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SOME NUMBERS YOU SHOULD KNOW: GROSS PROFIT MARGIN

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In my last article, I talked about my first law firm management position and how that experience developed the need to discover meaningful metrics for law firms, one of my primary missions, and to find ways to convey the information such that it taught owners what the numbers really meant. It was the only way to ensure that they could make good business decisions.

In that article, I also invited PBA members who are willing to learn more about metric to schedule a call with me. Thus far, only two managing partners have stepped forward. I understand. You folks hate “the numbers.” That’s ok. I really didn’t expect the phone to ring off the hook. But I’m proceeding with my mission, nonetheless.

The most important metric to understand is gross margin, also referred to as gross profit margin. What is it? Most simply, it’s the amount of revenue left over to pay owners, once the overhead is paid. It’s very easy to compute. Take the total revenues received for the period (usually a fiscal year) and deduct all the expenses — excluding owner compensation and benefits — for the same period. What is left is gross profit / profit margin. Gross profit is a number. Profit margin is expressed as a percentage. It’s calculated simply by dividing the gross profit by total revenue.

Here's a simple example. The firm brings in \$500,000 for the year. Adding up all the expenses that are not owner compensation or benefits produces a total of \$250,000 for the same period. That means that the gross profit is \$250,000 and that the profit margin is 50%. This is also expressed as the firm has a profit of 50 cents for every \$1 produced.

What constitutes owner compensation and benefits? No matter what you call it, no matter your type of entity, no matter your tax structure, the money that goes to owners on the annual K-1, 1099 or W-2, etc. is owner compensation. Whether called draw, distribution, salary or bonus, it’s all owner compensation.

Note that owner compensation is paid from profits. Firms that borrow in any manner to make partner distributions in the absence of profit are on a very slippery slope to insolvency. We've all witnessed the explosions which seem to happen overnight; a firm dissolution and an incredible amount of unpaid debt revealed. Usually followed by nasty public litigation among former owners.

Benefits to owners do not include things like dues, registration fees, CLE costs and so forth. That's just overhead. The only owner benefits that are in the same category as compensation are contributions to retirement and profit-sharing plans, medical insurance, and possibly life insurance, depending on the type and premiums involved.

Returning to the simple calculation of gross profit and profit margin above, we find it provides us with a wealth of useful information. First, it tells us that the firm has a maximum of \$250,000 to distribute for owner compensation and benefits. And using 100% leaves the firm with zero to invest in capital improvements such as talent acquisition and growth, upgrading technology infrastructure, or space renovations. If any of these types of expenditure are necessary, the firm will have to borrow to finance them if it distributes all of the profits to owners. There's nothing wrong with that, and it can provide a tax-neutral way to handle capital expenditures.

Knowing that our profit margin is 50% tells us that of every dollar we produce, 50 cents is going to be profit. We can compare that easily to benchmark numbers. For example, for the average firm handling a variety of practice areas, we know from surveys that nowadays a well-managed firm has a profit margin between 45% - 55%. Firms that concentrate in niche areas can achieve a profit margin as high as 75%. Some practice areas that are labor-intense, such as elder law, may only achieve a profit margin of 25 cents. Mega firms, which have very high leverage of people and/or technology, may also achieve profit margins in stratospheric ranges as high as 80% – 85%.

Profit margin is a key number when considering bringing someone aboard as of counsel or joining a firm as counsel. Of counsel arrangements are almost exclusively "eat-what-you-kill," meaning that of counsel attorney get a percentage of revenues they bring into the firm. They may get a higher percentage for work they bring in and do themselves, as compared to work they bring in and delegate to others. But it's all percentage-based, so it self-corrects based on how productive the of counsel attorney is.

The problem is that many firms set those percentages based on what seems reasonable, rather than what their profit margin dictates they can afford. For example, let's say a firm has a profit margin of 45%. That's in the "well-managed" range. But if they agree to do a 60/40 split, with the of counsel getting 60% of the

revenues they produce, the firm will actually lose 5 cents for every dollar the of counsel brings into the firm.

I am always asked what “normal” is to pay an of counsel. But it can vary significantly from firm to firm, depending on how “efficient” they are, meaning how many cents of each dollar goes to overhead. In working with literally hundreds of firms throughout the year, I can tell you that firms have arrangements going anywhere from 90/10 to 10/90. I kid you not!

The most frequently asked question about of counsel arrangements by owners who call the hotline is something like: “We’ve added on four of counsel over the past two years. Our revenues are way up. But our partners are earning a lot less. How is that possible?” The answer is always the same: the firm ignored their profit margin when setting the of counsel compensation percentage. Remember this basic economic rule: increased gross revenue does **not** equal increased profit. It’s literally possible to work one’s way into bankruptcy if you are paying out more than your profit margin as compensation.

Another couple of instances where understanding profit margin is critical involve mergers/acquisitions and lateral moves. Let’s say you are at a firm with a lackluster 35% profit margin. Sometimes profit margin is low because of the areas of practice. More often than not, it’s a result of poor management. It can also be caused or exacerbated by insufficient productivity of fee earners and/or a lack of technology tools for time capture, billing, matter management, document production, discovery management and so forth.

An owner who is unhappy with compensation would likely benefit greatly by going to a firm with a higher profit margin. Keep in mind that the actual compensation scheme will be the final determinant. But I can pretty much guarantee that moving to a firm with the same or lower profit margin will result in a quick departure.

With respect to mergers, one of two factors is usually responsible when mergers fail. One is cultural incompatibility. Lawyers are usually inaccurate when performing due diligence regarding cultural compatibilities. The other factor is widely disparate profit margins.

If the “acquiring” firm has a higher profit margin, it will be up to those coming aboard to adapt to the policies, procedures, **and** productivity guidelines. Failing to do so will quickly have a negative impact on the acquiring firm’s profit margin. Tensions will rise, compensation adjustments will be forced and perceived underperformers will be pushed out. If the incoming attorneys can adapt quickly and meet standards, they will experience significant reward from the higher profit margin.

On the other hand, if the “acquiring” firm has a lower profit margin, the incoming attorneys will see less of what they produce in revenues reaching their pockets. If they aren’t able to significantly impact the firm’s profit margin by introducing more efficient practices, they will consider the merger a bad strategic move. This will result in defections over time. Until, as we frequently see, no one from the merger remains at the conference room table. Departures often start within the first year.

Now that you have a handle on what gross profit / profit margin is all about and how vital it is to understand what it is at your firm, you probably are wondering how you can go about improving it. Next month we’re going to focus on just that: The levers of profitability.

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