partner*: A sophisticated problem-solver who is often uncomfortable with the social

72. *See* Hildebrandt & Kaufman, *supra* note 68, at 19 (describing structure and mechanics of traditional two-tier structure and noting, in 1990, that "[u]ntil recently, income [i.e., nonequity] partnership was not considered to be a permanent position"); H. Edward Wesemann, *The Nonequity Tier: Firms May Create Long-Term Problems by Putting People in 'Limbo'*, LEGAL TIMES, Feb. 3, 2003, at 40 (noting that until recently, "few firms have spent time fretting about documenting what it means to be a nonequity partner because it was only meant to be a transitionary classification").

> aspects of client interaction. This person will generally not lead a legal team but may lead a project team on a specific legal issue.[73]

Clay suggests that the proper delineation of equity and nonequity partners tracks the divide between business generators and "partners that fit into the category of self-sufficient, service or technical specialist partners."[74]

D. Intended and Unintended Incentives in Two-Tier Firms

On one hand, the movement toward the two-tier format may be viewed by some associates as an attempt by powerful partners to hoard firm profits.[75] However, many law firm consultants and managing partners argue that most associates welcome the opportunity and flexibility of a properly structured two-tier system. For example, lawyers who have demonstrated sufficient productivity and technical skills to warrant promotion to nonequity partner now have the title and the institutional support to focus on business development.[76] Conversely, some associates welcome the relative security and reduced professional demands of nonequity status.[77]

73. Jeff Blumenthal, *Bitter Medicine: Law Firms in a Squeeze Increasingly Take Difficult Step of Turning Equity Partners into Nonequity Partners*, BROWARD DAILY BUS. REV. (S. Fla.), Dec. 9, 2002, at A9.

74. *Id.* The same article quotes the chairman of Duane Morris, an Am Law 200 firm, "I think nonequity partners fill a very important role at a firm. You need business generators, but you also need people to do the work." *Id.*

75. *See, e.g.*, Jeff Blumenthal, *Two-Tier Partnership Finds a Place in Philly*, LEGAL INTELLIGENCER, Oct. 29, 1998, at 1 (quoting a law firm partner, "I think [the two-tier structure] would interfere with the spirit we're trying to engender . . . . The only reason to do that is pure economics, and I think that's selfish. If a young attorney earns the recognition, partnership should be willing to share the wealth.").

76. *See., e.g.*, Blum, *supra* note 67 (quoting R. Bruce McLean, firm chairman of Akin Gump Strauss Hauer & Feld, "[The two-tier system] gives our young lawyers the tools to go into the marketplace and develop business" and that "to the outside world, Akin Gump's 'income' and 'capital' partners are indistinguishable."); Blumenthal, *supra* note 73 (quoting Gregory Jordan, chairman of Reed Smith, "[By promoting them to nonequity status], we give them the tools of partnership to grow their practice . . . . We don't have an up or out approach with nonequity partners, so it's not necessary that they be business-getters at that stage.").

77. *See, e.g.*, Giuliani, *supra* note 33, at 30 (noting in 1990 that "[i]n several surveys of large firms more than 75 percent of associates said they believed that a two-tier partnership was inevitable at their firms and that it was a highly desirable innovation" because it offered an alternative to high quality lawyers who were unwilling to make the personal sacrifices required under the traditional up or out single-tier system); Hildebrandt & Kaufman, *supra* note 68 (noting that the "income partner" track is likely perceived by some associates "as a possible career alternative or lifestyle choice" that may "help recruiting rather than hinder it").

Hildebrandt consultant Larry Bright is quoted as saying that a two-tier partnership structure allows a firm to "keep the good people while controlling the pot .... Most second-tier partners make, not a stratospheric income, but a handsome living. And it enables the firm to keep people who are good lawyers but don't want to sacrifice their personal lives in order to make partner."[78]

In addition to the perceived flexibility of the two-tier structure, the nonequity track can be used as a management tool to prune the partnership of unproductive equity members. Especially during economic downturns, the promotion-to-partnership tournament can actually work in reverse, as pressure builds within two-tier firms to quietly demote (or de-equitize) unproductive equity partners to the nonequity level.[79] Indeed, there is some empirical evidence that a perpetual tournament involving both associates *and* partners has begun to emerge.[80] As shown in Figure 1, data from Altman Weil's 2004 *Survey of Law Firm Economics* suggests that the number of billable hours by law firm associates has, contrary to popular perceptions, remained remarkably stable between 1985 and 2003 at 1,850 hours.[81] Yet, the average number of hours worked by partners in their twenty-fifth to twenty-ninth years (nonequity and equity combined) has steadily risen from 1,538 to 1,703.[82] Since 1997, the average number of billable hours by these lawyers has consistently been above 1,700.[83] It is certainly possible that higher billable hours logged by partners can be explained by two factors: (a) the growing ranks of nonequity service partners, who earn their keep by billing

78. Ronald J. Fleury, *Tier Partners: What's in a Name?*, N.J. L.J., Aug. 23, 1990, at 1, 22; *see also* Matt Fleischer-Black, *Indiana Firm Reconsiders Nonequity Tier*, THE RECORDER, Feb. 2, 2004, at 7 (quoting Hildebrandt consultant Joel Henning on the appeal of nonequity partnership, "It's a pluralistic profession today, with . . . people who have different levels of commitment to the practice. Thus, you have terrific lawyers who want to have good jobs with good firms, but are not interested in collections and debt structures.").

79. *See* Blumenthal, *supra* note 73 (reporting observation by legal recruiter from Major Hagan & Africa that the economic downturn in 2001 and 2002 has been accompanied by "an upswing in de-equitizations").

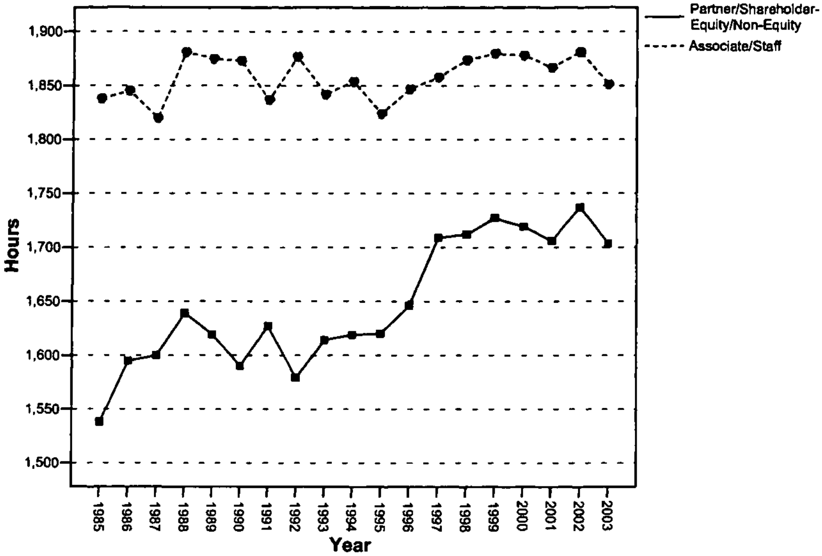
80. In his recent book, Professor Regan makes a similar observation. *See* MILTON C. REGAN, JR., EAT WHAT YOU KILL: THE FALL OF A WALL STREET LAWYER 37 (2004) (noting that the tournament within the firm "is not just for promotion to partner any more. It continues after partnership, as partners must compete for compensation, status, and continued employment.").

81. ALTMAN WEIL, THE SURVEY OF LAW FIRM ECONOMICS 138 (2004) (presenting tabular data in which fifth-year associates averaged of 1,838 hours in 1985 and 1,851 hours in 2003 with a peak of 1,881 hours in 1988 and 2002).

82. *Id.*

83. *Id.*

Figure 1: COMPARISON OF AVERAGE ANNUAL CLIENT (BILLABLE) HOURS FOR 25 TO 29 YEAR PARTNERS AND 5 YEAR ASSOCIATES



hours alongside associates; and (b) the growing specter of de-equitization, which mitigates the potential for shirking.

In general, law firm consultants and managing partners within the Am Law 200 marketplace readily concede that the movement toward two-tier partnerships has been driven by economic factors.[84] The perceived benefits of this structure fall roughly into four categories: (1) improved client service through lower lawyer attrition;[85] (2) an elongated evaluation period that reduces errors in promotion to equity partner;[86] (3) alignment of voting power with

84. *See* Fleury, *supra* note 78 (noting in 1990 that consultants and managing partners "agree that . . . the segregation of partners into tiers is motivated by purely economic considerations"); Hildebrandt & Kaufman, *supra* note 68 (noting in 1990 that in most cases, the decision to adopt a two-tier system is "driven by law firm economics").

85. *See, e.g.*, D.M. Osborne, *Latham Opts for Two Tiers*, AM. LAW., Jan.–Feb. 1996, at 13 (reporting that "[c]lients service concerns were the impetus for the partnership rejiggering at [Latham & Watkins]" and quoting Latham partner that "[c]lients are demanding that experienced people stay with them and that there not be a revolving door of junior and midlevel people on their accounts"); *see also* Jamie Heller, *Murtha, Cullina Forms Two-Tier Partner System to Keep 'Good Legal Technicians'*, CONN. L. TRIB., June 24, 1991, at 3 (reporting that large law firm in Connecticut adopted a two-tier structure "to retain lawyers who are excellent 'legal technicians' but whom the firm would not otherwise name equity partners").

86. *See, e.g.*, Giuliani, *supra* note 33, at 28 (asserting that one of the best reasons to adopt a two-tier partnership is "to give partners more time to evaluate" potential equity

economic contribution, which reduces the likelihood of rainmaker defections;[87] and (4) favorable market dynamics spawned by higher profits per partner, such as easier recruitment of lateral associates and partners and the ability to attract higher caliber law firms for potential mergers.[88] Regarding this last factor, law firms have essentially realized that PPP is a function of both the numerator (total firm profits) and the denominator (the number of equity partners).[89] In theory, two-tier partnerships should be highly profitable because this structure is explicitly designed to restrict the denominator to a small number of talented lawyers who are proven business generators.

Notwithstanding the perceived benefits of two-tier partnerships, law firm consultants also caution their clients that the creation of a nonequity tier can produce disastrous results if the structure is poorly designed or poorly executed. Law firm consultant H. Edward Wesemann notes that "[a]dvising a likable associate that she has been elected to nonequity partnership is certainly a less onerous task than telling her she has been rejected for equity partnership and must either remain an associate or leave the firm."[90] Thus, some law firm consultants contend that too many law firms that switch to the two-tier format neutralize potential benefits by promoting too many lawyers to the nonequity tier.[91]

The use of a nonequity tier to deal with unproductive equity partners also presents serious potential risks for a law firm. For example, rather than deliver an intended "wake-up" call, the client-service ethic of de-equitized partners may instead deteriorate, causing assigning partners to favor senior associates with comparable skill and

---

partners); Hildebrandt & Kaufman, *supra* note 68 (arguing that the "true value" of adopting a two-tier system is the opportunity to "raise the standards" for what it means to be an equity partner).

87. *See, e.g.*, Giuliani, *supra* note 33, at 30 (observing that "most firms that have created two-tier systems . . . want[ ] to prevent dilution of equity partner voting interests").

88. *See, e.g.*, Blumenthal, *supra* note 73, at 9 ("Firms want the good public relations that go along with high PPP. It helps with recruiting both lateral partners and upper-echelon, entry-level talent as well as retaining key personnel."); Wesemann, *supra* note 72 (reporting the increasing importance of PPP for recruitment and mergers).

89. Wesemann, *supra* note 72; *see also* Blum, *supra* note 67 ("It's simple mathematics. Remove from the total a firm's more junior partners—who tend to take home a smaller piece of the pie—and the average will jump.").

90. Wesemann, *supra* note 72.

91. *Id.* (discussing tendency toward overly liberal promotion policies in two-tier firms); *see also* Blumenthal, *supra* note 75, at 1 (quoting Altman Weil consultant Thomas Clay, "Too many firms . . . use the [two-tier] system to avoid making tough decisions about the professional futures of borderline associates. The result . . . is that firm managers often promote associates who are not worthy of the distinction to partner.").

a more responsive attitude. Thus, as their work dries up, they become a pariah with no realistic prospect of making a substantial contribution to the firm.[92]

In summary, the two-tier (or multi-tier) partnership model offers a theoretically coherent and appealing basis for producing a more stable and profitable law firm. Yet if a law firm's management does not adequately comprehend and safeguard against the potential pitfalls, the two-tier system may create a set of deleterious incentives that may undermine rather than enhance a firm's long-term profitability.[93] Fortunately, the dataset assembled for this study permits us to more closely examine these possibilities.

II. SUMMARY OF DATA AND METHODOLOGY

This study uses descriptive statistics to delineate statistically significant differences between single-tier and two-tier firms. Drawing upon these results it then uses multivariate regression analysis to: (a) examine what factors are relevant to adopting a two-tier structure; (b) explore whether the determinants of firm profitability are different in single-tier versus two-tier firms; and (c) assess whether the switching to the two-tier format, after controlling for a variety of other variables, is associated with higher firm profitability.

The interpretations and conclusions presented in this study depend upon an awareness of the data's strengths and limitations and the accuracy of the theory that underlies the statistical models. Therefore, Part II provides a detailed discussion of the dataset used in this study. Section A provides some background information on how the data was assembled, including the analytical reasons for including certain categories of information. Section B explains the theoretical basis for several important independent variables used in this study and, where necessary, how these variables were created. Table 1 summarizes descriptive statistics of several key variables.

92. Wesemann, *supra* note 72 (commenting that de-equitization rarely produces the desired "wake-up call" and that these reclassifications "only exacerbate whatever deficiencies were previously evident in the demoted attorney's work"); *see also* Blumenthal, *supra* note 73 (reporting observation of law firm consultant Joel Rose that de-equitization "almost always creates a cancerous situation at a firm").

93. *Cf.* Denney, *supra* note 71 (summarizing the microeconomic factors that militate against the trend toward two-tier partnerships and concluding that law firms "should be *increasing* the number of equity partners rather than limiting them").

Table 1. Descriptive Statistics of Key Variables*

Variable	Mean	25th Percentile	Median	75th Percentile	Std. Dev.	*Valid N*
Firm Size, 2003	466	253	354	578	347.9	*N=200*
Firm Size, 1993	296	171	234	354	206.3	*N=196*
2003 PPP (Am Law 200)	$761,025	$471,250	$610,000	$890,000	$454,939	*N=200*
1993 PPP (Am Law 100)	$440,960	$300,000	$380,000	$490,000	$237,807	*N=99*
NE:E Ratio	0.40	0.02	0.33	0.60	0.475	*N=190*
Leverage (Lawyers per Equity Partners)	3.51	2.72	3.39	4.13	1.08	*N=199*
% Lawyers in NYC and Global Cities, 2003	21.8%	0.0%	9.6%	28.7%	29.5%	*N=192*
% Lawyers in NYC and Global Cities, 1993	20.6%	0.0%	1.5%	25.3%	32.7%	*N=196*
Avg. Associate Hours Billed per Week	44.7	42.9	44.5	46.6	2.95	*N=148*
Likelihood of Staying Two Years Score	3.58	3.27	3.63	3.92	0.50	*N=147*
Vault Prestige Score (1 to 10)	5.97	5.12	5.78	6.64	1.02	*N=100*
Mid-Level Prestige Score (1 to 5)	4.04	3.75	4.00	4.32	0.45	*N=148*
Number of Branch Offices, 2003	9.08	5.00	8.00	11.00	7.35	*N=192*
Number of Branch Offices, 1993	6.16	3.00	5.00	8.00	5.29	*N=196*
Change in NE:E 93-03	.239	.000	.210	.416	.453	*N=168*

* Sources: Calculations made by author from data drawn from the 2004 Am Law 200, the 1994 Am Law 100, the 1994 and 2004 National Law Journal 250; the 2004 Am Law Midlevel Associates Survey; and the Vault Guide to the Top 100 Law Firms (5th ed.).

A. *The Base Dataset*

The core dataset for this study is the 2004 Am Law 200, which is comprised of the 200 largest U.S. law firms based on gross revenues. This list is published annually in the July (Am Law 100) and August (Am Law 101–200) issues of *The American Lawyer*. The financial

and other descriptive data included in the 2004 listing are based on operating results from 2003. From this information, I generated a large number of additional variables for each law firm. To create a set of time series variables for Am Law firms, I added 1993 financial data on the Am Law 100, which was published by *The American Lawyer* in the summer of 1994.[94] Because the Am Law "Second Hundred" did not appear until 1999, my ten-year longitudinal sample is limited to the eighty-seven law firms that appeared on both the 2004 Am Law 200 and the 1994 Am Law 100. I also generated a five-year longitudinal sample for the 174 law firms that appeared on both the 2004 and 1999 Am Law 200.

I further augmented the dataset by adding information from the *National Law Journal*, which annually publishes data on the 250 largest law firms based on the number of lawyers ("NLJ 250"). In general, there is a very large overlap between the Am Law 200 and the NLJ 250. Variables added from this source fell roughly into two categories: (1) number of lawyers in a specific U.S. city, which I aggregated based on location within a metropolitan area ("MA") and utilized to create a variable, discussed below, to partially control for market segmentation;[95] and (2) the number of lawyers within a firm categorized as equity and nonequity.[96] The equity/nonequity data is necessary to create the ratio of nonequity to equity lawyers (NE:E), which is a variable that reflects deviation away from a single-tier model. In a single-tier model, NE:E should be zero because the numerator (i.e., the number of nonequity partners) is by definition zero. Because the NLJ 250 has been published for nearly two decades, I was able to generate various longitudinal variables, including the change in NE:E between 1993 and 2003.

---

94. *The American Lawyer*, July/Aug. 1994 (publishing tables of financial information on the 100 largest U.S. law firms based on annual revenues).

95. *See infra* Part II.B.2. This geographic data is ultimately the focus of a separate empirical project. *See* William D. Henderson, *The Changing Economic Geography of the Am Law 200* (forthcoming SSRN working paper, summer 2006).

96. *The American Lawyer* annually publishes the number of lawyers and equity partners for each Am Law 200 firm. It also calculates the average partner compensation, which in a two-tier firm is usually significantly lower than average PPP. However, the magazine has not consistently published the number of nonequity partners or the combined total of equity and nonequity partners. It is worth noting that the delineation between equity and nonequity partners in the NLJ 250 is determined by the law firms. In contrast, the existence of a two-tier partnership under *The American Lawyer* definition is determined by applying a uniform criteria, which has produced some dissonance within firms. *See infra* note 109 and accompanying text. The important point is that the *National Law Journal* data on the number of equity-nonequity partners has significant limitations.

In order to gauge how internal firm dynamics affect firm profitability, including how these dynamics might diverge in two-tier versus single-tier firms, I added data from the 2004 American Lawyer Mid-Level Associate Survey ("Mid-Level Survey"), which was compiled from more than 4,300 survey questionnaires from associates at approximately 180 large law firms.[97] Full or partial data was available on approximately 145 law firms from the 2004 Am Law 200. I was specifically interested in the internal firm work ethic and the level of attrition. As a rough measure of how hard associates work within a firm, I utilized the "average number of hours billed per week" from the Mid-Level Survey.[98] All other things being equal, we would expect profits to be a function of hours billed. As a proxy for anticipated future attrition, I used the average response score for "likelihood of staying two years."[99]

Regarding associate attrition, it should be noted that its effects can be difficult to interpret. On the one hand, excessive turnover can lead to poor client service. As noted earlier, the two-tier firm is sometimes advocated as a structure that can mitigate this problem.[100] High attrition can also be a sign that a firm is not paying associates a competitive salary, which can be a symptom of poor management. Conversely, if we envision associates working within the promotion-to-partnership tournament,[101] attrition of less talented or less dedicated associates is a built-in part of the model.[102] Further, it is at least plausible that this process is more rigorous in single-tier firms, since the tournament prize is equity partnership.

Finally, I theorized that a firm's relative prestige (i.e., reputational capital) could provide a competitive advantage in at least three ways. First, higher prestige can affect client demand and permit

---

97. *See The Mid-Levels Speak: Associates Survey*, AM. LAW., Oct. 2004, at 131, 133 (reporting a 44% response rate).

98. *Id.* at 131

99. *Id.* The reasons for an associate leaving can run in a variety of directions. For example, the billable-hours requirement may be too demanding, or an associate may realize that he or she will not make partner. Alternatively, associates in some prestigious firms may be more likely to receive an attractive offer from outside the firm. *See infra* note 163 and accompanying text.

100. *See supra* note 85 and accompanying text.

101. *See generally* GALANTER & PALAY, *supra* note 1, at 100–02 (discussing the dynamics of the promotion-to-partnership tournament).

102. For example, when Cravath, Swaine & Moore, a highly prestigious and profitable single-tier firm in New York, "lost 96 of its 300 associates in 1993 and 67 more in 1994," a Cravath partner shrugged off the loss to the poor economy of the previous years and suggested that the firm "didn't lose anyone [we] really wanted to keep." Karen Dillon, *Brand Names at the Brink*, AM. LAW., May 1995, at 5, 7.

a firm to charge higher fees.[103] Second, prestigious law firms are probably more likely to have a client base that is more loyal to the firm than the billing partner (i.e., firm-specific capital). As a result, prestigious law firms may be less vulnerable to grabbing and leaving.[104] Third, prestige can also be a valuable firm attribute in the recruitment of new associates, providing an employer with a non-monetary but important competitive advantage.[105] This study utilizes two proxies for firm reputation: (1) a prestige score published in 2002 by Vault, Inc., which compiles career information on various industries and professions, including high-end legal services ("The Vault 100");[106] and (2) a prestige score generated by *The American Lawyer* as part of its Mid-Level Survey.[107]

B. Key Independent Variables

This Section summarizes the rationale and method of calculation for five important independent variables used in this study: (1) a tier variable, which distinguishes between single-tier and two-tier firms; (2) the proportion of lawyers located in New York City and eight

---

103. *Cf. Law Firm Profitability*, *supra* note 35, at 209 (suggesting that large firms in New York City may be more profitable because of "client price insensitivity"). Similarly, Bruce MacEwen, a well-known blogger on law firm economics, has commented that on important legal matters, "Nobody ever got fired for hiring Skadden [Arps, Slate, Meagher & Flom]," a highly profitable and prestigious law firm headquartered in New York City. *See* Nobody Ever Got Fired for Hiring Skadden (Apr. 24, 2004), http://www.bmacewen.com/blog/archives/2004/04/nobody_ever_got_fired_for_hiring_skadden.html.

104. *Cf.* ROBERT W. HILLMAN, HILLMAN ON LAWYER MOBILITY 1:5–6 (1997) (noting that lockstep compensation systems, which once prevailed in larger firms, have come under siege because "increased mobility has permitted lawyers with the ability to transport clients and revenues to demand a larger share of firm income").

105. For example, Anthony Ciolli recently conducted a large-scale empirical study to identify which elite law schools provide prospective students with the best placement prospects at the nation's top law firms. *See* Anthony Ciolli, *The Legal Employment Market: Determinants of Elite Firm Placement and How Law Schools Stack Up*, 45 JURIMETRICS J. 413, 413 (2005). Ciolli determined the desirability of law firms based on composite score derived from PPP and the Vault prestige score. *Id.* at 417–18. Using a massive amount of data culled from Martindale-Hubbell, including geographic as well as firm placement of elite law school graduates, Ciolli was able to show that the likelihood of landing a highly prestigious law firm job is incrementally increased by attending certain law schools. *Id.* at 428–31. For example, if maximizing placement odds is the primary determinant of where a student should attend law school, Ciolli shows that a student would be better off attending Chicago or Columbia rather than higher-ranked Yale or Stanford. *Id.* Important variables in Ciolli's model include the lack of a class rank, which helps students, and a pass/no-pass grading system, which has a negative effect on placement. *Id.* at 433–36.

106. *See* BROOK MOSHAN GESSER ET AL., VAULT GUIDE TO THE TOP 100 LAW FIRMS 13–14 (2003).

107. *See Mid-Levels Speak*, *supra* note 97, at 131.

"global" international cities, which I use to partially control for market segmentation; (3) firm leverage, which measures the balance between equity partners and all other lawyers within the firm; (4) the ratio of nonequity to equity partners, which is a type of firm leverage and reflects a strategy choice on the part of firm management; and (5) the Vault and Mid-Level Survey prestige variables.

1. Tier Structure

For the purposes of this study, I classified law firms as single-tier or two-tier using data from the 2004 Am Law 200, 1999 Am Law 200, and the 1995 Am Law 100. *The American Lawyer* classifies a firm as single-tier if all partners "receive a Schedule K-1 tax form and receive no more than half their compensation on a fixed-income basis."[108] (It is worth noting, however, that this definition classifies some partnerships as two-tier even though the firm's management claims that the firm is single-tier.[109]) I created a dummy variable to code for single-tier versus two-tier or multi-tier. I also created a series of dummy variables to distinguish between firms that remained single-tier between 1994 and 2003, firms that became two-tier or multi-tier, and firms that remained two-tier.

Obviously, the use of a single dichotomous variable for tier structure masks considerable heterogeneity of partnership tracks among Am Law 200 law firms.[110] Although it would be ideal to have sufficient data to implement a more nuanced coding system, the theory underlying the single-tier versus two-tier distinction is relatively simple and theoretically coherent. Specifically, the tier variable represents two ends of a continuum in which single-tier firms are more likely to (a) have higher levels of firm-specific capital (i.e., clients that are loyal to the firm rather than individual lawyers) and

108. *The Am Law 100: A Guide to Our Methodology*, AM. LAW., July 2004, at 101 (also noting that "[m]any firms put their first-year equity partners or lateral equity partners on fixed incomes for a short time. When this is merely a transitional arrangement, and these partners are otherwise treated as equity partners, we categorize them as such.").

109. *See, e.g.*, Susan Beck, *A Series of Fortunate Events*, AM. LAW., Feb. 2005, at 74, 78 (reporting fallout among partners at Bingham McCrutchen after *The American Lawyer* reported the firm as two-tier and noting that the chairman of the firm "insists that the firm still isn't a two-tier system, but is simply following this magazine's definition of an equity partner"); Frankel, *supra* note 12, at 93 (quoting chairman of Foley & Lardner, whose firm was classified as two-tier, stating that the firm has "one class of partners only" and noting that the first year Foley was identified as a two-tier partnership in the Am Law 100 survey, he issued a memo that "we had no secret deequitization program").

110. The heterogeneity of two-tier firms, and thus the limitations of this study, is directly addressed in Part IV.B., *infra*.

(b) evenly share the benefits and burdens of partnership (e.g., lockstep or modified lockstep compensation). In contrast, two-tier firms are more likely to (c) have clients that are loyal to individual lawyers and (d) place greater emphasis on a marginal product approach (e.g., eat-what-you-kill). Based on the literature review in Part I, these predicted tendencies are all reasonable assumptions.

2. Proportion of NYC/Global Lawyers

As large corporate law firms, the Am Law 200 is in many respects a homogeneous group. For example, virtually all of the law firms in the sample are highly selective in their hiring practices, recruiting at the nation's most prestigious law schools and requiring exemplary law school records from graduates of lower-ranked schools.[111] The pay range for associates is, not surprisingly, fairly narrow. The average starting salary is $117,496 with a standard deviation of $12,972; the top entry-level salary is $140,000, which was offered by three firms.[112] The average salary of all associates is $136,024 with a standard deviation of $21,478.[113] Yet, at the level of equity partner compensation, the range of PPP is much wider. The average 2003 PPP at an Am Law 200 firm is $761,025 with a standard deviation of $454,939.[114] Further, sixteen firms posted PPP of more than $1.5 million, approximately double the average.[115] Obviously, within the Am Law 200, equity partner profits are subject to much greater variability than associate salary.

Some of the large PPP differentials among Am Law 200 firms are certainly attributable to the proportion of a firm's lawyers in various geographic markets. On this dimension, the Am Law 200 marketplace is extremely diverse. For example, in this dataset, the average law firm had an average of 9.08 offices with seventy attorneys

111. For example, BCG Attorney Search, which provides lateral recruitment services for large law firms, publishes a 281-page compendium of grading and law review requirements at the nation's top fifty law schools as ranked by *U.S. News & World Report*. This manual is explicitly designed to permit law firms to accurately assess law school performance relative to the law school's prestige. *See* THE 2004 BCG ATTORNEY SEARCH GUIDE TO CLASS RANKING DISTINCTIONS AND LAW REVIEW (2004), *available at* http://www.bcgsearch.com/bcgguide.pdf.

112. These figures were calculated based on data obtained from the 2004 NLJ 250. NAT'L L.J., Nov. 15, 2004 at 516–27.

113. These figures were calculated based on data obtained from the 2004 American Lawyer Mid-Level Survey. *See Mid-Levels Speak*, *supra* note 97, at 131.

114. *See supra* Table 1.

115. Author observations of assembled Am Law 200 dataset.

per office.[116] However, six of these firms had only a single office,[117] and four of these firms posted PPP above the median. In addition, even though 21.4% (21,210) of all Am Law 200 lawyers in 2003 were located in the New York City Consolidated Metropolitan Statistical Area ("CMSA"), fifty-five Am Law 200 law firms had no New York office.

Starting with the premise that law firm profitability is enhanced by attracting high-end noncommodity legal work that commands a premium price, I hypothesized that this type of work is likely to be concentrated in larger legal markets. I then aggregated the total number of Am Law 200 lawyers by MA. The top 10 MAs are set forth in Table 2:

Table 2. Number of Am Law 200 Lawyers by MA*

MA	# of Am Law 200 Lawyers	% of All Am Law 200 Lawyers
New York	21,210	21.4%
Washington	13,512	13.6%
Chicago	6,988	7.1%
Los Angeles	6,475	6.5%
San Francisco	5,688	5.7%
Boston	3,904	3.9%
Philadelphia	3,155	3.2%
Atlanta	2,856	2.9%
Houston	2,753	2.8%
Dallas	2,742	2.7%

*Source: Calculations made by author from data drawn from the 2004 National Law Journal 250.

Next, using the geographic data for each firm in the sample, I correlated the proportion of firm lawyers located in New York City with PPP and obtained a remarkably high coefficient: $r = .696$, $p = .000$, $n = 192$.[118] When I performed the same analysis on the

116. These figures were calculated based on data obtained from the 2004 NLJ 250. *See supra* note 112.

117. Two firms are located in New York, three firms are in Boston (but one recently dissolved), and one firm is in Washington, D.C.

118. A correlation coefficient (r) is a number that describes a statistical relationship between two attributes (e.g., PPP and proportion of lawyers located in NYC). It is expressed as a value between -1 (a perfect negative correlation) and +1 (a perfect positive correlation). The p-value of a correlation coefficient reflects the probability that r occurred by chance. For example, if "$p<.05$", there is less than a 1 in 20 chance that the

proportion of firm lawyers in Washington, D.C. (the second largest Am Law 200 location), the correlation coefficient was positive but not statistically significant (.078, p = .282, n = 192).[119] When I combined the proportion of firm lawyers in the other top ten MAs into a single "Other Major U.S. Cities" statistic, the correlation with PPP was both negative and statistically significant (-.189, p = .009, n = 192). Finally, the correlation between PPP and the proportion of the firm's lawyers in all remaining locations ("Regional Cities") was also negative but much stronger (-.515, p = .000, n = 192). I performed a similar analysis with lawyers in international cities and discovered that PPP was strongly correlated with the proportion of lawyers in the eight large non-U.S. markets[120] (.370, p = .000, n = 192) but uncorrelated with the proportion of lawyers in all other international locations (.028, p = .701, n = 192).

Finally, building on these results, I created a single statistic for the combined proportion of a firm's lawyers in the New York City MA and these eight "Global" markets. The resulting variable produced a very high correlation with PPP: .719, p = .000, n = 192.[121] In this study, I use this geographic variable as a proxy for the likelihood that a law firm is attracting high-end noncommodity legal work. A careful analysis of the profitability data corroborates this assumption. When the Am Law 200 firms are separated into four different categories based on the proportion of lawyers in New York and Global Cities (see Table 3), the differentials in average PPP are too large to be explained by higher billing rates necessary to support a higher cost of living, especially since clients have an incentive to gravitate to lower-cost markets if the nature of the legal services being offered is truly fungible. Moreover, between 1993 and 2003, the New York City MA added 9,920 Am Law 200 lawyers—5,000 more

---

statistical relation occurred randomly; "p<.01" reflects a 1 in 100 chance; "p<.001" reflects a 1 in 1000 chance, etc.

119. The regression results of Chadwick and Hanna, which was based on Am Law 100 data from 1993, found that "a D.C. home base" was associated with approximately $80,000 in additional PPP after controlling for a variety of other factors. *See* Chadwick & Hanna, *supra* note 55, at 63–64. In contrast, this study utilized the proportion of lawyers located in the Washington, D.C. MA, which is presumably a more precise measure of any putative geographic effect.

120. My designation for Global Cities includes seven non-U.S. locations with the most Am Law 200 lawyers: London (2,867), Paris (1,022), Hong Kong (625), Frankfurt (543), Brussels (422), Tokyo (389), and Singapore (192). Beijing is also included on this list because it is the location in China with the largest number of Am Law 200 lawyers (87).

121. For a more detailed explication of how geography is an important and understudied variable in the legal marketplace, see Henderson, *supra* note 95 (using this dataset to study many unusual and surprising patterns between geography and law firm profitability).

lawyers than any other U.S. market.[122] Obviously, in terms of profitability, there appears to be something unique about the New York City legal market.

Table 3. PPP by Percentage of Lawyers in NYC/Global Cities

Market Segment	Mean	Percentile 25	Median	Percentile 75	Std Deviation	*Valid N*
> 50% NYC / Global	$1,276,618	$877,500	$1,115,000	$1,662,500	$548,036	*N=34*
10% to 50% NYC / Global	$794,417	$560,000	$742,500	$928,750	$315,852	*N=60*
> 0% to 10% NYC / Global	$539,884	$445,000	$510,000	$590,000	$160,600	*N=43*
No NYC / Global Lawyers	$491,727	$365,000	$450,000	$575,000	$170,487	*N=55*
Group Total	**$736,094**	**$470,000**	**$595,000**	**$862,500**	**$418,972**	***N=192***

For the purposes of this study, I use the proportion of NYC/Global lawyers as a continuous variable to control, at least in part, for the degree of firm concentration within the high-end, noncommodity legal market. Obviously, this statistic is not a perfect proxy for the systemic effects of geography on law firm operations and strategy.[123] However, based on the regression results presented in Part III, this variable is consistently one of the most important variables in explaining the profitability of Am Law 200 law firms.

3. Firm Leverage

In the context of law firms, the term "leverage" refers to a very specific concept: the extent to which partners, who own the firm, maximize the firm's revenues (and presumably profits) by billing out the time of lawyers who work for the firm as employees. Leverage is often measured as the ratio of associates to partners, though other

122. *See id.* (presenting and analyzing geographic data on Am Law 200 law firms). The Washington, D.C. MA was second, adding 4,916 lawyers. In contrast, MAs such as Cleveland, Milwaukee, and Detroit, which all had a relatively large base of Am Law 200 lawyers in 1993, added fewer than 100 lawyers each by 2003.

123. The data necessary to completely control for type of legal work, such as a profit margin for specific types of client matters and specific types of clients, is obviously not available.

methods of quantifying leverage are sometimes used.[124] In a two-tier partnership, however, it is unclear whether nonequity partners should be classified as partners or associates, though one of the leading consulting firms for legal services has concluded that "[nonequity partners] can call themselves 'partner' and perhaps attend partner meetings, but actually they are highly paid associates with a percentage bonus interest."[125] In addition, the proliferation of staff attorneys[126] and of counsel positions[127] has obscured the definition of who should be classified as an associate.

In this study, the leverage variable was calculated by dividing the total number of lawyers within a firm by the number of equity partners.[128] Under this definition, a firm can increase its leverage by adding partners to a nonequity tier.[129] The advantage of this method is that it captures the economic rationale for leverage but avoids making distinctions between various types of nonpartner lawyers.

Finally, the type and degree of leverage a firm can successfully employ may vary with its relative standing in the marketplace. For example, a less-prestigious Am Law 200 firm may find it difficult to increase the ratio of associates to partners and simultaneously maintain a traditional "up or out" promotion-to-partnership

---

124. *Compare Associate Career Patterns*, *supra* note 34, at 584 (defining leverage as "the ratio of associates to partners") *and* Marc Galanter & Thomas Palay, *The Large Law Firm in Transition: An Historical Analysis*, *in* LAW FIRM MANAGEMENT, *supra* note 35, § 8.4.4 (defining leverage as "the ratio of associates to partners"), *with* Giuliani, *supra* note 33, at 28 (law firm consultant asserting that leverage is "often misconstrued to mean the ratio of associates to partners. A better definition is the realizable value of associate hours divided by the realizable value of partner hours.").

125. *Success and Failure*, *supra* note 35, § 7:19 n.9 (quoting ALTMAN WEIL, THE 1990 SUMMARY OF LAW FIRM ECONOMICS 62 (1990)); *see also* Frankel, *supra* note 12, at 95 ("[W]hat does partnership mean when 'partners' don't share significantly in the firm's good fortune or help determine its future? Is a nonequity partner at Kirkland any different than a senior associate at Cravath?").

126. *See, e.g.*, Galanter & Palay, *supra* note 124, § 8:32 (discussing growth in the number of staff attorneys outside the partnership track who perform "low-end price sensitive business").

127. *See, e.g.*, ALTMAN WEIL, INC., COMPENSATION PLANS FOR LAW FIRMS 73 (James D. Cotterman ed., 4th ed. 2004) (noting proliferation of lawyer titles within large law firms, "such as 'senior attorney,' 'special counsel, 'senior counsel,' or the elegantly simple 'counsel.' ... [T]he lack of standardization of terminology leaves one at a loss to divine precisely what a law firm means by making the distinction.").

128. *The American Lawyer* uses the same definition in its annual ranking of law firms. *See supra* note 12.

129. *Cf.* Alexander Stille, *Turning to Two-Tier Partnerships*, NAT'L L.J., Oct. 22, 1984, at 1, 25 (noting that "many of the Chicago firms have been practicing their own version of leverage for some time camouflaged by the two-tier system.... Kirkland & Ellis seems to have a relatively low partner-associate ratio: of its 272 lawyers, 122 are partners and 150 are associates. But ... only 58 partners are part-owners of the firm.").

tournament. Obviously, highly qualified associates will tend to migrate toward other firms where the difficulty and probability of making partner are commensurate with the value of the promotion. As a result, even though promotion to nonequity partner may be a relatively expensive method of increasing firm leverage, it is likely that at least some firms may have to make fairly liberal use of this strategy in order to attract and retain high quality associates. In these firms, the economic benefits of higher leverage may be positive but ultimately relatively small.[130]

4. Ratio of Nonequity to Equity Partners

The ratio of nonequity to equity partners (NE:E) is a continuous variable that reveals the extent to which a two-tier partnership has departed from the single-tier model. However, as a theoretical matter, a large NE:E has the potential to both enhance and hinder law firm profitability, and it is unclear which effect is likely to predominate. For example, as discussed in Part II.B.3, a firm can increase its leverage by adding nonequity partners. And presumably leverage enhances a firm's profitability. In addition, restricting the number of equity partners should, in theory, increase PPP by keeping the denominator small.[131] Further, a nonequity partnership track can mitigate attrition that might otherwise reduce the quality of client service.[132]

However, the existence of a nonequity partnership track also has the potential to set in motion a system of incentives that undermines a firm's long-term profitability. Specifically, the prestige and security of nonequity partner status may be very attractive to highly competent lawyers who would prefer to practice law rather than develop clients. Notwithstanding their willingness to bill a large number of hours, it is possible that "service partners"[133] are actually making a contribution comparable to that of senior associates but are

130. Variations in leverage strategy based on relative market position may explain some of the rather peculiar and counterintuitive statistics on the value of additional firm leverage. *See, e.g.*, Kellie Schmitt, *Could Higher Leverage Mean Higher Profits?*, RECORDER, Nov. 22, 2005, at 1, *available at* http://www.law.com/jsp/article.jsp?id=1133949910389 (citing examples of firms with similar levels of associate to partner leverage but disparate levels of profitabilty).

131. *See supra* note 89 and accompanying text.

132. *See supra* note 85 and accompanying text.

133. ALTMAN WEIL, INC., *supra* note 127, at 53 (describing the "archtypical service partner [as] one who originates no business of his or her own [and] contributes to the profits of the firm through personal labors on behalf of others' clients"); *see also supra* note 73 and accompanying text (providing taxonomy on types of law firm partners).

earning higher salaries. Further, the availability of a "service partnership" track has the effect of reducing the incentives for client development among both senior associates and nonequity partners. Conversely, if management is too parsimonious in promoting lawyers to equity partner, the firm can be beset by serious morale problems.[134] As noted in Part I, one of the potential hazards of the two-tier system is that it may permit management to delay or avoid difficult personnel decisions. Over a period of time, it is possible that a deleterious self-selection process takes hold and the two-tier firm ends up with an associate pool with too few actual or potential rainmakers. Obviously, this outcome would have a negative effect on law firm profitability.[135]

As shown in Table 4, over the last decade, there has been a clear trend toward two-tier partnerships, and the proportion of nonequity to equity partners.

Table 4. Change in Proportion of Nonequity to Equity Partners (NE:E), 1993 to 2003*

	Mean	S.E. Mean	25th %	Median	75th %	*Valid N*
1993 NE:E	0.19	0.07	0.00	0.00	0.16	*N=175*
2003 NE:E	0.41	0.03	0.02	0.33	0.60	*N=189*

* Sources: Calculations made by the author from data drawn from the 2004 and 1994 National Law Journal 250.

5. Prestige Variables

This study utilizes two proxies for firm reputation. The first is the Vault prestige score, which was derived from a 2002 electronic survey of large law firm associates at 126 leading law firms. Since law firm recruiting is affected by inclusion in the Vault 100,[136] law firms have a strong incentive to cooperate by disseminating the anonymous survey instrument to their associates. Although Vault does not report

134. *See, e.g.*, ALTMAN WEIL, INC., *supra* note 127, at 26 ("[Our consulting engagements have shown us that] when lawyers are placed permanently into special, lower-prestige categories, morale problems invariably result over the years. Establishing a lower class of partners as an intermediate step for a limited number of years is often preferable.").

135. *Cf.* Wesemann, *supra* note 72 (observing that "some [two-tier] firms are finding what is relatively painless in the short term can have devastating long-term ramifications").

136. *See generally* Ciolli, *supra* note 105, at 417 (stating that "[m]any prospective and current law students aspire" to obtain positions with Vault 100 firms).

its response rate, more than 9,500 associates completed the survey.[137] Prestige is ranked on a one to ten scale with ten being the most prestigious. Associates are asked only to rank the firms with which they are familiar; in addition, they are not permitted to rank their own firm. The Vault prestige variable is, therefore, probably a good indicator of a firm's national prominence and, by extension, its ability to attract high-end, price inelastic clients. One of the disadvantages of the Vault 100, however, is that it is limited to only 100 firms.

The second measure of prestige is drawn from the 2004 Mid-Level Survey.[138] Associates were asked to rate their own firm's prestige on a scale of one to five, with five being the most prestigious. The advantage of the Mid-Level prestige variable is twofold. First, it provides a fairly direct measure of how valuable the associates perceive the prize of partnership—and thus, the effort they might exert in the promotion-to-partnership tournament. Second, the correlation between the Vault and Mid-Level prestige variables is 0.70 ($p < .000$)[139] and the Mid-Level prestige variable includes approximately forty-five more observations than the Vault 100. Thus, in some regression models, the Mid-Level prestige variable has both theoretical and practical advantages.

III. RESULTS

Part III uses descriptive statistics and multivariate regression analysis to examine and test several hypotheses related to single-tier versus two-tier law firm partnerships. Section A compares single-tier versus two-tier partnerships by market segment. Section B reviews the data on firms switching to the two-tier format and uses logistic regression to model the determinants of tier structure. Section C uses linear regression to model and compare the determinants of profitability in single-tier versus two-tier firms. Section D uses linear regression to assess whether tier structure or the ratio of nonequity to equity partners is related to changes in law firm profitability over time.

137. GESSER ET AL., *supra* note 106, at 13.

138. *See Mid-Levels Speak*, *supra* note 97.

139. Presumably, some of the variation between the two variables is attributable to associates' perception of their firm's prestige within a regional market. In contrast, the ranking of 126 law firms in the Vault survey is more likely to reflect a national perspective.

A. Comparison by Tier Structure and Market Segment

The descriptive statistics reveal significant differences between single-tier versus two-tier law firms along three dimensions: profitability, leverage, and prestige. However, the superior profitability of single-tier firms appears to be primarily a function of their reputational capital (and presumably the lawyers and clients the firm attracts) rather than the tier structure per se. A careful review of the data as presented in Tables 5, 6, and 7, shown together below, corroborates this relationship.

Regarding profitability, it is clear that single-tier firms are significantly more profitable than two-tier firms. Using an independent sample t-test, the mean PPP of a single-tier firm ($1,048,690, n = 42) is statistically different (p = .001) from the mean PPP of a two-tier firm ($684,557, n = 158). Moreover, even though single-tier firms are disproportionately concentrated in New York City,[140] which is the most lucrative legal market, this pattern of higher profitability is visible when the data is broken down according to the proportion of lawyers in New York and Global Cities (see Table 5). In a partial correlation calculation, which controlled for the proportion of lawyers in New York City, the negative relationship between profitability and the two-tier structure is still statistically significant (-.183, p = .011, n = 189).

One possible explanation for the higher profitability of single-tier law firms is that they utilize higher leverage. However, single-tier firms actually have *lower* leverage than two-tier firms. As shown in Table 6, when leverage is broken down by the proportion of New York City/Global Cities and tier status, it is surprising to observe that the mean leverage is consistently higher in two-tier firms. In a partial correlation calculation, which controlled for the proportion of lawyers in New York City and leverage, the negative relationship between profitability and the two-tier structure is even more pronounced (-260, p < .000, n = 187).

140. *See, e.g.*, Frankel, *supra* note 12, at 94 (reporting that "the most profitable New York firms have resisted the temptation to establish second-tier partnerships, relying instead on the willingness of associates to work at firms where they have little chance of making partner" and that "[m]ore than half of the Am Law 100 firms with only one partnership tier are based in New York").

Table 5. PPP by Market Segment, Tier Structure

Market Segment	Tier Structure	Mean	S.E. of Mean	Std Deviation	*Valid N*
> 50% NYC / Global	Single-Tier	$1,488,333	$142,694	$552,652	*N=15*
	Two-Tier	$1,109,474	$113,841	$496,222	*N=19*
10% to 50% NYC / Global	Single-Tier	$882,778	$97,856	$293,568	*N=9*
	Two-Tier	$778,824	$44,782	$319,809	*N=51*
> 0% to 10% NYC / Global	Single-Tier	$574,167	$75,381	$184,646	*N=6*
	Two-Tier	$534,324	$26,060	$158,518	*N=37*
No NYC / Global Lawyers	Single-Tier	$578,333	$93,905	$281,714	*N=9*
	Two-Tier	$474,783	$20,311	$137,756	*N=46*

Table 6. Firm Leverage by Tier Structure, Market Segment

Market Segment	Tier Structure	Mean	S.E. of Mean	Std Deviation	*Valid N*
> 50% NYC / Global	Single-Tier	4.04	0.22	0.85	*N=15*
	Two-Tier	4.70	0.19	0.83	*N=19*
10% to 50% NYC / Global	Single-Tier	3.23	0.26	0.77	*N=9*
	Two-Tier	3.91	0.15	1.08	*N=51*
> 0% to 10% NYC / Global	Single-Tier	2.81	0.27	0.67	*N=6*
	Two-Tier	3.41	0.11	0.68	*N=36*
No NYC / Global Lawyers	Single-Tier	2.20	0.33	1.00	*N=9*
	Two-Tier	2.88	0.11	0.75	*N=46*

Table 7. Firm Prestige (Vault, 1 to 10 Scale) by Tier Structure, Market Segment

Market Segment	Tier Structure	Mean	S.E. of Mean	Std Deviation	*Valid N*
> 50% NYC / Global	Single-Tier	7.353	0.344	1.239	*N=13*
	Two-Tier	5.905	0.222	0.861	*N=15*
10% to 50% NYC / Global	Single-Tier	6.509	0.298	0.842	*N=8*
	Two-Tier	5.775	0.132	0.768	*N=34*
> 0% to 10% NYC / Global	Single-Tier	5.696	0.415	0.720	*N=3*
	Two-Tier	5.269	0.187	0.592	*N=10*
No NYC / Global Lawyers	Single-Tier	5.898	0.509	1.019	*N=4*
	Two-Tier	5.156	0.181	0.479	*N=7*

A third significant distinction between single-tier and two-tier firms is the large disparity in prestige. Consistent with Gilson's and

Mnookin's theory that firms that adopt the "sharing model" can flourish if they have sufficient reputational capital,[141] single-tier firms have much higher Vault prestige scores. Further, as shown in Table 7, this pattern is present in all market segments except for firms with no presence in New York or Global Cities.[142]

Yet, it appears that the superior profitability of single-tier firms is probably attributable to superior prestige rather than incentives that flow from the partnership structure. This result is evident from the regression model summarized in Table 8, which used PPP as the dependent variable and four independent variables: (1) tier structure; (2) proportion of lawyers in New York and Global Cities; (3) firm leverage; and (4) the prestige score from the Am Law Mid-Level Survey. Tier structure has no statistically significant relationship to firm profitability after controlling for market segment, leverage, and prestige. Yet, as shown in Table 8, the remaining three variables were all strongly predictive of PPP.

Table 8. OLS Regression Model, 2003 PPP is Dependent Variable

Variable	B	Std. Error	Beta	Sig.
(Constant)	$863,908	$269,216		0.002
Two-Tier in 2003	$20,473	$69,698	0.019	0.769
Percent of Lawyers in NYC and Global Cities	$824,603	$93,142	0.590***	0.000
Partner-Lawyer Leverage	$89,486	$26,545	0.213***	0.001
Mid-Level Prestige Score	$272,959	$59,613	0.273***	0.000
Adj. R^2	**0.637**			
N	**131**			

*** Significant at p = .001

B. Firms that Switched to Two-Tier Format

At first glance, the results in Section A present a puzzle: Why are firms switching to a partnership structure that is clearly associated with lower profitability and higher leverage? Gilson's and Mnookin's discussion of reputational capital provides important insights.[143] For example, consider a single-tier law firm that is considering the creation of a nonequity track. If the firm lacks sufficient reputational capital, it is vulnerable to grabbing and leaving by its most productive

141. *See supra* Part I.A.

142. The distribution for the prestige score in the Mid-Level Survey is nearly identical to the Vault variable presented in Table 7.

143. *See supra* Part I.A.

partners. Further, because these "partners with power"[144] have the potential to destabilize the firm by actually carrying through on their threat to leave, they can broker the adoption of the two-tier format, which essentially institutionalizes the grabbing of their marginal product to the firm. Service partners and technical specialists,[145] whose primary contribution is billing the requisite number of hours, will be relegated to this tier, and their compensation will no longer be based primarily on firm profits.[146]

This hypothesis is corroborated by descriptive statistics in Table 9, which summarizes the differences in profitability and prestige between law firms that remained single-tier or switched to two-tier during the 1994 to 2003 observation period. An examination of the mean and standard error suggest that the firms that switched to the two-tier structure were (and are) significantly less profitable than the firms that remained single-tier.[147] Similarly, the firms that switched are also less prestigious than the firms that remained single-tier. Although the prestige variables are from surveys taken in 2002 and 2003, it is likely that there was a similar prestige gap between these firms a decade earlier. For example, there is a correlation coefficient of 0.904 ($p < .000$) between the prestige scores of the fifty firms that appeared on both the Vault 50 in 1998 and the Vault 100 in 2005. In other words, prestige appears to be a very "sticky" variable.[148] Patterns essentially identical to Table 9 are also present among Am

---

144. NELSON, *supra* note 37, at 5 (arguing that "the organizational rationalization of the firm will be controlled by the partners with power," which is "inextricably tied to 'control of clients' ").

145. *See supra* Part I.C.

146. *See, e.g.*, Blum, *supra* note 67, at 27 ("Instead of sharing in profits, nonequity partners are paid like senior associates, with a guaranteed base salary . . . ."); James W. Jones, *When Is a Partner Not a Partner?*, N.J. L.J., June 9, 1997, at 35 (law firm consultant and former managing partner of Arnold & Porter observing the trend toward "multi-tiered partnerships, sometimes involving nonequity partners, contract partners, or others whose compensation is not really tied to the earnings of the firm."); *Nonequity Partnership; No Vote, No Profits, No Liability*, TEX. LAW., July 7, 1997, at 26 (noting that nonequity partnerships "are salaried positions generally").

147. The range created by adding or subtracting an amount equal to 1.96 standard errors creates a confidence interval in which there is 95% likelihood that the parameter's true mean falls within that range. *See* CHRISTOPHER H. ACHEN, INTERPRETING AND USING REGRESSION 41–42 (1982). Therefore, when the mean for firms that remained single-tier fall outside the confidence interval created by the mean and standard error of the firms that switched to two-tier, as is the case for all variables in Table 9, we can conclude the two populations are statistically different along that dimension (i.e., profitability or prestige).

148. *See, e.g.*, *Profit Sharing*, *supra* note 34, at 388 (asserting that "it is easier to retain firm-specific capital than to create it").

Law 200 firms that remained single-tier or converted to two-tier between 1998 and 2003.

Table 9. Profitability and Prestige of Firms that Remained Single Tier, or Switched to Two-Tier, 1994–2003

Variable	Status	Mean	S.E. Mean	Std Dev.	Valid N
2003 PPP	Stayed Single-Tier	$1,226,250	$116,667	$571,551	N=24
	Changed to two-Tier	$906,200	$52,918	$264,592	N=25
1994 PPP	Stayed Single-Tier	$657,292	$62,361	$305,504	N=24
	Changed to two-Tier	$409,200	$23,485	$117,426	N=25
Vault Prestige Score (1–10)	Stayed Single-Tier	6.95	0.235	1.153	N=24
	Changed to two-Tier	6.07	0.158	0.706	N=20
Mid-Level Prestige (1–5)	Stayed Single-Tier	4.62	0.071	0.316	N=20
	Changed to two-Tier	4.03	0.080	0.401	N=25

Presumably, most firms began as single-tier before making the decision to adopt the two-tier structure.[149] It is reasonable to assume that the decision to switch was influenced by a desire to either protect or grow the profits for the group of lawyers who would be placed in the equity tier.[150] Therefore, I constructed a logistic regression model to predict the probability that a firm is single- or two-tier.[151] The model included four independent variables that should, in theory, be relevant to the decision to create a nonequity partnership tier: (1) law firm size, because larger law firms make it more difficult to monitor shirking by unproductive partners;[152] (2) profits per partner, because smaller profits create greater pressure to place less productive

149. *See* ALTMAN & WEIL, INC., *supra* note 9, at 11–12 (reviewing survey results of two-tier status among law firms and observing, "The correlation to firm size is unmistakable. While class distinctions within partnerships are still uncommon among small- and medium-sized firms, they are becoming quite the trend among large law firms.").

150. *See, e.g.*, *supra* note 84 and accompanying text.

151. Logistic regression is used to predict the likelihood of a single dichotomous outcome (e.g., single versus two-tier partnership structure). *See generally* FRED C. PAMPEL, LOGISTIC REGRESSION: A PRIMER (2000) (discussing appropriate applications of this methodology).

152. *See, e.g.*, *Law Firm Profitability*, *supra* note 35, at 205 (noting that "[p]artners may be less subject to peer pressure in large firms and these organizations may, thus, have a more difficult time identifying and controlling partners who shirk"); *see also* Ribstein, *supra* note 5, at 1720 (noting that "it may be harder to police shirking in larger firms").

partners in a nonequity tier;[153] (3) proportion of lawyers in New York City, because some have suggested that the city's larger concentration of single-tier firms is related to cultural norms;[154] and (4) prestige, because lack of reputational capital makes a firm more vulnerable to grabbing and leaving, and a two-tier structure can be used to formalize the marginal product approach.[155]

The results of this model are summarized in Table 10. Three of the variables are statistically significant at the conventional .05 level: 2003 PPP, percentage of lawyers in New York City, and firm prestige. Surprisingly, higher PPP is associated with a greater likelihood of having a two-tier structure. Some methodologists, however, recommend the Baysian information criterion ("BIC") as a more rigorous test for significance in a logistic regression model.[156] The BIC is calculated by subtracting the natural log of the sample size from the Wald statistic.[157] A BIC greater than zero is presumed to be evidence of a significant relationship; a value of 0 to 2 is weak, 6 to 10 is strong, and greater than 10 is very strong.[158] Applying this method of evaluation to the results in Table 10, the relationship between tier structure and profitability is not significant. In addition, firm prestige

153. *See, e.g.*, *supra* notes 88–89 and accompanying text. The specifications for the models summarized in Table 8 and Table 10, in which PPP and tier structure are alternatively dependent and independent variables, implicitly contemplate a possible endogenous relationship between PPP and tier structure—i.e., that causality may run in both directions. However, in the OLS model summarized in Table 8, it was shown that tier structure is not associated with PPP after controlling for leverage, prestige, and market segment. I further tested for the possibility of an endogenous relationship by regressing tier structure onto all the independent variables in Table 8. The resulting error term from this equation was uncorrelated with PPP after controlling for tier structure, leverage, prestige, and market segment. For a summary of this test for endogeneity, see JEFFREY M. WOOLDRIDGE, INTRODUCTORY ECONOMETRICS: A MODERN APPROACH 507 (2d ed. 2003).

154. *See, e.g.*, *supra* note 68; *see also* Frankel, *supra* note 12, at 94 (noting that in the Am Law 100 2004 rankings of profits per partner, "it is still the New York firms that remain holdouts with regard to tiered partnerships"); Thom Weidlich, *No-Share Partners on Rise*, NAT'L L. J., Oct. 25, 1993, at 1 (suggesting that "the two-tier setup has been more popular in the Midwest than on either coast" and that tradition "almost assures against it[s use] in New York").

155. *See supra* notes 144–46 and accompanying text.

156. *See* PAMPEL, *supra* note 151, at 31, 35–36 (citing A.E. Raftery, *Bayesian Model Selection in Social Research*, *in* SOCIOLOGICAL METHODOLOGY 139 (P.V. Marsden, ed., 1995)).

157. The Wald statistic is calculated by squaring the ratio of the coefficient (ß) and the standard error (S.E.). *See id.* at 35. In this model, the natural log of sample size (n =132) equals 4.883.

158. *Id.* at 31 (summarizing Raftery's rule of thumb for interpreting results and noting that "the BIC test of significance for a coefficient provides more information than traditional significance tests" and that it is "especially helpful to logistical regression").

emerges as the most important predictor variable in the model. Interpreting the exponentiated coefficient (Exp(B)), an increase of one prestige point on the Mid-Level prestige score is associated with a 98.4 percent reduction in odds of being a two-tier firm (1- 0.016 = 0.984), after controlling for firm size, profits per partner, and proportion of lawyers in New York City.[159] When the same regression model is run using the Vault prestige score, the prestige score once again emerges as the only variable with predictive power (Exp (B) = .157, p < .000, BIC = 10.057); the BIC values for the remaining three independent variables were all less than zero.[160]

Table 10. Logistic Regression Model, Predicting 2003 Tier Structure

Variable	B	S.E.	Wald	Sig.	Exp(B)	BIC
Constant	17.966	3.805	22.293	0.000	63,440,753	
Firm Size	0.000	0.001	0.265	0.607	1.000	-.416
2003 PPP	0.264	0.132	3.999	0.046	1.302	-.883
% of Lawyers in NYC	-5.410**	1.780	9.232	0.002	0.004**	4.39
Mid-Level Prestige Score	-4.111***	0.983	17.489	0.000	0.016***	12.61
Pseudo R^2	**0.429**					
N	**132**					

*Significant at p= .05 ***Significant at p= .001

In summary, the lack of reputational capital in a firm's relevant market appears to be a key factor in the decision to adopt a two-tier structure. Insofar as reputational capital becomes less important in the market for high-end legal services (because more corporate clients obtain a better value by shopping for lawyers rather than

159. For a primer on how to interpret coefficients of a logistic regression, see PAMPEL, *supra* note 151, at 18–39.

160. The sample size for this model was 94. The pseudo R^2 was .376. Pseudo R^2 is a measure of fit for a logistic regression model that roughly corresponds to the R^2 statistic used in linear regression. A value of zero means that the logistic model has no explanatory power for explaining the variance of the dependent variable; a value approaching one reflects a very accurate model. *See id.* at 48–54 (noting that "the dependent variable in logistic regression [which is binary] does not have variance in the same way continuous variables do in regression," and that "maximum likelihood procedures provide model fit measures [such as pseudo R^2 that are] analogous to those from least squared regression[;]" noting lack of consensus on best measures of fit for logistic regression models but that "measures of goodness of fit that vary from 0 to 1 can be helpful").

firms), it appears that the trend toward two-tier partnerships will continue to ebb forward.

C. *Determinants of Profitability in Single Versus Two-Tier Firms*

As discussed in Sections A and B, single-tier firms tend to be more profitable, less leveraged, and more prestigious than two-tier firms. Further, because single-tier firms enjoy higher indices of reputational capital, they are presumably in a better position to attract and retain large, price inelastic clients who are loyal to the firm.[161] Yet, these same attributes suggest that single-tier firms may have a competitive advantage in the market for entry-level associates. Further, assuming that a significant number of firm associates are truly engaged in a promotion-to-partnership tournament,[162] single-tier partnerships generally offer a larger prize of equity partnership in a highly prestigious and profitable law firm. Therefore, it is possible that single-tier firms are generally better positioned to attract more talented and harder working associates than their two-tier counterparts. Alternatively, an established nonequity track for service partners in a two-tier firm may be attractive to talented lawyers who want the title of partner but may lack the ability or desire to engage in business development. In essence, a two-tier partnership can be cast as a tournament with a higher probability of obtaining a smaller, but perhaps more desirable, prize—nonequity partner.

In fact, the statistics on hours billed per week and attrition suggest significant differences between single-tier and two-tier firms. For example, as shown in Table 11, associates in single-tier firms billed on average 1.8 hours more per week than associates in two-tier firms. Using an independent sample t-test, I confirmed that these means were significantly different ($p = .029$). Similarly, associates in two-tier firms reported that they were more likely to remain with the

---

161. *Cf. Profit Sharing*, *supra* note 34, at 357–58 & n.73 (hypothesizing that firms with a sharing approach are more likely to have longstanding ties to large institutional clients, such as banks, that bring in a steady and predictable flow of work).

162. *Compare* GALANTER & PALAY, *supra* note 1, at 100–02 (discussing existence and incentive effects of the promotion-to-partnership tournament), *with* Kevin A. Kordana, *Law Firms and Associate Careers: Tournament Theory Versus the Production-Imperative Model*, 104 YALE L.J. 1907, 1923–33 (1995) (arguing that associates are attracted to large firms for a combination of high pay and the development of general human capital skills rather than the opportunity to become a partner). The most recent Am Law Mid-Level Associate Survey contains clear evidence that at least some associates are very interested in their partnership prospects. *See* Amy Kolz, *Can You Hear Me Now?*, AM. LAW., Oct. 2005, at 104 (reporting that associates' score on "communication regarding partnership prospects" was the lowest among the twelve categories of associate satisfaction).

firm for the next two years; this difference was also highly statistically significant (p = .005). In other words, the dynamics of the promotion-to-partnership tournament appear to be different depending upon tier structure: associates in single-tier firms are working harder while associates in two-tier firms are more content with their jobs.[163]

Table 11. Hours Billed, Attrition, 2004 Am Law Associate Survey

Variable	Tier Structure	Mean	S.E. Mean	Std. Dev.	*N*
Average Hours Billed per Week	Single-Tier	46.32	0.772	4.09	*N=28*
	Two-Tier	44.47	0.241	2.48	*N=106*
Likelihood of Staying Two Years Score	Single-Tier	3.34	0.085	0.45	*N=28*
	Two-Tier	3.61	0.042	0.43	*N=105*

To explore the possibility that differences in the partnership tournament in single-tier versus two-tier firms lead to differences in the underlying determinants of firm profitability, I specified a linear regression model with profits per partner as the dependent variable and five independent variables related to firm profitability: (1) proportion of lawyers in New York and Global Cities; (2) leverage; (3) prestige; (4) average associate hours billed per week; and (5) likelihood that associate will be with the firm for at least two years.[164] The first three factors were included in the regression model summarized in Table 8. The fourth factor, average hours billed per week, is presumably associated with higher firm profits. The theoretical relationship between profitability and the fifth factor, likelihood that an associate will remain with the firm during the next two years, is more ambiguous. For example, low scores on this variable could be associated with excessive lawyer attrition that could

163. Although it is tempting to impute dissatisfaction or unhappiness to associates in single-tier firms, another possibility is that associates in single-tier firms have more attractive outplacement options. *Cf. Associate Career Patterns*, *supra* note 34, at 581–86 (suggesting that highly leveraged and prosperous partnerships in New York City may be able to sustain the traditional out-or-out partnership model because the outplacement prospects from these firms may be significantly above average).

164. Using 1993 Am Law 100 data, Chadwick and Hanna found that law firm size was a relevant determinant of law firm profitability after controlling for number of branch offices. *See* Chadwick & Hanna, *supra* note 55, at 63. Therefore, in another regression model, I included all the variables in Table 12 plus the number of lawyers and the number branch offices. However, firm size had no statistically significant relationship with profitability while number of offices was associated with *lower* PPP. The remaining variables in the model remained statistically significant, and overall, the model that included firm size and branch offices was not a better predictor of firm profitability. In the interests of brevity, that expanded model is omitted.

adversely affect client service.[165] Alternatively, a high score may be partially a function of a liberal promotion to nonequity partner and the lack of better employment options.[166] From the perspective of firm management, this attrition variable should have either a positive relationship or no relationship with firm profits, after controlling for the other four variables.

Table 12. OLS Regression Model, Dependent Variable is 2003 PPP

Variable	B	Std. Error	Beta	Sig.
(Constant)	-$1,451,438	$447,735		0.002
% Lawyers in NYC / Global Cities	$450,735	$91,096	0.322***	0.000
Calculated Leverage 2003	$56,742	$22,486	0.135*	0.013
Mid-Level Prestige Score	$204,553	$51,484	0.204***	0.000
Average Hours Billed per Week	$42,667	$9,348	0.290***	0.000
Likelihood of Staying Two Years	-$229,218	$57,464	-0.235***	0.000
N	**131**			
Adj. R^2	**0.732**			

* Significant at p = .05 *** Significant at p = .001

As shown in Table 12, all five factors appear to be determinants of firm profitability. Further, the model explains more than 73% of the variance between firms. However, the variable for the likelihood that an associate will remain at the firm for two years has a negative relationship with firm profitability. In other words, the more secure or content an associate feels in his or her job, the less profitable it is for the firm, after controlling for market segment, leverage, firm prestige, and hours billed.

To determine whether this pattern was more predominant in two-tier law firms (because, for example, these firms were attracting a disproportionate number of lawyers interested in the service partner track), I ran the same regression model separately for single-tier and two-tier firms. The results, which are summarized in Table 13, suggest at least three significant distinctions between single- and two-tier law firms in the Am Law 200 marketplace. First, there is a negative relationship in two-tier firms between profitability and the

165. *See, e.g.*, *supra* note 85 and accompanying text (discussing how a nonequity tier can be used to ensure client continuity).

166. *See supra* note 163.

likelihood that an associate will stay two years (p = .001); in contrast, this relationship is not statistically significant for single-tier firms. Second, the financial benefits of leverage appear to be more pronounced in single-tier firms; one unit of leverage is associated with an additional $136,941 in profits per partner, versus $38,804 in a two-tier firm. As noted earlier, because of competitive labor markets for high quality associates, the creation or expansion of a nonequity partnership track may be the only feasible way to increase leverage.[167] Although it may be more expensive than running an up-or-out tournament with more associates, it is noteworthy that higher leverage is, nonetheless, associated with higher profits. Third, the reputational capital appears to be more valuable in single-tier firms; one unit of prestige (on a one to five scale) is worth approximately $358,000, versus $168,000 in a two-tier firm. This finding is consistent with the Gilson and Mnookin framework.[168]

167. *See supra* Part II.B.2.
168. *See supra* Part I.A.

Table 13. OLS Regression Model, Dependent Variable is 2003 PPP, by Tier Status

MODEL FOR SINGLE TIER				
Variables	**B**	**Std. Error**	**Beta**	**Sig.**
(Constant)	-$2,184,240	$1,202,017		0.083
% Lawyers in NYC / Global Cities	$386,536	$151,147	0.282*	0.018
Calculated Leverage 2003	$135,941	$64,138	0.247*	0.046
Mid-Level Prestige Score	$357,719	$98,783	0.306**	0.002
Average Hours Billed per Week	$33,136	$17,316	0.249	0.069
Likelihood of Staying Two Years	-$165,173	$154,340	-0.138	0.430
N	**27**			
Adj. R^2	**0.863**			
MODEL FOR TWO-TIER				
Variables	**B**	**Std. Error**	**Beta**	**Sig.**
(Constant)	-$1,558,069	$522,552		0.004
% Lawyers in NYC / Global Cities	$436,896	$127,409	0.301**	0.001
Calculated Leverage 2003	$38,804	$26,189	0.108	0.142
Mid-Level Prestige Score	$167,528	$70,361	0.163*	0.019
Average Hours Billed per Week	$50,965	$12,061	0.331***	0.000
Likelihood of Staying Two Years	-$240,341	$67,731	-0.273***	0.001
N	**104**			
Adj. R^2	**0.633**			

* Significant at p = .05 ** Significant at p = .01 *** Significant at p = .001

Overall, the separation of the sample by tier structure also produced a better fitting model for single-tier firms.[169] Although the sample size is relatively small (N = 27), the model explains over 86% of the variance in profitability among single-tier firms. In contrast,

169. Here, I am commenting on how the goodness-of-fit measure (adjusted R^2) is higher in the model run on the single-tier firm (Table 13) versus all firms combined (Table 12). If tier status were irrelevant to law firm profitability, the reduction in the sample size would ordinarily lead to a diminution (or no change) rather than an increase in this statistic.

the model is a less robust predictor in two-tier firms, explaining approximately 63% of the variance in firm profits. This divergence suggests that single-tier firms may be more homogenous (e.g., more elite) in their client base and/or the caliber of lawyers they attract to the firm. Conversely, the greater heterogeneity among two-tier firms suggests a potentially larger role for effective (or ineffective) management or incentive systems as determinants of law firm profits.[170] This last observation is certainly good news to law firm consultants.

D. *Tier Structure and Changes in Profitability over Time*

Section D explores a simple but important question of law firm strategy: Is switching to the two-tier format associated with higher increases in law firm profitability over time? To test this hypothesis, I specified a regression model with the increase in profits per partner between 1994 and 2003 as the dependent variable and four independent variables: (1) the proportion of lawyers in New York and Global Cities in 1993;[171] (2) change in the proportion of lawyers in New York and Global Cities between 1993 and 2003; (3) profits per partner in 1994; and (4) a dummy variable for whether a firm remained single-tier or switched to two-tier during the observation period.

Table 14. OLS Regression Model, Change in PPP between 1994 and 2003

Variables	B	Std. Error	Beta	Sig.
(Constant)	$81,366	$87,056		0.355
Percent of Lawyers in NYC, Global 1993	$362,430	$103,165	0.532***	0.001
Chg in % NYC, Global, 1993–2003	$782,727	$356,243	0.244*	0.033
1994 PPP	$0.44	$0.15	0.452*	0.005
Changed to Two-Tier, 1994 to 2003	$90,123	$55,063	0.181	0.109
N	**49**			
Adj. R^2	**0.563**			

* Significant at p = .05   *** Significant at p = .001

170. The heterogeneity of two-tier law firms is the topic of Part IV.B, *infra*.

171. Because the dependent variable is change in PPP between 1994 (the first year that *The American Lawyer* reported tier status) and 2003, it would be ideal to use a locational variable based on 1994 data. Unfortunately, the dataset only includes locational data for 1993 and 2003. The difference, however, is presumably negligible.

The results, which are summarized in Table 14, reveal a modest relationship between switching to the two-tier format and higher law firm profitability. This relationship, however, does not satisfy the conventional .05 or .10 threshold for statistical significance. Therefore, it remains unclear whether switching to a two-tier format is an effective strategy for increasing law firm profitability. One possibility is that the sample contains both effective and ineffective implementations of the two-tier structure, which would result in positive and negative effects on profitability that offset one another.

An alternative strategic advantage of the two-tier structure may be its ability to increase the proportion of nonequity to equity partners, thus tempering the growth of the denominator in the PPP calculation.[172] To test this hypothesis, I specified a similar regression equation with the increase in profits per partner between 1994 and 2003 as the dependent variable and four independent variables: (1) the proportion of lawyers in New York and Global Cities in 1993; (2) change in the proportion of lawyers in New York and Global Cities between 1993 and 2003; (3) profits per partner in 1993; and (4) change in the ratio of nonequity to equity partners (NE:E) between 1993 and 2003.[173]

Table 15. OLS Regression Model, Change in PPP between 1994 and 2003

Variables	B	Std. Error	Beta	Sig.
(Constant)	$123,058	$52,415		0.021
Percent of Lawyers in NYC, Global 1993	$480,945	$88,442	0.612***	0.000
Chg in % NYC, Global, 1993–2003	$1,246,622	$253,650	0.421***	0.000
1993 PPP	$0.320	$0.121	0.274**	0.010
Change in NE:E, 1993 to 2003	$117,102	$58,632	0.153*	0.049
N	**86**			
Adj. R^2	**0.527**			

* Significant at p = .05 ** Significant at p = .01 *** Significant at p = .001

172. *See, e.g.*, Blum, *supra* note 67 ("It's simple mathematics. Remove from the total a firm's more junior partners—who tend to take home a smaller piece of the pie—and the average will jump.").

173. In the case of a single-tier firm, NE:E is obviously equal to zero. *See supra* Part II.B.4.

The results, which are summarized in Table 15, suggest that increasing the size of the nonequity tier is associated with an increase in profits per partner. Specifically, even after controlling for market segment, change in market segment, and initial profitability, we would expect an increase in the ratio of nonequity to equity partners of one unit (e.g., from 0 to 1 NE:E, or 0.5 to 1.5 NE:E) over the ten-year observation period to result in an increase in profits per partner of approximately $117,000. However, the average increase in NE:E between 1993 and 2003 is relatively small: 0.239 units, with a standard deviation of 0.453.[174] Thus, for most firms, this strategy would not be expected to produce large gains in profits per partner. Overall, initial profitability and a firm's foothold and growth in New York and Global Cities appear to be more robust predictors of increased profitability. Further, successful, large-scale expansion of the nonequity tier may depend on other factors not controlled for, such as a firm's prestige.[175]

In summary, there is little empirical evidence that either switching to the two-tier model or expanding the relative size of the nonequity partnership track produces significant financial benefits for a firm's equity partners. If this is true, it raises the question of why the Am Law 200 marketplace has steadily migrated to the two-tier format.[176] Certainly one plausible answer is law firm stability.[177] Specifically, the exit of key partners can often operate as a catalyst for the breakup of the firm.[178] To forestall such an outcome, the two-tier structure can be used as a mechanism to bond the firm to the marginal product approach, thus funneling more income (and, perhaps more importantly, managerial control) to the firm's most powerful partners. In addition, the distribution of income *within the equity tier* may be skewed toward the partners with the most significant books of business. Therefore, returning to the Gilson and

174. *See supra* Table 1.

175. It is perhaps telling that Kirkland & Ellis, a highly prestigious two-tier firm, was one of the most aggressive in the expansion of its nonequity tier. Kirkland's increase in PPP between 1993 and 2003 was $1.2 million, which is the fourth highest in the sample.

176. For a summary of the number of firms that have switched to the two-tier format, see *supra* notes 12–18 and accompanying text.

177. *See supra* text accompanying note 87 (discussing how two-tier structure might be utilized as a method to mitigate the potential for defections that could destabilize the firm).

178. *See, e.g.*, WILLIAM G. JOHNSTON, ANATOMY OF LAW FIRM FAILURES: A LOOK AT US LAW FIRM DISSOLUTIONS FROM 1998–2004, at 14–16 & Exhibit A (2004) (reporting that partner defections were catalysts in numerous large law firm dissolutions between 1998 and 2004), *available at* http://www.hilderbrandt.com/PublicDocs/DOC_ID_1739_492004850218.pdf.

Mnookin framework, we might expect greater variations in profit distributions in two-tier firms, which are associated with the marginal product approach, versus single-tier firms, which more closely track the sharing model.[179]

IV. DISCUSSION

This final Part covers two topics. Section A outlines a unified theory on the adoption and operation of single-tier versus two-tier partnerships in the Am Law 200 marketplace. Section B concludes with some preliminary observations that two-tier partnership structures are much more diverse than the coding system used in this study suggests. Therefore, careful qualitative examinations of successful two-tier firms may provide important information on what formats provide effective incentives for both partners and associates.

A. *A Theory of Single-Tier Versus Two-Tier Law Firms*

The findings set forth in Part III of this study suggest that the movement toward the two-tier model, which is ostensibly driven by a pursuit of higher profits per partner, may be substantially influenced by a firm's relative standing in the marketplace. Specifically, tier structure appears to be a function of a firm's reputational capital.[180] Further, large disparities between single-tier and two-tier firms suggest that they are organized and operate under significantly different rules and constraints.

Single-tier firms, for example, are more likely to have a larger base of lucrative clients with longstanding ties to the firm; thus, partners lack the incentive (and possibly the ability) to obtain higher compensation through grabbing or leaving.[181] Insofar as the single-tier structure reflects a commitment to share both the risks and rewards of the partnership, single-tier firms allocate work to the most cost-effective associates and partners without squabbles over business origination credits.[182] In the long run, this internal dynamic further solidifies the firm's reputation for high quality service.[183] The higher

179. *See supra* notes 39–44 and accompanying text.

180. *See supra* Part III.B.

181. *See supra* notes 52–54 and accompanying text (discussing benefits of firm-specific capital, such as reputation); *see also supra* Tables 5–8 and accompanying text (descriptive statistics and regression results showing strong relationship between prestige and law firm profitability).

182. *See supra* notes 45–47 and accompanying text (discussing perverse incentives that can affect the performance of firms using the marginal product approach).

183. *See supra* notes 45–46 and accompanying text (discussing how lack of sharing within a firm can undermine quality and efficiency of work product).

profitability and prestige of single-tier firms also has significant effects on recruitment, attracting top graduates of the nation's leading law schools who are willing to work longer hours to attain the prize of equity partnership.[184] The caliber of associates the firm attracts, in combination with strict partnership admission standards, mitigates the risk of shirking. Finally, the halo of the firm's prestige also benefits the lawyers who are vanquished in the partnership tournament, supplying them with excellent outplacement options as a consolation prize.[185]

In contrast, single-tier firms with low indices of prestige appear destined to become two-tier firms.[186] The firm's most lucrative clients are primarily drawn to the firm based on the reputation and service of individual lawyers. This rainmaking class of partners is loathe to share firm profits with their less productive counterparts. Unless these "partners with power" are rewarded at their marginal product, there is a substantial risk that they will leave the firm and their clients will follow.[187] As the profit pie shrinks, other members have an incentive to defect, thus threatening the very survival of the firm.[188] Thus, a less prestigious firm bonds itself to the marginal product approach by adopting a two-tier (or multi-tier) partnership structure. Long-term control of the firm, including the division of profits, is thus given to the lawyers who are qualified, by dint of their marginal product, for the equity tier.[189]

Yet, this study's empirical findings suggest that the two-tier structure raises other difficult incentive problems. For example, a two-tier firm will allocate a large percentage of its profits to powerful

184. *See supra* Part III.C.

185. *See supra* notes 159–61 and accompanying text (suggesting that outplacement options might be better in single-tier versus two-tier firms).

186. *See supra* Part III.B.

187. *See supra* notes 143–45 and accompanying text (theorizing about why firms are switching to a partnership structure associated with lower PPP).

188. *See supra* note 178 and accompanying text (discussing how departures of key partners can lead to the collapse of a firm); *see also* Heidi Moore, *Testa Hurwitz To Disband*, DAILY DEAL, Jan. 17, 2005 (reporting that 280 lawyer Am Law 200 firm voted to disband "after failing to find a merger partner following ten major partner defections in [the previous month]"). Testa Hurwitz was included in the dataset used in this study; they are categorized by *The American Lawyer* as a single-tier firm.

189. As one law firm consultant has observed, "When the voting control is in the hands of those [partners] who don't drive its economic growth, you put the firm at risk of a move toward mediocrity." *Meaning of Partnership*, *supra* note 53, at 8 (quoting Ward Bower of Altman Weil, Inc.); *see also* Stille, *supra* note 129 (observing, in 1984, that the movement toward the two-tier system is "to toughen partnership standards; to reward stars and cut dead wood; to centralize power in the firm and to retain valued specialists but separate them from the select few who actually run the firm").

and mobile rainmaker partners and limit the class of new equity partners. But to mitigate attrition costs in order to maintain (or build) client loyalty to the firm, it must construct a partnership tournament that is attractive to highly capable new lawyers. The smaller prize of nonequity partnership warrants less sacrifice by young associates and makes high billable hour requirements (or expectations) more difficult to enforce.[190] Yet, the lower economic value of nonequity partnership is counterbalanced by the more liberal promotion standards to the nonequity tier and the psychic benefits of making partner; to the outside world, no distinction is made between equity and nonequity status.[191] Indeed, from the perspective of young associates, nonequity partners may appear to have struck the best balance between professional and personal success.[192] Thus, two-tier firms run the risk of creating a deleterious self-selection dynamic if the firm attracts a disproportionate number of associates who are content to settle for service partner status. The difficulty of creating a proper incentive system might explain the mixed financial performance of single-tier firms that switch to the two-tier format.[193]

B. Heterogeneous Incentive Structures in Two-Tier Firms

All of the significant findings in this study depend upon a relatively crude dichotomous variable: single-tier versus two-tier (or multi-tier) partnership structure as defined by *The American Lawyer* magazine.[194] The principal theoretical framework has relied upon tier structure as a proxy for two ends of a continuum. Single-tier firms represent one pole and presumably hew closer to Gilson's and Mnookin's sharing model, lockstep compensation, and a larger tournament prize of equity partnership. At the other end are two-tier firms, which track, albeit imperfectly, the marginal product approach, eat-what-you-kill compensation, and a higher probability of winning a

---

190. *See supra* Part III.C.

191. *See supra* note 44; *see also* Fleury, *supra* note 78, at 1 (noting that law firms "want the line [between equity and nonequity tiers] to be transparent to the outside world"); Kenneth M. Hildebrandt, *What To Do if the Business Climate Continues To Slow*, ACCT. L. FIRMS, June 2001, *available at* http://www.westlaw.com (law firm consultant noting that one of the advantages of nonequity status is that lawyers "can forgo the risks and rewards of associated with ownership, but would still be viewed by the outside world as a partner").

192. *See* sources cited *supra* notes 77–78 (referring to nonequity status as a "lifestyle choice" for "good lawyers [who] don't want to sacrifice their personal lives in order to make [equity] partner").

193. *See supra* Part III.D.

194. *See supra* Part II.B.1

less valuable prize.[195] As it turns out, this simple tier variable has significant explanatory power. Yet, it would be a mistake to rely on this study to draw any broad conclusions on what is the "best" partnership structure.

This cautionary note applies with special force to two-tier partnerships. Although the regression models for law firm profitability in Part III generally had impressive predictive power, the unexplained variance for two-tier firms was 36.7% versus only 13.7% for single-tier firms.[196] This large disparity suggests that two-tier law firms are probably much more heterogeneous than single-tier firms. In fact, this study's blunt coding method masks a wide variety of tier formats meant to embody dramatically different incentive structures for both associates and partners.[197] Further, the large quantity of reputational capital in most single-tier firms is presumably much more forgiving of firm mismanagement. In contrast, to hold the firm together, managing partners at non-prestigious two-tier firms need to reward star performers at their marginal product while simultaneously motivating young lawyers, without the lure of equity partnership, to stay at the firm and work long hours.

Probably the best way to understand how a law firm manager can thread this very narrow needle is to conduct a detailed qualitative examination of the different types of two-tier law firms. To illustrate this point, consider some similarities and differences between two prominent two-tier firms based in Chicago,[198] Winston & Strawn and Kirkland & Ellis, which are summarized in Table 16. Both firms have leverage in the top quartile of Am Law 200 firms.[199] In addition, both firms have high ratios of nonequity to equity partners that place them

195. *See, e.g.*, Terry Carter, *A Delicate Balance: Law Firms Seek Ways To Please the Superstars Without Demoralizing Others*, A.B.A. J., Mar. 2005, at 28 (commenting that "[i]mplicit" in the movement toward two-tier partnerships "is some emphasis on eat-what-you-kill").

196. *See supra* Table 13.

197. Unfortunately, this information is not readily collectible. Large law firms do not divulge the inner-workings of their equity and nonequity tiers—though it is remarkable how much about their firms they are willing to provide to the legal press. Apparently, firms fear that a negative inference will be drawn if they fail to cooperate.

198. Chicago has actually been referred to as the "land of the two-tier partnerships" because of its early adoption by many of the city's leading firms. *See* Cindy Collins, *Anchoring Associates: Akin Gump Creates Intermediate Fast-Track Step to Partnership*, OF COUNSEL, Nov. 2, 1998, at 17.

199. Leverage is defined as a firm's total number of lawyers divided by number of equity partners. *See supra* note 22.

in the top 10% nationally.[200] Further, both firms are leaders in the disparities between the average compensation of nonequity and equity partners.[201] However, this gap is much more pronounced at Kirkland & Ellis because of its towering profits per partner ($1,900,000), which is the fourth highest in this study.

Table 16. Comparison of Two Large Chicago Law Firms

Firm	Total Lawyers	Leverage	NE:E	2003 PPP	Avg. Comp. NE partners
Kirkland & Ellis	805	4.40	1.06	$1,900,000	$400,000
Winston & Strawn	854	5.44	1.20	$815,000	$305,000

Yet, the large profits per partner differentials may be strongly influenced by differences in the firms' two-tier partnership structures. For example, Winston & Strawn appears to operate a two-tier model in which the nonequity partnership track can be a permanent position within the firm.[202] Over the years, the structure has drawn criticism from within the firm. In 1995, when the firm's profitability began to slide, Winston & Strawn's managing partner openly questioned whether the firm had been "too generous in handing out nonequity partnerships in the first place."[203]

The following year, the American Lawyer Mid-Level Associates Survey gave the firm low marks for a high billable hours requirement and overall associate satisfaction.[204] According to one Winston & Strawn associate, "Long hours with average pay have resulted in

200. *See Fixed Income Devotees*, AM. LAW., July 2004, at 95 (listing the seven firms in the Am Law 100 in 2004 that had more nonequity than equity partners, including Kirkland & Ellis, ranked third, and Winston & Strawn, ranked seventh).

201. *See A Pay Differential*, AM. LAW., July 2004, at 95 (showing in table format the PPP and average compensation for nonequity partners for the seven firms in the Am Law 100 with the largest proportion of nonequity to equity partners).

202. *See* HEINTZ & MARKHAM-BUGBEE, *supra* note 8, at 33–41 (describing characteristics of this type of two-tier firm and designating it as Model B). There is some evidence in the legal press that Winston & Strawn's nonequity partners are viewed primarily as service partners. For example, in 1993, the managing partner of Winston & Strawn, Gary Fairchild, commented that the firm's nonequity partners "oversee 'individual engagements,' ... while equity partners are the 'principal client managers.'" Weidlich, *supra* note 154. The same story reported that Winston & Strawn had no set timetable for promotion to the equity tier. *Id.*

203. *See* Karen Dillon, *Going to Extremes*, AM. LAW., July-Aug. 1995, at 13 (reporting comments of firm's managing partner, James Neis).

204. *See* Ann Shoket, *Special Report: 1996 Midlevel Associate Survey; Chicago, Highlights*, AM. LAW., Oct. 1996, at S36.

significant attrition at the firm .... [Winston] wants to have a New York practice with New York hours but pay Chicago salaries."[205] Yet, by 2004, the firm's overall associate satisfaction was the second highest among Am Law 100 firms.[206] Its score for family friendliness was 3.80, which was at the 75th percentile among firms in the sample. In addition, its score for likelihood of staying at the firm for the next two years was 4.27, which is at the 95th percentile among all firms in the sample. Based on these statistics, it is certainly possible that the nonequity tier may hold out substantial long-term appeal for Winston & Strawn associates.

The partnership structure at Kirkland & Ellis presents a dramatic contrast. Kirkland & Ellis essentially operates a two-stage up-or-out tournament for equity partnership in which associates are eligible for the nonequity tier after approximately six years; thereafter, the newly-minted partners have four years to acquire the necessary skills and track record to be promoted to equity partner.[207] During the second stage of the tournament, nonequity partners are annually evaluated and ranked against one another, with those at the bottom of the class typically leaving the firm.[208] Those not admitted to the equity tier at the end of the four years also generally leave the firm.[209] Associates at Kirkland & Ellis bill an average of 51.5 hours per week (compared to 46.7 at Winston & Strawn), which is among the highest of any two-tier firm in the sample.[210] Not surprisingly, the firm's family friendliness score was 2.78, which is in the bottom 5% of the sample.

Yet, Kirkland & Ellis's two-tier structure may contain a significant competitive advantage. Specifically, even though the firm

205. *Id.* (quoting anonymous Winston & Strawn associate).

206. *Associate Satisfaction Leaders*, AM LAW., July 2004, at 94.

207. *See* HEINTZ & MARKHAM-BUGBEE, *supra* note 8, at 25–33 (describing characteristics of this type of two-tier firm and designating it as Model A).

208. *See* Frankel, *supra* note 12, at 92 (discussing rank and yank dynamic among Kirkland's nonequity partners and noting the firm's management makes "no pretense that they are true partners").

209. Carrie Johnson, *The Slow Demise of 'Up or Out'*, N.J. L.J., Jan. 26, 1998, at 30 (quoting head of Kirkland & Ellis' recruitment committee that firm generally promotes ten nonequity partners to the equity tier out of a typical class of fifteen to twenty and that lawyers who fail to achieve this status after four years generally leave the firm).

210. Associates at the following single-tier firms, all based in New York City, reported higher average billable hours per week: Sullivan & Cromwell (54.9); Cravath, Swaine & Moore (53.6); Davis Polk & Wardwell (51.6); and Paul, Weiss, Rifkind, Wharton & Garrison (51.6). Only Paul Weiss had lower profits per partner than Kirkland & Ellis, and only just barely: $1,840,000 versus $1,900,000.

has a well-known reputation for being a "sweatshop,"[211] Kirkland & Ellis's score for likelihood of staying two years (3.57) was slightly below the median for two-tier firms (3.65) and significantly above the median for single-tier firms (3.22). This unusual disparity may be explained by the following observation from an associate in a large, highly prestigious (single-tier) firm in New York City:

> In my opinion having a two-tiered partnership is a great boon to associates at top firms. Having two tiers of partnership greatly increases the possibility that senior associates at large firms will find a good "next stop" if they do not make it to equity. The practice of Kirkland making almost all competent 7th years nonequity partners both keeps them at the firm longer and retains within the firm substantial institutional knowledge and gives the associates turned partner a psychological boost and a huge leg up on their next job. Track the movement of Kirkland nonequities, and you would be shocked. If you were a CEO trying to sell the Board on a new general counsel, what goes down easier, a "partner at Kirkland" or an "associate at Davis Polk"?[212]

As this passage suggests, Kirkland & Ellis's two-tier structure provides a potentially valuable hedging feature for associates who make it to the nonequity tier—an attribute they are willing to pay for through more grueling work conditions. In summary, two-tier structures can take a variety of forms, and some systems of incentives may be more advantageous to some firms than others.

CONCLUSION

This study provides a new empirical context to evaluate the continued movement to the two-tier partnership structure. Drawing upon a comprehensive dataset of Am Law 200 law firms, it documents that single-tier firms are (a) more profitable than two-tier firms, (b) utilize lower leverage, and (c) have higher indices of prestige. Therefore, at first glance, the economic benefits of the two-tier structure are not readily apparent. However, a careful interpretation of several multivariate regression models, which examine the determinants of law firm structure and profitability,

---

211. *See, e.g.*, BROOK MOSHAN GESSER, VAULT GUIDE TO THE TOP 100 LAW FIRMS, 2005 EDITION 169, 173 (2004) (reporting on firm's reputation as the "mother of all sweatshops").

212. Email from associate to William D. Henderson (Aug. 25, 2005) (on file with the North Carolina Law Review). The associate asked to remain anonymous.

suggest that tier structure is largely a function of firms' relative standing in the market for high-end corporate law services. Other factors, such as firm size and profitability, do not appear to be statistically relevant.

Further, the success and stability of a relatively small cohort of elite single-tier Am Law 200 law firms is probably attributable to three interrelated factors. First, a highly prestigious firm enjoys high client demand for high-end, noncommodity legal services, which enhances firm profitability. Second, the superior profitability and prestige of these firms creates significant advantages in the recruitment of highly talented young associates, who, in turn, are willing to work longer hours under more grueling conditions in order to attain the tournament prize of equity partnership. Employment at a prestigious law firm also generates superior outplacement options, thus permitting associates to hedge the risk of investing in firm-specific capital. Third, the high profits per partner in these firms, in combination with client loyalties that run primarily to the firm rather than individual lawyers, mitigate both the incentive and the ability of partners to grab and leave. Thus, highly prestigious firms are better positioned to share the benefits and risks of partnership—embodied in the single-tier partnership structure—and foster a long-term institutional outlook, which redounds to the benefit of clients and further solidifies the firm's reputation for superior quality and client service.

However, the synergies of a single-tier partnership require a critical mass of reputational capital in order to make the model self-sustaining. Further, because client loyalties in less prestigious firms tend to run to individual partners, the sharing ethos of a single-tier structure can actually become a source of firm instability. In order to diminish the possibility that a firm's most valuable rainmakers will grab and leave, less prestigious firms must apportion profits at a level that approximates each partner's marginal product. The adoption of a two-tier format, therefore, can be seen as a governance structure that bonds the firm to the marginal product approach and consolidates managerial power within the equity tier. Although the two-tier format is not associated with statistically significant higher growth in PPP, firm stability arguably provides ample economic benefit to justify the movement to a two-tier or multi-tier partnership structure.

Finally, drawing on the multivariate regression results presented in this study, the mixed financial performance of two-tier firms may be partially attributable to a deleterious self-selection effect in which

the firm attracts a disproportionate number of associates who aspire to the less demanding role of nonequity partner. With the exception of a handful of highly prestigious Am Law 200 firms, most law firm managers at major corporate law firms face the daunting challenge of needing to reward stars performing at their marginal product while simultaneously motivating young lawyers, without the carrot of equity partnership, to stay at the firm and work long hours. This problem can be solved, or mitigated, by liberal promotion to nonequity partner. However, as the results of this study suggest, striking the proper balance is easier said than done.