# THE EARLY WARNING SIGNS

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## Introduction

As the legal marketplace has gone through cycles of growth, stagnation and recession over the years, I have had the opportunity, on several occasions, to write or speak about the key metrics that you need to watch to determine the economic and financial health of a law firm. Some of you may recall my monograph where I discussed the need to *"Follow the Rules."* The *"Rules"* were spelled out as *"realization, utilization, leverage, expense controls and speed of collections."* And these Rules held firm for as long as I can remember. If you ignored any one of them, it was likely that the law firm was going to experience some challenging times.

The business of the business of law is a relatively simple process:

- Lawyers create legal work product
- Paralegals, lawyers and business department staff produce the legal work product and deliver it to clients
- Accounting and finance personnel bill the clients for the work and process the payments.

All are relatively simple steps. But as a result of the evolution that the legal marketplace is experiencing, it turns out that managing this relatively simple process has become increasingly more complex. Law firm managements as well as lenders, vendors and others who are interested in doing business with a specific firm all need to look out for the "early warning signs" if they want to avoid the kinds of financial and performance issues that can significantly impact the health and viability of a law firm.

More recently, I expanded this list and modified the philosophy to *"Mind Your Rulers."* While I kept the original five Rules in place, the additional *"R"* was in recognition of the fact that the legal business has become more complex and competitive, so we needed to add an additional performance metric to our analysis— *"risk management."* And I still adhere to my overarching philosophy that if you ignore any one of these Rulers, the law firm was increasingly likely to have some bad times on the road ahead.

But we continue to be asked by clients, candidates considering lateral moves, attorneys and business executives, and lenders and vendors to law firms, if there are other indicators beyond the obvious ones that can be used to foretell a coming performance problem at a law firm. At an earlier stage of my career, while I was a management consultant for troubled companies performing turnarounds and profit-- improvement projects, I learned to look for and identify the *"Early Warning Signs"* of company ill-health. Having spent most of the past quarter-century working in and with law firms, I have adapted those observations to the law firm market place and thought it made sense to share them with you. So, these early warning signs follow.

**The Early Warning Signs**

We have identified a series of areas that, in toto, represent a valuable set of early warning signs. If a firm is dealing with them well and effectively, then the early warning signs are positive. If it is not, then these early warning signs flash and require attention. These early warning signs include compensation guarantees, underperformers, concentration, collaboration versus silos, succession planning, client service and client retention, utilization and leverage, expense controls, innovation, growth philosophy and strategy, the role of information technology in strategic planning, the role of marketing, retention and the firm's compensation philosophy, and risk management.

These early warning signs are discussed in the following paragraphs.

**Compensation Guarantees**

While it may still make sense to guarantee (for the short term) the compensation of a new lateral partner to ensure that the transition from their old firm to the new firm does not cost them any earnings due to the start-up associated with such a move, longer term guarantees on earnings, such as the type used at Dewey LeBoeuf, are an early warning sign that flashes red and yellow lights and sounds alarm bells. These long term and, in some cases, unreasonable levels of guaranteed income to lateral partners can tear at the very cultural fabric of a law firm. Partners who have been at firms through the ups and downs over the past are expected to stand by while some *"white knight,"* with, or without their troops following them to the new firm, is expected to lead the new firm to new heights in revenues and profitability. But it usually does not happen and can put a relatively well performing firm in a state of financial risk. Data from the largest firms, according to Citibank and others, suggests that the success rate of lateral partners within their first two to three years at a new firm (defined as *"meeting original expectations"*) is still somewhere only around 25%. This means that only 1 in 4 laterals hit the numbers you expect them to hit – how will the firm pay for these long term guarantees?

**Underperformers**

As the prior paragraph implied, three out of four lateral partners are underperformers—i.e., they are not performing at the level you expected of them. Unfortunately, so are many other partners in many law firms today. The Smock Law Firm Consultants annual survey of the Legal Marketplace has found for the past 5 years that the top issue of concern to law firm management has been underperforming partners. Of course, this finding presupposes that most firms have defined what are expected or acceptable levels of performance by their partners. But, the underlying indicator of law firm performance with respect to this issue is how the law firms deal with these underperformers. Do they have a formal program of rescuing such underperformers or do they first cut their compensation, then reduce them from equity to non-equity status and, maybe, finally start a process to counsel them out of the firm or are they more regimented and start the outplacement process quicker, especially with regard to laterals who did not hit their expected performance targets within the first 12 to 18 months on board?

Firms that might appear *"more humane"* by giving the underperformer more time, even without cutting pay or status, are not really helping anyone. The continuing, contributing partners must give up some of their income potential to pay for the underperformers. And underperformers who have had their pay cut and who have had to tell their spouse that their status was reduced only become *"pissed off underperformers."* The most humane approach is to formally work to rescue the underperformers worth rescuing and to cut ties, as humanely and quickly as possible with the others. It begs the question – how will the law firm generate the profit necessary to retain their best talent if they are overburdened with the compensation of these underperformers? This topic is covered in greater detail in our monograph "*Dealing with Underperforming Partners – at the Top of Every Managing Partner's 'To Do' List*")

**Concentration**

Another early warning sign is the concentration of the firm where either (1) a relatively few clients account for the overwhelming share of the firm's business or (2) a relatively small number of lawyers account for the overwhelming share of the firm's business. In either case, the firm is vulnerable if such clients exert extraordinary pressures on fees and rates or take their business elsewhere, or if such lawyers exert extraordinary pressure on their compensation, or status within the firm, or leave the firm to take their supposed rainmaking skills elsewhere. What is the firm doing to reduce these levels of concentration?

**Collaboration vs. Silos**

It has been demonstrated that a law firm with collaborative practices and lawyers within those practice areas tends to provide better client service and better financial performance for the law firm than those firms that are actually a series of *"individual"* practice areas, or lawyers, operating within *"silos"* in their firms—merely sharing the overhead but not the work, the clients, and in some cases not even the internal staffing resources. While such silo firms may provide extremely good results and incomes for some of the individualistic participants, there is often (and usually) no sense of *"firm"* which, frequently, results in a splintering of the organization. Also, silo firms do not effectively collaborate on the acquisition of new clients. The new business process operates in the same silos and it is not uncommon for lawyers at such firms to be competing against one another to acquire new clients. In the present and expected legal market, the future success of most, if not all, firms of reasonable size is dependent on their ability to collaborate and cooperate.

**Succession Planning**

The legal market place continues to be undergoing an evolution. The process is being driven by several factors:

- Pressure from client organizations to provide the same or more legal services as in the past but with more cost predictability and a lower cost
- Competitive pressures to become lower cost providers of legal services since the years of the *"Great Recession"*
- New and ever evolving technology that is fundamentally going to change how law is practiced
- The largest number of lawyers in the history of the profession are moving towards their retirement years as the *"Baby Boomer"* generation ages.

The magnitude of these changes would be called a revolution in almost any other industry. But due to the imbedded resistance to change exhibited by most lawyers and law firms, they are moving at an evolutionary pace in the legal marketplace. And therein lies both the challenge and the opportunity.

In order to address these changes, law firms need leadership and management. But the pool of talent that has provided these leaders and managers for the past twenty to thirty years is aging. And, as firms look to meet the challenges of this evolution, they are discovering that leaders and managers are required at several levels – firm management, practice management, and client relationships.

The steps that a law firm takes (or fails to take) to address succession can be an early warning sign of problems in the not too distant future or it can be indicative of a firm that truly has considered the longer term and is proactively taking steps to develop a pool of talented and capable client handlers, managers, and leaders for the future.

**Client Service and Client Retention**

It really is all about the clients. And a law firm that understands, at every level of the firm, the principles of excellent client service and strives to meet or exceed the expectations of their clients is a law firm that is ahead of its competition. In all likelihood, such a firm retains its clients—more of them and for longer periods of time, than law firms that do not have a deeply seeded (and understood) philosophy of client service. You can hear it in the way they describe their relationships with clients--the expressions used to characterize their work product as *"business solutions to clients' business problems"* and not merely practicing law; responsive; no surprises to clients; and becoming a trusted advisor to clients. If you compare the firm overview that appears on a law firm's web sites with those of their competitors, and you cover up the names of the firms, you should still be able to identify each firm by their operating and management philosophies as well as their client service commitments. But to really understand the level of a client service commitment at any given firm, you really must speak to them—not just the managing partner, but to a cross section of partners, other lawyers and key members of the non-lawyer management team. A true client service philosophy runs through the entire organization, at every level.

A firm with a strong sense of client service may see as much as 80 per cent, or more, of their work coming from existing clients. It is always easier to sell new work to the clients who know the firm and are delighted and happy with the results the firm achieves for them. Additionally, it is more expensive for a law firm to sell new work to new clients--more expensive in the time that it takes, more costly in the efforts needed to acquire that new client, and more costly to get up the learning curve on the client's business than it is to serve an already existing client. If there is a large level of client turnover every year, that firm is more than likely spending for marketing and business development at a higher rate per lawyer than a firm with a relatively stable client base and a steady but not overwhelming stream of new clients each year.

**Utilization and Leverage—A Matter of Practice Profiles**

Both of these early warning signs have previously been discussed in my earlier monographs *"Follow the Rules"* and *"Mind Your Rulers"* but are worthy of a bit of repetition at this point. Utilization is best defined as *"how busy the firm is"* and is simply the ratio of billable time to total time available, or time recorded, or average hours vs. budget or some other standard set by the firm. Managing Utilization is the balancing act that helps the firm achieve acceptable activity levels—the key word being *"acceptable."* The main points to consider are how hard the people in a firm are willing to work, whether or not the firm culture supports the standards set by the firm and, once standards are set, is there enough work to dole out to everyone? Firm culture must support the targets and the issuance of fair rewards for overachievers.

One point to keep in mind when looking at utilization, however, is the nature of the practice profile of the firm since budgeted hiring levels will reflect that profile. For example, a firm that is heavy on litigation or bet-the –ranch rapid-response transactions may well be staffed to provide a larger number of lawyers on these matters than a firm with a lobbying or land use and zoning practice where fewer lawyers get the work out. The result of a downturn in the workloads of either firm can have a significant negative effect on the utilization of the litigation practice but much less so on the land use practice.

Leverage is simply the ratio of associates and other non-partner attorneys to partners. It is the management principle that enables a partner to distribute work to associates and other non-partner attorneys. The principle of leverage, however, is also practice-centric. It is limited by the type of practice area, as in the examples above. The key is for the firm to optimize the allocation of resources and balance specialization with capacity.

Fluctuations, over time, in either utilization or leverage are often indicative of some problems—warrant further analysis.

One other point regarding leverage – there is a second type of leverage to be analyzed and that relates to the financial definition of leverage—usually an indicator of how much debt an entity is carrying in relation to the equity in a business. An over financial leveraged law firm, may well be indicating that it does not generate the cash flow to sustain the levels of leverage it has on the books and may indeed be using some of the proceeds from borrowing to pay for more than capital expenditures—such as partner draws or other operating expenses. This is another early warning sign that bears looking at more closely.

**Expense Controls**

The primary goal of expense control/management is to provide enhanced services at the same or lower costs than competition. Doing this effectively assumes that the law firm has created a zero-based budget from the ground up and has implemented a process by which management can *"ruthlessly"* monitor expenses. As firms react to overspending or inefficiencies in their operations or processes, or any other motivator that gets management to cut expenses, it is important to remember that indiscriminate expense cutting merely to meet short term profit goals will likely have a direct and negative impact on the ability of the firm to deliver high quality services over the longer term. It is important to differentiate between simple cost cutting vs. creation of new efficiencies. And it is also important that a law firm have a culture where the process of legal process improvement and increasing efficiencies is routinely practiced rather than episodic and expenses cutting fire drills reactive to fluctuations in the marketplace.

**Innovation**

This early warning sign should perhaps more properly be called the *"lack of innovation."* During the twenty years I spent as an Executive Director/Chief Operating Officer for three large NYC based firms, I had lots of opportunities to recommend and implement innovative changes at these firms. In addition, during that time, I was actively involved with the New York City Executive Directors group. One of our laments was that whenever any of us attempted to bring about an innovative change into the way our firms did things, one of the first questions we heard from our respective managements was *"what are the other firms doing?"* It is pretty tough to be truly innovative if you have to document that others have already made this change. It kept us feeling like followers more often than the market leaders we were each striving to be. While several of the innovations I was personally involved with have become routine methods and processes at my former employers, the challenge now is to establish a culture where innovation is a normal and accepted way of conducting business. Some firms have organized for innovation and many have successfully established processes to implement innovations throughout their organizations—from the methods used to create legal work product to those used to produce it, deliver it to clients, and even to bill for the services and get paid by their clients. An early warning sign can be found in firms that stifle innovation and have not learned as yet how to bring about change in a competent and cost effective manner. Such firms will lose out to their competition.

**The Philosophy of Growth**

Most, if not all law firms have accepted the management mantra that you must be striving to grow the business. A business, even a professional services practice, that is not growing is doomed to failure. However, too many law firm managements have not settled on a definition of or strategy for growth that has been communicated and understood by their constituents. Does the plan call for growth in head count, number of offices, number of clients, revenue per client, net income, number of partners—after all it is a partner driven business, income per equity partner, or some other metric? And, how much growth is desired, regardless of the metric? Defining the desired growth is the first step. But this early warning sign also goes into evaluating the strategies that the firm has embarked upon to achieve the targeted growth.

The specific strategies being employed by the firm need to be logically consistent with the objectives. While some firms do a reasonably good job of defining their growth objectives, their strategies reflect *"business as usual"* and show no logical consistency to the strategic objectives of the firm. Achieving the desired growth objectives in these firms becomes nothing more than an accident or dumb luck.

**The Role of Information Technology in Strategic Planning**

When I first started working inside law firms, it was felt that such businesses needed to use technology just to be competitive. But law firms back in the early 1990's did not need to be state of the art technologically. Indeed, most law firms lagged other professional services, such as accounting and medicine, when it came to using technology in their business. Virtually no law firms were conducting research and development in information technology applications. Today information technology has become such an inherent part of the practice of law that a law firm cannot survive unless they are as up-to-date as possible with the advances and breakthroughs that are being made.

Considering how important technology has become and that the likelihood of the next game changer is a matter of how soon not if, it still surprises me that the Chief Information Technology Officer of most law firms does not have a seat at the table when strategic business plans are being conceived and developed. In almost any other industry segment, the CIO is a direct participant in strategy development and execution. In law firms generally, she/he is forced to play catch-up with the Firm's strategic plan when so much of the future is riding on the ability of the firm to be able plan for, acquire and implement technologies. There are some firms that have gotten this message, driven by their clients emphases on technology. But firms that are lagging in their strategic technology planning are flashing an early warning sign regarding their long term health.

**The Role of Marketing**

In too many law firms marketing is still nothing more than support—preparing pitch books, presentations and proposals, maintaining the mailing lists of the firm, updating the CRM database, and other similar, tactical support. But the lack of marketing as a component in the strategic planning process of a firm is an early warning sign. The marketing function, in most industries, has been used to determine what products and services the firm should sell, to whom should they be sold, how will those products and services get to the marketplace and at what price point should they be sold at.

There are law firms today who not only have their Chief Marketing Officer sitting at the strategic planning table, but they rely on the CMO's staff to provide analytics about clients, industry sectors, geographic markets, targets, competition and pricing. Marketing and/or training departments in some firms are providing sales and new business development training for newer and future partners. And client service planning and execution is beginning to take hold at some firms. Those firms that are ignoring these opportunities are flashing an early warning sign that they will be ill prepared to meet the market demands of the future.

**Retention and the Firm's Compensation Philosophy**

The first early warning sign I addressed in this monograph was compensation guarantees. One of the key elements of retention of talent, especially in this time of increasing competition in this marketplace, is the overall compensation philosophy of the firm (and, of course, how it is carried out). More than the problem associated with guarantees is the question of whether the firm is striving to be a compensation leader. Very few firms can even attempt to make that claim with a straight face. Is the firm trying to be competitive with other firms in its geography? What about the firms in a firm's market niche? Across all practices or limited to only a few practice areas? Does the firm employ a different philosophy for compensating partner level talent from that of the non-partner attorneys? What philosophy governs the compensation of the business department staff that supports the practices of the firm? Does the firm include benefits and perks when it measures compensation for comparative purposes? The answers to these questions form a key component of a law firm's ability to retain its people. And the inability of firm management to articulate their compensation philosophy is a clear early warning sign that the firm is vulnerable to poaching and disgruntled personnel.

It has been our experience that virtually every law firm has its own method/process for compensating its partners. It might be objective, subjective, or a combination. Some work very well and some not so well – based on whether they respond effectively to the above questions. Those that do clearly answer the questions posed above and have three key characteristics – (1) they reward those who bring it in; (2) in the context of rewarding those who bring it in, they are deemed to be fair; and (3) they are directly aligned with the firm's overall strategy (what it is trying to achieve in the market). And, alignment means actually rewarding those who contribute to the firm's overall strategic direction.

It is true that people do not only leave to make more money someplace else. But if people feel that they are being taken advantage of by their employer, or feel that they do not understand the basis of how they are being paid, or do not understand why there are differences in how others in the firm are being paid, their trust and loyalty to the organization will suffer. So just as important as interesting work, or a *"better"* boss, or a better platform, or a better opportunity for personal growth, a missing or an ill-conceived compensation philosophy will drive people away.

**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 a law firm will represent, what type of matters the firm 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. This early warning sign relates to firms that have not paid attention to the full scope of their exposure to their business risks.

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