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Alternative Fee Arrangements: Risk Sharing Requires A Strong Partnership

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The economic recession has brought renewed pressure on law firms to adapt to the concept of alternative fee arrangements. Simply put, corporate counsel are balking at increasing hourly rates in the face of significant internal pressure to slash their budgets.[1] While alternative fees have been used for decades in many areas of large firm practice, corporate counsel are increasingly looking for firms to offer innovative ways to structure fees that reflect a firm-client partnership with respect to risk sharing.[2] Those firms embracing the demand for innovation are poised to establish new and lasting "partnerships" as the business model for operating law firms continues to evolve.

The concept of alternative fees goes beyond discounted hourly or even blended rate structures. Many large corporations have sought to push law firms beyond simply slashing hourly rates towards a host of alternatives, including fixed fee models.[3] The primary reason may be cost control, but progressive corporate counsel also highlight the lack of alignment between firms' traditional billable hour fee structures and the goals of their clients.

Clearly, those firms who demonstrate an innovative mentality towards partnering with clients to share the risk of legal expenses stand to reap significant rewards. However, the change required for many firms to succeed should not be taken lightly. Law firms must adapt a new skill set which can generally be described as project management: developing reliable forecasting methods, pushing cost accountability to the lowest levels of firm personnel, rewarding efficient problem resolution, creating best practices for streamlining the process of legal work, and establishing relationships with clients that lead to open and honest communication. To a business executive, these areas have long been required for running a market-leading organization.

If one accepts that the paradigm shift away from billable hours is upon us, the question becomes how can a law firm adapt and grow using alternative fee structures. The first task is to define a suite of alternative fee offerings for potential clients. Among the most common are: risk collars, fee caps, fixed fees for a single engagement, fixed fee menus, portfolio fixed fees, retainers, success fees, holdbacks and full contingencies. Some of these concepts are self-explanatory, but others require a brief description.

The term "risk collar" refers to an hourly billing arrangement built around an estimated budget for a particular matter. The client pays a bonus if work is completed under budget and/or gets a discount if the work goes over the budget. Fee caps are used to create a ceiling for total billings at a set hourly rate, and the law firm agrees to absorb the cost for work performed above the cap. Fee cap arrangements often include a safety valve provision where both parties agree to renegotiate if the fees exceed the cap by certain number of dollars or hours.

The fixed fee varieties are generally implemented by providing a set price for the scope of work entailed, and the clients typically pay the fixed fees on a monthly basis to provide liquidity to the law firm. A great example of the successful implementation of a fixed fee program can be found in Orrick's partnership with Levi Strauss & Co.[4] The global law firm was able to capture almost 100% of the apparel maker's business by committing to a fixed amount for all legal services provided. The obvious benefit is revenue growth for Orrick and cost stability for Levi Strauss, but there is an intangible benefit of having a dedicated relationship that will likely result in fostering a more open relationship between the organizations which should further support cost containment.

Success fees and hold backs both typically call for a set fee to be paid for the specific engagement and then a bonus award if the desired results are achieved. This concept has gained traction because it requires firms and clients to confront the often difficult question of defining success, particularly in complex litigation. Examples of success metrics include time and type of disposition, favorable judicial rulings, and resolution before costs reach a certain level. Offering a success fee for a mutually set goal ensures the firm will allocate sufficient resources to maximize profit margin while still providing flexibility to do the work as efficiently as possible. Expectation setting at the outset benefits both parties because it aligns goals and requires clients to carefully consider the amount they are willing to spend in order to achieve the desired results.

An example of the rewards that await firms who proactively market alternative fee proposals is the partnership between Jackson Lewis and Pfizer.[5] Jackson Lewis preemptively approached Pfizer about taking on all of its U.S. labor and employment work for 2008 and 2009 on an alternative fee basis. The firm conducted an analysis of the historical geographic distribution of Pfizer cases and selected partners that would be best suited to represent Pfizer across 36 locations. Jackson Lewis also created a list of firm experts that would be available to assist in various areas of employment law and provided Pfizer with access to a dedicated site that tracked case activities. As a result, Jackson Lewis was awarded national counsel status in return for an annual cap on fees. Pfizer has been a leader in alternative fee arrangements and reducing the number of outside firms it does business with across all areas of the law through its Pfizer Partnering Program which has led to double digit reductions in spending over the past several years.

The foregoing leads to two conclusions. First, corporations will continue to push on their external legal vendors for more predictable fee structuring. Estimates are that about 11%, or $7 billion, in legal fees come from alternative billing arrangements and most experts project substantial growth in the future. Second, relationships created on alternative fee arrangements will only be successful if there is an open and honest dialogue between the parties. Most of the RFP processes initiated by corporations today simply do not provide the level of detail firms need to provide an accurate estimate of costs. Firms must be able to understand not only past spending patterns but also have access to information supporting clients' perceived business risks in the future.[6] Corporate counsel must be privy to some elements of firm cost structure to have reassurance that there is true risk sharing taking place. The parties must carefully define the scope of the engagement and be willing to modify agreements to share the burden of unforeseen circumstances.

In short, alternative fees may be the path towards legal cost stabilization and increased firm accountability, but it will not come without significant effort by both sides. Despite the economic pressures facing businesses today, the fact remains that over 80% of all legal work is done on an hourly basis.[7] The concepts discussed will only gain traction if billing agreements are structured in a sustainable manner that is mutually beneficial. What is fairly certain is this trend is going to force substantial change within the legal industry. The question is whether firms and their clients are willing to develop the processes necessary for the change to succeed.

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