



LAW FIRM PARTNERSHIP & BENEFITS *Report*TM

Associate Compensation Increases

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What a Great Chance to grab a Competitive Advantage

Among professional service firms, there is a definite increase in competition for talent. But competition for talent could indicate a commensurate increase in salaries and billing rates that will probably put tremendous pressure on law firms to be more efficient and effective in the delivery of legal services. This pressure will change a law firm's business model and culture. How will the staffing and business models change, and how will law firms use these trends to improve their competitive position? These issues will be the focus of this article.

The Changing Environment

There is a global increase in the competition for talent among professional service firms. Many lawyers note that there does not seem to be such a big crisis when MBAs and CPAs receive large salary increases. But law firms must realize that almost all of the businesses that use that talent usually bill based on a fixed fee, not on a law firm's business model of cost-plus basis (which is hourly rate times effort). Firms that use MBAs and CPAs take risks by basing their fees on results. They manage their projects according to the value added to the client. Will law firms ever get there? I think the tipping point has been reached and commercial law firms will be there soon.

As some big, major metropolitan law firms have increased their salaries and bonuses, others have had to follow. As some big-city firms increased salaries, others in the Midwest had to follow in some form. Unfortunately, most firms are still basing their profit drivers on increasing the volume of dollars through billing rate increases, billable hour increases, firm growth and leverage of associates. But in order to get the hours and volume of billings, these firms have been giving billing discounts to clients that in turn reduce the firm's return on its investment in time. The critical problem developing for these firms is that the old business model will fail when more competitive firms start focusing on the return on investment. Law firms must redefine leverage based upon return on investment and their value added to clients. Leverage must be redefined as the leverage of all assets of the firm, including accumulated knowledge, experience and expertise, regardless of whether it is coming from partners, associates, para-professionals, administrative assistants, substantive systems or expert systems. Law firms must focus on "return on investment" as opposed to "hours billed." This focus will enable law firms to

become more efficient and effective, which may reduce hourly volume, but will definitely increase profits. I am often quoted as saying that an increase in the return on standard billing rates by 10% in a \$50 million firm will increase profits by \$5 million without any increase in overhead.

In the April 2004 *Corporate Counsel* magazine article, "Staying Power," published before Thomas L. Friedman's book *The World is Flat*, Krysten Crawford predicted 1990s ideas should have shown the impending death of the billable hour. Ideas such as law firm convergence (limiting the number of outside counsel that will be on approved list), legal auditing, task-based billing, research outsourcing and online auctions were all discussed. Now that salaries have significantly increased again, will key ideas such as law firm convergence, research outsourcing, online auctions and the shifting risks to law firms increase as clients become more sophisticated in the use of technology and take note of the value proposition?

Of particular concern for buyers of legal services is the value proposition. Is the 20% of the work where general counsel would hire a high billing rate firm being shifted to 10%? In other words, the knowledge and power of general counsel is pushing legal tasks down the value curve. The tasks are not so valuable to the general counsel as to require the use of highly leveraged firms and high billing rate associates with heavy, time recording pencils.

There is increasing pressure — due to higher salaries and billing rates — on older associates and partners to perform to higher levels of contribution. In order to fill their ranks with associates that may get past the third year, high billing rate firms start with an assumption that there will be natural and forced attrition. Although large law firms may not be able to get an adequate return on their investment in new associates, that is an investment that will put a lot of performance pressure on those moving into the middle associate ranks. This is particularly true with the salary compression that will occur. Look at this situation in terms of hydraulics. When you try to push a large volume of water through an ever-decreasing diameter of capped pipe, pressure increases at the top. The same is true with the increasing pressure on performance as one moves up in the firm.

Strategies and Solutions

Law firms that don't practice in major markets may not be able to pay the high salaries, but there is a place for them in the market. Because of their lower overhead, they will be able move into areas of the market that the high overhead firms cannot touch.

There are three strategies for smaller firms to compete. One is to go after the clients that cannot, or refuse to, pay the high billing rates and leverage used by big firms. These clients may feel their problem is important enough to hire a high-priced lawyer, but do not feel the rates and leverage employed add much value. For example, a CEO asked his big-firm lawyer to look over a merger agreement regarding the CEO's ability to fire a merged employee. That lawyer had written the agreement. Instead of \$600 bill, the CEO received a \$6000 bill.

The second strategy is to go after the soft underbelly of the big firms. The soft underbelly includes those niches of service where clients of the large firms are pushing certain services toward a commodity. Those clients cannot see paying for the big firm's leverage and billing rates to do repetitive

litigation and transactions. In most of these cases, clients do not see the big firms creating a learning curve, or sharing the risk through fixed budgets with the client. As one general counsel stated: "I want the billing rates and the legal fees to represent my view of the value added to my company." Most high billing rate firms don't recognize that perception.

The third is a staffing strategy. This strategy includes identifying the associates who long to be in their hometown and look for a good mix of work and life. This strategy includes hiring fewer associates to do the work, with significant support from the firm's knowledge base, substantive systems and support staff to make the associates more effective (doing the right things) and efficient (doing things right the first time). It also includes keeping associates with the firm by building loyalty through identification with a career path and involving them in all aspects of the business. Progressive firms provide a periodic and simple explanation of how the law firm makes money, and where the leaks in profit occur. The associates of those firms have taken a lead role in finding ways to help the firm get a higher return on their billing rates and finding ways of performing legal tasks more efficiently. Finally, this strategy involves hiring non-lawyer professionals to perform tasks at lower billing rates, including financial analysis, initial client interviews, project management and many other tasks that some associates are not qualified to perform. I am not talking just about paralegals, but about well-trained professionals who can operate at, or above, an associate's capabilities.

What are the strategies that will take advantage of the changes in the competitive environment from the increase in salaries?

First, there are some questions a firm must be able to answer. Do you know how to "qualify" a client for intake? Do you have the capabilities and skill set to get the information on the client's perception of value added? Do your lawyers have the sales negotiation skills to interact with the client and provide a scope of effort that meets a mutually acceptable perception value added? If you don't have a good answer for these questions, you need to address them and train your lawyers to deal with them.

Second, recruiting and maintaining loyal people will depend on work/life issues. In professional service firms, there are some key indicators of how to retain high value associates. What benefits do professionals want? For multiple income families, there are specific needs that should be part of any recruiting and loyalty building initiatives by law firms. The National Association of Law Firm Recruiters (NALP) identifies contact with senior lawyers and a clear career path as critical. The NALP Foundation also found that 42.6% of women of color left their firms because they did not have access to client development and client relationship opportunities (*ABA Journal*, August 2006). A Robert Half International study of 1400 financial officers showed that 30% want flexible schedules, 17% want retirement savings plans, 16% want extra time off, 13% want spot bonuses that reward performance, and 13% want health care benefits and health insurance. As a critical point for law firms who want to achieve flexible work schedules, the people managing files must be extremely organized and excellent project managers. This talent is not a skill set imbedded in most law firms.

Law firms have been trying alternatives for years to counter higher associate salaries by using contract lawyers and hiring pre-trained laterals. Other, more sophisticated, firms have gone further by creating substantive systems to make the work more efficient and avoid reinventing the wheel. Some firms have even created expert systems that eliminate scores of lawyers in performing complex transactions, eg, Blue Flag by the Linklaters firm. The result of such efforts avoids write-downs and write-offs, and

therefore provides a higher return on the investments of firm resources.

Your Checklist

Focus on realization. Move professionals to a client-driven, not leverage-driven, work ethic. If associates at high-er salary levels and higher billing rates are encouraged to add value with every minute they spend on a client file, and are encouraged to be as efficient as they can be, the return to the firm will be higher and the firm will be able to re-capture the increases in salaries.

Focus on intake. Take on a new matter as an investment, not a way to increase volume. As an investment, there must be a fair return on that investment. There must be a skill set in a law firm responding to clients' requests for proposals. More and more of these requests are coming, and the better your firm is prepared with a knowledge base and the ability to understand the value-added proposition that clients want, the more successful the firm will be in capturing the market sought.

Focus on process. Law firms need to focus on creating specific processes and mapping the way in which particular solutions are provided. If a law firm can create a process for the delivery of legal services, then associates will understand the total process, will be more involved in the matter, will buy into supporting senior lawyers and will focus on the client's needs. Associates will see their role in context and buy into a client-focused team.

Focus on your market. Stand steady on billing rates to establish a competitive position. Focus on your competitive position and differentiation from other firms. What is the competition doing and what kind of culture are they building? Look carefully at the business model they are using. Then beat it and go for the clients the competition will have to abandon because of their rates and/or for the soft underbelly where your niche and pricing can cut into the high billing rate firms.

Staffing strategy. Look at the people who used to be on your recruit list and keep them on a string so you can pull them in when they feel disenfranchised at their original firm. Build loyalty with career path counseling, education on the way the firm remains viable and profitable, efficiency in the practice, knowledge management and attention to work/life issues.

Culture. How can law firms who don't want to pay such high salaries recruit in this new environment? Build a foundation of mutual trust and teamwork among the professionals in the firm and use that collaboration to attract people who want to work in a client-driven firm — not a billable hour shark tank where they have to watch their back at all times and deal with internal competition.

Approach. Know the clients. Know their perception of value added. Find ways of using alternative billing to provide predictability. Build effectiveness and efficiency into the culture of the firm — focus on return on time rather than volume. Map and manage the processes used in delivering legal services, and through that, find tasks that professionals other than attorneys can perform. Create substantive and expert systems and find ways of outsourcing tasks that other professionals can do more efficiently.

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