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What's Your Firm's Survivability?

By Ward Bower

A few months ago, economists confirmed what many of us have sensed for a while — that the US economy has been in recession since March of 2001, exacerbated by the events of September 11. As a result, US law firms are increasingly anxious about what's in store for them. Will this recession be a non-event like 1981 and 1986, where law firms seemed immune from the woes of the rest of the economy? Or will it be more like the wrenching events of 1990-92 with layoffs, hiring moratoria, reduced partner incomes and the business failure of major firms? In large part it depends on the economic health of not only your law firm, but its clients, as well. And your vulnerability to the economy is influenced by your ability to survive reduced profits and loss of clients in a recessionary environment.

Profitability

A law firm's ability to absorb reduced partner incomes depends on its current profitability, both in absolute and relative terms. In absolute terms, reduced profits still must be sufficient to assure partner incomes will exceed associate compensation by enough to keep good associates engaged and employed. But partner incomes must also be sufficient, in a relative sense, to keep *partners* engaged and motivated, and certainly sufficient to keep them from leaving to join other, more profitable firms. For the most part, that means that partner incomes must compare favorably with other firms that might be interested in poaching your best partners. For national or international firms, those competitors would include others so situated, the same for regional and local firms.

Generally, market profitability can be established by computing average profits-per-partner (PPP) in peer firms. One measure of competitiveness vis-à-vis other firms is the relative performance of your firm in relation to the labor market segment in which it competes. For larger firms, comparative partner income data from specific competitors is available from league tables published each year by various legal press sources. For others, it is available statistically in surveys conducted by independent third parties, including the annual Altman Weil® *Survey of Law Firm Economics*.

Firms with average partner incomes greater than the averages of peers are clearly less vulnerable to loss of key partners on economic grounds than are firms whose averages are less, provided compensation is administered to ensure that those partners who drive the economics of the firm are fairly rewarded. But profitability is only one of the factors influencing law firm vulnerability — and survivability — in a down economy (or otherwise).

Stability

The second primary survivability factor is the stability of the firm's client base — and thereby its revenue. A key indicator here is the ability of the firm to survive loss of its key client(s), taking into consideration also its year-to-year revenue growth. Potential client loss is always a threat to law firm economics, but especially so in a recession where there is increased risk of client bankruptcy, acquisition, or loss by another means such as client "convergence" or reconsolidation of work in a smaller number of law firms, or client reduction in use of outside counsel.

Generally speaking, major client(s) whose revenues exceed 4% of the total firm revenues place the firm at risk in the event of their loss, because at a 40% margin (typical) the loss of 4% of revenues translates to a 10% reduction in average partner incomes. Not many firms can sustain that in a competitive environment, especially in a recession or economic slowdown where revenues of that magnitude would be hard to replace in the short term.

Profitability / Stability Analysis

It is helpful to look at these two indicators of law firm survivability in tandem since a firm's vulnerability can be tied to either or both factors. Firms with no client over 4% of revenues and above average partner incomes obviously are best positioned in today's legal marketplace. Likewise, firms with one or more

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clients over 4% of revenues and below average profitability are at high risk.

In between are firms with above average partner incomes but greater-than-4% client exposure ("captives") and vice-versa — below average profitability but a diversified (none over 4%) client base — "headhunter targets." Captives can expire with key client loss and headhunter targets are vulnerable to key partner poaching.

Survivability

Survivability is a function of both profitability and stability. Highly diversified (less concentrated) firms still can be highly vulnerable if partner incomes are sufficiently low (generally 75% of market averages or less). Likewise, even highly profitable firms can fail with the loss of a major client. For example, in a firm with a typical 40% margin, a lost 10% client would reduce partner incomes by 25%.

Beyond these points of "defective vulnerability" (less than 75% of market profitability and up to 10% client concentration), these factors might offset or mitigate each other — e.g., a firm with a 6% client but profitability of 150% of market average might be no more vulnerable than a firm with 4% concentration and average profitability. That is to say that some firms in relation to the marketplace are highly profitable enough to survive a client loss of 4% or more, and others are stable enough to survive below 75% of average market profitability, up to a point.

Strategy Ramification

The concept of law firm survivability as a function of profitability and client concentration is critical in a recession, but remains important even in a healthy economic expansion. In less profitable firms, improvement of partner incomes is a strategic priority. Likewise, diversification is critical to firms overly reliant on one or a few clients. ◆

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