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# Manage Profitability or Rely on Luck: Why Law Firm Profitability Matters More than Ever

By Joseph B. Altonji on April 27, 2021

A few weeks ago, I addressed "What's Next for the Legal World?" in a post focused on critical challenges facing law firms. In it, I argued that "profitability management as a survival skill" is now a feature of the industry, and made the key point that *institutional* profitability management skills will be critical as a survival mechanism for law firms everywhere. In this post, I want to focus on why. After all, the legal press is currently chattering extensively about just how fast the profitability of major law firms is growing – and it is, indeed, growing fast! So why is managing it so important now?

Law firms have long been viewed as profitable enterprises and organizations where the partners make a good to very good living. Clients know that and, frankly, don't care. None of this is about how much money lawyers make – even the young lawyers whose services firms are currently so desperate to retain. Rather, it's about figuring out how to bring the most effective combination of resources together to address whatever the clients' needs are, *at the right price.* Profitability management, combined with market price signaling (how much are particular services worth?) are ultimately the critical tools needed to ensure that firms are refining their service models to be market responsive while delivering whatever services they provide. Why do we reach this conclusion?

First, it's probably time that we stop thinking about law as a homogenous industry. It's not and hasn't been for a long time. There are many different subcomponents of the legal industry that share only the broad commonalities that they provide services that are considered "legal", their owners (generally) went to law school, and they share jurisdictionally based ethical codes. As participants in an "industry", however, they vary dramatically. Plaintiff lawyers don't get hired to do real estate closings. Tort defense shops do not compete with Wall Street firms. Local business firms do not serve the same clientele as global vereins. They are all "lawyers", but they are not in the same business. How any particular firm needs to organize to ensure it is delivering services profitability varies as much as the firms themselves do. Compound this reality with the growing complexity of the legal industry writ large enough to include ALSP's, the Big 4 Accounting firms and other participants in the legal space, along with rapidly advancing technology that constantly creates new capabilities, and it is clear that *how* a particular type of service is delivered today will likely not be the way it is delivered next year, or certainly in 10 years. Clients expect firms to innovate, adapt, change and refine their approaches and adjust pricing to reflect those changes and their assessment of value.

How can law firms know whether they are adapting in the right ways to client demand-driven change? *By constantly measuring and managing the profitability of their service delivery in response to market-delivered pricing signals, and refining their approach based on those results.* Whatever else law firms choose to do, at a minimum they must deliver a reasonable living to the lawyers who work there as well as a sufficient return to the owners to keep them from seeking alternative homes. However, what it takes to do that is changing fast. Services that were once entirely performed by lawyers can no longer be done that way if the goal is to both deliver the service to the client at the market price *and* make a profit. We recently had the opportunity to work with a client that had within its practice mix a range of practices focused on lower market value tort defense matters. Years ago, these practices were of high value to the clients, and the firm gladly entered the practices and dedicated high-end partner resources to doing the work. Over time, the *real* market value changed – rates held constant for many years – but the firm's way of handling these services did not change. The end result is a situation where the practice cannot possibly compensate the partners in it given the cost structure, putting the firm in the painful position of having to make difficult choices fast. This firm may have sensed that the situation was developing (how could they not? but by choosing not to make “profitability” an active part of their culture, they were able to ignore it for too long.  Had they been on top of profitability management from the beginning, they would never have allowed the situation to develop!

Second, following on from the previous discussion, law firms are businesses and, as businesses, need to make strategic choices around 1) investment and disinvestment, 2) resource allocation and 3) reward distribution.   No well-run business would ever consider allocation of investment capital without a clear understanding of both how the business should be organized to provide an acceptable ROI but also have a clear understanding of how to know when it does.  Unfortunately, law firms regularly make investments without any clear understanding of their expected profitability.   As a strategic matter, what businesses *should* your law firm be in?  The obvious answer to that should be the ones where your firm can profitably compete while providing high quality service to the client…*not* ones where you can do the work and add to the top line revenue but where you don’t make a profit and you don’t provide something special to the clients.  So how do you know?   Well developed profitability management skills are critical.

Given the rapid changes in the industry, any current analysis around profitability, while perhaps more than a point-in-time assessment, cannot be expected to have long-term predictive power.  Firms must have ongoing monitoring capability which is responsive to changing price signals from clients (Are rate pressures increasing? Discounts growing?  Diversion of tasks to ALSP’s increasing?) and be able to constantly reevaluate and change how specific work is done.  As new technologies become available, for example, how will they be adapted for specific practice areas, and what will this mean for the firm?   At what point does it no longer make sense for the firm to continue an area of work as it currently is being done (or at all), and what should it do about it when it reaches that point?   (Disinvestment is an amazingly rare phenomena in law firms, at least in part because, absent a strong culture around profitability management, it’s easier to ignore unprofitable practices.)

Finally, over the long term, the firm must be able to retain the critical resources it needs to continue to provide its highest value strategic services as effectively as possible.  This ultimately means that those who make this possible must be remunerated in a manner consistent with the contributions they make, but how can that happen if we don’t understand where the profits come from and in what ratios?   Note that we are not here arguing for compensation systems based purely on profitability metrics but are suggesting that, over time, the generation of profits must become a factor in how the owners allocate the available profits.

Institutional skill around understanding and managing profitability, therefore, is not a standalone goal.   We need to develop these skills *because* they are integral to the longer-term strategic success of the firm, not because we just want to know some numbers.  Strategic investment or disinvestment in a business should be about where resources can be deployed to the greatest advantage by providing services to the client at a price commensurate with their market value. Absent profitability skills, keeping the firm on track long term may come down to luck.