

## How to Migrate from Traditional Billing to Alternative Fees

### Overview

- Defining the goals
- Planning the approach
- Types of alternative billing structures
- Key considerations to keep in mind

### Defining the goals

- Begin with the end in mind. What do you seek to achieve? The most commonly cited answers are listed below, along with key strategic questions to consider.
  - Savings: How will you accomplish savings? . . .
    - By working with your current firms in essentially the same capacity, but under a different billing structure? By looking for cost control measures that are NOT rate reductions or billing discounts (which are by nature temporary and may not lead to bottom line cost reduction.) If so, do savings for the client automatically mean reduced profit for the firm?
    - Can you work with your current firms differently to deliver the same quality, but with better approaches to accomplishing the work? What would this look like in terms of better management of process and resources, and improved utilization of technology? What kinds of efficiencies can firms adopt that cut the fat but not the bone (e.g. leaner staffing structures, better knowledge management to avoid reinventing the wheel, pushing to others work that lawyers don't need to do, etc.)?
    - By working with some new firms that might bring fresh approaches and more experience with alternative fee structures? To what extent will you engage in strategic use of competitive bidding to identify the respective strengths of different firms in these areas? Or even to gauge if costs at other firms might be lower because of geographic location or different business models in place?

- However you choose to approach it, the potential savings are real – 15% and up based on published survey data and case studies.<sup>1</sup> And these savings are not rate discounts that don't really reduce overall bottom line and aren't sustainable year after year; rather these savings are true cost control measures that last and create a platform for further efficiencies.
  
- Focus on results, risk sharing & greater alignment of interests:
  - Are you interested in having a portion of law firm compensation depend on achieving successful outcomes that are pre-defined by the client? What would this look like?
  - Who will bear the risk of new pricing and staffing structures? What should you expect the firm to “ante up” to control costs, and how will you either share the risk or reward it in your work? Incentive fees? Bonuses? By offering a larger portfolio of work to make the improved process more profitable for the firm?
  - How can you assign matters among your firms to better increase their alignment with your cost control efforts? For example, you can offer them a retainer to make them responsible for an entire arm of legal services, which encourages them to help the client avoid problems rather than minimize the amount of counseling/service they must provide to remediate problems? How can you link firm fees to matter outcomes and success?
  - If your law firms are willing to put a larger portion of compensation “at risk” via correlation to successful outcomes, are you willing to position them to earn higher fees than they otherwise would if they deliver greater economic value by reducing the liability / total resolution cost or by increasing potential recoveries or gains?
  
- Predictability & administrative convenience:
  - How much do you value the predictability and administrative convenience that comes with paying a set fee for the work delivered?
  - To achieve this, are you willing to invest some time and effort in properly crafting the terms up-front to verify that the fee amount is “right” for the work delivered and can be adhered to?

---

<sup>1</sup> See, e.g., WSJ: “Billable Hour Under Attack,” August 24, 2009, Page A1. In a survey (n=370), in-house counsel reported average savings of 15% from alternative fee arrangements.

- Are you willing to invest additional time later on to revisit the arrangement as necessary in light of changed circumstances around matter activity assumptions? Can you create a process for re-evaluation in the event of named contingencies (something of a decision tree) that allows a safety valve but still plans and delivers predictable costs and outcomes related to alternative paths?
- Other: this “how to” is constantly evolving. We welcome your ideas on additional goals and ask that you forward any you’d like to share to [accvaluechallenge@acc.com](mailto:accvaluechallenge@acc.com) and reference this ‘how to.’

### Planning the approach

To select the alternative fee structure that is right for you, it is helpful to: (1) identify people to support the analytical process, (2) identify sources of data, and (3) define the scope of work involved in the underlying matter(s). These steps will help to effectively devise the fee terms and monitor them as the engagement proceeds.

- Staffing your team: Who will perform what roles?
  - Front line lawyer . . . should have extensive knowledge of matter activity and complexity, and would be a key resource in helping to craft the proper scope assumptions to support the alternative fee. (It will also be important to have similar participation from the front line lawyer’s counterpart – the law firm attorney most knowledgeable about the matter.)
  - Senior lawyer / Practice Group Leader / Chief Operating Officer/ Law Department Executive Leader/ GC . . . is a good source to consult for strategic thoughts and buy-in on the alternative fee structure ultimately proposed and adopted. (A senior law firm attorney – like the relationship partner – should also be involved to help signal the law firm’s broader commitment to making the alternative fee work.) Part of the conversation may include “guaranteeing” an expanded book of business to incent the firm to create new staffing and fee structures that are otherwise not part of their regular processes.
  - Finance / Accounting / Procurement . . . can be helpful in performing quantitative analysis to show what certain matters have cost, or are projected to cost, under the current hourly rate approach. They can also be helpful in modeling different fixed fee alternatives (comparing cost side-by-side), and in structuring payments and providing periodic financial reports.

- Project Manager . . . someone in your department who is skilled at project management can be very helping in tracking progress versus the initial assumptions as time progresses. Alternatively, you can ask your law firm to appoint someone to do this on their end, and provide you with periodic updates.
- Sources of data
  - Client's historical information on what component pieces of work have cost in the past (this may require some digging and analysis)
  - Client's projections as to what matters or projects are envisioned to cost in the future (this will require some estimates and calculations)
  - Proposed fee structures / bid information solicited from and provided by firms with respect to a particular piece of work or portfolio of work (which can serve as a helpful "market price" reference *in lieu* of the client's historical data and which can help bring the firm's broader client experience to bear)
- Defining the scope of work
  - Analyze the underlying budgeting or work plan documents to understand what component pieces of work are projected within this matter. (If you don't have these documents in place, ask outside counsel to lay out the details).
    - Examples of litigation components / milestones include: How many company witnesses will be interviewed for fact investigation / development? How many depositions do we plan to take and defend in this matter? How many expert witnesses do we plan to work up (both offensive and defensive)?
    - Examples of transactions components / milestones include: draft term sheet; produce initial draft of license agreement; negotiate outstanding issues with other side; perform due diligence; finalize documents and conduct closing
  - Construct a current cost projection . . . using any and all available information—both from the client and the law firm based on historical costs and experience, and even if it entails multiplying estimated number of hours times to craft a starting point
  - Determine: what is a "good" (value) amount relative to the current cost projection

- Can be based on years of accumulated expertise, and a sense of what something “should” cost if done efficiently
- Can be based on calculated projections and targets that the client and firm put in place to govern what the client will pay for a particular item
- Can be based on competitive bidding among firms of “like” quality and expertise . . . to establish what market offers as the going price for that piece of work

### Some Common Types of Alternative or Value-Based Billing Structures

- To clarify . . . a **discount off hourly rates or blended rates** – while helpful in part – is not an alternative or “value-based” fee. Rather, the hallmark of an alternative fee structure is that, in some way, it utilizes a unit of measure other than time spent to determine what the client will pay for the work performed. It looks at the value of the service to the client or its worth in the larger marketplace, not the profitability of the service to the law firm.
- **Capped fees under an hourly rate approach** are commonly used to set a ceiling on what the client will pay the law firm on a particular matter, or for a particular piece of work. When executed properly, this approach resembles a fixed fee (discussed below), but in theory gives the client the added up-side of paying less if the law firm bills fewer hours than anticipated (thus not reaching the cap). While that sounds good, many observers have noted that the interests remain unaligned. The law firm does not have the incentive to invest in approaches that would reduce the cost of producing that piece of work, because it does not share in any upside for doing so. And since they know they can bill until the cap, many don’t attempt to control their costs until they’ve exceeded the cap.
- **Fixed fees** are used to affix a particular price to a “deliverable” or a distinct piece of work. Litigation examples include paying X as the “all in” fee for a law firm to draft and argue a summary judgment motion, paying Y as the “all in” fee per deposition taken, and paying Z per page or per gigabyte for first level review on a document production. Transaction examples include paying X to produce initial draft of license agreement; Y negotiate outstanding issues with other side; and Z to finalize documents and conduct closing.
- **Portfolio fixed fee.** Some clients have implemented a broader application of the fixed fee approach by assigning large portfolios of work to a single firm for a fixed fee (usually after a competitive bidding process). This larger pool of work enables client and firm to

better manage and “cover” or “self-fund” individual outliers where the activity assumptions proved to be off. It also provides the firm with a unique incentive to help the client reduce legal risks and problems since they are being paid to serve an area (e.g. HR and employment litigation, or serving the companies IP needs), and they make more and do better when they prevent problems rather than rationing services.

- ***Per capita fees / Ad agency model.*** While the fixed fee model described above focuses first and foremost on the project / deliverable, the *per capita* approach focuses on the professional(s) performing the work. The “ad agency” model fixes a set price to “purchase” the full-time or half-time services of a certain person or team of people, on the presumption that they will then produce the work required. Savings, from the client’s perspective, are calculated vs. “rack rates” for an equivalent amount of that person’s time. But the model is arguably flawed in that it does not measure efficiency, or create incentives to produce the work in less time.
  
- ***Performance-based holdback.*** Any of the approaches listed above can be supplemented with a provision tying a portion of law firm compensation to achieving pre-defined outcomes or success metrics. This can (and is) also done in more conventional engagements structured under the hourly rate model. The holdback amount (e.g. 20% of fees billed) is typically subject to a multiplier (e.g. 0, 1, 2, or 3) depending on the extent of success achieved. Examples of pre-defined outcomes or success metrics include one or more of the following:
  - Winning on summary judgment, at trial or on appeal
  - Resolving a matter at or below a specified amount
  - Closing out a matter within a specified period of time
  - Completing a merger, acquisition or deal
  - Managing the entire matter at or below budget
  - Scoring well based on pre-established client criteria (like responsiveness, creativity, diversity etc.) or process-based measurements (like performing Early Case Assessment in Litigation, managing to budget, and submitting reliable forecasts)

## Key Considerations to Keep in Mind

- Measure, measure, measure. There is truth to the old adage “you can’t manage what you can’t measure.” And measuring forces you to first define success – what gets measured gets done, and people tend to perform toward targets that are defined more successfully. Focus closely on what the client is buying, and whether the deliverables produced are in line with the original assumptions. Just because activity heats up on in one area of a matter does not automatically mean the fee should be adjusted. If other areas are less active than projected, the two may offset. Or if services that are in hot demand are not the higher level work, then they may not add proportionately higher level costs to the project.
- Encourage compensation and performance reviews linked to results, and not just to “lots of activity.” This applies to both in-house and outside counsel. Too often we assume that we’ll drive change by telling firms to do better, but if we aren’t holding the department to the same standards of management and results and performance to goals, then the message will be meaningless and the outcomes will be poor.
- Communicate early and often. What are the underlying assumptions about matter activity and complexity? What is the client buying under this fee structure? Does the fee represent an estimate or an actual quote? What are the expectations around quality, and the availability and participation of certain lawyers? For the alternative fee to work well, all of this should be addressed in advance. Beyond communication, though, there is an element of trust and cooperation in making these arrangements work. The crystal ball is never perfect.
- Plan for the unforeseen. It is important to determine how you will address material changes in case activity or complexity if the matter varies significantly from the agreed-upon assumptions.
  - Sometimes the answer lies in setting a “unit price” for certain work (e.g. “all in” fee per deposition), which can serve as the basis for calculating the revised total if the number of units changes significantly.
  - Other times, when the unit approach is inapplicable, client and firm can agree upon a “fee collar” or “look back” provision. Under this approach, the firm tracks hours spent, and at the end of the period generates a “shadow invoice” showing what the client would have paid on an hourly basis. If the amount of the shadow invoice varies from the fixed fee amount by, e.g. more than 15% in either direction (up or down), then firm and client will confer in good faith to ascertain why and discuss how to apportion the difference (i.e. below 85% or above 115%). In some instances, the apportionment ratio is agreed-upon in

advance. (Some critics argue that provisions such as this are flawed in that they essentially revert back to the hourly rate structure, and un-do the benefits of an alternative fee approach. Others, however, see them as a way to address the risk of uncertainty, while ensuring that the law firm still has some “skin in the game” in terms of covering the initial portion (here, 15%) of the overage.

- Focus on Competitive Advantage. The real long-term benefit of alternative fee billing is that it will create incentives for law firms to invest in processes, systems and technologies that accentuate their competitive advantage, enabling them to produce their work more efficiently – passing along a portion of the value to clients (as savings) and keeping a portion for themselves (as profit). Not all firms will be able to do this in all areas. To get the full benefit as the client, it will be necessary to periodically scan the market to find superior offerings on an apples-to-apples basis.
- Choose progress over perfection. In selecting your reference point for measuring success, look to show improvement and savings versus what you were spending before, as opposed to obsessing over whether you are as close as possible to the optimal price point. Success on the latter front will come over time.