

10 YEARS LATER

A LOOK **BACK AND AHEAD** A
DECADE AFTER THE ABA COMMISSION
ON **BILLABLE HOURS REPORT**

BY JIM HASSETT AND MATT HASSETT



In August 2002, the **American Bar Association (ABA)** published its influential **ABA Commission on Billable Hours Report** summarizing the research of a distinguished panel of experts. The report highlighted many disadvantages of hourly billing and said that “the overreliance on billable hours by the legal profession:

- Results in a decline of the collegiality of law firm culture and an increase in associate departures
- Discourages taking on pro bono work
- Does not encourage project or case planning
- Provides no predictability of cost for client
- May not reflect value to the client
- Penalizes the efficient and productive lawyer
- Discourages communication between lawyer and client
- Encourages skipping steps
- Fails to discourage excessive layering and duplication of effort
- Fails to promote a risk/benefit analysis
- Does not reward the lawyer for productive use of technology
- Puts client’s interests in conflict with lawyer’s interests
- Client runs the risk of paying for:
 - The lawyer’s incompetency or inefficiency
 - Associate training
 - Associate turnover
 - Padding of timesheets
- Results in itemized bills that tend to report mechanical functions, not value of progress
- Results in lawyers competing based on hourly rates”



LIFESTYLE IMPLICATIONS OF THE BILLABLE HOUR

Anyone who has ever worked at a law firm knows that the billable hour can create stress. In the preface to the 2002 report on the billable hour, ABA President Robert Hirshon wrote:

The unending drive for billable hours has had a negative effect not only on family and personal relationships, but on the public service role that lawyers traditionally have played in society. The elimination of discretionary time has taken a toll on pro bono work and our profession's ability to be involved in our communities. At the same time, professional development, workplace stimulation, mentoring and lawyer/client relationships have all suffered as a result of billable hour pressures.

A decade later, in a June 22, 2012 article in *The Wall Street Journal*, Frank Partnoy, Professor of Law and Finance at the University of San Diego, noted that:

In the late 1990s, three researchers – James Evans, Gideon Kunda and Stephen Barley – conducted a 2½-year study of free-agent workers, including contractors, engineers and software developers. They found that, throughout the United States, one of the most significant differences in how people approach work is whether they are paid by the hour.

For a range of jobs and income levels, people who were paid hourly worked longer and cared less about nonwork activities. They suffered from higher stress during downtime, and they worried more about having enough work. When work was available, they were tempted to work as much as possible. A vacation or a day off meant a loss of money. Other studies found that the problem got worse as people made more money, because they felt that their time was more valuable and therefore more scarce.

According to Partnoy, one possible solution is to stop billing by the hour. Professionals could instead charge a fee based on the service provided: A fixed amount to file a legal brief or complete an audit or repair a leak. Lawyers, accountants and other professionals are increasingly trying to find ways to charge flat fees instead of hourly rates. This is particularly true at large law firms, where the combination of economic pressure and low morale among associates is leading partners to search for new ways to bill.

OVER THE YEARS

Although the report generated a great deal of discussion, for several years it seemed to have little impact on behavior. A small percentage of clients and firms continued to use non-hourly billing (as they had for years before the report), and the talk gradually faded away. Then, in 2008, two things happened: The economy declined, and the Association of Corporate Counsel announced its Value Challenge, mobilizing action around its declaration that “Many traditional law firm business models ... are not aligned with what corporate clients want and need: value-driven, high-quality legal services that deliver solutions for a reasonable cost.”

In 2009, when the alternative fee arrangement (AFA) buzz was still building, we interviewed chairmen, senior partners and C-level executives at 37 AmLaw 100 firms for our *LegalBizDev Survey of Alternative Fees*. Since we assured participants that all quotes would be anonymous, many of these law firm leaders spoke frankly and openly about the uncertainties that surrounded non-hourly work:

- “In-house counsel are just as nervous and as scared about alternative fees as the law firms are.”
- “General counsel really don’t know exactly what they’re trying to achieve. They just feel like everything has gotten very expensive [and that] the structure of the law firm promotes inefficiency. I don’t think they’ve really thought through what would work well for them.”
- “I think [clients] don’t know yet how to evaluate [alternative fee] proposals. Our long-term clients are honest with us [and] say, “I have no way to measure this, no way to know which of these deals you are offering us is the best deal, and no way of comparing your alternative fee arrangement with the simple discount off of standard rates that the other firm has offered us.”
- “When it comes to alternative billing arrangements, a number of clients are just not sure yet what it is they are looking for. They are feeling their way through this paradigm shift, just as we are.”

In the words of another senior partner in our survey, the whole discussion was also “like a junior high dance. There’s a lot more talking than dancing.”

While that comment still rings true today, several recent surveys have found that about half of law firms and law departments report that they have increased the use of AFAs in the past 12 months. (In Altman Weil’s 2012 Law Firms in Transition survey, 47 percent of firms reported that their AFA revenue had increased in the past year.

An ALM Legal Intelligence survey published in July showed that 50 percent of law departments and 62 percent of law firms reported an increase in the volume of AFAs between 2010 and 2011.)

AFA STRUCTURES

Lawyers have been very creative in coming up with a variety of AFA structures. In the LegalBizDev survey, we classified the most commonly used AFAs into nine types: risk collars, fee caps, fixed fees for a single engagement, fixed fee menus, portfolio fixed fees, retainers, success fees, holdbacks and full contingencies.

When the ALM Legal Intelligence Survey asked law departments which types they used from a slightly different list, the most common were flat fees (89 percent) and capped fees (57 percent), followed by blended rates, phased fees, contingent fees, success fees, flat fees with shared savings, defense contingency fees and holdbacks.

The most important difference between the two classification schemes is the fact that ALM included blended rates – a single hourly rate that applies to all lawyers on a matter – and we did not. This reflects a philosophical difference between two types of AFA definitions: narrow and broad. Our survey used the narrow definition which reserves the term AFAs for fees that are fully or partly non-hourly. The broad definition used by ALM and others also includes arrangements that are 100 percent hourly but include certain types of discounting.

The fact that two conflicting definitions of AFAs are in wide use adds considerable confusion to an area that was already confusing enough. If a firm claims that 50 percent of its work is performed on an alternative fee basis, that could mean that they are moving away from the billable hour (under the narrow definition), or it could mean that they are engaging in some creative hourly rate discounting (under the broad definition).

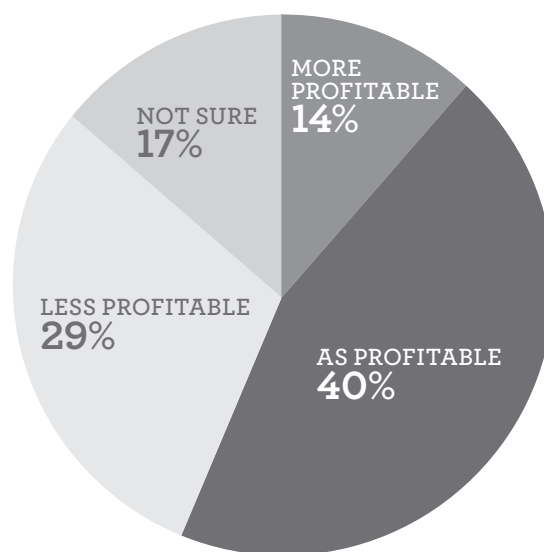
Some have a vested interest in maintaining this confusion. Announcing that a firm offers 50 percent of its work on an alternative fee basis sounds much more thoughtful and less desperate than saying, “Half the time, we have to slash our hourly rates because we need the business.”

THE BOTTOM LINE

The best estimate of the revenue from alternative fees is about 15 percent. The most recent survey of law

departments (Altman Weil’s 2011 Chief Legal Officers survey) reported 14 percent of revenue. The most recent survey of law firms – ALM’s 2010 Law Firm Leaders survey – put the figure at 16 percent. While in some ways 15 percent may not sound like much, it is important to emphasize that the AmLaw 100 performed over \$10 billion worth of legal work last year on a non-hourly basis (based on total gross revenue of about \$71 billion).

The ABA Commission predicted that the non-hourly approach would be a financial boon to law firms: “Alternatives that encourage efficiency and improve processes ... increase profits” (p. ix). But so far that has not been the case. Altman Weil asked managing partners, “Compared to projects billed at an hourly rate, are your firm’s non-hourly projects more profitable or less profitable?” Here is what they found:



2012 Law Firms in Transition Survey

To many people, Altman Weil’s most surprising finding was the 17 percent who were “not sure.” Some financial systems were set up for a simpler world of hourly billing, and these firms simply did not know whether they were making money or losing money on AFAs. Legal software vendors have been scrambling to update their systems, and in the four years that Altman Weil has been asking this question, the percentage of firms who were unsure has been going down. But the fact that 17 percent of firms still don’t know whether their multi-million dollar AFAs are making money or losing it shows how much work law firms still have to do to adapt to this new world.

AFA BENEFITS

Some law firms have actively promoted AFAs as a way to increase new business, and invested in training and systems to make them more profitable. For example, at Morgan Lewis, Richard Rosenblatt, the operations partner for the Labor and Employment Practice says that:

AFAs invite the client to engage with us and increase the ties that bind. We're now on the same team, and more likely to get the next engagement. This is an opportunity to get a bigger share of a shrinking pie.

Interestingly, the Altman Weil survey reported that about one-third of firms took this type of proactive approach because they believed non-hourly billing would help them

Differences of Opinion about Shadow Billing

One of the most interesting findings in the *LegalBizDev Survey of Alternative Fees* was the split in firms' opinions about "shadow billing," in which law firms provide information about actual hourly costs for matters where they are paid a fixed price.

Many firms resist client pressures to provide this information, for fear that it will be used against them. A deal is a deal in this approach, and the client should not get to look behind the curtain to see whether the firm has won or lost. As one senior decision maker put it in our survey: In some cases, what's happening is that even when there's an agreement that the fixed fee is going to be allowed, the client wants to reconcile the time and see if they got a good deal or a bad deal. And as long as that's the kind of relationship it is, it really isn't an alternative billing arrangement. If general counsel really want to get rid of the billable hour system for billing, then you can't have all these post-audit questions about it. If you agree on something, there's value and we found a way to staff it differently. We should benefit from those efforts.

Other firms allow and even encourage this sort of comparison. As one put it: If we hide things like hours, it's not going to work. We're interested in this from a partnership perspective. There has to be mutual trust. If clients think we're just doing this and reaping in additional money, it's not going to work.

win more work, while the other two-thirds said their use of AFAs was reactive, that they simply gave clients what they asked for. When Altman Weil compared AFA profitability for the two groups, they found that it pays to be proactive: "Firms that are proactive rather than reactive in their use of AFAs are more than three times as likely to enjoy higher profitability on their non-hourly work" (p. iv).

WHAT'S NEXT

Where are we headed? Clearly, the legal profession is changing, but there are differences of opinion how much it will change and how soon. In the ALM survey, about three-out-of-four participants predicted that AFAs will increase in the next five years (70 percent of law departments and 82 percent of law firms). Of all the firms that have moved in the direction of greater efficiency and non-hourly billing, none has generated more publicity than Seyfarth Shaw. In 2006, they started using Six Sigma and process improvement techniques to simplify and standardize certain types of legal work, and ultimately created a proprietary system called *SeyfarthLean*. According to an April 2010 article in *The American Lawyer*, they spent over \$3 million during the first few years on this initiative, and many articles have appeared describing its benefits. But if Seyfarth Shaw is at the head of this movement, it is interesting to note that six years into the effort, Seyfarth Chairman Steve Poor wrote in *The New York Times DealBook*:

Never underestimate the resistance to change from lawyers. ... Much of what we've done is most effective when deployed in a collaborative change process with clients. What we overlooked at the outset is that, by and large, our clients are lawyers, too ... The continuous move forward takes persistence and, perhaps, a bit of stubbornness (May 7, 2012).

When we asked one of the original members of the ABA Commission on Billable Hours – Mike Roster, who is now co-chair of the ACC Value Challenge Steering Committee – whether he was surprised by the slow rate of change in the 10 years since the report was issued, he said:

The ABA committee's report was all-encompassing but no one is going to change unless or until there is a need to do so. So I wasn't surprised that not much came of it. But the more recent pressures from clients, the economic meltdown, and now the growing evidence of major benefits being realized by companies and firms that take the plunge will all, I think, lead to long-lasting and highly beneficial changes.

Of course, it is impossible to predict just how quickly this move to alternative fees will proceed, or whether it will reach a tipping point any time soon. If the trend does pick up steam, alternative fees could completely transform the legal profession, from the way legal matters are handled to the way lawyers are paid. As Harry Trueheart, the Chairman Emeritus of Nixon Peabody, summed it up: A lot of education will go into this, and it's not cheap. Law firms will pay dearly as we as a profession learn to do this. There will be winners and losers.

Whether AFA growth proves to be fast or slow, it is important to note that this particular change is a one-way street, and there is no turning back.

In 2010, Tucker Ellis became one of the first firms with over 100 lawyers to generate more than half their revenue from non-hourly work. When we interviewed their Managing Partner Joe Morford about this trend, he noted that many clients were initially reluctant to make the switch, but that, "Once we started working for a client with alternative fees, not a single one has wanted to go back." ■

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