

Law Firm Business & Economics 101

by Bruce A. Elvin

Why is understanding the law firm as a business entity important for associates, law students, and you? If you work in a law firm, this insight allows for greater contribution to the organization's success and an enhanced ability to represent the law firm confidently to external constituencies, as well as the ability to recognize why certain decisions are made and the likely direction of the firm.

For those working in law schools and advising students, a demonstrated understanding of law firm business levers establishes greater credibility among students, allows for greater insight into different law firms, and leads to more valuable advice to students because financial information tells a story about law firms that will allow students to get beyond the websites.

Possessing an understanding of law firms as a business is also important to all NALP members who work with and advise law students or lawyers in their professional development because lawyers who understand the business side of law firms are better equipped to:

- Connect their daily practice to the strategic goals and directions of their firms.
- Understand firm decision-making and contribute to its success.
- Appreciate the profit drivers and levers of success earlier in their careers.
- Recognize the skills required to succeed in a law firm or other business environment.
- Understand the business and legal requirements of their clients.
- Become more effective leaders in the future by recognizing the evolving nature of the legal profession.

In other words, by understanding the drivers of your own business, you are more likely and able to “take ownership” of your work.

Fortunately, with a bit of introduction and explanation, all NALP members (and even practicing lawyers) can understand the financial performance and business operations of law firms, as they are relatively straightforward businesses. This is the case because law firms generally have only one primary revenue stream, a limited number of operating expenses, probably some debt, and usually only one class of owners. Keep in mind that while this article will assist you in interpreting what is happening in a law firm, the art of running a successful business is predicated on the judgment and decision making of its management. The consequences of its decisions manifest themselves in the financial performance discussed in this article, and the astute employee can use existing law firm financial performance to anticipate upcoming management decisions.

Legal Structure of a Law Firm

Most law firms are organized as partnerships, either as general partnerships or as limited liability partnerships. A “partnership” is simply an agreement among two or more parties to pursue a business for profit as co-owners. The U.S. states allow partnerships to be created under their respective laws, and the states impose very few specific requirements or terms that a partnership must include. Thus, partnerships can be tailored for the particular business at hand. Most law firms have written partnership agreements that differ from each other, but that also seldom change significantly — new partners to existing law firms typically have the choice to sign on as is, or to not become a partner.

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Within the last decade, many law firms have converted from being a “general partnership” to a “limited liability partnership,” or “LLP.” Generally speaking, in an LLP an individual partner is liable (1) for malpractice of other lawyers or certain other types of partnership liabilities only to the extent of his or her interest in the entity; and (2) for his own malpractice or that of those he “supervises.” Under a general partnership, an individual partner is liable (to the extent of his entire personal net worth) for all of the partnership’s debts and obligations, including malpractice against colleagues. Again, each state differs in what type of liability is limited, though these are fairly typical rules.

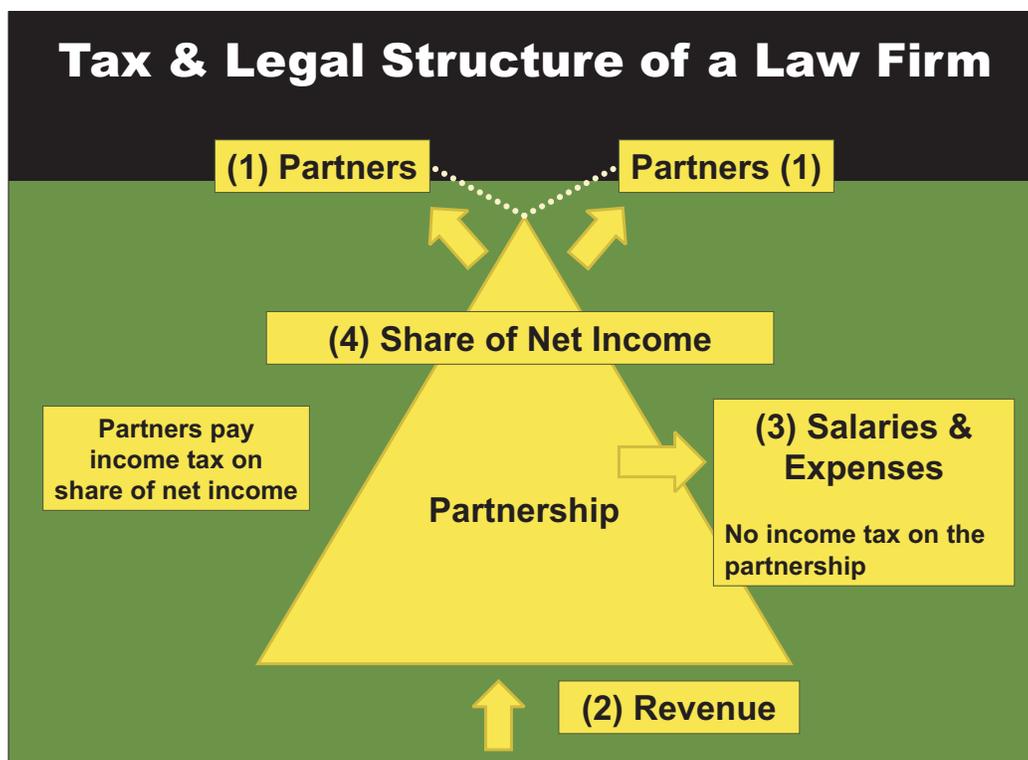
Partners, associates, and other billers work to generate revenue. Most law firms’ revenue is generated by hours worked and billed to clients by lawyers and paralegals. (3) The partnership pays out salaries and other expenses — rent, insurance, marketing, and other administrative costs — as well as interest on debt, if any. (4) In broad terms, revenue left after all expenses and debt service have been paid is net income, most of which is distributed to the partners as their annual “income.” (Law firms may keep a “small” portion of net income. This retained capital plus partners’ capital contributions are used as working capital for ongoing expenses.)

Business Issues: Revenue & Expenses

The Big Picture: “Money Flow”

As the pyramid graphic illustrates, the partnership is the legal entity around which all else flows. (1) The partners are the owners of the partnership. (2)

It is important to note that the law firm does not pay income tax. Rather, the individual partners pay income tax on their portion of the law firm’s net income (even on that portion which the law firm retains). The absence of an entity level tax is in contrast to businesses that are structured as “corporations,” on which there is a tax on the corporation’s income directly, and then another income tax on distributions to shareholders.



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Revenues

Law firm managers will point out that law firms are a “revenue-driven business.” In essence, this means that it is hard to cut costs in a law firm significantly without also cutting revenues, while revenues can often be increased with the same cost structure. Thus, understanding revenue and some of the terms used to assess it is vital.

Utilization Rate

Prior to the start of a fiscal year, law firm management will designate how many hours they believe each “fee-earner” should bill in the coming year. Successfully predicting this number requires years of experience and judgment by law firm leaders. It is a critical skill, however, because law firms will base their annual budget on these predictions.

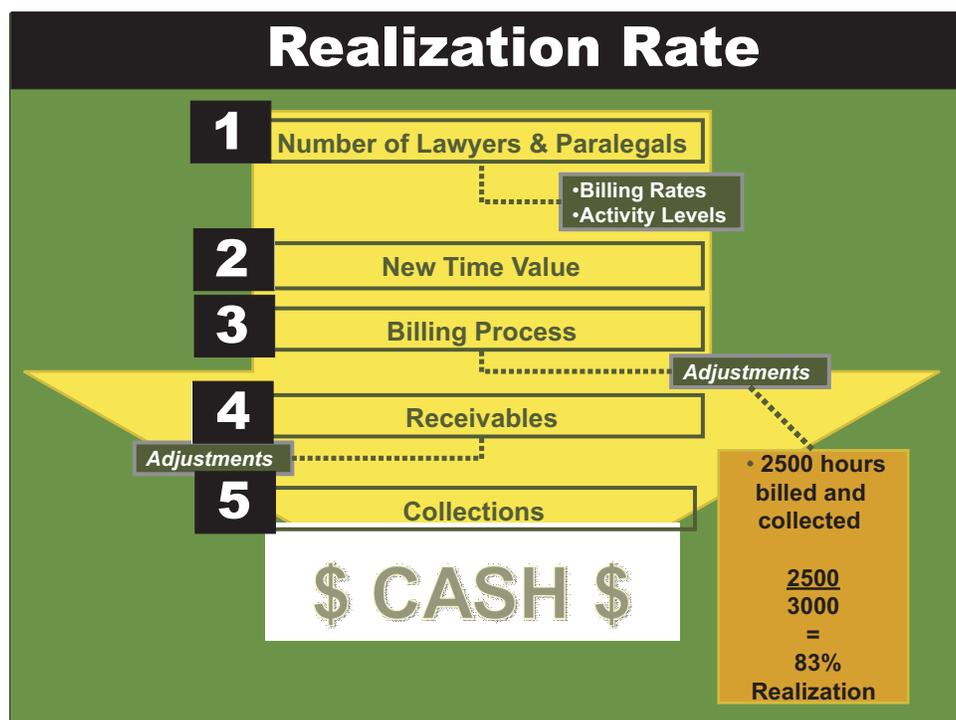
To assess how each biller is doing relative to her goal, law firms have established the notion of utilization rate. This rate is nothing more than the actual hours billed divided by the hours targeted for a given time frame. Utilization rate can be applied to practice groups, offices, entire firms, and other segments, too. The utilization rate for one of these

“entities” is a good indicator of how busy the entity is, which may be a leading indicator of decisions management may take in the near future, such as hiring more people if utilization is well over 100%, or cutting back if there is significant under-utilization.

The amount the firm could earn based on its hours billed is referred to as its “New Time Value” and is derived simply by multiplying the hours billed by each fee-earner, times his or her billing rate, and adding that up for all fee-earners in the firm.

Realization Rate

With new time value recorded, the billing process begins. The billing process typically starts with a partner (“Partner A”) reviewing the bill before it goes to the client. In the billing process, Partner A may see that 3000 hours were worked by a team of associates for a client project, but, based on experience or other insight about the client, the partner knows that only 2500 hours can actually be included on the bill that goes to the client. In this example, 500 hours of work were “wasted” or “written off.” Assuming the bill for all 2500 hours is collected, in law firm terminology, this is an 83% realization rate (2500/3000).



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Realization rates are one of the most important measures in a law firm, and they are often seen as measuring efficiency at producing income for the firm. They also may reveal a more nuanced picture about firm operations. Consider this basic example:

- *Partner A:* In the above example, the 2500 hours at \$400 per hour resulted in \$1 million billed and collected from the client, rather than \$1.2 million if all 3000 hours could have been collected.
- *Partner B:* Collects \$800,000 from clients. Total time billed to this client was 2000 hours at \$400 per hour, and there was a 100% realization rate.

Who has contributed more to the firm financially? While it is impossible to know based on this limited information, it would be imprudent to assume that Partner A has made a greater financial contribution to the firm simply because Partner A collected more than Partner B.

Realization rates can also exceed 100%. This result is often a product of “premium billing,” where the law firm and client have agreed that the firm can send a bill at, for example, 125% of the actual hours billed if the project is successful. Thus, realization rates are seen as a proxy for the “quality of hours” billed by a firm and may reflect the nature of the work, client base, activity levels, and training of the firm, too.

Uncollectables

Ultimately, the bill is sent out and becomes an “account receivable.” Law firms may see their new time value reduced even further here, as, in most businesses, some clients become unable to pay or refuse to pay and the firm ultimately accepts it will never collect its bills.

Impact of Revenue “Leakage”

Minimizing the “leakage” from new time value is an important goal of law firms. Simply put, if a firm has \$100 million in new time value, has to

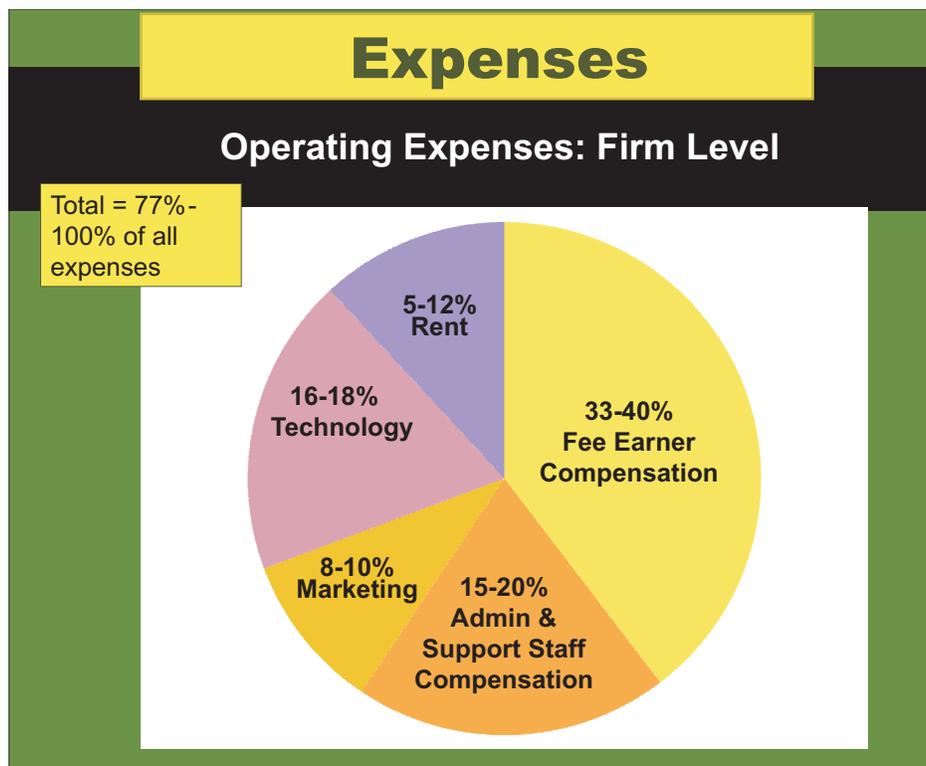
write off hours billed equal to \$5 million, and \$3 million becomes uncollectable, the firm collects \$92 million in cash (a 92% realization rate). If the firm were able to write off only \$3 million and were unable to collect only \$2 million, the firm would collect \$95 million in cash (95% realization rate). **This is \$3 million more collected by the law firm — for exactly the same number of hours billed and exactly the same expenses incurred.** Out of this total pool of cash collected, the law firm can pay its expenses needed to generate this income with the remainder as income to the firm’s owners — its partners.

Operating Expenses

The pie chart highlights the biggest expenses of many law firms and common percentages of all expenses. Not surprisingly, law firms focus on limiting these expenses to the extent possible. However, a major challenge is that most of the expenses are either relatively fixed or cannot be significantly reduced without leading to a direct reduction in revenue. Rent and technology are indispensable and are hard to cut because rent is typically subject to a multi-year contract and firms must keep current with technology to get their work done and to meet client expectations.

Similarly, without fee-earners, there is no revenue at all, and when business does pick up, finding laterals may quickly become a challenge. Thus, to maximize revenues over the medium term, some law firms may decide to absorb the expense of paying under-utilized fee-earners and others supporting revenue generation until demand returns. In 2008, however, some law firms have chosen to reduce the number of fee-earners, suggesting that they do not anticipate their demand in those practice areas returning in the near future.

Similarly, firms are considering how to maximize efficiency among administrative and support staff, though these costs as well can only be reduced a limited amount without damaging the quality of client service and thus revenues. In recent years, several large firms have moved different elements of their “back-office” operations out of their



high-rent, downtown office buildings in an effort to reduce these costs and to enhance their utility and support of the firm.

Marketing and related expenses are thus left as the primary pool of “non-fixed” expenses; as a result, these are often seen as the first to go in challenging economic times. Recruiting-related expenses may be quickly reduced, too.

Splitting Profits

Compensation of Equity Partners

Associates and non-equity lawyers have received their salaries. Support staff have been paid, too. Landlords have been sent their checks and BlackBerry bills were remitted. Equity partners have yet to be paid, however — and there is no guarantee that they will be. Money that remains after all expenses and interest have been paid is the firm’s net income or “profit” and is what the partners earn collectively for the year. (In many cases, partners are “paid” throughout the year to smooth out their

personal cash flow, but this money is in essence an advance against their portion of the firm’s net income.)

As an owner of the firm, each equity partner receives a share of the net income, though few law firms split the net income pie the same way. Approaches to splitting it range from “lockstep,” where equity partners are paid based on seniority, to more “incentive based,” where revenue generated for the firm is the primary factor in a partner’s compensation. Most firms today include elements of these two approaches, while also including other contributions to the firm’s success.

Another difference among law firms in the compensation arena is that some firms publish partner compensation to all other equity partners (and some to associates, even), while in other firms only the management has the complete list. Not surprisingly, compensation inputs and transparency strongly impact the culture of the law firm and help to explain individuals’ behavior. These choices are good examples of the flexibility of partnerships discussed earlier, as the partners

themselves can create a partnership to reflect the culture that they aim to produce.

Non-equity Partners

In contrast to equity partners, non-equity partners are not owners of the law firm. While some may receive a small share of profits, in general non-equity partners earn a salary. However, non-equity partners also are not liable for the debts and obligations of the law firm, would not be required to invest capital into the firm, and typically do not have other obligations of ownership.

An original rationale behind the non-equity partner position was to allow law firms to better align the financial contribution of equity partners with their compensation. Thus, talented associates without client relationships may be given the opportunity to develop clients with the title of “partner,” or a firm may put former equity partners with fewer clients into non-equity positions. Balancing the needs of the two tiers, plus associates and other fee-earners, is a significant challenge for the management of most law firms. Much has been written on the optimal approach.

Conclusion

Understanding one’s own business is fundamental to success in any field. This article provides tools to assess the internal workings of a law firm. However, it is also possible to use this knowledge and in many cases with publicly available information to compare law firm performance with that of peers and other law firms. This internal and external analysis provides an even richer understanding of one’s own organization or the marketplace generally, and allows for greater contributions to the future success of your law firm, students, associates, and you.

Bruce Elvin is Associate Dean & Director of the Career & Professional Development Center at Duke University School of Law. He teaches a course entitled “The Business and Economics of Law Firm Practice” as a Senior Lecturing Fellow at Duke and presented a program on law firm economics at the 2008 NALP Annual Education Conference. The author would like to thank George Krouse, Of Counsel at Simpson Thacher, for his teaching and editing of this article, and NALP 2008 conference co-presenter Diane Downs, Firmwide Manager of Attorney Development at Paul Hastings.