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The Risk of Idolizing False Profits

This course will outline how modern law firm leaders are adapting to the changing times to become healthy, client-focused businesses.



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1 Hour

CLM® Recertification Credit:

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COURSE DESCRIPTION

In days past, providing quality legal services was not only the best marketing tactic — it was a can't-miss opportunity to earn a handsome living. By contrast, the delivery of legal services today requires an astute understanding of finance and economics, pricing acumen, a marketing and business development mindset, and a deep understanding of market needs. In this CE course, we'll link these concepts together as we discuss how modern law firm leaders are adapting to the changing times to build strong, successful, client-focused businesses.

COURSE OBJECTIVES

- Describe the most critical aspect of a partner compensation plan.
- Examine new ways to measure profit and calculate profitability.
- Recognize assumptions embedded in the analysis of timekeeper and matter profitability.
- Analyze how to be strategic when pricing legal services.
- Identify the aspects of a multistage approach to incorporating and adopting profit.

The modern law firm leader must understand and then embrace measures of profit in order to thrive. The marketplace in which law firms operate has long been considered sheltered — if not immune — from economic market forces. But longtime barriers to entry have

come down, buyers of legal services have become far more sophisticated in their analysis and selection of providers, and globalization and technology have disrupted traditional operating models.

For many lawyers, like many professionals, an open discussion of the pursuit of profit can appear unseemly. Of course, there is potentially significant value in providing competent legal counsel to those in need, such as to a small business owner in a contract dispute, or to a multinational corporation in the midst of a merger, or to an individual purchasing a new home. But many lawyers have considered profit to be an inevitable byproduct of a successfully managing a case or a file, and not itself the objective.

But as demand has shifted, and competition has increased for a dwindling share of lucrative legal services, law firm leaders have been forced to think differently. Today's law firm leaders understand that pursuing profit isn't unseemly — rather, it's a key way to ensure that the firm is providing quality legal services, at competitive market prices, to price-conscious buyers, and generating sufficient value to reward the lawyers engaged in the practice of law.

REDEFINING PROFIT

Many law firms have an unsophisticated approach to measuring profit, namely by adding up total cash receipts received during the fiscal year and then subtracting from this the costs to operate the firm. What remains is profit, and this is distributed in total to the equity partners, and the process repeats the following year. One problem with this aggregate approach is that it masks underperformance. It's not only possible, but likely, that the firm delivers some services at a significant loss, but so long as other services deliver a significant premium no one's the wiser. This is why profits per partner (PPP) is such an opaque metric for assessing the fiscal health of a law firm, or for comparing two law firms. The underlying performance is wholly unknown when everything is rolled up.

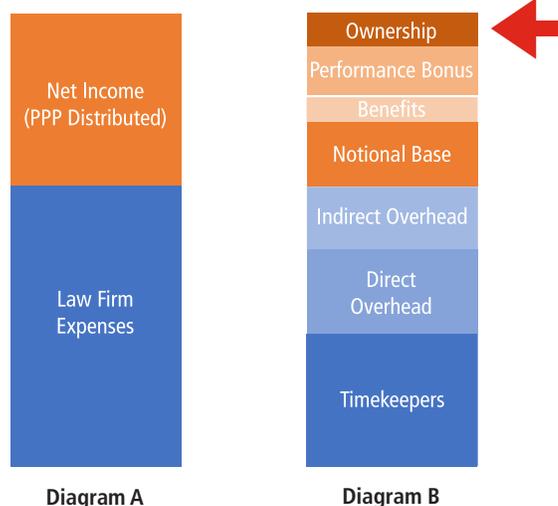
In a competitive marketplace, it's not only more sensible to know explicitly which services can be delivered profitably; it's often the best way to sustain a competitive advantage. It's also helpful to set prices and allocate resources based on an understanding of the underlying profit contributions of different practices, industries, offices and matter types. No, this doesn't mean that the most profitable work enjoys the most resources. In fact, mathematically speaking, doing so would impair profitability. Instead it means that firm leaders

would know better where to allocate resources in order to boost or maintain profits, rather than dole out resources as some reward for good performance. Done effectively, a low-rate but high-volume practice that some would starve of resources might benefit greatly from an investment in practice re-engineering, potentially delivering substantial profits (albeit at low margins).

Matters with declining margins due to price pressure might benefit from different staffing approaches. Matters with already high profits might earn a price increase, if analysis reveals high unmet market demand. In most law firms, different matters and even different practices operate across a spectrum of profitability. In other words, one-size-fits-all management solutions fit none.

To properly calculate profit, we must make a number of choices. The first is the level at which profit will be measured. As described above, aggregate organizational profit is a blunt instrument and wholly unhelpful to guide management decisions. Organizational profit is also, in many cases, calculated improperly or at least imprecisely.

In Diagram A below, we see the usual approach defining "profit," as characterized by what's left after operating expenses. In Diagram B, we see a more realistic reflection of partner compensation as a cost of business. From a practical standpoint, many law firms pay partners a notional salary or "draw" against future profit distributions. These draws, combined with budgeted performance bonuses and the cost of certain benefits provided to partners, functionally serve as operating expenses. As a result, the amount of remaining cash profits to be distributed to owners is much smaller, sometimes nonexistent.



According to Chris Johnson of *The American Lawyer*, “Big Law profitability is massively overstated and ... some firms generate virtually no profit at all.”

So, it's more useful to understand the profitability of a timekeeper and a matter. If we understand these, we can also calculate the profitability of a client, a practice, an office or an industry.

ASSUMPTION CONSUMPTION

There are a number of assumptions embedded in the analysis of timekeeper and matter profitability, and it cannot be overstated how critical they are to influencing and/or understanding the result. In most cases, there isn't a clear right or wrong approach, but absent a common understanding, the mismatched expectations will lead to unrest and unnecessary strife.

For example, does the firm measure performance on a cash or accrual basis? The latter is embraced by other business segments because it can provide a more robust understanding of profit contribution over time. How will the firm account for overhead expenses? Some mete out all costs in exhaustive detail; others ignore organizational costs that partners can't control. Do we assign lawyers based on capability and capacity, or does a busier lawyer get more assignments?

How we account for lawyer utilization can present a disproportionate, and quite possibly false, read on timekeeper profitability. Do we treat lawyers primarily engaged in rainmaking as more expensive than those primarily billing time — even when those billing time would otherwise be idle without the rainmakers?

The combination of these and related assumptions will produce different results, so it's important to understand the business purposes for which each calculation is most helpful. As firm information systems grow in sophistication, it's common for leaders to be presented with different dashboards depending on business purpose. Profit can be influenced and measured at multiple stages of the legal services delivery process, so it's important to provide analysis and decision support information in a way that's easily understood and digestible for the intended audience.

STRATEGIC PRICING (OR PRICING FOR PROFIT)

A key opportunity precipitated by a deeper understanding of profit is to be more strategic in pricing legal services. Traditionally, law firm pricing has been set from the inside

out, or by setting a price that covers the law firm's expenses and generates a healthy profit, often independent of what the market might be willing to pay. As clients have flexed their buying muscles, law firms have had to embrace what every other business segment long ago realized — value is defined by the buyer.

When sophisticated buyers of legal services know they can buy at half price and at greater quality than which they once purchased from a traditional law firm, the endgame for the law firm is either obsolescence or adaptation. But when adapting means lowering prices to meet market realities, this doesn't have to mean lower profits and smaller distributions for partners. By understanding what drives profitability, lawyers can re-engineer the work to make money even when revenue is flat or declining.

Law firm leaders must link pricing to profitability. Rather than maximizing hours, or even rate, the goal is to maximize profit. There are numerous levers available to partners to boost matter profitability, including staffing, technology and automation. Similarly, there are numerous ways to boost firm profitability, including high utilization, high realization, client retention and client penetration (aka cross-selling). The critical adjustment to the art of pricing is *knowing what the market is willing to pay for a service*. Without this knowledge, it's sheer luck when the price charged is roughly equivalent to the client's perceived value.

It's not uncommon to hear a smug senior partner boast, “My rates have never been challenged by a client.” It's also increasingly common for a sheepish partner to lament, “My client apparently doesn't care about quality; they just want lower rates.”

What these both have in common is a lack of understanding of market value. When a client has never complained about a price, it usually means the product is underpriced for the value delivered. When a client fixates solely on price, it usually means the product is overpriced for the value delivered. As we incorporate profitability metrics, we can shift away from a goal of selling as many hours as possible at the highest rates possible to a goal of maximizing profits — even if this means raising or lowering the price or spending more or less time delivering the work.

REWARDING PROFIT NOT PRODUCTION

A discussion of profitability is an interesting but futile academic discussion if the partners don't act accordingly to change their behavior. In many law firms, there's a clear recognition of

the importance of profits over hours, but there's no incentive to change focus. Partners continue to make choices that, unfortunately, pit the firm's long-term financial interests against their individual interests. It doesn't have to be that way.

Managing partners often exhort their partners to act in a "firm-first" manner, which is an acknowledgement that the partners have a choice. Instead of offering a choice of acting for or against the firm's interests, the choice for partners should be between maximizing one's compensation by furthering the firm's interests or limiting one's compensation by acting selfishly. The culture might not allow de-equitization or ouster of a partner who refuses to collaborate. However, the compensation plan can certainly withhold rewards for those who take more from the firm than they give. It's the responsibility of management to align what's good for the partner with what's good for the firm. Asking partners to find and then pursue this path on their own is simply poor management.

It's also important to note that not all partners are motivated by financial rewards. A compensation plan also serves as guiding principles for what it means to be an owner of the firm and it helps to manage expectations by linking rewards with actions. Modernizing a partner compensation plan can be time-consuming and cumbersome. Even when there's a clear vision of the end state, it might take a few years to implement because of the risk of disruption. Nevertheless, it's critical to incorporate measures of profit in partner compensation.

The most critical aspect of a partner compensation plan — and a goal that must be maintained throughout any adjustments to formulae, processes or dashboards — is transparency. Whether the plan is formulaic or subjective, open or closed, driven by an elected committee or by senior management, the most important goal is for the plan to provide clear guidance to partners as to what rewards will ensue when they engage in certain behaviors. The goal is not merely to reward profitable behavior, but to drive it.

This is not a task for the lighthearted, which is why so many law firm leaders avoid it. However, it's the role of management to align what's good for the partner with what's good for the partnership. Anything less just "kicks the can down the road" to the next management regime. In this case, it's probably better to accelerate the arrival of a new management team than to allow the firm to languish under an outdated compensation plan that often ignores profitability — and may even penalize it.

BUILDING A PROFIT CULTURE

Given law firms' longstanding focus on measures of production, it may take some time to build momentum to adopt measures of profitability. It's important to move thoughtfully in order to avoid significant disruption. With a hat tip to BigLaw Chief Financial Officer Madhav Srinivasan for offering insights based on his lengthy tenure in the profession, we suggest firms take a multistage approach to incorporating and adopting profit.

- 1. Measure.** Firm leaders will work through a variety of approaches for measuring profit, sometimes behind the scenes. While it's helpful to have a mandate from the partners, it's not necessary. Once a suitable model is ready, it's important to embrace change management principles to gain buy-in.
- 2. Monitor.** Once established, the profit measures are included in the firm's financial systems and reported, often in selected and targeted areas. Management provides targeted education to help understand how the profit measures can be used.
- 3. Manage.** As profit measures become more ingrained, management can shift to sharing deeper insight into the underlying drivers of profitability and providing training to help partners make better decisions.
- 4. Master.** At this stage, all partners have had intensive training and are expected to know and incorporate measures of profit into their decisions, e.g., pricing, staffing, etc. Where partners fall short, corrective action is taken.
- 5. Motivate.** Some partners will change behavior only when there are economic benefits or consequences in the compensation plan. For those not motivated solely by financial considerations, the compensation plan linked to the annual business planning process can serve as an excellent roadmap for incorporating more profitable actions.

THIS IS ONLY THE BEGINNING OF THE JOURNEY

As law firms develop more sophisticated approaches to measuring profit, it will become easier for law firm leaders to begin thinking differently. Rather than a one-time calculation, profit becomes a metric that can only be measured over time. Profit can also incorporate multiple independent variables that don't easily fit into today's simple models. Here are a few examples:

- Today's law firm measures and influences matter profitability by adjusting pricing and staffing to achieve

the optimal profit. Tomorrow's law firm will consider the high cost of client acquisition (aka selling, rainmaking) in its profit calculations and adjust pricing to win repeat engagements, forgoing some short-term profits to secure a more stable future.

- Today's law firm often treats timekeepers as a fungible commodity where the goal is to reach maximum utilization. Tomorrow's law firm acknowledges that an expert who can deliver a certain task flawlessly shifts over time from a competitive advantage to a competitive risk, i.e., when eventually no one else is capable of doing that work. As a result, tomorrow's law firm will consciously remove and rotate expertise periodically to diffuse risk and spread experience, even if doing so dilutes profitability in the short term.
- Today's law firm often treats process improvement as a necessary evil, because it can lead to billing fewer hours. Tomorrow's law firm marries process improvement with strategic pricing to proactively offer fixed fees for as many services as possible, thereby ensuring a profit even as the market demands lower pricing.

In the journey toward adopting a more modern sense of law firm profitability, there will be a number of roadblocks, detours, diversions and shiny things to capture your attention. Don't be dazzled by technology tools, crippled by recalcitrant partners, or awed by complexity. As with all successful journeys, it starts with a few simple steps in the right direction. We can't go backward, but we can learn the way from those who have made this trek before us. It's time to get started. ■

Rethinking Profitability, Partner Compensation and Pricing in a Changing Marketplace: Education Track

This course only touched on the nuances of tackling profitability in today's firm. To get more thorough instruction on profitability, join Timothy Corcoran at our Annual Conference & Expo in Grapevine, Texas. He'll be presenting three sessions about rethinking profitability, partner compensation and pricing. Register today at alanet.org/conf19.



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Timothy B. Corcoran is Principal of Corcoran Consulting Group, a Trustee and Fellow of the College of Law Practice Management, and was 2014 President of the International Legal Marketing Association. A former Chief Executive Officer, he advises law firm and law department leaders through the profitable disruption of outdated business models. Based in New York with a global client base, he authors *Corcoran's Business of Law* blog.

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