The ACC VALUE Challenge

ACC Association of Corporate Counsel

The "Slow-Motion Riot": Moving Toward Better Valuation of Lawyer Services

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Reconnecting Cost with Value

Fall, 2009 **- ACC Value Challenge Toolkit Resource -** **Susan Hackett, ACC**

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How do we re-connect value and cost?

BY FOCUSING ON OUTCOMES

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Is the billable hour dead?

NO … **BUT IT WILL NOT BE THE DEFAULT MODE GOING FORWARD.**

- It will provide historical context to new service and fee valuations we're all experimenting with … Think: "Billable Hour Training Wheels"

- It will remain a part of a flexible client service tool kit.

- Firms will need to be adept at proposing whatever relationship / staffing / fee structures clients want to best align what firms want to provide with what clients want to purchase.

- For some matters / clients, that will continue to include billable hours.

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Do Clients Really Mean it This Time?

-Change will be slow, uncomfortable, experimental. Very few of us, inside or out, are comfortable or sufficiently expert yet.

-Cost control is about improved efficiency and process (the "control" part), and not merely cost. Value is not "cheap."

-Clients want firms that are aligned with them, and that share the risks of service provision. Who bears what risks?

- Change is inevitable, the paradigm has shifted; clients will not go back (even if lawyers are hesitant to go forward).

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The Disconnects:

Clients often fail to reward firms proposing value-based arrangements – clients rarely accept alternative arrangements, and worry they won't be good for the client.

The "Black Box" of fee valuation – no one knows what's in it and if they do, there's a trust and transparency problem.

Many law firms do the same kinds of work over and over and yet have no idea out how much the next matter will cost.

Clients don't think law is different: they have sophisticated valuation techniques for all kinds of risky, unpredictable work.

Clients and firms think differently about what is bone and what is fat when discussing cost control with law firms.

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Value-Based Relationships:

- Clients and firms need to develop skills/toolkits that make it possible to value each matter to suit the matter's/client's/firm's needs.
  - Value-based fees are not "alternatives" – they should be the norm.
  - A focus on staffing/efficiency is required before focusing on fees.
  - Is fixed fee anything more than a (good) budget?
  - Outcome focus: Predictability, re-invented incentives, knowledge management, risk assessment and sharing.
- Component/segment/phase -based pricing: rewards efficiency.
- Competence and performance become the value metrics, not time spent.
- Which risks are greater for firms: pricing based on selling a large inventory of hours or pricing based on value and lean efficiency?

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Costs, Efficiencies, Metrics & Billing: Alternative/Value-based Relationships

- What kinds of value-based staffing and fee structures are out there and in use?* What are their pros and cons?
- Shadow billing, safety valves, and sidebar agreements will allow adjustment as firms experiment with new “risks.”
- The movement toward component or stage pricing, involving several value-based fee and staffing practices over the course of a representation.

*Credit to the AOL law department, which developed a great outline of fee structure categories which I’ve borrowed from in some of the following slides.]

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Volume and Discounted Fees

- Description: Law firm reduces its hourly rates, often in return for client guaranteeing a certain volume of legal work. (Not an "alternative" or value fee.)

- Advantages: Guarantees work for law firm / saves business development costs. Reduced rates give client an incentive to send more work to the firm.

- Disadvantages: Experience shows that rate discounts don't generate real savings (e.g., year over year) since the incentive remains for lawyers to bill more hours, not become more efficient, establish a set value to the service, or seek early resolution. Partners may be less likely to review bills carefully when rates are discounted. Some firms agree to discounts without understanding the costs of providing the services. Firms also risk offending other, similarly situated clients who hear about the discount. Discounted fees can be difficult to process since the rates charged are not the normal fees. Unsustainable year to year.

- Collars, cuffs, and performance bonuses or rewards based on achieving shared objectives (e.g. reducing overall costs, improving cycle time, early disposition, high damages award, etc.) can help align interests and minimize the disadvantages inherent in this billing method.

Blended Hourly Rates

- Description: All time is billed at the same price regardless of who works on the matter. (Again, not an alternative or value-based fee.)

- Advantages: Easy to negotiate and administer. Clients pay lower hourly rates and law firm's senior lawyers are encouraged to delegate work to the lowest cost provider.

- Disadvantages: As value is still based on time, the incentive is again for lawyers to bill more hours: there are no rewards for efficient or early resolution. Can result in the use of less experienced and less efficient lawyers: lower quality work product and increased hours?

- When to Use: Routine matters that don't require a wide range of expertise and where it is easy to predict the required tasks and the personnel mix needed to perform them.

- Collars, cuffs, and performance bonuses or rewards based on achieving shared objectives (e.g. reducing overall costs, improving cycle time, early disposition, high damages award, etc.) can likewise help align interests and minimize the disadvantages inherent in this billing method. Quality concerns managed by converging work to make bad outcome a risk to entire portfolio.

Staffing Structures Drive Alignment

- Description: A focus on choosing the level of talent and service team structure allows firms and clients to connect process and people to the client's desired outcome.

- Advantages: Forces firms and clients to discuss expectations and "what the matter's worth" up-front: does the matter require top talent, repetitive commodity work, leadership of non-lawyer teams, outsourcing or off-shoring, new skill sets, secondments and temporary or contract lawyers, one-off assignments or long-term teams? Scorched earth, "A"-work or operational staffing? Staffing decisions based on process analysis improve efficiency and productivity, and allow firms and clients to institutionalize work to the benefit of both.

- Disadvantages: Pushing work in some manner away from traditional staffing patterns or teams that are the norm won't work if the firm has not reshaped its lawyers' expectations on billing and comp, and redesigned their service or business model. If there are no mechanisms for rewarding or valuing efficiency or outcome-based client service, then those staffed to these matters will be punished for their efficiency and alignment with client interests.

- Firms will need to think about the impact on junior associates and promotion patterns. The firm may need to re-jigger their leverage and lockstep models. While restructured staffing models present challenges, there are also benefits: flexibility to create new comp and performance-based advancement options, flexible or distance working arrangements, balance and career development opportunities not usually offered under the "up or out" partnership track.

Operational vs. Strategic Work

- Description: Most firms like to think they provide "strategic" services, but most clients want to buy "operational" outcomes for day-to-day matters.

- Lawyers – at their best – bring judgment and exceptional skill to the clients they serve. But much of what lawyers provide to clients does not require (much or new) strategic thinking, but great performance under the leadership of experts who know how to get work done.

- If outside lawyers believe that most of what they provide is strategic service (treating every matter as if it deserves bet-the-company expense), then they will believe it beneath them to offer clients "operational" solutions, which recognizes that every matter is important to do right/well, but that most matters will be better handled by an increased focus on process improvements to drive cost-effective, predictable, and efficient performance, time after time.

- Many clients allow their outside counsel to make decisions about how their work will be staffed and billed. Clients just ask for a discount. Unless the work is billed on a fixed fee (and thus the client will not bear the risk for the firm's inefficiencies or mis-staffing or mistake over the scope/importance of the matter), clients must articulate what they believe is the appropriate staffing or find firms that suggest alternate strategies for the client to choose from if the client doesn't know.

Contingency Fees

- Description: Client pays law firm based on the results achieved. Payment is often expressed as a percentage of the recovery, settlement, or amount saved.
- Advantages: Clients only pay when law firms achieve successful results—they don't pay for time. Allows economically challenged clients to obtain legal representation. Allows law firms that carefully screen new matters and manage costs to fully leverage their efficiency and expertise. Finally, provided the terms are clearly documented in the fee agreement, both client and lawyer know at the outset how the fee will be determined.

- Disadvantages: Law firms assume all of the risk. As a result, those firms with little experience, inefficient operations, poor screening processes, weak financial skills, or a case that goes south risk losing big money and or making bad enterprise-risk decisions. In addition, some jurisdictions are placing caps on contingencies in certain circumstances. Finally, if law firm achieves a quick successful result for client with very little effort, client may feel lawyer/firm was overpaid.

- Can be used in conjunction with fixed or flat fees or straight hourly billing. (e.g., Client and firm might agree to segment a litigation matter in such a way that law firm bills for the initial investigation phase on a fixed fee or straight hourly fee basis. Once the details of the matter become clearer, client and firm could agree to a contingency fee arrangement; hybrid contingency - discounted or fixed fee together with recovery/savings based contingency (85% of negotiated rates with a 15% contingency, etc.).

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Retrospective Based on Value

- Description: Fee is determined by law firm at the conclusion of a matter and is based on client objectives as defined at the outset or an agreed fix fee. (Allows for both upward or downward value adjustments.)

- Advantages: Shifts focus from time spent to the value of results. The amount of the fee is based on the value to the client as defined by the client.

- Disadvantages: Requires a great deal of trust between lawyer and client. Client may not agree with how law firm values its services and vice versa. Hard to quantify "how you're doing" at firm or in dept if objectives are set without fixing an estimated fee at outset. Ex.: The Valorem firm sets an expected cost along with outcome and then client can adjust fee to value received.

- When to Use: When client and law firm know and trust each other—and when the value to the client of the results achieved can be fairly and accurately calculated.

- Straight or discounted hourly billing up to an agreed upon minimum fee with performance bonuses or rewards based on achieving shared objectives (e.g. reducing overall costs, improving cycle time, early resolution, high damages award, etc.) can help align interests and minimize the disadvantages inherent in this billing method.

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Retainers – back to the future!

- Description: (Portfolios of work) Client makes a deposit against charges for future services or commits to a sum in return for which law firm guarantees its availability for a period of time or to perform specified services.

- Advantages: Clients are more likely to seek legal help when they know the clock isn't ticking. Law firms are paid up front and thus can avoid collection and profitability problems provided retainer is kept current and accurately reflects the costs of providing legal services. The relationship and work is "institutionalized" to the betterment of the service and the client. Client service teams develop and less experienced counsel can be introduced to the client/work.

- Disadvantages: Clients must agree to pay up front. Disagreements about what is included in the retainer can occur if the details of the retainer are not clearly specified in the representation agreement. This can cause lawyers to think they're doing too much and/or it can cause clients to think they're receiving too little.

- While not required, law firms are wise to provide clients with periodic summaries of tasks performed/results achieved to demonstrate the ongoing value of the services. The scope and cost of work should be reviewed and adjusted periodically to assure a continuing "win-win." Retainers can be paired with other fees, especially for services outside the contract.

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Fixed or Flat Fees

- Description: Client engages law firm to provide a specific service for a set price. A fixed fee can address one segment of a larger matter (stages) or the entire workload for a case or recurrent type of work.

- Advantages: Fee is not based on time and both client and firm know at the outset what the fee will be. This allows client to budget accordingly and avoid billing surprises, and it rewards the firm that leverages its expertise and efficiency. It requires both firm and client to document with specificity what services will be performed for the fixed fee. It gives firm an incentive to improve workflow, make better use of technology and carefully staff matters.

- Disadvantages: Law firm assumes the risk of cost overruns. As a result, lawyers must foresee all contingencies and fully understand the costs of providing services, or risk losing money on the engagement. Client assumes the risk of a bad outcome. Thus, unforeseen circumstances could lead to tensions around the need for higher quality work product and/or additional effort.

- When to Use: High volume, regularly recurring, or operational (rather than strategic) work where costs are easier to predict based on knowledge of process and surprises are rarer. Clients must be comfortable assuming the risk of a bad outcome and law firms must be comfortable assuming the risk of cost overruns on some recurring work if there are steady profits on the rest of the work. For less commoditized work, fixed fee arrangements should include safety valves that re-open the agreement or separately bill for services in specified extraordinary circumstances.

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Fixed or Flat Fees

- The hardest work in developing such fees is looking for "valuation" tactics when most of the data we draw from to set flat fees looks back to hourly rate histories.

- What is the matter worth? How can we determine its "value" to the client? What kinds of tools and data will you need to assess "worth"? Is that information "mine-able" in the firm or company?
- Is a fixed fee anything more than a really good budget? What does that suggest about the skill sets and data necessary to good budget development and management, and whether most lawyers have them? (It's not just setting a budget and targets, but being capable of sticking to it.)
- How do we establish metrics for the firm and the department that will drive data development?
- The movement to rewrite the uniform task based billing codes or develop technologies that will establish and capture cost histories based on "outcomes" rather than "activities": e.g., lawyers billing all costs to a code for delivering services related to witness preparation, rather than billing to categories that include phone calls, meetings, research, travel, prep, etc.
- If "all-in" costs are incalculable, what is any given stage/segment/process worth?
- Setting flat fees with "safety values" that allow a variance from the pre-agreed terms in cases where certain pre-defined but unpredicted events take place.
- Does flat fee work on matters that aren't lower-level, repetitive, routinized work? Yes, but with different processes, experience, and skill sets driving them.

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Capped Fees (including collars, cuffs, floors, etc.)

- Description: Client pays law firm to a specified maximum amount, but no more.

- Advantages: Rewards law firms that know how to leverage their efficiencies and expertise. Client is able to predict maximum costs and shift some of the financial risk to the law firm.

- Disadvantages: Can hurt law firms if they misjudge costs or if unforeseen circumstances occur and there is no safety valve provision that allows for renegotiation and revision. Also, if cap is set too low, it can discourage law firm from conducting a thorough assessment during the early stages of a matter. Clients may worry that even if they could have finished sooner, the firm will bill to the cap limit.

- Eversheds model – Use company and/or firm forensic spend data to negotiate caps for discrete tasks or phases with the firm sharing in any savings against the cap numbers. Near-perfect alignment: Client gets predictability and lower overall spend (soliciting bids with this structure helps surface firms who are in a position to repurpose prior work product/service delivery models that they've developed for other clients and, even if we go with the incumbent, it tests the incumbency value proposition). Firm gets the chance to over-realize (it splits any savings against the cap). Moves client from discount structures that don't tend to generate real year-over-year savings and avoids need to haggle over rates and nit-pick bills. Manage unforeseen risks with clearly defined safety valves and quality concerns by converging work to make bad outcome a risk to entire portfolio.

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Success or Incentive Fees

Description: Client pays law firm a premium, percentage or multiplied fee if a certain outcome is achieved.

- Advantages: Rewards law firms for focusing on a target and working to achieve it.
- Disadvantages: Can incent firms to move toward desired results even if it's not consistent with their professional judgment. And there will be some ethical considerations to confront – while they may not prohibit such arrangements, they will have to be structured carefully.
- The plaintiff's bar has successfully and profitably prospered on success and incentive fees for many decades – through contingency fees. What lessons do we learn from them?

Reverse Contingencies

- When the risk to the client is "calculable," a reverse contingency allows a firm to be paid a percentage of avoided loss, requiring the firm to align incentives toward best results, but also requiring the firm to understand how much it is willing to put at risk. Reverse contingencies are, for instance, how hedge fund managers are often paid – based on "marginal value."
- If a firm's compensation system does not support and reward such innovative relationships, a lawyer whose whose comp is tied to one case/client and may not be rewarded if she takes significant risks (most firms don't have any way to "value" entrepreneurial risk), but yet she cannot take part in any or only a limited part of the upside she earns.

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Budgeting

- Several large companies have come full circle from discounts to alternative fee arrangements to “hard budgeting.” Effectively a value-based fee arrangement.
- Budgets have been a requirement in retainer letters for years. However, they tend to be observed in the breach or used only for accrual/forecasting purposes, not for cost management or case assessment purposes.
- To truly budget a matter, you need data that suggests the matter’s worth from the outset. This is the real work of value-based billing - shifting the focus from lawyer contribution to client/firm assessment of value by matter.

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Benchmarking

- Use of third party to solicit anonymous bids on fixed pieces of work (patents, large transactions, projects, pieces of litigation). Iterative process -- no fee unless >15% savings off the benchmark between the high and low bids.

- The punch line is that putting the work in play (even ostensibly) yields real savings, even if the client selects the incumbent. Prevents "reputation" billing, incumbent assumptions. Uncovers firms who are positioned to commoditize based on prior work for other clients.

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So what should firms do to implement value-based alternative fees? Create alignment?

1. Clients are probably as inexperienced and risk-averse as firms are.
2. Firms should offer to bear the burden, even if not all the risk.
3. Base the firm's proposal on data mined by the firm, the client, others.
4. Begin with a focus on a budget or the all-in cost of a task or stage, rather than focusing on all-in costs that daunt/appear incalculable.
5. Ask to experiment; run the matter parallel with hours? (Firms will do that initially anyway to measure what works and doesn't.)
6. Establish metrics / evaluation processes: continuous improvement.

Know that this will take time and trust to become comfortable or a norm.

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So what should Clients do to drive / reward firms that show interest in alignment?

1. Clients need to actually retain firms with value-based fee proposals – too often clients say they want them, but hire firms that still default to hourly bills or simply ask current firms for a rate freeze or discount.
2. Clients need to define in advance of the matter’s start what it is that they value most so that the firm deploys the best value-based option.
3. Involve procurement or finance folks in the company in your experiments to increase client buy-in and learn from their experience.
4. Mine the company’s cost and service data and share it.
5. Make movement toward value arrangements a part of in-house lawyers’ performance/compensation evaluations.
6. Experiment with firms; establish evaluation processes for new formats.

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How do we all put skin in the game? What is acceptable risk?

- Is the billable hour less risky or simply more "known"?
- Are lawyers who align with client interests or put "skin the game" engaging in unprofessional behaviors?
- What's riskier to the law firm enterprise: the current paradigm of inefficiency/spiraling costs, or up-front budgeting, process examination/improvement?
- Supervisory/staffing risks must be carefully considered when automating, routinizing, or pushing down work to contain costs: this is not a bar to value relationships, but may require different attention and project skill sets.

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Join us to collaborate in reconnecting legal costs to lawyer value, in promoting sustainable "value-based" practices, and in reinventing our profession to better serve our clients.

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In the end,

it's all about value.