Alternative Reality:

Road rules for ensuring that the cure for the billable hour isn't worse than the ailment itself.

(first published in *The American Lawyer*, May 2009)

Could it be that the crisis-opportunity trope we've heard so often in the past few months ("never let a crisis go to waste") applies to the legal industry too? More and more, large firms are finding ways to align their interests with those of clients, cutting costs by laying off lawyers and staff, slashing associate bonuses, withdrawing or deferring pricey offers to first-years, and freezing associate pay (or even rolling it back). The Association of Corporate Counsel is even using its bully pulpit to pressure firms into aligning the cost of legal services with the value delivered. Although the ACC "value challenge" does not expressly call for alternative fee arrangements, the era of finger-pointing between clients and their outside counsel over who is most resistant appears to have come to an end. No less than the presiding partner of Cravath, Swaine & Moore has expressed disdain for the hourly rate and called for something different. It may have taken a generation, but change is in the air.

Creating an intelligent alternative fee structure isn't rocket science, but it does require some thought. Here are some rules of the road.

- Understand each other's position. When it comes to legal matters, clients have two overriding interests: They want a positive result, and they would like a reasonable, predictable cost. Generally, the more important the matter, the less important the cost, and vice versa. Protecting a corporation's stock value on an alleged Foreign Corrupt Practices Act violation is more important than a cost overrun the work might create, but when it comes to negotiating form licensing agreements, the cost overrun trumps the result. Run-of-the-mill work had better be handled at the lowest possible cost, and there shouldn't ever be cost overruns.

From the client's point of view, the hourly rate is the worst of all worlds. Costs are unpredictable, there is no direct financial incentive for the firm to achieve a great result, and the risk of a cost overrun and a bad result are borne entirely by the client, since the fee is the same regardless of the outcome.

Now for the firm's perspective: Firms are businesses, just like their clients. They need to deliver a competitive return on their investment to their owners, the partners. If they don't, those partners will ply their trade somewhere else. We may be in a downturn that has produced a glut of underproductive talent, but over the long term, the global economy will grow as free-market economies take hold in the developing world. We know now better than ever that free markets must be appropriately regulated, and we know from experience that regulation creates demand for lawyers. The talent war may be in a lull, but upward pressure on law firm profitability continues as firms try to hang on to their best talent. As the economy rebounds, this pressure will only grow.

From the firm's point of view, the hourly rate carries the least risk. But the firm is paid only for its time—and not a dime more if it produces a great result or operates more efficiently.

- Follow the money. If clients want great results at reasonable, predictable costs, and law firms want to make more money, aligning their interests means finding value in great results and cost savings. That means looking at two pools of money: the "results pool" and the "cost pool." The results pool is tied to a great result; the cost pool is tied to efficiency—completing work for a lower-than-expected cost.

Flat fees work well for cost pools. They are the best vehicle for aligning interests when predictability of the cost is important. If the cost of a matter can be reliably and accurately estimated, a flat fee agreement can both lower cost to the client and enhance the firm's profitability. Let's say that a client and firm negotiate a flat fee of $100,000 for a matter. The firm then staffs and handles the matter so efficiently that it expends only $90,000 in lawyer time, and the client and the firm split the savings. The client pays $95,000, achieving a $5,000 savings (or 5 percent discount), and the firm earns a $5,000 premium on its time (or an additional 5.5 percent realization). Both sides win.

Contingency fees work well for results pools. They provide incentives for achieving great results and shift part of the risk of a bad result from the client to the firm. In a basic contingency fee configuration, plaintiffs firms get a percentage of whatever damages they collect; defendants get a percentage of the difference between an agreed-upon downside and the actual amount for which the dispute is resolved.

- Avoid windfalls. Particularly in the case of plaintiff contingency fee arrangements, it is important for firms that maintain ongoing client relationships to avoid windfalls. Clients don't like them. A personal-injury victim may well be satisfied with a quick settlement in a case where liability isn't an issue and the lawyer does little more than write a demand letter or file a complaint—even after the lawyer takes a 40 percent cut. But the likelihood is that even the lay client wouldn't continue that kind of relationship, paying a huge premium (in the form of a contingency fee) for a simple demand letter, over and over. Eventually, the client would negotiate a flat fee or pay by the hour. In contingency arrangements, the typical "full-service corporate" Am Law 100 firm's goal should be to improve realization on each matter by a few percentage points, without taking on too much of the risk of a bad result or cost overrun.

- Share the risk—and the rewards. Hybrid fee arrangements can deliver the best of all worlds. Combining flat and contingency fee arrangements is often the best way to align interests. When devising the arrangement, stay away from structures that shift the entire risk to one side or the other—after all, that is a principal deficiency of the hourly rate.

Instead, seek to provide incentives and allocate risk. Take, for instance, a motion to dismiss or a summary judgment motion. Let's say a client has paid a firm $500,000 in fees for discovery and other services leading up to trial, and the firm has provided the client a budget indicating that it will cost another $500,000 to try the case. The firm recommends filing a summary judgment motion, which it estimates will cost $50,000 to prepare and argue. If the firm is more confident than the client about the likelihood of prevailing on the motion, the firm and client could agree to a flat fee of $25,000 to prepare and argue the motion.

If the motion is granted, the firm could be paid $75,000 for the motion (with the $25,000 premium being paid out of the fees saved by not having to try the case). This will increase the firm's realization on the matter by 5 percent. If the firm loses the motion and the case goes to trial, it has discounted its fee by 2.5 percent. In this instance, the firm is sharing the risk of a bad result but enjoying a premium from the cost pool.

To avoid windfalls, prepare a budget for each matter and divide the work into discrete segments, the cost of which are easily and reliably estimated. Alternative fees endanger relationships when there are too many unknowns to reasonably estimate costs.

- Avoid capped fees. They aren't good for either side. Many lawyers equate capped fees with flat fees. But they aren't the same. In contrast to a flat fee with a split-the-savings provision, a capped fee encourages the firm to run the fees up to the cap and provides no opportunity for increasing the firm's realization rate. Neither of these features is attractive to the client or the firm.

- Always have a reopener. Fee arrangements should be used to build satisfying relationships. If either the firm or the client finds the fee arrangement unsatisfactory, it should be free to reopen discussions to establish a more satisfactory arrangement.

If their use is to continue to grow, alternative fee arrangements have to be thoughtfully structured, so they align the interests of firms and clients, allocate the risk of cost overruns and bad results, and share rewards for great results and improved efficiency. Applying these rules of the road creatively, but carefully, not only helps avoid the pitfalls of the traditional fee structures, but can also reduce costs for clients and improve profitability for law firms. Next column: how to pull a rabbit out of a hat.