Seven Ways Good Law Firms Lose Money

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1. A Checkbook Mentality

Professional restrictions on how law firms can manage finances over multiple years are at the root of this problem. At the end of the year, law firms essentially must be cash out all profits to the shareholders.

This creates two problems. First, it essentially eliminates any long-term view of law firm finances, restricting the firm's ability to make capital investments, hold reserves for future projects and so on. The second problem is that it creates a constant focus on expenses by many partners who will actively resist any expenditures that might reduce their payout. Since most attorneys – like most consumers – tend to live above their means, this tends to create a short-tem "gimme mine" mentality which can be hostile to the overall future of the firm. There are firms which go to the extreme on this issue, distributing profits quarterly or even on a monthly basis, leaving only enough to pay the next month's expenses.

The problem stems from the small firm traditions of the profession. The average sole practitioner takes out profits on a monthly and even sometimes more frequent basis, essentially seeing it as their own personal bank account rather than the bank account of the business. As a firm grows, this mentality too often remains.

This knee-jerk resistance to expenses results in minimalist staffing decisions, egregious delays in upgrading equipment, software and hardware, and a serious neglect of long-term investments in such areas as marketing, or anything that does not result in a short-term payoff.

This mentality results in attorneys who are overworked, under-supported, inefficient, unfocused on the long-term, and with no effective or well-funded marketing program. It is no surprise that this, then, is the profession that enjoys some of the highest rates of divorce, alcoholism, drug abuse, heart attack, and even suicide.

2. Technicians in Charge

The most successful businesses are built by entrepreneurial leaders who have a longer-term vision, develop strategies and approaches to creating that vision, and are willing to take risks and make expenditures to achieve their goal. The legal profession is notably short of entrepreneurs, since virtually all attorneys were trained in law school that to be successful is to be a good technician – in other words, doing good legal work is everything. As a result, most attorneys believe their most important role is to do the legal work, and often have a long-term view that ends at the front of their desk and encompasses only the piles of files. Their most common objection is "don't bother me – I have work to do."

It is, of course, critical that the attorney provide excellent legal work. However, unless the client is highly sophisticated, few clients know how to determine whether a lawyer is expert. They will usually hire on the basis of two factors: what someone else has said about them (the referral source), and their personal impressions of the attorney. In short, someone else's opinion, and their own personal emotional reactions.

Beyond this, the truth is that most legal work is not cutting edge, groundbreaking and precedent-setting, but straightforward work that does not always require the highest level of expertise.

As Michael Gerber says in his book *"The E – Myth,"* the technician works <u>in</u> the business while the entrepreneur works <u>on</u> the business. While all firms need attorneys who are great technicians, those firms controlled by technicians rather than visionary leaders are headed for extinction.

3. The Almost-Lone Ranger Syndrome

Sole practitioners have traditionally resisted hiring non-lawyer staff, seeing them as unnecessary overhead. Likewise, a major trend in the legal profession over the last decade has been to trim staff to control overhead. I contend that this approach is based solidly on the fact that most law firms do not understand how to build successful businesses, nor do attorneys understand how to most effectively manage people. Further, the checkbook mentality enters in, making "no" the default position on hiring.

Technology has emboldened those with the Lone Ranger perspective. While it is true that technology can significantly increase efficiency, the result simply raises the revenue ceiling, rather than removing it. Even the most efficient attorney only can work only so many hours a day, and therefore can produce only so much revenue.

The primary purpose of staff is and should be to leverage the ability of the attorney to operate at their highest levels of value to the firm. The secondary purpose it to themselves be a profit center. Any billable employee should produce revenue of approximately three times their base salary.

The five highest values of the attorney in the firm are as follows:

1. **Client development** – making sure there are clients to serve (and bill).
2. **Client relationships** – making sure that those who hire the attorney pay their bills and speak well to others about that attorney.
3. **Strategy** – knowing how the work must proceed to get the client to their goal.
4. **Managing the team to get the result** - the fact is that most of the work in virtually any matter, once laid out, is reasonably straightforward, and can – and even more, should – be done at the lowest level where it can be done correctly.
5. **High-level legal work** – the legal work which no one else in the firm is competent to accomplish.

When the attorney has a strong team, the attorney's capacity to handle matters dramatically increases from, for instance, $300,000 in revenue to $1 million or more, because the attorney is spending significantly less time in each matter, while still having others bill on the matter. And, while they still bill a significant amount in each matter but for both the high-level legal work, but also the management of the team.

The short-term view of many attorneys is "why should I delegate work to others when I can do it myself and bill for it?" The reasons are many. First, it creates a practical revenue ceiling based on the attorney's capacity for work. Second, it creates what I assert is an unethical situation where the attorney is billing at their rate for work that should be done by an associate, a paralegal, or even a legal assistant. Third, it occupies the attorney's time, limiting and in many cases eliminating time and focus for marketing, which is at the end of the day the single most important function. In fact, the attorney who is working at capacity actually has an unconscious aversion to marketing, due to the dread of even more work, and the fear that they do not have the capacity to deliver.

It is often asserted that the sole practitioner may spend up to half of their time "doing their own laundry," so to speak. That is, doing the administrative and operations tasks which are unbillable, in the name of controlling overhead. The reality is that the attorney is doing work for which they might pay a non-attorney $10-$20 an hour, work that is keeping them from doing billable work at their rate of $200-$400 per hour.

Another common objection to hiring is the frustration of finding and managing staff. Again, the frugal attorney will spend dozens of hours in the search and interview process, losing billable hours instead of paying a reasonable fee to someone better qualified and more experienced at the hiring process. Further, the attorney will then often provide insufficient training and information to the new staff member – and often even insufficient direction regarding their responsibilities – and in the end, complain about the quality of work and the frustration of managing.

The solution? Identify the least valuable functions of the attorney and hire good people (which means being willing to pay the price rather than hiring cheap) in order to move the maximum amount of inappropriate work from the attorney to the lowest level at which it can be accomplished. Nonbillable staff should be reducing the attorney's time in non-billable functions, while billable staff should be doing essentially only billable work, and not secretarial or clerical work. A paralegal should have a billing goal of at least three times their base salary. If this or close to it is not being achieved, they are being under leveraged, and you should seek to move any nonbillable work to non-billable staff. Any time a billable paralegal or associate is doing non-billable work, revenue is lost.

4. Systems, Shmystems

The majority of firms with less than 30 attorneys are not true firms. Instead they are more truly "collaborations," meaning a group of attorneys all working more or less individually under the same roof. Each attorney has their own procedures, forms, and files, and operates more or less independently from others in the firm with little or no oversight or quality control.

Even in firms which have invested in case management software or have developed extensive forms libraries and procedures, their usage is seldom required, and if required, such requirement is seldom enforced. As a result, some attorneys and their staff use firm systems, some use parts of systems, others use systems in their own ways, and yet others essentially opt out of the systems entirely.

In a recent article on my blog, www.resipsalawyer.com, I discussed how firms mangle the installation and usage of software:

> **How Purchase of Software Goes Horribly Wrong**
> There are five not very complicated reasons why a firm's good intentions – and a big bucket of money – often turns into a house of horrors.
>
> **First -** they don't do their homework. They don't thoroughly research exactly what they need, don't study the various offerings carefully, don't do a "test drive," don't get adequate references, and consequently they buy the wrong software.
>
> **Second -** they don't buy official training, assuming that they can figure it out for themselves, so people are frustrated, misuse or don't use the software, and start using "workarounds" to avoid it.
>
> **Third -** they don't buy an ongoing support and maintenance contract, depriving everyone from good troubleshooting and support, and often resulting in major downtime for the system, and consequent loss of productivity. Some software vendors seem to actually penalize clients who attempt to use the

"per call" services instead of buying the more expensive support agreement, and end up with horrendous response – days or even weeks – for troubleshooting.

Fourth - they don't document procedures in order to standardize how the software is being used, and to provide an easy guide for new employees.

Fifth - they don't place a senior partner or administrator in charge of its implementation and use, and don't enforce correct use.

The result? An amazingly high level of regret, teeth gnashing and blame to attorneys responsible for making the decision to buy software.

While clearly some software is better and easier to use than others, the real issues are the above. Even harder to use software will be more satisfactory if those five implementation problem areas are addressed. I have encountered literally dozens of firms which have highly capable software of various sorts that they have essentially discarded in frustration, because they didn't properly address the implementation and operational issues.

The solution? Identify what systems are needed – whether manual, paper checklists and procedures, or software – by careful study. By or build the right systems. Then, provide official training on the systems. Identify one team member who is responsible for quality control – that is, monitoring and enforcing correct usage. Provide new staff with formal training. Institute annual refresher training for all. And finally, require system usage by all, from the lowest level clerk to the managing partner. Where a senior attorney refuses to use the systems, install a strong team member who uses the systems correctly as their surrogate.

5. Socialism (and elitism) at Work

Many firms have compensation structures that are not only illogical and unfair, but socialistic in their approach and damaging to the long-term future of the firm.

One of the most common elements of compensation structures for partners is the "lookback." Most compensation models include a 2 to sometimes as much as a 5-year "look back" in the computations. In other words, compensation is partially calculated on historical production as well as current year production. The reason for this is purely socialistic. Partners wish to cushion their colleagues (and themselves) from a low revenue year.

This produces several negative effects. First, it requires the firm to compensate based on funds realized – and spent – in previous years. Second, it subtly dis-incents partners from striving to overcome a bad year, since the look back will cushion the downturn. Third, it creates a culture of "I've got mine" which negatively affects non-shareholders whose compensation is based more squarely on their current production.

One of the most damaging elements of a law firm compensation relates to partner share value. Traditionally, the value of a partner shares is based on the current value of the firm. This is often computed by outside experts, with the result that an outgoing partner must be paid a truly astronomical sum.

These two elements are responsible for driving the most valuable younger associates and partners out of firms to create their own, or join others, and become the competitor to the original firm. Younger attorneys see that, if they remain with the firm, they will be responsible for paying out huge sums to retiring partners and burdening the firm with debt, or decreasing profit and therefore bonuses and compensation.

Law firms which wish to stay competitive and innovative must develop a more honest and businesslike compensation and ownership structure.

In developing a better compensation structure, the first principle is that compensation for ownership and compensation for work done as an employee of the firm are two separate and distinct issues. All owners are also employees, but not all employees are owners.

Regarding ownership, shares should be set at a straight "par" value which does not change with the ebb and flow of firm revenues, and which provide a clear and reasonable buyout number for retiring attorneys. In this model, the value of shares is fixed, and the percentage of shares owned determines the percentage of profit received. Profits are then apportioned our according to ownership percentages and as a dividend – passive income. This compensation is completely separate from that earned by the owner as an employee who produces revenue.

Once ownership compensation is separated from total compensation, a clearer compensation structure can be created which applies universally to all attorneys. This compensation is based on four elements:

Element one: revenue production. Attorneys are paid a specific percentage of collections, normally approximately one third of revenues. This percentage can be adjusted up for partners, or can be a graduated scale of increased percentages based on higher levels of revenues. The billable hour requirement is normally three times the attorney's base or draw. There are differing structures for associates, depending on whether they are new or senior associates.

Element two: originations. Attorneys are paid a specific percentage of business which they originated through their marketing efforts, typically 15%.

Element three: management responsibilities. Attorneys may be paid specific salaries or fixed amounts for long-term or project work. For instance, the managing partner may be paid a salary of $100,000 a year for this role (with consequent reduction in billable hour requirements), and a junior partner may be paid a flat fee of $10,000 for managing installation of new hardware or software.

Element four: bonuses. Partners set aside specific amounts of profit to provide bonuses to attorneys and staff. These bonuses may be awarded on purely subjective bases or for specific achievements such as certification in a legal specialty or as a paralegal or legal administrator.

This approach to compensation creates an ownership scenario which is credible and acceptable to others in the firm, and minimizes the loss of good attorneys. It also creates a compensation structure which is essentially objective and calculable, reducing the typical dissatisfaction of more subjective compensation structures.

6. Who's got the A/R?

Another legacy of the small firm/sole practitioner mentality is that, in many firms, the attorney has virtually complete control over the management of receivables. They may decide to write off or write down a receivable, choose to not pursue a receivable because of client relationships, or due to simple reticence to be a bill collector. This too often results in firm receivables that are egregious.

The solution to this issue consists of several measures. The first measure is the development of firm-wide client intake standards, to better assure that attorneys take only clients with the ability to pay.

The second measure is close management of receivables, with standards for aging. For instance, the firm should have a policy for handling receivables at various stages, such as: at 45 days a specific communication is sent on behalf of the attorney: at 60 days a second communication may be sent: at 75 days the attorney is required to make a personal collections call and document it in a memo to accounting and the managing partner: and finally, at a certain point, the attorney is prohibited by policy from continuing service, and the firm sends the client a notice of intent to withdraw unless payment is received.

There will be, of course, necessary exceptions to each policy decision. However, the key is that the CFO takes charge of the management of receivables after a certain point, because the receivables are in every respect an asset of the firm and not simply those of the attorney.

It is important to reiterate, however, that management of receivables starts before there are receivables, with standards of selectivity on client intake.

7. Topside First Marketing

Too often, firms develop their marketing from the wrong direction. They spend dollars on "branding," public relations, logos and image, and larger issues of firm visibility, that give little attention to support of, or funding for, the personal marketing efforts of individual attorneys.

The fact is that most high-value business results from the individual marketing of attorneys, and their development of relationships with prospects, referral sources, and specific organizations. Further, in this as in virtually everything else, the Pareto principle, otherwise known as the 80 – 20 rule, applies. 20% of firm attorneys will generate 80% of the business. Further, those attorneys who are most effective at generating business have the greatest potential to develop more. So, those firms who wish to achieve the best results from their marketing expenditures will identify the leading business generators and focus on better and more efficient support for their marketing efforts. In other words, marketing dollars and staff are used to more directly support individual activities rather than "image" activities. The fastest path to firm growth is to support those who best know how to grow it.

There is an important side note here, however. The attorneys who are the firm's best marketers are seldom the firm's best managers. As a result, they become overwhelmed, their production falls behind schedule, clients become frustrated, and their marketing efforts slow. One of the most important elements of support for the strong marketer is the availability of a strong team for better leverage, and training for the attorney in team management, effective delegation and leveraging. The most successful lawyers do not attempt to do most of the work themselves. Instead, they move into the roles of team manager, client relations manager, and quality control. This comes in direct conflict with the tendency of many partners to resist making expenditures for such unnecessary things as paralegals and legal assistants. The most valuable attorneys should be surrounded by a strong and effective team led by a "second in command" younger attorney who directly supports and manages the senior attorney's work.

Beyond support for the 20%, firms should also develop specific marketing and practice management training programs for the 80% who are not yet strong producers, to help them develop skills and expand their business generation as rapidly as possible. Firms should provide formal and ongoing training programs and, where necessary, individual marketing coaching, as well as individual marketing budgets. The firm should also develop a formal senior attorney mentoring program, not only for the law, but for marketing.

Of course it is important for a firm to create a strong image. But it is even more important to remember that most clients don't hire firms – they hire attorneys. The overall firm image sets the stage. The attorney's personal interactions with clients, prospects, and referral sources sells the tickets.

For more information go to:

www.attorneysmasterclass.com

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