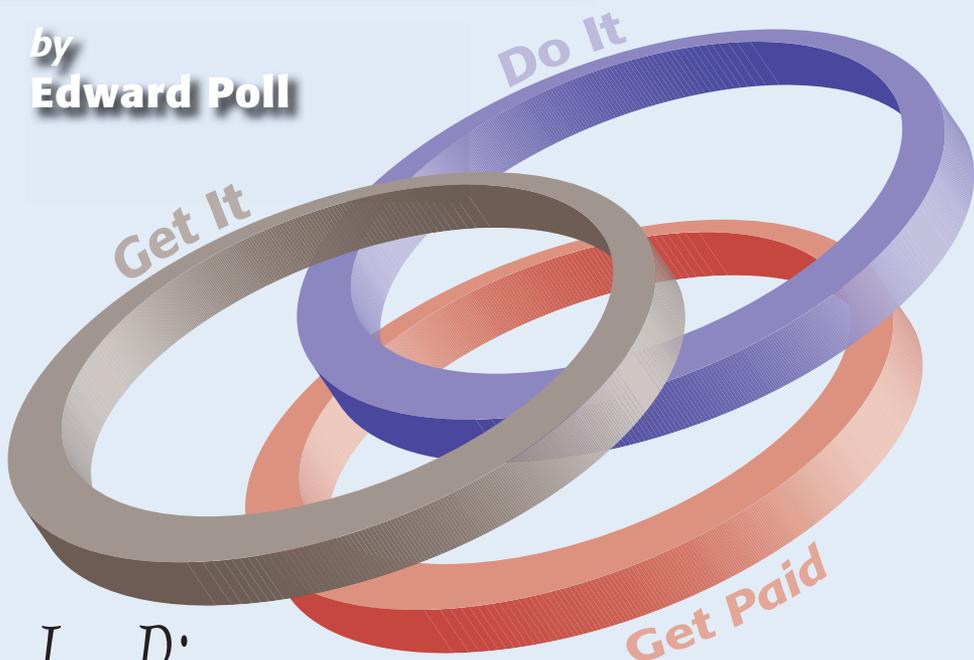


Law Firm Fees & Compensation: Value & Growth Dynamics

A LawBiz® Management
Special Report

by
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Section 1:

Cost Versus Value: The Rise of the Hourly Rate



Historically, until well into the post-World War II era, legal fees were based primarily on the nature of the service provided, the results achieved, and the amount at stake.

Determining an appropriate fee for the work was a matter of professional judgment.

That changed in the mid-1960s when clients began demanding detailed billing statements

and lawyers implemented timekeeping records as a management tool to seek greater efficiencies. As a result, today most lawyers are paid by the hour—almost in the same way as an hourly laborer. When lawyers are paid by the number of hours worked, though, self-interest can and often does affect their judgment about how much work to do for the client. Most lawyers’ billings are “features” lists: This is what I did, this is the amount of time it took to do it, and this is what you owe me. That approach breeds dissatisfaction among clients because it doesn’t address value and benefits—the worth to the client, as opposed to the cost of the service.

Negative Impacts of Hourly Rates

There are two fundamental considerations involved in evaluating the ways in which professional services can, and should, be billed:

- ▶ Any billing method that does not depend exclusively on time spent as a measure of value provides an incentive for efficiency and early resolution of the matter being handled.
- ▶ The value of legal services and the quality of those services, both as perceived by the client, are the defining characteristics of effective billing. From the viewpoint of clients, they are buying favorable solutions, results, and benefits—not time.

These two factors explain why the successful law firm of the future will *not* use straight hourly rates to bill for its services.

In fact, studies and surveys have already exhaustively demonstrated that clients, especially business clients, are fundamentally rejecting hourly rates as a valid billing gauge for legal services, with that rejection centering on eight key concerns:

- ▶ Perceived abuse in terms of overbilling
- ▶ Lack of predictability in the overall costs of the matter
- ▶ Lack of control over the factors involved in setting the bill
- ▶ Discouragement of efficiency
- ▶ Discouragement of value-added services
- ▶ Disconnect with technological efficiencies
- ▶ Inequality in hours spent delivering the same services
- ▶ Discouragement of risk and benefit sharing

The sum of these objections is that hourly rates reflect neither (1) the actual costs that go into the provision of legal services nor (2) the value that clients perceive in those services.

The hourly rate is also the focal point of other pernicious effects on The Business of Law®. Take, for example, its impact on four areas: client communication, firm governance, lawyer succession, and, ironically, firm financial performance.

Let's consider each of these four areas in turn.

Client Communication

Lawyers who are intent on piling up billable hours tend to focus on the task at hand without communicating to the client exactly what work they are doing. Such lawyers may be doing a great job dealing with documents, the court, and the opposing party, but because the client doesn't hear about these things, the lawyer fails to build up the client's confidence and trust. So ultimately, no matter how successful the end result is, the client doesn't understand what has been accomplished and may even refuse to pay the bill when it comes due. Clients appreciate communication—and the more, the better. But when client communication is just another itemized function charged by the hour, both lawyer and client lose focus on the real intent—which is building a relationship, not creating a new charge.

Firm Governance

Many states require that partners and other lawyers with managerial authority in a law firm must take reasonable measures to ensure that all lawyers in the firm conform to the Rules of Professional Conduct. (See, e.g., Rule 5.1 of the ABA Model Rules of Professional Conduct.) Some states either provide for or are considering providing that lawyers who have managerial responsibility within a firm are *personally* responsible when others in the firm violate the rules or are negligent in their performance of legal services. This is a heavy burden that many lawyers fail to attend to because they incline toward focusing only on rainmaking and their own billable hours. This leaves a lot of room for error by others who are essentially

The Defining Characteristics of Effective Billing:

- The value of legal services as perceived by the client
 - The quality of those services as perceived by the client
-

going unsupervised, thus increasing the risks of personal responsibility for lawyers with managerial authority over negligent colleagues.

Lawyer Succession

In many law firms, the older partners run the “business” side of the practice while the younger lawyers tend to be the followers. Because law firm compensation is generally based on hourly billing output, senior partners may not want to share information about clients or prospects with a next-generation lawyer, owing to fear the younger lawyer might “steal” business before the first lawyer is ready to step away from active practice. This creates a problem of client service continuity as older lawyers retire.

Financial Performance

Lawyers often think that financial success means ever-rising billable hours. The truth is that a lawyer’s inventory is not billable (or billed) hours—instead, it is the cash those hours represent. Uncollected billables are a financial liability that, at worst, can sink a firm.

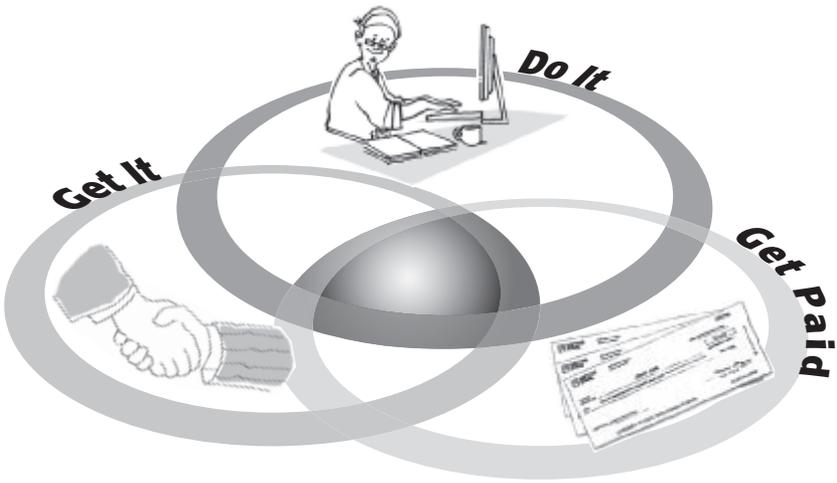
More than one law firm has been forced to file for bankruptcy even though it had substantial sums in outstanding accounts receivable. Had these firms been more diligent and aggressive in collecting the money owed for outstanding billed and unbilled work-in-progress (WIP) hours, they could have remained alive.

An Integrated Approach: The Three-Point Intersect

Law firms mirror their clients in business terms. To the extent that law firms provide the services their clients need, at a price the clients are willing to pay, firms will grow. Otherwise, they will be challenged to stay in business.

Every law firm is a business. And every business has three common elements: Get the work (sales); do the work (production); and get paid (finance). Where these three elements intersect for lawyers is what I call the location of The 3-Dimensional Lawyer™. When this intersection is achieved, the lawyer's practice, and therefore the lawyer, is in balance—in harmony. With effective communications between lawyer and client, it is in this balanced state that the client is well served and truly values the lawyer's efforts; the lawyer both enjoys the client and is challenged by the matter; and the client promptly pays the bill.

To achieve this balance, lawyers need to understand their own business operations better than they typically do. This understanding centers on the interaction between what law firms charge clients for their services, how effectively they collect their



The 3-Dimensional Lawyer™

fees from clients, and how lawyers themselves are compensated for the work they bill. The goal of this understanding should be to create an effective way of measuring, billing, and collecting the value of services provided.

Ensuring any firm's business success requires taking an integrated approach to the issues of fees, billing, collection, and compensation. This LawBiz® Special Report outlines the basics of such an approach. The key elements include:

- ▶ A written engagement letter that sets forth the clients' obligations and responsibilities, including the paying of their bills

Clients appreciate communication—and the more, the better. But when client communication is just another itemized function charged by the hour, both lawyer and client lose focus on the real intent—which is building a relationship, not creating a new charge.

- ▶ A budget for events, time, and money so that clients are not surprised by what is billed but instead buy into and accept it
- ▶ Billing methods that are easy to understand and clearly list actions taken on the client's behalf while relating the actions to the time it took to realize value, making the bill more meaningful to the client
- ▶ Clear delineation of value realized by the client
- ▶ Frequent communication to ensure that an actual or perceived problem does not result in a client deciding not to pay a bill
- ▶ Collection processes that create a formal system to secure client payment without delay or contention
- ▶ Compensation systems that recognize the contribution of the individual lawyer as well as the best business interests of the firm as a whole

The Ultimate Objective

Our objective as lawyers is to help people's lives improve. In the course of fulfilling that objective, we should provide and account for our services in such a way that clients understand the value as well as the cost of what we do. When that happens, fees are not an issue and client complaints do not occur. When that doesn't happen, lawyers are at best seen as a necessary but expensive evil.

The goal of this LawBiz® publication is to help lawyers and law firms run their practices in a more businesslike way that will improve the professionalism of the practice of law. The purpose is not simply to get more money for the lawyer; it is also to benefit the client. A profitable practice is much more likely to avoid ethical problems such as dipping into client trust accounts, either as direct fraud or as a stopgap "loan." Moreover, a law firm run as a business will also approach client service more efficiently—returning phone calls promptly, creating and adhering to a budget, providing sufficient details on clients' invoices, and effectively providing and conveying value. That, ultimately, is the true meaning of The Business of Law®.