Fee negotiations in the legal world

Please note that this chapter refers to commercial law firms rather than criminal or personal law practices.

The legal sector has probably undergone the biggest changes within the PSF world over the last decade. These changes are generating unprecedented pressures on lawyers, law firm management teams, client relationships and ultimately profitability. Long-established working practices including the way in which lawyers carry out and bill for their work are subject to intense re-evaluation both by law firms and clients.

Globalization has put established relationships at risk

In an effort to "follow their clients" many law firms built international networks to capture attractive work. These firms soon discovered that they had to engage in more business development (a polite way of saying "sales") and profit management (a less polite way of referring to managing the partnership) to compensate for the growth in fixed costs. Lateral hiring and mergers (both on the client and law firm sides) also undermined established, long term client relationships. Globalization further increased competition in many jurisdictions with new entrants seeking to win local instructions and build new relationships. Offering major discounts, at times even subsidising new business, has been a strategy commonly used to support these efforts. Clients of course have taken full advantage of these developments to apply pressure on established service providers as well.

Clients have become more sophisticated buyers of legal services

As clients noticed the increasing competition for their business they became more demanding of their legal advisers. The increased use of procurement approaches, as described in Chapter 5 of the book, has been particularly notable in the legal sector. In response law firms and lawyers are being forced to become more pro-active in terms of understanding clients' needs and in being more flexible in terms of billing.

I deliberately use the term 'forced' as many, if not most lawyers found the concept of competing for work on anything other than the quality of their legal know-how anathema. Many still consider it at best grubby and, depending on the jurisdiction, maybe even against professional rules of conduct to provide alternative fee arrangements or even discounts.

Early client efforts were focused on obtaining legal services at lower cost. Over time these efforts have moved towards obtaining ever increasing value, eg through the provision of added services at reduced prices. Clients, as part of a more sophisticated approach to supply side management, have focused on understanding better the work processes underpinning legal work and the services they truly require. This has led to an increasing number of clients redefining the manner in which they procure legal services, carving up larger projects into smaller parts, thus allowing for greater standardization. This is inevitably leading to increasing commoditization of services provided by external counsels, reduced costs and greater use of alternative fee arrangements, particularly fixed or capped fee structures.

The 2008 financial crisis and influence of the banks

The pace of change increased even further with the financial crisis of 2008 when the sector saw for first time a decline in both big ticket work (especially M&A and financings) and litigation. The resulting shift in power balance, together with continuing focus on corporate

profitability, has generated even greater pressure on business law firm margins and working practices. Business seems only now (mid 2013) to be picking up.

The dependence of many firms on banks for instructions accelerated many of the developments described so far. Enormous competitive pressures within banking, combined with a high flow of personnel between firms, facilitated a process of osmosis in which best practices relating to the sourcing of legal services spread throughout the market rapidly. These practices include the creation (and regular review) of multiple legal panels and the use of "robust" procurement techniques to seek additional value-added services and lower costs.

It did not take long for these approaches to be taken up by non-banking clients, adding further pressures on law firms to reduce the costs of, and increase the return on investment from their services. Although this may be considered business as normal in other industries, law firms and lawyers are still finding it hard to adjust to a world in which they find themselves treated the same as other services such as IT, catering or travel management.

The increased pace of change has been particularly noticeable in the UK and parts of Continental Europe, with the US following. These developments are spreading to other jurisdictions as global clients demand a global approach from their major external legal advisers and as domestic clients expect equal treatment.

How law firms have responded – mostly slowly

The changes described above are forcing private practice firms to undertake a fundamental review of the way in which the business of law is conducted. These reviews are resulting in a broad variety of strategic responses that can broadly be categorised into the following groupings:

1 **Becoming more client focused**. Many firms have started to change organizational structures or processes to increase their client focus. These include developing a sector approach to complement the more traditional practice area and geographic

organizational approach, or emphasizing business development and relationship management, either through the creation of diverse client facing roles or by making business development and client management responsibilities more formally the role of partners and part of the criteria for becoming partner.

Many firms have adopted more formal client relationship management processes such as periodic internal client reviews, external client satisfaction reviews and the adoption of more explicit client portfolio management techniques to help partners identify a firm's most important clients.

2 **Becoming a lower cost provider.** Some firms have sought out business areas in which they can generate economies of scope through standardizing processes (eg insurance claims processing, trademark management). Some firms have outsourced all or part of their non-legal support functions in the expectation that reducing these costs will allow them to offer lower fees whilst still generating attractive returns for their partners.

3 **Incorporating legal process outsourcing (LPO).** A number of firms have started to explore outsourcing legal processes to deliver select services at significantly lower costs. These firms are hoping to be able to both deliver standardized services at reduced costs and retain client relationships to win and deliver higher margin work. Whereas some firms are looking to third parties for these outsourced services, others are looking to retain these services within their own brand. A&O, for example, has set up an outsourcing office in Belfast, whereas Clifford Chance has invested heavily in India to provide extensive business service support as well as select legal services.

4 **Offering LPO.** A number of law firms have gone even further and have started to offer LPO services to their clients. Others on the other hand have taken equity stakes in LPO organizations[1] such as Law Vest as in the case of DLA Piper.

5 **Learning to love procurement.** A recent article[2] describes the rise of procurement in the legal world as well as the issues that law firms and in house legal departments have had with

procurement departments and procurement processes. It also illustrates some of the problems associated with having to deal with poorly instructed or resourced procurement staff. The article, however, also demonstrated how some selection processes have improved as a result of the involvement of procurement specialists. The article nevertheless showed that it will take considerable time and effort before the majority of law firms will be able to engage with procurement constructively.

Unrealistic assessment of the quality of relationships

Lawyers are probably more prone than other professional service providers to be self delusional regarding the quality and nature of their relationships. Most lawyers would like to think that their clients value them and the quality of their work and by implication the relationship. Such clients do exist and the book refers to them as "dolphin" clients, ie clients that will treat their lawyers fairly.

However, we increasingly see clients who do not care for a relationship with their lawyer ("plenty of other equally good lawyers about"). Rather, these clients just want a good deal and whatever deal they have, they want to get a better deal. The book refers to such clients as "sharks". It is the nature of sharks to take a bite – sometimes just for the fun of it. Lawyers need to beware and take appropriate precautions such as negotiating more robustly.

Sadly the majority of commercial law firm clients are sharks. Lawyers need to differentiate between the two types and deal differently with each. When dealing with a genuine dolphin it is clearly better not to over negotiate (give to get). However, when having to deal with a shark a completely different approach needs to be taken (bite back). This is described in great detail throughout the book.

Impact on individual lawyers

The changes described above introduced by banks and major corporates is having a major impact on the working lives of lawyers in both international as well as domestic law firms.

Compared to as little as ten or even five years ago many partners are finding themselves having to spend significantly more time on such non-billable activities as: pitching, pricing, matter management, relationship management, marketing and business development. They are also finding that they have to spend increasing amounts of time and efforts co-ordinating these activities. Lawyers will have to accept the need for a broader set of personal skills in the areas of finance and management and that these activities will account for a greater amount of their working lives.

One aspect lawyers will have to adjust to in particular will be the decline (but not demise) of the billable hour as the fee structure of choice. Alternatives such as fixed, capped and performance based structures are already common and will become even more so. As outlined in Chapters 4 and 14 of the book, lawyers will have to become increasingly adept at structuring fees in accordance with client needs and wishes, and at running matters accordingly to preserve profit margins. The times in which lawyers give discounts first and only think about the effects on profit second are coming to a close (but will probably still remain with us for some time).

To help partners deal with these issues many firms have started to collate and disseminate increasing amounts of financial information. This approach however has several problems associated with it:

Few partners are financially literate enough to fully understand and use all of the information available. As a result, many focus on immediate issues such as hours billed, hourly rates, write offs and costs, resulting in an unhealthy focus on short term issues.

Many firms still have very rudimentary financial reporting systems, incapable of reporting on a global or client basis. Worse still, all too often systems are being asked to report only on a limited number of performance indicators, such as hours billed and recovery rates, with more sophisticated indicators such as gross margin per partner hour (gMppH) only slowly becoming more established.

A third contributing factor to the sub-optimal financial management frequently found in law firms lies in the nature of partnerships.

Irrespective of whether a firm distributes profit on an 'eat what you kill' or 'lock step' basis, ie on the basis of work generated or billed or on the basis of seniority within the partnership, just about all firms distribute all their profits annually. This re-enforces short term behaviours. Current, relatively opaque performance measurement systems do not allow partners to predict their tenure within their partnerships more than a few years ahead. This makes many partners reluctant to support investments that are dilutive in the short term, even though they make financial sense on a longer term basis.

This is relevant to fee management for a number of reasons:

The focus on hours billed in most law firms puts partners under enormous pressures to be seen to be busy. Many would rather work at unattractive rates than spend time on non-billable activities such as business development, marketing, team management, setting strategy, etc. This also means that partners will often do the work themselves (to get the hours in) rather than delegate to junior resources, which is often more profitable for the firm but not always credited to the partner directly. After all, with few performance measures other than billings to show how a partner is performing, having clients and being busy is one of the only ways for partners to demonstrate to their peers (and themselves) that they are 'performers'.

In the absence of a strong firm culture and clear financial objectives, partners will often take decisions without fully understanding their impact on their firm. It is a common observation that when a client grumbles the partners' first reaction is to give a discount to protect their relationship or retain the work. In larger firms there is little direct connection between fees billed and partner remuneration. A senior partner in a Magic Circle firm confided that: 'most of our partners give a 10 per cent discount or agree a £10,000 write-off too quickly because they don't realise the impact on our collective profit pool when we all do this. They just don't feel the pain of granting the discount or write-off directly.'

A senior partner at a continental law firm echoed this sentiment in a slightly different way, highlighting partners' limited understanding of the firm's financial drivers: 'Most of our partners have a good feel

for the number of hours that a particular piece of work should generate. However, they have little understanding of the profit associated with the work. They often agree rebates thinking that the work will still be profitable when in fact the discount has turned a barely break-even project into a heavily loss-making one. We would have been better off sending the team on paid holidays than doing the work on the agreed terms.'

Engaging in risky activities such as negotiating with clients, which might put the relationship or future work at risk and which, on top of everything, also takes up valuable billable time, simply does not make sense from an individual's perspective.

Law firms therefore have to approach the challenge of improving their collective fee management competencies on a number of fronts simultaneously:

1. **Institutionally:** they need to provide the right financial information combined with the right incentives to ensure that partners are motivated to change their approaches to handling clients in relation to fees. Partners also require guidance as to what the firm or management expects and will need help and support, especially when occasionally work is lost on price.

   Some partners may object at this stage, citing their autonomy and entrepreneurialism; after all, as owner of the business they should be the one taking these decisions. We fully agree, but no matter how small or big the size of a partnership, most partners, especially less experienced ones, find it helpful to have a 'target' or a 'line in the sand' in the back of their minds. This helps them determine how much effort to put into a negotiation or where to put up a fight. Chapter 8 of the book discusses in greater detail the impact and importance of vetoes and meaningful targets on negotiation performance.

2. **Culturally:** firms have to ensure that partners feel supported by their management and by their peers when they go into a negotiation and hold out for their firm's interests. Losing the occasional client or piece is not necessarily something bad.

In fact it may be the best decision under the circumstances, for the client, the firm and the individual.

Furthermore, given that nobody is a perfect negotiator and that practice is one of the best ways to improve, making the odd mistake should be tolerated if not encouraged, as long as there is a willingness and ability to reflect on past negotiations and to learn from them. This is best illustrated by one of the leading international law firms which used to hold dinners for attendees of our fee negotiation programme, always hosted by one of the firm's top fee earners. The hosting partner would always give a short speech during the dinner in which they highlighted where they had personally made (big) fee negotiation mistakes and how they learned from them. These dinner speeches contributed in no small way to the successful roll out of the fee negotiation programme. It also made partners a lot more likely to consult others before going into a negotiation.

3 **Individually:** Partners have to ask themselves what financial and related contributions they want to make, where they currently are and what they would need to do differently. They will also need to be realistic about the time and effort it will take to improve and that this will probably involve taking some (managed) risks along the way. The notion that getting better in this area by taking no risk is simply unrealistic. This means several things:

- get training;
- invest time in preparing and consulting colleagues ahead of a negotiation;
- practice;
- accept that one doesn't always get what one wants but that in the long run, the harder and more often one tries the luckier one gets.

High Impact Fee Negotiations and Management for Professionals provides greater details to the issues raised above. The book also

shows how lawyers, with a modicum of preparation and practice, can significantly improve their individual performance as a fee generator and at the same time improve the quality of their client relationships.

Notes

1 See http://www.thelawyer.com/dla-piper-buys-stake-in-abs-in-waiting-lawvest/1010003.article (15th October 2013)

2 See http://www.thelawyer.com/in-house/learning-to-love-procurement/3010479.article (15th October 2013)