

## Value Focused Fees – It's No Longer Whether or Even Why Not – Now It's When?

(This will be stated in separate box inserted into the column) In article 1, we explored the structural impediments in large law firms to alternative fees, the role of the relationship partner, and the need for the client to push for and support the relationship partner in adopting alternative fee structures. Article 2 examined the pitfalls of some so-called alternative fee structures and laid the groundwork for an alternative fee structure that works for both the client and the firm. We now turn our attention to the client – and in particular the in-house team responsible for delivering legal services to the client. This awakening giant that has both enabled and empowered the firms to structure the relationships as they are today now holds the key to driving change to value focused engagement models.

The critical element in alternative fee structures is having an element of shared risk and performance. We call these “value-focused” fee structures, and while some debate the interstices of the definition of “value,” it really comes down to efficiency, effectiveness and customer satisfaction. The debate is no longer about why or whether we should move to value based legal service delivery models – it's about how and when.

The “stickiness” of the billable hour reflects four basic realities. First, billing by the hour is in the interest of the firm because the enterprise is built on increasing revenue, realization, and leverage.. Second, lawyers, while analytical and calculating, are known neither for creativity nor risk appetite. We tend to be conservative, focused on precedent, identifying legal barriers for our clients by amplifying the negative, and seeking ways to eliminate, avoid or mitigate actual, potential or imagined risk. Third, lawyers are generally better at arguing and debating than doing. We've had more than a decade of discussion about alternative fees and the demise of the billable hour, but little actual movement. Sure, there are pockets of enlightenment and the environment for change has ripened. Perhaps even a tipping point has been reached. But complacency and vested interests in perpetuation of the status quo, traits shared by both outside and inside counsel, remain as formidable hurdles to change. These barriers are due to the failure of the in house counsel to foster and demand change. Fourth, while law now is “big business,” most lawyers lack the training, instinct and interest in understanding how business really operates. Most are unprepared to perform the managerial functions essential to running an efficient and effective economic enterprise.

Let's examine how to get where we all agree we are going.

**We have to stop the “it's all about me” mentality.** It should be about the firm and the company, not the individual. Reducing net legal costs and increasing net recoveries contribute directly to the bottom line. In house and firm lawyers should recognize their interest and responsibility for each and be rewarded and penalized accordingly.

**We have to recognize that while the system may be broken, we're in this together.** While “in-sourcing” is always less expensive, we can not afford to have the capacity and capability inside for all types of legal service, let alone peak demand. While in-house lawyers need to reduce costs, they also need outside providers. This means the outside providers must be financially sound and profitable. The goals of providers' profitability and reduction of in-house costs are not mutually exclusive if both parties shift away from top line revenue growth for the firm to increasing profitability through cost reduction and efficiency.

**We have to make value the focal point of all relationships.** Article 2 said it best – if you pay by the hour you buy hours – not results or satisfaction. If we shift the engagement to value, we'll focus naturally on efficiency and effectiveness.

**We have to build systems that are not zero sum games.** The client's most basic fears about alternative fees are that they will ultimately pay more, that the firms are simply locking in profits and avoiding risk. Firms fear that clients will not treat them fairly and want to reduce firm profits. Individuals on both sides of the aisle fear performance criteria threatens their job and economic security and diminishes their "professional" independence and stature. Effective value focused structures recognize and reconcile these conflicting fears and interests.

**We have to move towards the highest and best use of lawyers.** Law firms are economically inefficient at providing process and content – partly because of high labor rates but primarily because both inefficiencies bolster revenue generating hours, which is consistent with the current structural model. Lawyers are good at (and get more job satisfaction from) advocacy and counseling – but those activities generally yield lower aggregate hours. Value focused systems should encourage efficiency in the former and reward effectiveness in the latter.

**We have to stop mutually destructive practices.** Every time we say "we hire the lawyer, not the firm," we empower the individual attorney to act as a free agent. Every time a firm "buys a book," we encourage the view of clients as chattel. Once we find a firm that walks the value talk, we should see the relationship as B2B not B2A, and stay with the firm so long as it continues to walk that talk. Firms, on the other hand, should hire and keep only those attorneys that get the importance of value focused engagements.

**We have to make this important for those that work for us.** It is the responsibility of leadership to replace law firm remuneration systems that encourage inefficiency and in house engagement models that ignore value focused disciplines. Without the right tone at the top, the mood in the middle and the focus on the floor cannot move to value.

**We have to understand that with change sometimes comes dislocation.** –For the good of the enterprise, it can neither hire nor afford to keep those that do not embrace the particular flavor of value focus that's appropriate for the enterprise. Those that won't or can't share those values may be perfectly good lawyers – indeed they may be great lawyers – they just are not going to be good lawyers in the enterprise and they should move on.

**We have to rally around those that are doing it right.** There are many paths to enlightenment in this area and one size does not fit all. We need to celebrate and promote the success stories, learn from what has and has not worked, and offer to be mentors to the increasing number of fellow travelers that want to start but somehow just can not find their way. The brighter we make the light of those who have taken the road less travelled, the easier it becomes for others to see their way.

**Finally, we have to have the courage to lead, the creativity to experiment, the fortitude to persevere and, yes, even the character to learn from failure.** There will be failures. It happens whenever something new is tried. So the fact of failure is not significant. What is significant is how we learn from those failures.

FMC Technologies, a Fortune 500 company, spends less today on total legal services than it did eight years ago. That's pretty astonishing in a world where law firms have raised their rates approximately 8 to 10 percent per year, internal costs (driven primarily by personnel expenses) increased approximately 4 percent annually, and there is increasing demand due to regulation, globalization and growing complexity. We have reduced actual legal spend while more than doubling the size of the company. One of the most important reasons for that performance is that we have for years used performance based, value focused fee structures. For several years, 100 percent of our U.S. work, and most of our international work, is done on an alternative fee basis. Our most common model is a variant of the hold-back model. We call our version the Alliance Counsel Engagement Model or ACES©. In our simplest iteration, we hold back 20 percent of the fees and expenses paid and then pay 0 to 200 percent of that hold back based on the firm's report card. That report card has six factors - -which, are the same six factors used in the Serengeti

Tracker attorney evaluation tool and the ACC Value Index. Those factors all relate to effectiveness, efficiency and customer satisfaction – in other words, value.

By having skin in the game, paying bonuses for truly outstanding performance (not just good quality work), we have constructed a system that requires up front establishment of expectations, encourages constant communication of progress and variations, provides meaningful feedback on performance, and fosters continuous improvement. Though our total legal expenses have declined over time, last year we paid on average 107 percent of invoice – in other words, we bought fewer hours, paid more for them, but received value in the form of efficiency and effectiveness. The firms realized a higher profit margin on those hours and had more inventory or capacity to sell to others. In my world, that's a win-win!

It can be done – but it requires discipline, introspection, creativity, dislocation and perseverance, The question for you is not should you move to value focused fees or even why haven't you? The environment and even your fiduciary responsibility to your company have answered those questions for you. The tools are there. The help and mentoring is available. The time is ripe. The only questions now are what particular type of value focused fee structure works for you and how will you get your stakeholders to change?