FIXED FEES

The thin edge of law firm transformation

Jordan Furlong

EDGE INTERNATIONAL

Large law firms are switching from the billable hour to fixed fees. As a measure of just how much has changed in the legal services marketplace over the past year, it's hard to top that.

In September 2009, O'Melveny Myers distributed an internal memo (quickly leaked to an online legal tabloid) setting out its intention to provide services on flat and fixed-fee bases. The firm plans to "*adopt a single rate card by FY2012, with volume and 'investment' discounts and appropriate alternative fee arrangements … becoming the leader in providing high-end legal services on a fixed-fee basis, reducing costs to clients, and achieving superior economic performance through practice management oriented toward cost-effective client service.*" If you'd predicted, at the height of the bubble, that O'Melveny management would soon circulate a memo with these contents, most lawyers would have been incredulous.

Also in September 2009, top management lawyers at Reed Smith and Mayer Brown told the legal press that their firms were thinking of going the fixed-fee route for certain types of services. "*Most clients want certainty of cost and value for money*," said Reed Smith Global Financial Industry Chair Paul Johnston. "*Our prime focus is to provide that.*" Rest assured that if their leaders are talking to the media about fixed fees, these firms have gone a lot farther down the road than "thinking about it." And for every AmLaw 100 firm willing to be publicly quoted about fee certainty, dozens more are quietly examining the subject. At a College of Law Practice Management conference in September, one panelist observed that "*there's not a single big firm that's not at least thinking about fixed fees.*"

Fixed fees are in, and the reasons are clear enough. Clients, reeling from the recession and anticipating a slow and painful recovery, have shifted gears. They're no longer wishing for lower and more predictable costs; they're requiring them. General counsel have heard their CEOs muttering about legal costs that continuously rise while every other department cuts back, and wondering darkly about just whose side Legal is on. That sort of thing puts the fear of God in GCs, and those GCs are determined to spread that fear around.

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Law firms, of course, are newly vulnerable to client pressure themselves. Profits per partner were down sharply in 2008, and hardly anyone expected them to seriously rebound in 2009. Partners in major firms had become accustomed to year-over-year double-digit increases in income, and many lawyers are still dealing with the shock that those days are gone. The rate-reduction card has already been played, but clients have trumped it by asking not for discounted rates, but for lower costs, period. Worse again, there are few easy cost-cutting levers left to pull. Secretaries have been fired, associate salaries have been frozen or reduced, first-years have been taken off the clock, and leverage has been slashed -- yet PEP continues to fall.

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And so we come to fixed fees. With cost certainty the new holy grail for GCs, and fixed-fee arrangements still (for the moment) relatively scarce among law firms, they offer a rare opportunity to actually get the client's attention, in a good way. But they have to be done right. Averaging out your last ten bills, say, and padding the result by 10% won't work particularly well, since clients know exactly how much they've paid you for legal work over the past several years. Going the fixed-fee route will require more effort than that.

But as it turns out, implementing fixed fees the right way also happens to be a remarkably effective way to start transforming your firm. Fixed fees, in fact, promise to be the thin edge of a wedge of creative disruption - one that could end up permanently transforming a firm's practices, systems and culture and turning it into a virtual paragon of innovation.

Now, we think that would be a very good result. We think it's the key to surviving not just this economic trough, but also the entirely new set of rules by which legal services will be delivered over the next few decades. We think that fixed fees, even just in small doses and in specific parts of your firm, can make for happier clients, more satisfied lawyers, and better-run and more profitable enterprises. But fixed fees come at a cost -- one that not every firm will have the ability or courage to pay. If your firm is one of them, read on.

For fixed fees to work, they need to represent the end result of a real change process. In particular, there are three things that a firm needs to change -- and that will change the firm -- in order to seriously engage with fixed fees.

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1. REALIGN RISK.

The beauty of the billable-hour system (from the lawyer's perspective, anyway) is that it places 100% of the risk of the engagement on the client. If a task takes longer or becomes more complex than expected, all the better: just add more hours to the tab. Billing by the hour shifts all the risk of complication to the purchaser -- and as every lawyer knows, there are always complications.

At the heart of the fixed-fee philosophy, however, is the notion of shared risk. The firm and its client regard themselves as partners in the joint venture of a legal task, each committed to the task's efficient and effective completion because each has a financial stake in that goal. By setting the fee in advance, the firm commits itself to an internal goal of "*beating the price*" -- streamlining its costs and fine-tuning its systems to ensure it comes in under budget. If the internal costs exceed the external price, the firm has to swallow the difference.

That doesn't necessarily mean the firm now bears 100% of the risk -- a dismal prospect, especially in litigation. Many clients are still willing to accept risk (indeed, they've done nothing but accept risk for decades now), up to a point. They'll talk about limited exceptions to the fixed price, mostly surrounding the truly unforeseen or unmanageable, and likely will agree to variations clearly arising from those causes (again, especially in litigation). But the lawyer will be asked to cover variations arising from the ordinary, established capriciousness of legal affairs. That's part of the expertise clients expect when hiring a large firm -- the ability to anticipate and roll with complications. In Rumsfeldian terms, fixed fees are expected to cover the "known unknowns" -- it's the "unknown unknowns" that can (but not necessarily will) give rise to acceptable budget overruns.

Taking a measure of risk on a project isn't asking a lot of professional service providers in other fields. But for most law firms, it's a pretty radical move. It requires an overhaul of work practices that were designed for profitable inefficiency. The traditional law firm gives work to the most expensive lawyers available and encourages them to take as long as they need. Risk-sensitive law firms, conversely, look for ways to download work to the cheapest competent performer, flowchart or mechanize predictable or repetitive tasks, and monitor costs against budget at defined stages of the process. Essentially, they think and act like clients.

Very few law firms behave this way, and the challenge of getting from here to there should not be underestimated. It requires a recalibration of the internal systems of large, complex organizations that are difficult to manage at the best of times. And it means helping lawyers, risk-averse by nature and training, realize that, to paraphrase Gordon Gekko: "*Risk is good.*"

2. REWIRE SYSTEMS.

The decision to sell work on a fixed-fee basis will require a firm to re-engineer its internal processes -- or, in some cases, to install such processes in the first place. This re-engineering doesn't need to start off as a full-scale, firm-wide metamorphosis from billable-hour shop to efficiency machine; in fact, going about the process that way virtually guarantees failure. Choose a practice group or practice area that seems amenable -- for reasons of lawyer personality, group leadership, or client tasks with predictable elements -- to innovation of this kind. But once you've chosen your construction site, be ferociously detailed about designing your blueprints and supervising the builders.

A fixed fee is nothing more than a project budget, and hitting a budget target requires business process and project management. This is not as easy as it sounds. Legal author and visionary Richard Susskind likes to cite the example of lawyers who tell him they're "project managers" because they've taken project management courses. He asks them how they'd like it if their project managers said they could practice law because they once took some legal courses. Project management is a professional undertaking and should not be attempted by well-meaning amateurs. There are as many different approaches to it as there are projects, and this article won't delve into this complex topic. Suffice to say that the key features of any project management system will include task schedules, costs monitored against budget, and quality control standards.

Against the backdrop of a given project management system, you'll need to add the personalized details of just what it is your firm or practice group does, how long it takes to do these things, and what it has cost in the past to accomplish them. Mining your historical billing data for a given type of project is a good place to start, but you can't end there. You also have to identify the key elements of these projects in order to design standards against which the quality and timeliness of their accomplishment can be measured. You need to figure out which of the most repetitive tasks are susceptible to automation, and which parts of the most basic work can be accomplished by contract or outsourced talent rather than high-priced associates. That sounds like a lot of work, and it can be -- but there are business process and project management experts galore who can show you how it's done.

The idea behind business process management is to find ways in which tasks can be broken down into their component parts, analyzed to map out consistent and measurable procedures, and accomplished in the most cost-effective high-quality ways. This goes against almost every instinct that traditional law firms have developed over the decades: maximize time spent (and therefore costs billed) on a project, reinvent wheels wherever feasible, and substitute precedents and anecdotes for systems, metrics and data.

But do you really have any doubt, deep down, about which approach is likelier to yield better results and more value? Do you really have any doubt that a firm internally transformed along rational business lines like these wouldn't be a more effective and professionally satisfying place to work?

3. RETHINK PRODUCTIVITY.

It's a unique feature of law firms that efficiency and productivity, which in the business world directly correlate, usually line up in inverse proportion. Law firms routinely measure lawyer productivity in number of hours billed, a metric that self-evidently serves the supplier's interests over those of the consumer. The first associates to be laid off at law firms this past year were described as the "least productive" because they had the lightest dockets -- and nobody at these firms seemed to find the equivalence of these two terms the slightest bit strange.

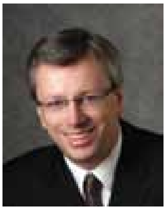
Fixed-fee billing systems, of course, attach a premium to efficient, systematized workflow -- you won't profit unless you can do the job for less than the client has agreed to pay, which means running a very tight ship internally. So moving to fixed fees means completely reversing the long-held definition of productivity -- which in turn will affect all the ways in which you evaluate, compensate, promote and value your lawyers.

A funny thing happens when you stop billing clients by the hour: you find yourself wondering why you compensate lawyers by the hour. The ability to reach or exceed annual hourly billing targets has long been an easy and convenient way to determine a lawyer's worth -- but in a fixed-fee system, it becomes close to useless. When revenue is no longer generated according to how much time is spent on a matter, then continuing to measure, reward and promote lawyers on the basis of expended time becomes an unaffordable irrationality.

So firms that invest in fixed fees will need to start finding new ways to figure out how valuable their fee earners really are. The project management systems that firms will institute in order to manage fixed-price work can also be used to gauge the effectiveness of the lawyers working within those systems. Over time, lawyers will become valuable not for their ability to maximize the hours billed to a client, but for their ability to minimize the number of hours they can bill to a file and still get the job done right. Continued employment and suitability for attaining or maintaining partnership will come to depend in no small part on how well a lawyer manages a project, controls costs and keeps to the system. This in turn will affect lawyer compensation and incentive structures, not to mention lawyer training and competence assessment.

If you're going to fix your fees, you need to be prepared for an internal redefinition of productivity -- an outcome that will have implications for everything from deciding who is and isn't an effective lawyer to making partner compensation even more of a headache than it already is. Be ready to reconsider everything about how you motivate, assess and reward your lawyers under a fixed-fee system -- but also be ready to find out how positive the results can be for lawyer morale and firm-wide profitability.

This article is not meant to be a fixed-fee how-to guide -- there are plenty of those available, and as client demands for price certainty continue to grow in the coming months, more of these models will appear. Instead, this article is intended to warn you -- and to encourage you -- that turning towards fixed fees inevitably requires more than short-term commitments, and produces more than one-dimensional results. Don't take this step lightly, but don't be reluctant to try, either. The potential rewards are tremendous for your clients, but even more so for you.



Jordan Furlong is a partner with Edge International and specializes in analyzing the extraordinary changes now underway in the legal profession worldwide. An award-winning legal magazine editor and blogger, he is an Honorary Fellow of the College of Law Practice Management and Chair of the College's InnovAction Awards. Contact him at jordan.furlong@edge-international.com.