

# Report to Legal Management

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## Tying Outside Legal Costs to Value

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



Pamela H. Woldow

By Pamela H. Woldow

**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.

That is, rather than being passive consumers of legal services as shaped and billed by their 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 response 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, because according to Altman Weil’s 2008 survey of CLOs in the United States, even before the current economic meltdown, their highest priority over the next three to five years was to control legal costs. Similarly, in a recent survey of major international firms by Eversheds, *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 of expenditures for almost every corporate law department, new approaches for pricing and billing legal services seem inevitable.

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**Outside Legal Costs ... continued from cover**

In a major paradigm shift from the days when law firms wrote the rules in the lawyer-client relationship, CLOs know that in today's hotly competitive climate 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)
- Bills that reflect actual value conferred — as they, the *client*, perceive that value

delivery are occurring in a variety of areas (e.g., greater law firm size, geographic spread, and specialization), many CLOs tell us that the most important innovation that will earn law firms more business from them is pursuing alternative fees. As V. Dion Haynes wrote in *Rethinking Legal Fees for Lean Times* (*Washington Post*, 10/24/08), "...the economic crisis is giving the prosecution a boost in the case of Fixed Fee v. Billable Hours." There is no doubt that the hourly rate is going to come under fierce attack as the most common measure of performance and value (an ironic twist, inasmuch as the hourly rate became the prevailing legal currency in the mid-twentieth century as clients demanded an alternative to the vague, non-itemized

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. As 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 of those firms, Morgan Lewis & Bockius, which 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 and inefficiency of hourly fees and procedures needed to track them, the incentives they create for bill-padding and over-lawyering, and the damage they wreak on the relationship between inside and outside counsel. The most common gripes are hardly new:

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**"Once again, CLOs are demanding changes in billing practices, and they are becoming less shy about insisting on innovative billing approaches."**

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Predictably, the high-stakes players and industry innovators tend to lead the way. Recently, top lawyers 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 that emphasized the need for law firms to improve their "...value add" and better align their service delivery with the goals and objectives of legal departments — just as general counsel need to be aligned with the goals of their own senior executive teams. (See ACC's CLO *Think Tank Executive Report*, April 2008.)

While changes in legal service

invoices for legal services).

Once again, CLOs are demanding changes in billing practices, and they are becoming less shy about insisting on innovative billing approaches. In *Law Firms Tightening Belts — By Request*, (*Washington Post*, 10/20/08), Haynes wrote, "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

- 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 CLOs Are Doing about Alternative Fees**

With or without the collaboration of outside law firms, a rapidly-increasing number of clients are forcing fundamental change 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.
- Requiring that outside law firms use contractors or offshore resources to perform routine or commodity tasks, such as document review; or directly sending the work offshore themselves. For example, Socrates Media, LLC, obtained pricing from its outside firms to customize a residential lease for all 50 U.S. states. When the firms proposed pricing that exceeded \$400,000, Socrates’ COO hired QuisLex, in Hyderabad, India, which did it — excellently — for \$45,000.

**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 the 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 to a variety of variables, or task-based fees.

**Barriers to Change**

Regardless of their clients’ pressures and priorities, 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 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.”

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**Outside Legal Costs ...** *continued from page 11*

**Why Can Other Professionals Provide Predictable Costs but Lawyers 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, lifestyle, 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. ♦

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