

# ACC Value Challenge

## Facing Up to the Challenge- Law Firm Metrics

By Michael Roster

### THE OPPOSING FUNCTIONS OF HOURS

It's time to face a fundamental problem that has existed in the legal profession for the past 35 years, ever since we moved away from fixed prices, retainers and the other approaches that had long been used and instead went to fees for services based solely on hours.

Hours are performing two diametrically opposed functions. On the one hand, they are a unit of production. In that capacity, we lawyers can budget how many hours might be needed for various tasks or matters and then see if there aren't ways to improve efficiency. But that means, as we do in manufacturing and everywhere else, looking at ways to reduce the hours needed for a given task and reduce the cost of those hours (that is, the actual internal cost of production).

And yet law firms simultaneously have made hours the basis of profitability, which means benefiting from an increase in the number of hours applied to a task or matter and benefiting from regular increases in the hourly rates.

You can't have the same unit (hours) functioning simultaneously for these two opposing purposes.

### Here's What Others Think

*"And why did we do that [move away from fixed prices, etc.]? Was it not the clients who asked for it?"*

– Law firm partner

*"The problem is simple when you put it in terms of production and manufacturing. Henry Ford would be proud."*

– General counsel

## HOURS UNDERMINE ALTERNATIVE FEE VALUE-BASED ARRANGEMENTS

So it's also no wonder firms and clients are still grappling with alternative fees and value-based relationships. The first instinct of lawyers on both sides is to look at hours as a means of comparison, and that is setting everyone up for failure. In addition to the contradictory goals of using hours for production costs versus profitability, if you are measuring success by a constant comparison with hours, the only way the new value-based approaches will satisfy everyone is if the work is delivered at exactly the same price as it would have been under the traditional hours arrangement. If the work comes in at less than the cost of production via hours (which it should, assuming the firm is now focused properly on expertise, effectiveness and efficiency), then clients will feel they have made a bad deal, particularly if they insist on still seeing hours. And if the work would have generated more revenue if billed by the hour, at least some in firm management will say, "see, this isn't working," even though the work is usually quite profitable under the alternative arrangement but the firm is measuring the wrong things.

This is why the three targets of the ACC Value Challenge are so important:

1. Reduce the client's cost from a historical benchmark.
2. Provide near certainty in cost.
3. Significantly improve outcomes.

If both the firm and the client focus on these targets, they are no longer looking backwards at the cost of production (that is, hours). Rather, they are looking forward at what outcomes are desired and being rewarded for achieving the targets.

### Here's What Others Think

*"We're actually finding that clients don't want [alternative fees] as much as... the press would have us to believe they do. Most of our clients used to be in big firms – at least the general counsels – and big-firm pricing is what they know. That's why we see more on the discount side as it plays out than we see on alternative fee structures."*

*– Managing partner of U.S. home office of worldwide law firm, quoted in August 13, 2012 National Law Journal*

*"In part there is a gap in confidence from the law firm side that the client will not understand or appreciate the value of what the firm does, so hours is a nice default. (Or: The reason this chest of drawers is so expensive is because of all the time it took to do the carvings. But, were all the carvings really necessary, i.e., is this not Rococo when what was required was Danish modern?)"*

*– Law firm partner*

*"If the targets become the norm, then doesn't the pressure continue and simply result in still lower costs through competition from the oversupply of lawyers in the marketplace? Doesn't this actually lead to the large law firm partner topping out at \$500k compensation rather than \$5 million? Why would it do anything otherwise? I am not saying that is a wrong outcome, only saying that ultimately, there is no way a large law firm can or should be expected to deliver huge net income distributable shares of the amounts we see today."*

*– Law firm partner*

## NEW MODEL FOR LAW FIRM ECONOMICS

Which brings us to the need for a more effective and internally more accurate way for firms to measure profitability. The model used, moreover, should be totally neutral as to whether a given matter, stage of matter, portfolio, or whatever is billed via traditional hours or alternative arrangements.

By creating a profitability model that is completely neutral as to how a matter is priced and billed, the firms will create a system that can accommodate whatever type of billing a client wants, and the firm's lawyers will no longer be schizophrenic about handling billable matters one way and alternative fee/value-based matters another way. And the firm will now be able to focus on reducing the cost of production (that is, less hours and lower rates that are based on actual cost per hour) without in the process working against profitability.

Why should clients get involved in this discussion? As in-house counsel, we function both as practicing lawyers and as procurement officers. In the latter role – that is, where we hire and manage outside counsel – we are functioning in much the same way as the procurement units anywhere else in our companies. To do the procurement job effectively means we need to understand the economics of our suppliers. What are their cost pressures, their methods of production and their measures of profitability? Are there factors that are driving our suppliers in ways that are inefficient or contrary to what is needed to reduce costs and improve quality? Have we properly aligned our interests so that we are rewarding our suppliers with enhanced profitability if they achieve our companies' goals?

We should also remember, if we lawyers don't get engaged in this way, eventually corporate procurement departments may be brought in to do it for us. Even then, as lawyers we know that the law firm with the cheapest hourly rates is not necessarily the cheapest law firm supplier overall, especially when you look at outcomes. The cheapest can sometimes be the most expensive.

Which means it's time to blow up the law firm formula.

### Here's What Others Think

*"We have a special committee, which we formed four years ago, so if you want to bring an alternative-fee matter that's pretty complicated and it takes some time to work it through, we refer you to the committee and they help you do a budget and they give you various examples of what works under this kind of matter, and that kind of matter. And we've been reasonably successful. So for our clients who want an alternative fee, we offer it and, in certain instances, the rates are better than the billable hours."*

*– Law firm chair quoted in August 13, 2012 National Law Journal.*

*"I think the problem is inextricably intertwined with the organizational model as well, and thus it [the organizational model] has to be blown up also. Otherwise the pressure to push the returns to the few at the top will not abate. Sorry to say, but greed at the top is one of the biggest entrenched interests that has to be broken."*

*– Law firm partner*

*"I fully agree. The formula must be rewritten, but to do that also requires a fundamental change within the law firm structure and/or culture. Not only is there a tension between the interests of the client (reducing risk) and of the firm (maximizing profit while reducing risk for the client), but on the firm side of that equation, there is an internal tension of maximizing personal and/or practice group profit, often at the expense of the greater good of the firm (i.e., fighting over origination credits, hoarding work, etc.). To truly effect change requires an evaluation of the level of trust within those relationships: firm-client, and partner-partner within the firm."*

*– Law firm partner*

## THE FORMULA

The formula for law firm profitability is often attributed to an American Lawyer article in the early 1990's written by David H. Maister, the highly respected consultant and writer, and then presented in a slightly different format in Maister's book *Managing the Professional Service Firm*. Law firms, consultants and others use slightly different versions of the formula, but in essence it provides:

$$\frac{\text{PROFITS}}{\text{PARTNERS}} = \frac{\text{PROFITS}}{\text{FEES}} \times \frac{\text{FEES}}{\text{HOURS}} \times \frac{\text{HOURS}}{\text{PEOPLE}} \times \frac{\text{PEOPLE}}{\text{PARTNERS}}$$

$$= \text{MARGIN} \times \text{RATE} \times \text{UTILIZATION} \times \text{LEVERAGE}$$

Here are some initial thoughts about the individual elements in the formula. Obviously much more could be said about the merits and the weaknesses, to both a firm and its clients, where a law firm's structure, operations, culture and billings are focused on maximizing these elements:

**Profits per partner**, especially when calculated as an average for the entire firm, has little if any meaning. It masks the real profitability or losses of each person and group. David Maister's book in fact suggests looking at individuals and groups, not necessarily a firm-wide average.

**Margin** is a way to compare overhead with revenue. Under the formula, to the extent costs are reduced or fees are increased, margin is improved. So that means margin looks better to a law firm's managers not only where revenue is increased (that helps the fraction) but also if the firm significantly reduces overhead. Reducing overhead is usually a good thing. But here, it often causes firms to have a minimum of secretaries and other non-billing support personnel as opposed to (a) having better mix of a lower cost support staff and (b) investing in other systems and services so that attorneys primarily spend their time on actual legal work, and do so with maximum effectiveness.

**Hourly rate** puts constant pressures on increasing rates, even if that might mean a loss of business for individual attorneys and groups who are quite profitable at their existing rates. It also masks the real efficiency, value and profitability of a \$1000 attorney and a \$200 attorney when each is assigned to their individual highest and best use.

**Utilization** means the number of hours billed. It puts an emphasis on billing hours versus what should be the goal for both sides, which is achieving the same and even better results with fewer hours.

### Here's What Others Think

"First, the book [*Managing the Professional Service Firm*] describes the pyramid nature of the professional services firm, describing how the profitability of a firm is derived. (A partner bills out the pyramid below him.) Therefore, the two drivers for profitability of a partner are how much he can bill his (or her) people out for, and how big the pyramid beneath her (or him) is. There are many tactical points presented for improving these, but it really helps focus the energy of the partner to think about the two main drivers."

– On-line book review at Amazon

"What good is growth, then, if it doesn't drive profitability? Growth is needed to encourage top employees to stay with the firm. A firm that is growing 10% a year has many more opportunities than one growing 5% a year. This counterintuitive idea (growth is more important for career advancement than size) is a great cue for picking the right place to work. If the growth stops, it is time to move on."

– Same on-line book review at Amazon

"Law firms 'recognized' the challenge, but really gave it much more lip service and passive-aggressive resistance than pro-active response. And when they did, they almost always benchmarked it against recorded hours. (So did general counsel!)"

– Law firm partner

**Leverage** is equity partners versus all other timekeepers, with many larger firms aiming for 1-to-3 and even 1-to-4 leverage even though some of the most profitable firms ignore the formula and operate with more partners than associates. One effect of this element is that profitability somehow looks like it increases under the formula if the firm de-equitizes existing partners, extends time to partnership and keeps increasing the number of associates with little intention of making most of them partners notwithstanding all the costs of hiring and training this cadre of professionals. Ironically, with the same staffing, the firm still has the same revenue and same costs, but by manipulating who is on which side of the fraction, law firm managers can make the firm appear more profitable. Clients as purchasers should actually prefer a culture that elevates more qualified lawyers to partnership since this approach helps assure continuity with our work and a longer term commitment by the lawyers doing that work.

**Realization**, while not included in this version of the formula, nevertheless is an important part of law firm profitability. It is the percent that is actually collected and is reduced by write-offs and the like. A practice group that is properly priced and focused on results rather than hours should actually achieve realization rates well above 100% as compared to work done by the hour, something firm managers often overlook when evaluating alternative fees.

## §

I would urge all readers (both law firm attorneys and the in-house lawyers who pay the bills) to spend a few minutes re-reading the formula several times and each time consider how it impacts the way law firms manage themselves and, for clients, what it then means as to how our work is handled. And then consider the following, which is advice regarding this formula that appears on the web from one of the many hundreds of law firm consultants and is typical of advice routinely given to law firm leaders:

“These factors, expressed as ratios, are interdependent, meaning one of them cannot be changed without affecting the others. For example, if you doubled your billing rate, profitability would also double, by definition... . Leverage is the ratio of non-equity fee earners to equity partners. The most profitable firms in a 2007 LexisNexis survey had the highest billable hour leverage. The goal is to increase leverage once partners reach or exceed the target billable hour threshold. Since there are only so many hours an individual can work, if you want to increase profitability it is imperative that work be passed to another fee earner once that threshold is reached. Delegation is one lawyer behavior that should be rewarded by compensation committees.”

<http://moores-law.com/?m=201202>

Just as I asked you to read the formula several times, do the same with this advice. And then consider the significant inefficiencies that are being reinforced by this conventional wisdom that is all based on hours and the formula.

### Here's What Others Think

*“I've been practicing law for over 30 years and have always understood the tension about hours. But when I read this, it hit me like a ton of bricks. That's often the case with the obvious: it's right in front of us and we don't see it. But now the question is: Where do we go from here? How do we measure profitability and determine compensation when the goal needs to be reducing hours and the cost of hours while in the process improving the firm's profitability?”*

*– Law firm partner*

## SELLING EXPERTISE AND SKILL, NOT HOURS

The fundamental mistake in all of this has been the absolutely wrong notion of the past three decades that the only thing a law firm has to sell is hours. Nonsense. What firms have to sell is expertise and skill. Hours are a unit of production, and as with manufacturing, it should be everyone's goal to reduce that cost of production while improving quality, outcomes and yes, profitability.

By irrevocably linking a law firm's profitability to increasing the cost of production, the formula has turned everyone in the wrong direction. Under the formula, profitability is enhanced with inefficiency and reduced if there is a focused use of expertise.

Which also leads to a churning of work, incentives to maximize hours, incentives to increase hourly rates, pressures not to write down a bill even for clear inefficiencies, stretching out time to partnership, de-equitizing or even eliminating so-called servicing partners, etc.

Firms should be asking instead: how can we best deliver expertise and be paid appropriately for it? Part of the breakthrough will be to no longer use hours as both a means to measure profits (which, as already said, results in pressures to raise rates and bill more hours) and at the same time a means to monitor productivity (which should result in pressures to lower the per unit cost of production and to try to deliver the same if not better product with less of those production units). For clients, it means asking: how can I incentivize my law firms to deliver expertise and improved results, reduce their cost to me for doing so, and actually maintain and even improve their profitability by achieving these goals?

### Here's What Others Think

*"You have it exactly right! This is an excellent, thoughtful article that I would urge you, in the strongest possible way, to publish. This paragraph alone makes it essential that you publish this article."*

– Law firm partner

*"You might also mention the corrosive effect that the focus on billable hours has on law firm morale and culture. If a partner is not making his/her billable hours target, that becomes a huge focal point – he/she is characterized as "not pulling his/her weight," even if he/she is doing fabulous work for the client, producing huge value for the client, helping to cement the client's relationship with other attorneys in the firm, etc. This tends to wear down the fabric of the partnership in so many ways. Law firm managers do not have the tools necessary to measure anything other than the factors used in David Maister's formula, or they simply do not want to take the time necessary to look at other (more intangible) items."*

– Law firm partner

*"In addition to the negative effect that focusing on hours can have, I suggest that over-emphasis on origination credits can have an equal, if not worse, effect in creating and delivering value for a client. Marketing experts tell you that you should "hunt in packs" to demonstrate the depth and breadth of your practice group or firm. Focusing on origination credits causes people to first ask "I will help you in developing that new prospective client, but if the work comes in, who will get the credit??" Remove the "hours" column and the "originations" column from the monthly or quarterly internal financial reports, reward teamwork, and you have just removed two of the biggest hurdles to ensuring that the client's interests are aligned with those of the firm."*

– Law firm partner

## WHERE WE SHOULD BE HEADING

Once a firm or practice group shifts to a true profitability set of measurements, the firm finally has incentives to:

- Keep reducing its cost of production – meaning moving matters to those with appropriate expertise while lowering leverage and hourly rates, where hourly rates are now used to monitor the cost of production, not how to maximize what can be billed.
- Measure and deliver better outcomes and being rewarded for that.
- Learn how to fix the cost of any given type of work.
- Along the way, improve profitability.

I'm not going to try to develop a grand unified theory here, although I believe that several exist. Rather, I offer the following as a possible starting point:

1. **Compute the cost of a given practice group**, office, attorney or whatever unit you pick. This cost is mostly if not entirely salary and benefits. Because of the way work is done and the way clients think of their work, practice groups may be the best place to start.
2. **Add the indirect costs** (space, support staff and services, etc.). In the past, many firms have used a formula that the indirect costs are 1.5 times salary for partners, 1 times salary for associates, and .5 times salary for paralegals. However, firms should also ask whether use of these percentages might be giving some seriously flawed results about profitability by practice group, matter and even individual attorneys; whether some groups (such as litigation) draw much more heavily upon space and support services than other groups (such as estate planning and probably most so-called servicing partners); and whether a rough but somewhat more granular estimate of the indirect costs wouldn't provide more accurate and sometimes revealing information.
3. **Compute the revenue** for the practice group, office, attorney or whatever. This means actual dollars received, not what is billed or is in the pipeline to be billed. Only what has been paid should count.
4. **Subtract the all-in cost** of the entity you are considering (practice group, office, attorney, or whatever) **from revenue** attributed to that entity.
5. **Consider ways of handling crossover issues.** For example, lawyers in the tax group may have contributed substantial expertise to a new form of bond offering being primarily handled in the corporate finance group.

### Here's What Others Think

*"I think it [the cost review] should be done by several different approaches, because the comparative exercise alone will bring out revelations on costing and allocation that will help to better manage the enterprise."*

– Law firm partner

*"Many of us have long believed that the non-attorney costs of the various practice groups are wildly different. At most firms, no one wants to hear that, probably because it might open Pandora's Box."*

– Law firm partner

*"Your seven part formula makes great sense for large firms doing work for large clients. However, given the oversupply of lawyers because universities continue to enjoy large profit margins from their law schools, the middle market won't fit easily into your seven part formula. I believe we need to lessen the numbers of new entrants into the marketplace or we will continue to have lawyers, especially at the middle and lower tiers, playing games with their means of production, i.e. hours."*

– General counsel

*"Remember, this is a core metric for value of each such unit based on billable profitability only. But it is KEY that even those who deliver \$10 million of client origination also be measured by personal production as one component. AND that every such person/unit leaves something 'on the table' for redistribution, over and above their 'cost'. If they are below cost, you need to know that. If they are above cost, but still below the amount needed to 'tithe', you need to know that."*

– Law firm partner

6. **The net result is the profitability** you might then attribute to the practice group, office, attorney or whatever.
7. **Deduct some percent from that overall profitability for redistribution firm-wide** as a way to encourage good institutional behavior. Many believe that 5% to 10% is a reasonable range. The firm also needs to develop a methodology for distributing this pool for desired institutional contributions such hiring, training, etc.

## CONCLUSION

The purpose of this paper is to continue a dialog between law firms and their corporate clients. Once we have a common understanding of what matters to both the firms and their clients, both sides will likely see much better economic results as well as improved professional satisfaction. Most important of all, these changes will help achieve the three ACC Value Challenge targets for the corporate client: reduced cost, greater predictability and significantly improved outcomes.



## ACKNOWLEDGEMENTS AND DISCLAIMER

The opinions expressed in this article are my own, and the sidebar commentaries are likewise solely those of the commentators. I have benefited greatly from the wisdom and ideas of steering committee members and senior staff involved in the ACC Value Challenge as well as other law firm and in-house counsel with whom I have worked through the years. Anything with which readers agree no doubt derives largely from these other professionals. I'll take the blame for anything that is in error or with which readers disagree.

## ABOUT THE AUTHOR

Michael Roster has served the past four years as the voluntary steering committee chair and co-chair for the Association of Corporate Counsel's Value Challenge. Until 1993, Mike was Managing Partner of Morrison & Foerster's Los Angeles office as well as co-chair of the firm's Financial Services Practice Group worldwide, resident in both Los Angeles and Washington, D.C. and a member of the firm's policy committee. He subsequently served as General Counsel of Stanford University and Stanford Medical Center and then of Golden West Financial Corporation. Mike also has been a chair and outside director for a number of publicly-traded, startup and non-profit companies and thus has had the joy and frustration of also being a client

## ABOUT THE COMMENTATORS

- **General counsel** includes attorneys who are or were a general counsel or chief legal officer or performed similar functions for one or more companies within the U.S. or elsewhere. Virtually all also were previously partners and associates at law firms but are identified here solely as GC's.
- **In-house attorney** includes any attorney who is or was at a company within the U.S. or elsewhere but not as a general counsel.
- **Law firm chair** includes current and former law firm partners who headed a law firm and/or were part of the top leadership group for the entire firm.
- **Law firm partner** includes current and former partners at various law firms, some located in a single city and some that are regional, nationwide or worldwide. Many of these partners also are or were practice group heads, office managing partners, etc.
- **Mid-level attorney** includes people who graduated from law school within the past 15 years and may currently be law firm associates, working at companies or government agencies, solo practitioners, business people, etc.
- **Senior administrator** includes a variety of non-attorneys who currently are or previously were senior administrators and other non-attorney managers at either law firms or in-house corporate law departments.