

**Beyond Value Billing:**  
**Implications for Specialization, Technology and Size of the Firm**

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**1. Summary**

Over the past several years an extensive literature has developed on the subject of “value billing” or “alternative billing” for legal services. See, e.g., *Beyond the Billable Hour: An Anthology of Alternative Billing Methods*, (Reed edit. 1989); *Win-Win Billing Strategies: Alternatives that Satisfy Your Clients and You* (Reed edit. 1992). The general thrust of these writings is that as competition for legal business increases, firms who wish to maintain their positions in the marketplace will have to develop fixed price, incentive fee or other alternatives to conventional, hourly-rate or cost-plus billing in which legal services are priced and delivered on the basis of their perceived value to the client.

Clients like value billing because they can base their business decisions on known or reasonably estimated legal costs. Also, it is easier for them to compare the pricing of one firm against that of another when all of them quote their services on a fixed-price, contingency or other value basis. For these reasons, so long as the level of competition for clients increases, the shift to value billing is likely to continue. In the author’s practice, flat-rate billing is up from 30% of fees five years ago to over 70% today, and is used for substantially all estate planning, estate administration and business entity formation assignments.

Of course, there will always be markets for unique, high-risk or “brand name” legal services where quality rather than price determines which lawyer gets hired. See Cobb, *Pricing Legal Services; The Value Curve* in *Win-Win Billing Strategies: Alternatives that Satisfy Your Clients and You*, *supra*, Chapter 5, pp. 31, 36 in which the author estimates that as much as 40% of the legal market may be for unique, experiential or “brand name” services. However, value billing may eventually become the norm here too -- not because of price competition but because hourly billing fails to adequately compensate the lawyer’s unique services. Cobb, *supra* at p. 39.

The purpose of this article is to examine the impact of value billing and the related phenomena of specialization and technology on the way law firms are structured and managed. Very briefly, the evidence seems to support the following general conclusions:

- Law firm success in a value billing environment requires good cost control and effective practice management without loss of service quality.
- The three most critical strategies for controlling the cost of delivery of legal services are (i) specialization, (ii) automation and (iii) optimization of firm size.
- The optimum size of the successful firm will be the *minimum* size necessary to service the clients who constitute the target market of the firm. Bigness, all else being equal, will be a liability.

## **2. Discussion**

### **A. Cost Plus v. Value Billing**

Under conventional hourly billing, charges for legal services consist of fees based on the time spent plus “costs,” i.e., out-of-pocket expenses the lawyer incurs which are not included in the hourly rate. This billing arrangement is comparable to “cost plus” billing in other industries (e.g., construction or military procurement) and rewards inefficiency since billings and profits actually go up as a function of the time spent.

This relationship changes under value billing, since the lawyer’s charges are based on perceived value to the client rather than the lawyer’s cost. There are many methods of determining “value” (flat fee, contingency, performance fee, etc.) and for purposes of this discussion the specific method used to arrive at “value” is unimportant. What is important is that whatever sum is charged is determined independently of the lawyer’s cost. Cost control becomes critical, since the price of the services is a constant and every dollar of cost saved translates to another dollar of profit for the lawyer.

### **B. Specialization**

Specialization is undoubtedly the most effective single strategy for controlling and reducing the costs of providing legal services. Why? Because focusing a practice on a limited number of problems (1) minimizes time-intensive training, research and development costs which must be incurred to competently perform the services, and (2) spreads whatever costs must be incurred over the largest possible number of cases.

Thus, the lawyer who specializes in estate plans does not need to rethink the trust boilerplate or the provisions of the pour-over will for every assignment; rather, he or she can use forms or drafting models which have been thoroughly researched before and focus only on changes which are appropriate for the current situation. This increases efficiency and also improves quality because the products of prior research and development costs are used again and again. The same principle applies to transaction practice generally and may also apply to litigation practice, at least where the office focuses on a particular type of litigation. See, e.g., Foonberg, *The Short, Happy Life of Hourly Fee Billings*, in *Beyond the Billable Hour*, *supra* p. 23 [bank collection cases].

Specialization is also crucial to effective practice management, i.e., the process of deciding (1) which assignments are appropriate for servicing by the firm (as opposed to being declined or referred), (2) preparing fixed-fee quotes or estimates for accepted work and (3) managing the firm’s costs to those quotes or estimates.

Informed decisions on these matters require a substantial experience base in similar cases, including a deep knowledge of the relevant market (who competitors are and what they charge, cost, quality and availability of services from non-legal providers, etc.) as well as knowledge of what the costs are of performing services in the lawyer’s own office. Good pricing decisions are critical, since if the quotes are too low the lawyer will lose money and if they are too high he or she will lose business. The specialist all else being equal will be a better estimator than the generalist, because he or she has done the work often enough to have an accurate idea of what the costs will be.

### **C. Automation**

The second key strategy for reducing and managing the cost of legal services is automation, i.e., the use of computers and peripheral devices to perform word processing, research, timekeeping, calendar control, financial accounting and other law office functions. Automation reduces costs mainly by reducing the time required to perform repetitive tasks (see endnote).

In the traditional cost-plus environment of hourly billing, automation was not aggressively pursued because it did not pencil. One writer observed that “[a] law firm can hardly benefit from increasing its costs through automation — in so doing turning a five-hour lawyer job into a two-hour job — if the firm bills clients on an hourly basis.” Bauer, *The Changing Legal Profession*, in *Win-Win Billing Strategies: Alternatives that Satisfy Your Clients and You*, *supra* at p. 13. Under value billing, however, automation makes sense because the price of the services is not a function of the lawyer’s cost. The price is a constant, and every dollar of cost saved falls to the bottom line.

### **D. Specialization and Automation**

Specialization and automation, although distinct cost-control strategies, are directly related. As discussed above, automation cuts costs by reducing the staff time needed to perform repetitive tasks. It follows that a law practice which has many repetitive tasks to perform (i.e., a specialized practice) has more potential to cut costs through automation than a practice where the work is widely varied.

Additionally, it is easier to optimize automated systems where the tasks performed by the office are highly structured. If a practice is confined to a specific area, such as tax, real estate, or a specific type of litigation, the lawyer can purchase most of the library needed for this on compact disks and use online services only occasionally. On the other hand, the lawyer who does everything either needs to buy a lot of CDs or spend a lot of time on-line — both of which can be expensive. To take another example, specialized calendars which work well for litigators are overkill for transaction lawyers, who can get better integration with other functions through the simpler calendars which come with personal information managers (PIMS). Again, the firm which does both litigation and transaction work may end up with one foot in each of these canoes.

Of course, *any* practice can get some benefit from automation. The issue is how much benefit in relation to the cost, and here as in other areas the advantage lies with the specialized practice.

### **E. Optimization of Firm Size**

Most of us associate size with success -- if a firm is large, it must have a lot of clients and so must be doing something right — right? In the competitive environment of value billing, however, this old way of thinking about size needs to be critically reexamined. As noted above, it is the author’s conclusion, or at least working hypothesis, that the optimum size of any firm is the minimum size it needs to be to serve its customers.

The first basic reality as regards size is that there do not appear to be any economies of scale in the practice of law. In fact, expenses of large law firms are equal to or higher than those of small ones, not only in absolute terms but also on a per-fee earner basis. The following statistics were

taken from The 1997 Survey of Law Firm Economics [Altman Weil Pensa Publications, Inc. 1997]:

<u>Size of Firm</u>	<u>Receipts</u>	<u>Expenses</u>	<u>Income</u>	<u>% of Gross</u>
Under 9 Lawyers	201.5	83.6	117.9	58.5%
9 to 20 Lawyers	212.9	84.1	128.8	60.5%
21 to 40 Lawyers	228.2	87.6	140.6	61.6%
41 to 74 Lawyers	234.4	91.7	142.7	60.9%
75 or More Lawyers	265.0	109.5	155.5	58.7%

Explanations for such numbers are not hard to find. Sizable firms require various staff people – office managers, network administrators, librarians and so on – who are not needed in smaller offices. There are also problems of coordination and control which require partnership and staff meetings to sort out. In short, size carries with it substantial overheads which are difficult to avoid and even more difficult to recover under value billing.

Another problem is that one of the key cost control strategies – automation – becomes more difficult to manage as firm size increases. Technology is a rapidly moving target, with computer hardware and software becoming obsolete in three years or so. This means that decisions about what hardware and software to buy need to be made quickly to avoid having to be reconsidered in light of new developments.

For the specialized small office with only three or four computers, system requirements are easily identified and buying a couple of new machines or an upgrade on the network software is relatively easy. However, upgrading a 200-station network is a much more costly and difficult affair, and takes longer because more people need to be consulted about the design of the system – usually through an automation committee or some other collective decision-making process. Such processes even when well-organized are not noted for their speed.

The difficulty is even greater for “full-service” firms with diversified practices, since they need to make quick decisions about many different applications packages at the same time. Such firms are also likely to experience more problems and delays with system implementation, because compatibility problems with applications increase exponentially with complexity – i.e., applications which work well by themselves may have conflicts with network software, utilities (e.g., virus-checkers) or other applications when run at the same time. Unfortunately, the state of the art of software design is such that these problems are not likely to go away anytime soon.

#### **F. Management Implications of Value Billing**

The above discussion has important implications for managing and structuring both large and small firms. For the small ones, the implications are relatively simple, i.e., specialize as much as

the local market will allow, automate the entire operation at an appropriate level, and stay small unless getting bigger will (a) attract new clients (b) who can cover the higher costs.

The message for large firms is not that they should dismember themselves into boutique practices, although much could be said for that approach from strictly a cost standpoint. As indicated by *The 1997 Survey of Law Firm Economics, supra*, large firms on average are still more profitable than small ones because their size allows them to attract larger clients with bigger revenues.

What the numbers do suggest, however, is that larger firms need to take a different view of the size issue than they have traditionally – namely, how do they retain access to their profitable clients while avoiding or at least minimizing their cost handicaps as against small, specialty firms? The balance of this article will outline some likely answers to these questions.

### **(1) Outsource**

The most obvious approach is to refer work to an efficient specialty firm, with referral fees where appropriate. Better yet, develop a pre-approved list of specialty firms which can be used to service the firm's clients. This "approved list" approach is currently being used by Merrill Lynch, Dean Witter and others to select and retain specialized investment advisors for their clients.

Such arrangements make sense for all concerned – for the client, because the client obtains the best service at the best price; for the referring firm, because it can eliminate fixed staff and overhead costs while retaining a reasonable portion of the fee; and for the specialty firm because it avoids marketing expense on the referred business. Such arrangements can be documented by agreements which protect the referring firm, e.g., by requiring the specialty firm to give notice of personnel changes, maintain malpractice insurance, comply with continuing education requirements, and so forth.

### **(2) Associate**

Temporarily associate specialty practitioners to handle matters in-house, i.e., where their services are billed and paid through the referring firm. The author has used this approach to handle small to medium-value litigation assignments for business clients by associating solo practitioners who specialize in business litigation. A big advantage is that one can pick the best-qualified specialist for each assignment rather than having to rely on the same group of associates or partners for all assignments.

### **(3) "Paradise" Support Operations**

Larger firms with "brand name" market presence can attain some of the efficiencies of specialized practice by "paradising" their support functions, including both staff and automated systems such as word processing and time and billing. This concept was developed by Citibank in the 1970's and would appear to have wide application to service businesses, including law firms.

What Citibank did was to divide up its operations departments, e.g., check processing and loans, among its marketing groups – corporate, multinational, consumer, high-net-worth individuals, and so forth. Thus instead of having one loan processing department which served all marketing

groups, the Bank created multiple loan departments, each of which was “paradised” (i.e., dedicated) to a specific marketing group.

The end result of paradisising was to create a number of smaller, more responsive and efficient business units, each of which retained the prestige and market presence of the Citibank name. Management accountability for results was much improved because all resources needed to support each customer group were placed under the control of the group head. Also, paradisising eliminated unproductive bickering between customer groups about cost allocations and management of shared support functions.

### **3. Conclusion**

Value billing has evolved and will continue to evolve as a response to competition in the market for legal services. The key strategies for success are (1) specialization, (2) automation, (3) being the right size, and (4) collaborating with others to provide the best and most cost-effective services where that is in the client’s best interest. The rewards for those who successfully pursue these strategies will be better client service and better financial returns for the firm.

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### ***Cost-Effective Automation***

*There is a tendency to assume that the most “advanced” [i.e., complex] automated support systems in the law office are the most effective. See, e.g., Miller, Using Practice Support Systems [Altman & Weil, Inc. 1988, reprinted in ABA Legal Economics, May/June 1988]. However, studies of the productivity impact of information technology in other industries indicate that most if not all of the productivity gains from such technology have been achieved by using computers to perform very simple tasks. See, e.g., Gibbs, Stupid Computer Tricks: How Virtual Reality, Speech Recognition and Other Good Ideas Can Hurt Business --Taking Computers to Task [Scientific American, July 1997, pp. 82-89] quoting Stephen S. Roach, chief economist at Morgan Stanley: “What IT [information technology] payback we’ve seen has been confined largely to low value, transaction-processing functions: moving trades, clearing checks, processing orders.”*

*Such experience as applied to the law office suggests that a successful effort should focus on simple things – retrieving client names and phone numbers, keeping the calendar, adding up time charges, balancing the books and typing boilerplate, to name a few. This also supports the view set forth in the accompanying article that small offices can manage automation as well (and in most respects, better) than large ones. Large R & D budgets or teams of rocket scientists are not needed to do the job.*