Cool with clarity

Under boss Peter Kalis, K&L Gates is revealing all about its financials – unlike many of its rivals
Clarity is K&L Gates boss Peter Kalis’s not-so-secret weapon in putting clear blue water between his firm and others’ opaque financial reporting

When K&L Gates posted its financial results this February it laid itself bare. For the first time ever a US law firm had published a level of detail in its end of year financial report that was similar to a UK firm’s LLP filing.

K&L Gates’ move came less than a year after the collapse of Dewey & LeBoeuf, a firm that had overstated its final year’s turnover by around 16 per cent, or some $150m (£99m). At the time of Dewey’s collapse, Peter Kalis, the chairman and global managing partner of K&L Gates, was reported as commenting, “I was embarrassed to be part of the same profession and industry as Dewey & LeBoeuf.”

This year Kalis and his partners decided to put as much distance as possible between their firm and the soiled image created by a firm that had been found out.

Typically, the majority of US firms either report no financial results at all to magazines such as American Lawyer or, indeed, The Lawyer, or primarily release basic headline information such as total revenue, average profit and headcount. In contrast, in February K&L Gates went the whole hog.

Its 2012 financial results statement, prepared to Securities & Exchange Commission reporting standards, revealed all the usual data as well as its level of bank debt (zero), lines of credit ($75m), investments in IT and other overheads ($109.6m) and partner capital ($173.7m). And that just scratches the surface – overall there was an unprecedented level of detail that immediately had the market asking ‘why?’

Bare comparison

Culturally, this level of disclosure is not an easy sell. As Pannone finance director Anthony Clare puts it: “In any organisation there’s a degree of reluctance to increasing the level of transparency if you don’t have to. There’s a feeling you’re giving away state secrets, even when 99 per cent of the time you’re not. The feeling is: if I don’t have to, why would I?”

US law firm financial reporting is significantly less transparent than the UK’s. Here most firms have converted to LLP status and, consequently, most file their annual financial statements at Companies House within months of the year-end. At that point the accounts are pored over (and yes, to answer a frequently asked question, the legal press does go back and retrospectively check results). Any anomalies, if they exist, should thus be quickly uncovered.

No such regime exists in the US. Bluntly, US firms’ financial results are largely taken on trust. Legal market reporters, the primary interested parties outside the firms, quiz current and former partners, recruitment and other consultants and whatever ‘informed sources’ they can find to make a judgement call on the financial position of firms that choose not to provide data.

Reporters can, of course, also fall back on the results of previous years as a guide, although these will also be guesstimates. The result is a system that makes it relatively easy for firms to fudge their figures if they don’t wish to divulge them (and, of course, Dewey proves that even providing figures is no reliable guide to honesty).

This is not to say firms do fudge their figures, simply that the conditions exist to allow it. K&L Gates’ decision to lay bare its books may just be the start of the end of all that. The Wall Street Journal said it “could well be the most complete picture of a US firm’s financial performance”, the New York Times described it as “ground-breaking”, while industry commentator Bruce MacEwen of Adam SmithEsq.com called the disclosure “genius”.

Video link

Kalis has long been one of the globe’s most outspoken firm leaders. In February, prior to the publication of his firm’s results and the resulting media storm, The Lawyer met him in London for a prearranged video interview.

The primary focus of the questions back then, by a man who has probably negotiated more law firm mergers than anyone else, was K&L Gates’ continuing international expansion, a trend highlighted by the firm’s January merger with Austi-


**Kalis is genuinely outraged by what happened at Dewey and some of the practices he believes go on at other firms in the US**

It’s worth recounting here verbatim what Kalis said in an internal email to his partners and associates about these surveys when the firm was announcing the increased financial disclosure (and it is equally only fair to point out that, by implication, *The Lawyer* does not escape criticism):

“The massive overstatement of revenues and other metrics by Dewey & LeBoeuf remained undetected and unchecked over multiple years by publications in the US and the UK. In a world capable of producing Bernie Madoff, this may seem insignificant. But there has been no indication that major publications are taking steps to detect any other mis-statements or to prevent future distortions of their rankings.

“Published finances of US law firms are based on data secretly supplied by law firms or other sources with little or no public accountability. We don’t know which law firms co-operated by dutifully supplying the leading surveyor of the US legal market to change its ways and have had no impact whatsoever. Fair enough – it’s their magazine. But at the same time, it’s my partners’ firm. We’re not a leaf on a stream. We’ll control our own fate.”

**A snapshot of how K&L Gates announced its 2012 financial results**

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**Feature**

The Question:

Why do you not report your year-end financial results?

Arnold & Porter No response

Clearve A firm spokesperson says: “Clary Gottlieb is a private limited liability partnership and has no obligation to disclose financial data outside the partnership. All financial data is available to all partners.”

Cravath No response

Davis Polk No response

Jones Day No response

Kirkland & Ellis No response

Milbank No response

Skadden No response

Sullivan & Cromwell No response

Wachtell No response

ian firm Middleton. Kalis also discussed, in his usual forthright manner: collaborative vs carnivorous behaviour in law firms; the development of his firm’s London office from legacy Nicholson Graham & Jones to a key plank in a billion-dollar practice; and why Swiss Vereins are a bet – and why logic suggests they might be a bad bet. (See video on TheLawyer.com.)

Just days later, however, K&L Gates published its results, shaking up the US legal market in the process. *The Lawyer* immediately called Kalis to ask if he had had a specific reason for going on the front foot.

“I was born with two front feet,” he says. “More fundamentally, current surveys of US law firms present incomplete, misleading and at times false information. In the UK surveys can at least be read in tandem with LLP filings. We don’t have that luxury in the US.

“For years, I’ve privately encouraged Alpha mail

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**Table:**

<table>
<thead>
<tr>
<th>Years ended 31 December</th>
<th>2012</th>
<th>2011</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Revenue per lawyer</strong></td>
<td>646,466</td>
<td>593,536*</td>
</tr>
<tr>
<td><strong>Net income per partner:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fully participating equity partners</td>
<td>899,860</td>
<td>636,920</td>
</tr>
<tr>
<td>All equity partners</td>
<td>890,367</td>
<td>626,658</td>
</tr>
<tr>
<td><strong>Compensation compression ratio</strong></td>
<td>7.9:1</td>
<td>5.8:1</td>
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</tbody>
</table>

*Net income available for: Fully participating equity partners 899,860, 636,920 *

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**Notes to the financial results:**

1. Southern California surveys and other fee-splitting, from other legal professionals to lawyers, 2011 handbook has been released in line with the 2012 presentation.
2. Ratio of the compensation of the highest paid equity partner to the average of first-year equity partner compensation.

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2011 operating results as reflected in the following table comparing 2012 and 2011 performance data. The results are stated on the modified cash basis of accounting used for US Federal income tax purposes.

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**At 31 December (US$ in thousands)**

<table>
<thead>
<tr>
<th>2012</th>
<th>2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash and cash equivalents</td>
<td>320,722</td>
</tr>
<tr>
<td>Investments in landhold</td>
<td>169,429</td>
</tr>
<tr>
<td>Improvements, information technology, furnishings and office equipment (net of accumulated depreciation)</td>
<td></td>
</tr>
<tr>
<td>Bank debt – year end</td>
<td>-0-</td>
</tr>
<tr>
<td>Law for year</td>
<td>-0-</td>
</tr>
<tr>
<td>High for year</td>
<td>-0-</td>
</tr>
<tr>
<td>Partner capital</td>
<td>173,784</td>
</tr>
<tr>
<td>Required</td>
<td></td>
</tr>
<tr>
<td>Discretionary balances subject to withdrawal</td>
<td>187,883</td>
</tr>
<tr>
<td>Annual retirement obligation</td>
<td>320,498</td>
</tr>
</tbody>
</table>

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*Amounts are based on frozen legacy retirement programmes. For the full report go to: http://www.klgates.com/files/upload/2012_Firm_Financials.htm*
Questions of transparency

The Lawyer: Why did you feel the need to publish this level of detail?

Kalis: Bennock, Heller, Tholen, Howell, Coudert, Dewey and K&L Gates were founded on the backs of billion-dollar bodies and are still growing, up. Behind each major law firm lies the life of thousands of people - clients, partners, employees, vendors, charitable causes - are dissolved. How many of these people are we going to sacrifice on the altar of opacity before we come to our senses?

LIP filings in the UK have shown that well-run, honest firms need not fear transparency. Transparency makes an organisation better because it empowers and empowers our clients and stakeholders, requires organisations to run themselves responsibly in real time, and discourages firms from tossing discos into the LIPs. Law is a public profession. We owe clients to clients, courts, and to other regulatory authorities as well as to our stakeholders and various third parties. We need, in short, to begin acting as if our judgment is accountable. They are public trusts.

How did you convince your partners to do it? Was there a vote or did the K&L Gates member’s agreement not require one?

Under our partnership agreement the global management committee is empowered to make this decision. Thirty-one percent - 13 percent of our partners representing our worldwide offices and 45 percent of profits - sit on our management committee and they would have to unanimously in favour of our financial disclosure in the form in which it was published.

The matter was fully discussed within the committee for a month - including distributions of drafts of the disclosure - culminating in the very last moment of adoption in our in-person meeting the week before.

Was the decision to publish influenced by the negative press last year?

Phil Bennock has been around too long to allow sentiment to dictate revenue. On the other hand, we understand that the disclosure contains strategic significance. Consider this - McKinsey says we're trending towards a $80bn global marketplace with 60 per cent or so in the US. In that market, how does one calculate the value of failed AmLaw100 firms? So, our own disclosure is for full transparency - not only revenues and profits, but also bank, retirement obligations, client concentration, liquidity, capitalisation and so on. We think this transparency will be a favourable differentiator in both the market for talent and the market for clients. Thirty-one percent of feedback on both fronts - clients and talent - has been overwhelmingly positive. Terms like 'confidence-inspiring' come up repeatedly. Perhaps this will be an example of 'doing well by doing good'.

How did you decide what to include and exclude? There’s nothing about revenue regulation by practice area. Is there another reason for that?

We tried to be as inclusive as possible, to achieve clarity and to avoid confusion. Our seven principal practice areas are defined in disciplinary terms (for example, corporate and transactional - banking). We have industries (for example, financial services). This works well for us for financial management standards.

But how, as one example of many, do you then count M&A work in the financial services industry for year-over-year purposes? We compare in-house revenue for financial services. I suppose you could create your own practice groups if you could double-count this work - once as the corporate practice discipline and once in the industry. But these options would be impossible to incorporate in any public, we resolved this conundrum by stating, accurately in the disclosure: 'Lawyers productivity was generally consistent across practice disciplines year-over-year, with the exception of intellectual property, where productivity increased by close to 10 percent.'

Does this year’s disclosure require you to change any accounting standards in the way you report it?

We changed nothing. We employ modified gross basis accounting system, as do most US firms, and as the disclosure states we also confirm our accounting to US federal income tax standards.

We doubt that all US firms confirm their accounting to US federal tax standards. For example, we run everything through our PNL in the year of unemployment unless the tax standards require that such expenditures be amortised. My impression is that some other firms are more liberal about the amortisation option which, of course, makes the current fiscal year look better by spreading the accounting impact of expenditures into future years.

I should also note that we have our public responsibility committee, as well as an audit committee; and once in the industry. But these options would be impossible to incorporate in any public, we resolved this conundrum by stating, accurately in the disclosure: 'Thus, the numbers in the disclosure are drawn from and are consistent with our audited financials, and the 2012 numbers are currently subject to an audit that will conclude in Q3 of 2013.'

What is in there that doesn’t get covered by the legal press when it reports on law firm finances?

Still, the income of financial stability: cash balances ($821mn), partner capital ($471mn), bank debt (zero), available lines of credit ($75mn), unfunded retirement obligations (0.3 per cent of annual revenue), clients accounting for over 5 per cent of firm revenues (none).

The focus on the balance sheet is another. The year-over-year geographic analysis of our headcount and revenues is another. The putative profit margin if we were to choose to exploit income partners out of profits instead of expensing them (41.4 per cent) is another. The fact that we have our work that is sourced in one office and performed in one or more other offices (27.5 per cent) is another.

The lawyer is in the driver’s seat, but that gives you a sense of why the mainstream media been so positive.

What do you think the decision to publish results in this much transparency will mean?

I’m proud of our decision to take this leap, especially in light of the extraordinarily positive response from our stakeholders (including our partners and our clients).

What it says about K&L Gates is that those two audiences – our clients and our stakeholders – are why we’re in business and that we try never to forget that.

Have you had any negative feedback from the market?

No negative feedback whatsoever. The client market and the market for talent – both inside and outside the firm - have responded enthusiastically. The business press and the accounting profession have been positive. The blogs have been positive. We haven’t heard much from anything at all from legal industry publications, bankers and our managing partners. Nor do we expect to.

Have you had any feedback from peers saying they’ll be doing it next year?

No, but why would they tell me? If they are, then we are the crows that feed on the dead through the business press. And once again, would say that these legal-social networks on the planet.

Is this a one-way street - will you be reporting to this level of detail every year?

It’s a one-way street. Annual disclosure is now part of our business.

"Publications make no effort to adjust metrics to account for different business models of different law firms and seek instead to exploit these apples-to-oranges comparisons in order to create storylines for their magazines. Metrics expressed as averages, for example, have been rendered increasingly irrelevant in an era of radically different law firm business models and geographic footprints as well as equally divergent approaches to sharing equity ownership.

Yet such problematic metrics remain central to the magazines’ appetite for and our dependence on them. It's a one-way street. Annual disclosure is now part of our business.