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The Investment Years

The last several years mark some of the highest levels of recurring profitability growth ever experienced for many law firms, outpacing historical profitability growth by a significant margin. Between 2019 and 2020, Profits per Equity Partner (PPEP) among AmLaw 200 firms grew 12% on average, and the Compensation Average for All Partners grew at 10%. While year-end data for 2021 is not yet publicly available, our work with law firms confirms that these growth rates will be met, if not exceeded when ultimately reported for 2021. Given that we are still early in the year, it is hard to predict whether law firms will experience another banner year in 2022. Headwinds around geo-political uncertainty and rising costs, including ever-increasing associate compensation, are likely to pressure profit growth to some degree. However, demand at this early stage appears strong, and results thus far indicate solid financial growth.

In light of this multi-year trend in profitability growth, one could argue that this is a unique time period in the evolution of law firms – one where excess profits present a rare opportunity to make significant internal investments to enhance law firm competitiveness, without negatively impacting partner compensation. And yet, the notion of setting aside firm profits, even in banner years, remains a challenge for many firms.

This is a fascinating irony about law firm 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 profitability growth. Some of the short-term focus is fueled by the cash basis partnership structure of most US law firms, which requires that firms distribute all profits within the taxable year to avoid phantom income (and thus income 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. This focus inhibits firms from making investments in other critical firm building activities. In our work with firms, we regularly hear partners express a desire to invest in resources which may increase the firm's long-run competitiveness, but only to the extent that it does not increase overhead and negatively impact partner compensation.

It would be naïve to say that growth in PPEP is not critical in today's legal industry. For better or worse, the publication of firm financials shapes perceptions of firms' relative market position and overall success. Firms simply cannot deemphasize profitability without risking negative media scrutiny and rumors of financial and partnership instability. External perceptions relating to declining profitability, or even low relative growth rates in profitability, can quickly lead to partner loss of confidence in the firm's future and threaten partner departures, or worse.

While profitability clearly represents a management priority, profitability cannot be management's only priority. Investments we see as particularly critical to ensure law firms' long-run competitiveness include:

Growth

Nearly every firm we work with is talking about growth. Firms recognize the need to build greater depth and bench strength in key areas of practice and industry focus in order to retain or grow market share. Other firms aim to expand their geographic platform or practice breadth. However, in spite of these growth goals, we observe significant variability in partnerships' willingness to invest in growth. While partners generally agree that growth is necessary, some firms are reluctant to commit to paying for growth in a material way. Given the war for talent at all levels, growth today is more expensive than ever before. Firms truly committed to growth will need to set aside profits to fund the resources needed to identify and pursue growth opportunities, the start-up time before new timekeepers start to generate revenue and profits, and in many cases today, premium compensation.

Technology

Technology increasingly represents one of the greatest untapped investment opportunities available to law firms. There are a wide range of opportunities for law firms to leverage technology more effectively in the delivery of legal services, and to factor technology into the design of staffing models and the mix of talent required. While some firms are further along in the adoption of innovative technologies, others lag behind, even with basic task management, financial management, staffing, and knowledge management technologies. Overall, the majority of law firms are still in the early stages of the application of AI in the practice of law, the automation of routine tasks, and the use of predictive algorithms. Practice-enabling technologies will be a rising source of differentiation and represent a critical investment for firms seeking to remain competitive in a rapidly evolving legal industry.

Efficiency and Alternative Staffing Capabilities

With clients keenly focused on efficiency and the advance of New Law providers, law firms are under pressure to move lower value and routine tasks to the lowest cost resources. Client are insisting, as an overall principle, that firms direct work to the most appropriate level resource for each specific task, which in some cases does not require lawyers, or even humans. To respond to client expectations around staffing and efficiency, firms must creatively and strategically evaluate their ability to offer efficient resources and alternative staffing capabilities to clients.

Some firms are fairly far down the path building business units comprised of lower-cost lawyer and non-lawyer roles, including staff attorneys, contract attorneys, and other professionals including scientists, technical specialists, nurses, consultants, project managers, etc. However, the large majority of the AmLaw 200 firms have struggled to develop high functioning alternative staffing models, in part because successfully developing these models requires a material investment to build the capability. Firms must not only invest in identifying and hiring the appropriate talent, acquiring the necessary technology to support their work, and developing a steady stream of work from clients, but also the management of these functions to ensure high levels of utilization and effective client service delivery.

Business Professionals

While the actual compensation of business professionals in law firms is relatively high (and growing) today, the headcount of mid-level and senior business professionals within law firms remains an ongoing source of debate. Many firms resist efforts to build out broader Chief or Director level roles to support the practice and business management of the firm. Partners tend to diminish the value of marketing, professional development, 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 professional roles often results in overly lean staffing and/or underqualified individuals being hired. How can firms implement important management initiatives without the horsepower or expertise necessary? Some of the roles we see as offering the greatest long-term investment upside include practice group management roles, knowledge management roles, legal project management and pricing roles, client service professionals, data analytics and reporting roles, and competitive intelligence roles.

If now is the time for firms to contemplate greater investment in the future, how should firms cultivate partner support for these critical investments? Cultivating support for investment starts with setting forth the notion that a portion of partnership profits must be reinvested in building a viable firm for the long-term. While still a minority of the overall profession, some law firms have been moving this direction. Over the past several years, these firms have sought to ‘set aside’ excess profits. A number of small and mid-size firms harnessed PPP loan money to increase working capital. Some larger firms are gradually ramping up contributed capital requirements. During this period of superior profitability growth, these calls for investment tend to be better received given the ability to mitigate a negative impact on partner compensation.

Breeding an investment mentality within a law firm partnership requires working with the partnership to generate a real understanding of the value of investments required to remain competitive over the longer-term. Partners must see a meaningful connection between the investments being made and the firm’s long-term success. There has never been a better time for firms to make critical investments which build long-term competitiveness. Creating a firm that will be successful over the long-term in this changing legal industry requires cultivating partner understanding of the importance of funding strategic investments, particularly in years of exceptional profitability growth.

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