

A low-angle photograph of two business people shaking hands in front of several tall skyscrapers. The person on the left is wearing a dark suit jacket, and the person on the right is wearing a grey pinstriped suit jacket. The background shows a clear blue sky with some light clouds.

# Tying Outside Legal Costs to Value

## Will the Current Economic Crisis Spark a Rush to Value Based Fees?

**A**s a result of the changing face of the legal profession and particularly the impact of the worldwide economic crisis, General Counsel, Chief Legal Officers and other in-house contractors of outside legal services are being compelled to take on a new and unexpected role: market maker and change agent.

Rather than being passive consumers of legal services as shaped and billed by outside counsel, CLOs find themselves in a new position with unexpected leverage: at the forefront of a major sea-change that positions them to call the shots, configure the product, define the lawyer-client relationship, and control pricing as never before. The practical question is how readily they embrace this power and how effectively they learn to use it.

Traditionally conservative and accustomed to traditional billing and service delivery models, CLOs are feeling the pressure to adapt to a new set of “best practices,” pressure that is increasing exponentially in responses to chaotic, apparently uncontrollable global financial events. They see the more innovative and far-sighted among them engineer fundamentally different relationships with their vendors and wonder how much and how fast they will have to retool their modus operandi.

Whether in the United States, the EU or the UK, CLOs have long obsessed about their “outside legal spend.” And well they should. According to Altman Weil’s 2008 survey of U.S. CLOs, even before the current economic meltdown, their highest priority over the next 3-5 years was to control legal costs. Similarly, in a recent survey of major international firms by Everheds, Law Firm of the 21st Century, corporate counsel identified containing costs, dealing with escalating rates and achieving value for the money as their top challenges. Because outside legal costs have long constituted the lion’s share

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of expenditures for almost every corporate legal department, new approaches for pricing and billing legal services seem inevitable.

In a major paradigm shift from the days when law firms wrote the rules in the lawyer-client relationship, CLOs know that as today's hotly competitive client they now can insist on:

Predictability of outside legal costs (requiring firms to budget accurately and hold to budget);

Efficient and productive lawyering (meaning strict attention to staffing and a relentless results-orientation); and

Bills that reflect actual value conferred -- as they, the client, perceive that value.

Predictably, the high-stakes players and industry innovators tend to lead the way. Recently, the big legal dogs from such major corporations as Sun Microsystems, Del Monte Foods, Coors Brewing, Edison International, Wal-Mart, Cisco Systems and Exelon Corporation met to compare notes about the performance of their outside counsel. The result was a white paper emphasizing the need for firms to improve value added and better align service delivery with the goals and objectives

of legal departments -- just as General Counsels need to be aligned with the goals of their own senior executive teams. (See ACC's CLO Think Tank Executive Report, April 2008).

CLOs are demanding changes in billing practices, and becoming less shy about insisting on innovative billing. Law Firms Tightening Belts -- By Request, (Washington Post, 10/20/08), stated, "Robert Ruyak, chairman and managing partner of Howrey, LLP, said he began feeling the heat from corporate clients last year. With tighter budgets, legal departments at Proctor & Gamble, Qualcomm, GE Healthcare and others prodded Howrey to provide significant savings in the form of alternative fee arrangements."

While circumstances are forcing a more assertive stance by top in-house lawyers, a number of CLOs tell us that they do not enjoy being the only party driving change. They have warm praise for firms that come to them with creative solutions, offering to collaborate in novel approaches to providing and measuring value. One respondent told Altman Weil in the 2008 CLO survey, "these are the firms that distinguish themselves and earn our business." Other CLOs see the current climate as contributing to more effective and more trusting relationships with preferred outside providers. As Mark Chandler, General Counsel & Secretary of Cisco Systems, Inc., put it, "once a model for delivering legal services is built around efficiency rather than time and hours billed, then law departments and outside legal service providers can truly partner with each other."

Cisco put its money where Chandler's mouth is when it decided that four areas in its approximate \$125 million annual legal spend (commercial litigation, mergers & acquisitions, securities and patent prosecution) would be awarded to firms only on a fixed fee basis. One firm, Morgan Lewis & Bockius, that now handles Cisco's commercial litigation nationwide on an annual flat fee, has found the relationship with Cisco to be so satisfactory that it has entered into such fee arrangements with other clients. As a result, Morgan reports that 40% of firm revenues are billed through alternative fee arrangements.

#### WHAT'S WRONG WITH THE BILLABLE HOUR?

For years, in-house counsel have complained about the ineffectiveness of hourly fees and procedures to track them, the

incentives they create for bill-padding and overlawyering, and the damage wreaked on the relationship between inside and outside counsel. The most common gripes are hardly new:

Hourly rates put the interests of the attorney in conflict with the interests of the client by emphasizing quantity over quality.

The number of hours it takes to complete a task does not necessarily correlate to the value of that task to the client, particularly if work is being provided by inexperienced younger lawyers.

Hourly rates reward lawyers who take the most time to complete tasks (particularly routine and repetitive tasks) rather than rewarding efficiency, creativity, or the use of technology to streamline service delivery and collaboration with in-house counsel.

#### WHAT THE CLO IS DOING ABOUT ALTERNATIVE FEES

With or without the collaboration of outside law firms, a rapidly-increasing number of clients are forcing fundamental changes in the mode of legal service delivery. The most common include:

Procuring work through Requests for Proposals (RFPs) or Tenders that specify the type of acceptable/preferred fee arrangement. In 2008, for example, Goodyear Tire & Rubber Company issued an RFP for its national product liability litigation and specified that it would only entertain all-inclusive fixed fee proposals.

Imposing their own billing hour limits and rewarding their outside firms for crafting alternative fee structures. For example, in May 2008, Fidelity Investments notified its outside counsel that it was imposing a mandatory discount program, effective July 1, 2008. A firm could be exempted from the mandatory discount if it entered into an approved alternative fee arrangement with Fidelity.

Conducting "convergence" initiatives that reduce the total number of legal providers and establish a Preferred Provider list. Fees are then negotiated and driven by the corporate counsel's values and priorities, not the firms' customary billing rates.

Using offshore resources for significant cost savings in litigation matters. Recently a major international corporation obtained pricing from its outside firm to conduct a document review for a products liability case. The review would have cost \$2,000,000 to conduct onshore but cost only cost \$350,000 with lawyers in India. Initially, the corporation considered having its outside counsel conduct the review. The firm would have used its associates billing at a blended rate of about \$250/hour. In contrast, India-based lawyers cost about \$30/hour (also a blended rate).

#### WHAT ARE VALUE-BASED OR ALTERNATIVE FEES?

Even if a proposed billing approach represents some departure from a firm's customary hourly rates, CLOs typically do not regard any method that uses an hourly billing rate as the basis for fee calculations, such as discounted rates or blended rates, as a true alternative fee approach.

Presently the big push is for value-based fees, which are not tied to the number of hours billed by the legal professional. Instead, the fees are based on the type of work performed and an agreed-upon value to the client. Value-based approaches abandon the old hours-times-rate approach and create incentives

for outside firms to manage costs, staff effectively and operate efficiently. Because greatest gains in these areas require collaborative discussion and "getting-to-yes" negotiation, value based fees actually encourage a more candid, mutually-beneficial and lasting relationship with the client.

Clients and outside counsel can explore a variety of value-based or other alternative fees, depending on the nature and volume of work. These can include retainer arrangements, success fees, flat fees, fixed fees, contingency fees (partial or full) keyed a variety of variables, or task-based fees.

#### BARRIERS TO CHANGE

Many law firms resist any systemic change that imposes more obligations on them or threatens existing profitability levels. Some claim they simply aren't able to undertake a billing paradigm shift because they are locked into their existing administrative and operative systems. Others report that they are unable to propose alternative fee approaches because they do not know what it costs them to provide the requested services. Billing that is based simply on rate-times-hours provides no information from which a firm can analyze the cost components of generating particular services, much less the efficiency of lawyers providing those services. Historically, because efficient lawyers were likely to bill fewer hours, firms had no incentive to improve efficiency or minimize over-lawyering.

The "inconvenience argument" generally falls on deaf client ears, inasmuch as their management demands that they provide efficient, value-driven legal services within their corporations and believe that law firms should be able to do the same. In the last four years, many large corporate legal departments have developed sophisticated metrics for determining the cost of services for matters and for component parts of services. "Why," they ask, "do we know how much, on average, it costs to generate a motion for summary judgment in our matters, but our firms have no idea what it costs? This is, after all, the firm's core business."

#### WHY CAN OTHER PROFESSIONALS PROVIDE PREDICTABLE COSTS BUT LAWYER CANNOT?

CLOs report considerable impatience when told, "it depends" when they ask how much a certain matter will cost. They have been through the challenge of implementing better metrics for their own costs and services, and they know professional services that have as many, if not more, variables that can affect cost are able to provide fees and define the variables that might cause deviations.



Even cardiologists performing open heart surgery are now offering flat fees. For example, Geisinger Health System, which runs three hospitals in central Pennsylvania, charges a flat fee on coronary-artery bypass surgery and all of the pre- and post-operative care that goes with it. Surely, the myriad possibilities -- health, life-style, genetics -- over which the physician has no control -- make such surgery novel each time. Yet, using metrics over a period of time have allowed this health system to project the average cost of such surgery.

#### WHO DRIVES, WHO RESPONDS?

One can hope that CLOs and law firms alike take inspiration from the sort of innovative, collaborative and mutually-beneficial relationships that make best-practices case studies. If outside law firms can't or won't step up to the negotiating table, however, ultimately it will be the CLO who has to assume the burden and discomfort of reshaping the provision and pricing of legal service. As one GC succinctly stated, "If a lawyer can't offer me alternative fees, I'll find an 'alternative lawyer'."

At present, many CLOs can claim that their foot-dragging stems from being forced to map new territory, evaluate new risks, change old habits and assume accountability for wielding their increasing economic leverage. As more and more success stories and exemplars of best practices emerge, however, there is no question that, in order to stay competitive and manage costs, the foot-draggers will soon be compelled to chase the first adopters down the road of change.

By Pam Woldow