Ward Bower

> ***"…specialty is the most significant factor influencing market pricing for legal services …"***

Pricing Legal Services

By Ward Bower

Billing for legal services is an art, whereas pricing is more of a science. The art of billing includes bill timing, format, presentation and follow-up, in accordance with client desires, preferences and expectations. Pricing legal services, hourly or by some alternative means, requires disciplined consideration of the micro-economics of law practice, of a firm's competitive marketplace position and strategic direction, and of client perceptions of value.

Setting Hourly Rates

The minimum hourly rate at which any lawyer's time can be billed can be determined empirically from a firm's income and expense budget and management reports relating to realization, including AR write-offs, billing discounts and collections.

A formula can be used to compute a minimum hourly rate: B = T ÷ (R x U), where

B = minimum hourly billing rate
T = target revenues for the lawyer
R = realization on that lawyer's time
U = expected lawyer utilization

Targeted revenues (T) for each lawyer can either be taken from the firm's income budget or can be computed from another formula, which involves a different computation for partners and associates. For a partner, T is the sum of per-lawyer overhead and "base" compensation (draw or salary), plus benefits. For each associate, T is per-lawyer overhead plus salary and benefits plus the desired profit margin (usually 20% to 30%), or the sum of compensation, benefits and overhead times 120% to 130%. For a partner drawing $300,000 with a 20% benefit load in a firm with a typical per-lawyer overhead of $140,000, T would be $500,000 ($300,000 + $60,000 + $140,000). For a $150,000 associate, in the same firm with the same benefit load, T would be $320,000 ($150,000 + $30,000 + $140,000).

R (realization) can be computed historically for each lawyer as gross fee collections (on a "working lawyer" basis — fees collected for the billable hours recorded by that lawyer) divided by the "standard value" of that lawyer's time recorded — hours times billing rate. The difference between these two figures represents either premium on work done by that lawyer or time written off at the time of billing, reduced rates (discounts) or fees billed but written off or uncollected. For most law firms, firm-wide realization is about 90%. For individual lawyers that number varies, greatly. The impact of R in setting billing rates can be substantial—at a typical partner T level of $500,000 and U of 1,800, the difference between 85% and 95% realization on hourly rates required to meet the target (T) is $40. ($330 vs. $290).

Examples 1 and 2, on page 5, demonstrate operation of the formula. The rates shown (B) are *minimums* necessary for this firm to achieve its desired level of profit. To the extent average hourly yields on these lawyers are less, or hours less, the firm's targeted revenues and profits will be reduced. If client perceptions of value received will not support these rates, discounts or write-offs will reduce partner earnings, or the firm may not want or may not be able to serve that client.

This computation of the minimum hourly rate is only the first step in the process of rate-setting. The remaining step is to position lawyer hourly rates in the external marketplace.

Market Pricing

Pricing data on lawyer billing rates for benchmarking purposes is sparse and some of that data is suspect. The most comprehensive source of hourly rate data compiled and presented in a statistically reliable format is the annual Altman Weil *Survey of Law Firm Economics.* Data are broken out by lawyer experience, specialty, firm size, lawyer position, geography and community population.

Where a lawyer's rate should be positioned in relation to the marketplace depends on client willingness and ability to pay and the desired strategic position in the market. If the firm's strategy is to compete on the basis of price, rates

Example 1

Associate Hourly Rate Computation

Assume	Associate A	Associate B	Associate C
Compensation	$100,000	$150,000	$70,000
Per lawyer overhead	$140,000	$140,000	$140,000
Benefits (20% of compensation)	$20,000	$30,000	$14,000
Desired profit (A+B+Cx25%)	$65,000	$80,000	$56,000
Historical R	90%	90%	90%
Expected U	1,800	1,800	1,800
B (minimum hourly rate)	$201	$247	$173

Example 2

Partner Hourly Rate Computation

Assume	Partner A	Partner B
Draw/salary	$300,000	$500,000
Per lawyer overhead	$140,000	$140,000
Benefits (15%)	$45,000	$75,000
Historical R	90%	90%
Expected U	1,700	1,700
B (minimum hourly rate)	$317	$467

would be lower than if the strategy is to compete on value — quality, expertise or depth in specialty.

Market Variables

Data clearly show that specialty is the most significant factor influencing market pricing for legal services, followed by experience/seniority. Following are the relative influences of variable factors on hourly rates, nationwide, in decreasing order of importance:

Chart A

Impact of Variables on Hourly Rates—2003[1]

(spread between median rate for top/bottom in each category)

Specialty	96%
Experience	79%
Firm Size	58%
Position (partner, associate)	47%
Community Population	40%
Geographic Region	40%

As shown in Chart B, the differential between senior partner and mid-level associate rates are decreasing.

Chart B

Ratio—Senior Partner (25 Years +) to Mid-Level Associate Rates[2]
1985 to 2003

1985	1.56 to 1
2003	1.49 to 1

Ultimately the client will determine the price by what he or she is willing to pay. Clients will pay most for "bet the corporation" type work (hostile takeovers, big ticket litigation) and least for commodity work that they believe any law firm should be able to do. In between are important specialized services that do not rise to "bet the corporation" level.

Strategic Implications of Pricing

Price positioning in the marketplace will influence the strategic direction of the firm in terms of practice mix, targeted market segments, geography, recruiting, and leverage. It will also influence salaries and overhead. Obviously a firm competing on price in a commodity practice, like insurance defense, cannot afford the same overhead or salaries as a Wall Street corporate finance practice. Some multiple-specialty firms have found that the client-induced rate pressures they face in a discrete practice area or for a particular client often result in hourly rates less than the calculated minimums necessary for the firm to meet its budget. In that case the firm needs either to change its economic model and expectations or divest or redirect the lawyers in that practice toward higher-valued work or different clients.

One final factor influencing hourly rates, emerging as the legal market matures, is brand name recognition. A study conducted in the mid-1990s in the UK demonstrated that brand name recognition in professional service businesses is worth a 10% to 20% premium in hourly rates. The 2001 joint Altman Weil/American Corporate Counsel Association *Chief Legal Officer Survey* found 54% of CLOs were influenced by branding in law firm selection. Generally, brand name recognition attaches to the largest firms in a marketplace, although it can be created for smaller firms through effective marketing.

Alternative Pricing

In recent years, law firm pricing has migrated away from hourly rates to alternatives that include fixed or flat fees, percentage and contingency fees. This movement is driven by law firms as clients increase their efforts to obtain hourly rate discounts and apply greater scrutiny to bills, questioning both hours billed and staffing (numbers and levels of lawyers). In this environment, hourly billers face ever-increasing pressures that actually penalize firms for efficiency. Although this article will focus on one example of alternative pricing—fixed or flat fees—the principles apply to contingent, percentage and other alternatives, as well.

Fixed/Flat Fees

Increasingly more popular in recent years, the fixed or flat fee can

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create a win/win situation for the client and the law firm. Clients enjoy the certainty of the total fee and the ability to compare law firms on the more meaningful basis of their total cost, as compared to only one element of that total cost (hourly rate). The law firm can budget its revenues more accurately and can even increase its profits through improved efficiency, process reengineering, cost reduction and substituting capital (technology) for labor. Cash flow can be improved by requiring payment up front or on a schedule.

Law firms frequently resist flat fee pricing on the basis that every case is unique and therefore fees can't be estimated, let alone set prospectively. Admittedly, that is the case sometimes, even most times. But that is not a reason to reject pricing on a flat fee basis, so long as the firm is protected against the matter that unexpectedly requires an unforeseen, major commitment of resources.

There are two methods of setting flat legal fees — prospective and retrospective. Both may — and should — be used together. The prospective method involves matter budgeting based on minimum hourly rates set by the rate formula outlined earlier in this article, adjusted to reflect market strategy and estimates of time involved in each step or phase of the matter.

The retrospective method involves identification of prior matters similar to the instant engagement, resurrecting past billing records to determine the range of resources required to handle similar matters, and setting the fee in relation to that experience. Client fee agreements can be negotiated that provide protection against "the case from Hell" which consumes unexpected levels of time and expense.

It is not necessary for every flat fee (or other pricing alternative) to meet or exceed what would have been the hourly fee, or even to be profitable. What *does* matter, however, is for flat fees *in the aggregate* to be sufficiently profitable. That will occur if matter management concentrates on efficiency, early resolution or disposition of cases and matters, and delegation to the lowest competent level.

Implementation

Law firm management should examine its pricing policies in terms of economics (the rate formula), price positioning in its legal market, strategic alignment with firm goals, client willingness and ability to pay, and commitment to alternative pricing. All firms should conduct this evaluation, and should do so sooner rather than later. ◆

1 Computed from 2003 Altman Weil *Survey of Law Firm Economics*, Altman Weil Publications, Inc., Newtown Square, PA.

2 Ibid.

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