

Legal pricing in transition:

How client demands and alternative fees are changing the way that law firms price their services



A LegalBizDev White Paper by Jim Hassett and Matt Hassett



www.legalbizdev.com
800-49-TRAIN

Contents

Executive summary	2
Why law firms are changing their approach to pricing.....	3
The cost-plus approach	5
Price competition, discounts, and loss leaders	8
Value pricing basics	10
Ron Baker's eight steps to implementing value pricing	13
The rise of the pricing function.....	15
Using metrics to define value.....	19
Where firms are today.....	23
Predicting the future.....	24
Appendix A: Case study showing the difficulty of calculating cost per hour in advance.....	29
Appendix B: The mathematical relationship between hourly discounts and profits	34
About this white paper	37
About the authors	38
About LegalBizDev	39

© Copyright 2012, LegalBizDev. Brief excerpts or quotations may be reproduced without advance permission and should be credited to LegalBizDev. This document may be freely copied and distributed. For more details, see www.legalbizdev.com.

Executive summary

Legal pricing is changing as a result of client pressures for efficiency on both hourly and non-hourly matters and the increasing use of alternative fee arrangements. Law firms are being forced to rethink their approach to two very fundamental questions:

1. When bidding for new work, how do I set a price that is high enough to protect profits, but low enough to get the work?
2. After winning the work, how do I manage the matter so that I make a profit (or at least break even) at that price?

Answering these questions will require lawyers to develop many new skill sets, including project management to deliver high quality legal services within limited budgets, and better bidding in the first place. Of the pricing strategies that other businesses use to maximize profitability, the two that seem most relevant to lawyers are cost-plus pricing, in which a profit margin is added to the cost of delivering a service, and value pricing, where the client's perception of value is the most important factor.

True cost-plus pricing would require firms to perform much more detailed projections and analyses of actual costs than the current hourly billing model. The cost of each billable hour ultimately depends on a number of factors that are difficult to predict, including the exact number of hours billed and paid in a given year. The most common response to client cost pressure is to simply discount the hourly rate, but most lawyers do not understand that a "small" discount can lead to a large reduction in profits, as illustrated in a number of examples in this white paper. A better understanding of true costs will help law firms to make better business decisions and to protect profitability.

In cost-plus pricing, cost is known before you set the price. In value pricing, you start with the price the customer is willing to pay and control your costs to live within that price. Many lawyers believe that value pricing will lead to higher prices and profits, and sometimes it can. However, the intense competition in today's legal marketplace is reducing the number of clients who are willing to pay a premium for value.

In response to these challenges, many firms are now creating pricing committees and directors to focus on this critical function. This paper includes interviews with pricing leaders from a number of large firms that are working to better understand their costs, improve value creation, measure value, and apply project management techniques to control both cost and value.

The paper ends with eight predictions, including a continuing increase in competition and that to succeed in the future law firms will be required to put more emphasis on both initial pricing and subsequent project management.

Why law firms are changing their approach to pricing

Some law firms are going to large companies and offering to do all their legal work for one fixed price, but the firms don't know how it will work out in the long run. I suspect in some cases it will come out really ugly.

This prediction was made in 2009, by a senior partner from an AmLaw 100 firm who took part in our *LegalBizDev Survey of Alternative Fees*.¹

In the years since, this prediction has become a reality and many fixed price legal deals have indeed turned out badly. In the 2011 "Law Firms in Transition Survey," Altman Weil asked managing partners and chairs, "Compared to projects billed at an hourly rate, are your firm's non-hourly projects more profitable or less profitable?"² Thirty-two percent said non-hourly matters were less profitable.

Of these 32%, there is no data on how many turned out "really ugly." But based on many stories I have heard off the record, I would guess quite a few. I also suspect that the true number of less profitable deals is much higher than 32%.

In college, I had a friend who spent a lot of time at the race track. He seemed to remember the times he won much better than the times he lost. I suspect many lawyers have a similar talent for forgetting deals that turned out badly. Especially when they answer questions in a survey.

In the survey results, 12% said non-hourly arrangements were more profitable, and 36% said they were about the same as hourly. The remaining 20% were "not sure." Apparently, their accounting systems weren't set up to analyze mere details like the profitability of individual fixed price engagements.

Would you invest in a company that didn't know which deals were profitable? Of course not. But if you are a partner in a large or mid-sized firm, there's a good chance you already own one.

How did this happen?

The answer can be traced to too many years of good news. For the last few decades, the law firm pricing model could be described as "cost plus a lot." Just keep raising prices until the overhead is paid and key partners make a lot of money. But now the game is changing, and clients are resisting rate increases.

¹ Jim Hassett, *The LegalBizDev Survey of Alternative Fees* (LegalBizDev, 2009). See <http://www.legalbizdev.com/alternativefees/survey.html>.

² http://www.altmanweil.com/dir_docs/resource/88adb851-ba55-4cce-9d97-fa06607c75bb_document.pdf

When money is flowing freely, everybody thinks they are smart, and nobody has to count too carefully. As Warren Buffett famously put it, “It’s only when the tide goes out that you learn who’s been swimming naked.”

Many lawyers would like to believe that the tide will come back in soon and the good old days of raising prices every year will return. But, as Barbara Boake and Rick Kathuria noted in their book *Project Management for Lawyers*, “The recession was merely a catalyst for an inevitable shift in the balance of power from seller to buyer that will have a long-term impact on the way lawyers work.”³ Very simply, clients are demanding more value for their legal dollar, and that is not about to change, no matter what happens to the economy.

In the foreword to our *LegalBizDev Survey of Alternative Fees*, Bruce MacEwen wrote that “this type of sea change in law firms’ fundamental revenue model is a once-in-a-career event.”⁴

When law firms begin offering non-hourly alternative fee arrangements (AFAs), they must address two fundamental questions:

1. When bidding for new work, how do I set a price that is high enough to protect profits, but low enough to get the work?
2. After winning the work, how do I manage the matter so that I make a profit (or at least break even) at that price?

Answering these questions will require lawyers to develop many new skill sets, including project management to deliver high quality legal services within limited budgets, and better bidding in the first place.

For the average partner, learning more about pricing must start with a very simple insight. As Bruce Clearing Sky Christensen, Executive Director of Warner Norcross & Judd put it, “Lawyers must understand that client perceptions of value may have nothing to do with the hours it takes to do the work.”

But don’t feel bad; lawyers are not the only ones who could be better at pricing. In the fifth edition of one of the most widely respected texts in this field, Thomas Nagle, John Hogan and Joseph Zale noted that:

In many business-to-business markets, where high-volume repeat purchasers negotiate their purchases, buyers are ahead of sellers in thinking strategically....Buyers have goals and a long-term strategy for driving down

³ Barbara Boake and Rich Kathuria, *Project Management for Lawyers* (Ark Group, 2011).

⁴ Hassett, *Survey*, 2.

acquisition costs, while suppliers rarely have comparable long-term strategies for raising or at least preserving margins.⁵

Wikipedia lists 21 different pricing strategies suppliers use in other businesses, ranging from loss leaders to premium pricing. Two of them are of special interest to lawyers: cost-plus and value pricing.

Cost-plus pricing is similar to the traditional hourly billing approach, and is exactly what it sounds like: a price is based on the cost of delivering a service plus a markup or profit margin. But that is much harder than it sounds, and not necessarily a good idea, as we will discuss in the next section.

The most popular alternatives are built around the idea of *value pricing*, where the client's perception of value is the most important factor. The best known proponent of this approach is Ron Baker, author of several books on the topic, including *Pricing on Purpose*. In practice, this too can be harder than it sounds, as we will also discuss below.

In a highly competitive marketplace like legal services, where some firms these days seem downright desperate for new work, there is also a giant complication: price competition. So, that too will be discussed in this white paper.

The legal profession is changing rapidly, and law firms are just starting to apply experts' insights into pricing, so there is controversy about what will work best. But on one point everyone can agree: law firms could make more money if they got better at setting their prices.

The cost-plus approach

In the fall of 2011, when I gave a speech at the retreat of a 1,000-lawyer firm, a senior partner asked, "In your experience, how do large firms determine costs?" I replied, "Mostly, they don't. Until recently, most firms were making so much money they didn't need to precisely calculate their costs."

Many lawyers seem to think of their standard hourly rates as being equal to the firm's costs. But traditionally, rates have actually been based on "cost plus a lot," and no one was quite sure which part was the cost and which part was the "plus a lot."

One underlying problem is that the compensation of equity partners typically is based on dividing the firm's profits at the end of the year. To cite an extreme example,

⁵ Thomas T. Nagle, John E. Hogan and Joseph Zale, *The Strategy and Tactics of Pricing: A Guide to Growing More Profitably, Fifth Edition* (Prentice Hall, 2010), 98.

consider Wachtell, Lipton, Rosen & Katz, which had the highest profits per partner in the AmLaw 100 in 2012: Some equity partners were paid more than this average, some were paid less. But let's consider a lawyer who was paid exactly that amount.

He may think of his \$4.46 million annual draw as a cost of doing business. But the chances are Wachtell Lipton could stay in business if he were forced to scrape by on \$3 million, or even \$2 million. What fraction of his draw is a true cost and what part is his share of the profits? Until the day that Wachtell Lipton guarantees equity partners a baseline salary, and identifies the rest as a discretionary profit-sharing bonus, the line between cost and plus will remain arbitrary.

Despite this lack of precision, most law firm pricing has traditionally been based on the cost-plus model. As Ron Baker points out in his influential book *Pricing on Purpose*, it seems fair to start from costs and add a reasonable markup for profit. But Baker strongly favors value pricing over cost-plus. After listing numerous bullet points that people use to argue in favor of the cost-plus approach, and explaining how they are wrong, he noted, "It is amazing how many businesses still cling to the cost-plus pricing method...Doing something stupid once is just stupid. Doing it twice is a philosophy."⁶

The authors of *The Strategy and Tactics of Pricing* were a bit gentler when they said:

Cost-plus pricing is...in theory, a simple guide to profitability; in practice, it is a blueprint for mediocre financial performance. The problem with cost-driven pricing is fundamental: In most industries it is impossible to determine a product's unit cost before determining its price. Why? Because unit costs change with volume.⁷

In traditional legal work, the "unit" you are selling is the billable hour. To see how the cost per hour depends on several variables, we have provided a detailed hypothetical example for a solo practitioner in Appendix A. For the reader who does not want to go through all the math, suffice it to say that until you get to the end of a year and know exactly how many hours you have billed and been paid for, and how much you spent on everything else, you can only estimate the cost per hour, and your initial estimate will almost certainly be wrong.

Now take the uncertainties for a single lawyer, and multiply them by 100 lawyers or 1,000, with laterals coming and going, and client needs constantly changing, and you will begin to get an appreciation for how difficult it would be to accurately predict the cost per hour at the beginning of the year. Any cost estimate at the beginning of the year will depend on a number of assumptions. And when some of those assumptions inevitably turn out to be incorrect, the cost numbers will need to change.

⁶ Ronald J. Baker, *Pricing on Purpose: Creating and Capturing Value* (Wiley, 2006), 88.

⁷ Nagle, Hogan and Hale, *Strategy*, 2-3.

However, that is not to say it is impossible to estimate costs in advance. Government contractors who work under cost-plus contracts are required to estimate their costs at the beginning of each year, bill the government all year long at the estimated rate, and then do a reconciliation at the end of the year to determine actual reimbursable costs. If actual costs exceed the original estimate, contractors typically must request permission to exceed the contract limit, giving the government 90 days advance notice. If costs are lower than the original estimate, at the end of the year the government gets a refund.

To make money within these rules, contractors set up elaborate financial reporting systems to provide early warning of variance from their projections, and they change their spending at the first sign of a problem. So it is certainly possible to run a company within narrow cost limits, but it requires a degree of financial analysis and control that would be a revolutionary change for law firms.

These days, many partners in large firms do not understand even the rough costs of each billable hour. Does it matter? Yes it does. As one AmLaw 100 decision maker put it in the *LegalBizDev Survey of Alternative Fees*:

Our partners are the salesmen as well as the producing managers on a lot of this work, so they've got to be armed with our own internal costs and how we can adjust those internal costs. If somebody comes back and says [that they'd] like to do this work, and [they know] what [they] need, but [that they] can only get \$150,000 for the project, then we have to say [whether we can make it work, or] if we're doing it with no profit margin or as a loss leader. There need to be people in the organization that can sit down with the partners and talk to them about costs and [then] arm them to talk to the general counsels.⁸

Cost-plus may or may not be a good basis for setting prices. But if law firms want to stay in business in an ever-more competitive world, they must ultimately charge at least as much as they spend. And that starts with understanding their costs.

⁸ Hassett, *Survey*, 43.

Price competition, discounts, and loss leaders

“**L**aw Firm Price Wars Break Out as Some Try ‘Loss Leader’ Bids for Work” said a November 2009 headline in the ABA Journal.⁹ The article was based on a post from my blog quoting AmLaw 100 senior partners who said things like:

“I have become aware of a large number of bids by competitors which I don’t think are sustainable.”

“Some firms are bidding alternative projects at very low costs. These are loss leaders which cannot survive in the long term.”

“Many firms are willing to discount their fees in order to keep people busy...It’s a jungle out there.”¹⁰

Since this piece appeared, in many markets legal price wars have evolved from front page news to a way of life.

In a survey published in the December 2011 issue of the *American Lawyer*, 81% of law firm leaders said that more clients are requesting discounts, and 55% said clients are requesting deeper discounts. In a separate survey conducted by Altman Weil, 90% of managing partners and chairs said that increasing price competition is not temporary, but rather a permanent change in the legal marketplace.

The economic balance of power has shifted to clients. Just a few short years ago large law firms reigned supreme. Now it seems that almost all large corporations and their in-house counsel are asking for some sort of price break from their lawyers – even from firms they have used for decades. Many general counsel are seeing their legal budgets reduced, and they are passing the pressure along to their outside law firms.

As Peter Zeughauser noted in *The American Lawyer*, “The Achilles heel of many firms is that they use discounting to achieve high levels of client satisfaction...without focusing their partners on improving profit margins.”¹¹

This problem is familiar in other businesses. *The Strategy and Tactics of Pricing* noted that:

Customer satisfaction can usually be bought by a combination of over delivering on value and under pricing products...The purpose of strategic

9

http://www.abajournal.com/news/article/law_firm_price_wars_break_out_as_some_try_loss_leader_bids_for_work

¹⁰ http://adverselling.typepad.com/how_law_firms_sell/2009/11/price-wars.html

¹¹ Peter Zeughauser, “Stuck On You,” *The American Lawyer* (October 2011), 64.

pricing is to price more profitably by capturing more value, not necessarily by making more sales.¹²

Discounting can have a much bigger effect on profitability than you might think. If you want to work through the math, see Appendix B for a discussion of formulas relating hourly discounts to profits. Or you can skip the math and take our word for it: the relationships are complex, and what may seem like a small discount can have a large impact on profits. Our appendix starts with an example in which a 10% discount reduced anticipated profits by 80%.

When law firms calculate their partner compensation these days, many are seeing all too clearly how last year's discounting reduced their income much more than they expected.

Lawyers often justify discounts as loss leaders, under the theory that low prices will start a new relationship and later lead to more profitable work. But will it? Once clients become accustomed to low rates, it will be very difficult to get them to pay more.

As Ron Baker noted in *Pricing on Purpose*:

Purchasing agents have been rewarded for demanding low prices by getting discounts, concessions and other price decreases, thereby creating little Pavlov's dogs. If you subsidize something, you get more of it, including low-price buying behavior.¹³

If you do decide to use loss leaders to build new work, it might be wise to make sure the first job is a large one. A few years ago, Ron Paquette published an article in the September 2007 issue of *Strategies: The Journal of Legal Marketing* describing research conducted by Redwood Analytics to evaluate the widely held idea that small jobs often grow into big clients:

It's called the acorn theory – from a tiny seed of work in one legal area can grow a mature oak of a client, which provides work across many practices. Nice theory. But how often does it happen in practice? We thought this theory was largely a myth... We've observed that regardless of the firm involved, most large clients appeared to have retained the firm for significant matters from the start of the relationship.¹⁴

So Paquette and his colleagues looked at the top five percent of clients at one AmLaw 100 firm, and went back 23 years to see whether these clients had started large or small. More than 90% had started large (that is, already in the top 20% of the firm's clients in their very first engagement). When Paquette analyzed similar data from an

¹² Nagle, Hogan and Hale, *Strategy*, 4.

¹³ Baker, *Pricing on Purpose*, 146.

¹⁴ Ron Paquette, "Cracking the Acorn Theory," *Strategies: The Journal of Legal Marketing* (Sep 2007).

AmLaw 200 firm, they again found that today's large clients had been large right from the start (in this case 84% of the clients). They concluded that:

Firms should be highly selective with regard to small clients. It is commonly held that small clients are on average less profitable than large clients. If your firm's growth strategy depends at all on growing small clients into larger and more profitable clients, think hard about the likelihood that this will happen.¹⁵

So what should law firms do? Many believe that law firms should turn to a different approach: value pricing.

Value pricing basics

Almost all law firms currently use variations on cost-plus pricing. But anyone who has ever heard of the ACC Value Challenge knows how important perceived value is to clients today.

If you have thought about applying value pricing with your clients, you have probably read about the work of Ron Baker. His most recent book, *Implementing Value Pricing: A Radical Business Model for Professional Firms*, provides an excellent overview of the theory of value pricing, and how it applies to accountants, lawyers, and other professional services firms.

As Baker defined it:

The word *value* has a specific meaning in economics: "The maximum amount that a consumer would be willing to pay for an item." Therefore value pricing can be defined as *the maximum amount a given customer is willing to pay for a particular service, before the work begins*. This is not to suggest we can capture one hundred percent of maximum value, but rather that we have the potential to access some of it utilizing strategic pricing.¹⁶

Does that sound like price gouging? It's not. As Stanley Marcus (former president of Neiman Marcus), put it, "You're really not in business to make a profit, but you're in business to render a service that is so good people are willing to pay a profit in recognition of what you are doing for them."¹⁷

In cost-plus pricing, cost is known before you set the price. In value pricing, you start with the price the customer is willing to pay and control your costs to meet that price.

¹⁵ Paquette, "Acorn Theory."

¹⁶ Ronald J. Baker, *Implementing Value Pricing: A Radical Business Model for Professional Firms* (Wiley, 2010), 233.

¹⁷ Baker, *Implementing*, 22.

Baker summed up the difference in these two diagrams:

Cost-Plus Pricing

Services » Cost » Price » Value » Customers

Value Pricing

Customers » Value » Price » Cost » Services

Baker felt strongly that value pricing should be embraced by lawyers, and that timesheets and hourly billing should be eliminated.

Baker's web page bio begins with this mission statement: "To, once and for all, bury the billable hour and timesheet in the professions." Chapter 17 of *Implementing Value Pricing* is titled "The Deleterious Effects of Hourly Billing" and describes numerous disadvantages including misalignment of interests, a focus on effort instead of results, hoarding of hours, leaving money on the table, and diminishing the quality of life. Chapter 18 explains why timesheets should be eliminated. Its title indicates the strength of Baker's feelings on this issue: "Why Carthage Must Be Destroyed."

Baker also emphasized that value pricing can sometimes produce far more revenue than the hourly approach. He gave the example of an accounting firm that was engaged to develop an exit and management succession strategy which produced substantial tax savings. Initially the CPA billed at standard hourly rates, but at some point he said to the client, "I don't believe hourly rates [are]...appropriate [in this case]... You tell me what all the value of this is to you... I know I will be happy with whatever you come up with." Ultimately he was extremely happy, because the total payment was "a little bit over \$1 million."¹⁸

By then, he had stopped tracking time on this engagement, so it is impossible to say exactly how much he would have gotten on an hourly basis. However, he did say his prices had "skyrocketed" and reading between the lines our guess is that hourly rates would have totaled less than \$100,000.

Any lawyer would love the concept of value pricing if it meant that she could get paid 10 times what she would earn for billing hours. And many law firms see value pricing as a ray of hope in a troubled marketplace, an opportunity to increase profitability at a time when there are unrelenting competitive pressures to charge less.

Baker noted that, "These types of engagements are certainly not the rule in any firm, they are the exception. Nonetheless, they do arise, and when they do it is critical to recognize the value you are creating and to utilize innovative pricing strategies to capture it."

¹⁸ Baker, *Implementing*, 160.

Companies like Apple have become very profitable by creating consumer perceptions of value, and pricing products like the iPad and iPhone accordingly. But there is only one Apple, and there are dozens of companies like Dell, HP, Samsung, Lenovo, and Asus who find themselves competing on price.

A small number of the most profitable law firms in the world have been using value pricing for years, just as Apple has. But they are at the top of the profession and specialize in “bet the company” work. If a client is defending a billion dollar law suit, or acquiring a powerful rival, or being accused of a white collar crime, she will care much less about the price than about the outcome.

When Jim Durham published *The Essential Little Book of Great Lawyering*, he estimated such “bet the company” matters at only about 5% of all legal work. The rest he classified as important matters (65-70%) or commodity work (25-30%). In the seven years since Durham published this book, all signs are that legal commodity work is growing, and “bet the company” and “important” work is shrinking.¹⁹

In my Legal Business Development Quick Reference Guide, I’ve written about the traditional marketing implications of these three different types of legal work, as summarized in the following table:

<i>Type of legal work</i>	<i>Value’s significance in marketing</i>	<i>Relationship’s significance in marketing</i>
Bet the company	High	Low
Important	Medium	High
Commodity	Low	Low ²⁰

But the world is changing, and when it comes to getting new business, the marketing significance of providing value is going up, and the importance of prior relationships is going down.

The next section discusses the nuts and bolts of Ron Baker’s eight steps to implementing value pricing. As we see it, the problem with value pricing is an expectations gap. Law firms want to believe value pricing will lead to higher prices and profits. Sometimes it can. But in most cases these days, when legal clients say “value” what they mean is “I need to pay you less.”

¹⁹ James A. Durham, *The Essential Little Book of Great Lawyering* (James A. Durham, 2006).

²⁰ Jim Hassett, *Legal Business Development Quick Reference Guide, Second Edition* (LegalBizDev, 2012).

Ron Baker's eight steps to implementing value pricing

The first four sections of Ron Baker's influential book *Implementing Value Pricing: A Radical Business Model for Professional Firms* review a great deal of interesting theories and a number of arguments against hourly billing. But if you want to focus on the "how to," you can jump directly to Part V of his book, which describes Baker's "Eight steps to implementing value pricing":

Conversation. Talk to the client to determine her wants and needs. This requires genuine communication, so you must listen actively and comprehend what is on the client's mind.

Pricing the customer: Questions for the value council. Pricing is of such importance that Baker says each firm should have a value council which studies the results of the value conversation, and considers the best strategy for pricing each matter.

Developing and pricing options. The analysis in steps 1 and 2 can lead to an internal discussion of several different options to offer a client, at different price levels. According to Baker, this can help the client think about what is really of value for him and help the firm close a deal.

Presenting options to the customer. Then it is time to effectively present the options to the client, and address any objections.

Customer selection codified into the fixed price agreement. Baker assumes this conversation will lead to a fixed price agreement, which must be written carefully to "memorialize the meeting of the minds between the firm and the customer." Chapter 32 includes a sample fixed price agreement.

Proper project management. Once the agreement is signed, the firm must manage the matter to live within the agreed-upon price. (If you are familiar with our *Legal Project Management Quick Reference Guide* and our nine project management training options, you may not be surprised to learn that we stress the importance of this step.)²¹

Scope creep and change orders. In today's dynamic business environment, changes in requirements are almost inevitable. The firm and the client must have plans in place to decide when changes in scope lead to a change in price, and to resolve any problems or disagreements.

²¹ Jim Hassett, *Legal Project Management Quick Reference Guide, Second Edition* (LegalBizDev, 2011). See <http://www.legalbizdev.com/projectmanagement/index.html>.

Pricing after action reviews. The US Army has a policy of after action reviews to evaluate missions after the fact and learn from what happened. This same type of retrospective review is helpful for setting future prices.²²

Each of these eight steps is described in depth in its own chapter. For example, in the chapter on Step 1's conversation, Baker talked about:

Twenty-seven questions you could ask the client.

How to start the conversation and effectively point it in the right direction.

How to listen carefully and hear what the client wants without dominating the conversation.

How the firm should deal with clients who try to conceal information about how much your services are valued or what other firms may charge.

How should you discuss risk with the clients?²³

Whether you agree with Baker's rejection of hourly billing or not, the information in this chapter can be very useful in finding the best price. Similarly, Chapter 29 goes over the key elements of Step 2 – what to do when you get back to the office and work on your pricing strategy based on that conversation. Again, there are long lists of useful tips.

What constitutes a good price? On page 245, there is a list of 16 items to consider, including:

“Not allowing your dumbest competitors to set your price,” which is related to the issue of avoiding price wars, as discussed previously.

What questions should you ask yourself before setting the price? There is a list of thirty-five questions on page 247.

Four types of buyers – price buyers, value buyers, convenience buyers and relationship buyers – and how to deal with each.

What are the psychological factors that affect the price sensitivity of the client?²⁴

Every lawyer can find valuable ideas and tools in this book, whether you agree with Baker's rejection of hourly billing or not. However, you may question his optimism about what the market will bear for value pricing. In the section on “Dipping your toe into the water” for fixed pricing, Baker suggested calculating your initial fixed price estimate with a budget based on what you think your normal billable hours would be and then adding a premium of 50% to 90%.²⁵ That would be great way for law firms

²² Baker, *Implementing*, 289.

²³ Baker, *Implementing*, 241.

²⁴ Baker, *Implementing*, 245-257.

²⁵ Baker, *Implementing*, 275.

to do it, if they could find clients who were willing to pay 50% to 90% premiums in the current marketplace. A few firms may. But from what we've seen, most clients are looking to cut costs, and the firms that win fixed price deals these days often get no premium at all.

While we are not aware of any AmLaw 100 firms that have gone so far as to appoint the value council mentioned in Step 2, there are a number of interesting changes going on in how firms handle pricing, as explained in the next section.

The rise of the pricing function

The most famous pioneer in the alternative fee movement is Bartlit Beck, a Chicago firm of about 70 trial lawyers which *The American Lawyer* named "Litigation Boutique of the Year" in 2009. As their web page explains:

Our approach to fees is unique, but simple. We believe our interests should be aligned with our clients'. To that end, we think we should get paid more if we win and less if we lose.

We do not bill by the hour. A law firm should not get paid more the longer it takes it to do the same task. Yet that is exactly the incentive hourly billing promotes. As the New York Times recently recognized, "the practice of billing for each hour worked can encourage law firms to prolong a client's problem rather than solve it." Our approach to fees is different.

Our fees don't depend on how long we can spend on a task or how many associates we can put on it. Our fees depend on our success.

We employ a variety of fee arrangements, including flat monthly fees, partial contingency fees, and similar alternatives. In virtually every matter, some portion of our fee is based on the outcome of the case.

In a 2009 online panel discussion I conducted for West LegalEdcenter, Fred Bartlit explained how his firm had centralized both pricing and project management.²⁶ At Bartlit Beck, there is no management committee:

One guy, Skip Herman, runs the entire firm, from deciding which cases to accept to setting the price and staffing each matter. We have no firm meetings and no conferences; Skip runs everything.

Other firms have not gone this far, but a number of large firms are centralizing the pricing function in a variety of ways.

²⁶ http://adverselling.typepad.com/how_law_firms_sell/2009/04/the-law-firm-of-the-future-is-open-for-business.html

Stuart Dodds became Baker & McKenzie's first Director of Global Pricing in July 2011, after serving for three years as Global Head of Pricing at Linklaters. His job includes four main components:

We help **set** the price in a proposal, help **get** the price, help our fee earners **manage** the price through project management, and then **review** how effective the pricing approach taken has been on a long-term basis for both our client and our firm. We are building a whole infrastructure within the firm with pricing do's and don'ts.

Much of Dodds' time is focused initially on the firm's larger clients, and one key goal is to help ensure pricing consistency and rationality for a firm with 70 offices around the world and over 3,800 lawyers.

In April 2012, Toby Brown was hired by Akin Gump to serve as its first Director of Strategic Pricing & Analytics. He had previously filled a similar role at Vinson & Elkins, where the firm's leaders put out the word that whenever pricing is an issue with an important client, Toby should be consulted early and often. One of the most important aspects of his job was to "create a culture of having conversations about value. Lawyers are really good at talking to clients about legal issues," said Brown. "Now, however, they need to add another dimension to the conversation to include value, pricing and efficiency... Sometimes I think my job is almost 100% business development."

Others with related titles also emphasize how pricing is tied to client satisfaction and new business. Matt Laws, senior manager of alternative fee arrangements and head of the pricing group at Reed Smith, said, "I see myself as working for the firm and for the client at the same time. I try to find that middle ground, a mutually beneficial arrangement."

Similarly, Brown said:

I like to walk the client through a whole list of questions. Sometimes, they won't immediately understand what their own price sensitivity is. My job is to get them thinking about what matters most to them. I can be seen as an internal consultant to the lawyers in the firm, and also to the clients.

Although at this time only a small number of firms have a separate pricing director or department, many see it as the wave of the future. "I find it hard to see how major firms could not organize themselves this way," said Michael Byrd, assistant director of pricing strategy and analysis at Mayer Brown. "What we do fits somewhere in-between finance and business development. It's at the same time both numbers-driven and creative."

Byrd sees the main benefit of a proactive pricing strategy as "increased competitiveness to keep us in the forefront of the market." Both Byrd and the partners he works with believe that in his 18 months at the firm, the new emphasis on pricing

has helped increase responsiveness to client needs, increase client satisfaction, and add value.

One key factor that is driving the pricing movement is the new emphasis on alternative fee arrangements (AFAs), including fixed and contingent fees. According to Altman Weil's 2011 Chief Legal Officer Survey, AFAs now account for about 14% of all legal fee revenue. This figure is still small compared to the 86% that is hourly, but it is measured in the billions and all of the forces of change are headed toward more AFAs.

In the good old days of hourly arrangements with rates that went up every year, it did not require sophisticated financial analysis to send a bill that multiplied each lawyer's hourly rate by the number of hours spent. But to make AFAs profitable, law firms now need to spend more time thinking about pricing.

At Winston & Strawn in early 2012, the pricing strategy role was shared by the co-leaders of the firm's AFA initiative: Kathrine Cain, the manager of business intelligence, and Keri Gavin, the controller. Cain reported to the firm's Director of Business Development, and Gavin reported to the firm's CFO, but they worked closely together to analyze the information that the firm needed for competitive pricing.

"The partners are encouraged to reach out to us for assistance with requests for alternative fee arrangements and budgets," Cain said.

Some partners were already very good at defining budgets and pricing strategies, while some were new to the concepts. We coach them through the process of defining a budget and identifying pricing options that align with their client's needs and expectations. In the two years since starting the formal initiative, we have made significant strides in providing the tools and techniques to support our lawyers and clients.

Cain said she and Gavin always consider a wide range of options for AFA proposals, based on the client's expectations and goals as well as the projected internal rate of return, the anticipated level of staffing for the matter, benchmarks based on previous matters, the firm's history with that particular client, and other factors.

Fish & Richardson uses a somewhat different model. There, the AFA group is led by Kurt Glitzenstein, a firm partner and patent litigator.

Glitzenstein says that since his firm specializes in intellectual property law, many of his firm's cases fall into just a few categories, such as patent litigation. Fish & Richardson is able to ask the same questions in nearly every case and obtain useful answers that will help in its pricing.

"We prefer to price on an AFA basis," he said.

To do that, my staff goes through a case and interviews the lead attorney about the details. Is it a judge whom we know well? How many patents are under litigation? What is the technology? How complex is it? As a result of inquiries like this, we can put together a litigation budget and use it as a guide for pricing. By asking the right questions, we can predict which cases will be more challenging to handle.

We think that the fixed fee arrangements that Fish & Richardson often proposes improve aspects of the lawyer-client relationship. Fixed fees allow lawyers and clients to focus on the merits of the case so that they can reach the best result, without the same level of concern as in a traditional hourly fee arrangement, that changes to the case strategy, or unexpected developments, will significantly increase the cost to the client.

Of course, in every firm, ultimately the success or failure of this new pricing movement will depend on buy in from the partners.

Mayer Brown's Byrd said that although it is not required that partners consult him when they need to respond to an RFP or develop an AFA proposal, it is highly recommended, and that his plate has been full.

Matt Laws, head of the pricing program at Reed Smith, where just about 20% of the annual revenue comes from AFAs, said his role "has been very well received...Partners do tend to call every time a potential engagement comes up."

Laws said Reed Smith does not have "any strict guidelines about what we can or cannot do to win a client's business. Any proactive approach to meeting a client's needs is likely to be approved."

In fact, Laws said, he sometimes finds himself and his team having direct contact with the clients' financial officers during the bidding process – something that would have been unthinkable only a few years ago:

In the old relationship, partners would work with corporate general counsel. Now, we see finance people and CFOs from the client companies. The process of online bidding, which has become more and more common, reduces the importance of the historical relationship between the firm and the client.

Another interesting trend in this area is a growing emphasis on project management. According to Baker & McKenzie's Dodds:

Over the last 18 months, the biggest change in the legal pricing field is a greater emphasis on project management and how we deliver services. Law firm clients are now looking for *demonstrable* value and efficiency, and we should not shy away from this challenge.

This should not be surprising, given that once a firm is committed to a fixed price or an hourly fee cap, the most important determinant of profitability is being able to meet the client's needs within a predetermined budget.

That's why efficiency is on everyone's minds these days. In the 2011 Altman Weil Law Firms in Transition Survey, managing partners reviewed 15 current trends, and gave their opinions about which were temporary and which were permanent. Price competition was number two on the list, with 90% saying it was permanent. The only trend rated higher was the related idea of improving practice efficiency; 94% saw that as a permanent change.

Firms are responding to these changes in a wide variety of ways, depending both on the firm's culture and available talent. Practice management staff are often involved in planning how to price proposals. To cite just one example, Womble Carlyle has identified Bill Turner, the director of practice management, as an internal point person to evaluate every significant price proposal in the firm and to analyze the pricing on every large RFP response.

The trend of appointing specialized pricing officials and devoting more effort to analyzing pricing is expected to increase. ILTA – the International Legal Technology Association – recently formed a Financial Management Peer Group to support this movement.

“Pricing is both an art and a science,” said Akin Gump's Brown.

We need to focus on both if we are going to grow our business. There are a host of pricing strategies out there, and lawyers are now just touching the surface. This is a dynamic world and my job is changing on almost a daily basis. The heat is getting turned up on law firms, and the pace of change is accelerating.

Using metrics to define value

In the legal profession, everybody's talking about value, but nobody seems to know how to measure it.

In September 2009, the Association of Corporate Counsel announced the creation of the ACC Value Index, a “client satisfaction measurement tool that helps ACC members to share meaningful information about the law firms they engage.”²⁷ Clients were asked to rate law firms on a 1 to 5 scale on six key factors:

Understands objectives/expectations

²⁷ http://www.acc.com/valuechallenge/valueindex/index_old2.cfm

Efficiency/process management
Predictable cost/budgeting skills
Legal expertise
Responsiveness/communication
Results delivered/execution

Then they answered a single summary question: “Would you use this firm again?”

The idea of Zagat-type ratings of law firms was controversial from the start. In November 2011, ACC announced that the Value Index had been closed because “ACC members voted ‘with their feet’ by continuing to use the eGroups for law firm referrals, instead of the Value Index.”²⁸

While the idea of a Zagats of law firms has disappeared for now, the six key factors in its rating system remain a great starting point for defining value. The key phrase in that sentence is “starting point.”

In a panel discussion at a March 2011 Georgetown Law School Symposium entitled “Value: How do we define it? How do we measure it?” Susan Hackett, then head of the ACC Value Challenge, noted that “Value is hard to define... The ACC Value Index offered an early set of categories of common interest to examine but it needs to move to the next level of assessment. The future of value assessment will be data-driven.”²⁹

Thought leaders are beginning to discuss exactly what value metrics should look like, and how they should be related to prices. In February 2012, Paul Lippe listed several value metrics that might be used to evaluate sales contracts:

- How quickly did the contract get done?
- How favorable are the terms to the company (opportunity gained and risk avoided)?
- How easy are the terms for other parts of the company (finance, manufacturing, sales, etc.) to understand and perform?
- How satisfied were the true business clients?
- How satisfied was the counterparty?
- How much did the contract cost?
- Did the contracting process improve?³⁰

²⁸ <http://www.lawweekonline.com/2011/11/acc-value-index-ending/>

²⁹ <http://www.integreon.com/blog/2011/03/value-how-do-we-define-it-how-do-we-measure-it-live-from-georgetown-law.html>

³⁰ http://www.abajournal.com/legalrebels/article/what_if_someone_could_measure_what_lawyers_do/

If you want to explore just how complicated this type of measurement can get in the real world, see the series entitled “A Value-based Client-firm Relationship” on the ACC’s web page.³¹ It includes 16 posts in which a client – Ken Grady, general counsel and secretary at Wolverine World Wide – and his law firm – Seyfarth Shaw, represented by Lisa Damon – talk through the details of how they defined value metrics and determined cost for work on a trademark portfolio.

Here is one list of possible value metrics from the law firm side early in their negotiation:

- “Success” rate, measured by things like first action allowance, watch hit outcome
- Overall satisfaction
- Timeliness of communication
- Effectiveness of “lessons learned” sessions
- Strategic participation/understanding of Wolverine business
- Proactive issue identification
- Budget variance
- Cost management effectiveness³²

Here are a few of the value metrics that the client proposed:

Trademark Risk Rate (total dollars spent defending trademarks, divided by total number of trademarks defended)

Counterfeit Recovery Rate (total dollars spent on anti-counterfeiting actions, divided by total number of units seized)

Specimen Response Productivity (days from first request for specimen to receipt of acceptable specimen, divided by number of trademarks for which specimens requested).³³

On the positive side, if you read all 16 posts about the details of this relationship, it is clear that the two sides developed a very trusting relationship, and that Seyfarth went the extra mile to be a proactive strategic partner that puts its money where its mouth is. On the negative side, this is uncharted territory, and it took months of discussion to come up with metrics that enabled both sides to measure how the process was going.

³¹ <http://www.inhouseaccess.com/2010/06/17/a-value-based-client-firm-relationship>

³² <http://www.inhouseaccess.com/2010/07/08/a-value-based-client-firm-relationship-part-iv/>

³³ <http://www.inhouseaccess.com/2010/07/08/a-value-based-client-firm-relationship-part-iv/>

When the time came to tie the metrics to a portfolio price for the year, Grady proposed, “One way to set the new fee relationship for year one of the relationship would be to:

Adjust the baseline based on what we know about the business (that is, increase, decrease or the same amount of portfolio activity)

Adjust that amount to account for improvements in the processes to handle the portfolio using lean activities we will undertake with Seyfarth

Adjust that amount to build in whatever cost-sharing is appropriate for Seyfarth to get up to speed on our business as reflected in the portfolio

We then could agree on a base price to handle the portfolio work. We can gainshare on additional improvements – we get part of the benefit (lower costs) and Seyfarth gets part of the benefit (we don’t get 100% of the lower costs). We could add a topper fee: depending on performance against certain other metrics (e.g., increase in average mark value using the equation I showed in the last post), Seyfarth gets an additional payment for helping to drive the increased average mark value.”³⁴

Here is one small part of how the payment system actually worked:

To measure Seyfarth’s systemic improvements, we will use two metrics: time to process an application, and time to receive a useable specimen (we have to file specimens in certain countries to show we are still using the mark). We need one score across both metrics to determine Seyfarth’s bonus, so we will combine the results on the two metrics by weighting them 80% on trademark applications and 20% on specimen gathering. We calculate the trademark application improvement metric, multiply it by 0.8, calculate the process improvement on specimens metric, multiply it by 0.2, and add the results. For every X% of weighted process improvement, Seyfarth will earn \$0.75.³⁵

This example is much more sophisticated, complicated and demanding than the simple value pricing example quoted above from Baker’s book, in which a client simply paid a hefty premium because he felt that he had received value in excess of hourly rates.³⁶

There can be little doubt that in the current environment, some clients will continue to look for metrics that allow them to precisely define value and tie it to payment. But we predict that many lawyers will see the example above as excessively complicated, with a whole lot of arithmetic and price uncertainty. So it is far less certain how many clients and law firms will ultimately develop and use metrics like this.

³⁴ <http://www.inhouseaccess.com/2010/07/27/a-value-based-client-firm-relationship-part-vi/>

³⁵ <http://www.inhouseaccess.com/2010/09/articles/clientfirm-value/a-valuebased-clientfirm-relationship-part-xiii/>

³⁶ http://adverselling.typepad.com/how_law_firms_sell/2012/01/legal-pricing-part-4-value-pricing-basics-.html

Where firms are today

As we noted at the beginning of this white paper, when law firms begin offering non-hourly alternative fee arrangements (AFAs), they must address two fundamental questions:

1. When bidding for new work, how do I set a price that is high enough to protect profits, but low enough to get the work?
2. After winning the work, how do I manage the matter so that I make a profit (or at least break even) at that price?

To be honest, when we started writing about pricing we thought that our research would be limited to the first question: picking a price in the first place. This requires external knowledge about your client and the marketplace, and internal knowledge about your own cost structure.

But the more we talked to people and reviewed the literature, the more obvious it became that the two questions are so wrapped up in each other that they are very hard to separate. Add in the fact that most firms don't even understand their own costs of doing business and that price wars are forcing bids down for many practice areas, and you have the makings of a very confusing situation.

Many lawyers would like to believe that if they could master the art of value pricing, they could make more money than ever before. Maybe some can. But with competition constantly forcing prices lower, we have not seen much evidence for that yet. Some believe that pricing will become more sensible when lawyers learn how to develop value metrics, but we remain to be convinced.

The two questions above are so difficult that firms like Baker & McKenzie, Akin Gump, Mayer Brown and others are setting up pricing directors and committees to help answer them, case by case.

Responsibilities and methods varied for the people we heard about and interviewed, but we are aware of only one who had independent decision-making power. And that one was Skip Herman, whose name is on the door at the pioneering 70-lawyer firm Bartlit Beck Herman Palenchar & Scott.

Partners are ultimately responsible for pricing, so they must understand the principles before they will accept help from a pricing director or committee. Some firms are moving to develop policies which limit partners' power to set prices depending on their training and experience, but these policies are very much a work in progress.

No matter how a firm is organized, pricing analyses inevitably get pulled into the question of how to manage matters. To set the right price, you must know what the

work requires. In the good old days when lawyers did not have to worry about how much things cost, that was relatively straightforward. But now that so many clients are demanding efficiency, the work must be done differently. That will inevitably change the cost of delivering a quality service, and ultimately its price.

Which takes the pricing discussion right back to a topic we have been talking about for years: legal project management (LPM) and process improvement. The best way to implement LPM varies from firm to firm, and even from one practice group to another within a firm, depending on its culture, clients, and goals.

In our experience, the approach that works best most often is to start with just-in-time training for a small group of influential partners who are open to change. We introduce LPM basics very quickly and then get them to immediately apply key concepts to actual matters. The focus is on changing behavior to produce tangible results. When these lawyers are successful, they can motivate other partners to embark on the same journey. Case by case, lawyer by lawyer, the firm begins building its experience in LPM and AFAs, and gradually changes the way it meets the needs of its clients. For an example of how this worked in one firm, see our recent post entitled “Legal project management in the real world: The case of Williams Mullen.”³⁷

One key to profitability is continuing business from a firm’s most important clients. For clients who demand AFAs, it helps to work in an atmosphere of mutual trust on a portfolio of matters. The firm may lose on some matters but with the right strategy and tools it can offset the losses with enough wins to profit overall. For some real world examples of this, see Rachel Zahorsky’s ABA Journal article “Facing the Alternative: How Does a Flat Fee System Really Work?”³⁸

If we needed to summarize where legal pricing stands today in a single phrase, it would be “in transition.”

Predicting the future

Clearly, legal pricing is changing as a result of the increasing use of AFAs, and client pressures for efficiency on both hourly and non-hourly matters.

So what does this mean for the next 10 years, or the next 10 months? Nobody knows. As Niels Bohr, winner of the 1922 Nobel Prize in physics famously said, “It is very hard to predict, especially the future.”

³⁷ http://adverselling.typepad.com/how_law_firms_sell/2012/02/legal-project-management-in-the-real-world-the-case-of-williams-mullen-part-1-of-2.html

³⁸ http://www.abajournal.com/news/article/facing_the_alternative/

In a blog post entitled “Staying Relevant,” Toby Brown recently put it this way:

We have reached a point in human history where predicting the future beyond a few years is quite a challenge. A perfect example is that of Facebook, which grew from zero to 100 million users in less than two years. What things will look like in five to ten years is anyone’s guess. So the best we can do now is keep a vigilant eye on the storm and stay prepared to constantly alter course.³⁹

While we don’t know exactly how things will turn out, it does seem safe to predict that changes in pricing will be driven by eight key trends:

1. **Alternative fees will continue to increase.** According to Altman Weil’s 2011 Chief Legal Officer Survey, 14% of fees are currently non-hourly.⁴⁰ This percentage has gradually been increasing. Conservative clients often require a long time to take the leap to try non-hourly fees, but this particular change is a one-way street. Tucker Ellis was one of the first mid-sized firms to derive more than half of its revenue from non-hourly fees, and managing partner Joe Morford, has noted that, “Once we started working for a client with AFAs, not a single one has ever wanted to go back to hourly.”⁴¹
2. **Lawyers will develop new metrics that measure value.** Sophisticated clients want to measure what they are paying for, and a sophisticated law firm should be able to measure its own results. Above we gave an extended example of the challenge of one past attempt to define value metrics. For an interesting discussion of why there is resistance to this idea, see Paul Lippe’s blog post entitled, “What If Someone Could Measure What Lawyers Do?” and the comments written by various lawyers at the end of that piece.⁴²
3. **Leading firms and clients will place increasing emphasis on aligning their interests.** One key to success for AFAs is creating a genuine sense of partnership by aligning interests. As one AmLaw 100 decision maker put it in our *LegalBizDev Survey of Alternate Fees*:

The firm and the client must have a very transparent conversation about the process. [It is important to discuss] how [the fee structure] will be mapped out and who will do what. [It is vital] to look at the delivery of services holistically, and to look at how the team in-house and the team outside can work together to deliver value for your shared client. That’s a real challenge, because it is tricky to transition from a negotiation

³⁹ <http://www.geeklawblog.com/2012/01/staying-relevant-part-1-perfect-storm.html>

⁴⁰ http://www.altmanweil.com/dir_docs/resource/50b7f12e-0be3-4074-8bfb-36a69a552297_document.pdf

⁴¹ http://adverselling.typepad.com/how_law_firms_sell/2011/01/why-alternative-fee-revenues-will-keep-going-up.html

⁴² http://www.abajournal.com/legalrebels/article/what_if_someone_could_measure_what_lawyers_do/

process to a collaborative process. If you can get into a collaborative discussion, you can get good results that work for both organizations.⁴³

This requires some sharing of risk. Another participant in our survey put it this way:

GCs should be thinking about what kind of risks they are willing to take early on in the life of a particular matter. Right now, they want firms to take all the risk and they are reluctant to take risks themselves.⁴⁴

4. **The distinction between bet the company, important and commodity work will be reflected in different pricing strategies.** In *The Essential Little Book of Great Lawyering*, Jim Durham estimated that about 5% of legal work fell into the “bet the company” category, 65-70% was “important” and 25-30% commodity work. There is every indication that the percentage of commodity work is going up, and the other two categories are shrinking. To be price competitive, it will be crucial to keep up with the process improvement and outsourcing alternatives for commodity work. As Toby Brown noted in his blog series “Staying Relevant:”

An emerging and compelling reason for lawyers to make different business decisions is coming from new breeds of competitors. One example is the Legal Process Outsourcer (LPO) market. These companies started as off-shore (typically India) based providers for first document review in litigation. They hire English speaking, American law trained candidates in other, lower wage countries. These much lower-costing, well-enough trained lawyers were appropriately suited for this level of work. So well-matched to the tasks, that in very short order, these document reviewers became viable competitors. Most lawyers glossed over this market encroachment, seeing it as commodity level work no longer worthy of their skills. In reality, this meant millions in fees were no longer going to US lawyers.⁴⁵

5. **Law firm profitability will be squeezed harder than ever before.** According to the 2012 Client Advisory from the Hildebrandt Institute and Citi Private Bank:

Many firms will need to work harder to maintain profitability at levels that meet the expectations of their partners. Indeed, we expect that 2012 may prove to be even more challenging than 2009 in terms of profitability across the industry, not because revenues will be as

⁴³ Hassett, *Survey*, 47.

⁴⁴ Hassett, *Survey*, 48.

⁴⁵ <http://www.geeklawblog.com/2012/01/staying-relevant-part-1-perfect-storm.html>

depressed in 2009 but rather because of the combination of slow revenue growth and rising expenses.⁴⁶

6. **Hourly billing and high partner profits will be questioned more and more in the future.** Clients generally do not live in an hourly billing world. They know their actual costs of doing business and plan to make a profit above those costs. They have pricing risks and plans to manage those risks. Clients often wonder why their law firms cannot do the same. Many corporate counsel started their careers as associates at large firms, and they know all too well how the profit model works for firms. Many are asking why partner compensation is so high. As Susan Hackett put it:

Surveys – such as these from Corporate Counsel and Empsight – are coming out. They usually confirm that the average in-house counsel who hires outside firms makes only slightly north of what a bonused first- or second-year associate in a big law firm makes. There are a few hundred large law department top leaders who haul in comparable returns for their work – usually through non-salary comp – but nowhere near the number or percentage of highly compensated partners that we find in the ranks at big firms where entire equity partnerships pull in hundreds of thousands or over \$1 million a year in profit per partner.

The average in-house lawyer is well aware that he shares with those high-profiting partners the same schooling, sophisticated law firm background, and top-flight experience on his resumé. He’s made his choice, but please remember that he will more likely identify with the “99 percent” – and not the partnership – when he’s assessing who’s getting coal this Christmas.⁴⁷

7. **Competition on price and value will increase.** The Hildebrandt/CitiBank 2012 Client Advisory also notes that, “[There is] continuing client resistance to fee increases [and]...it is unlikely...that the demand for legal services will grow robustly for the foreseeable future...The legal industry will be forced to live with uncertainty for some time to come.”⁴⁸ With some law firms aggressively providing more value at lower prices, the competitive bar is going up.

Whatever else may prove to be true, it seems clear that cost will remain a major issue. As Mark Smith put it in a blog post entitled, “Excuse me, I think your pricing is broken:”

The common refrain from private practice lawyers...is that in-house lawyers who talk about value based billing really just want to pay less,

⁴⁶ Hildebrandt Institute and Citi Private Bank, *2012 Client Advisory*, 10.

⁴⁷ http://www.abajournal.com/legalrebels/article/lawyer_comp_the_third_rail_of_legal_value_conversations/

⁴⁸ Hildebrandt, *Client Advisory*, 5.

and are not really interested in concepts like sharing risk. Opening a dialogue about pricing is simply an exercise in getting the law firm to do the same work for less money...

Of course they want to pay less!

The fact that the firm hasn't developed a model that really meets their needs...does not turn this into the client's problem. It's the private practice lawyer's problem. It's the firm's problem. It's the profession's problem.

The market has changed.

Forever.⁴⁹

8. **Law firms will continue to put more emphasis on pricing and project management.** In 2009, I conducted in-depth interviews with chairmen, senior partners and C-level executives from 37 AmLaw 100 firms for the *LegalBizDev Survey of Alternative Fees*. The final report included hundreds of quotes about what works, and what doesn't. The precise wording of every quote we published had been approved by the interviewee, but every statement was also anonymous. This confidential approach encouraged senior decision makers to speak frankly and openly, and provided a platform that made it easy for firm leaders to say what they really think, without being quoted by name.

In our personal opinion, the most insightful quote in the survey dealt with pricing, and came from a senior partner who had previously worked in house:

For most of the past decade, I was a senior executive at a publicly-traded real estate company, and I like to say that the two most important people we had in the company were the estimator and the project manager. Law firms historically have had no one play either of those roles. It's very dangerous to move into a world of fixed fees if you don't have somebody who's capable of estimating and you don't have somebody who's capable of project managing it.

In the three years since that survey was conducted, law firms have begun working to fill both those roles, sometimes with individuals, sometimes with departments, and sometimes with entirely new ways of doing business. All signs point to an ever faster pace of change.

⁴⁹ <http://intelligentchallenge.com/2011/10/28/excuse-me-i-think-your-pricing-is-broken/>

Appendix A: Case study showing the difficulty of calculating cost per hour in advance

To see how cost per hour changes with volume and other factors, consider the hypothetical case of Beth, an AmLaw 200 senior associate who specializes in labor law and is considering going out on her own.

Last year Beth billed 2,000 hours at an average rate of \$300 per hour. Since the firm charged \$600,000 for her time, and Beth was paid a salary of \$250,000, the firm's share of her billings was \$350,000. It seems obvious to Beth that if she hung her own shingle, she should be able to charge less and make more. Her first question is what she should charge per hour. She goes on the web and finds this cost-plus formula:

$$\text{Average Billing Rate} = (\text{Expenses} + \text{Desired Profit}) / \text{Realized Hours}$$

Realized hours, of course, are the hours which are not only billed but also paid. Since she will be a solo practitioner, the "desired profit" equals the amount she would realistically expect to take home in addition to her salary at the end of the year.

The table below shows Beth's first take on the finances of going out on her own.

<i>Projected expenses and revenue</i>	
Desired salary	\$250,000
Overhead (fringe benefits, taxes, rent, phone, etc.)	\$100,000
Total expenses	\$350,000
Realized hours (billed and paid)	2,000
Break-even hourly rate or cost per billable hour (Expenses/realized hours)	\$175 per hour
Total revenue (Realized hours x hourly rate)	\$350,000
Profit (loss) for end of year bonus or correction	\$0

At the beginning of the year, Beth's salary is only an estimate, since she will be her own boss, and what she earns will depend on her revenue and expenses.

Although her calculations suggested an hourly rate of \$175, Beth decides to start by charging \$200 per hour to leave a safety margin in cases expenses are higher than predicted, her billable hours are lower and/or some clients fail to pay their bills.

Beth asks a CPA friend to review her thinking. He says that he would like to see more details about exactly what she will spend on rent, insurance, payroll taxes, and everything else, but the analysis is basically sound. However, he says that Beth needs to factor in one more thing: the non-billable hours (indirect labor) that she has to work to set up the office, send out her bills, and find new clients.

Consultants often don't track the unbilled time they spend on marketing and administration. But from a CPA's point of view, that time has a value, and is a cost of doing business, so it should be included in the cost analysis. This may seem like hairsplitting to a new solo, but as Beth's firm grows it will be extremely important to track. Beth estimates that she will have 500 unbilled hours in addition to her 2,000 billed hours, for a total of 2,500 hours.

After talking to the CPA, Beth does not change her projection for the bottom line, but she does add a few lines to her chart:

<i>Projected expenses and revenue</i>	
Salary	\$250,000
Number of hours worked	2,500
Salary per hour	\$100
Direct labor (\$100 salary per hour x 2,000 realized hours)	\$200,000
Indirect labor overhead (\$100 salary per hour x 500 unrealized hours for administration, marketing and unpaid bills)	\$50,000
Other overhead expenses (malpractice insurance, health insurance, fringe benefits, taxes, rent, phone, etc.)	\$100,000
Total expenses	\$350,000
Overhead rate ((Indirect labor + other overhead)/Direct labor)	75%
Break-even hourly rate or cost per billable hour (Expenses/realized hours)	\$175
Actual hourly rate	\$200
Total revenue (Realized hours x hourly rate)	\$400,000
Profit (loss) for end of year bonus or correction	\$50,000

Note that she has used the cost-plus equation. She raised her hourly billing rate so as to add to her expenses an amount for desired profit.

So Beth goes out, rents an office, and gets started. At the end of the year, her big picture projections turn out to be close, but of course many details turn out to be different. On the negative side, her clients don't give her quite as much work as she expected, one client fails to pay a small bill, and it takes more time than she predicted to start the business. She ends up with only 1,500 realized hours instead of 2,000, and she worked 550 unrealized hours instead of 500. On the positive side, she controls other expenses like a hawk, and is able to spend approximately 14% below her initial budget. At the end of the year, her figures look like this:

<i>Actual expenses and revenue</i>	
Salary	\$250,000
Number of hours worked	2,050
Salary per hour	\$121.95
Direct labor (\$121.95 salary per hour x 1,500 realized hours)	\$182,925
Indirect labor overhead (\$121.95 salary per hour x 550 unrealized hours for administration, marketing and unpaid bills)	\$67,073
Other overhead expenses (malpractice insurance, health insurance, fringe benefits, taxes, rent, phone, etc.)	\$85,642
Total expenses	\$335,640
Overhead rate ((Indirect labor + other overhead)/Direct labor)	83.48%
Break-even hourly rate or cost per billable hour (Expenses/realized hours)	\$223.76
Actual hourly rate	\$200
Total revenue (Realized hours x actual hourly rate)	\$300,000
Profit (loss) for end of year bonus or correction	(35,640)

All in all, it was a reasonable first year. She “lost” \$35,640 (that is, she had to reduce her desired salary) instead of making a profit of \$50,000, but she also worked 450 hours less than planned and covered most of her salary while working independently. Most new solos would be happy with this result.

In terms of our example, however, the point is that the only way to truly know her costs was to wait until the end of the year, see what she actually spent, see how many hours were actually billed and paid, and then do the math. When her sales volume changed, her unit costs changed as well.

It could have turned out very differently. If she had been able to bill the full 2,000 hours and all were paid (realized) as originally planned, her cost per direct labor hour

would have been \$167.82. If her billable hours had declined to 1,000, the same expenses would have led to a cost per direct labor hour of \$335.84.

Appendix B: The mathematical relationship between hourly discounts and profits

In Appendix A, Beth's planned profit at the beginning of the year was \$50,000. The table below shows that this reduces to \$10,000 if the hourly billing rate of \$200 is discounted 10% to \$180.

	<i>No discount</i>	<i>10% discount</i>
Salary	\$250,000	No change
Number of hours worked	2,500	No change
Salary per hour	\$100	No change
Direct labor (\$100 salary per hour x 2,000 realized hours)	\$200,000	No change
Indirect labor overhead (\$100 salary per hour x 500 unrealized hours for administration, marketing and unpaid bills)	\$50,000	No change
Other overhead expenses (malpractice insurance, health insurance, fringe benefits, taxes, rent, phone, etc.)	\$100,000	No change
Total expenses	\$350,000	No change
Actual hourly rate	\$200	\$180
Total revenue (Realized hours x hourly rate)	\$400,000	\$360,000
Profit (loss) for end of year bonus or correction	\$50,000	\$10,000

In other words, in this case a 10% discount in hourly rate led to an 80% drop in profits (from \$50,000 to \$10,000).

If you read widely on this topic, you are sure to see hypothetical accounts where the same 10% discount reduces profits by a smaller or a larger percentage. Why the differences? It all depends on what the costs of the firm are.

So when you ask a math question about what losses will be, the answer is always “It depends.” To analyze this further we will look at a simplified version of the spreadsheet which introduces algebraic variables for the quantities of interest.

The two spreadsheets below show that in Beth’s case, the same 10% reduction would reduce profit by 80% if her overhead was \$100,000, but only by 50% if her overhead was \$70,000. This makes sense, since with lower overhead the profit is larger and the percentage loss through discounting is a percent of a larger number.

80% Loss in Profit

			Discount
			10%
Variable	Description	Budget	Actual
S	Salary	\$250,000	\$250,000
RH	Realized Hours	2,000	2,000
O	Overhead	\$100,000	\$100,000
E	Total Expense	\$350,000	\$350,000
BR	Actual Hourly Rate	\$200	\$180
TR	Total Revenue = RH x BR	\$400,000	\$360,000
PR	Profit = TR – E	\$50,000	\$10,000
Profit Reduction			80.00%

50% loss in profit

			Discount
			10%
Variable	Description	Budget	Actual
S	Salary	\$250,000	\$250,000
RH	Realized Hours	2,000	2,000
O	Overhead	\$70,000	\$70,000
E	Total Expense	\$320,000	\$320,000
BR	Actual Hourly Rate	\$200	\$180
TR	Total Revenue = RH x BR	\$400,000	\$360,000
PR	Profit = TR – E	\$80,000	\$40,000
Profit Reduction			50.00%

Below we give a data table that shows a range of losses in profit based on various combinations of discount rate and overhead in Beth’s case.

		Discount Rate			
		5.00%	10.00%	15.00%	20.00%
Overhead	50,000	20.0%	40.0%	60.0%	80.0%
	75,000	26.7%	53.3%	80.0%	106.7%
	100,000	40.0%	80.0%	120.0%	160.0%
	125,000	80.0%	160.0%	240.0%	320.0%

Raising salary would also increase expense, lower profit and make the effect of a discount on profit larger. We can do some “simple” math to sum this up for Beth. We will use the letter *d* to represent the discount rate. Then we have:

Original planned profit is total revenue less total expense:

$$P_{plan} = TR - E = RH \cdot BR - E$$

Profit after discount changes the billing rate to $BR(1-d)$ so we have:

$$P_{disc} = RH \cdot BR(1-d) - E$$

Then the change in profit is:

$$P_{plan} - P_{disc} = RH \cdot BR - E - [RH \cdot BR(1-d) - E] = RH \cdot BR \cdot d$$

The percentage change in profit is the change in profit divided by the profit:

$$\frac{RH \cdot BR \cdot d}{RH \cdot BR - E}$$

This formula implies that if Beth keeps her realized hours as planned:

1. Any increase in the discount rate will increase the percentage loss in profit.
2. Any increase in total expense will increase the percentage loss in profit.
3. Beth could offset the effect of the discount (d in the numerator) above by lowering expenses (E) so as to increase the denominator.

But for most lawyers, the main implication is simpler: these relationships are complicated. It may be wise to get more help from the trained professionals in your accounting department.

About this white paper

This white paper is based primarily on a series of blog posts that appeared in the Legal Business Development blog at www.jimhassett.com between November 2011 and April 2012. It also includes material from the article “The Rise of the Pricing Director” by Jim Hassett and Jonathan Groner, ©Copyright 2012 Bloomberg Finance L.P. That article was originally published by Bloomberg Finance L.P. Reprinted with permission. The opinions expressed are those of the authors.

This material will be updated and expanded, and included in the third edition of the *Legal Project Management Quick Reference Guide*, which is scheduled for publication in June 2013.

About the authors



Jim Hassett is the founder of LegalBizDev, which helps law firms increase profitability by improving project management, business development, and alternative fees. Before he started working with lawyers, Jim had 20 years of experience as a sales trainer and consultant to companies from American Express to Zurich Financial Services. He is the author of 10 books, including *The Legal Project Management Quick Reference Guide*, *The LegalBizDev Survey of Alternative Fees*, and *The Legal Business Development Quick Reference Guide*. He has also published more than 80 articles in the *New York Times Magazine*, *Of Counsel*, *Legal Management*, *Strategies: The Journal of Legal Marketing*, and other publications. Jim is a frequent speaker at law firms and at bar associations (including the New York City Bar, the New York State Bar, and the Massachusetts Bar), Harvard Law School, the Association of Corporate Counsel, the Defense Research Institute, the Ark Group, and at Legal Marketing Association meetings in Boston, New York, Philadelphia, Washington, Savannah, and Vancouver. He has conducted webinars through West LegalEdcenter, the National Law Journal, The International Lawyers Network, TAG Academy, and the Legal Marketing Association. Jim writes the blog *Legal Business Development* which was featured at the ABA TECHSHOW in 2009 and again in 2010 (in its list of “60 Sites: Latest and Greatest Internet Hits”) and by TechnoLawyer (in its list of “the most influential legal blogs” in BlawgWorld). He earned his Ph.D. in psychology from Harvard University.



Matt Hassett was convinced by his brother to begin research on legal pricing, alternative fees, and risk management. He has a Ph.D. in mathematics from Rutgers, and is the co-author of several textbooks and study guides in statistics and actuarial science, including *Probability for Risk Management*. Matt taught Mathematics at Arizona State University for over 30 years. As a consultant, he helped set prices for mortgage-backed securities (for American Southwest Financial) and for Medicare supplement insurance (for Oxford Life Insurance). He has also served as an expert witness on financial calculations, developed educational programs for actuaries, and worked at CVS Caremark as a director of experience analysis for health plans. As a Principal at LegalBizDev, Matt is currently developing new techniques to enable law firms to reduce risk and improve the pricing of alternative fee arrangements.

About LegalBizDev

LegalBizDev helps law firms increase profitability by improving project management, alternative fees, and business development. We offer coaching, webinars, workshops, retreats, train the trainer programs, publications, and more.

We help each individual identify the action items that are most likely to produce immediate and practical results for their practice, their personality and their schedule. Our proprietary process helps lawyers to make the best use of their limited time by building on best practices from other law firms and other professions.

Before we started working with lawyers, we had 20 years of success developing award-winning training programs for such clients such as American Express, Bank of America, Bank of New York, JP Morgan, State Street, TIAA-CREF, TD Waterhouse, Zurich Financial Services, and many others. In 2005, in response to the enormous changes and opportunities in the legal profession, we decided to limit our services exclusively to the needs of large and mid-sized law firms, and renamed the company LegalBizDev.

For more information on the programs that could be of the greatest benefit to you, call us today at 800-49-TRAIN or email info@legalbizdev.com.



LegalBizDev
225 Franklin St., 26th Floor
Boston, MA 02110
800-49-TRAIN
info@legalbizdev.com