

The Perils of Law Firm Profitability... and Thoughts on Best Practice (2nd Thoughts...)

By [Joseph B. Altonji](#) on November 20, 2015

In my last post, [The Perils of Law Firm Profitability... and Thoughts on Best Practice](#), I commented that “the profit of the law firm is what’s left over after you pay all the costs of the firm, *including* paying the partners for the real value their work contributes (not just the client billings directly, but other personal services including rainmaking, management and everything else the partner contributes.)” This prompted private questions about just how you are supposed to measure the value of rainmaking, management and “everything else” in the context of evaluating the profitability of law firm practices, clients and the like in a law firm. This post will offer some comments relevant to this issue.

First, however, it is worth noting that depending on the purpose of your analysis, there may be little reason to place specific values on rainmaking, management, and the like. Not all questions demand this level of effort, and even some that might under certain circumstances may not for others. For example, if a particular “service” practice in a law firm (aka materially net work-importing practice) is losing money before factoring in business generation or management costs, adding those costs won’t directionally change your conclusions. Similarly, ancillary work for a core firm client might be a net money loser for the firm – leading to the question of whether it is better to do it anyway to maintain the client relationship.

However, in some situations, it really is important to know what the real profitability of the work is after covering its fair share of the “cost” of intangible partner contributions. Take management as an example. If the Managing Partner is one of three partners in a relatively small law practice but the job itself is large, it is likely that she is paid at least in material part for managing, rather than for client work. If you charge the full amount of her compensation back to her law practice that will often be enough to tip her law practice’s profitability into negative territory (and of course all the other law firm’s practices benefit to the extent of their share of this “free” service!). How do you compensate for this? In this case there are two relatively straightforward ways to adjust. First, if the law firm’s compensation system specifically identifies the portion of the Managing Partner’s compensation allocated to law firm management, that amount, plus a proportionate share of her overhead, could be withdrawn before computing her hourly costs and added back to law firm overhead to be spread to all. Alternatively, if there is no direct linkage of compensation and law firm management, using a market proxy for compensation (e.g., What would it cost to hire a CEO for a business of this size in our market?) is an appropriate approach. That portion of the Managing Partner’s compensation (again, plus overhead) would be pulled from the practice costs of the Managing Partner and allocated to all law firm work as an “overhead” cost item.

Less dramatic overhead costs should probably be treated based on their materiality and purpose. For example, the compensation for a law firm’s General Counsel could be treated similarly to that for the Managing Partner. However, attempting to analyze the “value” of each partner’s time spent on various committees is probably not worth the effort under most circumstances. Practice Leader or Department Chair compensation probably should be evaluated depending on the question being asked. For example, if you are trying to assess practice group profitability, then the management cost of the Practice Group Leader should be included and there is really no reason to adjust it out, only to apply it back to the practice group’s timekeepers. However, if you are examining the profitability of specific clients, or for some reason of the lawyers themselves, then reallocating this practice group management compensation may be appropriate.

Adjusting for the value of rainmaking at a law firm is a somewhat different issue and under many circumstances should be considered. Rainmakers in most firms get paid for their rainmaking success. If they didn't, they would leave. However, if you examine the profitability of major rainmakers by allocating their entire compensation package as a part of the "cost" of the client work they personally do, very few would be "profitable." Rationally, this conclusion is ludicrous, but it is worse when extended to law practice groups. What happens when most of the rainmaking is concentrated in the Corporate law department, which spreads work out around the firm? The Corporate law department in a law firm becomes "unprofitable" because its partners are feeding the firm and being paid for their client relationships and business generation success, and the practices importing the work look materially more profitable than their actual contributions would justify.

Adjusting the cost structure of all work to account for the value of "making rain" for a law firm, while not exact, will get you closer to a reasonable assessment. Here as well, there are multiple approaches that can be used. In law firms with formulaic partner compensation, it is easiest to use the formula terms to define the "cost" of "sales." However, in most cases we recommend basing the analysis on a statistical assessment of law firm partner compensation drivers of the law firm in question. A third option might be to simply use a market proxy – e.g. 10-20% of revenue as the "cost of selling."

Any form of law firm profitability analysis can be done with high levels of precision, and all of the approaches discussed can help improve the *accuracy* of your analysis. But, as has been discussed here and in the prior post, the approach you choose should be aligned with your goals for doing the analysis in the first place. If you take the time to think through your questions, before embarking on your analytics, you will significantly increase the chance that your work will help you answer them!