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NEWS

Is Leverage Overrated?

Kellie Schmitt

[The Recorder](#)

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DLA Piper Rudnick's J.
Terence O'Malley.

image: Jason Doiy/The
Recorder

Law firm leaders throughout California identify increasing leverage as a key strategy in their business model. Leaders at Sheppard, Mullin, Richter & Hampton and Gibson, Dunn & Crutcher, to name a couple, are looking at ideas for ramping up their leverage.

"I'd like to increase incrementally our leverage," said Sheppard Chairman Guy Halgren. "I am confident that we could support higher than 2-to-1 leverage because our young attorneys are extremely busy."

Some consultants and a few law firm leaders, though, think associate-to-partner leverage may be overrated as a means of increasing a firm's profitability. In fact, Thomas Morrison, managing director of Citigroup's law firm group for the West Coast, says his company's recent study shows a correlation between high profitability and lower leverage.

In the current California market, Morrison says, demand for legal services is too low to support a high-leverage model, which he classifies as 3-to-1 and higher.

The key to maximizing profit per partner is optimizing associate use without having excess manpower, Morrison said. "It's a strategic balancing act," he said. "Increasing leverage over the last five years hasn't been profitable."

A 2005 Citigroup study of 146 firms nationwide showed that leverage dropped by 3.5 percent in 2004 for the 30 most profitable firms -- and Morrison anticipates another similar decline this year. Firms with lower leverage, such as Gibson Dunn (2.1-to-1) and Irell & Manella (1.6-to-1), are often listed among the state's most profitable firms on the *American Lawyer's* Am Law 200, he pointed out.

"One of the reasons these folks outperformed is because they reduced leverage," Morrison said.

Not everyone agrees with Morrison's take. Peter Zeughauser, a Newport Beach, Calif., law firm management consultant, said he believes leverage is increasing market-wide. Many law firm leaders also expressed surprise at the Citigroup study, arguing that today's market can support higher leverage models.

At Paul, Hastings, Janofsky & Walker, leverage is a key part of the firm's overall economic strategy, along with billing rates, hours and realization. While Managing Partner Greg Nitzkowski said the firm's 3-to-1 leverage is right for them now, they'll continue to scrutinize leverage as they strive to improve their overall economics.

"We can't rest because no one else is," Nitzkowski said. "Are law firms going to continue to use leverage to improve their overall economics? I say yes -- this is a trend."

Gibson, Dunn, which recently decided to create a nonequity partner tier, may see more of an



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opportunity with its low leverage than a firm like Paul, Hastings or Latham & Watkins, which are closer to optimization, Nitzkowski said.

Zeughauser, too, said raising leverage would make sense for Gibson Dunn. "They're producing high profits per partner by having a lot of partners work lots of hours for high rates," he said. "Increasing leverage is the next step to increasing profitability."

J. Terence O'Malley, the co-managing partner in the United States for DLA Piper Rudnick Gray Cary, takes a middle ground in the debate. He said leverage can lead to profitability, but only if matched effectively with a firm's billing rate structure and its level of utilization.

"If your associates aren't busy or the work being done is priced at low levels, high leverage will be your enemy, not your friend," O'Malley said. "To the extent a lean and mean staffing approach corresponds to high utilization rate, it will inevitably drive profitability."

In recent years, he's noticed that firms are focusing more on matching staffing with work flows and adjusting more quickly to surges in work by hiring laterally. DLA, for example, has hired upward of 100 lateral associates this year, O'Malley said.

"The marketplace is too competitive to allow you to be sloppy," he said.

While leverage is a part of a law firm's overall health, using it as a measurement of success can be overrated, said consultant Richard Gary.

"In and of itself, it doesn't tell you a lot about a firm -- it's probably a symptom of something else," he said. "It's dependent on a lot of things."

Certain practice areas such as litigation tend to be more highly leveraged because there's plenty of work for associates. Other areas like tax and corporate law require more partner expertise and tend to be lower leveraged.

At Irell, Managing Partner David Siegel says the firm has made a conscious choice to keep leverage below 2-to-1. "We always have been a model of lower leverage because we really focus on delivering quality legal work from fewer lawyers," Siegel said, "and giving the lawyers we do hire some greater opportunity for earlier responsibility."

That said, Siegel indicated the firm is interested in increasing its leverage slightly in upcoming years, but only if it can attract the same caliber of associates -- a challenge in the competitive Los Angeles market.

Liner Yankelevitz Sunshine & Regenstreif, a Los Angeles-based firm with 120 lawyers, has seen its leverage taper off from 4-to-1 as its transactional and contingency practices have grown over the past several years -- both areas that demand senior-level work.

The move is also client-driven, said Managing Partner Stuart Liner.

"They want a partner-level person negotiating, drafting and being on the telephone," Liner said. "Clients are sophisticated enough to figure out that if associates are not properly managed, they're capable of being less productive."

Clients are holding firms more accountable for how many hours and people are working on a case, which often translates into a lower leverage model.

Despite the varying approaches -- and predictions -- most analysts and leadership agree it all comes down to responding to the marketplace.

"You want to make sure lawyers will be fully utilized," said O'Malley from DLA. "If you can combine leverage with utilization, you have a happy ending."

BIGGER LEVERAGE NOT ALWAYS BETTER

Firm	Leverage	Profits/Partner
For some firms, high leverage hasn't translated into high profits...		
Baker & McKenzie	4:1	\$595,000

Jones Day	3.6:1	\$635,000
Reed Smith	3.2:1	\$560,000
Squire, Sanders & Dempsey	3.1:1	\$525,000
Sonnenschein Nath & Rosenthal	3.2:1	\$650,000
Shook, Hardy & Bacon	4.2:1	\$465,000
... while others have racked up big profits despite low leverage.		
Gibson, Dunn & Crutcher	2.1:1	\$1.375 million
Wachtell, Lipton, Rosen & Katz	1.2:1	\$2.585 million
Williams & Connolly	1.3:1	\$870,000
Quinn Emanuel Urquhart Oliver & Hedges	2.3:1	\$1.89 million
Munger, Tolles & Olson	0.9:1	\$1.045 million
Fenwick & West	2.3:1	\$935,000

Source: *American Lawyer's Am Law 200*

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