TIME VERSUS VALUE BILLING (SHIFTING THE RISK)

A. **What Is The Productivity Paradox?** The ultimate objective for incorporating technology into your practice is to reduce the amount of lawyer and staff time required to render a service. However, if you're only billing for time spent, the more time you save, the lower your firm's income will be. The investment in technology is difficult to re-capture when straight hourly billing is predominant. This is called the **productivity paradox**. To remain profitable, lawyers must deal with this issue. Hourly billing is essentially cost-based billing. You estimate the cost of rendering services, add a profit factor, bill by the hour and hope for the best. Due to the inherent weaknesses of this approach, more and more firms are transitioning away from cost-based systems (which are lawyer-focused) and moving to billing methods that are tied to value or benefits conveyed (which are client-focused).

B. **Why It's Relevant To You**: Since nearly all uses of technology in a law firm are designed to increase efficiency, lawyers have a pecuniary incentive to underutilize technology if they rely exclusively on billing hours. It is not our position that straight or blended hourly billing is without merit or should be entirely eliminated. However, there are many reasons for adding alternative billing methods to the mix which I'll outline below. Doing so not only encourages efficiency but more importantly, allows you to obtain a quick return on your technology investments.

C. **Example Alternative Billing Arrangements**: First, I want to give you some ideas of what I'm talking about. There's a lot more to "alternative billing arrangements" than simply offering flat fees on certain transactions.

1. **Fixed or Flat Fee**: The fixed or flat fee is the price that will be charged for defined services. It may be the total fee for the engagement or may apply to segments of the total services. It may stand alone or be combined with either an hourly fee or a contingent fee.

2. **Contingent Fee**: The contingent fee is a charge that depends on the results achieved. It requires clear agreement on what the desired results will be. Those results may be positive (direct) in the sense of achieving a desired objective, or negative (reverse) in the sense of avoiding exposure to

liability. A contingent fee may be combined with a fixed or flat fee, or with hourly billing.

3. **Fixed or Flat Fee Plus Hourly**: In this hybrid method, the portions of the services that can be defined as to scope are charged on a fixed or flat fee basis; the portions of the services that cannot be defined because of variables or uncertainties are charged on a time-rate or hourly basis. To illustrate the use of this method in litigation, a flat fee can be charged for handling what appears to be routine litigation with some agreement on what services are included for that fee. If it is necessary to do extra work, there can be an hourly charge for services beyond the original defined scope.

4. **Hourly Plus a Contingency**: By combining hourly billing and a contingency factor, client and lawyer are sharing risks within the limitations of the representation agreement. As in straight contingency agreements, both the client and the lawyer are motivated to obtain the maximum results since both will benefit. It is important to define clearly the way the contingent fee will be measured. If the achieved result justifying the contingent fee is not directly expressed in dollars, there must be some agreement spelled out on the amount of the contingent fee and how it will be measured.

5. **Percentage**: Typically, percentage fees have been based on a schedule of fees related to the amount involved in the matter being handled. The amount may be predetermined or may, in some instances, be related to the amount ultimately determined. Examples include a percentage of the value of estates being probated, the amount of a real estate transaction, and the amount of a bond issue. The percentage rate may be constant or may be graduated.

6. **Retrospective Based on Value**: This method differs in approach from most of the alternative billing methods in that the exact amount of the fee is not known to either lawyer or client until the matter is concluded. Factors that are to be considered in setting the final fee can be set forth in the representation agreement. Often these are the factors set forth in the Model Rules of Professional Conduct. It is possible to establish either a maximum or minimum fee that will be charged. May be combined with an hourly fee in setting a minimum by agreeing at the outset that the fee will be no less than a prescribed amount. The amount of the fee should be determined by the lawyer, not the client.

7. **Availability-Only Retainer**: Sometimes characterized as a "pure retainer", is a payment to the lawyer of a fee for which no direct services will be performed, in exchange for the lawyer's commitment to be available when

requested. This method is not widely used. It normally will be used when the lawyer has high-level expertise or prestige. The funds when received belong to the lawyer and need not be deposited into the client's trust account.

8. **Retainer As Deposit Against Future Services**: Distinguished from the payment of an annual retainer. The retainer as a deposit against future services is not per se a billing method, but a technique to ensure that the client will pay for services to be rendered or for disbursements to be made on behalf of the client. The funds when received by the lawyer must be placed into the client's trust account, subject to withdrawal only when services have been performed or disbursements made on behalf of the client. At the conclusion of the representation, any balance must be returned to the client. This technique can be used with a variety of billing methods, as it is a deposit against future charges however computed.

9. **Unit**: The unit fee is a subspecies of the fixed or flat fee in that a fixed charge is made for a specific service irrespective of the actual time spent in providing that service. Illustrative are fixed charges for each letter, phone call, deposition, etc. This approach normally is combined with hourly billing for services not included in the unit billing. Some representation agreements provide that for a specified service either the unit fee or the hourly rate fee will be charged, whichever is greater.

10. **Relative Value**: Involves the creation of schedules that break services down performed by a lawyer by subject matter and by task and assign a "relative value" or multiplier to each. Each fee charger can be assigned a different basic rate or charge that is then factored into the equation. There are variations in this method as used by individual practitioners who have developed their own schedules. Proprietary systems also exist. Once the relative value schedules have been established, the base rate factor can be changed, thereby producing a changed fee. The relative value method combines elements of hourly, fixed or flat fee, and value billing.

D. **Reasons For Moving Away From Exclusive Reliance Upon Hourly Billing**: Of course, there are some benefits to billing hours; and you already know what they are. Therefore, I'm going to focus on the reasons firms are moving away from them. As it turns out, this is an extremely hot topic in the legal industry today and there is no shortage of studies and books on the subject. I'm not trying to write a thesis on the subject so I'll just give you some of the highlights of my research.

1. **Disconnect Between What You Think You're Selling and What Clients Think They're Buying**: Lawyers often say (as I have said), "I have only my time to sell." However, clients rarely feel they're just buying a lawyer's "time." Instead, they believe they're buying solutions, a favorable

outcome, a specific service (i.e., representation at a closing) or product (i.e., estate planning documents). More importantly, hourly billing puts all of the cost risk on the client and clients would obviously prefer a different arrangement. Try to think of a product or service you purchase without knowing how much it will cost beforehand. I can only think of two: 1) medical services (although typically you're not spending your own money – it's usually coming from an insurance company or the government); and 2) cab rides (however, most cabbies can give you a pretty accurate estimate if you ask). Why are there so few examples of products and services we purchase without knowing the price in advance? Well, it's primarily because consumers demand to know the price of what they're buying before they buy it. It's as basic as having a sense of control and being able to make some type of cost-benefit analysis prior to the purchase.

2. **Billing Everything Hourly Will Cost You Clients**: Example: Assume a potential client needs a new 4 member, member-managed LLC established. Firm A offers them a guaranteed flat-fee to setup and you offer an hourly fee which should fall within a certain range. In almost every case, the client is going to hire the firm offering a flat fee because people choose to eliminate risk, they know that Firm A has an incentive to complete the work as expeditiously as possible, they like to know what something will cost before they buy it, they want to be able to budget, and many other reasons. Moreover, the organization of a standard, small LLC is a cookie-cutter operation for a firm that has a lot of experience with it. Consumers know this. Moreover, if it takes you longer than 1 or 2 hours to crank out the SS-4 and obtain an EIN, complete the Articles of Organization and Appointment of Statutory Agent, and complete an Operating Agreement, then something is wrong with the process and it should be automated. Is it worth it to charge a potential client only 2 hours of time to setup a new LLC? In my opinion, absolutely not; because the value of the service far exceeds that amount to the client. In the alternative, if you charge a $1,000 flat fee, the client will be happy because they know exactly what it will cost. If it takes you 2 hours to do the work, your effective hourly rate is $500/hour and because you charged a flat fee, there are no ethical issues with that whatsoever. Bottom line: if you do not offer flat fees for standard new entity formations when most of your competitors are, you are already losing clients.

3. **Hourly Billing Causes Clients to Distrust Their Attorneys**: One of the major complaints about lawyers is that we charge too much for our services. If we are only billing time, then that complaint translates into a client's belief that we're not efficient or productive; or at the very least, we have little incentive to minimize time spent because it would diminish our fee. The

reality is that almost any billing method which does *not* depend exclusively on time spent provides an incentive for efficiency and early resolution of the matter being handled. In other words, hourly billing provides a disincentive for efficiency and/or early resolution. Every consumer of legal services knows this.

4. **Hourly Billing Limits Your Profitability and Caps Your Income Potential**: Hourly billing limits your income to the number of hours you can bill. Since there are a finite number of hours in a year, you've immediately established an earnings ceiling for yourself if you primarily bill on an hourly basis. Moreover, fixed pricing billing systems can significantly improve your profitability. Consider this passage:

> "Customers want to discuss price up-front. ABA surveys indicate that customers are willing to pay a premium for a fixed price established in advance, even if they believe there is a chance that the price would be lower using hourly rates. Does that sound counter-intuitive? It is actually in accord with observed human behavior. Risk and uncertainty are the twin banes of human existence. Most people will pay dearly to avoid either, supporting a $1.5 trillion insurance industry worldwide. When you price by the hour, you are shifting the entire risk onto the customers. In a free market, they will naturally limit your reward. On the other hand, if you quote fixed prices before the service is performed, you can usually extract a premium simply because you are lowering the risk to your customers. For instance, in the mortgage market, a fixed rate of interest commands a higher rate than an adjustable rate because the fixed rate reduces the risk to mortgage holders." [1]

5. **Hourly Billing Can Encourage Deception, Frustrates Efficient Attorneys and Hurts Recruiting**: This is best illustrated through an example:

Facts: Jane Doe is an attorney for firm ABC in their estate planning department. Firm ABC evaluates its attorneys' performance exclusively upon hours billed each year. In other words, at the end of the year, bonuses and raises are determined based largely upon how many hours each attorney billed. However, Jane knows that 80% of the firms in her city flat-fee bill their estate planning work (which is true across the country). She also knows that in order to compete with the other firms,

[1] See Ronald J. Baker, "Hourly Billing Limits Profitability" (SmartPros, November 16, 1998)

she needs to do the same thing because the first thing out of a potential new client's mouth is always "how much is this going to cost?" She knows that clients love flat fees and certainty regarding what it will cost for her to take care of their estate plan. Moreover, if the potential client has already received a flat fee quote from another firm, she knows they're not going to hire her if she quotes them a dollar range based upon the amount of time it might take and her hourly rate. Firm ABC has a pretty good estate planning volume and Jane has taken the time to organize her forms and clauses and streamline her drafting process so she can keep up with the load. As a result, she can finish about any set of documents in 2 hours or less. However, Jane's firm requires that all services rendered to clients be entered into their billing system as time spent and won't let her enter anything as a flat fee.

Problems With This Scenario:

- Lies to the Firm: Due to the foregoing competitive considerations, Jane feels compelled to quote her estate planning clients a flat fee per document and presents it to them as a kind of menu. She has received very positive feedback from her clients with this approach, it allows her to be competitive, and she has no intention of changing it. However, if she quotes a client a flat fee $2,500, it only takes her about 3 hours to complete everything (1 hour for the initial meeting and two hours of drafting). Therefore, she has to lie and write down on her time sheet that it took 16.6 hours ($2,500 / $150/hr). Is Jane's firm hurt by this fabrication? Probably not, but the circumstances which forced it are wholly unnecessary. The true measure of financial performance is "dollars in the door" not hours billed. Moreover, it's often difficult to track hours billed versus hours collected. If an attorney bills 2,100 hours a year but only manages to collect on 1,400 of them, then his/her financial performance isn't nearly what the sheer number of hours would indicate.

- Lies to the Client: Because Jane can't bill $450 per estate planning client and expect to keep her job, she writes 16.6 hours on her time sheet. Those 16.6 hours show up on her client's bill. Therefore, it is represented to the client that she spent 16.6 hours even though she didn't spend close to that. The value of $2,500 is a fair value for the service rendered, it's what other firms charge for the same service and it's what you could bill hourly if you were inefficient at it. It is, however, a lie.

- Frustrated Attorney: Due to the time Jane spent streamlining her drafting process, organizing her forms, and the fact that she can draft very efficiently on the computer, it only takes Jane 3 hours to meet with a new client and complete all of the documents for them. The problem is that 3 hours would yield a fee of only $450 and she knows that the market rate for this particular type of plan is at least $2,500. Jane feels frustrated because John Jones, another attorney in the estate planning department would actually rack up 16 hours drafting the exact same type of plan because he is extremely inefficient with drafting. John is very knowledgeable about estate planning, but since John doesn't know how to type or use a computer, he either hand-writes everything out on legal pads or dictates on tape, either of which method requires his secretary to spend hours transcribing. She gives him a set of drafts, he marks them up, gives them back to her to make the changes; she prints yet another set for him to review and he often makes further changes which his secretary has to enter. By contrast, Jane produces final drafts the first time because she can create them herself. Jane is significantly more efficient than John and because she doesn't have to rely on support staff to produce work product, her overhead cost is much less. In spite of this, she is penalized by her firm's strict adherence to billing hours only and feels like the time she spent streamlining her document generation process was completely wasted.

- <u>Hurts Recruiting</u>: One of Jane's friends graduated from law school near the top of her class and went straight to the University of Florida to get her LLM. She wants to work in estate planning and Jane's firm is looking for a new attorney for that department. Like most new attorneys, Jane's friend is computer savvy, has her own laptop and is very fast on the keyboard. She's even purchased HotDocs and automated her own estate planning documents to the point that she can crank out a set in about an hour. Jane tells her, "we're looking for someone, but you'd be crazy to work here because you're penalized for being efficient and this firm is strictly old-school when it comes to billing hours." Jane's friend keeps looking and is soon competing with Jane at another firm in town that encourages efficiency and alternative billing arrangements that are client friendly.

6. **Hourly Billing Is a Primary Reason So Many Lawyers Are Dissatisfied**: In August of 2002, the American Bar Association released a report from the ABA Commission on Billable Hours (the "ABA Report"). The objective of the report was to examine the billable hour and its impact on the profession of law. In the forward of the report, the Honorable Steven G. Breyer, Associate Justice of the Supreme Court of the United States, noted that it's difficult for a practitioner to engage in pro bono work, law reform

efforts, and professional activities if trapped on the "treadmill - the continuous push to increase billable hours."

In the ABA Report, the ABA President Robert Hirshon summarizes the report in one sentence: "It has become increasingly clear that many of the legal profession's contemporary woes intersect at the billable hour." After notice ABA studies which "... show that many young attorneys are leaving the profession due to a lack of balance in their lives," he asserts "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 played in society."

7. **The Corrosive Impact of Emphasis on Billable Hours**: This is actual title to a section of the ABA Report. It states that over-reliance on billable hours by the legal profession has caused the following problems:

   a. <u>A decline of the collegiality of firm culture and an increase in associate departures</u>. For the past decade or so, law firms have been increasing billable-hour requirements in order to meet escalating costs and associate compensation requirements. Unfortunately, the increased need for billable hours has caused the pace of law practice to become frenetic and has had a negative effect on mentoring, associate training and collegiality. Lawyers no longer are being recognized primarily for the quality of their work and their talent. As a result, the quality of law firm cultures are in decline and the pressure for hours makes it impossible for many lawyers to achieve balance in their lives. Generally, associate morale is low. Associate departures are increasing at a time when turnover is recognized as costly to their firms. Talented lawyers are leaving the profession.

   b. <u>Discourages taking on pro bono work</u>.

   c. <u>Does not encourage project or case planning</u>. Looking at individual client matters, absent a request from the client, hourly billing arrangements do not require, or even encourage, the lawyer to prepare a project plan or case plan at the beginning of a client engagement. Rather, hourly billing allows lawyers simply to start working and reporting the hours. In some circumstances, the lawyer "makes it up" as the matter proceeds. Lack of planning often leads to inefficiencies that can result in excessive billings. In the alternative, billing arrangements that include flat rate or contingency components require lawyers to completely reverse their thought processes at the planning stage. For the lawyer to be successful, there must be a plan at the outset that enables the lawyer to set a fee for the work that is fair to both lawyer and client. While there will always be a few cases that are so unpredictable that hourly billing is required, too often hourly billing becomes a crutch for the lawyer who is not sufficiently knowledgeable and/or productive, or is unwilling to share with the client the risk of the lawyer's own inefficiency.

d. Provides no predictability of cost for client.

e. May not reflect value to the client. Every legal project has an intrinsic value to the client. The value may be greater than a fee based on the total of the hours billed. Or the value may be less. More importantly, with hourly billing the client does not have the information necessary at the outset to evaluate whether to or how to pursue a matter. Hourly billing often produces a result that is unfair to either the client or the lawyer. In some cases it may not be fair to either.

f. Penalizes the efficient and productive lawyer.

g. Discourages communication between lawyer and client. Clients may be discouraged from communication with their lawyers because they are concerned such action will start the billing clock. They may even suggest that their lawyers eliminate spending time on routine reporting letters or telephone calls.

h. Encourages skipping steps.

i. Fails to discourage excessive layering and duplication of effort.

j. Fails to promote a risk/benefit analysis. Hourly billing does not encourage lawyers to conduct a risk/benefit analysis with regard to determining how to proceed on matters. Without a predictable cost, a risk/ benefit analysis is impossible. Hourly billing results in work being conducted that may not be necessary, or work being performed prematurely or at a cost that is not justified.

k. Does not reward the lawyer for productive use of technology. Lawyers' overhead has increased dramatically due to the need for improved technology. The new technology has allowed the lawyers to be more efficient and to produce their work in fewer hours. As a result, the profession is facing increased costs and fewer hours to bill. Simultaneously, in many markets there is a level of competition that is preventing lawyers from increasing their hourly rates to reflect the added expenses of technology. As a result, instead of seeing monetary rewards for their improved efficiency and investment in technology, lawyers are seeing their profit margin decrease which ironically creates additional pressure to bill more hours.

l. Puts client's interests in conflict with lawyer's interests.

m. Client runs the risk of paying for:

   i. the lawyer's incompetency or inefficiency

   ii. associate training

   iii. associate turnover

   iv. padding of timesheets

n. Results in itemized bills that tend to report mechanical functions, not value of progress.

o. Results in lawyers competing based on hourly rates.

E. **Humorous Analogy**: Kevin Pratt, a lawyer in Colorado Springs, CO wrote an entertaining analogy on this issue which was published in the Denver Bar Association's Docket:

The Denver lawyer stepped up to the airline ticket counter and asked to buy a ticket for a flight to Chicago.

"No problem," said the clerk, "but before I issue the ticket, I should remind you of the new way we charge for tickets. This year we have adopted a 'basic rate' of three dollars a minute for our flights. The clock starts when you check in at the gate and stops when you pick up your luggage. We mail you a bill about two months after the flight."

"Well, I guess that's okay," commented the lawyer.

The clerk continued, "Remember, we call it a 'basic rate' because we sometimes adjust that rate up or down if the flight is very empty or very full. Too, we may multiply that rate if our expert pilot finds a tailwind. We also adjust the rate according to what you will be doing in Chicago. You look like a lawyer, so I'll assume it's very important that you get there by plane, so we quadruple the basic rate. Another thing, how much is your annual income? You see, if you earn a great deal and it turns out the plane crashes, we will have to pay more on your spouse's damage claim, and we have, of course, to consider that increased risk of the airline."

The astounded lawyer choked, "But how much will this trip cost me? How do I know you don't slow down on purpose? How do I know your bill will be correct?"

The clerk stared down over the end of his nose. "I can see you're not familiar with the complexities of airline work. There are so many things we just can't know in advance-the winds, traffic delays, the weather, the routing. Airlines are a business, and we have to make a profit to stay in business. Now don't worry, we're very honest and sensitive about all this billing business and I am sure you'll be pleased with our fully itemized bill when you get it. If there's any question just call." Then the clerk whispered, "But just so we understand each other, if you don't pay the bill in full and promptly, you'll never fly on this airline again."

"Oh," grunted the Denver lawyer, "is there anything else I should know?"

The clerk smiled thoughtfully and murmured, "On your flight there is a new copilot in training, and we charge an additional 50 cents a mile. Copilots are really very important, you know, to carry the pilot's charts, to fly on clear calm days, even to land the plane if the pilot is busy with other matters. Too, if you fly with us again, your copilot may have become your pilot. Wouldn't that be great? One other thing, if the copilot uses computerized flight routing there will be an additional $75 charge. But of course computerized flight routing is almost standard charge with technologically advanced airlines."

"But I just wanted to get to my meeting in Chicago and come home. Now I don't even know if I should fly at all," groaned the lawyer. The clerk smiled again. "Mature passengers come to understand that flying is just a cost of doing business. They never know how much it costs 'til we bill them. But then, there's really no choice, is there?" "No," conceded the lawyer, " I guess not."

And then the lawyer tried again. "Why can't you just give me a fixed price and I'll decide if I'll go or not?"

The clerk frowned. "But we can't do that. That wouldn't be fair to you. We might overcharge you and then you'd be unhappy. Or we might underestimate and then the airline would lose money and couldn't maintain the planes, and we certainly don't want that."

And so the Denver lawyer came to hate airlines and took his revenge by regaling acquaintances at cocktail parties about the new pitfalls of airline travel. Fortunately, none of you readers run an airline, so you won't feel defensive.

F. **Summary**: Many of your competitors will offer flat fee and other billing options for those tasks for many of the reasons outlined above. The number of lawyers per capita continues to grow and competition continues to increase in the legal market. You can bet that other firms are going to call your big clients and ask what they can do to get a piece of their legal work. Giving them predictable, flat fees or offering alternative billing methods for standard transactions is a big lure they can offer. Moreover, the best way to grow a firm's revenue is not the same as it was in the 1960s when hourly billing came to the fore. Technology itself and lawyers who are harnessing technology to improve their efficiency has changed the equation.