Why Hourly Billing Survives

By Rees Morrison

Most law firms bill ninety percent of their time on the basis of the hours worked by lawyers and paralegals multiplied by their standard billing rates, despite virulent criticism of hourly billing over the past two decades. If, as critics harangue, the system breeds many problems, then there must be equally powerful forces supporting the status quo. Those reasons are economic, psychological, and organizational.

The Method is Simple

Law firms find it very simple to multiply hours worked by a billing rate; law departments find it simple to understand such bills. Alternative methods of billing inevitably introduce more complexity.

Comfortable Standard Completely Familiar to All Sides

Everyone knows the system. A generation of partners does not know of any other way to bill, such as the "services rendered" bills of the sixties and before.

Applies When No One Can or Wants to Calculate Value of a Service

Hourly billing bypasses the difficulty of determining ahead of time the value of a particular legal service. If a law firm obtains a permit for disposal of effluent, can the company state that the permit was worth $21,000? If a law firm labors mightily on an acquisition that falls through, what can be the value other than the hours worked?

For law firms, the value of the same amount and quality of legal work to one client could be completely different than the value of the same work to a second client. Yet, it simplifies life to stay with the common denominator—hours worked. An hour is an hour is an hour, as Gertrude Stein did not say. Yet, no one cares how many hours it took General Motors to build a car; no one asks how many hours it took to complete a movie.

Because most clients appreciate that legal work of any significance cannot be standardized, hourly billing prevails. Unlike changing a car's oil, mowing a lawn, or installing 500 square feet of hardwood flooring, much work of lawyers cannot be predefined with any precision. Because clients find it so hard to assess the value of work or the effort to be expended, they fall back on the comfortable alternative.

Part of the enduring prevalence of hourly billing comes about because consumers of legal services purchase them in a highly fragmented market. If much more knowledge were available about how a service is provided, and the likely cost range, such as is true with eye exams, root canals or architectural plans for home improvement, we would see a reduction in information asymmetry. The online bidding services are a step in this direction as are competitive bids for fixed-fee work. (Over time, this argument for hourly billing will weaken. Groups of law departments may share data and thereby develop a better understanding of what a plain vanilla service costs. Vendors, especially those who offer case management software that tracks outside counsel spending, may try to aggregate such data. Surveys by consultants and trade groups could feed this growing body of shared knowledge and prices.)

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Lets Law Firms Make More Money

Hourly billing allows, indeed encourages, profligate work habits. Cost-plus billing, where every hour recorded can be an hour of pay or recognition can degenerate into disregard for market discipline. So too the obvious benefit of being paid for working more hours can lead overtly or covertly to inflating the number of hours worked. Cost plus can also override scruples about quarter-hour billing increments, which are never marked down, only up. Law firms naturally cling to a system that minimizes their responsibility for efficiency and maximizes their ability to earn money.

In conjunction with hourly billing, law firms have fostered the notions of "produce error-free work" and "leave no stone unturned." Law firms can also hide behind the risk of malpractice: "If we don't research everything, we might be held liable." Law departments can relieve them of some of these worries.

Alleviates Tension-Causing Intervention by Inside Counsel

Many lawyers in law departments, to put it bluntly, not only have no reason to question hourly bills, but, in fact, have sound personal reasons for continuing the arrangement. Outside counsel relieve pressure on inside lawyers. That pressure can be the pressure of knowing the law, delivering the bad news, making a tough call, slaving over the weekend, traveling extensively, or simply shouldering the load. Why would a mid-level law department lawyer want to bite the hand that serves her? True, calls for cost control may come from the top of the company and pressure the general counsel, but it is hard to translate cost-control goals into actions that personally benefit the lawyer in the trenches. For those on the firing line, it is most convenient if law departments do not require budgeting or estimating value, but only look at hours worked.

Most people are adverse to confrontation. They do not want to ask difficult questions about the value of work done nor answer them. A statement that "we worked six hours on this" is harder to challenge than "this was worth $1,500 to you." The latter conveys a paternalistic attitude of superiority also. Neither side would like to give the other unilateral responsibility for determining the value of a service.

Law departments are as much at fault as law firms for perpetuating hourly billing. Law department lawyers do not need to think hard about the economics of an assignment or the value of its results if they only look at hours clocked. Bills submitted on an hourly basis allow in-house counsel the equivalent of the line item veto. They can focus on the small end of the telescope and question the hours spent at a deposition, rather than thinking about the larger contribution to their company of the law firm's services.

Minimizes Transaction Costs for Both Sides in Engagements

Transaction costs increase when clients and law firms deviate from hourly billing. The most efficient basis for an assignment is for the law firm to record its time and bill it; much less efficient is an arrangement whereby both parties must agree in advance on any method other than hourly billing. Thus, transaction costs diminish at the start of a matter when the law firm begins clocking hours and also at the end of a matter, when the bill can be easily reviewed.

To be sure, someone in the company who retains the law firm can estimate a value for the firm's prospective work, but that foray into the unknown (a) takes time and effort on both sides, (b) requires agreement, (c) and opens up the estimators on both sides to later criticism. Who will look back and say that $25,000 was the value to the company of filing the application before FERC? When a company retains a firm, if someone has to scratch her head to come up with the value of the work to be done, it takes effort and time. Both the company and the law firm must agree to the value of the work.

Hourly billing removes accountability from both the purchaser and the seller of legal service for assessing value "It is what it is, sorry." Other methods of valuing services require someone to make judgments.

Increases Management Tools Within Law Firms and Departments

- Tracking and billing time by hours aids lawyers in running their businesses. Partners in law firms can give assignments with more precision and clarity when they can suggest to an associate how many hours a task should take. If a partner says, "Why don't you research this for five or six hours and let me know what you get?" they give more guidance as to the work effort and investment than if they said, "Work on this until you reach a value of $1,200 to the client."
- It is easier to write-off hours than value. The partner can think, "This should have taken the associate only eight hours to complete, not twelve, so I'll write-off the extra four." If the partner has to say that this should have been only $3,000 of value, it becomes harder to decide the amount and explain the write-off of the extra dollars.
- It is easier to show the billable hours of an associate than the value delivered.
- When law firms plan for hiring, they can think in terms of full-time-equivalent lawyers, which is a rephrasing of hours.
- When law firms increase the hourly billing rate across the board for each class year, it protects the partners from making decisions about relative abilities and improvements of the associates. This decision automatically boosts income if all other factors stay the same. Law firms would have a much harder time arguing that every year the value of what they have done for their clients has increased.
- Hours billed are under the control of associates and partners; collections from clients if something other than known controls depends on the payment policies of clients.
- Hours tracked permit the calculation of many more metrics. If a law firm works only on fees collected, it cannot calculate realization rates, blended billing rates, hours per associate, or set minimum standards of performance ("Thou shalt bill 2,100 hours."). Hours worked provides a *lingua franca* in the legal marketplace.
- The system perpetuates the lack of emphasis on project management in law firms.
- The hours logged by a lawyer becomes a proxy for quality of work and competence of the lawyer.

Law firms accept the Darwinian notion that assignments flow to the more capable associates or partners, so the busy lawyers—those with 2,000 or more hours—must be the better lawyers.

- Hourly billing commodifies lawyers' work. Hours are fungible and those who produce an hour of work are more likely to be seen as interchangeable.

No one would quarrel with using hours as one aspect of setting prices for legal services. After all, the ABA guidelines for ethical billing expressly permit that. Doing so, however, raises the question of whether law firms should establish different billing rates for the same lawyer for different tasks.

Works Regardless of Volume or Type of Services

Whatever the legal service, and howsoever much there is of it, hourly billing can apply. By contrast, alternatives to hourly billing generally flourish only where there is a sufficient volume of work coming from a law department. A small company, without any lawyers inside, tends to know even less about the value of a service or what is involved in this service. What these companies can understand is that an amount of labor went into producing the document submitted or advice given. Where legal work is sporadic, it is more difficult to assess the value of that legal work.

Law firms, conservative creatures, welcome the risk adverse arrangement of hourly billing. They take on fixed-fee work if the volume is large enough, but for episodic work, they fret that the risk of loss is higher than the opportunity for gain. People making decisions are usually adverse to risk. Smaller law firms have even fewer resources to absorb variable risk than do larger law firms.

Fits with Lawyers' Risk Aversion

Clients of internal law departments and the law departments themselves, if they pay a law firm on some basis other than hourly rates, may fear the risk of paying a windfall more than they fear the possible extravagance of hourly billing. Most law departments charge the greater portion of outside counsel costs through to the business or staff unit that incurred the costs. At the very least, in-house counsel can say "the law firm worked all those thousands of hours" and it takes an astute critic to challenge where those hours perhaps were wastefully recorded. On the other side of the bill, law firms see the glass half empty if they evaluate sipping from alternative billing methods.

One could argue that those who work on an hourly basis will be more creative and diligent in finding what they should do on behalf of their client. Those who work on a fixed fee may seek to reach the end result as economically as possible, possibly at the loss of innovation and effort. Some departments worry whether the law firm will shirk when its budget runs out.

Allows Law Departments to Bask in Their Costs-Per-Hour Comparison

Law departments often compare their internal costs of operation, expressed as a fully loaded cost per lawyer hour, to the blended rate of outside counsel. It is a simple matter to divide the budget of a law department—excluding outside counsel fees and patent maintenance fees—by the number of hours that the department's lawyers performed chargeable work. The inside cost per lawyer hour ranges from $120 to $195 an hour. By contrast, the bills of outside counsel, divided by the number of hours logged by lawyers on the bills, comes in much higher, on the order of $245 to $300 an hour with large law firms. This comparison heartens law departments.

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Hourly billing survives, indeed reigns supreme. Its prominence has withstood much criticism and waves of management initiatives, such as bill auditing, task-based billing, LEDES, ABC, TQM, partnering, and knowledge management, all of which failed to change this deep-seated style.

The hegemony of hourly billing rests on interlocking and reinforcing pressures: simplicity, familiarity, profitability, efficiency, and amiability. Of these forces, we suspect that simplicity and profitability are most prominent. Next in priority are psychological issues of amiability and efficiency. These have led to the ubiquity and longevity of hourly billing.

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