



What Is, and Is Not, an Alternative Fee Arrangement

Posted by: Law Technology Today December 10, 2014

The phrase “alternative fee arrangements” raises a question: alternative to what?

The obvious answer is “to the billable hour.” But lawyers—creative lot that they are—have bastardized the phrase to mean “alternative to stand rack rate hourly billing,” meaning that any discount off a firm’s standard hourly rates is an “alternative.” Interpreting the idea so broadly surely helps a firm’s statistics when it brags on how much of its revenue comes from alternative fees. But that kind of statistical sleight of hand misses the point.

Fee agreements promote specific behaviors. For example, billing based on time causes people to spend more time on matters. That fact doesn’t change if the hourly rate is discounted, blended, or rack. In a truer sense, alternative fees are about relationships with clients that are not based on how many six-minute increments it took to complete a task. Hourly rate billing is cost-plus billing. In the broadest sense, alternatives are those billing methods that are not cost-plus. But to be more precise, here are the definitions I use throughout the rest of this post:

Structures That Are Not Alternative Fee Arrangements

Hourly rates. Clients are billed for the amount of time a given lawyer works, whether in hours, tenths of hours, or some other fraction of hours, multiplied by an hourly rate. Most firms have standard rates, book rates, or rack rates for all of their lawyers.

hours x rate = revenue

Discounted hourly rates. Clients are billed for the amount of time a given lawyer works, whether in hours, tenths of hours, or some other fraction of hours, multiplied by an hourly rate that is less than the lawyer's standard, book, or rack rate. Most firms will discount hourly rates for many of their larger clients.

hours x discounted rate = revenue

Blended hourly rates. Instead of using each lawyer's standard, book, or rack rate, a common or "blended" number is used. For example, if the standard hourly rates for lawyers on a matter are \$800, \$600, and \$400 per hour, the negotiated blended rate may be \$550 per hour.

hours x rate = revenue if (and only if) revenue < cap amount

Why are these not alternative fees? All of these fee structures incentivize lawyers working under them to bill more time. More time yields more revenue. As a rule of thumb, if the term "hourly rate" appears in a fee structure, the fee is not an alternative, regardless of what adjective precedes "hourly rate." Discounted hourly rates, blended hourly rates, uncollected hourly rates, or Thursday hourly rates are all hourly rate structures, where more time spent equals more revenue. None of these structures create any incentive, let alone pressure, for efficiency.

I've been on panels with lawyers who have said that blended rates are alternative fees because they are not straight hourly rates, as if any minor deviation from stated rack rates is an alternative. First, a client would have to be stark raving crazy to agree to a blended rate. Firms assign lawyers with the lowest hourly rates to handle these matters. Why? Because firms that successfully utilize low-priced lawyers can achieve realization rates greater than 100 percent. Realization rates are now averaging in the range of 85 percent. Consider the internal value of a matter with realization rates greater than 100 percent.

How do you achieve those rates? As a simple example, say a client agrees to a blended rate of \$400. The partner on the matter bills at \$600, the junior partner at \$450, and the assigned associates bill at \$320. If the associates work 100 hours, the younger partner works 20, and the senior partner works 5, that's 125

hours at a blended rate of \$400, a total of \$50,000. The firm sees this as 100 hours at \$320 (\$32,000), 20 hours at \$450 (\$9,000), and 5 hours at \$600 (\$3,000), or a total of \$44,000. The realization rate is approximately 114 percent.

Under a blended rate, firms have two incentives. One is to have timekeepers with rates under the blended amount bill excessive hours; the other is to have lawyers with rates over the blended amount bill as few hours as possible. So clients lose twice: first because the incentive to bill more, not less, is still present; and second because the bulk of the work will be done by lawyers with less experience.

Is it possible capped fees can alter the incentive to bill more? The answer depends on the circumstances. If there is no benefit to being under the cap, what is the incentive to bill fewer hours, at least up to the cap amount? There isn't any. But if the savings are split, the firm is incentivized to bill as little as possible since the savings shared with it are "free money"; that is, fees for which the firm has incurred no cost. Any rational economic actor should want that free money, right? The answer is "of course," but the assumption that firms act as rational economic actors may be problematic. If a partner's compensation is driven by total billings and not total attributed profit, it may well be in the partner's self-interest to forsake the free money and maximize the total billings, even if it means exceeding the cap. Consider a matter with a \$1million cap where excesses are paid at 50 percent and savings are shared at 50 percent. If the partner bills \$800,000, the firm receives an additional \$100,000 (half the amount under the cap), for a total of \$900,000. If the firm bills \$1.4 million, it stands to be paid \$1.2 million. What benefits the partner more?

None of the approaches based on time fundamentally change the behavior of lawyers to the client's benefit. The "more is better" mentality that so infects the legal system is not limited or altered in any meaningful way.

Structures that are Alternative Fee Arrangements

There is no end to the variety of alternative fees that lawyers and clients can imagine. Over time, a few have come to stand out as being the most used.

Retainer Agreement

The typical example is when a client pays a standard monthly fee for defined work. It can be in the context of advising clients, so the outside lawyer is available without limitation to inside lawyers or

businesspeople to address various matters, such as human resource issues, contracts, and other routine topics. In the litigation context, retainers are a tool to level off uncertainty. For example, a national retailer sued by landlords but with a long record of early resolution of such claims may find it easier to have a lawyer on retainer to handle these matters from inception to filing written discovery, or to the point of the first settlement meeting, or whatever point of the litigation is agreed upon. This type of engagement differs from the situation where a client advances an amount, frequently called a retainer, against which future invoices are applied.

Fixed Fees

The concept of a fixed fee is simple: a specified sum. But a specified sum for what? It turns out that there are several answers. While conceptually easy, the variety selected makes a big difference in pricing, which is a topic addressed later.

1. Portfolio of cases. If a client has a group of cases or a steady flow of a certain type of case, the client may wish to group the cases. The data for handling prior cases likely shows a range of costs. Fixed fees level the alterations. Consider
2. Single case. On other occasions, clients have just one case and want to know the price for handling the matter. Single fee for single matter.
3. Phase of case. Cases have phases, such as pleadings, written discovery, depositions, experts, summary judgment, trial preparation, and trial. These phases can be priced separately, with a fixed sum determined for each phase. If the phase does not occur (early settlement, a decision not to pursue summary judgment, etc.), the fee for that portion of the matter is not paid.
4. Single case by time. Sometimes it is not possible to estimate the fee for a single case because the duration is not estimable. This tends to happen in more complex multiparty cases. In these circumstances, clients and firms can agree to a fixed monthly sum, which is paid as long as the case is active.
5. Multiple cases by time. Some clients have a track record that allows them to believe that they will have a certain number (or narrow range) of new cases during a year. A fixed fee for the time period requires a firm to handle the cases filed during a year (or other negotiated period) for a specified sum. As the cases mature into the following year, more certain budgets can be set per case. This approach

allows clients the certainty that their budgets will not be disrupted depending on when during the year cases are filed.

For any fixed fee matter, it is common for clients to include a bonus component or holdback to promote behaviors they desire. For example, a client desiring early resolution may pay only 80 percent of the agreed-upon fixed fee (of whatever variety) and pay a declining multiple of the holdback amount depending on how quickly the matter is concluded.

Contingency Fees

These types of fees are well-known from their prevalence in the personal injury world. This form of payment, recovery of a specified percentage of a defined sum, has become common in corporate plaintiffs' claims. The structure works well when the amount of potential recovery is sufficient to create an incentive for the lawyer to handle the case.

Reverse Contingency Fees

These are similar to traditional contingency fees, but instead are calculated as a percentage of the amount saved for the client who is a defendant in a lawsuit. To work, the base amount from which savings are calculated must be agreed upon in advance between client and law firm. The best circumstances for use are where damages are clear but liability is contested (like a contract claim) or where there were efforts to resolve before the lawsuit was filed and a firm demand from the plaintiff can be used as the baseline.

Hybrid Fee Agreements

In this category, I include the ACES system (employed by Jeff Carr, general counsel of FMC Technologies), capped fees with shared savings, and fee collars.

1. **ACES.** This system requires a budget for an entire engagement at the outset, agreed to by lawyer and client, and it is difficult to change the budget once set. While billing is still done on an hourly basis, the client pays only 80 percent of the invoiced amount as long as the lawyer is under budget. If the lawyer exceeds the budget for a given segment of the case, payment is only 20 percent of the amount over budget. The unpaid balance is put into an "at-risk bucket." At the end of the matter, performance to budget is one of five factors considered in determining whether the client pays the sum in the at-risk bucket plus a multiple of that amount. The budget certainty and the potential premium are the carrots to encourage efficiency, while the possibility of not being paid some or all of the at-risk bucket is the stick to influence desired behavior.

2. **Capped fees with shared savings.** Standard capped fees incentivize lawyers to bill as close to the cap as possible. The add-on of sharing (usually on an equal basis) the amount by which the lawyer comes in under the cap is an incentive to

AFA_Litigation_LIVE.indd 23 7/16/14 1:37 PM
24 Alternative Fees for Litigators and Their Clients

work more efficiently, since the shared savings are “free money,” or in hourly billing parlance, a way to achieve more than 100 percent realization.

3. **Fee collars.** A fee collar sets an amount a lawyer is to be paid. If the lawyer’s hours come in on target or at a specified percentage above or below, the fee becomes final. If the hours fall below the agreed percentage under, the savings are shared. If the hours exceed the agreed percentage over, the lawyer is paid only a percentage of the excess amount billed. As an example, a client and lawyer agree the fee is \$10,000 with a 20 percent up and down collar, meaning that if the lawyer bills from \$8,000 to \$12,000, the final fee will remain \$10,000. If the lawyer works only \$6,000 in billable time, the \$2,000 difference is split, and the client receives a \$1,000 credit, meaning the final fee is \$9,000. If the lawyer works \$14,000 in billed time, the lawyer is paid 50 percent of the amount over the \$12,000 collar, meaning the final fee is \$11,000.

Everyone knows that fee structures incentivize behavior. The real issue with any AFA is determining the behavior that the client wants and then fashioning a structure to produce that outcome. It is not quite that simple, however, because the fee structure is not the only incentive driving lawyer behavior.

There are obvious client relationship issues that must be considered in these circumstances, but the example illustrates the simple point that when money drives behavior, not everyone looks at things the same way.