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# THE LAWYER

## Cool with clarity

Under boss Peter  
Kalis, K&L Gates is  
revealing all about  
its financials – unlike  
many of its rivals





# All clear

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



**Matt Byrne**

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. Over 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 global legal market'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, for 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 Austral-



## Feature

### The Question:

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

**Arnold & Porter** No response

**Cleary** A firm spokesperson says: "Cleary 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

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

aged 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' law firm. We're not a leaf on a stream. We'll control our own fate."

### Alpha mail

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

ian firm Middletons. 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 Veins are a bet – and why logic suggests they might be a bad bet. (See video on [TheLawyer.com](http://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 encour-

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

**Pittsburgh – K&L Gates LLP today reported results for the year ended 31 December 2012 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**

### Years ended 31 December

(US\$ in thousands except per lawyer and per partner amounts)

	2012	2011
<b>Operating Results</b>		
<b>Revenues</b>	1,060,294	1,061,658
<b>Net income available for:</b>		
Fully participating equity partners	227,330	235,146
All equity partners	320,498	329,345
<b>Net income as a % of revenues:</b>		
Fully participating equity partners	21.4%	30.2%
All equity partners	22.1%	31.0%
<b>Statistics</b>		
Revenue per lawyer	616,486	593,536*
<b>Net income per partner:</b>		
Fully participating equity partners	899,960	636,920
All equity partners	890,367	626,608
<b>Compensation compression ratio**</b>	79:1	5.8:1

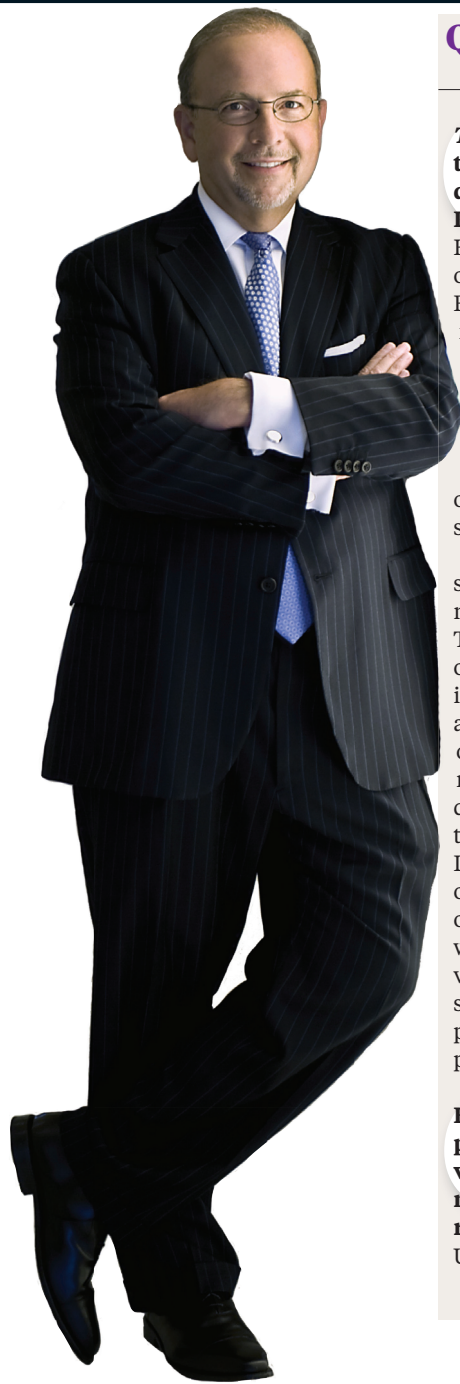
\*Restated to reflect the recategorisation in 2012 of certain government affairs professionals from other legal professionals to lawyers; 2011 headcount has been reclassified to conform to the 2012 presentation  
 \*\*Ratio of the compensation of the highest paid equity partner to the average of first-year equity partners' compensation

### At 31 December (US\$ in thousands)

	2012	2011
Cash and cash equivalents	220,722	260,765
Investments in leasehold	109,629	102,580
Improvements, information technology, furnishings and office equipment (net of accumulated depreciation)		
Bank debt – year end	-0-	-0-
Low for year	-0-	-0-
High for year	-0-	-0-
<b>Partner capital:</b>		
Required	173,784	169,460
Discretionary balances subject to withdrawal	187,883	200,539
Annual retirement obligation		
Expense as a % of revenues***	0.3%	0.3%

\*\*\*Reflects payments under frozen legacy retirement programmes  
 For the full report go to: [http://www.klgates.com/files/upload/2012\\_Firm\\_Financials.htm](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:** Brobeck, Heller, Thelen, Howrey, Coudert, Dewey and others – the bodies are piling up. Behind each major law firm implosion the lives of thousands of people – clients, partners, employees, vendors, charitable causes – are dislocated. How many of these people are we going to sacrifice on the altar of opacity before we come to our senses?

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

**How did you convince your partners to do it? Was there a vote or did the K&L Gates members' agreement not require it?**

Under our partnership agreement

the global management committee is empowered to make this decision. Sixty-nine partners – 13 per cent of our equity partners representing our worldwide venues and major practices – sit on our management committee and they voted unanimously in favour of our financial disclosure in the form in which it was published.

The matter was fully discussed within the committee for over a month – including distributions of drafts of the disclosure – culminating in the formal motion of adoption at our in-person meeting the first week of February.

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

I've been around too long to allow tempests in tea kettles to dictate strategy. On the other hand, we understand that the disclosure has strategic significance. Consider this – McKinsey says that we're trending towards a \$500bn global legal marketplace with 60 per cent or so in the US. In that gigantic US market, as the bodies of failed AmLaw 100 firms continue to pile up, we stand alone for full transparency – not only revenues and profits, but also bank debt, 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. The early 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 breakdown by practice area. Is there any 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) and by certain industries (for example, financial services). This works well for us from a management standpoint.

But how, as but one example of many, do you then count M&A work in the financial services industry for year-over-year public comparison purposes? Corporate or financial services? I suppose you could make arbitrary choices or you could double-count this work – once in the practice discipline and once in the industry area. But those options would be inherently misleading to the public. We resolved this conundrum by stating accurately in the disclosure: 'Lawyer

productivity was generally consistent across practice disciplines year over year, with the exception of intellectual property, where productivity increased by close to 10 per cent.'

**Did this year's disclosure require you to change any accounting standards in the way you report?**

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

We doubt that all US firms conform their accounting to US federal income tax standards. For example, we run everything through our P&L in the year of expenditure unless the tax standards require that such expenditures be amortised.

My impression is that some other firms are more liberal with 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 financials certified each year by our outside auditor, a Big Four firm [PwC]. The audit cycle concludes with a certification in the second quarter of the year following the year under audit. Thus the 2011 numbers in the disclosure are drawn from and are consistent with our audited 2011

financials, and the 2012 numbers are currently subject to an audit that will conclude in Q2 of 2013.

**What information is in there that doesn't get covered by the legal press when it reports on law firm financials?**

Start with the indicia of financial stability: cash balances (\$220m), partner capital (\$173m), bank debt (zero), available lines of credit (\$75m), unfunded retirement obligations (0.3 per cent of annual revenues), 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 pay income partners out of profits instead of expensing them (41.8 per cent) is another. The percentage of our work that is sourced in one office and performed in one or more other offices (27.5 per cent) is another.

There's more, but that gives you a sense of why the mainstream business press has been so positive.

**What do you think the decision to publish results in this much detail says about K&L Gates?**

I'm proud of our decision to take this step, especially in light of the extraordinarily positive

responses 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 of anything from traditional US legal publications, bankers and other managing partners. Nor did we expect to.

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

No, but then why would they tell me? Their firms are their businesses and they should run them as they see fit, and make decisions within their own private deliberations.

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

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

filling out surveys, which ones did not co-operate but whose results are nonetheless presented as equally authoritative, or what the methods and sources are for determining financial results when firms do not co-operate.

"The various rankings of law firms based on gross revenues might now be referred to as the 'Faux Firm 100' because of the inclusion of mere referral societies in which separate law firms share common brands. As recently as two weeks ago, the chairman of one such agglomeration described his group as composed of 'member firms'. Precisely. Yet, while those referral societies don't regard themselves as one firm, industry publications do. Just because it's easy doesn't make it right.

"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' approach to financial coverage of the legal industry and thus drive unfortunate and destructive behaviours within law firms.

"In their surveys, publications consistently ignore financial as-

pects of law firms that could have predicted law firm failures – debt loads, unfunded retirement obligations, undercapitalisation, illiquidity and the like. These indicia go right to the heart of institutional stability."

### Debt heat

Although it is true that K&L Gates choosing to reveal it has no debt is probably an easier decision to make than coming clean over a borrowing mountain, the firm has for years made a virtue – and no secret – of its no-debt approach.

Equally, it did not choose to reveal this unprecedented level of financial detail in a record year. Indeed, the firm's total revenue was broadly flat last year, at \$1.06bn.

Nor, with an annual average prof-

it per equity partner (PEP) of \$899,960, is it anywhere near the most profitable of US firms, so this was not a chequebook-waving recruitment play either. The firm is a definitively mid-market player, albeit one that has grown in the past decade into a billion-dollar-plus global firm with one of the most extensive networks on the planet.

So why do it? Was the move driven by internal or external pressures? Is Kalis purely altruistic in seeing the value of sharing this information? Or did he simply want his firm to be the first? Clearly, if transparency is of value to everyone in the market, what better way of making headlines and capital than to be the first? Or was he just sticking two fingers up to the legal press?

In Kalis's case there was probably

something of all of these elements. The collapse of Dewey last year looms large in his detailed answers however, as does Kalis's obvious irritation at the traditional method of reporting US law firms' financial results (see box).

Equally, Kalis knows as well as anyone the impact a stream of negative stories about a firm can have. As Howard KennedyFsi's CEO Mark Dembovsky says: "The negative impact bad press can have – the momentum it can generate – can be serious, or fatal."

### The sword of truth

K&L Gates has not suffered anything like the stream of partner exits of other firms, which subsequently went to the wall; but was the decision to go all-out influenced

by the negative publicity surrounding some partner departures?

It seems unlikely. Kalis is genuinely outraged by what happened at Dewey and some of the practices that he believes go on at other firms in the US. Equally, although he is by some way the single person most associated with K&L Gates, this move is not really about personal glory. (Kalis makes a point of flagging up MacEwen's 'genius' comment, saying: "In case you're wondering, the 'genius' is the product of a collaboration among a senior securities partner, our CFO and our immediate past CFO, who now serves as a senior adviser to the management committee.")

MacEwen himself is a big fan of the firm's move, telling *The Lawyer* that it is widely recognised that nu-

merous US firms "play around with the numbers".

"I used to think it was just with PEP, but since Dewey I'm not so sure," MacEwen adds. "Dewey was an extreme case, unquestionably, but a lot of the spin surrounding that firm was that 'everybody does it to some extent'. Call me an old-fashioned Scottish Presbyterian, but I take exception to that."

There are few canner operators in the US than the head of K&L Gates and it is unlikely he will have overlooked any of the pros and cons of being the first to break ranks. On balance, however, Kalis's gamble – if such it is – has paid off.

But, as he himself says, this is a one-way street: "Annual financial disclosure is now a part of our business."