STRATEGIC PRICING

By Ed Wesemann, Edge International

One of the most powerful strategies available to any professional service firm is pricing. Regardless of the service, the reputation of the provider, the sophistication of the buyer, the quality of the service or any other aspect of a firm's position in the marketplace, price plays a significant role in a client's decision to purchase a service. And, of all of the factors affecting profitability (price, utilization, leverage and margin), price is the only one that does not have a directly adverse impact on some other factor when it is increased. As a result, small adjustments in price have a major effect on net profit.

In fact, it is hard to envision a firm trying to create a strategic direction without answering three basic pricing questions: *How do you charge for your services? How do you set your prices? What is your pricing strategy?*

HOW DO YOU CHARGE FOR YOUR SERVICES?

This is an age-old debate in professional service firms. On what basis should fees be charged? Law firms, particularly since the advent of computerized billing systems, have defaulted to hourly billing systems. Accounting and consulting firms, on the other hand, have mostly opted to charge fixed fees.

But suddenly, the discussion of how lawyers charge has become a polarizing topic and attempting to defend the use of hourly billing is viewed as politically incorrect. But the fact is that most law firms have built entire billing systems and compensation standards on hours charged. And, despite the publicity around alternative billing, there has not been an outcry from most clients to get rid of the billable hour.

But, outside the issues surrounding billing by the hour, the structure a firm utilizes to price its services carries increasingly significant strategic implications. For example, many firms are now implementing advanced technologies as an integral part of legal service delivery. They then strategically use this technology as a differentiating factor in establishing a position in the marketplace. Other firms are creating strategies based on using knowledge management to increase client value and retention. Such strategies are expensive to implement and intentionally reduce the number of hours required to produce legal work. If the firm continues to charge by the hour, increasing hourly rates is its only means of recovering the strategy's costs or of using them to contribute to increased profitability.

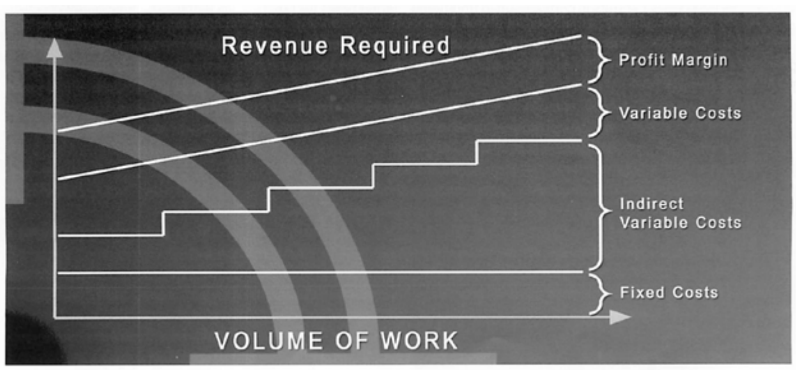
In 1989, the ABA published *Beyond the Billable Hour* (which it calls "a landmark book") describing ways lawyers could bill clients other than by billable hours. But in the 20 plus years since the ABA told lawyers it was okay to bill with fixed or value-based fees, little has changed in the pricing of legal services, except that hourly rates are more entrenched than ever and rates have risen dramatically. Frankly, unless clients scream for a change away from hourly rates (which, amazingly, is not happening), the billable hour is likely to remain the pricing standard far into the future.

As such, if firms are going to insist on charging by the hour, the strategy for setting price becomes even more important.

HOW DO YOU SET YOUR PRICES?

When asked how they go about setting rates, law firm managers usually mumble something about establishing margin and determining what the market will bear. In fact, most firms set pricing based as much on intuition as science, using more political wisdom than strategic thought. Regardless of whether a firm is charging a fixed fee or an hourly rate, law firms seem to use three basic methods to set pricing.

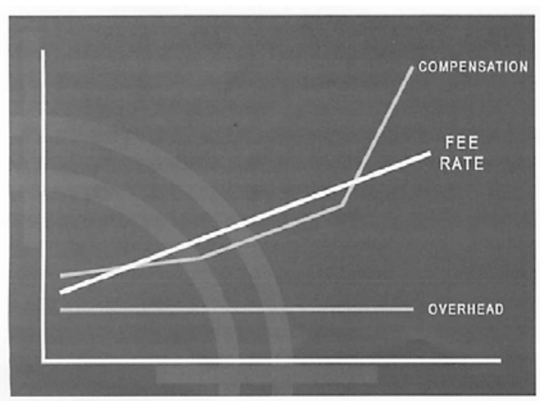
Cost Plus Pricing. The first method establishes the cost of providing a service and then adds a percentage "profit margin" to create a price. Managing



partners adore the concept of cost-plus pricing because it brings, in their opinion, a rational approach to pricing decisions and implies a level of accuracy. Plus, the method is inherently safe. After all, how can one lose money if the price is based on the cost of a service plus a margin of profit?

For law firms, the biggest deterrent to cost-plus pricing is determining an accurate and acceptable cost calculation. Like most businesses, law firms have both fixed and variable costs. But most costs are tied to the number of lawyers the firm has. That is, when a firm adds a lawyer, the lawyer needs an office, a portion of a secretary, a computer, etc. But the costs necessary to support a lawyer rarely arrive in single lawyer increments. Instead, costs are only indirectly variable and reflect the addition of groups of lawyers. For example, a firm rarely can add offices one at a time and, at some point, adding lawyers requires an increase office support staff.

Indirect variable costs are common in all businesses. But the unique aspect for many large firms is the rate at which the firm grows in "fits and starts" with little planning or predictability. Law firms tend to add lawyers both in response to the availability of work and in anticipation of work. This process includes bringing in large classes of first-year lawyers, which must be decided a year in advance, and bringing in lateral acquisitions, which is largely reactive to the availability of an individual or group. Predicting the volume of legal work poses a problem because volume, which represents the necessary divisor in establishing that cost calculation, is a highly unpredictable figure. Figuring cost per hour is much less complicated at the end of the year (as a reporting function) than at the beginning of the year (as a pricing function).



But even if a firm gets the math right, other difficulties emerge in translating cost into hourly rates. Basically, the problem is that cost-plus pricing is internally focused. For pricing to be effective, both the buyer and seller must accept the price. Yet clients could care less about a film's costs. Clients view price in comparison to what competitors charge, by how much they can afford and what seems fair. Even more importantly, cost-based pricing produces above-market prices when the market is weak and below-market prices when the market is strong. That is, cost-plus pricing completely ignores the market variables of competition and demand. The method is unresponsive to changes in the competitive environment.

But for most law firms, the concluding issue is that cost-plus pricing produces wacky results in comparison to traditional law firm pricing schemes. Law firm billing rates tend to be highly linear. They reflect a reasonably straight line from the most junior lawyer to the most senior lawyer, relating to experience. But the cost of a lawyer varies tremendously over time. This is most noticeable at the extremes. Most firms charge below cost for young lawyers, choosing instead to make their profit on senior associates and young partners. At the high end, the profit attained from a senior partner requires a subjective decision: how much of a partner's compensation is attributable to work performed and how much can be attributed to other factors like business development and capital at-risk? If a firm applied cost-plus pricing to a senior partner with high compensation and relatively low billable hours, that partner could end up with a billing rate of several thousand dollars per hour.

Competitive Pricing. In a "mature" market, what competitors charge is an important factor in establishing price. That's because in a mature marketplace, industry leaders can establish market pricing, and buyers are well aware of how much that price is. The good news for law firms is that the practice of law, even at its most sophisticated levels, is highly immature. In fact, it constitutes what may be the last cottage industry left in the modem world. The legal marketplace is populated by small market share providers and incredibly unsophisticated clients. It's true. In the U.S., the total market for legal services is just below $200 billion, and no law firm can claim anything even approaching one-half of one percent of that market share. Firms appear even smaller when viewed on a global basis. And, while we may pretend that buyers of legal services know what their competitors are paying, the combination of antitrust laws and Byzantine legal department accounting systems makes it tough for any client or law firm to effectively compare pricing. Some firms may glean insight from bankruptcy filings and anecdotal evidence picked up when partners from competing firms have lunch, but observing prices in the legal marketplace is similar to blind men touching an elephant.

Top Five Reasons Why Lawyers Prefer to Bill by the Hour

1. ***Clients won't accept any other form of billing***. Balderdash! Exactly who would pay a lawyer by the hour if another option existed? Okay, there are a few general counsel who institutionally benefit from continuing to mystify the legal billing process. And, there are the insurance company claims adjusters who have figured out how to manipulate the system to their benefit. But no one else wants to be billed by the hour. There simply is no alternative.

2. ***Billing in any other way is unethical***. Wrong. Check it out. Virtually every bar association and law society has gone out of its way to conclude that lawyers can bill any other way they want. As long as firms disclose the billing method to the client in advance and the client agrees, any method is legitimate (save the few provisions protecting widows, orphans and clients in comas).

3. ***Legal services are too complex and unpredictable to be performed on a fixed fee***. Tell that to the guys who build skyscrapers and perform brain surgery. Somehow they have determined how to break it down to a set price. Yes, there are change orders and unforeseen circumstances, and when this happens, the lawyer simply sits down with the client, explains the situation and renegotiates if necessary.

4. ***It is traditional for lawyers to bill by the hour***. Wrong again. Traditionally, lawyers considered a host of factors: the work performed, how the work benefited the client, the effort required, etc. Then they whipped off a "For Professional Services" bill. The billing-by-the-hour trend didn't earnestly begin until the 1960's, and it took computers to bring firms to complete dependence on hourly billing.

5. ***Some law firm meritocracies are built on billable hours***. This is true. Not only do some lawyers measure their value to clients by the hour, they evaluate each other on the basis of time expended.

What the Market Will Bear Pricing. Given the vagaries of the other two methods of setting prices, it is not surprising that most firms use their clients as the arbiter of acceptable pricing. But just how does a law firm know what the market will bear? I know one managing partner who believes in the "gag threshold" method. That is, when a client opens a bill, the dollar amount should be high enough to cause throat muscles to constrict, but not so high that the bill gets tossed in the trash. Indeed, for many firms, judging what the market will bear involves a game of brinksmanship—the firm raises rates until the client screams or, in the worst case, takes their legal work elsewhere.

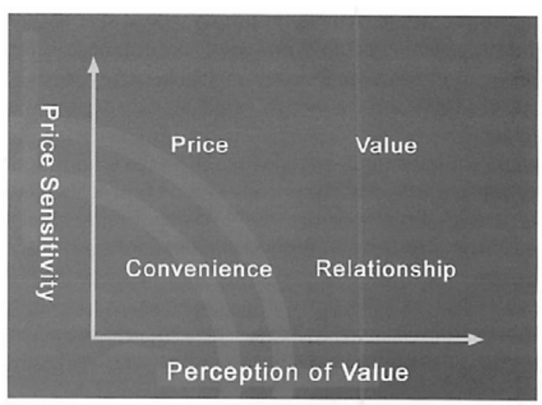
As an alternative, lawyers could simply ask clients how much they're willing to pay. But this strategy typically fails, not so much because the client lies (although the question begs for a low ball answer), but because most clients are simply unaware of how much they're willing to pay. Again, as one of the last cottage industries, law firms continue to customize services in a manner that makes it nearly impossible for any but the most astute client to compare prices among competitors. Not surprisingly, the result is often a level of sticker shock for the client that reaches or surpasses that "gag threshold".

For the law firm, all of this adds up to inefficient market pricing. That is, because firms lack any effective means of measuring the acceptable client price, they consistently fall prey to overcharging in weak markets and undercharging in strong markets. When a firm charges more than a client is willing to pay, the client will either complain or take their business elsewhere. In either case, the firm is offered immediate feedback of their price being too high. But, no such feedback exists when the price is too low. Most law firms, being the risk-averse organizations they are, safely react to this situation by preferring to charge too little, thereby avoiding the risk of offending or losing a client.

Worse, many lawyers routinely train clients to seek discounted fees. Most law firms have established a standard billing rate for each attorney (equivalent to the manufacturer's recommended price for a product). At many firms, though, partners regularly provide clients a discount from this rate, eventually reaching a point where charging "full rates" is a rare accomplishment. Clients are quick to figure out how to play this game.

PRICE SENSITIVITY

If law firms intend to charge clients based on what the market will bear, then they need a mechanism for figuring precisely what, in fact, each client is willing to pay. This involves understanding each client's unique circumstances in the marketplace and setting the firm's price in appreciation of those individual circumstances. To do this, firms must first determine the client's level of price sensitivity. To start with, four basic types of clients exist, each with their own level of price sensitivity:



Price-based Clients. There are no purely price-driven clients. All clients understand to some degree that "you get what you

Analyzing Price Sensitivity

Having done a little research on what the market will bear, it seems that 10 significant factors dictate clients' level of price sensitivity. To understand what to charge a value-based client, consider the following:

1. How well does the client know what other law firms charge for the services sought? (Clients without a point of reference tend to be less price-sensitive.)
2. How difficult is it for a client to compare fees among competing law firms? (The more defined the matter and the more routine the service, the greater the fee sensitivity.)
3. How difficult is it for a client to change law firms? (The less technically complex the matter, the more price sensitive the client.)
4. How much importance does the client place on having a high-prestige, big-name firm, and are you such a firm? (Price-sensitive clients tend not to care about prestige.)
5. In the scope of the client's legal budget, how significant is this engagement? (Clients tend to be more price sensitive on smaller, low profile engagements.)
6. How important is a successful result to the client? (Results with little impact on a client's profitability tend to be more price sensitive.)
7. Where does this engagement fall in the corporate hierarchy? (Engagements involving board of directors or corporate officer visibility are less price sensitive than projects reporting to people further down the chain of command.)
8. Who's paying the bill? (Engagements subject to court or agency review or those where client cost is partially shared by an insurance or other company, tend to be more price sensitive.)
9. Who initiated your first conversation about fees, the attorney or the client? (If the client initiates fee conversations or offers a fee agreement, it is a sure sign of high price sensitivity.)
10. What is the business purpose of the engagement? (If the objective is to correct or remediate a problem, the client may be more price sensitive than if the result were the accomplishment of a gain.)

pay for," i.e., they recognize some differentiation among the quality of lawyers and legal services. But for the extreme price-sensitive client, the driving consideration in selecting counsel is price. After the completely unqualified lawyers and law firms have been screened, price is what it's all about.

Of course, the best example of the extreme price-sensitive client is the insurance company. Insurance companies are in the business of assessing risk and, clearly, they have determined that above a certain level of quality, the difference among firms in affecting the actual likelihood of a successful outcome is insufficient to justify anything but the lowest possible price.

Extreme price-sensitive clients are easy to spot. Price is the first thing they ask about, and price is the dominant feature of any conversation.

Relationship Clients. At the other polarization of price sensitivity are relationship clients. These are clients who enjoy a special relationship with their attorney or law firm. They place such value on that relationship that, as long as they don't believe they're being gouged, they are essentially blind to price. Often the relationship involves a personal bond between the lawyer and client, but it can also involve the client and the firm. For example, when a client hires a pre-eminent firm or attorney, they are essentially saying, "Look at who is representing me!" They pay to create a relationship where none previously existed.

Relationship clients tend to be sensitive and selective about who in a firm will actually do their work, and they rarely address price as an issue.

Convenience Clients. For these clients, the driving issue is making problems disappear. Convenience may take many forms, ranging from handling a transaction in Santiago with minimum hassle, to defending a TRO at a 9 a.m. Monday morning hearing. Often, convenience is a function of urgency. Convenience always involves the client's ability to move a problem away from their desk and onto a lawyer's desk.

Not surprisingly, convenience clients are willing to pay the price for their urgency. They are not price sensitive (but bill them fast because they may be a few months later).

Value-based Clients. All clients are value-based to some extent. They make rational decisions about pricing based on what they believe they will receive in return for their investment. Then they compare this to competing firms in the marketplace. Clients may place value on the level of client service, the success of the outcome, or a variety of other perceptions.

Often, value is actually driven by price. Clients have very little information on which to base price decisions. Outside of a commodity-type service that a client may have used before, it is difficult to compare prices or gain insight into what legal services should cost. For this reason, clients may place greater value on expensive services and less value on inexpensive services.

PRICING STRATEGIES

The first reaction of most law firms is that they should charge as much as possible. But, like most products and services, pricing influences demand. At the broadest level, high prices will cause highly price-sensitive clients to rule out a firm. But to a client who equates price with quality, those same high prices make the firm even more attractive. Even so, a high price/high value strategy must be compatible to the legal services offered. For example, the client must care about quality in order to justify a high price; therefore, such a strategy would likely fail with routine commodity-level legal services. By the same token, a highly competitive pricing structure appeals to a broader marketplace but produces less revenue. In this situation, low pricing must support a strategy that anticipates attracting a high volume of work or a service delivery strategy that permits a firm to perform work at a lower cost than its competitors. There are several specific pricing strategies that firms may employ:

OVERPRICING THE MARKET

A firm can pursue a strategy of enhancing the value of its services by positioning itself as the highest-priced provider. Firms use a high-price strategy to call attention to themselves in the marketplace and create a basis for differentiation. This *"we're expensive, but we're worth it* strategy effectively supports several other possible practice and client-based strategies:

- Situations where a firm wishes to emphasize a particular expertise or practice area capability that differentiates it from its competitors.

- A strategy focusing on newly emerging or high growth industries or practices.
- Instances where the firm's client base is made up of or is targeting convenience clients or relationship clients.

The objectives of charging fees substantially higher than the market is to convey exceptional value to clients who base both their buying decision and their evaluation of performance on factors other than price. The “high-value service provider” recognizes that it will not compete for substantial portions of the marketplace but will compensate for losses in volume through exceptional profit margins. To achieve a high-value strategy, a firm must be prepared to address three tactics:

1. Understand clients' needs (including unexpressed needs) better than competitors,
2. Develop a marketplace reputation that is consistent with high value clients' needs and
3. Create a means of consistently delivering the fulfillment of the clients' needs.

It is important to recognize that a client's needs may involve a variety of factors beyond a high level of service. A high value client may seek a firm with the ability to win difficult cases, close complex deals, influence government decisions or enhance business through its reputation.

UNDER PRICING THE MARKET

Law firms also can build an effective pricing strategy based on their ideal clientele. For example, a firm that wishes to pursue price-based clients must build a strategy that combines pricing, market position and the operation of their practice. Price-based clients, by definition, make their purchase of legal service almost entirely based on price. Therefore, even to participate in a market with price-based clients, a firm must adopt the strategy of charging a price less than or equal to its competitors. To effectively compete on the basis of price, a firm must address three tactics:

1. Provide benefits and outcomes to the client that meet the client's minimum levels of expectation,
2. Manage a cost structure that permits the firm to provide the minimum levels of expectation at the lowest possible cost, and

3. Create a market intelligence function that educates clients about competitor pricing and the level of benefits and outcomes provided to competitors' clients.

A low-price strategy can work effectively for law firms capable of accurately defining service levels and managing costs. To use a basic example, a firm that strategically specializes in a specific area of insurance defense is capable of surviving and prospering in a crowded and competitive marketplace. In fact, a firm that defines itself to this market and develops an operating procedure and cost structure to this market will eventually drive competitors out of the practice.

But a price-based strategy can be dangerous for the firm who is uncommitted to the strategy. There is no room for second place in a price-based market. By definition, clients will migrate to the lowest price. For a price-based strategy to work, several conditions must exist:

- The firm must have accurately identified its clients as priced-based,
- The client base must be large enough to permit profitability through volume,
- The firm must have management both willing and capable of putting operating procedures and cost controls in place to permit profitable operation, and
- The lawyers must be prepared to, in conformance with ethical standards, manage cases on the basis of profitability.

COMPETITIVE PRICING

For many firms, competitive pricing simply serves as" a default. These firms are unable to establish a practice area expertise or capability that justifies over-pricing the market. They also are unwilling to go head-to-head with other firms in a pricing battle. Still, competitive pricing can be a highly credible strategy in support of other client-based strategies.

The best use of competitive pricing is in situations where a limited number of firms serve a specific industry or industry segment. Logic predicts that the more focused a firm's client base, the more likely they are to have knowledge of standard charges among competing firms. While competitive pricing may, in effect, limit the maximization of profits through higher pricing levels, it also prevents pricing from deteriorating if new firms attempt to serve the market or if a particularly aggressive client attempts to inappropriately reduce legal fees.

Competitive pricing strategies are most attractive to price clients and relationship clients, particularly in areas of practice that are firmly established but would not be characterized as commodity level work. For example, in the real estate practice, both developers and lenders anticipate legal fees to be approximately two percent of the value of a transaction. The primary objective of both clients is to close the deal. As such, these clients will tend to be suspicious of a law firm that dramatically under-prices the market, even if it is viewed as a credible firm. By the same token, in the eyes of clients, there is little a firm can do to bring exceptional value to the engagement. Therefore, a firm attempting to price above the market would quickly be eliminated from competition.

Competitive pricing accomplishes what open marketplaces are designed to accomplish — it creates a rational pricing base that reflects supply and demand. In professional services, markets tend to be fairly inelastic to changes in demand, i.e., when there is a recession and corporate transactional work dries up, corporate lawyers typically don't reduce their hourly rates. As a result, the entire marketplace takes on a stability that works to firms' advantage. By comparison, when a firm prices itself over or under a market, its price strategies deal with a limited number of clients and will, therefore, immediately feel changes in demand. Low-price strategies serve clients who are seeking any justification to achieve price concessions.

ADJUSTING PRICE TO VOLUME

This strategy pioneered by firms specializing in commodity-level work (such as residential real estate conveyances and insurance defense litigation), attempts to control cost by carefully adjusting price to match volume. That is, if the volume of work exceeds the firm's capacity to perform the work, the firm will increase its rates for new work before it hires additional attorneys. If the work continues to come to the firm at the higher rates, the risk of increasing capacity is justified. By the same token, the firm can attract additional work by reducing rates, if its attorneys are working below their capacity.

While adjusting price to volume makes sense in economic theory, it does not seem to work in practice. Although price clients are drawn to the lowest price, volume based price reductions and increases are rarely significant enough to justify the client undergoing the disruption caused by changing firms. Worse, the lower rate now becomes the benchmark and a return to the previous rate is viewed by the clients as a rate increase and a reason to move work elsewhere.

One area where adjusting price to volume may work is in the increasingly popular trend, particularly among high regulated industries, to pre-qualify a number of firms as a panel and bid legal work among the panel members. If, for example, health care institutions pursue this means of obtaining counsel with purposefully small chunks of work, it would permit bidding firms to reflect their current level of busyness in their price.

LOSS LEADERS

Law firms occasionally attempt to enter a new practice area or geographic market by temporally lowering prices with the intention of increasing them after they have established client relationships. The problem with this strategy is that it requires a firm to change its client's basic motivation from *price-based to relationship-based m* during the length of a single engagement. Unless a firm possesses a highly differentiated level of service or possesses a means of performing legal work that must be experienced by a potential client in order to be understood and appreciated, loss leader pricing is ineffective in the legal industry.

However, what has worked successfully for some firms, especially those in well-established practice areas, is to offer to perform a small transaction or litigation matter without charge—the ultimate loss leader. Some highly aggressive firms have used this approach to "tip the scale" with clients who are dissatisfied with their current counsel but have a fear of changing firms or are procrastinating about the decision.

PRICE STRATEGY IS HARD

Creating a pricing strategy is difficult. For many firms it is unseemly that a client's decision to retain a lawyer would be impacted by something other than experience, quality of work and personal relationship. Yet, as clients become increasingly aware of comparative pricing levels in the marketplace, pricing may be among the most important decisions a firm's management can make in a strategic planning process.

What makes pricing so difficult is that, while it is a free standing strategy, just like focuses on practice areas, geographic locations or industry clusters, it also cuts across all of a firm's strategies. The pricing strategy employed for each of a firm's locations and practice groups may be completely different. Pricing becomes even more complex as firms deal with global markets and emerging practice areas that blur the boarders of what constitutes the practice of law. The downside to strategic pricing is that a firm can end up with a hodgepodge of pricing scenarios and, in the worst case, have strategies for different strategies neutralize each other.

In looking at strategic pricing, consider the following path:

1. Start is the current fee structure - examine the clients and pricing

in each practice area, industry group, geographic location and any other reasonable segmentation.

2. Seek areas of significant difference and inconsistency. If the inconsistencies are sufficient, it may be necessary to approach this analysis on an attorney-by-attorney basis.

3. Look for logical truisms (e.g.,"IP litigation and white collar criminal defense have low price sensitivity, any area of consumer law has high price sensitivity). Test these truisms against the firm's experience, the current fee structure and the overall strategic direction.

4. Finally, attempt to build, or at least visualize, some form of rough matrix of the strategic factors (location, specific practice areas, industry focuses) compared to their influence on fee levels.

The result of your preliminary analysis may provide the genesis of a rational model on which to look at fee decisions. It will highlight those practice areas where the firm may want to place emphasis in order to boost profits.

For some firms, this exercise will result in a specific formulaic rate structure and an actual pricing matrix. Typically, however, the result of this thought process will be less defined. But, experience shows that the sheer act of discussing and determining a pricing strategy leads to more effective management decision-making, more viable strategies and more consistent implementation. The difficulty of establishing a pricing strategy is worth the effort.

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