Pricing and Profitability for Law Firms

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Chapter 1: The major forces that shift supply and demand in the legal industry today and their impact on the five major myths of pricing in law firms

The legal profession has faced a period of significant change and pressure that looks likely to continue for some time to come. We look at these market forces impacting legal services today, and examine why pricing has become so important to successfully managing this changing landscape.

The legal sector has seen a tremendous amount of change in the past three years, but the recession has not hit the legal sector nearly as hard as it has some other industries. In terms of a law firm’s survival, success and long-term profitability, it does not matter whether these changes were foreseeable. What will matter is how well law firms and their partners anticipate changes that are yet to come, how flexible the firm’s strategy and business model is in light of future change, and how well partners respond to the changing requirements of their marketplace.

An increasingly competitive marketplace makes effective pricing management critical. The marketplace has changed dramatically over recent years. In the past, the key aspect of profitability management was utilisation. This, combined with reasonably efficient invoicing and cash-collection procedures, could usually produce a profitable firm. However, the economics of most legal practices are currently facing a twin squeeze.

On the one hand, there is a downward pressure on fees, which is intense for some work types. This is exacerbated by a reduction in supply of certain types of work – for instance, M&A work that has been replaced by a balance of M&A and restructuring work. In addition, most mid-market firms have begun to experience a situation where sophisticated global competitors are taking away their key clients. This, in turn, has caused an increase in client buying power, allowing law firms even less control over their pricing. In addition, legal services have become far more commoditised over the past several years, with knowledge being valued less and less by clients. For example, ten years ago it would have been unthinkable for small limited companies to be incorporated by anyone other than a trusted solicitor. Today, there are myriad service providers that incorporate companies at a fraction of the cost charged by law firms, using a very efficient streamlined process – and no solicitors.

On the other hand, the cost of providing legal services has increased significantly for most firms. Associate costs, in particular, have increased dramatically over the past five years. This pressure may loosen a little during an economic downturn, but there will be no return to low associate salaries – and elite firms will continue to pay wages that mid-market firms cannot afford. In order to help contain overhead costs, many firms have considered outsourcing at least a portion of their operations; innovative firms also review whether to outsource distinct (lower value) elements of their legal work in order to contain fee-earner costs.
Because of this twin-squeeze, it is critical for today’s law firm to actively manage the firm’s pricing of its services. This needs to occur at all levels, within each market and submarket, at a firm, practice group and office level, at the work-type level, and at the matter-specific level. Proper pricing management will both contain this twin-squeeze and provide opportunities for firms to increase revenues.

Pricing is just one element of a law firm’s short-term profitability, yet the impact of pricing on the firm’s long-term success – including its market position – is also critical and often overlooked. The best managed law firms invest significant resources in understanding how different variables drive supply and demand of legal services. These supply and demand variables need to be understood, not just within the immediate region where the firm operates, but on a countrywide, regional and global basis. Understanding these major forces helps dispel five major myths that still circulate within the walls of most law firms today.

We start this report, therefore, with a brief summary of the major forces that will shape the supply and demand in the legal industry today – see Figure 1.

**The six major legal industry trends and their influence on pricing**

**Trend one – Changes in competitive environment**

It is well known that in all legal markets there exists a division among peer groups of firms. The remainder of this paragraph may over-generalise, but it will serve to make a point. The top of the market has been well established; in the UK the elite takes the form of the Magic Circle; in the larger Continental European countries there are usually no more than four or five firms holding this position, and in the smaller countries no more than two or three. Below the elite there operates, in the UK, an established upper mid-market of no more than an additional five to seven firms, and below this there are about an additional 100 firms operating solidly in a highly competitive mid-market. In the larger Continental European countries the upper mid-market tends to be much smaller, with most firms of ten partners or more operating in the solid mid-market. The entirety of the mid-market still tends to profess itself to be ‘full service’, meaning generally that law firms will serve any need for any client.
Focus occurs, if at all, on a geographic or on a broad practice-area basis (and in all fairness the UK firms have been better about this than their Continental counterparts). Yet, a true focus on a distinct set of legal work, on certain industry sectors or on client-types specialisation all too often is either still viewed as a branding exercise or, deeply in the heart of hearts, rejected by the partners.

In this context of pricing this is relevant for three reasons:

- In difficult market conditions, the largest elite firms have needed to keep up their capacities and have been reluctant to let go of partners and staff because they do not want to be caught short when the markets return. As a result, they are hunting for work in territory that has been happily accommodated by the mid-market, offering prices that are at mid-market level (or below) in order to keep utilisation up in the short-term and, if things go well, show the client a better service experience that binds the client in the long term. This has squeezed mid-market firms from the top-end down;

- As large firms have been letting go of partners and associates to keep up profitability, these individuals have opened and continue to open up boutique firms, doing high-end work for the same clients at a much more competitive rate (because of low overheads) than they had been able to offer in their large firms. (We will discuss later whether the price differential is warranted if the value proposition to the client is the same.) These boutiques have been squeezing the pricing of the mid-market from the bottom end. The same is true of LPO providers (more on legal process outsourcing further in this report); and

- The mid-market firms are the most vulnerable in this context – and this causes consolidation in the mid-market. Because of eroding prices (through panels, bids, discount demands, etc.), their margins come under pressure most quickly; their sensitivity to lower pricing is higher than that of the larger firms because their rates are already lower to start with – yet their cost base tends to be similarly structured. As a result, their profitability comes under pressure more quickly – this causes pressure on the talent side (with a knock-on effect on clients). This effect also causes consolidation as firms seek economies of scale and strategic rationales to gain size – one reason why early 2010 has seen a significant amount of merger activity in the legal mid-market.

Pricing therefore is much more than a financial exercise – it is a vital component to a firm’s competitive strategy.

**Trend two – Macro-economic changes**

The emerging markets – in particular Asia – have gained significantly in global economic importance: for example, in 1999, Japan and Hong Kong were the only two Asian countries whose financial institutions featured in the global top 50 by market capitalisation ($180bn and $20bn, respectively), compared against the US and UK ($1,054bn and $363bn, respectively). In 2009, this picture has changed significantly, with the US and UK accounting for $378bn and $118bn, respectively – compared to China whose banks were not on the map in 1999 – at $509bn, Japan at $121bn and Hong Kong at $19bn (Financial Times, 23 March 2009). While the effect is clearly compounded due to the time at which these market capitalisation snapshots were taken,
the effect does not belie the rise of the power of the East.

Innovation centres too, are moving on, with – on the basis of historic patent filings – emerging markets such as Turkey and Poland showing a much larger growth in historic patent filings than, for example, Germany. As industrial sophistication of India and China increase, more services innovation will follow – similar to how Japan revolutionised American manufacturing processes in the 1980s.

In the context of law-firm pricing, this is important for the following reasons. First, the frame of reference in which mid-market firms operate have to change – from serving a local clientele to serving a local clientele that operates globally and a global clientele that operates locally. This has an impact on client expectations, not only on the amount the client is willing to pay, but also in how the price is negotiated and achieved.

Second, clients have become used to outsourced services and service-delivery standards. Business process outsourcing (BPO) and legal process outsourcing (LPO) – covered in depth later in this report – are just beginning in the legal sector, and many firms in the mid-market still have not embraced the good business practices that follow sound processes (irrespective of insourced or outsourced). For firms to be able to have aspects of their services done cheaper provides them with more latitude as to what price they need to have in order to do work profitably – and to avoid the LPO providers’ end-run around the law firm as they work with clients directly, for a lower price at comparable quality.

Third, in the face of standardisation of legal processes, the relative importance of jurisdictions that have been exporters of their legal system (for example, the UK and US) will continue to increase, while the respective importance of other jurisdictions will decrease. Other large countries (for example, France and Germany) have likely missed their chance to establish themselves as legal exporters, and this will reflect in lower prices especially in the relatively undifferentiated mid-market when compared to similar situated firms in exporting jurisdictions.

Trend three – Changes in client requirements and referrer preferences

Clients have been under significant pressure to lower their costs. This has resulted in pressure on in-house legal counsel to reduce their budgets for in-house and external counsel and to reduce values of claims and risk losses. This pressure in turn has resulted in fundamental change in how companies procure legal services: purchasing legal services has become more professional, more institutionalised and more process, standards and performance driven.

Clients make more analysis-based make-or-buy decisions and concentrate their collaboration with law firms on a limited number of panel firms. In short, clients are becoming more and more sophisticated buyers of legal services, and this has a direct impact on the price a law firm can charge unless its sales and pricing processes professionalise at least at the same pace (to stay even), or more quickly (to get better and better prices in the long term). The best firms continue to anticipate trends and institutionalise processes that accomplish this.

Trend four – Regulatory changes

The UK Legal Services Act of 2007 will further drive market restructuring by reinforcing consolidation and concentration already underway. As of the date of this writing, Alternative Business Structures (ABS) will be implemented as of October 2011, allowing qualified non-lawyers to own legal
service providers as long as certain regulatory safeguards are maintained in the provider’s governance. This liberalisation of equity will have a profound impact on the way in which the legal market in the UK – and in due time globally – will operate in the future.

Initially at the lower-end of the market, one can predict process-driven providers providing what really should be standard legal services. In the mid-market we are already seeing LPO providers taking on paralegal-level tasks such as document due diligence and document reviews in litigation – both for clients and for law firms – and this trend will accelerate. There will be opportunities for law firms to reinvent their business models and adjust their capital and partner equity structure in order to operate in a competitive way. External capital also provides an additional option for raising capital to finance international operations, domestic acquisitions, or systems for better firm and pricing management.

In addition, a number of initiatives continue to review how firms can charge for their services. In the UK, US-style contingent fee agreements are not permitted as of this writing, except for pre-defined circumstances and not once a matter turns litigious. In litigation, the most a law firm can hope for is a conditional fee of no more than double the hourly charges. For example, Lord Justice Jackson’s 2009 recommendations clearly leave open the door for contingent fee arrangements, albeit in a more restricted form than available in the US today.

Trend five – Change in delivery of legal services

Aluded to in both sections previously is the fact that legal services are at the beginning of being delivered in a new way. Three examples illustrate the point:

- All of us know that there is significant inefficiency in how legal services are delivered today: there is very little in terms of process and quality control. Only the most sophisticated clients sit down with their lawyers before giving out a contract for a series of cases, map the process required to deliver a result and identify savings in how the work is being done – and by whom. Even fewer law-firm partners sit down with their clients to offer the same – after all, time is money. As a result, we still see too many three or five-year qualified lawyers – instead of much less expensive readers proof-reading pleadings, contracts and memoranda of law;
- LPO providers increasingly compete head-to-head with law firms for both management and delivery of legal work that is done by inside and outside counsel at a level of five years’ PQE or less – promising budgetary savings of 30 per cent or more over a number of years. We are aware of at least one instance where an LPO provider conducted a document review at one eighth of the cost of a Magic Circle firm’s offer – using a qualitatively better process; and
- In response to clients complaining of large bills to produce first drafts of documents, a major California law firm is on record for preparing initial drafts of transaction documents for free, in exchange for a major role in the deal.

The work that must be done by the traditional law firm, accordingly, will become less and less, especially as equity is liberalised. In respect of pricing, the impact will be profound: for the ‘brainy’ work, pricing will be maintained; for ‘lesser’ work, pricing will either fall or, at least, not increase significantly.
Trend six – Change in people demands
What may seem as all bad news for law firms can be seen as good news as well. According to one of our proprietary studies (carried out by our German partner firm Graf Pfeil), we know that associates are no longer expecting partnership automatically. They are looking for interesting work and good chances of progressing after they move on from the firm. They are less tolerant of WOMBAT-type work – that is, the proof-reading a three-year associate was happy to do ten years ago – which is good because this will go to others in the future. Rational performance standards around performing well on ‘true’ legal work will make them stay – at a cost. There is, therefore, even a talent opportunity for a firm that is able to manage its pricing like a business process and rationalises the ways in which it delivers its services.

For the well-managed firm, therefore, several lessons emerge:

- An external focus becomes a behavioural priority and part of the firm’s culture;
- Anticipating these trends becomes a management priority. This includes developing a deep understanding of one’s competition. In the context of pricing, the competition’s scale, its rates, cost-structure, capital investments and overall aspirations, are all very important in the determination of one’s own pricing approach. New market entrants also provide clues. In most cases, established firms have to react to new market entrants’ pricing propositions. Clients, then, often waive these pricing propositions in front of their long-standing lawyers’ noses, in order to achieve some reduction in rates. A progressive firm will be more profitable by being proactive in and developing, together with its key clients, its approaches to pricing; and
- The firm should invest in resources that allow information to be available to partners on these major trends, in a way so that they can anticipate trends to their advantage: for example, being able to determine whether the time is right to lock in a two-year rate agreement for a key client in a particular industry.

Impact of market forces on five major myths that hinder firms in implementing sound pricing-management practices
Using this statement as ammunition, I would like to briefly debunk the five major myths about pricing that circulate in many law firms today. They are:

- Pricing is all about rate setting;
- It’s all about alternative billing;
- Pricing is about negotiating price on individual matters;
- How partners price can’t be managed; and
- All clients are price-sensitive all of the time.

We address these five major myths in turn.

Myth one – Pricing is all about rate setting
Pricing of legal services is not about rate setting; or, better, not only about rate setting. For the past 20 years, most law firms have shown little creativity in how they price their services. Most firms continue to insist on billing only by the hour; this holds true in particular for most US firms. Many UK and Continental European firms are more flexible here. Irrespective of location, many firms have continued to maintain a belief that any pricing arrangement other than the hourly-rate billing will cause a loss. This assumption is usually made without any sensible matter-
by-matter profitability analysis and without examining ways in which engagements can be managed so that engagements that are not priced by hourly billing can at least match – if not exceed – the profitability of matters billed by the hour.

The recession has changed how most commercial clients manage their law-firm relationships. Their focus is more on total legal spend and less on the hourly rate charged by their lawyers. There are some exceptions to this. Some in-house counsel continue to believe that they are able to ‘control’ legal costs by focusing on their lawyers’ hourly rates, and many insurance defence litigation contracts remain priced on a heavily discounted hourly-rate basis. However, clients could continue to improve their cost management significantly in many cases if they were to focus their law firms on overall contract arrangements rather than focusing on discount structures for hourly billing. Conversely, in more and more firms, this approach also is unsatisfactory to entrepreneurial partners who desire more flexibility in how they can price the legal services they provide.

As in-house counsel are under increased pressure not only to control legal costs but also to ensure predictability of legal costs, clients have imposed pricing models on their legal service providers that are not based on the hourly rate. Law firms have slowly begun to respond to their clients’ needs in this regard. Many firms merely review their rate-structure once per year, using a variety of ad hoc factors, and many firms continue to rely on incremental, across-the-board rate increases. In practice, this often means that after a long internal discussion, they end up raising their hourly rates by, for example, £10 or ten per cent. This method may be convenient for the finance department and easily understood by partners. Yet, missing from this method is the view of how the market perceives the firm’s rates which are communicated to the market at large. An incremental increase in rates can only be explained by increased costs, and clients are not interested in their law firm’s costs: what they are interested in is how their law firm can provide a service at a cost that is reasonable to them.

In addition, even sophisticated work is no longer off-limits to rate pressure. The most glaring example of this is reverse rate auctions, a creative way to manage legal costs on a work-type basis. A reverse rate auction essentially involves law firms in an online bidding process for the lowest blended rate for a legal-services contract; the lowest bidder wins the contract. For example, even prior to the recession, at least one corporation asked firms to participate in a reverse rate auction for its entire portfolio of European M&A work. All firms that were invited – while grumbling – participated in the reverse rate auction. It was interesting to note that European M&A work once was among the most sophisticated and complex type of work an international law firm could do – yet, at least with this particular corporation, this service has been demoted to commodity status, in large part because this company has put rigorous structures around its corporate development, including how mergers and acquisitions are executed.

Myth two – It’s all about ‘alternative billing’
As a matter of terminology, clarification of the term ‘alternative billing arrangements’ is in order. We prefer the term ‘alternative fee arrangements’ or AFAs to ‘alternative billing arrangements’ for several reasons. First, it’s the technically correct term, and it has become the accepted term in the English legal market. Second, sending the client a bill is not the same as pricing a
service. Pricing occurs at the time when an agreement is made to provide a service – this is done upfront. Billing is merely the administrative effort of sending an invoice. Therefore, a firm that prices by hourly billing is arguably not pricing at all – in fact, it avoids the question of price by advertising and agreeing on an hourly rate and leaving the second equation to its discretion: no agreement on price is arguably reached at the beginning. Thus, hourly billing is the basis of payment, but it is not pricing. And there are no alternatives to sending an invoice: at some point in time, an invoice must be rendered.

While we do not advocate the abolition of the billable hour, we do advocate that several alternatives are looked at before pricing policies and individual fees for matters are established. In the past, the legal profession has had the great luxury of being able to set its price at the end of a matter when the invoices are sent. This approach avoids answering upfront questions about what value the client might derive from the lawyer’s services, and it discourages an upfront communication about this issue, in which it should be the professional responsibility of the lawyer to engage.

Myth three – Pricing is about negotiating price on individual matters

Most partners have a short-sighted view of pricing: ‘What rate/fee can I achieve with this client for this matter?’

As the previous tour d’horizon of major trends in the legal sector shows, and as we will see in the remainder of this report, good pricing decisions begin at a much more fundamental level than price execution. How the firm, practice group, and even a specific team manage the value of their services, and how that value is communicated to individual clients and to the market as a whole, are critical elements of any rational pricing strategy: if the firm and practice area are not clear about these issues, effective price execution at the matter level is much more difficult.

In addition, questions around how a price or offer needs to be structured to convince the client to ‘buy’, how a target price is to be achieved so as to ensure the matter achieves a predetermined profit hurdle, are all questions that have to be answered for the practice area as a whole, and for the type of service provided, before a partner can reach an agreement with his/her clients that is mutually satisfactory. Partners will have difficulties addressing these issues in a way that is right for the firm as a whole if left to their own devices.

Myth four – How partners price services can’t be managed

Many partners exhibit a reactive behaviour when pricing is to be addressed. This attitude is reinforced by several parameters:

- Many partners see the firm’s standard hourly rate as the maximum rate they should charge to a client. They are generally more comfortable offering a 25 per cent discount than a 25 per cent premium for superb value delivered;
- Many partners continue to believe that the rates they can charge are being heavily influenced by clients looking for a deal;
- Partners believe – often without analytic evidence of any kind – that their competitors are constantly undercutting their hourly rates and that they must give in to requests for discounts, in order to win work. As a result, they not only fail to probe deeper to understand why their clients push back on a rate increase, but they often also give in too soon to a
request for a discount instead of finding ways to provide more value to the client at a higher price; and

- Some partners often continue to view discriminating among clients based on rates with disdain. Sometimes they even advance the excuse that charging different rates to different clients is unethical or even against professional conduct rules – which, in most jurisdictions, is simply not true.

Many firms do not succeed in encouraging their partners to price more aggressively because there is too little of the right data available that would allow partners to recognise opportunities for improvements in pricing and to become better at recognising pricing mistakes.

Indeed, pricing mistakes are often hard to detect in law firms. Realisation is often the only measure that can be relied upon. However, realisation is much too imprecise a measure to use to truly understand pricing mistakes. Even if detected, not much is being done about correcting pricing mistakes and, therefore, there is no learning effect for future engagements. Partners also have virtually no incentive to stretch for the proverbial additional dollar in rate. In most firms, quite the opposite is true: whenever there is a rate increase, partners complain that all of their clients will leave.

This is exacerbated by managing partners and practice group leaders who, in many firms, are often unwilling to get involved in the pricing decisions of their partners. Even today we continue to see firms – other than those that are at the top of their market – that leave each partner to set his/her own rates. If these rates are inadequate to achieve profitable matters, the partner remuneration system often serves as the final (but poor) backstop to poor pricing judgments. Realisation also does little to detect opportunities for higher pricing: pricing is based on too many external factors, and realisation remains purely an internal measure.

**Myth five – All clients are price-sensitive all of the time**

The recession has caused most clients to be more fee conscious, and across the board rate increases are definitely out. Indeed, a good number of law firms have not raised their hourly rates. However, this does not mean that all clients are price-sensitive on all matters all of the time, as many partners continue to maintain. In the many client interviews we have conducted for our law-firm clients during the past two years, we continue to find that the following matter most:

- Overall value of services provided;
- Depth and breadth of expertise and experience; and
- Ability to achieve commercial results over and above legal acumen.

We have not been able to notice an appreciable increase in clients who solely select their law firm on rates. While a client will hardly ever select the high outlier, as long as the firm is within the relevant range, the overall value (however a client defines value) is key. The pure assumption, therefore, that all clients are always price-sensitive is simply not the case.

All last three chapters of this report tackle the issue of addressing clients’ needs and price sensitivities.

With those myths set aside, the next chapter provides context for pricing as a short-term and long-term driver of profitability.