ENSURING LONG-TERM FIRM PROFITABILITY –
FOLKS, IT’S NOT JUST THE RPL!

Peter A. Giuliani, Partner

The following monograph looks at the issue of law firm profitability – not just in the “short run,” but more importantly, over the “long run.”

CONVENTIONAL WISDOM REVISITED

In March of 2003, Of Counsel published an article by Steve Barrett, entitled “Revisiting What Produces Profits – It’s Still the RPL, Stupid.” In that article, Barrett collects a wide range of statistical information about the AmLaw 100 and 200 law firms and computes a correlation coefficient for each to determine how closely it tracks profits per equity partner. He found that revenue per lawyer correlates 92% with profit per partner among the AmLaw 100 and 85% among the Am Law 200 and concluded that managing law firm profitability is a matter of managing revenue per lawyer.

Barrett is correct, as far as managing short-term profitability goes (generally, year-to-year). Once fixed costs (largely lawyer and staff salaries, rent and operating costs) are covered, any increase in revenue drops to the bottom line. This is a matter of simple arithmetic. Indeed, seemingly small improvements in the components of revenue per lawyer (i.e. – hours, rates and realization) can – at the margin – produce significant improvements in profit per partner.

Thus, it would seem that the way to ensure your firm’s profitability is to emphasize generation of revenue (i.e. – volume). In fact, most law firm partner compensation systems reward partners who generate the largest “books of business.” Indeed, in recent consulting assignments, we have amassed a good deal of statistical evidence that supports the conclusion that partner compensation in most firms is driven by origination of or control of large “books of business.”

Unfortunately, looking only at revenue generation ignores the question, “is the business being originated actually profitable business?” To do that, one must look carefully at the firm’s cost structure and how efficiently it manages its workload. Law firms invest in “productive capacity” just like most other businesses. Their “productive capacity,” however, is not bricks and mortar, but a cadre of skilled professional lawyers, supported by a staff of paraprofessionals and non-lawyer support personnel. Managing the profitability of a law firm is a matter of making sure that the work being originated is the kind of work that puts this productive capacity to its highest and best use.

THE SHORT RUN

While the “man-on-the-street” may have his own definition of the term, economists have a very specific definition of “the short run.”

- In economic theory, “the short run” is defined as “that period of time during which a business cannot appreciably increase, decrease, or reconfigure its productive capacity.”
- For some businesses, like power generation and/or transmission utilities, “the short run” is a very long time, indeed. Service businesses, like law firms, by contrast can grow or shrink relatively quickly.

As a practical matter, however, most large law firms make and execute capacity decisions annually. They estimate Fall hiring, plan for attrition, make partner admissions, et cetera on fairly regular annual cycles. Only when they execute significant mergers or acquisitions, “spin off” offices or departments, or suffer major defections is the size and/or make-up of the firm appreciably altered.
So, for practical purposes, it is useful to think in terms of the annual fiscal cycle of the law firm as being its “short run.” During a typical year, it is unlikely that a law firm will materially change size or alter its ratio of timekeepers to equity partners. That being the case, Barrett is correct in stating that the best way to maximize partner profits, in “the short run,” is to maximize revenue per lawyer (or revenue per timekeeper if the firm has a sizeable paraprofessional or non-lawyer professional staff).

Perpetuating a “short run” profit maximization strategy, however, does not constitute implementing an effective “long run” profit maximization strategy. For example, in the wake of the savings-and-loan crisis, many law firms lined up to grab a share of the heavily discounted, slow-pay, work being doled out by the FDIC and RTC. While that may have been an effective way to keep partially idle lawyers busy in the “short run,” taking in an increasing load of this kind of commodity work over several years, without appreciably adjusting the firm’s staffing ratios and work management systems, eventually acted as a “long run” profit drain and actually helped to sink some well regarded firms.

Certainly, there are firms that succeed at earning high profits per partner with a “long run” strategy of seeking out high-volume, low-margin work. Successful insurance defense firms have been doing this for decades. The difference is that such firms manage their staffing ratios to match the requirements of the work. They have relatively few equity partners. Non-equity partners supervise the dockets of large numbers of associates and paralegals. They recruit, train and promote associate lawyers very differently from other firms that serve the high-margin end of the market.

Therefore, beware of the trap to which many firms fall prey when they focus solely on building volume. In the “short run,” this may be necessary to ensure that the firm “has a good year.” Continually repeating a “short run” strategy, however, does not constitute an effective “long run” strategy. Once one relaxes constraints on the size and configuration of the firm – the very definition of the “long run” – sustainable profit improvement involves management of a range of entirely different economic factors, especially realization and leverage.

**MANAGING FOR THE LONG RUN**

Managing profits over the “long run” is a matter of managing both the volume and quality of business that the firm attracts, while making sure that the work is **staffed and performed by the appropriate people** in the organization. The most profitable work in the “long run” consists of matters that can be billed at or near full rates, and that involve tasks that can be performed by junior lawyers and/or paralegals.

- **Managing volume** means developing business sources that will generate larger matters, a steady flow of smaller matters, or some combination of the two. The important goal is to develop **steady and sustainable** sources of business, not just any business to fill up existing plates. In the “long run,” you always face the nagging question: “If we’re struggling to fill plates, why do we have so many plates?”

- **Managing quality** means targeting areas of practice and/or business sources that will generate work that can be billed at or near full rates. All else equal, one would rather have $100,000 of work that can be billed at 100% of rates than the same volume of business that requires a 20% discount off full rates. Another way of saying the same thing is that $100,000 in collected fees, after a 20% discount, has used up $125,000 in resources to produce. This may be fine in the “short run” because the firm may have excess capacity. It is not appropriate in the “long run” because the firm should question why it has so much excess capacity that it needs to discount its work. Sure, some clients will only give out higher volumes of work if the firm grants a discount, and if the discounted work fits the firm’s other strategic goals, then it is appropriate to take on. That said, the firm should **give first priority to full-rate work** in its business development plans and its reward structure.

If a firm has done its work correctly in setting hourly rates at market levels, and if it is assigning tasks and supervising work properly, discounts and write-offs should be rarities. That said, clients do ask for discounts in exchange for volume or steady work. But be careful – because most, if not all, costs in a law firm are independent of the volume of work, **discounts come disproportionately off the bottom line**. If the firm’s operating margin is 40%, one should expect to make $40K profit on a $100K matter. **If one grants a 10% discount, however, profit is cut by 25%**. Continually offering discounted work is not an effective “long run” profit strategy.

It is not sufficient, however, that the sought-after work merely bear nearly full rates. It must also **make appropriate use of the firm’s productive capacity**. That means the firm must take care to staff the work by delegating tasks to the appropriate timekeepers. Thus, the third important variable (after volume and quality) in maximizing long-term profits is **leverage**.
Why is leverage so important? The most scarce and valuable resource of a law firm is partner time and, given what firms must pay partners to be competitive, it is also the most expensive resource. To be truly profitable, a firm needs to maximize the return earned on an hour of partner time and on a dollar of partner compensation. That means all other sectors of the firm’s capacity – associates, paralegals, non-lawyer timekeepers, ancillary businesses, non-hourly fee sources, etc. – must be put to work effectively with an appropriate amount of equity partner time dedicated to generating, managing and supervising the work of the firm.

In the “long run,” it does a firm little good to try to maximize revenue per lawyer, and staff the work with mostly partner time.

- If the firm has associates on staff, for example, they will gradually be starved out of the work they need to gain experience and build their skills. They effectively become an underutilized and expensive idle resource.

- Eventually, a firm attempting this kind of strategy will become a one-generation firm (by definition, a firm comprised mostly of equity partners already is a one-generation firm).

- Either way, bulking up partners at the expense of associates and other timekeepers is a losing strategy in the “long run.”

Equity partners need to have a strong work ethic and a commitment to responsiveness and excellence in providing client service. That is not sufficient, however. They need to manage assignments so that work is done by the appropriate people – paying attention to the long-term training and development of associates, the next generation of the firm. Also, they need to focus energy on developing new business – not just any kind of business, but the kind of business that bears full rates and can provide meaningful work for non-partners.

Summarizing, the essential “must-dos” of a successful “long run” profitability strategy are:

1. Attract and retain sustainable sources of full-rate business
2. Assign work to the appropriate level within the firm and manage matters accordingly
3. Manage the size of the firm to avoid persistently creating excess capacity that will need to be absorbed in the “short run”
4. Create and sustain efficient capacity by recruiting, training, developing and retaining high quality associates, paralegals and other timekeepers
5. Attract, retain and reward those equity partners who can do the other four “must-dos” well.

It is critical that firms not fall into the trap of building too much capacity or the wrong kind of capacity profile, and then be forced to pursue repeated “short run” strategies to generate profits. Better to be lean and leveraged, with some ability to be selective as to clients and matters, than to have too many equity partners doing any work that will keep them occupied.

**PRACTICAL AND SPECIFIC THINGS TO CONSIDER**

Enough theory – what are some practical things law firms can do to be sure they are focusing on “long run” profitability?

At the overall firm level, the emphasis should be on work ethic and work sharing. Specific focus, however, should be on building the most appropriate and highest quality capacity, consistent with the practice base of the firm. Practical and specific steps to doing this include:

- Rewarding partners who attract and retain profitable business, not just any business (“profitable business” is that business that will bear nearly full rates and provides delegable work)
- Rewarding partners who stay busy themselves, but also spread work to others and supervise matters effectively
- Recruiting fewer associates and paying them more – being highly selective in hiring
- Investing in training and developing skills of associates – both technical and career skills
• As soon as feasible, incorporating associates into practice groups and/or client service teams
• As part of the formal evaluation process, setting career-advancement hurdles every three years and, then, measuring progress against those goals
• Abandoning lock-step or “class” compensation system after the first three years – bonus high performers and those who are achieving career advancement goals
• Setting standard rates at what surveys tell you are market levels
• Setting and communicating guidelines and expectations for what types of matters may be considered for discounting
• Holding group/team leaders accountable for rate/pricing decisions on individual matters
• Actively managing discounting; requiring independent firm-level approvals in advance of client retention.

Related activities at the practice group level include:
• Assigning clear responsibility for making and monitoring work assignments (e.g. – holding bi-weekly meetings to review hours recorded and work assigned, planning work assignments in advance, and reviewing and managing non-client/firm “billable” matters)
• Holding regular team/group meetings to discuss matters and prospects “in the pipeline”
• Concentrating on driving work to appropriate people based on capability, career development goals and – as a short-term last resort – “availability” (i.e. – excess capacity)
• Introducing leverage statistics to group/team management information reports
• Within like kinds of matters, establishing standards and targets for matter-level leverage (i.e. – total hours divided by the hours of the supervising partner)
• Within like kinds of matters, identifying tasks that are most appropriately handled by associates and paralegals – do not let partners do associate-level work
• Rewarding those who are successful at delegating work to and mentoring associates.

In the end, successful management of profitability in the “long run” is a matter of encouraging partners to delegate and supervise work, rather than pile up their own plates, and to always strive to get the highest value-added work from their clients and referral sources. While there is no “one-size-fits-all” strategy, no law firm ever went broke by being highly selective about clients, equity partners, associates and other timekeepers, and by simultaneously serving clients with intensity and responsiveness.

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Peter Giuliani is a partner in Smock•Sterling Strategic Management Consultants. He has over 38 years of experience in the legal marketplace – both as a consultant to the country’s leading law firms and as a large firm Executive Director (for over seven years). His primary skill set is in the economics of law practice management and in developing strategies to maximize firm profitability. That skill set relates directly to Smock•Sterling’s overall mission of “helping our clients develop and implement strategy.”

SMOCK•STERLING
Strategic Management Consultants
725 N. McKinley, Suite 200 • Lake Forest • IL • 60045 • (847) 615-8833
6430 N. Central Avenue, Suite 207 • Chicago • IL • 60646 • (773) 763-6353
980 Post Road East • Suite 3, Room 10 • Westport • CT • 06880 • (203) 341-0601
www.smocksterling.com