

## The Perils of Law Firm Profitability... And Thoughts on Best Practices (Final Thoughts... For Now)

By [Joseph B. Altonji](#) on December 11, 2015

In my last two posts, "[The Perils of Law Firm Profitability... And Thoughts on Best Practices](#)," and its follow-up, "[Second Thoughts](#)," I discussed the need for and challenges associated with law firm profitability assessments. In this final post on this topic (for now), I wanted to address a more strategic, or perhaps philosophical topic: **Do we really need to rethink what we mean by "profitability" in the legal profession?**

In the first post noted above, I wrote: Law firm profit, properly measured, is not what the legal industry defines "profit" to be – everything paid to the law firm partners. Rather, no matter how you measure it, the profit of the law firm is what's left over after you pay all the costs of the law 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.) Profit measured that way would be very different than what the legal industry labels as profit, and for a significant number of law firms may actually be negative.

For a status quo industry, this issue may be of limited practical importance other than as an interesting intellectual exercise. However, we are hardly in a static industry, and as such, for the typical Managing Partner to be *unable to actually answer the question* of whether they are operating an economically profitable law firm strikes us as problematic. In an economic sense, few law firm leaders know whether their firm is profitable or not – and fewer still have asked the question in this way. For most, being profitable means something relatively simple: Do we make enough money to pay our partners at a level that keeps them happy? Under varying conditions, they might ask whether the law firm is profitable enough to attract new partners, or profitable enough to keep people from leaving. However if this last question is asked at all, it is likely that the law firm is in-fact unprofitable economically.

The day might be coming when law firms look to outside investors to routinely take equity ownership positions in law firms. We have already seen some of this overseas, and while current rules preclude such stakes in the US, a strong argument could be made that a change to these rules would be in the best interests of both the legal industry itself and the clients – a confluence that would suggest the change is inevitable. There will also be powerful incentives for law firms to actually consider going this route – whether as a means to equitize brand value for the strongest law firms ("cashing out" their key owners and perhaps ending remaining unfunded commitments) or to build capital for expansion or other strategic initiatives, or other goals a firm might have.

Having outside, non-attorney investors would force the industry to rethink the definition of law firm profit. Investors, after all, expect to "make a profit" and receive a return on their investment – which would have to come after the partners are paid for doing all the things they do as lawyers, including making rain, managing the law firm, and other services. (People don't routinely work 2500+ hours a year for free!) How many firms out there could take a reasonable slice off the top, say, 15-20%, to pay investors (including, of course, "dividends" on any shares the lawyers/"partners" own) and still have their lawyers satisfied with their incomes? We suspect the answer might be fewer than most would believe. Nevertheless, it will be the ones who can divert a share of income to investors without "underpaying" their lawyers who are actually "profitable" at a reasonable level, and they will be the ones most capable of tapping into external investment for whatever purpose.

So what does this mean for the legal profession now? In the short term, of course, we don't expect to see many law firms entering the public equity markets. But even without this change-driving disruption to the legal industry, would we be better off as an industry to move toward more conventional approaches to profitability measurement? There is a strong case to be made. First, applying more discipline to assessing the real "cost" or "value" of a partner's total services contribution to the firm, and separating this from what might be called the return and/or risk of ownership and capital investment would give law firm managers and the partners themselves a much better understanding of the performance of their own organization. Exposing a law firm as "unprofitable" would have a fairly profound effect on the law firm's culture – far more than a situation where partners can say, in effect, "No, we don't make as much as X firm, but we are profitable enough and our culture is more important." Yes, a law firm's culture is important, but in our experience, maintaining a good culture is very difficult in the face of continuing weak economic performance.

Second, and perhaps more important, thinking of profitability in economic terms is likely to be of significant value in advancing *client* welfare. This effect could stem from at least two sources including a) helping to shine a brighter spotlight on opportunities for efficiency improvement (and creating significant internal incentives for the leaders in various practices to focus on those efficiencies) and 2) helping the market for legal services to identify which firms are the strongest in driving client value and which are not. This would provide whole new metrics for services like [Peer Monitor](#) and [Aderant](#) to measure, creating a much greater incentive for the legal industry overall to focus on efficient legal service delivery.

Third, and perhaps most importantly, shifting our thinking on the meaning of "profitability" to something that is both measurable and more consistent with business practices in the rest of the world would create a much better framework for driving radical change in the industry. Our current models were built on the historic approach to delivering legal services – one hour at a time. Shifting toward a conception of law firm profitability that is simply focused on measuring the cost of the resources applied to the generation of a pool of revenue, and looking at the profit margin created, if used as a key performance measurement tool, would likely unleash significant creativity focused on how to deliver legal services on a more cost-efficient basis, even if radically different from prior approaches.

As we come to the close of 2015, we continue to see radically divergent financial performances among law firms. In a generally good year this year, some firms will have stellar outcomes, while others will see continued weakness. The latter, though, will be able to say, "Yes, we are profitable, even if we don't make as much as X." Would it be destabilizing in the short term to say, "No, you are not profitable"? Perhaps. Maybe even "of course." But would the law firm be better off in the long term to come to grips with its challenges and change to make sure it really is operating a profitable enterprise? The transition may be difficult, but the value in the end will be high.