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GPS for General Counsel: Navigating Fee Transition

By Pamela H. Woldow

As we enter the seventh quarter of the Great Recession, pundits have varying ideas about the direction in which the legal profession is moving. Some predict a continuing skid: more layoffs, less and less work for law firms, more law firm failures, attrition everywhere. Others talk optimistically about "things getting back to normal," a recovery that supposedly will lead back to the *status quo*, to calm waters and pre-recession revenue models. Still others foresee a "new normal," that is, a restructuring of legal economics and the changing face of the relationships between inside and outside counsel.

Frankly, the truth seems to be that no one can claim a firm fix on exactly where we're going. There are no reliable GPS devices to map the new topography of the legal landscape, no reassuring synthetic voices saying, "turn left here," no step-by-step directions for where to turn and how fast to go. That said, all corporate counsel report one near-universal map coordinate: the injunction from their senior management that they "do more with less"— sometimes a lot less. For 2009, on average, corporate legal departments were on the receiving end of budget cuts of 11.5% with a range of 0 to 75%, according to the *Altman Weil Flash Survey on Law Department Cost Control*.

There are, of course, two parallel courses for law departments with regard to legal cost belt-tightening: trim administrative overhead and salaries or reduce the outside legal spend. In 2008 and 2009, cost-cutting has been the number one priority, and most law departments have sought ways to control costs and rein-in budgets in both areas. That effort makes enormous sense since a recent BTI survey reported that, on average, corporate legal departments have experienced a staggering 75% increase in legal services costs over the last ten years, far outpacing inflation.

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This article focuses on tactics and techniques general counsel and chief legal officers are employing to reduce their outside legal spend. It also examines whether those tactics are working.

You can't talk about reducing outside legal spend without talking about alternative fee arrangements (AFAs). Although AFAs have been touted as a significant means of achieving savings for years, the recession has made them a hot topic of late, even though the term is used quite differently by different people. While AFAs have no universally-accepted definition, a useful baseline starts with what they are not. *AFAs are methods of pricing the delivery of legal services that are not based on the billable hour or solely on any other measure of time spent*. (Thus, discounted hourly rates, blended hourly rates and volume discounts predicated on hourly billings are not AFAs).

Instead, AFAs are approaches to pricing services that better reflect the *value that the client places on particular legal matters and the value conferred by outside counsel*. Examples of "real" AFAs include fixed or flat fees for multiple matters or classes of matters; fixed or flat fees for single matters; fixed or flat fees for phases of matters; retainers; and/or contingent fees.

The cardinal virtue of AFAs (from the in-house counsel's viewpoint) is that they permit greater predictability for forecasting, budgeting and controlling legal spend. Their cardinal shortcoming is that they represent new and uncharted territory for many general counsel long-accustomed to time-based fee arrangements.

Going in the Wrong Direction

Many general counsel suffer from the illusion that negotiating a discount in hourly rates will prove a panacea for all their cost problems. No need to go through all the rigmarole of determining how to define and assess value,

they think; just get the law firms to knock down their rates and the total dollar outlay is bound to diminish.

Not necessarily. Many general counsel have said that when an outside law firm's hourly rate is discounted, often the amount of time or the number of attorneys it takes to complete a task increases correspondingly, thereby nullifying the discount.

Our current economic woes have popularized another variation on this theme, one Susan Hackett, Senior Vice President and General Counsel of the American Corporate Counsel Association, has named "the merry-go-round-of-firms-raising-rates-so-clients-will-demand-discounts." Whether or not the client realizes they are helping to perpetuate this cycle, this exchange does not support strong, institutionalized, trusted relationships over the long-term. It is not the way to create a predictable spend (because hours tend to "float" inversely to the present negotiated rate), and it doesn't create a drop in total legal spend either. Discounted rates have all the same downsides of billable hours, with the added detriment that they add hours inflation. As Patrick Lamb of the Valorem Law Group puts it, "the most critical failing is that it puts the lawyer's economic interest at odds with his or her client's. The lawyer has an economic incentive to bill more, not less."

Charting a New Direction?

Recognizing that discounted rates often do not in fact generate reduced legal spend, many sophisticated legal departments are buying heavily into AFAs. For example, almost half of United Technologies' legal matters now are handled under a variety of alternative fee arrangements, from fixed fees to a combination of fixed fees and bonuses. This year, 45% of Microsoft's outside counsel fees will be paid under alternative arrangements. Pfizer is using a single firm to handle its U.S. labor and employment work for 2008 and 2009 on an alternative fee basis. Tyco has switched almost all of its outside legal work to an alternative fee structure. The list of other companies that have begun using AFAs is now quite long; a sampling includes Levi Strauss, American Express, Burger King, UPS, Boehringer Ingelheim, Cisco, Prudential Financial, and General Electric.

The above notwithstanding, either we're still at the nascent stage of a fundamental paradigm shift in legal billing, or else a lot of lawyers — in-house and in firms — are convinced that AFAs represent a passing fad. In a flash survey conducted by Altman Weil at the end of 2008, 82.6% of surveyed general counsel reported that less than 10% of their outside legal fees were AFAs.

Still, AFAs seem to be gaining traction, suggesting that a fundamental change may be underway. By April 2009, a survey conducted by the Association of Corporate Counsel found that a stunning 77% of members would like to consider alternative fee arrangements in work handled by outside counsel. A survey of corporate legal spending for 2009, the BTI Premium Practices Forecast, predicts an increase this year of more than 50 percent in corporate spending on alternatives to the traditional hourly fee model. The BTI survey of 370 lawyers who work for Fortune 1000 companies found that their AFA-spend has totaled $13.1 billion so far this year, versus $8.6 billion for the same period in 2008, and has produced average cost savings for those corporate law departments of 15%.

These are clear signs that the transition is gaining momentum and appears to be a trend. As one wag put it when asked the difference between a fad and a trend, "Trends matter, and trends shape the future. Fads fade."

Resisting a Change in Direction

The groundswell of belief that AFAs represent the future direction of legal pricing — or at least *one of several directions* — is not embraced by all. Many inside and outside counsel are not willing and able to enter into or entertain AFAs. They raise a litany of objections, which we summarize in the table on page 8.

This list of anti-AFA rationales is mentioned at every conference on legal pricing, whether attended by corporate counsel or law firms. Feelings run high, the first-adopter

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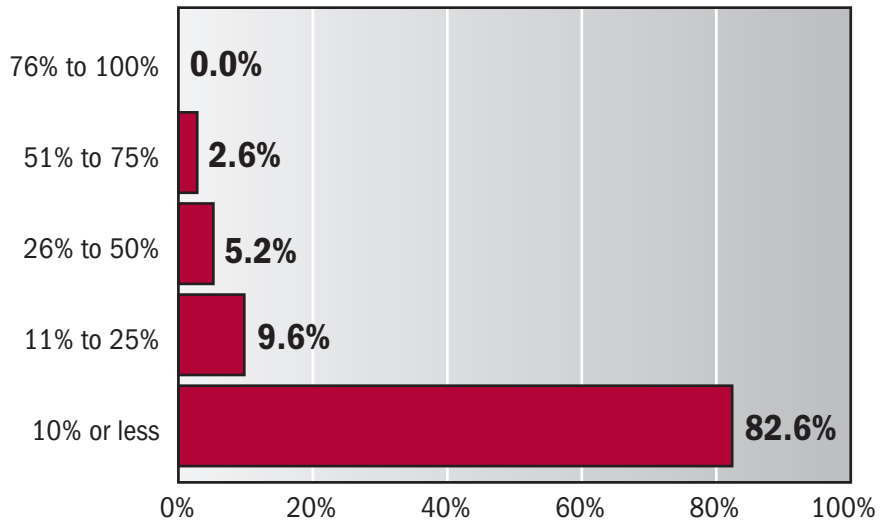
Percentage of your outside legal fees spent on alternative fee arrangements?



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change agents sparring with the don't-fix-it-if-it-ain't-broke defenders of the established time-based order.

Setting a New Course

In any system, large-scale structural change creates a steep new learning curve, and learning to negotiate and manage AFAs is no exception. Mastering the tactics and techniques of AFAs does require a new mind-set, as well as considerable effort by corporate counsel in defining measures of value, deconstructing engagements into specific tasks, translating their historical experience into new value models and working through zero-based negotiations where the parties start on equal footing. "This is more a matter of evolution — as new methods become more widespread, more general counsel will adopt them," says Paul Lippe, CEO of Legal OnRamp.

As more and more major players decide to innovate and commit to better aligning their interests, to achieving predictability of spend, to equalizing risk sharing and to using fees to encourage risk avoidance (and not just loss minimization), the skeptical attitude toward AFAs begins to sound like the resistance of the change-averse. Mike Dillon, General Counsel of Sun Microsystems, provocatively suggests those defenders of the status quo will "go the way of the Mastodon."

True, calculating and assigning a precise value to a matter, and assessing the risks and benefits of a transaction or case to the company, is new territory for many corporate counsel, and may compel new ways of thinking.

First, they will need to engage in discussions both inside and outside the company, but they cannot have such discussions without first thinking about how the work is structured, what exactly the work is that they are paying for (document processing, knowledge management, legal advice, research, photocopying, etc.), whether they need to pay someone with a law degree to do that work, and if not, whether a law firm should be doing it at all. Their initial focus needs to be what they're paying for, why they are paying for it and whether it is the best way to use the company's dollar.

Once corporate counsel have analyzed the legal component, a meeting between corporate counsel, the business people and the risk manager will yield a value that can be assigned to a given matter or group of matters. Facts may emerge along the way that impact the initial valuation, and then adjustments can be made. As companies use this process, they become progressively more adept at assigning value that reflects their business goals and risk tolerances.

The general counsel's next step is to talk with the proper law firm. Many say that in house departments should not spend time trying to educate law firms that do not "get it" — i.e., that do not understand why AFAs represent good business practices for *them*. General counsel should not waste their time on law firms that actively resist new ways of pricing services. In fact, they should grant preference to creative firms that initiate discussions of AFAs.

There are approximately 125,000 law firms in the US. Among them are plenty of firms that do "get it" and are attuned to client needs for predictable fees from excellent and efficient lawyers, wherever they may be located. These firms embrace new approaches to expanding their market share and competing for at least part of major clients' legal spend. Word-of-mouth already is flagging some of these thought-leaders, and tales of major representations moving from large firms to smaller innovators are becoming increasingly common.

We remind those who complain about how time-consuming it is to develop a new framework for negotiating and managing AFAs that one of the biggest time wasters in corporate legal departments is the need to spend hours and hours poring over legal bills after the fact to try to trim a few hours here and there. That effort exemplifies the "closing the barn door after the horse has left" mentality, and *post hoc* billing disputes are the most frequently cited reasons for souring relationships between in-house and outside lawyers. With AFAs, the cost is the cost. It doesn't matter if a firm takes two or 20 hours to complete a task because the price is defined from the outset and the firm is responsible

Corporate Counsel	Law Firms
Hard or impossible to assign value to matters in advance	AFAs are just a way to decrease our fees
Takes more time to enter into than billable hour arrangements and my time is already stretched	AFAs are hard to figure out because our operating numbers are based on billable hours
Makes it hard to compare data from previous years that were based on billable hours	We don't know what it costs to deliver services because it depends on the individual matter
Don't know if you are setting the right price	Getting efficient means we will earn less. Our system is based on working more hours, not fewer
The devil you know is better than the devil you don't	The system works for us. Why change?

for managing to the price and delivering the negotiated outcome as cost-effectively as possible.

Some general counsel worry about whether it can be shown that AFAs were in fact set at the "right" level. What they fail to grasp is that there is no right or wrong price. There never has been, and there never will be. Existing billable hour rates don't necessarily represent the "right" price; they are variable and only reflect what a firm hopes the market will bear or how much pricing leverage it believes it enjoys. Quite simply, "there is only the price someone is willing to buy at and the price someone is willing to sell at. This is how business in the real world operates," says John Chisholm of JC Consulting. "This is how the CEO and the CFO of a company operate. Indeed it is how the company operates." The irony of corporate counsel resisting AFAs is that never before have they had so much leverage in insisting on pricing that meets their needs, rather than the law firms' profit objectives. If they start with determining the value of a matter to the company, they are likely to end up with a fee that is right for the company.

Charting a Course

Once the value proposition has been established, corporate counsel must next select the right AFA approach, i.e., the best fee structures for the particular tasks at hand. To accomplish this, corporate counsel must succinctly communicate the value of the matter to outside counsel. That is, they must be utterly clear about how the company views the risk and reward of a particular matter when compared to the fee. They should make it clear that the law firm's proposed fee must bear a direct relationship to how the company views the worth of the matter. In those cases where corporate counsel are not yet adept at this form of communication, it behooves outside counsel to explore, probe and elicit information that bears directly on pricing the representation.

Although law firms may not immediately see the benefits of AFAs to *them*, new approaches to structuring and staffing legal service can help them to plan for predictable income streams and encourage them to develop practice management methods that reward them for efficiency and achieving desired results. For law firms as well as clients, effective fee arrangements establish the value of the matter, define the manner in which the fee will be paid, and create incentives for outside counsel to understand and achieve the company's goals.

Having worked with hundreds of inside and outside counsel in large, medium and small companies and law firms, we at Altman Weil have seen the importance of introducing AFAs at some clear and logical starting point, rather than attempting to use them for all types of matters and representation.

Often the best place to begin is with various kinds of repetitive matters because they can most easily be transitioned to AFAs. For some clients, commodity work focuses on employment matters. In others it means products liability, routine intellectual property, due diligence, and non-critical litigation. For such repetitive matters, it is important to ask if there are particular goals that will define a successful outcome. For example, some companies value fast cycle time (time to resolution/filing/completion), while others may have particular dollar targets they are shooting for. If there are such drivers, the parties should build in incentive payments that reward the firm for reaching the stated goals.

Driving It Home

Finally, the successful implementation of AFAs requires corporate counsel to build buy-in from their own lawyers — many of whom are perfectly content with the past approaches and relationships. General counsel must make it clear to their lawyers that they expect them to embrace cost cutting methods and that the company will tie compensation and bonuses to those expectations. "If you manage a team of lawyers," says Jeff Carr, General Counsel of FMC Technologies, "this means making [the use of AFAs] important to those who work for you — and that means making it part of their objectives, their performance goals, their compensation and ultimately their continued employment at your company. Unless and until you do so, your lawyers will take the conservative, less risky path of the status quo."

Driving on the Same Highway

AFAs work best when all parties' interests are aligned and where the continuing quality of the law firm-client relationship is given priority over raw bargaining power. When all is said and done, the key to successful AFAs is "to get the lawyers and the clients on the same page early about the goal, agree upon how close one can get to the goal, what an acceptable level of achievement is, and then structure the plan from there, knowing what costs make sense," says. Carl Herstein, a partner at Honigman Miller Schwarz and Cohn LLP. "You can always modify as you go along if it becomes clear that the worth of the matter has changed."

Over the last several years, law departments and law firms that have developed a "getting to yes" approach to fee negotiation, rather than holding to an adversarial approach, have been coming up big winners — in terms of solid, trusting client relationships and in terms of drawing more work into the firm. This notion of aligned interests must go beyond lip service to better modes of collaboration. For both corporate counsel and law firms, the world's present

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economic imperatives give new meaning to Benjamin Franklin's injunction that "if we don't hang together, we will most assuredly all hang separately." ◆

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