

Report to Legal Management

November/December 2007
Volume 35, Numbers 2/3

OUR 34TH YEAR

EDITOR

James Wilber
Principal
Altman Weil

CONTRIBUTING EDITORS

Ward Bower
Principal
Altman Weil

William F. Brennan
Principal
Altman Weil

Thomas S. Clay
Principal
Altman Weil

James D. Cotterman
Principal
Altman Weil

Daniel J. DiLucchio, Jr.
Principal
Altman Weil

Virginia Grant Essandoh
Senior Consultant
Altman Weil

Marci M. Krufka
Principal
Altman Weil

Charles A. Maddock
Principal
Altman Weil

Alan R. Olson
Principal
Altman Weil

Richard C. Reed
Senior Advisor
Altman Weil

Eric Seeger
Senior Consultant
Altman Weil

MANAGING EDITOR
Susan D. Sjoström

Hourly Billing: It's Business As Usual



Daniel J. DiLucchio

By Daniel J. DiLucchio

The use of alternative fee arrangements (AFA) in the legal profession has been discussed for decades. Yet, my day-to-day dealings with General Counsel and law firms suggest a continuing high level of discomfort with the topic. There is a struggle to identify opportunities for AFAs. And even if such opportunities are identified, they are often seen as too time consuming, too risky, or simply too unfamiliar to pursue.

Statistical data from recent editions of the *Altman Weil Law Department Metrics Benchmarking Survey* shows some increase in AFAs over the last half dozen years, but the hourly rate (including reduced hourly rates) still represents the predominant billing method employed by law firms.

Why Is There Still Such Difficulty?

Even though one can argue that advances have been made, there continues to be a struggle to arrive at mutually acceptable terms when it comes to AFAs. Law departments claim that law firms are not aggressive or creative enough in proposing AFAs. Law firms suggest that law departments are only interested in AFAs in an attempt to lower legal fees. Perhaps both are correct in their observations? The difficulty partially lies in competing goals and objectives, but there are other problems as well.

From the Law Department Perspective

Risk/Reward Problem

One of the primary responsibilities of a law department is the selection of the correct outside counsel for the appropriate work. When it comes to the most important legal issues facing the company, few General Counsel are interested in negotiating fee discounts, fearing that the result will be reduced service or inattention to critical matters.

This risk/reward dilemma results in one of the primary impediments to alternative fee arrangements. Insisting on an alternative fee arrangement may result in a brand name firm refusing to represent the company in a high profile matter. And no General Counsel or law department wants to explain that to the CEO or Board. As a result, there is an inverse relationship between the likelihood of negotiating an alternative fee arrangement and the seriousness of the legal matter facing the company.

continued on page 6

Inside This Issue

*Altman Weil Launches New Blog on
Lawyer Compensation*2

Update on Lawyer Retirement Perspectives3

*Leadership Dimension —
Practical Building Blocks of Strong
Legal Leadership*4

Hourly Billing... *continued from cover*

Using Hourly Rates Alone to Manage Legal Costs

The Harvard Business Review of May-June 1998 published an article entitled "Six Dangerous Myths about Pay." The first two myths presented in the article are:

1. Labor and labor costs are the same thing.
2. You can lower your labor costs by cutting labor rates.

Many General Counsel understand that these are myths. Some, however, still work as if billing rates are the same as legal costs. They assume that discounts on billing rates will lower legal costs. Managing the hourly rates of lawyers doesn't necessarily address the most important underlying issue of productivity. Legal fees are a function of fees *and* productivity, and many AFAs do not address both of these factors. For some law departments, it is easier to measure and manage fees while ignoring the productivity factor.

The Devil You Know

Without good data and good data analysis, real alternatives to hourly pricing, such as fixed fees, require a huge leap of faith. General Counsel may not like hourly pricing, but they know it and understand it.

Additionally, many in-house lawyers come from private law firm backgrounds and are comfortable with, and indoctrinated into, the hourly rate culture. They have no clear personal incentives to push such a change, as they are seldom evaluated on the costs of a matter. Overall, the company may want to reduce legal costs, but accountability on an individual level is rare.

Time and Resources

Identifying opportunities, analyzing data and negotiating arrangements can be time consuming for very busy

in-house lawyers. AFAs often take a huge up-front investment of time and resources, which are usually needed for more immediate substantive legal matters. Because law departments are leanly staffed and work demanding hours, they usually don't have the time or people to devote to such an undertaking.

"Legal fees are a function of fees and productivity, and many AFAs do not address both of these factors."

As law departments adopt e-billing processes and procedures, better data will become available and may lead to a greater level of comfort in establishing AFAs. Prior to e-billing, it was impossible for a law department to efficiently break down and analyze paper bills. With e-billing, law departments can analyze bills and gain a deeper understanding of the costs of handling matters. In many cases, matters can be broken down into distinct phases or tasks, enabling greater appreciation of the costs and presenting clearer opportunities for alternative billing approaches.

The unanswered question, however, is whether law departments will actually take advantage of the data they are collecting by creating alternative pricing schemes and asking their law firms to adopt them.

Reducing Overall Legal Fees

Law departments are criticized for only being concerned with paying less and not creating win-win situations. In some cases this is true, as law departments are under signifi-

cant pressure from the company to reduce, or better manage, legal fees. To some, alternative fee arrangements have become the code word for cost-cutting. Beyond cost cutting, however, is the pressure and desire for greater predictability of legal fees. This is a major driving force behind the AFA.

Other Law Department Issues

Even if the General Counsel does succeed at implementing a new alternative fee arrangement, will she be rewarded for her trouble? Is the size and likelihood of the reward worth the trouble? And, if there is a chance that she will be criticized later, is it worth the risk?

- Studies of consumer behavior indicate that people don't need to know they got the best deal; they just want to know that they didn't pay more than the next person. With billable hours, the law department knows that they are paying the same rate as the next law department, even if they think that it's too high. By using AFAs, law departments feel that they may lose comparative data and information necessary to prove the value of the arrangement.
- Law department billing policies and protocols are all designed around the billable hour and therefore reinforce old practices around hourly rates.
- Finally, law departments feel as though law firms are negotiating alternative billing as a way to make more money while doing the same amount of work. There is a fear of paying a fixed or flat fee of \$x only to find later that the law firm disposed of the matter with an expenditure of time value of \$0.5x. In addition, there is often a false sense that hourly fees and detailed billing create accountability.

The Vice President of a Fortune Global 500 company recently told me that her experience suggests that most alternative fee arrangements have escape hatches of some sort designed in the plan. Her experience suggests that during the life of the agreement, most law firms spend quite a bit of their time trying to get out through the hatch.

From the Law Firm Perspective

Lack of Pressure from Clients

Law departments talk about alternative fee arrangements, but as we noted above, they send mixed messages about their appetite for these arrangements. So, law firms are feeling pressure, but not pain, when it comes to AFAs. The result is that clients continue to allow, and in some cases encourage, law firms to bill by the hour.

Creating alternate billing structures that work for both parties takes creativity, time, effort and work. Without significant pressure from a client, this is not a priority for the law firm. When billable hours are readily available, busy lawyers will spend their time billing the hours.

Go With What Works

Why change what is working well? Law firms continue to make good money and the partners are generally paid very well. There is no significant pressure that would cause these organizations to pursue a different pricing strategy, based upon current income levels and the amount of legal work available — it is a sellers' market.

One simply needs to look at the rise in billing rates over two to three decades and compare it to the Consumer Price Index (CPI). Lawyer billing rates consistently increase by approximately twice the CPI. Why change that model?

There are no economic motivators, survival motivators or other

incentives to compel law firms to pursue significant alternative pricing strategies.

Inertia and Risk

For some firms, the only reason to engage in alternative billing is to pursue a perceived opportunity or differentiating strategy. Even for those firms that think there might be an opportunity in adopting AFAs, they are often too risk averse or too ill-prepared to set forth alternative strategies to clients and therefore generally do nothing.

In some cases, the law firm does not want to move to AFAs because of the risk of lowering costs — ultimately accelerating the commoditization of legal services — and increasing competition as a result. They are concerned that AFAs are a slippery slope, leading to revenue reductions and creation of a competition platform based only on fees.

Other Law Firm Issues

- Law firm time and billing systems and cultures are built around the billable hour. In addition, law firm compensation systems still reward lawyers for the number of billable hours they record and bill. According to the *Altman Weil Survey of Compensation Systems in Private Law Firms, 2006 Edition*, billable hours are the number one performance factor affecting associate salary. Billable hours ranked somewhat lower as a factor in partner compensation, but are still an important metric of partner performance in almost every firm.
- Prior to the advent of time and billing systems with analytical capabilities, there was very little good data on the cost to deliver legal services.
- Risk-sharing is hard to sell. All too often clients want the guarantee of lower costs but without the oblig-

ation of higher fees if the law firm achieves some larger success. This is a big frustration to law firms.

- More and more of what lawyers do can be considered “process,” which means legal work is becoming more commoditized. AFAs simply confirm and reinforce this fact. Most law firms are not structured or staffed to capitalize on the process opportunities presented, and view this movement as a threat instead of an opportunity.

The Table on page 8 summarizes many of the law firm and law department barriers discussed in this article.

Where Do We Go From Here?

The obstacles to alternative fee arrangements are significant, and in spite of all of the talk, attention and commotion, the actual use of AFAs appears to have remained relatively low over the past few years. It is doubtful that there will be much change in the status quo unless and until a number of fundamental changes take place.

First, corporations will have to take a stronger stance on AFAs. Right now, law firms feel pressure to pursue something other than the billable hour, but they don't feel pain. Law departments will need to gather better data, turn that data into information, and create a solid foundation upon which to build credible AFAs.

Second, law firms must appreciate that there are successful financial structures, other than the billable hour, which can be used to achieve successful economics.

Third, corporations must better prioritize their work and decide when they need to be “bullet proof,” and when they can take some appropriate risk.

Continued on page 8

Hourly Billing... *continued from page 7*

Fourth, corporate law departments must accept the fact that it might be possible for a law firm to reduce their overall legal costs to a corporation while at the same time improving their profit margin.

Law firms need law departments and the work that they provide. Law departments need outside firms to handle the legal work that they are not staffed to handle, or where specialization is required. An understanding of respective positions and

agenda is required to ensure a mutually beneficial relationship.

Without some fundamental changes in approach by both law firms and law departments, however, I expect it will be frustration, more dialogue and the billable hour, as usual, for the foreseeable future. ♦

Editor's note: This article is reprinted with permission from the Fall 2007 issue of GC Mid-Atlantic. ©2007 ALM Properties Inc. Further duplication without permission is prohibited. All rights reserved

Daniel J. DiLucchio is a principal of Altman Weil, Inc., working out of the firm's offices in Newtown Square, Pennsylvania. He can be reached at (610) 886-2000 or djdilucchio@altmanweil.com.

Barriers to implementing effective AFAs:

Law Firms	Law Departments
<ul style="list-style-type: none"> Receiving some pressure, but no pain, from clients for AFAs. 	<ul style="list-style-type: none"> Applying pressure, but no pain, to providers for AFAs.
<ul style="list-style-type: none"> Billing policies and procedures, time and billing systems configured for hourly billing. 	<ul style="list-style-type: none"> Billing protocols, matter management, e-billing and other systems configured for hourly billing.
<ul style="list-style-type: none"> Lack of sufficient data and analysis thereof for innovative or strategic pricing. 	<ul style="list-style-type: none"> Lack of sufficient data (although this is changing rapidly with e-billing systems) or the time/resources/personnel to analyze the data and engage in sophisticated pricing negotiations.
<ul style="list-style-type: none"> Compensation and other incentives based largely (sometimes totally) on productivity and the billable hour system. 	<ul style="list-style-type: none"> No individual or group financial incentives for in-house personnel to utilize alternative systems.
<ul style="list-style-type: none"> The Devil you know...Most lawyers in private law firms "grew up" under the billable hour system and are familiar with operating under the same. 	<ul style="list-style-type: none"> The Devil you know...Most General Counsel and in-house lawyers began their careers in private law firms and are familiar with operating under the billable hour system.
<ul style="list-style-type: none"> Law firms are risk-averse organizations. Often not willing to share risk with clients. 	<ul style="list-style-type: none"> Willing (sometimes eager) to share risk, but not necessarily reward.
<ul style="list-style-type: none"> Haven't taken advantage of AFAs as a differentiation strategy. 	<ul style="list-style-type: none"> Not sure whether the investment and risk will result in sufficient rewards.
<ul style="list-style-type: none"> Fearful of the "slippery slope" for all pricing/fee structures. 	<ul style="list-style-type: none"> Still rely on hourly rates as a means of comparing firm-to-firm costs.
<ul style="list-style-type: none"> Not likely to admit that much of the legal services provided are "process" and moving toward commoditization. 	<ul style="list-style-type: none"> Concern as to whether AFAs decrease law firm accountability (i.e., can we hold lawyers accountable without detailed time entries for tasks?).