

SMOCK ♦ STERLING

Strategic Management Consultants

MAINTAINING AND EXPANDING PROFITABILITY WITHOUT RAISING RATES – LAW FIRM MANAGEMENT'S PRESSING CHALLENGE

Peter A. Giuliani
John S. Smock
John W. Sterling

Wow! What a trip! Late in 2007, we were looking at a 13,500 Dow, oil was over \$90 a barrel – on its way to \$140 – and the Fed was continuing to inch up interest rates in anticipation of rising prices. At the start of 2009, stocks have given up almost 40% of their value, oil is less than \$40 a barrel and Treasury yields are barely above zero. No longer are we worried about rising prices – it is deflation we fear. Our vocabulary now has a whole host of new terms – “*economic stimulus package*,” “*TARP*,” “*Detroit bail-out*” – as the Federal Government begins to take an unprecedented and dramatically expanded role in private industry.

Yet, there are those of us who believe – like the little boy in Ronald Reagan’s favorite joke – that, somewhere in this pile of horse manure, is a pony. Historically, times of dramatic change in social and economic institutions have produced plenty of work for lawyers. Such times have also produced opportunities for adaptable law firms to innovate in ways that make them stronger and more stable.

In our last monograph, *We Are Optimists – We See the Glass as Half Full*, we stated that “*profit growth – at least in the AmLaw 200 – has largely been driven by rate increases throughout this decade...but, the era of readily accepted rate increases well above the rate of inflation is now over for the foreseeable future.*” If that is the case, and we are convinced it is, now is the time for some really innovative thinking about and acting on managing firm profitability.

2009 – the Short Run

With hourly rates off the table, law firms need to focus on the other short-term profit drivers in 2009 – collections, hours, realization and expenses. Tightening up discipline and paying attention to “*business hygiene*” may or may not grow per-partner profits in 2009, but these tactics are essential to keep profits from eroding, while firms focus on innovative profit drivers for the long run.

As we continue to conduct city-by-city interviews with clients and friends of our firm, we have been told fairly consistently that firms – except in New York – have not yet seen an appreciable drop-off in the volume of work (some practices are clearly down – but, others are up or holding), but they have seen a noticeable slow-down in clients’ payment cycles. Clients, quite simply, are holding onto their cash longer because of the credit squeeze. In the pecking order of “*mission critical*” uses for cash, legal fees are generally viewed as being way down the list of priorities (i.e., law firms put little pressure on collections, so the path of least resistance holds sway). Thus, the first order of business has to be making sure the law firm’s billing processes are not allowing clients to unduly slow down payments.

This is particularly critical for firms whose clients demand electronic bills. Our observations show that a large percentage of electronic bills that are rejected or delayed in payment would have sailed through the electronic review process if there had been accurate and timely communication regarding billing protocols between the billing partner and the firm’s billing coordinator.

Since 2003, the AmLaw 200 firms have been growing at a rate of about 3.4% per year and that kind of “*organic*” growth requires steady earnings growth to finance it.

- In fact, we roughly estimate that it requires a first-year investment of more than \$200,000 to finance a newly-hired law school graduate, and that it takes at least another eighteen months for a firm to recoup that investment. We also estimate that it costs the average AmLaw 200 partner \$40,000 per year to finance a typical law school hiring program.
- During that same period (2003 through 2007), AmLaw 200 revenue per lawyer increased at an annual rate of 6.1% and profits per equity partner grew at 7.4% per year, even after financing 3.4% growth in number of lawyers. With lawyers working at or near “*practical capacity*” – about 2,200 billable hours per year – much of that marginal growth in RPL and PPEP was directly fueled by rate increases.

But now, without the ability to increase rates or charge premiums, the focus going forward has to be on productivity.

- That means taking pains to ensure that *the right associates have enough work* on their plates to stay busy and that *partners are not doing associate-level work at partner billing rates*.
- It also means slowing the rate of growth in the number of lawyers to free up working capital.

Fortunately, for most AmLaw 200 firms, the dizzying inflation in associate starting salaries has come or is about to come to an end. That said, growth – even at a modest 3.4% per year – takes a lot of foregone earnings to finance, especially if rates are capped.

As for expense control (the tried and true immediate response to earnings pressure), most firms will start by cutting back support staff. Next, will probably come a wholesale purge of second- and third-year associates, like we saw in the 1991-1992 recession. While these tactics may produce some marginal savings in 2009 and 2010, the long-term costs associated with rebuilding decimated staffs (e.g., search fees and capital investment to replace skill gaps in the ranks through lateral hiring) will probably quickly erase any short-term savings. Also, when support staffers are fired, they go away, but the demand for the tasks they were performing does not go away. All too often, younger lawyers end up taking on some of these tasks, which erodes their ability to keep busy on billable tasks.

So, what can a smart firm do in 2009 to maintain healthy earnings, in addition to hunkering down to ride out the economic storm? Here are the ten top short term things to carry out.

- If you haven't done so already, designate your own in-house collections specialists to get clients to pay and give them authority and responsibility to do so. Partners are notoriously bad about chasing down payments, because they do not want to risk upsetting the client. We are not talking about hiring an outside firm to handle hard-core receivables, but an in-house professional team that can start working on collecting accounts – as soon as they hit 60-days old. And, give your collections people wide latitude to set up payment schedules for intractable accounts. In this day of near-zero interest rates, a *de facto* financing plan is far better than offering hefty discounts to get an account paid.
- Give practice group leaders the authority to police “*business hygiene*” within their groups, and hold them accountable for results. This means making sure that people submit their time currently, that partners get their bills out within five business days after month-end, and that partners stay on top of collections, especially old stuff that has been allowed to accumulate (by the way, if you haven't already gone to an effective practice group management structure, now is the time to get that done – delay will only erode profitability and hurt competitiveness).
- Within practice groups, ensure that group leaders set up systems and procedures to make sure that work is being assigned and performed at the right level. This is nothing more than playing old-fashioned “*Boston Celtics basketball*” – find the open man and get him/her the ball.
- Temporarily reassign lawyers whose groups are slow to other groups that have extra work. This may mean assigning transactional lawyers to your litigation or bankruptcy departments. In the long run, they will be better transactional lawyers for having had the litigation/bankruptcy experience.

- Have billing coordinators contact clients and electronic-billing intermediaries directly to confirm and document all billing protocols to ensure that when a client gets a bill, it will be “clean” and easy to approve.
- Cut the size of your summer recruiting program immediately – including the number of offers extended to new graduates – by 50%. (This will probably get a rise out of NALP, but *you* are running your law firm, not NALP.) Invest the money you save in incentivizing the “keepers” who have a good track record with the firm to stay. Also use the money to invest in training and retaining the best lawyers already on board. Unwanted turnover is very expensive, so retention dollars are considerably more productive than recruitment dollars.
- Rationalize, but avoid cutting your marketing budget – now is not a good time to slash it. Instead, firms should cut spending on “indirect” marketing (e.g., sky boxes, CEO public relations efforts, brochures, etc.) and shift money into “direct” marketing, such as one-on-one meetings with clients and referral sources, industry/trade association, and speaking/writing.
- Insist that all partners take time to meet with their clients to discuss how clients’ legal service needs are changing as a result of the recession. This is a good opportunity to learn how clients’ businesses work. It may not bring in a lot of new work (although you could be very pleasantly surprised), but it will help solidify existing relationships.
- Consider deferring technology upgrades and related expenditures where it can be done without affecting client service. The key question to ask your IT Director when you are reviewing his/her operating and capital budgets is, “*what bad things will happen to our clients, if we do not spend this money this year?*”
- Finally and most importantly (and this takes real management courage), take a hard look at all of your timekeeper staff and quickly cull those who are not making or will not make the grade. This goes for paralegals, associates and, especially, partners. A recession provides a lot of “cover” for restructuring the professional staff, especially if you cull at all levels of the pyramid, not just the bottom layer. Also, it is the right thing to do to ensure that the firm survives. You will have much more support for this than you think you will.

2010 and Beyond – the Long Run

So far, we have focused on what law firms can do to maintain profitability in 2009, without changing their basic business models. These short-run techniques are aimed at sustaining revenue per lawyer and reducing costs.

Economists will tell you that, in the long run, all variables are on the table. Leverage, firm size, pricing structures, office footprint, and practice concentrations can and should come into question. Given the radical changes that are being made in our economy – especially in the financial services sector upon which so many law firms depend – it is critical that law firms look at their practice structure and business model to make sure that they are relevant for now and in the future.

- These are turbulent times and the global economy is inexorably changing. When conditions are steady, tried-and-true strategies predominate and usually work. But when economic conditions are in flux, adaptability and innovation are essential.
- Law firms that can adapt quickly to a new order are destined to emerge as the leaders of the profession when economic stability returns. Those that merely hunker down and wait out the bad times will find themselves at a competitive disadvantage in the future.

“*Financial supermarkets*” like Citigroup have broken apart and have returned to their core businesses, simply because they got too big and diverse to manage. Goldman Sachs and Morgan Stanley are now commercial banks, and Merrill Lynch is owned by a commercial bank. Early on in the financial crisis, the leaders of these institutions recognized that their business models could not survive the turmoil, so they rapidly implemented measures that will forever change how they do business. There are lessons that law firms can learn from this.

Many large firms, for example, have been pursuing size and geographic footprint as the keys to their futures. In recent months the pace of merger activity among law firms does not seem to have abated. Yet, one might question whether the new economies are ready for national or global legal supermarkets. It may be time to question these types of growth strategies. It may also be the time to consider divesting certain practice groups and placing them with other firms whose core strategies make a better fit.

We also question whether the days of the primacy of the billable hour are finally coming to an end. The profession has been skating around the "*alternative billing*" issue for twenty-five years. Only recently has there been real progress in altering the pricing model for legal services – but, these recent efforts are gaining real traction with clients and the firms who adopt them.

- Smock Law Firm Consultants, and a number of our clients, have been offering professional services on a flat-fee basis for a number of years. With a little planning and careful definition of service scope, firms can develop reliable models for pricing services on a flat-fee basis.
- In times of economic uncertainty, clients will welcome innovative pricing proposals that take the uncertainty out of their legal budgets.

The traditional leverage model also needs to be challenged. Some firms are fortunate to have practices in which armies of associates can be swallowed up on big cases and big deals. For them, the leverage model will probably continue to work longer, although experienced and profitable paralegals are slowly making headway in absorbing work that previously would have gone to new associates and, leverage is best measured by dividing the number of all timekeepers by equity partners (the real owners). That is the metric that needs to be increased.

With the leverage model under attack, firms need to take a really serious look at how they recruit new lawyers. We strongly believe that a considerable amount of money is wasted on traditional law school recruiting programs, and even more is wasted on attrition costs because the recruiting programs are not selective enough and the firms do not subsequently and creatively focus on retention. Previously, we suggested a 50% reduction in summer programs as a way to shore up profits in 2009. It is probably a good idea to carry that tactic into 2010 and beyond and achieve real balance (which will vary by firm) between law school recruiting and lateral associate hiring.

If everything is "*on the table*" as we look at long run profit management, what should firms do to turn 2009's adversity into long term strategic advantage? Here is another "*top ten list*" - many of which will require real management courage and creativity/innovation to implement:

- Educate yourself about what works and does not in implementing alternative billing approaches. Then, start having serious two-way conversations with your clients about flat-fee, success fee, and other forms of alternative billing. Where you can negotiate flat fees, also arrange for advance billing - say 50% up front, 25% at some midway milestone and 25% upon completion.
- Use good historical cost data to measure matter profitability and profitability by major client or referral relationship to develop:
 - Matter staffing guidelines that will ensure that tasks are assigned at appropriate levels and that matters are managed profitably.
 - Flat-fee pricing models that work to your and your clients' advantage.
 - Tactics for seeking higher profitability work from existing clients and for screening new work from new clients.
- Analyze tasks that are regularly assigned to first- and second-year associates and consider whether any or all of those tasks can be performed appropriately by well-trained paralegals. If there is enough of this work, staff up on the paralegal side and reduce associate hiring accordingly.
- Get a reliable handle on what your recruiting programs are costing, both in terms of direct outlays (salaries, entertainment, training, etc.) and in terms of lost profits due to attrition – planned or otherwise. Only then can you accurately assess their costs and set up systems to track savings, investments and returns on investment, and achieve an appropriate balance between law school and lateral associate hiring.

- Keep information on first-round law school picks and lateral associates that you did not land and stay in touch with them. Many of them picked another firm without really knowing what they were getting into – you may have a solid shot at landing them a few years out.
- Look carefully at your practice groups and offices to reassess whether they still make strategic sense. If they fit, ensure they are carrying out a well defined strategy. If they do not fit, try to find homes for them at other firms where there is a better fit for the group or office. Controlled “*discontinued operations*” are clearly better for everyone in the long run than a public execution.
- Take a long hard look at your overall strategy and strategic growth strategies to make sure they still make sense. It may be preferable to remain a tightly-disciplined 500 lawyer firm for the foreseeable future than to try to become a 1,000 lawyer plus supermarket that may prove to be unmanageable.
- If you have made a number of recent acquisitions (smaller firms and groups), focus time and energies on successful integration of the practices acquired. Many expansion-minded firms fail to realize the economic rewards of their mergers and acquisitions (which justified the acquisitions in the first place), because they focus more on “*doing the deal*” and do not take the time to integrate the new practices with existing ones.
- Take effective strategic and operational planning to the practice-group level. While most firms have gone through at least one strategic planning process, fewer have actually had their practice groups – assuming practice group management is in place – conduct and execute on effective planning. While the economic turmoil is likely to affect every law firm in some way, individual practice groups are affected differently by the same crisis. It makes sense to have each group plot its own course within the context of an overall firm-wide direction.
- If you are fortunate and profits are steady for 2009, gradually increase your firm’s minimum required capital over time. This additional capital should function like the US Strategic Petroleum Reserve and provide a cushion against shocks that may occur in the future. One lesson most businesses learn the hard way is that, in times of economic turmoil, the better capitalized companies are better equipped to weather the storm – law firms can learn from them.

So far, the economic experts are saying that our present recession is not yet as bad for law firms as the 1991-1992 recession. While that may or may not be true, it is virtually certain that the recovery from this recession will be unlike any we have yet experienced. Our financial institutions and many other sectors of the global economy will be transformed in ways we still do not understand. Out of our present adversity will surely come great opportunity. To the extent law firms are able to shed “*status quo thinking*” and a “*hunker down mentality*” and are nimbly able to adapt to the coming transformation, they will continue to thrive and prosper.