1 The Life Phases of a Law Firm

Regardless of its size, location, or type of practice, every law firm, like most businesses, goes through a series of phases during its existence. In most cases, the beginning and ending of each of these periods are marked with significant changes in a firm's financial condition. Good times bring about a series of decisions and actions that allow a firm to continue its prosperity and generate even more profits for the owners. Bad times create the need for decisions and actions that determine whether a firm can continue to exist under the current circumstances, and what must be done to improve the situation and avoid a complete dissolution.

Unfortunately, in many law firms opportunities are often missed and trouble signs ignored. The result is that a firm is constantly involved in crisis management, without a plan and without a methodology to deal with the normal highs and lows that it will surely experience.

As an introduction to the issues of financial management, this chapter discusses the life phases of a law firm from a management and financial perspective. It discusses how to plan for the future, and be in a better position to recognize when difficult decisions must be made. It offers some suggestions on what these decisions should be, given the situation at the time. Later chapters in the book assist in analyzing and resolving some of the problems that occur throughout a law firm's existence.

The Planning Phase

Somewhere in books you have read or seminars you have attended, you have been exposed to the strategic-planning process. Strategic planning is important for a law firm, because it determines a firm's goals and objectives and establishes a methodology and timetable for implementing policies and procedures that achieve those goals and objectives. While still in its early stages, a firm must focus on certain issues that it will face in the months and years to come. In addition to management structure, marketing considerations, client service needs, technology, and so on, a firm must focus on how it can generate the most profits for the owners. It must do this in conjunction with the expectations of the owners, in line with their individual goals. Obviously, a firm will not last very long if its financial plan cannot support the income goals of its owners.

Preparing the Financial Plan

The financial plan is part of the overall business plan and incorporates a firm's income projections over at least a three-year period. In preparing the revenue portion of this plan, a firm should consider the following:

- *Hourly rate.* If it is a general practice firm, what hourly rate will it charge? The rate must take into account the area of practice, geographical location, types of clients, experience levels of the lawyers and legal assistants, and the competition. There are many different formulas for calculating billing rates, most of which take into account compensation, overhead, and expected profit. Chapter 4 describes in some detail a sophisticated methodology for determining a rate structure that will produce a desired profit level. Alternate billing systems are now a reality and must be seriously considered in proposals to prospective clients. In fact, many clients are now demanding that their attorneys provide some alternative billing process to the historical hourly rate system.
- *Lifestyle*. How hard does the firm want its people to work? Since gross revenues are a function of hours worked multiplied by hourly rates, the number of billable hours that are expected from each level of timekeeper becomes a crucial ingredient in the income-projection process. A firm must make a conscious decision to strike the proper balance between work and personal life. Everyone in a firm must buy into the production goals that are set for each timekeeper. Initially at least, compensation is tied to an individual's ability to meet a prescribed number of billable hours.

There are surveys published in many of the leading law office economic journals that provide guidance on average billable hours at each timekeeper level. This information is arranged by category—years at the bar, area of practice, location, and so on. As a general rule, owner hours are usually set at fourteen hundred to sixteen hundred; associates at seventeen hundred to nineteen hundred, and legal assistants at one thousand to twelve hundred. The expected number of hours depends on a firm's culture and how it views the production of hours among all of the other factors involved in a lawyer's association with the firm.

- *Leverage*. Although at the outset most lawyers strive to support themselves on their own time production, at some point a firm needs to understand the concept of leverage. In other words, there must be others in a firm who generate more profits than they consume and thus provide additional income to the owners. Leverage can come from younger owners, associates, and legal assistants. The key is that a firm needs to understand that eventually a structure must exist within the organization whereby each owner can make a reasonable income but not have to provide all of it himself. This must occur in order for the more senior lawyers to spend their time on nonbillable matters, such as generating new business, training associates, or managing the firm.

  This issue is particularly important as a firm begins to get some age on it and the more senior lawyers start reducing their revenue generation. Unless there are younger lawyers or other timekeepers generating revenues, it is difficult for the more senior members of a firm to sustain their earnings expectations. Again, the issue of alternative billing rates has probably changed the leverage concept. Now that some firms are charging for what they produce rather than how long it takes to produce it, there will be less emphasis on leverage and more emphasis on hiring experienced lawyers who can work efficiently and profitably.
- *Staffing levels*. The other side of the net-income equation is expenses, and this is strictly a question of expected level of service. Since a large percentage of expenses is devoted to compensation and benefits, the decision on staffing levels is very crucial. Staffing levels are dictated by the level of service that a firm is willing to accept, given its present situation. The issue of secretarial support, outsourcing of various administrative services, and the extent of day-to-day office administration and management must be addressed very early on as part of the financial planning process. The impact of technology needs to be considered in order to determine whether a firm can indeed live with

fewer support people, given a more sophisticated level of automation within the organization. Most general-practice firms operate with a 1:2 or 1:3 staff-to-lawyer ratio. This has not changed much over the years, even though firms have spent considerable amounts on technology. However, since new lawyers generally have a much higher level of computer skills, this ratio should improve substantially.

- *Billing and collections.* Finally, in order to convert the billable hours into cash to pay expenses and owners, a firm must have the systems in place to reduce the conversion cycle to a minimum. Ultimately, the success of the firm's ability to generate profits rests in whether it can create a billing and collection philosophy within the firm and with its clients that produces the maximum amount of revenues for the hours worked.

  The hours-to-collection cycle varies with the type of practice and clientele, but generally work should be converted into a bill within sixty to seventy-five days after it is performed, and translated into cash sixty to seventy days after the bill is issued. The longer the cycle, the more cash (at least initially) a firm will need to borrow or contribute as capital to keep going. Chapter 8 addresses the timing issue in some detail.

Creating a Budget

Once a firm addresses the financial management issues listed above, it then must create a financial plan or budget that will enable it to make certain that it can meet its net income projections, considering the expected billable hours, rates, expenses, and so on. In its early days, a firm must make assumptions based on the experiences of other firms, or by using surveys or other statistics. As it grows and matures, a firm can use its own historical information to provide the assumptions that will go into the financial planning process.

In addition to hours, rates, and expenses, a firm must also budget for write-downs in the billing process and write-offs in the collection process. The magnitude of these amounts depends on the ability of the firm to get good paying clients, to obtain engagement letters on all assignments, to get retainers wherever possible, and to foster an attitude among the lawyers regarding the necessity to manage their individual files so that reductions from standard rates are minimized.

This is easier said than done, since in its early stages a firm generally takes on certain work just to "pay the light bill" and doesn't worry so much about profits. However, if this mentality becomes pervasive throughout a firm, it is infectious. Soon a firm has an abundance of timekeepers and high billable hours, but no profits. There must be constant vigilance over the types of clients obtained, and a close watch kept over clients who cannot pay the amounts being charged to them. More importantly, there must be vigilance over those lawyers who constantly cut their bills. Originating business is important, but profitability on that business is what really matters and sustains a firm over the long term, even if it means reductions in lawyers and staff.

Financial Reporting

The financial planning process does not end with simply creating a budget. A firm must have a system of financial reporting at both the firm level and the individual lawyer level. These reports should be reviewed monthly, and problems corrected as soon as possible. There should be an individual or a group whose job it is to review new work, billing and collection activity, and write-downs and write-offs. Each lawyer must understand that he is accountable for his performance; generally this is accomplished at compensation-setting time, if financial management of client files is one of the criteria for determining a lawyer's contribution to the firm.

Cash Flow

One cannot discuss financial management issues without addressing the issue of cash flow, a subject that is foreign to most lawyers, even those heavily involved in their firm's management. Chapter 10 addresses cash-flow issues and solutions. Ultimately, however, each partner must have some stake in the game in the form of capital contributions, or a firm must have some alternative plan for providing cash to pay for those items that do not find their way into the income statement.

Financing

Whether a firm is financed with debt or capital generally depends on the philosophy of the owners, who determine how much equity comes from the owners and set the limit on outside borrowing. Some firms believe strongly that a firm should be owned by its owners and not by the bank. Others feel just the opposite. There should be some balance, but currently there are no guideline ratios for equity and debt. In a world where younger owners are buying more expensive goods and paying more for educating their children, bank borrowing will continue to be the predominant source of additional funds.

If a firm decides that it must get some of its capital from the owners, then how are the capital contributions allocated? The first rule is to tie the balances to the income percentage. A firm should first set new income percentages and then apply those percentages to the capital balance. For example, if I am a 15 percent income owner, then I should also be a 15 percent capital owner. If my income percentage is *less* than my capital percentage, then I am in essence providing capital financing so that others can make more income than me. If my income percentage is *more* than my capital percentage, the opposite is true. Those owners who take the most out of a firm should be prepared to put the most into it. Once the total capital needed for the year is determined, the amount required from each owner is then reduced by the owner's existing balance, and the new balance due is calculated.

Paying Interest to Owners

There are some firms who pay interest on individual owner capital accounts. The paying of interest on capital only makes sense when the income percentage and the capital percentage are not in proper alignment. If the income percentage and the capital percentage are exactly the same, then to pay interest on capital is a wash. In other words, an owner gets his share of the interest and then pays his income percentage share of the interest to all the other owners, in effect ending up with a zero balance. If a firm does not maintain a direct relationship between income percentages and capital percentages, then paying interest on capital does make sense and in effect gives a benefit to those owners who have put up the most money to run the law firm.

A majority of firms do have income percentages that are disproportionate to capital percentages, and this can justify some type of interest payment. There are actually some tax advantages to the owners for paying interest on capital. First, it is income not subject to the Medicare tax (assuming the owners have already passed the FICA threshold), and second, it may provide investment income that can be offset against personal-investment expenses of the owners.

There is no magical formula or amount that should be charged to newly admitted owners. The amount is based solely on the cash needs of a firm and how a firm wishes to satisfy these needs. Some firms pick an arbitrary number that has no relationship to the real capital requirements of a firm. This is fine, except that if an owner invests more in the firm than another owner, but still receives the same earnings, he is not being compensated fairly. Paying interest can make up the difference.

Paying for Good Will

A question that constantly gets asked is whether or not a new owner should pay for the good will that was created prior to his becoming an owner. This is a difficult question to answer, since in a personal-service environment it is difficult to value good will. However, it is possible to account for it.

There are situations where the founding owners have invested considerable amounts over the years to build a firm's name and reputation. In this situation, there is some justification for new owners paying something for the right to significantly increase their earnings as a result of the founders' effort. One option is to assess each new owner a fixed amount upon admission, determined on a year-by-year basis by the current equity owners. Rather than the new owner making a capital contribution for this amount, it can be deducted from his compensation over a five-year period. For example, if the amount is $40,000, the new owner's compensation is reduced by $8,000 per year, which would then inure to the benefit of the existing owners in accordance with their income percentages. This is one method of having good will paid to the older owners with pretax dollars from a new owner.

Capitalizing Profits

One method used to get owners to ante up some capital is to capitalize undistributed profits. The method that you use to do this will vary, depending on your ownership form. With a partnership or limited liability corporation, the owners are taxed on their distributed share of earnings, regardless of whether they actually receive the earnings in cash. Thus, it is possible for a firm to simply capitalize undistributed profits as the owner's capital contribution for that year. Since an owner never sees the money, in some cases he may not miss it. If necessary, a firm can give each owner enough cash to pay the taxes on the amounts that are not distributed, and then capitalize the rest.

If the firm is a professional corporation (PC), there is a different issue. Owners are treated just like employees. They receive compensation in the form of salaries and bonuses that are reflected on their W-2 forms. This can create a problem. The owner must actually receive the payment in order for it to be taxed as regular income and avoid both the personal service company income tax (currently 35 percent at first dollar) that is imposed at the corporate level, and the tax on dividends paid to owners. This can be a major dilemma, since most PCs, like other law firms, are undercapitalized. Therefore, a firm often does not have the necessary cash to make the distribution and avoid the tax.

The answer to this problem is either to issue notes at a nominal interest rate, or to permanently capitalize the excess earnings (or some combination of these two strategies). This records the compensation on the W-2 form for tax purposes, but retains cash in the firm without it being taxed at the corporate level.

Taxes

Unfortunately, many professional corporations are still paying taxes at the end of the year. This happens for several reasons.

- A firm does not have the systems in place so that the books can be closed in sufficient time to distribute all the cash-basis income as of December 31. Some firms complain that the year-end closing is delayed because of year-end entries, like depreciation, that are not known until late in January. The way to deal with this is to have a rule in the firm whereby no fixed assets are purchased after December 10. On that date, a firm sends the list of new assets to the accountants, and they prepare the depreciation entry by December 31 so it can be recorded in the December entries. In addition, a firm should start correcting any major accounting problems that could affect year-end closing in November, so that year-end closing can occur on time. Also, there is no accounting rule that I know of that prevents month-end closing entries from being made prior to the month's end.

- Some firms pay taxes because they do not have a compensation system that permits all the income to be allocated to the owners. Some firms have a small draw but a large bonus pool, and the bonus pool generally is estimated. This problem can be solved by assigning a percentage interest in the firm to each owner, thus permitting all of the income to be allocated at the end of the year.
- Firms generally do not have enough cash to pay the net income that was earned. As noted earlier, this problem can be resolved by processing the net income through the compensation amounts of the owners, paying the taxes, and recording the balance as owner notes. These notes can then be either paid the following year, or better yet, capitalized.

The Growth Phase

Assuming a firm is somewhat successful, it begins to undergo significant changes brought about simply by the addition of more work and more people to service the work. This growing-up stage is very important, and if it is not handled correctly, there may be future problems when the situation begins turning downward.

Unfortunately, smaller firms, of which there are thousands, prepare to get bigger without really knowing what it means. The following discussion may be helpful in determining what happens as growth occurs, and learning how to deal with the inevitable changes.

The Institution Emerges

The first thing that happens in the larger organization is the emergence of the firm as an institution, as opposed to a group of lawyers sharing space and expenses while operating as sole proprietors. Decisions are made with the entity in mind, rather than to satisfy individual desires. This group focus becomes the overriding factor for many of the other changes that begin to take effect.

More Emphasis on the Planning Process

The increased number of people and the magnitude of the revenues to be generated places special emphasis on the planning process. A firm begins to question many issues that it took for granted or paid no attention to in the past, such as

- How large do we want to be?
- How many offices do we want, and where should they be located?
- What kind of associates do we want to hire?
- How do we handle recruiting and compensation issues?
- Which services should we expand, and which should we eliminate?
- How do we want to be owned, governed, and managed?
- What are our overall objectives?

Suddenly a firm realizes that it is a large business with several employees who depend on it for their livelihood and the welfare of their families. Questions of how to deal with lateral hires, merger opportunities, and branch offices are now being raised. The owner retreat now takes on more significance than just being an event where the prior-year financial results are discussed.

Governance and Management

The planning process may reveal that a firm, operating as a loose confederation, cannot make the right decisions at the right time without more structure. This structure may take the form of a policy committee, headed by a strong managing owner, which guides the firm through the growth process. A firm may struggle with selecting the persons involved in this new governance mechanism. The result of this struggle can create certain problems among the owners, particularly those who believe their book of business justifies a major role in the decision-making process. Compromises must be made to keep a firm together as the management structure unfolds.

Expanded Client Services

The expansion of client services to a larger group of clients may create certain management problems, primarily in selecting work to be performed and scheduling people to perform it. A firm must decide on a practice-management structure that allows for the work to be performed at the most economical level without sacrificing quality. This means creating department managers or coordinators to assist the policy committee in managing the work and the people. A firm must also initiate a system for examining new work and making certain that it fits the service and profitability criteria established by the firm.

Nonlawyer Management

As part of its examination of governance and structure, a firm may find that the owners can no longer devote the necessary time to many of the management and administrative tasks required by a larger organization. To compensate for this, the owners may consider employing a nonlawyer professional manager, either full or part-time, who can assist in handling these activities as well as help the firm realize its longer-term objectives. The person hired for this position needs a strong financial background, and must be able to deal with the many personnel problems that now confront the firm on a routine basis. Chances are that if the firm has never had such a person, it will take two or three tries before the right person is hired. The main problem is likely to be the firm's reluctance to turn over many of the responsibilities that were previously the province of the owners.

Capital Needs

With the increase in size of staff, space, and equipment, a firm may find itself with a major capitalization problem for the first time in its history. Before, certain items were often simply purchased out of current earnings. But with a larger organization, the magnitude of purchases makes that option no longer feasible. A firm needs to consider debt financing more than ever before, and determine how that debt is to be divided among the owners. As the firm's capital needs increase, it must wrestle with a more formalized capitalization system where after-tax dollars are contributed by the owners not only upon admission, but for each year as well. Some owners may be opposed to debt financing, particularly if they are required to be guarantors on the loans.

Ownership Issues

Reviewing capitalization needs may ultimately raise the question, "what is an owner?" For perhaps the first time, a firm wrestles with the problem of having too many owners, which may dilute profits. There are several options to consider, including multitier ownership with nonequity owners, or permanent associates. The firm may have to develop more stringent criteria for ownership admission and may have to turn away some associates, even if it means losing good people who cannot pass the new criteria.

Retirement Planning

When owners reach their late forties or early fifties, some begin to think about retirement. A firm needs to address how retirement is funded—from current earnings, future earnings, or not funded at all. Questions may be raised about how to deal with the accumulation of work-in-process (WIP), accounts receivable, and unsettled cases, and whether any of these amounts actually belong to the owners and are earned by them over their lifetimes as owners. A firm must also decide how retirement amounts are determined, and whether owners are "forced" to retire at a certain age to make room for new owners to come in at the bottom and ensure continued growth and success. This issue is addressed more fully in Chapters 18 and 19.

Strategic Technology Planning

The growth in a firm's size and complexity creates a need for new types of information. For this reason, a firm needs both an overall strategic plan and a strategic technology plan, so the overall plan can be measured against expectations. With all the changes taking place in a firm's practice and administrative sectors, technology plays a key role in providing management with the efficiencies and economies required to practice in a different competitive environment. Unlike in 1995, when this book was first published, computer-literate attorneys are now the norm and will put added pressure on a firm to provide the tools necessary to both manage their practice and deal with the firm's administrative issues. Many attorneys now work out of their homes, their automobiles, or simply sitting at a restaurant having coffee and a donut. This creates a constant problem of finding a way to recapture some of the capital investment required by more creative billing practices.

Strategic Marketing Planning

To reach its objectives, a firm needs to develop a marketing plan that is in line with its desired clients and services. More emphasis is placed on individual lawyers marketing the firm to potential clients. The firm also will change the way it views marketing as one of the contributions made by partners and associates to the overall goods and objectives of the firm.

Compensation Policy Adjustments

Ultimately, all the changes that take place in a growing firm alter a firm's reward systems at all levels, but particularly for owners. With the emphasis on the institution as opposed to individual production, the compensation policy needs to be reviewed and perhaps changed to a system that evaluates total contribution to the firm, measured in more than just billable hours or collections. The increased need for management, marketing, associate training, and recruiting results in establishing criteria to which all owners must agree and understand as their basis for compensation. It is likely that reviewing compensation will create the need to establish policies for those owners who, for whatever reason, are not making a contribution commensurate with their compensation levels. A firm may realize the necessity of having a formal annual review program for owners, just as it does for associates and staff. The owner compensation issue is addressed in Chapter 17.

Looking into a crystal ball is not easy. However, as small firms become medium-sized firms, small problems become very large ones. The firm must begin at an early stage to identify those issues that will result from growth, and begin addressing them so that it can realize its strategic objectives while retaining an atmosphere that promotes the proper quality of work style and lifestyle.

The Trouble Phase

Unfortunately, despite all the warnings and despite all the advice regarding the need to constantly keep one's finger on the pulse of a firm, at some point even the most successful firm begins to get into trouble. You would think that with all that has been said and written over the past several years, that major problems in law firms simply could not develop without warning. Perhaps the signs are not obvious that adversity is right around the corner. Perhaps the firm leadership is not able to recognize the underlying problem areas that have the greatest potential for harm.

Following is a discussion of the "danger areas." These may be of use to those firms who have been successful and want to continue that way. Some of these situations may not seem like problems, since they may be the very things that allowed a firm to prosper in the past. But each firm needs to examine itself and decide if warning signs are apparent and, if so, whether corrective action should be taken. Having only a few of these problems, in most instances, may not be significant.

Relying on One Client

A firm should perform an annual analysis and ascertain the extent to which each client is generating revenue. A firm should be aware of the problems that can develop if one or more major clients disappear. In addition, this analysis reveals whether the firm is case-oriented or client-oriented, and the problems that develop if the firm cannot build a client base that supplies a steady stream of revenue over a long period of time. This analysis also reveals whether major clients are more aligned with specific lawyers rather than with the firm, which could be a financial disaster should those lawyers leave or retire, jeopardizing continuing work for those clients.

Democratic Management

Unfortunately, democracy does not work in a law firm. A firm needs to select from its ranks of owners and associates those people who are the best managers, put them on the significant committees, and let them run the firm. It's generally unproductive to include more than a few people in the management process. Obviously, there are decisions such as mergers, borrowings, lateral hires, expansion, office relocations, and owner admissions that require a consensus; however, these decisions should be based on recommendations by those entrusted with the management of the firm.

Lobster Taste and Hamburger Rates

As some firms try desperately to keep up with the Joneses, with respect to both associate compensation and office location and decor, their hourly rates are unable to keep pace. The result is that they can't produce the necessary income per owner even though they may have significant billable hours.

Firms need to look within themselves and decide who they are and what they want to be. It doesn't make sense to move into an office building with a significant square-foot decoration allowance and space per lawyer yet only be able to charge nominal rates. A firm should make certain that its lifestyle coincides with its client base and its revenue-producing capacity.

Information Blackout

In some firms it is believed that the less people know about what's going on, the better off they are, or that the more information they have, the more they have to gripe about. In addition, some firms feel that information, if not interpreted correctly, creates divisiveness within a firm. Experience shows that the opposite is usually true, particularly at the associate level, where blackouts appear to be the most prevalent. Why not articulate associate expectations, or tell associates how much the firm makes? Why not divulge what the criteria is to be an owner, and what it means in capital investment and compensation to be elevated to that position? Why not spell out how the owners' retirement plan works or how the compensation system is administered? Generally, dissemination of information creates more positive than negative results. In a law firm that's already a frail entity and struggling with owners, associates, and staff retention, these kinds of factual disclosures become even more important.

Formula-Based Compensation System

Listing this as a problem always raises eyebrows, since there are many firms with formula-based compensation systems that are indeed very successful. In the long run, however, formula-based compensation may not work. A firm should develop criteria for compensation that take into account not only objective factors such as billings, collections, and billable hours, but also many subjective factors such as firm management, practice development, *pro bono* activities, community and civic activities, and so on. Most pure formula-based systems seem to short-change these latter factors. Nothing can be more divisive and destructive than a compensation plan that's perceived as basically inequitable. A balance needs to be struck between a subjective system based on objective data and an incentive-based system that rewards those with exceptional performance.

High Owner Billable Hours

If owner billable hours are higher than associate billable hours, it can be a problem. This is related somewhat to formula-based compensation. In a system that rewards billable hours more than any other criteria, there's less incentive for owners to pass work down to younger associates, and less incentive to pass the work to others who can do it better and perhaps more efficiently. Generally, in firms where owner billable hours are higher than associate hours, it's a result of a compensation system that places excessive emphasis on hours production.

If one believes in the concept of leverage, then it makes sense that associates have more hours than owners. Owners should devote a significant amount of time to activities outside of client billable hours. Having owner billable hours exceed those at the associate level, while perhaps a short-term benefit, can indeed be a long-term problem.

Low Owner-to-Associate Ratio

Relating again to the question of leverage, firms need to seriously examine their current owner-admission policy and decide whether or not relatively unrestricted advancement to owner should be changed in favor of some other method. This could either be lengthening the time to achieve ownership, or creating a multitier ownership system. Statistics show that firms with the highest net income per owner are usually those that are highly leveraged with associates and legal assistants.

Undercapitalization

The question of capitalization is probably one of the more significant issues facing most firms, regardless of size. As firms continue to spend substantial amounts of money on new space, technology, and other inflation-driven expenses at the same time that owners want more take-home cash, they are often caught in a cash bind.

There's no right or wrong proportion of debt to equity in a law firm, except that the more successful firms seem to be those that have taken the position that a firm should be owned primarily by the owners and not by the bank. In these firms, each owner must make a capital contribution on some basis every year. It's bad enough that the firm must use the bank for operating capital to take care of slow months or receivable stretch-outs, let alone borrow heavily for capital asset additions, or even worse, to make scheduled payments to the owners.

No Ownership Agreements

You would think that most law firms would have a formal and appropriately detailed owner agreement. It's interesting to note that many do not. A firm may have an agreement, but often it's far from sufficiently detailed. As a result, when problems occur and owners start leaving, there's no clear, structured way for a firm to deal with issues such as paying out an owner, transferring clients, dealing with governance questions, practice-management issues, and so on. The ownership agreement should be updated on a periodic basis.

No Formal Retirement Program

Most small and medium-sized firms haven't even begun to address the question of how to deal with owner retirements. The problem becomes significant when owners reach their mid-fifties, and no plan has been put in place. There are enough pension vehicles available that firms should be able to provide adequate retirement for all owners and employees. Such programs tend to stabilize a firm, engender more firm loyalty, and create a cohesive team.

A retirement plan should be structured so that it fulfills two major goals: to provide adequate compensation so that owners are able to retire at a reasonable age (whether it is age 60, 65, or 70), and to serve as a funding mechanism so that young owners will have minimal or no liability in the future.

No Formal Plan of Governance

A firm should have a plan that allows for an orderly transition of management at all levels. A mechanism encouraging the best people to move into substantive management roles is critical. A firm should address the types of committees it wishes to have (recognizing that a too-elaborate committee system can be as troublesome as an excessively democratic process), how these committees are structured, how people are rotated on and off, whether specific constituencies are represented, and how the committees perpetuate themselves through the lifetimes of many owners. The system should be designed so that people are motivated to participate in management, and the firm should be in a position to select those who are the best managers (and not necessarily the best lawyers or biggest rainmakers).

Expense Orientation

Regardless of how many times it's been refuted, many lawyers still believe that the key to making more money in their firm is cutting overhead. But that just isn't true, as confirmed by practically every study that's been made on the economics of a law practice. *The key to more net income is more gross income.* A firm should develop procedures and programs that allow it to increase its gross revenues as much as possible.

There's no question that expense control (as opposed to expense reduction) is necessary, and management must be constantly aware of those areas of costs that can be controlled. In many instances, however, expense control is affected more by lifestyle and level of service than by objective economic considerations. Everyone wants to reduce expenses unless it affects him or her personally.

Inadequate Budget Reviews

A large percentage of law firms still don't follow through on periodic comparisons of actual-to-budget amounts to determine whether or not targets are being reached and, if not, what can be done to prevent an income shortfall. In addition, firms generally budget on an annual basis without further dividing the year into months or into seasonalized billings, collections, and hours so historical income trends can be projected. Making midcourse corrections during the year helps ensure that December 15 doesn't arrive to find the firm 20 or 30 percent below expectations.

No Institutional Focus

I've purposely left this issue for the end because it's the most important. A firm must do everything possible to create an environment in which all lawyers and staff have an institutional focus. As a partner once said to me, "If it is not good for the firm, then it is not good, regardless of how it affects individual partners." This is the ultimate institutional philosophy.

One cannot help but notice that the issues that a firm confronts as it grows are the very issues that will give it the most problems unless it can forecast what lies ahead and plan for the eventual results. While it may be difficult to predict the future, there are certain fundamental steps that a firm can take to avoid the full impact of potential problems caused by growth, by loss of significant clients, by loss of significant lawyers, or by a downturn in the overall economy.

Ownership

As a firm grows, it faces the question of who are the owners, and when and on what basis new owners are admitted. This brings up the question of whether the firm needs to consider a multitier structure to include nonequity, salaried owners. If not handled properly, a multitier ownership system can create a certain level of strife and low morale among both owners and associates.

In most cases, the issue of ownership can be dealt with effectively through the compensation process. However, if that is not possible, then you need to examine creating a different ownership level.

Although many firms believe that some type of second-tier owner is required, there usually is no general consensus on what it represents and more importantly, on the time and criteria for moving into the equity class. This issue is covered in Chapter 18.

Terminating Owners

Equally as important as the issue of promoting owners is the issue of terminating them in the event that a downsizing of the firm is required. This is not easy to do; however, it is the eventual result of making bad decisions in the hiring or promotion process, or of bringing in new laterals or owners in a merger situation.

Dealing with nonproductive owners is difficult and controversial, and each firm needs to develop its own individual, specific way to handle the problem. The discussion here is very general; the goal is to present the issues that a firm confronts when dealing with a nonproductive owner, and to suggest a variety of ways to resolve the situation. Of all the issues that a firm must face, this is perhaps the most private and personal, and the solution must be tailored for each individual firm.

Definition of a Nonproductive Owner

The nonproductive owner usually has some or all of the following characteristics:

- Doesn't work as hard as other owners
- Doesn't generate new business
- Is a trouble-maker
- Doesn't train associates or younger owners
- Doesn't participate in management
- Doesn't participate in outside activities that enhance the status of a firm
- Doesn't keep current in his field of legal expertise
- Was nonproductive as an associate

What Makes an Owner Become Nonproductive?

There are many reasons why an owner falls into this category. Unfortunately, most people either do not recognize or refuse to recognize the symptoms, and do not work to correct the situation. Here are some reasons why an owner may be nonproductive:

- Burnout
- Illness

- Substance abuse
- Personal tragedy
- Outside interests interfere with work
- Loss of interest in practicing law
- Legal specialty becomes obsolete, and won't or can't retrain
- Loss of major client
- Perception of unfair treatment by other owners
- Compensation too high
- Compensation too low
- Firm has not provided rules to follow

How to Deal with a Nonproductive Owner

Once you have identified individuals in the firm that may fit into this category, then the firm must work diligently and quickly to rectify the situation. Here are some suggestions:

- Cut compensation, or place on separate system geared to both originations and working credits
- Create a plan with expected milestones of achievement, where failure to achieve milestones results in dismissal
- Place in of-counsel relationship, with incentive-based compensation system
- Retrain
- Determine strengths, and offer assignments that utilize them
- Out-place to client or in other position
- Offer early retirement
- Terminate

Deciding Whether to Take Action

There are both downsides and upsides to effectively dealing with a nonproductive owner. Each situation must be examined separately to determine how best to deal with a particular one. They are all different, and there are no cookie-cutter solutions.

What Happens if You Do Nothing?

- Negatively affects the morale of the owners
- Provides bad example for rest of firm
- Hurts future business
- Drains cash through payout
- Reduced loyalty from others may cause split
- May affect future recruiting, lateral hires, or merger opportunities

What Happens if You Do Something?

- Improves morale
- Gives message that firm is serious about problem
- Increases income share for other owners
- Makes firm feel good to be helping fellow owner
- Reduces number of future nonproductive owners

Preventing an Owner from Becoming Nonproductive

Obviously, the best solution of all is to prevent the situation from occurring in the first place. Here are some suggestions on how this can be accomplished:

- Set standards that everyone understands, adhere to them, and enforce them
- Have a formal evaluation program for all owners
- Anticipate client losses
- Anticipate major changes in specialty areas
- Cross-train owners where possible
- Have a mentor program at the owner level
- Develop a formal retirement program with early-retirement options
- Provide an out-placement service
- Offer a professional counseling program
- Have a serious attitude about dealing with the problem
- Set strict owner admission policies along with a formal associate evaluation program
- Set compensation fairly and equitably

The subject of dealing with nonproductive owners is a difficult one and must be addressed individually in each firm rather than on a broad scale of what everyone else is doing. Each firm needs to examine its group of owners, evaluate them against some type of criteria or standard, and determine which are not producing in comparison to the standard.

Obviously, the first thing that needs to be done is to develop criteria or standards, which is missing from most firms. Generally, people respond well to rules if they know what the rules are and know that they are applied universally to everyone. Without standards, it is difficult not only to prevent a problem from occurring, but also to deal with it in an organized, meaningful, and effective way.

Payout of Terminated Owners

Eventually a firm will have the responsibility for paying out those owners who leave the firm, either voluntarily or involuntarily. Unfortunately, most firms address this issue only when the problem presents itself. This is the worst time to do so, since the departing owner may now be in an adversarial position with the owners who are staying, and who want to protect the long-term financial viability of the firm.

There is a popular view that payouts should be different, based on the nature of the termination. For example, an owner who retires or who terminates to become a judge should be treated differently from one who leaves to join a firm across the street, creating a competitive situation. I do not subscribe to this view, since I believe that during the lifetime of ownership, an owner of a law firm accrues certain benefits. The circumstances of his termination do not necessarily alter the value of those benefits, even though they may alter the provisions under which the payment is made. However, the amount may, in fact, be altered if certain conditions regarding the termination are not met in accordance with the firm's standing agreements.

Rather than provide examples of types of payouts and how they should be funded and recorded, in this discussion I instead have presented several aspects of termination that a firm needs to consider. In many cases, a firm's history and philosophy in dealing with departing owners determine the methodology that it selects to ascertain the payment that is to be made. It is important to emphasize that there are many legal, funding, and tax ramifications of paying terminated owners that must be examined very closely. Chapter 19 addresses this fairly complicated and important issue.

Summary

During its lifetime, a dynamic law firm will evolve through a series of events and conditions, both external and internal, which will materially affect its existence. The firm needs to be able to keep focused on its mission and to make certain that it has the management awareness to foresee problems and make plans to correct them. The planning process must be accomplished on an annual basis and updated periodically in order that the impact of current situations that affect the profession in general and the firm in particular can be evaluated. I hope that this chapter has set the stage for the remainder of this publication, which will address some of the issues noted in more detail.