September 2006

Business of Law

A supplement to
The Legal Intelligencer

PENNSYLVANIA LAW WEEKLY

ALM

Profits Per Partner: The Bane of the Profession

COMMENTARY

BY PETER R. SPIRGEL
Special to the Legal, PLW

Have you ever listened to the pundits on Wall Street explain why the stock price of a company dropped precipitously on a particular day? Often, the explanation involves the company in question "missing" their target earnings per share number (EPS) by a penny or two in the current quarter. Mind you, these are the same experts that repeat the mantra, "Investors must take a long-term approach to investing," while also changing their ratings on a company several times in one year!

Yes, EPS, together with other financial benchmarks, can be an important diagnostic tool in predicting the future performance of a company's business. However, the market's preoccupation with these short-term statistics has caused companies to manage to consensus earnings targets to the detriment of the long-term health of their business.

Profits per partner or "PPP" is equivalent to EPS for the legal profession, and publishing these numbers for public consumption is having a negative effect on the legal profession. If a company reported EPS of $5 in its most recent fiscal year, would you conclude that the company was doing well or struggling? Of course, with just this information, you could not possibly reach any conclusions regarding the financial health of a company. How many shares does the company have outstanding? Is it a start-up or a mature company? What industry is it in? What is its revenue?

While this undoubtedly seems obvious to any reader, how does the legal profession seemingly accept PPP as an indication of a firm's health? Each year, the legal industry press publishes lists ranking firms by their PPP. Clearly, the implication is that the higher a firm's PPP, the better the firm is doing.

Unlike EPS, there are no accepted standards for any of the components of the PPP calculation. In addition, all of the figures are self-reported, easily manipulated and thus, inherently unreliable.

EPS is calculated by taking net income, less dividends on preferred stock, divided by the weighted average of common shares. Not so with PPP. The definition of "partner" for this equation has never been established, leaving the denominator of the ration to each firm's interpretation and manipulation. What does appear to be clear is that the definition of "partner" excludes non-voting partners, often called income partners, or my favorite, the oxymoron, "non-equity shareholders." I'm aware that some firms have even timed the announcement of partnership promotions to avoid having the new partners counted in the denominator of their PPP calculation!

The definition of "profits" is also not defined. In a partnership, is it the average of each "partner's" distributive share as reported on their Form K-1? This number includes funds retained to buy computers and desks. It also includes political contributions and other non-deductible business expenses. A firm that self-financed the opening of a new office would have a lower PPP than the firm that financed this capital expense. Is the latter firm more profitable?

PETER R. SPIRGEL *is managing shareholder of Flaster Greenberg. He has a general business practice with special emphasis on taxation, corporate mergers and acquisitions and estate planning. He can be reached at peter.spirgel@flaster-greenberg.com.*

Publishing lists that rank firms by PPP suggests that lawyers accept this financial ratio as a reliable indication of a firm's health. Tell that to the former partners of Brobeck Phleger & Harrison, a firm that was reported to have PPP of approximately $1.1 million, only to close its doors a few years later.

There can be little doubt that the explosion in the number of non-equity partners within the legal profession has had a direct correlation to the publication of firms' PPP and the acceptance of PPP as a benchmark, if not the benchmark of a firm's health and success. Partnership status traditionally has meant technical proficiency, maturity, an ability to manage client relationships, an ability to interact well with fellow partners, and having good judgment. The industry's PPP tunnel vision has reduced lawyers possessing these qualities to non-equity status because their firms can't afford to include them in the denominator of the PPP calculation. These high-quality attorneys would be dilutive to the firm's earnings per share.

REPRINTED WITH PERMISSION OF *THE LEGAL INTELLIGENCER*

Managing to a PPP target forces firms to question whether certain practices are "compatible" with the firm's business plan. In this case, "compatible" has become synonymous with "profitable enough." In my capacity as a managing shareholder, I have interviewed scores of lateral attorney candidates from many firms whose hourly rate structure is forcing them to look elsewhere.

Companies often spin-off divisions because the market can't accurately value the combined entity. Stated differently, the market value of the company is increased by breaking it apart. Similarly, the influence of the PPP benchmark is causing firms to require homogeneous financial performance within the firm. Deviations in billable rates and hours worked are less tolerated. Associates and partners alike are under increasing pressure to increase billable hours because more hours equates to more revenue and higher profits. Is a firm that has a higher PPP because its lawyers work more hours more profitable? One thing is for sure: increasingly, they are not as happy. Work-life balance is suffering in our profession because firms feel they can no longer accommodate attorneys that are willing to work fewer hours

Surely, compensation systems could be designed that could accommodate differences in billable rates or hours worked; however, once a firm's PPP becomes an important factor, firms become less willing to do so — often making bad business decisions as a result.

Managing partners are often cited in the press as believing a strong PPP is crucial to attracting and retaining high quality legal talent. Why else would a law firm publish its PPP? Public companies are required to publish their EPS and other financial data. This is widely considered to be one of the major disadvantages of being public.

The legal profession appears to readily accept the by-products of the PPP push, namely high job dissatisfaction, high turnover and ever increasing hour requirements. Junior attorneys are increasingly leaving the profession because the likelihood of attaining partner status is increasingly remote, and the financial pressures required by their firm's lofty PPP goals are judged simply not worth the personal cost. The result is that junior attorneys increasingly have to be "bribed" to stay with lofty salaries and annual increases that continue to out-strip inflation.

With the higher salaries comes pressure to increase billing rates and billable hour requirements. Predictably, the result is highly compensated unhappy attorneys who become the pawns in the zero-sum game where law firms lure young talent from each other with the promise of a better work-life balance and better career opportunities. Each firm sincerely believes its pitch, ignoring the economic reality that the inflated salaries and the PPP quest inevitably bring: diminished career opportunities and a poor work-life balance.

Surely, every business has economic pressures and profit objectives to meet. I submit, however, that PPP is not the appropriate measurement of profitability and the legal industry's infatuation with this ratio is counterproductive. Unshackled from the need to report "average partner" profits, firms will more readily accommodate differences in individual practices and lifestyle choices. They will also be able to invest in long-term initiatives that don't have immediate returns without worrying about the "street's" reaction to their short-term earnings numbers.

There are other ratios used to rank law firms' profitability, such as revenue per lawyer (RPL) and value per lawyer (VPL). The inherent flaw with each of these ratios is that they measure averages derived from individuals. Each share within a class of stock is by definition identical. Each "partner" within a law firm is not. The focus on PPP is causing firms to view their attorneys as shares and not as individuals and it increasingly prevents firms from tolerating differences in billing rates and billable hours.

I'll admit that when the financial data of other firms are published, I read the articles with great interest. It's this thirst for information on the competition that fuels the media's coverage. However, like many articles in the supermarket tabloids, I don't take the numbers at face value. Until law firms go public, realize that such financial disclosure is inherently inaccurate. Instead of focusing on PPP, firms should manage to a different objective: satisfaction per attorney. PPP is but one of the many components of this formula. •

REPRINTED WITH PERMISSION OF *THE LEGAL INTELLIGENCER*