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GROSS PROFITS: A CLIENT’S PERSPECTIVE

Duncan A. MacDonald*

As you will see, 25 years of working in a highly regulated industry has shaped my thinking on today’s topic. I manage a legal department that oversees the activities of almost 2,000 law firms throughout the United States. Most of the firms are small and involved with routine collection work. However, about 15-20% of the budget I manage goes to hire very large law firms, many recognized as national or super-regional firms, who represent us in complex lawsuits, legislative and regulatory matters, and policy planning issues. On occasion, a modest portion of the “outside” budget has gone to economists, public relations firms, trade associations, an English professor and even an historian. All of these relations are created through tightly drawn contracts and are closely overseen by lawyers and business people. To my knowledge, none of these relationships result in “gross” profits to the provider of the service.

Our topic today is to determine whether some law firms nonetheless make gross profits from their clients. I intend to focus on the issue only as it relates to large law firms and clients. Yet I am not sure what we mean by the word “gross.” Does it mean excessive or unconscionable profits or profits obtained by fraud? Or do we intend it to mean something different, like the kind of profit that comes when a partner charges $400-500 per hour? Answering these questions is important, because profit, even handsome profit, is not alien to most business people—it is why they are in business. They want to make as much as they can fairly get and they admire others who do so as well. They recognize, in a modern application of their Benthamite heritage, that the accumulation of wealth among as many people as possible provides them with increased business opportunities.

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As I see it, our issue is not whether law firms profits are out-of-line—it is whether both the client and the law firm are properly managing their relationship to get the most value for the expense. If either fails, what they get is not gross profits but gross mismanagement and misunderstanding. In fact, there is more than enough evidence of such failure involving our profession. Clients’ well known irritation with lawyers tells us something goes wrong when they get together. I think I know what it is: hourly billing.

Let me tell you why. For 25 years or so, I have closely watched business colleagues deal with a myriad of other service providers. I have gotten into the thick of their deals, negotiating and drafting their contracts, and managing some aspects of their performance. Of all their service providers, however, business people seem to deal with their lawyers least favorably. Why so? Are the services the lawyers provide fundamentally different from those of other providers? Not in my experience: what lawyers do generally parallels other professionals, except their billing. Law firm hourly billing, because it is unlike general business billing, generates client hostility and cynicism, and on occasion, suspicions of a swindle. Many business people contend that it generates unnecessary work. They suspect that law firms often exaggerate the risk in an assignment just to keep their staffs gainfully occupied and to ensure a steady stream of profitable revenue.

Other service providers are less subject to such suspicions, even though what they do has much in common with law firms. They work on equally difficult problems for their clients, some of which can even threaten the life of the business. They manage contingencies, economic loss, client reorganizations, disputes (even certain aspects of litigation), and legislative initiatives—in effect, almost every kind of vexing problem a business can face. Consider, for example, what public relations firms do for a company facing a public crisis, like an oil spill or drug tampering incident. In the old days, the company’s first line of protection would have been to hire lawyers. Not anymore. Smart business people nowadays get as good or better advice from public relations (“PR”) firms. The PR firm is hired not to put a spin on things, but to provide tough advice. To counter the risk of a loss of public faith in the client’s brand or products, they advise the client to tell the truth, to cooperate fully with public authorities, including the media, and to spend money to rectify the situation. Among many business people today, unfortunately, law firms would be viewed as the last line of protection. They perceive, perhaps wrongly, that all the law firm will tell them is to hunker down for a long, drawn out
fight. Experience has taught them however, that this strategy too often backfires. It can breed public suspicion, provoke legal action, and generate unfavorable media attention against their company. The law firm, they perceive, might benefit from an aggressive stance, but the client probably will not.

Numerous other service providers do work that is similar to ours and perhaps should be ours. Consultants like Kroll Associates prevent and manage security breaches; Arthur Andersen helps beleaguered companies weather storms of competition; investment bankers one day aid and the next day prevent hostile takeovers; tax advisors tell both sides how to make the best out of the ordeal; and lobbyists orchestrate political responses. Up and down the economy, economists, collection agents, total quality management ("TQM") experts and a horde of other service agents at the beck and call of the business community serve as lawyers serve, except that they bill differently. Few, if any of them bill hourly.

Let me try to illustrate our issue with an example that at least will be familiar to in-house counsel. Big Company ("BC") gets hit with a troublesome antitrust problem and contacts Prestige Law firm ("PL") for counseling. BC asks the Managing Partner if PL has an attorney experienced with its kind of problem. The answer, except in rare cases, is almost always yes. In fact, the partner can usually be expected to go a step further, raving about "Mr. Antitrust" down the hall. The specs on Mr. Antitrust are predictable: he has practiced antitrust law for many decades, has written numerous articles on virtually every aspect of the law, has taught it in one of the top law schools, has argued many of the more famous antitrust cases (and won, naturally), and on and on. The clincher on Mr. Antitrust is a yawn: "He probably knows more about antitrust than anyone around."

Unfortunately, if you make the mistake of saying you think Mr. Antitrust can help you wrap up your problem quickly without a whole lot of work, you discover this is not exactly true. Somehow or other, Mr. Antitrust’s genius and experience do not come with enough to provide you with efficient, inexpensive service. In the hands of PL, your problem immediately begins to contort. The firm tells you it needs more facts, which you know is not the case, and that it makes sense to have a few associates do a “little” research. In short order, that is followed by a parade of contingency monsters—scare stories to entice you to make PL work more. They may or may not have to work more, for their rationale, whatever it is, is seemingly a smokescreen. The real culprit is billing by the hour. How else is the
firm ever going to feed all those expensive, hungry mouths if it does not keep them occupied by the hour? Sadly, law firms get away with this, except with a small, yet growing number of experienced in-house counsel.

The other speakers who look at this might say that PL’s behavior is unethical. I disagree. What we have here is a management problem—the failure of the client to demand delivery of the service under more rational and effective pricing schemes and the failure of law firms to break away from the practice, one which I think they hate as much as their clients. When businesses contract with other service providers—usually for a lump sum—they generally look for a reputation for quality and a commitment to achieve certain results. The means of achieving those results are quite irrelevant, so long as they are legal and ethical. It does not matter to the business whether the service provider puts ten people on the job or one, or how many photocopies they produce as part of their work product, or who flies first class or eats in fancy restaurants. Once a price is agreed to, what the service provider does with the money is less important than whether it achieves the desired goal.

Whether the service provider assigns ten inefficient people to work the matter at a small profit, or one person like Mr. Antitrust at a fat profit would seem of no significant ethical consequence. If the service provider fails to deliver (by not preventing, for example, a hostile takeover or minimizing the effects of a public crisis), it is rare that the post-mortems will include griping about the price. Just the opposite is the case when a law firm bills hourly, for the griping is certain to happen because of the bills that come monthly in ever differing sizes—drip by drip, like water torture—even at the end of a success. Hourly bills provoke the client to think that it has been taken advantage of, that too much work has been done to increase the firm’s revenues.

Think of our issue this way. A business asks a service provider (“SP”) to help on a unique problem and the SP agrees to so it, say, for $100,000. SP then decides to put its best person on the project—alone. SP knows this person will achieve the desired results for the client at a salary cost plus overhead of $40,000, leaving it with a $60,000 profit. Another service provider might have managed the service with more people and thus less profit, but in either case, it is unlikely that anyone would question the ethics of how they accounted. How they staff the project and how much profit they want to make is their call.
Now let us change one of the characters. This time the business hires a law firm to provide a similar service. Let us say that instead of negotiating to bill by the hour, the firm agrees to the same $100,000 lump sum price and similarly assigns its best person to perform (e.g., Mr. Antitrust). The law firm's expense being the same as SP's above, it too will make a $60,000 profit on the deal. Nothing ethically wrong here, is there? So long as the same results are achieved either way, whether the law firm makes its $60,000 profit from a lump sum approach or hourly billing approach ought to be ethically irrelevant to us and the client. Sure, it might seem odious that the law firm that bills hourly could overwork the matter to build up to the $100,000 revenue goal (deviously or clumsily), but had the firm instead negotiated an up-front lump sum fee of $100,000 and put six people on it versus the efficient one, because that is the way it manages, nobody could pin it with an ethical charge. The point here is that the way to get all of us out of these kind of tail-chasing ethical arguments is not to regulate them with endless rules and scarlet letter punishments, but to encourage practices by law firms and clients that abandon hourly billing. In short, to cause them to manage their relationship more efficiently, more creatively, and in keeping with the common marketplace practices. Doing this will:

Force smarter, more efficient consideration and management of contingencies. Many contingencies in fact will go away, because law firms will condition themselves to learn the patterns in contingencies, and thus, how to include them in the price in advance. Other service providers are quite good at this; lawyers can be, too.

Cause the firm to assign the most seasoned, productive, efficient, creative lawyers to manage the client's needs. Ideally, this will speed up delivery of the service to the client. If adopted throughout the profession, it could help shrink the number of lawyers in our already bloated industry. Moreover, it will likely encourage law firms to write contracts more clearly and efficiently, and to promote litigation less often in favor of Alternative Dispute Resolution.

End the absurd nickel-and-dime hostilities over flying and dining practices, photocopying, assignment of associates, and the like. These hostilities result from hourly billing, which
mandates constant, intensive auditing, forcing the client always to look for some evidence of chicanery.

Law firms can learn how to bill on a non-hourly basis by studying how their clients buy and sell services. It is a wonder that they have not already learned this, considering all the contracts they negotiate and draft for service providers. Learning from clients and their other service providers, especially how they budget with each other, will make law firms more sensitive to the roller coaster rides they create for their clients from bills that swing high and low, month by month. Clients want predictability; they cannot afford constantly to mis-forecast their budgets. From my own experience, a company more often then not would rather achieve a forecasted loss than achieve a gain that results from a mis-forecast.

Let me close by saying, that I do not believe that migrating away from hourly billing by itself will end client hostility toward our profession. Our problems go much deeper than our billing practices. For one, many people see the problem as an overabundance of laws and lawyers—each feeding on and causing the other to grow year-after-year with no end in sight. New laws spring from thousands of legislative, judicial, and administrative agency sources annually, each one requiring some kind of role for the 800,000 members of our profession: interpretation, notice, compliance, defense, challenge or, as is too often the case, a return to one of those sources for clarification. The cycle of law growth and lawyer growth naturally increases the intrusion of our profession into the lifeblood of our society and economy. The result is that people and organizations, have to rely—at great expense—on lawyers, more and more, just to make their way through the maze of public life. Is it any wonder why there is resentment out there? What I have proposed today is a modest way to deal with one significant cause of that resentment. Most of you, I am sure, will disagree with my proposal, holding perhaps, that the solution to gross lawyer profits is for still more tinkering, more ethical rules, and prosecutions of lawyers who bill in ways we do not like. You are wrong.