THE ANTECEDENTS AND CONSEQUENCES OF ALTERNATIVE STAFFING STRATEGIES

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Jae Eun Lee

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ALTERNATIVE STAFFING STRATEGIES

Jae Eun Lee, Ph.D.

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I explore the antecedents and consequences of law firm staffing strategies. My dissertation consists of five chapters, including an introduction, an overview of the legal industry, two empirical papers, and a conclusion. Law firms have gone through a major transformation of their business and staffing strategies over the last decade, providing a valuable empirical context for my research questions. Faced with an increasingly competitive business environment, law firms have revised their staffing models to varying degrees, and the effectiveness of different staffing strategies is largely under-investigated.

Several findings of my research are noteworthy. First, despite the general perception that law firms have mostly moved away from the internal development of human capital to a market-oriented external acquisition approach, firms differ in the extent to which they rely on internal versus external staffing strategies. Firms combine both internal and external staffing to varying degrees, and firm staffing strategies change across years. Second, as firms are embedded within the society and economy, firm-level phenomena are subject to multiple internal and external contingencies. I find that a firm's staffing is influenced by firm-level practices as well as the firm's structural and local market conditions. Third, staffing strategies are correlated with firm-level performance outcomes and the relationship becomes more visible when the staffing strategy is measured over a longer time frame. This is consistent with the resource-based view of

the firm and with human capital theory in that it takes time for resources, in this case human capital, to create positive returns. This study is among the few studies that examine the temporal relationships between resource inputs and performance outcomes.

Overall, my dissertation shows that internal labor markets are still relevant and important for law firms' staffing strategies and performance. Despite the growing interest in taking advantage of workers' prior experience and staffing through external labor markets, a majority of firms still hire workers without experience and promote employees from within. They do so, however, to a varying degree, and the extent to which they rely on internal labor markets not only depends on both internal and external contingencies but also has a direct impact on firm level performance outcomes. The findings are relevant not only for professional service firms but also for firms that rely on human capital for their business operation and firm performance.

BIOGRAPHICAL SKETCH

Jae Eun Lee graduated from Yonsei University, Seoul, Korea with a B.S. degree in 2006. She received her M.S. degree from London School of Economics in 2007 and Ph.D. from the School of Industrial and Labor Relations, Cornell University in 2016. She worked as a human capital consultant for Deloitte Consulting before joining ILR School. She will be joining Ithaca College School of Business as an assistant professor in the fall of 2016.

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Finally, I want to thank my husband, Joon Woo Sohn, and my son, Evan Sohn, for sharing my frustration and anxiety. They supported and pushed me to stay focused and to finish. My dissertation is theirs as much as mine.

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CHAPTER 1.

INTRODUCTION

Staffing strategies are critical for firms that compete based on the capabilities of their workforce. We have observed substantial variation in how firms staff themselves. The North Carolina-based SAS Institute, for example, is famous for its internal development practices, long-term compensation systems, and commitment-oriented human resource management practices (Pfeffer, 1998). Netflix, by contrast, only hires workers with prior experience who do not require additional training, pays market-based salaries without any performance-based bonuses, and focuses on short-term employment relationships (McCord, 2014). Why do some firms pursue internal staffing strategies while others focus on external staffing approaches? Do firms choose their staffing strategies or are they constrained by internal and external contingencies? What are the consequences of different staffing strategies? These questions are important not only to academics but also to practitioners and business organizations.

Three questions motivate this research. First, while the academic literature and business publications largely assume that all firms have moved away from internal labor markets to external labor markets for staffing, to what extent does this assumption hold? What is the evidence that firm staffing strategies have converged on an external market-driven approach? Second, if there is variation in the extent to which firms pursue internal versus external staffing strategies, which firms have maintained an internal staffing strategy while others have moved in

the opposite direction? What are the internal and external contingencies that influence a firm's choice of staffing strategy? Finally, what are the performance implications of an internal staffing strategy? What would be the most appropriate performance measure to examine the consequences of internal staffing?

There is growing evidence that traditional internal labor markets – hiring at the entry-level and promoting from within – have largely been replaced by external staffing strategies. Firms are less willing to hire inexperienced workers and train them, and are more interested in hiring experienced workers with skills who can perform a job right away without any training (Cappelli, 2012). The average tenure of employees is decreasing (Bidwell, 2011) and workers build their careers by moving across different firms (Arthur & Rousseau, 2001). Empirical research on the consequences of staffing through external labor markets, however, is unclear and mixed. Some studies find that employees with experience bring in knowledge and skills that enable innovation and superior performance (e.g., Almeida et al., 2003, Rao and Drazin, 2002) while other studies find negative or insignificant relationships between prior job experience and current performance (Medoff & Abraham, 1980). Still others find that the relationship between experience and performance depends on contextual factors (Dokko, Wilk, & Rothbard, 2009).

Prior studies have treated internal and external labor markets as discrete and fixed staffing approaches. But it is possible that firms change strategies over time or combine internal and external staffing to fill job vacancies. If we conceptualize a firm's staffing strategy as a moving point on a continuum with two extremes (100% internal versus 100% external), we have a continuous measure that allows for greater variation within and between firms. Treating a firm's staffing approach as a strategic positioning choice along a continuum that can be changed,

modified, and adjusted, rather than a fixed attribute such as firm's philosophy or culture may shed new light on the relationship between staffing and performance. This re-conceptualization allows us to explore the temporal relationships between staffing strategies and performance outcomes. For example, it is possible that the staffing decisions of last year as well as the staffing decisions of several prior years have an impact on performance outcomes because the firm has accumulated different types of capabilities by hiring different types of human capital (internal promotion versus external acquisition). The descriptive statistics of the data that I employed here confirm that firms not only combine internal staffing and external staffing strategies, but also the extent to which they rely each changes over time.

The context of this study is the legal industry and law firms operating in the U.S. from 2002 to 2012. Law firms were once famous for their strong norm of relying on internal labor markets, which is often referred to as the Cravath model. Paul Cravath, one of the founders of the law firm Cravath, Swaine, and Moore, began the practice of hiring new graduates from elite law schools (Sherer & Lee, 2002). These new lawyers were trained and mentored until they reached the point when they were either promoted to partner or asked to leave the firm (the up-or-out system). Lateral hiring of lawyers from other firms was rare and considered an exception to the rule (Sherer, 2008). Hiring new graduates and developing them within was considered to be the best way to develop and maintain firm-specific skills and culture (Swaine, 1948). Over the last several decades, law firms had adopted some variation of the Cravath model (Henderson, 2008).

Beginning in the early 2000s, lateral hiring of partners became more popular as law firms expected lateral partners to bring in clients and work that enabled faster growth (Henderson & Bierman, 2009). Industry publications and surveys reported that law firms have accepted lateral

hiring as an important growth strategy and that the number of lateral hires has been increasing in the last decade. R. Bruce McLean, a managing partner at Akin, Gump, Strauss, Hauer, and Felds, was quoted as saying "[I]n today's market, you've got to take laterals to be competitive … the market is changing quickly, clients' needs are changing quickly. Firms can't develop resources organically fast enough to keep up. They have to go outside to get talent" (Braverman, 2001: 93). There is still great variation, however, across firms in the extent to which they hire lateral partners or promote internal candidates. The most prestigious and successful firms, such as Cravath and Cleary Gottlieb, still eschew acquiring lateral partners and put greater value on internal development and promotion.

An increasingly competitive environment has put pressure on law firms to abandon their practice of hiring new graduates and developing them within. Clients have become more sensitive about legal fees and they are less willing to pay for the time of junior lawyers and the time of partners spent on training and mentoring associate lawyers. Associates with three to five years of experience are in great demand because they already have real world experience and a proven track record and their work can be billed at a reasonable rate. Some firms have adopted the new practice of hiring new graduates as fellows or residents and having a probationary period before hiring them as associates. As a result, it has become difficult for new graduates to get an opportunity to be trained and to build a career within the legal industry.

Despite the popularity of lateral hiring as an efficient growth strategy, there is an ongoing debate over the effectiveness of staffing through external labor markets. Some firms consider lateral hiring as an evitable strategy to stay competitive, as noted above by Bruce McLean from Akin, Gump, Strauss, Huer, and Felds. At the same time, there is some evidence that lateral

hiring does not necessarily lead to better outcomes and, in some cases, it can be harmful for firm survival. For example, in a 2012 survey, only twenty-eight percent of law firms responded that their lateral hires had been successful, and the most profitable firms reported that they used fewer lateral hires compared to their less successful counterparts (Henderson & Zorn, 2013). *The New Yorker* documented the collapse of Dewey and LeBoeuf due to its multi-million salaries for lateral hires and the political fight between laterally-hired partners and internally-promoted ones (Stewart, 2013). Others firms, such as Finley and Kumble, Heller Ehrman, and Howrey, pursued lateral hiring as their core growth strategy but ended up as epic disasters.

Taken together, the substantial changes in staffing models and the conflicting views on different staffing strategies provide an interesting and important setting for my studies. The context of law firms should be generalizable to other professional service firms as well as to other human capital-intensive organizations as all of them depend heavily on the knowledge and skills of highly educated employees to become and remain competitive. As law firms and professional service firms expand in size and in the range of practice areas they operate, they are increasingly exposed to external market pressures, and the careers of lawyers and professional employees are coming to resemble those of knowledge workers in large corporations. Given that the Cravath model is an extreme version of an internal labor market strategy, the retreat or breakdown of the model sheds light on the prevalence and consequences of lateral hiring for law firms as well as other sectors.

The choice of the legal industry as the context of this study was also driven in part by the availability of rich staffing data. Data on the staffing strategies of multiple firms across multiple regions and multiple years is extremely rare. Prior studies on this topic have used relatively

limited samples: a cross-sectional managerial survey (Rynes, Orlitzky, & Bretz, Jr., 1997), multiple jobs within one organizations (Bidwell, 2011), individual-level data (Dokko, Wilk, & Rothbard, 2009 ; Groysberg, Lee, & Nanda, 2008), and a small number of establishments (Hatch & Dyer, 2004). The availability of staffing data at both the regional office level and national firm level across multiple states and years allows me to explore the multi-level nature of firm decisions (i.e., the extent to which firm-level strategic decisions are subject to internal and external factors) and the temporal dynamics (i.e., the extent to which a firm's staffing strategy changes over time and the implications of such change) of a firm's staffing strategy.

Research Strategy and Methodology

As my research questions required multi-level, multi-year observations, I created an extensive database by combining several archival sources. As each of the empirical chapters includes a detailed description of data sources and variables, I provide only a brief overview of the methodology here.

Data Sources

There are three levels in the dataset: legal industry, national law firms, and regional law firm offices. Industry data came from several different sources. Gross domestic product (GDP) by state and by industry were collected from the U.S. Bureau of Economic Analysis. The total number of business and legal establishments by state and by metropolitan statistical areas (MSAs) were collected from the U.S. Census County Business Patterns. Occupational wage information came from the U.S. Bureau of Labor Statistics. I used the NAICS code 541110 for legal establishments. Finally, the number of practicing lawyers at the state level came from the American Bar Association.

Some firm level data came from several surveys included in the ALM Intelligence database (http://www.almlegalintel.com) and M. Diane Burton and I obtained a subscription for 2015. Firm-level performance data came from the *American Lawyer* Am Law 200. The Am Law 200 includes performance information such as revenue per lawyer and profit per partner for the top 200 U.S. law firms. Most of the information is voluntarily provided by firms, and reporters investigate missing data and confirm the data based on several ALM's publication throughout the United States, including *The American Lawyer*, the *Connecticut Law Tribune*, the *Daily Business Review* (Miami), the *Fulton County Daily Report* (Atlanta), the *Legal Intelligencer* (Philadelphia), *Legal Times* (Washington, D.C.), the *New Jersey Law Journal*, the *New York Law Journal*, *The Recorder* (San Francisco), and *Texas Lawyer*.

Firm-level characteristics such as size and leverage ratio were collected from the *National Law Journal* 350. The *National Law Journal* (NLJ) surveys the 350 largest firms in the United States annually regarding the number of attorneys in each category (equity partners, non-equity partners, associates, and other attorneys). Every year, the *NLJ* sends surveys to approximately 450 law firms to determine the 350 largest and publishes information on those top 350. Firms with more lawyers based in the U.S. than in any other country are eligible to be included in the list. The sample expanded from 250 to 350 firms in 2012.

Firm-level staffing data came from the *National Law Journal* Staffing Survey. This survey is a part of NLJ 350, includes the number of new graduates hired, the number of associates hired laterally, the number of partners promoted from within, and the number of partners hired in the previous year. Unfortunately, questions were not consistently asked every

year and for certain years, and some questions were omitted. For example, the number of internally promoted partners is missing for the year 2010.

The prestige score was collected from *Vault* Law 100 (http://www.vault.com/company-rankings/law/vault-law-100/). According to *Vault*, associates are invited to participate in an on-line survey that gives a list of law firms and asks participants to score each of the firms on a scale of 1 to 10 based on how prestigious it is to work for the firm. These scores are based on the perceptions of currently practicing lawyers at peer firms and Vault publishes the average score and ranking of each firm annually.

Information about mergers and acquisitions came from the *American Lawyer*, Law Firm Mergers, Acquisitions, and Closures. The *American Lawyer* collected law firm mergers, acquisitions, and closures for each year. It lists the name of primary firm, the name of secondary firm, the name of new firm, the date of the event, the type of the event (merger, acquisition, or closure), and the source of the data. Whenever I identified additional activities by different sources (news articles, websites, etc.), I added the new information to this database.

At the office level, I collected data regarding hiring and other firm characteristics from the National Association of Law Placement (NALP), Directory of Legal Employers (www.nalpdirectory.com). The NALP surveys information on law firm offices, including lawyer demographics, practice areas, compensation and benefits, diversity and inclusion practices, and so forth. Participation is voluntary and the information for the current year is available from the NALP website above. M. Diane Burton and I have secured a license agreement with NALP for the dataset of the previous years (2002-2013) and collected the data from the NALP Washington D.C. office. We also purchased the hard copies of these directories. Since two of the variables of

interest for this research were collected starting in 2006, my analyses are based on the data from 2006 to 2010. The sample sizes for those years ranged from 1,400 to 1,600 offices per year and about half of the offices participated all five years.

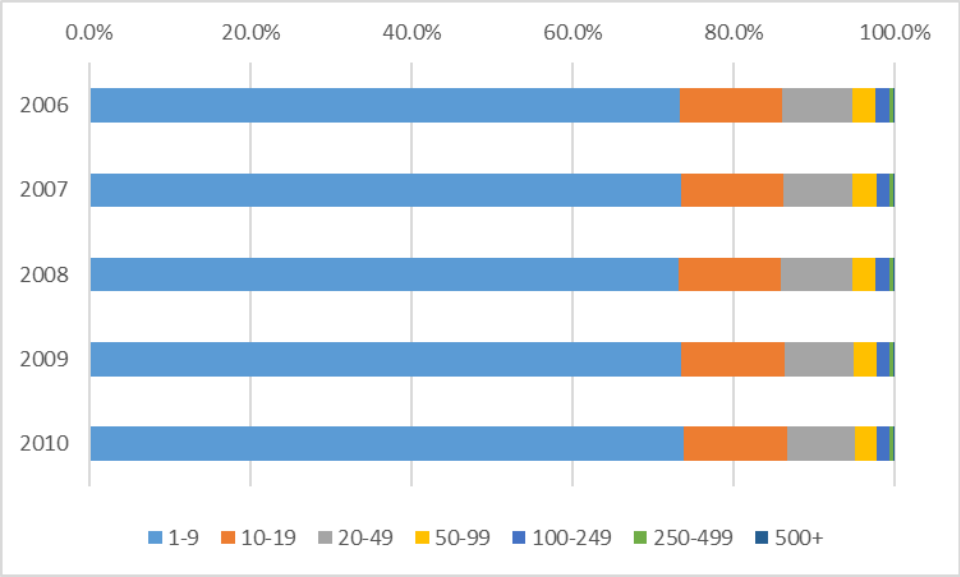
In order to match firms across different dataset and different time-frames, I needed to develop a matching strategy. Many law firms have experienced several mergers and acquisitions (M&A) over the last decade, and some of them changed their names by adding or dropping the name of partners. I assigned firms a different ID number when a firm went through M&A and changed its name. The logic is that M&A activities reflect a significant change in the corporate strategy and business operations, and thus the new firm is not simply a continuation of an existing firm or firms, but instead a new entity. I retain a consistent ID over time when a firm makes a slight change to its name, such as by adding a new named partner, without any M&A activities,

Comparability across Different Datasets

As my data covers three different levels (industry, national firm, and regional offices) across multiple datasets, I conducted supplemental analyses regarding the representativeness of firm- and office-level datasets when compared to the U.S. Census data. Although I used different time-frames for different analyses reported in my chapters, for this exercise I use the 2006-2010 data as an example to examine of the comparability of the three main datasets (U.S. Census, AM 200, and NALP Directory) based on the size and the location of establishments. Several findings are noteworthy.

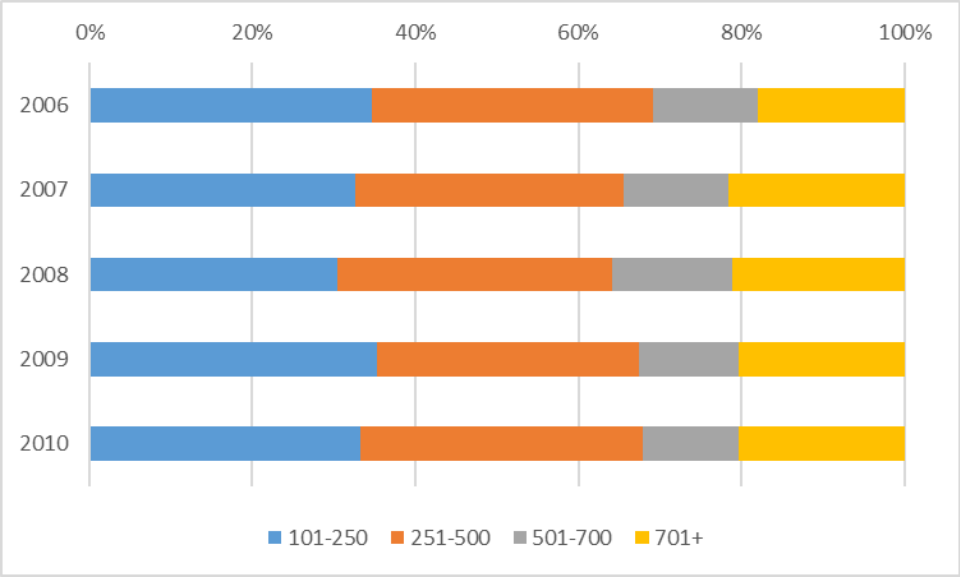
First, when compared to industry data, firm-level data are extremely skewed to the largest firms, while office-level data represents a more balanced sample. Legal establishments in the

U.S. are predominantly very small, with less than 10 employees (approximately 73 percent of the total) according to the U.S. Census County Business Patterns (Figure 1). Establishments with more than 100 employees were only 2.3 percent of the total. The sample of the Am 200 (Figure 2), by contrast, consisted of only firms with more than 100 lawyers, and about a third of that sample was made up by firms with 101–250 lawyers and another third were composed of firms with 251-500 lawyers. This suggests that my firm level data is skewed to largest firms, which is understandable given that the purpose of the Am 200 data is to report the top 200 firms. It is possible that many small establishments are part of one big national firm, so I examined the distribution of establishments included in the office level data drawn from the NALP Directory (Figure 3). The sample of NALP Directory included a wide range of establishments with



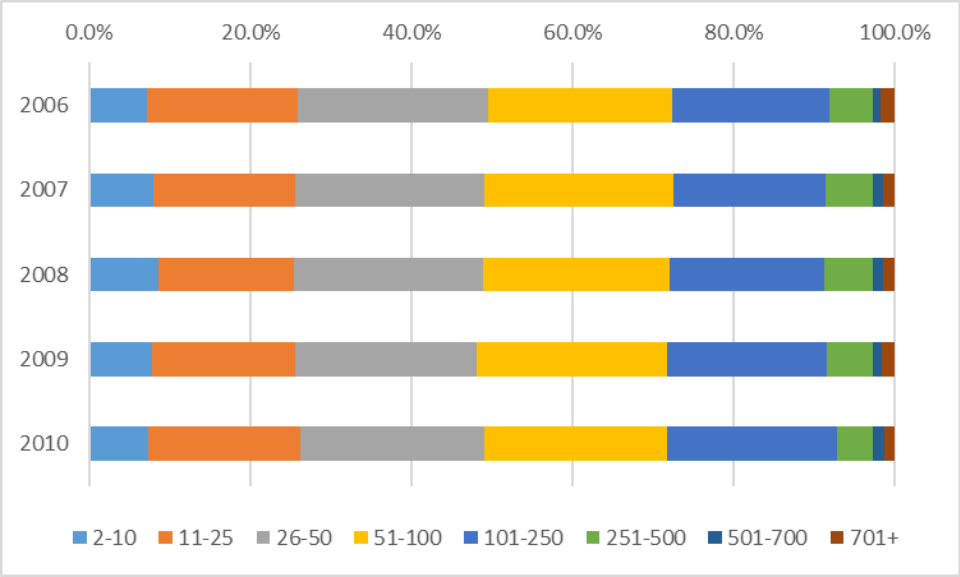
Source: the U.S. Census, County Business Patterns, Legal Establishments

Figure 1. U.S. Census – The Proportion of Establishments by Size, 2006-2010



Source : Am 200

Figure 2. Am 200 – The Proportion of Establishments by Size, 2006-2010

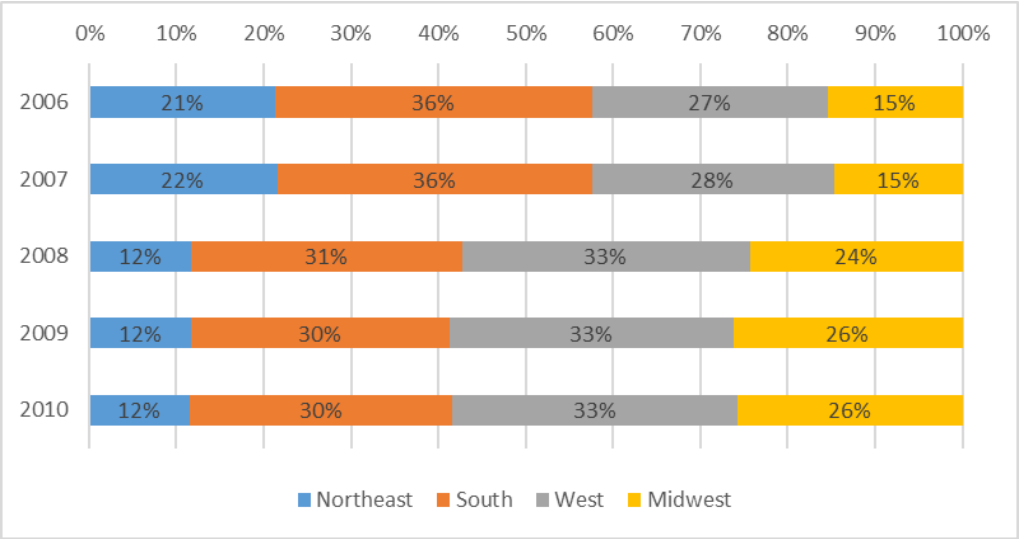


Source: NALP, Directory of Legal Employers

Figure 3. NALP Directory – The Proportion of Establishments by Size, 2006-2010

different sizes; offices with 26-50 lawyers consisted 23.7 percent of the total sample, offices with 51-100 lawyers consisted 22.8 percent of the total sample, and offices with 101-250 lawyers consisted 19.5 percent of the total sample in 2006, for example. This data is still skewed towards larger-sized establishments, however, when compared to the legal industry in general.

Second in terms of regional coverage, the office level data is moderately representative of the legal industry. Throughout the selected period (2006-2010), 19 percent of legal establishments were located in the Northeast, 35 percent in the South, 24 percent in the West, and 22 percent in the Midwest. Over the time, the distribution stayed the same according to the U.S. Census Business County patterns. The NALP Directory included a greater proportion of establishments located in the West, and the proportion of NALP establishments located in the Northeast decreased about 10 percent in 2008 while the proportion of establishments located in the Midwest increased about 10 percent in the same year (Figure 4). Given that offices generally report to the NALP Directory to indicate their hiring plan for the next year; it is possible that the 2008 financial crisis had different impacts on hiring strategy for offices located in the Northeast and for those in the Midwest. It is also possible that law firms relocated their offices from the Northeast to the Midwest, but this is highly unlikely give that the unchanged distribution of legal establishments at the industry level.



Source : NALP, Directory of Legal Employers

Figure 4. NALP Directory – The Proportion of Establishments by Location, 2006-2010

Third, although I did not use firm-office matching data for any of my analyses, I explored the possible overlap between firm-level data (Am 200) and office-level data (NALP Directory). About 40 percent of firms that reported to the NALP directory were included in the Am 200, although the proportion varied by year (Table 1). For the example period (2006-2010), the level of overlap steadily increased from 39 percent in 2006 to 45 percent in 2010, which suggests that a greater number of law firms have reported to both the NALP Directory and are included in the Am 200. One challenge in creating firm-office matched data is that not all offices from one law firm report to the NALP Directory. As the participation in the NALP Directory is voluntary, offices from the same law firm may or may not be part of the directory, thus the aggregation of office level data to the firm level may not be an accurate description of the firm.

Table 1. The Overlap between NALP and Am200 Sample, 2006-2010

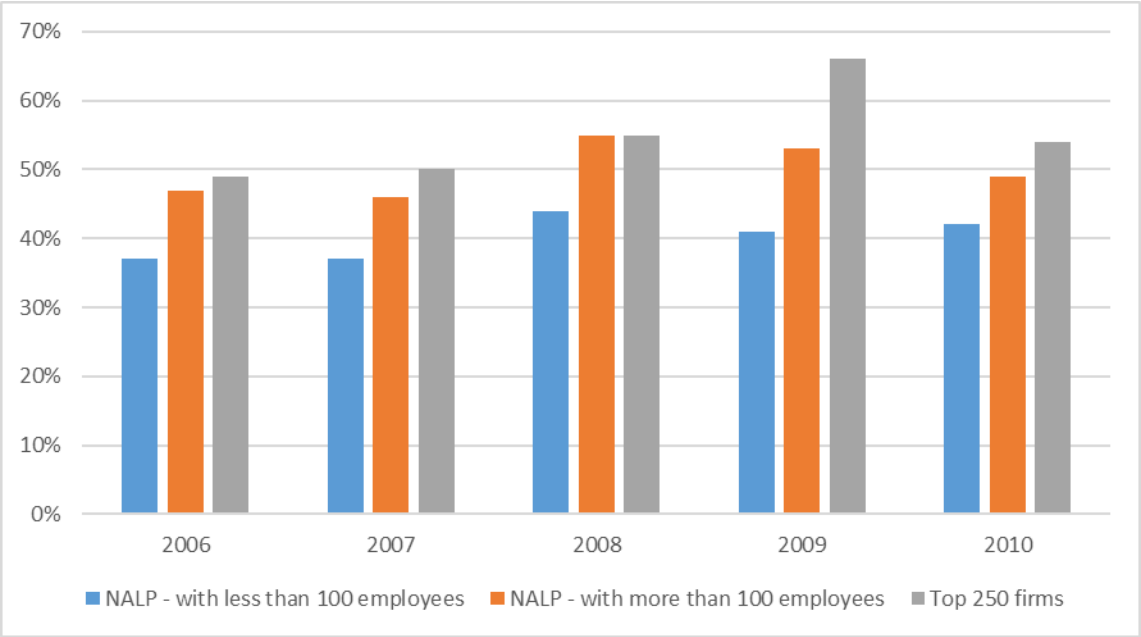
Year	Total No. of Firms (NALP)	Overlap with Am 200
2006	399	154 (39%)
2007	393	149 (38%)
2008	367	151 (41%)
2009	336	137 (41%)
2010	316	143 (45%)

Source: NALP, Directory of Legal Employers; Am 200

Taken together, the differences in the distribution of the sample across different datasets can be both a limitation and a strength of this research. First, my research findings cannot be generalized to the legal industry, in general, but are more specific to larger firms and establishments. Legal establishments with less than 10 employees or lawyers who practice as solo attorneys may be completely different in terms of business strategy and operation from larger establishments.

Second the hiring patterns, the main variable of interest for my dissertation, are similar across different samples. When comparing the proportion of new graduate hires out of total new associate hires drawn from the office-level data (NALP directory) and the firm-level hiring data (NLJ 350), I found some similarities as well as differences (Figure 5). Offices with more than 100 employees hired a similar proportion of new graduates to the top 250 law firms while offices with less than 100 employees are much less likely to hire new graduates. This is understandable given that all of the top 250 law firms have more than 100 employees. This suggests that my findings can be generalized to other establishments of a similar size. Unfortunately, I cannot

compare the hiring patterns of partners because the NALP directory does not collect the hiring information at the partner level.



Source: NALP, Directory of Legal Employers; NLJ 350

Figure 5. The Proportion of New Graduate Hiring, 2006-2010

Research Findings and Conclusions

This dissertation consists of five chapters. In the first chapter, I provide a general introduction and a description of the data that I used. As my research questions and analyses included a variety of factors across several years, I created a multi-level, multi-year database by combining and matching several datasets. In the second chapter, I provide a general overview of the recent changes in the competitive environment of the legal industry and staffing strategies of law firms. In the third chapter examines the internal and external influences on a firm's staffing

strategies. Based on Simpson and Gully's (1962) argument that organizations are subject to a variety of internal and external pressures, I examine which firms and under which conditions firms are more or less likely to hire new graduates fresh out of law school. I examined firm-level practices (whether having formal development practices in place), a firm's structural characteristics (size and prestige), and external labor conditions (labor supply and business competition), both independently and interactively. In the fourth chapter investigates the relationship between internal staffing and performance stability. I test the effects of internal staffing on the stability of revenue generation and profitability and I also test whether the magnitude of the effects changes when I consider temporal aspects of human capital acquisitions. Although the stylized fact of internal labor markets is hire at the entry level and promote within, I focused on new graduate hiring in Chapter Three and promotion of partners in Chapter Four. I will explain my two empirical papers more in detail in the following sections. In the last chapter, I provide conclusions and theoretical and practical contributions of my dissertation.

In chapter 2, I provide an overview of the changes in the competitive environment of the legal industry and in the staffing strategies of law firms. Law firms are facing an increasingly competitive business environment and experiencing slower growth. One reason for such slow growth is that clients and corporations have themselves become more subject to cost pressures. As a result, clients have been cutting costs by bringing work in house, putting pressure on outside counsel to lower their fees or adopt alternative fee structures, and putting law firms into competition with other law firms or their inside counsel. The level of competition also has increased due to the development of information technologies such as predictive coding, e-discovery and to the growth of legal processing outsourcing (LPO) firms.

In response to the slower growth and increasing competition, law firms were less likely to hire new graduates and train and develop them from within but more likely to hire lawyers with prior experience. Training of new lawyers is now viewed as more of a cost than an investment that will deliver returns, and clients are increasingly requesting that no junior associates be assigned to their matters, effectively reducing opportunities for junior lawyers to learn and practice. Instead, law firms often pursue lateral hiring of partners as an efficient growth strategy although there the effectiveness of such strategy is still unclear and debatable. Finally, I document an increasing disparity within and across firms in the level of performance and compensation. The performance gap between large, successful firms and small, less successful firms has increased, and the compensation gap between the equity and non-equity partners and the gap among associates' pay working in different types of law firms has also increased.

Given the general perception that hiring new graduates and training them within is costly, I was interested in which firms and under what conditions firms have maintained the traditional Cravath model of hiring new graduates. As I was interested in both firm-level and regional economic contingencies, I incorporated a multi-level approach by treating law firm offices (my sample) nested within a firm and a state. I found that having formal development practices in place, being large, or being prestigious was positively associated with new graduate hiring. Local economic conditions, such as the supply of experienced lawyers and the level of business competition, had negative effects on new graduate hiring. Finally, I tested the interaction between firm-level and local economic contingencies and found mostly insignificant results.

The findings of this chapter suggest that there is still great variation in the extent to which firms hire new graduates or workers with experience. I did not find any evidence that firms have

mostly moved away from the internal development to the external acquisition of human capital and it is highly unlikely that firms' staffing strategies will converge to external staffing in the near future. The results here, however, suggest that new graduates will have better chance of finding a job with certain types of firms, such as firms with formal development practices in place, large firms or prestigious firms, but they will have a disadvantage when there is a greater supply of experienced lawyers and when there is strong business competition.

I also examined the possibility of reverse causality -- where greater levels of new graduate hiring might cause firms to adopt formal development practices. I found that the proportion of new graduate hiring, but not the number of new graduate hires, was associated with a firm's having formal developmental practices. This rules out the possibility that firms hire new graduates prior to adopting formal development practices, but it confirms that having formal development practices in place and a greater focus on new graduate hiring reflect a firm's reliance on internal staffing strategies.

The importance of a multi-level approach has been discussed not only in studies of firm-level staffing practices (Phillips & Gully, 2015; Ployhart, 2006) but also in research on other types of organizational practices and phenomena (Hitt, Beamish, Jackson, & Mathieu, 2007). The findings of this chapter suggest that a firm's staffing strategy is subject to a variety of internal and external factors and that firm-level staffing strategies should be examined within the context of these factors. Insignificant interaction effects may be due to measurement issues or may indicate that firms do not necessarily consider external market conditions in relation to their internal practices.

As I have observed a great level of variability in the extent to which firms rely on internal and external staffing approaches, I was interested in the performance implications of their staffing strategies. If firms build different types of competitive advantage based on the types of human capital they acquire and maintain, staffing strategies should be important predictors of firm outcomes. I was surprised that there is a very limited theoretical or empirical research on the relationships between internal staffing and firm-level performance despite the fact that internal labor markets (ILMs) have been a long-standing topic across sociology, organizational theory, and human resource management. The existing literature mostly focuses on the adoption of ILMs (Davis-Blake & Uzzi, 1993; Doeringer & Piore, 1985; Jacoby, 1984; Pfeffer & Cohen, 1984) but rarely addresses the consequences of them.

Here, I focused on performance stability rather than the performance *per se*. That is because minimizing uncertainty and maximizing predictability are key goals of organizations Thompson (1967) and Osterman (1987), even though the concept of performance stability has largely been under-investigated in the fields of organizational studies and human resource management. The theoretical relationship between internal staffing and performance stability is somewhat more developed. Internally promoted employees are more likely to accept and conform to existing organizational rules and procedures, which will lead to greater continuity in corporate strategy and business operations. An internal staffing strategy helps firms to predict labor costs and headcount as well as to minimize performance loss due to job-person mismatch. While these features of internal staffing are associated with performance stability, I expected that the effects of internal staffing on performance would vary depending on the context, similar to the effects of lateral hiring that I discussed before.

In addition, in this chapter, I incorporated the temporal dynamics of human capital accumulation. According to the resource-based view and human capital theory, it takes time to develop firm-specific resources that can be sources of sustained competitive advantage; thus, it is important to capture the temporal aspects of the relationship between resource inputs and performance outcomes. So far, researchers have failed to sufficiently explore how changes in the accumulation of resources lead to changes in firm performance over time (Ployhart, Weekely, & Ramsey, 2009), and it is unclear how to theorize and measure the temporal aspects of resources. Here, I explored different measures using different time frames based on the assumption that not only staffing decisions of last year but also staffing decisions of prior years will influence firm-level outcomes.

Several findings of this chapter are noteworthy. First, similar to the prior chapter, I show that there is still great heterogeneity among firms in how they staff their companies and that the level of differences across firms remained at a similar level during the last decade. The results suggest that the extent to which firms pursue internal versus external staffing strategies varies not only across different firms but also across years. Thus, staffing strategies should be considered as a firm's strategic choice that changes over time.

As hypothesized, an internal staffing strategy was positively associated with performance stability and the effects of internal staffing on performance stability became greater as the time frame of internal staffing measure increased. The levels of performance variance in both revenue generation and profitability were much lower when a proportion of new partners were internally promoted. In addition, the relationships between internal staffing and performance stability

became stronger when internal staffing was measured based on the prior four years than when internal staffing was measured based on the prior two years.

Taken together these studies show that internal staffing is still a relevant strategy for firms operating in today's competitive markets and it has important performance implications for them. By incorporating the temporal dynamics of resources, I also show that it takes time to observe the effects of resource accumulation and that resources that are accumulated throughout a long period cannot be easily copied or lost.

CHAPTER 2.

THE TRANSFORMATION OF THE LEGAL INDUSTRY AND THE CRAVATH MODEL

Law firms were once famous for their strong norm of internal labor markets, often referred to as the Cravath model. The Cravath model emphasizes the internal governance of human capital, where young lawyers are recruited directly from law school, and trained and developed from within. Promotion and compensation are largely based on seniority, and lateral hiring from other firms is rare and considered to be an exception. In recent decades, the dominance of the Cravath model has eroded, and law firms have become more open to staffing through external labor markets (i.e., lateral hiring) and making staffing decisions based on performance rather than seniority.

Although it is largely accepted in the trade press that the Cravath model is undergoing a substantial transformation, we have little precise knowledge of the extent to which law firms have abandoned, revised, or maintained the Cravath model. On the one hand, lateral movement of lawyers continues to increase both at the partner and associate level (Kinney, 2014a; Kinney, 2014b), and a majority of law firms have started to introduce performance-based pay systems (Goldberg, 2010). On the other hand, some firms, such as Cravath, Swaine, & Moore, and Boies, Schiller & Flexner, and Cleary, still value the "build rather than acquire" approach and focus on internal labor market-based staffing strategies.

How much has the Cravath model been revised? What external factors have led law firms to revise their staffing approaches? What are the consequences of these revisions? These are important research questions for the field of strategic human resource management as firms across many industries face an increasingly competitive business environment and substantial changes in the composition and skills required of the labor force. The legal industry is a particularly interesting context in which to examine these changes given that the Cravath model is an extreme example of an internal labor market system and law firms vary greatly in the extent to which they have abandoned, revised, or maintained the Cravath model in response to the changing business environment.

In order to establish the relationship between the competitive environment and staffing strategies, I first describe the recent changes in the competitive environment, then document changing staffing strategies, and conclude by linking the patterns and drawing out implications. In the first part, I examine the changes in the competitive environment that law firms face based on the industry data drawn from the U.S. Census county business patterns, the U.S. Bureau of Economic Analysis gross domestic product, the U.S. Bureau of Labor Statistics Occupational Employment Statistics. These industry level data provide a general overview of the market size and employment statistics of the legal industry. In the second part, I examine the changing patterns of law firms' staffing strategies based on the firm-level and office-level data that I collected for my dissertation. These firm-level and office-level data are usually focused on the largest law firms; thus the findings should not be generalized to the industry in general without caution. Nonetheless, these largest law firms were the strongest advocates of the traditional Cravath model and the changes in the staffing strategies

should be the most evident in these firms. I draw from several difference sources such as the *American Lawyer* Am Law 200, the *National Law Journal* (NLJ) 350 survey, the NLJ staffing survey, and the National Association for Law Placement (NALP). Finally, I discuss three important implications of these changes. As the transformation of the Cravath model is still in progress, I consider legal industry and law firms as important research contexts in which to examine the interactions between changes in the competitive environment and firms' staffing strategies.

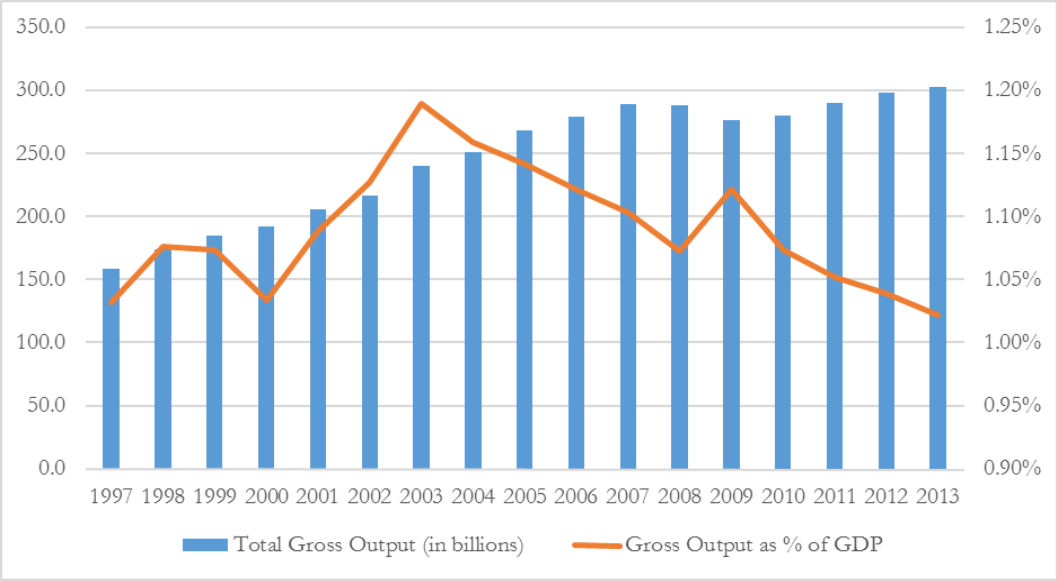
CHANGES IN THE COMPETITIVE ENVIRONMENT

The business environment that law firms face has become more competitive in recent years. Corporations are under heightened competition and pressures to reduce costs due to globalization of product markets and the rise of shareholder value model of the firm; and these pressures have spilled over into the law firms and other business service firms that corporations hire. Corporations have tried to cut costs by bringing work in house, putting pressure on outside counsel to lower their fees or adopt alternative fee structures, and by putting law firms into competition with other law firms or their inside counsel. With greater information about law firms and lawyers available, corporations now can easily compare costs and shop around. IT systems such as predictive coding and legal process outsourcing (LPOs) have started to replace some of the legal work that was traditionally handled by associate lawyers.

Slowing Growth

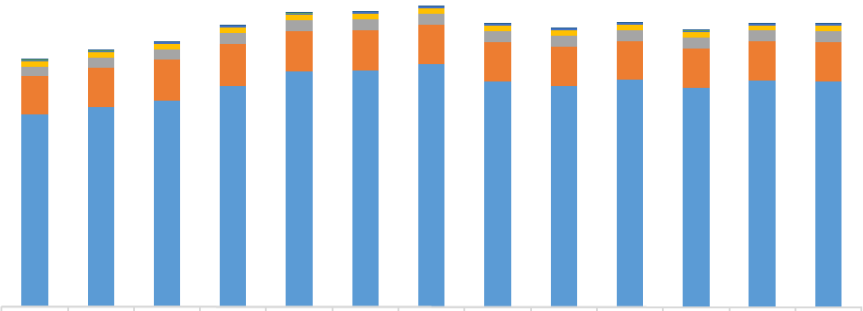
National indictors show that the size of the legal market continues to expand but at a significantly slower rate than the U.S. economy. Gross output from the legal industry increased from $158.4 billion in 1997 to $302.1 billion in 2013 (Figure 6). After experiencing a slight decrease in 2008 and 2009, the industry recovered to pre-financial crisis levels. The percentage of gross output from the legal industry as a part of total GDP, however, peaked in 2003 and then began a downward trajectory. This pattern suggests that the rate of growth in the legal industry is lower than that of national economic growth.

There has been a parallel and relatively modest change in the number of legal establishments. The total number of establishments increased from 167,852 in 2001 to 173,289 in 2013, peaked in 2007 and remained approximately the same until 2013 (Figure 7). The vast majority of legal establishments are small-sized professional firms with less than 20 employees, and establishments with 100 or more employees comprise less than 1% of total establishments.



Source: Bureau of Economic Analysis, GDP by Industry Data

Figure 6. Legal Industry- Total Gross Output, 1997-2013

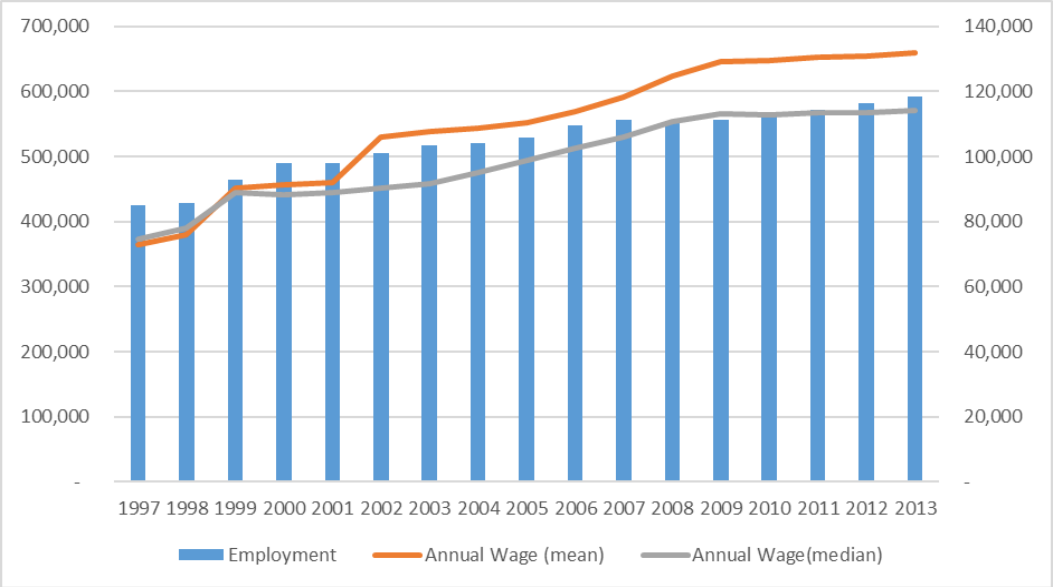


	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
>1000	12	11	15	17	18	19	15	17	15	10	12	8	9
500-999	73	63	61	64	62	63	71	68	69	62	60	52	49
250-499	202	211	205	212	215	215	219	221	217	202	204	196	203
100-249	772	774	846	859	840	882	846	868	833	812	823	811	823
50-99	1528	1588	1646	1704	1692	1649	1676	1698	1678	1692	1684	1690	1693
20-49	5856	6024	6240	6350	6101	6107	6019	6056	6095	5940	5995	5996	6010
< 20	159,409	160,534	161,547	163,838	166,010	166,213	167,163	164,426	163,771	164,729	163,487	164,579	164,502
Total establishments	167,852	169,205	170,560	173,044	174,938	175,148	176,009	173,354	172,678	173,447	172,265	173,332	173,289

Source: U.S. Census, County Business Patterns

Figure 7. The Number of Legal Establishments by Size, 2001-2013

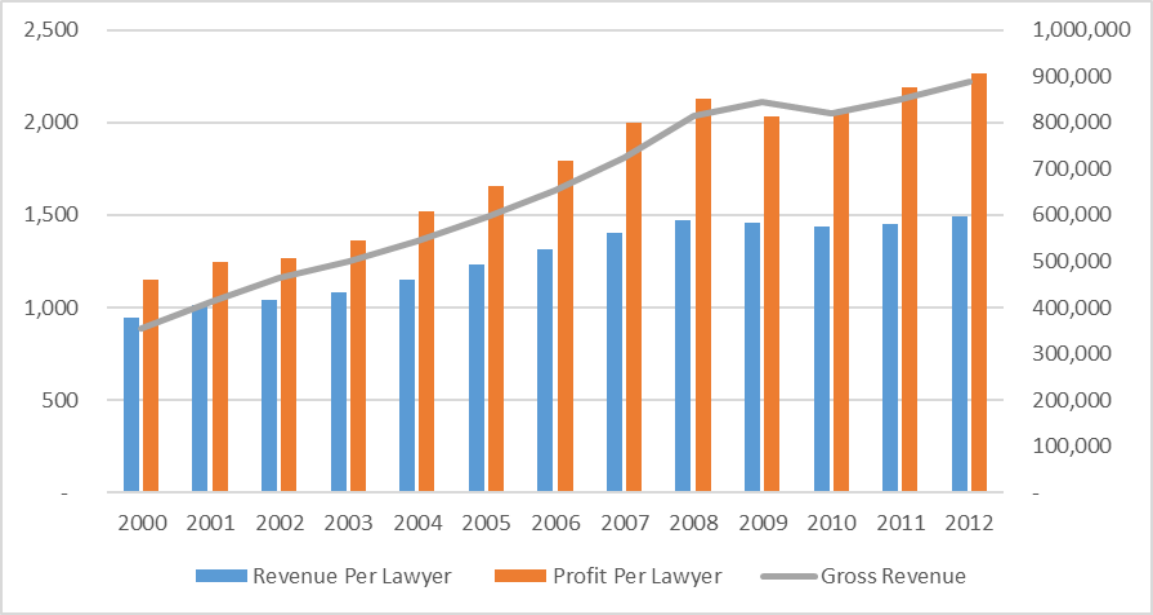
Both employment and wages of lawyers continue to rise, but the growth rate has slowed substantially since 2008 (Figure 8). From 2000 to 2007, the compound annual growth rate (CAGR) for the total number of employed, the median wage, and the mean wage were 1.83%, 3.76%, 2.66% respectively. From 2008 to 2013, the rates decreased to 1.37%, 1.13%, and 0.66%. The increasing gap between the level of median wage and mean wage is noteworthy. The difference between the two increased dramatically in 2002 (from $3,160 in 2001 to $15,600 in 2002), peaked in 2003 ($16,310), slightly decreased from 2004 to 2006, began to rise again in 2007, and continued to grow ($17,690 in 2013). This pattern suggests that wage increases are not equally distributed across different levels of wage earners and that there are extremely high wage earners that skew the mean upward. With currently available data, however, it is hard to examine the exact cause of that difference.



Source: Bureau of Labor Statistics, Occupational Employment Statistics

Figure 8. The Number and Annual Wage Level of Lawyers, 1997-2013

The top US law firms have experienced substantial growth during the last decade, but the rate of growth has been somewhat lower since 2008. From 2000 to 2013, the gross revenue of the top 200 US law firms more than doubled and the profit per equity partner, the dominant indicator of law firm profitability, also doubled (Figure 9). Both revenue and profit decreased in 2009 and 2010 and recovered to the pre-financial crisis level in 2012. Between 2000 and 2007, the compounded annual growth rate (CAGR) was 5.75% for revenue per lawyer and 8.22% for profit per equity partner, but the rate decreased to 0.67% and 1.86% for 2008-2013 period. The legal industry grew at 6.00% CAGR between 2000 and 2007, and the growth rate decreased to 0.98% between 2008 and 2013. These patterns suggest the legal industry has suffered from substantial performance loss since 2008 and that the annual growth rate from 2008 to 2013 has been almost flat, staying around 1%.



Source: The American Lawyer Am 200

Figure 9. Performance of Top 200 U.S. Law Firms (in $100,000), 2000-2012

The slower growth is especially evident in recent years. The Thomson Reuters Peer Monitor (2009-2014), which publishes quarterly benchmarking data based on 143 law firms across different size categories and market segments (48 Am Law 100 firms, 42 Am Law second 100 firms, and 53 midsize firms) reported that since the 2008 financial crisis, law firms have faced weak demand, rising expenses, and declining productivity (Table 2). The level of demand for legal services, measured as total billable hours, stayed virtually flat with some negative years. Productivity, measured as hours worked per lawyer, steadily decreased from 2011 and on. The negative productivity is apparently due to a combination of decreasing demand and increasing lawyer headcount. Despite the decreasing demand and productivity,

the fee for legal work has been increasing at a modest rate, which suggests that law firms have successfully avoided lowering fees as their competitive strategy. Expenses, both direct and overhead, have been increasing and growing much faster than demand. The increase in direct expenses is due to higher lawyer headcount and nominal wage increases, while the rise in overhead costs is due to the fact that more law firms are hiring professionals in areas such as marketing, technology, and finance as a part of business strategy that transforms law firms into more business-like organizations.

Table 2. Annual Growth Rates of Legal Market, 2009-2014

	2009	2010	2011	2012	2013	2014
Demand	-0.6%	1.0%	-1.1%	1.5%	-0.6%	0.1%
Productivity	2.3%	0.7%	-3.8%	-0.3%	-1.5%	-1.2%
Rates	4.7%	2.0%	3.0%	4.0%	3.1%	2.9%
Direct Expenses	-5.2%	-4.5%	5.2%	2.3%	1.8%	3.3%
Overhead Expenses	-2.7%	-0.6%	3.4%	3.9%	2.0%	2.7%

Source: Thomson Reuters Peer Monitor (2009, 2010, 2011, 2012, 2013, 2014),
The %s note the change from the previous year.

Overall, the legal industry has been expanding at a much slower rate since the early 2000s, especially following the 2008 financial crisis. A slower growth rate and lower productivity means law firms now face greater competition and cost pressures. What is puzzling, though, is that the fee for legal work and law firm expenses are increasing at a faster rate than business demand or productivity. It is possible that law firms had not fully realized the magnitude of recent market changes or they have successfully avoided price competition. Law firms, however, have started to adjust their practices, such as embracing alternative fee

arrangements in response to the increasing cost pressures from corporate clients regarding how law firms bill their work and assign lawyers which I will discuss later.

The Growth of In-House Counsel

Part of the economic slowdown in law firms may be attributable to the relative growth in the use of corporate in-house counsel. Beginning in the early 1980s, large corporations faced greater budget constraints due to heightened competition and pressures to reduce costs, and in response, they attempted to control legal costs either by in-sourcing their legal work or by applying pressure on outside counsel to reduce their costs. In that process, the relationship between law departments of large corporations and outside legal counsel, typically law firms, began to shift from a long-term, comprehensive, and enduring arrangement to a less exclusive and more task-specific one (Galanter & Palay, 1990).

There is some evidence that corporations are increasingly in-sourcing their legal work. For example, corporations are more likely to handle their legal work in-house than employing an outside counsel, according to the Association of Corporate Counsel 2011 Census Survey (2011). For example, in 2006, 30% of respondents hired outside counsel to handle their tax issues, 35% for mergers and acquisitions, and 69% for litigation. In 2011, the percentage decreased to 20%, 28%, and 65%, respectively. A Thomson Reuters (2014) survey on in-house counsel reported that 50% of legal departments increased their budgets and their numbers of employees over the prior two years.

As the roles and responsibilities of in-house counsel in handling corporate legal work have expanded, the status of in-house counsel has improved as well. Until the 1970s, the main

role of in-house counsel was to support an outside law firm in handling legal issues, and corporate counsel were considered second-class citizens of the legal profession (Liggio, 2002). The average compensation of corporate counsel was about 30% of the compensation of the CEO. More recently, as corporations internalize their legal services in order to control costs, the status of in-house counsel has improved as well. Two key indicators of such a change is the change in job title and the level of compensation. For example, 77% of respondents hold the job title of general counsel, while 24% hold the title of Chief Legal Officer (CLO), and 17% hold the title of Vice President, according to the Chief Legal Officer 2015 Survey (Association of Corporate Counsel, 2015). The percentages in 2012 were 74%, 10%, and 2%, respectively. This change suggests that in-house counsel has started to assume executive roles and the status that comes with it. The median compensation of general counsel ranges from $220,000 to $550,500 depending on the industry (In-house Counsel Compensation Report, 2015) (Major, Lindsey, & Africa, 2015), which is on a similar level with the average compensation for non-equity partners at large law firms ($338,000).

The relationship between legal departments and outside counsel is also increasingly subject to cost pressures. As law firms now face greater competition for business, there has been a dramatic power shift from outside law firms to inside law departments (Heineman, Jr., 2012). For example, 23% of CEOs reported that cost was the primary factor in the selection of outside counsel, a dramatic increase from 1% in 2004, according to a 2005 survey conducted by the Corporate Legal Times (2005). In-house counsel became more aggressive in shopping around among law firms, and they increasingly chose a particular lawyer or law firm for a specific project rather than pursuing long-term, comprehensive relationships with law firms.

In addition, as a means of reducing outside legal costs, in-house counsel actively pursue different billing structures. A departure from the traditional billable hour approach, alternative fee arrangements (AFAs) are a popular strategy for companies to control their legal costs (for a range of different types of AFAs, see ALM Legal Intelligence. 2012). The ALM survey reported that between 2010 and 2011, 50% of law departments and 62% of law firms increased their use of AFAs. The most highly cited reasons for greater AFA use were cost predictability/transparency and cost savings for legal department, and the ability to attract and/or maintain clients for law firms.

Unlike the traditional billable hour approach where lawyers bill for actual hours worked, AFAs give clients have more power in defining the value and the billing rate for work. Under AFAs, law firms share the risk of legal expenses with their clients, especially when the legal matter becomes significantly more complex and time-intensive than initially expected. As AFAs have become popular only recently, their effects on law firm performance are ambiguous. The 2014 Altman Weil survey (2014) reported that about 30% of law firm respondents said that AFAs are less profitable than billable hours, 15.9% reported them as more profitable and 40.2% just as profitable as billable hours (Clay & Seegar, 2014). Another 2014 survey by BTI Consulting Group and Law 360 asked lawyers about the effectiveness of AFAs, and 39% of the respondents reported that AFAs were less profitable than hourly rates while 22% reported they generated more profit using AFAs (Li, 2014).

In sum, in-house counsel have both put greater cost pressure on external law firms than they had in the past and they now compete with their external law firms for legal business. Corporations are no longer as committed to long-term, comprehensive client-law

firm relationships, and they are demanding more cost-efficient legal services. Corporate law firm clients have started to exercise some control over issues such as billing, over which law firms once had complete discretion. Law firms have started to embrace practices such as AFAs without a clear understanding of the effects of such changes on performance outcomes.

Regional Expansion

During the last several decades, law firms have also expanded their base of operations from primarily local or regional locations to national and international ones. Geographic expansion has important implications for staffing strategies. Two of the most highly cited reasons for geographic expansion are (1) to open new branch offices to "defend their client base" from competitors in new locales (Nelson, 1988), and (2) to take advantage of dense networks of professionals and thick regional labor markets developed in regional clusters (Sassen, 2001). Based on the geographical expansion of the top 50 law firms between 1986 and 2006, Henderson and Alderson (2008) reported that the moves had largely focused on five global cities (Chicago, Los Angeles, New York City, San Francisco, and Washington, D.C.). By contrast, 10% of Fortune 500 companies moved their headquarters from these five global cities to other regions (Southeast Sunbelt - Atlanta, Charlotte, Miami; Southwest Sunbelt - Dallas, Houston, Phoenix; Non-Global West Coast & Rockies - Denver, San Diego, Seattle). Henderson and Alderson (2008) concluded that the expansion of law firms is less about law firms following the geographic growth of clients but more about taking advantage of global cities' rich network of highly specialized human capital.

This pattern of law firm geographic expansion was consistent through 2013, the latest year of available data. My own analyses using the National Law Journal 350 survey of the top 350 US law firms showed that between 2002 and 2013, the number of branch offices increased from 1,612 to 2,789 in the U.S. and from 452 to 769 overseas. Moreover, the top three cities with the highest number of new branches were New York (added 51 new offices), Chicago (added 37 new offices), and Los Angeles (added 30 new offices), while most other cities added less than 10 offices. Thus, the expansion of law firms has been concentrated on a few global cities, which is contrary to the general perception that many or most law firms have expanded to new regional areas to acquire new clients.

One important implication of the regional expansion for firm staffing strategies is the growing popularity of lateral hires. Opening a new branch office is often expensive and risky, and it can decrease firm profitability at least for the first few years (Clay, 2002; Smith, 2003). Lateral hiring of lawyers with portable books of business is viewed as a fast way to increase revenue and profit for the new office (Galanter & Henderson, 2008). In addition, as law firms have expanded to cities to take advantage of the local network of professionals, the competition for lateral lawyers has intensified. As Galanter and Henderson (2008) noted, although large firms compete nationally, the labor mobility of partners is primarily local – with 96.8% of all lateral movements among the AM 200 occurring between offices in the same geographical market between 2000 and 2005.

The Growth of Non-Law Firm Competitors

Advances in information technology (IT) are also changing how law firms operate. IT systems such as predictive coding and e-discovery help lawyers search documents with

keywords as well as build analytical search models and identify documents that include key concepts (Neil, 2012). These systems not only provide greater efficiency, but there is some evidence that these technology-assisted processes produce results that are even more accurate than those produced by human beings (Grossman & Cormack, 2011). As these processes dramatically reduce the number of hours that lawyers need to spend on reviewing documents, they in turn reduce the number of lawyers needed to perform a job. The *New York Times* (2011) cited Mike Lynch, a founder of e-discovery firm Autonomy, who estimated that e-discovery would lead to headcount reductions, by which 500 lawyers could be replaced by one; and the development of more sophisticated software could reduce manpower by another 50% (Markoff, 2011). Estimates are that the market size of e-discovery will grow from $1.8 billion in 2014 to $3.1 billion by 2018 (Kenny, 2014).

In addition, legal process outsourcing (LPO) service firms have expanded the scope of their work. These firms provide services that were traditionally done by junior lawyers or paralegals, such as document review and drafting, e-discovery, legal research and support (The Law Society, 2012). Most of these service providers operate in countries where labor and operating costs are significantly lower, and they provide legal services at a substantially lower fee than law firms. Because there is no publically available data set on the LPO market, there are several different estimations. Lacity and Willcocks' (2012) study of the London School of Economics Outsourcing Unit estimated the global LPO market to be worth $2.4 billion in 2012, with a rate of 28% annual growth. India-based providers, the primary LPO firms used by U.S. law firms, exported legal services worth $640 million in 2010, and the market is expected to grow to $4 billion by 2015. An industry report estimated that the global

LPO market was at $1,085 million in 2012, and it is expected to reach $8,568 million by 2020, growing at a rate of 29.6% per year (Grand View Research, 2014).

Because these technological developments are a relatively new phenomenon, we do not have a clear understanding of how they will influence the legal profession. There is some evidence that they will reduce the number of jobs in the legal profession, especially lower-level jobs. Jackson (2011), a freelance writer for the American Bar Association and attorney specialized in law and business reporting, wrote that firms increasingly outsource to LPO firms tasks normally performed by first- and second-year associates. Mystal (2011) similarly wrote in *Above the Law* that new technological developments and the growth of LPO industry may cut down the number of associates that law firms need and that corporations such as IBM have started to adopt programs for the work of junior level associates. Kuruvilla and Noronha (2015) noted that there is a negative relationship between outsourcing and entry-level employment in large U.S. law firms. Citing a trade publication, they reported that entry-level associate hours billed as a percentage of total lawyer labor hours billed (per client) declined to 2.9% in 2011 from 7% in 2009. Without comprehensive data, however, it is difficult to fully assess the magnitude of the effect or which firms and jobs will be most affected by LPOs.

Increased Information about Law Firms

The dramatic rise in available information about law firms and lawyers has shifted the price negotiation power from the law firms to the clients and customers. Law firms were once famous for their strict confidentiality regarding their operations. Information about partnership arrangements, relationships with clients, organizational structure, and business

results were largely kept in private. Tom Goldstein, a journalist, recalled that in the early 1970s, law firms were reluctant to discuss even basic topics such as lawyer head count (Galanter & Palay, 1991). This confidentiality was supported and encouraged by the professional codes of conduct (the Canons of Professional Ethics adopted in 1908 and the new Code of Professional Responsibility in 1975), which restricted any type of advertising and solicitation of business because such activities can adversely affect professionalism. For example, the 1975 Code of Professional Responsibility sets forth the following:

> A lawyer shall not prepare, cause to be prepared, use or participate in the use of, any form of public communication that contains professionally self-laudatory statements calculated to attract lay clients; as used herein, "public communication" includes, but is not limited to, communication by means of television, radio, motion picture, newspaper, magazine, or book. (American Bar Foundation, Code of Professional Responsibility, Disciplinary Rules 2-101 (A)).

This tradition of secrecy came to an end immediately after the Supreme Court ruled that the restriction on lawyer advertising violated the First Amendment in 1977 (Bates v. State Bar of Arizona, Galanter & Palay, 1991). This court decision enabled law firms and lawyers to talk about their practices and operations freely. Industry publications such as the *National Law Journal* and *The American Lawyer* started to publish detailed information about law firms' hiring and compensation practices, clients, fees, business outcomes, and so forth. Law firms not only became the subjects of these publications, but also important sources and aggressive disseminators of the information (Galanter & Palay, 1991).

Today, many outlets and websites publish the ratings and rankings of law firms and lawyers. For example, Martindale-Hubbell publishes attorneys' experience and credentials, as well as ratings from peers and clients of lawyers. *U.S. News & World Report*, Vault.com, and

The American Lawyer are among the many that publish the rankings of law firms on a variety of topics. Super Lawyer and Avvo.com provide basic information and peer and client ratings for lawyers, and serve as platforms for lawyers to publicize their work.

Although the impact of these kinds of publications on the legal industry and the profession is under-investigated, there is some evidence that greater information about law firms and lawyers has made it easier for clients and customers to compare the prices and the level of service across different service providers. For example, corporations now rely on available metrics when they hire outside law firms as a way to justify legal spending. A 2013 survey of in-house counsel reported that among firms with more than $50 billion in revenue, 33% of them changed their law firms due to the dissatisfaction regarding the price and the level of customer service (Steeves, 2013). With greater information about different types of service providers, corporations are less willing to pay a price premium for certain work and are more likely to choose cost-effective ways to handle their legal work, which substantially shifted the power of negotiation from law firms to clients and customers.

There are concerns regarding the ethical aspects of publicizing information about law firms and lawyers. Micah Buchdahl (2014) reported that there is growing concern about whether the promotion of ratings will lead to “deceptive and misleading” advertisements and also about which ratings or rankings are “bona fide.” Several state and national bar associations have attempted, but failed, to stop the publication business, and in response, they have begun to establish a variety of requirements for proper usage and participation in the ratings/rankings.

In sum, the changes in the competitive environment that I noted above suggest that the law firms now face an increasingly competitive and unstable business environment. The growth of legal industry market has been slowing down while the competition with other law firms, in-house counsel, and non-law firm competitors, has been intensified. As law firms face decreasing demand for legal work and increasing cost pressures, they have started to revise their staffing strategies, which I will discuss in the following section.

CHANGES IN FIRM STAFFING STRATEGIES

The Cravath Model

One of the most distinctive features of U.S. law firms is their historic strong norm of internal labor markets (commonly referred to as the Cravath model). The Cravath model was the standard form of employment in large law firms for much of the 20th century. Paul Cravath, the managing partner of the highly prestigious law firm now known as Cravath, Swaine, and Moore, first developed the practice of hiring lawyers straight from elite law schools and placing them under a strict "up-or-out" system. This model requires law firms to heavily invest in training and development of junior lawyers, and only the best lawyers or associates are promoted to partner after a multi-year tournament. Those who do not make partner after a pre-specified period of time (most often five to seven years) are asked to leave the firm so that the firm can develop and promote a new generation of young, potentially more competent, lawyers. Compensation was largely based on the seniority of lawyers (lockstep compensation), and all partners shared the same status as an equity holder and

residual claimant of the firm. There was virtually no movement in and out of the firm except the departure of associates who did not become partners; and hiring of experienced lawyers, especially from competitors, was frowned on (Galanter & Palay, 1991; Smigel, 1969). Historically, almost all large firms adopted some variant of the Cravath model (Galanter & Henderson, 2008; Henderson, 2008).

The dominance of the Cravath model began to unravel in the 1980s. Sherer and Lee (2002) documented the introduction of permanent or staff lawyer positions as a response to the growing demand for corporate legal work during the 1980s. Permanent lawyers refer to those who stay with the firm even if they do not make partner; law firms often retained their expertise in order to handle the imbalance between the limited supply of law school graduates and the increasing demand for legal work. In addition, firms have gradually accepted non-traditional positions such as non-equity partner (partners who receive salary) and of-counsel as a way to retain expertise of lawyers who did not make equity partners. Although these non-traditional positions were considered a departure from the original Cravath model, most firms still hired fresh graduates at the entry level and groomed and socialized them to have a strong sense of collegiality (Brill, 1990) and as such maintained a strong internal labor market.

Beginning in the early 2000s law firms became more accepting of the lateral movements of lawyers. Some viewed hiring experienced lawyers with a portable book of business as a more efficient growth strategy than investing in the training and development of inexperienced, entry-level lawyers (Henderson, 2008). Law firms, like other types of firms, also became more open to market-based employment systems, where compensation and promotions are based on the performance rather than the seniority of lawyers (Goldberg

2010). The extent to which law firms further transformed the traditional Cravath model in response to business competition and cost pressures is, however, an empirical question. Below, I examine the staffing patterns of the top 250 U.S. law firms from 2000 to 2012 based on the data derived from the *National Law Journal*.

The Growth of Lateral Hiring

As law firms face heightened pressure to expand business and reduce costs, lateral hiring of experienced lawyers has become an important practice for firm growth and survival. Firms have come to recognize that lateral hires may offer firms higher quality work or generate higher revenue without the cost of internal training and development (Lindsey & Fanning, 2007). The unwillingness of clients to pay for associates' training has pushed law firms to hire more lateral lawyers who are already trained and to hire more temporary lawyers to handle document-intensive demands (Rose, 2006). Firms often consider lateral hiring of top performers from competitors as a faster method for expanding market share and increasing profits than training and developing junior associates. A 2011 survey of lateral hiring practices reported that more than half of the surveyed law firms expected to add lateral partners and that more than half of the managing partners spent more than 10% of their time recruiting lateral hires (Harper, 2011).

Contrary to the general assumption that lateral hiring has been consistently increasing, the staffing data for the top 250 U.S. law firms show that since 2006, both the hiring of new grads and experienced lawyers into associate positions has fallen, but lateral associate hires have fallen at a faster rate (Figure 10). The number of associate hires fell substantially after

2006 for both new graduate and lateral hires and it continued to fall until 2012. The number of total associate hires peaked in 2006 (7,105 new graduate hires and 3,253 lateral hires) and then followed a consistently downward trend. The lateral hiring of associates decreased substantially in 2008 and it decreased to the lowest number of hires, 783, in 2010. The number of partner hires (whether internally promoted and hired laterally) remained at a similar level throughout the period. Similar to the associate hiring pattern, the number of partner hires peaked in 2006 (2,653 internally promoted partners and 2,485 lateral hired partners) and then decreased slightly. The number of internally promoted partners exceeded the number of lateral hires until 2006, when the pattern was reversed.

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
associate_incoming class	7,902	6,576	6,942	6,680	7,105	7,924	8,337	7,703	7,105	5,281	5,965	4,770	4,295
associate_lateral		3,639	4,903	5,943	6,883	7,951	8,383	6,713	3,253	3,572	783		
partner_promoted from within	1,963	1,542	2,080	2,187	2,386	2,525	2,653	2,411	1,993	1,587		1,733	1,647
partner_lateral	2,046	1,385	2,103	2,070	2,142	2,327	2,485	2,468	2,313	1,840	1,991	2,128	1,850

Source: The *National Law Journal* Staffing Survey, the sample here is the top 250 law firms.

Figure 10. Number of Associates and Partners Hired from Within versus Externally, 2000-2012

What is noteworthy is that the negative impact of 2009 financial crisis on hiring was much more visible for the hiring of associates than the hiring of partners, and firms have continued to reduce the number of associates rather than the number of partners. I suspect two reasons for such difference. As clients are less willing to pay for junior associates' work, law firms may need a greater number of partners to attract and maintain clients. In addition, law firms reduced the hiring of lateral associates much more than the hiring of new graduates, which may suggest that law firms did not perceive hiring of lateral associates to be as cost-effective as most trade journals have assumed. The development of IT and the growth of LPOs may have also helped firms to reduce the number of associates they need altogether. It is also possible that the lateral hiring of associates is more common for smaller firms, which are not included in the NLJ Staffing Survey. Smaller firms may not have the capacity or resources to train new graduates and instead to take advantage of the skills and experiences of associates trained in the bigger firms. Further investigation is required, however, to understand why firms mainly focused on the reduction of associates as their business strategy and whether the strategy is successful.

In terms of partner staffing, the hiring pattern has been somewhat stable throughout the observation period, except for a slight decrease during the 2009 financial crisis. While lateral hiring of partners is often pursued as an efficient growth strategy, firms are not certain about the effectiveness of this strategy. In a 2012 survey, only 28% of law firms responded that their lateral hires had been successful, and the most profitable firms reported that they used fewer lateral hires compared to their less successful counterparts (Henderson & Zorn, 2013). Henderson and Bierman (2009) argue that while lateral hiring of lawyers who

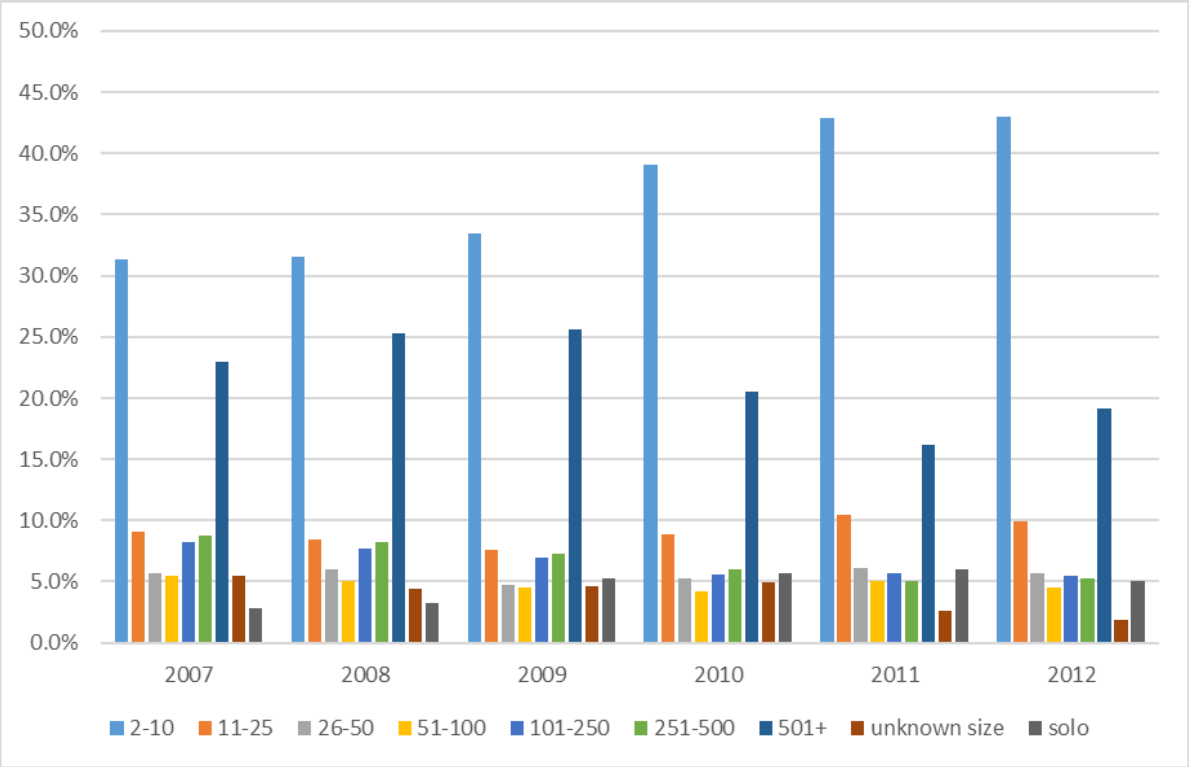
specialized in high premium practices, such as capital markets and intellectual property, may be a profitable strategy for the short term, it may lead to firm instability and hurt long-term sustainability. Heavy reliance on lateral hiring likely undermines the sense of shared history and culture among lawyers and demotivates associates to work hard for a partnership position. Note also that some firms that focused on lateral hiring as a core growth strategy, such as Heller Ehrman and Thelen Reid, went out of business during the financial crisis of 2008-2009.

Fewer Opportunities for New Graduates

Changes in the competitive environment of law firms have also led to changes in training and development practices. Training and mentoring are critical factors for the professional development of young lawyers (State Bar of Wisconsin, 2011), and law firms have traditionally assumed the responsibility for on-the-job training of their associates (Green, 2005). In today's legal market, however, where cost pressures are increasing, associate training is deemed more of a cost than an investment that will deliver returns. As senior attorneys and partners are under pressure to bill hours and generate business, they are less willing to invest their time in "non-revenue generating" activities such as training and supervision (Fortney, 2000). Green (2005) reported that there is a consensus among large law firms that opportunities for high quality, on-the-job training are on the wane as pressures to provide cost-effective service continue to rise. Traditionally, training costs were passed on to clients by billing junior lawyers' time to clients, but recently, clients increasingly request that no junior associates be assigned to their matters or simply refuse to pay for their work

(Henderson, 2008; Jones, 2007; Schmitt, 2007). In addition, clients are more likely to handle small, repetitive, work in-house or outsource it to less expensive firms (Gibson, 2008; Smith, 2013; Steeves, 2013), effectively reducing opportunities for junior lawyers to learn and practice.

As law firms and clients are less willing to invest in training entry-level associates, the number of associates hired in large law firms, where new graduates can be exposed to a variety of work and clients, has shrunk in recent years, and new graduates are taking jobs in small establishments and jobs in business and industry. For example, among the new graduates who took the legal jobs, the proportion of taking jobs in the firms with more than 100 employees decreased from 40.0% in 2007 to 29.9% in 2012, with the lowest point at 26.9% in 2011, according to the National Association of Law Placement (NALP) Recent Graduate survey (Figure 11). By contrast, the proportion of new graduates taking jobs in the smallest establishments with less than 10 employees increased from 31.3% in 2007 to 43.0% in 2012 and the proportion of becoming a solo practitioner also increased from 2.8% in 2007 to 5.1% in 2012, with the highest point at 6.0% in 2011. The total number of respondents to NALP survey changed from 20,611 in 2007 to 19,042 in 2012. Although there is no prior research on the training and career development for new graduates working for a small establishments or for those started as solo practitioners, given that big firms used to be the primary training places for new graduates, it is clear that the number of new graduated trained in large firms has decreased. In addition, law school graduates are increasingly taking jobs in business and industry, rising from 12.5% in 2000 to 17.9% in 2012.



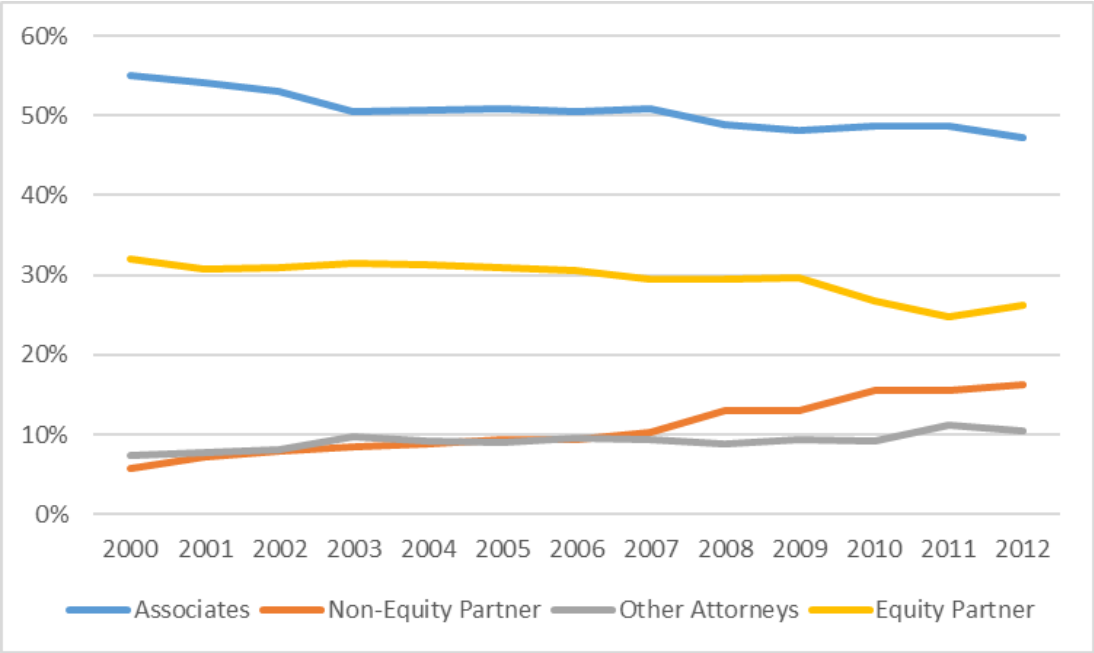
Source: The National Association of Legal Placement, Recent Graduates

Figure 11. The Proportion of New Graduate Hiring by Establishment Size, 2007-2012

As a result, the workforce composition of large law firms has changed. The associate lawyers accounted for 47% of lawyers working for the top 250 US law firms in 2012, down from 55% in 2000 (Figure 12), and the proportion of equity partners also decreased from 32% in 2000 to 26% in 2012. By contrast, non-equity partners accounted for 16% in 2012, up from 6% in 2000 and the proportion of lawyers categorized as 'other attorneys' also increased marginally from 7% in 2000 to 10% in 2012. Although I do not have information on the changes in the labor supply for these top 250 firms, total labor supply of new graduates (the

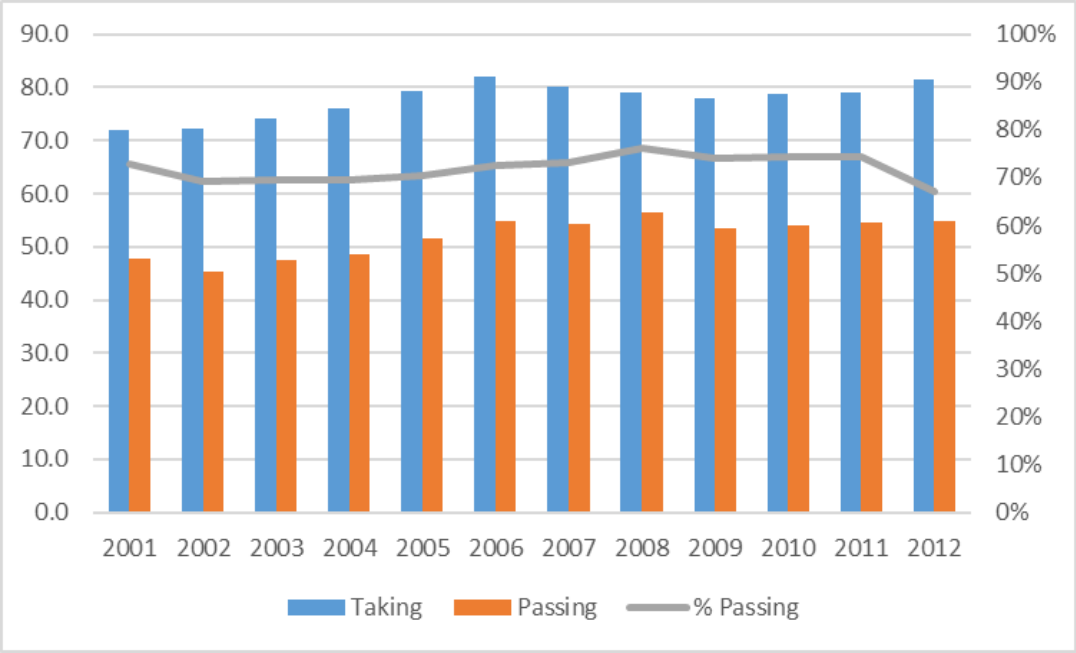
number of persons taking and the passing bar exam) did not change greatly over the last decade (Figure 13).

Law firms are also experimenting with different employment options to handle cost pressures in the development of entry-level lawyers. Greenberg Traurig, for example, introduced a "residency" program for new associates (Elefant, 2013). New graduates are offered the chance to be "fellows," similar to associates, but they are paid much less, they bill less, and they receive more training. After the first year, residents either become a regular-track associate or leave the firm. Paul Hasting adopted "secondment arrangements" through



Source: The National Law Journal 350

Figure 12. The Proportion of Associate/Partners/Other Attorneys in the Top 200 Law Firms, 2000-2012



Source: National Conference of Bar Examiners.

Figure 13. The number of persons taking and passing bar examinations (in 1,000), 2001-2012

which the firm loans out lawyers to work in-house for a client for a pre-specified period. Secondment arrangements offer legal services at a lower cost, and they frequently strengthen the tie between the law firm and the client.

Growing Disparity Within and Across Firms

The breakdown of the traditional Cravath model has also led to greater disparity within and across firms. The traditional Cravath model values seniority, partnership, and collegiality among lawyers. These values are reflected in one-tier partnerships and lock-step compensation, where rewards and promotions are primarily based on a lawyer's seniority. The Cravath, Swaine, and Moore policy, where the Cravath model was invented, states that its

lockstep structure fosters cooperation and eliminates competition for work, clients, training, and bonuses among partners and associates. Clients are clients of the firm, not of one particular partner; thus, all members share the same credit. One-tier and lockstep compensation are the two dominant practices that ensure equity among lawyers within the same rank (Henderson and Bierman, 2009).

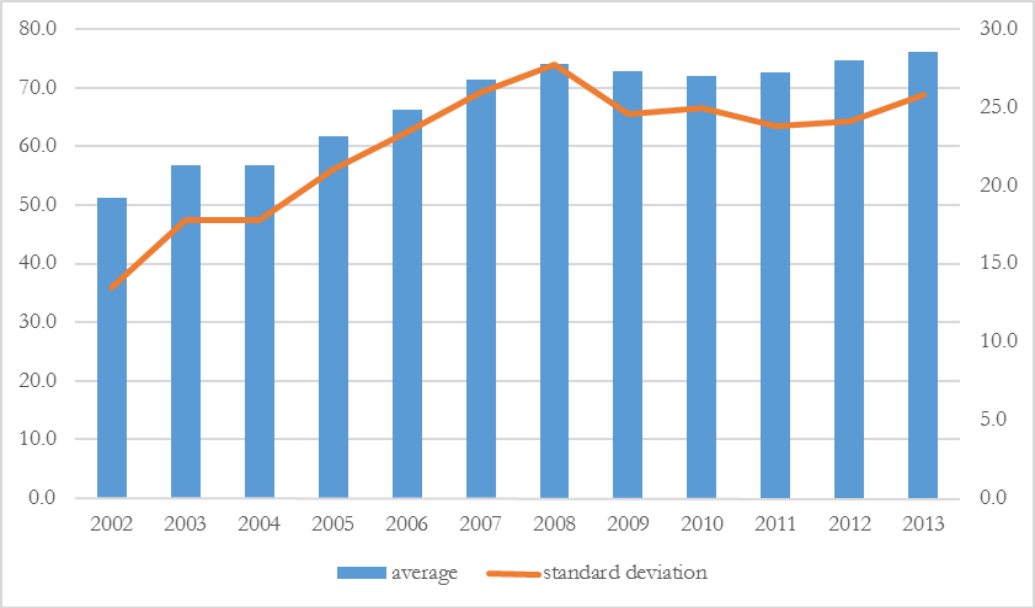
Recently, some evidence shows that law firms have begun to move away from a one-tier, lockstep model toward a merit-based system, where rewards and promotions are based on individual performance. In 2000, 166 firms out of 250 firms had two-tier partnership (defined as having non-equity partners), and in 2012, the number of firms with two-tier partnership increased to 211. In terms of compensation practices, the 2014 Partner Compensation Survey (Major, Lindsey & Africa, 2014) reveals that among 2,088 respondents, only 14 (1%) retained a pure lockstep model, 280 (13%) generally follow a lockstep model, while the vast majority, 1,794 (86%), do not incorporate a lockstep model at all. In a 2012 survey, among 2,016 respondents, 33 respondents (2%) had a pure lockstep model, 312 (15%) had a general lockstep model, and 1,671 (83%) did not have a lockstep model at all. Similarly, a Citi Private Bank - Law Firm Group (LFG) 2009 survey reported that almost half of the top 50 U.S. law firms were planning to switch to performance-based compensation systems (Goldberg, 2010). At the forefront, Howrey, Husch Blackwell Sanders, Long & Aldridge, and McGuire Woods introduced merit-based compensation and promotional plans for associates. Some firms, such as Baker Botts and Bingham McCutchen, have adopted hybrid compensation systems, where total salary is based upon seniority as well as merit.

As a result, the level of differentiation between lawyers has increased, and the compensation gap between employees is growing rapidly. The average compensation for equity partners was $971,000 in 2014 compared to an average of $338,000 for non-equity partners according to the 2014 Partner Compensation Survey conducted by Major, Lindsey & Africa (2014). While the average compensation for non-equity partners has remained almost flat in nominal terms since 2010 ($336,000 in 2010, $335,000 in 2012), the compensation for equity partners increased by more than 10% during the same period ($811,000 in 2010, $896,000 in 2012). There is anecdotal evidence that the gap in compensation between the highest and lowest earning partners, even within equity partner ranks, has widened in recent years, according to a 2013 Report on the State of the Legal Market (Georgetown Law, 2013). The compensation spread was traditionally around 4:1 to 5:1, but it has increased to 6:1, 7:1, or even higher. The increasing spread is due to the perception of firms that they need to make "rainmakers" happy if they do not wish to lose them to competitors (Major, Lindsey & Africa, 2014).

De-equitization of partners has recently been documented as a popular practice for reducing labor costs. Law firms used to use this strategy to allow attorneys near retirement to avoid making a capital contribution to the partnership. In this process, equity partners become non-equity partners. Recently, firms have started to de-equitize partners who are in the middle of their careers, but who are not performing well or not meeting business targets (Coe, 2016). Non-equity partners are often seen as second-class citizens, but law firms have increased the number of them as a way to reduce costs and to distinguish between those who create revenue and bring in new clients from those who are still competent lawyers but cannot or do not want

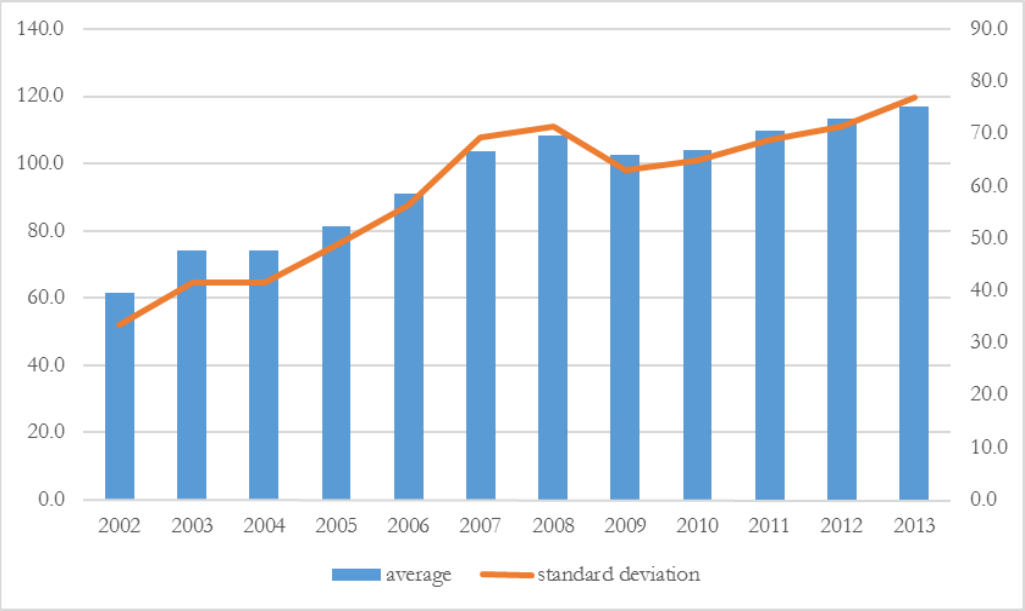
to play the role of ‘rainmakers’ or cultivating client relationships. One survey in 2016 revealed that 48% of all firms have de-equitized their partners and that the rate was higher, 64%, for larger firms (Altman Weil Survey, 2016). Whether de-equitization is a successful strategy for both firms and employees is debatable, but it certainly increases the distinction in the status and the compensation between rainmakers and other types of partners.

In addition, although it has largely been under-investigated, the differentiation across different firms is increasing as well. Drawing on the performance data of the top 200 US law firms (Figures 14 and 15), the average performance (revenue and profit) increased until 2008, slightly decreased in 2009, and stayed virtually flat until 2013. The standard deviation in performance followed a similar trajectory: increased until 2008, a sharp drop in 2009, and returned to pre-crisis level by 2013.



Source: The American Lawyer Am 200

Figure 14. Revenue per Lawyer of the Top 200 Firms (in $10,000), 2002-2013



Source: The American Lawyer Am 200

Figure 15. Profit per Lawyer of the Top 200 Firms (in $10,000), 2002-2013

This result suggests that there is growing performance disparity among firms, even among the 200 largest firms in the U.S. The disparity is also evident in the pay gap for first-year associates. Table 3 shows that the difference between the minimum and maximum level in first-year associate pay (nominal) across different establishment sizes increased from $53,000 in 2003 to $92,000 in 2014. Over the period of 2003 to 2014, average compensation for first-year associates working in offices with 2-25 lawyers increased from $59,500 to $78,000 (the highest level) while compensation increased from $102,000 to $160,000 for first-year associates working in larger offices (251-500). Barton (2015) analyzed the IRS data and found that a solo practitioner in 1988 earned $70,747 on average after adjusting for inflation, while a solo practitioner in 2012 earned $49,130, a 30% decrease in real income in

2012 dollars. $49,130 is not the starting salary for these solo practitioners but it is the average earning of 354,000 lawyers who filed taxes as solo practitioners. The level of real income decrease for solo practitioners is a stark contrast to the consistent increase in the average compensation level of partners at large law firms.

Overall, these results suggest that earnings dispersion is growing in the legal profession as a whole. The compensation gap is increasing not only within firms and across different classes of lawyers, but also across different types of firms. Equity partners and lawyers working in large firms have mostly benefited from the growth of the industry, while lawyers working in small size firms, those with non-standard employment contracts, and solo practitioners are losing out. It is also possible that the new structure of legal careers is creating

Table 3. First Associate Compensation by Establishment Size, 2003-2014

Year/Size	**2-25**	**26-50**	**51-100**	**101-250**	**251-500**	**500+***	**700+**
2003	59,500	71,000	80,000	85,000	102,000	113,000	NA
2004	65,000	72,900	81,000	88,500	97,250	120,000	NA
2005	67,500	80,000	83,000	88,000	105,000	125,000	NA
2006	67,000	80,000	85,000	90,000	115,000	135,000	NA
2007	68,000	81,000	90,000	105,000	115,000	120,000	145,000
2008	73,000	92,500	95,000	110,000	125,000	125,000	160,000
2009	70,000	92,500	104,000	110,000	125,000	135,000	160,000
2010	72,000	95,000	95,000	105,000	125,000	117,500	160,000
2011	73,000	86,000	91,000	110,000	125,000	120,000	160,000
2012	70,750	90,000	100,000	110,000	145,000	125,000	145,000
2013	78,000	110,000	100,000	110,000	160,000	125,000	160,000
2014	68,000	105,000	110,000	105,000	160,000	125,000	135,000

Source: The National Association of Legal Placement, Recent Graduates

a ‘middle class’ of lawyers who work as in-house counsel or non-equity partners at large firms that used to move down to smaller and less prestigious law firms or forced to be solo practitioners.

CONCLUSION

Law firms today are facing slower growth and increased competition, and we have observed many firms deviating from the traditional Cravath model and moving toward a more market-based staffing system. While some prestigious and highly productive law firms still adhere to the traditional Cravath model, many firms have abandoned or revised the model by accepting more lateral hires, abandoning the up-or-out system, and introducing performance based employment systems. What, then, are the implications of the new model for law firms and the legal industry as a whole?

First, the increasing popularity of lateral hires may impede the development of firm-specific skills. Internal labor market theory (Doeringer & Piore, 1985) suggests that employers and employees have an incentive to invest in firm-specific skills only when long-term relationships are assumed. Gilson and Mnookin (1989) specified two sources of firm-specific skills for law firms: 1) the institutional knowledge of clients’ businesses, and 2) a firm’s general reputation for quality work. These firm-specific skills are embedded within a firm, and as a result, clients are attracted to the firm rather than to any specific partner. The Cravath model helps lawyers build firm-specific skills by emphasizing the intensive development and socialization of junior lawyers and the equal sharing of credit for clients’ work. Lateral hiring, by contrast, relies on the general skills and the ability of individual

lawyers, often partners, to attract clients. Because these individuals can bring in and take away their skills and clients when they move between firms, firms that focus on lateral hiring may be unable to build and preserve sustainable firm-specific skills. Greater reliance on lateral hiring not only undermines the level of cooperation, trust, and coordination necessary to provide legal services, but also negatively influences associates' perception of long-term career prospects within the firm (Henderson & Bierman, 2009).

Second, fewer opportunities for younger lawyers to be trained and mentored may lead to skill depreciation in the legal industry in general. Law firms now expect new graduates to have practical skills, such as drafting contracts and conducting due diligence, before hire (LexisNexis, 2015), and they have criticized law school curricula for being too theoretical and antiquated (Segal, 2011). Career consultants advise law school students to gain marketable experience through internships and volunteering before completing their degree program in order to increase the chances of finding employment (Law Practice Today, 2011). While traditional on-the-job training provided by law firms is on the wane, it remains uncertain who will take charge of the training and development of new graduates.

In addition, it is unclear whether minorities are more likely to be affected by the decline of training and development opportunities. According to the 2015 NALP hiring data, the overall percentage of women associates has declined in all but one of the last six years, and the percentage of African-American associates has dropped since 2010 and now stands at just under 4% of associates (NALP Bulletin, 2016). At the partner level, in 2015, 7.52% of partners were minorities and 2.55% of partners were minority women and many firms did not have any minority partners at all. Although Kay and Gorman (2012) reported that the

presence of formal training and mentoring programs did not help minorities to advance, minority junior lawyers may find it even more difficult to advance in an environment with less investment in training and development.

Finally, the growing disparity within the legal profession has largely been under-investigated. It is possible to assume that the level of performance gaps across firms may decrease as information about law firms and lawyers becomes widely available and clients are more willing to shop around to get the best deal. In reality, however, growth has primarily occurred in large firms. The disparity among lawyers (partners versus associates and equity partners versus non-equity partners) is also growing. This is partly due to the compensation practices that excessively reward a few rainmakers and may also be a side effect of the general economic trend toward growing disparities between the highest and lowest-paid positions (Schwartz, 2015). Overall, we lack a clear understanding of what drives such disparities, where the disparity is more visible (e.g., which types of firms, which practice areas, etc.), and the firm-level and employee-level consequences of such disparities.

Whether the Cravath model will survive is still an open question. Law firms exhibit considerable heterogeneity in the extent to which they have revised their traditional employment model, and they have started to recognize the long-term risk associated with short-term growth through lateral hiring. The revision of the traditional Cravath model influences not only individual firm performance, but also the legal profession in general. Thus, it is an important research setting for investigating those factors that help firms pursue or resist the trend toward more lateral hiring, and the performance implications of internal and external hiring.

CHAPTER 3.

INTERNAL AND EXTERNAL INFLUENCES ON FIRM STAFFING STRATEGIES

INTRODUCTION

It has been widely accepted that firms have mostly moved away from the traditional staffing model – in which new college graduates were recruited at the entry level and developed within – to an external labor market approach where firms hire employees with prior work experience and employees build their career by moving across different firms (Bidwell, 2013; Cappelli, 1999; Rynes, Orlitzky, & Bretz Jr., 1997). While a common assumption in the business and academic literature is that this shift away from internal development to external sourcing of human capital is prevalent and inevitable, the reality is that there has always been great variation among firms in the extent to which they rely on internal versus external staffing strategies (Baron, Davis-Blake, & Bielby, 1986; Osterman 1987; Osterman & Burton, 2005). In addition, despite the growing popularity of external hiring (Jacoby, 2005; Royal & Althauser, 2003), there is evidence that firms still fill most jobs with internal candidates (Bidwell & Mollick, 2015). While there is extensive research on whether hiring employees from other firms is productive or not, relatively little is known about when and why firms pursue one staffing strategy over another.

An investigation of firms' staffing strategies is particularly relevant given the talent shortage debate. On the one hand, one in three U.S. employers claim that they experience difficulty in filling jobs (Talent Shortage Survey, 2015). Lack of applicants, lack of experience, and lack of technical competencies or hard skills are often cited as reasons for the talent shortage. On the other hand, new college graduates are having difficulty locating jobs. The 2015 U.S. College Graduate Employment Study reported that forty-nine percent of college graduates considered themselves as underemployed and forty-one percent of the graduates earn $25,000 or less a year. Cappelli (2012, 2015) noted that as firms are less willing to invest in employee training, new graduates are finding it more challenging to gain work experience, which could eventually lead to firms' difficulty in acquiring talent. In addition, any job requires a certain level of firm-specific skills that cannot be acquired via external labor markets; thus firms will continue to experience a certain level of talent shortage if they only focus on an external staffing strategy. Based on a nationally representative survey of manufacturing establishments, Osterman and Weaver (2014) similarly reported that they did not find any support for the skill mismatch argument – persistent unemployment is caused by a mismatch between the skills firms need and the skills of the workforce – and the required skill levels for most jobs were at the community college level or below which is within the reach of the vast majority of Americans. Instead, they identified inadequate demand - firms simply do not have any vacancies - as the main cause of persistent unemployment.

Existing research on staffing strategy is limited in two ways. First, although firms combine different staffing strategies, prior literature has examined them in separate streams of literature. A vast majority of recruitment research has focused on new college graduates

(Breaugh, 1992; Rynes, 1991), while the employee mobility literature has mainly focused on the effects of hiring employees from other organizations (Groysberg, Lee, & Nanda, 2008; Rao & Drazin, 2002; Somaya, Williamson, & Lorinkoa, 2008). Thus, we have little knowledge of the extent to which firms combine both staffing strategies – hiring new graduates as well as experienced workers. Second, firms are embedded within the surrounding society and economy, and thus their hiring strategies may be influenced by external market conditions (Boxall & Purcell, 2008). Campbell, Coff, & Kryscynski (2012) theorized that labor market conditions influence the costs and benefits of acquiring certain types of human capital, and Sherer (2011) also noted that the value of human capital is relative rather than absolute, in that relative value depends on the supply and demand. From this perspective, external market conditions may influence firms' staffing strategies. Yet, prior literature has generally assumed that firms have complete autonomy in executing their strategy. This paper attempts to address these limitations.

In this chapter, I explore which types of firms hire inexperienced entry-level workers versus lateral workers. In particular, I compare the hiring of inexperienced new graduates and the lateral hiring of experienced lawyers at U.S. law firms. Although it is possible that lateral hires could enter a firm at the entry level, this practice is highly unlikely for workers moving across firms within the same industry. Given that firms combine both types of hiring to a varying degree, I focus on the relative, rather than absolute, level of each types of hiring. Thus, the question is not whether a firm hires entry-level workers or not but whether it hires entry-level workers more or less than experienced workers given the total number of hires. Based on the idea that firms are subject to internal and external pressures (Simpson & Gulley,

1962; Boxall & Purcell, 2008), I consider firm-level and regional market contingencies both independently and interactively. Firms may strategically seek to pursue one type of hiring over another, however, internal and external pressures may enable or constrain the execution of their strategy.

I test my hypotheses using a sample of regional offices of U.S. law firms over a five-year period (2006-2010). I combined several different data sources: office-level hiring patterns for new graduate and lateral hires as well as organizational characteristics from the National Association for Law Placement (NALP) Directory of Legal Employers; prestige scores from the Vault 100; lawyer statistics from American Bar Association; and other regional factors from the U.S. Census and U.S. Bureau of Economic Analysis. The analytical approach takes into account that these local offices are nested within states and firms.

This research contributes to the literature on internal labor markets and worker mobility by demonstrating how firm-level and environmental factors influence a firm's hiring patterns. Based on the literature on internal organizing from human resource management, organizational sociology, and business strategy, I test a comprehensive set of antecedents of a firm's staffing strategy and show that firm-level decision-making is the result of a complex interaction between internal and external pressures. The empirical results show that despite the general perception that external hiring of experienced employees is an on-going trend, firms still vary greatly in how they organize and develop human capital.

RESEARCH CONTEXT – U.S. LAW FIRMS

The context of this study is the hiring patterns of U.S. law firms from 2006-2010. Law firms provide an excellent setting for my investigation as they are unambiguously dependent on human capital and have undergone significant recent changes in their hiring strategies. Law firms were once famous for their strong internal labor market (commonly referred to as the Cravath model), where most lawyers were recruited from law schools, especially from elite schools or from the top of the class, and then groomed and socialized to have a strong sense of collegiality (Brill, 1990). The traditional Cravath model emphasized the "up-or-out" principle in which these junior lawyers either attain partnership after several years of tenure ("up") or are asked to leave the firm ("out"). Lateral hiring was an exception to the rule and rare (Sherer, 2008). Cravath, the originator of the model, believed that "a staff trained within the office would be better adapted to its methods of work than a staff recruited from older men who in practice elsewhere, might have acquired habits inconsistent with Cravath methods", hence he insisted that the staff should be recruited just out of the law schools (Swaine, 1948:2). Historically, almost all large firms adopted some variant of the Cravath model (Galanter & Henderson, 2008; Henderson, 2008).

More recently, the dominance of the Cravath model has started to dwindle, and lateral hiring has become increasingly accepted as firms recognize that lateral hires bring in new and valuable skills without any of the long-term costs that are associated with internal training and development (Lindsey & Fanning, 2007). In addition, as corporate clients face greater budget constraints due to heightened competition and pressures to reduce costs, they are increasingly reluctant to pay for the time of junior lawyers working on projects or the time of partner

lawyers training junior lawyers (Henderson, 2008; Jones, 2007; Schmitt, 2007). As a result, firms have started to search for third, fourth, and fifth year lawyers with specific skills (Zappe, 2013) and the demand for midlevel associates is increasing by as much as 50 percent in some practice areas (Zillman, 2012). Firms hire mid-level associates based on the assumption that they are trained and have experience along with relatively reasonable billing rates (Savage, 2015). A 2012 survey by *American Lawyer* reported that 74 percent of the manager partners responding planned to increase lateral hiring for both associates and partners, while only 15 percent planned to increase entry-level lawyers (Weiss, 2013).

Although lateral hiring has become a popular staffing strategy, there are some concerns over the growing reliance on lateral hiring. Henderson (2010) cautioned that greater focus on lateral hiring can harm the production of next generation of lawyers with legal skills and client-relationships because firms will be less willing to invest in the training and development of entry-level lawyers. In addition, a firm may find it difficult to develop firm-specific human capital as lateral hires can easily leave the firm with their skills and clients. Lateral hiring may also negative influence junior associates' perception of long-term career prospects within the firm (Henderson & Bierman, 2009).

Givem these risks, is it true that all firms moved away from the Cravath model and hired more laterals? If not, which firms still hire new graduates without experience and train and develop them when lateral hiring is often considered as a more cost-effective staffing strategy? What are the internal and external factors that influence a firm's hiring of new graduates? These are the research questions that I attempt to answer in this paper.

The context of this study should be generalizable given that firms increasingly prefer hiring applicants with prior experience to hiring new graduates or applicants without any experience (Cappelli, 2012; Rynes et al., 1997). As law firms expand in size and in the range of legal practice areas they serve, they are increasingly exposed to external market pressures, and the careers of lawyers are coming to resemble those of knowledge workers in large corporations. Lawyers became more subject to merit-based employment systems where rewards and promotions are based on individual performance. Similar to other new graduates, securing a stable employment and an opportunity to be trained and mentored is becoming more and more difficult for law school graduates (State Bar of Wisconsin, 2011). Thus, I expect the findings of this study have important implications for professional service firms as well as other firms that rely on the human capital to become and remain competitive.

THEORY & HYPOTHESES

Firms generally have two choices in acquiring and developing human capital; recruit at the entry level and develop them within, or rely on external hiring and take advantage of expertise and experience acquired elsewhere. The former approach is often referred to as an internal labor market whereas the latter is referred as an external labor market (see Osterman & Burton 2005 for a review). The two approaches represent alternative strategies for human capital acquisition that require distinctive approaches to human resource management. In order to establish an effective internal labor market, firms need to develop a full range of human resource management (HRM) practices, such as selective hiring systems for entry-level employees, careful workforce planning, extensive training and development programs,

and careful matching between employees' skill sets and firms' strategic needs. By contrast, staffing through the external labor market requires a deep knowledge of labor market conditions and an efficient search and recruitment function. Firms must design market-based compensation systems, match the skills of external candidates to their internal needs, and effectively integrate experienced employees who bring new skills and knowledge or specialized expertise. Theory suggests that relying on internal labor markets is beneficial when firms require a cohesive organizational culture or firm-specific human capital, whereas relying on the external labor market helps firms adjust to rapidly changing environments (Becker 1962; Lepak & Snell 1999). Thus, internal and external labor market staffing strategies imply different business strategies or underlying philosophies towards human resource management.

The distinction between internal and external labor markets is also relevant to the costs and benefits associated with hiring experienced and inexperienced employees. Prior studies have noted that experienced hires bring in not only new knowledge and skills (Almeida & Kogut, 1999; Rao & Drazin, 2002) but also cognitive and behavioral rigidities that may impede performance in the new firm (Bidwell, 2012; Dokko, Wilk, & Rothbard, 2009; Hatch & Dyer, 2004). These experienced hires require less investment in training and skill development, yet they cost more to hire in terms of higher salaries (Ang, Slaugther, & Ng, 2002; Bidwell, 2012; Parent, 2000). The benefits and costs of hiring inexperienced employees are likely to be exactly the opposite. They require more investment in training and development and it may take longer for them to be productive, but it will be easier to teach them firm-specific skills and to socialize them into a firm-specific culture given that they do

not need to ‘unlearn’ knowledge or skills acquired from prior jobs (Nystrom & Starbuck, 1984; Starbuck, 1996). The investment in employee training and the intense socialization process are costly, yet they will pay off over a long period of time.

Although internal staffing and external staffing strategies imply different business strategies or underlying philosophies towards human resource management, firms may combine both strategies as needed. In their survey of staffing professionals, Rynes, Orlitzky, and Bretz, Jr. (1997) noted that there has been a considerable shift towards more experienced hiring in recent years while new graduates are still an important source of entry-level hiring (Cline, 2010). There is evidence for increasing employee mobility and decreasing tenure (Bidwell, 2013) as well as the predominance of internal staffing for executive positions (Bidwell & Mollick, 2015). Within the context of this study, U.S. law firms, it is widely accepted that lateral hiring became a dominant form of hiring in recent years, yet the data suggests that there is a great level of variation across firms and across years in whether firms hire inexperienced new graduates or experienced employees. Moreover, institutional and economic forces inside and outside an organization may help or constrain the execution of a particular strategy (Baron, Davis-Blake, & Bielby, 1986). Firms may pursue one strategy over another, yet the supply of human capital and the level of business competition may make that strategy too costly. Thus, a multi-level, multi-variable investigation of firms’ hiring patterns is warranted.

In my analyses, I first test the relationship between having formal development practices and a firm’s hiring of new graduates. My assumption is that having these development practices helps firms to train and develop their own human capital; and thus,

they may focus more on hiring new graduates without prior experience. Then, I investigate the independent effects of firm-level structural features such as size and prestige, and regional market factors, such as labor supply and business competition, on firms' hiring patterns. Finally, I examine the interactive effects of having formal development practices and other variables on firms' hiring patterns.

Formal Development Practices

The human resource management (HRM) literature has long examined how organizations adopt HRM practices to develop and retain human capital. Tsui and colleagues (1997) propose two extreme approaches to employment relations: quasi-spot contract and mutual investment. The quasi-spot contract resembles a pure economic exchange between an employer and an employee with the relationship being relatively short-term and closed-ended, and the exchange between the two is confined to monetary rewards for well-specified activities. By contrast, the mutual investment approach assumes a long-term, open-ended relationship between an employer and an employee. Here, the obligation of the employer extends to an investment in the employee's career within the firm and employees are expected to be involved in tasks that fall outside of prior arrangements, such as mentoring junior colleagues and accepting job transfers when requested.

Given the two extreme ends of employment relations, I expect that having formal development practices is positively associated with new graduate hiring. I specifically focus on having a rotation practice and providing training as reflecting a firm's commitment to the internal development of employees. Having these practices promotes the development and transfer of organization-specific skills that are hard to obtain from external labor markets.

First, job rotation is an intra-firm mechanism for sorting and matching employees to jobs (Ortega, 2001). Firms rotate employees through various jobs so that employees can acquire new skills and firms gain information about the quality of employee-job matches (Jovanovic, 1979). Employee development through job rotation is one of the corporate strategies to proactively accumulate firm-specific human capital (Campion, Cheraskin, & Stevens, 1994). Training is another practice that shows organizational commitment to internal development. Human capital theory suggests that individual employees invest in the development of general skills while firms are more likely to invest in training that focuses on firm-specific skills (Becker, 1964). The firm incurs direct costs for training such as employee wages paid during training and costs associated with course development and execution (Mirabal, 1978) as well as indirect costs due to forfeited productivity and lost time during the training period (Head & Buchanan, 1981). Thus, adoption of training programs displays a firm's commitment to long-term, open-ended employment relationships. Lepak and Snell (1999) also noted that the choice between training and staffing represents a firm's relative emphasis on a make or buy strategy.

I assume that having formal development practices in place is the precondition for new graduate hiring for two reasons. First, once an organizational practice is adopted or institutionalized, it is very difficult to abandon such a practice (Zucker, 1977). The establishment of a formal training or rotation program at the firm level requires the approval of the top management and coordination among different departments and stakeholders. The number of new graduate hires may change across years, and it is unlikely that firms adopt or abandon formal development practices based on the number of hires of a given year. Second,

given the perception that hiring employees with prior experience is a more cost-efficient strategy than hiring inexperienced new graduates, firms may prefer to hire employees with prior experience unless they consider their internal practices as effective and competitive in developing entry-level lawyers.

H1. Firms that have formal development practices are likely to hire more new graduates than lateral workers.

Firm-Level Structural Factors

Firm-level structural factors may also influence a firm's hiring strategy. Following the literature in organizational sociology, I hypothesize that organizational size and firm prestige are associated with a firm's hiring strategy. These structural factors reflect the level of a firm's internal resources available for developing its own human capital.

First, prior literature has posited that organizational size is an important antecedent of the adoption of an internal labor market. Large bureaucratic organizations adopt lifetime employment and career ladders as an efficient organizational arrangement (Weber, 1947) and they tend to have the resources and skill to establish promotion ladders (Oi, 1983). The size of an organization is correlated with the number of vacancies and the number of hierarchical levels, with larger firms providing greater promotion opportunities (White, 1970). In addition, a large labor pool within the organization allows employers to find qualified employees to fill vacancies from within (Pfeffer & Cohen, 1984). Prior studies have shown that establishment size is strongly associated with internal labor markets (Baron et al., 1986; Pfeffer & Cohen, 1984). With an effective internal labor market in place, large organizations are more able to

recruit employees at the entry level and develop them within than organizations with smaller sizes.

Having prestigious status is critical for attracting high quality applicants, and this is especially so for firms that compete primarily based on the capabilities of employees. If we assume that the ability of workforce is normally distributed, then not all firms can enjoy the benefit of having a highly competent workforce (Boxall, 2011; Wright, McMahan, & McWilliams, 1994). Firms that are able to attract high quality applicants and hire the best will have greater motivation to establish an internal labor market to develop and retain them, and being prestigious is an important factor in attracting high-quality new entrants (Rider & Tan, 2015). Law firms attract graduates from elite law schools with the perception that those firms will provide them with strong training and development programs, competitive salaries and bonuses, and good outplacement options (Gilson & Mnookin, 1998). For example, by working for a prestigious law firms, an associate is not only exposed to a great variety of work and high-profile cases but also gains creditability in the job market and can signal his or her competency (Henderson & Zaring, 2007). Although Sherer and Lee (2002) reported that prestigious law firms were at the forefront of abandoning the traditional internal staffing approach, i.e., the Cravath model, Henderson (2005) reported that a majority of prestigious law firms, particularly the most profitable ones, still maintained an internal staffing strategy.

H2. Firms that are (a) large, and (b) prestigious are likely to hire more new graduates than lateral workers.

Regional Market Factors

I next introduce regional factors that may influence firms' staffing strategies. Firms are not isolated entities but rather are embedded within local economies that provide both support for and regulation of firm-level activities (Boxall & Purcell, 2008; Rubery & Grimshaw, 2003). Baty, Evan, and Rothermel (1972) noted that organizations are highly constrained by their regional labor markets. Organizations depend on the kinds of people that they can recruit for the execution of their strategic goals; thus, organizations may need to adjust their goals based on the opportunities that the local labor market provides. Sorensen (2004) also noted that regional labor markets are a potentially important source of opportunity as well as a constraint, and his earlier work (1999a, b) demonstrated that labor market conditions have significant consequences for firms. In this paper, I focus on two types of local market conditions: the supply of experienced workforce and local business competition.

Firms need to compete in labor markets to acquire human capital (Coff, 1997) and the level of competition directly impacts how firms acquire and retain human capital. The costs associated with acquiring and retaining employees would be less if there is an abundant labor supply. When labor supply is greater than demand, not only it is easier for firms to hire employees but also employees are less likely to leave the firm (Gerhart, 1990; Sun et al., 2007).

One important aspect of the external labor market that the prior literature has largely ignored is the existence of several different labor markets from which firms hire workers. For example, unemployment rates are significantly different not only for different occupations but also different types of human capital, such as experienced and inexperienced. Within the

context of this study of law firms, the distinction between labor markets for new graduates and lateral hires is particularly salient. Entry-level positions are filled through campus recruiting and internships, while lateral positions are mostly filled through personal networks or through the use of headhunters. Law school graduates may have learned legal rules and the process of legal reasoning, but they need a probationary period in order to acquire more complex and practical skills as well as client-related experience (Gorman, 1999). Entry-level junior lawyers mostly engage in basic and repetitive tasks such as gathering information, drafting documents, and performing analyses, whereas more experienced lawyers are in charge of business development and client relations and able to lead more complex cases (Maister, 2007).

Given the separate labor markets for new graduates and experienced workers, I hypothesize that when firms face an abundant supply of experienced workers, they may perceive it to be more cost-effective to hire them when compared to hiring inexperienced entry-level workers.

H3. The size of local labor supply of experienced human capital is negatively associated with a firm's hiring of new graduates.

The extent of product market competition that firms face also shapes managerial decisions (Pfeffer & Leblebici 1973). When an organization has some degree of control over its environment, it has more freedom to invest in business activities, regardless of cost or quality, and efficiency in operation and responsiveness to customer demands are not vital. A highly competitive environment, by contrast, makes it difficult for firms to take risks when outcomes are uncertain. Greater external pressure leads organizations to be more coordinated

and control-focused. Thus, firms facing greater business competition are less likely to hire entry-level employees based on the assumption that these employees need investment in training and development.

Prior studies have also reported that experienced hires are an effective way to expand business. Carnahan and Somaya (2013) showed that supplier firms received less outsourced work when buyers hired employees from the supplier firm's competitor, and similarly, Somaya and colleagues (2008) found that inward mobility of workers from competitors is associated with better performance. Both studies suggest that lateral hires from competitors bring in client-related social capital that may help firms obtain business from specific clients. Firms facing greater competition for business may find lateral hiring more effective to attract new customers and expand business. Thus, I hypothesize,

H4. The level of local competition is negatively associated with firms' hiring of new graduates.

Enablers versus Constraints

The idea that firms are subjected to a range of internal and external pressures (Simpson & Gully, 1962) has long been recognized, but the degree to which firms have discretion or choice given the constraints imposed by internal and external contingencies has not been widely explored. Firms may pursue certain hiring strategies by adopting relevant organizational practices; nonetheless, these choices may be constrained or facilitated by both structural and regional conditions. For example, a firm establishes development practices in an attempt to develop employees internally, but local business competition and the local labor pool may make lateral hires more cost effective. These arguments suggest a firm's use of

formal development practices should be considered jointly with the firm's structural and local market conditions in order to understand whether, and how much, a firm's staffing choices are constrained by both internal and external contingencies.

First, I hypothesize that the relationship between having formal development practices and new graduate hiring will be moderated by the firm's structural factors. Large or prestigious organizations may be more likely to take advantage of the development practices they have to develop and maintain an internal pool of highly qualified candidates. The structural factors of being large and prestigious create financial and human resource advantages in not only attracting the best candidates but also motivating employees' investment in firm-specific skills. Having well-established development practices in place, such as training and rotation, may reinforce these advantages by providing formal or informal processes that facilitate the development and the retention of new graduates. By contrast, smaller and less prestigious firms have limited resources for attracting and retaining high quality candidates, and thus it may be difficult for them to benefit from having development practices in place.

H5. The relationship between having formal development practices in place and new graduate hiring will be moderated by firm (a) size and (b) prestige: The positive relationship between new graduate hiring and having development practices is stronger for larger offices, and highly prestigious offices.

The extent to which local market contingencies moderate the relationship between a firm's commitment to internal development and new graduate hiring, however, is an empirical question. On the one hand, it is possible to hypothesize that the relationship may be weakened

when local market conditions offer lateral hiring as a more cost-effective hiring strategy. Sun et al. (2007) reported that employees took advantage of a favorable external labor market and left their firm even if they exhibited a high level of organizational citizenship behavior. A similar argument can be made for firms, in that firms take advantage of external market conditions regardless of their internal practices. If there is an abundant labor pool of experienced workers or if the level of business competition does not allow firms to invest in employee training, then firms may be more likely to hire employees with experience even if they have formal development practices in place.

On the other hand, employers may view having formal development practices and new graduate hiring as their competitive advantage when local market conditions force other firms to pursue lateral hiring. Sherer (2011) pointed out that the value of different human capital is relative rather than absolute and that scarcity of the human capital, as a function of supply and demand, is more critical than rarity. For example, although firm-specific human capital is generally rare, but if the demand for general human capital is greater than the supply, then the general human capital is relatively scarce. By contrast, greater supply of general human capital may decrease the value of the general human capital. Building on this line of reasoning, firms may take advantage of their formal development practices by hiring more new graduates, especially when they perceive external market conditions as providing a greater level of general human capital.

Taken together, I suggest two competing hypotheses:

H6. The relationship between having formal development practices and new graduate hiring will be moderated by (a) the size of local labor supply and (b) the level of local

business competition; the positive relationship between having development practices and new graduate hiring is weaker when there is a large lateral labor pool or a higher level of business competition.

H7. The relationship between having formal development practices and new graduate hiring will be moderated by (a) the size of local labor supply and (b) the level of local business competition; the positive relationship between having development practices and new graduate hiring is stronger when there is a large lateral labor pool or a higher level of business competition.

DATA & METHODS

I test the hypotheses using a national dataset of U.S. law firm offices from 2006 to 2010. I focused on the branch offices of law firms to examine both the establishment level factors and regional market contingencies. I combined several different data sources: entry-level and lateral-level hiring in branch offices and organizational characteristics from the National Association of Law Placement (NALP) Directory of Legal Employers, prestige scores from the Vault 100, the number of lawyers for each state from the American Bar Association, and other regional factors from the U.S. Bureau of Economic Analysis and the U.S. Census County Business Patterns.

I excluded two types of samples from the total number of establishments that participated in the NALP, Directory of Legal Employers. First, I excluded establishments with less than 10 employees. My assumption is that offices with less than 10 lawyers do not operate similarly to other larger offices, in that they are less likely to have staffing strategies

that can be directly compared to those of larger offices. For example, Sherer and Lee (2002) excluded offices with less than 25 lawyers in their analyses of law firms' adoption of senior and staff attorney tracks based on the assumption that these smaller offices do not compete directly with larger offices. These establishments (2-10 lawyers) consisted about 7% of total sample across years.

Second, I excluded establishments that reported their number of hiring only at the national firm level. Law firms can report their number of hires at the regional office level or at the national firm level, as indicated in whether they are using the collective (national-firm level number) form or not. As most law firm hiring occurs at the regional office level and the interest of this study lies in the influence of regional economic and labor markets, I excluded firms that used the collective form and focused on firms that reported the number of hires at the local office level. Firms that reported using the collective form varied by year, but on average, they consisted of about 16% - 18% of the total sample. There was no significant difference between the proportion of firms that had training practice in place (one of my main independent variables): Among firms that reported using collective forms, about 28.5% - 31.7% (varied by year) of them had a training practice in place while it ranged between 23.1% to 24.8% for those who used individual office format. Although firms that used collective forms had slightly higher probability of having training practice in place, the difference is not substantial. In addition, the differences in the existence of training programs across offices may indicate that the establishment of training practices is a characteristic of an office, rather than a national firm. Thus, I consider office-level data as more accurate and appropriate for my analyses.

The final sample consists of 3,999 observations of 1,230 regional offices nested within 877 firms in 46 states.

Variables

Dependent Variable. The NALP Directory of Legal Employers collects hiring information from law firms across the U.S. annually. Law firms voluntarily provide the number of lawyers hired from a pool of new graduates, laterals, and post-clerkship candidates for prior years. Post-clerkship applicants are considered as hires with experience and were often rewarded with a signing bonuses of $75,000 at the maximum in 2016, yet their experience is not from the private sector and they are often much less experienced than lateral hires. As my main focus is on the comparison between inexperienced versus experienced hires, I only focus on new graduate and lateral hiring and excluded post-clerkship hiring.

Given that my interest lies in the relative level of new graduate hiring out of total hiring, I calculated the hiring proportion (transformed into percentages) of new graduates out of the total number of hires for a given year. The number of hires and the hiring proportion reflect two different values: absolute versus relative value. As the main interest of this study lies in the relative importance of each type of hiring strategy, I consider the proportion, rather than the mere numbers, of hiring more appropriate for the purpose of this study. The difference between the number and the proportion of hiring is addressed in the results section.

Independent Variable. I created a variable indicating the presence of formal development practices based on two types of practices: rotation and training. Rotation and training are two dominant practices that law firms adopt to train junior-level lawyers and help them build their careers within the firm. The rotation variable indicates whether the office

provides a rotation opportunity among different practice areas for junior associates, and the training variable indicates whether the office provides billable hours credit for training time. These practices were coded as binary variables and they were collected from the NALP Directory of Legal Employers. The formal development practices measure is created by combining the two practices (α=.09). Given that the nature of the measure is formative rather than reflective, a high level of internal consistency (reliability testing) is not a major concern (Bollen & Lennox, 1991; Diamantopoulos & Winklhofer, 2001), and I assume that firms choose one or more of these practices based on the resource availability within their firm.

Structural variables include office size and the prestige of the law firm. The number of lawyers at the office includes the number of partners and associates working in a given office collected by the NALP Directory of Legal Employers. Prestige was measured as being in the top 50 in the Vault 100 for a given year. Vault identifies the 100 most prestigious law firms in the U.S. based on interviews and surveys of thousands of associates, and this list is often considered to measure each firm's status within the industry (Rider & Tan, 2015). The choice to top 50 firms is based on the reasoning of Sherer and Lee (2002). The authors claim that firms in the top 50-100 are more likely to move in and out of the top 100 year to year and they do not enjoy the benefit of prestige as much as the top 50 firms.

Finally, I measured two types of regional conditions. I lagged regional variables by one year based on the logic that the prior year regional labor market and economic conditions would influence the hiring strategy of the subsequent year. The local labor supply was measured by the number of practicing lawyers at the state level and log-transformed. The number of practicing lawyers was collected from the American Bar Association. The level of

business competition is often measured as the proximity of focal firms to other firms or the density of establishments (Sorenson & Audia, 2000; Stuart & Sorenson, 2003). The logic is that geographical concentration influences the founding or the failure of organizations through the effects of knowledge-spillover within an area (Almeida & Kogut, 1999; Jaffe., Trajtenberg, & Henderson, 1993) or by the intense competition among firms located closely to each other (Jaffe, 2003; Stuart & Sorenson, 2003). This measure, however, does not take into account the amount of resources that firms share. For example, the level of business competition will be different for 100 firms sharing a market of $10 million and 100 firms sharing a $10 billion market. In this study, I estimate the state gross domestic product (GDP) to be the overall regional market size and measured the level of business competition by first dividing state GDP by the number of legal establishments at the state level and then reversed the value so that greater competition reflects less GDP per legal establishment. It is likely that some offices provide service to out-of-state clients, yet prior literature found proximity to clients to be important for firm survival (Jaffe, 2003); thus I consider the state GDP to be a reasonable proxy for the size of market. I also ran a supplemental analysis using a different competition measure – based on the assumption that establishments with more than 100 employees are the potential clients of law firms, I divided the number of establishments with more than 100 employees by the number of legal establishments at the state level. The results were mostly similar. I collected state GDP from the U.S. Bureau of Economic Analysis (http://www.bea.gov/), the number of total establishments and legal establishments from the U.S. Census County Business Patterns (http://www.census.gov/programs-surveys/cbp.html). I used the NAICS code 541110 for legal establishments.

Although lawyers can practice within the where that they passed the state bar exam, it is possible that the movement of lawyers across firms or the business operation of law offices happen mainly within a city. Galanter and Henderson (2008) noted that law firms compete for human capital and business mostly at the local level, but it is not clear what the appropriate level of analysis should be. Thus, I also collected regional economic variables at the metropolitan statistical areas (MSAs) from the U.S. Census and the Bureau of Economic Analysis. MSA-level data, however, resulted in a much smaller sample size, decreasing the number of observations from 3,999 (state-level) to 2,753 because certain small cities are not included in MSAs. I ran supplemental analyses using these variables at the MSA level, and the results were mostly similar. I will discuss this more in detail in the results section.

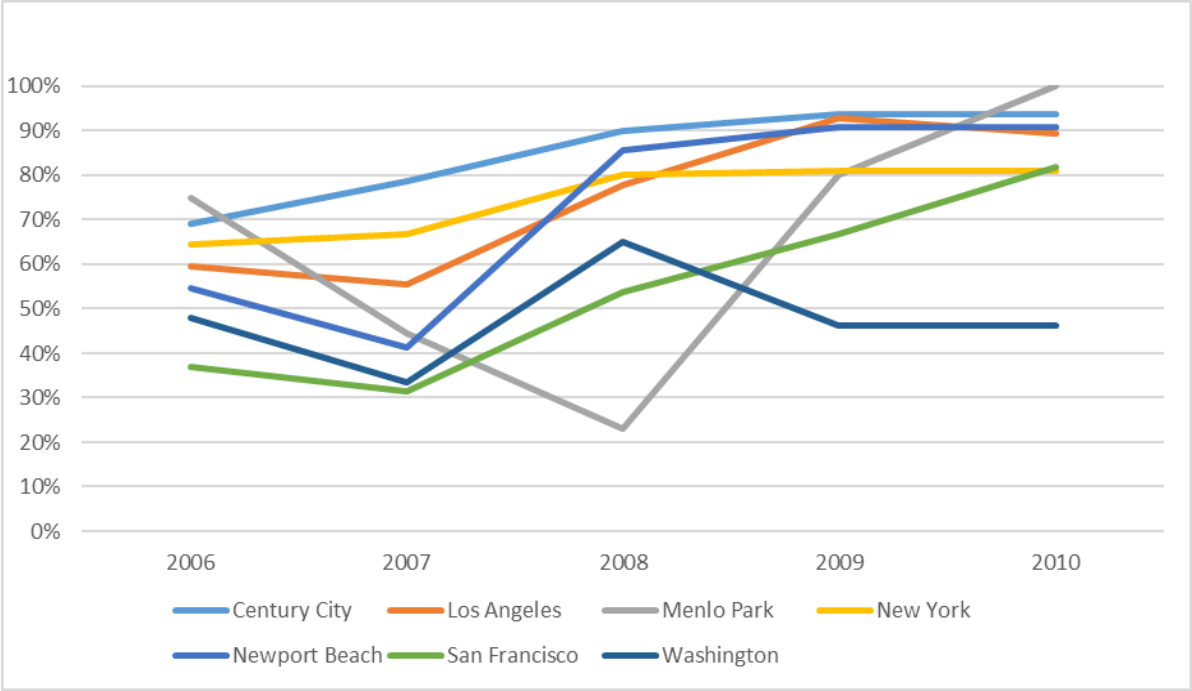
Controls. I controlled for the size of the firm (categorical variable; the total number of lawyers between 11-25, 26-50, 51-100, 101-250, 251-500, 501-700, 701 and more) so that the measure of size (independent variable) can reflect the size of the establishment or office at the regional level. I also controlled for the number of branch offices as another measure of size. Lateral hiring is often considered as an efficient way to establish branch offices (Galanter & Henderson, 2008; Sherer, 1995), thus the number of branch offices may influence the staffing strategies of each office. Prior studies have noted that the leverage ratio – measured as the number of junior attorneys relative to partners – and having a two-tier system (dummy-coded) are important aspects of law firm operation (Hitt et al., 2001; Hitt et al., 2006; Kor & Leblebici, 2005; Sherer & Lee, 2002), so I included them as control variables as they may influence law firms' hiring patterns. Firms that pursue the higher leverage ratio business model may hire a greater proportion of new graduates because the compensation level for new

graduates is often lower than for lateral hires. Law firms have adopted two-tier systems to reward different types of partnerships (equity versus non-equity) based on performance level, and this is a substantial deviation from the traditional Cravath model (Henderson, 2005). Thus, firms with a one-tier system may be more likely to hire new graduates, which is consistent with the Cravath model, while firms with a two-tier system may be more open to lateral hires. Total number of hires is also included in order to control effects due to size. Finally, I include year-fixed effects to account for changes in economic conditions over time.

ANALYSIS & RESULTS

I used multilevel regression models to estimate the effects. Multilevel regression analysis statistically models within group as well as between-group relations (Bryk & Raudenbush, 1992; Snijders & Bosker, 1999). Unlike ordinary least squares regression, multilevel analysis considers statistical dependencies of observations within groups and differences across groups and therefore provides less biased estimates for standard errors of regression coefficients. Prior studies have used multi-level approaches in examining firms nested within nations (Cuervo-Cazurra & Dau, 2009), plants/facilities nested within counties and states (Kassinis & Vafeas, 2006; Lee & Lounsbury, 2015), and individuals nested within teams and organizations (Leana, Appelbaum, & Shevchuk, 2009; Phil & Leana, 2008). Here, I estimated a three-level model with local offices nested within states and firms. I included random effects for the state- and firm-level variance to account for different intercepts for offices belonging to different firms and states. The fixed effects in the model focused on office-level variation in the entry-level hiring ratio.

One problem with the sample is that firms are located across different states and thus are not perfectly nested within states. The current multi-level statistical model cannot take such abnormality into account, but I included firms as random effects at least to control for the non-independence among offices of the same law firm within the same state. For example, in the case of O'Melveny & Myers, regionally close offices are more likely to have similar hiring patterns while distant offices present different patterns (Figure 16). Century City, Los Angeles, Newport Beach, and Menlo Park offices significantly increased their hiring of inexperienced new graduates from 2006 to 2010 while the hiring at the Washington D.C. office mostly stayed at 40 percent. This suggests that closely located branch offices may share some similar attributes, and thus controlling for three levels would be more robust than controlling for two levels (region and office). As multi-level approach treats firms perfectly nested within state, firms that have offices across multiple states are treated as different firms, in that the approach takes account of non-independence of offices located within the same state. The final sample consists of 3,999 observations of 1,230 regional offices nested within 877 firms (327 unique firms) in 46 states.



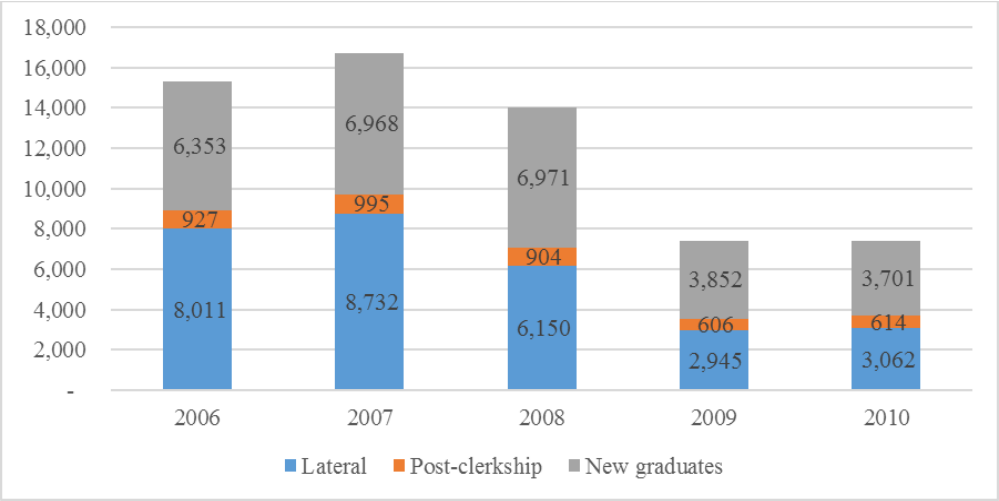
Source : The National Association of Legal Placement, Directory of Legal Employers

Figure 16. The Proportion of New Graduate Hiring for O'Melveny & Myers LLP, 2006-2010

Figures 17 and 18 show the overall hiring patterns. Figure 17 presents the number of hires for each different category (lateral, post-clerkship, and new graduates) and Figure 18 presents the hiring proportion of laterals and new graduates out of the total hiring (lateral, post-clerkship, new graduates). Three things are noteworthy. First, total hiring declined over time and especially after the 2008 financial crisis. The number of hires dropped from 15,291 in 2006 to 7,377 in 2010, with the largest drop in 2009. The total number of new graduates hired exceeded the total number of lateral hired since 2008. Second, the gap between the ratio

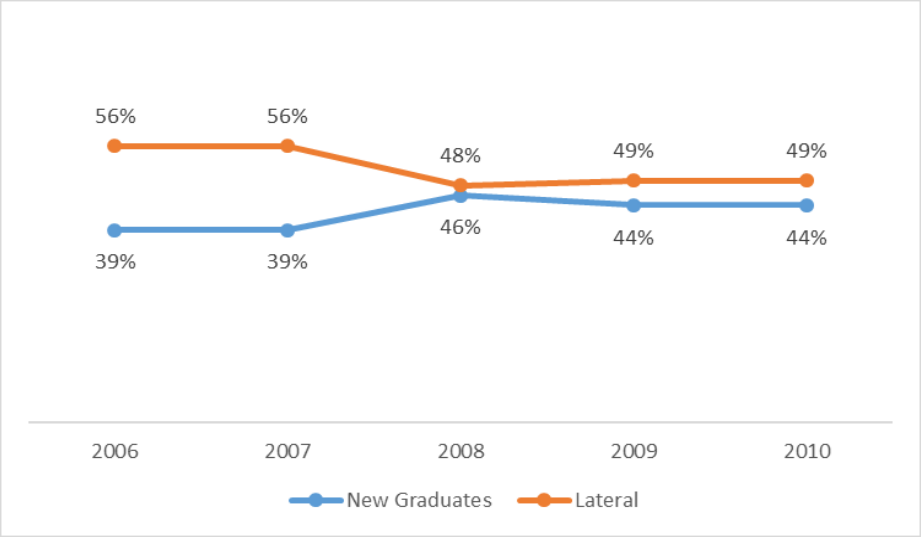
of lateral and new graduate hiring has somewhat been closed starting in 2008. This is contrary to the widespread perception that lateral hiring is consistently growing.

Finally, there is a mismatch between the total number and the proportion of different hiring strategies. For example, in 2010, the total number of new graduates hired exceeded that of lateral hired (Figure 17), yet the proportion of lateral hiring exceed that of new graduate hiring (Figure 18). This is due to the fact that the total number is the sum of the total hired while the proportion is the average of hiring proportion of each firm. A post-hoc analysis revealed that this is due to the size of hiring firms in that large firms hire a great number of new graduates while smaller firms hire smaller numbers of laterals (Table 4). For example, in 2006, firms with more than 100 lawyers hired a total of 3,952 laterals (45.8%) and 4,219 new graduates (47.3%) while firms with less than 100 lawyers hired 4,059 laterals (58.6%) and 2,134 new graduates (36.6%). This shows that the hiring of new graduates is disproportionally concentrated in large firms.



Source: The National Association of Legal Placement, Directory of Legal Employers

Figure 17. The Number of Hires, 2006-2010



Source: The National Association of Legal Placement, Directory of Legal Employers

Figure 18. The Proportion of Different Staffing Strategies, 2006-2010

Table 4. Post-hoc Analysis of Hiring, 2006-2010

Year	**Size**	**Lateral - total hired**	**New graduated - total hired**	**Lateral - hiring**	**New graduated - hiring**
2006	Less than 100 lawyers	4,059	2,134	59%	37%
	More than 100 lawyers	3,952	4,219	46%	47%
2007	Less than 100 lawyers	4,245	2,343	59%	37%
	More than 100 lawyers	4,487	4,625	47%	46%
2008	Less than 100 lawyers	3,280	2,233	50%	44%
	More than 100 lawyers	2,870	4,738	39%	55%
2009	Less than 100 lawyers	1,759	1,184	53%	41%
	More than 100 lawyers	1,186	2,668	38%	53%
2010	Less than 100 lawyers	1,668	1,204	52%	42%
	More than 100 lawyers	1,394	2,497	41%	49%

Source: The National Association of Legal Placement, Directory of Legal Employers

Table 5 provides means, standard deviations, and correlations for the main dependent, independent, and control variables. First, total hiring is positively related to office size (.68, $p<.05$) and firm size (.27 $p<.05$); large firms and large offices tend to hire more. Second, being prestigious is positively related to office size (.27, $p<0.05$) and firm size (.26, $p<0.05$), which suggests that these structural factors (being prestigious and being large) tend to go together. Second, the proportion of new graduate hiring is positively associated with all of firm-level factors: the presence of internal development practices (.13, $p<0.05$), office size (.20, $p<0.05$), and being prestigious (.15, $p<0.05$). It is, however, not significantly associated with firm size (-.02, ns), which may suggest that whether to hire new graduates or laterals is based on the strategy of an office or an establishment not on the strategy of a firm. Interestingly, the main independent variable, having internal development practices, is not highly correlated with office size (.03, ns), but it is negatively associated with the firm size (-.12, $p<0.05$), and positively associated with being prestigious (.11, $p<0.05$). Thus, the establishment of internal development practices is not necessarily a feature of large organizations. Finally, the number of lawyers in the local population is positively, but very modestly, associated with the level of local business competition (.04, $p<0.05$), which suggests that states with larger labor markets tend to have more business competition.

Table 5. Descriptive Statistics and Correlations

		Mean	SD	1	2	3	4	5	6	7	8	9	10	11	12
1	New graduate hiring	42.2	31.8	1											
2	Formal development practices	0.5	0.6	0.13*	1										
3	Office size**	3.9	0.9	0.20*	0.03	1									
4	Prestige	0.2	0.4	0.15*	0.11*	0.27*	1								
5	Lawyer population**	10.8	1.0	0.01	0.05*	0.18*	0.28*	1							
6	Business competition	62.2	14.1	-0.09*	-0.06*	0.01	-0.01	0.04*	1						
7	Firm size	6.4	1.7	-0.02	-0.12*	0.26*	0.45*	0.30*	0.02	1					
8	Branch office	12.9	11.9	-0.04*	-0.06*	0.03*	0.30*	0.16*	0.01	0.59*	1				
9	Total hiring	10.6	15.7	0.08*	0.06*	0.68*	0.35*	0.20*	0.07*	0.27*	0.04*	1			
10	Leverage	1.2	0.9	0.17*	0.10*	0.10*	0.52*	0.24*	-0.04*	0.31*	0.12*	0.27*	1		
11	Two-tier	1.7	0.5	-0.11*	-0.03*	-0.06*	-0.18*	-0.02	0.04*	0.08*	0.08*	-0.09*	-0.21*	1	
12	Year	2008	1.4	0.07*	-0.03	0.00	0.03*	0.05*	-0.28*	0.06*	0.09*	-0.16*	-0.03*	-0.01	1

* $p<0.05$
** logged variables

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Table 6 provides results for the main analyses for new graduate hiring. Across all models, having formal development practices is positively associated with the proportion of new graduate hiring, which provides support for hypothesis H1. It shows that firms' commitment to internal development is important for new graduate hiring even after controlling for all other structural and environmental factors. In model 2, I test the effects of structural variables on staffing strategies and, consistent with the hypotheses, large and prestigious establishments are more likely to recruit new graduates. The positive effect of formal development practices on new graduate hiring still holds even after including the structural factors. The results provide support for H2a and H2b.

Model 3 and 4 shows the effects of local market conditions on new graduate hiring before and after controlling for office level characteristics. In model 3, I did not find any significant effects of local market conditions, which suggests that these market conditions are not associated with law offices' staffing strategies. In model 4 where I included office size and prestige, however, the effect of local supply of experienced labor on new graduate hiring became significant and negative. This suggests that offices operating in areas with a larger experienced labor pool are less likely to hire new graduates controlling for the size and the prestige of offices are the same. The level of business competition, however, is not significantly associated with firms' staffing strategies. Overall, Hypothesis 3, but not 4, was partially supported.

In model 5 and 6, I tested the interaction effects between structural and local market factors and development practices. Among the interactions between having formal development practices and structural factors, only the interaction between formal development practices and prestige was significant and positive. This provides support for H5b, suggesting that offices are

more likely to hire new graduates when they are prestigious and have formal development practices in place. None of the interactions between having formal development programs and regional market factors were significant. Firms may not necessarily consider external market conditions in relation to their internal practices, thus, I found no support for hypothesis H6 nor H7.

Taken together, firms with formal development practices, and firms that are large or prestigious hire a higher proportion of new graduates than lateral workers. Firms also take advantage of the external market conditions by hiring more experienced workers when the external labor markets supply a greater number of experienced workers. The relationship between having formal development programs and new graduate hiring strengthens when a firm is prestigious.

Among the control variables, the effects of different types of size are noteworthy. Although the office size is positively associated with new graduate hiring, the size of firm has either no relationship or a negative association with new graduate hiring. This suggests that new graduate hiring is not necessarily a characteristic of large firms, but more of a large establishment. Thus, it is possible that the effects of size at the national firm-level and local establishment level on a firm's staffing strategy are different and distinct. Although these findings must be interpreted with caution given the categorical nature of the firm size measure and the fact that the models assume a linear relationship. More research is needed to fully understand the relationship between size and hiring practices.

Table 6. Multilevel Linear Regression: Estimates for New Graduate Hiring

	Model 1	**Model 2**	**Model 3**	**Model 4**	**Model 5**	**Model 6**
Formal development practices	4.38*	3.72*	4.37*	3.73*	3.33*	3.68*
	(0.96)	(0.93)	(0.96)	(0.93)	(0.94)	(0.93)
Office size		11.48*		11.58*	11.46*	11.64*
		(0.87)		(0.87)	(0.87)	(0.87)
Prestige		7.66*		7.80*	7.75*	7.82*
		(1.79)		(1.79)	(1.79)	(1.79)
Lawyer population			-1.55	-3.10*		-3.08*
			(1.02)	(1.21)		(1.22)
Business competition			0.07	-0.05		-0.05
			(0.06)	(0.07)		(0.07)
Practices * Size					0.58	
					(1.02)	
Practices * Prestige					4.58*	
					(2.08)	
Practices * Lawyer						1.55
						(0.94)
Practices * Competition						-0.03
						(0.07)
Firm Size	-0.39	-1.42	-0.34	-1.33*	-1.49*	-1.40*
	(0.57)	(0.55)	(0.58)	(0.56)	(0.55)	(0.56)
Branch office	-0.11	-0.13	-0.11	-0.13	-0.13	-0.13
	(0.07)	(0.07)	(0.07)	(0.07)	(0.07)	(0.07)
Total hiring	0.05	-0.30*	0.05	-0.30*	-0.30*	-0.30*
	(0.04)	(0.05)	(0.04)	(0.05)	(0.05)	(0.05)
Leverage	5.13*	5.40*	5.06*	5.41*	5.21*	5.33*
	(0.84)	(0.84)	(0.84)	(0.84)	(0.85)	(0.84)
Twotier2	-3.31*	-2.04	-3.12*	-1.83	-2.12	-1.89
	(1.40)	(1.34)	(1.40)	(1.34)	(1.34)	(1.34)
Year	Yes	Yes	Yes	Yes	Yes	Yes
Constant	36.60*	1.19	56.46*	33.82*	2.31	34.31*
	(3.99)	(4.88)	(10.69)	(12.44)	(4.89)	(12.49)
Log likelihood	19046.81	-18952.15	-19045.01	-18948.67	-18949.05	-18947.27
$\chi 2$ statistic	166.70	385.61	168.54	390.46	394.05	394.23

Robust standard errors in parentheses, 3,999 observations for 1,230 offices
* $p<0.05$

Supplemental Analyses

I performed several supplemental analyses. First, I ran firm-fixed regressions to estimate within firm changes (Table 7). In terms of office level predictors, the results are similar to those from multi-level analyses. Having formal developmental practices in place, office size, and prestige had positive and significant effects on new graduate hiring across all models. I, however, did not find any significant effects of local market conditions. Neither the supply of experienced labor nor the level of business competition had any significant association with new graduate hiring.

I provide two possible explanations for the difference between random and fixed models. First, given that there is systematic difference between firms, but not within firms, it is possible firms do not respond to the market conditions but instead choose to open branch offices in certain places to take advantage of the local resources (e.g., greater supply of experienced labor). As Henderson and Alderson (2008) noted, local market conditions may influence the regional expansion strategies of law firms whereby law firms expand to cities with rich network of highly specialized human capital. In the case of O'Melveny & Myers that I discussed above, staffing strategies varied greatly by the location of the office. The Washington D.C. office, with its abundant supply of experienced lawyers, had consistently lower level of new graduate hiring.

Second, it is possible that the timespan of the data that I employed here (2006-2010) is too limited to capture substantial changes in the local market conditions. I ran a separate analysis to focus on the effects of 2008 financial crisis (2009-2010), but I did not find any significant effects of local market conditions on new graduate hiring. As the local market conditions change

slowly and firms need time to adapt to such changes, a future study over a longer timespan is necessary. Finally, none of the interactions were significant.

Table 7. Supplemental Analysis: Firm-fixed Estimates for New Graduate Hiring

	Model 1	**Model 2**	**Model 3**	**Model 4**	**Model 5**	**Model 6**
Formal development practices	3.15*	3.17*	3.16*	3.17*	3.38*	3.03*
	(1.42)	(1.42)	(1.42)	(1.42)	(1.46)	(1.45)
Office size		12.13*		12.15*	11.99*	12.18*
		(2.70)		(2.71)	(2.70)	(2.71)
Prestige		5.72*		5.73*	5.86*	5.69*
		(2.77)		(2.77)	(2.79)	(2.78)
Lawyer population			-3.81	-0.18		-0.00
			(11.87)	(11.85)		(11.86)
Business competition			-0.01	0.03		0.03
			(0.18)	(0.18)		(0.18)
Practices * Size					-1.53	
					(1.71)	
Practices * Prestige					0.81	
					(2.89)	
Practices * Lawyer						0.88
						(1.65)
Practices * Competition						0.00
						(0.10)
Firm Size	0.56	0.58	0.56	0.58	0.55	0.56
	(1.32)	(1.31)	(1.32)	(1.31)	(1.31)	(1.31)
Branch office	-0.40*	-0.38*	-0.40*	-0.38*	-0.38*	-0.38*
	(0.16)	(0.16)	(0.16)	(0.16)	(0.16)	(0.16)
Total hiring	-0.16*	-0.26*	-0.16*	-0.26*	-0.26*	-0.26*
	(0.05)	(0.06)	(0.05)	(0.06)	(0.06)	(0.06)
Leverage	0.64	-0.36	0.65	-0.35	-0.32	-0.33
	(1.76)	(1.77)	(1.76)	(1.77)	(1.77)	(1.77)
Twotier2	-0.23	0.10	-0.24	0.12	0.14	0.07
	(2.48)	(2.47)	(2.49)	(2.48)	(2.48)	(2.49)
Year						
Constant	36.69*	-11.26	78.40	-11.50	-10.76	-13.43
	(9.54)	(14.12)	(127.71)	(128.82)	(14.14)	(128.92)
R^2	0.04	0.05	0.04	0.05	0.05	0.05
F statistic	10.37*	10.81*	8.65*	9.26*	9.32*	8.12*

Robust standard errors in parentheses, 3,999 observations for 1,230 offices
* $p<0.05$

Second, I ran the multilevel regression analyses using regional variables at the MSA level as opposed to the state level (Table 8). Overall the results are similar. The size of the labor supply of experienced workers was negatively associated with new graduate hiring (-1.84, $p<.05$) while the level of business competition did not have any effect (.00, ns). The negative effects of labor supply still held and the size of effects increased when I included office level characteristics and the interaction effects. None of the interactions were significant. The interaction between having formal development practices in place and the prestige was not significant here, and I suspect this is due to the reduced variation by smaller sample size. Although these results may indicate that the effects of labor markets on firm-level strategy and decision-making are similar both at the state level and the MSA level, we need further investigation of the effects of local-, state-, and federal- level institutions and economic conditions on firm-level strategy and operation.

Third, I ran the analyses using a different competition measure – the number of establishments with more than 100 employees divided by the number of legal establishments – and found that the level of competition is significantly and negatively associated with the new graduate hiring. Without office level characteristics, the local supply of experienced labor was not significantly associated with new graduate hiring (-.50, ns), but the effects of business competition on new graduate hiring was significant and negative (-10.73, $p<.05$). When office level characteristics were included, the effects of both local market conditions became significant and negative (the labor supply: -2.43, $p<.05$, business competition: 7.81, $p<.05$). The interaction between having formal development practices and business competition, however, is not significant. The difference between the effects of business competition measured with state GDP

and the number of establishment may indicate number of current and potential clients is a more accurate proxy for law firm competition than the size of market *per se*. Given the limited prior research, however, we need further investigation on how to conceptualize and measure local market conditions at different levels.

Table 8. Supplemental Analysis: Local Market Factors at the MSA-level

	Model 1	**Model 2**	**Model 3**	**Model 4**	**Model 5**	**Model 6**
Formal development practices	4.27*	3.75*	4.20*	3.73*	3.20*	3.50*
	(1.21)	(1.17)	(1.20)	(1.16)	(1.20)	(1.17)
Office size		10.40*		11.09*	10.41*	11.19*
		(1.06)		(1.07)	(1.07)	(1.07)
Prestige		7.33*		7.24*	7.66*	7.24*
		(2.18)		(2.16)	(2.19)	(2.16)
Lawyer population			-1.84*	-3.99*		-3.79*
			(0.73)	(0.72)		(0.74)
Business competition			0.00	-0.01		-0.00
			(0.04)	(0.04)		(0.04)
Practices * Size					1.07	
					(1.27)	
Practices * Prestige					4.19	
					(2.58)	
Practices * Lawyer						1.50
						(0.97)
Practices * Competition						0.06
						(0.05)
Firm Size	-1.06	-1.94*	-1.05	-1.90*	-2.03*	-1.98*
	(0.71)	(0.69)	(0.70)	(0.68)	(0.69)	(0.68)
Branch office	-0.08	-0.11	-0.07	-0.09	-0.12	-0.09
	(0.08)	(0.08)	(0.08)	(0.08)	(0.08)	(0.08)
Total hiring	0.11*	-0.21*	0.12*	-0.22*	-0.22*	-0.23*
	(0.05)	(0.06)	(0.05)	(0.06)	(0.06)	(0.06)
Leverage	5.92*	5.91*	5.84*	6.12*	5.61*	6.04*
	(1.03)	(1.06)	(1.03)	(1.05)	(1.07)	(1.05)
Twotier2	-3.36	-2.19	-3.11	-1.76	-2.31	-1.82
	(1.72)	(1.66)	(1.71)	(1.64)	(1.66)	(1.64)
Year	Yes	Yes	Yes	Yes	Yes	Yes
Constant	38.17*	5.94	54.15*	39.45*	7.27	37.64*
	(4.97)	(6.07)	(8.76)	(8.64)	(6.11)	(8.80)
Log likelihood	-13184.37	-13131.35	-13182.87	-13124.56	-13129.22	-13122.61
$\chi 2$ statistic	115.23*	240.90*	115.46*	249.48*	246.24*	255.25

Robust standard errors in parentheses, 2,753 observations for 1,016 offices
* $p<0.05$

Finally, in order to test for reverse causality, I examined the effect of the new graduate hiring on having formal development practices (Table 9). The effect was positive and significant (.07, p<.05) after controlling for office size (ns), prestige (.11, p<.05), firm size (-.05, p<.05), leverage ratio (.03, p<.05), the number of branch offices (ns), the number of total hires (ns), two-tier system (ns), the supply of experienced lawyers (ns), and the level of business competition

Table 9. Supplemental Analysis: Having Formal Development Practices in Place

	Model 1	**Model 2**	**Model 3**
The proportion of new graduate hiring		0.07*	
		(0.02)	
The number of new graduate hires			0.02
			(0.02)
Office size	0.01	0.01	0.01
	(0.01)	(0.01)	(0.01)
Prestige	0.12*	0.11*	0.11*
	(0.03)	(0.03)	(0.03)
Lawyer population	0.02	0.02	0.02
	(0.02)	(0.02)	(0.02)
Business competition	-0.00	-0.00	-0.00
	(0.00)	(0.00)	(0.00)
Firm Size	-0.05*	-0.05*	-0.05*
	(0.01)	(0.01)	(0.01)
Branch office	0.00	0.00	0.00
	(0.00)	(0.00)	(0.00)
Total hiring	-0.00	-0.00	-0.00
	(0.00)	(0.00)	(0.00)
Leverage	0.03*	0.03*	0.03*
	(0.01)	(0.01)	(0.01)
Twotier2	0.04	0.05	0.05
	(0.03)	(0.03)	(0.03)
Year	Yes	Yes	Yes
Constant	0.47	0.45	0.48
	(0.25)	(0.25)	(0.25)
Log likelihood	-2195.52	-2190.92	-2194.98
$\chi 2$ statistic	54.52*	63.98*	55.80*

Robust standard errors in parentheses, 3999 observations for 1,230 offices
* p<0.05, In order to present the effect sizes of hiring more clearly, I transformed the proportion of new graduate hiring to a ratio between 0 and 1 and I divided the number of new graduate hires by 10.

(ns). I ran the same analyses using the number of new graduate hires, rather than the proportion of new graduate hiring, and found that the effect of new graduate hires on having formal development practices to be insignificant (.02, ns). These results suggest that it is highly unlikely that firms that hire a greater number of entry-level inexperienced lawyers adopt formal development practices, but it is possible that a greater focus on new graduate hiring and having formal development practices reflect a firm's greater reliance on internal labor markets.

DISCUSSION & CONCLUSION

The idea that organizations are subject to a range of internal and external pressures (Simpson & Gulley, 1962) has long been recognized, but rarely tested. This study contributes to a relatively limited stream of research that simultaneously investigates the impact of both internal and external pressures on organizations. I incorporated ideas from the literature of organizational sociology, human resource management, and an ecological perspective on regional competition and examined a comprehensive set of factors potentially associated with a firm's hiring strategies. In particular, I explored which firms are more likely to hire new graduates and develop them within.

Consistent with the human resource management literature, I find a positive relationship between having formal development practices (training and job rotation) and new graduate hiring. Having these programs may reflect a firm's greater reliance on internal labor markets where workers without prior experience are recruited at the entry level and developed within. Consistent with the long-established literature on bureaucracy and human capital, I find firm size and prestige to be positively associated with new graduate hiring but the local supply of

experienced workers was negatively associated with new graduate hiring. Thus, both internal and external contingencies influence firms' staffing strategies.

The critical empirical test this study attempts is to determine whether firms are enabled or constrained in their strategic choices by their structural and local market conditions. The results showed that large firms hire a greater ratio of entry-level inexperienced lawyers than smaller firms regardless of whether they have formal development practices or not. This may indicate that these firms have greater levels of internal resources that can be dedicated to informal training of entry-level, inexperienced, lawyers, and/or they can attract more competent new graduates with a faster learning curve. Prestigious firms hire a greater ratio of new graduates and they are more likely to do so when they have formal development practices in place. Being prestigious and having formal development practices may reinforce each other in attracting new graduates with better abilities.

Among the external constraints, the interaction effects between local contingencies and having a formal development practices were insignificant. The significant effect of local market conditions and the non-insignificant interactions effects suggest that firms do consider external labor market conditions when they hire employees, yet they do not necessarily consider the interaction between their internal policies and the external conditions.

The difference in the effects of business competition measured differently is interesting. Prior studies have found that the geographical concentration of firms influences their survival and failure (e.g., Jaffe, 2003; Stuart & Sorenson, 2003), yet we have little knowledge of how to conceptualize business competition as a predictor of firm-level strategy and decision-making. In this study, I employed two different types of resources that firms compete for: state GDP as a

proxy for market size and the number of other establishments as a proxy for the number of current and potential clients. I found the former to be unrelated to firm hiring strategies while the latter had a significant association. The differences between the two measures may indicate that firms attend to different types of economic indicators differently. As law firms and professional service firms in general largely depend on the number of clients for business outcomes, the local pool of clients would be more important than the level of local economic prosperity. We need further investigation, however, on how to conceptualize and measure business competition at different levels and across different industries.

The dramatic growth in the use of external labor market strategies has received a great deal of attention from both practitioners and scholars (Jacoby, 2005; Royal & Althauser, 2003). Although much of the writing in this stream of literature proposes that the shift away from internal labor markets to external staffing is very likely to continue, the results of this study suggest that there is still great variation across firms in the extent to which they rely on internal versus external labor markets. Increasing market pressures and decreasing attachment between firms and workers has been one of the most notable trends in today's employment systems, yet some firms may resist this trend by taking advantage of their internal systems and structural characteristics.

This study has limitations that require further investigation. First, I investigated organizational structural factors, such as size and prestige, management values and philosophy towards different types of human capital may also be important factors influencing a firm's hiring strategies. I argue that the measure of the presence of formal development practices reflects these values and then show how they are associated with different staffing strategies. The

supplemental analyses partially confirmed the idea that it is unlikely that firms hire a greater number of new graduates and then establish formal development practices but it is more likely that firms that value internal labor market approached tend to have formal development practices in place as well as hire more new graduates than lateral workers. Second, the insignificant effects of interactions between having formal development practices and local market conditions suggest that firms may not necessarily consider the market conditions in relation to their internal practices. Or, it is possible that the measures of market contingencies may be too crude. Future studies may explore more detailed conception and measurement of local economic conditions as the predictor of firm-level strategy. Finally, given that external staffing strategy is assumed to be a fast growth strategy, prior performance may influence a firm's staffing strategy. I am unable to test such possibility because performance data at the branch office is not available.

CHAPTER 4.

INTERNAL STAFFING STRATEGIES AND PERFORMANCE STABILITY

INTRODUCTION

In recent years, we have observed increasing employee mobility and firms' greater reliance on external labor markets to staff their organizations (Cappelli, 1999). Jobs that used to be filled with internal employees are now open to external candidates, and internal and external candidates compete with each other across all levels of organizational hierarchies to gain employment (Bidwell, 2011; Royal & Althauser, 2003). Not only do firms take advantage of external labor markets and the associated flexibility (Bidwell, Briscoe, Fernandez-Mateo, & Sterling, 2013) but employees also have become more mobile and build their careers by changing their employers, a phenomenon often referred to as the "boundaryless career" (Arthur & Rousseau, 1996).

Understanding the extent to which firms rely on internal versus external staffing is important given that firms acquire and build different capabilities with internal mobility and external hiring of human capital. For example, internal mobility coupled with training and development of employees fosters a long-term employment relationship based on firm-specific skills (Doeringer & Piore, 1985; Osterman, 1987). External hiring, by contrast, may enable firms to overcome their institutional inertia or other disadvantages (Rao & Drazin, 2002) or acquire new knowledge (Almeida & Kogut, 1999). As firms increasingly combine

internal and external staffing to fill jobs, how to balance the two in order to gain a competitive advantage has become an important issue.

Although much literature has separately explored the consequences of internal and external mobility for individual career and performance outcomes, less is known about the firm-level effects of such mobility. At the individual level, external mobility and having prior experience from other firms have both positive and negative consequences. Some studies have found that employees with prior experience in the same organization absorb information from on-the-job training more efficiently (see Rynes, Orlitzky, & Bretz, Jr., 1997 for a review), while others have found that workers who moved to a competitor firm experienced an immediate decline in performance at least for the first few years and firms that hired workers from their competitors with better capabilities suffered more extreme negative stock-market reactions (Groysberg, Lee, & Nanda, 2008). When directly compared, internally promoted employees tend to perform better and are less likely to quit, while externally hired employees are compensated better and more likely to be promoted (Bidwell, 2011). To date, research on how different types of mobility affect firm-level performance has been limited, especially when firms combine both approaches to fill jobs.

Departing from the traditional approach that viewed internal and external staffing as two discrete strategies, this study investigates the performance effects of a firm's relative focus on internal versus external staffing approaches. Firms combine internal and external staffing and do so to varying degrees. I explore whether variation in the ways firms combine internal and external staffing to fill positions is associated with variation in performance outcomes such as revenue and profits. Based on the idea that internal staffing promotes

strategic persistency, employment predictability, and performance consistency, I examine the relationship between internal staffing through promotion and performance stability. I also test whether the size of effects changes when I employ a longer time-frame of internal staffing. Finally, I explore whether internal staffing works as a double-edged sword by limiting a firm's flexibility, especially when the firm faces an external shock (the 2008 financial crisis in this study).

The context of this study is the top 200 U.S. law firms. Law firms are an excellent context for my investigation as they constitute a knowledge-intensive industry that has historically relied on internal labor markets. Law firms were once famous for their strong internal labor markets (commonly referred to as the Cravath model), in which most entry-level lawyers were recruited from law school, then groomed and socialized to have a strong sense of collegiality and commitment to the firm (Brill, 1990). More recently, heightened competition and cost pressures from corporate clients have pushed law firms to abandon their traditional system and to engage in lateral hiring as a faster way to acquire specialized expertise and clients and to increase revenue. As law firms are increasingly exposed to external market pressures, the careers of lawyers and professional employees are coming to resemble those of knowledge workers in large corporations. Thus, the context of this study should be generalizable to other professional service firms and to knowledge-intensive organizations, all of which depend on their employees' knowledge and skills to become and remain competitive.

THEORY AND HYPOTHESES

Thompson (1967) noted that one key goal of organizations is to minimize uncertainty, and this is mostly done through a 'sealing-off' of the central productive function. Osterman (1987) makes a similar argument, that maximizing predictability is one of the central objectives firms consider when they design employment systems. Predictability refers to a condition where firms can secure a qualified labor supply at a foreseeable cost, so that they can plan output and set prices in advance. In this context, whether the price of labor is high or low is not as important as the certainty in the supply and the cost of labor. Achieving predictability places a premium on the internal staffing approach as it ensures a steady surplus of the internal generation of human capital where the supply and the cost of labor are mostly under the firm's control. External staffing allows firms to take advantage of external labor markets without any long-term investment in human capital, yet it exposes the firm to the fluctuation in the external labor market environment. The idea that internal staffing promotes stability and external staffing enhances flexibility has been widely accepted (Bidwell et al., 2013), yet we lack a theoretical framework for and empirical investigations of the ways in which these different staffing choices lead to differences in performance outcomes

In the context of this study, the competitiveness of law firms largely depends on the types of human capital that firms acquire and develop. The primary asset of professional service firms is knowledge (Greenwood & Empson, 2003; Maister, 2007), and this knowledge resides in partners and associates (Bartlett & Ghoshal, 2002; Hitt, Bierman, Uhlenbruck, & Shimizu, 2006). Although 'entry at the lower level and promoted from within' matches the stylized fact of the internal labor market approach (Doeringer & Piore, 1985; Osterman,

1987), in this study, I focus on the internal promotion of partners but not on the entry-level hiring of associates.

The upper-echelons argument (Hambrick & Mason, 1984) asserts that a firm's leaders or top management teams have a substantial influence on organizational outcomes, and prior studies have reported that several characteristics of the top management teams, such as composition (Cannella, Park, & Lee, 2008; Carpenter, 2002), average tenure (Finkelstein & Hambrick, 1990), and size (Haleblian & Finkelstein, 1993), are significantly associated with firm performance. In law firms, partners form the top management team who are in charge of managerial decisions, including developing and executing business strategies and managing human resources (Løwendahl, 2000). They build relationships with current and potential clients and develop social capital through their client networks which should contribute substantially to positive firm-level outcomes (Hitt et al., 2001). Thus, I expect that the staffing strategy of partners is an important predictor of firm performance.

Strategic persistency

Prior studies have noted that long-tenured top management teams tend to pursue persistent, unchanging strategies (Finkelstein & Hambrick, 1990). As individuals spend a longer time in an organization and especially when they are successful in climbing up the organizational ladder, they become strongly committed to their organization's established policies and practices (Katz, 1982; Wanous, 1980). These individuals develop considerable social cohesion during their tenure at the organization, and thus, they are less likely to challenge the status quo or the norms (Bantel & Jackson, 1989; Michel & Hambrick, 1992).

Finkelstein and Hambrick (1990) found that long-tenured managerial teams exhibited more persistency in their strategic choices, while Wiersema and Bantel (1992) found that shorter average top management tenure leads to strategic changes within a sample of Fortune 500 companies.

Similarly, internally promoted employees are more likely to accept and conform to organizational rules and procedures, thereby leading to more stability in operational performance. In order to be promoted, employees not only need to reach certain years of tenure but also build a successful career within the firm by adhering to its organizational rules and processes. The process of socialization and selection reduces variation across candidates for promotion, thereby enhancing continuity in corporate strategy and business operations (March & March, 1977). When a firm fills managerial positions with a greater number of internal movers than external hires, then the managerial group will be less likely to introduce significant changes and more likely to accept the status quo than a managerial group with a greater number of external hires. This continuity in strategy and operations will lead to greater stability in performance outcomes, especially when the external environment is stable.

Employment predictability

An internal staffing strategy may also promote performance stability by making an implicit or explicit commitment to the long-term employment of employees (Doeringer & Piore, 1985). Slichter (1919) noted that the practice of filling job vacancies through internal promotion motivates employees to stay with the firm with the hope of getting promoted later in their career. Internal staffing also facilitates the development of firm-specific skills, which

provides incentive for both employees and employers to continue the relationship. Firm-specific skills, by definition, are valuable only for the focal firm and raise the value of a worker to the employer but not the value of the worker in external labor markets. The firm will face increased training costs and foregone productivity if the employee chooses to leave, and the employee may not be able to benefit from the having the skills that are not readily applicable to other settings (Pfeffer & Cohen, 1984; Williamson, 1981).

External staffing of human capital, by contrast, does not presume a long-term relationship between employees and employers (Brett & Stroh, 1997), and thus both parties can re-define or terminate the employment relationship more easily. Bidwell (2011) noted that external hires have a greater probability of both voluntary and involuntary exits than workers entering the job through promotion or transfers.

Performance consistency

Finally, internal staffing reduces performance loss due to job-person mismatch because employers tend to have more information about internal candidates than external candidates (Greenwald, 1986; Sackett & Lievens, 2008; Schmidt & Hunter, 1998). Employers have access to not only externally observable information but also detailed information on the unobservable aspects of internal candidates such as actual job performance and organizational fit (Bidwell, 2011; Bidwell & Keller, 2014; Chatman, 1989; O'Reilly, Chatman, & Caldwell, 1991). When staffing internally, firms can closely monitor employee behavior and select the best candidate for open job postings (Cappelli & Cascio, 1991), thereby reducing the possibility of performance loss due to job-person mismatch.

External hiring mostly relies on externally observable indicators of ability such as education and experience (Bidwell, 2011) that may or may not be correlated with subsequent job performance. Employers have incomplete information about external job candidates, and external job candidates have incomplete information about the job and the organization Thus, the likelihood of performance loss is greater for external hiring. In addition, every job requires a certain level of firm-specific skills that cannot be transferrable to other firms, and lateral hires tend to experience performance decline when they move to another organization (Huckman & Pisano, 2006; Groysberg et al., 2008).

At the same time, prior studies suggest that external hiring of human capital provides a firm with a distinctive value that cannot be acquired internally. Kor and Leblebici (2005) propose that external staffing helps a firm develop a new knowledge base in a relatively shorter period of time. Lateral hiring can save a firm considerable costs and time when it is growing or expanding rapidly, and it also enhances the diversity of ideas and experience. Others have also shown that employee mobility leads to interfirm knowledge transfer (Song, Almeida, & Wu, 2003) and product innovation (Rao & Drazin, 2002). Given the mixed results, firms may experience greater variation in performance in the case of external hiring than with internally promoted employees.

Internal Staffing and Performance Stability

Taken together, internal staffing will lead to more stability in performance outcomes than the external staffing approach. Strategic persistency and performance consistency ensure the continuation of a firm's business strategy and operations, thereby limiting changes that

may lead to either a substantial increase or decrease in revenues and profits. Predictability in employment relations also helps firms develop long-term business plans and to control labor costs effectively.

I expect the stabilizing effects of internal staffing to be similar across revenue generation and profitability for two reasons. First, revenue generation is depends on a combination of business strategy and external market conditions while profitability depends on a combination of revenue and operational costs. Internal staffing promotes the continuation, and gradual change if necessary, of a firm's business strategy as well as the predictability of labor costs.

Second, economists argue that the goal of owners is to maximize profits while the goal of managers is sales maximization (Baumol, 1958; Palmer, 1973). Management is motivated to maximize its own income and prestige, which often depend on the firm's sales rather than profits (Amihud & Kamin, 2001). Thus, the coherence between the level of revenue generation and the level of profitability will be different for owner-controlled firms and for manager-controlled firms. In the case of law firms, partners, especially ones with equity stakes, are the owners as well as managers. Partners are not only in charge of managerial decisions such as setting the firm's business strategy, hiring and retaining employees, and leading project teams (Løwendahl, 2000) but they are also the final claimants for the profits. Thus, I hypothesize the internal staffing of partners will have the same effect on revenue generation and profitability.

H1. Greater reliance on internal staffing will be associated with more stability in (a) revenue generation and (b) profitability.

Human Capital Accumulation and Performance Stability

It is widely acknowledged that it takes time for unit-level resources to affect unit-level performance (Kozlowski & Klein, 2000). According to the resource-based view of the firm, valuable and rare resources contribute to a firm's competitive advantage, but this advantage will be sustained only if the resources are inimitable and/or non-substitutable (Barney 1991). The extent to which resources are inimitable depends on the unique historical conditions under which the resources are created and the level of causal ambiguity in the relationship between the resources and associated competitive advantage (Armstrong & Shimizu, 2007). A good example is a firm's reputation or prestige, which is one competitive advantage that cannot be acquired easily or quickly. Although prior literature has recognized time as an important factor influencing the relationship between resources and performance, it has not been sufficiently explored how changes in the accumulation of resources lead to changes in firm performance over time (Ployhart, Weekly, & Ramsey, 2009). Helfat and Peteraf noted that it is important to "incorporate the evolution over time of resources and capabilities" (2003:998), yet it is unclear how to theorize and measure the temporal aspects of resources.

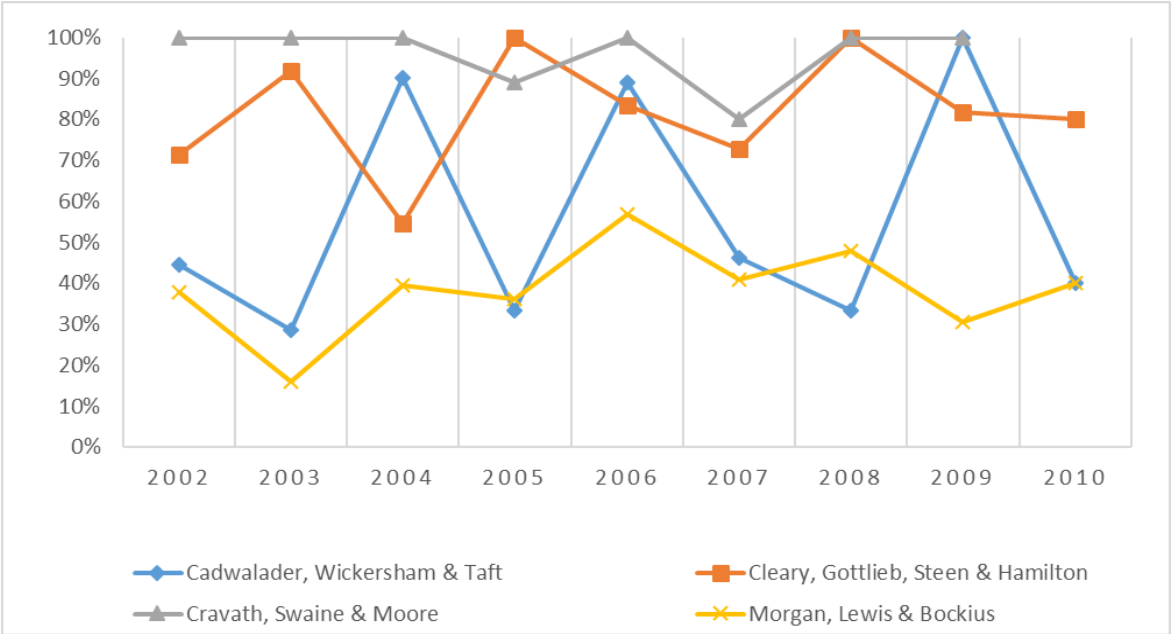
Human capital theory also suggests that investment in human capital requires time to create positive returns (Strober, 1990) because the generic form of human capital must transfer to firm-specific knowledge and skills and it takes time to do so (Ployhart et al., 2009). Huckman and Pisano (2006) reported that while the skills of a surgeon are often assumed to be portable across organizations, the performance of the surgeon at a given hospital depends on the volume of work performed at *that* hospital but not on the volume of work at *other* hospitals. This suggests that even jobs that are often presumed to require general human

capital may benefit from firm-specific skills and that it requires time to develop such skills. Internal staffing strategies, which value and promote firm-specific skills, may take longer than external staffing strategies to show positive returns because it takes time not only to train and develop employees but for those employees to improve their productivity. Dierickx and Cool (1989, 2012) suggest that "most resources are the cumulative results of a series of investments" (2012:1) and resource accumulation depends on the duration of investment.

Similarly, I expect the effects of human capital on performance will be more visible as the duration of investment increases. In the case of law firms, they largely depend on the ability of partners to attract new clients and maintain current ones. Although associates only with proven track record are promoted to partners, these promoted partners need time to acquire relational skills to develop and maintain effective relationships with clients (Hitt et al., 2001).

In addition, a firm's staffing approach may change across years based on internal and external business conditions. A sample of N.Y.-based law firms drawn from my data showed substantial differences in their staffing strategies not only across firms but also across years (Figure 19). Between 2002 and 2010, Cravath, Swaine, and Moore did not hire any lateral partners and all of their new partners were promoted from within except for 2005 (89% promoted from within) and 2007 (80% promoted from within). An opposite example is Morgan, Lewis, and Bockius where the proportion of internally promoted partners of all partners added in a year ranged from 16% to 57%. Internal staffing of Cadwalader and Cleary fluctuated greatly, ranging from 33% to 100%. As is obvious from these examples and the

data presented in Figure 19, not only do firms vary in the extent to which they focus on internal versus external hiring but also firms change their staffing approaches across years.



Source: The National Law Journal Staffing Survey

Figure 19. The Proportion of Internal Promotions Among New Partners, 2002-2010

Given that a firm's staffing strategy likely changes over time and the firm can accumulate different types of human capital depending on the staffing strategy, it is necessary to take into account such changes. As presented in the case of law firm hiring, it is not just the prior year staffing strategy but the staffing strategies over several years may affect a firm's performance outcome. In this paper, I assume that the average internal staffing ratio of prior years reflects an accumulated inflow of internal candidates, and I test the effects of internal staffing for three different time-frames: 2-year, 3-year, and 4-year average. I hypothesize that

the effects of internal staffing strategies on performance outcomes will be stronger when a firm invests in internal staffing strategies longer, in that the performance will be more stable when the time-frame of internal staffing gets longer.

H2. The effect of internal staffing strategies on (a) revenue stability and (b) profitability will be greater when a firm invests in internal staffing longer (2-year < 3-year < 4-year).

External Shocks and Staffing Outcomes

What happens, then, when a firm faces an external shock? The general assumption is that internal staffing strategies promote stable, long-term exchanges between employers and employees at the expense of flexibility, while external staffing strategies promote more flexible employment conditions that enable firms to easily adapt to changing demand for their products and services at the expense of internal stability (Bidwell et al., 2013). When faced with a significant shock, in the case of the 2008 financial crisis, do firms that focus on internal staffing outperform or underperform those with an external staffing approach?

Environmental shocks are unexpected events that create uncertainty in an industry (Tushman & Anderson, 1986). They bring about significant changes in the industry structure, competition, customer expectations and demand, and so forth, and firms often need new and/or improved resources to respond to these changes (Sirmon, Hitt, & Ireland, 2007). Anderson and Tushman (2001) noted that when the environment is unpredictable, firms with a more flexible configuration will be able to exploit unexpected changes in the market and outperform those that have committed to long-term investments that are difficult to undo.

Following this line of reasoning, internal staffing that promotes a consistent and stable business operation may not necessarily be beneficial when the external market conditions fluctuate greatly. Internal staffing generally assumes a long-term relationship between a firm and employees and firms that focus on internal staffing may experience difficulty in reconfiguring their human capital in response to the changes in customer demands or business competition. Based on the overall decline in employee tenure and wage premiums on tenure over the last two decades, prior studies have suggested that firms have substantially abandoned internal staffing practices in the face of external market pressures (Chauvin, 1994; Osterman, 2008). In the context of this study, partners with substantial portable business were in higher demand than ever during the financial crisis because law firms concentrated on hiring these partners as a way to increase revenue and profits (Urda, 2009).

In addition, internal staffing may lead to rigidities in staffing levels, which can be costly to firms if they cannot reduce labor costs in a similar proportion to their revenue decrease (Osterman, 1987). There is some evidence that the internal staffing approach helps firms maintain psychological contracts (Robinson et al., 1994) and induces genuine cooperation from their employees (Lee, 2015), especially when firms face intense competition. Employees may appreciate a continued commitment from their employer, yet the stability associated with internal staffing, however, may hurt the bottom line if competitors have access to significantly cheaper labor from external labor markets. Thus, I hypothesize

H3. Internal staffing will be associated with decrease in (a) revenue generation and (b) profitability during a financial crisis.

Research Context – The Transformation of the Cravath Model

One of the most distinctive features of U.S. law firms is their strong norm of internal labor markets (commonly referred to as the Cravath model). The Cravath model was the standard form of employment of large law firms for most of the 20th century. Paul Cravath, the managing partner of the highly prestigious law firm now known as Cravath, Swaine, and Moore, developed the practice of hiring lawyers straight from elite law schools and putting them under a strict "up-or-out" system. Law firms heavily invest in training and developing junior lawyers, provide generous salaries, and only the best lawyers or associates are promoted to partner after a multi-year tournament. Those who do not make partner after a pre-specified period of time (mostly 5 to 7 years) are asked to leave the firm so that the firm can develop and promote a new generation of young, potentially more competent, lawyers. In theory, the Cravath model values firm-specific knowledge and skills that can only be developed within a firm more than the general skills available in the external labor markets. Historically, almost all large firms adopted some variant of the Cravath model (Henderson, 2010).

Beginning in the early 2000s, as business organizations experienced heightened market competition and cost pressures, they became more and more sensitive to the billing practices of legal services. In a 2005 survey conducted by the Corporate Legal Times, twenty-three percent of CEOs reported that cost was the primary factor in the selection of outside counsel, which was a dramatic increase from one percent in 2004. Clients are unwilling to pay for the training of junior lawyers and expect attorneys to be versed in the practice of law when they are assigned to client matters. In addition, the business model and performance of law

firms became more visible to the media, the public, clients, and other firms by trade journals such as the American Lawyer, which publicizes information on law firm operations and financial outcomes (Margolick, 1984). Clients, mostly the legal department of corporations, no longer rely on law firm referral networks to find capable lawyers, and they have become much more mobile in searching for cost-effective legal services (Galanter & Henderson, 2008).

As a result, lateral hiring of experienced lawyers has become an important practice for firm growth and survival. Firms have started to see lateral hires as a major originator of revenue and source for bringing in new clients (Lindsey & Fanning, 2007). Unwillingness of clients to pay for associates' training has pushed law firms to hire more experienced lawyers as well as to hire more temporary lawyers to handle document-intensive demands (Rose, 2006). Lateral hiring of top performers from competitors is a faster way to expand market share and increase profits than training and developing junior associates. A 2011 survey of lateral hiring reported that more than half of the law firms responding to survey expected to add lateral partners and more than half of managing partners spent more than ten percent of their time on recruiting laterals.

Particularly interesting is that, while lateral movement of lawyers is widely accepted and law firms are eager to attract laterals, the effectiveness of this strategy is highly questionable. In a 2012 survey, only twenty-eight percent of law firms responded that their lateral hires had been successful, and the most profitable firms reported that they used fewer lateral hires compared to their less successful counterparts (Henderson & Zorn, 2013). Some firms that pursued lateral hiring as their core growth strategy, such as Finley and Kumble ,

Heller Ehrman, and Howrey ended up as epic disasters. Other firms, such as Cravath, Boies, Schiller & Flexner, and Cleary maintain the traditional model that focuses on "build rather than lateral" and the lockstep compensation (Todd, 2012).

The transformation of the Cravath model is still in progress, and law firms exhibit considerable heterogeneity in the extent to which they have revised their traditional employment model. Law firms need to respond to the cost pressures from their clients, but at the same time, build firm-specific skills to be competitive. Lateral hires are often cited as the driving force for higher profits as well as a cause for firm failure. New graduates need training and work experience to build their careers, but it is more and more difficult to find these opportunities. These contradictions suggest that law firms are an appropriate context for my research.

METHODS

Sample

The sample for this study was drawn from the list of the 200 largest U.S. law firms by total revenue published annually by The American Lawyer. As these law firms consist of all private partnerships, The American Lawyer collects information on financial performance and operational details through surveys and follow-up phone calls to partners. The time frame for this study is 2004-2010, although I included data from 2002 to 2012. As the main independent variable –internal staffing– is the average of prior years, I used information from 2002 and 2003 to calculate the independent variable for 2004, but excluded these samples (2002 and

2003) from the analyses because they do not have enough prior information to calculate the independent variable. Similarly, as the main dependent variable is the variation in performance over 3 years, I used 2011 and 2012 performance to calculate the level of performance stability for 2010, but excluded 2011 and 2012 samples. As not all of the law firms were listed for every year, I have an unequal number of observations for each firm. The dataset has been used widely in other studies (e.g., Hitt et al., 2006; Kor & Leblebici, 2005). The final sample consists of 202 - 207 firms depending on the analytical model.

Variables

Dependent Variables. Stability in revenue generation and profitability are the primary dependent variables for this study. Revenue generation was measured using revenue per lawyer and profitability was measured using profit per partner for each firm. AM 200, which is derived from The American Lawyer, surveys the financial information of the largest U.S. law firms. While most law firms provide their financial information voluntarily, when firms refuse to cooperate, reporters of The American Lawyers call partners to gather information and calculate revenue and profits. Gross revenue includes fee income from legal work only and does not include disbursements or income from non-legal ancillary businesses. Revenue per lawyer is calculated by dividing the gross revenue by the number of lawyers and profit per partner is calculated by dividing the profits by the number of partners.

In this study, I measured the variation of revenues and profits by calculating the difference between the maximum and the minimum level of performance across a 3-year period. This measure reflects the extent to which performance outcomes vary across years.

Performance stability measures employed by prior studies (Hunter & Coggin, 1983; Kim, Whang, & Burgers, 1989; Sørensen, 2002) were not applicable for my study for two reasons. First, these measures were based on general accounting measures, such as cash flow and liabilities, or stock market based measures, such as earnings per share and return on invested capital, and these measures are not available for private law firms. Second, the focus of these studies was to compare the level of performance across firms by using pooled cross-section time series data while I focused on within-firm changes and used firm-fixed analyses. As I control for the level of performance in predicting the stability, I consider the variance approach as more suitable for this study.

Independent Variables. Internal staffing was measured as the proportion of internally promoted partners out of the total hires for the prior year. The data was collected from the National Law Journal staffing survey which includes information about the staffing patterns and procedures of approximately 300 U.S. law firms. It includes the number of internally promoted partners, lateral partner hires, associates fresh out of JD programs and associates recruited laterally.

In this study, the use of proportion is more appropriate than using the number of hires because I am interested in the extent to which a firm chooses to staff internally or externally given a fixed number of job vacancies. In particular, because large firms often recruit greater numbers of both internal and external candidates, using proportion mitigates bias due to size. Then, I created 2-year, 3-year, 4-year averages of internal staffing of prior years in order to test the effects of human capital accumulation on performance. For example, for 2006, the 2-year average reflects the average of 2005 and 2006, the 3-year average reflects the average of

2004, 2005, 2006, and the 4-year average reflects the average of 2003, 2004, 2005, and 2006. I also ran supplemental analyses using different internal staffing measures. The averages of prior years may be biased by the total number of hires. For example, three partners promoted from within when there are five job vacancies may not necessarily be the same as thirty partners promoted from within when there are fifty job vacancies, although they are the same in terms of proportion. As my main focus for this paper is the extent to which firms pursue internal staffing, I consider that the averages of the prior years would be more appropriate because a firm with three internally promoted partners out of five new partners should be considered as pursuing an internal staffing strategy more than a firm with ten internally promoted partners out of fifty new partners. Nonetheless, in order to test the potential differences due to different calculation, I created a new measured by dividing the total number of internally promoted partners out of the total number of new partners for each period (2-year, 3-year, and 4-year), rather than averaging prior yeas' proportions. The results were similar.

Controls. I controlled for the proportion of associates hired fresh out of law school relative to total associate hiring. As the traditional Cravath model emphasized hiring associates fresh out of school, and training and developing them from within, it is possible that internal staffing of associates may influence the internal candidate pool for partnership, thus it is important to control for the proportion of associates hired out of law school.

Leverage ratio, defined as the total number of associates in a firm divided by the total number of partners (Sherer, 1995), reflects law firms' structure of human capital and has been shown to affect firm performance (Hitt et al., 2001; Kor & Leblebici, 2005; Sherer, 1995).

The firm size (measured as the number of lawyers) and the number of branch offices are included as control variables as these factors may greatly influence the revenue and profits of a law firm. In order to minimize bias due to the size of hiring, I controlled for the number of hires (partners and associates). Firm prestige was measured as the top 50 firms from the Vault's Law 100 (dummy coded). Vault surveys the perception of lawyers on how prestigious it is to work for a specific firm on a scale of 0 to 10 and it publishes the prestige score for the top 100 law firms. The choice to top 50 firms is based on the reasoning of Sherer and Lee (2002). The authors claim that firms in the top 50-100 are more likely to move in and out of the top 100 year to year and they do not enjoy the benefit of prestige as much as the top 50 firms. I controlled for whether the firm was involved in merger and acquisition activities in a given year (dummy coded) because it may affect firm performance (Hitt et al., 2001). In order to test the moderating effects of recession on relationship between internal staffing and firm performance, I dummy coded recession for 2009 and 2010. I controlled for either the current or the prior performance based on the model specification. Finally, year-fixed effects were included in order to guard against annual fluctuations in firm performance.

ANALYSIS

I test the hypotheses with panel data with repeated observations on a same set of firms. To account for non-independence among observations and to control for all time-invariant heterogeneity across firms, I employed the firm fixed-effects model. Fixed-effects regression assumes that firm-specific residuals do not have a distribution and treats them as fixed and

estimable. It also helps minimize biases due to heteroskedasticity and autocorrelation (Finkel, 1995). Thus, the estimates are based on within-subject change not between-subject change.

The matching of independent and dependent variables is as follows.

[Performance variance ($\text{Max}_{(t, t+1, t+2)} - \text{Min}_{(t, t+1, t+2)}$) = intercept + control variables + Internal staffing ratios ($\mu_{t, t-1, t-2}$)]

For example, for year 2006, the performance variance was calculated based on the difference between the maximum and minimum level of performance between 2006-2008, while the internal staffing strategy was measured as the average of the internal staffing ratios for 2004, 2005, and 2006. The control variables are measured at the focal year, which is 2006 in this case.

RESULTS

Table 10 presents the descriptive statistics, including means and standard variations. The average internal staffing ratio of partners is somewhat similar across different time frames: 0.57 for the 2-year average, 0.58 for the 3-year average, and 0.58 for the 4-year average. Internal staffing of partners is positively associated with variance in revenue and profits, which is contrary to my predictions. We cannot, however, make any inferences based on aggregate means and bivariate correlations because these can mask within- and between-unit variance in longitudinal models (Rogosa, 1995). The firm size is negatively associated with internal staffing ratio suggesting that large firms are more likely to hire lateral partners. The levels of revenue and profit appear to be highly correlated with the variance in revenue and profits, which suggests that firms with higher revenue and profits are likely to experience

Table 10. Descriptive Statistics and Correlations

No.	Variables	Mean	SD	1	2	3	4	5	6	7	8	9
1	Revenue per lawyer – Variance**	74.7	71.6	1								
2	Profit per partner – Variance**	173.7	241.0	0.80*	1							
3	Internal staffing of partners (2-year)	0.57	0.20	0.17*	0.08*	1						
4	Internal staffing of partners (3-year)	0.58	0.19	0.16*	0.08*	0.93*	1					
5	Internal staffing of partners (4-year)	0.58	0.18	0.15*	0.08*	0.90*	0.97*	1				
6	Internal staffing of associates (2-year)	0.54	0.20	0.22*	0.17*	0.38*	0.40*	0.40*	1			
7	Internal staffing of associates (3-year)	0.54	0.19	0.25*	0.18*	0.37*	0.41*	0.41*	0.96*	1		
8	Internal staffing of associates (4-year)	0.54	0.19	0.28*	0.20*	0.37*	0.40*	0.41*	0.93*	0.98*	1	
9	Revenue per lawyer**	678.8	245.4	0.43*	0.42*	0.23*	0.24*	0.24*	0.38*	0.37*	0.37*	1
10	Profit per partner**	950.7	611.8	0.42*	0.49*	0.22*	0.23*	0.22*	0.33*	0.32*	0.32*	0.89*
11	Prestige	0.18	0.39	0.24*	0.26*	0.13*	0.14*	0.13*	0.29*	0.30*	0.31*	0.56*
12	No. of partner hires	18.27	19.18	-0.06*	-0.05	-0.26*	-0.27*	-0.27*	-0.18*	-0.18*	-0.17*	-0.11*
13	No. of associate hires	54.29	63.21	0.10*	0.13*	-0.03	-0.04	-0.05	0.05	0.07*	0.09*	0.22*
14	No. of branch offices	5.68	3.79	-0.24*	-0.21*	-0.24*	-0.26*	-0.26*	-0.29*	-0.31*	-0.32*	-0.29*
15	Leverage	1.20	0.78	0.27*	0.34*	0.17*	0.17*	0.17*	0.27*	0.29*	0.31*	0.56*
16	Size (logged)	6.06	0.60	-0.02	0.02	-0.06*	-0.07*	-0.08*	0.06*	0.04	0.03	0.14*
17	M&A	0.07	0.26	-0.05	-0.05	-0.12*	-0.12*	-0.12*	-0.14*	-0.14*	-0.13*	-0.12*
18	Year	2007	2.01	-0.21*	-0.06*	-0.09*	-0.08*	-0.07*	0.13*	0.06*	0.01	0.22*

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Table 10 (Continued)

No.	Variables	Mean	SD	10	11	12	13	14	15	16	17
10	Profit per partner**	950.7	611.8	1							
11	Prestige	0.18	0.39	0.61*	1						
12	No. of partner hires	18.27	19.18	-0.06*	0.29*	1					
13	No. of associate hires	54.29	63.21	0.32*	0.56*	0.67*	1				
14	No. of branch offices	5.68	3.79	-0.25*	0.14*	0.58*	0.30*	1			
15	Leverage	1.20	0.78	0.70*	0.59*	-0.01	0.51*	-0.16*	1		
16	Size (logged)	6.06	0.60	0.25*	0.56*	0.57*	0.71*	0.51*	0.32*	1	
17	M&A	0.07	0.26	-0.11*	-0.03	0.15*	0.02	0.12*	-0.08*	0.03	1
18	Year	2007	2.01	0.17*	-0.02	-0.06*	-0.11*	0.10*	-0.08*	0.07*	-0.02

* : p<.05

** in $1,000

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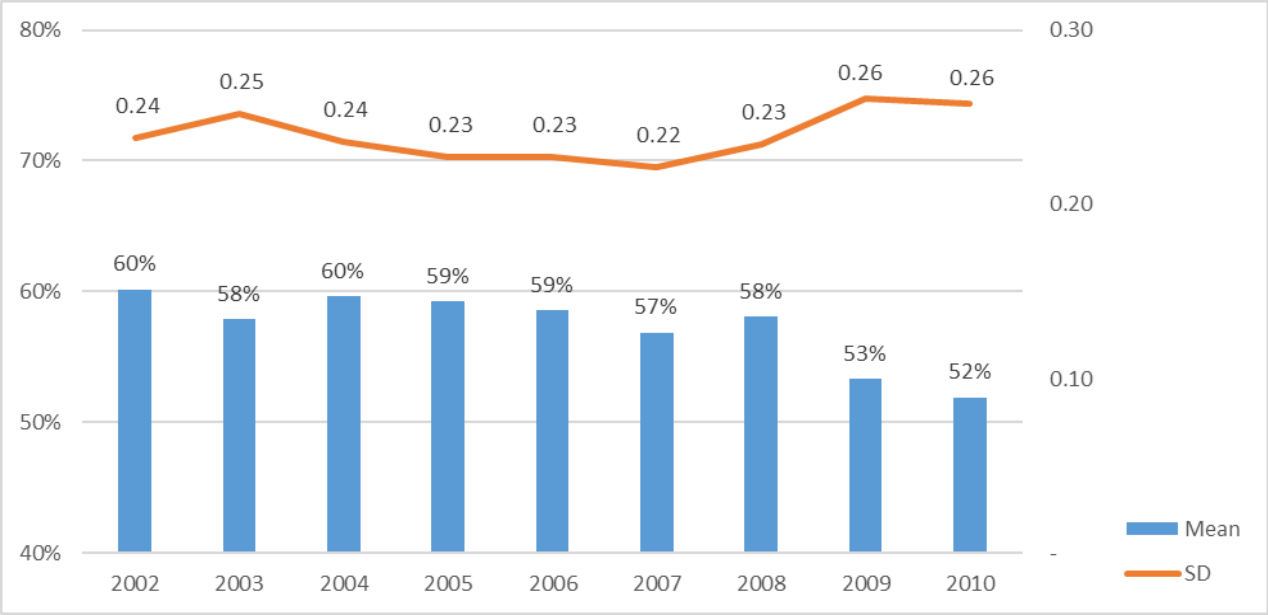
greater levels of variation in their performance level. The number of partner hires is negatively associated with the internal staffing ratio of partners while the number of associate hires is positively associated with the internal staffing ratio of associates. This may suggest that expanding firm size by hiring more associates versus more partners represents two different growth strategies.

Figure 20 shows the average and the standard deviation of internal staffing of partners over time. In 2002, 60% of new partners were internally promoted, while the proportion decreased to 52% in 2010. This may reflect the increasing popularity of lateral partner hires; nonetheless, more than half of the partners were still internally promoted. The standard deviation in the proportion of internal staffing stayed relatively stable across the 10-year period, ranging from 0.22 to 0.26. This suggests two things; first, firms vary to a great degree in the extent to which they promoted internal candidates versus hiring laterally, and second, contrary to the general assumption that most, if not all, firms moved away from internal staffing strategies to external staffing strategies, the level of variation across firms' staffing strategies did not decrease over the last decade.



Source: The National Law Journal Staffing Survey

Figure 20. The Average and the Standard Deviation -Internal Staffing of Partners, 2002-2010

Tables 11-13 show the firm-fixed effects regression estimates testing the hypotheses. As the dependent variable is performance variance, negative coefficients represent lower variance and should be interpreted as greater stability. Consistent with my prediction, a greater level of internal staffing of partners was associated with less variance; that is greater stability in revenue generation and profitability. The results suggest that firms that increase the proportion of internal staffing (promoted partners) experience greater stability in both revenue generation and profitability, supporting hypotheses 1a and 1b. This pattern is consistent across different time-frames, although the 2-year average of internal staffing of partners did not have any significant effect on the revenue variation.

As hypothesized in H2a and H2b, the size of effects increases as time-span of the predictor variable expands. The effect of internal staffing on revenue generation increases from -14.24 (ns) when the internal staffing is based on prior 2-year average to -37.96 ($p<.10$) and -61.07 ($p<.05$) when the internal staffing is based on prior 3-year and 4-year average. The pattern is similar for profitability, in that the effect increases from -119.50 ($p<.05$; when internal staffing is based on prior 2-year average) to -269.35($p<.05$; when internal staffing is based on prior 4-year average). The results suggest that the effects of internal staffing on performance become greater and more significant when the internal staffing is observed for a longer period of time.

Among the control variables, the effects of internal staffing of associates on revenue and profit stability are insignificant and it seems that there is no difference in performance stability whether a firm hires more or less associates fresh out of school. The difference in the effects of internal staffing of partners and associates may show the importance of firm-specific human capital since new associate hires do not have any firm-specific skill and knowledge. The size of a firm and the number of branch offices are associated with only stability in profitability but not with stability in revenue generation. The results suggest that the profitability of large firms tends to be stable while firms with multiple branch offices tend to experience more fluctuation in their level of profitability across years.

Table 11. Fixed-effects Regression Analysis of Revenue Variation

	Model1 2-year	**Model2 3-year**	**Model3 4-year**
Internal staffing of partners	-14.24	-37.96+	-61.07*
	(15.70)	(20.95)	(25.01)
Internal staffing of associates	-24.70	-11.21	14.05
	(19.94)	(24.14)	(28.51)
Revenue per lawyer	-0.02	-0.02	-0.02
	(0.03)	(0.03)	(0.03)
Prestige	-18.71	-18.39	-19.26
	(13.91)	(13.80)	(13.75)
No. of partner hires	0.17	0.13	0.15
	(0.19)	(0.18)	(0.18)
No. of associate hires	-0.09	-0.07	-0.06
	(0.07)	(0.06)	(0.06)
No. of branch offices	3.26	3.08	3.05
	(2.28)	(2.25)	(2.24)
Leverage	-22.44+	-23.64*	-21.49+
	(11.71)	(11.32)	(11.07)
Size (logged)	27.27	27.34	28.56
	(22.55)	(22.20)	(22.11)
M&A	-1.11	-0.57	-1.13
	(7.16)	(7.09)	(7.06)
Year-fixed	Included	Included	Included
Constant	-8.94	-0.49	-12.80
	(132.05)	(130.75)	(130.31)
No. of firms	207	207	207
R^2	0.12	0.12	0.13
F	7.72*	8.11*	8.36*

Standard errors in parentheses, revenues and revenue variation in $1,000

* $p<0.05$, + $p<0.10$

Table 12. Fixed-effects Regression Analysis of Profit Variation

	Model1 2-year	**Model2 3-year**	**Model3 4-year**
Internal staffing of partners	-119.50*	-234.91*	-269.35*
	(54.41)	(72.39)	(86.52)
Internal staffing of associates	-28.49	-38.47	-33.30
	(69.05)	(83.16)	(98.26)
Profit per partner	0.21*	0.21*	0.21*
	(0.04)	(0.04)	(0.04)
Prestige	-28.61	-29.92	-33.34
	(48.32)	(47.78)	(47.68)
No. of partner hires	0.01	-0.13	-0.01
	(0.66)	(0.64)	(0.63)
No. of associate hires	-0.04	-0.01	-0.01
	(0.24)	(0.22)	(0.22)
No. of branch offices	21.04*	20.45*	20.22*
	(7.95)	(7.82)	(7.80)
Leverage	-53.59	-48.60	-46.08
	(41.13)	(39.60)	(38.75)
Size (logged)	-173.55*	-171.22*	-165.92*
	(78.27)	(76.72)	(76.52)
M&A	-7.66	-10.03	-11.93
	(24.84)	(24.52)	(24.44)
Year-	Included	Included	Included
Constant	1109.95*	1166.56*	1150.56*
	(444.64)	(437.74)	(436.47)
No. of firms	207	207	207
R^2	0.07	0.08	0.08
F	4.31*	4.79*	4.68*

Standard errors in parentheses, profits and profit variation in $1,000

* p<0.05, + p<0.10

In Table 13, I show the effects of internal staffing of partners and associates on revenue generation and profitability during the recession, and I did not find support for H3a or H3b. When faced with the recession, a greater level of internal staffing of partners is associated with a lower level of revenue generation only at a marginal level (p=.068), but it

had no effect on profitability. This suggests that firms that focus on internal staffing may not necessarily experience performance loss when faced with an external shock. It is possible that firms with internal staffing strategies may be flexible enough to reconfigure their labor force to adjust to the changing needs of customers and/or employees may be more willing to share the risks and costs associated with the recession when firms pursue internal staffing strategies.

The difference between internal staffing of partners and associates is noteworthy. Internal staffing of partners is positively associated with both revenue and profits while the effects of internal staffing of associates are negative. This result suggests that hiring employees without experience may be costly because firms need to invest in the training and development of employees until the employees become productive. The investment, however, pays off when these employees acquire firm-specific skills and are promoted to the executive level. The net effect of internal staffing for both partners and associates is negative for revenue (-3.98) but it was positive for profits (18.27).

Overall, the results suggest that internal staffing strategies help firms achieve stability and the longer a firm accumulates internal human capital, the more stable its performance is. Internal staffing, however, can hurt a firm's revenue generation when external business conditions require more flexibility. In addition, the differences in the effects across the internal staffing of partners and the internal staffing of associates suggest the importance of firm-specific skills in gaining competitive advantage.

Table 13. Fixed-effects Regression Analysis of Internal Staffing and Recession

	Revenue per lawyer		Profit per partner	
	Model1	Model2	Model3	Model4
Internal staffing of partners	48.22*	58.57*	166.15*	169.28*
	(21.06)	(21.79)	(67.50)	(69.97)
Recession * Internal staffing of partners		-40.58+		-12.16
		(22.24)		(71.11)
Internal staffing of associates	-66.31*	-62.55*	-152.08*	-151.01*
	(23.91)	(23.97)	(76.43)	(76.73)
Recession	173.70*	199.60*	34.07	42.07
	(41.02)	(43.35)	(130.21)	(138.45)
Time	34.37*	34.44*	66.48*	66.55*
	(2.08)	(2.08)	(5.70)	(5.72)
Recession * Time	-35.40*	-35.97*	-22.68	-22.89
	(6.50)	(6.50)	(20.62)	(20.67)
Prestige	29.82*	30.33*	117.42*	117.59*
	(13.65)	(13.64)	(43.75)	(43.79)
No. of partner hires	-0.02	-0.02	0.48	0.48
	(0.18)	(0.18)	(0.59)	(0.59)
No. of associate hires	0.07	0.07	-0.17	-0.17
	(0.06)	(0.06)	(0.20)	(0.20)
No. of branch offices	-2.68	-2.87	-21.42*	-21.48*
	(2.30)	(2.30)	(7.41)	(7.42)
Prior performance	0.30*	0.31*	0.24*	0.24*
	(0.03)	(0.03)	(0.03)	(0.03)
Leverage	0.26	1.18	141.34*	141.63*
	(11.19)	(11.19)	(35.92)	(35.98)
Size (logged)	-96.97*	-102.03*	168.70*	167.11*
	(22.99)	(23.12)	(74.72)	(75.34)
M&A	-3.53	-3.14	-7.95	-7.84
	(7.21)	(7.20)	(23.07)	(23.09)
Constant	971.87*	990.70*	-600.74	-594.06
	(131.18)	(131.41)	(423.01)	(425.04)
No. of firms	207	207	207	207
R2	0.65	0.65	0.43	0.43
F	124.94*	116.56*	52.33*	48.55*

Standard errors in parentheses, revenues, revenue variation, profits, and profit variation in $1,000, * p<0.05, + p<0.10

Supplemental Analyses

As noted before, I ran several supplemental analyses using the new measures and found similar results (Tables 14 and 15). The means of the new measures were comparable to that of the prior measures employed in the main analyses, such that the means of 2-year, 3-year, 4-year averages of internal staffing proportion based on the total number were .56 while the means for the prior measures were 0.57-0.58. In terms of revenue variation, 2-year average of internal staffing did not have any significant effect (-23.07, ns), 3-year average had marginally significant effect (-37.90, $p<.10$), and 4-year average had significant and negative effect (-49.67, $p<.05$). In terms profit variation, the average of internal staffing across all years had significant and negative effects and the size of effects got larger as the time-frame of the internal staffing got longer: 2-year average (-151.18, $p<.05$), 3-year average (-239.34, $p<.05$), and 4-year average (-273.38, $p<.05$). I did not find any significant effect for the interaction between internal staffing and the recession.

Table 14. Supplemental Analyses – Revenue Variation

	Model1 2-year	**Model2 3-year**	**Model3 4-year**
Internal staffing of partners	-23.07	-37.90+	-49.67*
	(15.83)	(20.35)	(24.11)
Internal staffing of associates	-5.53	2.08	5.85
	(12.49)	(12.98)	(16.25)
Revenue per lawyer	-0.00	-0.00	-0.00
	(0.00)	(0.00)	(0.00)
Prestige	-52.91*	-50.20*	-49.94*
	(11.53)	(11.16)	(11.14)
No. of partner hires	0.24	0.19	0.20
	(0.19)	(0.19)	(0.18)
No. of associate hires	-0.09	-0.08	-0.08
	(0.07)	(0.06)	(0.06)
No. of branch offices	4.60+	4.56*	4.60*
	(2.39)	(2.28)	(2.27)
Leverage	-6.21	-5.20	-3.28
	(6.06)	(5.81)	(5.60)
Size (logged)	-4.20	-8.27	-10.46
	(24.06)	(22.95)	(22.77)
M&A	-1.24	-0.77	-1.10
	(7.18)	(7.06)	(7.02)
Year-	Yes	Yes	Yes
Constant	166.09	194.38	210.27
	(139.36)	(133.22)	(132.59)
No. of firms	206	206	206
R^2	0.14	0.14	0.14
F	8.62*	9.16*	9.33*

Standard errors in parentheses, revenues and revenue variation in $1,000

* p<0.05, + p<0.10

Table 15. Supplemental Analyses – Profit Variation

	Model1 2-year	**Model2 3-year**	**Model3 4-year**
Internal staffing of partners	-151.18*	-239.34*	-273.38*
	(54.98)	(70.51)	(83.55)
Internal staffing of associates	-2.54	-16.62	-13.02
	(43.34)	(44.89)	(56.11)
Profit per partner	0.00*	0.00*	0.00*
	(0.00)	(0.00)	(0.00)
Prestige	-153.73*	-144.68*	-141.41*
	(40.04)	(38.67)	(38.61)
No. of partner hires	0.25	0.10	0.14
	(0.68)	(0.64)	(0.64)
No. of associate hires	-0.02	0.03	0.02
	(0.24)	(0.22)	(0.22)
No. of branch offices	20.67*	19.30*	18.26*
	(8.32)	(7.90)	(7.86)
Leverage	-28.46	-21.21	-24.37
	(21.30)	(20.37)	(19.65)
Size (logged)	-150.95+	-150.83+	-133.81+
	(84.49)	(80.40)	(79.79)
M&A	0.65	-1.51	-1.93
	(24.93)	(24.47)	(24.34)
Year-	Yes	Yes	Yes
Constant	1020.21*	1073.37*	999.74*
	(484.56)	(461.86)	(459.37)
No. of firms	206	206	206
R^2	0.09	0.09	0.09
F	5.28*	5.56*	5.49*

Standard errors in parentheses, profits and profit variation in $1,000

* p<0.05, + p<0.10

DISCUSSION

This study contributes to the strategic human resource management literature, including human capital theory and the resource-based view of the firm by advancing our understanding of the relationship between human capital acquisition and performance outcomes. While the general assumption in the business and academic literature is that firms have largely moved away from the traditional internal staffing approach to external sourcing of human capital, I show that there is still great heterogeneity among firms in how they staff their organizations. In addition, these staffing choices have important implications for firm performance. Prior studies help us understand how and why firms adopt internal labor markets but are limited in examining the consequences of adopting internal staffing strategies (Lee, 2015). This study is among a few studies that investigate the effects of internal staffing on firm performance.

First, this study contributes to human capital theory by investigating firm-level performance implications of internal staffing. I propose that internal staffing helps a firm achieve performance stability by ensuring strategic persistency, employment predictability, and performance consistency. The results suggest that a greater level of internal staffing of partners, but not that of associates, leads to more stability in both revenue generation and profitability. This is consistent with the upper-echelons argument (Hambrick & Mason, 1984) in that because internally promoted partners have built their careers successfully within the organization, they have greater motivation and ability to maintain the performance capabilities of the firm and their relationships with key clients. As for associate lawyers, it

may matter less whether the lawyer is fresh out of school or has experience elsewhere because both types of hires are new to a given firm.

The difference between the effects of internal staffing of partners and associates may reflect the importance of firm-specific skills. Internal labor market theory (Doeringer & Piore, 1985) suggest that training new employees can be costly but employers reap the benefit of training once these new employees develop firm-specific skills over time. In this study, hiring associates fresh out of school is costly, yet once they acquire firm-specific skills and are promoted to partner, they are more productive than laterally hired partners. This is consistent with recent studies that have shown the value of firm-specific skills for professional employees (Groysberg, et al., 2008; Huckman & Pisano, 2006). One remaining question, though, is whether internal staffing of partners and internal staffing of associates represent the same strategy. Although 'entry at the lower level and promoted within' matches the stylized fact of the internal labor market approach (Doeringer & Piore, 1985; Osterman, 1987), it is possible that firms may benefit more by taking advantage of junior level employees' prior experience and promoting only high performing associates Or, the costs associated with the training and development of junior level employees are inevitable if a firm wants to develop firm-specific skills (Hatch & Dyer, 2004).

Third, this study contributes to the resource-based view of the firm by incorporating the temporal aspects of resource accumulation. There is very limited prior research on how to incorporate temporal dynamics and changes into the investigation of the relationship between resources and performance (Ployhart et al., 2009). Here, I explored the differential effects of 2-year, 3-year, and 4-year averages and found that the effects of internal staffing became

greater when staffing was measured across longer time-frames. This result provides support for the resource-based view of the firm in that resources that are accumulated throughout a long-term period cannot be easily copied or lost.

Fourth, this study expands the literature on strategic human resource management by showing that the effects of HR practices may not be consistent across different types of performance outcomes or under different contextual circumstances. The stability enhancing aspect of internal staffing may come at some cost when firms need to adjust their operations more flexibly in response to an external shock. Major events, such as a recession, bring about significant changes in industry composition and customer demand (Sirmon et al., 2007), and rigidities associated with internal staffing hinder firms in their ability to reconfigure their business strategy and skill composition to respond to these changes. The results of this study also suggest that firms with a greater focus on internal staffing may not necessarily underperform when faced with an external shock. Contrary to the general assumption that internal staffing may cause inflexibility in firm strategy and business operation, it is possible that the internal staffing approach may be as flexible as, if not more than, the external staffing approach, which explains the non-significant effects on the firm-level performance outcomes.

LIMITATIONS & FUTURE STUDIES

This study has several limitations that should be addressed by future studies. First, the study is based on one specific industry. Although law firms are increasingly exposed to external market pressures and have largely embraced a market-based approach in formulating their strategy and business operations, thus the findings of this study are highly relevant for

other professional service firms and knowledge-intensive firms, it is not clear whether the results would apply to other industries where high level of employee turnover is expected. For example, restaurant sector where the overall turnover rate is above 60% in 2014 may find it difficult to pursue internal staffing strategies. Internal staffing strategies, however, may be more important for firms in these sectors to become competitive.

Given the limited prior research on the temporal aspects of human capital accumulation, the measures of internal staffing are highly explorative. In this study, I tested the effects of 2-year, 3-year, 4-year accumulation of human capital, but it is possible that this time-frame is different for different jobs, firms, and industries. For example, it takes a relatively short time period for professional service firms to see positive returns from their investment in human capital while it may take longer for technology-based firms to develop and maintain firm-specific human capital. Thus, future studies need to explore the temporal dynamics of human capital accumulation in different contexts with different contingencies.

Finally, it is possible that there is a virtuous cycle between internal staffing and performance stability. Not only internal staffing promotes performance stability but firms with stable performance are able to plan stable employment relationships. Thus, firms that experience greater fluctuation in performance may be in a difficult position to pursue internal staffing strategies. I was not able to test such input-performance cycle due to the limited time-span of the current dataset, but it would be an interesting research question for future studies.

CONCLUSION

Although the movement away from internal staffing to external sourcing of human capital has been widely documented, the results of this study suggest that internal staffing is still relevant and important for firms. Every job requires a certain level of firm-specific skills that cannot be acquired from the external labor markets. The investment in human capital may be costly at an employee's early career stage, but it will pay off as he or she acquires firm-specific skills and moves up the career ladder. Internal staffing, however, may not necessarily be helpful when external market conditions are volatile and unpredictable. To conclude, internal staffing strategies may lead to a sustained competitive advantage as it takes longer to build then to buy human capital, yet firms that need to be flexible may not benefit from the internal staffing approach.

CHAPTER 5.

CONCLUSIONS

The general assumption found in the academic literature and business publications is that firms have shifted from internal labor markets to external staffing approaches. The growth of short-term, performance-based employment relationships, less investment in employee training and development, and lower employee tenure and higher mobility have been documented. Some consider these changes to be the inevitable result of an increasingly competitive and unstable business environment. In reality, however, there has always been, and continues to be, great heterogeneity among firms in terms of the extent to which they rely on internal versus external labor markets. It seems highly unlikely that employment relationships have converged or will converge into one type of employment system. My dissertation speaks directly to this issue by examining the extent to which employers vary in how they staff their organizations and by exploring the causes and the consequences of this variation.

Law firms, the context of my dissertation, provide a useful setting to examine the movement away from the internal to the external staffing approach. They were once famous for their strong norm of relying on internal labor markets but have experienced substantial changes in their staffing strategies during the last decade or so. Throughout my dissertation, I have shown that law firms no longer enjoy stability in their business operations, and they have revised their staffing strategies to respond to the increasingly competitive environment in

which they operate. I also have shown that, contrary to the general prediction that all firms have moved or will move to external staffing strategies, law firms still vary greatly in the how they staff their firms. I argue that my findings are likely to generalize across firms in other industries as well.

Theoretical Contribution and Future Studies

My dissertation contributes to three literatures. First, I contribute to organizational sociology by investigating the multi-level aspects of organizational phenomena. The idea that organizations are subject to a variety of internal and external pressures (Simpson & Gully, 1962) has long been recognized, yet there is limited empirical research on the extent to which firm behavior is influenced by such pressures. Investigating the effects of contextual factors on firm-level strategy and decision making is critical for understanding how firms are enabled or constrained by the context within which they are embedded. My research shows that firms are not entirely autonomous nor entirely subject to external pressures but are influenced by a variety of internal and external pressures -- a finding which calls for greater attention to multi-level theory building and empirical investigation.

Second, I contribute to the resource-based view of the firm by exploring the temporal aspects of resource accumulation. Although the prior literature has emphasized the importance of the time between the investment in resources and the returns to performance, we have limited theory and available measurements of such phenomena. By exploring different time frames of resource accumulation, I found results consistent with the resource-based view, in that the longer the investment, the greater the returns. As I focused on the

executive level of human capital at professional service firms, future studies may explore whether these findings can be generalized to other industries and other types of organizations. In addition, although the results of my study showed that the size of effects increased as the time frame of internal staffing increased, it is possible that the effects are not linear and may even decrease at some point. Future studies may explore such possibilities.

Finally, I contribute to human capital theory and the internal labor market literature by showing that internal staffing strategies are still relevant and important for firm-level performance outcomes. Firms still vary greatly in how they staff themselves but they do so without enough knowledge of the performance implications of their staffing strategies. The prior research on internal and external staffing at the individual level is informative, yet it is unclear whether this can be directly applied to the firm or establishment level. As this study is among the few that have investigated the relationship between staffing strategies and firm-level performance outcomes, future studies may explore the boundary conditions and mediating mechanisms of this relationship.

Practical Implications

Firms and managers may benefit from my studies in two important ways. First, firms need to consider external market conditions in relation to their internal practices. The results of my research show that firms respond to external market conditions but they may not do so in consideration to their internal structure or practices. Responding to the external market conditions, in this case the availability of experienced workforce and the level of business competition, is important, yet the competitive advantage may come from taking advantage of

their internal practices and adopting strategies different from those of other firms. In the case of law firms, it may be cost-efficient to hire lateral lawyers when the supply of a lateral workforce is abundant, but firms with effective internal development practices may gain competitive advantage by hiring more new graduates and training them with firm-specific skills.

Second, managers need to consider the amount of time needed to see positive returns from their investment in human capital. In my research, the effects of internal staffing on revenue stability were not significant until I took into account the prior four years of internal staffing. Given the limited research on the time frame between resource investment and performance outcomes, managers may find it difficult to continue their investment without any immediate returns. Nonetheless, managers should be aware of the time necessary to observe the effects of resource accumulation.

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