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Alternative Fee Arrangements: The Time Finally Has Come

By Thomas S. Clay and Daniel J. DiLucchio

Introduction

Seismic shift! Transformational change! The end of lawyers! Death of the billable hour! Power to the clients!

With all of the changes in the legal profession today, perhaps more than any other issue, the current conversation revolves around the use of alternative fee arrangements (AFAs). Are we truly on the brink of a tsunami about to break over the legal profession — bringing irrevocable changes? Or are we at the leading edge of a developing dynamic in the legal profession whose resulting change is unclear?

What is clear, even to the casual observer, is the rapidly burgeoning interest in alternative fee arrangements among clients and in particular general counsel. We see a growing, probably permanent, change to the value proposition between clients and firms. Its magnitude and pace will be determined by competitive pressures from clients as well as competitive responses by law firms.

New law firms are springing up, founded on the premise of alternative fee arrangements and a new and different value proposition. The degree to which these "disrupters" will hasten change may be very high. As clients become accustomed to new, value-driven fee arrangements, they will see greater and greater benefits, including cost management and predictability. Once AFAs are in place, we see no obvious reason or rationale for a return to the billable hour.

Thomas S. Clay

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Our experience suggests that every practice area, or at least some portions of all practices, in every law firm, has the potential to offer alternative fee arrangements. There is a presumption among some lawyers, and it seems especially prevalent among litigators, that because their practices are so complex or unpredictable, alternative fee arrangements will not work. If this is true, how then can other (fast-growing) law firms that deal with the same variables offer alternative fee arrangements? Alternative fee arrangements are being used in *all* areas, and firms must learn how to use them effectively.

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SPECIAL ISSUE: ALTERNATIVE FEE ARRANGEMENTS

James Wilber
Editor

Alternative Fee Agreements: Back to the Future

It's back to the future for legal pricing. For several hundred years, lawyers priced their services based on what value was being conveyed to the client — with time expended being only one criterion of that pricing equation. For the last 20 years the profession has been talking about getting back to that model, and in the next few years we may actually see this movement finally come to fruition.

Pushed in this direction by clients who face enormous pressures related to the cost of legal services, many law firms are looking for ways to get back to a value-based billing model. Clients want to meet them in this revisited future. What is clear about the journey is that it will end well and be successful from a commercial point of view only if both lawyer and client can find a *mutually-beneficial* pricing structure.

Value-based billing that originally arose from a trust-based relationship between lawyer and client is now being driven by hard economic realities and an increasingly commercialized profession. But ironically, the end result may actually be renewed collaboration as we find a new equilibrium, because the surest way for alternative fee agreements (AFAs) to succeed is for them to be mutually beneficial and based on a relationship of trust.

"... many law firms are looking for ways to get back to a value-based billing model."

As far back as the literature about AFAs extends, it is rife with references to the need to have such arrangements result in a better situation for *both* the client and the lawyer or law firm representing it. This, of course, makes complete sense, for how would it be possible to make such a dramatic change in the way that legal services are sold and purchased, transactions often worth hundreds of thousands, if not millions, of dollars, if the outcome truly was not better than the status quo for both the law firm and the company? Who would consider taking such a leap, much less actually jumping, unless the end result held out a promise that this was a better way to transact legal business for both parties?

This article explores the relationship dynamics involved in clients and their lawyers moving away from basic time-and-materials pricing to the promising new methods being adopted around the world, and posits the premise that such new arrangements will not be successful, nor will they ever be sustainable, unless the relationship between the parties is one of trust, where both sides move away from their historical pasts to a better future that win-win AFAs can provide. The article does not address AFAs where the work is completely routine and predictable or where the only consideration is cost. Those fee agreements are easy to construct. Instead, it addresses the more complex and sophisticated types of legal work, be they litigation or transactions, and the less predictable, where the goal of entering into a new arrangement that will actually be beneficial to both sides is paramount.

The Billable Hour — a Brief History

Any history of the billable hour needs to start with the first of what is now four books published by the American Bar Association on the topic of hourly pricing and the movement away from it. As was asserted at the very beginning of that first book in 1989[1], "law firms and corporate counsel agree on one issue: current methods of valuing legal services and billing need to be reworked." That first book arose from the work of a taskforce appointed by the ABA's Section of Economics of Law Practice (now the Section of Law Practice Management) in 1987. The taskforce's efforts resulted in the landmark first book mentioned above. The book served to initiate a dialogue between law firms and clients and encouraged practitioners to begin adopting innovative pricing methods.

The first two chapters contain an excellent history of how legal services had been priced over the years and how they might be priced differently going forward. Dick Reed wrote the first

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Arrangements ... *continued from cover*

While we do not anticipate the seismic shift some are predicting, we do believe that all lawyers in all law firms of any size need to take note and start making some decisions about how to proceed. The response should be thoughtful, but swift enough to be useful and relevant.

Strategic Necessity or Competitive Opportunity

It concerns us that too many lawyers either are not paying attention to what's going on in the marketplace or, through complacency or arrogance, are ignoring the evidence. Some are comfortable in a fur-lined rut. One of the biggest threats law firms face is attaining a competitively viable strategic position *too late*. Once other firms have developed, refined and begun to use AFAs competitively, it will be very difficult for followers with minimal experience or knowledge to compete. If an RFP asks for an AFA proposal, a firm must be able to respond intelligently. If a client says "Another group has offered an alternative fee, what can your law firm offer?", the response cannot be "What would you like?" or "I'll get back to you."

It is imperative that law firms, regardless of their current thinking and experience with alternative fee arrangements, adopt one of two strategic positions: reactive or proactive. Doing nothing, waiting to see how other firms handle alternative fee arrangements, or waiting to see what clients ultimately decide once they have greater experience with this tool, are not viable options for a successful law firm.

As one general counsel said, "If a lawyer cannot offer me an alternative fee, I will find an alternative lawyer."

Strategic Necessity

Considering the development of AFAs as a strategic necessity is the bare minimum that a firm must do to stay in the game going forward. (Ideally, over time, firms will build to the second, more sophisticated stance.) In this baseline posture, firms will acknowledge that it is very likely clients will ask for proposals which include alternative fee arrangements, and that most RFPs will include similar requests — and they will be prepared with specific AFA responses. A firm that waits for an RFP to arrive before beginning work on AFAs is already behind the curve.

To be ready, firms must do the work necessary to determine what sort of alternative fee arrangements they can offer, articulate how the AFAs will benefit the client and understand the internal implications to the firm's processes and profitability. Although in this posture firms may not be able to aggressively market alternative fee arrangements, they at least will be well prepared to respond quickly and clearly to RFPs, and will be able to demonstrate that their proposal is reflective of clients' needs.

The ***strategic necessity position*** would include:

- ***Education.*** Law firms must develop initiatives and processes to educate their lawyers fully about alternative fee options and current market offerings. This should be discussed firm-wide and practice area by practice area as well.
- ***Inventory.*** Many lawyers cannot tell you what types of alternative fees their firm has offered in the past. Most firms don't have a centralized means by which to collect data on what has been proposed or done, or what has been successful (or not). This information needs to be systematically inventoried and made available throughout the firm to improve the educational process.
- ***Project Management***. It is impossible to propose alternative fees — and still be successful economically — without making changes to legal service production processes and improving internal project management skills. To try to invent a project management process *after* an alternative fee proposal has been tendered and accepted has proven disastrous in the past. Firms should immediately dedicate themselves to understanding the discipline of project management and begin to educate lawyers on its scope and scale.
- ***Cost of Services Data.*** Firms should begin to develop means by which they will evaluate the cost of services sold in order to determine how to price and evaluate alternative fee arrangements. Although it is difficult in most cases to get absolute precision, there must be a fundamental understanding of how to develop and use cost data effectively. Again, waiting until after alternative fee arrangements have been proposed to develop the data may lead to disastrous economic results.
- ***Fee Approvals***. It should be made clear that centralized approval of alternative fees will be required, at least early on. There are too many

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AFAs Defined

Let's be clear. AFAs are defined as a fee arrangement that is not based on hours multiplied by rates. Therefore, an AFA might include flat fee or fixed fee arrangements. AFAs are not discounts on hourly rates, blended rates or progressive discounts. In addition, AFAs should not be confused with alternative billing arrangements, which might include such techniques as retainers, quarterly payments, discounts for prompt payments or other methods of billing.

Arrangements ... *continued from page 3*

instances in which partners have unilaterally proposed fees that were not appropriate or economically sound. Many firms are appointing committees or "fee czars" to review and approve alternative fee arrangements. All firms should do this.

If firms that are just beginning to deal with AFAs will commit to each of the above steps, they will be in a far better position to deal effectively with current clients who make AFA requests, and to respond to such RFPs. As they gain experience and knowledge and achieve some initial success, they should have the means to move to a more aggressive approach, if desired.

Competitive Opportunity

Approaching AFAs as a competitive opportunity takes a firm to the next level. Initiatives should be directed toward maintaining current clients and their work, as well as moving the firm forward in acquisition and growth of new client work by proactively demonstrating a willingness to engage in alternative fee arrangements. This is an aggressive position requiring rapid change and agility within the firm.

Achieving this position includes all of the elements of strategic necessity described above, plus:

- ***Start with Current Clients***. We recommend that firms select a manageable number of current clients with the objective of determining whether or not each of those clients might benefit from alternative fee arrangements. Every client has different business, strategic and operational objectives, as well as legal objectives. In addition, larger clients have multiple objectives depending upon the different types of work they need. Therefore, each client has to be treated separately and independently in determining whether or not they are logical AFA candidates. In the best of all worlds, the determination is reached collaboratively, with the client participating as an equal partner.

- ***Marketing***. Although not all clients have decided AFAs are the route for them, many have. In response, many firms are now marketing their expertise with alternative fee arrangements. It is unlikely that widespread generic marketing will suffice. Instead, firms should focus their efforts by practice type, industry, etc. Firms will need to be careful about selecting areas of focus, as it is not likely that THEY can engage in all kinds of alternative fees for all clients at the same time.

- ***Cultural and Operational Issues***. When firms begin to consider alternative fee arrangements, lawyers very quickly begin to spot potential challenges and conflicts. For example, how do you "credit" lawyers for fee revenues? If people have been paid based upon the number of billable hours recorded, what does this change mean? What if the alternative arrangement actually results in a less than profitable outcome? All of these questions are important and will need to be dealt with by firm leadership proactively in order for any firm to engage in the competitive opportunity position.

Getting Started

What should a law firm do to get started? Don't be surprised when you search the literature surrounding AFAs and don't find an easy answer. This will require work; there is no silver bullet or magic wand. We recommend that you take the steps outlined below. Some firms may have already started down this path, or jumped into the middle, but each step is an important facet of a full, effective AFA program.

1. ***Ensure leadership support***. This is fundamental. Experience proves that a guiding coalition dedicated to development of resources, methodologies and processes will ensure real accomplishments. Such a coalition might work across various practice groups, assisting in evaluation of opportunities, establishing methodologies, and defining acceptable alternative fee arrangements.

2. ***Proceed with specific practice groups or specific lawyers first***. Often there will be practice groups that seem to lend themselves to AFAs (e.g., labor and employment, intellectual property) or there may be lawyers who understand the need for AFAs and are enthusiastic about the opportunity. It is always better to begin with a high degree of enthusiasm.

3. ***Develop an "inventory" of firm experiences with AFAs***. We have found that many firms are not aware of other fee arrangements that have already been negotiated. This is an opportunity to evaluate experiences, successes and failures – and then build upon them.

4. ***Set measurable objectives at the firm, practice area, or client level***. For example, set a goal that 20% of the firm's fee arrangements will be AFAs within 12 months. A measureable goal will ensure progress. Without it you will not progress very quickly.

5. ***Break down projects, matters and litigation into component parts***. This will provide a much more manageable way to evaluate costs, processes, staffing, technology and other efforts required to produce the work. Many firms struggle with alternative fees because they are trying to create AFAs on a firm-wide or practice-wide basis. This is usually too broad a basis to be effective.

6. ***Collect cost data about past matters, transactions, and projects***. It is important to dig deeply and understand what it costs the firm in terms of time and effort to produce work. This, however, is only a first step. The time and effort spent on prior matters is good to know, but don't assume that the firm was performing at peak efficiency on those matters. This is where project management and reengineering come into play.
7. ***Reengineer work to achieve a reduction in time, effort and overall costs***. Rethink staffing choices to be sure that the right people (lawyers, paralegals, staff) are performing the right level of work. Be sure to evaluate the need for additional or new resources such as systems analysts, program managers, and IT people. The importance of effective management, including delegation, staffing, and the use of technology cannot be overstated.
8. ***Start potential initiatives with current clients***. AFAs work best when a relationship of trust already exists.
9. ***Review the results, learn and adjust***. There is risk and potential failure. Don't let this reality deter efforts. As some would say, if you aren't ever failing, you aren't trying hard enough.

Leading Change

Make no mistake, this is all about change — and potentially rapid and extensive change. To be effective in implementation of alternative fee arrangements on any broad scale, it is critical that firm leaders get change management right. By far the best resource, in our opinion, is the change management principles set forth by John Kotter in his book *Leading Change*. Rigor in following these principles will greatly enhance the potential for a successful outcome.

Kotter suggests:

- ***Establish a sense of urgency***. Kotter believes that at least 75% of key individuals need to share urgency in order to succeed. He also suggests that in the absence of this sense of urgency, complacency will overtake any initiative.
- ***Form a powerful guiding coalition***. Many firms have developed task forces to study or evaluate AFAs. This is not enough. Your leadership group must have the mission and authority to begin implementation throughout the firm.
- ***Create a vision and communicate it effectively***. The vision should be relatively simple, specific and provide guidance to senior leadership. An objective such as "25% of our fee revenue will come from AFAs by 2012" is clear and compelling.
- ***Empower people to act***. We recommend that practice group leaders not only be empowered, but encouraged to act as they lead the efforts of their constituencies.
- ***Consolidate improvements and produce more change***. Evaluate where you are effective, but also where you have not been effective, in winning business and being profitable with AFAs. Sharing this knowledge across the organization is absolutely required for the best progress to be made. Digital dashboards and other technologies facilitate this.

Finally, as a corollary to Kotter's principles, we believe that it is imperative to ensure alignment of internal law firm policies, systems and procedures that are affected by your new initiative. As we stated previously, you will need to make changes in fee structures and work process, and there will be other areas that will be impacted and require your attention, including:

- Alignment of compensation systems with new strategic objectives (behaviors you want to reinforce) and metrics. Current alignment in law firms evolves around personal fee receipts, billable hours and origination. This is insufficient for the new model and potentially counter-productive.
- Alignment of professional development training to ensure building requisite skills such as project management skills.
- Alignment of marketing and business development activities to ensure that they support the vision.
- Realignment of client relationship strategies and tactics at a fundamental level to ensure collaborative implementation and ongoing assessment of AFAs.
- Increased engagement by leaders at the firm, practice and office levels who inspire and encourage people to achieve alternative fee objectives and take necessary risks.

Summary

Close observers of the legal profession believe strongly that the use of alternative fees will increase, but there is no agreement as to how fast the change will occur. We think it is abundantly clear that firms that want to maintain a competitive stance must at least adopt the first position set forth above, while those that want to set the pace for their competitors will act aggressively to seize this critical opportunity in the new legal market. ◆

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Pamela H. Woldow

GPS for General Counsel: Navigating Fee Transition

By Pamela H. Woldow

As we enter the seventh quarter of the Great Recession, pundits have varying ideas about the direction in which the legal profession is moving. Some predict a continuing skid: more layoffs, less and less work for law firms, more law firm failures, attrition everywhere. Others talk optimistically about "things getting back to normal," a recovery that supposedly will lead back to the *status quo*, to calm waters and pre-recession revenue models. Still others foresee a "new normal," that is, a restructuring of legal economics and the changing face of the relationships between inside and outside counsel.

Frankly, the truth seems to be that no one can claim a firm fix on exactly where we're going. There are no reliable GPS devices to map the new topography of the legal landscape, no reassuring synthetic voices saying, "turn left here," no step-by-step directions for where to turn and how fast to go. That said, all corporate counsel report one near-universal map coordinate: the injunction from their senior management that they "do more with less"— sometimes a lot less. For 2009, on average, corporate legal departments were on the receiving end of budget cuts of 11.5% with a range of 0 to 75%, according to the *Altman Weil Flash Survey on Law Department Cost Control*.

There are, of course, two parallel courses for law departments with regard to legal cost belt-tightening: trim administrative overhead and salaries or reduce the outside legal spend. In 2008 and 2009, cost-cutting has been the number one priority, and most law departments have sought ways to control costs and rein-in budgets in both areas. That effort makes enormous sense since a recent BTI survey reported that, on average, corporate legal departments have experienced a staggering 75% increase in legal services costs over the last ten years, far outpacing inflation.

"... corporate legal departments have experienced a staggering 75% increase in legal services costs over the last ten years ..."

This article focuses on tactics and techniques general counsel and chief legal officers are employing to reduce their outside legal spend. It also examines whether those tactics are working.

You can't talk about reducing outside legal spend without talking about alternative fee arrangements (AFAs). Although AFAs have been touted as a significant means of achieving savings for years, the recession has made them a hot topic of late, even though the term is used quite differently by different people. While AFAs have no universally-accepted definition, a useful baseline starts with what they are not. *AFAs are methods of pricing the delivery of legal services that are not based on the billable hour or solely on any other measure of time spent*. (Thus, discounted hourly rates, blended hourly rates and volume discounts predicated on hourly billings are not AFAs).

Instead, AFAs are approaches to pricing services that better reflect the *value that the client places on particular legal matters and the value conferred by outside counsel*. Examples of "real" AFAs include fixed or flat fees for multiple matters or classes of matters; fixed or flat fees for single matters; fixed or flat fees for phases of matters; retainers; and/or contingent fees.

The cardinal virtue of AFAs (from the in-house counsel's viewpoint) is that they permit greater predictability for forecasting, budgeting and controlling legal spend. Their cardinal shortcoming is that they represent new and uncharted territory for many general counsel long-accustomed to time-based fee arrangements.

Going in the Wrong Direction

Many general counsel suffer from the illusion that negotiating a discount in hourly rates will prove a panacea for all their cost problems. No need to go through all the rigmarole of determining how to define and assess value,

they think; just get the law firms to knock down their rates and the total dollar outlay is bound to diminish.

Not necessarily. Many general counsel have said that when an outside law firm's hourly rate is discounted, often the amount of time or the number of attorneys it takes to complete a task increases correspondingly, thereby nullifying the discount.

Our current economic woes have popularized another variation on this theme, one Susan Hackett, Senior Vice President and General Counsel of the American Corporate Counsel Association, has named "the merry-go-round-of-firms-raising-rates-so-clients-will-demand-discounts." Whether or not the client realizes they are helping to perpetuate this cycle, this exchange does not support strong, institutionalized, trusted relationships over the long-term. It is not the way to create a predictable spend (because hours tend to "float" inversely to the present negotiated rate), and it doesn't create a drop in total legal spend either. Discounted rates have all the same downsides of billable hours, with the added detriment that they add hours inflation. As Patrick Lamb of the Valorem Law Group puts it, "the most critical failing is that it puts the lawyer's economic interest at odds with his or her client's. The lawyer has an economic incentive to bill more, not less."

Charting a New Direction?

Recognizing that discounted rates often do not in fact generate reduced legal spend, many sophisticated legal departments are buying heavily into AFAs. For example, almost half of United Technologies' legal matters now are handled under a variety of alternative fee arrangements, from fixed fees to a combination of fixed fees and bonuses. This year, 45% of Microsoft's outside counsel fees will be paid under alternative arrangements. Pfizer is using a single firm to handle its U.S. labor and employment work for 2008 and 2009 on an alternative fee basis. Tyco has switched almost all of its outside legal work to an alternative fee structure. The list of other companies that have begun using AFAs is now quite long; a sampling includes Levi Strauss, American Express, Burger King, UPS, Boehringer Ingelheim, Cisco, Prudential Financial, and General Electric.

The above notwithstanding, either we're still at the nascent stage of a fundamental paradigm shift in legal billing, or else a lot of lawyers — in-house and in firms — are convinced that AFAs represent a passing fad. In a flash survey conducted by Altman Weil at the end of 2008, 82.6% of surveyed general counsel reported that less than 10% of their outside legal fees were AFAs.

Still, AFAs seem to be gaining traction, suggesting that a fundamental change may be underway. By April 2009, a survey conducted by the Association of Corporate Counsel found that a stunning 77% of members would like to consider alternative fee arrangements in work handled by outside counsel. A survey of corporate legal spending for 2009, the BTI Premium Practices Forecast, predicts an increase this year of more than 50 percent in corporate spending on alternatives to the traditional hourly fee model. The BTI survey of 370 lawyers who work for Fortune 1000 companies found that their AFA-spend has totaled $13.1 billion so far this year, versus $8.6 billion for the same period in 2008, and has produced average cost savings for those corporate law departments of 15%.

These are clear signs that the transition is gaining momentum and appears to be a trend. As one wag put it when asked the difference between a fad and a trend, "Trends matter, and trends shape the future. Fads fade."

Resisting a Change in Direction

The groundswell of belief that AFAs represent the future direction of legal pricing — or at least *one of several directions* — is not embraced by all. Many inside and outside counsel are not willing and able to enter into or entertain AFAs. They raise a litany of objections, which we summarize in the table on page 8.

This list of anti-AFA rationales is mentioned at every conference on legal pricing, whether attended by corporate counsel or law firms. Feelings run high, the first-adopter

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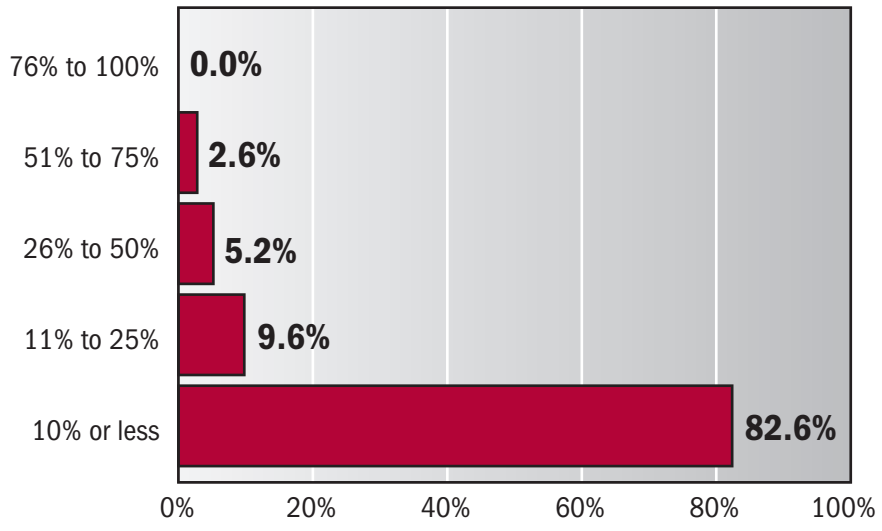
Percentage of your outside legal fees spent on alternative fee arrangements?



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change agents sparring with the don't-fix-it-if-it-ain't-broke defenders of the established time-based order.

Setting a New Course

In any system, large-scale structural change creates a steep new learning curve, and learning to negotiate and manage AFAs is no exception. Mastering the tactics and techniques of AFAs does require a new mind-set, as well as considerable effort by corporate counsel in defining measures of value, deconstructing engagements into specific tasks, translating their historical experience into new value models and working through zero-based negotiations where the parties start on equal footing. "This is more a matter of evolution — as new methods become more widespread, more general counsel will adopt them," says Paul Lippe, CEO of Legal OnRamp.

As more and more major players decide to innovate and commit to better aligning their interests, to achieving predictability of spend, to equalizing risk sharing and to using fees to encourage risk avoidance (and not just loss minimization), the skeptical attitude toward AFAs begins to sound like the resistance of the change-averse. Mike Dillon, General Counsel of Sun Microsystems, provocatively suggests those defenders of the status quo will "go the way of the Mastodon."

True, calculating and assigning a precise value to a matter, and assessing the risks and benefits of a transaction or case to the company, is new territory for many corporate counsel, and may compel new ways of thinking.

First, they will need to engage in discussions both inside and outside the company, but they cannot have such discussions without first thinking about how the work is structured, what exactly the work is that they are paying for (document processing, knowledge management, legal advice, research, photocopying, etc.), whether they need to pay someone with a law degree to do that work, and if not, whether a law firm should be doing it at all. Their initial focus needs to be what they're paying for, why they are paying for it and whether it is the best way to use the company's dollar.

Once corporate counsel have analyzed the legal component, a meeting between corporate counsel, the business people and the risk manager will yield a value that can be assigned to a given matter or group of matters. Facts may emerge along the way that impact the initial valuation, and then adjustments can be made. As companies use this process, they become progressively more adept at assigning value that reflects their business goals and risk tolerances.

The general counsel's next step is to talk with the proper law firm. Many say that in house departments should not spend time trying to educate law firms that do not "get it" — i.e., that do not understand why AFAs represent good business practices for *them*. General counsel should not waste their time on law firms that actively resist new ways of pricing services. In fact, they should grant preference to creative firms that initiate discussions of AFAs.

There are approximately 125,000 law firms in the US. Among them are plenty of firms that do "get it" and are attuned to client needs for predictable fees from excellent and efficient lawyers, wherever they may be located. These firms embrace new approaches to expanding their market share and competing for at least part of major clients' legal spend. Word-of-mouth already is flagging some of these thought-leaders, and tales of major representations moving from large firms to smaller innovators are becoming increasingly common.

We remind those who complain about how time-consuming it is to develop a new framework for negotiating and managing AFAs that one of the biggest time wasters in corporate legal departments is the need to spend hours and hours poring over legal bills after the fact to try to trim a few hours here and there. That effort exemplifies the "closing the barn door after the horse has left" mentality, and *post hoc* billing disputes are the most frequently cited reasons for souring relationships between in-house and outside lawyers. With AFAs, the cost is the cost. It doesn't matter if a firm takes two or 20 hours to complete a task because the price is defined from the outset and the firm is responsible

Corporate Counsel	Law Firms
Hard or impossible to assign value to matters in advance	AFAs are just a way to decrease our fees
Takes more time to enter into than billable hour arrangements and my time is already stretched	AFAs are hard to figure out because our operating numbers are based on billable hours
Makes it hard to compare data from previous years that were based on billable hours	We don't know what it costs to deliver services because it depends on the individual matter
Don't know if you are setting the right price	Getting efficient means we will earn less. Our system is based on working more hours, not fewer
The devil you know is better than the devil you don't	The system works for us. Why change?

for managing to the price and delivering the negotiated outcome as cost-effectively as possible.

Some general counsel worry about whether it can be shown that AFAs were in fact set at the "right" level. What they fail to grasp is that there is no right or wrong price. There never has been, and there never will be. Existing billable hour rates don't necessarily represent the "right" price; they are variable and only reflect what a firm hopes the market will bear or how much pricing leverage it believes it enjoys. Quite simply, "there is only the price someone is willing to buy at and the price someone is willing to sell at. This is how business in the real world operates," says John Chisholm of JC Consulting. "This is how the CEO and the CFO of a company operate. Indeed it is how the company operates." The irony of corporate counsel resisting AFAs is that never before have they had so much leverage in insisting on pricing that meets their needs, rather than the law firms' profit objectives. If they start with determining the value of a matter to the company, they are likely to end up with a fee that is right for the company.

Charting a Course

Once the value proposition has been established, corporate counsel must next select the right AFA approach, i.e., the best fee structures for the particular tasks at hand. To accomplish this, corporate counsel must succinctly communicate the value of the matter to outside counsel. That is, they must be utterly clear about how the company views the risk and reward of a particular matter when compared to the fee. They should make it clear that the law firm's proposed fee must bear a direct relationship to how the company views the worth of the matter. In those cases where corporate counsel are not yet adept at this form of communication, it behooves outside counsel to explore, probe and elicit information that bears directly on pricing the representation.

Although law firms may not immediately see the benefits of AFAs to *them*, new approaches to structuring and staffing legal service can help them to plan for predictable income streams and encourage them to develop practice management methods that reward them for efficiency and achieving desired results. For law firms as well as clients, effective fee arrangements establish the value of the matter, define the manner in which the fee will be paid, and create incentives for outside counsel to understand and achieve the company's goals.

Having worked with hundreds of inside and outside counsel in large, medium and small companies and law firms, we at Altman Weil have seen the importance of introducing AFAs at some clear and logical starting point, rather than attempting to use them for all types of matters and representation.

Often the best place to begin is with various kinds of repetitive matters because they can most easily be transitioned to AFAs. For some clients, commodity work focuses on employment matters. In others it means products liability, routine intellectual property, due diligence, and non-critical litigation. For such repetitive matters, it is important to ask if there are particular goals that will define a successful outcome. For example, some companies value fast cycle time (time to resolution/filing/completion), while others may have particular dollar targets they are shooting for. If there are such drivers, the parties should build in incentive payments that reward the firm for reaching the stated goals.

Driving It Home

Finally, the successful implementation of AFAs requires corporate counsel to build buy-in from their own lawyers — many of whom are perfectly content with the past approaches and relationships. General counsel must make it clear to their lawyers that they expect them to embrace cost cutting methods and that the company will tie compensation and bonuses to those expectations. "If you manage a team of lawyers," says Jeff Carr, General Counsel of FMC Technologies, "this means making [the use of AFAs] important to those who work for you — and that means making it part of their objectives, their performance goals, their compensation and ultimately their continued employment at your company. Unless and until you do so, your lawyers will take the conservative, less risky path of the status quo."

Driving on the Same Highway

AFAs work best when all parties' interests are aligned and where the continuing quality of the law firm-client relationship is given priority over raw bargaining power. When all is said and done, the key to successful AFAs is "to get the lawyers and the clients on the same page early about the goal, agree upon how close one can get to the goal, what an acceptable level of achievement is, and then structure the plan from there, knowing what costs make sense," says. Carl Herstein, a partner at Honigman Miller Schwarz and Cohn LLP. "You can always modify as you go along if it becomes clear that the worth of the matter has changed."

Over the last several years, law departments and law firms that have developed a "getting to yes" approach to fee negotiation, rather than holding to an adversarial approach, have been coming up big winners — in terms of solid, trusting client relationships and in terms of drawing more work into the firm. This notion of aligned interests must go beyond lip service to better modes of collaboration. For both corporate counsel and law firms, the world's present

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chapter ("How Did We Get to Where We Are – And What Are We Going to Do About It") and Mary Ann Altman, one of the co-founders of Altman Weil, wrote the second ("A Perspective — From Value Billing to Time Billing and Back to Value Billing").

Dick pointed out that when it came to billing, lawyers, working without time records, would review the file and make a judgment, taking into account the impact of the fee on the client "who most times was someone who the lawyer knew both as a client and as a friend. This is not nostalgia; this is fact." Dick's statements incorporated by implication the essential point being made in this article — that alternatives to hourly pricing are most likely to succeed where there is a relationship of trust between the client and the lawyer (or, as Dick said, where they are "friends"). Dick foreshadowed the ensuing discussions that resulted from the ABA book when he said:

> *Today [that is, 20 years ago in 1989], consideration of billing methods is very much on the minds of lawyers, clients and the courts. Perceptive lawyers recognize that hourly billing can penalize the efficient lawyer. Clients are questioning not only the amount of the fee but also the billing methods and appear to be thinking more in terms of the value of the benefits received.*

In her chapter, Mary Ann Altman traced the history of legal services pricing, starting with the following statement:

> *Because I was involved personally in the introduction of time records to the legal profession approximately 30 years ago, I can attest to the fact that one of the reasons time records were instituted originally was to determine the cost of providing legal services. At that time, lawyers had, for many decades, produced bills to clients that were based on the value of the services rather than on the time involved, although time certainly was a mental factor in determining value. Once time records became available to lawyers, lawyers quickly began to use these time records as a billing, rather than as a cost-accounting, tool. It was much easier to ask the bookkeeping department to multiply the time record by a dollar factor and prepare a bill than it was for the lawyer to exercise judgment in a determination of the value of the case.* ***Personally, I have always felt that pure hourly billing, particularly where a lawyer bills all the work that he or she does at one hourly rate, does not make any sense*** *[emphasis supplied].*

Mary Ann went on to recount how hourly pricing, once it became the new way of billing for legal services, was well received by clients too — because their legal bills were now based on something tangible that they could understand rather than on a value of services concept. Business clients could, in particular, correlate the "product" that they were buying to the products that they themselves produced and sold, and within large corporations managers could justify the payment of those bills to their superiors. The CFO, she said, may be unaware of the overall value of the legal services to his or her employer but could clearly comprehend hours and time billing. Court-approved fees also quickly became subject to time and hourly billing.

Mary Ann also discussed why trust in the relationship between the client and the lawyer is critically important if they hope to move away from the pricing they know to a new paradigm that often is scary and foreboding. She pointed out that most lawyers really do not know the cost of producing the legal services that they sell. Hourly rates are based on competitive positions and the marketplace. The process of annually reviewing hourly rates generally involves securing information on what other lawyers are charging rather than how the cost of operating the firm has increased. Determining the total cost of producing legal services is a difficult and complex process Mary Ann said, and "using time records as a basis for determining the cost of legal services originally was and still is a valid reason for time record-keeping. It is not the 'be all and end all,' however, in setting a fee."

Two Decades of Alternative Fee Agreements

That first ABA book was followed by a second one in 1992, and now the book's title proclaimed the need for any new arrangement to be beneficial to both the client and the lawyer: *Win-Win Billing Strategies, Alternatives That Satisfy Your Clients and You*.[2]

With regard to the need for a relationship of trust between the lawyer and client if there is any hope of moving away from hourly pricing, it was written in the forword that:

> *Some have resisted change, however, and the legal profession — and, consequently, its clients — have still been sorely in need of a billing methods road map. This challenge has been met by the publication of* ***Win-Win Billing Strategies****.... In his second book Richard C. Reed and LPM's Task Force on Alternative Billing Methods have created the first comprehensive analysis of what constitutes value, and how to bill for it.* ***Both law firms and corporate clients will benefit from the guideposts Reed provides*** *[emphasis supplied].*

Then in 1996, the third ABA book on the topic was published.[3] This book asserted that interest in alternative billing arrangements among corporate counsel and their law firms had skyrocketed. It seemed, the book mentioned, that every legal periodical

was examining the subject, from the point of view of the clients who wished to limit the costs of legal services, and from the perspective of the lawyers who were motivated to change or were resistant to it.

Dick Reed again identified the need for a relationship of trust if the new pricing paradigm was to become successful:

> *The theme that runs through these considerations is the **need for client trust**, which results when lawyers identify the objectives of their clients, determine the value to the client of their services, charge based on client value, and deliver quality services. Meeting these objectives will require many changes in the way law is practiced. **Where there is client satisfaction, there will be client trust, and where there is client trust, most often there will be client satisfaction.***

Dick ended the 1996 book's preface with a prediction:

> *Although in preparing the two earlier books, the Task Force on Alternative Billing Methods never contended that hourly billing would completely disappear, it is probable that straight hourly billing (billing by hours spent without limit and without regard for the benefits conferred) will virtually disappear in the years ahead. Without a doubt, quality and value will be the keys to excellence and success in the years to come. Lawyer-client relationships based on mutual trust and satisfaction are prerequisites. The time has come to say goodbye to time as the **sole** criterion for measuring the value of legal services.*

What Those Who Know Are Saying Today

Fast forward 20 years from 1989 to the end of 2009 and the beginning of 2010. Never has the topic of alternatives to hourly-priced legal services been more in the forefront than it is today. Never has so much been written and talked about it, and more importantly, never have there been more examples of progressive law firms and progressive corporate clients taking the leap of faith needed to move to this new paradigm.

"... most lawyers really do not know the cost of producing the legal services that they sell. Hourly rates are based on competitive positions and the marketplace."

This fact is obvious from a search of the literature. Looking at two very recent examples illustrates it. In an article in the *Philadelphia Inquirer* from January 4, 2010 ("Comcast's Top Lawyer Calls the Workload Shots," by Chris Mondics), the following appears:

> *That relationship [between client and lawyer] is rapidly changing….Now the company increasingly wants its outside lawyers to do more to jettison the traditional hourly billing rate. It is pressing for flat fees or other alternative billing arrangements that emphasize efficiency and expose firms to financial risk if matters drag on too long or conclude unsuccessfully…. "The objective is to get a sense that the law firm is managing its own business more efficiently for our mutual benefit so they have some skin in the game. We are not looking to be punitive; we are looking to be more businesslike [quoting Comcast's General Counsel, Art Block]."…The law firms themselves say the push for greater efficiency and alternative billing arrangements can work for both sides, provided there is a good working relationship. "You have to have a good strong relationship for these things to be effective, and I think they can be very effective." [quoting Robert Helm, chairman of the litigation department at Dechert LLP who represents Comcast on some matters].*

The second recent example among dozens that exist that show the importance of trust in moving away from hourly pricing is contained in a just-published survey.[4] Participating in the survey were senior leaders from 37 of the AmLaw 100 firms. Previewing the findings of the survey regarding the extent of use of alternative fee arrangements among large law firms today, the study's author summed it up as follows: "In the long run, the use of alternative fees will grow only if arrangements can be structured in a sustainable way that makes business sense for both sides."

Conclusion

Although the idea to move away from hourly-priced legal services to true alternative fee arrangements has been around for at least 20 years, more activity related to AFAs seems to have occurred and been discussed in the media in the past six months than in the two decades preceding it combined.

Why should 2010 be any different? In reviewing the literature on this topic, it appears that the authors and experts were right — alternative fees agreements will not be widely adopted by the profession until such arrangements can be made acceptable to both providers and purchasers of legal services. The best way to achieve that is through a relationship of trust and a mutually beneficial outcome.

The pivot point, of course, is economic necessity, and the fact is that some law firms will not go willingly.

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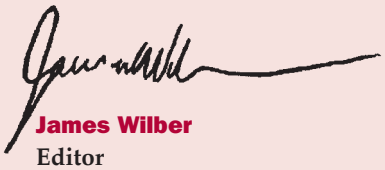
We believe that the new legal economy will spur a reinvention in the delivery of legal services in which clients will enjoy lower fees and take a more collaborative role in structuring and managing projects, and law firms will ultimately find new ways to be efficient and profitable. It is almost the rosy ideal envisioned in 1989. ◆



James Wilber
Editor

[1] *Beyond the Billable Hour, An Anthology of Alternative Billing Methods*, edited by Richard C. Reed, American Bar Association Section of Economics of Law Practice, 1989. After he retired from the Reed McClure Law Firm in Seattle, where he was managing partner, Dick worked for several years as a consultant with Altman Weil.

[2] Edited by Richard C. Reed, American Bar Association Section of Law Practice Management, 1992.

[3] *Billing Innovations: New Win-Win Ways to End Hourly Billing*, edited by Richard C. Reed, ABA Section of Law Practice Management, 1996.

[4] *The LegalBizDev Survey of Alternative Fees*, by Jim Hassett, LegalBizDev, Boston, Massachusetts, 2009.

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economic imperatives give new meaning to Benjamin Franklin's injunction that "if we don't hang together, we will most assuredly all hang separately." ◆

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