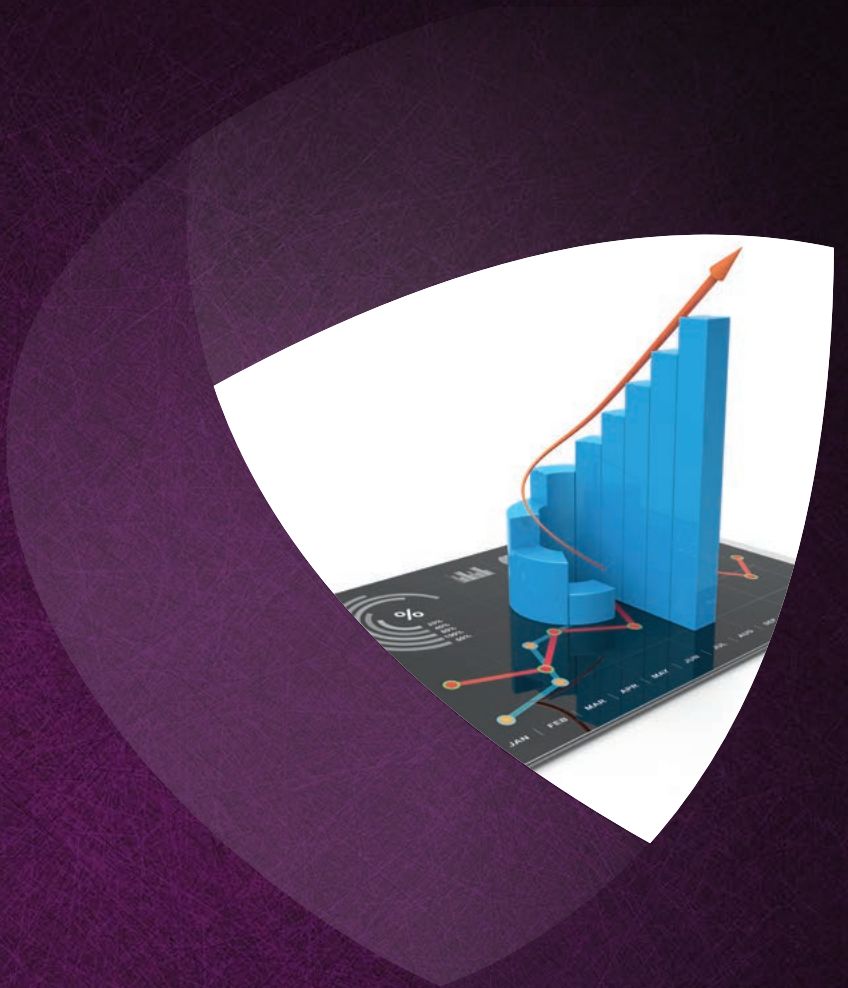


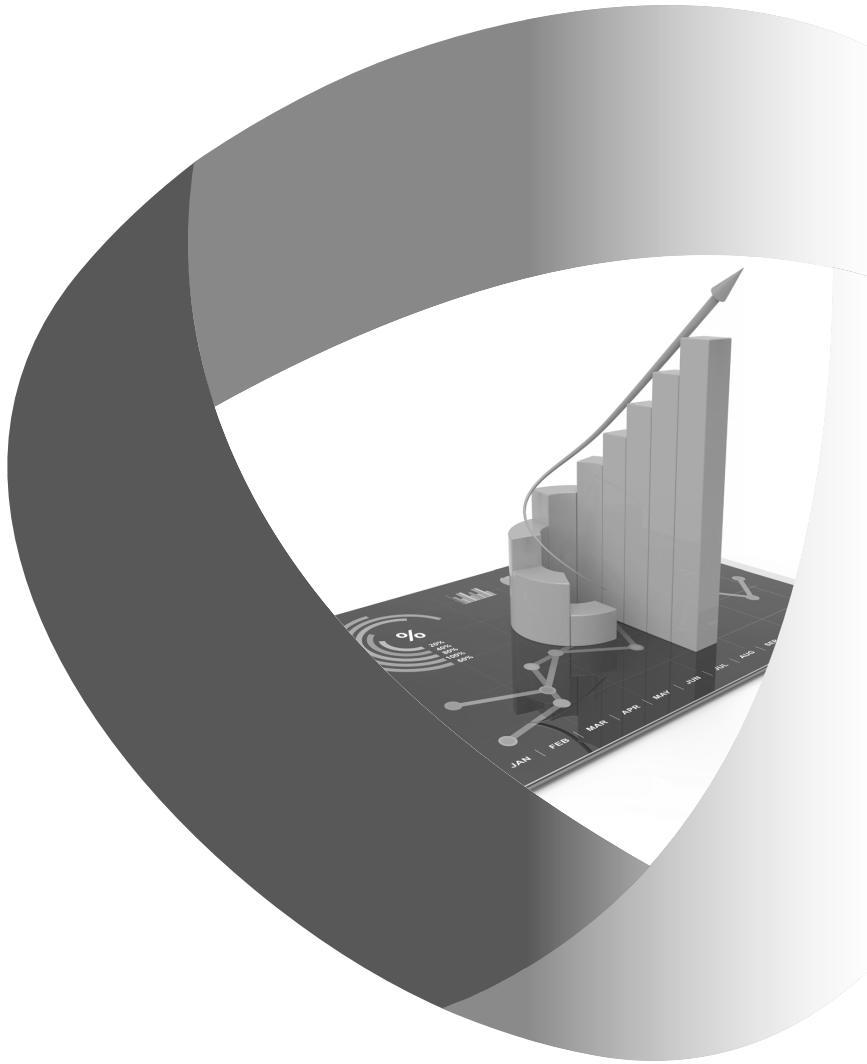
The Mechanics of Law Firm Profitability: People, Process, and Technology



EDITED BY EDWARD BOWES

The Mechanics of Law Firm Profitability:

People, Process, and Technology



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Executive summary

For the majority of law firms these days there is an internal struggle between longstanding cultural norms and an evolving data-focused business environment, in which firms must be willing to adapt and accept new ways of analyzing their business. Today's hyper-competitive market requires firms to acknowledge and focus on their bottom line, and the impact their standard practices have on it.

Take the example of law firm partner compensation plans. Despite increasing client demands for AFAs, fixed fees, and a renewed emphasis on collaboration and cross-selling, compensation plans simply have not kept pace with the changing legal landscape. Rather they continue to reward yesterday's one-dimensional behaviors. For the most part law firms have yet to actually define their bottom-line, with even the determination of profit margins a relatively new measurement in the industry. This begs the question, how should the modern firm reposition itself to face these challenges?

Many law firms today are wrongly focused on increasing market share, when they should really be paying more attention to what makes them a more profitable business. Market share is irrelevant if you are not profitable. Law firms cannot simply grow their way to prosperity by way of slashing fees to undercut the competition – instead, firms must focus on value creation and increasing a client's willingness to pay for a particular service. The question should be: “What can your firm do better, or more efficiently, and more profitably than anyone else?”

The Mechanics of Law Firm Profitability: People, Process, and Technology is illustrative of the changing scope of matter management in support of client value, practice efficiency, and ultimately law firm profitability. The book examines why a focus on profitability and metrics is reshaping law firm operations and matter management; how to define the bottom line and to distinguish between “good” revenue and “bad”; and how to change the dialogue from “hours and revenue” to “revenue and profit”, while changing the mindset from increasing market share to simply running a profitable business.

Keith Maziarek succinctly remarks in chapter two; “...at the end of the day, every venture is in business to bring in more money than it spends” – and law firms are no exception.

In chapter one Jack Bostelman, president of KM/JD Consulting LLC, and Chris Boyd, senior director of professional services at Wilson Sonsini Goodrich & Rosati LLP, outline how implementing knowledge management projects into a firm can increase profitability, and create more value from work undertaken. Using a base case model that is given to the reader, they show how a firm’s financial figures can be improved with three kinds of Knowledge Management (KM) project – proving that a rethink of a lawyer’s day-to-day practice can have tangible financial benefits.

Chapter two features Keith Maziarek, senior director of client value at Perkins Coie, outlining the weaknesses of using realization figures as the primary method of measuring profitability – and how any focus that is “revenue driven” will lead to sub-optimal business decisions. The chapter then moves on to briefly discuss the relationship between revenue and profits per partner (PPP), and how PPP can affect, and be affected by, the overall profitability of a firm.

Continuing the discussion on PPP, in chapter three Toby Brown, chief practice manager officer at Perkins Coie, explores the issue of how firms should treat partner compensation in relation to profitability – and runs through developing a comprehensive partner compensation system based on “revenue and profit” as opposed to the more current “hours and revenue” basis.

To further develop on the issue of partner compensation in terms of profitability, chapter four features Timothy Corcoran, principal of Corcoran Consulting Group LLC, discussing the complexities of partner compensation; including how firms should measure and reward profitability; keeping compensation plans transparent; and making compensation plans work during partner successions.

In chapter five Anthony Davis and Wendy Chang, partners at Hinshaw & Culbertson LLP, follow on from chapter two’s considerations on “bad revenue”, and how firms are moving away from the “any work is profit” mentality, to explore how a firm can use the client intake process to boost profitability. The chapter brings light to the fact that with proper client management, and the confidence to reject those clients destined to be unprofitable, a firm can make significant improvements to its profits.

Chapter six moves to focus the issue of profitability in relation to the hiring of laterals, with David Parnell, founder and principal of True

North Partner Management, discussing the upfront financial analysis of the acquisition and the nuances surrounding the first year profitability during the process.

In chapter seven, Michael Roster, co-chair of the Association of Corporate Counsel's Value Challenge Steering Committee, outlines how firms should take to viewing their different practice groups as individual, autonomous entities – and redefine the firm itself as a provider of multiple specialist services through the use of “departments” (practice groups) rather than a singular business entity. The chapter leads into explaining how some practice groups can widely differ, and judging them all by the same standards can lead to negative financial impacts. With profitability managed at an individual practice group level a firm can optimize their profits to a finer degree.

However, managing profitability is not an easy task; as Jim Hassett, founder of LegalBizDev, discusses in chapter eight. Through multiple interviews with many senior level partners at law firms, a telling picture is painted showing the obstacles that law firms face in managing their profitability – and where many of them fail. These issues often preventing firms from moving towards a position of profit include effectively controlling the bidding processes and knowing where to count a loss as “acceptable”.

In chapter nine James G. Perkins, chief operating officer and chief compliance officer at Procopio, gives an overview of how the regional firm uses and manages their profitability, how they established and utilize their profitability model, and why the concept of “managing on the edge” is fundamental to firms operating at regional levels.

Finally, the book finishes with a case study from Faegre Baker Daniels which outlines how the firm managed to lay the foundations for sustainable and profitable growth within a niche market by making changes to their core practices and the overall culture of the firm. The case study gives an insider look at a number of methods Faegre Baker Daniels utilized to encourage profitability, including pricing initiatives, process improvement, and knowledge and project management.

About the authors

Jack Bostelman is president of KM/JD Consulting LLC in San Francisco, California, which advises law firm leaders on practice management, including knowledge management and other productivity improvements. Before founding KM/JD Consulting, Jack was a partner for over 20 years at pre-eminent AmLaw 20 firm Sullivan & Cromwell in New York City, where he had a nationally recognized transactional securities law practice and exercised management responsibilities.

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Toby Brown is chief practice management officer at Perkins Coie. In this role Toby leads the firm's revenue management and efficiency programs, legal project management, pricing, process improvement, practice innovation, alternative staffing, and new partner integration. Toby has more than a decade of experience in practice management and pricing with Am Law firms and is the former director of the Utah State Bar.

Toby presents nationally on legal pricing, marketing, technology and law firm management for associations, law firms, legal departments, law schools, and paralegal programs. He has published numerous articles on these topics, as well as a report on Law Firm Pricing: Strategies, Roles, and Responsibilities (Ark Group, 2013). He has served on a number of legal services boards, bar association task forces, and legal market organizations. He received the Peer Excellence Award, the President's Award, and the Anne Charles Award from the National Association of Bar Executives. Toby maintains the ABA award winning 3 Geeks and a Law Blog with two colleagues at: www.geeklawblog.com.

Wendy Chang, partner at Hinshaw & Culbertson, represents lawyers in all types of complex matters that involve the practice of the law, including risk management counseling, ethics, crises management, fee related issues, discipline defense, hotline counseling, professional liability, and litigation defense. Ms. Chang is a certified specialist in Legal Malpractice Law by the State Bar of California's Board of Legal Specialization. Ms. Chang is a member of the American Bar Association's Standing Committee on Ethics and Professional Responsibility, and is an advisor to the State Bar of California's Commission for the Revision of the Rules of Professional Conduct. She is a past chair of the State Bar of California's Standing Committee on Professional Responsibility and Conduct.

Ms. Chang also represents businesses in all types of business litigation, with particular emphasis in high exposure complex litigation, trials, and appeals. Ms. Chang represents corporate and governmental entities in a variety of high exposure media interest litigation, including complex tort defense, fraud and conspiracy claims, insurance litigation (coverage litigation, bad faith), contracts, and complex business disputes from filing through mediation, trial, arbitration, and/or appeal. She regularly appears before the trial courts and the courts of appeal. Ms. Chang also represents businesses in defense of employment litigation, in discrimination, harassment, and retaliation claims. She has served as an independent workplace investigator for public entities in sensitive matters relating to human resource issues.

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Jim Hassett is the founder of LegalBizDev, which helps law firms increase profitability by improving project management, business development, and alternative fees. Before he started working with lawyers, Jim had 20 years of experience as a sales trainer and consultant to companies from American Express to Zurich Financial Services. He is the author of 13 books, including the *Legal Project Management Quick Reference Guide*; *Legal Project Management, Pricing, and Alternative Fee Arrangements*; *Client Value and Law Firm Profitability*; and the *Legal Business Development Quick Reference Guide*. He has also published more than 80 articles in the *New York Times Magazine*; *Bloomberg Law*; *Of Counsel*; *Legal Management*; *Strategies: The Journal of Legal Marketing*; and other publications. Jim is a frequent speaker at law firms and at bar associations (including the New York City Bar, the New York State Bar, and the Massachusetts Bar), Harvard Law School; the Association of Corporate Counsel; the Defense Research Institute; the Ark Group; and at Legal Marketing Association meetings in Boston, New York, Philadelphia, Washington, Savannah, and Vancouver. He has conducted webinars through the Ark Group; West LegalEdcenter; the National Law Journal; The International Lawyers Network; TAG Academy; and the Legal Marketing Association. Jim writes the blog “Legal Business Development” which was featured at the ABA TECHSHOW (in its list of “60 Sites: Latest and Greatest Internet Hits”) and by TechnoLawyer (in its list of “the most influential legal blogs” in BlawgWorld). He received his Ph.D. in psychology from Harvard University.

Keith Maziarek recently joined Perkins Coie as the senior director of client value. In this newly-created role, Keith works closely with the legal operations executives at the firm’s top clients to establish strategic pricing arrangements, implement customized communication/collaboration tools and efficiency solutions, improve performance monitoring and reporting, optimize service delivery models, and establish metrics that will enable client legal departments to qualify and quantify the value they are capturing through their work with the firm.

Prior to joining Perkins Coie, Keith served as Head of Strategic Pricing for DLA Piper LLP. There he developed, implemented, and managed the firm’s strategic pricing, profitability, and legal project management functions, with a focus on the practice in the Americas.

Keith has authored several published articles on the topic of alternative fee arrangements, and also speaks regularly at industry conferences. He is the immediate past co-chair of the LMA's annual P3 Conference, the industry's largest annual event addressing transformation in the legal industry related to pricing, project management, and process improvement. Keith holds an M.B.A. from the Kellogg School of Management at Northwestern University, with majors in Management and Strategy, Managerial Economics, and Analytical Consulting, and a B.S. in Business Management from the University of Illinois-Chicago.

David J. Parnell is an author, speaker, *Forbes* and *American Lawyer Media* columnist, and the founder and principal of True North Partner Management, a partner-level legal search and placement firm. Along with his experience in private placement, he has previously worked in-house with the likes of Intel, Xircom, and DreamWorks SKG. Complementing his *Forbes* and *ALM* columns, his work can also be found in publications such as *The American Lawyer*, *Huffington Post*, *Venture Capital Post*, *Fox News Magazine*, *Lawyerist*, *Law360*, *Bloomberg*, *Australasian Lawyer*, *NBC News*, *The Global Legal Post*, *Business Insider*, and *NZ Lawyer*, among others.

James G. Perkins, chief operating officer and chief compliance officer at Procopio, leads the firm's non-legal operations including finance, human resources, administration, marketing, and information services. With 20 years of experience at the firm, he has more than 35 years total leading as a chief operating and chief financial officer in the professional services, management consulting and manufacturing industries.

Steven Petrie manages the strategy and operations department at Faegre Baker Daniels. In this capacity, he oversees the collection, extraction, and application of financial data and performance metrics for purposes of business analysis, practice development, creative pricing, and strategic planning. Steve holds a Yellow Belt certification in Legal Lean Sigma and provides guidance for the firm's institutional efforts in the areas of legal process improvement and project management. Steve's department is also home to the firm's administrative operation functions. Prior to his career in law firm management, Steve worked for the strategy and operations practice of a large consulting firm. He is a frequent industry contributor on topics of law firm economics, profitability analysis, alternative pricing, and process efficiency.

Michael Roster is co-chair of the Association of Corporate Counsel's Value Challenge Steering Committee. He was formerly managing partner of Morrison & Foerster's Los Angeles office as well as co-chair of the firm's Financial Services Practice Group worldwide, resident in both Los Angeles and Washington, DC.

Mike was subsequently general counsel of Stanford University, Stanford Medical Center, and Stanford Management Company – and then executive vice president and general counsel of Golden West Financial Corporation. He has also served as an outside director and vice chair of Silicon Valley Bank, chair of the Stanford Alumni Association, chair of the Association of Corporate Counsel, and chair of two start-up companies (Insert Therapeutics and Encirq). He is a former director of the California Bankers Association and the Federal Home Loan Bank of San Francisco.

Mike is currently an adjunct faculty member at USC Gould School of Law where he teaches advanced contracts. He also is a director of MDRC, a non-profit corporation based in New York that evaluates the effectiveness of government and other non-profit programs, and several years ago he chaired a project funded by two foundations that developed a private sector approach to eliminate abuses in consumer credit cards in the US.

Vanessa Savoie is a senior strategy and pricing analyst at Faegre Baker Daniels law firm in Minneapolis. She is part of a team that works with firm leadership to provide data driven solutions so that attorneys may best serve their clients, and effectively manage their practices. In support of firm management, she applies analytical rigor with creative problem solving to the business review process, complex financial modeling, pricing, and strategic planning. She truly enjoys partnering with and supporting the firm's professionals across the country and internationally.

Vanessa studied Psychology and graduated with honors from the University of Wisconsin-Stout in 1996. After graduation she transitioned her interest in research design, methodology, and statistics into a career in Finance and Technology. She has been fortunate to have worked at some of the Twin Cities' largest companies, including; U.S. Bank, Carlson Companies, FICO, and Ameriprise Financial.

In her spare time, she loves spending time on the run with her two children, dog, and horse. Vanessa has also recently discovered obstacle races, enjoys the challenge of training for them, and likes competing in them with friends.

Tom Snavely has almost two decades of process improvement, operations management, and project management experience. He earned an M.S. in Technology Management from the University of St. Thomas, a Certified Black Belt in Lean Six Sigma, and a Mini Master of the Lean Enterprise. Tom has developed Lean Six Sigma programs and training for several organizations that were new to these concepts. He has created and developed project management offices for several organizations to align project opportunities to strategic goals and the ultimate success of these projects. As a consultant and an operations manager, Tom has aided several organizations, and a private equity firm, to achieve strategic operational goals through process improvement and organizational change management. As a project manager, Tom has led operational and information technology projects for new innovative applications and complex business systems such as PeopleSoft and SAP. Tom has co-authored an article that is based on developing teamwork as a method to foster innovation, an article focused on collaboration with clients to optimize law firm operations for *Managing Partner*, and a chapter for an Ark publication that shares how Faegre Baker Daniels has implemented process improvement and legal project management. He has helped a local university develop a curriculum that is designed to teach MBA students Lean Six Sigma and its applications in the “real world.” Tom is involved with youth development programs throughout the twin cities and is a board member for the Minneapolis YMCA.

Mark Voigtmann is a partner at Faegre Baker Daniels and leader of the firm’s construction law and real estate litigation practices. He is the author of *The Automation Legal Reference: A Guide to Legal Risk in the Automation, Robotics and Process Industries*, published by the North Carolina-based International Society of Automation. He also co-authored a set of contract documents created for an incremental, education-based lean project delivery model used in two \$200 million hospital projects, among others. Both within the firm and in the construction industry, Mark implements sophisticated project management and process improvement strategies to deliver optimal efficiency across the board.

Chapter 2:

The “every dollar is a good dollar” fallacy – The difference between good and bad revenue

By Keith Maziarek, senior director of client value at Perkins Coie

The concept of performance measurement in the business context can take many forms across different industries. It is these measurements which provide the basis on which analysis is performed, and on which strategy and operations plans are built. Despite the varying measures of performance across industry sectors, typically an optimal and generally accepted model has been established which accurately measures performance based on the economic forces at play. Understandably this is often the result of a process of evolution over time, but mature markets have most often evolved mature methodologies by which to evaluate the relative strength of their players.

In the legal services sector, historically two metrics have dominated the conversation surrounding financial performance: realization at the matter, client, and timekeeper level, and profits per partner (PPP) at the firm level. For the purposes of our conversation here we will first focus on realization as this has been the driver of compensation and financial growth decisions at law firms for decades.

Realization is a purely revenue-based metric. Generally speaking, realization is expressed as a percentage figure, calculated as the proportion between two measures of revenue generation. There are two primary “flavors” of realization that are most commonly tracked:

1. **Billing realization** is the percentage of fees billed as a function of worked fees. This means that the fees billed will equal the fees at standard rates, less the fees worked after any hourly rate discounts are applied, less the fees associated with any write-offs of time.
2. **Collection realization** is the percentage of fees collected as a function of fees billed. This means that fees collected will be just that – revenue that has been received by the firm – compared to the fees that were billed.

There are any number of variations on how some of the data points used in these calculations can be derived, but what is constant is that these calculations only express revenues as a function of revenues. A few glaring weaknesses of using realization as a primary performance metric quickly come into focus, namely:

1. Most significantly, it ignores the crucial data point of cost. No matter where you set your rates or what percentage of that price you are able to collect, if you don't know your breakeven price, the percentage of your billing rate that you collect is somewhat arbitrary.
2. It is based on the relatively inconsistent reference point of billing rates, which often don't take into account market value of different services. Some services are more commoditized or more specialized than others, and as a result, command different prices as they represent different values to clients. Depending on the methodology used to set rates, if a somewhat uniform approach is used across all practices, highly commoditized services will always appear to have weak financial performance because they will have to be significantly discounted from their standard rates.

The comparative anecdote I like to use to illustrate the imprecise nature of evaluating financial performance purely as a function of revenue is a hypothetical conversation between two friends, one of which happily reports that they've sold their home. This brings up the inevitable question, “Did you get a good price for it?” If the answer to that question is, “Yes, I got 90 percent of my asking price,” nothing meaningful is conveyed, because it doesn't indicate whether or not:

1. They made any money (a.k.a. captured any profit) from the sale, because you don't know what they paid for it in the first place. The price they agreed on could be lower than what they paid or owe on the loan, in which case, is 90 percent of the asking price good? It's impossible to say.
2. Their asking price was, high, low, or consistent with the market. Collecting 90 percent of a price that is 150 percent of the comparable market price would seem to be a solid gain, but 90 percent of a price that is set 25 percent below market comparable prices is nothing to brag about.

The lack of either of these reference points somewhat distorts the measure of financial performance. Realization can be a relevant data point, which is discussed later in this chapter, but on its own, it's an insufficient measure of profitability.

To be fair, the period over which realization became the focus of analysis was one of great economic prosperity in the legal services sector. Traditional law firms controlled nearly complete market share; corporate profits were high, so scrutiny over legal spend and discounts demanded were low; and large corporate clients lacked systematic purchasing frameworks aimed at achieving savings from economies of scale, and didn't engage in sophisticated, competitive bidding activities among qualified pools of service providers. Buyer power was moderate and infrequently leveraged – the legal department was run by lawyers, many of whom had come from private practice and were comfortable with the billable hour system as they had learned it. As we all know, however, times have changed.

Not all revenue is created equal

The point of this exploration of the dynamics of realization is to demonstrate that a revenue-driven metric can, and typically does, distort the evaluation of financial performance. In a revenue-only driven world, every dollar (or pound, or euro, etc.) is a good one. Financial decisions, then, can be clouded as unprofitable work is viewed as being worthwhile because it is, after all, revenue. It's a very bird-in-the-hand perspective that tends to ignore opportunity cost, as the assumption is that the first offer received is the only one available, but that is almost never the case.

To illustrate how sub-optimal financial decisions can be made when revenue is coveted and margin is ignored, consider the following case study:



A partner meets with a long-time client, and in the course of the discussion, learns that the client's financial position has weakened, and as a result, all service providers are required to freeze their rates and prices for the next two years. In this particular instance, the prices were frozen two years ago for the same reason, so the discounts afforded to this client have gotten uncharacteristically high in comparison to other similarly positioned clients. Historically this client has generated approximately \$3 million in annual fees for the firm, making a compelling case to continue doing the work, because the alternative is to lose that \$3 million.