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The Value Proposition

Is profitability consistent with clients' best interests?

Every law firm presents two distinct value propositions: one to its clients, and the other to its attorneys and staff. This perception of value, from both perspectives, helps to differentiate a firm from its competitors.

From an external perspective, a law firm's value proposition consists of its unique combination of quality, service, and value — all within the context of its practice mix. This is what keeps clients coming back to the firm year after year.

At the same time, a firm also has an internal value proposition — a unique blend of profitability, professional reputation, and culture that attracts and binds attorneys and staff to the firm.

The internal value proposition

Though these value propositions are, in many ways, distinct, it's important for law firm managers to understand how one proposition can influence the other, particularly as managers begin to assess their firm's 2005 performance over the coming weeks by scrutinizing billing rates, hours billed, and, ultimately, profitability. Indeed, profitability is the one component of a law firm's internal value proposition where the interest of the firm and its clients may diverge. More on this later.

Conversely, the firm and its clients have parallel interests when it comes to the second component of a firm's internal value proposition: professional reputation. This is a key aspect of the firm's appeal to attorneys and staff, and it also attracts clients to the firm.

Finally, from a client's perspective, culture is the least significant element of a firm's internal value proposition. Clients aren't overly concerned with a law firm's culture — which is a composite of several factors ranging from institutional values to the workplace environment — unless it affects the firm's work product.

Profitability

The Firm Perspective. Profitability is important for many reasons, with partner income and viability of the firm as a business being the most obvious. Higher profits contribute to partner retention and overall firm stability. When queried about profitability, most partners say they want to do about as well as their peers at comparable firms.

But higher profits have indirect benefits as well. For Am Law 200 firms, where profits are publicly disclosed, higher profits enhance a firm's stature in the professional community. Also, for all law firms, higher annual profits generate investment capital that can be used for practice expansion, partner recruitment, and technology.

The Client Perspective. Certainly profitability is important to law firms; but in several respects, it's also important to their clients.

In the areas of practice expansion, partner recruitment and retention, firm stability, and investments in technology, the interests of the firm and its clients in higher profits are parallel. Most businesses — clients included — want their vendors and service providers to be not only cost-competitive, but also reliable and effective.

Clients have no direct interest in income levels at their outside law firms. Similarly, lawyers have no business interest in how much money their clients earn, so long as they pay their bills promptly. From this perspective, law firm profitability is not an issue.

But there is an issue with respect to profits per partner at the largest law firms — particularly the Am Law 100, where profits per partner averaged $960,000 in 2004, according to the most recent Am Law 100 survey. A million-dollar income is high by any measure and may cause clients to ask whether their lawyers are charging too much. Yet clients may not focus on the fact that a partner's income must fund his or her current living expenses, benefits, and future retirement — not to mention a very healthy tax burden.

Associate compensation can present issues as well. Several years ago, clients bristled when starting salaries at many firms jumped to $125,000. What clients failed to understand was that for many firms, adopting the new salary structure was a competitive necessity. Firms were forced to follow the market if they wanted to remain attractive to law students and lateral hires.

The components of profitability

At well-managed firms of similar size in similar locations, expenses per lawyer (EPL) tend to be comparable. The result is that revenue — specifically, revenue per lawyer (RPL) — drives most differences in profitability from firm to firm.

In the billable hour model, revenue is a function of hours, rates, and realization. These factors affect clients in different ways:

• Billable hours — firms want higher totals, clients want lower totals.

• Rates — firms want higher rates, clients want lower rates.

• Realization (billing and collection) — firms want higher percentages, clients are indifferent.

The calculation in the accompanying table shows how hours and rates affect a hypothetical Am Law 100 firm. In the base case scenario (600 lawyers, 1800 hours/lawyer, $370/hr average billing rate, 90 percent realization, and 200 equity partners), net income per partner (NIPP) totals about $600,000.

Case A: A 50 hours/lawyer increase in billable hours produces an 8 percent increase in NIPP — to almost $650,000.

Case B: A $10/hour across-the-board increase in billing rates generates a similar 8 percent increase in NIPP.

Case C: Combine the two — an approximate 3 percent increase in both average billable hours and billing rates — and the law firm achieves a dramatic 17 percent increase in NIPP, to almost $700,000.

It's easy to see why there will always be a strong financial incentive for law firm managers to either boost hours or raise rates. This is where the interests of clients and firms diverge.

> “Every firm needs to understand its unique internal value proposition and the role that profitability plays in it.”

Partner compensation

Another aspect of a law firm's internal value proposition that impacts client relationships is its partner compensation system. In most merit-based systems, whether subjective or formula-driven, compensation is based primarily on quantitative factors such as business origination and billable hours. If subjective criteria are also considered, “soft” factors such as administrative contributions, specialized expertise, and community service activities may also be taken into account.

Clients are particularly affected by quantitative factors. But, while partners may have a short-term incentive to maximize hours and collections, in the long term its growth in client relationships that leads to higher compensation. Most partners understand this. The strongest firms have systems that include client-oriented behavior, such as teaming and efficiency, in the factors that determine partner compensation.

Every firm needs to understand its unique internal value proposition and the role that profitability plays in it. So long as a firm's profits per partner are in line with those of peer firms and its billing rates are competitive, most clients will overlook absolute profit levels. Instead they will focus on quality, service, and value.

If these conditions are not met and clients complain, a firm should be prepared to defend its performance and discuss the benefits of high profit levels to clients. But be forewarned: It's not an easy case to make. LFI

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Profitability at a Hypothetical Am Law 100 Firm

	Base Case	Case A	Case B	Case C
Headcount	600	600	600	600
Hours/lawyer	1,800	1,850	1,800	1,850
Total hours	1,080,000	1,110,000	1,080,000	1,110,000
Billing rate	$370	$370	$380	$380
Value of time	$ 399,600,000	$ 410,700,000	$ 410,400,000	$ 421,800,000
Realization	90%	90%	90%	90%
Revenue	$ 359,640,000	$ 369,630,000	$ 369,360,000	$ 379,620,000
Costs	240,000,000	240,000,000	240,000,000	240,000,000
Net income	$ 119,640,000	$ 129,630,000	$ 129,360,000	$ 139,620,000
Equity partners	200	200	200	200
NIPP	$598,200	$648,150	$646,800	$ 698,100