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Law Firm Pricing Infrastructure: Why and How

“Over the past two decades, most companies have recognized the bottom-line impact to be gained through effective pricing. Yet awareness by itself is not enough. Tapping the full promise of pricing requires an infrastructure to drive real and sustained pricing performance.”¹ With this ZG Alert, we hope to spotlight the fact that these observations, which are from “Building a better pricing infrastructure,” an article in the August 2010 McKinsey Quarterly discussing the building blocks of a robust pricing methodology, are highly relevant to law firms, in particular as they broaden the array of innovative and customized alternative fee arrangements (AFAs) they extend to their clients. We offer this as a supplement to our March 2010 ZG Alert on AFAs because we believe that intelligent pricing aligned with a firm’s performance goals is a factor that will continue to differentiate leading law firms from the rest, and we offer suggestions for ways to build and maintain an effective pricing infrastructure without unduly burdening the firm’s lawyers and staff.

The Case for a Robust Pricing Infrastructure

As is well recognized, most law firms have approached the pricing of their services with reference to the number of hours worked by their lawyers in providing those services to the firm’s clients. The analysis has been somewhat simplistic. Subject, of course, to what the firm’s target clients will tolerate, the firm determines a billing rate for each of its lawyers by dividing the total cost of the lawyer’s salary and benefits (and the putative cost of support services provided to the lawyer) by the number of hours the lawyer is expected to bill to clients, and adding a profit factor. Under this type of a pricing system, the cost of the services provided to the clients is simply the amount determined by multiplying the lawyer’s hourly billing rate by the number of hours worked. The firm makes a profit if the lawyer works, and the clients pay for, the number of hours budgeted in the determination of the lawyer’s billing rate. If the lawyer bills fewer hours, or the clients pay for an insufficient percentage of the billed hours, the firm makes less of a profit. Conversely, if the lawyer bills to clients and the clients pay for more than the budgeted number of hours, the firm’s profits increase.

With rare exceptions, no consideration has been given to the type of services provided by the attorney. The client has paid the same hourly rate for an hour of relatively simple legal work as for the analysis of the most difficult, “bet-the-company” problem. In some often unarticulated sense, there has been a feeling that things “balance out” for both the firm and the client. We submit, however, that by not using empirical data to price

their services, firms well may have lost the opportunity to realize higher prices for at least certain of the services provided, at a cost to overall firm profitability.

McKinsey points out in “Building a better pricing infrastructure” that organizations that rely on an effective pricing infrastructure tend to be able to drive price increases, and these increases—even when seemingly small—can boost profitability significantly:

- ▶ “[A] one-percentage-point improvement in average price of goods and services leads to an 8.7 percent increase in operating profits for the typical Global 1200 company.
- ▶ Since a well-executed pricing-improvement program often yields price increases of two to four percentage points or more, sustaining a long-term price advantage may represent roughly 15 to 25 percent of a typical company’s total profits.”²

We believe that, especially at a time when clients are questioning the traditional law firm pricing model, an effective pricing infrastructure can provide similar boosts to law firm profitability.

The Building Blocks of a Robust Law Firm Pricing Infrastructure

A handful of our law firm clients have begun to develop a pricing infrastructure, but have reported that the process of compiling historic billing and profitability data has been extremely time-consuming and labor-intensive for lawyers and staff alike. We are as sensitive to this concern as we are certain that the

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benefits of gathering and analyzing relevant data will outweigh its costs. Pricing infrastructures can take a variety of forms, some of which can be extremely intricate and sophisticated, but they do not have to be. Law firms that implement even a basic infrastructure that takes into account the building blocks we present below will reap enviable benefits.

Establish Clear Criteria for What Constitutes a Successful Fee Structure

At the outset, the firm should establish a clear understanding among its partners about what constitutes an appropriate fee structure for the matters it handles. Certainly, a pricing arrangement should be deemed successful only if it allows the firm to provide the delivered service profitably, and if the price of the service is one the client is willing to pay—and, perhaps more importantly—leaves the client willing to engage the firm for an additional assignment.

If the basis of the firm's fee structure is the hourly rate, the firm should analyze its methodology for determining that hourly rate. Is the firm pricing its lawyers' hours appropriately? Should a lawyer's hourly rate be the same no matter what type of legal work the lawyer is performing? Should the rate vary depending upon how important the work is to the client? Should the same work be priced differently in different geographic markets? In the absence of client pressure to the contrary, should the firm always price its services on an hourly basis? Does that incentivize the greatest efficiency in its lawyers' work habits? Does it provide the best result—and hence greatest satisfaction—for its clients?

Populate a Pricing Experience Database

To assist in answering these questions and in developing the infrastructure for a more robust pricing methodology, law firms should create a database containing information regarding the types of matters the firm regularly handles and the firm's experience in handling those matters. How many hours of partner and associate time did the matter take? Was the firm's expectation regarding the expected cost to the client borne out? Was the client's? Did the firm become more efficient in the handling of repetitive or similar matters? To build this database, the firm can use simple forms, to be filled out by the responsible partner at both the beginning and end of the assignment. As the database grows, the firm will capture a great deal of useful information—about what did or did not prove successful for the firm, as measured by the profitability of the matter and the level of client satisfaction achieved, and which lawyers at the firm were better

at estimating the ultimate cost of a project and at setting, meeting, or exceeding the client's expectations.

Populate a Legal Experience Database

Firms also should create an "experience database" that tracks the experience and capabilities of every lawyer at the firm, including matter-specific expertise. While most firms have a very good sense, at least at the department level, of the range of knowledge and experience of their lawyers, we suggest a more granular database, available firm-wide, to assure that there is always a path to assigning the lawyers with relevant experience to a client's matter. A note of caution here, however: firms should resist the temptation to assign the same attorney to every matter for which the attorney has the most relevant experience. Substantive expertise should be spread among multiple lawyers to broaden the firm's ability to provide the requested service.

Provide Training in Matter Management

Law firms should develop a system for providing matter management training to their attorneys. Efficient matter management is critical to appropriate pricing and client satisfaction, but it is a skill not generally addressed in the traditional law school curriculum or in the law firm setting. Too often attorneys are driven to finding the "perfect answer," without regard to cost. Certainly, some of the attorneys at the firm instinctively will know when a matter or an issue requires more work, or when enough is enough. These attorneys should be identified and asked to assist others in developing the instincts that allow them to provide the appropriate oversight to deliver services to the clients efficiently.

Importance of a Pricing Infrastructure to the Determination of Appropriate Alternative Fee Arrangements (AFAs)

Much has been written about the increased client focus on law firm pricing methodologies. No longer are clients automatically accepting the hourly rate as the default pricing mechanism. And the presiding partner of at least one noteworthy firm would prefer the demise of the billable hour as the basis for law firm pricing.³ But, whether or not the billable hour will become a thing of the past—and we tend to doubt that it will—it is clear that client demand for more certainty in the cost of legal services inevitably will force firms to provide more AFAs.

Matters that are billed in any of a variety of AFAs can and should be profitable for law firms. To determine what AFAs they will offer, some firms have created practice-specific or firm-wide AFA

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committees. Others have appointed partners to oversee the use of AFAs. These actions are laudable, but unless a firm knows how to design AFAs intelligently by drawing on data regarding the firm's prior experience in providing the services being priced, there is a great likelihood that the firm will leave a profit-making opportunity on the table. As law firms veer further away from traditional hourly billing, the ones that emerge as the most profitable likely will be those that keep track of and analyze matter pricing and profitability and draw on this knowledge to set future fee structures that emulate the arrangements that were most successful in the past.

Closing Advice

As with any innovation in a law firm, the creation and implementation of a pricing infrastructure will succeed only if there is

buy-in from the firm's key stakeholders. It behooves the firm's leadership not only to educate its partners about the long-term benefits of making informed pricing decisions, but also to link pricing success and failure to partner compensation. As the *McKinsey Quarterly* article points out, there are ways to promote pricing successes via nonfinancial incentives, such as "recognizing exceptional performance by peers and managers; rewarding counterintuitive behavior, such as walking away from deals as part of an initiative to shed unprofitable business; and tying advancement to specific pricing skills—which sends a strong message that they are essential, not merely nice to have."⁴ We urge law firms to apply this thinking as they create or fine-tune their pricing infrastructures. As always, we stand ready to assist our clients as they think through these issues.

1. *McKinsey Quarterly*, "Building a better pricing infrastructure," Aug. 2010, p.2, available at www.mckinseyquarterly.com.
2. *Id.*, p. 2.
3. Evan R. Chesler, "Kill the Billable Hour," *Forbes Magazine*, Jan. 12, 2009, available at <http://www.forbes.com/forbes/2009/0112/026.html>.
4. "Building a better pricing infrastructure," p.4.



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