Pricing Legal Services

By Pauline Doohan
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## CASE STUDY: Bryan King – Turning e-billing to law firm advantage

E-billing uptake in the UK and wider European legal markets

Reasons for the disparity between e-billing in the UK and the US

- Time recording
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- Client relationships
- Diversified practice areas
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- Embed the discipline from the beginning
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BUSINESSES EXIST to deliver a perceived value proposition to the market. Businesses fail because they build something that no one wants or they cannot deliver on the value proposition. Law firms, like any other value creating entity, are not immune to this principle.

2.1 The value proposition

A firm’s value proposition in its simplest form is the benefit that the client can expect to receive by engaging the firm’s services. A firm’s perception of how it creates value must be closely linked to how the benefit is perceived by the client, otherwise the value proposition is flawed and the business will cease to exist. The legal industry flourished for decades under the proposition that a law firm exists to deliver legal advice at a value linked to the technical expertise of the lawyer performing the work and at the cost of the time it takes to complete that work at charge out rates derived from a combination of a firm’s cost structure, profit expectation and the level of seniority of the lawyer involved. The fact that the industry flourished under this value proposition assumes that the client perceived the benefit and was willing to pay the price.

The recent change in the client’s situation, which has been driven primarily by reduced legal budgets and reinforced by advances in in-house legal technology, has modified the client’s perception of benefit to the extent that the value proposition no longer holds true. Although the need for legal advice of the highest quality still exists the difference is that clients are no longer willing to assume the entire economic risk of the engagement.

Unfortunately, the business model that supported the pre-recession value proposition is entirely different to the one required to support the client’s perception of value in today’s market. Worse still, the former business model encouraged inefficiencies in the way work was staffed and produced, so the level of change now required to adapt is significant for many firms.

A reactive approach to meeting the changing needs of the market will not be sustainable. Firms need to fully understand the change required and then adapt their business model to deliver accordingly. The client’s perception of value will inform their price point but the business model will dictate if the firm can deliver at the price that the market expects and in a manner which is profitable. The aim is to adapt to the needs of the market while maintaining a financially viable organisation that will survive and continue to meet the demands of that market.

2.2 The value spectrum

The client is in the market to buy services that solve business problems and they relate the cost of those services to the importance of the issue to them.
The relative value of legal services to a client is best represented on the value spectrum set out in Figure 2.1. The higher up the value spectrum services sit, the less price sensitive they are, the lower down the value spectrum they sit, the more sensitive they are. The shape of the value spectrum is also indicative of where the volume of work lies and where competition from other firms and service providers will be greater. The further down the value spectrum the client perceives the service to be the more certainty they will require when it comes to pricing.

- Services at the top of the value spectrum represent ‘bet the company’ (BTC) type work, which clients rely on a small number of high caliber, trusted advisors to provide. Examples include highly contentious litigation or takeover bids that threaten the reputation or future of a company. Price sensitivity for these types of services is low and lawyers can charge high hourly rates or a premium for the work completed. Clients demand partner effort and are willing to pay for it.

- CYA services are also perceived to be of relatively high strategic value to the client but not as business critical as BTC matters. Examples include high-level M&A, contentious litigation and compliance matters. Firms employed at this level of the market generally have a good reputation for being a safe pair of hands and have the brand value to back them up. Price sensitivity is greater than for BTC work, but clients are willing to pay reasonable hourly rates for the work.
Operational services are the type of legal services that are part of the normal course of doing business for a client. Services such as commercial property transactions and commercial agreements fall into this category. From a strategic point of view the impact of the outcome of the work on the overall business is perceived to be less business critical and more part of the normal course of events, so the client is more conscious of the cost of the work. Many firms in the market will be able to perform this type of work, which increases price sensitivity.

Commodity services are of the type that must be performed as part of the day-to-day operations of keeping the business functioning. They are repetitive in nature and do not require the judgment of expensive lawyers. Price sensitivity will be at its highest at this end of the market and competition from innovative start-ups and LPOs will be at its greatest.

Lawyers need to fully appreciate that the relative value of legal services to a client often bears no relation to what they might perceive the work to be worth. Understanding the relative value of legal services to the client will be fundamental to reaching a pricing solution that represents value for money in the eyes of the client and ensures the firm is in with a chance to win the work.

2.3 Profitability

Coming up with a pricing solution that meets the client’s perception of value is one thing; delivering on it and making sure the firm earns a profit is another. Law firms exist for two reasons: to deliver legal advice, and to generate a profit that warrants a partner’s investment in the firm. If either hypothesis fails to hold true the firm will cease to operate. A limited focus on creating value for the client without the business model to back it up will therefore be unsustainable.

Regardless of the shape or size of a law firm there is only one formula for how a law firm earns a profit. How to apply this formula is dependent on where a firm’s services sit on the client’s value spectrum, which will determine the business model required to compete at that level of the market. Only then will a firm be in a position to develop pricing strategies that it can profitably deliver on.

2.4 The measure of success

Profit per equity partner (PEP) is the primary indicator of performance for a law firm. It represents the return that partners expect to receive for taking the risk of investing their capital, time and effort as owners of the firm. One firm can be as profitable as another in net profit terms but if that profit has to be divided between more partners in one firm than the other the significance of PEP as the key performance indicator becomes obvious.

The formula for arriving at PEP is simple and once understood in the context of a firm’s strategic value focus is key to empowering partners to take control and make informed pricing and management decisions that will impact the long-term success of the firm.
CHAPTER 2 – UNDERSTANDING PROFITABILITY AND VALUE

2.5 A simple formula

Two key levers influence a firm’s PEP: 1) The average profit earned per fee earner; and, 2) The number of fee earners that contribute to the profit earning potential of each equity partner (including that equity partner). The more profit each fee earner can make and the more fee earners there are to each equity partner, the greater the profit earning potential of each equity partner.

PEP = Profit Per Fee Earner (PPFE) x (Leverage +1)

A firm with high leverage and low PPFE can be equally as profitable as a firm with low leverage and high PPFE. High leverage and high PPFE is difficult to achieve while low leverage and low PPFE gives rise to serious concern.

2.6 Profit per fee earner

Two key drivers govern the profit earning potential of fee earners: revenue per fee earner (RPFE) and cost per fee earner (CPFE). The more revenue each fee earner can earn at the lowest cost to the firm the more profit the firm will make. RPFE and CPFE are in turn influenced by a number of key variables, each of which, when carefully managed, can maximise revenue and in turn impact profitability.

PPFE = Revenue Per Fee Earner (RPFE) – Cost Per Fee Earner (CPFE)

2.6.1 Revenue per fee earner

Revenue is the value of fee earner effort actually recovered by the firm. It is primarily influenced by the amount of available time that is turned into billed hours and how much of that time the client is willing to pay for. The more time that can be billed and recovered at the highest achievable rates the more revenue will be earned.

Three key metrics dictate the revenue earning potential of a firm/practice area.

RPFE = Utilisation Rate x Chargeable Rate per hour x Realised Rate

2.6.1.1 Utilisation rate

Utilisation is a measure of the time spent on fee earning work relative to the total time a fee earner is contracted to work, expressed as a percentage.

\[
\text{Utilisation} = \frac{\text{Billed Time} \times \%}{\text{Available Time}}
\]

Utilisation represents how much of a fee earners time is turned into potential revenue for the firm. It is indicative of how busy a firm/practice area is and the available capacity to perform more work. Utilisation is difficult to influence in the short term at firm- wide level as in principle it requires partners to either sell more work or reduce the number of fee earners required to perform existing levels of work.

Generally, low utilisation indicates that a firm does not have enough work to keep its lawyers busy while high utilisation is indicative of a healthy workload. Caution should be exercised when taking utilisation figures at face value as an
uninformed view can lead to management decisions that negatively impact the long-term health of the practice area/firm. Examples of when utilisation figures do not reflect the true story:

- Time records often do not reflect the true value of fee earner effort on a matter. This can be due to a failure to record time accurately due to tight budgets, perceived personal inefficiency or weekly time recording disciplines that underestimate total effort spent. The absence of properly recorded effort impacts revenue earning potential, profitability analysis and the quality of data available to inform future pricing decisions.

- General administration and infrastructure inefficiencies can impact the potential of fee earners to complete tasks, resulting in low apparent utilisation of available time. This, in turn, impacts the understanding of resourcing needs and ultimately salary costs.

- High utilisation in the partner ranks can suggest that the leverage potential of the work is not being realised. This can result in write offs of time and a lack of focus on investment activities, including business development, client relationship management and people development.

- High utilisation on specific transactions can hide the fact that the client is being charged for internal inefficiencies, potentially impacting pricing competitiveness and client satisfaction.

- High utilisation can indicate where fee earners are being over worked, which has the potential to impact job satisfaction and increase absences due to stress or illness. Ultimately, this will add to the cost base of the firm.

While utilisation is an important indicator it is often over managed as the key indicator of performance, which can result in behaviours that are unprofitable and prejudicial to the future success of the firm.

### 2.6.1.2 Chargeable rate per hour

![Total Budgeted Overheads
Total Anticipated Billable Hours](chart)

Chargeable rates are typically calculated using a cost plus methodology. The total budgeted overhead costs of a firm, including support, facilities and technology, plus the firms required profit margin are divided by the total anticipated billable hours (adjusted to take account of write offs). The average rate is then adjusted by fee earner category. Charge out rates work on the assumption that a fee earner’s value increases with time and that all fee earners of a similar category have a similar charge out rate regardless of the type of work performed. Chargeable rates give an indication of the necessary level of income required to cover firm-wide costs and deliver a profit if the fee earner can achieve the desired number of billable hours.

Chargeable rates are difficult to influence in today’s market as the client has a wide view of the rates being charged by competitor firms for a similar
value of service through the use of spend management technology and benchmarking reports. As in-house legal teams continue to take more work in-house and competitor firms and alternative providers adopt smarter operating strategies, chargeable rates are more likely to be negotiated down rather than up. According to research performed by CEB (see case study, p49), in-house counsel see rate negotiation as being the most efficient tactic for reducing external spend. The only way firms may be able to influence rates in the medium term is to prove to the client that the value of service being offered is at a level that the client will benefit from and cannot easily be replicated by competitor firms.

### 2.6.1.3 Realised rate

The realised rate is the difference between the chargeable rate per hour and the rate paid by the client after all write-offs, discounts, and other adjustments have been taken into consideration.

| Realised Rate = | Chargeable Rate – Recovered Rate |

Rather than focusing on raising or maintaining chargeable rates in a competitive market firms should be focusing on improving the average realised rate as the driver of profitability. Of all of the levers of profitability, increasing the average realised rate is the one that can be most influenced in the short term.

Some of the common factors that give rise to low average realised rates include:

- Charge out rates being set too high so the cost of the effort expended outweighs what the client is willing to pay, resulting in discounting and write-offs.
- Inefficient working practices that cannot be passed on as a cost to the client, including:
  - Reinventing the wheel.
  - Work being performed at too high a level.
  - Training staff on the job.
  - Using multiple fee earners on a matter.
  - Too much partner input or oversight.
- Inefficient billing processes. Delayed billing often results in discounting as the client’s memory of the value received has faded. Studies have shown that the faster a bill is sent out following the completion of a transaction the less likely the client is to dispute the bill. Where discounting happens on already discounted rates the impact on the average realised rate is significant.

In order to better influence realised rates firms need to ensure that: rates being charge are relative to what the market expects; work is being performed at the right level and as efficiently as possible; and billing processes are efficient.

### 2.6.2 Cost per fee earner (CPFE)

Cost per fee earner is the average cost of employing a fee earner, taking into account salary costs, direct benefits and a contribution towards the overhead costs of running the firm. A notional salary
for partners should also be included to give a true reflection of the actual cost of performing the work.

\[
CPFE = \frac{\text{Salary Cost} + \text{Overhead Cost}}{\text{Total Fee Earners}}
\]

Cost per fee earner represents the break-even threshold that must be achieved before any profit can be made. The high fixed cost of running a law firm means that it is very difficult to influence, even in the medium term. However, many firms are coming up with innovative ways of addressing the high-cost issue by outsourcing back-office functions or relocating practice areas and back-office functions to lower-cost centres. This is not an option for all firms and not one that can be influenced in the short term in any event. Such a decision must be part of a wider strategic review and take into account the cultural issues involved.

Caution should be exercised against cost-cutting measures that may impede the optimal functioning of the firm e.g. technology investments, knowledge management, implementation support, trainees and junior resources.

### 2.6.3 Maximising PPFE

Maximising PPFE in a market that has no tolerance for rate increases requires firms in the short term to carefully manage realisation and in the medium to long term ensure a steady volume of work to keep utilisation high. At all times costs should be managed but without impacting the necessary long-term investments that enhance the delivery model.

### 2.7 Leverage +1

Leverage by definition is the ratio of fee earning staff to the number of equity partners at a firm. Leverage +1 takes into account that an equity partner is also a fee earner for the purposes of calculating PEP. The perceived value level of the work dictates the optimum leverage of any given firm or practice area transacted and the actual level of seniority required to deliver a quality product to the client. As the perceived value level of work decreases a firm should be able to deliver a quality product with less senior lawyer effort and more junior or non-lawyer effort.

From the point of view of profitability, a firm that has a low leverage ratio needs to be achieving and realising on high charge out rates to compensate for the significant time and effort required of senior lawyers to complete the work. A firm with high leverage, on the other hand, should be moving lower complexity work to junior fee earners who will be billed out at multiples of their salary cost to ensure margins are sustained. Leverage is only effective as an indicator of profitability if the fee earner population is made of a sufficient variety of fee earner levels and firms actually use the population as a pyramid.

Examples of ineffective leverage include:

- Firms boast significant leverage figures only to find out that the majority of
fee earners represent the fixed share partner population at the firm.

- Firms boast a good mix of senior, mid-level and junior associates but the reality on the ground is that all matters are staffed as one partner and one associate. The lack of experience of junior associates is compensated by additional partner time on the matter to which they are staffed.

### 2.7.1 Managing leverage

Leverage is often cited as the key to profitability but firms often overlook the difficulty in influencing this lever as a means to improve profitability.

Leverage for the sake of leverage will never work. In order for leverage to work it has to be managed. Firms with ‘managed leverage’ boast the following characteristics:

- The role of partners and senior lawyers is more managerial and supervisory than technical.
- Partners and senior lawyers are trained in people management skills.
- They have a junior fee earner resource base that can cope with the volume of work.
- They invest in training junior lawyers to ensure they can deliver work at the quality the client expects.
- They invest in streamlining processes and procedures to ensure that the level of risk is managed and the most efficient operating methods prevail.
- They invest in knowledge management to ensure that know-how is recycled to improve the quality of the deliverable and delivery times.
- They have performance-management systems that reward the behaviours that drive the performance levels required.
- A promotion model that services the leverage model.
- A continuous volume of profitable work.

### 2.7.2 The modern day leverage challenge

The client does not trust the leverage model

Clients expect that a leveraged piece of work is an expensive piece of work. The blame for this lies firmly with the law firms who have mis-managed the leverage model to the point where a leveraged piece of work often costs the client more and/or may have quality issues.

This culture of leverage mis-management has driven the current climate that sees corporate clients demanding only to have senior fee earners staffed to a matter to ensure they are getting the best value for their money. The problem for law firms is that unless the work is attracting high hourly charge out rates it is unsustainable in the long term. Until firms can convince their clients that they can provide quality at the right price they risk having to settle for lower margins on the work or deciding whether or not they can afford to continue operating in these markets.

Opportunities to gain market share are limited

Leverage requires an available volume of new work to keep the model flowing.
The challenge lies in the fact that many markets are already saturated and market share can only be gained at best by stealing it from others. The lack of a continuous flow of new work disrupts the partner promotion cycle that is necessary to prevent the leverage model from becoming top heavy in the senior lawyer ranks. Firms in this space are faced with the difficult decision of having to reduce partner numbers to keep leverage levels where they need to be.

**Adopting an effective leverage model takes time**

The greatest challenge for law firms is that creating a well-managed leverage structure is not easy to achieve in the short term. An effective leverage model requires:

- Investment in understanding how work is currently being performed and what needs to change to move that work to a lower-cost resource.
- Recruiting and training additional resources.
- Changing performance management and reward structures.
- A greater focus on BD.
- Training senior lawyers in people management skills.
- Investment in knowledge management and IT systems.

### 2.8 Not one size fits all

While there may be a formula for achieving profitability there is, however, no one-size-fits-all approach to how each of the levers should be applied in practice. Similar PEP figures can be achieved by applying the levers in different ways depending on the drivers of value at that end of the market (see Table 2.1, p14).

A higher PPFE due to higher realised rates will compensate for lower leverage (Firm A), while lower PPFE due to lower charge out rates will be compensated by a high leverage ratio (Firm B). Low PPFE due to low realised rates and low leverage result in low profits per partner and give rise to concern (Firm C).

### 2.9 The business model

#### 2.9.1 Aligning the business model

The problem with achieving desired profitability often lies in a misalignment between the strategic value focus of the work transacted and the business model required to deliver on it. Examples include:

- Core work requires heavy senior lawyer input but the group is top heavy with juniors; as a result, partners spend too much time fee earning and juniors are underutilised.
- Conversely, core work requires extensive junior input but the group is heavy on senior lawyers, so senior lawyers do junior-level work and write down rates, resulting in low realisation.
- High fee-earner costs coupled with low utilisation results in profits being eroded.

The strategic value focus of the firm will dictate how best to apply the levers of
profitability in practice (see Table 2.2, p15) and therefore inform the business model required. None of the levels can be ignored but some need to be managed more carefully than others relative to the strategic value proposition.

A pre-2008 firm achieved its PEP through an over reliance on high charge out rates and a steady stream of work from a booming market. High PPFE figures ensured that the leverage model was not exposed.

A firm with a BTC value focus will achieve its PEP by maximising PPFE through charging and realising higher than average rates per hour. The high overhead cost of having teams of highly-skilled lawyers of the caliber the client requires will require rates to remain high to maintain profitability. The work will be of such strategic value to the client that they will not tolerate a highly leveraged model.

Firms with a CYA focus will have to focus on a number of levers to achieve their PEP. Rates will be lower than the BTC level so higher utilisation and leverage is required to ensure profitability. It is a more difficult model to manage as the client still requires a significant amount of partner input and may be intolerant of too much leverage yet expect discounts on rates. It is one of the harder value segments to maintain from the point of view of profitability and one under threat from competitors attempting to steal market share.

Firms with an Operational value focus will have to focus a number of levers to ensure profitability. With rates under pressure and work that can lend itself to some element of standardisation but still requiring some senior lawyer input, a focus on balancing leverage while maintaining utilisation and rates is required.

A firm with a Commodity value focus will focus on the leverage lever as being...
the main driver of profitability for the firm. PPFE will be much lower, dictating the need for a higher multiple of fee earners to each equity partner. High utilisation and the use of technology are key to ensuring that profits are maximised.

### 2.10 Critical success factors

Business models are difficult to change in the short term but need to be aligned over the mid to long term if the firm is to have any chance of surviving and competing on price. Critical success factors will be to:

- Understand the client’s perception of value before arriving at the firm’s strategic value proposition.
- Understand the business model that aligns to the strategic value perception.
- Understand the level of change that needs to take place in existing practices.
- Get partner buy-in to the change.
- Invest in the infrastructure and personnel to make the business model work.
- Adapt performance measurement and reward strategies to align the organisation to the strategic value drivers.
- Lead from the top.

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