

Issues Law Firms Should Consider in Slowing Business Climates

In the past, many law firm leaders proclaimed, "Last year was our best year ever." Now, after years of double-digit revenue growth, the leaders are asking, "How can we position ourselves?" Partners at law firms of all sizes are becoming anxious about their firm's performance. Firms are beginning to re-evaluate their expense structure as well as their revenue production capabilities.

While there are no immediate "quick fixes," forward-looking executive committees and managers will review both short-term and long-term issues in the coming months. In the short term, management needs to be concerned with maintaining high realization rates, continuing to bill and collect, managing underproductive assets (i.e., timekeepers who are not sufficiently busy), and reviewing the firm's administrative structure to ensure the firm is positioned to ride out any slowdown in workloads.

While there are some ways to increase profitability in the short term, there are also issues with long-term impact that need to be evaluated, like the associate track system, the partnership structure, an unfunded retirement plan and the practice management system, which are likely to have more far-reaching significance. While any changes to these systems are unlikely to produce additional profits in 2001, adjustments will, over the long run, benefit the firm by ensuring that it remains competitive in a continually changing legal marketplace.

Short-Term Responses

Historically, law firms have not responded well in the short term to a changing economy. For example, in an attempt to protect profitability, many firms cut too deeply the associate lawyers, which resulted in many partners working on associate-level work well after the economy rebounded. In addition, as the economy strengthened, many law firms found they now had an inverted leverage model (i.e., with far more partners than associates), which is the opposite of the model that most were working toward before the economy slowed. The following are a few short-term focused recommendations for firm managers to consider in the coming months:

- o **Maintain High Realized Rates:** Critical to maintaining the firm's level of profitability is ensuring that realized rates do not slip. First, firms must understand what actually affects realization rates. Realization reductions sometimes come when discounted rates are offered to certain clients. While there are many valid reasons for negotiating rates with clients, it is important for partners to understand the financial repercussions--in the form of lower realization rates--when deals are negotiated.

One of the most significant sources of realization reduction, however, is write-downs made by the billing lawyer, which are typically done to reflect his or her perception of the value provided to the client. This realization reduction is especially common at firms where the partners undervalue their services.

Yet another common realization reduction comes from writing off uncollectable accounts receivable. This can be managed by keeping clients informed on the status of the project and, perhaps most important, billing clients in a timely manner. Weak billing policies are closely tied to low realization rates. Finally, many pricing, billing and collection problems come from clients that the firm should not have accepted in the first place. Focusing on stringent client intake procedures can help mitigate this problem.

- o **Managing Underproductive Assets:** When the economy is strong and a firm is doing well, law firm managers tend to be more forgiving of their underperforming lawyers. However, when workloads slow, it is critical to ensure that the firm's human capital is well managed and that problems are addressed quickly. When economics are tight, lawyers who are not performing at the firm's minimum expectations will inevitably be closely watched by all partners. Many often wonder why firm management is not dealing with those who are not pulling their weight. Partners will often focus on underperforming lawyers as a major firm issue and

may create divisions within the partnership. Firm management should be working closely with underperforming lawyers, helping them to increase their productivity.

o Evaluate the Administrative Structure: As the economy slows, it is common for management to look to the firm's administrative structure for quick-fix expense savings. While this is worthwhile, most managers will find that the firm's executive director has kept overhead expenses controlled over the last few years. Still, staffing has sometimes been overlooked. Today, most law firms' lawyer-to-secretary ratios range between 1.75:1 and 2:1. This means that, on average, each secretary works for slightly less than 2 lawyers. As firms continue to improve efficiencies through the use of technology, this ratio can increase to more than 2:1 without any productivity losses.

Another staffing measure to consider is the firm's total administrative staffing-to-legal staffing ratio (in this ratio, non lawyer timekeepers are counted as one-half of a legal timekeeper). At most firms, this ratio should be close to or just under 1:1, which means that for every administrative staff member, there is one (weighted) legal timekeeper.

Evaluating these short-term issues may result in some short-term increase to profitability, but there are factors with a longer-term focus that, if addressed today, may increase the firm's profitability and competitiveness over the long term.

Long-Term Responses

o Associate System: In 1998 and 1999, firms were desperately seeking inventive ways to keep associates from leaving, often to join dot-com companies that were offering the possibility of incredible financial opportunities. To combat these pressures, law firms threw remarkable amounts of money at untrained first-year associates. And the historical "lockstep" associate compensation system required firms to adjust the entire lockstep system upward. This adjustment not only put significantly more pressure on associates to work harder at higher billing rates in an attempt to cover some of the additional salary costs, but it also put a strain on partner compensation. This happened because, in some cases, the distinction between senior-level associates' compensation and the lowest [partner compensation](#) tier was almost eliminated, and because, in partnerships, individual partners pay their own benefits and generally draw at a reduced percentage of projected income during the year. On a monthly basis, partners were now taking home less income than when they were senior associates. This issue had many first-year partners questioning the advantages of becoming a partner.

The last year brought the return of now jobless associates, who were once again interested in a guaranteed annual compensation of at least \$160,000. Since, like any other professionals, associates do not take kindly to pay cuts, law firm partners are now faced with two options: Continue with the current system, or develop a new approach to associate compensation. The first smart move most law firms made in last year was to choose not to increase first-year associate starting salaries. Now it is again time to re-evaluate the entire system.

There is a clear trend in the legal industry toward adopting a new approach. Increasingly, firms are choosing to eliminate the lockstep system, replacing it with a merit-based system where career progression and compensation increases depend on individual performance, similar to the approach used by most large law firms for determining partner compensation. After all, it seems reasonable that a firm should review partners and associates in a similar manner. Associates who become partners would consequently not suffer a shock by being subjected to a completely different compensation system.

o Partnership Structure: There is a renewed interest in the two-tier partnership, and many law firms are either reconsidering the concept or are evaluating this structure in a great deal more depth than they did in the past. One significant reason for moving to a multitiered partnership structure is to give lawyers more

career opportunities. Increasing numbers of young lawyers do not regard becoming an equity partner in a law firm as their ultimate goal. Rather, they feel that being a good lawyer in a stable environment without the worries of ownership better suits their personal career goals. These lawyers want more choices. A multitier system gives these lawyers just that--options to choose their own career path. They can choose to forego the risks and rewards associated with ownership, but would still be viewed by the outside world as a partner. Then there are those who strive to be equity partners but who do not possess the necessary qualifications (although all partners must meet high quality standards). A two-tier system works for these lawyers as well, because the structure creates a position in which a firm can retain those lawyers who make a valuable contribution, but do not yet (if ever) meet all the standards or requirements of being an owner. The additional time spent as a non-equity partner may help the lawyer develop the skills necessary to be an equity partner.

Another reason for adopting a multitiered structure is that firms simply cannot afford to continue adding new equity partners when net income is not growing rapidly enough to accommodate them. When small differences exist between what senior associates and first-tier partners earn, and after the initial euphoria of being made partner wears off, new partners begin to expect higher compensation for bearing the risk of ownership. If, however, these partners are moved into a position with guaranteed compensation and do not have the risks of ownership, smaller difference in compensation can exist without causing internal rifts.

o *Unfunded Retirement Obligations:* Historically, law firms created unfunded retirement plans because there was no tax-effective means of saving money for retirement for members of a law firm partnership. To ensure that partners were taken care of during their retirement years, firms created retirement plans that used current firm income to pay retired partners. Until about 15 years ago, only a few partners in each firm retired under these plans, and they were supported by a larger number of working lawyers. It was not too much to ask younger lawyers to support the firm's founders in their retirement. However, many firms are now paying in excess of 5 percent of their net income to fund these plans. With the increasing pressures on firm profitability, firms that have not already eliminated their plans or those that have simply capped their plans are now being forced to consider ways to deal with this problem. While unfunded retirement plans are usually not the primary reason for partners to decide to move to another firm, departing partners often cite the drain these plans have on current income as one of the reasons for making the decision to move. In addition, during merger discussions, firms often encounter--and occasionally cannot overcome--unfunded obligations written into one or both of the firms' partnership agreements.

Because of the financial problems and other uncertainties associated with these plans, many firms are cutting back on or eliminating unfunded plans over time. However, cutting back on these plans is extremely difficult in most firms because management has to reconcile the competing interests of older partners, who would prefer to maximize unfunded benefits, and younger partners, who would opt to minimize them. Any modifications to an unfunded plan must be carefully planned and communicated to both current and retired partners.

o *Practice Management:* If law firms intend to remain profitable and competitive in the long term, they must recognize that changes taking place in the legal market are forcing traditional law firms to rethink not only how they provide services, but also how their human capital is managed. The most forward-thinking law firm managers recognize the value of practice management because it organizes the firm's core services in a more business-minded manner than in the past. Historically, the position of practice group leader was more a status symbol than a real management position. Today, it has become an extremely important component of a firm's management structure.

In the broadest sense, practice management means managing the legal work, clients and professionals. There are currently many different models of practice management in law firms. In some firms, practice groups are set up around substantive areas, such as corporate, business litigation and tax. In others, practice groups are organized around industries or core client groups, such as financial institutions,

telecommunications and healthcare. In still others, practice groups mix both substantive areas and industry or client segment groups. No matter which structure a particular firm chooses, there are a few key practice management functions, including work assignment and workload monitoring; supervision of work, service and specialization standards; training, mentoring and development; development of systems and procedures, such as knowledge management and other applications of technology; quality control and review processes; business planning; and development and implementation of business and marketing plans and strategies.

Effective practice managers are held accountable for effectively and profitably running their departments. For this to be accomplished, practice management needs to be valued by the partnership. Practice managers need authority to run the practice within the guidelines of practice plans, and practice managers need to have a significant say in the compensation of lawyers within their group. Most important, practice managers must work with the members of the practice and develop a business plan that is closely tied to the firm's strategic business plan.

Addressing both the short-term and long-term issues facing law firms will not only help weather the current economic slowdown, but will also increase the firm's profitability and competitiveness in the mid- to long term.

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[*How to Hire a Legal Recruiter for Your Law Firm: How Law Firms Recruit Attorneys Using Legal Recruiters*](#)