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Alternative Fee and Billing Arrangements: A Primer

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The most significant current public discourse regarding law firm revenues is the increasing popularity of Alternative Fee (or Billing) Arrangements. The tide has even provided a generally accepted acronym of AFA. These arrangements are aimed at destroying or at least seriously maiming the invidious hourly billing process, which economically incentivizes inefficiencies and subordinates a law firm's economic interests to those of the client. The hourly rate may be either dead, suffering a lingering death or in a simple state of somnolence, depending only on whether the observer is an optimist, a pragmatist or an ostrich. Nonetheless, keeping careful track of hours billed will remain a much needed tool to monitor productivity, efficiency and, most significantly, profitability on engagements.

The facts are plain. We all know about the rising tide of fixed fees, alternative billing, and holdbacks depending on results, success fees, radical convergence and fixed retainers. Let's be completely clear on what this means: ***Clients, particularly those of significant economic clout are passing all or most of the risk on legal engagements to the law firm***.

However, the implementation of an AFA that serves the best interests of both law firm and client requires careful planning and implementation so as to maximize revenue production, limit the risk assumed by a law firm and provide the greatest value to the client. Some of the detailed planning and implementation of an AFA are described in detail below.

Added to this new discourse is yet another game changer: The data base recently announced by a significant group of corporate counsel (the "ACC Value Index") under which law firms will be rated by clients on a scale of one to five for six criteria ([1] understanding objectives/expectations; [2] legal expertise; [3] efficiency/process management; [4] responsiveness/communications; [5] predictable cost budgeting skills; and [6] results delivered/execution]) and this data base will be available for all corporate counsel. Thus far, more than 1,800 evaluations have been made of 600 law firms. Currently these evaluations are being made on a general basis. Inevitably, I am confident, they will likely be subdivided in to different practice areas.

The one area in which law firms consistently score the lowest in the ACC ratings is in the area of cost budgeting skills.

Let's also be clear on what the passing of that risk mandates: Legal work must be handled efficiently by experienced well trained lawyers.

Let's also be clear that passing the risk will require law firms, for their own survival, will be required to vastly improve their budgeting skills. The inevitable result of the combination of passing the risk as well as the public data and rankings is that there will emerge a new critical category of either non-lawyer managers or specifically trained lawyers who will function as project managers, of the kind that exist in so many other industries. In order to further compete effectively in this new transparent world, law firms will require (a) client relationship managers; (b) competent and efficient lawyers; and (c) embedded quality control standards and personnel. Deployment of resources to fulfill an engagement while taking every reasonable precaution that a matter results in taking on too much water in a rocky sea. Critical function of these project managers, sometimes dubbed as "client relations managers" involves risk management, monitoring work flow and budgetary issues. Risk management is essential in assessing the financial risk the firm is undertaking in an alternative fee arrangement. Budgetary management is critical in monitoring the successful and cost efficient Similarly, budgetary proficiency requires, particularly on an hourly fee engagement, the ability to more accurately provide a fee estimate, monitor and manage the progress of the matter keep the client timely informed of any required changes in the budget, with detailed and informed reasons, while being able to adequately explain why a higher budget was not foreseen.

These client relationship, project and risk managers will need to deploy existing technologies, in use for more than a half of a century, to provide an informed and intelligent assessment of the likely cost and risk involved in any engagement. These technologies have been used by engineering firms, consulting firms, architects, R&D firms and other service providers who have been delivering services for fixed fees for decades. The application of these skills will permit a law firm to propose an AFA on a more fully informed basis than is currently the vogue: A partner receiving an RFP for an AFA simply circulates an email to his or her partners and billing department inquiring as to total fees charged in the past on similar engagements aligns the responses on a bulletin board in his or her office and then tosses a dart at the board, with the fee closest to the dart being the suggested AFA total.

The consequence of the increasing demand for AFA's is that as the recession subsides, the entire ecology of the law firm/client relationship will radically change. Leverage is largely irrelevant. Law firm survival and success will be dependent on the effective deployment of the relationship managers, project managers, efficient lawyers and quality control.

And, speaking of game changers, the most remarkable example of convergence and the complete passing of the risk was the deal announced in November of last year between Orrick and Levi Strauss. Under that arrangement, Orrick undertook the complete legal representation of Levi Strauss on a worldwide basis for a fixed single fee, with the exception of trademark work to be continued by Townsend & Townsend. The deal requires Orrick to provide all legal services required of Levi Straus, anyplace in the world on every matter (with one small exception in the trademark area). Orrick is taking on the entire risk. If outside counsel is required in a jurisdiction in which Orrick does not have an office, Orrick is required to engage and pay for that counsel. A super sub-specialist needed that Orrick does not already have in its ranks? Orrick's problem.

The advantages and risks are obvious. Orrick obtains predictable and regular payments of significant amounts. Levi Strauss no longer has any risk in exceeding its legal budget for any reason. Levi Strauss no longer has a need to put its counsel's detailed bills under a microscope. Win-win situation? Maybe. But one cannot over-estimate the risk taken by Orrick. Similarly, one should not under-estimate Orrick's potential rewards.

With proper risk management and assessment, together with excellent project management, this model is beyond intriguing. Consider your own client base and ponder whether such an arrangement might provide advantage to the client and the firm. Risk is always measured against reward. But, the opportunity may provide the firm with enormous opportunities: expansion in to new practice areas, developing new relationships with firms around the world, and, of course, regular and predictable cash flow.

The clout of the ACC, a potent force in the buying and selling of legal services is contributing mightily to new realities, which will have staying power. The ACC plainly told law firms that hourly billing will be subject to material cuts. Those decreases, in this buyers' market are most often a return to 2008 rates or a flat 10% reduction of 2009 rates. Firms that had hoped for a modest 3% or 4% rate increase in 2010 have been knocked down. Firms that had based budgets on the expectation of a flat 2010 now need to confront a likelihood that 2010 will show less revenue, a fact further exacerbated in the widespread reduction in timekeepers. The remedies are few: Further reductions in support personnel, more efficient reliance on technology and more efficient work flow management. And enhanced management of AFA engagements.

Accordingly, while AFA's may be as diverse as the imagination may allow -- from fixed fee to straight contingency engagements -- a more prudent and mutually acceptable approach to an AFA, particularly on more complex engagements, would be one in which the law firm agrees to either undertake a matter for which it will bill a fixed monthly amount is paid, which amount should be the equivalent under which, *after careful assessment by an appropriate risk manager of all available data,* the law firm makes an informed assessment of (a) the likelihood of success on the engagement; (b) the amount of personnel, both professional and support staff likely to be required; (c) the level of professional staff required, from junior to senior associate; (d) the length of the engagement; and (d) any unique or novel reasonable foreseeable issues that may arise.

Once these key ingredients for the AFA recipe are gathered and assessed by the client relations manager teams, the next steps are the most critical: Preparation of a work flow chart, including time lines and identification of critical path points (time proven PERT or GANTT charts or variations of these tools are probably the best tools for this purpose). Identification of the professional staff who will proceed along the time line, informed estimates of the time and (at least for internal purposes) the hours and typical hourly rates must be estimated.

The work flow chart, whether using PERT, GANTT or another format, must be reviewed in detail with the client so that there is a shared understanding of expectations, milestones, activities and critical paths. In reviewing the work flow chart, the client must receive assurance and comfort that historical bubbles of unexpected time charges (such as those arising from personnel turnover, unwarranted legal research, extended conferences among teams of lawyers, opposition to foreseeable motions to disqualify, extended document review, extraordinary disbursements, etc.) will not be chargeable to the client except upon express prior approval. Again, it is the responsibility of the client relation manager to monitor these activities and, inform the client of a change in circumstance and request approval.

Upon gathering the required ingredients of the work flow charts, an informed estimate by the firm of the total fees to be charged for the project based on ordinary and customary hourly charges should be made. The most attractive proposals to the client are ones in which the firm offers to charge a fixed monthly fee equal to a total of 65% of time logged on a particular month (based on customary rates and total fees to be charged on an engagement of this type) divided equally among the projected number of months estimated necessary to complete the project. Clients will likely a cap of these payments. Cash flow would thus be predictable and regular, to the benefit of the firm and the client. The ultimate premium would then be a "kicker" of a fixed amount payable upon the (very carefully defined) successful conclusion of the matter, which should be equal to 110% or more of realization rates, had the more customary hourly rates have been charged.

The engagement agreement should also contain carefully defined exceptions for extraordinarily material variances of the particular engagement as well as the ability of the law firm to identify those variances to the client in a more timely fashion.

The firm's financial success on AFA engagements would thus be contingent on the two most significant aspects of this process: careful risk assessment during the intake process and regular monitoring of the work flow and the processing thereof, following closely the work flow charts.

Anything short of this process, again, on more complex engagements, would be the equivalent of the firm rolling the dice in Las Vegas.

Certainly, these processes are shockingly revolutionary to law firms and the historical billing process. However, this system or its equivalent has been successfully deployed for more than half a decade by other service providers.

Further, monitoring the quality and efficiency of the professionals involved in the engagement as it proceeds and at its conclusion provides a clearly objective instrument to measure performance and value of the professionals involved in servicing the client.

These procedures give law firms the tools they so sorely lacked in the past, namely, the ability to make an intelligent and well informed AFA proposal and to more accurately and regularly report to the client on the progress of the matter.

These added complexities, acquisition of newly required skills on the part of partners responsible for the matter as well as the use of client relations managers is a direct consequence of the new world of AFA's which properly deployed add profitability to the law firm, predictability to the client and an informed assessment by the law firm of the degree of risk it is assuming in an AFA engagement.

At the end of the day, the result should be a satisfied client and enhanced profitability to the law firm.

This primer, originally written in March, 2010, has a number of valuable follow up pieces, well worth reading, including:

Alternative Fee Arrangements and Value Billing -- The Continuing Public Dialogue

Alternative Fee Arrangements and Value Billing -- The Continuing Public Dialogue

Alternative Fee Arrangements: Lesson II of the Primer

Yet a Little More on Legal Project Management

How to Effectively and Efficiently Integrate Marketing Your Alternative Fee Arrangements with Your Other Marketing Activities