

The Six Drivers of Law Firm Profitability

Norman Clark
Principal
Walker Clark, LLC

Six factors have the greatest overall impact in the profitability and long-term financial performance of small and midsize law firms worldwide. The relative impact of each of these “drivers” varies from firm to firm; however, the solution to a law firm’s profitability problems -- whether short term or chronic -- is almost always found in one or more of these six factors:

🏆 Fee levels

Are you charging a high enough fee?

🏆 Productivity

Are your fee earners fully utilized?

🏆 Realization

What percentage of the work is getting billed?

What percentage of the work that is billed is actually paid?

How promptly are you billing work in progress?

How quickly are fees paid?

What are the principal reasons for write-offs and write-downs?

🏆 Cost management

How well do you manage operating costs?

How accurate is your budgeting process?

How do you decide about unbudgeted expenses?

To what extent are budget execution issues centrally managed?

What control and accountability do individual partners have concerning budget execution?

To what extent do you consider the impact of short-term cost-management decisions on long-term business results?

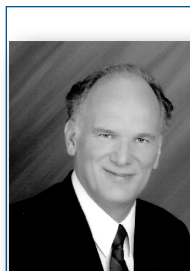
🏆 Staff compensation

Are your fee earners paid more than they produce?

🏆 Leverage

Are you delegating work – especially fixed fee work – to less expensive but competent fee earners?

This monograph investigates the challenges that each of these key profitability factors present to small and midsize law firms. It also suggests a set of highly-effective strategies that law firms worldwide are using to manage each of these factors to improve financial performance and to produce sustainable, long-term business growth.



Norman K. Clark is a lawyer and a founding principal of Walker Clark, LLC. He advises law firms worldwide on issues of business strategy, marketing, and improved profitability, and is considered a leading expert in the challenges of law firms in emerging economies. Norm is the Senior Vice Chair of the Law Firm Management Committee of the International Bar Association and a Fellow of the College of Law Practice Management.

Driver 1: fee levels
Focus on value, not price.

Are your fees high enough for you to deliver legal work profitably? In some firms, the answer is *no*. In many more firms, the answer is *we don't know*.

Client demands for lower fees and substantial discounts have become a significant challenge for many law firms. Local law firms in some emerging markets, in areas such as Africa, Latin America, and the Caribbean, find themselves in price wars.

Price sensitivity in some practice areas—such as trademarks, collections and asset recovery—stimulates price consciousness in other ones. Even new clients, with no prior relationship with the firm, often expect a significant discount for a single case or transaction, while presenting only the faintest possibility of any future work.

Although increasingly price-sensitive, these clients are not suckers for any low price. They are not fooled (at least not for long) by a discount from an artificially high 'published' rate that nobody actually charges.

In this climate, there is a strong temptation simply to compete on price. Slash your fees to the lowest possible level. Distinguish yourself as the cheapest provider in your market.

Being the cheapest is not a strategy.

Any competitive advantage based on having the lowest price soon evaporates, even in high-volume, price-sensitive legal services. All that it takes is for a competitor to offer fees that are one dollar, one euro, one naira, one won, or one peso lower than yours.

As one general counsel said, when describing the decision to fire a law firm

that did insurance defense work in personal injury cases, "The only thing the old firm had going for them was price. When another firm beat their price and delivered equal quality, there was no reason to stay with the old firm."

When a practice area becomes price sensitive, law firms have few attractive choices. Most mid-sized firms simply withdraw from the competition. Firms that stay in the low-price, high-volume market must often entirely overhaul their internal work processes, service delivery systems, and administrative structure in order to lower their operating costs. Even if they are successful in managing 'bare bones' costs, they often find that the volume that they need to sustain thin profit margins never materializes.

Some firms can pursue a third strategy. Operate the high-volume low-price practice at little or no profit, using it essentially as a loss leader to attract and retain clients who also have the high-value corporate work that the firm really wants. In most instances, however, the actual return on this investment is usually disappointing. The new clients do not come or, if they do, they do not bring the work that the firm actually hopes to lure through its loss leader. Firms also often have unrealistic expectations about an existing client's predisposition to remain with the firm simply because of a low-price service that the firm offers in addition to the higher-value commercial legal work.

As one general counsel put it, "We just don't buy legal services that way."

Are your fees high enough?

Rather than joining the local price war, might you not actually need to raise some of your fees?

In our firm's work with law firms in both emerging markets in Africa, Latin America, and Asia, as well as in more mature markets in Europe and North

America, it is not uncommon to discover that a law firm has not raised its fees in the past three to four years..

In some instances, fees that once were 'market average' have actually dropped below the median. Their fees stayed the same, but the market moved upward.

Every firm should review its fees every year. Review the published rates also review the rates that are actually charged to clients. Sometimes the median published rate will have gone up, while the median rate actually charged to clients will have decreased, due largely to deep discounting and pre-billing write-downs of fees charged by mid-level and junior partners as well as all levels of associates.

What is your firm's 'profit point'—the fee that you must charge to ensure a minimum level of profitability? Many law firms still guess at this.

However, most legal markets no longer allow the luxury of thinking, "With a fee this high, we must be making a profit."

How much does it cost your firm to produce one hour of legal services? This concept, known as the 'fully loaded operating cost per hour', is a critical, but widely overlooked, gauge of fee profitability. Even if the numbers are not as complete or precise as you would like, your firm needs to know its profit point. Only then will you be ready to discuss fees intelligently with your clients. Without this information, you will only be guessing.

The value conversation

Once you decide that you must raise your rates, what is the best way to inform a client?

Keep this one principle in mind:

It is unlikely that you will lose a client solely because of a reasonable fee increase.

Client surveys conducted by Walker Clark and other major consultancies affirm that an existing professional relationship—not price—is one of the top considerations in selecting a law firm for all but the most routine legal services. Purchasers of legal services—including high-volume services—tell us that a price increase is often an excuse to fire a law firm, but it is seldom the only or most important reason.

Consider also that your clients face the same pressures in their own businesses. They understand that most legal services are not consumer electronics; they do not expect prices to drop forever. Your client may bargain hard, but he or she still expects you to earn a reasonable profit.

Lead your clients to think about value instead of price. Ask yourself questions like these:

What is the total cost to the client?

Some law firms compensate for low hourly rates by recording more hours, often producing a higher total cost than a firm with a higher hourly rate, but which bills fewer hours. If cost is important to your client, can you demonstrate how your firm will deliver services at the lowest total cost?

Be prepared to talk about the bottom line to the client. For example, one small firm was able to win almost all of a major energy company's litigation simply by having the courage to review the two competitors' invoices. Even though the firm's partners charge hourly rates that were 10% to 15% higher than those charged by the competitors, the firm was able to demonstrate how well-managed delegation of work to associates and more efficient use of partner time would have produced total legal costs that were almost 25% lower.

The more confident that you are about the profitability of your fee, the easier it becomes to set a fixed fee for work that

lower-priced competitors might assume to be impossible to offer with confidence.

When successful marketing requires successful differentiation of your firm from the competitors, the ability to offer competitive, but profitable, fixed fee can instantly move your firm onto the short list.

What is the true return on the client's investment?

Most low-price competitors never discuss value with their clients, only price. Suggest real business benefits that you can deliver. You can enhance the overall value of your services through a superior understanding of the client's business goals.

Beyond good legal work, how can you help the client reach those goals? Every dollar, real, or peso of business benefit to the client will proportionately increase the true return on the client's investment in your services.

What are you really selling?

Clients say that they value experience, judgment, and understanding of the business more than price. A past or existing professional relationship is often decisive when hiring a law firm.

If a client says that low price ranks above all other factors, consider whether this client will contribute to or hamper your firm's long-term business interests.

Unprofitable clients are voracious consumers of law firm resources, especially partner time. The hour spent working for a marginal client is an hour that is forever lost for more profitable work or for business development.

This does not mean that you should automatically dump all marginally profitable clients. Instead, be sure that you can articulate a solid business case for keeping the marginal client, expressed in terms such as long-term prospects for

more profitable work or the client's potential to refer other more profitable clients to you.

Except for the most heavily commoditized legal services, value, in the minds of sophisticated purchasers of legal services remains a blend of successful results for the client and consistently high levels of service quality. This is why the conversation with the client must focus on quality, not price.

Escaping the 'iron laws'

Law firms often feel trapped by what business strategist Barry Sheehy has called the 'iron laws' of client expectations:

- Whatever you charge today will be too much tomorrow.
- Whatever you deliver today will be too little tomorrow.

Lawyers can escape this trap. First, set fees based on your firm's profit goals and internal operating costs. If you need to reduce fees, look for ways to improve productivity and reduce costs, without compromising client services.

Second, demonstrate your special ability to deliver services that your lower-priced competitors cannot provide at a level of quality that they cannot afford to emulate.

Let value, not price, drive your strategy.

Driver 2: productivity
Working harder
or working smarter?

Productivity presents a paradox. Some partners are so productive as fee generators that they are actually unproductive when viewed in terms of the long-range business results.

Productivity is probably the most difficult of elements to manage. It is affected by

complex internal relationships within the firm, such as delegation of work from partners to associates. It also calls to account the traditional cultural assumptions of the partnership, such as where they want to set the balance between financial reward and quality of personal life.

Measuring productivity

Although not perfect, the billable hour is the most practical way to measure productivity in law firms. Most lawyers feel comfortable with it.

However, many law firms resist using the same method to record the unbilled work that the firm performs for clients. Why record time that you are not going to bill?

This rationale denies the firm a useful productivity tool that it could have at no significant additional cost. The additional time and effort needed to record the unbilled work is negligible. In return, the firm receives a highly reliable, practical means to evaluate and improve the delivery of legal services and products to clients.

If a firm does not record all of its activities it is difficult to make informed decisions about issues such as staffing ratios, delegation and work pricing when clients want a mode of billing other than hourly rates.

The second argument against the billable hour is that it can produce unhealthy internal competition, inefficiency and poor teamwork.

This is like blaming the kilogram for obesity. Problems like poor teamwork or vicious internal competition come from deep inside the firm's workplace culture, not from measurements.

Productivity gaps

Productivity levels vary widely from one legal market to another, as well as among law firms in the same jurisdiction. In

some Latin American or Caribbean firms, for example, the most productive lawyers might record fewer than 1,200 hours per year, with the firm's overall average being less than 1,000 hours per fee earner. Compare this to ranges of 1,500 to 2,000 hours that are common in similar firms in the United States and United Kingdom. In those firms the productivity figures for top producers may exceed 2,400 hours per year.

There is no special merit—and many potential dangers—to expecting lawyers to bill more than 2,000 hours per year.

On the other hand, the 1,000-hour mark is a critical threshold for most law firms anywhere. Average productivity of less than 1,000 hours per fee earner is usually too low to remain competitive and profitable in the emerging international legal market. At these levels, it is increasingly difficult for the firm to offset client demands for lower fees and discounts. The resulting margins are usually too slender to sustain long-term profitability and growth, especially if the firm must also contend with increasing operating costs in critical areas such as facilities, technology and staff.

What does a 'productivity gap' mean in terms of profits? Consider this example:

Two law firms, with similar practice areas and in the same market, each have ten associates. In firm AB&C, associates produce an average of 1,500 hours' billable work per year, for a total of 15,000 hours. In firm DE&F, they produce an average of 1,200 hours, for a total of 12,000 hours.

In other words, firm DE&F uses ten lawyers to produce the work and resulting fees that AB&C produces using eight. So, in effect, DE&F is paying the salary and support costs of two extra associates. If the average salary for associates at DE&F is equivalent to \$50,000 per year, the firm is spending a minimum of

\$100,000 in costs that it could be avoiding through greater productivity.

The cost is even greater when considering per capita support costs, such as secretarial staff and office services.

DE&F's profitability strategy is clear. It must bring its average associate productivity up to the level of its competitor firm. In doing so, its associates will produce additional fees at virtually no additional operating cost—pure profit!

There are also possible competitive effects from low productivity. AB&C might have a subtle but decisive competitive advantage over its less productive rival. Although DE&F appears to have excess work capacity (associates appear to be only 75% as busy as those in AB&C), its lower productivity may make it more difficult for it increase performance quickly to meet extra demand.

Lower productivity at DE&F is more likely the result of systemic practice management weaknesses such as poor delegation of work, rather any defect at the level of performance expectations or work ethic. Unproductive firms are seldom lazy. These managerial failings can be hard to overcome quickly.

Partners and the productivity paradox

How can a law firm close its productivity gap?

In many firms, the typical partner does so much billable client work, that little time remains for marketing, business development, or attention to the professional development of younger lawyers.

Productivity can become a paradox. The partner who is working the hardest on day-to-day client work may actually be contributing the least to the long-term success of the firm. This “overproductive”

partner can be an even greater threat to long-term performance than the apparently underproductive associate.

He or she is certainly a greater risk to long-term profitability than the partner whose performance has declined due to personal problems or transition to retirement. The partner is overproductive and underproductive—perhaps even counterproductive—at the same time.

Comparing average billable hours of partners and associates is a reliable diagnostic for overproductive partners. In most law firms worldwide, associates produce a higher average of billable hours than partners. This reflects the substantial responsibilities that partners have for non-billable functions, such as marketing, firm or practice group management, and mentoring junior lawyers.

When the numbers are inverted, so that partners are producing more billable hours on average than their associates, the firm is usually suffering from the overproductive partner syndrome. Although they are undoubtedly working hard and bringing in fees, overproductive partners are not using their time for the best long-term benefit of the firm.

What is the best use of a partner's time? Research and observations by Walker Clark, LLC, in law firms worldwide support the proposition that for every hour a partner invests in developing new business from existing clients, the firm can expect to gain an average of between 10 and 16 hours of new work.

For example, if a partner who personally bills 1,500 hours per year can delegate 10% of those hours to an associate and devote the time saved to business development from existing clients, this can produce at least another 1,500 hours of new work for the firm.

To manage the subtle risks posed by the overproductive partner, some firms have

expanded the concept of billable hours for partners to a more inclusive standard of 'revenue generation hours,' which also includes time spent on marketing and business development.

For example, a partner is required to produce 1,500 revenue generation hours each year, of which at least 1,200 must be billable hours and at least 200 must be devoted to approved marketing and business development activities. The remaining 100 hours may be devoted to either type of revenue generating activity, at the partner's discretion. These goals are frequently documented in an individual business plan for each partner.

Some firms also set targets for the number of billable hours delegated to associates.

Flogging associates seldom works.

The key to improving productivity is held by the partners, not the associates. A successful productivity strategy involves more than just working harder. Partners need to work more intelligently, with improved awareness of how work flows through all levels of the firm, and with greater concern for long-term financial performance than for short-term results.

This is not all about numbers, however. Clear standards for individual productivity and contribution to the firm are critically important. They should take into account the realities of the firm's market and client base, as well as the realistic limits of the partners' financial expectations.

Equally important, the partners must pay attention to the balance between business necessities and respect for the personal and family lives of everyone in the firm.

Regardless of standards and strategies, the most important factors in individual and group productivity professional services firms are the climate and culture in which people must work. These are

the factors that power strategies and inspire people to achieve challenging goals.

Driver 3: realization ***Stop leaking cash!***

Realization describes how much of a firm's labor is realized in the form of cash. Does every hour of billable work ultimately result in an hour's worth of fees? Whether a firm uses fixed fees, hourly rates or some other basis for billing, the concept of realization recognizes the old maxim that "a lawyer's stock-in-trade is his or her time."

Realization is a strong profitability force in firms that bill mostly on an hourly rate; but it can also apply to fixed-fee billing, especially if the fees paid do not fully cover the value of the fee earners' time.

There are actually three distinct realization rates. Each one points to a critical spot in the work and billing cycle at which a firm can lose significant amounts of money that it has already earned.

No firm can ever achieve perfect realization; but integrated management of these three measurements can help a firm make dramatic improvements in overall profitability.

1. Recording realization: *What percentage of billable work is actually recorded?*

This is the hardest realization rate to calculate accurately because there are usually no records of unrecorded work. Interviews of law firm associates in some firms, however, reveal that roughly 10% to 15% of billable work they perform is never recorded.

The most frequent reasons are: "I assumed that the client would not pay for this work;" and, in a distant second place, "I forgot."

Forgetfulness and delay work together in nasty ways. There is a strong correlation between timeliness and accurate time recording. The longer a fee earner waits before recording billable work, the less accurate the recorded time will be. In most cases, tardy time recorders err on the side of underestimating the time they actually spent.

When Walker Clark, LLC, has tried to measure it, this leakage typically runs between 3% and 10% per day of delay. Lawyers who work on many different files during a day tend to have the highest leakage rates. Those who work on only two or three matters during the day are usually more accurate, closer to 3%, but still not perfect.

Consider this model. Assume that an associate performs an average of six billable hours per day at a rate of \$100. The associate typically works on a significant number of different files each day and occasionally handles substantive telephone calls from clients. She typically does not record time until the next day. Even conservatively estimating only a 3% loss, unrealized billable time would be 0.18 hours per day, with a value of \$18. If the associate works 220 days per year, the total loss for the year becomes 39.6 billable hours, with a total value of \$3,960.

What if the associate works in a firm where colleagues also fail to record work the same day it is performed? Even in a firm with only five associates, the loss in potential billing value, due solely to delay and forgetfulness, will be \$19,800. If the firm has three partners, each of them could suffer an average loss of \$6,600 in potential profits.

This model assumes a 'next day' culture. What if the habit among the firm's associates is not to record work until the end of the week? The overall loss will be even greater, since the leakage rate of 3% compounds itself over time.

2. **Billing realization:** *What percentage of recorded work is actually billed?*

Pre-billing write-offs and write-downs typically reduce realization by 5% to 15%. Some practice areas, such as bankruptcy and employment law, seem to have lower billing realization rates than others.

When asked why they write off recorded hours before they are billed, partners give the same response as their associates: "The client will not pay." However, most partners admit that they have seldom confirmed this assumption with the client.

There is a strong relationship between unbilled work in progress (WIP) and billing realization. Law firm partners are more likely to write off or write down old unbilled work than recent WIP.

3. **Collection realization:** *What percentage of billed work is actually paid?*

Misunderstandings about fees and bills happen, even in the best-managed law firms and with the most loyal, promptly-paying clients. For firms that bill on an hourly basis, a collection realization rate above 95% is considered excellent. Ninety percent is more typical.

When multiplied against each other, the three realization rates can cut deeply into profits.

Consider the typical realization rates for a reasonably well-managed law firm of diligent, attentive fee-earners: a 90% recording realization, combined with a 90% billing realization, combined with a 90% collection realization. None of these rates is bad by itself, but they combine (90% x 90% x 90%) to produce an overall realization of 78%.

This is why recording realization, which is unknown in most law firms, is so important to overall profitability. A firm may have excellent billing and collection realization rates of 98% each. However, if only 80% of all billable work is actually

recorded, the overall realization is actually worse (76.8%) than in the firm with consistent rates of 90% in all three realization categories.

For a law firm with an annual fee turnover of \$10 million and an overall realization rate of 78% (90% x 90% x 90%), closing only half of this realization gap will produce \$1.1 million in additional revenue. This usually requires no additional investment other than a commitment to greater diligence in billing WIP and collecting fees.

Any improvement in realization produces almost pure profit. It does not require a 'get tough' collections effort against slow-paying clients. Instead, most of the keys to improved realization can be found in the inner workings of the firm.

Law firms with high realization rates above 95% display several best practices in managing this high-yield aspect of profitability.

- ➔ **All potentially billable work is recorded the same day that it is performed.**

Associates and junior fee earners do not make assumptions about what work will or will not get paid by the client. Moreover, these firms have a culture of promptness. The day's work is not done until the time sheets are in.

- ➔ **The firm has clear guidelines governing write-offs and write-downs by partners.**

Only the billing partner may write off or write down recorded time. Except for correcting obvious errors, the amount of work that a partner may write off or write down is limited. Some firms limit the percentage of the total bill that the partner may adjust. Others limit the value of the work being removed from the bill. Major write-offs or write-downs may require the agreement of a second partner or

approval by a practice group head or managing partner.

These guidelines are not just important for ensuring consistency among partners. They also enable management to know exactly the amount of potential revenue being withdrawn from the invoice, the nature of the work involved, and the reasons for the action.

- ➔ **Every partner is responsible for monitoring the WIP and accounts-receivable that he or she manages**

Prompt billing of work is the individual responsibility of the partner managing the matter, not the accounting department, practice group leader or managing partner. Likewise, the primary responsibility for prompt collections rests with the partner, not a clerk or bookkeeper in the back office.

Firms that successfully manage realization rates to levels above 95% have a culture of individual partner accountability. Partners are required to monitor WIP and to explain why unbilled WIP has built up beyond acceptable limits. They are required to brief the managing partner, an accounts-receivable committee or their fellow partners concerning their efforts to collect overdue bills.

In extreme cases, a firm might even reduce or withhold a partner's draw or advance profits distribution pending resolution of WIP and accounts-receivable problems. Interestingly, these sanctions almost never need to be used in firms that stress the partner's individual ongoing responsibilities for billing WIP and collecting bills.

- ➔ **The firm works to reduce the reasons for fee disputes**

Law firms that succeed at realization management understand that time records are more than the raw data for

invoices. They also use time records as documentation of how the firm works.

Close attention and ongoing analysis of time records can actually reduce fee disputes. They can quickly and reliably identify and quantify causes of fee disputes that arise from inefficiencies or inadequate quality assurance within the law firm.

For example, instead of simply assuming “we spent more time on this task than the client will accept as reasonable,” the firm confirms its assumptions through a proactive inquiry into the nature of the work and the factors that can contribute to it taking longer than expected. If a particular task often takes substantially longer than expected, this alerts the firm’s management to a need to investigate further for possible internal problems such as work distribution practices, quality assurance or fee earner skill levels.

The best way for a law firm to reduce write-offs due to fee disputes is to eliminate the causes that are within the firm’s control. Addressing these issues costs only a fraction of the amount that the client refuses to pay.

What would another 10% -- even another 5% -- in revenue add to your firm’s profitability? What would it mean to be able to achieve that increase at little or no additional cost -- as pure profit? For most law firms that amount is already there, waiting to be picked up through better management of realization.

Driver 4: cost management
The Seven Deadly Sins of cost management

The temptation to slash costs

Throughout the fiscal year, but especially toward its end, law firm managers are attracted to last-minute, often dramatic,

cost cutting crusades as a quick way to improve profitability and increase the year-end distributions to partners. Some cost savings can be accomplished overnight. Most revenue increases take months.

The temptation can be almost irresistible.

Moreover, the most attractive opportunities to save money are usually close at hand, inside the firm. You don’t have to alienate clients with higher fees or annoy partners by demanding that they bill more hours and collect more bills.

Poorly thought-out cost management can produce quick results, but can also make things much worse. There is an almost infinite number of ways to mismanage costs in a law firm; but seven common mistakes seem to be particularly dangerous for small and midsize law firms. Sometimes the best cost management strategy is not some clever innovation, but merely a matter of avoiding these seven deadly sins.

Sin #1: not knowing what it costs to produce a legal service

Fully-loaded operating cost per lawyer hour (FLOC) is one of the most important but underused financial measurements available to a law firm. It provides data concerning the question that most law firm partners are unable to answer: What is the true cost of the production of a legal product or service?.

Here is the formula and an example from a 20-lawyer firm:

1. Calculate the firm’s total operating costs (including salaries and cash benefits) for the entire year.
Example: \$3,000,000
2. Divide this total by the total number of hours billed by lawyers during the year. Example: 30,000

3. The result is the fully-loaded operating cost per lawyer hour. Example: \$100 per lawyer hour.

The result is a reasonably accurate, workable estimate of what it costs the firm to produce one hour of legal services. This measurement can also be applied at the practice group level to take into account the varying economic dynamics of different practice specialties and the specific client sectors each serves.

For example, a FLOC estimate can use actual compensation data for individual lawyers or levels of lawyers in the firm to refine the minimum profitable fee with even greater precision. This can be especially useful when trying to calculate whether it makes financial sense to delegate work to a junior fee earner.

FLOC is a simple concept; but a surprising number of small and midsize law firms have never heard of it. Instead, they use guesswork and wishful thinking to propose a fee that they hope will be competitive and profitable. This is the leading reason why law firms lose money on fixed fee work and slash hourly rates to unprofitable levels.

Sin #2: over-investment in multiple offices

Except for lawyer and staff compensation, facilities costs are the biggest single cost item for most law firms. These costs are usually higher, as a percentage of fee revenue, in firms with multiple offices.

Multiple offices can nudge upward a wide range of items in fully-loaded operating cost, such as support staff requirements and equipment. Overall the fully-loaded operating cost per lawyer in multiple-office firms is approximately 10% higher than in single firms. As some Latin American firms learned when they opened offices in London, New York, or Miami, this premium can be even higher in some locations.

One of the worst mistakes that a law firm can make is to open a new branch office without a convincing business case for doing so. Before investing in bricks, mortar, and full-time staff in a new location, the firm should investigate starting with a virtual office or serviced space in a business centre. These new office models can reduce facilities costs by as much as 90%, while giving the firm a prestige address in a desirable market.

Sin #3: marketing to the wrong people

Where does your firm spend its marketing money? Are you chasing clients or fees? Many law firms aim most of their marketing expenditures in the wrong direction.

In most small and midsize commercial law firms, approximately 20% of the clients generate 80% of the fees. In smaller law firms, this “20-80 rule” might actually be closer to 10% of the clients producing 90% of the fees. Firms that deliver relatively standard, high-volume legal services to a large number of clients sometimes have a correlation of clients to fees that is closer to “40-60.” On balance, however, a “20-80” correlation, or something close to it, describes the financial performance of most commercial firms’ client bases worldwide.

Nonetheless, a firm may spend up to 80% of their marketing budget to reach clients who will produce only 20% of the fee revenue. These targets are typically smaller businesses and individuals who will pay relatively small fees or provide only one-time engagements. Firms that concentrate their marketing budget and efforts on existing or recent clients at the top of the “client pyramid” – the 20% who produce 80% of the money – almost always realize a much higher return on their marketing investment.

Money spent marketing to small clients with little realistic potential for bigger fees is usually money that is wasted.

Sin #4: failing to keep up with technology

The economics of law firm technology have changed dramatically since 1995; but many firms are a decade behind in how they manage technology costs.

Leasing computer equipment and software is now less expensive for most small and midsize firms than purchasing it. Even if a firm elects to own its equipment, the partners must resist the temptation to shave costs by postponing upgrades and replacements. When computers start to break down and software begins to fail, the overall costs in lost productivity and higher unplanned replacement costs almost always surpass the short-term savings.

Sin #5: not investing in retention

“Who cares?” is an expensive, wasteful response when someone leaves your firm. When an associate leaves the firm, the total resulting costs – including recruiting, lost fee earning capabilities, and replacement costs – can easily equal six months of the departed person’s compensation. Staff departures can also produce significant expenses in terms of overtime, temporary staffing, and replacement training.

Firms with high staff turnover rates suffer an additional unexpected and usually unmeasured cost. Departures can create an avalanche effect. For example, secretaries who are already unhappy with their working conditions will not be happier when they have to do additional work to cover for their departed coworkers.

Sin #6: ignoring partner performance issues

Unsatisfactory partner performance is a critical cost management issue that too many firms ignore.

Few law firms can afford to carry an unproductive partner at his or her traditional level of remuneration for very long. At the same time, most law firm partnerships understandably dread the prospect of having to impose sanctions such as substantial reduction in remuneration, de-equitizing the partner, or asking the partner to leave the firm. So they often wait until substandard partner performance has become a profitability crisis before they address the issue. In smaller firms, especially, one or two unproductive partners can pull an entire practice group from profit to loss.

It is never comfortable to confront a partner whose performance has declined, especially if the partner is a well-respected senior member of the firm. The matter must be addressed objectively, candidly, but humanely. In many cases, counseling, coaching, and a resetting of the partner’s goals and responsibilities can help the partner to return to making a profitable contribution to the firm.

This will usually require skilled outside assistance to do this correctly. Attempting to do it yourself almost always makes it worse.

There is no cheap solution to the problem of declining partner performance; but the most expensive approach is to do nothing at all.

Sin #7: slashing costs without managing risks

This could be the deadliest cost-management sin of all.

Any significant cost-cutting measure must take into account the probable long-term results of the decision. Many firms develop well-informed, carefully thought-out business plans to manage expansions; but very few apply the same

intellectual rigor and business prudence to cost reductions.

Consider this case study.

A 25-lawyer law firm decided to boost year-end profits by more than \$500,000 by firing 15 junior clerical staff. Most of these worked in the firm's high-volume collections and trademarks registration practices. The firm's ten partners were delighted to pocket an extra \$50,000 each, even the two who supervised the collections and trademarks departments.

The staff cutbacks created a minor "avalanche," as five more senior staff also departed the collections and trademarks practice within the first four months. The firm did not conduct exit interviews, but rumors attributed the departures to a fear that "the ship was sinking." These senior staff were essential and had to be replaced, with overtime, temporary staffing, and replacement costs totaling more than \$60,000. This was an unexpected and unbudgeted cost.

The collections and trademarks departments tried to work more efficiently with fewer staff. The overworked "survivors" had to work faster and longer as they struggled to handle the work left behind by their fired coworkers. Despite these efforts, processing times for client matters and response times to client inquiries began to grow steadily. The two practices also experienced an average increase of 20% in recorded time arising from the need to correct an increasing number of errors. Of course, this rework could not be billed, as the clients would have justly refused to pay for it.

The clients began to notice that something was wrong. Client dissatisfaction and fee disputes increased sharply approximately four months after the cutbacks. By the end of the fiscal year, the firm had lost \$1,000,000 in potential fees; and fee disputes had increased the average fee payment time

for the two departments from 58 days to 147 days.

The staff cutbacks had other impacts. Absenteeism increased in the two departments, resulting in more than \$20,000 in overtime and another \$35,000 in temporary staffing costs in the first year alone. These costs were unplanned and unbudgeted.

The firm "saved" \$500,000, but its failure to anticipate and manage the risks of its cost-management scheme cost the firm more than \$1.1 million, for a net loss of more than \$600,000. This does not include the intangible negative value of the long-term damage to the firm's reputation among collections and trademarks clients, declining staff morale, and increased potential losses due to fee disputes. The partner who manages the trademarks practice is rumored to be in negotiations to join the firm's arch-rival.

Prune, don't slash and burn.

Dramatic cost reductions get people's attention and can produce short-term improvements in profitability. These gains can be wiped out, however, by failing to anticipate the long-term consequences.

Although not nearly as dramatic, a careful analysis of the benefits and long-term impacts can lead to more subtle, but potentially more rewarding, opportunities to improve profits by improving the way we manage costs.

Driver 5: staff compensation
It's about much more than much more money.

Remuneration of salaried professionals is the largest item in most law firms' operating budgets. This expense typically consumes between 40% and 60% of a firm's total revenue, depending on the location, size, and practice specialties.

In most businesses, one of the best ways to improve long-term profitability is to invest in extra production capacity – in other words, to hire more workers. But law firms that follow this strategy are often disappointed by the results. They pay ever-increasing salaries to attract more associates and to keep them; but partners do not see an equivalent return in terms of increased profits.

As one partner in a Mexican firm said, “We are throwing money into a bottomless pit.”

Associate compensation is usually the most poorly managed element of law firm profitability. In some firms, partners have simply given up. They believe that associates’ financial expectations will continue to rise, and that partners’ expectations should diminish as profit distributions grow more slowly or even stagnate.

One partner in a Brazilian law firm recently commented, “Whether we like it or not, these young lawyers are changing the legal profession and will make it less profitable than before.”

This assessment is half correct. While it is true that the legal profession is changing, the changes do not have to be at the expense of continued profitability.

The changing face of law firms

Law firms *are* changing, especially in the fast developing legal markets in emerging economies.

In 2004, Walker Clark, LLC, conducted a demographic study of 240 large and midsize law firms in Latin America, employing a total of more than 5,000 lawyers. It revealed that Latin American law firms are getting younger and more junior in terms of experience.

- ➔ Half of the lawyers in Latin American law firms are 35 years old or younger, as record numbers of university graduates enter the profession. The

‘youngest’ law firms are in Brazil, where the median age was 32.

- ➔ Half of the lawyers in the region have nine years or less experience since qualification. The ‘least experienced’ law firms were in Brazil, with a median of six years experience post-qualification. This has been caused, in part, by the rapid growth of many firms at associate level.

These dramatic changes have been major factors in the profitability challenge presented by associate compensation. Most Latin American law firms are well-leveraged, with partner to fee-earner ratios frequently reaching 6:1 or higher, even in smaller firms. This is in contrast to ratios of approximately 1:1 for firms in the United States and roughly 1:2 in Europe.

Latin America’s experience has been replicated to greater or lesser extent in every emerging legal market in the world. Law firms are becoming younger, more female, and more dependent on associates than ever before.

It is not surprising, therefore, that law firms are confronted by a large bloc of people within their ranks expecting more money than ever before. It looks likely that this trend will continue for at least the next five to ten years.

What do associates *really* want?

It is not about money.

Over the past ten years, Walker Clark members have conducted focus groups, interviews, and informal discussions on the subject of career expectations with more than a thousand associates in law firms throughout the world. The message is consistent: Compensation is not the most important reason associates choose and stay with a law firm. In some groups, it was not even mentioned.

Three other factors are always found at the top of the list, although not always in this order:

➔ **An opportunity to acquire and practice legal knowledge and skills**

Associates want to learn their new profession. They expect greater responsibility and more challenging work as they gain experience with the firm. The prospect of merely grinding out billable work, day in and day out for five, six, or seven years is not an attractive prospect.

➔ **An opportunity to work closely with a partner/mentor**

Associates believe that the best way to learn is through a close professional relationship with a partner or other senior lawyer. They are frequently disappointed by law firms that pay only lip service to mentoring.

➔ **Career paths, options and goals**

Associates want to know what they must do to succeed in the firm. Does success mean only eventual admission to partnership, or can it also include a well-paid, satisfying role as a senior non-partner? Young lawyers are attracted to firms offering a career plan that documents the requirements, options, and guidance needed for a young lawyer to manage advancement in the firm. They also value having agreed, realistic performance goals by which they can measure their progress in the firm.

This does not mean that money is unimportant. However, the research suggests that associates will accept a lower salary than they could earn at another firm, providing their firm delivers the professional development, career management opportunities and supportive work environment that they value more.

But this does not mean that firms can get away with paying associates

uncompetitive salaries. When associates' salaries drop below the median in the market for lawyers with similar credentials and experience, they are at serious risk of being recruited away from the firm, despite the attractive non-monetary benefits that they currently enjoy.

This research suggests a good starting point for developing an associate compensation strategy: Pay at or above the median, but invest more in professional development opportunities.

Overpaid or under-managed?

Are your associates paid too much or are they producing too little?

Many law firms cannot answer this question. They do not measure the total economic contribution and profitability of each associate. Their associates may or may not be overpaid, but they are certainly under-managed.

The first step in managing associates better is to measure their profitability. This should not be used as a whip to drive associates to work harder. Instead, it is best utilized as a diagnostic device.

Most associates work under the close supervision of a partner or other senior lawyer. Low profitability is usually caused by a deficit in skills or professional supervision, not laziness. It is frequently accompanied by an unsatisfied desire for professional development. It can often be remedied by offering the associate training in basic business skills, or ensuring the partner provides better supervision. Such weaknesses usually affect most associates to some extent, not just the one.

The second step in better financial management of associates is to have agreed performance goals. In many firms, the only goal that an associate has is: "Do the work my partner gives to me, as best as I can." By contrast, law firms that manage associate profitability

regularly measure their performance against a set of individual goals. Each one is specific, measurable, agreed, realistic, and time-related, and each is ultimately linked to the firm's business plan.

To be meaningful, performance goals must be supported by ongoing feedback by a partner or senior lawyer, along with formal periodic evaluation and incentives. For this reason, firms that have a strong system of performance goals also have partners who regard mentoring and professional development as one of their most important duties.

Climbing out of the bottomless pit

When one is in a hole, the first thing to do is to stop digging.

Rather than continue to throw money at associates and hope to keep them, many law firms need to reverse their thinking and begin to treat associates as the firm's most important strategic asset.

Each associate in the firm should be a profit centre, rather than a cost centre. Each should produce a profit for the firm by earning more in fees than he or she consumes in salary and overhead costs. Senior associates should also contribute by bringing new clients to the firm and winning new work from existing clients.

Like any other strategic asset, associates must also be viewed as an investment – not a liability – and partners can expect a positive return on that investment. Like all investments, this requires attention to performance, intervention when performance does not meet expectations, and support to protect the investment through better mentoring and professional development.

Better management – not just more money – will produce the short-term profitability that partners have a right to expect. It will also provide the best long-term return, in the form of a cadre of

lawyers who will be prepared, when the time comes, to assume leadership of the firm and take it into the future.

Driver 6: leverage *Moving the world*

"Give me a place to stand and with a lever and I will move the whole world."

Archimedes
(287-c. 211 BCE)

Archimedes probably never realized that he was describing one of the most important factors in law firm profitability: leverage.

An well-leveraged firm can, indeed, move a whole world. More than any other single factor, leverage can explain why some small and midsize law firms can produce profits per partner that surpass those of much larger competitors.

Despite its power, leverage is the most frequently overlooked profitability driver. Although many partners intellectually understand the concept of leverage, most do not know how to manage it.

The powerful nuances that define the partner-associate relationship in law firms add complexities not found in many other businesses. Moreover, some clients distrust leverage, viewing it as a ploy to dump their important legal work on less-competent associates.

How can law firms measure their ability to move the world? There are two types of leverage that are easy to measure, but critical to long-term profitability.

Staffing leverage

Staffing leverage is a straightforward measurement. What is the ratio of associates to partners? Some firms will include in recent law graduates who have not yet qualified as lawyers in the associates group. Firms sometimes also

include lawyers “of counsel” in the partners group.

Law firm leverage varies widely by region and practice specialty. Overall, small and midsize law firms tend to be much more highly leveraged in Latin America than are law firms in North America, for example. It is not unusual to find Latin American law firms with staffing leverages of 4-to-1 or 5-to-1. This is a common phenomenon in fast-growing legal markets, where most of the growth in law firm size takes place in the associate ranks, while partnerships grow more slowly from the founding family or founding partners.

Law firms in the United Kingdom vary widely in their staffing leverage, but most seem to be in or near the range of 2-to-1 to 3-to-1.

By contrast, staffing leverage above 2-to-1 is very rare in U.S. law firms, except for large firms and some firms that specialize in high-volume cases and matters. Overall, the average staffing leverage in the U.S. is significantly less than 1-to-1, especially among smaller firms, where it is often as low as 0.4 – to-1. In other words, the typical American law firm, of whatever size, tends to be top-heavy, with more partners than associates.

Staffing leverage can also vary widely according to practice area. High-volume practices such as intellectual property and some litigation specialties are more highly leveraged, with staffing leverage sometimes exceeding 6-to-1. Highly specialized practice areas, especially in the corporate law sector, tend to be more partner-intensive due to the more sophisticated nature of the work. A lower staffing leverage, in the range of 1-to-1 or 2-to-one, is more common.

With staffing leverage ranging from negative numbers in the United States to very strong ratios in Latin America, as well as varying widely among practice

areas, what is the ideal staffing leverage for your firm?

The partner’s time is the fulcrum that gives leverage its great force. There are two questions that can help you evaluate whether your firm is adequately leveraged.

1. Do you have enough people so that a partner could delegate 60% to 80% of his or her work to an associate or other fee earner?

One of the major reasons why partners in small and midsize firms do not delegate work, especially in the United States, is that there is nobody to do the work.

2. Can your partners spend 10% to 20% of their available time in marketing and business development? In most practices, the best use of a partner’s time is in marketing, not billable work.

Staffing leverage is only one part of the formula. Are high staffing leverage ratios being used to their full potential? This requires an investigation of a second, and frequently overlooked leverage measurement.

Workflow leverage

Is your law firm like this?

- By six o’clock all of the associates have gone home; but the partners are still working in their offices at eight or later.
- Partners each bill an average of 1,400 or 1,500 hours per year; but the average associate barely breaks through the 1,100 mark.
- Associates complain that they do not have enough work.

These are signs of inadequate workflow leverage. There may be associates to whom work can be delegated, but the work never gets to them.

Workflow leverage measures the amount of work that partners delegate to non-partners, whether associates, trainees, or other non-lawyer fee earners. One simple way to do this is to compare how many hours work in a matter are delegated by the partner to how many hours of the work the partner performs personally.

A workflow leverage of 5-to-1 is strong in most practice areas. In other words, for every one hour of billable work that a partner supervises in a matter he or she delegates five hours in that matter to non-partner fee earners. Higher volume practices may have even higher workflow leverage --- 8-to-1 or 9-to-1 – especially if the firm relies heavily on non-lawyer fee earners to perform functions that, in other firms, might be performed by associates.

If leverage is a forgotten factor in profitability in most law firms, workflow leverage is its most deeply hidden aspect. Some firms believe that they need only to hire more associates. This will improve staffing leverage, but it will not improve profitability unless more work is flowing through the delegation pipeline from partners to associates. In fact, simply hiring more lawyers without improving delegation will often worsen profitability.

If your firm has good staffing leverage but you are still disappointed by your profits, you should investigate whether your firm has adequate workflow leverage.

Consider these three questions:

1. Are partners doing legal work that could be done just as competently by associates?

Partners often keep work, rather than delegate it, because they underestimate the knowledge and skills of their associates.

2. When partners delegate work, do they provide adequate guidance to associates?

Giving work to associates without specific instructions about what is expected from them is abdication, not delegation. Poor communication of the partner's expectations and standards is the most frequent reason why delegated work is not done correctly the first time. When errors arise, the firm invests substantial unbillable time – usually at the partner level – to correct problems that should have been avoided.

3. What does quality assurance mean in your firm?

After-the-fact inspection of an associate's work product is still the most common method of quality assurance in most law firms. It is also one of the most unreliable and expensive methods.

Rather than send work back to an associate to correct – or, even worse, having the partner correct the work – the firm should try to identify and eliminate the causes of the errors. Clients will seldom pay a law firm to fix mistakes that it should have avoided in the first place. They often will pay for the minimal additional time needed to ensure quality.

Three keys to successful leverage

Improved leverage can produce clear, measurable improvements in productivity, reduced overhead, and long-term, sustained growth in profits per partner. There is no minimum size that a law firm must be before it can take advantage of leverage as a profitability tool. Even a solo practitioner should consider whether he or she could improve the business performance of the practice by finding another lawyer or fee earner to share the work.

Each firm must take its own unique approach to the leverage issues; but there are two values that can be observed in law firms that manage leverage well:

1. The best use of a partner's time is not always fee earning.

One of the most important goals of leverage is to free partner hours for activities that will produce an even greater return per hour invested than will most billable work. Marketing and business development activities, especially with existing clients, can produce new fees far greater than the fee that the partner would have earned had he or she spent that time doing billable work.

Professional supervision of delegated work and professional development and mentoring of associates will also produce disproportionately large, long-term benefits. This is why the core goal of leverage must be to free partner time for more profitable activities.

This new view of the value of a partner's time is part of the culture in firms that manage leverage successfully. Partners are rewarded for using the firm's staffing leverage to produce the greatest possible workflow leverage. They understand that the old excuse, "I can do the work better and faster myself" is actually one of the least profitable ways to practice law. They also demonstrate to clients who insist on "partner only" service how delegation can deliver equal quality to the client at a lower cost.

2. Leverage does not work without quality assurance.

Delegating work without clear quality standards and procedures can sometimes be worse than not delegating work at all. Firms that manage workflow leverage well have comprehensive quality assurance systems to eliminate the causes of errors and to minimize rework.

Establishing a quality assurance system is relatively simple. Some practice groups have been able to develop and document very successful quality assurance protocols in less than a day -- even though they had no previous experience with quality control or professional risk management tools and

methods. All that is required is a detailed understanding of the functions and tasks that go into delivering a legal service to a client, supplemented by a little bit of imagination about what could go wrong.

There are five essential questions that need to be considered:

- 👤 What are the major tasks or steps in the production and delivery of a particular legal service to the client?
- 👤 Which ones pose the greatest risk of mistake or error?
- 👤 What knowledge and skills does a fee earner need to be able to avoid these risks?
- 👤 What supervision and consultation should the partner provide in order to avoid the risks?
- 👤 How should that supervision and consultation be documented?

Quality assurance improves the probability that delegated work will be done correctly the first time and every time. It also reduces the supervisory time that partners must devote by providing documented, efficient procedures that everyone understands and can observe.

3. Our best long-term investment is in the development of our associates.

Some partners have good reason to worry about whether associates will be able to handle delegated work, especially functions that formerly only the partner performed. Most law firms do not invest enough in developing the knowledge and skills that associates need to assume greater responsibilities and eventually become a partner.

Professional development is more than just investing in the future. There is a short-term payoff: increased confidence. The associate develops increased confidence that he or she can do the work competently and -- even more importantly

– that he or she will know when to ask for help. The partner becomes confident that the associate can meet his or her expectations and the client’s needs.

Looking for the fulcrum

Perhaps Archimedes couldn’t actually move the world with his lever and fulcrum. However, law firms can substantially move their profitability forward with a fulcrum forged from three elements.

The first element is a better understanding of the best value of a partner’s time.

The second component is a reliable system for quality assurance, based on the work itself.

The third ingredient is commitment, a long-term and ongoing investment in the knowledge and skills that associates need to assume someday the leadership and stewardship of the firm.

***Building a unique
profitability strategy for
your law firm***

In some firms, profitability is most greatly influenced by the three drivers that produce revenue: fee levels, productivity, and realization. For example, an established law firm that has enjoyed a relatively stable client base and a mature legal market might find that profits have nonetheless declined as a result of fees that haven’t kept pace with market expectations, declining productivity especially among associates, gradually falling realization rates, or a combination of these factors. In other firms, cost-related factors may be at the root of disappointing profits, due to unwise cost management, overpaid and under-managed associates, or poor leverage.

Changing competition and client expectations can define and limit the

opportunities available to improve profitability. For example, if a firm is working hard but trapped in a price war, it might not be practical to raise fees or increase billable hours. The firm might have to look for ways to improve realization and leverage, instead.

This is why “textbook solutions” or generic “best practices” usually fail to address the practical challenges of improving profitability.

Instead, a successful profitability strategy must be the result of an intensely firm-specific investigation and integration of all six factors. Every law firm truly is unique; and the best path to sustained profitability is the one that best reflects the needs and expectations of the firm’s clients, the dynamics of the market in which it competes, and its unique professional culture and business values of its owners.