# Adapt Or Die: Law Firms In Tomorrow's Economy

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*In part 1 of this series, we discussed the history of the adversarial relationship between corporate clients and their outside law firms and how new roles such as chief technology officer are changing the power dynamic in some corporations. Here we take a look at the fate of the billable hour.*

**Overhead-Based Billing and Corporate Demand for Value**

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For years legal pundits have crowed about the death of the billable hour. I mean, for years and years they've predicted its demise. And despite the fact that many more corporate clients are demanding deviations from that time-honored measure of cost; and the fact that there are more varieties of alternate fee arrangements than there are counts in a RICO indictment, the billable hour is still here. But it is gasping for breath and failing fast.

The problem with the billable hour is not just that the rates associated with that measure have risen steadily, outpacing inflation, for the last 40 years. The problem is not just that it encourages inefficiency — like paying a kid to pull weeds in your yard by the hour rather than by the job. The problem is not just that it rewards quantity over quality.

No, the essential problem with the billable hour as it relates to corporate clients (who account for a majority of BigLaw's revenue) is that it is disconnected from the value of services rendered. For the corporate client, who by definition measures success and failure based on the value delivered to its bottom line, this disconnect is unfathomable. That the value disconnect has been unfathomable to the corporate client for many years is not new; but now, because of the market power corporate clients exercise within the legal industry, that disconnect is also untenable.

Historically, the billable hour came about as a way of reflecting a law firm's

incremental cost of doing business on a per-lawyer basis. When most legal providers worked in solo practice or small firms, the amount of a fee attributable to the cost of doing business was relatively small. As firms grew to mammoth size, so did firm overhead. Because make no mistake, while I went to law school and not business school, even I know that the cost of doing business is called “overhead.”

Overhead costs in a law firm run the gamut from the cost of office space, equipment, staff salaries and benefits, marketing, vendor services, utilities, insurance, taxes, private chefs for the partners lunch room and those expensive Impressionist paintings that were at one time de rigueur at the well-heeled law firm. In short, just about any cost associated with running the business is considered when arriving at the necessary rate to charge clients for their services and the measurement of that rate nearly always takes the form of the billable hour.

No matter what that measure is called, whether it is a flat fee or a blended rate, or a fixed fee or a phased cap, it is all ultimately based on that same incremental assessment of the cost of doing business, plus an added profit margin. Consequently, the billable hour, by whatever name it is given, is a reflection of the law firm’s cost of doing business.

Why should a client pay for a firm’s marketing costs, or phone bill or taste in art, or for any overhead cost? What correlation is there between the firm’s overhead and the value of the services delivered? There is none. And corporate clients know it.

Corporate clients are demanding that their law firm vendors be measured by the same standards as any other vendor: by whether the services they provide deliver value in acceptable proportion to their cost. For the past several years, and particularly after the market contraction of 2008, many corporations have applied diligent scrutiny and required detailed accounts of exactly what services are being performed and how much those services will cost, projected over ever-increasing time horizons.

The first step corporate clients took to demystify the bases for the high cost of legal services was to try to gain visibility into why the bills were what they were; and the second step was to try and to inject some degree of predictability about when the expense would be incurred. Detailed, task-based bills became standard parts of

corporate billing guidelines for outside counsel by the early nineties; mandatory budgets rose to prominence by the late nineties and multi-quarter budget projections have gained popularity since 2008 — all part of the war on the billable hour. Alternative fee arrangements were the next phase of that war.

Now, armed with years of experience showing that legal services continue to escalate and remain untethered to their value proposition, some corporations are demanding a fundamental change in the way legal services are priced. Value pricing, in which the value of the legal service to the client determines the amount the client is willing to pay for that service (with bonuses or taxes applied for outlier results) is gaining traction in the industry.

The implications of this trend are significant, since they will ultimately require the economic model of law firms to shift from passing on overhead, to trimming the cost of delivery to match the value of the service delivered. It will also require more risk taking on the part of law firms. If firms are required to participate in the upside of the value calculus and receive bonuses for outstanding performance, they will also be required to take the downside risk that the ultimate fee for an engagement will not cover expenses.

By tethering the success of the client to the success of the firm, this new economic model will require firms to more strategically select market sectors to pursue for business. Given the intense competition most firms already experience in trying to win and keep corporate clients, this economic shift will also require a new way of designing and executing client development strategies.

*Tune in tomorrow for part 3 of this series: "Ad Hoc Client Development and the Conflict Conundrum."*

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