

Soft Cost Recovery – What is the Future in the “New” Economy?

by Robert C. Mattern, Mattern & Associates LLP

The practice of soft cost recovery in the legal environment is under intense scrutiny. As clients are increasingly pushing back on soft cost charges and Partners are reluctant to charge anything “extra,” now is the time to take a fresh look at cost recovery practices.

More than 50% of firms have still not fully integrated into the print and scan sides of cost recovery, which leaves them with a declining revenue stream and increases the impact on their overhead. Copies and faxes are not nearly as standard in legal workflow as in the past, but cost recovery programs have not been updated to reflect this shift, to their own detriment.

Why is Cost Recovery a Critical Issue at this Time?

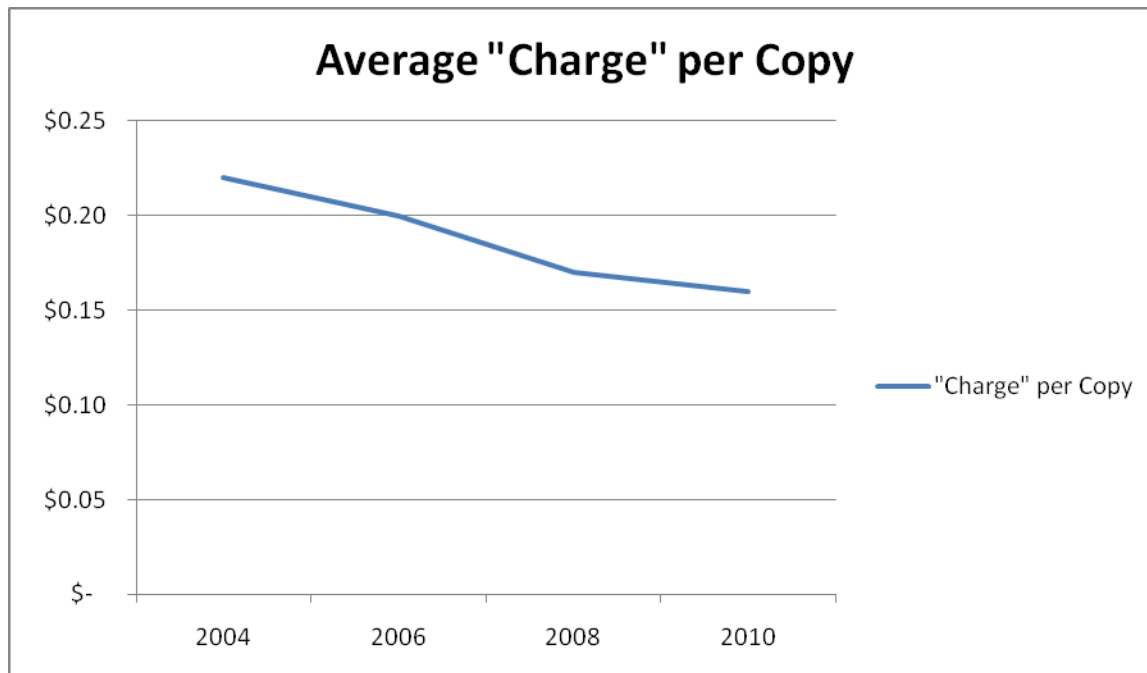
Hildebrandt Baker Robbins and Citi Private Bank reported in their 2010 Client Advisory: “Although law firms did a good job at paring back expenses during the past year through both staff reductions and aggressive cost control measures with revenue growth likely to be modest at best, more cost cutting will become the norm.”

Instead of just continuing to cut costs, law firms should explore alternative methods of cost recovery. The findings and recommendations outlined in this article have been developed through years of work and client engagements in the cost recovery area, as well as from the analysis of the Mattern & Associates LLC Cost Recovery Survey, which my firm has conducted bi-yearly since 2004.

The History of Soft Cost Recovery

The recovery of costs, particularly those which are directly attributable to a client and additional to the hourly or flat fees being charged, has been a long-time practice in the legal industry. The justification behind these costs has been that client-generated expenses accumulating above and beyond overhead expenses directly attributable to the individual client are additional to the legal services rate charged by the firm.

A “soft” cost is a charge for which there is no hard invoice, such as copies made onsite with in-house labor. The labor is covered under payroll, the copier lease is in another expense category, and the supplies are under another. This lack of a “total” charge with back-up (hard cost) requires the firm to develop a reasonable “charge” for the expense, thus passing the cost onto the client. These copy charges, previously in the 25 to 30 cent range, now average 17 cents per copy. The costs associated with the production of copies have continued to decrease and the clients paying these charges have become more aggressive in pushing back on these charges, therefore dictating the rates a firm can charge.



The other type of cost is a “Hard Cost,” Which is a charge where there is an invoice (back-up) for client-generated expense. An excellent example of a hard cost is overnight services, where the cost is clearly defined by the vendor’s invoice. In most cases (89%), the firm passes these costs through to the client without any mark-up.

The American Bar Association provides guidelines on these charges, stating that they should be “reasonable” and disclosed prior to the engagement, preferably in writing. In some situations, the firm has represented that these expenses are being passed through at cost, when in reality they were being passed through at an inflated rate. Charges passed through do not have to be at the firm’s cost as long as the firm discloses that they are being marked-up and the rate is deemed reasonable by the client.

What is the “new” legal economy?

The new legal economy and the impact it will have on the traditional law firm structure was a hot topic at the 15th Annual Law Firm Leaders Forum held last March in San Francisco. Without discussing leverage and firm structure, the deliberations about this topic touched on the continued pressure to reevaluate rates and to consider Alternative Billing Models/Fee

Structures such as fixed fee billing. Clients want more control over what is billed, how many hours are billed and how they are “charged.”

How does a firm respond?

In this economy and with the numerous pressures outlined above, how should a firm respond? First, a firm must acknowledge that the game and the rules have changed, not only in regard to support services and cost recovery, but to the overall client billing relationship. Emphasis is now placed on results, fixed costs and value.

In regard to the support services, I would recommend that legal administrators:

1. Redefine How You Examine Support Services

Stephen Covey states in his book, The Seven Habits of Highly Effective People, that a person should begin any task with the end in mind. Generally speaking, law firms have not done this with support services and cost recovery. For years, the mantra of law firms has been to maintain as many support services (copies, litigations support, etc.) on-site as possible. The reasoning was that the firm had invested money in the assets (equipment, labor, software, etc.) and wanted them to be utilized to capture cost recovery revenue. What began to happen is clients started refusing to pay for these in-house generated services.

According to our data, a firm will realize less than 50% of the revenue billed on in-house services. However, when a hard charge is generated (offsite work), more than 90% of these charges are paid in full. A prime example of this is a large Midwestern law firm that wanted to offer to their end users, and therefore their clients, complete in-house litigation support at considerable expense. The firm discovered after building the solution (and after the end users came) that the clients refused to pay for these in-house generated charges. The firm was then forced to try to dismantle the services and resume the original overflow model due to the significant impact on their overhead. Some clients also refused to pay for these services regardless of where they were completed.

I recommend firms define their support services by beginning with the cost recovery piece. There is no point keeping services in-house if you are not going to be reimbursed for the charges and if they become strictly overhead. In prior times this was an afterthought; now it should be the key driver in any support services analysis. Many times we are asked to conduct an outsourcing RFP for a firm’s legal administrator, but he/she is not interested in the cost recovery benchmarking aspect of our scope because it is not their area of responsibility. To make a fully informed decision regarding your support services, you must look at what you are getting paid for, or “the end,” as Covey would say.

2. Redefine Cost Recovery – You may be charging instead of recovering costs.

Do you “charge” for copies or do you “recover” your costs? Most people think it is one and the same, however, it is not. When you *recover* your costs you are recovering the direct costs of that product or service and it is easily substantiated. When you *charge*, you are formulating a rate based upon a combination of direct and indirect costs, or based upon what other firms charge. If you are charging a set price for copies (example 17 cents) and have to go through an extensive, convoluted analysis to justify this price to the client, then you are “charging,” and not recovering, your costs. If your Attorneys are writing off a substantial amount of soft costs, this is indicative that you are “charging,” not “recovering,” your costs. In the “new” legal model, clients are more likely to reimburse costs, rather than being “charged” for them.

One option is you can set up your own onsite outsourcing contract as a vehicle to recover the associated costs (we refer to this as “Mattern Plan B Cost Recovery™” - patent pending). This takes the firm out of the cost recovery business, offers lower rates to the clients and greatly increases the recovery of the firm’s costs.

In summary, with the current economic situation not dramatically improving for the foreseeable future and a painful round of cost cuts, is it time to look in another direction to bridge the expense gap? I believe that, revisiting and renegotiating the Firm’s cost recovery strategy and policy is an excellent area to examine to assist in further expense reduction.

Robert C. Mattern is President of Mattern & Associates LLC, support services and cost recovery advisors that service mid-size and large law firms. Mattern & Associates is a supporter of the ALA - involvements include exhibiting at the ALA Annual Conference & Exposition, presenting educational sessions for Chapter events, and publishing in ALA’s Legal Management Magazine. E-mail Rob at rmattern@matternassoc.com or visit Mattern & Associates website at: www.matternassoc.com.