

## A PRIMER ON LAW FIRM ALTERNATIVE FEE ARRANGEMENTS

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Alternative fee arrangements (“AFAs”) come in three main categories – fixed-fee, hourly-based, and, to a lesser extent, value-added. Specific models and variations of each may be applied to an entire matter, certain stages of a matter, or across a group of matters according to the unique needs and goals of both the client and the firm. In addition, they can be combined as situations or objectives require, and reinforced with precautions and provisions to prevent unnecessary hardship or enrichment to the client or firm.

### **Fixed-Fee AFAs**

The fixed-fee structure is what most people think of as AFAs, and as studies show, the most popular alternative fee option.<sup>1</sup> Requiring more creativity and planning, as well as greater awareness of client needs and goals, fixed-fee alternatives are the most effective means to address each of the key value points – optimization of resources and efficiency, alignment with the client’s risk, and cost of service consistent with ultimate results – while providing greater cost predictability to the client.<sup>2</sup>

Within this structure, the client and firm agree to a precise fee for the matter, matter stage, or group of matters. In the absence of any billable hour framework, fixed-fee arrangements require the most amount of preparation by the law firm to ensure accurate pricing, cost control, and profitability. Additionally, regular communication between the law firm team and the client is essential.

Depending on the nature of the matter, allocation and management of law firm resources is critical for purposes of efficiency and cost control, and for the firm to demonstrate its valuable case management skills to the client. For example, more routine discovery work, document reviews, or due diligence investigation may be handled by associates and staff under a partner’s supervision, or outsourced to other firms or vendors that specialize in that type of work at a lower price. Likewise, the involvement of more senior partners in key negotiations, high-stakes trials, or other important junctures needs to be considered, justified to the client, and factored into the

fee. Fixed-fee work offers the firm the greatest incentive to revisit its methods and develop new best practices, which in the long run benefits the client, the firm, and the relationship between them.

Whether the risk is high stakes or de minimis, a client that clearly defines the threat – in terms of possible payouts, internal business and operational considerations, public reputation factors, etc. – expects an appropriate, corresponding commitment from the firm. Overstating the risk may lead to the client being disappointed with the firm’s proposal or efforts, while understating the risk causes the firm the firm to feel resentment over a perceived windfall to the client. This underscores the importance of honest communication, a willingness by both sides to show their cards, and the use of safety valves and renegotiation clauses when the situation changes sharply from either side’s expectations.

Like client risk, however, lopsided results may also cause resentment, as in a perceived boon to the firm in the form of an earlier than anticipated settlement or deal closing, or a seeming windfall to the client from a prolonged litigation matter or complicated transaction.

Along with fixed-fee billing for individual matters, flat fees can be also expanded and scaled, depending upon the situation, client, or law firm:

### Bundling

In a bundling arrangement, the firm receives a large number of matters that it handles for a specified fee. Perhaps the most strikingly comprehensive example of late comes from Pfizer; the 19 outside firms in its Pfizer Legal Alliance are each paid an annual fee, in monthly installments, determined by the type and volume of work each firm handles for the company. The fee is all-inclusive; every aspect of a firm’s representation – “from phone calls to closing arguments” – is reflected in the annual payment, though Pfizer will adjust the fee if the firm takes on more work than originally anticipated.<sup>3</sup>

Tyco International Ltd. has similar arrangements with its outside counsel, assigning all matters of a particular sort to one firm. According to Tyco senior litigation counsel David Nicholas and litigation partner Michael Roberts of Shook, Hardy & Bacon (the firm that handles all of Tyco’s product liability cases), the basis for success in this structure is trust. “We both have to believe that one’s not going to take advantage of the other,” a theme common to all AFA variations, not just flat-fee engagements.<sup>4</sup>

### Subscriptions & Retainers

Slightly different from bundling, subscriptions and retainers allow the client to “buy” access to either certain attorneys at the firm or the entire firm itself for a monthly rate. Engagements along these lines can be written to include all types of matters, or to exclude more complex work that can be priced separately, or built into a renegotiated monthly fee.<sup>5</sup>

These kinds of relationships have gained momentum among boutique firms and smaller companies, which are more nimble in their ability to accept change.<sup>6</sup>

### **Hourly-Based AFAs**

Hourly-based alternatives preserve the billable hour, but within a more client-oriented construct tied to attorney performance or matter outcome. Although there is greater alignment with client risk and results relative to the cost of service, “more time still equals more revenue” and there is little impetus for firms to develop new ways to handle matters.<sup>7</sup>

There are some who consider rate and volume discounts within the realm of alternative fee structures, presumably because the concession of law firm revenue and risk in any form qualifies it for inclusion. This not only consists of *straight discounts* (a reduced rate for a single matter) and *volume discounts* (reduced rates based on the amount of legal work a client assigns to a firm), but also *blended rates*, within which all of the lawyers working on a matter bill the same rate, irrespective of seniority or associate or partner status. Arguably, discounts may benefit clients by reducing their expenses, and in the case of volume discounts, ensuring work for the firm. They contribute little, however, to converting the focus away from the firm’s objectives to the three key marketing value points so important to the client. Moreover, they endanger the firm’s own value proposition.

The following are brief descriptions of various hourly-based approaches:

### Fee Caps

A fee cap imposes a ceiling under which the firm bills the client hourly, but for fees above that amount the client isn’t charged. Of all hourly-based AFA models, fee caps offer the most incentive for law firms to streamline workflows and make more efficient use of personnel, outsourcing, and other resources. Determining the cap is critical to the success of this approach – if the cap is overly inflated, total fees less than the cap offer the client no benefit from the arrangement, and if it is underestimated, the firm may not be rewarded for the value of its services.

### Risk Collars

Akin to fee caps, risk collars require the firm and the client to agree on a target matter budget, using the billable hour as the standard work unit. Unlike fee caps, however, the firm is incentivized and rewarded for a total fee figure that comes in under the collar. If the fees exceed the target, the firm still gets paid, but at a discounted rate.

To illustrate, let's assume an arrangement involving a targeted budget of \$100,000 with a 50% risk collar:

- If the firm's total fees are \$80,000, the client would pay \$80,000 in regular hourly rates, plus 50% of the savings  $[(\$100,000 - \$80,000) \times 50\% = \$10,000]$  for a total of \$90,000.
- If the firm's total fees are \$120,000, the client would pay \$100,000 in regular hourly rates at budget, plus 50% of the overage  $[(\$120,000 - \$100,000) \times 50\% = \$10,000]$ , for a total of \$110,000.

One could claim that a risk collar is essentially a discount, in that the firm bills hourly regardless of outcome with no restriction on its total fees. Others might suggest that introduction of a budget, along with the carrots and sticks associated with it, warrant consideration as a meaningful alternative. For the sake of argument, we've included it in the discussion.

### Outcome-Dependent Holdback

With an outcome-dependent holdback, client and counsel establish a metric defining a successful outcome or range of outcomes. Work is billed at an hourly rate, but a portion or percentage of the fees billed is held in reserve for future payment to the firm according to the metric or at the client's discretion.

Because success is defined at the outset – i.e., a settlement, verdict, or arbitration award within a specific dollar range; type of disposition; favorable ruling or decision, etc. – the holdback causes more risk to be shared. The key is the amount of discretion built into the metric; in fairness to both client and counsel, it should allow both parties to reasonably predict the holdback payout and thereby provide worthwhile incentives to the firm.

### Budget- or Time-Dependent Holdback

With a budget- or time-dependent holdback, client and counsel establish a metric based upon the perceived cost of the matter or the timeframe within which the client wants

the matter resolved. Similar to the outcome-dependent holdback, work is billed by the hour, but some amount is held in reserve, payable to the firm for its successful achievement of budgetary or timing objectives.

Given the focus on time and money instead of outcome, there may be more incentive for the firm to optimize workflow, explore outsourcing options, and pursue other efficiencies. As with outcome-dependent holdbacks, a greater amount of risk is shared because the client has a larger role in defining successful results. Estimating the ultimate cost and timing, however, can be more difficult, especially if the firm lacks the necessary tools or depth of experience to properly forecast.

Some holdbacks have been taken to new heights. Valorem Law Group, for example, includes a line on each invoice where the client can make any adjustment it deems appropriate to the stated fee,<sup>8</sup> and FMC Technologies has agreements with outside firms that can result in payment of the entire holdback amount plus a bonus for achieving a successful result.<sup>9</sup>

### Contingency Fees

Despite its historical connection to plaintiffs' firms, there is a place for the common contingency fee as an AFA structure in the broader arena, as many firms have begun to explore and profit from.<sup>10</sup> Threshold issues in determining whether a billable-hour firm would enter into a contingency arrangement generally revolve around comparative minimum fee estimations and a higher likelihood of success, but the results can be several times greater than standard hourly billing revenues.<sup>11</sup>

The traditional contingency fee model is included here because most firms evaluate the opportunity and success against standard hourly billing revenues. Additionally, contingency cases encourage firms to streamline processes and leverage specialists to achieve workflow and cost efficiencies, and there is far greater shared risk. Results can be drastically disproportionate here – windfalls occur when the firm's share in the verdict or settlement vastly exceeds the corresponding hourly fees, or when the cost to the client is far less than the value of the representation.

### **AFA Combinations**

Once a firm thoroughly understands the unconventional thinking and atypical infrastructure that AFAs demand, and is also comfortable proposing and implementing AFA engagements, it will then be primed to advance to the next level – mixing and matching different AFA models into even more flexible and creative configurations.

There are countless combinations and variations of AFA models, each of which is dependent upon the nature of the work, client goals, definition of success, necessary resources and expertise, etc. Perhaps well ahead of their time, James Shomper and Gardner Courson, two attorneys in the E.I. du Pont de Nemours & Company legal department, provided an introduction to this idea for a 2000 *ACCA Docket* article that has become the blueprint for AFA thought and implementation:

Example 1: Outside counsel gives client a volume discount in return for performance awards based on various criteria (fees below a specified target, early disposition, control of local counsel fees, and so on).

Example 2: Outside counsel gives client a fixed fee through some predefined period (an initial investigation phase) and then reverts to hourly billing.

Example 3: Outside counsel gives client an hourly rate through an initial phase and then reverts to one of the incentive-based billing arrangements.

Example 4: Outside counsel and client agree on a budget for an initial phase (or the entire case), and in return client agrees to pay law firm a bonus if the fees are below budget (the bonus might be a percentage of the savings under budget).<sup>12</sup>

As one might imagine, the only restriction to combining AFA models is the firm's capacity to adapt and the creative thinking it can apply to the client's specific needs.

## **Safety Valves & Savings Clauses**

Due to the potential for unpredictability in any legal matter, firms are advised to discuss "safety valves," "look backs," and "savings clauses" when broaching the subject of AFAs with clients. To be effective, these safeguards need to inure to the benefit of the client, the firm, or both, depending upon the kinds of unforeseen circumstances that may arise:

Savings clauses can be used to ameliorate the risk of uncertainty. A properly drafted savings clause can prevent potential wide swings and avoid unanticipated windfalls to one party or another. They should not be used to eliminate all risks, but instead should allow a prenegotiated out if the unanticipated occurs.<sup>13</sup>

At the same time, the firm needs to have patience before seeking to exercise this escape device:

[O]utside counsel should be careful not to jump the gun and attempt to capitalize on the look back provision while the litigation or transaction remains underway, as this can badly damage the relationship and spirit of joint enterprise.<sup>14</sup>

Escape clauses and renegotiation provisions encourage regular communication between client and counsel to avoid surprises, and where when one or both sides may be new to AFAs, they offer certain assurances to exploring AFA options with less hesitation or resistance.

### **Value-Added AFAs**

Another AFA category involves providing additional services that may not fit squarely into the hourly-based or fixed-rate dynamic. Although less prevalent, they tend to be the most innovative, with the potential to secure a stronger law firm-client relationship.

Value-adds, best deployed as adjuncts to primary billing arrangements, benefit the client's bottom line, although not necessarily with respect to any one matter or collection of matters. Instead, they may utilize firm knowledge or personnel to help the client with a particular process or task, possibly one for which the client didn't know it had a need.

### Packaging High-Value Representation with Low-Value Work

Whereas "bundling" in the flat-fee context involves a firm handling a volume of matters for a specific rate, there are other opportunities to package work in a way that benefits the client and the firm.

One example is a situation where the firm, through an AFA or even a billable-hour arrangement, secures high-value matters by agreeing to also handle lower-value work, such as reviewing all of a client's confidentiality agreements and letters of intent at a greatly reduced rate in conjunction with handling the client's mergers and acquisition matters.<sup>15</sup> Another illustration would be a litigation firm taking on all of a client's collection matters at no charge in exchange for handling more lucrative commercial litigation cases. This type of arrangement consolidates a larger amount of work with the firm, offsetting any economic risk from the low-value matters with the high-value matters, while providing the client with quality representation at a savings.

### Secondments

There may be times when the client's legal department is short-staffed and could use some temporary assistance. While a firm's natural instinct would be to pursue handling

the work itself at hourly rates, placement of a firm attorney onsite with the client may be a wiser move.

This practice, known as secondment, offers advantages to just about everyone involved – the client receives the short-term coverage it requires from a skilled lawyer presumably more familiar with its business, the rest of the legal department doesn't bear the burden of the additional work, the firm gains an inside presence with the client while enjoying a reduction in the overhead associated with the seconded attorney, and the secondee receives valuable experience and perspective.<sup>16</sup>

Because most secondments generally begin with the client soliciting a temporary attorney from outside counsel, the intuitive and resourceful firm might take the initiative to propose a secondment itself, ideally as part of a larger AFA arrangement. In its most recent round of outside firm reviews, Royal Bank of Scotland sought more value-added services from its firms, and specifically cited secondment in that category.<sup>17</sup> And while secondees sometimes transition from temporary roles to permanent positions with the client, that may not be so bad if it generates an even stronger relationship between the client and the firm over the longer term.

#### Extra-Matter and Extra-Legal Services

Technology provides unique opportunities for firms to enhance the value of their services, even in areas unrelated to a particular case. Oftentimes, lending technological assistance and expertise can be as meaningful as competent legal representation, and the examples are many:

- A firm creates and hosts an extensive online repository, accessible via a secure extranet, that allows the client and its other outside counsel to exchange active and inactive matter documents, repurpose research and forms, share ideas in an online forum, and reduce the client's costs.
- A firm compares the client's litigation portfolio over the past five years to its competitors and the industry as a whole; the firm then analyzes the inconsistencies and advises the client regarding those areas where it leads and lags.
- A firm hosts a summit regarding current issues that impact the client's business, invites all of the client's other outside firms to attend, and facilitates strategic planning forums; invitees attend the summit in person or by means of a controlled online connection.

In *The Trusted Advisor*, David Maister wrote that “[b]ecoming a trusted advisor at the pinnacle level requires an integration of content expertise with organizational and



interpersonal skills.”<sup>18</sup> As we will discuss later, trust is not something a firm can proclaim, but a bond that has to be earned. Making strategic use of non-attorney resources to assist a client is one way a firm can demonstrate other aspects of its value in pursuit of pinnacle, trusted advisor status.

### Vendor Benefits

Since 1992, the DuPont Legal Model has enabled the DuPont legal department to maintain a mini-marketplace among the firms and vendors it engages.<sup>19</sup> Although the requirements DuPont places on its outside counsel can be onerous, it rewards their compliance by compelling its vendors (“Primary Service Providers” in the areas of court reporting, litigation support, legal staffing, document management, etc.) to extend the same discounts, service levels, and preferential treatment to its firms.

Like the secondments illustration, it is the client who drives this process, not any of its outside firms. But consider the firm whose clients may not be as large as DuPont, but which could benefit from the relationships that the firm negotiates with its own vendors:

- “Guest” access to real-time depositions and court proceedings via West LiveNote and other streaming audio and video services, paired with privileges to a secure deposition transcript repository.
- Sharing the services of a library consultant relative to legal research contract negotiating, filing and shelving, and research support.
- Utilizing media relations and other marketing consultants for client needs such as litigation and crisis communications, media training, and other public reputation management activities

General counsel and in-house law departments, particularly in a poor economy, often feel pressure to prove their worth to the organization in the absence of any revenue-generating activity. Firms that find ways to assist their in-house clients to be more efficient and to help them validate their contribution to the business stand to gain far more than other firms that simply provide legal representation.

## AFA VALUE METRIC

Resource Allocation	Alignment with Client Risk	Fees Relative to Results
<p><b>Flat Fees</b>, depending on the nature of the matter, require appropriate allocation of law firm resources, not only for purposes of efficiency and cost control, but also for the firm to demonstrate its effective case management skills to the client.</p>	<p><b>Flat Fees</b> offer the most “win-win” potential of any AFA option, but they require communication and trust between the client and the law firm to fully align the firm’s interest with the client’s risk.</p>	<p><b>Flat Fees</b> offer the closest measure of shared value between the client and the firm, with both anticipating an outcome commensurate with input and investment. Plus, they offer the biggest bonus to the firm for streamlining processes while delivering quality service.</p>
<p><b>Fee Caps</b> offer firms the greatest incentive to streamline workflows and make more efficient use of personnel, outsourcing, and other resources. If they don’t, they gamble that any work above the cap comes from their own pockets.</p>	<p><b>Fee Caps</b> cause firms to share in the client’s risk if the ultimate outcome exceeds the established ceiling. On the other hand, if total fees – the cap – are overestimated, the firm doesn’t shoulder any client risk.</p>	<p><b>Fee Caps</b> limit the client’s obligation to a specific dollar figure, similar to flat-fee arrangements. The cap needs to be determined carefully; if it is inflated, total fees that are less than the cap offer the client no real benefit. If it’s too low, the firm suffers unnecessarily.</p>
<p><b>Risk Collars</b> can offer a greater incentive to the firm to seek out more efficient methods and approaches to handling the case, depending on the risk collar percentage and the budget to which both the client and firm agree. The lingering presence of the billable hour can reduce the motivation due to the possibility of partial recovery above the target.</p>	<p><b>Risk Collars</b>, like holdbacks, provide incentives for the firm to an end-of-matter reward from the client for meeting the stated objective of overall lower costs. Above the target, there is only a proportionate sharing of risk.</p>	<p><b>Risk Collars</b> give the client a net discount on hourly rates if total fees exceed the budget, whereas with a successful outcome, the client achieves a total matter savings (total fees less than the budget) and the firm receives the full amount of its billings (which may be based on a higher than normal rate). Budgets and targets must be realistically calculated, but the firm ultimately controls the hours, which can reduce the benefit to the client.</p>
<p><b>Outcome-Dependent Holdbacks</b> give the firm little if any incentive to approach the work differently, including the personnel, vendors, or other resources it uses.</p>	<p><b>Outcome-Dependent Holdbacks</b> causes more risk to be shared because success and failure are defined at the outset. Accurately predicting the outcome is the most difficult aspect.</p>	<p><b>Outcome-Dependent Holdbacks</b> introduce client discretion. A poor outcome lets the client pay less or none of the holdback, and if results are satisfactory, the client can pay a more or all of the holdback. Fairness dictates that client and counsel establish a metric that allows each to predict the payout. In the end, the firm controls the number of hours, risking only the amount of the holdback.</p>
<p><b>Budget- or Time-Dependent Holdbacks</b> place the focus on time and money instead of outcome, with more incentive for the firm to optimize workflow, explore outsourcing options, and pursue other efficiencies.</p>	<p><b>Budget- or Time-Dependent Holdbacks</b> compel the firm to share a greater amount of risk because the client has a larger role in defining success. Projecting the ultimate cost and timing can be more difficult, especially if the firm lacks the necessary tools or depth of experience to properly forecast.</p>	<p><b>Budget- or Time-Dependent Holdbacks</b> penalize or reward (up to the value of hourly-rate billings) the firm in accord with the client’s goals, but the carrot and stick may only represent a portion of the total fees. The firm remains in control of the most important factor – the total hours put into the matter.</p>
<p><b>Contingency Fees</b> provide incentives for firms to streamline processes, manage workflow, and leverage specialists to achieve cost efficiencies.</p>	<p><b>Contingency Fees</b> place far greater risk, given its often “all-or-nothing” premise. Unlike hourly billing, the firm’s decision to take the case is dependent upon its estimation of the client’s chances of prevailing.</p>	<p><b>Contingency Fees</b> create situations where the legal representation and the results can be disproportionate for both client and counsel. Better than anticipated results may yield a return to the firm far greater than the billable hour equivalent, and a poor outcome may unfairly “short” the firm. Both scenarios can generate windfalls as well as resentment for either party.</p>

## FOOTNOTES & REFERENCES

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