

# LEVERAGE:

## The Secret to Increased Profitability in a Competitive Market

Higher-leveraged law firms have the opportunity to reap higher profits per partner.

BY KRIS SATKUNAS

As most legal professionals have discovered, many of the cultural distinctions that have long separated law firms from the business world, when examined more closely, have turned out to be based upon myth rather than the realities of practicing law. One of these myths is that leverage does not significantly improve law firm profitability. Fueling the myth are skeptics that insist there is no correlation between leverage and firm profitability.

The traditional reasoning goes like this: Our most senior, experienced lawyers bill at the highest rates. Therefore, our profitability is maximized by generating more partner-level work, rather than increasing hours for associates. This viewpoint differs significantly from the model used by the business world, which seeks to generate value from large pools of employees and reserves highly paid executive and managerial positions for a relatively small group at the top tiers of the corporate ladder.

But the two models shouldn't diverge as much as they do. Law firms stand to benefit greatly from the realization that even if their relatively unleveraged approaches have been profitable, they can substantially increase profitability by improving leverage. Once management makes this leap, it's crucial to execute this strategy at a matter level.

### DOING THE MATH

Why doesn't maximizing billing rates also maximize profitability? The answer: While using nonequity lawyers reduces the overall revenue, the profits per partner are increased.

To understand the power of leverage, it helps to agree on a definition. Applying leverage is the practice of utilizing the lowest-cost resource to perform a particular function. The most common law firm metric is the measurement of nonequity lawyers (including nonequity partners, of counsel, and associates) to equity partners.

Take the example illustrated in **Figure 1**, which compares a firm with a low leverage of one nonequity lawyer per partner with a firm that has high leverage of three nonequity lawyers per partner. The low-leverage firm, which had 50 partners and 50 nonequity lawyers working on matters, generated total revenue of \$58.5 million and net profit of nearly \$40 million.

At the higher leveraged firm, which had only 25 partners working on matters compared with 75 nonequity lawyers, the

## SHORTCUT

Law firms can benefit substantially from the realization that even if their relatively unleveraged approaches have been profitable, they can substantially increase profitability by improving leverage - the practice of utilizing the lowest-cost resource to perform a particular function.

revenue generated was lower, not quite \$51.8 million. And the profit at the higher-leveraged firm was significantly lower, \$20.7 million.

But the critical factor in comparing the two firms is that the profit per equity partner at the higher-leveraged firm was a full 30 percent higher – reaching \$828,000 per partner, as opposed to the \$639,000 in profit per partner realized by the lower-leveraged firm. That's a substantial gap that can mean the difference between retaining top-tier talent and losing it.

### WORKING THROUGH THE WHITE NOISE

So, if leverage has such a significant impact on law firm profitability, why does the legal industry as a whole show low or no correlation between leverage and - profitability - i.e., how do many of the world's most profitable firms maintain astonishing low leverage rates?

The explanation is that other factors tend to drown out the negative effects of low leverage and the positive effects of increasing leverage. For example, consider the factor of utilization. Improving leverage works only if a firm actually puts its associates and other nonequity lawyers to work. Other elements that can mask the effects of leverage include pricing, realization, matter-type mix, and specialty practices.

Those that oversee firm profitability should not let the noise generated by these factors lead them to

conclude that leverage is unimportant. While there are nonleveraged firms - i.e. those that maintain a one-to-one ratio (or lower) between partners and nonequity lawyers - that are highly profitable, these firms could be even more profitable by improving their leverage (as illustrated in Figure 1).

A key assumption for firms examining leverage is that some hours worked by equity partners can be shifted to nonequity lawyers. If not, the firm already has maximized its leverage.

### EXECUTING THE STRATEGY

Understanding the analysis behind the concept and the importance of implementing change are the first steps. But how does management execute a leverage strategy? An increase in the ratio of nonequity lawyers to equity partners does not guarantee improved profitability. Several additional steps also must be taken to ingrain the importance of leverage in the firm's daily operations.

Execution of a leverage strategy occurs tactically at the matter level. The definition of leverage underscores this crucial point; in essence, applying leverage is the practice of utilizing the lowest-cost resource to perform a particular function.

Many firms measure leverage at the matter level by tracking the percentage of work performed by nonequity partners. Redwood Analytics uses a

Figure 1

| EXAMPLE 1: PROFITABILITY EFFECT OF LEVERAGE |                     |                     |             |
|---|---------------------|---------------------|-------------|
|   | Low leverage        | High leverage       |             |
| Leverage                                    | 1 : 1               | 3 : 1               |             |
|   |                     |                     | Std Rate    |
| Partners                                    | 50                  | 25                  | \$400       |
| Associates                                  | 50                  | 75                  | \$250       |
| Total Hours Worked                          | 180,000             | 180,000             |             |
| <b>Total Revenue</b>                        | <b>\$58,500,000</b> | <b>\$51,750,000</b> | <b>-12%</b> |
| Associate compensation                      | \$9,000,000         | \$13,500,000        |             |
| Overhead expenses                           | \$17,550,000        | \$17,550,000        |             |
| <b>Profit</b>                               | <b>\$31,950,000</b> | <b>\$20,700,000</b> | <b>-35%</b> |
| <b>Profit per partner</b>                   | <b>\$639,000</b>    | <b>\$828,000</b>    | <b>30%</b>  |

A leverage strategy is not executed in a vacuum. A firm must both improve matter leverage *and* incentivize its leveraged lawyers to increase their productivity on other fronts to improve profitability.

leverage index. Whether a firm uses one of these metrics or another proxy really isn't important. Ultimately, the focus on matter leverage will change behavior.

Those critical of the idea of adjusting partner-heavy matter pricing models are likely to ask pointed questions, such as:

- Does better leverage on a matter equal higher profitability for the matter?
- Does higher profitability on a matter equate to higher profitability for the firm?

The likely answers are “yes” and “maybe.”

### IMPROVING MATTER LEVERAGE

As **Figure 2** illustrates, the more leveraged matter has lower revenue, but generates more profit per partner hour. Central to the argument for improving matter leverage is the assumption that partners will push work down so they can use their time to nurture strategic client relationships, develop business, mentor other lawyers, and drive other firm-building

activities. Firms that successfully focus on the tactics of improving matter leverage but do not efficiently redeploy leveraged partners will suffer reduced profitability.

Hence, it's important to ensure that a leverage strategy is not executed in a vacuum. A firm must both improve matter leverage and incentivize its leveraged lawyers to increase their productivity on other fronts to improve profitability.

In cultures that reward partners primarily based on billable hours, executing a strategy to increase leverage can be challenging. Firms should educate partners and associates as to how the firm benefits when work is properly passed to the lowest-cost person available with the right skill set, rather than being hoarded. In addition to the financial implications, passing work to junior attorneys broadens their skills, improves their value to the firm, improves job satisfaction, and ultimately reduces turnover costs.

In an era in which associate satisfaction is closely scrutinized (as evidenced by recent salary increases),

**Figure 2**

| EXAMPLE 2: PROFITABILITY EFFECT OF LEVERAGE |                    |                  |             |
|---|--------------------|------------------|-------------|
|   | Unleveraged Matter | Leveraged Matter |             |
| <b>% Partner Work</b>                       | <b>50%</b>         | <b>25%</b>       |             |
|   |                    |                  | Std Rate    |
| Partner Hours                               | 100                | 50               | \$400       |
| Associate Hours                             | 100                | 150              | \$250       |
| Total Hours                                 | 200                | 200              |             |
| <b>Total Revenue</b>                        | <b>\$65,000</b>    | <b>\$57,500</b>  | <b>-12%</b> |
| Direct Expenses (Associate)                 | \$8,750            | \$13,125         |             |
| Overhead Expenses                           | \$19,500           | \$19,500         |             |
| <b>Profit</b>                               | <b>\$36,750</b>    | <b>\$24,875</b>  | <b>-32%</b> |
| <b>Profit per Partner Hour</b>              | <b>\$368</b>       | <b>\$498</b>     | <b>35%</b>  |

these softer reasons to apply leverage within a firm's model are increasingly important.

### ENCOURAGING BENEFICIAL BEHAVIORS

As with any initiative, it's important to report back with results. Firm managers will increase buy-in by remembering to share trends in firm and practice level leverage ratios. Variations in client/matter leverage should be measured and communicated to firm attorneys so they can see the progress that follows from their efforts.

The bottom line is that numbers don't lie: Higher-leveraged firms have the opportunity to reap higher profits per partner. One of the keys to maximizing profitability in today's hyper-competitive legal market

is to make marginal improvements. Managers who ignore the old mantra that leverage is not important to profitability, and instead do the math, will find they have opened the door to a better way of doing business. ✱

### *about the author*

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### ALA Resources

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- *Secrets of the Business of Law: Successful Practices for Increasing Your Profits!*, by Edward Poll
- *Results-Oriented Financial Management: A Guide to Successful Law Firm Financial Performance*, by John G. Iezzi
- *The Profitable Law Office Handbook: Attorney's Guide to Successful Business Planning*, by Edward Poll

The following are accessible via ALA's Legal Management Resource Center, <http://thesource.alanet.org>:

- In the Documents Directory, visit the folder "Financial Management" and its subfolder "Profitability, Leverage & Related Topics"

The following article is available in the ALA Management Encyclopedia<sup>SM</sup> (ALAME), [www.alaencyclopedia.org](http://www.alaencyclopedia.org):

- "A Cost Accounting Tool to Enhance Profitability for Law Firms"

### On the Web

- "Law Firm Leverage and Profitability," by Michael Koehne – [www.thespaceplace.net/articles/koehne200503.htm](http://www.thespaceplace.net/articles/koehne200503.htm)
- Hildebrandt International, "Are We Approaching a Profitability Plateau?" – [www.hildebrandt.com/Documents.aspx?Doc\\_ID=2521](http://www.hildebrandt.com/Documents.aspx?Doc_ID=2521)
- *Law Practice Today*, "Managing People, Process & Strategy for Increased Profitability: How Human Resource Departments Can Leverage Technology to Become a Strategic Profit Center" – [www.abanet.org/lpm/lpt/articles/fin04071.shtml](http://www.abanet.org/lpm/lpt/articles/fin04071.shtml)

### On the Shelf

The following titles are available for purchase or download through many online retailers, including [www.amazon.com](http://www.amazon.com):

- *Profitability and Law Firm Management*, by Andrew Otterburn
- *Maximizing the Profitability of Law Firms*, by Robert Mowbray