

December 7, 2006

## Guarding the Jewels

### In Study of Law Firms, Economists See Partners Eager to Keep Associates Away From Clients

By AARON RUTKOFF

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The American law firm has some unusual labor practices. Junior employees, recruited and cultivated at great effort and expense to the firm, either make partner after years of hard work, or they're asked to leave -- if they haven't yet done so on their own -- at which time they're replaced by another fleet of young lawyers.

Up to now, many economists have argued that the privileges and financial rewards of partnership drive the fearsome up-or-out competition. The quest for partnership is like an elimination tournament, the theory goes, which pushes young lawyers to invest time and energy developing valuable skills. Partners can wield the up-or-out mechanism as both carrot (i.e. "you made partner!") and stick (i.e. "you're fired!"), assuring that ambitious associates work their tails off to become productive lawyers.


But economists James Rebitzer and Lowell Taylor explain the up-or-out system differently. For them, the system is a natural solution to a property-rights problem. Law firms, in their view, contend with a constant challenge: protecting their only real assets, relationships with clients. And any dissatisfied attorney can, at least theoretically, walk away with those assets by stealing clients. That's why firms need to jettison top attorneys whom they aren't letting into the partnership.

In their new paper, "When Knowledge Is an Asset," to be published next year in the Journal of Labor Economics, Messrs. Rebitzer and Taylor argue that it's law-firm partners' desire to protect their "knowledge assets" that maintains the law firms' unusual and fragile labor structure.

Mr. Rebitzer is the Carlton Professor of Economics at Case Western University and an associate at the National Bureau of Economic Research, which first circulated "When Knowledge Is an Asset" as a [working paper in October](#)<sup>1</sup>. Mr. Taylor is a professor of economics and public policy at Carnegie Mellon University's Heinz School and a former member of President Clinton's Council of Economic Advisors. They spoke by phone with The Wall Street Journal Online's Aaron Rutkoff.

**Wall Street Journal:** *You've developed a new model that explains why law firms have such severe labor practices, one that allows only a small portion of associates to ultimately become partners. Can you give me*

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*the condensed version of your theory?*

**James B. Rebitzer:** The one-sentence summary of the model is when knowledge assets are very valuable, the structure of the organization is going to adapt to try and take advantage.

#### LEGAL THEORY



2 • **Read the full text**<sup>3</sup> of "When Knowledge Is an Asset," by James Rebitzer and Lowell Taylor.

What's special about the law firm and makes the problem acute . . . is that because there aren't physical assets that bind the firm you have to find other ways to keep the firm together.

A solution that seems to be pretty effective and pretty stable, when people can walk out of the firm with valuable assets, is to try and take the returns and [distribute them among] a relatively small number of people. And that's the key to the model.

**WSJ:** *Why did the two of you become interested in studying law firms?*

**Mr. Rebitzer:** We were interested in the very high-powered promotion incentives they have. They are very simple organizations with essentially one promotion: You're an associate, then you're a partner.

And as we were doing that work. . . it kind of imprinted on our brains just how screwy these enterprises were, how different they were from every kind of enterprise we'd seen. . . . Why was the jump from associate to partner such a huge jump in income and power? Why did they let go of people who they obviously still thought were very talented, and who they had put huge amounts of money and resources into attracting?

Talking to partners in some of these firms, it became clear to me how fragile they were, how concerned they were with people leaving with key assets.

**WSJ:** *What makes law firms particularly vulnerable to the loss of their key assets?*

**Lowell Taylor:** Think of the typical, textbook firm. There's an owner who owns a bunch of capital -- think physical capital, like forklifts and production lines. And then you hire workers to work on that production line. A group of employees can't grab the production line and leave General Motors. . . . Suppose you're running a law firm . . . Your firm couldn't possibly look more different because you have no physical capital at all -- say, maybe an office with a couple of desks. The real capital, the thing that gives this firm value, is the client list. That's the simplest way to put it.

**WSJ:** *So the delicate nature of the client-firm relationship determines the way law firms are organized?*

**Mr. Rebitzer:** That's the story we're telling. [The relationship] changes everything. You staff leanly at the partnership level because you don't want to give too many people the keys to the kingdom, which are these client relationships. As a consequence, to compensate for that, you've got hire more people to help, who are these junior attorney-apprentice types. But you have more of them than you're ever going to bring into the firm, so you've got to let some of them go.

**WSJ:** *What about other partnership enterprises that are built around serving clients, like accounting or*

*medicine?*

**Mr. Rebitzer:** Knowledge assets are not unique to law firms. Our framework suggests you need a case-by-case analysis. What I would not be surprised to see is that the problem of controlling valuable knowledge assets exists in other contexts, and what I would ask is what are the methods -- proprietary, contractual, reputational -- of controlling those assets.

One of the things that's different about doctors is that they have not one big client, or a few big clients, but a set of small clients. And it may be that in accounting services, the reputation of competency and incorruptibility rests more with the firm itself rather than with an individual accountant. In other words, you might remember the lawyer who won a big case for you more than you would an accountant who helped you balance your books. You'd perhaps be more inclined to give your legal work to a great lawyer who left his firm than you would give your accounting work to a great accountant who left a big firm. But I'm speculating a bit here.

**WSJ:** *How does the up-or-out organizational model give law firms more control?*

**Mr. Taylor:** Put yourself in the shoes of the partner in a small law firm. So you and a couple of partners have very valuable clients -- basically corporate contacts, people with whom you've built up trust over time.

Now you need a team . . . [and] you want to make sure that the mix of people in this team meet two criteria: either they are weak enough so that they can't grab-and-leave with the clients or they're rich enough so that they don't want to.

At the senior level, you run lean to protect your key assets. [And] . . . junior attorneys . . . won't have had the opportunity to build up the rapport to steal a client -- at least not early on . . . . The junior people may be doing all the work, but they really are held at arms length from the client. The consequence is a pyramid with a very wide base and a very narrow top.

The most effective way to get around this problem would be if [law firms] could do non-compete arrangements, but that appears to be viewed as unethical and, indeed, illegal in the legal profession.

**WSJ:** *And, historically speaking, law firms weren't always as vulnerable as they are now?*

**Mr. Rebitzer:** This form of organization . . . pretty much appeared with the rise of large corporations in the U.S. economy and with the attempts of the law firms to provide services to those large corporations.

You look at the folks who originated the modern corporate law firm, like [Paul D.] Cravath, and it's very clear to the historians who write about it that he was very interested in no one doing to him what he had done to his previous employers -- which was walking away with Westinghouse. Cravath also established a brand new way of finding junior attorneys that would have the exact attributes that Lowell described -- meaning that they're really smart and work very hard but they're not a threat to take clients away. The good way to find people like that is to get them out of law schools, because people come out of law schools really smart but in no position to take clients from anybody -- because they don't know how to do much.

**WSJ:** *And before large corporate firms, back in the 1800s, we didn't see an up-or-out system? Did you even*

*have to go to law school to be a lawyer?*

**Mr. Rebitzer:** About one third were law-school graduates, but two thirds were people who would simply apprentice with a senior practitioner.

**Mr. Taylor:** I'd work it like this, if I'm a 19th century attorney: I'm running this very small business with this small client list. I hire a junior attorney and pay him extremely low wages -- or maybe even works for free, like an apprentice -- and in exchange for that, he takes over my firm when I retire and he takes on an apprentice of his own. What I'm doing is selling the assets of my firm very slowly to my apprentice. That's the solution to the problem.

Now, all of that is well and good until some time in the [late] 19th century when these law firms could no longer serve their clients with a one- or two-person team. Suppose now that you're client is Westinghouse, and they're bringing you these complex legal problems where you need a team of 20 or 30 or 40 attorneys working on it together. You can no longer use this apprentice system.

**WSJ:** *So the practice of eliminating so many junior employees protects the partners' access to clients?*

**Mr. Taylor:** The really weird part about it, if you think about it, is that so many people are dismissed. A good law firm, a top law firm in New York say, will hire really junior people right out of Columbia and Harvard and Yale, keep them around for about seven years -- and by all accounts these people are working like dogs. They're doing a great job.

Yet more than half of them don't get promoted. I think it's less than that. It's just an extreme anomaly that so many of these people don't get promoted.

You'd think the second prize, instead of getting fired, would be a somewhat smaller salary than being partner. And firms don't do that, which may seem surprising. To us, it's not surprising at all. The worst thing you could, in our conception, would be to keep a bunch of people around who are competent but underpaid because they'd be the ones who walk off with all the clients.

**WSJ:** *Some law firms have created a position that's more than associate but less than partner. How do these people fit in?*

**Mr. Rebitzer:** Basically, they're people that are very good at some aspect of the job but who aren't expected to -- and don't -- pose a threat to develop independent relationships with clients that they could then walk away with.

**WSJ:** *The alternative theory about law-firm organization is all about incentives pushing people to compete for partnership. Why is the asset-protection model you've laid out a more appealing explanation?*

**Mr. Taylor:** We don't deny that these are, in fact, pretty powerful incentives. The threat of losing your job relative to getting partner is probably a good incentive. So the incentive model makes sense, we just don't think it could possibly be the whole story. Because otherwise it doesn't make sense that the losers have such a severe penalty.

There are plenty of lawyers who work in other environments -- that is to say not law firms, who work directly for corporations or for attorneys general offices, places like that. And they don't do this [up-or-out] system at all. They're just regular employees. And that makes sense, in our conception of things, because if General Motors is hiring lawyers just do to internal legal work they don't have to worry about the lawyers walking off with the client -- they are the client!

If it's the incentive system, where it's good to motivate junior people by giving them high-power incentives, why don't corporations do [the up-or-out] approach also?

**WSJ:** *Why don't we see this severe up-or-out model used more often, as a way to organize other enterprises?*

**Mr. Taylor:** Remember, the up-or-out system happens because there is this perpetual problem with assets. Law firms never establish much in the way of assets aside from their reputation or their clients, whereas even biotech firms or other knowledge firms eventually start getting real assets. Things like patents--

**Mr. Rebitzer:** Buildings and capital equipment, specialized capital.

**Mr. Taylor:** Law firms are almost unique in the extreme degree in which their assets are knowledge-based.

**Write to** Aaron Rutkoff at [aaron.rutkoff@wsj.com](mailto:aaron.rutkoff@wsj.com)<sup>4</sup>

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