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Tools for the Nimble In-House Counsel: Intelligent Design for Alternative Fee Arrangements

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Executive Summary

Interest in alternative (non-hourly) fee engagements has accelerated in recent months. One of the common arguments for maintaining the billable hour is that the level of effort required in the delivery of legal services is inherently unpredictable. Yet every day, C-level executives are required to make decisions that are even more uncertain and consequential than lawyers' fees for open-ended litigation. Should an aircraft manufacturer develop a new line of planes? Should a widget manufacturer open a new plant? Should a company sell a division? These types of strategic decisions will affect a company for years or decades to come and they are often made in the face of extreme uncertainty. In some cases, financial analysts may develop computer simulated models to shed some light on the costs, benefits and risks. One of these modeling methods, known as Monte Carlo analysis, can be a useful collaborative tool when developing fee engagements between inside counsel and outside law firms. This technique is commonly used in other functional areas that require formal project management techniques. It is also embraced by practitioners of continuous improvement initiatives, such as Six Sigma.

In practice, we at Womble Carlyle have found that constructing a statistical model to price engagements forces us to think carefully about the assumptions. The assumptions behind these models frequently get at the heart of the value question and prompt upfront communication between the client and the lawyer before the engagement. By carefully thinking about the costs and benefits, both the lawyer and the client build a trusting relationship by having clear and realistic expectations of each other.

Understanding Cost Variation in Legal Services

The late Dr. Edwards Deming, the father of the modern quality movement, used to teach many of his management principles through a game known as the "red bead experiment." In the game, Deming recruited willing workers from the audience and directed them to use a special paddle to draw beads from a bin that contained a mix of red beads and white beads. The workers were told to fill their paddles with only white beads. This was an impossible task because workers had no way to separate the red beads from the white beads when using their paddles to draw the beads. Dr. Deming, with his towering presence and deep base voice, would play the role of the "typical" manager, mocking and criticizing these willing workers when they inevitably drew red beads. He would grant the "high performers" merit-based pay bonuses for their unique ability to draw more white beads. He would threaten to fire people and shut down the factory if the group had too many red beads. The full game took more than two hours to play and highlighted many timeless principles of good management. One of the important takeaways was that until leaders can begin to understand the true sources of variation in a system, imposing reward and punishment schemes on actors within the system will have little effect.

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Unfortunately, in today's hypercompetitive economy and especially during the most recent economic downturn, both outside law firms and in-house counsel may sympathize with Deming's willing workers. In-house counsel are under relentless pressure to control costs from their General Counsels, CEOs and Board of Directors. They are understandably irate when their law firms send them a $20,000 bill that solves a $10,000 problem. Meanwhile, outside lawyers work very hard to achieve to a good outcome for their clients and are told that their rates are too high, that they work too slowly, that they used the wrong people, or that they misunderstood the objectives of the engagement.

In response to these and other issues, the Association of Corporate Counsel (ACC) has wisely issued the Value Challenge—a call for national dialogue to reconnect the law firm business model and the delivery of legal services with corporate needs and objectives. As this discussion has gained traction and as general economic conditions have deteriorated, many have begun to explore "alternative" fee arrangements that move away from traditional hourly billing.

At the beginning of a new engagement, an in-house counsel, under pressure to control costs and frustrated over their law firm's billing practices, may finally dictate to their law firm, "we will not pay more than $X for this case." Outside law firms, sometimes for economic reasons and sometimes perhaps out of sheer comfort, may avoid offering alternative fee engagements in favor of traditional hourly billing.

When discussing fees for the engagement, both sides negotiate for favorable terms. In a more sophisticated dialogue, some may even develop a budget for the case; but frequently missed in these horse-trading discussions is an intelligent assessment of the risk related to that budget. The word "risk" in this context has special meaning; I am not referring to risk in the context of the matter's outcome, but rather the risk that the actual effort on the part of outside counsel will exceed what was budgeted. In hourly rate arrangements, the client bears nearly all of the risk of unexpected developments while under a flat fee, the law firm bears those risks. Regardless of who bears the risks, a rational fee schedule requires both sides to have an understanding of those risks—this should be a collaborative effort rather than a competitive one. Consider this: which engagement is easier to price, one that has an estimated cost of $50,000 where unknown conditions may drive costs somewhere between $45,000 to $55,000 or one that is estimated to cost $50,000 but may vary between $10,000 and $90,000? In the case of the second scenario, would the client feel good about a flat fee of $50,000 when the lawyer only put in $10,000 of effort at their hourly billing rate? Conversely, would the law firm feel good about a flat fee of $50,000 when they had to pay $90,000 in labor costs?

In some alternative fee discussions, the client may ask the lawyer for a flat fee and the lawyer may quote a flat price, and that is where the discussion ends; but when we fail to discuss alternative scenarios and the uncertainties that may affect the final costs, we miss an opportunity for a discussion about value and the client's real objectives. Unfortunately for both the lawyer and the client, the party on the other side of the transaction or litigation matter also gets a vote when it comes to costs. Their interests, coupled with the interests of other stakeholders such as judges, regulators, arbitrators, and various third parties all influence the cost, regardless of our best efforts to accurately budget the case. These variations are like Deming's red beads. Unfortunately, there are limits to what the client and outside counsel can do to limit the variation, but we can use quantitative methods to at least understand the risks.

Quantifying Risk

How exactly do we quantify the variability associated with a certain case? Let's start with an (overly simplistic) example of a litigation case that is budgeted by phase.

	Estimated Cost
Case Assessment, Administration	**$15,000**
Pre-Trial Pleadings and Motions	**$35,000**
Discovery	**$70,000**
Trial Preparation and Trial	**$60,000**
Total	**$180,000**

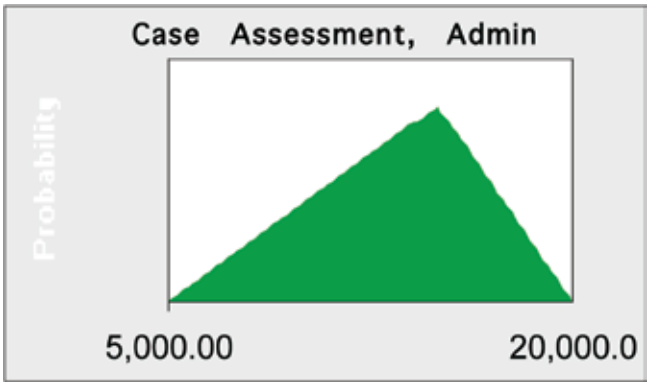
Let's be wildly optimistic and assume that when the bills are fully settled, we have a 50% chance of hitting our budget for each one of the phases to the penny (what do you think the real odds are that you will hit your $70,000 Discovery budget to the penny?). The probability of hitting the total budget can be found by multiplying the probabilities of each phase. 50% x 50% x 50% x 50% = 6.25%. Hence, we only have 6% chance of hitting our budget under our most optimistic assumptions. So we know our actual legal bills won't be $180,000, but the real question is how far off are we likely to be? We might go back to the drawing board and figure out the best case and worst case scenarios for each one of the phases. Maybe it looks something like this:

	Best Case	Estimated Cost	Worst Case
Case Assessment, Admin	$5,000	$15,000	$20,000
Pre-Trial Pleadings and Motions	$15,000	$35,000	$60,000
Discovery	$40,000	$70,000	$140,000
Trial Preparation and Trial	$30,000	$60,000	$90,000
Total Cost	$90,000	$180,000	$310,000

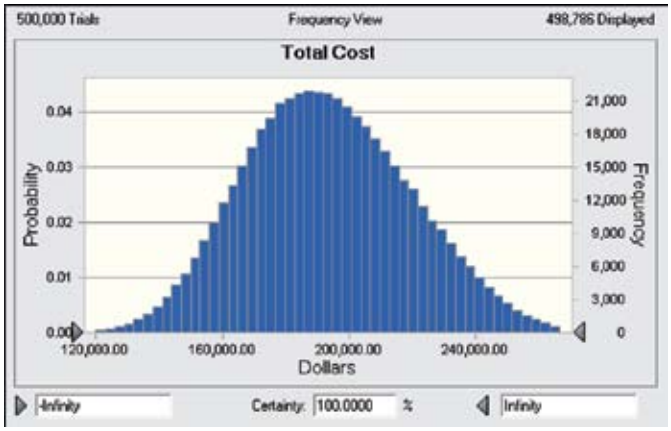
This is a good starting point and it's a helpful exercise to begin thinking about how the case may actually unfold, but unfortunately, this still doesn't tell us much we should budget. There is a very wide difference between $90,000 and $310,000 because the best and worst case scenarios represent two very extreme (and unlikely) situations: the best case scenario assumes that we will hit the lowest possible cost for all four phases and the worst case scenario assumes that we will hit the worst case in all four phases. But the actual outcome is likely to be somewhere in the middle. We still haven't answered our question: how far from our original budget are we likely to vary?

Monte Carlo Modeling

To address the issue, we can create a statistical model. One technique, known as Monte Carlo Simulation, allows us to instruct the computer to create random data within parameters we specify. Using the parameters above, we can tell the computer to begin generating data points for each of the four phases using the lower and upper limits described above. We can also tell the computer that we think the estimated cost is more likely than the other numbers. This will weight the computer's picks towards our "Estimated Cost" column. For example, when the computer is picking random data points for "Case Assessment, Administration," it will only choose numbers between $5,000 and $20,000, but it will tend to favor numbers closer to $15,000 than either $5,000 or $20,000.



Similar distributions would be assigned for the other three phases using the budgeted parameters. Next, the computer begins picking numbers over and over. Each time it will sum the numbers it picked for each of the four phases. The number of "trials" (or iterations) is up to the analyst; for this example, I had the computer repeat the calculation 500,000 times (it took about 5 seconds on an ordinary laptop). The result of these calculations is a set of data that looks like a bell shape curve.



From this bell curve, we can extract several meaningful pieces of information. First we can define confidence intervals depending on our tolerance for risk. Our original best/worst case scenarios represented a 100% confidence interval, but unfortunately, the difference between the best and worst cases are so wide that it is not all that helpful. We might pick a lower level of confidence, recognizing that there is still a chance that our actual expenses could fall outside of that range. For this example, I selected an 80% confidence interval; I can be 80% confident that the cost is likely to vary somewhere between $160,000 and $229,000.

	80% Confidence Interval		
	Best Case	Most Likely	Worst Case
Total Cost	$160,000	$192,000	$229,000
Percentage Variance	(13%)		16%

There is still a 10% chance that my actual costs may be below $160,000 and there is a 10% chance that they may be above $229,000, but this is a much more workable range than the previous range of $90,000 to $310,000. Again, we want to know what is likely to happen rather than what is possible. Could the law firm now accept a fixed fee of $190,000, knowing that costs may vary between $160,000 and $230,000? It's certainly a judgment call, but the judgment is aided by having better information about the likely costs of the case.

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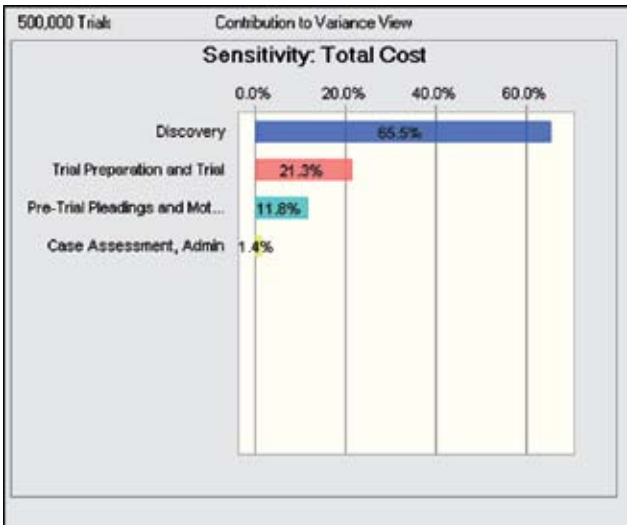
You will also notice that the highest point of the curve is $192,000 rather than $180,000. While our best guess was $180,000, once we allow for the risks, the computer is telling us that the average is more likely around $192,000. In fact, this computer model reports that if we had stayed with our original budget of $180,000, we would have been over budget 68% of the time! One of the other helpful pieces of data constructed from this curve is a sensitivity analysis that tells us which factors within the model created the variation.



In this case, the Discovery phase drove 66% of the variation within the model. In such a simple example, we might have already guessed that, but in more complicated models where there are dozens of variables, knowing which elements create variation can help us sharpen our focus to the riskiest aspects of the matter. How can we better manage discovery? Who will be responsible for the work during discovery? How many depositions? Etc. These types of follow-up questions lead the client and the lawyer back to the original assumptions and often lead to a substantive discussion on the value of the services provided (e.g. what is the right level of expertise for this type of work? Should we consider any alternatives to the current projections?). In conclusion, the Monte Carlo methods allow us to

- Gain an understanding to how much our budgets may vary;
- Determine the feasibility of our best guess estimates;
- Determine which elements of the matter may affect our cost estimates.

Monte Carlo analysis can be helpful for quantifying the financial aspects of the matter, though it doesn't necessarily point to hourly or alternative billing. It can (and should) be used by both in-house counsel and outside law firms regardless of the pricing method. If the in-house counsel desires a flat fee, they should know how far to the left/right on the cost curve the law firm is setting the fee. For example, if the law firm sets the fee at the 80th percentile, maybe it's best to pay them hourly. It's likely that either the client or the law firm will have more tolerance for risk than the other. If so, there may be room to provide one with certainty and the other with savings/profits. The most efficient fee arrangements arise when both the in-house law department and the outside law firm have a solid understanding not only of cost, but also of risk. By creating efficient fee arrangements, both groups can achieve a win-win solution and accomplish the common goal of aligning the cost and delivery of legal services with the client's ultimate business objectives.

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