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Client Value and Law Firm Profitability

Bloomberg BNA recently conducted this e-mail interview with LegalBizDev founder Jim Hassett, Ph.D. about his recent research on what law firms are doing to maintain profitability while meeting client demands for greater value. His new book ''Client Value and Law Firm Profitability'' summarizes confidential interviews with leaders from 50 AmLaw 200 firms. It is available through www.legalbizdev.com and on Amazon.

Bloomberg BNA: Tell us about your book—what was your goal and who did you talk to?

Jim Hassett: In the last few years, millions of words have been written by law school professors and consultants about how the demands of the clients of major law firms are changing and what law firms should do about it.

The only thing that's been missing from the conversation is statements by the people who actually run large law firms. These senior decision makers deal with these issues every day, and their very livelihood depends on coming up with the right answers. I wanted to hear their honest opinions about these highly sensitive issues but knew they could not speak openly if they were quoted by name, so I devised a research approach built around anonymity. I conducted every interview myself, and promised that while firm names would be listed in the report, the name of every individual I interviewed would remain confidential and no quote would be linked to a particular person or firm.

Leaders from 50 of the AmLaw 200 agreed to speak with me for this book. Forty-two percent were managing partners or chairs, and the remainder were senior partners and staff, including CEOs, COOs, and CFOs. They were indeed unusually frank in their responses, including the AmLaw 200 chairman who said that ''[l]awyers are about as dumb as you could possibly be about understanding how our product is made. The lawyers who understand how to make it and who can manage that process efficiently are going to be the winners.''

They also spoke freely about both problems and solutions, like the managing partner who said, ''I have a $10 million practice. But that could be a disaster for a firm, because it could cost them $11 million to get $10 million. But nobody ever talks about it that way.''

BBNA: What was your most surprising finding?

Hassett: While almost everyone agreed that client demands for greater value and lower fees have been putting pressure on law firm profits, firms were remarkably inconsistent about how they measure profits. When I asked, ''If you compare profitability for two lawyers in your firm, is there a software program or formula used to calculate profitability or is the comparison more intuitive?'' a surprising 26 percent said there was no such formula or program and that the answer was intuitive. For the other 74 percent, definitions and formulas varied widely, including total revenue, profits per equity partner, leverage, several different types of realization, and a variety of approaches to cost accounting.

To dig more deeply into this important issue, we conducted follow-up interviews with industry leaders from firms that sell software to analyze law firm profitability. Jeff Suhr, a VP at Intellistat/Data Fusion, reported that his company currently has 91 clients actively using their tools. How do they calculate profitability? Ninety-one different ways. The fundamentals are basically the same, but there are important differences in the assumptions and details. These differences can have significant implications for the way profitability is interpreted and can affect the way in which the figures are used to motivate lawyers to change their behavior so that they can better meet client needs in a way that can be sustained.

BBNA: What are law firms doing to protect the bottom line?

Jim Hassett founded LegalBizDev to help law firms increase client satisfaction and profitability by improving project management and business development. He is the author of 13 books, including The Legal Project Management Quick Reference Guide, The Legal Business Development Quick Reference Guide, and Legal Project Management, Pricing and Alternative Fee Arrangements. Jim has also published more than 80 articles in the New York Times Magazine, Of Counsel, Legal Management, Strategies: The Journal of Legal Marketing and other publications. He 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 the Legal Marketing Association. Jim earned his Ph.D. in psychology from Harvard University.

Hassett: They are trying lots of things, with mixed success. According to our data, the two most effective ways of protecting profitability are quite new to the legal profession: legal project management (LPM), and new staff positions in such areas as pricing, value, and LPM.

Other tactics have led to more mixed results, including relying on new technology, knowledge management (KM), and contract attorneys and outsourcing. The book includes many quotes from proponents saying that technology, KM and outsourcing were the most valuable steps they took, and from others who said that they were a waste of time and money. These differences of opinion can be traced both to the different needs of different firms and to the details of how they tried to implement change in each of these areas.

BBNA: Lots of people seem to agree that legal project management is important, but what exactly does it include?

Hassett: That is an excellent question. The field is so new that experts disagree about what should be included and excluded from the concept. This has slowed progress, as seen in the remarks of one senior executive who noted: ''We were just at a board meeting last week where we were talking about whether we should do formalized project management training. My answer to that is obviously yes, we absolutely should. But first we need to agree on what legal project management is.''

In my book *Legal Project Management, Pricing and Alternative Fee Arrangements*, I reviewed the short history of this movement and proposed the broad definition we use in our coaching, our training and this research: ''Legal project management adapts proven management techniques to the legal profession to help lawyers achieve their business goals, including increasing client value and protecting profitability.''

This broad definition includes everything from budgeting and communication to process improvement, knowledge management and personal time management. We believe splitting hairs over what is and is not LPM is just another excuse to avoid action. Law firms need to move as quickly as possible to the real problem: What must we do today to meet client needs while remaining profitable and competitive?

BBNA: Where is the pressure for LPM coming from?

Hassett: From clients. One of the best sources of information about client demands is the *Chief Legal Officer Survey* which Altman Weil has been publishing for the last 15 years. (Full disclosure: LegalBizDev is a strategic alliance partner of Altman Weil.) One key question in the 2014 survey, which was released in November 2014, was, ''Of the following service improvements and innovations, please select the three that you would most like to see from your outside counsel.'' This year's answers from 186 CLOs were greater cost reduction (58 percent), more efficient project management (57 percent), and improved budget forecasting (57 percent). Since LPM leads to cost reductions and to improved budget forecasting, you could say that the top three client requests were LPM, LPM and more LPM.

[T]he focus on total profits per partner distracts people from one of the most critical questions in today's competitive legal marketplace: which matters, practices, partners and offices make money and which don't?

In business, everything starts with meeting client needs. But lawyers who understand LPM and apply it to their practice are still a tiny minority. As one senior executive put it: ''One of the problems that we have, and frankly that most firms have, is just teaching lawyers how to manage a project, getting them out of the habit of just automatically starting out with some rote process. Just because the client says, 'I think I might have a lawsuit' doesn't mean you go off and conduct 40 depositions. Lawyers need to sit down and talk about what the client is trying to accomplish. It might turn out that we are able to accomplish the client's end goal without taking any depositions.''

When I asked about which aspects of LPM were most critical to firms' short-term success, it is interesting that the top two areas participants singled out were defining scope and managing client communication. These issues cannot effectively be addressed by the expensive software that so many firms see as a starting point. They require partners to change their behavior and become more efficient.

BBNA: Can in-house counsel help law firms become more efficient?

Hassett: Absolutely. Many law departments need to become more efficient themselves if they expect their firms to deliver better service. A few years ago, an AmLaw 100 Chairman I interviewed for an earlier research report (*The LegalBizDev Survey of Alternative Fees)* noted that ''It is very difficult for a law firm to tell a client that a matter is not going well because of what is going on in the legal department. I think we've all had experiences over the years with in-house counsel who are not good managers. . . [This] can increase cost and reduce the quality of outcomes.'' Another participant echoed this theme when he described some problems he was having with a very large client but noted, ''I am reluctant to tell [the GC] that his own people cause a fair amount of inefficiency, because he's not going to want to hear it.''

My new book lists the top three things clients should do to increase value:

1. Define objectives and scope at the beginning of each matter.

2. Increase transparency about client needs.

3. Improve in-house project management.

As one chair summed it up, ''Clients have to jointly work with us to figure out what it is they want us to do less of in order to meet their expense goals. You can't do scorched-earth approaches to matters at reduced fees.''

BBNA: How are new staff roles contributing to profitability?

Hassett: In 2012, Jonathan Groner and I wrote an article for *Bloomberg Law Reports*[1] entitled ''The Rise of the Pricing Director.'' At that time, despite extensive networking, we were able to find only a handful of people who held the title of pricing director in a law firm or performed that function. Law firms generally move a little slower than glaciers, but the growth in pricing directors in the two years since has been meteoric. According to a 2014 survey by ALM Legal Intelligence, ''Seventy-six percent of big firms now employ some sort of pricing officer. And these posi-

[1] Jim Hassett & Jonathan Groner, *The Rise of the Pricing Director*, BLOOMBERG L. REPS., Feb. 6, 2012, *available at* http://op.bna.com/ccw.nsf/r?Open=sbon-9rgnly.

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tions are in the midst of a remarkable growth spurt.''

With 20/20 hindsight, it is easy to see the reason for the rapid growth of the pricing director title and function. The well-documented changes in the legal profession over the last few years have placed intense pressure on profits. It is therefore not surprising that a new host of high-level executives has emerged to help law firms set their prices in a way that will help them to maintain profitability.

Many firms agreed on the value of hiring people with business backgrounds and empowering them to use their skills to help lawyers make crucial decisions on pricing and efficiency. As one managing partner put it: ''I think what's had the greatest positive effect is our business managers. They can much more impartially sit down and analyze profitability. They build up a database of what it costs us to do things, and they're just invaluable. They work with enough lawyers that they're able to focus on the numbers and their minds work differently . . . These non-lawyers are focusing on the business side of the equation and what it costs to do things, pushing back and helping lawyers have a little bit of backbone. They can now show them a model and say, 'No, that's too low, you're going to lose your shirt.' ''

BBNA: Is profits-per-partner a good metric to measure a law firm's influence?

Hassett: In my opinion, it is definitely over-emphasized. Unfortunately, when lawyers talk about profit, many think first and foremost about profits per equity partner, the figure publicized in the *American Lawyer* annual rankings of the top 200 firms. This is widely perceived as a sign of financial health and sometimes used to recruit laterals to higher profit firms. It is also misleading.

In any other business, profits are defined as the revenue that is left over after all expenses have been paid. In the law, partner salaries come out of the ''partner profits'' pool. In a law firm, if there were no partner profits, partners would be paid nothing for their work. This leads to considerable confusion. For example, one managing partner in our study said: ''As a partnership, everything we make above our cost is profit. I once had a lawyer who stood up and said, 'How did we lose money this month?' I said, 'We didn't lose money, we just didn't make as much money as we would have liked.' It's very hard for a law firm to lose money, that is, be in a situation where you're not paying your partners anything.''

In other businesses, companies analyze which product lines and groups are most profitable, and they act on that information by fixing or discontinuing unprofitable products or people. In law firms, the focus on total profits per partner distracts people from one of the most critical questions in today's competitive legal marketplace: which matters, practices, partners and offices make money and which don't?

If that's not bad enough, there are a number of other problems with these figures, starting with the fact that they are not audited. An August 22, 2011 *ABA Journal* article by Debra Cassens Weiss reported that ''More than half of the nation's top 50 law firms could be overstating profits per partner to the *American Lawyer* magazine . . . An analysis by Citi Private Bank Law Firm Group reportedly found that 22 percent of the top 50 firms overstated profits per partner by more than 20 percent in 2010. Another 16 percent inflated partner profits by 10 to 20 percent, and 15 percent boosted partner profits by 5 percent to 10 percent.''

BBNA: Will the legal market ever ''bounce back'' from the recession, or do law firm partners now need to learn how to excel in a totally different environment?

Hassett: Most of the people we interviewed believe that the world has permanently changed, like the managing partner who said: ''The way law firms deliver legal services to clients is undergoing a huge revolution. It's going to change before our eyes in the course of a very short period of time. And it's all being driven by clients who want to get value for their money.''

As the chair of another firm summed it up: ''I believe that we're still in the beginning of the process. There are a number of famous economists who have talked about disruptive technologies and disruptive business processes. I think there's a lot of evidence out there that this profession is being subjected to those pressures. Five years from now, if I turn out to be wrong, that will be great. But if I'm right, then I have to believe that those firms that adapt more quickly will have a competitive advantage, because the firms that don't adapt quickly enough will be out of business.''