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# LAW FIRM MANAGEMENT

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# Value-based pricing comes to law firms

The concept of value-based pricing (VBP) received a big boost in the health care industry thanks to various initiatives launched in the wake of the Affordable Care Act. Will this transfer over to the legal industry? Law firms could soon see a similar demand for change in how they charge clients trying to get the most bang for their buck.

## BENEFITS OF VBP

VBP is a successor to alternative fee arrangements (AFAs), but, instead of billing based on the services provided, it charges clients based on what they value. In other words, it's a more customized approach to fees that rejects a one-size-fits-all model. VBP recognizes that different clients place different values on different factors. One client, for example, might be primarily concerned with winning at trial to deter other potential lawsuits, while another may focus more on ending a case as soon as possible.

Used properly, VBP allocates risks between attorneys and clients, aligning attorneys' incentives with clients' goals so the firm has more skin in the game. It shifts the focus from hours billed to desired outcomes. The result, ideally, is a stronger partnership with clear benefits for both parties.

One benefit to using VBP is that your firm won't have to devote valuable resources to tracking time and compiling detailed invoices. By sidestepping lengthy client invoice approval processes, you may improve your firm's

cash flow and avoid unpleasant invoice disputes. VBP also allows you to learn more about your client's business, plans and objectives, all while being rewarded for achieving positive results.

*VBP allocates risks between attorneys and clients, aligning attorneys' incentives with clients' goals so the firm has more skin in the game.*

At the same time, VBP also benefits clients. It provides greater transparency and more certainty than hourly billing, which in turn improves the client experience. VBP further frees clients from the tedious process of scrutinizing invoices and the worry over runaway costs.

## TIPS FOR GETTING STARTED

Implementing a VBP billing model requires careful planning and preparation, as well as



## 3 VALUE-BASED FEE STRUCTURES TO CONSIDER

After receiving input from clients, let's say that your firm has decided to give value-based billing a try (see main article). Now what? You have several options for structuring your fees, including:

- 1. Success fees.** You and the client define the specific results — for example, winning a summary judgment motion — that will trigger a bonus payment over and above the regular fee. Firms generally reduce their regular fee in exchange for a share of the potential upside. Your arrangement also might include a “broken deal” or similar discount if you don't achieve the desired outcome.
- 2. Performance-based holdbacks.** Part of the client's fee is “held back” and paid out over time based on metrics-based evaluations of your firm's performance. Metrics might be service- or outcome-related.
- 3. Reverse contingent fees.** This might be an option if your client is the defendant. Reverse contingent fees are based on a percentage of the difference between the client's actual costs (including damages or settlement amounts and legal costs) and the previously estimated value of the client's exposure in the matter.

And remember, you may use different options for different clients.

some close collaboration with your client. Follow these steps:

**Establish the client's value points.** Discuss with the client how it values the various types of work you perform for it and determine project scope. If the client has a portfolio of continuing work, it may prove wise to assess value provided based on the total return on the client's investment, rather than matter by matter.

**Assess your capabilities.** Using historical data, determine whether you can provide the necessary services at the amount the client is willing to pay. You may well need to develop or refine processes, procedures and systems to accurately estimate and manage costs.

**Offer several tiers of value.** This means presenting different prices based on the amount of value sought. This can be an effective way to demonstrate to the client what it might sacrifice to save money and to get a handle on the client's price sensitivity, which can be useful information going forward.

**Prioritize project management and communication.** You must determine early on who will do what work and according to what timetable. Regular monitoring will play a crucial role, ensuring that everyone involved is adhering to the plan.

**Monitor work for “scope creep.”** The dreaded scope creep can easily eat into your profits. Alert the client to such creep as early as possible, providing it with alternatives on how you can proceed and issuing a change order if the client approves extra work or work that wasn't contemplated in the original fee agreement.

### MONEY TALK

For law firms, a common hurdle to adopting VBP is the reluctance attorneys often feel when it comes to talking to clients about money. Those who can get over that will likely find that clients welcome the opportunity to explore ways to build a more aligned and mutually beneficial relationship, whether for a single matter or several engagements. •

# Unlock the door to success

## THE IMPORTANCE OF KEY PERFORMANCE INDICATORS

Successful law firms know that long-term sustainability requires constant self-examination and -evaluation. These firms often rely on key performance indicators (KPIs) to help them make more informed decisions when charting their futures.

### FINANCIAL KPIs TO CONSIDER

For many firms, the biggest consideration is financial performance. KPIs that will help shed light on your firm's financial health include:

**Realization.** How much revenue does your firm collect compared with its billings (net realization), and how long does it take to collect that revenue? Determine how the amount billed compares with the amount of time worked (billing realization).

**Unbilled days.** How long does it take to bill clients for work? Compare the fee portion of unbilled work-in-progress with the average fee billings.

**Uncollected days.** This is the ratio of the fee portion of accounts receivable to average fee billings.

**Profitability per attorney and client.** You need to know how individual attorneys and clients are affecting your profits when making decisions about compensation and client relationships. Also look at profitability for each type of matter when considering which types of work to pursue.

### BEYOND THE FINANCIAL

It's admittedly hard to shift your focus away from billing-related metrics, but you also need to consider other KPIs that are specifically aligned with your firm's strategic plans and goals. After all, strong profits per partner are no guarantee of continued success.

For example, you can't afford to overlook client development. To measure your firm's performance in this area, you could look to the number of new clients per month compared with the total number of active clients; matters per client; and attorneys with time on a client's matters (or practice areas per client). Evaluate your firm's marketing and client initiatives to determine which are working

and which should be refined or discarded. This might involve measuring, among other things, the cost of client acquisition.

And make sure you don't overlook client satisfaction. Satisfied clients are returning clients and referring clients. Firms are increasingly turning to the net promoter score (NPS) to measure satisfaction. They ask their clients a single question: "On a scale from 1 to 10, with 1 being not at all likely and 10 being extremely likely, how likely are you to recommend the firm to



family, friends or colleagues?” Clients who reply 1 to 6 are “detractors,” and those who say 9 or 10 are “promoters.” Calculate your NPS score by subtracting the percentage of detractors from the percentage of promoters.

#### 4-STEP SOLUTION

Once you’ve decided to implement a KPI program, what’s next? Four steps can have you on your way to an effective KPI program:

- 1. Select KPIs.** Select quantifiable KPIs linked to your goals. For example, if your goal is client growth, you might look at your rate of converting consultations into clients.
- 2. Set targets.** Establish targets for your KPIs that tie into the goals, perhaps based on comparable peer benchmarks. Using the example above, you might target a conversion rate of 50% to 60%.

**3. Monitor KPIs.** Track relevant data and measure the results against your targets. Bear in mind that you generally need several months’ data to detect trends.

**4. Act on KPIs.** Use the information to make solid decisions.

Be sure to cycle through the steps regularly. By doing so, you might find that some KPIs are no longer relevant and could be replaced with more suitable metrics.

#### KNOWLEDGE IS POWER

The adoption of innovative technologies over the past decade has provided law firms with a wealth of available data. Your financial advisor can help you wade through it to select the most appropriate KPIs for your goals and then evaluate and act on them to position you for the long haul. •

## Why two-tier partnership structures are the right solution

With many law firms’ high-performance expectations, demanding workload and long hours, some of today’s lawyers are “opting out,” searching for a better work/life balance. The partnership track isn’t the lure it once was. But your firm may be turning away profitable legal talent if it continues to phase out associates who don’t fit the partnership track. The solution is a two-tier system of equity and nonequity partners.

#### LOOKING AT THE NUMBERS

The two-tier concept has continued to gain in popularity. According to Altman Weil, Inc., a legal

consulting firm, the number of nonequity partners in the 200 largest law firms rose to about 42% in 2017. This system is attractive not only to the attorneys seeking to become nonequity partners, but equity partners, as well.

It’s no secret that there are more law-school grads than plum, partnership-track positions. Not every lawyer is owner material, but many are, nevertheless, capable of making significant legal and financial contributions. In addition, many younger attorneys reject the idea that their job is their life; they seek to find a work/life balance much different from those on an equity partnership track. They refuse the late



nights, frequent travel and mental pressure generally associated with equity partnership tracks. Similarly, some lawyers simply want to practice law, not generate new business or assume management responsibilities.

Current equity partners can take a bigger slice when their firm has fewer of them. With increased operating costs, intense competition and budget-minded clients, limiting the number of profit-sharers may keep current equity partners satisfied and engaged.

Hiring midcareer lawyers is increasingly common. But despite having high expectations for such lateral movers, firms may be wary of offering untried attorneys full equity partnership. Offering these lateral hires a nonequity stake to begin with is a good way to make sure the relationship will last before offering an equity stake.

### ADDING NONEQUITY PARTNERS

Some firms have created “permanent associate” programs, placing non-partnership-track attorneys in satellite offices with lower-profile, less-challenging work. But if you try this, be careful: Such permanent associate programs can create a demoralizing “second class citizen” environment that discourages attorneys from producing their best work.

Nonequity partnerships offer an alternative for attracting and retaining talent. Lawyers in this tier enjoy the title of “partner” but firms typically compensate them with a combination of salary

and performance bonuses, not profit shares. In fact, one of the advantages of adding nonequity partners is the flexibility to determine the best means of their compensation.

Nonequity partners don’t make capital contributions to the firm or assume personal liability for debts. But they may be granted limited voting rights and participate in partner meetings where strategic decisions are made.

### FINDING THE RIGHT CANDIDATES

Don’t use nonequity partnership positions to dispose of underperforming lawyers who traditionally would be asked to move on to another firm. Instead, reserve them for high-billing senior associates who desire a 9-to-5 workday, or unproven lateral hires.

Also, consider this track for older equity partners whose business development activities have slowed or for experienced lawyers with valuable niche knowledge who have no desire to be owners. Keep in mind that some of these nonequity partners may eventually become equity partners. Nevertheless, it’s important to make your nonequity track a respected and professionally challenging alternative to equity partnership so that good lawyers will remain loyal to your firm.

### REMAINING COMPETITIVE

For most ambitious young attorneys in private practice, equity partnership remains the ultimate prize. But the organizational structure that once supported this goal has become less viable in the 21st century. Firms looking to remain competitive should consider exploring whether including nonequity partners is right for them.

Transitioning to a two-tier partnership system can be complicated. Be sure to consult your financial and law firm management specialists to help define your nonequity partner position and set compensation rules. •

# What the new tax law means for law firms

Just before the end of 2017, President Trump signed into law the Tax Cuts and Jobs Act (TCJA). Many types of businesses stand to benefit from the sweeping legislation — but the boon for law firms is limited. Here's a quick review of the TCJA and some of its impact on law firms.

## THE PASS-THROUGH DEDUCTION

The TCJA's new pass-through deduction generally allows S corporations, limited liability companies, partnerships and sole proprietorships to deduct 20% of their income before calculating their taxes. Sounds great, right?

But the TCJA considers large law firms to be “specific service businesses,” for which the deduction begins to phase out when taxable income reaches \$157,500 for single filers and \$315,000 for joint filers. It phases out entirely when taxable income exceeds \$207,500 and \$415,000, respectively.

## COSTS IN CONTINGENCY-FEE CASES

The House version of the tax law would have prohibited contingency-fee attorneys from deducting case-related expenses before the case was resolved. Fortunately, the final law left it out.

Note, though, that the IRS generally disallows such deductions, deeming such costs loans rather

than business expenses. Only attorneys in the Ninth Circuit can take the deduction. That court allows attorneys to deduct the costs if they had a “gross fee” contract where the attorney receives a percentage of the gross recovery, with costs paid by the attorney taken solely from his or her percentage.

*The TCJA considers large law firms to be “specific service businesses,” for which the pass-through deduction phases out at certain income levels.*

## DEDUCTIBILITY OF ALIMONY

Family lawyers often use the deductibility of alimony payments as a bargaining chip to increase alimony payments by higher-earning spouses. The TCJA repeals the deduction for the paying spouse, which could push the spouse into a higher income bracket, leaving him or her with less cash to pay alimony.

The law also excludes alimony from the recipient's taxable income, but that spouse would typically pay a lower tax rate than the paying spouse, so the overall tax bite would increase. The changes apply to divorce agreements executed (or, in some cases, modified) after December 31, 2018.

## MUCH MORE TO CONSIDER

We've covered just a few highlights of the impact of the TCJA on law firms and their clients. Your firm may be affected in other ways, and of course your clients will be affected by numerous other provisions. In addition, like any legislation that covers hundreds of pages, much remains to be resolved. •





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