Profitability's about how you get there

By Edwin B. Reeser

Management effectiveness is often evaluated by profitability. There are several measures of profit, some are effective for performance and some are effective "spin." Broad partner understanding of the difference may be critical to keeping the firm on a sustainable course.

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Profit Margin on Operations

The "PMO" ratio is "partner profit," the pool of net income, divided by firm revenue. The average PMO for the AmLaw 100 is 36 percent — just like our hypothetical firm with $100 million in annual revenue and $36 million in profits.

Suppose PMO falls to 32 percent, but still delivers $36 million profit. What happened? The firm would have to increase revenue to $112.5 million. Expenses would increase from $64 million ($100M - $64M = $36M profit) to $76.5 million ($112.5M - $76.5M = $36M). So both revenue and expenses increased by $12.5 million. The firm made no profit on a revenue increase which historically should have delivered $4.5 million of profit.

Where did the additional revenue and expenses come from?

Revenue could be from an unusually large receivables collection or perhaps a contingency — a nonrepeating event. Or revenue could be from new cases. Time working on new cases that grow the stabilized receivables base can front load costs by two to three months or more, before revenues flow to the firm.

A positive explanation for increased expenses could be that they were incurred precisely because revenue, from whatever source, was there. It presents an opportunity to pay deferred expenses or make expense advances in a year when partner profits would not be diminished thereby. A negative explanation could be a commitment of attorney time to a case(s) that resulted in no revenues.

Note the large impact on the firm for unproductive work. A PMO of 36 percent requires $4.5 million of unproductive work costs to offset $4.5 million profit from $12. 5 million in revenue, which cost $8 million to generate. Just consider what happens when a firm operates at a 20 percent margin!

Quality and risk evaluation of new matter intake is important for all firms, but especially low-PMO firms. Compounded by partners' fear of de-equitization or pay cuts, there can evolve an attitude of taking cases simply because the partner can feel "If it works out, I save myself. If it doesn't, I am dead anyway."

A low PMO can mean greater swings in profits. Combine that with high leverage from relatively few equity partners, and profits per equity partner (PPEP) will be subject to larger swings. Throw in a few guarantees, and the impact on partners without guarantees is even greater.

Furthermore, firms that "invest" in contingent fee cases must monitor how long and active it will be, and how to pay for attorney and overhead costs. A low-PMO firm has less ability to underwrite contingent fee cases.

Let's look at some quick examples to illustrate what PMO tells us.

Reduce our firm's equity partner headcount from 50 to 47. That increases in PPEP from $720,000 to $765,957 (a 6.4 percent increase). It appears the firm is making more money — but PMO clearly shows it is not.

Now reduce revenue 5 percent, to $95 million, and increase PMO to 37 percent, delivering a profit pool of $35.15 million. The equity partner headcount maintained at 50 has PPEP of $703,000, a drop of $17,000 or 1 percent. Now reduce the headcount to 48. PPEP becomes $732,292, increasing $12,292, a 1.7 percent increase. Simply put, removing partners participating in the profit pool fast enough delivers increasing PPEP results, even though the pool is shrinking. Examine profit pool size as well as PMO over 10 years, and see how it compares with reported PPEP. Growth in size of the profit pool and PMO are significantly more important than PPEP.

Profits per Equity Partner

PPEP is a mathematical average, the profit pool divided by the number of partners. Potentially more illuminating is the median in the equity partnership. Is that midpoint moving towards or away from the average PPEP? How many partners are actually making more than PPEP? Is the value of the median point income increasing or decreasing as reported PPEP rises?

If PPEP is rising, the midpoint value is falling, and fewer partners are earning as much as PPEP, the firm may eventually have a serious problem. Stability of the firm may be lessening precisely as financial reports suggest it is strengthening with higher PPEP.

Firm profitability is crucial to building a strong firm with a compensation system designed to sustain the enterprise year after year. Should the firm ignore the sources and measures of profit, it is only a matter of time before the model breaks down.

Jewelers, Grocers, Lawyers and Profit-Based Compensation

Comparing firm profits is problematic, especially based on PPEP. Compare a grocery store with high sales volume, low profit margin, and low cost of goods, with a jewelry store with lower sales, high margins, and high cost of goods. Both are good businesses, but not operationally comparable. Comparing profits between firms with a different practice base is similarly difficult.

How can a firm, especially one with a broad spread of differently priced practices, sell "groceries and gems"? The law firm must examine the leverage employed in the firm and the productivity of the assets. That means individual lawyers, practice groups, and geographic locations. "Productivity" is not "utilization," despite what many reports will have you believe. "Utilization" is recorded hours — spinning the hamster wheel. "Productivity" is the combination of rates and hours billed and collected, and they can be hugely different. Working fewer hours with higher collections and rates, delivering higher profits is more productive. On the income side, a labor practice delivering $325 per hour rates at net 82 percent collection on recorded hours is not as productive as an M&A practice delivering $600 per hour rates at net 95 percent collection on the same number of recorded hours.

Gross billings and recorded hours are not the driver; it is profit that matters. Determine net contribution to profit from a partner, practice group or office and how much is available for distribution back to the group for that contribution. Paying back more than what was contributed is poor policy, yet it is common.

Until firms measure and reward profit generation, it is going to be difficult to combine a wide array of practices and pay each fairly. Like it or not, two classmates from the finest law school in the country, both working in the same firm, but with the practices outlined above, are not worth the same to the firm, and probably shouldn't be paid the same. But that is the way many firms do it, and why we have some real problems by ignoring the contribution to profits in our measurement of firm performance and compensation rewards.

It may be easier to now see why accurate measure of firm profitability has been slow in coming, because it leads to a very clear picture of why change is needed. However, a firm that bases compensation on profit contribution can successfully present a broad offering of practices in a wide array of geographic locations, building a formidable competitive platform and attractive recruiting pitch. And, it can still compensate for other factors in a vast number of ways.

Numerous firms that have failed in recent years did so close on the heels of what they reported as their best years ever, or on the threshold of their greatest year ever. On further examination of PMO trends for the preceding months and years, it is usually obvious it could not have been so.

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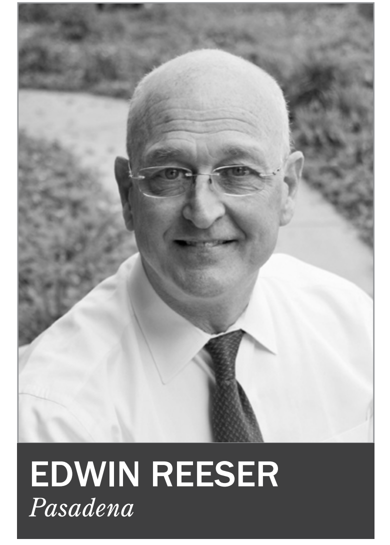
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Defining boundaries mitigates risk of harassment

By Kevin Whittaker

Recently, stories involving startups targeted with shocking claims and lawsuits alleging gender-based discrimination have attracted national media attention. These recent matters present two important lessons with respect to social media and electronic communications that all employers, not just startups, can learn from.

From Fortune 500 companies to small non-profits, employers continue to find themselves defending against claims of gender-based discrimination, harassment, and retaliation. According to the Equal Employment Opportunity Commission's website, in 2005, employers faced 75,428 new workplace discrimination charges. Of all the charges filed in 2005, 31 percent alleged gender based discrimination. Flash-forward eight years to 2013, the number of new charges increased to 93,272. This figure accounted for a 17 percent increase in gender-based discrimination charges.

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The media is quick to highlight gender based employment issues, especially in the startup world. Last month, the Wall Street Journal ran an article titled, "Torment Claims Make GitHub Grow Up: Incident Shows How Rising Startups Are Often Ill Equipped To Deal With Complex, Inter-Office Dynamics." Launched in 2008, GitHub is a San Francisco-based software collaboration company. According to the Wall Street Journal article, in March, an anonymous user posted the following message on the internet, "The self-proclaimed Queen of GitHub is leaving her throne. The masses cheer." The subject of the message, Julie Ann Horvath, fired back online and accused her colleagues of gender-based harassment. She urged her 24,000 Twitter followers to boycott GitHub. An investigator ultimately concluded that the gender-based harassment claims were unsubstantiated. However, the investigator also concluded that the company maintained poorly defined personal and professional boundaries.

Another example of gender-based issues arising in the startup world has been media attention directed at the online dating application, Tinder. This situation presents a striking and highly visible example of poorly maintained personal and professional boundaries, which has resulted in litigation. Tinder's former Vice President of Marketing, Whitney Wolfe, filed a lawsuit against the company setting forth shocking allegations of gender based discrimination and harassment. Wolfe's complaint and attached exhibits alleges that her superior, Chief of Marketing Justin Mateen, created a hostile work environment by berating her for possibly talking to another man. He allegedly sent her gender-based text messages, including, "I will shit on him in life… He can enjoy my leftovers." At a company party, Mateen allegedly engaged in a series of gender-based and harassing comments toward Wolfe by addressing her as a "gold digger" and a "whore," while other senior leaders stood by. Her complaints to senior management of Mateen's severe, inappropriate and pervasive conduct were never acted upon, which, she alleges, forced her to resign and file a lawsuit.

There are two important lessons that employers can learn from the allegations raised against GitHub and Tinder. First, employers need clearly defined policies and ample training on the use of social media by employees and how to respond to social media campaigns. A single tweeter can reach an exponential number of readers. If a tweeter disparages other employees, or the company, improper responses can trigger claims of harassment, discrimination, slander, and/or defamation. Clearly defined policies and training on how, and who, should respond, or not respond, to such campaigns can mitigate and help avoid potential legal risks.

Second, employers must implement well-defined policies and provide training on electronic communications to employees at all levels of an organization. Not only can individuals who misuse electronic communication be held personally liable, but the employer can also be held liable under the doctrine of respondeat superior for not taking action to prevent a hostile work environment. Even communications after work hours can trigger liability back to the employer, especially in instances where a superior is communicating with a subordinate. Accordingly, strict policies and training on the appropriate use of and conduct over electronic communication is absolutely essential at all levels. These policies should include methods for reporting misconduct of electronic communication and what actions the employer takes to prevent misuse of electronic communication.

Legal consequences can be mitigated by simply implementing effective policies and training programs with an emphasis on social media and electronic communications conduct. Ultimately, such implementation can assist organizations reach their business goals and objectives without the shadows of time consuming and costly litigation.

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