THE BOTTOM LINE
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ISSUE FOCUS: BEYOND THE BILLABLE HOUR

MCLE SELF-STUDY ARTICLE: BURYING THE BILLABLE HOUR: EIGHT STEPS TO IMPLEMENTING VALUE PRICING IN YOUR FIRM

(Check end of this article for information on how to access 1.0 self-study credits.)

By Ronald J. Baker

A business is defined by the value it creates for its customers. Your price speaks volumes about your value proposition, more so than any other component of your firm's marketing. The business world pricing revolution began in the 1980s, when many of the *Fortune* 500 companies began to employ professional pricers, and organizations such as the Professional Pricing Society were founded to assist companies in achieving excellence in pricing for value. Yet many law firms are still defined by "hourly rates." The legal profession has taken its collective intelligence, experience, judgment, education, wisdom, knowledge, and intellectual capital and commoditized them into a one-dimensional hourly rate. This article will illustrate that pricing by the hour is the wrong measure to determine the value created for the client—like plunging a ruler into your oven to determine its temperature.

Theories of Value

Professionals undervalue their services because they are operating under the *labor theory of value*, which posits that the value of a service is determined by the amount of labor used in its production. Conversely, professionals who subscribe to the *subjective theory of value* believe that the services they offer are only valuable to the extent that there is a potential buyer desiring them. Value is

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in the eye of the beholder. For any transaction to take place, both the buyer and the seller must profit from the exchange and receive more value—in their subjective perception—than what they are giving up.

Today, thousands of firms price their services according to the external value created—as perceived and determined by the client—rather than internal costs incurred in generating those services. Changing the pricing culture in your firm will not be easy. It requires confronting the inherent challenges involved with pricing—all of which take hard work, commitment, leadership, creativity, innovation, and dedication of resources to continuing education.

“What costs can we afford to incur on this project given the price obtainable from the client and still earn an adequate profit?”

All Transformation is Linguistic

The word *value* has a specific meaning in economics: “The maximum amount that a consumer would be willing to pay for an item.” Therefore, Value Pricing can be defined as the maximum amount a given client is willing to pay for a particular service, before the work begins. This is not to suggest we can capture 100% of maximum value, but rather that we have the potential to access more of it with strategic pricing.

This definition contradicts the popular term *value billing*. The difference is Value Pricing is always done *before* the work begins, whereas value billing is usually marking up—or more frequently, marking down—the invoice to the client *after* the work has been performed.

A cardinal rule on behalf of clients in firms that value price is: no surprises. Just as no auto mechanic performs work not pre-authorized by the customer, these firms only provide services after price, payment terms, and scope have been predetermined and agreed to by the client. This creates a better client experience, with fewer write-downs and write-offs, lower collection and financing costs, and greater client loyalty—not to mention superior profitability for the firm.

Transitioning from Hourly Billing to Value Pricing

Not all pricers in a law firm are created equal. Firms should establish a value council and appoint a Chief Value Officer (CVO) in order to centralize the pricing function and make it a core competency within the organization. Pricing is too important to the profitability and health of a firm to accept anything less than excellence in this vitally important skill.

If you diagram hourly billing, a form of cost-plus pricing, it would look like this:

Service → Cost → Price → Value → Client

Value Pricing inverts the above chain by recognizing the economic fact that the client is the ultimate arbiter of value:

Client → Value → Price → Cost → Service

Thus, Value Pricing turns the order of cost-plus pricing inside out. Goods and services do not magically become more valuable as they move through the factory and have costs allocated to them by cost accountants. The *costs do not determine the price*, let alone the value. It is precisely the opposite: the *price determines the costs* that can be profitably invested in to make a product desirable for the customer at an acceptable profit for the seller.

A coat is not worth eight times as much as a hat because it takes eight times as long to make it. Rather, manufacturers are willing to devote eight times as long to the making of a coat because customers value it eight times more than a hat. The cause and effect is the exact opposite of the conventional wisdom of cost-plus pricing.

Firms that value price do not ask, “What prices do we need to cover our costs and earn a profit?” Rather, they ask, “What costs can we afford to incur on this project given the price obtainable from the client and still earn an adequate profit?” Costs in a law firm are

largely fixed, but pricing is a policy. In most law firms, services are being priced based on the costs being incurred and not the *value* created. These firms have ample data on their costs, hours, activities, efforts, and other inputs, but a paucity of information on the value they create for clients.

For a firm to value price effectively, it must understand the five Cs of value:

1. *Comprehend* value to clients.
2. *Create* value for clients.
3. *Communicate* the value you create.
4. *Convince* clients they must pay for value.
5. *Capture* value with strategic pricing based on value, not costs and hours.

These five components determine the wealth-producing capacity of any firm, and will drive internal profits in the long run

In firms that use value pricing, costs only determine if a service should be provided, and in what quantities. Costs do not play a role in determining external value to the client, or setting prices (except as a minimum). Firms that value price know their costs *before* they begin the work, not afterwards with timesheets.

Value pricing reverses what is now an artificial ceiling on firm income, inverting the ceiling into a floor.

The Eight Steps Required for Implementing Value Pricing

Follow these eight steps on every major engagement, and your firm will be on its way to pricing based on value created for the client.

Step 1

Have a conversation with your client to determine their needs and wants before every engagement. Begin the conversation with a phrase similar to the following:

> "Mrs. Customer, we will only undertake this engagement if we can agree, to our mutual satisfaction, that the value we are creating is greater than the price we are charging you. Is that acceptable?"

This question will initiate a *value quest*, with both the firm and the client focused on uncovering every aspect of value. Then ask them the questions in Exhibit 1. This is your opportunity to *comprehend* and *communicate* the value you can add, establishing the scope of value and then the scope of the work to be performed. Sometimes a member from the value council attends this meeting, especially if the client relationship partner is not a member of the value council, or is uncomfortable with pricing.

Step 2

The information gleaned from Step 1 is then presented to the value council, where three options, at three levels of service, are established. For example, American Express' Green, Gold, and Platinum cards vary in price based upon the value and services they deliver. Firms should offer clients options, not a take-it-or-leave-it single price. This allows the client to *convince* himself or herself of value. It also reveals the client's individual price sensitivity, which the firm can use in future pricing. It helps the firm answer the question: Did we leave money on the table? Timesheets, hourly realizations, and financial statements cannot answer this question.

Step 3

This step involves narrowing the range of acceptable prices to the client, then constructing three different value/price options. It is important to remember that the firm can lose a client by pricing not only *above* the range the client is willing to pay, but also *below* that range. We simply must get over the false idea that there is one optimal price for a client. There is a *range* of optimal prices, commensurate with the value being created. Dutch psychologist Peter van Westendorp developed the van Westendorp Price Sensitivity Meter by posing five questions, to which I have added two more:

1. At what price would this service be so expensive the client would not consider buying it?
2. At what price would the service be expensive, but the client would still buy it?
3. At what price would the service be perceived as inexpensive?

4. At what price does the service become so inexpensive the client would question its value?

5. What price would be the most acceptable price to pay?

6. What costs can we afford to invest in at the target prices and still earn an acceptable profit?

7. At what price would the firm walk away from this client?

The value council then goes through the twenty questions to ask before establishing a price (Exhibit 2). Based upon the answers, the council then conjectures three internal prices for each level of service, based upon their assessment of the client's subjective value and price sensitivity. In tough economic times, this three-tier pricing model is a great opportunity for firms to offer less expensive options for struggling clients. When times get better, many clients will often choose to upgrade to a higher level. Establish the following three prices:

1. **Reservation price**. Below this price, the firm would turn down the work. It *must* get this price. It will generate a normal profit.

2. **Hope for price**. A firm *should* get this price more often than not. It will generate a supernormal profit.

3. **Pump fist price**. This is an *aspiration* price, when the firm is adding extraordinary value. It will generate a windfall profit.

Many firms use the Five Ts of constructing options to develop their Platinum, Gold, and Green offerings. The Five Ts are:

1. **Timing**. When will the work be done? The quicker the turnaround, the higher the price.

2. **Terms**. Payment terms are just another word for pricing. The lower the price, the quicker the terms, or even payment is due upfront.

3. **Talent**. Who will work on the matter? A partner will cost more than an associate, who will cost more than a junior associate.

4. **Tailoring**. How will you deliver your knowledge to the client? Written opinions, seminars, attending board meetings, etc.

5. **Transference**. Does your firm provide educational opportunities, such as seminars, classes, or internal education? You can make these available from zero price to full price, depending on the option level selected by the client.

Many firms use the following nine-box model, developed by the obscure Austrian economist, Barron von Joseph Neinbach:

	Reservation	**Hope for**	**Pump Fist**
Platinum	$C	$B	$A
Gold	$M	$N	$L
Green	$Z	$Y	$X

From this brainstorming session, the value council then determines at which price the three options will be presented (obviously, not all nine prices are presented to the client). The upper bound of these prices should be based upon the value being created, yet all will be lower than that value so as to ensure the client also earns a profit. This way, you're selling profit at a discount.

For example, if you know the client is highly price sensitive, you may only present the reservation price for all three options. However, if there are some services that are adding marginal value, a hope for price may be quoted for the Gold and Platinum levels. If extraordinary value is being created, quote the pump fist price.

This is where the art of pricing comes into play. It requires judgment, but the more the value council does it, the better the members will get, since pricing is also a skill.

Firms that use this model report that it makes a firm "compete with itself." To receive a pump fist price, the firm must conjure up ways to add extraordinary value. This is a worthwhile thought experiment that focuses on value, not time.

Offering the client three options is superior than offering one price, take-it-or-leave-it. It's also far more strategic than offering the client a range of prices, since they focus on the low price, the firm considers it can go as high as the larger price, setting the relationship up for failure right from the start.

Many people ask how to ascertain value since it's subjective and there's no formula. The answer is with a deep understanding of your client's value drivers, which requires a deep *conversation* with the client.

Step 4

Present the options to the client. A member of the value council should attend this presentation, especially if the relationship partner is not a member of the council, or is uncomfortable discussing price.

Step 5

The option selected by the client is then codified into a Fixed-Price Agreement (FPA). The firm can include as much detail as required as to the scope of work, client responsibility to provide information, timelines for delivery of work, etc.

> **There is nobility in earning what you are worth.**

Step 6

The firm would perform adequate project management on the scope of work, detailing who will perform the work, timelines for delivery to the client, and other planning details.

Step 7

If the firm finds *scope creep* while performing the work, the client is informed, given the option of how to proceed, and a Change Order will be issued if the firm is to perform any additional work. This policy also applies to any new services the firm provides not specified in the FPA.

Step 8

The U.S. Army has a policy of performing After Action Reviews (AAR), which take place *after* every mission. After assisting many firms in implementing AARs, I am convinced it is a practice that would have numerous benefits for firms, especially as it relates to the roles of the CVO and value council, helping them evolve pricing into a core competency. For a sample of AAR questions the value council would answer after every major engagement has been completed, see Exhibit 3.

Conclusion

There is nobility in earning what you are worth. Yet if a firm's leaders do not think it creates more value for its clients than is reflected by hourly billing, clients may never understand a value proposition beyond hourly rates.

Hourly billing is a risk-averse and simplistic tradition that has been taught for multiple generations. Your firm will be unable to adopt value pricing if it continues to denominate everything into hours, thus remaining mired in the mentality that you sell time.

Now is the time to change your conversations with clients from hours to value. Do this upfront, before you begin any work—a service needed is always valued more than a service delivered. Appoint a CVO and establish a value council—a group of intellectually curious leaders who will become, over time, experts in creating and capturing value.

Make your firm one of the pioneers that is blazing the trail for others by burying the billable hour and pricing based on value. Your firm will become obsessed with value. Your clients will appreciate it, and they will not bother asking about hours. I guarantee it.

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Exhibit 1: Questions to Ask the Client

- What do you expect from us and how do you see us helping you address challenges and opportunities?
- What specific results do you hope our services will help you achieve?
- How do you define a successful relationship?
- Ideally, how would you like to measure, or judge, success?
- If price were not an issue, what role would you want us to play in your business?
- What resources can we expect your organization to devote?
- What if you did nothing?
- What if the matter fails?
- What will you be able to do that you can't do now if we succeed?
- What will the difference be to your reputation, brand image, and customer loyalty?
- What are the three greatest benefits from this matter's success?
- We know you are investing in total quality service, as are we. What are the service standards you would like for us to provide?
- How important is our service guarantee to you?
- How important is rapid response on legal issues and questions? What do you consider rapid response?
- Why are you changing firms? What did you enjoy about your former firm? What did you not like about your former firm that you do not want us to repeat?
- How do you suggest we best learn about your business so we can relate your operations to the legal issue involved and so we can be more proactive in helping you maximize your business success?
- What is your budget for this type of service? (Remember: budgets are elastic; if the value is there, the money will be found).

Exhibit 2: 20 Questions the Value Council Should Ask Itself Before Establishing a Price

1. What is the client's cost of not solving this problem in dollars?
2. What is the economic benefit to the client if they solve the problem?
3. With whom on the organization chart are we dealing?
4. Who referred this client to us? Why were we referred in the first place?
5. Do they have any time-sensitive deadlines for the completion of this project? Why do they need to do it now and not in six months?
6. Who's paying for the service? Are they spending other people's money?
7. Do we have any competitors? If so, who?
8. What price information do we have about these competitors?
9. How profitable is the client's company? How long have they been in business?
10. Have they engaged with someone else prior to us to do similar work? Who was the prior firm and why are they changing?
11. How sophisticated is the client?
12. Does client add to the firm's skills or markets?
13. Do we like this client?
14. How do we help reduce the client's risk of hiring our firm? (Offering a guarantee is very effective)
15. Does this client represent significant long-term business potential?
16. Are we dealing with the economic buyer? (This is the person who can decide to hire you immediately).
17. Is this a client we'd hate to lose?
18. Does this client serve as a reference for other clients?
19. Are we competing with the client "doing nothing?"
20. What is the risk of this client to the firm? (There is no actuarial model to price risk based on the billable hour).

Exhibit 3: After Action Review: To be completed by the Value Council/CVO after each major engagement

Question	
Did we add value for this client? Any unexpected value added?	
How could we have added more value?	
Did we capture value?	
Could we have captured more value through a higher price?	
If we were doing this type of matter again how would we do it?	
What are the implications for product/ service design?	
Should we communicate the lessons on this matter to our colleagues and how?	
How could we have enhanced our client's perception of value?	
What did we teach this client?	
What other needs does this client have and are we addressing them?	
Did this matter enhance our relationship with this client?	
What impact has this matter had on developing our client's trust in us?	
How would you rate our client's price sensitivity before and after this job?	
How has this matter advanced us?	
Did we have the right team on this matter?	
How high were the costs to serve?	
What could we do better next time?	
Do we need to update our client complaint register?	
How could we thank this client for their business?	

Resources

■ *The Strategy and Tactics of Pricing: A Guide to Growing More Profitably*, 4th ed., Thomas T. Nagle and John E. Hogan, Prentice-Hall, 2006.

■ *Extraordinary Guarantees: Achieving Breakthrough Gains in Quality and Customer Satisfaction*, Christopher W. Hart, Spire Group, 1998.

■ *The Firm of the Future: A Guide for Accountants, Lawyers, and Other Professional Services*, Ronald J. Baker and Paul Dunn, John Wiley & Sons, Inc., 2003.

■ *Pricing on Purpose: Creating and Capturing Value*, Ronald J. Baker, John Wiley & Sons, Inc., 2006.

■ *Measure What Matters to Customers: Using Key Predictive Indicators*, Ronald J. Baker, John Wiley & Sons, Inc., 2006.

■ *Mind Over Matter: Why Intellectual Capital is the Chief Source of Wealth*, Ronald J. Baker, John Wiley & Sons, Inc., 2008.

■ *Implementing Value Pricing: A Radical Business Model for Professional Firms*, Ronald J. Baker, John Wiley & Sons, Inc., 2010.

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FROM THE CHAIR

By Will Hoffman

LPMT has long recognized the importance of alternative fee arrangements (AFAs) as an integral part of law practice management. Especially in today's business climate, both clients and lawyers seek alternatives to the billable hour. This issue of *The Bottom Line* extensively discusses the pros and cons of AFAs.

In California, the limitation on innovative fee structures is the prohibition on "unconscionable" fees.

"A MEMBER SHALL NOT ENTER INTO AN AGREEMENT FOR, CHARGE, OR COLLECT AN ILLEGAL OR UNCONSCIONABLE FEE."

Rules of Professional Conduct, Rule 4-200(A) states: "A member shall not enter into an agreement for, charge, or collect an illegal or unconscionable fee."

This limitation is broader than that of the "unreasonable" metric of the parallel ABA Model Rule. For example, ABA Model Rule 1.51(a) states, "A lawyer shall not make an agreement for, charge, or collect an *unreasonable* fee . . .."

The State Bar Commission for the Revision of the Rules of Professional Conduct considered both the ABA Model Rule 1.5 and the current CRPC rule 4-200 in developing its Proposed Rule 1.5 [4-200] "Fees for Legal Services." The proposed CRPC revisions keep the "unconscionability" standard as the benchmark for imposing discipline on lawyers.

[A little history: The Commission first met on September 28, 2001. It then spent the last decade writing and rewriting the proposed new rules. In June 2010, LPMT submitted extensive comments, including a recommendation that the Bar acknowledge and encourage AFAs. On September 22, 2010, the board approved the final package and transmitted it to the Supreme Court, only later to withdraw it to prepare a new, comprehensive petition to the Court. As I write, the "preparation of this comprehensive petition is pending." S*ee* The State Bar Web page re the proposed CRPC.]

Current CRPC Rule 4-200(B) lists eleven (nonexclusive) factors "to be considered, where appropriate, in determining the conscionability of a fee . . .." Proposed Rule 1.5(c) carries these criteria forward, with the recognition that "in-house expense" may be equivalent to the term "fee."

Yet even within California's apparent broad tolerance for most fee arrangements, the Bar is still in thrall to the billable hour: "The time and labor required," Rule 4-200(B)(10).

Rule 4-200 mentions "value" once. "The amount of the fee in proportion to the value of the services performed." Rule 4-200(B)(1). Proposed Rule 1.5(c)(1) ratifies this factor.

But how should one measure "value" in the context of the CRPC? The Commission's comment on proposed Rule 1.5(c)(1) is not encouraging. It perceives value as a cost-benefit determination: "Carried forward from current rule 4-200(B)(1), subparagraph (1) recognizes that lawyer should assess the costs and benefits of the lawyer's services in determining what tasks to perform."

One measure of the lawyer's "value" is the amount another would charge for the same result.

As elaborated in this issue of *The Bottom Line*, value need not be based on the amount of time expended but on the value provided to the client. Hence, the price/fee to the client for a particular task should allow the amortization of significant costs to develop an innovative legal product or service, even though, on its face, it may appear to consume relatively little time in its delivery.

Consider the example of a lawyer's having spent 100 hours developing a complex spreadsheet that may streamline otherwise time-consuming calculations. Using the spreadsheet, the lawyer can produce the necessary data in one hour rather than the ten it would otherwise take. One measure of the lawyer's "value" is the amount another would charge for the same result. May the lawyer charge ten times a standard hourly rate? Five times? Should the lawyer separately identify the charge for that particular task as a fixed fee?

What do you think? How have you handled such circumstances?

TECHNOLOGY ECLIPSES TIME IN THE LAW FIRM FEE DYNAMIC

By Edward Poll

All pricing is arbitrary. Whether the pricing decision is to sell a pharmaceutical drug for hundreds of times its production cost to cover research expenses, or to sell an automobile below its production cost ("and make it up in the volume," as the ads used to say), that decision is up to the seller. The seller must understand costs, set profit targets, and gauge market demand. The decision is the seller's choice; but the seller must convince the buyer that the price is right.

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Defining a "Reasonable" Fee

Lawyers are not exempt from this dynamic. A lawyer in any area of practice, at any firm, can charge for services at an hourly rate, a flat fee, a contingency fee, or a mixture of these and other billing methods. Moreover, the amount of those charges can vary widely. The only requirement, according to Rule of Professional Conduct 1.5, is that "a lawyer shall not make an agreement for, charge, or collect an unreasonable fee." The Code defines "reasonableness" by such factors as:

- The time and labor required;
- The novelty and difficulty of the questions involved;
- The skill requisite to perform the legal service properly;
- The customary local fee for similar services;
- The amount involved and the results obtained;

- The time limitations imposed by the matter; and
- The experience, reputation and ability of the lawyer.

Some of these criteria are relatively objective, particularly time required and customary local fees. But to a much greater extent, the Code's guidelines of how to define a reasonable fee are directly related to the value that the client receives in terms of a lawyer's skill, timeliness, experience, reputation, and results.

Value is determined by the client, not the lawyer. But, it's the lawyer who must educate the client about "value."

Value is determined by the client, not the lawyer. But, it's the lawyer who must educate the client about "value." Controversies arise over what is a reasonable price when a client fails to see the "value" being offered. That is especially true when tremendous advances in electronic and computer technology enable lawyers to do more and better work in less time, which defines the service dynamic that clients increasingly demand.

Determining Technology's Impact

The time savings, efficiency, and commoditization of routine tasks and services afforded by computers and other electronic technology have freed the great majority of lawyers to focus on the creative, problem-solving aspects of their law practice while being able to meet client needs better. At the same time, though, the increased efficiency results in lower revenue without promising greater volume of work. Will lawyers be able to overcome this phenomenon, or will more become technologically unemployed?

With business and individual clients alike becoming more resistant to or unable to pay for legal services charged according to standard billable hours, technology may hasten the end of the billable hour fee system. Doing more work faster will reduce revenue when billing is done by time. But without momentum from technology, it is quite unlikely that neither general counsel, individual clients, nor attorneys will push to change the current time-focused system.

It seems inescapable that lawyers will have to alter their fee and cost structures in the new world created by changes in technology. Law firms that partner with their clients in ways that use technology to meet client needs through greater efficiencies can reduce clients' legal costs while maintaining or increasing the law firm revenue. A new fee dynamic is required to do this, by creating an environment of sharing the efficiencies offered by technology, such that both lawyer and client benefit.

Transforming the Fee Equation

The more widely available something is, the more of a commodity it becomes. When hand-built horseless carriages gave way to the Model T, millions bought cars—and lots of skilled carriage builders went out of business. The same dynamic applies regarding technology and the law. The Industrial Revolution and subsequent rise of automation demonstrated that the more equipment is used to make something, the less labor is required, and the lower the price could be charged. With a lower price, volume increases and profits likewise should rise.

As law firms enhance their use of electronic technology, the principles are the same as in the industrial world, it is just the pace that has changed. Increased machine power reduces labor, which tends to reduce cost which tends to reduce price which increases volume, and profits. The key to higher volume is partnering with clients ... understanding what they need, listening to what they want, and bridging the gap between the two by providing value. Value is defined as listening to clients to understand what they want and showing them how lawyers can provide value by addressing that want and delivering what they need to address their challenges.

This requires a transformation on both sides of the fee equation. Clients must accept the kind of billing arrangements that would allow the lawyer to make more money while being more efficient. This does not mean regarding legal services as a commodity—it means rewarding lawyers with more work for eliminating inefficiencies, duplications, and unnecessary services.

By the same token, on the law firm side, maintaining billings while becoming more efficient requires changing the billing system to embrace alternative fee arrangements. Using contingent, fixed, capped, value fee approaches where time is not the relevant issue to determine the fee is essential to make the most of the leverage from technology.

The E-Discovery Revolution

Consider, for example, the fact that e-discovery software can analyze documents required for litigation discovery in a fraction of the time for a fraction of the cost when compared to using lawyers for the task. Some programs to search electronic files not only find documents with relevant terms at high speed, they extract relevant concepts and deduce patterns that would have eluded lawyers examining paper copies. Inescapably, many lawyers who used to conduct document review will no longer be billable. Profitability for the firm will come from the ability to swiftly analyze the millions of equivalent paper pages that electronic documents represent. And document review lawyers will be out of a job.

Recently I heard the story of a lawyer who was served with 12,000 pages of documents the night before a hearing. The other side buried him with paper. But, by use of technology he was able to use optical character recognition (OCR) software and scan the documents in a matter of a couple of hours, and then find the “smoking gun” in time for the hearing—without hundreds of lawyers doing the document review. Not only has this technology impacted the number of lawyers required, it therefore impacts the cost of legal services. And perhaps more importantly, technology will impact the quality of the legal service/product delivered to the clients. Technology will reshape the way law is practiced—both by the sole practitioner and by the larger law firms.

Certain consequences are inevitable. First, leverage will be transformed. Traditionally getting more work done by less expensive labor has been the law firm’s profitability strategy. In the future, clients will be demanding leverage by seeking to direct the staffing/technology mix so that applications/databases/and other technological advances—not paralegals or associates—provide the cost efficiency. Firms must learn to staff accordingly, or have far more lawyers than they can support. Second, some work, such as litigation discovery, will be forever commoditized. This does not mean that this work will by definition be billed at a flat or discounted rate—it means instead that it must be billed by some measure other than hourly rates if both clients and firms are to benefit. As a result, the rules of professional conduct must likely be altered to permit billings without reference to time, particularly in determining appropriateness of fees where there is a dispute.

Collaboration and Understanding

Are clients ready for the kind of billing arrangements that would allow the lawyer to make more money while being more efficient? Undeniably there is somewhat of a trend among clients to view certain legal services as a commodity, and to apply standardized rates or flat fees where appropriate. However, most clients recognize the importance of and are willing to pay a fair fee for value. What they do not want is to pay too much—to pay for inefficiencies, duplications, or unnecessary services. And this is where the leverage from technology is the lawyer’s advantage.

Collaboration in the context of providing greater value in legal services produces more effective representation at a lower cost to the client without discounting either the value or the per hour fee of the lawyer. How firms demonstrate understanding of the client’s goals and objectives and use technological efficiency to achieve them will be the new client service benchmark. Law firms must make client service and satisfaction their number one objective if they expect to receive the greater volume of work that efficiency supports. Firms that partner with their clients, and can show their clients how they can reduce their legal costs (without reducing the lawyers’ per unit fees) will have a strategic advantage in the marketplace as true value-added service providers. The firm that adopts technology to reduce the costs of its operation, and then passes those savings on to the client while maintaining its own profitability, will be the successful firm of the future.

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PRICING AS AN ELEMENT OF YOUR MARKETING STRATEGY

By Dr. Sylvia Hodges

A lot has been said and written about pricing and alternative fee arrangements (AFAs) before, during and since the Great Recession. Clients supposedly want AFAS and predictability, but in the end all they really want is a good discount—or is it? Many lawyers argue at conferences and dinner parties that the law is too particular and unforeseeable to put a price tag on it.

On the other end of the spectrum, firms such as Valorem Law, Exemplar Law, Axiom, Riverview Law, and others built on new pricing models challenge the status quo.

> AFAs are nothing innovative when seen in the broader commercial context . . Other businesses have had to address the questions previously - law firms are just coming up to speed now. Many law firms are slightly behind the curve of what it means to be efficiently run as businesses. They just didn't have the same economic pressure,

says Stuart Dodds, Director, Global Pricing at Baker & McKenzie in Chicago.

He likes to refer to AFAs as "appropriate" fee arrangements.

Fact is, more and more companies are subjecting their legal departments to clear guidelines and budgets in the department's internal management. "Our experience in 2011 was that approximately 60% of the RFPs we received requested information on flexible pricing requests and AFAs, confirming flexible pricing as a priority with our current and prospective clients. They merit a significant emphasis within the Reed Smith marketing strategy," says Matthew Laws, Reed Smith's Alternative Fee Arrangement Senior Manager in Pittsburgh.

Clients are increasingly data and metrics driven; their legal operations experts conduct detailed cost analyses; they benchmark themselves and their legal service providers. "Client's use of the procurement department and the involvement of the finance team has placed an additional emphasis on the pricing function within the marketing mix and the respective strategy of offering flexible pricing options," says Laws. Clients expect that if you know your business, you know how long a matter should take and how much it should cost. "If you do something often enough, you should have data and have it analyzed," said a client I recently interviewed. "If you don't, that's negligence."

Pricing as a Marketing Strategy

Mark Chinn, Author of *How to Build and Manage a Family Law Practice* and *Systems, Checklists and Procedures for the Family Lawyer*, says that he wanted to create a firm that relied on systems and procedures that could almost function on its own. Naysayers warned him that 'you can't do that with legal services' as they are too complicated. Chinn stubbornly believes that "everything can be systemized if you put enough thought into it." The key is to find *a* way to do things by developing checklists, synchronizing what people do, and how they do it. A law firm has to function like an orchestra. "To be a good musician in an orchestra," Chinn says, "doesn't mean you can play what you want. Everyone needs to be on the same page. You follow the music and the director."

AFAs require a commitment to learn the intricacies of their clients' businesses, anticipate their clients' needs, and seek out close collaborations with the client.

Most clients prefer flexibility in terms of rates and billing and many see AFAs as the answer, albeit not necessarily the panacea. Delivering "value" to the client is at the heart of the AFA discussion. And value can mean so many different things. That's why AmEx offers different cards-green, blue, clear, gold, platinum, or black, all with different features and benefits. If nothing else, AFAs make costs more predictable and 'budgetable' for clients. More often than not, cost certainty is more important to clients than merely getting the lowest price. In fact, if a price quote is extremely low, clients may worry that the low-cost provider may not deliver at that price. "There is no magic AFA," says Toby Brown, Director of Strategic Pricing & Analytics at Akin Gump. "But it needs to be a 'win' for the client and it needs to be a 'win' for the firm. Anything else won't work."

Above all, firms must improve trust by more closely aligning their definition of value with that of their clients. AFAs can support this process. The ACC defined value as a combination of:

- A total focus on partnering/collaboration
- Rigorous cost-control (more than simply lowering cost)
- A commitment to risk-sharing and reward-sharing
- Longer-term relationships–continuity, predictability
- A focus on new skills, staffing, and lawyer development
- Lean, efficient, process-oriented management
- Continuous improvement/accountability
- Transparency through data

AFAs require a commitment to learn the intricacies of their clients' businesses, anticipate their clients' needs, and seek out close collaborations with the client. The larger effort requires honest communication, mutual flexibility, and openness to making tangible changes. "AFAs are as much about communications as they are about numbers. It is important to manage to the AFA, not just staying within the agreed-upon budget. If the assumptions change, lawyers need to be proactive about the communication with the client," says Michael Byrd, Director of Pricing Strategy and Legal Project Management at Mayer Brown in Chicago.

Critics of AFAs question their value to clients if they net just as much revenue and profit for the firm as would a billable hour arrangement. However, AFAs can have value to a client even if a particular matter ultimately costs the client the same amount it would have cost under the billable hour system. "You develop an estimate of value for the client," recommends Kevin Christian, Pricing Strategy Consultant and President of LogiPrice, Inc. "Ultimately, the price has nothing to do with the hours." The firm needs to price according to what it is that clients try to achieve. What is their objective, then ask them why. What factors affect this? Using hourly rates as a metric is measuring input rather than output. "Karl Marx's Labor Theory needs to go

away," says Ron Baker, Founder of Pricing Think Tank VeraSage. "Nobody cares how long it took you to get to a solution. What counts is what value you created.

Managing more efficiently and focusing on the output rather than the input, however, is still challenging for many firms. The recruitment and compensation models of law firms pose some of the biggest obstacles to embracing AFAs. The number of hours billed form the key performance indicator for individual lawyers and their practice groups at firms. Introducing AFAs can create disconnect between a firm's actual fees on a matter and how it continues to evaluate and compensate the associates who work on it. Acceptance of AFAs is often mostly an internal struggle. The firm's culture and the mindsets of its professionals and staff must be aligned with the AFA philosophy to make it work.

"Most firms' data would show that a large portion of their work is not customized, and AFAs run counter to many firms' view of themselves as offering highly customized services."

The purpose of an AFA is not to reshape a firm's business model—although this is exactly what it might do in some firms—but to meet clients' needs. "The traditional model adds a layer of cost, that firms like ours just don't have," says Andy Daws, VP, North America at Riverview Law. "The world is changing, some sit up and take notice. We run our firm efficiently, like any good business." The issue is however, that "professions are not designed to change. They are designed to protect the status quo," says Baker. "That's the problem." Mayer Brown's Byrd hence sees change management to be as important to pricing as the numbers aspect. Chinn compares the thinking required to do billing by value versus billing by the hour with speaking different languages.

Among other things, firms must educate their lawyers to thoroughly understand cost structures and develop sophisticated metrics for pricing and modeling AFAs. Christian uses a cause-and-effect chain for price modeling. Why does the client need to win the lawsuit? What happens if they don't? He breaks it down logically, step by step, then attaches numbers to each stop. "It is definitely more complicated to price AFAs. What I recommend is a deeper conversation with the client about their value drivers – finding out what's important to them and tailoring a pricing arrangement accordingly." says Doug Woods, Pricing Manager at Ogletree Deakins in Atlanta. He recommends introducing AFAs with a client on a smaller-scale matter.

Patrick Lamb, Founding Member of Valorem Law Group and author of *Alternative Fee Arrangements: Value Fees and the Changing Legal Market,* advocates "chunking," such as pricing a certain period of time, or phases of a matter. "A client might try to avoid a single, large flat fee to avoid feeling she has paid too much if the case settles early. To address this concern, you can price the different phases separately. When you do this, the all-in price is lower than the price of the various phases added together."

This necessitates treating cases as projects, using project management concepts, and thoroughly examining historical revenues and costs to accurately forecast fees on future matters. It may even require new roles, responsibilities, and hierarchies within the firm. "We need to get away from the perception that everything is customized and special," says Lamb. "Most firms' data would show that a large portion of their work is not customized, and AFAs run counter to many firms' view of themselves as offering highly customized services."

Firms that have done their AFA homework tend to maintain or improve profitability when offering AFAs. Some firms have formed committees composed of practice group leaders and experts from different areas such as finance, knowledge management, marketing/business development, and IT, to analyze matters and improve predictability of matter costs. For many firms, this might necessitate embracing profound structural changes along the following lines:

- Data mining of practice management and knowledge management systems to create accurate cost predictions for matters

- Developing and maintaining pricing databases, detailed records of costs on previous matters that can help firms create pricing models for future AFAs
- Developing metrics that monitor the profitability of AFAs
- Applying project management principles to matters the firm knows well and has studied to deliver efficient services.
- Training lawyers to manage within a budget and to structure AFAs properly
- Finding new ways to organize the firm, assess lawyers' value, and determine their compensation

> "Done right, AFAs can be both highly profitable as well as a powerful competitive differentiator to the legal buyer,"

Chinn recommends that you need to understand why some cases cost so much. What are the factors that drive cost? The type of opposing counsel, the personality of the parties involved?

Who should do all the work? Opinions vary between having pricing teams, or as Baker calls them "value counsel", hiring pricing experts who report directly to the executive director or managing partner, or pricing as a natural fit in finance or marketing. "Pricing is a marketing function and folds into the value proposition. You need to know what clients want. That's marketing's area," concludes Dodds. "Flexible pricing within the marketing strategy has the role of expanding opportunities with new clients and current clients. By proactively assisting current clients to utilize alternative fees it avoids the need to explore flexible pricing outside the firm," says Reed Smith's Matthew Laws. "Done right, AFAs can be both highly profitable as well as a powerful competitive differentiator to the legal buyer," say K&L Gates' David Bowerman, Director of Client Development and Matthew Prinn, Associate Director for business development in their article *Marketing's Role in the Legal Industry's Pricing Revolution*. Christian, on the other hand, recommends hiring PhDs in mathematics or related areas, for larger firms.

Marketing, finance, MBAs, PhDs, teams or individuals. Pricing is not easy. No one should attempt it alone, in particular if new to the topic. "That's why actors hire agents," explains Baker. "So they get better prices. We're all terrible selling ourselves. There's too much emotional baggage attached to it." Rather than hanging on to doing things the way we always have and dismissing necessary change, let's now focus on it, professionally.

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PRICING FOR A WIN-WIN PARTNERSHIP

By Henry Turner, Jr.

Clients want results, and as importantly, they want to know the amount they will be required to invest to obtain those results. Value fees infuse these concepts into the attorney-client relationship. Although they are commonly called alternative fees, calling them value fees is a much better way of describing them. The adjective "alternative" differentiates the fee from hourly billing, where a client pays for time regardless of result. That is an old model that has no place in the current marketplace. Value fees fundamentally alter the attorney-client relationship so that the attorney produces a result that is aligned with a client's investment. As a litigator working for a business litigation boutique, Valorem Law Group, my experience is with value fees in commercial litigation. However, many of these points apply to value fees for transactional work.

1. How to structure value fee arrangements.

The number of value fee arrangements is limited only by the imagination, but they generally fall into two categories:

1. Contingency Fees; and
2. Fixed fees.

Contingency fees are familiar and often used by plaintiff's counsel in personal injury cases. The mechanics are simple: the lawyer takes a percentage of the recovery as her fee. There are also "reverse contingencies" where lawyers receive a percentage of the amount saved. In a litigation context, this means that if a client has $1 million in exposure, the lawyer gets a percentage of any resolution less than $1 million. The structure can be graduated, such that the lawyer gets a higher percentage the greater the savings. In a non-litigation setting, I've seen this used in tax disputes where a property owner gets a tax bill, fights it with the local assessor, and the lawyer receives a percentage of the difference between the original and reduced tax bill (or nothing if the attorney can't get it reduced). However, because there is risk of a complete loss, clients and outside counsel should look at contingency fees as an investment and scrutinize them accordingly. The idea is to minimize the cost of reaching the successful outcome while only taking the steps needed

to reach the outcome. This idea of marrying cost-containment with a focus on outcome-determinative actions permeates any value fee.

Fixed fees are the structure I am most familiar with from my work at Valorem. The fixed fee can be for a portfolio of cases, a single case, or for each phase of a case. Fixed fees provide budget certainty, ironically more than is provided by a budget. Like hourly fees, fixed fees are indifferent to the outcome. Another component is needed to align the lawyer's economic interest with her client's. This is easily accomplished by holding back of a percentage of the fee, a "holdback." For Valorem, the holdback represents a large portion of our profit on the case. It shows the client we are sharing their risk and are betting on our ability to get the best outcome for them. It also alleviates clients' concerns that we will either: (a) stop working when costs equal the fixed fee; or (b) only staff the case with cheap but ill-suited labor in order to maximize the profit margin.

Your clients are business people. They think of things in terms of production cost.

The holdback is tied to whatever outcome the client agrees is a successful result, and the client decides whether to award it to us after the outcome of the case is known. In a simplified example, the fixed fee will be $100,000. The holdback is 25% to be paid when we get the agreed outcome. Therefore, we get $75,000 on the fixed payment schedule, and only get the remaining $25,000 if we achieve the successful result. The client gets cost certainty: it can count on paying no more than $100,000 in fees. It also knows that it has incentivized us to get the result because 25% of our fee is tied to the result. Under this example, we also have the incentive to not expend any more than $75,000 to get the result, because the $25,000 holdback is not guaranteed. It is and should not be the client's problem how much we spend to get the result. If we want to turn a profit, it's up to us to figure out how to get the result while not spending more than $75,000.

The fixed fee model can be altered in a number of ways. You can charge a lower fixed fee and combine it with a percentage of the outcome when cash stream is an issue for the client, but your due diligence shows that the investment is worthwhile. You can charge a flat fee for each month the case is alive but also create a performance bonus to get it resolved at a certain time. This creates an incentive for the lawyer to move forward on a case, not "sit" on it. We also have offered clients different tiers of fixed fees. Each tier has an agreed scope of work. The higher the tier, the more services are included, which lessens the client's risk but increases their investment. Long and short, there a myriad of ways to customize the fixed fee but the principles are the same: (1) budget certainty for the client; (2) shared risk; (3) fixed revenue for the lawyer; and (4) a financial incentive to get the client's desired and agreed outcome.

2. Setting a value fee.

So you'll ask: "Hank, that's all well and good, but how do I come up with a value fee?" A proper value fee will not involve adding up the number of hours you think a matter will take and then quoting a fixed fee based on those hours. That is simply a "wolf in sheep's clothing." If you commit to pricing on a value basis, you can no longer think about pricing in terms of hours. Your clients are business people. They think of things in terms of production cost. That is how you have to think of your delivery of services. I can't provide a comprehensive set of inputs or tell you how to value them. But I can tell you that we typically analyze the following when pricing a piece of litigation:

- **Past experience with type of case:** We rely on our experience litigating a variety of cases to give us a baseline for what certain types of cases cost and the likely resolution of the case. This is a key data point to use when structuring a value fee.

- **Assessment of how competitors would price the matter:** What would an AmLaw 250 firm charge for the matter? What about a boutique? What about your typical competitor? Clients

will know these numbers, which will give them an idea of the case's value.

- **Jurisdiction:** Certain jurisdictions move cases to trial quicker than others. Certain jurisdictions make it easier to see judges and get disputes resolved quickly. Certain judges are thornier than others. The length of the judicial process and the efficiency in resolving motions, discovery disputes, etc. all impact the cost of delivering legal services because the longer the time to resolve a matter, the greater the risk that a value fee arrangement will not be profitable.

- **Size of matter:** The greater the number of documents and key witnesses (and difficulties in accessing them), the higher the production costs. Think of a securities fraud case involving related-party transactions over a number of years and between numerous corporate entities. Technology can bring down some of these costs but only to a degree. Compare that to a case where only one contract is at issue and it was between two individuals.

- **Reputation of opposing counsel or party:** If opposing counsel is known to be unreasonable, that will increase the number of petty disputes during litigation and lessen the likelihood for an efficient settlement. Both of these add time to the process, which adds costs. Additionally, your adversary may want to "scorch the earth" and use litigation as way to destroy your client, regardless of costs. The "jerk on the other side" factor must therefore be factored into the fee equation.

- **Settlement likelihood:** As part of your due diligence discussed, it is important to know where your client stands on settlement. If your client has both the desire and financial ability to settle early, and is realistic about setting the upper parameters that they are willing to settle at, this will lower the cost of the matter and accordingly your fee. If your client has no desire to settle early (or ever), that will increase the matter's costs. Moreover, a client that seems wholly unreasonable about early settlement, especially if your initial due diligence determines that is the best option, may not be the best client to have in a value fee situation.

- **Personality of the decision makers:** An indecisive client equals more costs. A client who wants an inordinate amount of your attention equals more costs. A client who is dispassionate about the outcome equals less cost. A client who is reasonable about the outcome equals less costs. These are just rules of thumb, but they show the importance of understanding your clients' personality as you partner with them on the risks they face.

- **Client's business goals:** Your client may want to resolve a matter in a certain quarter for financial reporting reasons. He may want to resolve the matter in a way that maintains a future relationship with the other side. He may want to minimize public attention to the dispute. He may want to prolong the litigation to allow for other business relationships to be developed with the opposing party's competitors. He may not be able to articulate an expected outcome at the outset. Any of these factors will impact the timing of the matter's resolution and the number of steps that need to be taken, which will have a commensurate change in your production costs. Additionally, if this is a repeat client, economies of scale will help drive the cost down. If you know the client's business well, then it will be easier to figure out a solution to their business problem. You will know the players and may have insights into the facts, which will lower investigation costs. You may have legal research, motions, and pleadings (or form transactional documents) that you can modify to avoid reinventing the wheel.

Figuring out the value to put on each of these inputs requires significant due diligence. More work has to be done on the front end because the lawyer is making an investment in the outcome of the matter and taking on more risk than in an hourly-based arrangement. The due diligence process is, however, a great opportunity to get to know your client and set expectations for your relationship.

3. Benefits to Attorney-Client Relationship.

Value fee arrangements promote a greater sense of partnership between you and your client. **First**, your client will feel that you have taken the time at the front end (the due diligence process) to truly understand her needs, as opposed to an hourly arrangement where you may just take the case, comfortable that you'll make a profit just by billing by the hour, and figure out the client's business goals later. **Second**, since your client is not paying for your time, but rather for the result, she will be more inclined to "pick up the phone" and have discussions about the facts of your matter and her business, both of which increase the chance that you can come up with a creative solution to resolve the case sooner (and thereby realize more profit). **Third**, the client will feel a greater sense of partnership with you since she understands that your fee: (a) requires you to share their risks; (b) puts the burden on you to contain costs (lowering the time they have to scrutinize bills); and (c) focuses you solely on the outcome that they want as opposed to the process (which is where much of the profit in hourly-based fees comes from).

Value fees create the economic incentive for lawyers to focus their process on the client's desired outcome while managing costs and risks relative to the client's investment.

For those who think the last point is too touchy-feely, remember that holdback we talked about earlier? Well a client that feels satisfied and fully engaged is more likely to pay you the entire holdback. You know what that means? More profit. And clients will be fine with you realizing that profit because it means that they got both (a) the outcome they wanted; and (b) a satisfying attorney-client relationship. Think of it like buying an iPhone from a great Apple store employee. Do you really care what Apple's profit is on the iPhone they sold you? No. Why? You got the cool product you wanted and you were satisfied with the experience you had in the Apple Store. End of story.

4. Operating under a value fee.

Handling a case under a value fee boils down to two words: project management. It's a simple equation:

Profit = Revenue - Cost.

Your revenue is the amount of the value fee and it is fixed. The only way to increase your profit is to control your costs. Cost management requires you to take a hard look at the way you practice, recognize inefficiencies in your practice (pick up a book on Lean Six Sigma principles), and reduce inefficiencies in your handling of the matter. Eliminating inefficiencies does not mean not doing your job or lessening your ethical representation of your client. It does mean taking only those steps that: (1) directly serve the client's desired goals; and/or (2) are in the agreed scope of work under the value fee. As my colleague Patrick Lamb always says: "Don't boil an ocean to brew a cup of tea." Sure it may be risky not to take a deposition of all ten witnesses in a case. But if three depositions will get you the facts you need to settle a matter or try a case, then the cost of taking the other seven depositions is a production defect. It will not only increase your costs (cut into your profit), but more importantly, it wastes your client's investment.

Value fees can be risky propositions. Clients, particularly businesspeople, know that nothing in life is certain but they still need a result. Value fees create the economic incentive for lawyers to focus their process on the client's desired outcome while managing costs and risks relative to the client's investment.

Henry Turner, Jr.'s practice concentrates on complex commercial litigation and trademark infringement disputes. He began his career in 2003 with Jones Day, where he focused on complex commercial litigation, securities fraud class action defense, and internal investigations. In 2008, he joined the Valorem Law Group, a Chicago-based boutique that provides litigation and dispute resolution services through value-based fee arrangements. He has served clients at every stage of the business disputes they face, from advising them on strategies to informally avoid or resolve disputes to representing them at trial to verdict.

PRICING, CLIENTS AND BUSINESS MODELS

By Donna Seyle

In a blog post titled, How to Compete on Price, Jordan Furlong concludes:

> It probably goes without saying that the single biggest inefficiency in most law firms is the fact that tasks are worth more the longer they take and the more resources they consume. Hourly billing—and more importantly in this context, hourly compensation—is a productivity hemorrhage that's becoming far more damaging to firms than to clients. And it is not sustainable.

The value of the work lawyers perform is related to the special skills and knowledge we bring to bear upon a client's circumstances to enable resolution.

We all know this in our hearts, yet law firms hang on to the billable hour model for dear life.

In The Billable Hour: How Sick Is It?, Jim Hassett, says:

> In every profession, sellers love the billable hour, because it puts all the risk on the buyer side. Believe me, if. I could sell all of my company's services on an hourly basis, I would switch over in a heartbeat. But I'm stuck with fixed price work, because I sell to lawyers, and they hate buying services by the hour. They know better.

The shift from the billable hour to alternative pricing is not about money. It's about two things:

- how you perceive your work; and
- how you perceive your relationship with your client

If anything, the billable hour has served to commoditize work product by assigning value to it in terms of the time it took to produce it. The value of the work lawyers perform is related to the special skills and knowledge we bring to bear upon a client's circumstances to enable resolution. How long that process takes has no bearing upon the worth of those skills and knowledge.

Clients and Billing

The billable hour system has had a divisive effect on the attorney/client relationship. The legal process can be extremely laborious and time-intensive if you enter into it with an adversarial posture rather than focusing on resolution or desired result. As attorneys, we can get consumed by the procedural power of our craft. The more we practice with an attitude of flexing our muscles, the more costly our services become when based on the billable hour system. The client, not knowing what is or is not really necessary to complete the assignment, lives in fear of uncertain costs and powerlessness to control them.

THERE IS A LEVEL OF MUTUAL TRUST THAT GROWS BETWEEN ATTORNEY AND CLIENT WHEN THERE IS WILLINGNESS TO SHARE THE RISK OF BOTH THE PROFIT AND THE OUTCOME.

Although the billable hour pricing model provides a solid income stream which law firms have found reliable, it has also created a state of anxiety and frustration for the client and the lawyer who is serving that client. As long as there is any level of mistrust between attorney and client, the entire relationship is fraught with mutual disquiet and resentment.

There is a level of mutual trust that grows between attorney and client when there is willingness to share the risk of both the profit and the outcome. This is the kind of environment in which long-term relationships develop. When an attorney or law firm is willing to consider the undue burden borne by the client in a billable-hour arrangement by offering alternative fee structures, there is the intangible benefit of having a dedicated relationship evolve.

When attorneys and clients align their goals and understandings, the conflict of interest related to the efficiency with which legal representation is provided is now eliminated. Attorneys are on the same side of the cost-containment issue as are the clients. Moreover, our work as lawyers is no longer a commodity of time. The knowledge, analysis, and legal insight we bring to bear on the client's matter is valued, and our perception of ourselves as lawyers is enhanced.

The Alternative Pricing Business Model

Jay Shepard puts it like this: "Think of alternative billing not just as a change in your billing. Think of it as a fundamental change in your business model."_

Alternative pricing of legal services also isn't really about pricing; it's about efficiency and cost-containment. Besides the monstrosity of a job it takes to reinvent a large law firm based on pricing other than billable hours, these firms are resistant because they are afraid: afraid of the unknown and afraid to take risks. Since law firms have never been efficient or cost-effective, their fears may be well-founded. Law firms have gotten away with raising their hourly rates year after year, and their costs are hardly ever considered. In short, if law firms had to compete in the business world, they would fail miserably. Unfortunately, that's exactly what it's come to.

Now, law practices must align their business model with traditional business concepts. They are losing clients who have suffered as a result of the recession and can no longer afford to take on uncertain and overpriced legal fees. Law firms cannot afford to reduce their rates, or create fee structures that shift the cost risk from the client to the firm, because they have not addressed cost-containment. The reality is, clients don't care about your costs, and costs should not be a factor in pricing your work.

Law firms have begun to admit that they never really engaged in developing a costanalysis of the legal product. They have simply followed a strategy of hiring lots of associates and setting billable hour requirements that will finance the firm's operations. When you are in a marketplace stressed by unemployment and reduced spending patterns, that system doesn't work.

Getting real about the business of your law practice requires thinking about things like P&Ls and client satisfaction. Your product is your knowledge: what price will you put on each action requiring use of that

knowledge? And how happy will your clients be with the value they received from your knowledge in light of the price they paid?

The problems created by a billable hour system can be summarized as follows:

- It demeans our work by categorizing what we do as a service. We are knowledge providers. We sell intellectual capital and innovation to get the best possible results for our clients. Our knowledge has intrinsic value. It has nothing to do with how long it takes to apply our knowledge to our client's circumstances and create solutions. The pricing of our product must relate to the value the client places on that solution.
- It creates a conflict of interest between attorney and client. When law firm profitability and partnership shares are tied to numbers of hours billed, it is the attorney's best interest to take longer to perform tasks, whereas the opposite is in the client's best interest.
- It rewards inefficient workflow, reinvented wheels, maximized activity and over-accomplished tasks.
- It creates a level of suspicion and distrust on the part of the client. Instead of creating a working partnership with our client, there is an underlying conflict where the clients are constantly requiring justification for our work that we must defend.
- The client is forced to live with the uncertainty of an open-ended financial obligation, and must bear all the risk associated with the cost of legal services we provide.
- Not all time spent requires the same level of skill. Researching, formulating legal theories of the case, drafting complex documents have far more value than preparing a motion for filing, yet all of these tasks are billed at the same hourly rate.

What do I see when I look at these realities? The face of opportunity.

What do I see when I look at these realities? The face of opportunity. If a big firm associate exodus can make an end-run around their former employers, so can sole practitioners and small firms. Newly-formed law practices have a huge advantage over big law: they are not institutionalized. They have no framework, no structures, no traditions to dismantle. They do not have the burden of keeping a behemoth business functioning as they break down the old and institute the new.

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BONUS ARTICLE: USING AND FUNDING STRUCTURED SETTLEMENTS

STRUCTURAL CHANGES

By Patrick Farber and Amy Fisch Solomon

Structured settlements and the laws governing them are ever changing. Issues like how they are taxed, when they can be used, and whether they can be sold seem to be in a near constant state of flux. For plaintiff trial lawyers who are charged with properly advising their clients regarding settlement of their cases, this instability can be disconcerting, to say the least.

If it looks like a structured settlement (or periodic payment plan for tax-deferred structures) would benefit your client, you'll need to consult with qualified financial and tax advisers. But before you make that call, you should understand the latest developments regarding structured settlements and how they might affect your case.

The Periodic Payment Settlement Act of 1982 launched the structured settlement movement by enabling parties involved in personal injury and workers' compensation cases to receive structured settlements for their injuries instead of lump-sum payouts.[1] Typically, the defendant in a lawsuit buys a single-premium annuity on behalf of the plaintiff from a life insurance company, which is contractually obligated to make the future settlement payments.

The income received through structured settlements is exempt from state and federal income taxes and excludable from gross income under the federal tax code. Internal.Revenue.Code §104(a) determined that damages for specific injuries (that is, personal injury or sickness, medical malpractice, products liability, workers' compensation) could be excluded from gross income and thus tax-free. Interest earned on the annuity payments is also tax-free.[2] Qualified structured settlements provide guaranteed long-term, tax-free income.

But what if the plaintiff is not a person or has not suffered physical injury or illness? Does that mean settlement funds aren't tax-free? Not necessarily. For example, in one confidential case, a homeowner's association (HOA) sued its building contractor because of damage from leaking windows in the association's newly built rec room. The HOA claimed that because of poor construction, the building's windows would always leak.

The parties agreed to a periodic payment settlement that provided payments every ten years for forty years so the HOA could replace the windows when necessary. Even though the plaintiff is not a person and suffered no physical injury or illness, the settlement payments are tax-free as long as they are paid directly to the HOA.

The settlement called for the annuity-issuing life insurance company to pay the HOA directly. The HOA is a tax-free entity, so it enjoys the same tax benefits as a person who settles a personal injury claim involving a physical injury or illness.

Even when cases do not qualify for tax-exempt status, the tax-deferred and financial-planning aspects of the settlements may make them worthwhile.

Even when cases do not qualify for tax-exempt status, the tax-deferred and financial-planning aspects of periodic payment settlements may make them worthwhile. According to industry figures, in 2010, life insurance companies issued $5.8 billion in annuities to fund future payments in more than 32,000 cases; that was up from $5.5 billion in 2009.[3]

Periodic payments are becoming common in non-personal injury cases, like those involving construction defects, employment discrimination, and punitive damages, because they offer the security of lifetime payments and tax-deferral advantages.

For example, in another confidential case, after a thirty-year-old man was killed in an auto accident, his wife and child filed suit. At trial, the jury's award to the plaintiffs included $11 million in punitive damages. A tax-deferred structure for this portion of the award provided that the plaintiffs would receive $2.5 million in cash up front. The widow would then receive $150,000 annually for twenty years, and the child would receive $50,000 annually for five years after turning age eighteen, a $150,000 at age twenty-five, and another $300,000 lump sum at age thirty.

Periodic payments have also slowly become part of mass tort physical injury litigation. Plaintiff lawyers, their clients, and special masters have recognized that certain individuals in mass tort actions have a need for lifetime income because of ongoing medical needs.

Recent class action settlements—including those involving medical device manufacturers, large pharmaceutical companies, and toxic waste cleanup sites—have allowed present-value settlements to be extended by the use of annuities to provide guaranteed long-term payments to meet long-term needs.

In a large class action involving toxic drinking water in California, the defendants and class members agreed to a confidential settlement of more than $300 million. The 1,400 adult and minor plaintiffs either had developed cancer because of the contamination or believed the chances were good that they would.

Each plaintiff was offered a lifetime annuity as part of the settlement. For those with cancer, the lifetime annuity would pay for medical bills and, since most could no longer work, would help maintain their lifestyle. Those without cancer established annuities for future medical bills and lifestyle expenses. Minors who had lost parents due to illnesses caused by the water contamination received annuities that would pay for living and college expenses.

While the settlement was for the class, each lifetime annuity was tailored to the needs of each individual plaintiff. The tax-free annuities took present-value settlement dollars and increased their value fourfold by extending the payments over the lifetime of the plaintiffs.

In another development, elderly injured parties are combining pooled special needs trusts (SNTs) with life annuities to preserve government benefits while receiving income for nonmedical needs. Pooled SNTs are established and managed by a charity for individuals primarily over age sixty-four. Because they are created through a nonprofit entity, support a "pool" of individuals, not a single individual, and the settlement money remains in the trust and is not owned by the plaintiff until distributed, the income from these trusts is not counted against needs-based public benefits such as Social Security and Medicare.

In one confidential case, family members sued an assisted living home for the mistreatment of their seventy-three-year-old mother. A pooled SNT was created. The woman received $135,000 cash with a $2,150 monthly payment guaranteed for five years. Her public benefits were not affected.

Pooled SNTs can be used for an individual of any age, but this is the only type of special needs trust available to people age sixty-five or older.[4] Some restrictions apply. For example, pooled SNTs must be for the "sole benefit" of the trust beneficiary.

In states that have accepted the Deficit Reduction Act of 2005, a transfer penalty will apply for funds placed in a pooled SNT.[5] The penalty can create up to five years of ineligibility. Other states allow only one transfer of funds into a pooled SNT. Check with your state for specific rules. In most states, direct disbursements (or gifts) to children or spouses are not permitted, as the disbursement must be for the elder plaintiff only.

Choosing a Structure

Life annuities provide lifetime guaranteed income to maintain the injured party's standard of living. These payments can be paid at intervals determined by the annuity carrier and the plaintiff's needs.

Over the years, annuity options available to the injured party have become more creative. In another confidential case, the plaintiff sued a church for clergy abuse he recalled suffering as a child. He did not remember physical abuse, just emotional abuse. Because the man claimed he could not work, the settlement included a lifetime annuity, and the periodic payments were tax-deferred because his injuries were emotional, not physical. The $2.7 million settlement provided a taxable $285,000 lump-sum payment, plus monthly guaranteed payments of $1,250 for twenty years.

Until recently, these types of payment arrangements were used only in traditional cases of physical injury or sickness. Although they do not meet the criteria of a typical structured settlement, guaranteed, tax-deferred annuities are making up more of the annuity market.

Stepped annuities involve increases of the annuity payments for a fixed period or over the lifetime of the structure. In a case involving a thirty-five-year-old computer programmer who lost both hands in an accident, a stepped benefits plan was created to compensate for loss of earnings. The confidential plan called for monthly payments guaranteed for twenty years, with payments increasing by $1,000 per month every five years until the plaintiff reached age fifty-five. At fifty-five, a life-only annuity would begin, paying him $10,000 a month for the rest of his life.

Stepped annuities help hedge against inflation. Instead of buying one annuity that will pay one rate over its lifetime, stepped annuities that adjust for inflation can guarantee payments to the injured party to cover-cost-of-living increases.

Joint and survivor periodic payments are created for joint settlement recipients. These annuities involve one contract for two annuitants. When one of the annuitants dies, the survivor continues to receive annuity payments at a prearranged percentage of the original annuity. For example, say the settlement calls for monthly guaranteed payments for twenty years, payable jointly to a man and his wife. If either spouse dies before the twenty-year contract expires, the surviving spouse would continue to receive full monthly payments, tax-free.

U.S. Treasury bond structures involve the purchase of U.S. Treasury strips or bonds. These can be laddered so that every few years the interest rate increases. Laddering bonds is similar to using stepped annuities. Treasury securities can be purchased with one-, five- and ten-year maturities, with the longer-term securities providing larger yields. The bonds continually mature so the injured party can take advantage of rising rates. If interest rates drop, the injured party will still hold longer-term bonds with higher yields.

Because Treasury bonds can be called by the government, these periodic payments cannot include payments for a lifetime, they must be for a fixed amount of years. Because of this, the injured party may also need a separate annuity to cover ongoing lifetime care costs.

Deferred periodic payments are also ideally suited for structuring attorney fees when an attorney or firm wishes to generate a steady, long-term stream of income or create income at retirement. Anyone who accepts a periodic payment annuity has a large amount of flexibility when it comes to how to receive payments.

Factoring Futures

In most cases, it is in the plaintiff's interest to receive settlement payments over time, but many plaintiffs have been lured into selling their structures to "factoring" companies in return for a lump-sum payment. These companies, with their aggressive commercials and promises of fast cash, have made factoring a booming business.

While there may be circumstances where plaintiffs may find themselves suddenly in need of a significant amount of money, the cost of converting a structured settlement to a lump-sum payment can be high, with

factoring company fees and taxes taking a large piece of the payout.

Concerned about the potential problems with factoring transactions, the federal government and many states have passed laws requiring prior court approval of structured settlement buyouts. Under the federal law, if court approval is not received, a 40% excise tax is levied against the factoring company on its discount (the difference between the actual amount that would have been paid to the injured party and the amount paid for the structured settlement by the factoring company).[6]

While most state statutes on factoring are similar, in 2009, California passed a law that created even greater judicial oversight of these transactions.[7] The law states that the lawyer who handled the initial settlement must be notified before a buyout takes place. This ensures that plaintiffs are adequately protected, fully informed, and acting in their own best interests.

The law also provides explicit guidelines for courts to consider when deciding whether a buyout is appropriate. The guidelines require courts to review the injured party's current and future financial needs, determine whether the party has received independent legal and financial advice concerning the buyout, and assess whether the "discount rate" proposed by the factoring company reflects current market rates. The guidelines ensure that injured parties are aware of the value of the structured settlement versus the value of the lump-sum buyout.

Pending legislation in Oregon[8] is designed to amend the state's Structured Settlement Protection Act—and contains many of the same features of the California law. A New York law that became effective this year requires factoring companies petitioning the court to include "a statement setting forth whether there have been any previous transfers or applications for transfer of the structured settlement payment rights and giving details of all such transfers or applications for transfer."[9] Another new provision of the New York law states that "the payee shall attend" the hearing on the proposed transfer unless the court excuses such attendance 'for good cause'."[10]

Structured settlements have created financial security for millions of plaintiffs. As applications continue to grow and attorneys become more creative, structures will find their way into more and more settlement discussions.

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Endnotes

1 Pub. L. 97-473, 96 Stat. 2803 (1982).

2 26 U.S.C. §104(a)(2) (2006).

3 Life Ins. & Market Research Ass'n, _____[Author name?] , _______[Title?]______________, _____ [Page #s?], ____(Date?)________, _________ [URL?]__________.

4 42 U.S.C. §1396p(d)(4)(C) (2006).

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7 Cal. Ins. Code Ann. §§10134-10139.5 (West 2009).

8 Or. H. 2922, 2011 Reg. Sess. (Jan. 11, 2011).

9 N.Y. Gen. Oblig. Law §5-1705(d)(iv) (McKinney 2002).

10 N.Y. Gen. Oblig. Law §5-1705 (McKinney 2002).

CLOUD COMPUTING FOR LAWYERS

By Sarah Eggleston

The cloud this. The cloud that. Everybody is talking about the cloud. Somehow if you are not in the cloud, you're just not doing something right. You're behind the times. Jump in with both feet immediately. Well, that might be fine for most, but lawyers have to think twice.

The use of this latest and greatest wave of technology raises ethical issues you need to be aware of. The State Bar of California's Standing Committee on Professional Responsibility has published at least two Opinions (one formal and one draft) that discuss cloud computing. In late 2010, the Bar published Formal Opinion 2010-179. In early 2012, it also published Draft Formal Opinion Interim 10-0003. When the State Bar starts talking about violating the duties of competence and confidentiality in using cloud computing, it's time to look for guidance.

Nicole Black has written a book that just might fill in the gaps and provide some of the guidance necessary to help even the biggest luddite determine whether or not to jump in to cloud computing.

Black knows her stuff. She is an attorney and founder of lawtechTalk.com, a blog devoted to emerging technologies and how they benefit law practice management.

Cloud Computing for Lawyers is aimed at solos and small firm attorneys looking for a general understanding of cloud computing. This book delivers. Though it falters a bit in the practical advice for implementation, it conscientiously explores the basic underlying concepts, ethical concerns, and security issues.

The first few chapters of the book explore general questions that everyone has about the cloud: What is it? Is it going to last? Can I save money using it? For me, a reasonably technology-savvy person, the first chapter, or "what is it?" chapter was the most helpful. When the cloud is discussed or defined, Ms. Black uses general, non-jargon language. She puts the cloud in a context I understand, using applications such as Gmail. Gmail is something everyone is familiar with. It's her first analogy and sets the tone for the rest of the chapter. (By the way, she does include the very techy language, but it is included in an appendix for those who need all the technical details.)

The middle portion of the book discusses both ethical and security issues. To tackle the ethical implications of cloud computing in a law practice, Black hands the reigns to Stephanie Kimbro. Kimbro is noted for her expertise regarding virtual

law offices. Here, she does an excellent job by using Model Rules as guideposts. She discusses how different states have interpreted these rules, giving readers plenty to think about and determine whether or not they are comfortable moving into the virtual world and cloud computing. The steadfast analysis doesn't stop with the discussion on privacy and security issues. Again, state laws and other outside experts are consulted to give the reader a comprehensive idea of what threats and concerns must be considered. A cloud computing Service Level Agreement questionnaire is even included.

In the second half of the book, Ms. Black stumbles a bit from her strong start. She moves into implementing cloud computing into a law practice and cloud computing applications. This is where, while worth reading, it could have been much more practical. Systems and set-ups were talked about in very general terms. More examples from current cloud practitioners or actual implementation plans would have been helpful. Here, she has very detailed appendices that could have been easily incorporated into the main chapters of the book. I know she wanted to ease up on the jargon, but these technical details could easily have been incorporated as an illuminating case study.

> **Kimbro is noted for her expertise regarding virtual law offices. Here, she does an excellent job by using Model Rules as guideposts.**

Overall, I think it was a good book and worth reading. It opened my eyes to issues that I had never considered. But, the practical aspect of it was lacking. I wanted to see more examples of actual cloud computing implementations and what tools were used and why. More examples of tasks made more efficient and actual time and money savings tied to the cloud. These examples would round out an essential primer on cloud computing and provide comfort to the novice user—essentially the book's target audience.

Sarah Eggleston is the Director of the Riverside County Law Library. She graduated from Southern Connecticut State University with her Library Degree in 1993 and from Whittier Law School with her Law Degree in 2009. Sarah began her career working in public libraries as a reference librarian and outreach specialist. However, for the past 12 years her focus has been on public law libraries. She has worked in a variety of law-related settings including working for major law firms and the Los Angeles County Law Library, the largest truly public law library in the US. About 2 years ago, she became the Riverside County Law Librarian. Since coming to RCLL, she has greatly expanded their book collections and services offering more practice-related materials and legal research classes for both attorneys and the general public.

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