

Next Generation Law Firm Economics

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Session Description

What impact will the shift away from the billable hour have on law firm economics? What sorts of firms will be profitable in an environment dominated by fixed fees and other alternative pricing arrangements? Where does technology and technology leadership fit in the new equation? What are some examples of technologies that have transformed practice economics. What will law firm economics be like in 2020?

Roadmap

- Fundamental change?
- Action?
- Recipe for success?
- Takeaways?

KEY QUESTION

Is the current downturn a cyclical “blip” (a normal phase of the business cycle) or a harbinger of more fundamental and long-lasting changes in the legal market?

Peer Monitor Economic Index (PMI)

i/+^ 2010
strategic
unity

Q4 PMI Score: 55



A HARBINGER OF FUNDAMENTAL CHANGE

- There is mounting evidence that we are seeing a fundamental shift in key aspects of the traditional law firm model.
- This change was not *caused* by the current downturn, but it has been accelerated and exacerbated by it.
- The *cause* of the change we are seeing was the essential unsustainability of the old law firm economic model.

DRIVERS OF LAW FIRM PROFITABILITY

Leverage

Productivity

Rates

Realization

Expense Management

Profitability

DRIVERS OF LAW FIRM PRODUCTIVITY

Level

Productivity:

- Declining steadily since the late 1990's.
- Driven by associate pushback to unsustainable billable hour requirements.
- Aggravated by a "seller's market" for talent that drove up salaries as productivity declined.

bility

Expense

DRIVERS OF LAW FIRM

PROFITABILITY

Leverage

Leverage:

- Struggle to maintain leverage as:
 - Firms hired more associates to make up for declining productivity and
 - Firms made partners at a faster pace than the firms were growing.
- Most firms sustained or grew their leverage but at a very high cost.

ility

Expense

DRIVERS OF LAW FIRM

PROFITABILITY



Levera

Realization:

- Dropping fairly steadily in years just prior to downturn.
- Reflected increasing client demands for discounts and resistance to “premium” arrangements.

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Expense m

DRIVERS OF LAW FIRM PROFITABILITY

Leverage

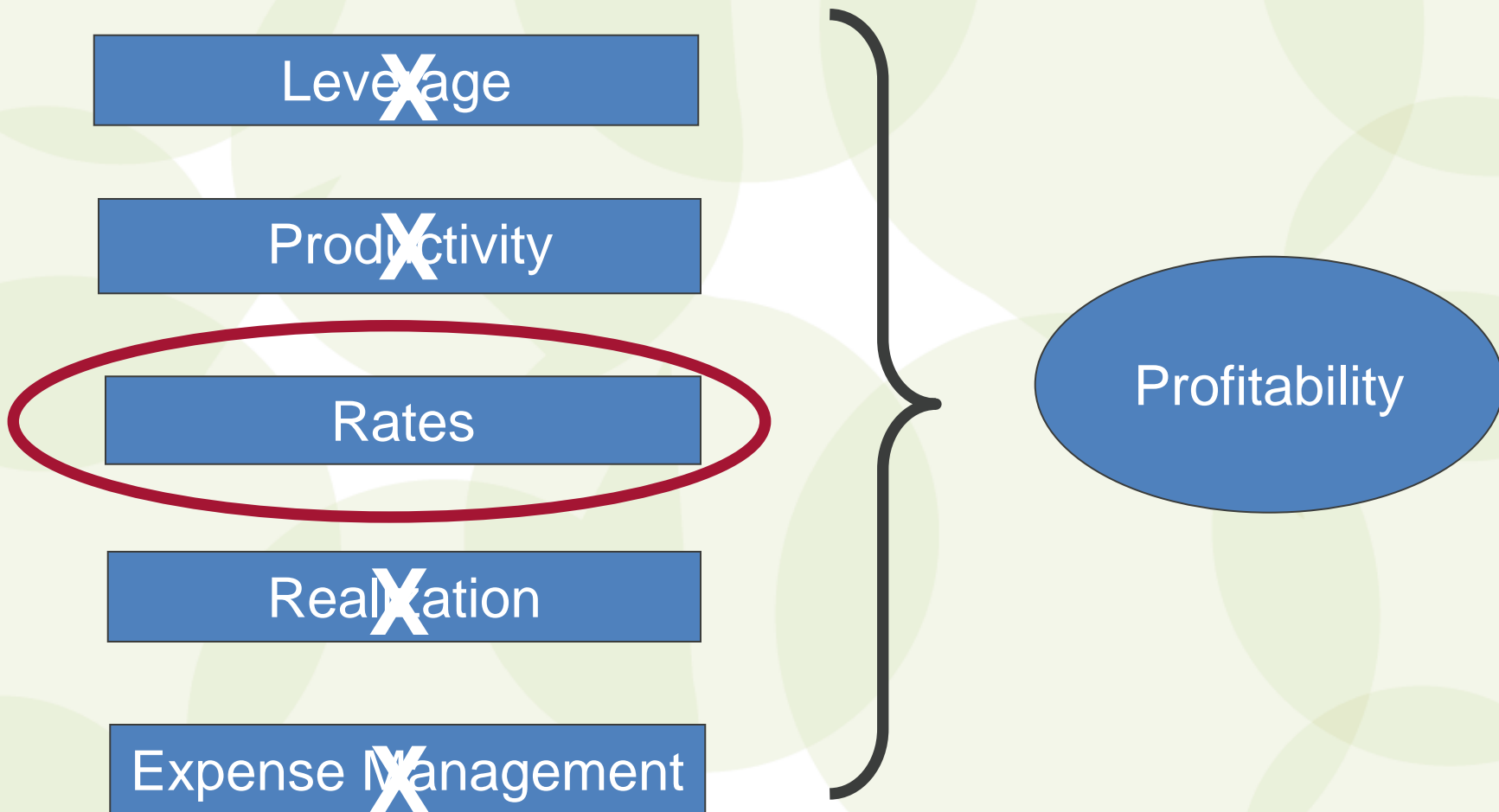
Expenses:

- During years prior to downturn, expenses grew at a much faster rate than inflation.
- Principal driver was rapidly escalating associate salaries – followed by space and technology costs.

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Expenses

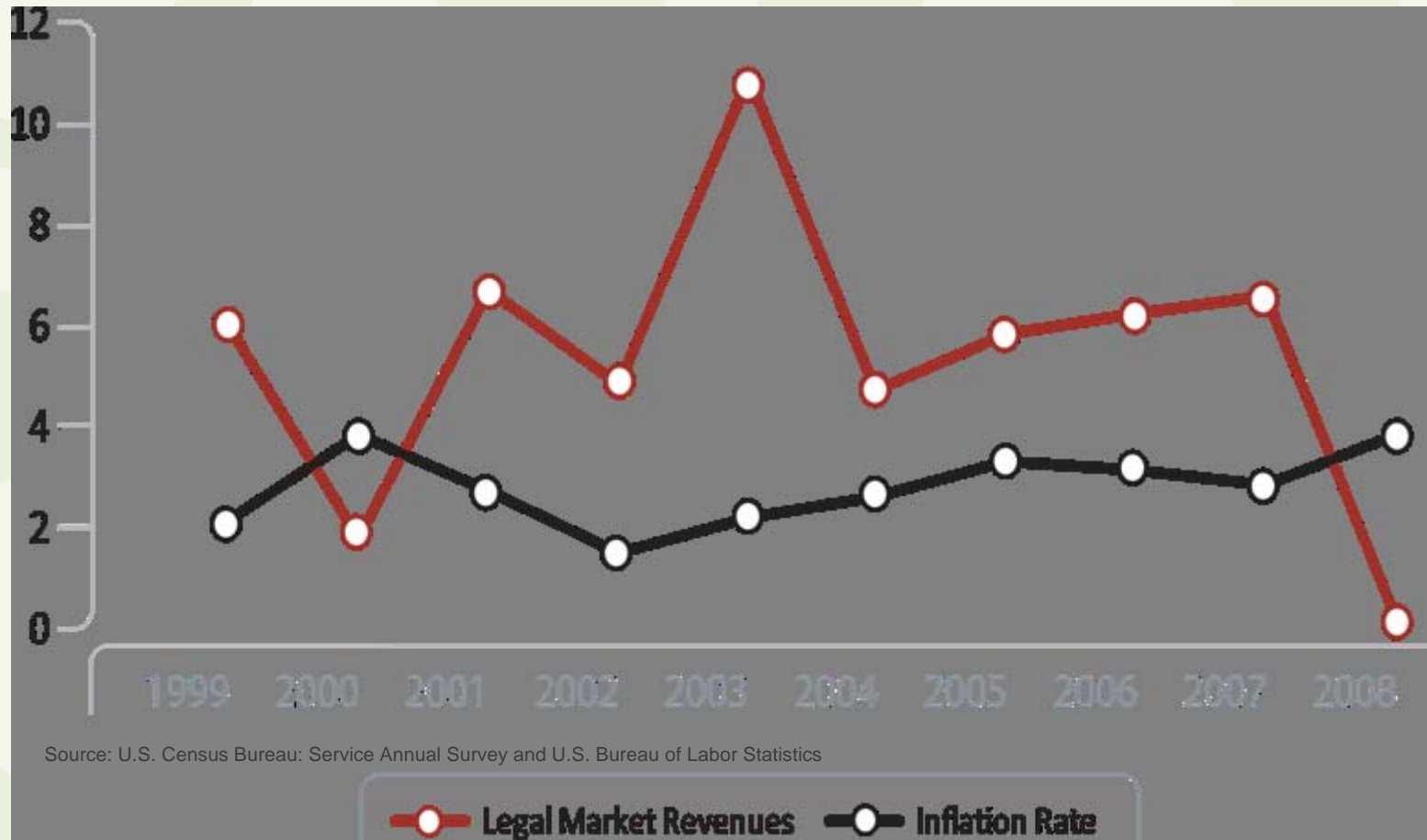
DRIVERS OF LAW FIRM PROFITABILITY



LOSS OF RATES AS A RELIABLE DRIVER OF PROFITABILITY

- Prior to the recession, firms were raising rates at a clip of 6-8% per year – well ahead of annual inflation rates.
- Had firms not been able to drive these rate increases, the economics of the “boom years” would have looked very different.
- Partly as a result, the overall costs of legal services grew exponentially – ultimately to a point that strong client resistance became inevitable.

Percentage Change in Legal Market Revenues vs. Inflation (1999-2008)



A BUYER'S MARKET FOR LEGAL SERVICES

- For the foreseeable future, we are likely to have a buyer's market for legal services in which clients increasingly focus on overall value.
 - Little tolerance for “routine rate increases.
 - Expanding use of competitive proposal processes.
 - For billable hour based matters, increasing demands for discounts, blended hourly rates, capped fees, multi-year fee arrangements, etc.
 - Expanding use of alternative (non-hourly based) pricing arrangements.
 - A growing determination to bring the economic interests of the client and the law firm into better alignment.

INCREASED FOCUS ON EFFICIENCY

- Clients will be increasingly focused on considerations of efficiency and cost effectiveness.
 - Prime evidence – growing willingness of many clients to “disaggregate” legal services.
- Firms will need to respond by implementing new models for –
 - Pricing legal services;
 - Designing and managing better legal work processes;
 - Recruiting, managing, and retaining professional talent; and
 - Partnering with other service providers to improve efficiency in service delivery.

NEED TO REDEFINE “COMMODITY” WORK



- The new models may require firms to re-think their willingness to undertake “commodity” work.
- Client focus on efficiency, combined with increasingly sophisticated technology, may well force a redefinition of “commodity work” – and underscore the importance of *all* firms being able to deliver more standardized work products along with their more specialized services.

NEED FOR STRONG LEADERSHIP

- The need for strong and insightful leadership in law firms has never been greater.
- The world has changed. Focus on growth and expansion that drove law firm strategic and management decisions for the decade preceding 2008 has been replaced with a different imperative – the necessity of focusing on efficiency in the delivery of legal services.
- Adapting to this change will require significant shifts in law firm culture and a fundamental reorientation in the way law firm leaders think about their businesses and their roles.

THE NEED FOR BETTER PERFORMANCE METRICS

MEASURING AGAINST THE NEW MODELS

- If “what gets measured gets done,” the change in law firm models that we predict over the next few years will necessitate new measurement tools to help law firm leaders (as well as their clients) judge the performance of lawyers and their firms.
- It will take time for new metrics to be developed and adopted across the market, but some firms have already begun experimenting with a variety of tools that show promise.

Chart 11

Current and Possible Future Performance Metrics

A number of the metrics that we list as “possible future” measurement tools are already being used in several firms and by banks, consultants, and other service providers to the legal market.

| Management Category | Today's Key Metrics | Possible Future Metrics |
|--|---|--|
| Firm Performance | <ul style="list-style-type: none"> Profit per Equity Partner Profit per Partner Revenue per Lawyer Profitability Indices Leverage Realization | <ul style="list-style-type: none"> Profit per Shareholder Expanded Leverage Return on Capital Employed (ROCE) Highly Levered Profitability Profit per Shareholder (per \$100M) Market of Interest (Rating) |
| Expense Management | <ul style="list-style-type: none"> Expenses per Lawyer Staffing Ratios Functional Expenses per Lawyer | <ul style="list-style-type: none"> Efficiency Index Return on Assets Expenses per \$1 Million Compensation per \$1 Million |
| Practice Performance | <ul style="list-style-type: none"> Fee and Growth Realization Utilization Leverage Matter Profitability | <ul style="list-style-type: none"> Client Concentration or Diversification Practice Contribution to Profit Profit per Possible Shareholder Profit per Employee Market Share Expected Outings Profit Contribution by Client Type |
| Partner Performance | <ul style="list-style-type: none"> Originations Working Attorney Fees Realization Billable Hours Leverage | <ul style="list-style-type: none"> Profit per Share of Practice Owned Real Profit of Many Originated or Managed Unit Size of Work Completed or Managed Client Satisfaction Rating Employee Satisfaction Rating Cross-Staffing or Cross-Working |
| Client Development/ Market Strength | <ul style="list-style-type: none"> Client Turnover Rate Client Diversification Index Fee Growth Realization Originations | <ul style="list-style-type: none"> Client Strength Market Share by Equity Class Market by Client for Equity Class |
| Balance Sheet and Risk | <ul style="list-style-type: none"> Capital per Partner Debt per Partner Debt/Equity Ratio Debt/Net Fixed Asset Ratio | <ul style="list-style-type: none"> Value Indication (Market) Return on Capital Risk Index |
| Management and Leadership | <ul style="list-style-type: none"> PEEP Growth Fee/Revenue Growth Turnover Firm Rankings | <ul style="list-style-type: none"> Return Share Growth Leadership Index Client Satisfaction Index Return on Human Capital Employee Satisfaction Index Management Value Share (Return) |

Measurement Categories

- Firm Performance
- Expense Management
- Practice Management
- Partner Performance
- Client Development/Market Strength
- Balance Sheet/Risk
- Management and Leadership

Firm Performance

*Movement towards organizational efficiency and better asset management
measures that consider returns relative to risk*

Today's Key Metrics

- Profits per Equity Partner
- Profits per Partner
- Revenue per Lawyer
- Profitability Index
- Leverage

Drivers of Change

- Changing leverage models
- Increased transparency of law firm financials
- External ownership
- Multidisciplinary practice

Possible Future Metrics

- Profit per Employee
- Matter Profitability
- Return on Capital / Return on Equity (accrual basis)
- Risk-adjusted performance
- Profit in excess of partner "salaries" / Profit per Share
- Value of Income Stream

Expense Management

Pressure to reduce costs in short term and improve cost-structure long term to account for efficiency and returns

Today's Key Metrics

- Expenses per Lawyer
- Staffing Ratios
- Functional Expenses per Lawyer

Drivers of Change

- Changes in staffing models
- Adoption of more systematic procurement models
- Outsourcing of substantive legal work

Possible Future Metrics

- Efficiency Index
- Return on Assets
- Employees per \$ Million
- Compensation per \$ Million

Practice Performance

New pricing models and greater accountability at matter / practice Level

Today's Key Metrics

- Fees & Growth
- Realization
- Utilization
- Leverage
- Matter Profitability

Drivers of Change

- Alternative pricing
- Performance pressure

Possible Future Metrics

- Matter Contribution to Profit / Margin
- Practice Contribution to Profit
- Profit per Practice Member
- Profit per Employee
- Market Share
- Extended Leverage
- Profit Contribution by Client Decile

Partner Performance

New pricing models and increased need to maximize firm performance

Today's Key Metrics

- Originations
- Working Attorney Fees
- Realization
- Billable Hours
- Leverage

Drivers of Change

- Alternative pricing
- Performance pressure
- Staffing model changes

Possible Future Metrics

- Profit per share of practice managed
- Total profit of work originated/managed
- Unit cost of work originated/managed
- Client satisfaction Rating
- Employee satisfaction Rating
- Cross-selling / Cross-working

Client Development / Market Strength



Shifting power balances and more savvy consumers of legal services

Today's Key Metrics

- Client Turnover Rate
- Client Diversification Index (e.g., percent of revenue produced by top 10 clients)
- Fee Growth
- Realization
- Originations

Drivers of Change

- Pricing pressure
- Client retention issues
- Use of “dual-counsel” situations

Possible Future Metrics

- “Brand” Strength
- Wallet Share for Target Clients
- Growth in Share for Target Clients

Balance Sheet/Risk

Changing partnership models, industry consolidation

Today's Key Metrics

- Capital per Partner
- Debt per Partner
- Debt / Equity Ratios
- Debt / Net Fixed Assets Ratio

Drivers of Change

- Changes in staffing models
- Lower risk tolerance of banks
- Increase in capital needs as to fund investments

Possible Future Metrics

- Value Index / Firm Valuation
- Return on Capital
- Risk Index (use of debt, capital, performance over/under market, etc.)

Management & Leadership

Acceleration towards more sophisticated management needs & smarter approaches to managing human capital

Today's Key Metrics

- PPEP Growth
- Fee Growth
- Turnover
- Firm rankings

Drivers of Change

- Continued industry consolidation and competition
- Smarter approaches to measuring and deploying human capital

Possible Future Metrics

- Market Share Growth
- Leadership Index
- Client Satisfaction index
- Return on Human Capital
- Employee Satisfaction Index
- Management Value Index (“value” / “cost”)

MEASURING AGAINST THE NEW MODELS

- Going forward, measuring the health and effectiveness of law firms will require the use of several new measurement tools for both financial and non-financial performance assessment.
- One of the serious misuses of metrics in the past few years has been over reliance on PPEP as the defining index of a firm's value and quality.
- In the future, more flexible and comprehensive tools will be required.

The traditional model will continue under stress from several directions

**Talent Model
built on:**

- High leverage
- High turnover

**Legal
Business
Model**

**Pricing Model
built on:**

- Time and materials
- Steady price increases

Processes & Costs driven by:

- Guild/craftsman legacy
- Protectionism
- Lawyer prerogatives

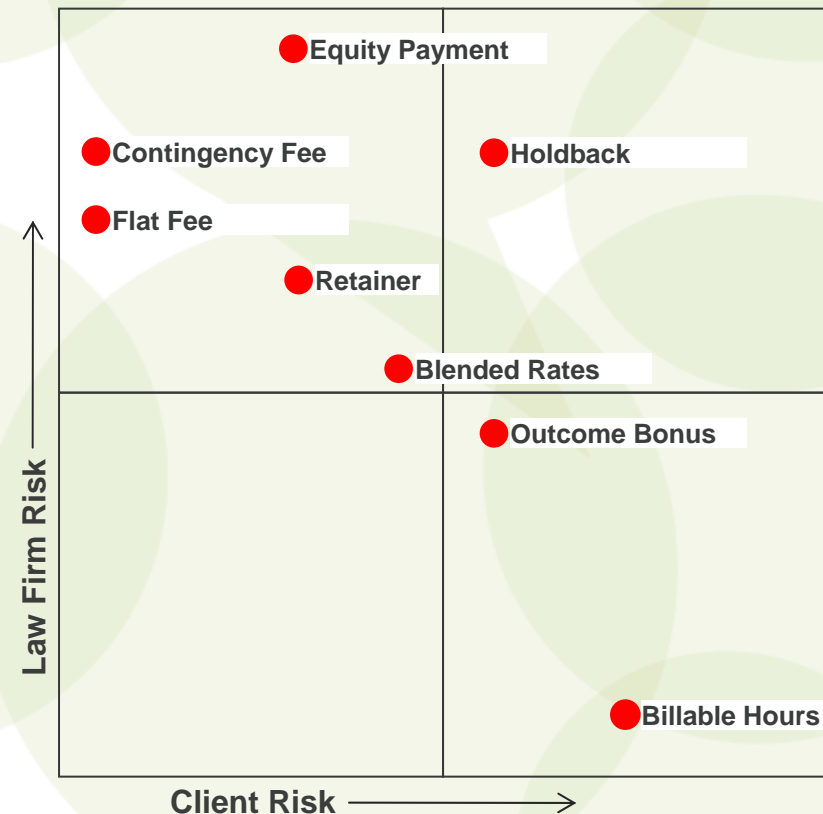
Alternative Pricing Models

Alternatives to the billable hour have not gained traction because they increase law firm risk but this is changing rapidly in 2009

Alternative Billing Arrangements

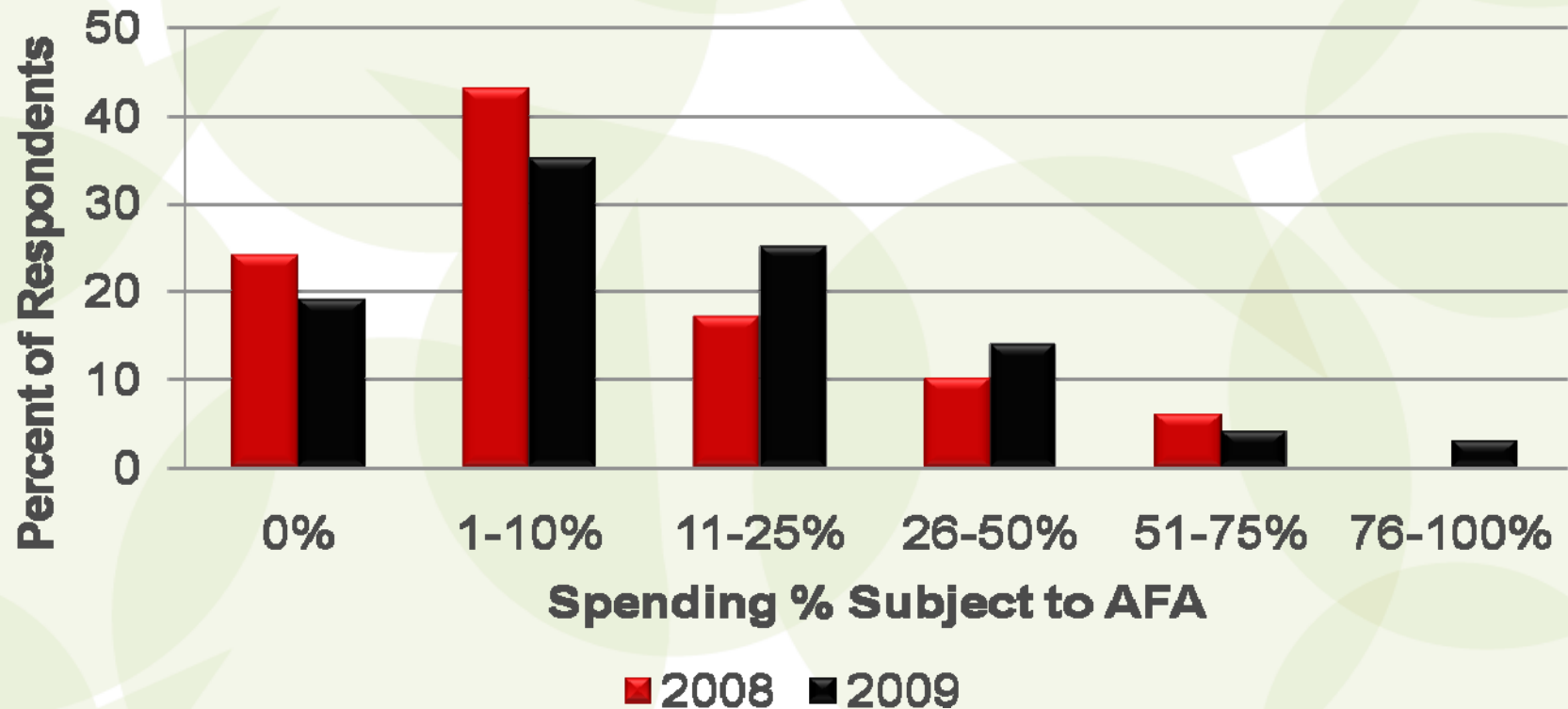
- **Blended Rates:** Firm bills all time on a matter at the same rate, regardless of the level of attorney working on the case – ends up being a lower rate for senior attorneys, slightly higher for junior.
- **Bonus Based on Outcome:** Hourly rates that are reduced, blended, or discounted, and then a pre-agreed-upon bonus is awarded to the firm upon successful completion of the matter.
- **Contingency Fee:** Firm agrees to share in percentage of the recovery.
- **Flat Fee:** Firm agrees to provide services at a fixed price.
- **Retainer:** Firm handles all work for a company, either by matter or by time period, at a fixed price.
- **Holdback:** Client pays standard rates, but a percentage is “held back” each month, and that sum is awarded to the firm on successful completion of the matter.
- **Equity Payment:** Law firms accepting part of their payment in the form of equity in the client’s company

Alternative Law Firm Billing Arrangements by Party Risk



Marked Shift in Client Attitudes

Percent of Outside Counsel Spending Subject to AFAs

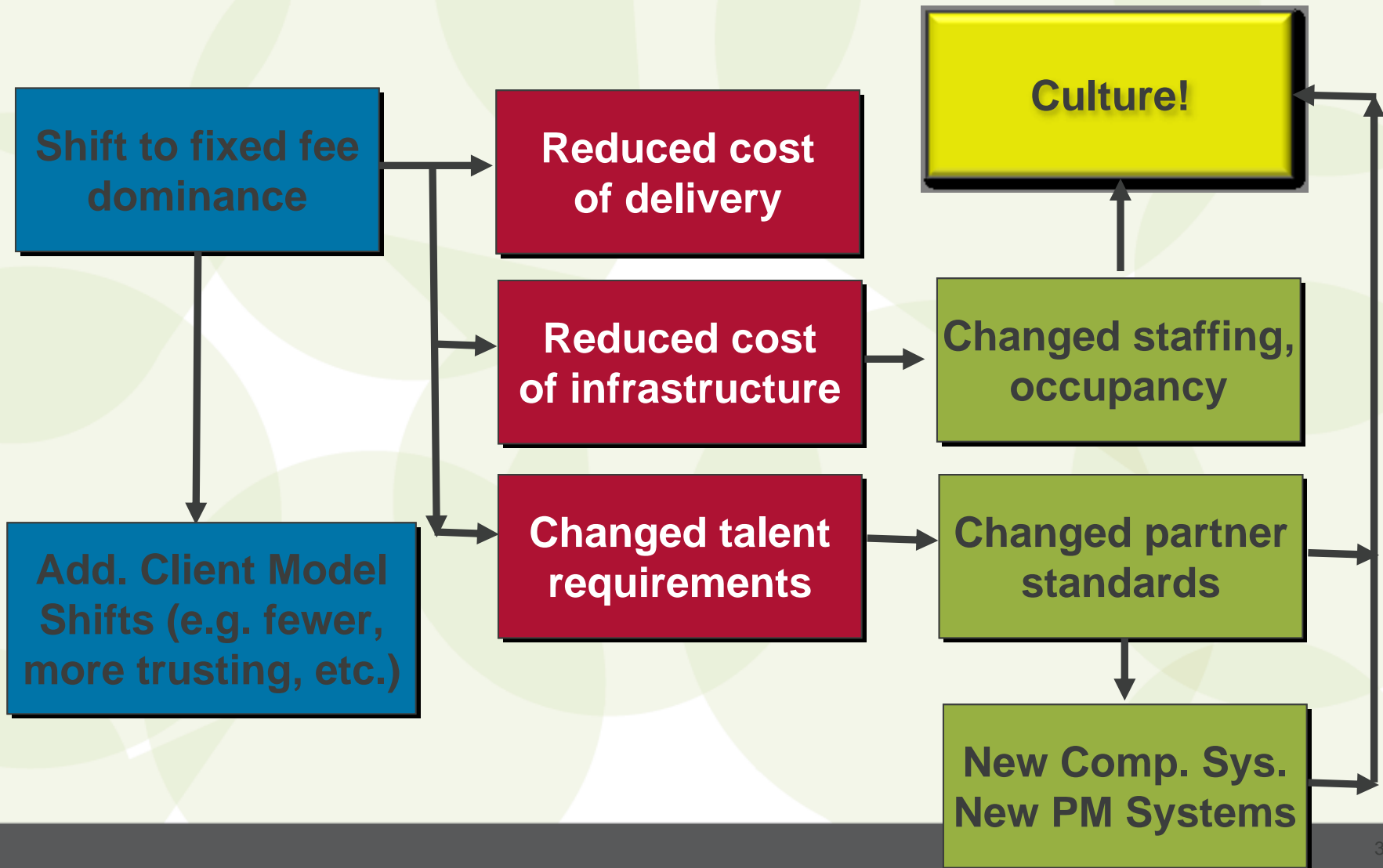


Source – 2009 Hildebrandt Baker Robbins Law Department Survey; 190 major corporations; input collected summer of 2009

Alternative Fee Arrangements

- Rather than a radical revolution Alternative Fee Arrangements are simply natural evolution.
 - Transition from hourly pricing is occurring more slowly than is portrayed in the press
 - Portfolio Pricing made some of the earliest gains
- Fixed fees/project pricing is the long term future of alternative pricing
 - There are other models as well, but none match client needs (predictability, value, price control) as well
 - Assumptions and the potential for change orders
 - Budgets based on cost rather than billing rates
 - Portfolio pricing is project pricing on a larger, multi case scale

Pricing Ripple Effects Illustration...



Questions/Discussion