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Good morning Ladies and Gentlemen,

Mr. Gaillarde, thank you very much for this kind introduction.

As you look at your law practices, are there any of you who have clients that you provide a cap on your fees? A fixed fee? How many demand an estimate? Why do clients demand an estimate?

Picture this: A large old tree needs to be removed from your garden. Your gardener tells you not that the cost of the removal is \$250 but instead that he charges by the hour. After all, he does not know how deep the roots of the tree are and how long it will take him to remove the entire tree, cut out all the roots and remove all of the debris. He also tells you that he will tell him how much you are to pay him after he is done removing the tree. I see a frown of worry and concern appear on your forehead. Imagine how your client feels, and your ticket usually is higher than \$250.

Now also imagine that this tree is 2 meters from your house, and a bad removal could greatly damage your house. You still don't care how long it takes to remove the tree, but you want it done so that the tree doesn't damage your house. Do you have a different concern if the tree is on your 10 ha estate in the middle of nowhere? So you might seek a skilled tree logger if the tree is near your house but the neighbourhood kids if the tree is in the middle of nowhere.

The point is this: Many law firms focus on the product they sell – a patent application, a trademark license – and charge their client for the amount of time it takes to produce this product, irrespective of who their client is and irrespective of how important that particular service is to the client. My presentation deals with an alternative approach to the pricing of legal services based on how long it takes to do the job, the concept of "value pricing." How much is your work worth to this particular client?

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My presentation has three parts:

First, I will explain some of the problems with pricing legal services on the basis of how long it takes to perform them, meaning the problems with the cost of production, or billing by the hour times the hourly rate, approach.

Second, I will introduce the concept of value pricing, a concept that starts with an assessment of the client's needs and not with the lawyers' service product.

Third, we will work through some questions that a fictional intellectual property firm may want to ask when considering whether to apply the principles of value pricing in their practice.

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So, what is the trouble with pricing by the hour?

Think back to the tree removal guy. If he says he charges you based on how long it takes him to remove the tree, he essentially wants to be assured a guaranteed profit margin (cost of performance, plus $x\%$, that $x\%$ being whatever he thinks the profit should be to which he is entitled).

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In a law firm context, the cost structure of a typical law firm is shown on this chart.

If we start with fee income, being 100% or €1, typically, partners expect a 30% profit, the old adage being, 1/3 for associates and administrative staff, 1/3 for all other costs, and I, the partner, walk out with 1/3 of my fee income. No problem with that, but why not pick 45% or 5%? What right does the lawyer have to a guaranteed profit margin? Most business people will tell you, "none, really".

The other problem with this approach is this: if I increase my personnel costs (i.e. I add another associate), my fee income must correspondingly increase if I am to maintain my profit. Problem is: fee income will only increase if I can get the client to buy my service, if I can get the client to buy my product.

Add to that that nearly all of my costs are fixed, i.e. do not vary (immediately or in the short term) with revenue. This means that any increase in revenue helps maintain my profitability, and we know how that works, right: Either I increase my hourly rate or I increase the total hours worked, or both. What happens to the client when I increase my hourly rate? Remember the frown that you have when you talked to the tree cutter? So if I don't increase my hourly rate, I increase the amount of time it takes me to do the job. Another frown appears on the customer's forehead.

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Formulaically I can express my revenue model as follows:

My fixed costs (being that there are no variable costs) plus my desired net income (i.e. at my desired profit margin) are those that I need to cover by revenue. I either figure out how many hours I need to bill or how much my billing rate needs to be, but:

Look at the numerator: Still a cost based approach that purely focuses on the product that I am trying to sell and the profit margin to which I feel I am entitled -- and that is how I derive at what I must be entitled to charge my client.

If I am to retain my profit margin, this means that either my fixed costs must go down or my utilization (production) of that fixed overhead must increase

And here is the biggest problem: if I only have one rate that I apply to all of my clients (in the most extreme), then one the hours can go up, turning my client's wrinkled forehead into a cringe.

The real problem is: clients don't care about lawyers' costs, rate or hours; they just care about what our service will cost them.

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In the foregoing determination, other than the wrinkle on the client's forehead, the client was nowhere to be found. Having costs drive the price is a 100% inward focus. It ignores market demand and worse, it cheapens the great intellectual capital that many of you have spend years, even decades, to acquire into one commodity: the hourly rate. And it commoditizes what is otherwise a highly customizes service (especially in the IP context). So your client gets, for an off the rack price, a custom fit.

Add to that the client who demands a fee cap. Sure, you say, to please your client. I agree to charge you my hourly rate, up to a certain amount. If I stay within that, I will only charge you time incurred. If I go above that, I charge you the cap. So you have all the risk. In a fixed fee arrangement, if you get the job done efficiently at a lower cost than the fixed price, then you at least get to reap the benefit of your efficiency. If you have a cap, the client gets it both ways. On the other side of that coin, even the cap (based on production) ignores what that job is really worth to the client.

**When my costs drive my price, Determining price based on costs
Costs in law firms are generally fixed**

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For the law firm, all of this adds up to inefficient market pricing. There is no match at all between the service that you provide and the client's needs. Go

back to the tree pruning example. The client might be willing to pay a lot more than just an hourly rate times time spent if the tree does not knock of 19th century stucco off the wall.

The bottom line is this: Clients don't care about hours or charge-out rates. They don't care. At all. Clients care about value, to their specific situation.

But if you look at your firm and your product, figure out how much it costs to do, price accordingly , you don't match that up with the value to the client.

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Value pricing is a tool by which this value chain can be turned from upside down to right-side up.

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The principle is this:

Start with client

Figure out what the client values

Figure out – negotiate -- how much the client should be willing to pay for that value

Figure out what price delivers that value

Get costs in line to achieve the desired profit on the service you are selling

You gotta talk to the client – beforehand – and understand who he is and what he wants.

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Many law firms simply don't even attempt to value their services to the market. That is, because firms lack any effective means of measuring the acceptable client price, they consistently fall prey to overcharging in weak markets and undercharging in strong markets. When a firm charges more than a client is willing to pay, the client will either complain or take their business elsewhere. In either case, the firm is offered immediate feedback of their price being too high. No such feedback exists when the price is too low. Most law firms, being the risk-averse organizations they are, safely react to this situation by preferring to charge too little, thereby avoiding the risk of offending or losing a client.

So, but what do clients value?

Look at this 2004 survey of FTSE 100 companies.

Price came in not first, it came in sixths. 6th! So, while you are talking to your client about price, talk to him about whether you are doing these other five things, too, right? What do clients value?

Commerciality

Expertise

Innovation (now there is a new one)

Personal relationship with the lawyer

Responsiveness

If two lawyers charge €300 per hour and one is more responsive than the other, who wins? I don't think I have to answer that question for you

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So, you ask, Michael, what exactly is value pricing? Let me tell you what it is not. It is not gag reflex pricing. This means that we don't work on an engagement for three months, then send the client a bill that is so high that the client, when he opens it, "gags", chokes. Some lawyers do that. If the client recovers, he pays the bill. And if the lawyer was really good, really responsive, really commercial, the client may use him again in the future. Or maybe not.

It also isn't about negotiating the bill at the end of the engagement. Don't ever let your client be surprised. Don't ever let your client allow to have that gag reflex. Discuss with the client up front what he needs out of the service. Discuss with him up front how much you will charge for the service. Negotiate up front the total price you will get.

Now, how do I do that, you ask? Here are some tools.

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Knowing what value pricing is not, what then is value pricing?

There are 5 essential elements to the firm's value pricing model.

- 1. You must understand your lawfirm's overall strategy. This means it must have a strategy and the law firm's managing partners must constantly enable the other partners to implement that strategy.**
- 2. As part of that strategy will be the firm's value proposition. What that is and how we might apply it in the IP firm context will follow a little later.**

- 3. Based on the firm's value proposition, go out, talk to the client and determine how sensitive he may be to your price. Not every client is the same. More on that element later as well.**
- 4. Once you understand how each individual client's fits into the firm's value proposition, you agree – in advance, please – the price of that service that the client will pay. That means you have to define a scope of the work; it's called an engagement letter or at least a confirming e-mail what you will do for the client. If there is a change, you must agree on a change procedure, i.e. if out of a "simple" patent application becomes a more "complex" one or if the brilliant engineer who is to be your contact person at the client's changes to the bottom-end buffoon.**
- 5. Once you have the price understood, you figure out how to get the job done most profitably. Will you use that brilliant associate who is at a cheaper cost rate? Will you use computers to help? PSLs? Paralegals? Only the smallest amount of any job will require the input of a lawyer with 50 years experience!**

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Let us use an example to see how value pricing might be used in the IP firm setting

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Have a look at this completely fictional scenario of an IP firm, i.e. a firm that does nothing but IP work.

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To keep this presentation with the agreed time frame, I will focus on what I think is the two most important elements of the , i.e.

Understanding the firm's value proposition given the firm's strategy

Understanding the client'

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What is your competitive position/value proposition to client?

Price (cheapest)

Quality (best)

Different (niche)

The point here is this: It is exceedingly difficult for a lawyer to be all things to all clients. Who are you to your client? Who is Alpha and Berta? Remember the tree surgeon.

From the facts I gave you, I am not so sure it is.

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Now that we know what the firm's value proposition is, we have a look at how sensitive our selected client group might be to the price that we charge for our very valuable service.

There is really only one essential components that determine price sensitivity: understanding the client

Look at the client mix of Alpha and Berta. Shouldn't how it packages its services to each of these clients be different? Isn't the value proposition to the entrepreneur who has his first ground-breaking product to bring to market completely different, and the precision of the patent, e.g., so much more important than to megacorp that cranks out patent after patent in the hopes that one will stick? The entrepreneur may be willing to pay a much higher price because he has much much more to lose if there is a problem with the patent down the road (venture capitalist due diligence, trade sale, etc.) the Mittelstand company that does five patents a year may have different needs; we will come back to that.

So, here are some 10 questions that my partner Ed Wesemann developed that you may want to ask yourself before and during your price discussion with your client:

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1. How well does the client know what other law firms charge for the services sought? *(Clients without a point of reference tend to be less price-sensitive.)*

2. How difficult is it for a client to compare fees among competing law firms? *(The more defined the matter and the more routine the service, the greater the fee sensitivity.)*

3. How difficult is it for a client to change law firms? *(The less technically complex the matter, the more price sensitive the client.) How good is your relationship with the client? Is there value to your understanding the client's organization, from where to get information, who to talk to, understanding how the client ticks? Of course there is. Clients want*

convenience. They don't want to have to explain every time that Joe is head of engineering. Clients don't willingly change law firms (paneling aside)

4. How much importance does the client place on having a high-prestige, big-name firm, and are you such a firm? (Price-sensitive clients tend not to care about prestige.) Is it important for you to have prestige? This goes back directly to your value proposition! Is Walmart prestigious? Is Printemps or Neiman Markus? You get the idea.

5. In the scope of the client's legal budget, how significant is this engagement? (Clients tend to be more price sensitive on smaller, low-profile engagements.) Go back to the entrepreneur v. megacorp.

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6. How important is a successful result to the client? (Results with little impact on a client's profitability tend to be more price sensitive.) Again the entrepreneur and the Mittelstand.

7. Where does this engagement fall in the corporate hierarchy? (Engagements involving board of directors or corporate officer visibility are less price sensitive than projects reporting to people further down the chain of command.) A high profile software license litigation might be different from a copyright application.

8. Who's paying the bill? (Engagements subject to court or agency review or those where client cost is partially shared by an insurance or other company, tend to be more price sensitive.) Litigation context

9. Who initiated your first conversation about fees, the attorney or the client? (If the client initiates fee conversations or offers a fee agreement, it is a sure sign of high price sensitivity.) Set yourself apart by initiating the fee discussion yourself. Don't wait until the client gets his gag reflex!

10. What is the business purpose of the engagement? (If the objective is to correct or remediate a problem, the client may be more price sensitive than if the result were the accomplishment of a gain.) This feeds directly into the patent-loss leader problem that Keith addressed. The client is looking for a gain, but its outcome is uncertain because he doesn't know if 9 of 10 patents will be a hit. So, share the risk – get a kicker if the product does well!

The bottom line is that if a law firm is pricing to what the market will bear, it is necessary that it understand its clients' level of price sensitivity. And, logically, pricing to the market must take advantage of favorable market conditions as well as the unfavorable.

But going away from the pure hourly rate model allows the lawyer to be entrepreneurial and customize his service and his level of service to the value proposition and price sensitivity of the client.

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What does this then mean for the patent application which is the loss leader as Keith has addressed?

If we step away from the proposition of loss leader, we must understand the value proposition to the client. If the value proposition is purely driven based on price (who can do the job for cheapest), then we must find away to do the patent application at a lesser cost. In any law firm, this requires the use of leverage – use of less expensive associates – to drive the cost into the lower ranks of the firm. Yes, quality will go down, but providing a first class product and be in a price competition will equal a loss.

I can't maintain a value proposition that is based only on price if I run a 1:0.5 leverage. The key is to invest in systems, training and processes that allow me to do the job at a lesser cost. It's ok to have a loss leader, if it furthers my value proposition and therefore my overall firm strategy.

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What does this mean for the price sensitivity questions I have to ask?

Well, it depends entirely who my client is.

For the large corporate, one might think about a risk sharing agreement, such as a volume discount.

A volume arrangement, as work does contribute to the fixed costs which will not change if the work increases

A risk sharing arrangement coupled with a volume agreement, i.e. "we do all your work for cheaper, but we get a kicker if your patent takes off." The clients will like this because you share the risk in their business with them, and if you are getting squeezed on price because the application is a loss leader, you really have nothing to lose. The client will be much happier to pay the guy who helped him make lots of money a kick-back than pay, begrudgingly, some lawyer a high fee as a "hoop he has to jump through" to protect his work.

Again, it's ok if I have some loss-leading work, i.e. the patent application. But, if till loss-leading volume work

If law firm does this at a loss and patent maintenance work does not follow, all risk, no upside

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For the Mittelstand client, the value proposition may be different. You may decide that you specialize within IP and only to rocket-science bio-tech work. If you do that, the patent is still a loss leader. But again, what is a medium-sized business worried about?

Put yourself into the client's shoes: How big is the legal staff in a medium-sized client? 1 person? 3 people? Here, it's all about convenience. Take as much work off the plate of the client as you can. Once the patent is registered, how about the patent licenses to others? Doing the trademark work around the patented product? Now, you of course have to watch that you don't tick off your general full service firm that referred you this client in the first place, but that's a question of implementation and detail.

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Wrapping this up: Start with your client. Talk to your client. Figure out what drives that client. What does this client value? What is your value proposition to the client? What is he willing to pay? Then figure out how you get your work done in the most cost efficient matter so that you can make your profit.

Thank you very much for having me today.