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## *Getting Away from the Hourly Rate:*

### **Ready, Set, Go!**

*Editor's Note: This article is the last of a four-part series.*

The limited success of the efforts to move away from time-based billing leads to the obvious question of “Why?” We believe that the continued longevity of the hourly rate, with its deleterious impacts on corporate clients and the relationships between those clients and their law firms (many of which we have diagnosed in earlier articles in this series), results from a variety of causes. The greatest one, in our view, is the absence of a program or process by which to evaluate, design, and implement fee arrangements that do not rely solely on the amount of time devoted by counsel to determine that counsel’s remuneration.

The term “alternative fee arrangement” (AFA) is not entirely satisfactory. It’s an “alternative” to what? Despite that imprecision and due to its common usage, we continue to use the term alternative fee arrangement to denote a fee arrangement that is not entirely dependent on time-based billing as a measure to determine the fee to be paid by the client to its outside counsel. Some use the same acronym to denote an “appropriate fee arrangement.” In either event, the goal is to achieve a fee arrangement that avoids use of the hourly rate as the exclusive means of computing the fee or circumscribes its use by including some sort of cost control or value-based component in the arrangement. An AFA can be successful only if the parties have developed a relationship with a strong core of mutual trust. Accordingly, an AFA will not work if one either party wants or expects to “beat the system” or “really get a deal,” which necessarily would be at the expense of the other party to the arrangement.

All too often in-house counsel and outside counsel attempt to create a fee arrangement on an *ad hoc* basis, taking into account whatever factors seem appropriate to them at the time. Factors that can be conflicting! Without any training, and absent an approach or defined procedure for that task, the odds that they will succeed in their effort are pretty low.

It’s time to develop an approach that can guide both inside and outside counsel through the minefield that surrounds their desired destination. With many factors to consider and to take into account in the exercise—some factors relate to the client, some to the firm, and some to the matter—most attorneys (whether in-house or outside) would achieve greater success in developing and implementing effective alternative fee arrangements if they followed a set procedure that walked them through specific questions and steps toward their mutual goal.

Before commencing that analysis, though, we need to discuss value in the context of the legal service that business organizations need and that outside service providers (including law firms) provide to those organizations.

### **Value and How It Applies to Legal Service**

Value has occupied center stage in discussions within the legal profession (at least in respect of the legal service purchased by and provided to, or on behalf of, business organizations) for a number of years. In 2008, the Association of Corporate Counsel (ACC) launched the ACC Value Challenge “to reconnect the value and cost of legal service.” A primary thrust of the ACC Value Challenge

has been to stimulate the use of AFAs and reduce the prevalence of the hourly rate.

ACC did not define that term; rather, it elected to empower its members and their law firms to discuss the concept and agree on a definition. This bottoms up approach seems to have stalled, however, since the aggregate amount of fees paid without using the hourly rate (as reflected in surveys) seems to have plateaued. Moreover, the absence of a definition of “value” has hindered the profession in its efforts to move toward greater use of AFAs, because each participant in the discussion brings his or her preferences, perspectives, and biases into that conversation. Until disparate meanings of such a key term are harmonized, the discussion cannot lead to a common position.

A similar disparity of meaning has long existed with the word “productive.” For many outside counsel (especially those who are responsible for law firms’ performance and productivity, such as managing partners), the more time a lawyer bills to clients, the more productive that lawyer is. In-house attorneys, on the other hand, think like business professionals (at least, once they’ve been in-house counsel for some time); to them, productive connotes an element of efficiency so that greater productivity means something like getting things done more quickly or with less effort.

Another dynamic that influences the notion of value from in-house counsel’s perspective is driven by their clients, the managers of the business. First, most nonlawyer managers don’t understand why legal service expense can’t be treated like payroll, or fuel, water, and current expenses. When the CFO directs a 5 percent reduction in operating expenses, why is the legal department the first group to the table with reasons they cannot comply?

Confusion also exists among nonlawyers regarding why legal expenses and settlements must negatively impact the manager’s bonus calculations. It’s as if product developers or

buyers who infringe on competitors’ trademarks, or operating managers whose organizations fail to comply with applicable laws, believe that, even though their derelict actions cause the business to incur unnecessary costs, legal costs should not be baked into their bonus calculations. They seem to disassociate the cost of legal service from the related or underlying situation because they don’t understand how that service adds (or at least prevents a loss of) value to their operations.

Value does not exist in a vacuum. It is not an immutable physical constant like the speed of light. Instead, it represents the relationship between the cost of something and the benefit that one enjoys from that something.

What a client “enjoys” from legal service will vary; it depends on the context. In some situations, a successful conclusion to a matter may mean little if it took too long. (Think of a company’s concern that a departing executive will deliver its proprietary information to a competitor. A temporary restraining order (TRO) achieved a year after that individual’s departure will mean little; a TRO must be secured within a few days to have practical impact.) The legal effort in a bet-the-company case, while very expensive, will represent great value if successful, but the same effort expended in a slip-and-fall would represent negative value as it would far exceed the risk associated with the injury.

Thus, we need to focus not on value itself, but the subsidiary qualities that comprise it if we wish to apply the concept meaningfully to the subject of fee arrangements. These “value-related qualities” (VRQs) can serve a firm well in an effort to devise AFAs, as we’ll see below.

What is a VRQ? In essence, a VRQ represents a trait or a characteristic of legal service that matters to the client; the more of that trait possessed by a specific service delivery, the more closely the client will achieve its business goals for the engagement. For example, speed may be a critical component of a successful representation, as in the above TRO example. In a bet-the-company

proceeding, cost concerns rank far lower on the client's wish list than does the certainty of a successful conclusion of the matter.

Both of those traits are VRQs. Here's a nonexhaustive list of possible VRQs, not all of which matter equally as to every representation:

- Expertise
- Cost
- Consistency of effort or treatment
- Predictability of cost
- Speed of resolution or completion
- Reliability
- Convenience
- Security of data and other information
- Certainty of resolution
- Accountability
- Overall responsiveness
- "No surprises" communication

Each VRQ represents a quality that is more measurable than the general, vague term "value." Accordingly, each one can be measured to some degree and, perhaps at least as importantly, each can be discussed by client and counsel in a productive fashion. This discussion enables not only measurement of success in meeting the client's definition of a valuable service by counsel, but it also makes progress more attainable through dialogue.

## Components of the AFA Analysis

### *Step 1: What Is It Worth to You?*

Whether the client needs counsel to work on a transaction or to represent the company in a dispute or litigation, that effort should lead to some value being generated for the client. The value may be a positive one, such as the ability to acquire another company or to purchase real estate for a new factory. In other contexts, the value may be a negative one, in that the assignment relates to preventing a loss, such as disputing a claim against the client by a counter-party or a lawsuit to challenge another party's assertion of a right in property claimed by the client. In either

situation, the client needs counsel to assist it in adding to or preventing a reduction in the assets of the company.

The value that the client places on the project will provide the context for the discussion by client and counsel about the legal service itself. Without that context, any discussion of the legal service (and the fee for that service) will represent mere guesses that have little if any relationship to the purpose of the representation.

### *Step 2: How Big a Role Does the Legal Service Play?*

Recognizing the need for representation in such a context enables the client and its counsel to reach an understanding as to how that legal service will enable the client to realize that value. For different types of matters, the legal service constitutes a differing proportion of the effort required to achieve the objective. For example, in the negotiation of a simple commoditized contractual relationship like the purchase of a copier, the legal effort, if any, will be very limited in scope and complexity and might be effected by means of a fill-in-the-blanks purchase order with legal review solely to ensure that the parties to that agreement are in good standing or otherwise able to complete and enforce the transaction.

On the other hand, an ongoing relationship between two organizations by means of which one organization will provide copying services to the other, including providing the equipment, personnel, and other supportive services, would require a more complex document that follows lengthy negotiations involving the parties' lawyers, among others. This transaction obviously would require more involvement and more complex legal service than the former. The legal service would also occupy a much more critical position in the negotiations.

Understanding the criticality of the legal service to achievement of the client's business goals allows for a meaningful discussion of what the legal service will mean for the

client. Sometimes the legal service occupies a central function in that business plan and the plan cannot be achieved without the lawyers' efforts. Even in that instance, however, the cost of the legal service must bear a reasonable relationship to the overall benefit to the client of reaching its objectives, as determined in Step 1 above.

At this stage in the discussion, however, the client and its counsel should be in a position to agree on an estimate for a fee that would reasonably compensate counsel for the service needed to allow the client to reach its goal. Reaching that estimate might require that they agree on various assumptions and aspects of the representation that will be beyond their direct influence. Nonetheless, this estimate (even with the uncertainty attendant to those assumptions) should serve as the anchor for a fee arrangement.

### *Step 3: How Should Counsel's Positive Contribution Be Rewarded?*

One of the goals of in-house counsel in discussions about various types of AFAs is to align more directly the incentives of outside counsel with the client's business goals in the engagement. For example, a client that is very concerned about uncontrolled costs will react negatively when time-based billing rewards the billing professional for spending more time on the assignment regardless of how well that time contributes to achieving the objective. Accordingly, it's entirely appropriate to build into the fee arrangement a mechanism by which counsel will be rewarded for achieving the benchmarks set by the client and even penalized for failing to achieve those benchmarks.

In that regard, the base fee agreed to by the client and counsel can be enhanced or reduced to reflect counsel's success (or lack thereof) in helping the client achieve the latter's business objectives in the matter. How to do so will, of course, vary from engagement to engagement and it will depend on how well the client and counsel can measure the achievement of those benchmarks.

### *Step 4: How Do We Know If Counsel Has Satisfied the Goals of the Engagement?*

If a fee arrangement that the client and counsel contemplate will provide that a portion or all of the fee is to be paid to counsel only upon attaining certain benchmarks, those parties must obviously determine what those benchmarks will be. Without specifying those terms, the parties will allow their arrangement to create a difference of opinion (at least) when the fee comes due (assuming satisfaction of the requirements in the mind of one or the other of them).

An AFA generally contemplates some form of "value arrangement." It is in recognition of the criticism of time-based billing that it divorces the fees charged by outside counsel from the degree to which their effort advances the clients' interests. "Value" for purposes of this discussion must be viewed from the client's perspective because (i) the lawyer's role is to serve the client by advancing or protecting the latter's legal interests, and (ii) the client pays the lawyer for his/her service. Accordingly, the client's definition of "value," as expressed in the VRQs that matter to that client for the specific matter, must be accepted and used to measure the success of counsel's efforts for the client's purposes.

## **Pulling It All Together**

The steps described above may seem somewhat esoteric and hard to apply on a day-to-day basis. Let's run through these questions again and drill down toward a more practical explanation in each instance.

*Determining "what it's worth to you".* In order to develop an AFA that serves both their interests, client and counsel must start with an understanding of the client's business goals. That understanding must be informed by an equivalent appreciation of the work that will be needed to achieve those goals. As to the former, the questions above will allow them to commence the analysis. Does the client have a slip-and-fall case to defend?

Does it face a bet-the-company proceeding? Is the transaction a simple vendor agreement, or does it encompass a merger of two multinational organizations each of which operates many and varied lines of business in dozens of jurisdictions?

Does the legal service merely effectuate and document a transaction, the parameters and risks of which are well understood by the parties and the overall size of which is easily quantifiable? Or is the legal service an integral and indispensable element of a business deal that is of indeterminate scope, such as a groundbreaking transaction that has no precedent?

In addition to those transaction-focused questions, client and counsel should also attempt to measure the effort that will be required. For this analysis, data will be critical. Data-rich matter-management and e-billing systems should contain a wealth of detail regarding prior work that, to one degree or another, may be comparable to that being contemplated. Parsing and analyzing those data will enable the parties to frame and hone their thinking about the effort that will be necessary. Obviously, the more the examined past work resembles the current project, the more reliably that past data can be relied upon for this purpose.

Some data types that might be of use in this analysis are the following (some may be more relevant to litigation or to transactional work):

- Jurisdiction (state, type of presiding entity)
- Law firm(s), lawyer(s) who worked on the prior matters and their roles(s) and rate(s)
- Analyses of the prior work, such as decision trees, project plans, etc.
- Outcomes of the comparable past efforts
- Lessons learned from the past work
- How comparable are the matters (past and contemplated) in terms of complexity?

With such information, and having performed that analysis, the parties must

consider how the work can be accomplished in the most efficient and effective manner. These criteria relate to the assemblage of a team (as previously discussed in an earlier installment of this series). The disparate roles of the team members should be reflected in their respective base fees.

*Addressing the “how big a role does the legal service play” question.* Mark A. Robertson and James A. Calloway discuss the notion of a Value Curve in their book *Winning Alternatives to the Billable Hour* (American Bar Association 2008) (see pages 19–23). While their Value Curve is designed to illustrate the relative value of services versus the volume of work available to the firm, it sets out four general classifications of legal services:

- Unique
- Experiential
- Brand name
- Commodity

If we think about Unique services being the kind that involves C-suite authorizations and participation, and Commodity services being straightforward junior partner or second/third-year attorney type of work, we can begin to assess the role that the legal service plays in the specific matter at hand.

For example, suppose a company has been found to be violating federal laws by not securing the appropriate certifications and inspections for a core process or product that represents 60 percent of the company’s sales volume and corresponding profit. To further complicate the violation, penalties are extreme and apply to each brick-and-mortar operating unit in the organization. Add the re-engineering costs of the process and suddenly the shareholders are at risk of serious stock price erosion.

Juxtapose this situation with the routine drafting of contracts for the purchase of services, products, or raw materials, IP registration and protection, or the processing of paperwork for employees from other

countries to work in this country. Each situation requires quality legal services, but the risk profiles for the matters vary wildly. That risk profile can be a significant driver of the value and affect how central the legal services are to the business objective. Higher risk suggests greater cost of legal services; lower risk suggests lower costs.

*How should counsel be rewarded for a successful representation?* Once counsel and client have agreed on how much the legal service will benefit the client upon successful completion of the assignment, they need to determine whether the fee arrangement should include incentives to force counsel's representation to incorporate and further the VRQs that constitute the client's definition of high-value legal service. To ensure that the client's "value" definition is significantly reflected in the service as delivered, they will want to design into the fee arrangement some incentives that will reward behavior by outside counsel consistent with the client's VRQ-based goals and/or penalize behavior that is not.

Once counsel and client agree, in Step 2, on a baseline estimate of what an appropriate fee might be (which could take into account the firm's financial needs related to the expected effort it will expend and the relative contributions of other members of the service team, even if from disparate organizations), they can focus on how to use the fee to create incentives for the lawyers to meet the client's definition of high-value legal service. That definition should be expressed for the specific context by explicit reference to the VRQs.

The incentives for counsel might consist of a "holdback" of some portion of the agreed-upon fee, payable upon counsel meeting those VRQ-related goals, or they may call for a premium (above the agreed-upon fee) payable on similar terms. Speed to completion or resolution could be incentivized, for example, with a straightforward cash bonus if the transaction or litigation is successfully concluded earlier than expected. A

better-than-expected settlement could entitle counsel to a percentage of the favorable variance to the expected result. Bonus payments could be made available based on feedback provided by key executives who worked with outside counsel or in-house's counsel evaluation of performance.

While VRQs can be very effective motivators if they are achievable and unambiguous, behavioral risks are ever present. Counsel need to be very careful. There will be a temptation to staff the engagement to maximize short-term profits to the firm. Doing so might result in inappropriately junior staff being used to perform activities more suited to senior staff. That said, don't overlook possible development opportunities that may make sense within the scope of the AFA. One of the key "rewards" is the promise of future business.

Assuming the financial agreement reached up front is adequate from both parties' viewpoints, staying focused on the goals established as success factors, and expressed in the agreed-upon VRQs, is key. Client and counsel must clearly express their respective expectations and they must agree to those in coming to terms on a fee arrangement as well as the measures of goal achievement. VRQs can be pivotal in the measuring of overall value.

*How can you measure whether counsel has satisfied the terms of a value-based arrangement?* If the fee arrangement sets out the client's value definition for the engagement in terms of measurable VRQs, the in-house and outside attorneys can develop metrics by which to determine the degree to which the latter has met the client's value-related expectations (*e.g.*, speed of resolution, cost certainty, etc.). This section of the fee arrangement should be structured to avoid, as much as possible, later disagreement regarding the evaluation of counsel's performance and the impact of that performance on possible financial outcomes. We can't emphasize this enough. Metrics need to result in clear "yes" or "no" answers with

respect to incentives. There can be no after-the-fact negotiation.

Metrics must be based on collectible data and they must relate to the performance indicators or evidence of behavior about which the law department needs to know. By using quantifiable VRQs, the law department and its counsel will have set the stage for collecting the data relevant to whether counsel earns the value-related portion of the fee (which could be the entire fee or some negotiated portion of it) and whether counsel has satisfied the AFA in its entirety. The data must be available to, and understandable by, both client and counsel.

In essence, meeting the VRQ-related goals of the AFA will, by definition, equate with the satisfaction of the agreed-upon goals. It will simplify the task for both client and counsel.

### **Why Take a Different Approach?**

Given the inertia within the legal profession frustrating the desire of in-house attorneys and their corporate clients to realize greater and more measurable value from their legal service expenditures, a dramatic break with the hourly rate tradition is called for. That method of computing counsel's compensation has outlived its utility in many (if not all) situations. By making the client's own "value" definition the central focus of the fee calculation, client satisfaction will occupy center stage.

We believe the biggest benefit from the application of a process such as we've described is that it establishes a framework for achieving clarity and mutual understanding of objectives, scope, and expectations. Said differently, this process requires open and timely communications, both at the start and for the entire duration of the arrangement.

Second, this type of process drives ownership by both parties. In-house counsel and outside counsel should align on elements

of risk, process, procedure, and the value generated for both parties. As soon as one party, for whatever reason, sees its interests as represented in the fee arrangement negatively impacted, crisp and immediate conversations should occur for mid-course corrections.

Third, improved predictability of costs/revenue should enhance each party's ability to harness resources required to deliver results in an orderly manner.

By using this approach, law departments and law firms derive respective benefit. Law departments will receive higher-value legal work (as defined by the client) from outside counsel. Further, this approach will require more fulsome discussions between client and counsel regarding goals, expectations, etc. In-house attorneys will realize a greater ability to demonstrate to corporate executives how well they manage work, thanks to more meaningful metrics that are directly linked to value. Clients will see a fuller and more specific alignment of their counsels' interests with their own value-related goals for the engagements.

AFA's also, typically, reduce a great deal of administrative effort associated with the processing of monthly invoices that would now usually be broken down in task code format (whether those codes are drawn from the Uniform Task-Based Management System or some other source). While data processing impacts may be minimal, to the degree monthly invoices are subjected to mechanical or human reviews, time previously devoted to performing these reviews can be reinvested in high-value work. Eliminated is the volleying back and forth of dialogue surrounding billing adjustments. (Note: Today most invoice processing systems have the flexibility to handle AFA's routinely.)

Law firms will discover that meeting the client's own expressed value-related goals in a measurable manner will lead to higher client satisfaction. The use of client-satisfaction surveys should reflect that and should

likewise serve as a basis for internal compensation and other decisions. Those data will also allow for greater comparability (in measuring individual lawyers' contributions to the firm's success) for those decisions despite the variability of the AFAs themselves. Law firms will also realize administrative savings from the elimination of some invoice processing as clients will more clearly see the correlation between what they pay and what they receive.

AFAs should cause law firms to review their structures and practices in order to eliminate inefficiencies because they will become more responsible for the financial impact of their work on clients. Greater efficiency will, in turn, result in lower cost. It should lead to more nimble law firms. In light of the changing dynamics of the legal profession, nimbleness is a positive market differentiator indeed.

The current state of affairs regarding fee arrangements for counsel to business organizations has led to client satisfaction crises for some law firms and their clients. Other firms may not have faced such a crisis yet, but many of them will if client satisfaction continues to drop.

While numerous law firms claim in their marketing that their clients lie at the core of their service mentality, their billing methods belie that claim by continued dominance of time-based billing. The increasing fluidity of the market for legal service—clients seeking lower costs by changing firms or by looking to legal service outsourcing companies and other non-law firm vendors—has contributed to the uncertainty.

Creating AFAs, collaboratively with its clients, allows a firm to refocus (or in some cases focus for the first time) on the client's own "value" definition, which will likely lead to a reorientation of law firms' priorities. The astute firm will see this change as a grand opportunity to evaluate their service model and improve on efficiencies while being more mindful of their clients' value perceptions and needs. Greater client satisfaction should increase client-retention rates and a more stable environment for all. ■

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