The Pernicious Effect of the Hourly Rate on Client/Counsel Relations*

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DuPont Legal, like most corporate law departments, is charged with managing the legal exposure of the company. As part of that task, DuPont Legal assures that the cost of the legal service is proportional to the overall corporate objective for which the legal service is deployed.

To a large degree, corporate law departments like DuPont Legal discharge that overall responsibility by retaining outside law firms to represent the corporations. In that context and to meet the expectations of corporate management, the in-house lawyers must review the legal fees charged by those law firms and assure themselves and corporate management that those fees bear an appropriate relationship to the work involved.

That determination continues to bedevil in-house counsel. The hourly rate/1/ long has been the predominant method by which corporate clients compensate their outside law firms./2/ That

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subject is closely related to other subjects that often dominate surveys of in-house counsel: value and budget pressures. For example, "[w]hen asked about their biggest management challenges, [respondent general counsel] are not shy about mentioning budgets. 'We're all under relentless cost pressure.' "/3/

Of the top five pressing issues that they face, 81.96 percent of in-house counsel who responded to a survey listed "[r]educing outside legal costs" as among the most pressing. The response achieved a weighted average score of 2.55, the lowest weighted average score of any of the responses./4/ (The lower the score, the higher that response ranked in terms of its pressing nature.)

In addition to the need to control the costs of legal service while relying more than they might prefer on the hourly rate, in-house attorneys face the prospect of periodic increases (often annual) in the hourly rates that law firms charge. More often than not, law firms simply "announce" such increases with little advance notice to the in-house attorney. In some instances, firms even send invoices to clients without mentioning that the fees evidenced in those invoices reflect higher hourly rates.

In-house lawyers find the practice of hourly rate increases particularly problematic and irritating since they face increased budgetary pressures from year to year. It all seems to come down to value: do the law firms' billed fees reflect value commensurate with the amounts in question? Can a firm's annual increase in the hourly rates that it charges represent sufficient additional value?

I. The Value Imperative

The question of how outside counsel fees compare to the value that in-house counsel place on outside counsel's performance has plagued in-house attorneys for some time. In 1997, in-house counsel graded their outside counsel at 3.4 (out of a highest possible score of 5) as to whether the charges for legal service were commensurate with the value of those services, while the outside counsel gave themselves a grade of 4.3. In 1998, in-house counsel responding to the same survey gave outside counsel a C, while outside counsel awarded themselves a B+ that same year./5/ The gap between the scores awarded to outside counsel by in-house counsel and those that outside counsel awarded to themselves on that measure persisted in annual surveys by that same organization./6/

For quite some time, many authors have explored the idea of using fee structures to create incentives for outside counsel to provide legal service more cost effectively and with a greater direct correlation to the value of the legal service that those fees represent./7/ The actual use of alternative fee arrangements (AFAs), however, has been much less common than one might expect from the extent of its treatment by consultants and others./8/ Thus, despite the interest of in-house counsel, the hourly rate persists. A review of the history of the hourly rate and the interest in AFAs might shed some light on their apparent inconsistency between goals and reality.

A. History of the Hourly Rate

The hourly rate was virtually unknown, in respect of how law firms billed their clients for

legal work, until approximately the middle of the twentieth century. Revealingly, "[s]tarting as early as the 1940s, management experts concluded from various studies that lawyers who kept time records earned more than attorneys who did not."/9/ Nonetheless, until at least the late 1950s, clients' bills did not reflect itemized time records, although the firms were beginning to keep records of how their attorneys spent their time./10/ Gradually, management consultants promoted time keeping to law firms, and they even proposed that firms adopt time-based billing as a means of increasing their revenue. By the 1970s, bills increasingly reflected the amount of time spent on clients' matters and the fees were calculated on that basis alone./11/

This is not to say that law firms imposed the hourly rate on totally unsuspecting, naive clients. As corporations established law departments more and more frequently up to and during the 1950s, in-house lawyers, who faced expectations on the part of their companies' managements that they manage the legal work, began asking law firms for data to justify the legal fees reflected in invoices that, up to that time, contained no detail and merely charged a single amount "for professional services rendered."/12/ The hourly rate thus served the interests of both law firms and corporate law departments. For law firms, it led to a "cost plus" arrangement for billing purposes that removed all outcome-related risk from their shoulders. It provided to corporate law departments a convenient proxy for an accurate measure of whether the clients received value commensurate with what they paid for the work. It fit well into an accounting-based approach to managing legal service and, therefore, was well accepted in the 1950s and 1960s.

B. Effects of the Hourly Rate

Although it did serve, to some degree, the interests of both in-house and outside counsel, the hourly rate has several negative impacts on the costs of legal service and on the relationships between in-house and outside lawyers. The most significant impact flows from the fact that the fee borne by the client will bear no relationship (other than, perhaps, an entirely fortuitous one) to the value of the legal work delivered because the fee is determined solely by reference to the amount of time devoted to the work. The efficiency or inefficiency of the lawyer(s) whose work is covered by the fee will have a greater impact on the size of the fee than the value that the work bears to the client's need.

Another significant effect of the hourly rate is that it means that the financial component of the relationship between the client and the outside lawyer is a zero-sum game insofar as the client wishes a lower fee and the lawyer prefers a higher one. A client that tries to control the costs represented by the fee can only do so by reducing the number of hours for which it pays or negotiating a reduced hourly rate. Each of those means of reducing costs leads to less reward for the lawyer without changing the dynamics of how that lawyer works and the effort devoted to the assignment by that lawyer. In short, either the lawyer or the client "pays" for the lawyer's time.

The hourly rate has had adverse effect on the relationship between the client and the outside lawyer, and it is a subject that both in-house and outside counsel have frequently tried to avoid in the past. If a client does not want to grant the lawyer and law firm *carte blanche* to bill inordinate amounts of fees, that client is oftentimes forced to police counsel by after-the-fact invoice review

to ensure the accuracy of rates, timekeepers, and agreed-upon activity. A more acceptable approach would be a prospective or "forward looking" discussion between the client and counsel to ensure alignment as to anticipated activity, rates, resources, and costs for the period in question. Under either approach, however, the hourly rate undermines the relationship between counsel and client.

As corporate law departments became more sophisticated, the negative effects of the hourly rate became clearer. Even as in-house attorneys became accustomed to reviewing invoices based on detailed time records, they began to question whether the hourly rate created incentives for outside counsel that were contrary to their corporate clients' interest in cost-effective legal service. They began to search for ways to more closely align the interests of the law firm with those of the client, at least as to cost effectiveness. Such a fee arrangement would also reflect a closer alignment between the amount of the fee and the value that the legal work represents in the eyes of the client. In the earlier-cited 2001 survey, when asked to rank the five most important things that outside counsel could do to improve the working relationship between inside and outside counsel, 80.37 percent of the respondents listed "[b]e more concerned with costs."/13/

C. The Client's Perspective and Alternative Fee Arrangements

In-house lawyers consider the value of the legal service as a necessary, inherent element of the service that they seek from outside counsel. In order to demonstrate that the value exists in adequate proportion, in-house attorneys express interest in AFAs. That interest likely will continue.

That interest stems from several sources. First, as legal fees continued to escalate, in-house attorneys and corporate management both began to question whether the total cost justified the effort when considered in the context of the specific assignment. In other words, it is not just the total amount of the fee that raises questions, but its relationship to the business matter from which the need for that legal service arose.

Second, the hourly rate leads to focus on the amount of time that the billing attorneys spend on the matter. In order to manage the work, the in-house attorneys must focus on the billing data to such a degree that it can distract them from more substantive review of the work./14/

Third, the very nature of a review of time records, as reflected in an invoice for legal services, is distasteful to both the in-house and outside attorneys. It suggests that the former will second-guess the work of the latter, and it often leads to less-than-pleasant discussions between them.

The electronic submission of invoices for legal services (e-billing) can facilitate the in-house attorney's review of invoices identifying instances of erroneous billings through arithmetic errors, the use of incorrect hourly rates, the inappropriate addition of timekeepers, and even the allocation of time to the wrong matter. Much of the tedium associated with invoice review can be accomplished by the e-billing systems that are now available./15/

Can we find an alternative? Clearly, a fee arrangement that does not rely solely on the number of billed hours to determine the amount owed the outside counsel (*i.e.,* an AFA) will

eliminate or reduce the need to scrutinize those time records. Can we expect inside and outside attorneys to develop AFAs in light of their failure to do so to this point? Yes, with some preparation and a great deal more data than they usually have at hand. To do so successfully, however, they need to understand the importance of approaching the effort in a true "partnering" spirit.

To develop and implement a successful AFA, client and counsel need to share information. What each knows about the assignment and about the most effective means of completing it is very important to the fee arrangement. That information might consist of internal data and prior experience./16/ For example, a client might better understand the firm's financial needs if it understands the firm's internal compensation system or the cost structure of the firm on which the firm's hourly rates are based./17/ Both parties should err on the side of disclosure. Some information that is usually kept secret may not be necessary to designing the fee structure, but disclosing it demonstrates that the disclosing party trusts the other with that information. Such demonstrations of trust can be very effective in establishing the type of relationship the clients and firms want to have.

If outside counsel truly believes that he or she can do the work more effectively than can competitors (and what law firm does not believe that it is the best at what it does?), he or she should be willing to put something at risk to demonstrate that. Counsel should also be willing and able to put something on the table that is important to the client, such as certainty as to the fee. The client, as part of the same bargain, should be willing to provide its outside counsel an incentive to share the risk of the engagement. This is manifested typically by a willingness to pay a premium to a firm that accepts such a risk and achieves certain agreed-upon goals. If, for example, the client and counsel design the AFA to provide the client greater budgetary certainty and that certainty is achieved together with the desired result, does outside counsel deserve a premium in accord with the financial risk that she or he accepted?

Use information about the cost of the service in determining what sort of AFA is appropriate. Do not simply guess how much the work had cost previously and then use that guess as the basis for the new arrangement. To the degree such an estimate fails to achieve the client's and firm's aims, it might set them back in their relationship.

Identify benefits and risks for the client and the firm in any proposed AFA. Sometimes risks cannot be avoided (*e.g.,* there is a great deal more work than anticipated, and the firm cannot afford to handle it all for the agreed-on fixed fee). If the client and counsel have acknowledged the existence of those risks and agreed to address them when they (the risks) materialize, client and counsel will be better prepared to do so without rancor or feelings of either one having been undercut by the other.

It is important that both in-house and outside counsel recognize that they might need to review an AFA periodically. Any fee arrangement is premised on certain assumptions, and it reflects the circumstances at the time that it is created. Since that context can change over time, sometimes radically, client and counsel must be prepared to revisit the terms of their fee arrangement when circumstances warrant such a step.

As we mentioned, the hourly rate causes the fee arrangement to constitute a zero-sum game between client and counsel. For one to improve its position, the other's position must be worsened. One step that in-house and outside counsel can take together is to search for creative ways of making the delivery of legal service to the client more efficient. Such a collaborative effort also depends on a mutually supportive or synergistic relationship between them.

A client that has significant economic "clout" may be able to achieve apparent cost reductions simply by demanding that law firms reduce their hourly rates and then monitoring, extremely closely, the number of hours for which the client pays. That might, however, be a shortsighted approach for at least three reasons. First, that approach exacerbates the "zero sum" aspects of the fee arrangement, and it increases the likelihood that the relationship will be adversarial. This cuts against the goal of "partnering" relationships (or even good, old-fashioned client/counsel relationships) in which the client expects its counsel to look out for the client's interests in more than a very narrow manner. Moreover, a relationship that is premised on a "zero sum" fee arrangement is likely to be a short-lived arrangement.

Second, a firm must remain profitable in order to stay in business. If it charges hourly rates, it can reduce those hourly rates only so far and remain viable./18/

Third, even reduced hourly rates cannot control the overall cost of legal service. Such an arrangement merely puts a premium on the client's ability to manage the work and thereby minimize the amount of time devoted to its assignments. Cost control via reduced hourly rates, therefore, has limited utility despite its superficial attraction.

A collaborative search for cost efficiencies by client and counsel is potentially far more effective. It is more consistent with the type of client/counsel relationship that many law departments espouse than is a unilateral approach. Moreover, it enables the parties to explore AFAs that might take advantage of identified efficiencies. If they can successfully eliminate steps or activities previously completed when performing legal service, they can reduce the cost of providing that service. And they do so in a way that does not represent an arbitrary reduction of the fees due counsel. Rather, they can achieve the same legal protection for the client, with less expenditure, by intelligently streamlining the workload. An example of such efforts might involve a company that, together with two regional employment litigation firms, developed pleadings that were made available to local counsel handling the matters covered by the arrangement. The two regional firms were responsible for the fees charged by local counsel, but, through the sharing of work product, they were able to realize efficiencies in representing that client that allowed them to successfully manage that financial risk./19/ Creative retention, dissemination, and reuse of work product constitute an effective cost-control technique.

Further, the discussions about efficiencies may highlight different characteristics of the representation that affect its value to the client. The firm and client should develop a deeper understanding of the work and the value or risk associated with that work, as well as the related challenges. This, in turn, will have implications for the type of alternative fee arrangement that might be appropriate.

By exploring efficiencies, the client and counsel will also investigate possible mutual benefits. How can the client benefit from the fee arrangement? How might counsel benefit? If they can identify different advantages for each of them that do not adversely impact the other, they will have the makings of a workable arrangement that will be self-reinforcing and, therefore, self-sustaining. Each will have something to gain from the relationship. Neither will have reason to feel unduly disadvantaged.

An effective AFA depends on the ability of the client and counsel to come to terms on a multiplicity of difficult issues. Perhaps even more important, however, is the fact that they may very well have to revisit issues during the course of the relationship as circumstances evolve and change. As a result, it is important that they have a relationship that enables them to address issues that may arise, whether or not anticipated. In other words, they need a healthy, respectful relationship.

II. Increases in the Hourly Rate

In the context of the need for such a healthy, respectful relationship, law firms' routine of increasing their hourly rates periodically/20/ can be extremely counterproductive. This results from several attributes of such increases.

First, increases in the hourly rates that law firms charge their clients eliminate any incentive for the firms to be more efficient. Law firms typically justify increases as necessary to allow them to pay higher salaries to their associates./21/ If a firm imposes (or attempts to impose) an increase automatically, it obviates the need for the firm to justify the increase or the need to identify any efficiency gains that may offset the proposed fee increase. The market for legal services for corporate clients has not relied on competitive pressures to keep charges down.

A good relationship between a firm and a corporate client, which we often refer to as "partnering" and which we at DuPont strive to establish with the members of our Primary Law Firm Network, should be characterized by communication, collaboration, and information sharing. Circulating redacted AFAs is but one example of the type of information that our network partners track and share with one another. Accordingly, DuPont Legal's Network of Primary Law Firms provides a platform that serves to identify best practices that its members can share for their and DuPont's benefit.

For a healthier exchange to occur, both client and counsel need clearer communication with respect to issues such as productivity, technology utilization, resource leveraging, increased experience, efficiency, and cost considerations that impact their economic health. By clearly addressing such issues, they will establish the basis for the open communication and collaboration that will serve them well over the course of the relationship. In short, greater alignment between the parties will result as to all facets of the litigation.

An AFA should be dynamic, like any good relationship. The unilateral adoption of fee increases by law firms undermines that relationship. AFAs, as opposed to the hourly rate "zero sum"

game, underscore the importance of candor, communication, and a greater understanding by the parties of each other's financial interests.

We do not mean to say that law firms, if they bill their clients on the basis of hourly rates, must forever live with present rates. Such an artificial constraint on law firms' billing practices could result in adverse and unintended consequences for the firms and their clients. Increases in those rates should, however, reflect something other than a reflexive price increase to offset a firm's inability to control its own costs. Almost every business in America must consider the competitive impact of an increase in its prices for customers before putting such an increase into effect. Unlike most other businesses, law firms profess to look after the interests of their clients almost in a paternalistic sense, yet they often impose rate increases without any apparent regard for the effect that the increases will have on their clients' finances.

We make the point that law firms should expect to, and their clients should expect them to, justify increases in their hourly rates. A simple statement by a firm that an increase is warranted to keep up with the market is or should meet skepticism at least. Instead, a firm should provide clients sufficient data to establish that the firm has settled on the increase as a last resort and that it has attempted, at least, to avoid the need for an increase through efforts to more efficiently achieve the client's goals. A firm should make a measured, disciplined, articulated case for any rate increase that it proposes to impose on its clients.

At the same time, it is only fair that clients share information with the law firms about their (the clients') financial and budgetary goals. If the costs of legal service consume a greater portion of a company's expenses each year, the firms should know that and work with that client to ameliorate that situation. In short, give careful consideration to each client and the uniqueness of that client. The ability and willingness of the client to assist the firms in various ways/22/ should be taken into account as well when approaching the subject of fee increases and AFAs.

Greater transparency between clients and law firms about finances and billing, in both directions, would enable them to achieve firmer, more supportive relationships. Together, they would be able to explore how to more efficiently and effectively deploy the talents of the lawyers (inside and outside) so as to reach the client's business goals most expeditiously.

III. Conclusion

The hourly rate is still very much alive. Corporate law departments have a love/hate relationship with it, however, and long for a viable alternative. They think that AFAs are more appropriate for much of the work they assign to outside law firms.

While the hourly rate is still the predominant method of calculating legal fees, law firms should pay attention to its effects on their relationships with their corporate clients. This advice pertains even more strongly to increases in hourly rates. Their impact on the relationship between a firm and its corporate clients can be particularly insidious.

Given the necessity of the hourly rate, however, at least in the near future, it is important that law firms and corporate clients approach it with greater understanding and appreciation for its strengths and its weaknesses. Greater transparency between client and counsel and a higher level of information sharing between them should at least ameliorate the worst impacts of the current reliance on the hourly rate.

AFAs provide a challenge and an opportunity to both law firms and law departments. If those parties can overcome their internal resistance to experimenting with AFAs, they will both discover marketing and other opportunities that will redound to their mutual benefit.

ENDNOTES

/1/ The term "hourly rate" refers to any time-based amount that is used to calculate an overall fee, even so-called blended rates and discounted hourly rates.

/2/ In a survey conducted in 2001, 78.2 percent of the respondents reported that during the year 2000, a median of 80 percent of the total amount of their companies' outside legal work was covered by standard hourly rates. Discounts from standard hourly rates covered a median of 40 percent of their companies' outside legal work for 55.2 percent of the respondents. For no other type of fee structure did more than 25.5 percent of the respondents respond favorably and no specific alternative fee arrangement covered more than 10 percent of the work (median) of those respondents who used that type of arrangement. ACCA and Serengeti, "2001 ACCA Partnering with Outside Counsel Survey: Assessing Key Elements of the In-House Counsel/Outside Counsel Relationship" at 158 (hereinafter, 2001 ACCA Partnering Survey).

/3/ Stickel, "GCs Are Crunched by the Numbers," *Corp. Legal Times,* May 2002, at 1.

/4/ 2001 ACCA Partnering Survey at 197.

/5/ Lauer, "Maybe Humpty Dumpty Was a Lawyer," *Law Dep't Mgmt. Adviser,* Dec. 1, 2001, at 5-6.

/6/ *Id.*

/7/ *See, e.g.,* Goehl, "How to Boost Business and Profits with Creative Pricing: The COUMADIN Case Study," *accessible at* <www.imakenews.com/sugarcrestreport/e_article000121157.cfm?x=r>.

/8/ *See* R. Rawson *et al.,* "Fee Arrangements," *appearing in* 1 *Successful Partnering between Inside and Outside Counsel* § 8.2, at 8-3 to 8-5 (R. Haig ed., 2000).

/9/ Ross, *The Honest Hour: The Ethics of Time-Based Billing by Attorneys* 16 (1996).

/10/ *Id.* at 17.

/11/ *Id.* at 19. That the hourly rate developed, as a result of consultants' recommendations, in order to increase law firms' revenues probably surprises few in-house attorneys.

/12/ Rawson *et al., supra* endnote 8, at 8-3.

/13/ The weighted average score for that response was 2.10. 2001 ACCA Partnering Survey at 195.

/14/ During the 1990s, a cottage industry of legal fee auditors arose, at least in part, to relieve in-house counsel of the tedium of reviewing long, detail-packed fee invoices. The use of third-party auditors introduced other issues, such as ethical questions and mistrust between in-house and outside counsel on account of the activities of those third-party auditors. *See, e.g.,* Gurnee, "Do Audits Spell Doom for Attorney-Client Relationships?" *Def. Comment,* vol. 13, no. 2, at 3. *See also Brennan,* "Driven to Defection," *Nat'l L.J.,* May 18, 1998, at A1, A27.

/15/ E-billing offers several benefits in addition to the reduction of the tedium that has heretofore accompanied invoice review. It provides in-house counsel greater control of the process by which proposed rate increases of law firms are reviewed and approved. It creates a data-rich environment and allows a far more meaningful and focused analysis of the work completed. Finally, it provides the parties with a platform to advance their dialogue *vis-à-vis* AFAs.

/16/ *See* endnote 15.

/17/ Increases in hourly rates are often justified, in a very general, unsubstantiated manner based upon increased

costs. Rarely, if ever, do firms substantiate such increased costs or analyze why they are justified in simply passing those increases through to their clients without any meaningful attempt to reduce or ameliorate their impact. Outside counsel should, at a minimum, demonstrate that, despite the impact on the client of the increases in his or her costs to provide the legal service needed, he or she has adopted efficiencies or otherwise worked to offset that increase.

/18/ The recent decision by the firm of Brobeck, Phleger & Harrison to disband highlights the financial risks in the legal profession even for firms that, until recently, were thought to be well positioned in the market.

/19/ *See* Lauer, *Conditional, Contingent, and Other Alternative Fee Arrangements* 42 (1999).

/20/ Rate increases are often annual although they occur at other intervals.

/21/ The escalation in salaries for new lawyers that prevailed in the late 1990s evidenced such a cause.

/22/ A client might assist firms in their own marketing, making referrals to other law departments, for example, or even advertising its success with the firms, as DuPont Legal has done in respect of its Network of Primary Law Firms.