

A Little Off the Top

There's less than meets the eye to discounts on billing rates.



By REES W. MORRISON

Compelled to try to control legal costs, general counsel across the land are hypnotically drawn to billing-rate discounts. "Eight percent off your standard rates" mesmerizes those who have to account for spending on outside counsel. "Look what we've saved!" they proclaim. Well, maybe.

I'm suspicious of discounts on legal fees as a cost-control tool. Ultimately, they don't alter the dysfunctionality of hourly billing. Law firms still enjoy a cost-plus arrangement, inducements to pad law firm bills are everywhere, and in-house lawyers must still flyspeck long bills. Several other aspects of fee discounts are problematic, too.

Management Matters

FROM WHAT BASELINE?

Start with this question: When a law firm agrees to discount its "standard hourly rates," how does the in-house lawyer know the firm's rack rates? Law firms do not routinely publish their standard rate cards. In fact, if firms are well managed, they tailor rates according to the strength of the practice, the demand for it, the kind of work on offer from the particular company, personal relationships, and more.

Shaving something off a mythical rate may sound good. But what the company really wants is to be billed at rates that are, by some definition, advantageous. The company may not have the clout, cash, or cachet to be entitled to the most favorable rates of the firm, whatever those are. But when it requests discounts, it wants to be treated better than other, nondiscounted clients.

How to confirm that status is one major problem with

discounts. In a world where all too many clients get "discounted" rates, there may be no relative gain.

PROVE IT

Another problem is how to prove what the company has actually saved. If everything remained the same—including the lawyers working on the matters, the hours they all work, and the kind of work required—then discounts would easily compute into savings. Things don't stay the same.

If you can calculate the effective billing rate of a law firm before it imposes a discount, you can test whether that effective rate has, in fact, declined by the amount of the discount several months later. (A firm's effective billing rate is the total fees billed divided by the total hours billed.) That comparison, of course, is clouded by the arrival of new timekeepers and the departure of former timekeepers—not to mention the changing distribution of hours among the consistent billers.

A WORM IN THE APPLE

What has always been troubling about billing-rate discounts is whether firms make up for the discount by billing a few more hours. It is unknown and probably unknowable whether an additional hour or two, here or there, tucked into a long invoice, wipes out the putative discount.

I suspect that associates don't know about the discounts applicable to matters they work on, but the billing partner certainly does. Nor do associates know or care about how much of each dollar billed the firm collects—that is, the realization rate. But if realization rates count for much in compensation decisions, the partners know, and the urge to sprinkle in a few extra hours might overcome some of them. The in-house lawyer tasked to review the bill may be stymied trying to find those scattered incremental hours.

Think of your primary law firm. If its average standard rate is \$400 per hour with a gross margin of 35 percent, the firm makes a profit of \$140 each hour. That profit is reduced

by nearly 30 percent if it grants you a 10 percent discount (\$40 per hour). To maintain its total profits at the same level, the firm needs to bill you for 40 percent more hours. But if it bills you for just a few more hours here and there, that also reduces its loss and, by the way, effectively wipes out your savings.

SWAMPED BY PAY HIKES

Billing for more hours is one way to keep up profits; raising rates is another. As law firms boost rates, discounts fail to keep pace. Managing partners may well anticipate requests for discounts by building in a little bit extra so that they can amiably agree to a phantom concession. You shouldn't pat yourself on the back for wringing out a 7 percent discount if the hourly rates have jumped by 12 percent.

What I'm suggesting is that, for some long-running matters, it would be cheaper to hire lawyers who bill at their full rates but guarantee not to raise those rates for the next year or two.

DEFINE 'USUAL'

Another challenge for counsel seeking discounts is that there are no shared benchmarks on what leaves money on the table versus what is overreaching. Based on my consulting experience with many corporate law departments, it's routine to obtain a 5 percent discount merely by asking.

To push the discount level up to 7 percent, the company needs to retain the firm for a number of years and put it to work on fairly significant matters. At 10 percent discounts, the law firm's billing committee becomes engaged. The firm probably wants close to seven figures in fees and some expectation of ongoing volume.

Some law departments wrangle 15 percent discounts, but those seem to be for major acquisitions or huge lawsuits. If you dangle \$2 million or more in fees in one fell swoop, a firm might oblige with a 15 percent discount. After all, the firm benefits by locking in a large amount of work over a period of time without any marketing costs.

When nosebleed discounts of 20 percent or more come about, there is some mix of whopping fee volumes, clients in dire financial straits, law firms seeking to break into a practice area, and/or persuasively insistent general counsel.

Profit margins at many large law firms are upwards of 25 percent. So the ability to shave that margin by some portion—if indeed a discount translates into a reduction—shouldn't surprise anyone. In short, discounts sound good, but do you know when you've locked in real savings compared to your competition?

ONE SIZE FITS NONE

When they turn to discounts to cut legal fees, most companies try to impose a blanket discount on all their primary law firms. It seems equitable, but an across-the-board discount may be a blunderbuss response. It actually penalizes law firms that were charging competitive rates. A firm with an effective billing rate of \$450 an hour may find it much

How Much?

Some general guidelines in asking law firms for discounts.

5%

Just ask.

7%

Retain the firm for several years on some fairly significant matters.

10%

Send the firm close to \$1 million in fees and an ongoing volume of work.

15%

Hire the firm for a huge lawsuit or major acquisition, worth \$2 million in fees.

20%

Promise the firm whopping fees or access to a new practice area, or plead dire financial straits.

easier to swallow that 10 percent discount than a firm running leanly at \$350 an hour.

Moreover, if the two firms billed the same number of hours with the same distribution of those hours among partners, associates, and paralegals, a gaudy discount from a very expensive firm would prove more costly than no discount from a relatively inexpensive firm. No law department should insist on discounts that drive away efficient firms while deluding itself about savings from expensive firms that shave a bit off their stratospheric rates.

It may make more sense to request that firms lower their billing rates by class level. For example, perhaps first-year associates should have their billing rate discounted 60 percent; second-year associates, who have begun to deliver a little more value, might be discounted by 30 percent; and so forth. The assumption—and it's a good one—is that the less experienced the lawyer, the more likely that lawyer's rates are too high for the value delivered.

Fine-tuning such as this would require an electronic billing system that kept an eye on whether rates billed conformed to discounts granted. Such software would instantly point out when firms were not honoring the discounts they had proffered. Without it, somebody still has to eyeball the bill to make sure that each timekeeper is billed at the agreed-upon rate.

BEST OF THE WORST

For their part, law firms emphasize the nominal value of the discounts they grant in various ways. The best way is to have each invoice show the total amount of the bill and then, on a separate line, the discount applied. Everyone can read that clearly.

But displaying the reduction is the simple part. Other disabilities—"standard" rates, provability of savings, additional hours billed, rate increases, appropriate levels, and even-handed applicability—handicap the usefulness of fee discounts. Better than no discounts, to be sure. Well, maybe.

Perhaps discounts are like democracy: flawed, but better than any other fee management method. Alternative billing arrangements, such as fixed fees or value determinations for completed matters, raise formidable complexities. Discounts to billing rates are, by contrast, clean and well-understood, with manifest savings.

And that's why they will continue to be favored. Just as hourly billing is the whipping boy of critics yet somehow survives, discounted billing rates are rife with problems, but no other technique for reducing legal fees works better.

Rees W. Morrison, a lawyer and consultant at Rees Morrison Associates, hosts the blog Law Department Management (www.LawDepartmentManagement.typepad.com). He can be contacted at rees@reesmorrison.com.