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INSIGHTS

Overcoming the Value Extraction Bias

Money is a short-term result that incentivizes short-term decision making. - Simon Sinek

There is a fascinating irony about partnerships. While the notion of partnership is founded on the concept of shared interests, many firms undermine these interests with a laser-like focus on short-term results in the form of maximizing profits per partner. Some of the short-term focus is fueled by the partnership structure, which requires that firms distribute all profits within the taxable year to avoid phantom tax for partners. For many firms, the inevitable result is a focus on growth in annual partner profits, instead of long-term growth of the firm. While firms may communicate externally and internally a desire to build the firm's resources and capabilities, we frequently observe a direct tension between firm building efforts which will create long-term value for the firm as an entity and for the firm's clients (i.e., value creation) and efforts to protect or enhance partner profits in the current year (i.e., value extraction).

It would be naïve to claim that the absolute number and growth of partner profits are not critical in today's legal industry. For better or worse, the publication of firm financials, and in particular Profits per Equity Partner (PPEP), continues to shape perceptions relating to firms' relative market position and overall success. Firms simply cannot de-emphasize profitability without risking unhealthy legal media scrutiny and rumors of financial and partnership instability. Given the fragility of some partnerships today, external perceptions and negative press coverage can quickly lead to partner loss of confidence in the firm's future and an unwinding of the firm.

While partner profits clearly represent a management priority, they cannot be management's only priority. For many firms, there is a greater focus on equity partner profits than any other metric or indicator of the firm's overall performance, competitiveness, and long-term viability. This narrow focus inhibits firms from making investments in other critical firm building activities. In our work with firms, we regularly hear partners express a greater interest in seeing an increase in PPEP than building the capabilities or tools which might help the firm deliver better service to clients. To compound the issue, the aging of law firm partnerships means that in many firms, a number of influential partners are nearing retirement. Given their shorter time horizons, funding investments in the firm's long-term future is unlikely to be attractive to this growing demographic.

So, if firms are failing to invest sufficiently in building the resources and capabilities required for long-term health, where are the greatest deficiencies? Below is a brief look at investments we see starved to the greatest extent in firms with a shorter term, profit-centric mentality:

- **Partner Development:** The partners of a law firm represent the firm's most valuable assets. Partners typically own the client relationships, bring in the work, and operate as highly productive working attorneys to boot. They are the firm's most direct interface with clients, communicating about matter status and results delivered, and negotiating price. Partners are also critical people managers, overseeing teams of lawyers and providing formal and informal training and mentoring to other lawyers and staff. Yet few firms invest substantial resources in teaching partners how to manage teams or communicate with clients. Few firms provide leadership and performance coaching to a material number of partners (such coaching is typically reserved to new leaders or problem partners). Of course, partner training and coaching is expensive, and perhaps the harder sell – it requires partners to invest non-billable time in these efforts.

- **Practice Development:** In spite of rapid changes in the industry and the increased commoditization of some practices, many firms remain reluctant to invest in practice research and development. Efforts to explore emerging practice areas or move into less price pressured practice areas require investment of lawyer time and often research and marketing/business development support. However, when firms do invest in these areas, they tend to set expectations of a short-term ROI, which means that most initiatives are abandoned early on. While investment isn't

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an excuse for long-term underperformance, pursuing practice areas offering future growth and demand will require commitment of resources to explore and pursue these opportunities.

- **Leadership and Business Management:** Many firms, even a number of large ones, resist having more than a handful of individuals in high-level C-level roles. Partners tend to dismiss the value of non-lawyer marketing, client management and practice management functions. These roles face constant pressure to justify their existence, and in years of lower PPEP, they are often the first ones to go. Cultural resistance to investing in business management often results in overly lean and/or underqualified leadership and management. How can firms implement important management initiatives without the horsepower or expertise necessary?

- **Client Service:** As a result of growing client pressure to improve the efficiency in legal service delivery, a number of firms have made an effort to introduce new practice habits to their partners via project management, knowledge management or process improvement. However, for many firms, these introductions have been tepid at best. Project management and process improvement continue to be met with high degrees of skepticism, and firms are struggling to get the buy-in needed to make broader client service improvements. Some partners feel that investing in the required systems, personnel, and training to implement these initiatives represents an unnecessary allocation of resources that could otherwise be used to pay the firm's partners.

These examples illustrate the notion of a value extraction philosophy – the prioritization of profitability over the creation of long-term value for the firm as a whole or for its clients.

To overcome a 'value extraction' bias and pursue a 'value creation' strategy, firms must cultivate a philosophy which supports reinvestment in the firm. This starts with setting forth the notion that a portion of partnership profits must be reinvested in building a viable firm for the long-term. This may translate to periods of flat profitability, or perhaps even a temporary reduction in profits, to allow the firm to make strategic long-term investments.

Overcoming a value extraction bias also entails working with the partnership to generate a real understanding of the value of resources dedicated to improving client service, and developing buy-in around the need to make changes which will drive greater efficiency and deliver superior client value. Engagement and support for efforts to improve client and firm value will require that partners see a meaningful connection between the investments being made and the long-term success and direction of the firm.

Lastly, value creation also requires the leadership courage necessary to pursue investments which may be unpopular and/or risky. Short-term decisions that boost PPEP can be easier to make than efforts to build longer term capabilities. These critical investments require leaders to expose themselves to potential criticism, pursuing models that haven't been fully tested in law firms and that necessitate thinking outside of the traditional law firm model.

Under the pressure to deliver ever increasing profitability, it is no wonder that many firms have developed a short-term focus. However, by focusing most heavily on profits, firms have cultivated a partner philosophy built around extracting profits from the firm as opposed to funding investments. Creating a firm which will be successful over the long-term will require cultivating support for reinvestment and funding efforts which create long-term value for the firm and its clients.

London

Principal: Giles Rubens
giles.rubens@fairfaxassociates.com
44 (0)20 3633 3943

Washington

Principal: Lisa Smith
lisa.smith@fairfaxassociates.com
202.365.4180

California

Principal: Kristin Stark
kristin.stark@fairfaxassociates.com
415.215.9294

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