FOR METRO AREA IN-HOUSE COUNSEL

New York Law Journal

ALM

GC New York Law Department Management

Thursday, April 17, 2008

The Road To Alternative Fees

Techniques to overcome reluctance of firms and law departments alike.

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Why aren't alternative fee arrangements more common? By now, it is widely recognized that parties need to find better ways to match performance to cost and value delivered. The first part of this article explains why both law departments and law firms are reluctant to try alternatives out. Two central reasons are: 1) the risk of agreeing on a set fee for what is perceived to be unpredictable work; and 2) the effect the fee may have on the quality of services provided.

More important, what are some techniques law firms and law departments might draw on if they want to abate the reluctance and increase the frequency of billing arrangements that are not based on hours worked? The article's second part discusses some methods.

For these purposes, the term "alternative billing" covers fee arrangements that are not based on hourly rates. Thus, discounts do not count nor do retainers, where a law department simply makes advance payments against eventual bills submitted. Rather, alternative fee arrangements fall into either of two broad camps: fixed fees or value-based determinations. A fixed fee might be per matter, such as $15,000 for a representative patent application or $400,000 to handle all environmental advice of a company for 12 months. A value-based determination is when the law department decides on the value of the services provided by the law firm, such as $25,000 to obtain a particular zoning variance. Another fixed fee might be based on a standard, such as $20,000 per 10,000 square feet of leasehold.

Both law departments and law firms view with some trepidation alternative fee arrangements. Here are four common reservations that I hear about during my consulting projects.

Someone may get burned. Both sides have fears. The corporate client worries that there will be a windfall to the firm, where the client pays much more than it thinks it would have paid under an hourly basis. The law firm worries about a hemorrhage, where its work exceeds its payment, i.e., the law firm takes a bath. Humans being predisposed to weighing potential losses more heavily than potential gains, the respective anxieties stop one side or the other from proceeding. As a variation of this, some in-house lawyers worry that the law firm might shirk its responsibilities if it looks like the money will end before the matter. The quality or quantity of work may decline as the firm nears its fixed-fee ceiling.

I disagree, and for three reasons. If you choose a reputable law firm, it is full of capable, ambitious, and proud lawyers who will do a good job. A firm presumably would like to re-enlist for a second round of legal services so it will keep pushing. Finally, the fixed-fee agreement can provide for performance milestones so that the managing attorney in the law department can compare progress to expenditures and minimize a mismatch.

The clock is ticking. Transaction time is the second deterrent to alternative fees. Put simply, it takes time, energy, and negotiating skills to figure out a deal. If the partner at the firm or the responsible lawyer in-house is busy, or disinclined to pursue alternative billing in the first place, it is easy to take a pass.

Comfy old shoes of hourly billing. Third, hourly billing, in contrast to exploratory, daring and novel alternatives, is familiar, trustworthy, and unimpeachable. Status quo is the comfortable default option, which makes it an uphill fight to get to a replacement that might or might not be better.

Dollars skew strategic choices. Another reason why there is reluctance by both law

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firms and law departments to venture into new billing terrain is that they fear the arrangement will skew judgment. As mentioned earlier, law departments fear that if a law firm reaches the end of its fixed fee, its dedication to the matter and quality of work will drop off.

Law departments also fear that if they create a bonus incentive, law firms will be driven to act on those incentives even if they diverge from what the department wants. This would happen, for example, if the company agreed to pay a bonus for a victory at trial. The law firm, knowing that it does not receive a bonus if the company settles the case before the trial concludes, would be motivated not to pursue all options even if settlement emerges as a more reasonable one. And what if the company thought that a scorched-earth policy made sense, and fashioned a bonus around that, but then later changed its mind and wanted a go-slow, lay-low approach?

Even with this caveat about alternative fees, no one can deny that hourly billing also drives strategy and firm performance. That which takes longer to accomplish may look more attractive to the firm; research into legal nooks and crannies has its appeal; and avoidance of early settlement may cut against the financial interests of the client.

Thus, the primary obstacles to entering into an alternative fee arrangement are risk, resources to devise them, upset to norms, and strategy concerns.[1] On top of this, if you stray from the beaten path of hourly rates at a law firm, you have to take it up with firm management.

Overcoming Hindrances

Fortunately, some techniques have been tried and found useful if firms and their corporate clients wish to overcome these hindrances.

Spread risk over a large amount of work. A sizable portfolio of work helps spread the risk of any individual matter and helps assure a payback for the effort of crafting the arrangement. With a bigger pool of work to be done, the law firm will make money on some of it, lose on other matters, but both sides will more likely end up with a fair outcome than if there is only one or a few matters. Obviously, some small law departments do not have large pools of work, so they can neither sink nor swim with alternative rates.

Share and analyze historical data. Sharing extensive data as much as possible also helps. Law departments need to be as forthcoming as possible about describing the historical data they have regarding amounts and types of work in the past, their management style, expectations of law firms, strategic goals, and plausible outcomes of matters, together with extrapolating all that background information into the future.

Law firms, too, ought to be more forthcoming about their experience handling matters of the kind being considered. Law firms rarely, if ever, mine their own data, let alone share it with the law department so both sides can better understand the economic parameters. For instance, a firm might analyze the average length and cost of all the responses it prepared to Equal Employment Opportunity Commission (EEOC) charges and offer that data as a reference point for the negotiations with a law department. Nor are all law firms frank about their profit margins and parameters for partner compensation, both of which play into alternative fee arrangements.

Reduce the risks. Techniques to protect both sides from adverse outcomes are available. For example, collars help. A collar is an understanding between the law department and the law firm that if actual costs exceed a certain amount or percentage or fall short by that there can be some correction. Additionally, an alternative fee arrangement might carve out certain unusual events. Stated parameters that hedge the bets of both sides will also narrow the range of unknowns and thus reduce risks. Holdbacks also cushion risks. If a law department defers payment of some portion of the fees, those held back sums can be used for a bonus at the end of the matter.

It might be that there is insurance available to protect both sides against unanticipated turns of event. If such insurance is not available, perhaps there ought to be a market for it.

Create hybrid deals. Arrangements can also be mixes and matches of hourly fees and fixed rates. A deal might include some work at hourly rates, where it is highly unpredictable, and some at agreed-to amounts, where the services are predictable or very large. In addition to both of those techniques, the alternative arrangement may need to be revisited periodically and it may be better to wait until further into a matter.

For this reason, sometimes law departments agree to pay on an hourly-fee basis for an initial period, perhaps 30 or 60 days, and then negotiate something other than hourly billing. The initial period, often referred to in litigation as "early case assessment," covers basic fact investigation, preliminary strategy sessions, budgets, and familiarization with each other. Both sides thereafter have a better understanding of what will be involved and the costs. The problem then becomes whether the law department has any realistic leverage once it starts to negotiate an alternative fee arrangement.

Match bonus amounts to likelihood. Bonuses for the law firm that achieves a particular goal, such as resolution of a case before substantial discovery begins or completion of a transaction by a certain date, need to be in line with that probability.

If the odds of a bonus at the outcome are less than one in four (25 percent or less) a bonus might be sizable, such as up to 50 percent of fees billed. Whereas, if the company is likely to prevail substantially on a motion for summary judgment or complete the zoning approval by year's end, the bonus for that success ought to be negligible. Regardless, a bonus as percentage of fees is not the only standard. An absolute dollar amount might also work its charms.

Trust and respect each other. Trust goes a long way in these arrangements. If the law firm has represented a company for years, both sides have a reservoir of respect and confidence so that the alternative fee arrangement will not strain the relationship. In the end, both sides want an ongoing relationship and both sides may have to give and take a bit.

Law firms and law departments need to explore alternatives to hourly billing. The pressures these days are great to match performance better to cost and value delivered. Although there are acknowledged challenges to fashioning alternative fee arrangements, there are ways to ameliorate those challenges.

1. Another concern with alternative fees arises from the accounting side. Law departments are typically required to accrue for legal fees unpaid, and it is hard to decide whether and how much to accrue for some alternative arrangements.