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Flat is the New Down: Combating the Risk of Profit Stagnation

Over the past five years, the majority of law firms have experienced substantial growth in profitability. Between 2019 – 2023, the AmLaw 200 increased equity partner pay in excess of 9% annually (CAGR), and based on current estimates, average profitability growth for 2024 will exceed 12% among AmLaw 200 firms. Recent profitability growth has been heavily driven by billing rate increases, and more recently, an increase in attorney productivity. As we look ahead to 2025 and beyond, law firm leaders face intense pressure to meet partnership expectations of substantial, year-over-year profitability gains but simultaneously recognize that outsized billing rate increases and billable hours improvements may not be sustainable. With intensifying competition and market segmentation, low or no profitability growth poses material talent and market share risks, particularly in light of a growing market perception that “Flat is the new down.”

So, how can firms avoid profit stagnation?

Further advances in profitability and partner pay will require firms to 1) more broadly implement client and matter profitability as performance management and compensation tools and 2) harness a broader range of profit levers.

Profitability as a performance management and compensation tool

Not all revenue is created equal, and yet, law firm partners often mistakenly equate revenue dollars with profitability. This misunderstanding is in large part driven by firms’ reliance on revenue based metrics for purposes of setting partner compensation. While collections on business generation and personal production are indeed important metrics in setting compensation, too many firms fail to put sufficient emphasis on profitability. The lack of emphasis on profitability often stems from a concern that measuring profitability can be divisive. In some cases, certain profitability metrics can lead to forming misguided conclusions about the value of a practice or an attorney. These fears over ineffective application of profitability metrics prevent many firms from properly educating partners about the profitability of their work and incentivizing them to develop more profitable work.

It is time for law firms to overcome these fears and focus on the profitability metrics which align partners’ behaviors with the best interests of the firm. Matter profitability, at the individual matter level or rolled up to the client level, offers a reflection of how efficiently work is delivered and how well costs are managed for a particular matter or set of matters for a particular client. Tools such as matter and client profitability better inform and complement revenue based metrics and focus partners on behaviors which create enhanced firm profitability.

While many firms have robust tools in place to measure client and matter profitability, the application of client/matter profitability to partner performance management and compensation setting is spotty at best. Firms inadequately harness these analyses due to internal resistance to profitability, a lack of resources necessary to teach partners about profitability, or a lack of follow through in maintaining profitability coaching over time. When implemented as an ongoing coaching and performance management tool, client and matter profitability educates partners on how to staff matters more efficiently, negotiate better billing rates or pricing arrangements, or improve their billing and collection practices. Client/matter profitability can also be rolled up by the originating or responsible partner to capture the profitability of a partner’s ‘book of business.’ To avoid a winner takes all approach to book of business profitability metrics, many firms use nominal or budgeted values for certain inputs or alternatively, apply analyses which focus on relative profitability through margin based approaches.

Perhaps the greatest benefit of factoring profitability into the partner compensation setting process is the ability to meaningfully coach partners on how to improve the profitability of their clients and matters. When firms consider matter profitability in compensation and simultaneously work with partners to explain why certain clients are unprofitable and how the profitability of those clients can be improved, partners are typically more engaged in the conversation and more incentivized to make profitability improvements. This requires not only solid data reporting but also coaching and the resources necessary for partners to modify their staffing, pricing, and billing practices in a way which will yield a more profitable result for the firm.

Harnessing a broader range of profit levers

From a day to day management perspective, most law firms heavily emphasize both billing rates and billable hours, as two critical levers of individual attorney performance and overall firm revenue growth. While these two levers are certainly among the most powerful levers in driving profitability, other levers can offer equally valuable benefits to firm performance.

Value Based Pricing: Value-based pricing presents law firms and their clients with an opportunity to collaborate in risk-reward sharing arrangements and to align incentives with the client's goals for a particular matter or portfolio of work. While some firms effectively tap into value based pricing for particular practices, other firms lack the resources and capabilities to capitalize on the value of work through non-traditional pricing arrangements. Going forward, maximizing profitability will require law firms to more creatively and proactively offer their clients pricing models that reflect the value of the outcome, rather than the amount of time spent.

Leverage: For firms with sub-practices or specialties which allow for greater delegation of work, expanding the utilization of lower-cost lawyer and non-lawyer resources can dramatically enhance the profitability of work. For many practices, this may simply require broader use of productive associates. In more routine practices, an expanded leverage model includes broader use of staff attorneys, contract attorneys, and other non-lawyer professionals including economists, technical specialists, nurses/doctors, consultants, project managers, etc.

Cost of Resources: When partners think about costs, they often focus on overhead. While cutting overhead can improve profitability, doing so typically offers short-term and relatively marginal gains. Longer-term profitability gains through better control over the cost of resources requires additional leverage, as discussed above, and equally importantly, harnessing technology. Emerging technologies offer law firms the opportunity to tremendously increase efficiency and reduce the cost of resources required to complete certain tasks. Capturing the value of these efficiency gains to enhance firm profitability will require not only substantial investments in technology tools and training but also mastering value based pricing.

Collection Realization: Due to the widening gap in standard billing rates across practice areas, many firms have de-emphasized realization rates in recent years. It is true that billing realization (the value of time billed on a matter at agreed upon rates divided by the value of time worked on a matter at standard rates) has become a less meaningful metric. However, collection realization (measured as the value of time collected on a matter divided the amount of time billed on a matter at agreed upon rates) remains a critical and key lever to enhancing profitability. While collection realization is already fairly high in many firms, firms still face between 3-10% of leakage and lost profits due to non-compliance with client outside counsel billing guidelines and processes, or in some cases, weak collections processes and policies. There is an ongoing opportunity for firms to continue to maximize profitability by renewing their focus on collection realization and improving billing and collections systems and processes.

Recent consecutive years of exceptional profitability growth and firm performance have contributed to lofty partnership expectations for 2025 and beyond. In order to avoid the risk of stagnant profits, firms must double down on leadership and partnership efforts to more carefully manage the profitability of work and tap into a broader range of profit levers in the day to day operations of the practice.

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