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# Finally, Time to Deal with Pricing

Back in 2008, we and other industry observers predicted that alternative fee arrangements would accelerate as the legal market dealt with decreased demand and price sensitivity brought on by the recession. We were only half right. Alternative fee arrangements have certainly become more common, and most firms have at least some experience with alternative arrangements, but they remain a relatively small part (15-20%) of the revenue of most firms.

While the application of alternative fee arrangements is gradually increasing, there is an argument to be made for accelerating the use of these arrangements and rethinking pricing altogether. Since the start of the recession, realization rates have dropped precipitously across the industry, from c. 93% to c. 82% relative to standard rates. This percentage point decline is magnified when you look at the impact on profitability – it can represent 20% to 30% of many firms' profit margins. In our work with firms we often look at the fee arrangements and resulting realization rates for clients and matters. It is not unusual for firms to have 80% of their revenue from fee agreements based on something other than standard hourly rates. Not surprisingly, this is dominated by discounted rates, but also includes rates held for two or three years, blended rates, not paying for certain categories of time, and of course write-downs of time. For many firms, as little as 20% of fees are based on current standard hourly rates.

The saving grace for law firms has been continued rate increases. While rate increases in recent years have been offset by heavier discounts, firms have been able to preserve profitability. Although this approach may make sense in the near term, there is an unintended consequence of rate increases - client dissatisfaction. Many clients are focused not only on billing rates but on the overall cost of legal services. They are demanding larger discounts but more importantly are rethinking litigation strategy, bringing more work in-house, looking for alternative ways to staff matters - including increased use of legal process outsourcers (LPOs) - and other strategies to reduce the overall legal budget of the company. There is strong sentiment among many general counsel that the cost of legal services has outstripped the value provided. This has resulted in fewer dollars/pounds/euros being spent on outside law firms. While a segment of the legal market has been able to preserve or even expand their market share, most firms have felt some impact of the shrinking demand for outside counsel services.

One strategy is to focus on only the highest-value, non-price sensitive legal services. Unfortunately, the percent of work going to outside counsel that falls into this category is very small and getting smaller. Even firms at the top of the market have at least some work that is price sensitive. As a result, there is a premium on figuring out how to change both the pricing and the approach to delivering an expanded range of legal services cost effectively. The firms who are able to get it right will have a competitive advantage.

Other professional services industries have already moved in this direction. Consulting, accounting, investment banking and medicine all provide major portions of services on a fixed, value or per procedure basis. While hourly rates will continue to be appropriate for some portion of law firm work, there is still significant room to rethink the approach to pricing legal services and better align pricing and services with client expectations of value.

## Where do we go from here?

Making progress in changing the pricing and delivery of legal services will require change within firms, some potentially significant. We have seen success when firms tackle the following:

***Provide support for lawyers.*** Firms providing support for lawyers to more effectively plan and manage matters are getting more traction than those who do not. This often includes pricing managers, pricing analysts and project management support. In some firms the director of pricing is a key C-level role. In fact, we have seen a number of instances where the director of pricing operates as a regular member of the pitch team, demonstrating to potential clients that the firm is serious about pricing and has the infrastructure to deliver on its promises. Support also comes in other forms: project planning, pricing, negotiations, project management and training all represent key resources lawyers need to effectively price and manage alternative fee arrangement matters.

***Implement matter profitability.*** In order to assess pricing options, as well as the success of matters, firms need to evaluate cost and profitability at the matter level. The measurement of matter costs is generally calculated based on hourly cost (not billing) rates for each individual or type of resource, factoring in direct costs such as salary and benefits and an allocation of all or a portion of overhead. The hourly cost rates can then be applied to the matter budgets and actuals to determine cost and profitability.

***Align partner compensation approach.*** Most firms value origination of business first and working attorney collections second, in determining partner compensation. Both of these factors are counter to the behavior required to encourage change in pricing and service delivery. In order to change partner behavior, firms need to measure and value the effective use of alternative pricing arrangements and the profitable staffing and management of matters. At a minimum, firms need to introduce profitability of work originated and managed as a key metric.

***Rethink staffing model.*** Firms are starting to use staff attorneys more effectively, but improvement is needed. Firms continue to struggle with defining staff attorney roles and identifying appropriate compensation levels. Staff attorneys paid and billed a notch below career track associates typically have a limited impact on the delivery of legal services relative to those paid and billed at a substantially lower rate, who can take on more routine tasks and lower the overall cost to the client. Firms are also using LPOs and contract attorneys to deliver cost effective legal services. All of these resources are starting to shift the traditional law firm model, and we expect that the appropriate model will vary from firm to firm depending on their practice and needs.

***Develop pricing models and tools.*** Investment in the development of advanced pricing models and tools will be essential to success. Those making inroads in this area have started by evaluating past experience. By looking at closed matters, firms can map the typical course of a specific type of matter, the tasks required to complete the matter, the firm's costs on the matter, profitability relative to cost, and the types of events that create meaningful variability in a matter's progression. This information helps lawyers and pricing professionals plan, price and manage matters more effectively. As firms expand their portfolio of pricing models and experiences, the models get more sophisticated. Firms are also beginning to provide more tools to support pricing and budgeting. These range from off-the-shelf solutions to custom tools.

***Invest in technology solutions.*** Over the long term, technology solutions will likely replace a portion of what lawyers do. In the short term, effective use of technology offers an opportunity to complement existing practices and augment firms' efforts to provide better value to clients. Leveraging new technology to avoid cannibalization over time will require firms to change internal processes and challenge assumptions, as well as embrace new external partners in the delivery of legal services. The challenge for leaders will be managing change and encouraging adoption.

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It would certainly be easier to hope that we don't need to make these changes, and that billable hours and hourly rates will continue to increase, but over the medium to long term that is unlikely to happen. It is time to start taking change more seriously. The firms who can innovate and get the foundation right now will be well positioned to succeed in the long term.

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