Sandpiper Partners LLC

2012 PROFITABILITY AND PRICING MODELS[1]

- Reassessing the Traditional Approach
- New Math, New Formulas

Introduction - Changing Market Dynamics

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How are pricing and profitability influencing law firms today? What does "pricing and profitability" really mean? How have they affected the law firm sector landscape? We need to look at where we have been to get a better grasp of where we are going on both the global and domestic fronts.

The best way to describe the situation is an "evolution". Webster defines "evolution" as a process of change in a certain direction; an unfolding from a lower or simpler to a higher, better state of growth. Firms have definitely gone from a simpler to a more complex direction in recent years. The legal sector is a mature profession operated with a relatively simple business model but whose pace of change is accelerating. It does lag behind accounting firms by 15 to 20 years in terms of innovation, and accounting firms lag corporations by about five years.

Where have firms come from? Pre-1950's, the concept of value billing was king. There is the story about the lawyer who went to meet with a CEO carrying a different bill in each side of his pant's pockets. If the client were pleased, he would pull one bill out. If not, he would pull the other. Compare that to seven years ago and a very different story about a lawyer who was approached by a client who could pay big bucks. Not only did he have to twist the lawyer's arm to get him to take the case but the deal was for only three days of the lawyer's time- the day after Thanksgiving, the day after Christmas and the day after New Year's along with some help from a first year associate -- all for a grand total of $8 million..

The business model pre-2008 was to maximize hours and rates. Then demand started to plummet and firms came to the realization that their cost structures were way too high. There were too many associates and while firms could distinguish the best from the weakest, they could not differentiate the middle. Many also could not differentiate their

[1] Based on Briefing held October 5, 2011 in New York City.

client base and struggled with issues of identity. Who were they and what did they stand for? The result of this upheaval was to freeze rates, offer some discounts, do some cost reductions, have significant lay-offs, and use late or deferred start dates. These changes were accompanied by clients demanding increased accountability.. Accordingly, control shifted to the client side.

Today the biggest law firms -- the twenty at the top of AmLaw 100, have deep relationships, solid reputations and are still able to do value billing. They have had some cost reductions but minimal layoffs and are very profitable. At the lower end of the AmLaw 100 the crisis hit before 2008 and had already undergone significant changes. Thus, they were better managed, had cost structures in place, changed expectations for partners and were ready to go while others languished. The most challenged group, the AmLaw 21-70, were trying to break into the top 20. They were gaining in reputation, but they had too many associates. They were following the ideal business model, maximize rates and maximize hours, but that put their cost structures out of alignment. So, in the 2008-09 period, this is where most of the discomfort was happening.

Firms need to be better managed and smarter about their finances and billing because of what is happening in the marketplace. They need to be smarter about how they are pricing their products. There is value in keeping a client on your roster and maybe taking a hit on one particular project so that you maintain a relationship. Further, how a law firm reports its profits as opposed to how a law firm manages itself is completely different. The reality is that firms are going to have to adopt more of a corporate model down the road.

Spotlight: Top 10 Factors Currently Impacting Law Firms*

1. ***Increased consolidation and specialization*.** Look at Cravath or Cahill. Both firms are very specialized and very profitable. Look at Hogan Lovells. Consider globalization and how firms have become more relevant to their client's business. Look at DLA in the marketplace and how lateral movement can be advantageous.
2. ***Effects of a more demanding workforce*** who want to know what is in it for me and more sophisticated buyers who are price and efficiency driven.
3. ***Continuing need to reduce cost while facing increased risk***. Until about eight years ago, firms' response to risk was "we have insurance." Now firms have entire committees dedicated to looking at risk and are more proactively addressing it.
4. ***Firm culture has to change*.** People do not like change but in this era, it is a necessity. With an evolving business model and added pressures across the board, lawyers have to adapt. The old response that managing costs simply cannot be done does not fly in today's world.

5. ***Different expectations for partners.*** The mentality is no longer of a sole proprietor. Firms have expectations for their partners and are holding them accountable for hitting goals, which was unthinkable, not that long ago. Today, "WHAT GETS MEASURED GETS DONE".

6. ***New policies and procedures to drive consistency.*** As firms continue to get more complicated, this has to be done. A consequence is that this makes partners feel different and that they have less control.

7. ***Different criteria for advancement.*** Factors that need to be considered include looking at how business is developed. No more of the waiting for the phone to ring mentality. There has to be more accountability to clients and to the firm. The firm has to demand more to drive profits and there needs to be increased pressure at the margins.

8. ***Improve client relationships.*** Providing legal services is no longer enough. Meet with clients and become a business advisor. These relationships also need to be more institutionalized. Accounting firms have to rotate partners. Similarly, law firms need different points of contact.

9. ***Have more dispersion of partner compensation.*** Of the AmLaw 100, 68 firms report the average partner earns in excess of $1 million dollars. Also 18 of the AmLaw 200 share that statistic. The question is "should partners be commanding that type of compensation?" Firms have been relying on cost reduction and project management to cut costs, but at some point those savings are going to max out. There is going to have to be a greater dispersion between the lowest partner and the highest one where before it used to be tighter. Of course, firms will continue to have to pay up for their best partners.

10. ***More sophisticated leadership is necessary to manage more complicated firms.*** Now that just maximizing rates and hours is not realistic, there needs to be more sophisticated oversight.

* Prepared by David Gaulin

Benchmarking Data on Fee Structure

Elizabeth Duffy, Associate Director, Acritas

Acritas conducts an annual global survey of general counsels and interviews 2,500 lawyers around the world each year. Of particular interest are the findings around fees and premium rates that clients are willing to pay. About 800 lawyers in the US are interviewed annually from key regions and industry sectors. In 2011, 513 interviews have already been conducted and constitute interim results. Typically, Acritas talks mostly to general counsels who make up 70% of the sample group as well as heads of IP and Litigation. They also only look at organizations with $50 million of revenue or upwards.

Since 2007, a question has been posed asking "what do you believe will be the major changes in the legal services market over the next two years?" In 2007, the responses focused on change in fee structures away from the hourly rate along with increased use of technology. In 2008, cost pressures became more apparent- lower, competitive rates, continued move away from the hourly rate and consolidation topped the list. By 2009, increase in fixed fees where the clients specify what they prefer as well as increased cost pressure dominated the answers. By 2010, it was back to change in fee structures with ongoing concern about cost pressures and the need for reduction in fees. Interestingly, back in 2007, 19% of the respondents were talking about change in fee structure compared to 37% in 2010, which is a real shift. For 2011, the main issue on everyone's mind is alternative fees and the need to specify more precisely what does and does not work in these arrangements. Outsourcing legal services is another hot topic. Clients also want input into how a matter is sourced internally.

What types of rates and fee structures are being used globally? 66% of work is done by hourly rates, 25% by fixed fees and 9% by alternative fees. By individual region, 81% of US work is done by hourly rates. If we compare that number to mainland Europe, the UK and Asia, there is much more of a fixed fee structure than in the U.S. and a greater level of comfort around using it. Clearly, the US is entrenched with the hourly rate along with Canada, which is the only other place to rely so heavily on it. In terms of an age break, the under 40 set is much less attracted to the hourly rate. So, this may be generational which could mean a ten year shift rather than immediate change. Indeed, despite all the hype, 2011 has seen a return to hourly rates. In 2010, work done by hourly rates in the US was 72% and that number has increased in 2011 to 83%. Some suspect there has been an increase in litigation so that might be the reason for the uptick. Anecdotally, when speaking with general counsels they wanted to be more innovative, but then they just reverted back to the hourly rate.

If we are using the hourly rate, what are clients willing to pay? Clients actually told Acritas that for the right work, there would be no upper ceiling. Overall, clients indicated that they would be willing to pay a 17% premium on top of the average cost. The largest organizations went further and said they would pay 22% above. Regionally, clients in the mid-West were willing to spend the most and pay 22% over. The Finance community would spend 20% above while Corporate was willing to shell out 17% higher than average.

What would clients expect if they are willing to pay that premium? 1) specialist knowledge and expertise within a sector; 2) efficiency, speed and timeliness -- the ability to get it done by tomorrow; 3) responsiveness, 24 hour access, direct line to "the bat phone"; 4)highest quality work and advice, no less than 100%; 5) best partners working on the matter and 6) highest quality, top notch client service 7) experience and results.

When we look at the statistics across regions, some interesting trends emerge. In the US, clients want speed and efficiency. In the UK, it is more about people and relationship based. In Asia, they are focused on results because they feel they should be getting the entire package to begin with.

Challenges and Opportunities to Change Firm Culture & Behavior

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Pre-2008, there was a stretch of 17-18 years where law firms experienced record profits and revenues. Overall 90% of the partnerships had never seen a down year. The legal industry somehow felt immune to economic turmoil having thrived through other tough times like the end of the Internet "bubble." The last few years have been a different story. Firms have resorted to looking for work by chipping away at competitors. Clients treat lawyers more like vendors. General counsel ask to knock percentages off. There is an increased focus on cost and that has forced firms to behave more like businesses. In today's marketplace lawyers are treated just like everyone else, which is not so special.

At Akin Gump, the severity of what happened with the economy forced people to think differently. Now partners are more frightened by the status quo than by change because there is a recognition that they are not going to survive sitting in the status quo. The biggest difference for partners is their relationships with clients. For partners the psychological barriers to handling these changes seems to have been broken down but it is vital that they have the tools to institute them whether it is hiring consultants, having practice managers collect better data on fee arrangements or even more specific guidance from management about what is expected.

People have seen the light at Reed Smith and developed a culture where change is "okay." In the last ten years, they have grown from 300 to 1,800 lawyers. The truth is that change is positive as long as it is successful. There is a feeling at the firm that it is easier to build trust if a change works. DLA has also been growing over the last six to eight years. There has been great firm-wide acceptance of bringing in laterals. Yet, trying to implement a simple process can sometimes be painstaking. It is necessary to really sell the change, offer a great amount of explanation and make the firm leadership understand why, then quantify the results. In corporate organizations, you have got a gun to your head every 90 days but nothing happens that quickly in law firms.

Duane Morris operates under the philosophy that what gets measured gets done. Since 1986, they have been doing just that by using profit centered** accounting. On a monthly basis, they look at profitability at the working and billing attorney level. The firm has grown by 300% since the late 90s and 2000s. Again, there is a strong belief that measuring is the way you get the performance that you are looking for. Measuring has helped the firm in many ways including transforming the trial practice and eliminating other practice areas that were hemorrhaging money. When you have a system that measures, so much becomes clearer including where to reward and where to cut. Hence, the firm does a profit sheet on every attorney, every month. This is distributed to practice group and office heads as well as reviewed at the partner level. The information is not given out to associates but it is discussed with them.

For Susman Godfrey, it is hard not to be pessimistic about the long-range future of law especially with the 2012 election around the corner. If the Republicans get elected, they want tort reform. If there are no regulations, then there is little need for lawyers. Right now there is a general sense that lawyers and law firms are bad. If things get really terrible, how do we make the practice of law more enjoyable? First, if you have the best lawyers, you will get the work. How do you get the best lawyers? The answer is transparency. At Susman Godfrey associates know the range of compensation and how they get it. The firm is run like a democracy and associates get to participate. The truth is that there are too many lawyers out there and not a demand for all these law school graduates. Susman Godfrey believes in catering to the crème of the crop. Go out and hire someone else for document review and things of that nature.

Of course, there are differences between smaller firms (Susman Godfrey has about 90) and larger firms. Both can agree that there are going to be fewer lawyers making a lot of money. Having transparency in your compensation model is key, however.

In a large firm, how do you make the environment better for associates?
At large firms, associates went from being scared out of their minds about whether they would have a job to the "what's in it for me" mentality. If you want to keep the best and the brightest around, you need to make sure the work is interesting for associates, that the partners are involved and that some thought goes into your development of associate tracks.

What if you encounter a silo mentality at your firm? How do you manage through it?
If there is less work, there can be a tendency to latch onto a client. In today's climate, it is important to make it more of the firm's client, that is a client of the firm's management and practice group. Practice group leaders should visit with clients at least once or twice a year. Also, make sure your lawyers know especially if you have done a lot of lateral hiring that the firm is not interested in having stand alone practices or providing them a booth in a shop. Integrate laterals into the firm and give them resources to succeed. When it comes to associates, move them in and out so they have more exposure to partners.

How do you deal with complaints from clients about fees?
A typical complaint from clients especially when it comes to alternative fees is that if the firm makes a killing, the client does not think it is a fair arrangement. This can be a very tricky issue especially because the client might not want to re-up with your firm if it feels ripped off. Measuring against hourly rate can be useful in creating a scorecard. Lawyers have to be more business savvy. If a client feels bad, this can be an impetus to give money back. Again, they need the proper tool kit -- how to staff, how to model, how to

report -- to enter into these deals wisely. Fear is a great motivator and so is invoking the competitive spirit.

Many firms have hundreds of partners worldwide and the fact is that different people have different skills. Some will be great at setting up these arrangements while others will not. Firms need to incentivize people through compensation. When they are rewarded, other people want to follow. Successes need to be celebrated. Then others will want to emulate.

"Heads we win, tails they lose" type clients need to be weeded out. It is hard to consider doing this in such a bad economy but we cannot always let the clients win. At a place like Susman, it is "good for us to do well when we win and we will share the pain of a loss." Susman's never going to be the low cost provider but they can win on value, efficiency and quality.

What are the pricing pressures on litigation?

Duane Morris does IP litigation with monthly fixed fees. It is vital to do a good job of going over the scope of a case. When the scope changes if that is driven by the client, there is less resistance to reworking the fee arrangement. Again, define the scope -- even do a phased basis of scope and define things like the number of depositions. If the other party gets more aggressive, then change the scope. Relationships are a critical part of pricing and profitability. Manage clients' expectations and cultivate room for development.

Susman Godfrey does a lot of fixed fees. From the outset, the firm is clear with the client that the client does not get time reports. The reason the firm can do a better deal is that the firm is experienced, having done a lot of them. The philosophy is 1 out of 4 deals might be misquoted and turn into a loser. If 3 out of 4 succeed, the firm is getting a premium. It is important to make the client understand that the firm is more likely to win your case if it is handled efficiently. Fixed fee gives you a better product in litigation. Do not do a scorched earth approach. And it is not about making the other side mad. If you have a $1 million fee and $200,000 of work gets the job done, make sure that it is praised and financially rewarded. By the same token, have some adverse consequences for lawyers' write-offs.

How do you make sure the data and time entry are accurate? How do you manage it?

In a firm like Akin Gump with over 1,000 lawyers, you have to look at everything. The firm needs to know how many things a lawyer is working on and interview every partner. The firm is not just looking to see if a person was productive; it needs to discern if any other method of discounting is being provided. Akin Gump's compensation system includes a full analysis and that is how it hedges.

How does a firm take control?
Susman Godfrey has a monthly report that looks at fixed fee vs. hourly. If it gets out of whack and you are exceeding the fixed fee, there is mismanaging going on which can then be controlled. Partners need to talk and think through the hard questions. Akin Gump does not even allow anyone to enter into an alternative fee arrangement without sign off from the executive director. Of course, there will always be some bad deals. Firms should try to avoid engagements in the first place that do not make sense for them.

Hypothetical on Pricing

Russ Haskin, Director of Consulting and Services, LexisNexis-Redwood

The Problem: Given the bad economy, Southern Theta Development Corporation asks for a discount from its law firm on its billing for legal services. Although they are not a big client, Southern has paid its bills in a timely manner and Mr. Doe, the President, is a highly respected community leader, who recommends the firm any chance he gets. Attorney Allen proposes to his firm offering a volume discount where if Southern spends $75k, it gets a 5% discount, $125k a 10% discount and $200k a 15% discount.

Data on work attorney history and client history including hours and billing from 2006-2009 were distributed. The most recent statistics from 2009 showed 206 hours on corporate work and 42 on trusts and estates for 248 hours total. Standard amounts for billing were $93,114 for corporate, $11,640 for trusts and estates and $104,753 total. Direct costs were $48,749 for corporate, $4,824 for trusts and estates and $53,573 total.

Attendees' Consensus Answers:
Attendees were asked to look at the data and come up with a recommendation for attorney Allen's firm. Most suggestions were to offer some type of fixed fee arrangement:

*$7,000 per month, $85,000 annually, define the scope of the work on a monthly and annual basis. Focus on value and predictability. Readjust the number of hours from partners to associates and push some of the work down to associates.

*$90,000 fixed fee. Stay away from the term volume discount. Shift work down to associates. Talk to client about what they are facing going forward -- litigation, new products -- to determine the scope.

The Answer: Attorney Allen's firm gave the trusts and estates work for free (about a $4000 value) and offered to do the rest for an $85,000 fixed fee for a one year contract. The firm knew that it could work with leveraging under this plan. There is a worry, however; that once you set the precedent of doing work for free, the client will want that and then some more next year. So, it could be dangerous. Also, it is important to keep in mind that most mistakes are done in the beginning of alternative fee arrangements. That is where firms tend to fail. Try to get it right from the start.

Tools and Analytics

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How do you create change? How much are firms using AFAs?
Things have plateaued with AFAs. But the mindset is here to stay. Susman Godfrey represents plaintiffs on a contingent fee basis. Doing this gave their lawyers some skin in the game. They also have opportunities to represent defendants by the hour. However, working this way was not profitable. Also, Susman has twice as many partners as associates so it needs a different formula. They needed to come up with a different way of billing clients in defense work, a way where they could make the profit level they wanted. Additionally, they wanted to give clients a reason to enter into the fee arrangement.

They know clients love predictability and they want a budget. Thus, Susman Godfrey decide to charge a monthly fee from $25k to $1m. They make the fixed monthly fee as little as possible. All arrangements include a kicker. What is the risk to Susman? But how do you measure success on the defense side? Is not that hard to do? Most clients want to get rid of litigation quickly -- an incentive might be built into a case, for example, $50k per month bonus. If the case ends within a year, there will be a $1m bonus. They want the lawyer to have incentive to end it quickly. If certain benchmarks are met -- motion to dismiss, motion to summary judgment -- these milestones help measure success. The bottom line is that alternative fee arrangements of this type are more profitable for Susman Godfrey. A word of caution: it can be difficult to get clients to be receptive to these arrangements unless you have a brand as well known as Susman Godfrey. For a less prominent firm, it is harder to do.

DLA Piper does not have the number and volume of AFAs like Susman. In its experience, when clients are talking about AFAs, they really want to talk about discounts. Reed Smith has 20% to 30% of its billing in AFAs on the transactional and litigation side. It can be a challenge doing project management, budgeting and staffing these engagements properly. Smaller firms are able to manage these engagements in a more hands on manner.

Twenty to 25% of Dechert's overall revenue is from AFAs. Two years ago there was firm-wide, project management training. The firm wanted to provide attorneys with analytics and data. The project management team sits down with partners on a monthly basis and utilizes the philosophy that what gets measured gets managed. The portfolio over 2011 from 2010 showed positive results and illustrated that there is value in taking time to understand the metrics. It allows for much more focused discussion.

Akin Gump is not where Dechert is. Its approach to AFAs began with denial, then reluctant acceptance that it had to do it. For a time, the firm focused on things that did not work out like firing associates and hiring staff attorneys. Later came a move to contract attorneys and outsourcing. Now the firm is getting to the point of acceptance about AFAs and acknowledgement that there could be an upside. In fact, in some situations, it may work better.

How do you define an alternative fee arrangement? How do you manage one?
There is no one size fits all approach. A good way is to state that it is not based on the number of hours. Be clear that you are not talking about a discount. It is possible to have a budget for different phases, too.

At Dechert, data partners need to manage the AFAs. When a partner is looking to price, the firm is able to look back at the history: what were the trends, what have the margins been, number of hours with that client, trends with staffing and the way the matter has been previously leveraged. But the firm does not like to rely just on history. The world has changed and those considerations need to be married with the "perfect scenario." Project management walks through different assumptions with partners who typically underestimate. In terms of an intake procedure, Dechert has a process by which as soon as a partner wants to do an AFA. He/she has to seek advice from a project management specialist and different scenarios are modeled. Weekly profitability and realization scenarios also are provided. Additionally, Dechert has a strict policy on hours entered for AFAs and suggests that this is done on a daily basis.

Susman Godfrey, first and foremost, recommends changing the habits of lawyers when they are working on AFAs. These type of cases need to be handled in a different manner than by the hour. It is a different mindset. Law firms simply cannot put so much time in a case that there is no way they can make any money. If that is what is happening, then the case has not been managed properly.

Here are four tips on how Susman manages AFAs - 1) change your client's expectations. Make clear that we, the firm, choose who works on the case. Make the client understand you are the boss. Let the client understand that you want to get paid your kicker or bonus and that they have to have faith in you. 2) Have frequent peer review within the firm. Other lawyers need to review the matter on a monthly or quarterly basis and look at things like number of depositions, if opportunities have been frittered, what is the number of attorneys on the trial team? They need to look for any inefficiency. 3) If you can have the same people working on the case, it will be helpful. The average case lasts 3.6 to 4 years on the plaintiff's side. A lot of turnover can be disruptive. 4) After the case is over, have a presentation/post mortem. At Susman, there is a post case analysis including checking the case acceptance memos to see what was said at the outset. Most firms do not do post mortems, and that is a mistake.

How do you collect and disseminate data? What data?
Duane Morris has a long history of looking at the economic data, particularly attorney profitability and practice group profitability. About five to seven percent of its business is on a contingent fee basis and seven percent falls under AFAs. The firm uses metrics for different pricing that is hourly based -- discounts, blended, staffing. The firm does a lot of modeling up front and has financial analysts to assist them. Partners also have dashboards. All reports are on the Internet. Firm management sees all data while associates only have access to their data. A monthly report is issued as well with key statistics.

In an age of information overload, how do you get partners to focus?
The key is to have project management people. Have the data centralized; get a group who has collected all the data centrally. Make sure practice group leaders have help. Try to find ways to cut through the clutter with innovations like a Blackberry icon that will allow senior management to access key metrics from their dashboards when they are away from the office or one that deals with the problem of too many emails and funnels them. Also, if a partner wants to dig deeper and get more information, have a print application that will send the request back to the office and have an entire report ready by the time he/she returns. The reality is that the more complicated something is, the more partners tune out. Simplify and filter information so that it is accessible. Remember, lawyers should spend most of their time practicing law.

What are the most important things to focus on?
Looking at profit and collections. For fixed fees, always measure actual versus budget, assumptions versus what happened. Measurements are key. Susman Godfrey has a fixed fee report that measures what it received monthly with the value of the time of the case. It also breaks down contingent fee cases on a monthly and life to date basis and places them on a list from highest to lowest which they then scrutinize. Each quarter, the partner in charge of a case must present a status report. All cases are separated into three categories that are placed on three separate sheets of paper: probable/75% likely a winner; possible and improbable/loser/write offs. Every month, a list of the top ten cases goes out -- top hours and how they are being staffed at a glance. There is constant vigilance.

Akin Gump is less focused on AFAs. They are always looking at “standard” rates and “effective” rates. Collections are important at all times but especially at the end of the year. Management meets with every practice group leader every quarter. They go over the data and walk through productivity, rates and collections. It is useful to really have an agenda and expectations.

Fundamentally, profits are key but having cash is essential because that is how you have to pay people. At the end of the day, it all goes back to relationships with clients. Maintaining great relationships keeps the work flowing.