MIND YOUR RULERS!

FOLLOWING THESE SIX RULERS ALLOWS LAW FIRMS TO ACHIEVE DESIRED FINANCIAL GOALS DESPITE FLUCTUATIONS IN THE ECONOMY

Gary B. Fiebert, Partner

Introduction

As the financial crisis that started in 2008 has come and gone, we are left with an evolving landscape for law firm profitability. Clients are increasing the pressures on fees, demanding lower legal costs and more predictability, while overall demand for legal services continues to be flat or down somewhat. In-house counsel are bringing more work in-house and new forms of competition have entered the legal marketplace and made significant inroads on work that heretofore was considered by law firms as low value but high margin (e.g. – document discovery and word processing).

The last time I wrote about this particular issue and its impact on law firm profitability, I focused on the primarily internal factors that impact profitability of law firms – realization, utilization, leverage, expense control, and speed of collections (i.e. – the Five Rules to be followed by law firm management to ensure that the firm is properly positioned to handle financial functions in the legal business.

The importance of these rules for sound financial management cannot be overstated. In fact, I am still frequently asked to identify the single most important performance factor impacting the financial well-being of a law firm. But, reality is far from the simplistic notion that a *"single silver bullet"* – be it hours, rates, realization, collections, headcount, or expenses – can be utilized to maximize results.

And now, as the landscape for the business of law continues to evolve, we have to recognize that an internal focus on profitability is simply inadequate. The role of the client in this process of optimizing and maintaining the financial health of a law firm has taken us from simply *"Living by the Rules"* to the somewhat more challenging environment where your law firm needs to *"Mind Your Rulers!"*

Please do not misunderstand my position. While we all recognize the concept of *"the client as king,"* I am not at all suggesting a level of subservience or some newly defined form of allegiance to clients. Rather I am expanding the original five rules to add a sixth – *"risk management."* And it is this sixth principle that takes us from five *"**Rules**"* to six *"**Rulers**."*

Historically, when law firms first begin to feel the impact of a financial downturn, their managements usually react by scrambling to protect the bottom line. Low hanging fruit is plucked in an effort to reduce costs. Associates and staff are let go and many firms again begin to explore and implement a variety of out-sourcing and insourcing programs in a further effort to reduce the cost of their services. But, virtually no firm reduces their rates and while rates maybe held at lowered levels of prior years, the impact will generally be felt on law firms' bottom-lines and in partners' earnings and not necessarily on lower costs to clients. I submit that a more focused analysis and a better planned response will have avoided much of the knee jerk reaction that many firms experience. If a firm diligently lives by certain rules, it is better able to handle financial fluctuations in the legal business. And, living by these certain rules is a continuous process, not a sometime crisis influenced event.

The original **Rules** to which I am referring relate to realization, utilization, leverage, expense control, and speed of collections. The concepts behind the rules were set forth initially to me over lunch in 1992 by John P. Quinn, then a senior partner at Price Waterhouse. But the strengthening of the clients power, role, and independence in their relationships with lawyers and law firms necessitates that we now add Risk Management to this list. And my personal experience and observations 23 years later bear witness – **Minding Your Rulers** is what is necessary for sound, holistic law firm financial management.

Consistent and continual allegiance to the Rulers empowers law firm managers to focus on the essentials and manage their law firms to achieve their goals.

- The Rulers mandate that each aspect of a firm has direct bearing on the others – should one area be mismanaged, one or more will likely suffer.

- It is much like squeezing a balloon – you may tighten your grip on one area, but another part of that balloon is apt to expand out of control and eventually burst.

As I said, when a financial downturn initially hits, firms usually begin to trim the fat to get in shape. It is very easy in the short run to maximize profits by cutting expenses to the bare essentials – eliminating staff and timekeepers, halting investment spending such as technology and marketing, and pushing for collections. Additionally, new work may be accepted to bolster revenues but the type of work, or the profile of the client might not fit the standards of the firm. Thus, in taking these steps the profitable future of the business is often compromised. Eventually, revenues decline, people have difficulty accomplishing their work due to lack of resources, and profits frequently follow the decline in revenues. However, **Minding Your Rulers** transcends linear management mechanisms and treats the firm as a whole, with each piece functioning as a result of the other to reach desired outcomes.

Identifying the Rulers

The Rulers are not separate – instead, they are wholly dependent upon one another for success. The best way to understand how to mind the Rulers is to first define them.

Realization

Realization is the percentage calculated by dividing the amounts ultimately collected by the value of the work actually performed. There are, of course, variations on this, but the key is to be consistent. Typically, firms today have seen true realization rates erode to 90 percent or less.

A key element of realization performance is the pricing decision (i.e. – billing rates). Firms should strive to maximize rates, yet set them realistically and competitively for the market, the law firm's skills and services. As an example, New York first-tier firm billing rates are not more applicable to second-tier firms than are New York first-tier rates applicable generally to the first-tier rates of other U.S. cities. Equally important to the process of maximizing realization is the requirement that you limit write-offs.

Utilization

The principle of utilization asks the question *"how busy are you?"* Utilization is the percent of billable time to total time available, or time recorded, or average hours versus budget, or some other standard set by a firm. Managing utilization is the balancing act that helps the firm achieve acceptable activity levels. The main points to consider while managing utilization are how hard the people in the firm are willing to work, whether or not firm culture supports the standards that you set, and, once standards are set, is there enough work to dole out to everyone? Firm culture must support the targets and the fair reward for overachievers.

Leverage

In simple terms, leverage is the ratio of associates to partners. It is the management principle that places a partner against the number of associates to whom that partner can distribute the work. The principle of leverage is practice-centric. It is somewhat limited by the type of practice area on which one is focusing. As an example, a localized real estate land use and zoning practice relies on lobbying and networking, and only includes senior-level partners who hold contacts closely. Such a practice is likely to be far less leveraged (i.e. – require few, if any, associates) than a bet-the-ranch litigation or a rapid-response major financial transaction practice.

The key is to optimize the allocation of resources and balance specialization with capacity. Leverage, when applied correctly, requires that a firm is always looking for opportunities to increase efficiencies – not with an eye to reducing head count, but rather to increase efficiencies throughout by recognizing and using the right resources.

In the land use and zoning practice example, leverage is likely to be no more than 1:1. Contrast this with a large litigation practice with relatively few rainmakers and many associates. Such a practice is likely to be highly leveraged at a rate of 3:1 or more. And here is where the Rulers come into play. If the highly leveraged practice is under-performing on utilization and realization, then the practice will likely become over-leveraged, and profits will decline because there is not enough work to keep the associates busy. If the associates are not required to put in the hours needed with the result that the rainmakers themselves are not aptly rewarded, they may leave the firm. Alternatively, rainmakers may bring in new work that is not properly vetted for conflicts or quality issues, or the clients ability to pay, in order to keep the associates busy. But the outcome of accepting the wrong work can be just as damaging to the firm.

Another key component of managing leverage lies in achieving budgeted hiring and retention levels so as to successfully have the work force in place that supports your leverage target.

Expense Control

The primary goal of expense control/management is to provide enhanced services at the same or lower costs than the competition. Doing this effectively assumes that you have built a zero-based budget from the ground up and have implemented a process by which you can ruthlessly monitor expenses. As you react to overspending, or inefficiencies in your operations or processes, or any other motivator that gets you to cut expenses, it is important to remember (again) the promise that indiscriminate expense cutting merely to meet short term profit goals will have a direct negative impact on the ability to deliver high quality services.

Risk Management

The overarching goal of risk management is to identify, mitigate, control and minimize the risks inherent to the business. As the marketplace and the law firm business model continues to evolve, risk management has taken on an increasing level of importance. From deciding on what type of clients your firm will represent, what type of matters you will accept, and vetting them for any potential conflicts, risk management also includes the protection of client confidential information in accordance with client requirements, cyber-security, office security, the safety of all personnel, insurance management and other related issues that, if inadequately or poorly managed, can have a significant impact on the financial performance, or even the financial viability, of a law firm.

Some firms consolidate the responsibility for risk management with their General Counsel while others use a variety of committees. The challenge is to ensure that there is adequate management and oversight for all of the potential risks involved in operating a labor intensive business in today's highly competitive and rapidly evolving marketplace.

Speed of Collections

Bringing in the cash is not enough! The amount of time that elapses from the performance of the work until you collect your fees has a direct bearing on financial performance. The value of this time represents the firm's investment in client services. Firm management is charged with managing the investment in client services via achieving (and maintaining) acceptable patterns in billing and collections. Again, this can vary by practice type. Successful firms may have a three-to-four month time line while under-performing firms may be at six months or more.

This Ruler focuses on cash flow! And, firms handle this challenge of managing their investment in client services in different ways, with some firms deploying a billing and collections committee to monitor the billing attorneys and client intake, other firms appoint a single person with the responsibility to oversee all billing and collection activity (the billing gorilla), including the imposition of rewards for on-time submission of time records or penalties for the late submission of time or bills to clients. During the intake process, managers must ask a series of questions: does the new matter make business sense? Are the pricing terms and conditions in conformance with firm standards or are non-standard terms included? Does the client have a good payment history with the firm? Does the billing attorney have a good collection track record? Should a renewable retainer by required?

By adequately answering questions such as these, firms can take major steps in improving the quality of its investment in client services. Whether your objective is to finance a growing operation or to sustain or maintain a shrinking or downsized operation, success depends upon the ability to generate the cash needed to meet your obligations.

CONCLUSIONS

Minding these Rulers is a constant process and a real balancing act. But, no one Rule has it over the others. Please remember – we may be able to squeeze and tighten down any one part of the balloon, but if we ignore the other parts, that balloon can still go pop. And, there is not a single performance measure that tells a firm how well it is doing, nor is there a single performance measure that a firm can turn to for a cure if its profits are less than the firm would like them. Said another way, it is not the job of management to maximize firm profits. I already said that the easiest way to maximize profits is to cut all discretionary spending to the bone. Managements' job is to optimize profits based upon the profile and the strategic objectives of the firm. But if you mind your Rulers, you will generally be in better shape than those who do not.

The Rulers concept differs in application depending upon the firm structure and practice areas, so individual law firms must first analyze the firm characteristics such as size, ownership, practice areas, clients, environment, management and organizational structure, geographic reach and scope, and degree of community involvement. Then, each of the six Rulers must be configured accordingly, and minded rigidly. Law firms that ignore or mismanage any one Ruler do so at their peril.

The good news here is that one size does not fit all. How these Rulers are managed has as much to do with the size of the law firm and the type of practices it supports as it does with the type of clients served and the skills of the managers responsible for implementing and minding the Rulers.

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