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K&L Gates's Big-Tent Strategy:

Constant Growth, Not a Penny in Debt

BY NATE RAYMOND

"IN BUST TIMES, WE'RE VIEWED AS A VALUE PLAY," SAYS K&L GATES CHAIRMAN PETER KALIS, "IT'S SORT OF OUR LOT IN LIFE."

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K&L GATES GROWS THE OLD-FASHIONED WAY—WITH HEFTY CAPITAL CALLS AND NO DEBT.

By Nate Raymond

THE LAWYERS and staffers in K&L Gates's Pittsburgh headquarters won't have any trouble finding their new offices when they move in a few months. In fact, it would be hard for any Pittsburgh resident not to know where the firm is relocating—"K&L Gates" blares from the top of a 37-story building that was formerly One Oliver Plaza. When K&L Gates signed the 200,000-square-foot lease in 2007, chairman Peter Kalis boasted that the new offices reflected the Pittsburgh-born firm's growth—it has gone through eight mergers domestically and internationally since he became boss more than a decade ago—as well as its commitment to the city. But behind the PR and hometown pride was something old-fashioned for a firm of K&L's size: It has spent millions of dollars to build out the Pittsburgh space without borrowing a cent from a bank.

More than 70 percent of large law firms have some form of debt on their balance sheets in 2008, according to PricewaterhouseCoopers. Yet even though K&L Gates has 33 offices with currently more than 1,800 lawyers around the world, it is financing its operations solely through partner capital contributions.

Since the recession began two years ago, K&L has completed three mergers and opened five new offices. The firm's merger with Chicago-based Bell, Boyd & Lloyd is the largest firm merger announced this year, with 250 lawyers coming on board, according to Altman Weil, Inc. (Bingham McCutchen ranked second with its acquisition of 120-lawyer McKee Nelson in August.) K&L is not immune to layoffs—it laid off 36 associates in March and has deferred 80 first-year associates until January—but the cuts pale in comparison to other Am Law 100 firms of its size. Revenue should pass $1 billion this year, Kalis predicts, in what has been a "decent" year despite the economic slowdown.

At a time when some firms are faced with debt they incurred years earlier, K&L markets itself as a no-debt operation, a firm that will not suffer the fate of other rapid-growth operations—namely Heller Ehrman and Thelen—since it has never taken out a bank loan. And recent lateral hires say that K&L Gates's lack of debt made the firm an easier pick during a time of economic uncertainty. But with the economy showing signs of stabilizing, a question remains: Will playing it safe be the right strategy when the boom times return?

K&L GATES WAS BORN OUT OF WAR. When World War II hit, a number of lawyers at Reed Smith, also based in Pittsburgh, enlisted. On their return, they discovered that many associates who hadn't fought in the war had made partner, while the veterans weren't given cred-

PHOTOGRAPHS BY SCOTT GOLDSMITH

it for their years of service. After a frank discussion with Reed Smith's managing partner, seven associates quit to start their own firm, Kirkpatrick, Pomeroy, Lockhart & Johnson.

Kalis, now 59, joined the firm the same year as its first merger, with Washington, D.C.'s Hill, Christopher & Phillips in 1981. The son of a Greek immigrant restaurant owner, Kalis grew up in Wheeling, West Virginia, a town that gave birth to two other future law firm leaders, Orrick, Herrington & Sutcliffe chairman Ralph Baxter and Reed Smith chairman Gregory Jordan. Kirkpatrick's hiring partners loved Kalis's resume: student body president at West Virginia University; Rhodes Scholar; law journal editor in chief at Yale Law School; clerkship for U.S. Supreme Court justice Byron White. "From day one, he stood out," says former K&L chairman Charles Queenan.

At Kirkpatrick, Kalis made partner after just four years at the firm. (*The American Lawyer* caught wind of him a few months earlier, publishing a two-page "up-and-comer" profile in 1984, while he was still an associate.) Lucrative work from Kalis's insurance recovery litigation practice added to his reputation.

Kalis took over as chairman and managing partner in 1997. Mergers were nothing new to Kirkpatrick, but under Kalis, the firm's growth exploded as many of its clients grew into multinationals, and the firm tried to meet their legal needs around the globe. Kalis counts on two deputies to help him find prospective merger partners and make the integrations work—Janice Hartman, a corporate partner in Pittsburgh, who, as the firm has evolved, has become Kalis's deputy in charge of scouting out laterals and merger partners, and, more recently, R. Charles Miller, a Washington, D.C.–based financial services partner in charge of integration. But make no mistake, the firm's growth is Kalis's mission.

Two mergers stand out. In 2005 Kirkpatrick & Lockhart pushed into Europe through a merger with London's Nicholson Graham & Jones. Nicholson Graham had a reputation for representing start-up companies, but was struggling as Magic Circle competitors stole the clients that became successful. The transatlantic combination immediately shifted K&L's growth plans. A few months later, Kalis and Hartman sat down to swap notes about the merger environment with partners at another firm that was shopping around for a suitor, Seattle's Preston Gates & Ellis. Talks quickly evolved from the general to the specific; a merger between the firms was approved in December 2006. Just as important as the West Coast operations to Kalis's team was the firm's three Asia offices, built up by David Tang, one of the firm's rainmakers who is also chairman of the board of the Federal Reserve Bank of San Francisco.

K&L GATES: *BY THE NUMBERS**

Current Head Count:	1,800
Revenue Per Lawyer:	$620,000
Gross Revenue:	$959,500,000
Profits Per Partner:	$855,000

* FINANCIALS ARE FOR 2008

K&L partners insist that the firms they merge with are, in Hartman's words, "very strong firms" in stable financial condition. But they acknowledge that some of the firms had fallen behind in market position, with a merger often seen as the best-case option to compete long-term. In several cases, large partner defections preceded the combinations. Charlotte-based Kennedy Covington Lobdell & Hickman, whose 175-lawyer firm merged with K&L in July 2008, suffered a six-partner defection to Winston & Strawn earlier that January. Bell, Boyd saw five partners depart for Bryan Cave six months before merger talks with K&L were disclosed.

No new mergers or offices are in the immediate offing. Still, expansion is tempting: Kalis says that he could see expanding the firm into a fourth continent with an office in Brazil.

"Follow the clients" has long been K&L's mantra. Its growth has been based on meeting the demands of current clients and positioning itself for new ones. Companies with roots to the Pittsburgh days still strongly influence the firm's direction. The firm's top 20 clients—70 percent of them predating the merger with Nicholson—used more than nine offices on average in 2008.

Take Halliburton Company. Michael Zanic, a Pittsburgh corporate partner, calls Halliburton "a poster child for why we do the mergers, or why the mergers are a success." In 1998 Halliburton acquired Dresser Industries, Inc., a K&L insurance recovery client. In April, Halliburton, following a yearlong review of its outside law firms, picked K&L as one of three firms out of 111 contenders to be a preferred provider. K&L can now compete with Baker Botts and Haynes and Boone for what in recent years has been roughly $90 million in Halliburton legal spending. "K&L has already wound up in the last several months doing work for us in areas like Alaska and Seattle, and others where they would not have worked for us before," says deputy general counsel James Ferguson.

"A FIRM THAT DOESN'T HAVE DEBT* ISN'T GOING TO COLLAPSE," *SAYS NEW LATERAL PARTNER DAVID BERNSTEIN.

The type of work K&L does for Halliburton has also expanded into mergers and acquisitions, Zanic says. Growing the corporate practice area is a priority. Middle-market deals have traditionally been the firm's bread-and-butter, but through the London and Asia offices, K&L is trying to position itself to pitch for larger, cross-border transactions. "The fact that we had Asia clients list on [London's] Alternative Investment Market in the last year or so—we wouldn't have been able to do that before, because we didn't have that presence," says David Tang, who now oversees the firm's Asia offices.

To boost revenues, K&L partners are encouraged to refer work to other offices when they do not have the practice capabilities at home, or when the possible assignment isn't in their region. The firm measures the flow of money in and out of offices, and referrals are taken into account in partner compensation.

Results can come quickly. In January 2008 K&L merged with Dallas's Hughes & Luce, which grossed $77.8 million the year before. In 2008, $26 million of the Dallas office's $101 million in revenue came from work originated by other K&L offices, while it referred $20.9 million of work to 24 of the firm's other offices. "We believe the combination has probably exceeded our expectations," says Edward Coultas, the former managing partner of Hughes & Luce who now heads the Dallas operation.

Not every client sees the value in K&L's pitch. Microsoft Corporation general counsel Bradford Smith told *The Seattle Post-Intelligencer* only a few years earlier that Preston Gates's merger with Kirkpatrick was "a positive development" that gave the Seattle firm "more depth and breadth." Yet in May, the company—whose founder, Bill Gates, is

CORPORATE PARTNER JANICE HARTMAN HELPS SCOUT OUT MERGER PARTNERS AND NEGOTIATE DEALS. K&L REQUIRES ANY FIRM THAT IT ACQUIRES TO PAY OFF ITS DEBT.

the son of retired Preston Gates partner Bill Gates, Sr.—unceremoniously dumped the firm from its preferred provider list as the software giant looked to trim its legal costs. Microsoft and K&L partners say the firm continues to do some legal work for the company on intellectual property matters.

And despite the mergers and new work, K&L's financial growth has been less than spectacular compared to other Global 50 firms. It ranked No. 122 in revenue per lawyer in 2004 among The Am Law 200; in 2008, it ranked No. 126. In contrast, Global 50 firms Dechert; Ropes & Gray; and Paul, Hastings, Janofsky & Walker all nudged up their places in market rankings by the double digits. Profits per partner have fared better but are still less than stellar.

In large part, K&L's weaker revenue per lawyer is explained by the firm's geography and practices. Many other large firms, such as Dechert, whittled out underperforming practices in order to focus on marquee work. K&L takes a different approach. While the firm does not tolerate practices that charge below-market rates, K&L is also comfortable housing its M&A lawyers under the same roof as a practice geared toward school districts. And for every major market K&L operates in, there are other smaller ones where it stands alone. Among the 50 largest firms globally, K&L is the only one with offices in Anchorage; Fort Worth; Research Triangle Park, North Carolina; and Spokane. In part, the firm's choice to practice in these lower-billing-rate locales explains why its revenue per lawyer—$620,000—is about 25 percent lower than that of the average Am Law 100 firm.

While Kalis acknowledges that these markets' lower rates dilute its financial results compared to competitors, he says the firm has never closed an office and doesn't plan to start now. "It's probably not a business model that's everyone's cup of tea; it just happens to work well for us," Kalis says. "A lot of those same cities that pull down the average [revenue per lawyer] also generate a lot of very substantial work for the large cities. Take Harrisburg. It won't shock you to learn that our partners have an advantage there in cross-selling our Asia practice or cross-selling our European practice, because who in the hell else is going to sell [to those clients]?"

And while its results are lower than competitors [see "Peer Pressure," below], K&L has shown more resilience to the economy than other firms. In 2008 profits per partner climbed 6.9 percent, to $855,000, in a year when the average Am Law 100 firm saw a 4.3 percent decline. Revenue per lawyer nudged up 1.6 percent when other firms fell 1 percent on average.

WHAT MAKES THE GROWTH AN EASY SELL RIGHT NOW is the firm's conservative balance sheet. Despite its size, K&L carries zero bank debt. The firm has credit lines with Citigroup Inc. and other banks, but it does not use them. Instead, K&L is an all-capital firm. One of Kalis's first decisions as chairman in 1997 was to double the amount of income that partners had to put in as capital. Ever since, the firm has relied on capital contributions to finance its growth. In 2008 K&L held back about 50 percent of its distributable income as permanent capital. As of September, its current capital levels were about 31 percent higher than a year earlier.

Newly admitted equity partners put up 35 percent of their compensation. Every year they put in another 5 percent, capping out at 60 percent. Consultants say that K&L's requirements are higher than typically seen at law firms. Even some of the newly merged K&L Gates firms say their partners are putting in more capital under the K&L regime than they did when they were independent, though some don't mind. Extra money beyond what's required accrues interest, and K&L partners who leave the firm get their capital back the following August.

Because the capital is substantial, K&L has a bank facility set up for new partners to borrow from. K&L does not track how many partners use it, but Kalis guesses "most" new partners do. Borrowing is increasingly a common way to pay for capital at law firms; Citi says partner borrowing grew at 28.4 percent in the early months of 2009.

K&L's no-debt attitude dates back to its origins, partners say, but became particularly hardened during partner Charles Queenan's reign as chairman in the 1980s. Firms then on the push to grow could only envy the speed with which Finley, Kumble, Wagner, Underberg, Manley, Myerson & Casey took on new partners, becoming in its heyday the second-largest firm in the country. But Finley, Kumble borrowed heavily to finance its growth and to pay partners. It collapsed in 1987 with more than $60 million owed to the banks. "Finley, Kumble was something that reinforced what we did at the firm," Queenan says.

But other firms did not learn those lessons. More recently, Brobeck, Phleger & Harrison and Coudert Brothers collapsed, with banks chasing their receivables. The credit crunch that began in 2007 only provided more corpses. Heller Ehrman dissolved with more than $50 million owed to Citi and Bank of America Corporation, while Thelen dissolved owing $60 million to Citi. The debt was never the main reason the firms collapsed—partner departures and revenue declines are larger culprits—but it often served as a pressure point.

Firms that have recently or in the past borrowed money for at least short-term financing include White & Case; Orrick; DLA Piper; and Holland & Knight. Firms that borrow typically insist that they do not borrow heavily and do not use the money to pay for partner distributions, a practice criticized by competitors and consultants alike. Still, borrowing has become tougher, forcing changes in how many firms operate. As credit facilities come up for renewal, banks add new covenants to their agreements—setting minimum cash flow requirements, limiting distributions to equity partners, and putting restrictions on how many partners could leave before the loan is in default.

"IN BOOM TIMES, WHEN THE MARKET IS FLOODED WITH COUNTERFEIT MONEY, WE HAVE A HARD TIME COMPETING, KEEPING, AND RETAINING TALENT," KALIS ADMITS.

Big firms continued to borrow more as the recession unfolded. According to a survey by PricewaterhouseCoopers, nearly 70 percent of firms with more than 450 lawyers had some form of debt in 2008. Those firms had a median $273,000 in debt per equity partner. The credit crunch made borrowing tougher, yet somehow by the end of 2008 those firms had borrowed 19.8 percent more than they had the year earlier, PwC says.

Citi, the dominant lender to the industry, says law firms entered the credit crunch with less debt than before the dot-com bust; total firm liabilities represented 10.6 percent of net income in 2007, compared to 19.8 percent in 2000. But Citi also says that as the current recession hit,

PEER PRESSURE

K&L Gates has grown its head count, revenue per lawyer, and profits per partner over the last ten years.

	2008			1999			Ten-Year Growth Rate		
FIRM NAME	Number of LAWYERS	PPP	RPL	Number of LAWYERS	PPP	RPL	CAGR Head Count	CAGR PPP	CAGR RPL
Sidley Austin	1,702	$1,430,000	$875,000	890	$575,000	$540,000	8%	11%	6%
Greenberg Traurig	1,734	1,310,000	695,000	438	605,000	485,000	17%	9%	4%
K&L Gates	**1,552**	**855,000**	**620,000**	**761**	**205,000**	**390,000**	**8%**	**17%**	**5%**
Reed Smith	1,484	940,000	660,000	510	335,000	325,000	13%	12%	8%
Morgan, Lewis	1,363	1,450,000	820,000	1,116	505,000	455,000	2%	12%	7%
Kirkland & Ellis	1,333	2,470,000	1,050,000	745	1,340,000	685,000	7%	7%	5%

SOURCE: *AMERICAN LAWYER* RESEARCH

firms turned to banks again. Firms borrowed 26.5 percent more from Citi in the first quarter of 2008 than a year earlier. Borrowing increased at a slower pace in 2009—likely since credit was tighter and in reaction to the Heller and Thelen dissolutions—but still inched up 5.9 percent in the first quarter, Citi says.

By not borrowing from the banks, K&L partners say, the firm has avoided many of the financial pressures that have plagued other large firms in the last two years. Merger candidates also liked the firm's no-debt approach. "I don't want other people controlling the destiny of my partnership," says Hughes & Luce's Coultas.

SUSANA RAAB

KALIS, HARTMAN, AND PARTNER CHARLES MILLER (PICTURED) ARE A SWAT TEAM—FINDING, WOOING, AND INTEGRATING SMALLER FIRMS. UNDER KALIS, K&L HAS COMPLETED EIGHT MERGERS—THREE SINCE THE RECESSION BEGAN.

THE LACK OF DEBT is also an encouraging indicator for partners on the move. David Bernstein says that when he was looking to leave Clifford Chance, K&L stood out as a firm that was growing when most were contracting, and was not at risk of going under. "A firm that doesn't have debt isn't going to collapse," Bernstein says. Sue Hodges, a corporate partner in San Diego who recently left Pillsbury Winthrop Shaw Pittman for K&L, cites K&L's conservative finances as one of the factors she looked at before joining. "To anyone who has witnessed some of the issues that have befallen some of the really good law firms, the concept of a firm that has no debt and that is very well run is very attractive," she says.

Still, despite their fiscal conservatism, the firm has high expenses in some areas, such as nonequity partners. K&L Gates ranked last year among the top five of Am Law 100 firms when it comes to the number of income partners among its salaried lawyer ranks, at nearly 40 percent. Many law firm consultants and bankers, including Citi law firm client head Dan DiPietro, take issue with firms that incur this expense. "The number of firms getting significant contributions from that population are not that many," DiPietro says. "It's a relative handful."

Kalis disagrees. He defends his firm's choice to keep income partners, arguing that clients would prefer more experienced lawyers over first-year associates any day. He adds that firms are moving away from pyramid-shaped structures and more toward a diamond, where a large bulge of mid-career lawyers can bill at medium rates. "For a firm like ours, that seems to be where the demand is," he says. That said, the income partners are "a class of our lawyers that you have to manage the hell out of," Kalis says, and if one falls behind, the drop in productivity will show up in that attorney's paycheck.

And while it is a strength now, Kalis does not expect that the firm's debt-free approach will always have its appeal. K&L Gates's heavy reliance on partner-contributed capital means that partners are taking home less of their compensation, which in 2008 ranged from $500,000 to $4 million for equity partners. In turn, K&L may face recruiting troubles when the market recovers. Because it has thinner profit margins and higher expenses, the firm is unable—Kalis says unwilling—to offer high-priced guarantees to lateral partners. "In boom times, when the market is flooded with counterfeit money, we frankly have a hard time competing, keeping, and retaining talent," Kalis says.

But that's a problem for next year, or even later on. For now, Kalis's firm is growing. "In bust times, we're viewed as a value play," he says. "It's sort of our lot in life."

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