



Future of Litigation

We Control Our Own Destiny (and Profitability)

By John Sterling

In light of the past year's global financial system crash, George Maynard Keynes is very much in the news again. Asked about the long-term impact of deficit spending, Keynes was said to have replied, "In the long run, we're all dead." We would argue that from a law practice management standpoint, in the long run, we should all be financially healthy and profitable.

In the short run, we are generally faced with a choice of taking whatever work is available at the going rate or creating zero revenue. Taking near-term work is marginally better than having no work at all. However, in the long run, we have considerably greater control over our own financial destiny.

In September 2008, DRI commissioned a study to elucidate "the future drivers of litigation." Smock Sterling Strategic Management Consultants, *Future of Litigation* (DRI, 2009), at 1, <http://www.dri.org/open/Article.aspx?ID=151>. This article briefly recaps those research findings, discusses the client relationship considerations that drive practice finances, and analyzes the ways that we can appropriately adjust the levers that affect profitability to thrive in the context of the client relationships that we elect to sustain.

Future of Litigation: A Brief Recap

The central finding of DRI's *Future of Lit-*

igation research was that over the next five years, quality litigation practices are likely to thrive. We can expect strong needs for legal services in a number of areas including practices related to the financial services industry, complex commercial disputes, employment and labor disputes, intellectual property, bankruptcy, and regulatory and administrative law defense.

Practice managers will continue to face major challenges, but legal trends will also create growing demand for outside legal advice. Those challenges include:

- The impact of electronic discovery on litigation, which will create growth as document review continues to expand, but will also challenge firms to apply technology effectively to manage those documents and the discovery process overall
- Growing concerns about costs among in-house counsel and a strong desire to develop alternative approaches to billing beyond straight time and materials
- The serious effect of the decline in the number of trials on professional development: where is the next generation of trial lawyers going to get their experience?
- A backlash against mandatory arbitration along with a growing embrace of mediation processes

- Globalization, which, on the one hand, will create cost pressures, but on the other, create new business opportunities.

Client Relationship Considerations

The great challenge facing law firms in the coming decade is the need to strike an effective balance between maintaining and enhancing strong client relationships and delivering solidly growing profits to shareholders. Obviously, firms cannot survive without clients, and professional life is miserable without positive, enriching relationships with those clients. Yet, firms will be hard pressed to retain their best lawyers if they are not financially strong.

Unless a client relationship is based on a close personal relationship, that is, friendship, the strength of that relationship will largely be determined by perceptions of value. Put simply, clients measure outside counsel functionally, based on quality of advice, responsiveness, results achieved, and so on, in relation to fees. Value is not simply being cheap—it is meeting and exceeding expectations for the level of fees charged.

Over the past 20 years, some areas of defense practice have become extraordinarily price sensitive. In many instances, price sensitivity reflects clients' expectations regarding what it takes to bring cases to resolution. Because insurance companies in particular have built reserves explicitly for the purpose of settling cases, expectations regarding the work of outside counsel have become increasingly constrained—those clients expect



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outside counsel to work quickly toward settlement at very low cost.

In other areas, growing complexity and potentially unsecured exposure has led to a markedly different set of expectations. In those cases, extensive discovery processes and legal analysis by highly experienced trial attorneys drives client expectations. While it would be naïve to suggest that “money is no object” in these cases, client expectations are high, and value is not synonymous with low rates.

Regardless of the place within the value spectrum in which a practice operates today, the *Future of Litigation* research suggests that outside counsel expect clients to seek new approaches to setting fees. In discussing alternative fee arrangements in research interviews, both in-house and outside counsel shared a wide variety of examples. In fact, there were more variations on successful approaches to alternative fees than interviews. An analysis of those anecdotal examples uncovered some basic guidelines for pursuing alternative fee arrangements.

First, it is imperative that private practitioners understand their own costs and the underlying economics of their practice and firms. Whether the focus is on managing margins, a fairly high-level instrument, or on managing select profit drivers, a lawyer must understand his or her own practice economics in order to construct good alternatives.

Second, it is incumbent on outside counsel to understand a client’s underlying motivation for seeking an alternative fee arrangement. Underlying motivations fit patterns. Some clients simply need to cut costs. Fee arrangements responding to this motivation generally involve discounts and blended rates. Other clients need predictability, particularly if they have a block of recurring or continuing litigation. Fee arrangements in this context generally involve fixed caps for matters—or more often, for blocks of business. In ongoing relationships built on trust, those fixed fee arrangements can be adjusted annually to bring charges in line with actual costs. Yet other clients are driven by risk-management models or strategies. In this context, fee arrangements tend to involve

some form of contingency. Usually, defense lawyers assign an overall value or exposure to a case, based on assessments of positive and negative outcomes. Work is billed at a discount, and an attorney generally receives a fee close to standard rates for an outcome close to an expected outcome and is rewarded with a premium when out-

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comes are close to the most positive potential outcome.

So, when considering relationship dynamics over the mid to long term, it is imperative that practitioners understand their true costs, understand clients’ motivations vis-à-vis alternative fee arrangements, and have solutions ready for clients driven by their motivations.

In addition to determining how to charge for work, however, lawyers need to consider who they should be serving. Over the long run, lawyers do have control over who they serve. Certainly, in the near term, we have an incentive to take and do the work that is immediately available. But, over the long term, lawyers are free to walk away from clients who do not value the level of skill and experience that they bring to the table. Of course, doing this requires a considerable investment of time and effort in marketing the practice and its capabilities to a set of clients whose value equation accommodates the higher rates warranted by skill, experience and time spent on matters. However, over the long run, we do control our own destiny relative to the clients that we serve and the relationships in which we invest our time.

Financial Levers

In today’s law firm management environ-

ment, one financial measure has become almost universal—profit per equity partner (PPEP). The *American Lawyer* AMLAW 200 statistics and *Legal Week’s* annual rankings of the top 50 UK firms focus intently on profit per partner. In many respects, PPEP has become *the* defining statistic for financial performance of law firms.

Assuming that a practice is comfortable with its clientele—balancing the increasing demands of those clients for value with the firm’s need to effectively manage profitability becomes the long-range challenge. Fortunately, lawyers can improve the financial performance of a practice in a number of ways. With a solid understanding of clients’ value expectations, a practice can actively finesse one or more financial levers to improve profitability. Over the long range, the structure of a practice is not fixed and, in fact, should align with clients’ expectations.

Figure 1 on page 16 illustrates five key, law firm profit levers. The basic model illustrated in Figure 1 sets aside a potential sixth profitability lever—namely, the time value of money. Certainly, a firm carrying substantial debt, even in a revolving line of credit, has cause to actively manage cash effectively to control this factor. However, because firms are generally cash businesses that “*wipe the slate clean*” relative to financial performance at the start of each new fiscal year, we will set aside the time value of money for purposes of this profit discussion.

The following points highlight the potential measures that practice leaders can use to move profit levers in directions that align a practice’s structure with clients’ value expectation.

Billing Rates

For definitional purposes, billing rates are the standard “published rack rates” for all timekeepers in all client-serving departments or practice groups, including paralegals, patent agents, engineers, and other nonattorney timekeepers. Billing rates are an obvious lever on the revenue side of the profit equation (*i.e.*, revenues minus costs).

Prior to the financial crisis, over the past five years profits grew substantially—and at many firms that profit growth was

driven by increases in billing rates. In some respects, it was a self-reinforcing cycle. As the largest and most expensive firms raised rates, they created a price umbrella under which mid-sized firms could raise rates and still remain a relative bargain. In the face of so-called “rate compression,” large firms would again be compelled to raise rates, and the cycle would repeat.

At the same time, general counsel have increasingly resisted billing-rate inflation. This rate sensitivity has been accentuated by the highly visible run-up in starting salaries for associates, discussed further below. (See “Costs” on p. 17.) This sensitivity, coupled with severely reduced demand brought on by the global recession appears to have broken the cycle of rate increases.

Future profit growth associated with simple rate increases are likely to require more than a letter informing clients of an increase. Either a practice will need to demonstrate clear value associated with those higher rates, that is, superior results relative to the rates, or, a practice will need to realize the higher rates through alternative fee arrangements.

Hours/Productivity

Productivity is simply a measure of the

number of hours per timekeeper at the individual and practice group levels. Number of billable hours simply and bluntly drives revenues and profits. Clearly, there are physical limits to the number of billable hours that a firm can expect from a timekeeper—though the range of expectations is quite broad.

A key element to understand vis-à-vis billable hours’ relationship to firm profitability is that the last few hundred billable hours are generally the most profitable. Essentially, timekeepers work much of the year to cover the direct and indirect costs associated with their work. A simple example can illustrate the point.

- Imagine for a moment a staff attorney earns \$100,000 annually. In addition, her employment agreement includes employee benefits, such as retirement funds, insurance, and payroll taxes of \$35,000 annually in direct costs. Further, employing that attorney requires office space and other overhead to provide an appropriate working environment. Assume that those costs add another \$25,000 annually in indirect costs. Thus, total direct and indirect costs for our hypothetical staff attorney are \$160,000 annually.

- Now, imagine that our attorney’s billing rate is \$160 per hour.
- In this scenario, our staff attorney will work half the year (1,000 hours—assuming hours are all billable, which, of course, they are not) simply to cover direct and indirect costs associated with her employment.
- If that professional carries a billable hour expectation of 1,500 hours, only the final third of the year actually creates profits.

Firms adopt many tactics as incentive to timekeepers to increase their billable hours. These incentives include publishing standards, under which it is culturally inappropriate to fall and which may result in symbolic or actual sanctions, offering billable hour bonuses for hours above the standards, and giving awards and recognition, to name a few.

In some respects, tactics designed to drive up billable hours may run counter to goals associated with client satisfaction, which is one critical argument in favor of implementing an integrated strategy rather than pursuing financial goals and client satisfaction goals separately. For example, adopting alternative fee solutions often drives down billable hours on targeted matters. If a firm also incentivizes lawyers to increase their hours, those two strategies could work in counter purpose to one another.

Leverage

Leverage in a law firm is defined as the ratio between hours or dollars billed by equity shareholders or partners and hours or dollars billed by all other timekeepers. Many crude statistics measure leverage in terms of full-time equivalent (FTE) ratios, for example, the number of equity partners to the number of other timekeepers. On an even more simplistic level, some measure leverage as a simple partners to associates ratio.

In a perfect world, where everything else is constant, increased leverage would lead to increased profitability. The reason is easily understood—people other than partners would create profitable revenue: the more of them there are, the more profitable the firm would become.

Figure 1: Five Profit Levers



Unfortunately, we do not live in a perfect world, and all other things generally do not remain constant. As noted above, the last 100 billable hours in a year largely fall to the bottom line, while the first 100 simply cover costs. If a firm does not have enough work to keep nonequity timekeepers fully utilized, increasing leverage will tend to increase costs rather than profits.

More importantly, managing leverage really requires getting the right skills and people working on behalf of clients on a given matter. If a matter calls for partner level knowledge and experience, assigning the work to associates simply to improve leverage does the client a disservice. Conversely, if a partner hordes work to keep his or her billable hours high, some of that work undoubtedly should have been completed by less experienced professionals who command a lower rate than that partner. Again, managing leverage is really about having the right people on the right matters.

Over the long term, leverage becomes critical to profit because managers can balance both a practice and firm's staffing mix appropriately to match with the needs of clients. As law firm models evolve over the coming decade, firms will have more strategies available to manage leverage. First, a wide variety of nonpartner track careers are likely to develop in law firms, enabling firms to leverage more experienced and skilled lawyers in new ways, that is, beyond leveraging nonequity partners. Second, labor shortages in developed economies will encourage firms to retain senior people beyond traditional retirement ages, providing another option for capturing leverage from experienced, highly skilled professionals. Third, contract attorney business models will continue to expand, providing alternatives for managing capacity and leverage over the short term. Finally, off-shore service providers are likely to proliferate, providing another option for leverage and capacity management.

Realization

Billable hours and billing rates are simply accounting methods if a firm does not or cannot collect the time billed at agreed-upon rates. Realization is a measure of the difference between the net fees collected

and the fees that would have been collected had the total hours billed been invoiced and collected at standard rates.

Realization can exceed 100 percent in instances in which premium rates are billed or if matters billed under fixed fee arrangements take less time than originally anticipated. Often, realization falls short of 100

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percent, due to agreed-upon rate discounts, write-downs of inefficient or unauthorized time, or clients' objections to invoiced amounts.

While improving realization appears to be a financially driven goal, achieving that goal generally requires either improved client orientation or improved business processes.

Client-oriented initiatives that improve realization include aligning staffing with client needs and expectations—that is, placing the right people at the right rates on client matters—developing alternative fee approaches, and other steps that lead clients to demand or expect fewer discounts.

Business-process oriented initiatives can increase realization primarily by improving the timeliness and accuracy of the billing process. Clients' objections to invoices can often be traced to untimely billing—for example, sending bills for work that was completed months earlier, by which time a client has forgotten the value associated with that time.

Costs

Costs are largely self explanatory. In a law firm, the overwhelming majority of costs

can be traced directly to people—salaries, benefits, payroll taxes, and the space and other overhead required to ensure that people can remain productive.

As entry-level associate salaries accelerated in the last few years—with little impact on rates of associate retention—people-related costs grew substantially. If the experience of the run-up in associate salaries of the late 1980s and early 1990s is a guide, it will take many years to bring starting salaries in line with historic trends. Meanwhile, the global recession has dramatically slowed the rate of associate attrition, and firms are cutting salaries and cutting back on hiring.

The coming decade offers law firms a wide range of potential cost-management strategies and tactics—alternative career paths, outsourcing, virtual offices and telecommuting, and other approaches to managing capacity, personnel costs, and overhead. It is rare for a firm to “save its way to prosperity,” but cost management is not an inconsequential aspect of profitability. Ultimately, effective cost management in a law firm implies strong people strategies.

Law Firms Can Finesse Profit Levers

Over the long run, every one of these profit levers can be adjusted substantially—particularly the mix of people and skills. Practices that do not bring the professional mix into alignment with clients' expectations can expect to suffer.

Further, each of these major profit levers is best managed via an integrated approach. Each profit lever requires considerations beyond the purely financial to have a sustained, positive impact on financial results.

The type of integrated action that this discussion recommends is often best implemented at the practice group level. Practice groups, in truth, the leading partners in those groups, actively supervise matters, assign work, manage client relationships, train junior lawyers, and frequently, prepare and send invoices. Generally, therefore, actions taken at the practice group level can have the greatest actual positive impact on profitability.

Destiny/Profitability, see page 58

Destiny/Profitability, from page 17

A discussion of profitability would be incomplete without acknowledging that many firms have improved their profits per equity partner—at least in part—by actively managing that denominator. Entry into equity partner ranks is becoming increasingly difficult. Further, retaining equity partnership—once akin to tenure—

now depends on continuing productivity and business development success.

If more rigorous standards than those of the past will govern election to and continuing participation in equity partnership, those standards should reflect a firm's strategic priorities. Firms will need frameworks to align day-to-day priorities with firm action plans, objectives, and strat-

egies, as well as tools, such as balanced scorecards. Thus, equity partnership restriction can be informed by and aligned with the vision and strategy embraced by the firm.

Ultimately, over the long run, we all control our own destiny—which clients we serve and how we structure our practices to serve those clients. ■