



THE ART AND SCIENCE OF SETTING AND RAISING RATES

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I've been servicing the business needs of the legal profession for many years — more years than I often care to admit. For more than three decades I have observed lawyers and their firms worshipping at the altar of the billable hour. I thought it was always so. Much to my surprise, when I began my research for this article I found my assumption was totally wrong.

The use of the billable hour as a lawyer's "currency" actually emerged in the 1950s. Originally, state law limited legal fees, which were normally paid by the losing side in a case. Lawyers supplemented their income with bonuses (e.g. tips), from satisfied clients or with annual retainers. Eventually, maximum-fee laws were repealed. By the early 1900s, lawyers used a combination of billing methods including set fees for particular tasks, annual retainers, a discretionary "feels right" amount, and contingency fees, which the ABA approved as ethical in 1908.

A new trend emerged in the late 1930s and the 1940s, as state bar associations started publishing minimum fee schedules that set standard prices for different services. Although the schedules only "suggested" a minimum fee and were deemed voluntary, they were enforced by threat of disciplinary action against a lawyer whose fees were regarded as too low. The ABA model ethical code, which was in effect until 1969, said that it was unethical for an attorney to "undervalue" legal services.

Much transpired in the following years. The federal rules of civil procedure were reformed in 1938. Regulation of business activities increased dramatically over the next two decades. Legal matters became more complex and less predictable as a result. All made it increasingly difficult for the lawyer to set a flat fee in advance. The harder it was to price work on a flat fee basis, the more difficult it was for lawyers to ensure a reasonable income. Additionally, clients were growing increasingly dissatisfied with the uncertainty of the "feels right" method.

In 1975 the Supreme Court killed set fee schedules by declaring them a “classic illustration of price fixing” in violation of the federal antitrust laws. Put it all together, and both lawyers and clients found hourly billing more appealing as the predominant billing method.

There you have it, folks, the rise of the billable hour. And it didn’t take long for attorneys to realize that the billable hour could be effectively used as a business tool to turn the practice of law into a more profitable business. And that may well be the point in history where the practice of law and the business of law started to diverge. Firms became able to budget, and to set rates so as to produce a fairly reliable revenue number. Firms began focusing increasingly on the financial management aspects of running the law practice as a business in order to maximize profits. And as a result the billable hour emerged as the standard for nearly every kind of legal work.

To further improve profitability, law firms began requiring standards, or “quotas” of billable hours. Some may call them guidelines or targets, but we all know that bonuses, financial penalties, elevation to partnership, and even job retention all hinge to a great extent on hitting the target. And the target has certainly moved higher as years progress. In 1958 the ABA position was that there were only approximately 1,300 fee-earning hours per year, assuming a 5-day work week and half days on Saturday. That schedule would be regarded as a part-time work week in most mid to large-size firms today.

Today’s target of billable hours is increasingly as many as 2,000 a year. Since it can take as much as three hours in the office to produce two hours of recorded billable work, it means that a lawyer might spend a total of 3,000 hours at the office to produce 2,000 billable. Can you say “quality of life?” NOT!

To delve further into thinking about the quality of life as related to the impact of huge billable hour requirements, as well as the inadvertent impact on ethics and client perceptions, is the subject for another article. And I hope to write it in the future. Right now my purpose is to assist you with the age-old questions of how to set your rates, and when to raise them, and how. I will focus on the hourly rate, since it is the most widely used method. Consider as the backdrop that a mere change of \$5 per billable hour can translate to the loss or gain of \$10,000 per lawyer in a firm with a 2,000 hour target. Since nothing else changes, that means a direct impact on the bottom line. So even a small rate increase in today’s demanding environment can significantly enhance earnings, even in a small firm.



So how does one go about setting the hourly billing rate? There are a few methodologies used to determine the desired optimum hourly rate. Beyond that, certain economic factors out of your control will come into play to determine whether you can actually charge your desired rate.

Your firm's place in the pecking order of competitors, along with rates for comparable work at other firms in your region, will exercise external control on your firm's ability to set rates. We'll come back to those factors in a minute. Let's start with the methods used to determine desired rates.

The Rule of 3s. This simple methodology, passed down like folklore, is based on compensation. The billing rate is set as a 3 time multiple of salary, divided by potential billable hours. For example, let's look at an attorney who is to be compensated at the rate of \$90,000 annually. Add to that direct benefit costs such as health insurance, any pension contributions, and so forth. Let's say that those costs equal \$27,000 per year. That means that the total target revenue for that attorney is \$117,000 (compensation) times 3, or \$351,000. If the attorney is to work 1,900 billable hours for the year, then you divide the total target revenue by the hours which you anticipate will be worked. ($\$351,000 \div 1,900$) That calculates to a desired hourly billing rate of \$185.

The Rule of 3s is handy because it can also be used backwards to determine an appropriate compensation number. If your clients are paying \$185/hour for a 5th year associate, and your billable hour target is 1,900 hours, your potential revenue will be \$351,000. Under this old reliable standard, you know that you should be paying \$90,000 or less in compensation, including benefits, for a new hire who fits that slot.

The basis for the Rule of 3s was that one third went to compensation and direct benefits, one third went to firm overhead, and the remaining third went into the partnership profit pool for distribution. Several factors have served to distort this otherwise simple and effective formula over the years. Overhead has risen to more than one third at most firms. Skyrocketing salary and benefit expense for staff are partially responsible. Compensation has risen faster than billing rates at most firms. The technology boom, despite much resistance over the years, has hit most law firms; further increasing the expense side and reducing the profit margin. And despite efforts to the contrary, poor billing and collection procedures have also squeezed the profit margin by reducing the actual revenue realized. An hour produced rarely produces an hour billed and collected. According to published surveys, the realization for most law firms is now about 90 percent. That represents a 3% decline just in the past decade.



So what does it all mean? Well, the Rule of 3s isn't dead, but it isn't quite as accurate as we'd like. Nowadays you probably need to multiply by a factor of 3.5 to account for the changes in overhead and compensation costs. Take a look at the margin at your firm to determine how much you will need to "wiggle" the number.

Formula calculation. A more complex method for determining the minimum hourly rate at which a particular lawyer's time can be billed takes into account not just hours produced and compensation, but also realization (account receivable write-offs, billing discounts, and collections.) The formula is expressed as $B = T / (R \times U)$ where

B = minimum hourly billing rate

T = target revenues for the lawyer

R = realization on that lawyer's time

U = expected lawyer utilization

This formula, along with detailed instructions and explanation, is set out in an excellent article entitled "*Pricing Legal Services*", by Ward Bower of Altman Weil Consulting. [Contact Mr. Bower at 610-886-2000 or at wbower@altmanweil.com.] I will not attempt to repeat the explanation here. The "math" is a little more daunting than the simple Rule of 3s, but it is definitely more precise.

What the market will bear. Another method of setting fees is based on what I call "what the market will bear." Akin to the old "feels right" methodology, it has nothing to do with what anyone else charges, nor what your overhead or compensation calls for. It has to do with what you believe a client will be willing to pay for your expertise and service.

In order to use this methodology, you have to be able to differentiate yourself from those around you. For example, a former client of mine is a solo practitioner in a small town. He happens to be a superb negotiator of large international deals. He is the "go to" person to make it happen. He has connections everywhere. He oversees and coordinates the work of some of the largest law firms in the nation on behalf of his clients, to make sure everything is done right. His rate? Let's just say his rate is as high or higher than any name partner in a major city like New York, plus he typically gets a "kicker" on top, based on results. So if you have rare expertise, an unparalleled track record, or anything else which clearly differentiates you from your peers in the client's eyes, you can charge just about anything and get away with it.



Ok, let's say you're not a one in a million attorney. If you're like most attorneys, you're solid, diligent, and hard-working, and want to set your hourly rate as high as you can without scaring your prospects into the waiting room of your competitors. You work hard to develop and maintain the client relationships. You run as tight a ship as you can. Yet you continually feel pressure from the other firms down the street and around the corner. How do you set your rate?

Benchmarking. In this case, we're looking at the remaining rate setting methodology: benchmarking. Simply put, it means obtaining data which indicates what your colleagues are charging for similar work, or experience, or other factors which tell you you're looking at comparable, meaningful data. And then set your rate accordingly. When you set your rates by benchmarking the idea is to match what your peers do—to have a competitive rate—not to stand out in the crowd.

How do you obtain meaningful information? What you seek is to learn how to perform strategic intelligence gathering. At the outset, I have to say that this is more difficult than it sounds for two reasons.

First is a little something called the Sherman Anti-trust Act. Lawyers have to be exceedingly careful about exchanging information on billing rates, compensation, cost charges (e.g. do you charge \$1/page for fax or the actual cost of the call) or anything else which might be construed as having a possible price or wage-fixing effect on the marketplace, whether intentional or not. Second is the fact that your colleagues are normally very tight-lipped about what they charge, hoping that they have successfully employed a strategy which prices them at or just under your rate, and that of their other competitors.

So how do you find out what the “going rate” is? Asking newly hired attorneys and paralegals, as well as your clients, can be very effective. Attorneys and paralegals normally know what their billing rate was at a former firm. And you may be surprised to find that many of your clients will share with you how your rate compares to other firms they use for the same work. You will have to gauge which clients you can ask, and whether you should do it before the drinks or after, in order to ensure a forthright answer. Obviously some subtlety is required to do this effectively.

In some cases fees become publicly available, like on corporate tax filings, in publicly litigated fee disputes and so forth. But the information available through these methodologies may not be meaningful or representative. So the remaining methodology is through use of benchmark data. There are a limited number of



resources for reliable benchmark (survey) data. Altman Weil and the National Association of Law Placement have long been the standard sources to go to, and there are a few others. [PBA members are encouraged to contact me for a listing of benchmark resources available.] The Altman Weil *Survey of Law Firm Economics* breaks out data by lawyer experience, specialty, firm size, lawyer position, geography, and community population. But to be honest, when I receive a call from an attorney in any but the three large counties asking for benchmark data relevant to their community, I am empty-handed.

You may well ask why local Bar Associations don't just do their own surveys. Good question. Again, there's that pesky Sherman Anti-trust Act. Data must be collected anonymously and retrospectively. An independent accounting firm has to do the calculations, and then the report must be printed, advertised to the general marketplace (not just participants) and sold. It should always be reviewed by anti-trust counsel before it is distributed. In small communities especially, many firms take the stance that they want to buy the information, but not disclose their own. So it's not the easiest thing to do.

Regardless of whether you use the Rule of 3s, (or some variation thereof), a more precise calculation, what the market will bare, or benchmarking to set your hourly rate, there will come a time when the rate needs to be increased. For that reason you want to make sure that you have language in every hourly-basis engagement agreement which lets you increase your rates at least once per year.

When should your rates be increased? Well, let's differentiate between rate increases you need, and those you can get. You need a rate increase when inflation takes a bigger bite of your profit pie. Salaries and overhead go up. Sometimes the increases are dramatic, as for example the post-9/11 malpractice and business liability insurance premiums. Sometimes they are just persistent and significant, such as medical insurance premiums and compensation costs. But the bottom line is that you have to raise your rates periodically just to maintain your relative fiscal position.

Needed rate increases are best implemented sparingly (such as annually) and in small increments. You will rarely lose a client over a small rate increase. They understand the impact of inflation. Implementing a needed rate increase should be done consistently each year. A letter to active clients can be included with the monthly bill, advising that the increase will take effect at a date in the future. I always felt it was fair to give thirty days advance notice, but your sensitivities may



differ on that point. Returning clients can be advised through execution of a new engagement agreement, or by letter or email confirming the new matter and advising of the current rate in effect.

On the other hand there are rate increases you can get. These are the increases which have the most positive impact on your earnings. When can you get these increases? A variety of considerations will reveal when you can implement a substantial rate increase:

1. you have more work than you can handle
2. your firm is in major growth mode in terms of clients and/or practice areas
3. the client's matter is a break-the-company case
4. the economy is going gangbusters — periods of economic prosperity
5. the type of work you do is in extremely high demand in the marketplace
6. clients tell you your rates are “more” than fair, or your performance and/or service is far beyond that which they receive from your competitors
7. you have just handled a case with a decidedly good outcome which gained you some notoriety, or have otherwise become better regarded by virtue of some award, accomplishment, or recognition

The methodology for implementing significant rate increases will vary from needed increases. Generally it is best to implement these increases as new clients come in. You will want to track the impact on your normal conversion ratio of prospect to client. Expect to lose a few more than usual, but that is fine. Better to have a few less clients at a much more profitable rate.

Once you have tested the waters on new clients, you can then implement the increase with new matters for existing clients. You probably don't want to include your major clients at this point. But you should be discussing an impending significant increase with those clients to make sure that their budget can support it. They will appreciate your sensitivity to their financial management needs. If their budget cannot support it, agree to implement the increase on matters opened in their next fiscal year, so they can budget accordingly.

Make sure that existing clients know they are getting a discount from the current rate in effect. When you do increase them, you may even consider giving them an interim step increase which is a little lower than the significant one you have employed for new clients. And then following up with another increase down the road.



Finally, some of you are wondering how you can possibly charge different rates to different clients for the same work. Some firms believe they can only charge one rate, just like some are convinced that all client billing has to be done at the same time, and never more than once a month. Time to change your thinking in both regards.

Established loyal long-term clients deserve a lower rate, and I have no problem justifying that. Major clients often deserve a volume-discounted rate, and again, I have no problem justifying that. Of course, you will need an automated time & billing software program to deal with the many vagaries which can arise when you start making such differentiations.

Keep in mind that your firm should never forego an increase just because you can't increase the rate for all clients at the same time. Some of the loaf is always better than none. Gather meaningful information whenever possible to use in assessing your rates relative to your competitors. And keep your eye open for opportunities to effect a significant increase in your rate. Remember, if you have more work than you can handle, you should be increasing your rate for new clients.

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