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An Economic and Demographic Case for Alternative Fee Agreements

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We have known for some time that the profession is aging. Until now the effect such aging could have on law firm revenues has been masked entirely by raising hourly billing rates well in excess of general inflationary pressures, rising costs of operations and the increased experience of its practitioners. Now we are in an envrionment where competitive and market forces will almost certainly alter the ability to raise hourly billing rates consistent with historic patterns. The time has come to embrace alternatives to hourly pricing.

Alternative fee agreements (AFAs) for the purposes of this article include pricing schemes that are not based on the billable hour. This excludes discounted and blended rate programs, even though they are techniques frequently used by the profession.

While much has been said about providing certainty to clients on legal bills and sharing risk to create a mutuality of interests, the bottom line is the mandate from clients that legal spending must be reduced. It is driven by economic necessity and "C suite" orders. Ignore this at your own risk. It is *the* top prioirty of general counsel according to a recent Association of Corporate Counsel (ACC) study.

To set the stage for the discussion let's quickly review how law firm partners make money. The practice of law is a revenue per timekeeper dominated activity which is the net yield of three factors — chargeable hours, hourly rate (time value) and realization (the percentage of time value collected). Further profitability comes from controlling margin and utilizing leverage. No law firm has been able to escape this very basic economic fact, unless it has expanded beyond professional service into some sort of ancillary business.

Let's look at how those metrics have changed over the years using data from the archives of the *Survey of Law Firm Economics* (an Incisive Legal Intelligence Survey). The data reflect averages of firms of all sizes, from all geographic regions, in urban and rural areas. The period 1985 (the earliest we have good data on all of the metrics) to 2008 includes times of economic expansion and contraction. See Table 1 on page 3.

These are profession data points. The largest firms have different values for each metric, but have experienced similar

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Table 1

	1985	2008
Rate – Partners	$128	$352
Rate – Associates	$82	$227
Realization	95%	88%
Hours – Partners	1,538	1,723
Hours – Associates	1,838	1,862
Leverage – Lawyers	0.78	1.27
Leverage – Paralegals	0.21	0.24
Leverage – Staff	1.00	0.87
Margin	43.6%	40.3%

changes over time. We can see from the above Table that rates are up and realization down (but not nearly so much as to significantly mitigate the power of rising rates). Partners are working many more chargeable hours (and many more marketing hours on top of that) while associates have slightly elevated hours.

Lawyer leverage is up, driven mostly over the last ten years by an explosion in non-equity partner positions. Additionally, with the turmoil in the marketplace over the last 18 months, the law firm pyramid is reshaping itself into a diamond, with its above-center bulge filled out with very senior associates and non-equity partners (all high-priced in both rate and compensation). Paralegal leverage is up slightly, and may be destined for even higher levels as first and second year associate billable hours drop. Staffing ratios have decreased as technology has taken a foothold in the profession (much more could and should be done with technology — but that is best left for another article and another day).

Finally, margin has decreased as the cost of people (including benefits), space, technology (including communications and collaboration tools in law firms that now routinely span the globe) have risen. But let's put these metrics into an indexed ranking and see where inflation falls relative to pricing/realization (see Table 2). Indexing simply reduces each metric to a ratio of the most current year (2008) to the base year (1985). It permits easy comparisons of different metrics and how each changes over time.

Table 2

	1985	2008	Index
Rate – Associates	$82	$227	277
Rate – Partners	$128	$352	275
CPI	110	212	193
Leverage – Lawyers	0.78	1.27	163
Leverage – Paralegals	0.21	0.24	114
Hours – Partners	1,538	1,723	112
Hours – Associates	1,838	1,862	101
Realization	95%	88%	93
Margin	43.6%	40.3%	92
Leverage – Staff	1.00	0.87	87

Now it should be apparent that revenue per timekeeper (the most influential factor in profitability) has improved primarily due to pricing increases (even net of realization decreases) well in excess of inflation, assisted by a solid boost in hours billed at the partner level.

This brings us to the economic case for AFAs. Eighty percent of respondents in a recent study by the ACC indicated that reducing outside counsel legal spending is their top concern, the first time in three years that this was the case. Some may argue that such a reduction can be accomplished by bringing more work in-house and forgoing some work altogether. It seems doubtful, however, that significant and sustainable gains will be made in this way. Instead, it is more likely that clients will make a concerted effort to get more work from outside counsel at a given price (efficiency gains) or obtain absolute price reductions.

Also in the ACC study, in-house counsel "predict" (some might say have just signaled their position) that outside counsel billing rates will not increase for 2010 — the first time in the nine years this study has been conducted. If the ACC "prediction" proves true, what will the next decade look like? If law firms forgo even one year of pricing increases, that increase is likely gone for good, as is the compound effect of that increase going forward.

Billing rate increases are generated from additional experience and value as well as inflation. Chart A illustrates the profession's experience/value curve in pricing. It tracks lawyer billing rates by years of experience.

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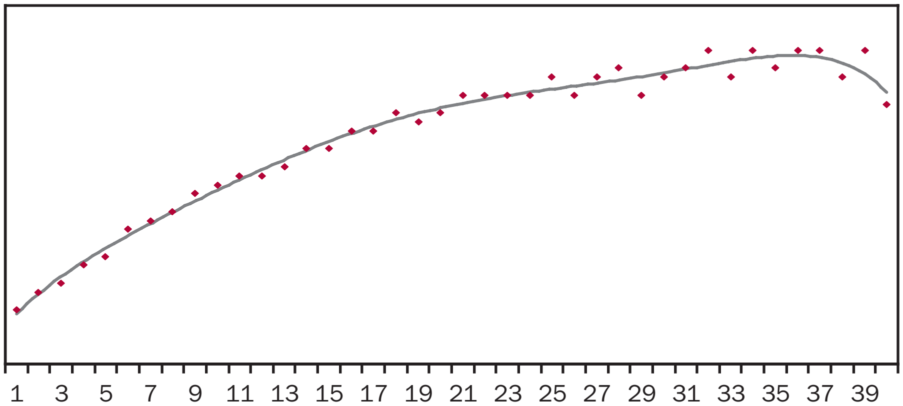
Chart A
Hourly Rate Profile — By years of experience



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As Chart A demonstrates, there is a modest, gently upward sloping value curve until very late in a lawyer's career. At that point many in the profession are backing away from the practice of law for a variety of reasons. This generally upward curve's effect on revenues, however, is mitigated by the profile of chargeable hours based on years of experience. Chart B demonstrates that the highest number of chargeable hours typically comes in the sixth to seventh year. From that point hours recorded follow a downward trend. Certainly partner hours today are higher than they were two decades ago, but there still remains a decline in partner hours as partners age. This does not play well in a profession that is aging and presents a demographic argument to abandon hourly billing.

Revenue continues to grow over a career because of rate increases, as is seen in Chart C. And that reflects only the experience/value portion of the rate increases.

But what if rates don't go up, only go up a little or even decline? Remember what the general counsel indicated about reducing (not restraining the growth of) payments for outside counsel. The easiest way to do that is to mandate discounts — rate reductions in a more palatable form. What might a new rate curve look like? It may very well show absolute reductions across the board and more severe reductions as experience decreases. We already are aware of clients pushing back on the use of first and second year lawyers because of the cost versus the value.

We do not see a good end game as long as law firm revenues are premised on hourly rates and hourly billing. Clearly lawyers need to improve efficiency in delivering services to clients. But the benfeit of those efficiencies under the current structure are likely to enure mainly, if not entirely, to the client.

The answer is to change to fee structures that allow the provider to retain those additional efficiencies. This is the heart of AFAs — discerning a means to charge for services that is not time based so that efficiencies in delivering those services can be captured by the service provider. Clients will still bargain hard to achieve their top priority of reduced spending, and law firms will need to re-engineer how they do the work, but if done right, the benefits can accrue to those firms.

Therefore, AFAs must alter the focus from rates and hours to something else. That something else can be an agreed upon fixed fee or results. Either will move the conversation away from the time to do the work to the client's perception of the value of the work.

Fixed fees generally work best on matters where the process and outcomes are generally well known in advance, are subject to minimal variation from matter to matter, and where there are a significant quantity of matters to handle. Result pricing is evident in contingency or percentage fees — the lawyer's compensation is directly tied to the result obtained for the client.

Each approach has different risk and return characteristics. And each has an infinite number of permutations, limited only by creativity. For example, many years ago a law firm

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Chart B
Chargeable Hours Profile — By years of experience

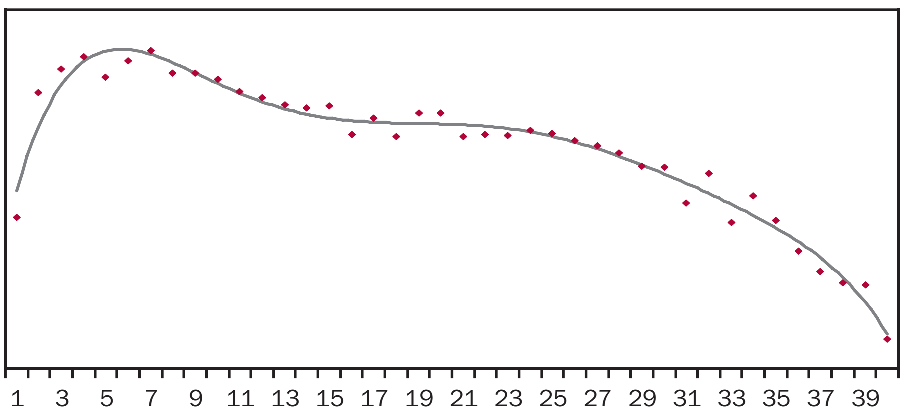
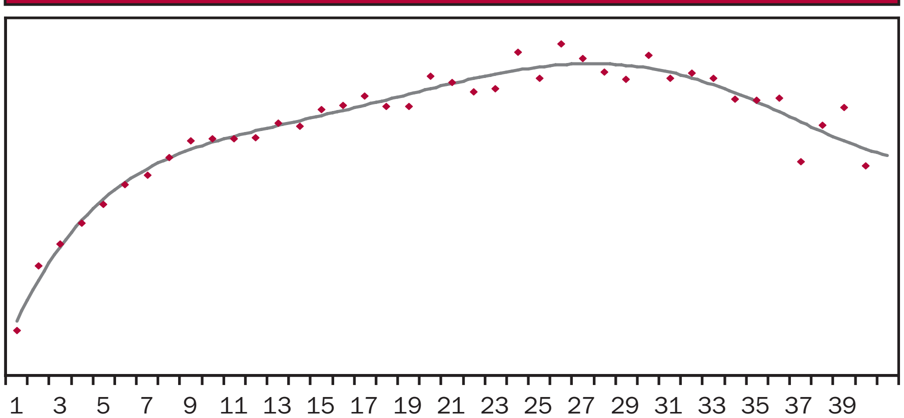


Chart C
Time Value Profile — By years of experience



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partner had an epiphany when looking to capture a larger share of a key client's work. This partner understood the client's business model and what levers applied to a successful venture. The client was a developer. The partner offered a fixed price per square foot to cover legal work from project inception to completion. It was well received because the key lever for this client was cost per square foot. The pricing worked for both sides. The client had certainty with respect to legal costs in a way that aligned with how the ventures were assembled. The partner had a significant portfolio of projects, mostly large, that would keep the team busy and generate ample fees.

Some law firms are investing time to examine their legal services delivery model to identify and reduce inefficiencies and waste. Using project management techniques, the same sort of principles used in other business functions and in other industries, law firms can reduce variation in the delivery of standard legal services, and learn to better forecast the costs and time needed for the many non-standard legal services.

Of course, many lawyers believe that their particular practice consists entirely of non-routine elements which are impossible to predict and which contain too many variables, making reasonable prediction impossible. These lawyers are often surprised to learn that the art of practicing law contains no more uncertainty or variability than other complex business processes, such as designing and constructing a building over multiple years with multiple suppliers, vendors and materials. A consistent approach to project management techniques provides a greater level of certainty over many variables, and provides a framework to deal with the unknown. Furthermore, lawyers who embrace project management techniques are learning to speak the language of business. This will assist them to serve as more capable advisors to business clients.

Law firms should take the intiative to alter the discussion from time to value. Do it now because the aging lawyer population is on a downward hours path and faces a severely limited pricing environment. ◆

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