The Client Cost Conundrum: Legal Service Pricing in a Post-Recession Market

Legal Service Pricing in a Post-Recession Market

Executive Summary

Pricing can have an overwhelming effect on law firm profitability, yet some firms neglect to consider key factors that can affect what work will actually cost – and what clients will pay for it.

Experts suggest basing a firm's pricing strategy – whether it involves hourly billing, flat fee charges, discounts or another approach – on several elements, ranging from internal cost to market conditions.

This white paper will identify economic factors that influenced relationship changes between clients and law firms after the Great Recession; pinpoint current legal service pricing best practices; highlight pricing strategies that can attract and retain clients; and help law firms learn to address efficiency and other factors that may affect many pricing scenarios.

Industry Reaction

Pricing in the legal industry has undergone changes in select markets since the 2007-2009 Great Recession.[1]

The U.S. economy's slow recovery took a toll on a number of industries, including law. As consumer spending lagged and output grew at less than half the average rate experienced during other recoveries[2], many firms found clients had less to spend on legal needs.

In 2009, demand for law firm services declined at a rate of 5.1 percent; it has since varied from flat to slightly negative. From 2010 to 2013, the growth in demand for legal services totaled less than half of the industry's pre-2008 levels[3].

"The recession didn't change lawyers' ability to provide legal services, nor did it cause clients to think any less of lawyers' abilities," says Patrick Johansen, CLM, CPP, National Practice Manager at 850-attorney firm Seyfarth Shaw. "What happened was this pushback by the client to say, 'I have to make cuts somewhere.'"

Industry members reacted in the following ways.

Clients

Although in-house counsel, in particular, had previously paid attention to cost, the recession likely intensified pricing concerns, according to Amar Sarwal, the Association of Corporate Counsel's Vice President and Chief Legal Strategist.

"The recession was really a big trigger for outside counsel [to examine how they deliver services]," Sarwal says. "At that point, a lot of the flexibility was gone for companies. They just didn't have the money to pay outside counsel."

In response to cost concerns, various companies, Sarwal says, told inside counsel to supervise hourly bills more closely. Some tried to estimate upcoming legal costs and also asked law firms to determine what they anticipated spending on items such as expert witness costs – and then compared the results.

“They’re looking at a unit cost level, as opposed to an aggregate level, to get a bit more budget control,” he says. “Inside counsel rely heavily on outside lawyers to price matters.”

Some organizations also urged legal service providers to give them a price reduction. Sixty-eight percent of law departments say they received discounts from firms in 2015. The number of law departments that received a discount of more than 10 percent has increased 4 percent in the past two years; the amount of firms receiving a 6 to 10 percent discount grew by nearly 9 percent.[4]

“With billable hours, [inside counsel] want to go back to their chief financial officer and say, ‘I got a discount,’ and everybody’s happy,” Sarwal says. “No one is really paying rack rates.”

Jasper Consulting Director Colin Jasper, a former Program Director at the Australian Graduate School of Management’s business-to-business pricing program, says a number of firms were reluctant to say no to post-recession discount requests because they feared they’d lose work.

“Many firms were trying to hold onto what they had and were much more willing to make deals with clients,” Jasper says. “That changed the relationship.”

The use of alternative fee arrangements (AFAs) has also increased since the recession – from about 5 percent of total revenue at the world’s largest firms in 2008-2009 to around 22 percent in 2015.[5]

Because clients who are concerned about potentially high legal costs may perceive AFAs as offering more certainty than a billable hours estimate, Suffolk University Law School Institute on Law Practice Technology and Innovation Director Andrew Perlman expects their use to increase over time.

“It makes the cost more transparent,” he says. “With billable hours, you know exactly how much you’re paying for each hour of work, but the big variability is how many hours lawyers are going to spend on projects, and that can change tremendously.”

More than half – 56 percent – of corporate counsel say they currently use AFAs, and 88 percent of legal departments and 92 percent of law firms believe they’ll remain a permanent part of legal billing.[6]

AFAs can often be successfully utilized in practice areas that involve systemized legal services; as Perlman says, with fewer variables, firms may be able to gauge a degree of predictability in regard to outcomes, helping to price matters accurately. Seventy-seven percent of firms who are proactive in their use of AFA report it can be as or more profitable than hourly billing.[7]

Law Firms

As clients dealt with tighter post-recession budgets, some, according to Perlman, opted to use nontrade service providers, such as legal process outsourcers (LPOs), or bring work in-house, indicating they may not be happy with outside counsels' efficiency.

In some instances, firms responded by proactively finding ways to strengthen internal processes and gather metrics that showcase the value they provide clients.

"You'd think the change had been driven mostly by clients, and to some extent, it is," Perlman says. "But it's not always in the way you'd expect. Some firms see the trend and are responding with greater technology use."

Perlman has seen an increase in data analysis – by both law firms and their clients – to better price and determine the value of legal services.

AFAs pose a particular risk of loss if firms haven't calculated all involved costs correctly. After examining the actual time and staff involved in each type of transaction, firms may find they need to fix any efficiency gaps to increase productivity and output.

"People feel like they can't raise their rates," says Barron Henley, Partner at Affinity Consulting Group, a law firm efficiency and software consultancy. "So they're starting to look at what they can do internally to be more efficient to maintain or increase profitability."

A firm Affinity worked with in Los Angeles, after considerable analysis of its flat fee/transactional practices, had decided it needed to shut down the practice because it wasn't profitable enough. The firm's estate planning department was investing 10 hours in each plan, which it charged $2,000 to complete, resulting in an effective hourly rate of $200.

However, implementing several process improvements, including utilizing an automated document assembly tool, allowed the firm to reduce its 10-hour time investment to just 1.5 hours per estate plan, producing an effective hourly rate of more than $1,000 an hour.

"Reductions can be that dramatic," Henley says.

Business Partners

Technological innovations have helped change the legal field in recent years[8], particularly through the use of technological tools that can help reduce inefficiencies and drive down the cost of legal services.[9]

The introduction and adaptation of new software and technological systems offered by a variety of vendors has helped many firms monitor and/or improve key process areas.[9,10]

Document assembly tools, for example, and time-tracking systems that produce a daily itinerary to help attorneys account for each action can help firms reduce and more accurately estimate the time they spend on various matters.

Some in-house legal departments also employ technological tools to gain insight into certain processes, such as e-discovery. Just 28 percent of inside counsel feel their outside counsel is providing enough information about this process.[11]

Meanwhile, 96 percent of corporate in-house legal departments use metrics and reporting to enhance legal operations; some use the information to negotiate rates and bills with outside firms.[12] Furthermore, more than 64 percent of firms are currently developing data on the cost of their services.[13]

Additionally, attorneys have identified emerging technologies as the factor expected to have the biggest impact on the practice of law in the next five years.[14]

Sarwal anticipates more professionals from outside of the legal industry will enter the market in the coming years, either with pricing-related technology offerings or other outsourced process assistance.

“It’s definitely going to happen,” he says. “The question is when.”

Pricing Your Practice

On a global scale, the majority of companies in the medical device, pharma, telecom and network, consumer business, technology, automotive, machinery and parts, and process industries use a defined pricing strategy. Just 2 percent do not.[15]

Some industries employ multiple pricing strategies. More than half of retailers, for example, use more than 10 strategies. Discounts, which 97 percent of retailers use, are the most popular.[16]

A significant number of companies view pricing strategies as a key profitability component. Forty-three percent report structuring their pricing more effectively was their first- or second-choice strategy to increase profit margins.[17]

Typically, several factors are considered when determining an organization’s pricing. Premiums in the insurance industry, for example, are a function of estimates for all potential costs that could occur – ranging from the actual expense of repairing a vehicle to the cost of a legal defense in the event a policyholder is sued, says Robert P. Hartwig, Ph.D., CPCU, President and Economist at the Insurance Information Institute.

Historical claims data and future projections are typically part of the pricing equation.

“Actuaries calculate the price of the insurance policy based on estimated risk and operating costs,” says Philipp Biermann, Partner and Professional Services Industry Pricing Expert at management consulting firm Simon-Kucher & Partners. “Consequently, customers' willingness to pay and considerations about the optimal price still play only a subordinated role, and profit potential remains untapped.”

Using increasingly advanced analytics, insurers can now factor in additional elements.

“The way insurance companies will estimate cost and, ultimately, the price of their products in the future has changed, based on the explosion of available data and the ability to analyze it,” Hartwig says.

Big data should continue to play an important role in the insurance industry in the coming years, says Biermann.

“As assurers store more and more socioeconomic client data about specific characteristics, [such as] hours of sport during a week, level of education, etc., the more precise their actuarial pricing will become,” he says.

Although pricing may differ per matter type or client,[18,19] law firms, too, may benefit from implementing a defined pricing strategy. Profits per equity partner increased at three-fourths of firms that changed their strategic approach to pricing in 2014. [20]

The following preparation and planning steps can help firms arrive at a cost-effective price.

Find Out What Clients Want

In an effort to strengthen client relationships, some law firms are working to better understand their clients’ needs. Approximately 29 percent of firms say they’re working to identify each client’s unique pricing preferences to support the firm’s overall pricing strategy.[21]

To better comprehend what clients want, 85 percent are initiating direct conversations about pricing and budgets.[22] Nearly three-fourths of firms are participating in client industry groups and events. [23] Thirty percent have a formal client survey program to obtain feedback; 24 percent undergo post-matter reviews. [24]

Some firms have taken steps to learn about important aspects of their clients’ business. Twenty-two percent of firm leaders say they thoroughly understand their top 20 clients’ business models, earnings and growth strategy; 29 percent of firms say their knowledge of their clients’ business and client relationships give them a key competitive advantage.[25]

Surveys, reviews and other interactions can provide valuable insight into what goals and practices resonate with clients. However, if, like 44 percent of firms, you do not have a systematic program in place to track client loyalty and satisfaction, implementing one may help identify additional areas to improve.[26] Almost half of firms surveyed (45 percent) measure their program’s effectiveness annually. [27]

Some, like Minnesota-based law firm Knutson+Casey, have also begun sharing tools that originally had internal applications with potential clients to help them understand the pricing process.

Knutson+Casey’s personal injury practice group offers a settlement calculator on the firm's website to give clients an idea what their claim may be worth. The calculator is based on a formula partner Randy Knutson had developed for his own personal use to value cases during his more than two decades in the legal industry.

Visitors key in various statements, such as the amount of wages they've lost, to come up with a total. The firm's calculator estimates pain and suffering compensation, an element that can vary in personal injury cases, will be roughly 1.5 times a client's medical bills, according to Brand Manager Corey Alverson.

By bringing potential personal injury clients to the site, in addition to providing information, publicly shared settlement calculators can function as a marketing tool for a law firm.

"The amount of personal injury calculators out there has definitely increased – that goes along with the increase in attorney websites in general in the Internet age," Alverson says. "Firms that are trying to rank better SEO-wise [search engine optimization] are adding content they feel will help potential clients."

Increase Internal Efficiency

Pricing, according to Corcoran Consulting Group's Timothy Corcoran, a law firm profitability consultant and former Legal Marketing Association president, should take efficiency into account.

"You can't just lower your price," Corcoran says. "You also have to look at how you deliver services."

Overstaffing, in particular, can have a significant effect on profitability. Sixty-one percent of firms say overcapacity is diluting their firm's profitability.[28]

"Law firms are like the grocery store with all the cashiers working at 2 a.m. on a Saturday," Corcoran says. "One of the challenges firms have is that they are, by design, supposed to have the capacity ready for when the client calls."

Basing hiring decisions on anticipated future work needs instead can help firms avoid adding excess attorneys – and potentially enhance revenue. Seventy-seven percent of firms that changed their approach to attorney staffing reported an increase in profits per equity partner from 2013 to 2014.[29]

Charting processes can help firms identify areas where they can streamline operations to increase efficiency, Henley says.

The assessment process can be a sobering experience for firms that determine pricing by multiplying their desired hourly rate by the amount of time work will take. The system does not provide an accurate price, Henley says, because it doesn't account for the support staff and steps involved in handling a matter.

"When firms tell us what they want to make per hour, we say, 'OK, what is the effective hourly rate right now?' and they often have no idea," he says.

To calculate a support staff member's cost, Henley advises multiplying the individual's annual salary by approximately 1.4 percent to factor in benefits and overhead; divide the total by the number of work hours the person performs each year to estimate an hourly rate.

For example, an hour of a $45,000-a-year support staff member's work costs the firm approximately $30.29 if the individual works roughly 2,080 hours a year.

"If I charge $3,500 for something and I need to figure out costs, that's one of them," Henley says. "If that person spends two hours on a transaction, that's $60.54 to subtract out when trying to determine an effective hourly rate."

Obtain Metrics for Insight

Many law firm partners do not yet consider it a priority to implement technology that can help firms track processes and highlight areas for potential improvement, says Connie Brenton, Chief of Staff/Director of Legal Operations for data storage provider NetApp and Co-Founder of the Corporate Legal Operations Consortium (CLOC), a group of Bay Area in-house legal operations directors.

Yet many could benefit from echoing an in-house cost mentality.

"Firms measure profits per partner," Brenton says. "In-house departments track efficiency metrics."

Multi-practice law firm Pepper Hamilton, which employs more than 500 attorneys, uses a client dashboard product that offers a transparent view of the time attorneys spend on matters. Director of Strategic Pricing and Project Management Peter Lane Secor says entries are added on a nightly basis.

"We've been able to look at groups of matters, and their drivers, and talk about best practices," Secor says. "Firms really need to collect more information about their engagements to make better decisions going forward – how long cases lasted, the number of depositions and document review size – that provides more ability to understand staffing and pricing moving forward."

When firms fully comprehend the components involved in a case, they are also better able to convey what the cost of selecting experts, filing a motion and other related expenses will be.

"That allows us to talk with the client about the things we are going to do and why we're doing them," Secor says, "rather than the hours we spend on people."

Consider a Pricing Review Process

The ability to bring in revenue can vastly impact what a partner makes. Seventy-four percent of law firm partners consider originations to be a very important compensation influencer; 66 percent say they're the single most important factor.[30]

In theory, the more firms charge, the more firms and firm members will make. But with clients' increased emphasis on cost savings, the push for higher prices can clash with one of partners' central job responsibilities, growing and retaining business.

"Lawyers put sweat and equity into their relationships. They want to keep the clients, so they're willing to compromise," Johansen says. "If the conversation they're having is, 'You need to be cheaper,' they're going to want to go cheaper."

Offering discounts, however, can be dangerous.

"If a firm operates on a 30 percent margin, if you give a 10 percent discount, which firms often do now, you need to realize you've effectively given away a third of your profit on that matter," Jasper says.

To prevent relationship-based pricing challenges, some larger firms give pricing committees control, establishing limitations for the partners. Smaller firms occasionally appoint a managing partner or a chief financial officer to a pricing role, says Jasper.

An AFA committee at Pepper Hamilton helps partners consider pricing and fee structures.

"Just the other day, we had a partner who had been authorized to give a 15 percent discount – but there's nothing wrong with 11.5 percent or 12," Secor says. "Discounts aren't just 5, 10, 15 and 20 percent."

Some firms have added a dedicated pricing professional to facilitate the process. As of 2015, 76 percent of U.S. firms have hired some type of pricing officer – an increase from 67 percent in 2013.[31]

The number of pricing professionals has been increasing within the legal industry for nearly nine years, according to Johansen, who places the current total at more than 100.

The position can vary.

"In some firms, it's a policy-level role to help firms figure out pricing strategy and hold partners accountable for their performance," Corcoran says. "A lot of pricing folks' job is to almost help firms negotiate so they don't lose their shirts."

If a firm chooses to add a pricing professional, the individual needs to be able to effectively communicate with both internal and external parties, according to Toby Brown, who currently helps create pricing arrangements as Chief Practice Officer at 900-attorney law firm Akin Gump.

"You have to find or build somebody who understands the numbers and has the gravitas to be able to talk to the client – and also, as importantly, to partners," Brown says. "Lawyers are really smart, assertive people. If they question something, you've got to have the backbone to stand up to them."

Whether your firm employs a pricing conduit or not, clients should feel like the conversation is a dialogue about how to best meet their legal and cost needs.

"So many people think lawyers are out there trying to get top dollar," Brown says. "Of course they want to get good money for their work – good people with a good track record should – but more often than not, partners are trying to keep a lower price to get work, and trying to help clients understand the value."

Price Accurately Against the Market

The majority (94 percent) of law firm leaders say increased price competition is a permanent market trend.[32]

Firms sometimes gauge their competition's pricing based on intel obtained from potential clients, which is not, according to Brown, always the best method.

"If a firm wins work, they usually don't find out, but if they lose, a lot of times a client will call and say, 'XYZ firm gave a bid that was 30 percent less' – which is not really good market information at that level," Brown says.

Jasper has worked with more than 200 law firms.

"I've never met one who says, 'We're the ones doing the undercutting on price,'" he says. "Clients aren't going to tell you you're too low, because their role is to push for a better price. If a client gets three quotes, in two-thirds of the occasions, a firm will be told it's more expensive than one of the other bidders."

To obtain detailed competitor, client and other industry information, firms with more than 100 attorneys employ roughly two to three full-time staff members.[33] Fifty-seven percent of firms rely on both internal marketing teams and law librarians to provide competitive intelligence research and analysis.[34]

Many firms utilize technology in market research. Nearly 86 percent of firms rely on tools such as Google, LEXIS Publisher and Westlaw Watch to monitor key competitors' current information and developments, along with client and industry information; social media can also be a useful tool to track competitors' movements. [35]

Advertise Your Services as an Asset

In today's competitive market, not every firm that is vying to be a go-to, full-service worldwide provider will make it, Sarwal says. He feels regional firms with a strong value proposition, on the other hand, have driven profits by identifying what they do well.

"So many firms try to be everything to everyone," he says. "[Successful firms] focus on the rare skills they bring to the table."

Alternative billing formats – such as flat fee, blended rate and capped fee arrangements, the three most popular choices for both law firms and legal departments[36] – may help some clients feel they are receiving greater value.

Ninety-one percent of firms said they have instituted AFAs to attract clients.[37]

"If someone is bidding for a particular piece of work, it's somewhat easier to compare one firm to another with an AFA, [in regard to] how much it is actually costing," Perlman says. "An hourly rate is not that helpful because you don't know much time will be spent."

Whether firms offer AFAs or bill by the hour, to showcase the value they provide, they need to offer clients more than just a fee total.

"If you just allow the client to look at pricing, they'll always want to lower the price," Jasper says. "You have to help clients understand pricing, in context and relative to what's at stake."

Overly detailed invoices – such as a 27-page document Jasper once saw a client submit for a six-figure matter, which noted that a first-year lawyer had spent 18 minutes delivering a pencil – can give clients the wrong impression.

"A better invoicing practice would be more along the lines of, 'Here's what we said we'd do,' creating context. 'Here's what we've done so far, here's what we said it would cost, and here's what it has cost so far,' – so [clients] can see we're on budget," he says.

Showing clients all the favorable things you have achieved can help build a sense of trust and encourage them to hire you again, regardless of any lower fees competitors are charging.

"Firms need to be better about communicating the business case, then moving on to their capabilities and what they bring to the table – their track record, knowledge of the client – that justifies why they should be chosen, even if they are more expensive," Jasper says. "If they're not doing that, they're not optimizing pricing opportunities in proposals."

Conclusion

Law firm revenue is not likely to return to pre-recession levels, when U.S. firms saw a 37.5 percent increase and profits per equity partner grew at a 25.6 percent cumulative rate. (Profit per partner growth was a scant 3.1 percent as of November 2014; Am Law 100 firm revenue increased 5.4 percent from 2012 to 2013.) [38]

As a result, it is more important than ever for firms to carefully calculate the fees they offer, using data and analysis of firm processes, information about what competitors charge, and a thorough understanding of client needs.

Once firms arrive at a price that is fair to clients and profitable for the firm, leadership needs to proactively convey the value it will provide to clients – emphasizing factors such as experience and the ability to reduce client risk, which can frequently carry more weight than cost.

Although they tend to be more reactionary in their business approach, Brown advises firms adopt a proactive stance, constantly reviewing legal service pricing methods and familiarizing themselves with client concerns.

"If they want to survive in the newly competitive environment, law firms have to go on the offense," he says. "If they do, they'll have better outcomes – and they'll strengthen their relationship with clients."

About ALA's White Paper Initiative

In the coming months, ALA will produce several white papers in which it delivers to members' knowledge and insights in critical areas within the business of law. These white papers will identify hot topics that are currently trending in the industry, provide detailed information and analysis of the topics' impact, and outline actionable solutions.

The papers will cover topics that fall within five areas of knowledge including Financial Management, Human Resources Management, Legal Industry/Business Management, Communication and Organizational Management, and Operations Management.

ALA is open to ideas for topics for future white papers. Please contact *publications@alanet.org* with areas of interest.

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