FOR METRO AREA IN-HOUSE COUNSEL

New York Law Journal

ALM

GC New York

Thursday, November 15, 2007

Law Department Management

Most-Favored Nation: Least-Favored Arrangement

Requesting the best rates has its problems.

BY REES W. MORRISON

IN their efforts to reduce what they spend on outside counsel, many law departments have asked the firms they rely on significantly to give them a special privilege—the best hourly rates that the firm has agreed to for any other client. Like agreements between nations to lower tariffs to the lowest rates applied to the best trading partner, these so-called "Most-Favored Nation" requests may seem innocuous, but they are not.

Not that MFN requests are every-day occurrences. Mostly, only large and prestigious companies' law departments feel they deserve the best treatment. Even then they press for that advantage mostly with law firms where they spend a lot and over whom they have some leverage. But an MFN demand seems like an easy cost-saver and it is simple to explain, so we are likely to see more such requests by law departments in the coming years.

I am not in favor of MFN arrangements. I dislike this request, despite having consulted to law departments for 20 years on how to manage costs. My objections, discussed in this article, fall into three areas: philosophical, economic and practical.

Rees W. Morrison, *co-head of law-department management consulting for Hildebrandt International, hosts the blog www.LawDepartmentManagement.typepad.com. He can be reached at rwmorrison@hildebrandt.com.*

Philosophical

Philosophically, it seems to me unfair to piggyback on the negotiation efforts, longevity or volume of other law departments. Perhaps some buyers who want to drive down legal costs could care less about fairness, but long-term business relations depend on some shared trust and evenhandedness.

Second, it seems clear to me that no attorney-client relationship is exactly like any other such relationship and therefore no economic terms between lawyer and client can be on the same footing. Even the simplest criterion, amounts paid to a law firm, is not the same client to client.

A law firm can distinguish any client from any other client, and honestly (though disingenuously) swear that "your company gets the best rates of all our clients like you." One client might have a law firm representing it in a massive class action lawsuit; the second might use the law firm for two or three acquisitions. The technologies, resources, client knowledge, intensity and other factors differ hugely. Since no client is identical to another, a basic philosophical premise fails.

It is blazingly obvious that not all clients are created equal, and not all competitive arrangements deserve the same treatment. Can law departments insist on symmetrical terms? MFN arrangements make both sides hypocrites. Law departments think they are better than they are in the eyes of the firm, and law firms sign on for what they know is unenforceable. MFNs breed loose morality.

Thus, from a philosophical standpoint, MFN agreements lack fairness, ride roughshod on logic, and breed poor morality.

Practical

Consider the practical issues arising from MFN arrangements. One is that large law firms find it difficult to monitor the constantly changing swirl of billing arrangements its partners agree to. A comprehensive, diligent and intrusive effort that clamps down firm-wide on variant billing arrangements might ferret out some near-equivalents, thus preserving MFN commitments, but the hours and heartburn would not be worth it. For example, firms will find it hard to manage individual write-offs on bills or other accommodations, such as prompt payment discounts. My suspicion is that firms don't even track and analyze all their idiosyncratic engagement terms.

During a recent webinar, a law firm partner rued the difficulty of assuring clients "our best rates," especially when discounting is rampant. Within a large law firm, it is nearly impossible to know the different permutations of write-offs on bills before they go to a client—and then under an MFN commitment how does a firm handle amounts written off after objections by clients?

In the real world, how can a law department find out what another company is being billed by a firm? If you can't verify a law firm's compliance with your terms, how practical can it be? Second, there are too many dimensions

to any given matter. Matters differ so much in staffing, complexity, prior familiarity, write-offs, billing policies, availability of law firm resources, urgency, partner personality, firm compensation systems, and a host of other dimensions. And many of these change over time. It's impractical to think there can be equivalence.

Even more fundamentally, since the quality of lawyers working on matters of various clients differs, as does the consistency of the team, what does it assure a client if billing rates are as low as any comparable client is offered? MFN rests on hourly billing rates, which is enough to hold it in contempt. By that I mean that hourly billing encourages firms to bill more hours. Billing by the hour is tantamount to cost-plus agreements, and the pressures to bill more time to a matter are constant.

Looked at pragmatically, therefore, most-favored nation agreements can't be patrolled by law firms or enforced by law departments. Further, they are based on hourly billing rates, which is a suspect economic arrangement.

Economic

From an economic perspective, MFN agreements thwart competition and improvement. If pressed to accede to MFN status, law firms, quite naturally, will eventually say that they cannot agree to give any law department automatically equivalent arrangements because of the cascading problem. If they agree to lower rates for one client, that theoretically should set in motion equivalent reductions for other MFN clients.

Even so, a law firm's refusal of an MFN guarantee, rate discounts, or other alternative fee arrangements because "if we do it for you, we'll have to do it for everyone" is flimsy.

In an ideal world, billing rates should not be monolithic for any lawyer—fixed for the year no matter what the lawyer is doing or for what client under what circumstances. Even less should rates be fixed by year out of law school or on some other broad band of lawyer, such as third-year partners.

More creative law departments, those that negotiate better economic arrangements, are penalized if another law department can free ride and gain from their structuring or negotiating prowess. I am completely in favor of each law department striving to obtain the best terms from those law firms that represent it; I oppose concepts that get in the way of innovative and free-flowing deals between firms and departments.

> It is blazingly obvious that not all clients are created equal, and not all competitive arrangements deserve the same treatment. Can law departments insist on symmetrical terms?

Another economic point argues against these agreements. To my understanding, MFN agreements primarily govern the billing rates of individual lawyers. The firm says: "The hourly rates we charge you will be as low as the rates we charge our client who gets the most advantageous billing rates." An MFN assurance could also apply to flat-fee arrangements. "If our best client pays $16,000 for a routine patent application, we'll charge you the same."

What MFN does not apply to are discounts off a bill. Hours are hours, but each matter is unique. Write-downs on an individual matter can't adhere to MFN commitments. If this reasoning is true, and write-offs don't fall under the MFN guarantees, the economic barn door hangs wide open.

Nor are all dollars to a law firm the same. For many law firms, cutting-edge litigation for a prestigious client is worth more than the same fee income from a passel of commodity cases for an obscure client.

The third ground for tossing out MFN agreements, economics, emphasizes the race to the bottom that it triggers, the blow against competition, and the non-monetary aspects of some representations.

Conclusion

MFN agreements should be one of the least-favored techniques for law departments to pursue. As any lawyer knows, you can distinguish the facts of Situation A from the facts of Situation B, so no representation is like any other representation. Inherent contradictions exist when a law department seeks similar treatment to what can always be viewed as dissimilar circumstances. Worse, the dance around MFN causes administrative friction, not to mention evasion or hypocrisy on both sides.