

NZLS COSTS & CASHFLOW SEMINAR

NOVEMBER 2005

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*Simpson Grierson (Equifee)***INTRODUCTION**

It seems appropriate, if not necessary, to draw to the readers' attention a couple of caveats and comments:

- 1 Mindful of the price fixing and other strictures of the Commerce Act 1986, nothing in this paper, or any other aspect of the Workshops, should be misconstrued as advocating price fixing or a return to the reintroduction of a scale of charges for legal services, or anything remotely akin to that.

Since the New Zealand Law Society (NZLS) Scale of Professional Charges was abolished in the early 1980s, it would I think be fair to say that the pricing of legal services, particularly those aspects that have become relatively commoditised, such as residential conveyancing, have been largely market driven.

The problem is that, by and large, the legal profession lacked (and still does) the training or disciplines needed to operate in a relatively open market, in order to deal with this abrupt change to the means by which fees are set.

The sole purpose of this paper is to hopefully equip practitioners with a better understanding of pricing strategies and the tools with which to implement alternative strategies if they so choose

- 2 My background in legal practice is some 25 years as a general practitioner in a provincial firm, primarily in property and company/commercial work. Understandably, practical costing examples upon which I can speak with some knowledge are largely confined to those areas of legal practice.

However, those examples are only used throughout the seminar as a means of illustrating the far more important principles associated with alternative pricing strategies. Those principles

are universally applicable to legal practice in New Zealand, regardless of firm size, geographical location, or practitioners' personal areas of expertise and endeavour

- 3 Although there is a body of New Zealand and UK case law surrounding the costing of legal services and, in particular, the cost revision and appeal procedures, this seminar is intended to have a particularly practical bent, rather than purporting to be a learned treatise.

Whilst the cases often make interesting and informative reading, the day-to-day hurly burly of legal practice rarely affords the time to consider these in depth. I have tried to distil and incorporate in this paper, guiding principles where the case law lays down useful guidelines. For those who are interested in further reading into this aspect of the topic, I commend the following (in no particular order):

- Gallagher v Dobson [1993] 3 NZLR 611
- Property & Reversionary Investment Corp v The Secretary of State for the Environment [1975] 1 WLR 1504, [1975] 2 All ER 436
- Re Chapman Feenstra Cartwright & Gendall [1977] 2 NZLR 196
- Rawlinson v Purnell Jenkinson & Roscoe (CA 128/97, 21 October 1997)
- JBL Consolidated Limited (In Receivership) (unreported), Auckland High Court, 1950/80, 20 August 1982
- Maltby v D J Freeman & Co [1978] 2 All ER 913
- Treasury Solicitors v Register & Another [1978] 2 All ER 920
- Parsons v Young Swan Morrison McKay [1986] 2 NZLR 204

THE MODERN LEGAL PRACTICE — BUSINESS OR PROFESSION?

Nowhere is the clash between the self image of professions and the image of commercialism better demonstrated than in the context of any discussion of the charges for legal services. The belief that one who performs a service for satisfaction, not gain, which permeates many definitions of professionalism, effectively removes price from overt (if not covert) examination.

Any discussion of the economic basis of charging for legal services generally starts with two anomalies. The first is semantic. A “fee” is the price that the client pays for the service and yet the word “price” is rarely used by professionals, including lawyers. One does not ordinarily speak of the price of a semester of education, the price of a loan, or the price of a visit to the dentist.

Numerous ways can be identified of describing “price” in the service sector of the economy, including honorarium, retainer, etc. To some extent, the nomenclatures used for price provide an insight into a profession’s own conception of its services while, in other circumstances, it is no more than a cosmetic embellishment to hide the reality of what in the final analysis is a commercial transaction.

The strategy of establishing soundly based charges for professional services is no more than the projection and direction of all issues within a legal practice in order to maximise profits, or achieve whatever other objectives are stated in the firm’s plan. It requires a realistic attitude to fees by those who are to establish them and this attitude must derive both from practice objectives and the personal aspirations of those who share directly in the success of the practice and those who hope to.

The second anomaly is that, despite what some members of the profession may say to the contrary, legal practice is not a business in the accepted sense of the word. Law is neither a business, nor simply a profession, the latter of which is defined in the Oxford Dictionary as a vocation or calling, especially one that involves some branch of learning or science.

Can it really be suggested that it is in the best interests of the community that the proper approach to remuneration is purely on a time and supply basis, related to the question of whether there are sufficient people in legal practice? No profession worthy of the name has ever been motivated merely by the monetary reward, but lawyers nonetheless have a moral right to be paid properly for their skills and services.

Whether these views of professionalism are accepted or not, there remain other factors which separate legal services from conventional business activities. The law, like many professions, possesses a set of ethical rules and minimum standards of behaviour, so that the normal interplay of market forces is inhibited — although few would argue that anything else is acceptable.

A further anomaly is created by legal aid, the cost of which is met out of public funds, resulting in a predetermined agreement on fees and the absence of any discretion the individual practitioner can exercise.

These facts mean that the profession is placed in a less favourable position than the average business person who possesses greater opportunities to exploit a commercial relationship, possibly to the detriment of the other party.

While it cannot be denied that the revenues of a practice are vital for its continued existence, and are one important measure of development, it is also true that the freedom of price flexibility which is available to most other businesses rules out many of the strategies which might be used by lawyers. In any event, the adoption of pricing strategies requires more than skill and knowledge.

The reality of the situation is that the practitioners cannot and, for the most part, would not, even if the profession's own rules permitted it, involve themselves in the more dubious methods of the marketplace. Therefore, a precondition to the successful use of fees as part of the practice development strategy must be a change of attitude by practitioners to the whole subject.

Given that situation, to compare a legal practice to business, insofar as fee policies and strategies are concerned, could lead to totally incorrect decisions. While the fundamental need of any organisation must be to ensure that revenue at the very least covers costs, beyond this the peculiar position of the legal profession must be an important part of fee decisions, specifically:

- the belief (justified or not) that the client's interest supersedes self interest
- a predilection by lawyers derived from history, education, training and embarrassment, to distance themselves from direct involvement in pecuniary matters
- legal interference in the mechanisms of the supply and demand position; and

- the degree to which practitioners are constrained, even in the absence of a scale of fees, by the Principles of Charging promulgated from time to time by the NZLS.

The last two parameters, in particular, demonstrate that professional practices are a business only in a somewhat restricted sense when, as is the case, there are legal and other mandatory controls on what lawyers may or may not do, who shall be permitted to practice and what fees may be charged. It therefore follows that some techniques that are effective in a business environment are of limited use or of no application at all for the purpose of expanding and developing a profitable practice.

THE DEATH OF THE SCALE OF CHARGES

As it is now more than 20 years since the abolition by the NZLS of its scale of (minimum!) charges covering much of the work undertaken by property lawyers, it is timely to reflect on the changes that have occurred in the intervening period, in relation to the way in which we cost legal services.

Ill prepared for the loss of the scale, lawyers cast around for a replacement methodology, which was soon identified in the form of the time recording/billable hours methodology that had already been in vogue with our accounting brethren for many years.

The adoption of this practice by the New Zealand legal profession has inevitably thrown up a number of deficiencies. Few practitioners would contend that it is the optimal method of ascertaining what is a fair fee (from the point of view of either the client or the practitioner) and yet, collectively, we have been for the most part unable to devise a viable alternative.

There is, however, an alternative which is increasingly finding favour with both the accounting and legal professions internationally, and with an increasing number of firms in New Zealand. That is strategic value pricing.

Before looking at this option, it is necessary to have a rudimentary understanding of the economic issues that initially gave rise to the billable hour and timesheets.

Cost-Plus — Labour theory of value

It was Karl Marx who developed the Labour Theory of Value which he expounded in his book *Value, Price and Profit*, first published in 1865, in which he noted

A commodity has a value because it is a crystallisation of social labour. The greatness of its value or its relative value depends on the greater or less amount of that social substance contained in it; that is to say, on the relative mass of labour necessary for its production. The relative values of commodities are therefore determined by the respective quantities or amounts of labour, worked up, realised, fixed in them. The co-relative quantities of commodities which can be produced in the same time of labour are equal.

However, Marx's theory crumbled when put to the test of explaining how and where people spend their money in the marketplace. The reality of market forces is that the customer or client and not the supplier, determines the value of the service, from which it follows that the client also determines the price that they are prepared to pay.

The client is unlikely to be impressed with the notion that the price of a particular job carried out by a law firm is determined by what it cost that firm to produce that work, plus a margin for what the partners consider should be their profit, if in fact there is no alignment between the cost to the client and the client's perception of the value.

Marx's economic theories were progressively discredited, with one of the century's most influential accounting theorists, William Paton, noting in a speech he delivered at a conference in 1970, that:

The basic difficulty with the idea that cost dollars, as incurred, attach like barnacles to the physical flow of materials and stream of operating activity is that it is at odds with the actual process of valuation in a free competitive market. The customer does not buy a handful of classified and traced cost dollars; he buys a product, at prevailing market price. And the market price may be either above or below any calculated cost figure.

Benjamin Franklin is often cited by business people for his much-repeated mantra "time is money". This little adage has certainly infected the way professionals view the value of the services they deliver, even if it was unfortunately taken out of context. What Franklin wrote in its entirety on the subject of time was:

As you have desired of me, I write the following hints, which have been of service to me and may, if observed, be so to you. Remember that *time* is money. He that can earn ten shillings a day by his labour, and goes abroad or sits idle, one half of that day, though he spends but sixpence during his diversion or idleness ought not to reckon *that* the only expense; he has really spent, or rather thrown away five shillings besides.

Franklin was not speaking of value, or price; he was articulating the concept of opportunity cost. Whilst it is also an important economic principle, a seller's opportunity cost has little to do with the value provided to the client.

Perhaps one of the most significant contributions made to management accounting theory was the invention of the return on investment (ROI) measurement. The importance of the ROI cannot be over-emphasised since it was the dominant theory taught to at least two generations of accountants and MBAs. Once the MBAs began to migrate into professional service firms, they brought with them the idea that firms could perform cost accounting similar to manufacturing industries.

The result was that Wall Street law firms began to use timesheets in the 1940s. The theory was that by tracking time, firms could perform cost accounting — not pricing — and determine if any one job or client was profitable.

However, the application of time recording to the professional service industry and, in particular, to law firms was undoubtedly a clumsy adaptation of its original purpose. Time recording was originally adopted for cost accounting purposes, and then became the method by which professionals priced their services. What was expected to be a way to track the inventory of professionals — time — became the inventory that was in fact sold.

In New Zealand, faced with the abolition of the scale of charges and bereft of any of the necessary tools with which to put a robust alternative in its place, there is little wonder that most firms seized with alacrity, the opportunity to price their services by the seductively simple methodology of an hourly dollar rate multiplied by a given number of recorded hours.

Deleterious effects of cost-plus pricing

The manifestation of the labour theory of value — and its cousin, the ROI formula — in the modern law firm is the computation of the hourly rate. Sometimes a rule of thumb is used to compute the hourly rate, such as three to five times the professional salary, which is just another way of adding a desired ROI into the firm's cost structure. The true formula for computing the hourly rate looks like this: *Hourly rate = overhead + desired net income*

Expected billable hours

Four pernicious effects result from this cost-plus formula.

First, one way to increase the firm's revenue is to increase the overhead, which clearly misaligns the interests of the buyer and seller. Raising overhead cost with no resulting increase in value to the client is a recipe for argument.

Second, no client believes that it is their job to provide the professional with a decent standard of living. Clients do not lie awake at night wondering if their lawyer is making enough money. On the contrary, it is the lawyer's job to provide a service that is so good that clients willingly pay a profit in recognition of what is done for them.

Third, the formula is a self-imposed ceiling on the professional's income, not to mention profit. The irony is that cost-plus pricing works far more to the detriment of the lawyer than it does to the client. On occasions, cost-plus pricing will result in the client being overcharged but, in a far greater number of instances, cost-plus pricing will see the lawyer grossly under-remunerated relative to the value received by the client.

Finally, the formula does not take into account the firm's intellectual capital. Worse, it commoditises the firm's intellectual capital into a series of relatively homogeneous hourly rates. It simply represents the firm as a bundle of overhead costs and desired profit wishes of the partners, without looking to the value that is created for the clients.

One of the most vocal defences of the formula is that it is essential for proper cost accounting, to enable the firm to measure how much profit is being made on each job or on each customer. But the formula is not cost accounting — it is profit forecasting. Cost accounting does not allocate a profit. The formula is nothing but a wish list and may or may not bear any relationship at all to the value created outside of the firm's walls. If you want true cost accounting, you must remove the Desired Net Income factor from the formula, and calculate a true cost per hour.

Why Persist With Hourly Billing?

Particularly since the advent of computerised billing systems, law firms have defaulted to hourly billing systems. In large measure, this is because lawyers are administratively lazy and highly risk averse. Billing by the hour is simple, requires little judgement, and successfully shifts the risk of cost overruns from the lawyer to the client. The fact that the time required to perform a service has as much to do with actual value as the lawyer's shoe size, is lost on most law firms; most firms have built entire billing systems and internal compensation regimes on hours charged.

So why do lawyers persist in billing by the hour, and do legitimate reasons exist for doing so? The vast majority of law firms subscribe to one or more of five "philosophies" regarding their billing system:

1 **Clients won't accept any other form of billing**

This is a self-fulfilling prophecy because it is a case of "Hobson's Choice" - lawyers don't provide clients with any alternative. It is also highly presumptuous. If lawyers took the time and trouble to develop other forms of costing which better served the client and the lawyer, it is difficult to see why such alternatives would not, to one degree or another, be embraced by a significant proportion of a firm's client base

2 **Billing in any other way is unethical**

I would suggest that just the opposite is the case. The NZLS Rules of Professional Conduct for Barristers & Solicitors ("the Rules") requires practitioners to take into account no fewer than eight criteria when fixing a fee, only one of which is the time.

Slavish adherence to time records only, will in many cases do either the lawyer or the client a disservice. As long as the broad costing criteria set out in the Rules are adhered to and the fee arrangement is consensual and informed, it is difficult to see how any such arrangement could be categorised as unethical

3 **Legal services are too complex and unpredictable to be performed on a fixed fee**

Try telling that to the people who build skyscrapers and perform brain surgery. They seem to be able to come up with a price which is transparent, understandable and capable of being negotiated and agreed in an informed manner.

To be sure, as with the building of skyscrapers, lawyers are often subject to changes of direction on a transaction or a litigation matter, whether brought about by the client or circumstances beyond the control of either the lawyer or the clients. All that this necessitates is further discussion with the client and renegotiation of the price or pricing methodology, as the need arises

4 It is traditional for lawyers to bill by the hour

That is not correct. For as long as anyone can remember, practitioners in New Zealand have been obliged to take into account a variety of factors when setting the fee. Even at the time of the Scale, a great deal of work fell outside the ambit of the Scale and practitioners were compelled to give proper consideration to what constituted a fair fee.

Billing by the hour has only been with us for the last 20 years or so, and it is only in the last ten years that the vast majority of firms have embraced computerised billing system and, in so doing, entrenching the profession's dependency on hourly billing

5 Some law firms' meritocracies are built on billable hours

This is correct. Not only do some lawyers measure their value to clients by the hour, they evaluate each other on the basis of time expended. Performance and salary reviews for staff often see billable hours as one of the key components. Partners have also been known to be pushed out of firms because their billable hours aren't where the other partners think they should be.

Whether these practices are good for the profession, individual firms and practitioners, or clients, is highly debatable.

NZLS PRINCIPALS OF CHARGING

The NZLS principles of charging have recently been rewritten. Most practitioners will, however, already be familiar with the eight key criteria which we are required to take into account when determining a fee that is fair and reasonable from the point of view of both the client and the practitioner:

- the skill, specialised knowledge, and responsibility required
- the importance of the matter to the client and the results achieved
- the urgency and the circumstances in which the business is transacted
- the value or amount of any property or money involved
- the complexity of the matter and the difficulty or novelty of the questions involved
- the number and importance of the documents prepared or perused
- the time and labour expended
- the reasonable costs of running the lawyer's practice

Skill

The degree of "skill, specialised knowledge and responsibility" required to complete the task will be relevant. Where the task is routine and does not need an experienced or specialised practitioner, the costs can be expected to be lower than where cases are novel, complex, or require particular expertise. In such cases, there is an expectation that the work will be able to be completed quickly by a competent practitioner. There ought to be no need for arduous research, or the applications of specialised skills, for which a premium might be expected.

Most clients seek the services of the principals of the firm and, accordingly, the fees charged by a principal who will bear ultimate responsibility for the work will be correspondingly higher. In a similar vein, the charges made by a non-lawyer or a relatively inexperienced lawyer ought to be less than those charged by a qualified and/or experienced lawyer.

Simply as a matter of work production efficiency, most lawyers understand the need to delegate work to a level at which it can be done competently and cost effectively.

Time

The amount of time spent on the work will be directly relevant to the bill. It is common practice in modern firms to record carefully the amount of time spent by any member of a firm on a particular matter, and use those individuals' charge-out rates, multiplied by the time they spent on the matter, as a starting point for the bill of costs. Such calculations should not, however, be given too much weight.

There will be instances where the time spent is disproportionate to the nature of the task, suggesting that the lawyer undertook unnecessary work or is not competent or efficient in the area. Conversely, there will be occasions where the value or benefit received by the client is significantly in excess of what the time records alone would suggest is a proper fee.

Whilst the reality of life in the modern law office requires the keeping of time records, these records must only be used as a guide to ascertaining the proper fee. Otherwise (in the words of Holland J) “... *the incompetent will be encouraged to be prolix and dilatory and the efficient and truly skilful will be inadequately rewarded.*”

Value of the subject matter

Despite the abolition of the scale of charges, it is common to charge more where the value of the transaction is high. This approach is mandated by the NZLS Rules of Professional Conduct for Barristers & Solicitors, which provide “*value or amounts of any property or money involved*” are a relevant consideration in determining the level of fees.

Few would argue that such an approach is inappropriate, given the assumption of considerably greater risk and responsibility (and professional indemnity insurance premium costs) where the firm or practitioner deals with transactions or matters involving large sums of money.

Importance to client

A related consideration is the “importance of the matter to the client”. Unlike value, importance concerns how clients perceive the matter. Where clients stress the importance of a matter, it may be appropriate to take extra precautionary steps beyond what might be done by a normal prudent lawyer. Research may be undertaken in greater depth, staff involved may be of greater seniority, documents may be perused and checked by more people, and so on. Such increased costs can and should be passed on to the client in the fee.

As discussed elsewhere in this paper, clients are the sole determiners of the importance of a particular matter to them, and therefore the perceived value of a particular result or outcome. If the client attaches a very high level of importance to a particular result or outcome, and that

expectation, together with the value of a favourable result, is aligned with those of the lawyer, the imposition of a premium that meets with the clients' approval is clearly defensible and appropriate.

Results

The Rules also provide that the "result achieved" will be relevant. This will be particularly so in respect of litigation, where a negative result will be of no benefit to a client and may well mean additional liabilities are imposed by the Court. The same analogy can, however, also be drawn with property and commercial transactions, where the proposed acquisition of a property or business may be preceded by extensive negotiations and a considerable amount of time and effort applied to due diligence on behalf of a purchaser (all of which may end up being for nought if the deal is not consummated).

In such circumstances, it may be appropriate to reduce the fee, although it cannot be said that there is an obligation to do so. Any such decision will inevitably be determined by a whole range of factors, including the practitioner's relationship with the particular client, the value of that client to the firm on an ongoing basis, and the firm's broader marketing and public relations strategies.

Any discussion about a fee that is in some way tied to the results inevitably generates discussion on contingency fees (see discussion on Contingency Fees elsewhere in this paper) where the lawyer and client expressly agree that the fee will be calculated in light of the outcome.

These particular criteria should not be taken as authority for the proposition that if the lawyer effectively carries out the clients' instructions and achieves the desired result, it is acceptable to charge more than would otherwise be appropriate.

However, there are frequently instances where the lawyer's efforts and/or skill could be regarded as being above and beyond the call of duty, and which produce a result which exceeds the clients' requirements or expectations. That additional success may be measurable either in terms of time-frame, monetary outcome, or a variety of other benchmarks. In such circumstances, it is entirely appropriate to add a premium to the fee for the premium component of the result.

Complexity

Where the work is difficult and requires the application of special skills, the costs will correspondingly higher. The complexity of the matter, and the novelty of the questions involved will also be relevant when fixing fees. Aside from the fact that greater time will be spent than where the issues are straightforward, where the matter is complex more skills and expertise will be required and a client can be expected to pay a premium for this. Where an issue is novel and will require fresh research and a corresponding degree of skill, this will also justify an increased fee.

Documents

Also of relevance will be “the number and importance of the documents prepared or perused”. At one level, this is a particular instance of the complexity of the matter. Where documents are prepared which are longer than necessary or where they could have been dispensed with altogether, there will be no grounds for increasing the fee. It is far more demanding to draft concise and clear documents than rambling and lengthy ones.

The development over the years of a broad range of precedent resources (including those developed internally by law firms, as well as those commercially available from legal publishers) and word processing, has made the production of even complex documentation, a markedly easier exercise than it used to be many years ago.

The debate sometimes centres on the question of whether the client or the law firm is entitled to the benefit of those increased efficiencies that flow from the use of precedents.

My view is that, for the most part, the lawyer is entitled to the benefit of those efficiencies, not the client. The development or purchase of precedents invariably involves a very substantial time and/or cost investment by the firm. This material represents part of the firm’s intellectual capital. The practitioner is entitled, in my view, to charge a fee that represents value to the client, rather than a fee that is determined necessarily by the cost of production of that work.

There are countless analogies in the wider marketplace, such as music CDs that have a retail price of around \$35.00, but the production and manufacturing cost might only be \$0.30.

Urgency

In some cases, the client will need the immediate assistance of a lawyer. Examples might be an arrest, or where an injunction is required to preserve property or evidence. The realities of commercial are such that commercial transactions will also sometimes have to be undertaken with considerable urgency. A lawyer will, in those circumstances, have to put to one side other commitments and give precedence to the urgent matter. The Rules quite properly provide that the “urgency of the circumstances in which the business is transacted” will be a relevant consideration in determining the level of fees.

Overheads

The Rules note that the “reasonable costs of running a practice” are to be taken into account when setting the fees. There are huge variations between the overheads of different practices, from small suburban sole practitioners without support, to large city based national firms complete with comprehensive support systems.

Some law firms are well known for their plush offices and disparaging comments are, from time to time, made about the money spent on such things as original artworks with which they are adorned. It has been observed that the costs of such trappings must be drawn from the fees charged to the clients.

It is patronising and presumptuous to suggest that all law firms should take a homogenous approach to these issues. Clients want, and expect choice. The divergence in the approach of different law firms to these issues provides that choice. It is difficult to see how any harm comes from that choice *per se*.

To an extent, by choosing the firm, the client chooses the kind of overheads he or she will be willing to contribute to. The nature of the work may well be more suited to a particular kind of practitioner or firm. When determining whether a bill is reasonable, it will be entirely appropriate to take into account the fact that the bill represents more than just the time spent by the lawyer, and that the law firm’s cost of premises (including artwork, if that be case) support staff, and so on must be included.

In my experience, the vast majority of practitioners give scant consideration to anything other than the time expended. Moreover, I would argue that the list is not conclusive and does nothing more than prescribe a minimum number of well recognised criteria that a practitioner must take into account in arriving at a fee.

Before setting a price, we might (amongst other things) also be asking ourselves:

- Who referred the client to me?
- What is the nature of the relationship with the referral source?
- Who is paying for the service?
- What is the client's financial position?
- Who was their previous lawyer, and why are they changing?
- Who is their banker, and their accountant?
- How sophisticated is the client with respect to legal services?
- Is this client a potentially valuable source of further referral work?
- Does this client add to the firm's intellectual capital, or are we simply utilising existing skills?
- What risk is the firm exposed to with this client?
- What is the potential profit or loss to the client from our services?
- Does this client open up a new niche or market segment for us?
- Is the client engaged in a business in which we are interested?
- What price do we want for this job?
- Do we like this client?

Conspicuously, these questions and even most of the NZLS costing criteria go far beyond just the time and labour involved. Basically, you are trying to determine the value of the work to the client and the value of the client to the firm, by looking at an entire range of factors. The more you know, the better equipped you will be to set a price commensurate with those perceptions of value.

There is nothing wrong *per se* with estimating the amount of labour required, but this should be done before the engagement, not after. Moreover, it should not be the determining factor in setting a price — only one of many. Clients do not buy hours, and they are therefore superfluous in determining value.

A BETTER WAY — STRATEGIC VALUE PRICING (THE SUBJECTIVE THEORY OF VALUE)

Value, like beauty, is in the eye of the beholder

Austrian, Karl Menger, was one of a number of prominent international economists who, in the early part of the 20th century, turned Marx's Labour Theory of Value on its head once and for all. Menger wrote:

The determining factor in the value of a good [or service] then, is neither the quantity of labour or other goods necessary for its production, nor the quantity necessary for its reproduction, but rather the magnitude of importance of those satisfactions with respect to which we are conscious of being dependent on command of the good... the value of all producer and capital goods [and services] are ultimately consumer driven.

Value is therefore like beauty — it is in the eye of the beholder. The subjective theory of value explains people's appreciation of housing, artwork, wine, entertainment, amongst other commodities. It describes pearls as valuable — not because people dive for them, but people dive for them because they are valued. And yet, most lawyers are still misguided by the Labour Theory of Value, continuing to teach each new generation, "you sell your time".

Cost-plus pricing requires a firm to look inside itself and determine the cost of producing the work. Strategic value pricing requires the firm to look outside itself to the client to determine the value. The cost of producing the work has absolutely no bearing on what the client is prepared to pay for it. In contrast, the value attaching to the work as perceived by the client is everything.

What clients really want

The principal reason for a law firm's failure to deliver what the client wants is miscommunication and misunderstanding between the client and the firm. In turn, the largest single component of this miscommunication is over how "success" for the matter is to be defined. We tend to think that we know what clients want of us but frequently this differs from what the client truly wants, or at least expects.

Renowned law firm management consultant David Maister, cites the example of an engineering client who recounted the story of an Arab Sheik who had consulted a multi-national engineering firm

to build a bridge. The engineer advised the Sheik that he didn't need a bridge which, professionally speaking, he clearly did not. The Sheik went to a competitor, who built him a bridge, and thereby obtained for him the public glory he was looking for. Technically, he didn't need the bridge, but the engineer failed to understand his clients' real purposes.

Because we are technicians of the law, we tend to have a very process focused approach to the work we do for clients. Mindful also of the professional liability implications of poor or inadequate advice, most lawyers regard a "once over lightly" approach as anathema. Yet, that is precisely what clients are sometimes looking for. These clients have to be distinguished from clients who are wanting a top job done but aren't prepared to pay for it.

Commercial clients for example often make it clear that they don't want to wait three weeks for a 10 page \$5,000.00 opinion, but they are quite happy for the lawyer to spend 2-4 hours looking at it and providing them with a two page memo with appropriate qualifications as to the inadequacy of the research, given the time available.

Commercial clients are often looking for a pragmatic solution. They are not looking to eliminate legal risk entirely, because the commercial cost of doing so is not justified. Constantly insisting on a full-blown opinion will only irritate the client and they will probably look elsewhere.

Many lawyers equate their role as giving advice in the sense of recommending that the client take a particular course of action. However, there are situations in which the client expects to make his or her own decision, and just wants to make sure that both sides are considering all points of view, the technical being only one of them. In this situation, the best approach is for the lawyer to listen as much as to speak, and to help clients to both analyse their problem and reach their own decision concerning it.

Viewed in this way, the task of the lawyer is to both give the client an education in available options, and make a pertinent recommendation. It is not the task of the lawyer to choose.

Does this mean that the lawyer should always do as the client wants? Clearly not. This is an ethical point. It is an approach required for sheer self protection. If we ensure that the client understands the limitations of the options they have chosen, then we have managed their expectations and have a chance of meeting the quality standards or success measures. The key is a full and thorough

mutual exploration of options, and a significant part of the professional's added value is the ability to generate such options.

Moreover, if it is a mistake to assume that we know what the client wants at the outset of the assignment, it can be disastrous to assume that the client's goals will remain unchanged.

Most matters in which we engage with clients are dynamic in the sense that they are constantly evolving, even if there is a broad agreed and understood objective — the route by which we get there will often alter extensively along the way.

What clients really value

Numerous studies have been done in New Zealand and overseas in recent years to ascertain what clients really value. The results are not new and, aside from minor variations, the results are invariably the same. Clients generally identify ten main criteria:

- reputation for obtaining results
- competitive fee levels
- experience in the client's sector
- having a real understanding of the client's needs
- being a specialist in the relevant field (technical ability)
- quality professional staff
- previous experience with the firm
- size of the firm
- ability to come up with imaginative or innovative ideas; and
- speed of initial response to an enquiry.

Typically, two of the above factors are ranked substantially higher than the other eight, which pale into relative insignificance by comparison. These are

- having a real understanding of the client's needs
- quality of professional staff.

Clearly, therefore, people and the relationship between them are the paramount criteria and not, perhaps surprisingly, legal knowledge or fees. Competitive fee levels are typically down at around 8, size of the firm is invariably last at 10, and previous experience with the firm also tends to be at the bottom end — so much for client loyalty! In the eyes of most of our clients, we are only as good as our last job.

Such results may seem at first surprising but, on reflection, they can in fact be very encouraging. If these results are true, it confirms and highlights the importance of service **from the client's point of view**. This message is of fundamental importance to the attitudes, practices and culture that underlie client management.

Client fee sensitivity diminishes in inverse proportion to the extent to which the firm and individual lawyers within the firm can move toward total satisfaction of the two most highly ranked criteria from the client's point of view.

If anything, fee sensitivity represents a useful barometer of client satisfaction levels in relation to those key criteria. Although I have never undertaken a formal survey, anecdotal evidence during my more than 20 years as a Law Society cost reviser has lead me firmly to the view that more than 50% of the fee complaints to District Law Societies are not about the fee *per se* but, rather, some aspect of the firm's failure to meet the client's perceived needs. Conversely, meet or, preferably, exceed the client's needs and a proper fee will almost always follow.

The Five Cs of value

The main function of a law firm's marketing strategy is not simply to acquire revenue at any price, but to gain its share of highly profitable work. It is not enough to price based upon a client's willingness and ability to pay. You must increase that willingness by constantly communicating the value of your offerings.

Thomas Nagle and Reed Holden have developed the Five Cs of value:

- *comprehend* what drives sustainable value for clients
- *create* value for clients
- *communicate* the value that you create

- *convince* clients that they must pay for value received
- *capture* value with appropriate price measures and strategies.

Every job for every client has value drivers, and the firm's job is to understand what those are. Why does the client want you to provide the service? What is the motivation for engaging you? Most lawyers do not pay enough attention to the actual motivations of the client, presuming they already know why they are being engaged to perform the service. Yet there are almost always motivations other than simply "I need someone to document this deal" or "I need you to sort out the bank paperwork so I can pick up my loan". It is not enough to focus on the technical product. You must probe deeper to discover the client's true expectations and desires.

Whilst we should not decry the importance of technical competence, do not make the mistake of believing that, for the most part, is why your clients engage you. From their perspective, technical competence is a given — it is most certainly not, in most instances, a point of differentiation. Clients could not care less that you completed your law degree with honours. If you do little more than show real empathy, make yourself readily available and return their phone calls promptly, they will consider you better than 99% of other lawyers.

We should not for one moment make the mistake of assuming that what we perceive that the client's value is in fact what is important to them.

Moreover, since value is always subjective — and, ultimately, solely determined by the client, not the amount of labour hours you put into the job or your overheads, or your profit desires — you have to get close to the client to understand exactly what they value.

Even if the firm does a stellar job in creating value for clients, there will no doubt be instances where the client does not understand the value. This places the onus on the firm to communicate to the client the full value of what it is delivering.

For this reason, marketing and the firm's pricing strategies are inextricably intertwined. The marketing function is the main way to communicate the sense of value to the client at all stages of the engagement. If the firm does not understand the value of what it is providing, how can the client be expected to?

Convincing clients to pay for the value is an integral part of every lawyer's responsibility. It requires negotiation skills, which most professionals are loath to even consider, equating it to car salesmen or being beneath the status of a professional.

But, the fact of the matter is, you are going to have a price negotiation at some point with the client, either at the beginning of the engagement or at the end. It simply cannot be avoided, since price is a major factor in any client's decision whether or not to purchase. You need to face this issue squarely and be confident as to the value you are providing.

The work that lawyers perform and the bills they render more often than not run into the thousands, if not tens of thousands, of dollars. With the exception of the legal profession, I can think of no other provider of goods or services that considers it appropriate to be engaged by a member of the public to carry out work, the value of which may run into thousands of dollars, on the basis that the client has no idea what the cost will be until the work is concluded and the account rendered.

Some might say that it is little short of arrogant. The only way to deal with the matter satisfactorily is to incorporate the management of the client's cost expectations into the client engagement process — a process which, by definition, must occur not only at the outset of the relationship, but at the outset of each and every file matter opened.

The client engagement process and the tools needed to implement that process are worthy of a separate conference paper or workshop in their own right. Suffice it to say, however, that this process, handled correctly, is the key to the implementation of a successful strategic value pricing strategy across the firm.

Summary

- Our clients don't want our services, they want what our services will do for them. They are looking to extract value from our offerings

- Creating value is what we get paid to do. In a competitive market, those who understand and create value best will prosper. The first step to persuading clients to pay a fair fee is to deliver more value than our competitors do

- To create more value, we must first understand what our clients are buying so we can sell what they are buying
- Value is benefits minus costs. We need to use this concept to drive our businesses because it is what drives our clients' decisions to buy
- Benefits are features of our services that solve our clients' problems. The more we understand our clients' problems, the more opportunities we will have to create value. We must understand our own businesses and those of our clients better
- Clients seek out legal services because they have problems. Therefore, they want solutions and that takes "can do thinking". They don't want to hear "no"
- Costs such as time, effort, and emotional or mental costs, are "expensive" to our clients. They destroy value. It is worth money to clients to have those costs reduced. Some of you will recall a series of New Zealand Insurance (NZI) television and print media advertisements which highlighted the company's by-line "peace of mind". NZI was not selling insurance. It was selling peace of mind
- We can create value for clients by giving them something extra from time to time, at little cost to us. A proactive approach generates considerably more goodwill with clients than a reactive response to a request for a discount from good clients who are, for example, seeking to have their loyalty and volume of work recognised
- To persuade clients to pay more, we must understand what they value. Value is what we are capable of providing, and what clients are prepared to pay for. Most firms understand what their clients want, but not what they are prepared to pay for, or how much they are prepared to pay
- We do have a choice, you can compete on price or value. If you don't compete on value, you will have to compete on price.

FITTING INTO THE MARKETPLACE — MYTHS ABOUT PRICING

Bill Gates once said, “Profit is not a natural condition. It takes some special work to create.” Part of that special work is being able to price for profitability. One of the best ways to increase your profit is to manage price effectively, yet this is one activity lawyers often shy away from because they are afraid that if they increase their prices, they will alienate their clients, lose work, and see their market share dwindle.

As lawyers we tend to feel more comfortable managing costs or increasing sales, but the reality is that most law firms, like most businesses, have ripped as much cost out of their businesses as they can and, in a crowded and competitive market, increasing sales is difficult, time consuming, and expensive.

Increases in price, on the other hand, are much more effective in enhancing profitability. In fact, a price increase can have an effect on profitability, which is three to four times greater than that coming from a proportionate increase in sales.

Revising a firm’s pricing strategies requires a number of steps — the first is to dispel some of the common myths about setting legal fees.

Myth One — price is the issue

Perhaps one of the biggest myths in legal practice today is that price is what matters most to the client. To be sure, there are some categories of work where that is probably true, particularly in those fortunately few aspects of legal work that have become highly commoditised. As a general statement, in relation to pricing of legal services, the statement is simply incorrect.

People buy anything, including legal services, for a raft of emotional and illogical reasons, as much as they do for logical ones. Certainly, price is an issue but by no means the sole factor, or even the one which is accorded the greatest weight.

Myth Two — the market sets the price

In this client/customer centric world, another pricing myth is that the market sets the price. This myth says that clients will tell lawyers what they can charge and the lawyer is powerless to do anything about it because, according to Myth One, price is the issue. To believe in this myth is to

believe that marketing has no effective role to play in business success and that brand (of both the firm and individual lawyers within the firm) is unimportant. Quite possibly your marketing is ineffective. Possibly you do not have a very powerful brand, either as a firm or as individuals, but it does not have to be that way.

You do not have to be passive about what the market chooses to offer you for your services. You can actually influence the amount your clients will be happy to pay. First, you can create a demand by finding those problems that bother your clients so much that they will gladly pay a proper fee to have them solved. It is not enough just to identify the problems however.

You need to understand what those problems are costing your clients (whether in money, time, stress, or whatever) and what it would be worth to them to have them solved. Second, you must discover what would enhance the value of those services even more. What do your clients value? Convenience? Speed? Reliability? Personal attention? Expertise? You wrap these value enhancers around your basic offering. Finally, you must sell the value that you have created.

Myth Three — you must watch your competitor's price

This myth is the result of believing the first and second myths. It says that, since price is the issue and is set by the market, you must match your competitor's price because if you allow them to undercut you, then you will lose work. In reality, the only time you have to match your competitor's price is when there is absolutely no difference between your competitor and you — no difference in your offering, your firm, your brand, your marketing, or your ability to sell.

Price is the issue only when clients perceive the offering to be a commodity item available from a number of firms who are just as good or as bad as each other, or even if they aren't as good or as bad as each other, the client has no way of telling the difference.

Myth Four — you have to lower prices to attract business

If you believe the first three myths, you're likely to believe this one too.

This myth does not just say that lower fees increase demand, which may have some truth to it, but that you **must** lower your fees if you want to increase sales.

This is also the myth in which the belief that “biggest is best” has its genesis. One needs look no further than the University of Waikato’s inter-firm comparison reports and, in particular, the extraordinarily high profitability of some two and three partner firms to be able to dismiss that notion.

Moreover, the acceptance of this myth is in no small part attributable to an inappropriate focus on the top line rather than the bottom line. As already noted, increased profitability in relation to existing clients is far more successful, effective and easily achieved than a corresponding increase in gross fees.

The common thread to all of these myths is lawyers’ failure to understand the correlation between value on the one hand, and fee levels on the other hand.

PROFESSIONAL FEES AND THE MARKETING MIX

Lawyers tend to view fees and costing in a vacuum without considering that professional fees are an integral part of the firm's overall marketing strategy. The public perception of a firm's fee levels and the way in which the fee aspect of the relationship is managed between the firm and clients speaks volumes about

- how the firm perceives itself
- what types of business it is in
- what types of clients it has and is seeking; and
- how the firm perceives the value that it brings to its relationship with its clients.

Many clients, particularly those who do not avail themselves of the services of a lawyer on a regular basis, are poorly equipped to judge the quality of the work carried out for them and the advice they receive, other than by their perception of the intangible service indicators and the fee.

Even the firm's willingness or unwillingness to negotiate on fees says a great deal. If a firm has a fee structure that is generally regarded as being a little on the high side and its fees are not negotiable, that sends a number of messages. There is, of course, the risk that the firm will just be perceived as arrogant but, more likely, the perception will be that the firm is busy, that it is confident in its own belief that the fees represent value from the client's perspective, and that the firm does not need to indulge in cut pricing or fee negotiation to remain in business and profitable.

Ask yourself — if you needed an essential but not immediate medical procedure, and you were aware of two surgeons, one of who would charge \$20,000.00 and could undertake the procedure immediately, and the other was \$30,000.00 but couldn't do it for two months because they were heavily booked, which one would you assume was the better?

Every time you set a fee, you are either reinforcing or undermining whatever image and reputation you have hopefully already determined you want the firm to project. Having done that, it is essential to remain faithful to that philosophy through, amongst other things, the fee structure.

STRATEGIC VALUE PRICING AND SELF ESTEEM

Psychologist, Nathaniel Branden, has studied self esteem extensively. His treatise on the subject is *The Six Pillars of Self Esteem*, wherein he defines self esteem as

- 1 confidence in our ability to think, confidence in our ability to cope with the basic challenges of life
- 2 confidence in our right to be successful and happy, the feeling of being worthy, deserving, entitled to assert our needs and wants, achieve our values and enjoy the fruits of our efforts.

In today's competitive business environment, low self esteem is a competitive disadvantage, while high self esteem amongst a firm's professionals confers a competitive advantage. Yet how can professionals feel good about themselves, their work, their service to clients and the wider community, if they believe they are commodities and are constantly being beaten up over their price, or the lack of billable hours they are charging.

Many years ago, a senior member of the profession once said to me, when describing his methodology for charging, "you have to have a good conceit of yourself". He did not mean that we should be conceited — rather, he meant that in order to charge properly, you have to have a high level of self esteem, without which you can't possibly sell a message of high value to the client.

You will never get paid more than you think you are worth and if you do not think you are worth more than your hourly rate, why would your clients?

STRATEGIC VALUE PRICING AND ETHICS

Nothing I have said should be construed as a prescription to rip off your client, or charge extraordinarily high prices for services. Practitioners should also be aware that Section 142 of the Law Practitioners' Act 1982 makes it clear that a bill can still be subject to revision, even if the practitioner and the client agree on the quantum of the fee at the outset.

Cost-plus pricing gained acceptance and, to a large extent, retains its popularity, because it was perceived as a fair pricing method. Any business is entitled to earn a reasonable profit on its internal costs. Of course this begs the question of who gets to determine what is reasonable. The fact of the matter is that there is a natural — and healthy — tension between buyer and seller, tempered by the competition in the marketplace.

Lawyers are subject to the same laws of economics, customer psychology and pricing emotions as all other businesses, and must therefore stop hiding behind the security of the billable hour and price up front — in so doing, accepting the resulting risk and uncertainty that entails. The rewards lie in much higher levels of client satisfaction and higher levels of remuneration for the firm, and most cost complaints (formal and informal) would be eliminated if prices were established transparently and with the full consent of the client.

The practicality of this viewpoint has been adopted in many jurisdictions as best illustrated by a statement from the New York State Bar Association:

Indeed, subject to the economic realities of the situation and an attorney's professional obligations, virtually any billing method that an attorney and client can both agree upon and abide by will result, almost by definition, in a fair fee.

Strategic value pricing and ethics are not mutually exclusive concepts; they co-exist in the marketplace everywhere else — from airlines having different fares for different passengers, to “overpriced” picture theatre confectionery.

As one commentator has colourfully put it, “... *capitalist acts between consenting adults are allowed*”.

Practitioners must obviously be mindful of their professional and ethical obligations in relation to charging as set out, in particular, in Chapter 3 of the NZLS Rules of Professional Conduct for Barristers & Solicitors.

There are two Rules that are particularly pertinent:

- Rule 3.01, which reads

“A practitioner shall charge a client no more than a fee which is fair and reasonable for the work done having regard to the interests of both client and practitioner”

- Rule 3.02, which reads

“A practitioner must not receive a reward, whether financial or otherwise, of which a client is unaware in respect of services rendered to the client”.

Both Rules are expanded with useful commentary.

CLIENTS’ EXPECTATIONS

Understanding clients’ expectations

The keys to effective client management include the ability

- to understand your clients
- to see what you do from their point of view
- to identify their expectations; and
- to manage the delivery of your services so as to meet or exceed those expectations.

By understanding the client, we will learn to think like a client. By getting and staying close to the client, we will be able to understand what we do from the client’s point of view. Client management is about the client’s experience of what we do, seen from the client’s point of view.

If client service is primarily about understanding the client — what does that mean? Does a client choose to instruct you because you are a qualified solicitor, or because of your technical skills? Except very rarely, when you possess niche expertise that cannot be obtained elsewhere, it will generally be sufficient that you are a qualified solicitor. Clients expect you to be legally competent — you can’t generally compete on legal competence, but a firm can compete on service.

The client is more concerned about whether or not they can work with you on their level, than about your degree or your qualifications. In over 20 years of legal practice, I can't recall ever being asked by a client, or even a prospective client, about my legal qualifications. Lawyers seem to be far more concerned about these issues than clients who, in my experience, are not bothered what degree you have or which university you went to.

It should be remembered that clients will feel from time to time all or most of the following, particularly at the outset of the relationship:

- insecure because they have to reveal their personal business details to another person, or because they have not used a solicitor before and don't know what to expect
- sceptical about whether you can really help them
- worried about whether or not they can really trust you
- doubtful about whether you will really understand their needs; and
- worried about costs.

Client alignment means getting and staying close to your client so you can understand them better and start to see yourself and what you do for them from their point of view.

If it is true that the legal work is only a small part of the overall legal service as perceived by the client, if it is true that the client values all the other service intangibles, then the message to law firms is clear and intense. If we can also ensure that we provide the client with those service intangibles effectively and consistently, if we can ensure that we build some, if not all, of those service elements into our service production and delivery systems, then we will not only be doing more to provide a fuller service from the client's point of view, but we will also encounter less fee resistance.

This aspect of the perceived legal service is the largest and ripest area of practice development available to us - an area that many law firms have not yet identified, let alone actively and fully tackled in a purposeful, systematic and proactive way,

The ramifications of this view of legal work from the clients' point of view are fundamental to client management generally, but fee levels specifically. If the vast majority of the clients' expectations are met or exceeded, they will not only happily pay for it, they will pay sometimes significantly in excess of what others are charging, and in excess of what the clients themselves might have originally perceived as being a reasonable charge.

When you ask yourselves, "what more or what else can we do to improve our profitability?", the answer lies largely in the service intangibles which may compromise up to 80% of the overall perceived product. We don't need to keep cutting prices, we don't need to become even more expert in the law, but we do need to offer a better service, as defined by the client. We need to work more in the 80% service zone.

Managing clients' expectations

It is not sufficient merely to identify the client's needs and expectations, it is essential to manage them. If not managed, there is the potential for the client's expectations to run rampant and nowhere is this better illustrated than in the context of fees. Drawing again on my years as a cost reviser, I would frequently find that by any objective criteria, the fee that was in dispute was demonstrably fair and reasonable, and yet the client's dissatisfaction was palpable.

Appropriate questioning would often reveal underlying issues. To take a straightforward house purchase, for example, there would be times when the practitioner had charged an appropriate fee but the client would be extremely unhappy with the fee.

A common explanation, particularly with first home buyers and buyers of modest means, would be the fact that they had found themselves short of funds on settlement. In their minds, the aggrieved client was expecting a fee of \$X. When it turned out to be several hundred dollars more than that, they found that they were unable to comply with their solicitor's request to bring in sufficient funds on settlement date to cover the remainder of the purchase price and the lawyer's costs and disbursements.

In other words, the complaint about the fee had absolutely nothing to do with whether the fee was fair or reasonable — it had everything to do with the lawyer's failure to manage the client's expectation as to what the fee would be, resulting in acute embarrassment to the client.

How can this be avoided? The answer one might think is demonstrably obvious. If the lawyer had had a client engagement agreement incorporating a cost estimate in place at the outset of the transaction, would these problems have occurred? Clearly they would not have, or if the client was inevitably going to be short of funds anyway, the lawyer and the client would have had ample time to make alternative arrangements without any inconvenience to the lawyer, or embarrassment to the client. Everyone would have been happy.

By carrying out work for a client in accordance with a client agreement, you will be able to successfully satisfy the client's needs and expectations effectively and consistently.

Without the client agreement, you may have carried out the work to a high standard but you may still have a dissatisfied client because their expectations may not have been defined or met.

The client's needs are what the job specification is about but the client's expectation of service is what the client agreement and care plans are about. The quality of the legal work specified in the job description will go towards satisfying the client's needs, and the quality of service in the client agreement or care plan will go towards satisfying their client's expectations.

For example, if you take instructions to form a new company for a client, you will take details of the proposed new business, its shareholders, directors, the form and content of its constitution, etc. You go ahead and register the company, at the conclusion of which you have met the client's needs — they have their company. So why is the client dissatisfied?

- Maybe they expected the whole thing to take two weeks rather than four
- Maybe they expected you to keep them informed of progress (or the lack of it)
- Maybe they expected your office to be open at 6.00 p.m. when they telephoned

- Maybe they expected you to advise them on a shareholders' agreement as well, but you didn't raise it
- Maybe they expected a fee of \$500.00 but you charged \$1,500.00
- Maybe you don't know why they are dissatisfied, and you should.

There are other desires in addition to needs and expectations. For example, clients may not expect or need you to visit them at their office or workplace, but they may be impressed when you do. Some types of client or job don't usually expect or need copies of letters being sent to the client, but they do seem to like it if they get them. They don't normally need or expect monthly progress reports, but they are impressed when they do get them.

It is this third level of desire or aspiration that the leading client management firms are already aiming their sights at in order to exceed client expectation.

COST ESTIMATES

Transparency in fees

It is increasingly recognised that one of the main contributors to client dissatisfaction with the fees rendered by lawyers is the fact that clients were not prepared for it and/or were unaware as to how it was to be calculated. It is, in my view, essential for lawyers to grapple with this issue at the outset of the relationship and, so far as practicable, provide clients with a written estimate clearly setting out the lawyer's and the clients' expectations of each other and what the cost will be or the methodology for calculating it.

It is frequently said, most often by litigators, that many areas of legal work are difficult, if not impossible, to provide an accurate estimate in respect of. It is certainly accepted that there are aspects of legal work where it is more difficult to estimate a fee, but I would suggest that, even in the case of litigation, it is still possible to provide a client with broad parameters, even if this can only be done one stage of the proceedings at a time.

There is nothing wrong with qualifying the estimate with appropriate warnings about the uncertainty of the process the client is embarking on, but the practitioner should keep in mind that the object of the exercise is to alert the client to the likely range of costs, given both a best case and a worst case scenario.

Having provided an estimate, it is vitally important for practitioners to continue to monitor the actual cost relative to the estimate, and alert clients to any significant departure from the estimate as early as possible. Relativity of the final fee to the estimate is a factor which a cost reviser on a Cost Revision is obliged to take into account in determining what constitutes a fair and reasonable fee.

In England and Wales, the concept has been taken one step further, by requiring lawyers to give prospective clients accurate information on costs at the outset of a matter, and of keeping the client informed of the position on costs regularly. The English Rules recognise that it is not possible to give an accurate estimate in all cases, but aim at ensuring that the best information possible is given to the client at the outset. This may mean simply an explanation of the method of calculating the fees, along with regular information on the current level of fees incurred.

English practitioners are also required to inform clients of various matters in respect of costs, such as the clients' right to set a limit on costs, the possibility of the costs being covered by insurance or Legal Aid, and the implications of an adverse order for costs in litigation. Perhaps most interestingly, the lawyer is required in all matters to consider with clients whether the likely outcome will justify the expense or risk involved.

Aside from passing reference to the obligation of a practitioner to draw the possible availability of Legal Aid to the client's attention, there is no other obligation to discuss costs at any time.

As in all things, the profession's willingness and ability to adopt self regulatory measures will be infinitely preferable to externally imposed requirements. The sooner the adoption of these practices becomes routine, the better for both the profession and its clients.

The Auckland District Law Society has developed its own form of client engagement for use by practitioners. It is not dissimilar to many that practitioners would encounter when clients are dealing with engineering firms, surveyors, accountants, and many other professionals.

Anecdotally, the form, or any variant, is only used by a very small number of law firms. The reasons aren't clear but what is clear is that the legal profession is dragging the chain when it comes to the implementation of something along these lines, which many other professions regard as second nature.

The ADLS form touches on the issue of fees but then refers to the fact that the firm will give the client an estimate. It is always preferable in the engagement process to incorporate all elements of the engagement arrangement including, critically, the cost estimate.

Some firms have developed their own protocols, procedures and documentation. It is not about complying with a standard form but, rather, each firm developing a process and documentation which they and the bulk of their clients are comfortable with.

Cost estimate do's and don'ts

In terms of managing the fee aspect of the firm's relationship with clients, the written cost estimate is undoubtedly the most important single component. However, for it to be effective, a few simple but essential points need to be borne in mind:

- 1 Don't provide a global figure even for the fee component, let alone for the total. Clients like to see the total cost broken down into its constituent components, as this is not only the most transparent representation of the total cost from their perspective, it also assists the client in understanding how the total cost is arrived at.

A straightforward house purchase might for example, appear as follows:

Reviewing Agreement for Sale & Purchase, obtaining title search, advising on Special Conditions, and related matters	\$X
Additional research and reporting to you on easements and restrictive covenants	\$X
Ordering, receiving, reviewing, and reporting to you on Council LIM report	\$X

Bank X Limited Loan Agreement review, preparation of mortgage documentation, attending you on signing, Solicitor's Certificate, LINZ registration \$X

Preparations for settlement, guaranteed search, Transfer, Notices of Sale, settlement statement, undertaking settlement, LINZ registration, reporting to you, and related matters \$X

- 2 With the exception of very small matters (perhaps under \$100.00), it should become standard practice to provide a cost estimate on all files. An unhappy client, who is charged \$200.00 for something they thought (rightly or wrongly) would cost \$100.00, can do just as much damage to a firm's reputation as someone who is charged ten times that.

It has been said to me that some files are virtually impossible to provide an estimate on because there are so many variables and unknowns. It is accepted that some files are more difficult to cost than others, but that should not of itself constitute an excuse for not attempting an estimate. It is entirely appropriate to provide an estimate and then tag it with appropriately worded qualifications, identifying the areas of uncertainty

- 3 The estimate should always be in writing
- 4 The estimate should be sent out as early as possible after the commencement of the particular matter. Clearly, it will be unhelpful, if not imprudent, to send the estimate out without having developed a clear understanding of the scope of the instructions and the nature of the task. Clients won't always be happy with the estimate but, at least if there's a problem, the problem can be dealt with very early in the transaction, rather than at the end when there tends to be considerably less room for both the solicitor and the client to move
- 5 It is important to resist the temptation to underestimate. As identified earlier in this paper, our own sensitivities and embarrassment with regard to the subject of fees often makes it difficult for us to be as candid with the client at the time the estimate is provided as we perhaps should. It is essential to resist this temptation for a number of reasons.

First, having to provide two or three revised estimates because the original estimate was pitched too low seriously undermines the firm's credibility, and the positive that would otherwise have been achieved by using the estimate.

Second, it needs to be remembered that one of the principle reasons for using the estimate is to manage the client's fee expectations. It is far better to overestimate and then be able to charge the job at something less than the estimate, yet still be well paid, than it is to underestimate and have to provide an upward revision of the estimate, even if the final fee is demonstrably fair and reasonable

- 6 It is desirable to have a fee estimate threshold which triggers some internal review process within the firm. It may be felt appropriate, for example, that any estimate where the fee component is more than \$3,000.00 should be passed to at least one other person of appropriate seniority and experience within the firm for a second opinion before it is sent to the client
- 7 Critically, it is essential to have a (preferably computerised) review system in relation to the fee estimate. Most Trust management programmes have the ability to load a fee estimate. The default trigger point is often set at 75% of the estimate but that can generally be altered.

It is important to put a protocol in place whereby fee earners are provided with a report, say, every second day, that identifies those files where the recorded billable time has hit the 75% (or other) threshold. It is then essential for the fee earner to make an assessment of the file to determine whether the job can be completed within the remaining 25% of the budget or whether, on a realistic assessment of the remaining work required, the estimate is likely to be exceeded.

If it is likely to be exceeded, a critical part of the client expectation management process is to send a revised estimate immediately, clearly identifying those components of the job where the cost is going to increase and the amount by which it will increase. Not all of the fee components may necessarily increase, and it is therefore helpful for the client to reproduce the original estimate with the old figures crossed out and a new figure alongside each, so that the client can clearly see the "before and after".

Needless to say, the revised estimate should also be accompanied by a clear explanation as to why an increase has occurred. This process is made a lot easier if the fee earner has been able to identify in the original estimate elements of the job that may “blow out” as the matter unfolds.

A recent personal example involved a large orchard purchase, financing arrangements, a new company, and a shareholders’ agreement. I was able to provide an accurate estimate in relation to all the components, with the exception of the shareholders’ agreement.

I provided an estimate for that also but I flagged it as being the component that was most difficult to provide a cost estimate for, because of the complexity of the issues, the fact that many of the issues hadn’t yet been identified, let alone discussed and resolved, coupled with the fact that all three of the shareholders were obtaining independent legal and accounting advice.

It therefore came as no surprise (unpleasant or otherwise) to the clients when I provided them with a revised (increased) estimate once matters had significantly progressed in relation to the formulation of the provisions of the shareholders’ agreement.

In the final analysis, there is an acid test that can be applied to all of the foregoing recommendations. Put yourself in the client’s shoes and ask what information you would like to receive, and how you would like the fee aspect to be managed. As professionals, we can do a lot worse than simply put ourselves in our client’s shoes for a moment.

COST COMPLAINTS

If the client’s cost expectations are properly managed from the outset of the relationship, cost complaints should (and, in my experience, do) reduce very substantially. That said, there will always be a number of clients who are, for one reason or another, dissatisfied and that complaint will have to be dealt with constructively by the lawyer. The following comments may be of assistance:

Look deeper

Having undertaken or reviewed hundreds of cost revisions over the last 20 years, if I had to isolate one point of commonality between them all, it would be that clients frequently don't have a *bona fide* concern about the costs (and, in many cases, freely admit that they are incapable or unqualified to say what a fair fee would be) but there is some other aspect of the relationship which, from the client's point of view, has been unsatisfactory which triggers a complaint that the bill is too high.

This is an interesting concept because the complainant will often end up acknowledging for example that, but for the lawyer's efforts taking too long, the lawyer's failure to keep the client informed as to progress, or failing to return phone calls promptly, the fee would be appropriate.

The clients are frequently making a qualitative judgement as to the service level and are seeking a discount to reflect that perception.

Therefore, when a client complains about your fee, it is well worth resisting the temptation to become overly defensive and according the client the latitude, with appropriate questioning, to ascertain whether in fact the complaint is more in relation to performance or service delivery expectations. The value in identifying the clients' real concern is that it will often expose other ways in which the lawyer can take remedial steps to address the clients' concerns, without necessarily having to consider a fee reduction.

Demonstrate value

Particularly if the client has not been provided with an engagement letter and a cost estimate at the outset, the practitioners' first responsibility to both themselves and the client is therefore to devote some time to explaining to the client what was involved in the fulfilment of the clients' objectives, and what the practitioner accomplished for them.

We need to constantly remind ourselves, particularly with clients who do not have regular contact with us, that the things that we take for granted are often largely a mystery to the client.

This is of course a considerably more time consuming process than sending out a relatively standardised engagement specification and, inevitably, the practitioner is "on the back foot". However, that is the price that we pay if we are not prepared to deal with these issues at the outset of the relationship or the particular task.

Discount or not?

The reality is that we don't always get it right all of the time, and sometimes we fall short of our own standards. In those circumstances, it is sometimes better to simply acknowledge the fact openly to the client and agree on an appropriate reduction to reflect that fact. This of course pre-supposes that, with an open mind, the practitioner considers that the clients' complaint has merit and that the relationship is one that the practitioner considers is worth preserving.

In my experience, too many lawyers leap to a discount as a speedy means of resolving the complaint. This is dangerous and often unnecessary, and should only occur after an objective assessment of the merits of the clients' complaint. If the complaint has merit, then discounting is an option that should be considered. If the complaint does not have merit, discounting it to simply get rid of the problem can actually do more harm to the firm's broader reputation than taking a more hard-nosed approach.

Cost revision —cost benefit analysis

I deal with cost revisions in a little more detail in the next section of the paper but, suffice it to say, that they are time consuming affairs, the vast majority of which involve relatively small sums of money (under \$3,000.00) and the cost to the firm of having to deal with a cost revision is frequently far greater than the proportion of the fee in dispute.

Some practitioners will want to defend the fee to the death, and that is obviously their prerogative. Others may take a more commercial view of the matter and conclude that a modest discount is a more cost effective solution, and one that preserves the option (if the practitioner desires it) of maintaining the relationship with the client.

COST REVISIONS

One of the peculiar features of the relationship between lawyer and client is the fact that the client is not usually in a position to determine whether the fees charged are reasonable. This difficulty is recognised by the fact that the Law Practitioners Act sets out a comprehensive procedure by which a client may seek to revise a bill of costs rendered by the lawyer.

The core feature of the procedure is that, in the first instance, it is a peer review. The individuals reviewing the bill of costs will be lawyers who practice in the same district as the lawyer whose bill is under examination.

While the Act provides for a review of the bill by the District Law Society, in practice this task is delegated to nominated “revisers” under the powers of delegation provided in the Act. A client may seek a revision of the bill of costs by applying in writing (no special formalities are required) to the local District Law Society.

When such a request has been made, the practitioner will be asked to submit an itemised bill of costs showing a full breakdown of how the bill was calculated. The Act gives no guidance, or principles, as to the basis on which the revision should proceed, implicitly leaving such matters to the Rules of the profession, the principles of natural justice, and the discretion of the revisers.

In the event that either party disagrees with the decision of the revisers as to the appropriateness of the bill, they may appeal to the Registrar of the High Court in the District. The Registrar may conduct the appeal as a fresh revision if desired. If either party is not satisfied with the decision of the Registrar, there is a right to apply to the High Court for a review of the Registrar’s decision. The right to seek revision of a bill of costs is in addition to any other contractual rights to dispute the bill.

In rare circumstances, where the amount charged is grossly excessive, it may also be grounds for a complaint that the over-charging is so serious as to amount to professional misconduct. This has the potential to expose the practitioner to a different (and more serious) range of processes and potential penalties under the Act.

Practitioners’ attitudes toward, and reactions to cost revisions, are many and varied. Some take great pride in the fact that they have concluded a lengthy career in the law without ever being subjected to a cost revision. Others take the view that, unless they are subjected to a cost revision from time to time, they are probably not charging enough. Wherever practitioners place themselves on that continuum, cost revisions should be taken seriously. They are the manifestation of requirements imposed on District Law Societies by the Law Practitioners Act. They are a quasi judicial process, the initial findings in respect of which are subject to review and appeal through the Courts. They should not be taken lightly.

Practitioners should also be aware of the fact that Section 153 of the Law Practitioners Act allows cost revisers to make awards of costs (analogous to judicial costs awards in litigation) against the complainant and/or the practitioner. In practice, this is rarely used but its application can be appropriate in the case of extremely uncooperative practitioners or vexatious complainants.

APPROACHES TO COSTING

Discussion with colleagues

As I have already indicated elsewhere in this paper, costing is as much an art as it is a science or, as one of the English Judges has put it, costing of legal services is *“an exercise in balanced judgement, not an arithmetical calculation”*.

The very subjectivity of costing provides the profession with both opportunities and challenges. Historically, the profession’s mixed success in dealing with this issue following the abolition of the Scale of Charges has been exacerbated by the entirely understandable unwillingness to discuss professional fees with competitor colleagues.

This is hardly surprising when one considers that, without the skills to take a more sophisticated approach, the vast majority of lawyers saw themselves as having little option but to compete on price. Why then would you discuss such a sensitive subject with competitors?

I reiterate my comments at the outset of the paper, that nothing in this paper or the presentations should be construed as condoning or encouraging a breach of practitioners’ obligations under the Commerce Act relating to anti-competitive commercial behaviour, price fixing, or the like. That said, there is I think still scope for practitioners to confer with colleagues (ensuring of course that they do not breach client confidence) to ascertain what other firms are charging for similar work. In the final analysis though, the fee charged to your client has to be fair and reasonable to that client in all the circumstances of that particular case or transaction.

Spreadsheet analysis

The alacrity with which practitioners have embraced what, for most, is now electronic time recording, has meant that we have once again become lazy in terms of the costing process, giving undue weight to the time and labour expended on a file when it is one of a number of factors which practitioners are obliged to take into account when arriving at a fair fee.

As I have also indicated, it is my view that those factors are only a starting point, and there are often many other considerations that can and should go into the melting pot when distilling a fee.

The weighting accorded to each of those factors also needs to be considered. In the seminar, I will show how this can be done using a simple Excel based tool that firms can adapt to their own requirements.

Rules of thumb

Rules of thumb are generally industry specific formulae or other methodology which produce an estimate of the fee for a given set of parameters. While rules of thumb are sometimes developed by interpretation of actual practices in the market, they are frequently derived from less objective sources. Furthermore, rules of thumb are at best a blunt instrument in that they fail to differentiate between the subtle but often very important nuances from one transaction to the next.

Despite the weaknesses in the rules of thumb approach, such rules are from time to time applied and they cannot always be ignored. They should however only be relied upon as a broad reasonableness check on a fee calculated by approved methods.

In the conveyancing context, two rules of thumb that I have seen applied, with subtle variations, are:

- (a) 15% of the real estate agents' commission
- (b) billable time recorded, plus 0.2% of the consideration.

These rules of thumb generally appear to be applied in transactions where the transaction exceeds \$1.0M.

They have, as I say, some limited use as a broad reasonableness check but, certainly in the context of a cost revision, they would carry little, if any, weight. Use of an analysis tool such as the spreadsheet referred to in the previous section provides a far more robust and defensible approach.

COSTING ALTERNATIVES & INNOVATIONS

Contingency fees

One arrangement that has obvious advantages is where the client pays no fees unless the lawyer is successful in the clients' action. An arrangement in which the payment or level of the fee is contingent on the outcome of the case has the advantage for the client of minimising the fruitless outlay of money on unsuccessful actions. It also enables litigants who have no funds to pay for an action to bring cases concerning wrongs that would otherwise go unremedied.

There are numerous variations of the manner in which a contingency fee might be calculated. Examples are:

- speculative fee — the normal fee only is payable in the event that the action is successful
- fair percentage — lawyer takes a fixed percentage of the winnings
- sliding percentage — lawyer takes a percentage if the case is settled, a higher percentage if a trial is necessary, and a higher percentage again if the matter is appealed
- fee premium (uplift) — the lawyer calculates the hours spent and charges the normal rate, plus a premium, where the case is successful.

Although traditionally contemplated in the context of litigation, similar arrangements (if permitted) could, with appropriate adaptation, be applied to commercial transactions and even some property transactions.

That said, there is a general prohibition on contingency fees in New Zealand, although increasingly there are calls for a liberalisation of this area of the law. It is well known that some jurisdictions (notably the United States) have embraced contingency fees for some time. There are dangers in drawing comparisons with the US system, however, which is lightly regulated and where the absence of costs awards against unsuccessful litigants in most cases removes a disincentive to bringing litigation which is present in New Zealand. The absence of a right of action for personal injury in New Zealand is also a fundamental difference. It is by no means clear that the evils of the American legal system are able to be attributed to contingency fees at all.

The law in New Zealand on contingency fees is relatively clear. The torts of maintenance and champerty that emerged from English common law still exist and have not been altered by case law or statutory intervention.

Maintenance arises when a person, without lawful justification, assists a party to a civil action to bring the action, thereby causing damage to the other party.

Champerty is a particular form of maintenance whereby the funder (maintainer) of the action supports the action in return for a promise of a share in the proceeds of any action. A lawyer who agrees to bring a case on the condition that the fees are to be paid only from a share of the proceeds if the action is successful is committing the tort of champerty.

The commentary to Rule 3.01 of the NZLS Rules of Professional Conduct for Barristers & Solicitors draws practitioners' attention to these issues but is relatively circumspect on the subject. Indeed, the commentary makes it clear that Rule 3.01 which requires practitioners to only charge a fair and reasonable fee, having regard to the interests of both client and practitioner, is "*... drafted in terms, which contemplate the possibility of charging a contingency fee.*"

Whilst the strict legal position is that there is an unequivocal prohibition on contingency fees, the reality is that this approach to costing is being employed and the change appears to be driven as much by the public as practitioners.

Simpson Grierson (*Equifee*)

Some law firms are particularly proactive and innovative with regard to not only the means by which the fee is arrived at, but also the means by which the client meets those fees.

A commendable example in recent times is Simpson Grierson's development of *Equifee*.

This concept is primarily available to the firm's new venture/private equity clients who might be involved in the development of a product, service or market, particularly where the enterprise has shown some initial promise but lacks the funding and expertise to take it to the next level.

Under the *Equifee* scheme, the firm will discuss with the client, treating all or part of the firm's legal costs as an investment (by way of a separate entity from the firm) in the client's enterprise. Each case is considered on its merits.

This will often hold considerable attraction for the proprietors of such enterprises, who are frequently cash-strapped and for whom such funding as is available, is earmarked for business development activities and not for legal costs.

Such schemes do bring with them additional issues, such as the potential for conflicts of interest, that need to be thought through. Those issues aside, such lateral thinking is to be commended.
