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Strategies for Alternative Fee Arrangements

According to recent industry surveys, media coverage, and law firm reports, in response to client demands for greater predictability and the need to manage legal costs more effectively, law firms are displaying significantly increased enthusiasm for and use of alternative fee arrangements (AFAs) in both litigation and transactional matters. Top Wall Street and national firms have stated that they have shifted 20 to 40 percent of their work to AFA arrangements. The trade press has reported that many firms, including Cravath, Swayne & Moore LLP, are increasingly embracing AFAs.[1] O'Melveny & Myers LLP, for example, reportedly is implementing a focused strategy to bill significant portions of work through alternative arrangements.[2]

Heavy corporate users of legal services are insisting on a substantial shift to non-hourly fee arrangements. Citigroup Inc. has said that alternative fee arrangements make up about 30 percent of its outside legal costs.[3] Pfizer Inc. announced plans to have 75 percent of its legal work done by a select group of law firms, each retained on a flat-fee arrangement.[4] Cisco Systems Inc. has said it uses fixed fees or AFAs for about 80 percent of its legal work.[5] The reasons for this renewed interest in AFAs are clear: clients want to drive costs down, they want greater predictability, and they want their lawyers to have "skin in the game."

To remain competitive, leading firms not only must be responsive to requests for AFAs, but proactive in initiating conversations about them with current and prospective clients. In this *ZG Alert* we outline commonly used AFAs and recommend steps to help firms structure win-win AFAs. Our aim is to encourage law firms to collaborate with their clients in devising fee structures that align their interests. The client's principle interest is to achieve a desired result at a predictable cost, often lower than its cost would have been under an hourly fee arrangement. The law firm's interest is to deliver the client's desired result at a cost commensurate with the client's perception of value, while at the same time achieving the highest level of profitability it can command. Properly structured and negotiated AFAs should align these interests.

Alternative Fee Arrangements: Definitions

In addition to the hourly rate, there are two basic fee arrangements (flat and contingent) and any number of hybrid fee arrangements.

Flat Fee: Under a flat-fee arrangement, the client pays an agreed-upon sum of money for an agreed-upon amount of work. The fee can be paid in advance, when the work is completed, in installments tied to milestones during the engagement, or on agreed-upon dates, such as monthly. Unlike hourly fee arrangements, under which the client bears the risks of cost overruns and bad outcomes (*i.e.*, the client pays for all the hours expended on the project, no matter how many hours were spent or what outcome was achieved), under flat-fee arrangements the law firm assumes the risk of cost overruns and the client assumes the risk of a bad result.

Contingent Fee: Under a contingent fee arrangement, the law firm gets paid only if it achieves a financial recovery or other result for the client. Typically, the law firm receives a percentage of the total recovery. When a contingency fee is utilized, the law firm assumes the risk of a cost overrun and also of a bad outcome.

Like the hourly rate, pure flat and contingent fees shift the risk of cost overruns and bad results entirely to one side or the other. In contrast, when elements of hourly, flat, and contingent fees are combined in a hybrid fee structure, risk can be shared and interests can be aligned. Although individual law firms label or define their hybrid AFAs differently, the approaches defined below, which are in common use, are sensible win-win options.

Flat Fee with Shared Savings: Many firms keep track of their time when using flat fees. If at the conclusion of the work fees calculated on the basis of the hours worked would be less than the flat fee, the client and law firm share in the savings. This structure effectively aligns the client's and law firm's interests because it provides an incentive for the law firm to deliver the work at a cost below the amount of the flat fee. Although the firm receives less revenue than it would have had it collected the agreed-upon flat fee, its realization rate exceeds 100 percent for the hours worked.

Capped Fee: Under a capped fee, the client pays up to an agreed-upon sum for an agreed-upon amount of work or for an engagement. Capped fees often are used in conjunction with an hourly rate agreement, but the total amount charged by the hour cannot exceed the cap. If there is no shared savings component, the law firm's incentive is to bill up to the cap. As in the flat-fee arrangement, the law firm assumes the risk of a cost overrun in a capped-fee agreement, while the client assumes the risk of a bad result.

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Partial contingency or success fee: Under this arrangement, the law firm might be paid a fraction of its fee under an hourly, flat, or capped-fee arrangement, and an additional amount if the result exceeds agreed-upon criteria. The additional amount might be an agreed-upon sum or a percentage of the recovery.

Defense contingency fee: Under a defense contingency fee arrangement, a firm defending a client against a monetary claim agrees with the client on an expected outcome. If the firm achieves a better result than the expected outcome, the client pays the firm a percentage of the savings.

Phased Fee: In a phased-fee arrangement, the law firm and the client agree upon fees for discreet phases of the work. In litigation, phases might include discovery, dispositive motions, interlocutory motions, trial preparation, trial, and appeal. In transactions, phases might include due diligence work, preparation and negotiation of the transaction documents, and the implementation phase of the transaction, including the closing and post-closing matters. Different phases might utilize different structures, including the hourly rate, a flat fee, a contingency fee, or an AFA.

Holdback: Holdbacks can be employed under hourly and flat-fee arrangements. Under a holdback fee agreement, the client withholds an agreed-upon amount or percentage of the fee until an agreed-upon milestone or result is achieved, or until completion of the engagement. The obligation to pay the amount withheld is triggered if the law firm achieves a result. In some instances, the law firm and the client include a contingent element with a holdback; if certain criteria are met, the firm is paid the holdback plus a bonus or success fee.

Blended Rate: A blended rate is an agreed-upon hourly rate that applies to all lawyers working on a matter.

Some firms consider discounts to the hourly rate a form of AFA. Many in-house counsel insist on such discounts, using them as a surrogate for effective cost management. Under limited circumstances, we have seen law firms agree to discounts during the recession to maintain volume, keep utilization high, and send a friendly message to clients. Although discounts can be used to grow the top line, unless firms use them in conjunction with a two-tier billing rate (that is, a "standard" rate that the firm ordinarily would charge, which is higher than a discounted "preferred client" rate), or unless they are combined with opportunities to earn back the discount, they erode the bottom line. We recommend that they be used sparingly, especially when demand for services is healthy.

Planning Alternative Fee Arrangements: The Law Firm's Analysis

We believe clients choose among comparable law firms on the basis of relationship, reputation, and perceived value. The fee structure can drive the perception of value as much as the amount of the fee. Because the hourly rate fee structure is a "cost-plus" approach to pricing, it is perceived by many clients as incentivizing law firms to bill more hours so that they can be more profitable. Although hourly rates often are perceived as being "safe" for the law firm, AFAs can produce higher realization rates than the hourly rate if they are well-planned, -staffed and -managed. When structured with this approach in mind, calculating the AFA does not have to entail complex cost calculations. We suggest law firms consider the following points when discussing, structuring, and evaluating AFAs:

- **Understand the client's objectives and needs in each engagement and structure the AFA accordingly.** Is the engagement a straightforward matter in which the client is most interested in the predictability of fees, or is it "bet-the-company" litigation in which the amount of the fee is largely secondary to the client's need to prevail? In the latter circumstance, the client may well be willing to pay a premium for a great result.
- **Rather than seeking windfalls through AFAs, approach them as mutually beneficial, win-win opportunities.** AFAs can help clients manage budget risks, and thereby increase client satisfaction, strengthen client relationships and, at the same time, improve the firm's realization rate. Small, single-digit increases in realization can improve a firm's profitability significantly.
- **Prepare a matter-management plan and budget prior to deciding on a fee structure.** Scenario planning is a key part of structuring an AFA. Firms must prepare matter plans and budgets that anticipate different courses a litigation or transaction may take. Line items for each step of the matter should include "high-" and "low-" cost estimates to set reasonable expectations for the client and the firm in negotiating the AFA.
- **Consider whether the work should be bundled into a portfolio of matters or segmented into parts.** Some entire matters are suitable for a single AFA. Others might be suitable for phased-fee structures. Still others are well-suited for bundling into fee arrangements that encompass an entire portfolio of work, allowing the firm and the client to benefit from agreeing in advance on a fair return for the portfolio (based on an agreement about an acceptable average cost for each matter).

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- **Maintain an open dialogue with the client about the AFA.** The firm and the client should agree at the outset of the matter that if, as the matter progresses, the AFA will give an unreasonable windfall to either of them, they will revisit and modify the AFA at various milestones. Every AFA should include a "re-opener clause" that anticipates this possibility.
- **Prepare a billing timetable that informs the client when it should expect to be billed for each portion of the fee.** Most clients operate on annual budgets. Knowing how much they are going to have to pay during the budget cycle is critical for their budget management.
- **At the end of each matter, measure the firm's realization rate under the AFA against what the rate would have been under hourly billing**. From a law firm's point of view, realization rate is the best measure of an AFA's success. To calculate the rate accurately, each timekeeper must keep regular time records as if billing by the hour. The firm should track its results and use this information in formulating subsequent alternative arrangements.

In Conclusion

Despite reported increases in the use of AFAs, data from a 2009 LexisNexis survey revealed that 71 percent of 150 in-house lawyers surveyed believe law firms are not doing enough to respond to the financial pressures clients are facing.[6] This perception may be because many firms believe their clients' AFA strategies are too focused on cost. A recent LexisNexis study found that 77 percent of 300 participating law firm lawyers believe clients are too focused on reducing cost at the expense of quality and long-term results.[7] For over a quarter of a century, we have believed that AFAs can produce win-win results for clients and law firms alike, and we believe both will be best served if firms are proactive in initiating discussions about AFAs. We would be happy to speak further with our clients and other friends about them.

Endnotes

1 As reported in Michael Orey, "From Cravath: How to Cut Corporate Legal Costs," *Bloomberg BusinessWeek*, Nov. 1, 2009, http://www.businessweek.com/managing/content/nov2008/ca20081121_351307.htm.

2 As reported in Alison Frankel, "Whole Lotta Shakin' Going On," *The American Lawyer,* Nov. 1, 2009, http://www.law.com/jsp/tal/PubArticleTAL.jsp?id=1202434635671&slreturn=1&hbxlogin=1.

3 As reported in Brian Baxter, "Law Firm Leaders, Citigroup GC Discuss Fixed Fees," *AmLaw Daily*, Sept. 30, 2009, http://amlawdaily.typepad.com/amlawdaily/2009/09/law-firm-leaders-opine-on-future.html.

4 As reported in "Pfizer's Top Lawyer is Out to Change All the Rules," *Corporate Legal Times*, Dec. 31, 2009, http://www.cltmag.com/pfizers-top-lawyer-is-out-to-change-all-the-rules.html.

5 As reported in Nathan Koppel and Ashby Jones, "'Billable Hour' Under Attack," *The Wall Street Journal,* Aug. 24, 2009, http://online.wsj.com/article/SB125106954159552335.html.

6 LexisNexis, "State of the Legal Industry Survey," Dec. 2009, available at http://www.lexisnexis.com/about/releases/1120.asp.

7 Id.

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