

E-Billing Software Aids in Constructing an Effective AFA

Constructing an effective AFA agreement requires thorough billing analysis.

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Budget-squeezed legal departments are rushing to negotiate alternative fee arrangements (AFAs) with their law firms. But designing effective AFAs requires a detailed upfront review of past costs and projected needs. Law departments that have implemented e-billing and matter management systems have a big leg up in crunching the numbers needed for determining the best kinds of AFAs for various types of matters.

A substantial majority of law departments now face the challenge of structuring AFAs. According to a November 2009 survey by Hildebrandt Baker Robbins, 55 percent of law departments have implemented or will implement alternative fee arrangements with their outside counsel and 27 percent are considering this approach. Only 18 percent have no plans to abandon the hourly fee approach.

But the term AFA encompasses a wide variety of billing approaches, including fixed fees, unit costs for specific tasks, hour caps on certain tasks and success-based arrangements.

"There are 31 flavors of AFAs," says John Weber, general manager of CT TyMetrix, which provides Web-based e-billing and other management solutions for corporate law departments. Weber says law departments typically need multiple types of AFAs for different kinds of matters. That requires categorizing and segmenting the legal work historically outsourced to law firms. "With the segments set, the question of which AFA to apply becomes simpler, even arithmetic," Weber says.

Law department consultants say e-billing software can aid the process.

"Software can tell the average cost of matters by type, such as EEOC litigation, prosecution of patents, registration of trademarks or drafting leasehold agreements," says Rees Morrison, president of Rees Morrison Associates. "It can give data on typical durations and costs. That greatly helps in setting fixed fees or unit costs."

Altman Weil General Counsel Pam Woldow agrees. "There are e-billing programs that can give [companies] a lot of rich data that can be transformed into information, then transformed into knowledge," she says, including comparisons of costs by law firm.

Construction Tools

The first step in the process for general counsel is to use e-billing data to segment the department's portfolio of work into categories of matters and then into categories of activities for each matter, Weber says.

"[The software] can identify the level of resource used—partner, associate, paralegal—and the relative number of hours by task and biller," he says. "Similar matters, like general liability lawsuits, real estate transactions and regulatory filings, can be analyzed for historical and projected cost to compare variances in rates, costs, individuals and resource levels assigned to accomplish particular types of tasks."

For matters that generate high costs, Weber recommends segmentation by the stages of litigation that most drive cost, such as pleading, document review and filing preparation. Then certain types of alternative fee structures can be assigned to each specific category.

E-billing systems also can drill into a law firm-by-law firm analysis, determining billing rates by level of lawyer, the effective hourly rate for the firm as a whole and the ratio of professional fees to out-of-pocket expenses.

"All three can be negotiated, fixed or set to decline," Morrison says. "For example, a company could mandate that outside counsel's effective billing rate be phased to decline by X percent a year for the term of an agreement."

Ongoing Process

Once an AFA is in place, in-house counsel need to analyze its effectiveness in reducing the department's historical outside counsel costs. Woldow consulted on one case in which outside counsel agreed to discounted rates but ended up billing more hours, resulting in virtually the same overall fees for similar activities. Fortunately, the legal department identified the problem.

"The corporation had good data, which helped," Woldow says. "They had some benchmarks."

And companies can use such data to expand and refine their AFA programs as they realize results. For example, Kim Townsan, senior manager of legal administration at United Technologies Corp. (UTC), says her company first began using AFAs in 2002-2003, starting with fixed fees for U.S. patent prosecution. Since then, the company has expanded AFAs to other practice areas, and last year 55 percent of UTC's outside counsel spending comprised AFAs.

It's an ongoing process. "We segment our spend and analyze it, then look for opportunities to drill into it," Townsan says. "For example, we're currently undertaking an effort, using our e-billing data, to look at a specific task: document review. We are determining our average hourly rates over the past couple of years as we consider unbundling this task and outsourcing to non-law firm preferred providers."

AFAs can also be constructed to change during the course of the agreement. Morrison likes the fixed-fee approach because it promotes law firm efficiency but suggests including "collars" above and below the fixed-fee amount. "If the firm's total cost is more than 20 percent above the fixed fee, half of that the firm eats. That's the penalty," he says. "Maybe the company pays the other half because something big happened. Likewise, if they come in 10 percent below their standard billing rates, the firm gets to keep this as a premium for being efficient."

Morrison says that a billing agreement can also contain protective carve-outs.

"The company says, for example, 'We don't expect more than one class action to be filed during the year. If there's more than one, we'll treat that in some different fashion,'" he says.

Unintended Consequences

Blane Prescott, a senior vice president of Hildebrandt Baker Robbins, warns that focusing too much on cost metrics, rather than the results a firm delivers, can have unintended consequences.

"People often want to measure cost, efficiency and other forms of metrics," Prescott says. "I don't want the metrics to blind us to what's really important in the long run, which is the bottom-line end result."

That's why in-house counsel should evaluate a law firm not solely on fees but also on the results it obtains on the company's overall portfolio of cases.

"For example, you may say it's really important to stay within the budget. What if staying in the budget means you didn't spend a lot of money [on outside counsel fees] but you ultimately lost the case? That's not a good result," Prescott adds.

Morrison recommends including a success-based component based on the total cost of resolving a matter, including settlements and judgments as well as the outside counsel fees, so the law firm has a stake in concluding the matter in the most cost-effective manner.