

A Primer On Alternative Fee Arrangements

Law360, New York (September 14, 2012, 12:29 PM ET) -- In response to recent economic instability in the United States, the legal industry (like many industries) has experienced widespread change in the landscape in which business is conducted. Increasingly, in an effort to cut costs, law firms are finding that many of their clients are moving more legal matters in-house rather than employing outside counsel. Others, however, are rethinking the way their outside counsel bill for services rendered, specifically by instituting fee caps or other alternative fee arrangements ("AFA").

As discussed in this article, these changes are not a temporary stopgap for difficult times, but instead, appear to be permanent reconsiderations of the customary method of doing business between the corporate client and its outside legal counsel.

This changing of the guard is necessary in large part because of rapidly increasing legal costs. Over the past 10 years, some estimates state that legal costs to U.S. companies have risen nearly four times as fast as overall costs to those companies. Such cost increases are particularly difficult for clients to accept in the midst of the "Great Recession." The overwhelming disparity between business expenses and legal costs is a fact that is certainly not lost on in-house corporate counsel, many of whom describe "better value" as their single largest unmet need from law firms.

Partially in response to this value-oriented focus, corporate clients are now seeking to partner with their outside counsel in new and different ways, one of which is through the use of AFAs. Although some law firms may be "forced" by their clients to consider using AFAs, outside counsel should not be looking at this as a negative development, but rather as an opportunity for lawyers of all experience levels in firms of all sizes to provide better value to their clients and generate increased revenue. If done correctly, AFAs can create closer aligned incentives between the client and outside counsel than may be present under the traditional billable hour model.

This goal of aligned incentives is crucial because it is (or perhaps should be) every lawyer's goal to create partnerships with his or her clients rather than being treated or viewed as another "vendor." An oft-made perception clients have is that the billable hour provides an incentive for a lawyer to work inefficiently (the more hours you bill the larger the invoice becomes), which is only heightened when the in-house counsel submits an invoice for payment approval that vastly exceeded his or her expectations. Replacing the hourly billing method with an AFA, particularly one in which there is a fixed fee component immediately forges a heightened sense of partnership between the lawyer and the client.

For instance, a law firm working at a fixed fee for a certain defined project is incentivized to work efficiently with the correct staffing of experienced attorneys and junior lawyers to maximize its profits and work within a defined budget. In turn, a pre-arranged agreement with a set fee provides in-house counsel with certainty of cost, which alleviates internal budgetary pressures and provides some degree of certainty to the legal budget. Put another way, AFAs provide in-house counsel with the knowledge and comfort that their outside counsel has "skin in the game."

Although the fixed fee approach discussed above is one type of an AFA, it is important to note that AFAs are not as simple as merely setting a fixed fee and commencing with representation. Indeed, there are multiple different types of AFAs to consider, and each plan must be fashioned to meet the needs of the specific client and the specific matter.

No matter the fee arrangement, the critical first step in determining which AFA is most suitable to a client is ascertaining the client's key drivers and how the client defines success. Key drivers can be such things as predictability of fees, timing of fees, overall level of fees, winning the matter, or early resolution of the matter. Every lawyer knows that "success" can take many different forms, such as early disposition, obtaining a specific and favorable result, meeting budgetary expectations, and/or driving cost savings through efficiencies/staffing. This mantra is central to every AFA, where each separate matter may dictate a different approach or model.

With the client's drivers in mind, the AFA must be creatively designed and sufficiently flexible to meet the goals and expectations of the particular case. Below are a few examples of common AFAs:

- **Fixed Fee by Matter:** Here, the law firm is paid an agreed-upon fixed fee for its representation of the client in a given matter and if the law firm exceeds the fixed fee, the client is not responsible for paying any of the overage. Fixed fee arrangements often are combined with incentive arrangements keyed to achieving success in the matter (as defined by the client at the beginning of the engagement).
- **Fixed Fee by Phase:** In this fee arrangement, the law firm's fees are fixed by each phase of a matter. For examples, the "phases" of litigation can mirror the American Bar Association's Litigation Task Codes: Case Assessment, Development and Administration (Phase 1); Pretrial Pleadings and Motions (Phase 2); Discovery (Phase 3); Trial Preparation and Trial (Phase 4); and Appeal (Phase 5). The law firm bears the risk if it exceeds the fixed fee during any phase for any reason.

- **Fixed Fee by Phase with Success Sharing Bonus:** This model operates in the same way as the "fixed fee by phase" arrangement discussed above, but with one important difference. Before getting started on a particular matter, the law firm and the client meet to determine the client's definition of success for the particular matter. If the law firm achieves "success" as defined by the client, the law firm earns a success sharing bonus (which can be a percentage of the entire fixed fee amount or the fixed fee amount in a particular phase). This arrangement provides the client with budget certainty and also incentivizes the law firm to obtain a specific and optimal result for the client.
- **Holdback:** This arrangement allows for the client to withhold a certain percentage of the total fee (either billed by an AFA discussed above or by the standard billable hour), which is paid to the law firm (if at all) at the client's sole discretion. In evaluating whether to pay the holdback amount, the client can assess the law firm's performance against certain criteria such as quality of the work, the results obtained, the law firm's level of efficiency, and the law firm's ability to demonstrate cost-savings.
- **Blended Rate:** Although some may not consider any form of the billable hour a true "alternative fee arrangement," many law firms use the blended hourly rate in this capacity. The blended rate maintains the normal billable hour system with the following important tweak — the client is only charged one compromised hourly rate that applies to all lawyers (associate, partner, counsel, etc.) working on a certain matter, regardless of experience or seniority.

Although clients may be in favor of AFAs due to budgetary certainty, some are still apprehensive of AFAs because they too are evaluating whether they are getting a good economic deal. Similarly, full-scale adoption from the law firm perspective is also slow because the single biggest concern for law firms is whether profitability can be maintained if the billable hour model is abandoned.

There are many ways, however, for law firms (and clients) to alleviate those fears and provide assurances that a new change in billing structure does not demand a blind march into the abyss. Perhaps most importantly, in order to successfully implement AFAs, law firms should embrace the technology that is available to mine their historical pricing data.

This data eliminates the temptation and potential disaster of coming up with a proposed fee out of thin air and crossing fingers, hoping that the billable hours do not surpass the amount of the agreed-upon fee. Moreover, many of the available programs allow law firms and clients to track their budgets in real-time, to make sure that their projects are staying true to the agreed upon budget. These programs also allow for the mapping of a matter to aide in the elimination of inefficiencies by ensuring the proper staffing for each aspect of the project.

In addition to the technological advancements that allow for outside counsel to confidently shift certain matters away from the billable hour model, utilizing an AFA may provide the added bonus of an opportunity for outside counsel to obtain faster payment on their invoices, given that the fee arrangement is pre-approved by the client. For instance, a client that uses quarterly billing may be convinced to pay a portion of the fee on a monthly basis because of the elimination of the need for the review of time entries and approval of unexpectedly large invoices (thereby eliminating substantial in-house time, effort and cost).

In light of the recent economic downturn and the tectonic changes in the legal market, the move away from the billable hour model and toward an alternative form of billing is no longer in doubt. To be sure, instead of fighting tooth and nail to maintain the status quo, outside counsel would benefit by incorporating innovation and flexibility in their billing models when pitching work to both current and potential clients.

This move toward AFAs is one of the many changes of the guard in the legal community, but it is one in which law firms of all sizes and attorneys of all experience levels can leverage to generate increased revenue and, most importantly, to provide better value to clients.

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