Counting the costs

By Edwin Reeser

The past decade has seen law firms attempt to run themselves 'more like a business' by implementing more mechanical procedures, typically along the lines of the following:

1. Time sheets submitted within 24 hours;
2. Prebills to lawyers within seven days of month end;
3. Prebills corrected, delivered to accounting within 14 days;
4. Bills posted within 20 days of month end;
5. Final bills on transactional matters presented at closing;
6. Clients to pay bills by the 60th day following posting.

Basically, law firms worked to pull the 'receivables turnover period' to an average of less than 60 days, when for many firms it had previously been 90 days or more.

Firms became stricter about achieving higher 'realisation' rates on billable time recorded, increasing hurdles to both client intake approval and obtaining permission to make prebill reductions. This squeezed realisation rates to the 92 - 94 per cent range, from previous decade figures of around 86 per cent, or even less.

Immense pressure was piled on attorneys with billing and collection responsibility to collect accounts receivable prior to the fiscal year-end. It became necessary to match the heroic collections effort of the year before just to stay even. Any slippage and profits suffer. Measures to compel partner compliance with billing and collection policies considered draconian a decade ago are routine today.

Then, over the past five years law firms have become increasingly focused on cost control. To the extent that there are meaningful costs that are manageable, other than the variable cost of lawyers and staff, those controls are already in place.

Capital for the size of the enterprises has generally become too small, with the availability of cheap money, in large amounts, from banks to support operations and advance partner draws. That is changing fast, however. Partner financial risk has been lowered, especially with the change to limited liability structures from general partnerships. This makes a difference. Imagine what would be going on today if instead of being LLPs, these law firms were joint and several liability entities as many were only ten years ago?

What occurred in 2007 and 2008 was more desperate. Financial 'engineering' of results became commonplace in many firms. Costs were deferred, income accelerated. The manner in which profits are measured and distributed was recharacterised. There was opaqueness as to the reasons and facts supporting decisions, and non-participation in management by partners to the point that they had little information, and even less say, in the management of their own firm. 'Paper tiger' images of once great firms are all that remain for some, while others do not remain at all.

The ability to improve collection efficiencies has been used, but the inability to maintain this in the face of a client base that is slower in paying its bills has reversed this tool against the firm and is now leveraging profits downwards. The ability to draw against debt for capital requirements is reduced, or at a minimum, more expensive. Real cash reserves are almost nonexistent, as it is been distributed out of the enterprise to the partners each year.

How are firms going to reconfigure themselves to deliver better-quality services and products to their clients? What should they look like and why?

With nowhere to turn, and with all tools essentially already used in the quest to jack up profits and distributions in a competition for talent based on revenue per lawyer (RPL) and profits per partner (PPP), these firms have destroyed their financial foundations as well as the cultural 'glue' that holds them together when times are challenging. And they have built into their operating structures the mechanisms that not only make it easy to bring in talent, but also for talent to leave, further increasing entity fragility and leading to the increasingly commonplace sudden collapses of erstwhile icons of long-term professional stability that were created.

This operational 'hollowing out' has done two things.

First, it has significantly, and falsely, overstated the true operating performance of the entities, and the industry/profession over the past decade. Much 'profit' was simply

an acceleration of the collection of revenues, pulling into the present income that used to be recognized in the future. This has been magnified by the reallocation of income within many firms. Compare the arithmetic mean to the arithmetic average for PPP and the disparity will clearly show that two-thirds of partners do not make the reported 'average' PPP in a typical firm.

Second, the move has milked out the resources that would buy the firm the time needed to implement a plan and to adjust operations to survive.

There now is little to no time. Firm partners will have to rally together and take a huge collective reduction in income while they restructure themselves dramatically – a very large investment comprised of a combination of reduced income and actual capital investment, to save their firms. Or they could take their clients somewhere else, seeking to become part of one of the inevitable law firm survivors that can adapt. Or they could pursue another viable means of serving clients at a cost bearable to the client, and still enough to earn a good living. This is not unlike being in a pool of non-swimmers and attempting to survive by crawling up on the shoulders of others, condemning them to drown. With so many partners having become relegated to a status of less than reported PPP levels, with deteriorating life quality based on ever more rigorous policies and procedures, with clients screaming for relief from high bills, not getting it and threatening to leave (and thus causing the inevitable forced departure of the partner responsible partner for the account), and with the firms operating at overhead levels that are unmanageable and yet very high, there will certainly be consequences.

Given what has become the slaughter of those least responsible for the problems, talent must be justifiably anxious about being cajoled into taking pay cuts and putting up big bucks for those that have failed in leadership to let them try it again. And the premise that legions of hardworking talent is available every year to replenish those that have grown exhausted and left is about to become history as well. Many partners were dismayed to find themselves in firms where they didn't have a quality of life apparently worth living even before this crisis delivered double digit percentage pay reductions. However, now is the time to look beyond the obvious carnage. What is going to be happening next? How are firms going to reconfigure themselves to deliver better-quality services and products to their clients? What should they look like and why? This is not limited to the debate about the billable hour (which some big firms have finally given lip service towards recognising as an issue).

However, instead we regularly see leadership talking about how they are not doing that badly, just as well as anyone else in any case, and that clients will not 'endorse suicide rates'. The ships are going down and passengers are just being moved to the upper decks. We are now running out of decks and the water is too cold and deep.

It is time to get a new strategy and a new business model; time to build a model focused on client-service needs and demands, like every other industry in the real world. If clients want world-class service at a price that is 20 per cent below what you can deliver, and you don't find a way to do it, somebody else will. Indeed, they are beginning to do it already and the only thing that allows you to survive is that the clients have not found them.Yet. ■

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