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Why Profits Per Partner Keep Increasing at Major US Law Firms

Summary: Major US law firms have continued to see increasing profits per partner over the last several years, even in a bad economy. Learn why in this article.
It's an interesting paradox for many U.S. law firms: their per-partner profits have grown over the last several years, even as the economy has been soft.

How does this happen in a struggling economy? One reason is that billing rates have continued to increase at a healthy pace, while the demand for litigation, bankruptcy transactions, and other practices has stayed strong. Firms have also benefited from their own tough economic management. In fact, it is often easier to make and implement tough decisions when people are concerned about the economy and the success of their firm than in the good times.

Thirty years ago the top U.S. firms earned between $300,000 and $400,000 a year per partner. After adjusting for inflation, that is now over $800,000.

But in fact, many firms now earn more than $1 million per partner. Besides rate increases, this kind of economic growth far exceeding the pace of inflation was brought on by productivity increases, leverage, and expense management, among other things.

So managing partners have had a good run, partners are feeling comfortable, and profits will just keep climbing, right? The reality is that some are not so sure.

See the following articles for more information:

- **Law Firm Business Fundamentals: How to Run a Successful Law Firm**
- **How Law Firms Can Survive a Tough Economic Legal Market**
- **Making Sure Your Law Firm Will Not Fail**

PROFIT-DRIVERS

Some managing partners are starting to look at the profitability of their firms and wonder where future income growth can come from. Many feel they have already gotten as much as possible out of their individual profit-drivers.

- **See Law Firm Profit Components for more information.**

While there are always individuals whose productivity can be improved, the average productivity in many firms is quite high, so squeezing more billable hours out of the existing lawyers isn't necessarily going to be the answer. In fact, there is a limit to the number of possible billable hours (after all, there are only 24 hours in a day), and some firms are getting close to it. This is a particular issue for Washington firms, who have generally been among the leaders in pro bono commitment and other activities that don't directly generate revenue.

There is always room to better manage expenses, but for firms that have already done a good job in that area, they may find it difficult to cut back without a fundamental change in the business model.

Adding associates only makes sense if they are economically leveraged -- simply adding bodies does not create profits. But not all matters can be highly leveraged, although most can probably be better leveraged than they are. And some clients are resisting staffing changes.

Rates continue to climb, but in some cases to a point where clients are starting to push back. And while Washington rates tend to be somewhat lower than those in New York and Boston, they are higher than those in most other markets.

Interestingly, these profit pressures are felt everywhere, not just at the top-earning firms. Some firms have found that they hit the ceiling at $500,000 per partner, while others have hit it at $900,000.

THE COMPETITIVE PRESSURES

The pressure to improve profits comes from the very competitive legal environment. The range of per-partner profits is vast. This has created a real economic segmentation among firms and has been part of the fuel for the increased mobility of partners we have seen in the last decade. The Washington market is among the most competitive, in part because of the strength of Washington-based firms, and in part because of the impact of the out-of-town firms with a significant presence in D.C. The most profitable Washington-based firms have solid profits per partner, but the profits of some of the out-of-town competition have been significantly higher (at least at the firm level).

Many lawyers are earning more than they ever thought they would. And absent competition and the fact that profitability information is publicized annually, it might be enough. But for firms that want to continue to retain the top lawyers and practice at the highest levels, the profit pressures aren't likely to abate in the near term.

- **See How to Keep and Attract the Best and Brightest Talent for more information.**

SO WHAT DO WE DO ABOUT IT?

Many firms have made significant strides and are operating efficiently and profitably. In fact, without a fundamental change in the business or operations of a firm, there may only be minimal opportunities to improve profits. As a result, some firms are beginning to rethink the way they do things. Some of these are strategic decisions about the kinds of business they do and don't do, and others are more operational. Examples include the following:

Taking a hard look at the mix within the practice and spinning off practices that may not be critical to a firm's core practices and may be less profitable. What firms often don't consider is that a few practices operating at a lower level not only dilute the firm's economics, but may also affect outsiders' view of the firm's capabilities and strengths. Spinning off practices is not easy, but as part of an overall strategic plan, a firm can begin to move in the direction of a comprehensive and rational set of services.

Taking a hard look at the office mix and either closing offices that no longer make sense in the firm's future, or limiting the work done in those offices. A number of firms have offices in smaller legal markets for a variety of historical reasons--a client once needed support there, there seemed to be a growth opportunity, it made sense as part of a regional strategy, and so on. But what often happens is that once a firm arrives in a smaller market, the initial goal gets lost as the firm begins to establish a local presence. Then over time the firm finds that the market can't support the rates or doesn't always need most of the services that are available.

Looking at ways to deliver services more effectively. This doesn't mean just continuing to increase rates. It means determining the value of the service to the client and then figuring out how that can be delivered in a way that provides the highest-quality service and returns a profit at the same time. This might include investments in knowledge-management or other technology, staffing appropriately, or pricing differently.

Firms have found that even on the largest high-value transactions, an element of the work is relatively routine and can be handled differently than they might handle the highly sophisticated portions of the transaction.

- **See Seven Key Trends of Law Firms Improving Legal Service Delivery for more information.**

Making fundamental changes to the firm's operating structure. While historically the feeling has been that there are fewer opportunities to realize economies of scale as firms get larger, the reality is that this is limited more by culture than by size. In fact, by the time a firm gets to 400 or 500 lawyers (and there are more than 90 firms that are larger than 400 lawyers), they can start to achieve such economies. The opportunities actually increase as firms grow. Some firms, for instance, are outsourcing segments of the firm's back office (everything from accounting and technology support to word processing and research), moving the bulk of the operations to less-expensive space, sometimes in another state, centralizing services to eliminate duplication across offices, and even restructuring spaces for lawyers to minimize occupancy costs.

Making fundamental changes to the ownership structure of the firm. The partnership mix (the mix of equity and non-equity partners) has certainly shifted over time--with more firms having non-equity each year. While skeptics say this has the effect of raising the averages without real increases in compensation, if properly applied over time it can truly differentiate the returns delivered to the owners.

See the following articles for more information:

- **Benefits and Drawbacks of Two Tier Partnerships in Law Firms**
- **Two-Tier or Not Two-Tier? The Equity Partnership Dichotomy**
- **The Benefits of a Two Tiered Partnership**

While we don't want to minimize the hard work it has taken for firms to achieve their current levels of profitability, it likely pales in comparison with the kinds of tough decisions and changes they'll need to move to the next level. The real winners will be the firms that have a clear strategy for making these decisions, not just a profit-improvement plan.

See the following articles for more information:

- **Capitalizing on a Law Firm's Growth--Is Bigger Better?**
- **Managing Strategically, Managing Operationally**
- **Opening Branch Offices**