What do law firms sell? What do clients buy?

By Steven A. Lauer © 2004 *

Competition among law firms is intensifying. Many companies have decided to avail themselves of the services of fewer law firms than they did previously. Whether labeled "convergence" (the term applied by DuPont to its program of focusing its legal work on a core group of "primary law firms") or something else, the implications for law firms are clear. As more and more law departments undertake similar programs (AT&T, Marriott, Liberty Mutual and Chrysler are among the better-known companies that have already done so), the aggregate number of available "slots" on corporate lists of approved counsel has declined and probably will continue to decline.

That decline often has been precipitous. It's usually not just a game of musical chairs, with one fewer participant after each round. The members of DuPont's network of Primary Law Firms (DuPont Legal refers to the firms in the network as "PLFs") survived but hundreds of firms that had handled that legal work previously were left to look for new business from other clients. Chrysler uses a mere handful (in relative terms) of regional firms for its product liability cases. In 1996, Prudential Insurance reduced its list of approved outside counsel for the entire law department from about 1000 names to 276 and we (I served as the project manager for the law department's effort to restructure the outside legal service) then used a series of requests for proposals to award most of the outside legal work that we anticipated needing to only eighty law firms. The next year, the law department engaged in another series of RFPs and reduced the circle to seventy firms.

As they reduce the number of firms, many law departments are striving simultaneously to restructure the relationships that they want to have with the law firms that remain on their lists, as did the Prudential Law Department. DuPont uses the term "convergence" to suggest not just the use of fewer firms but a closer, more collaborative relationship with the company's law department (the roles of inside and outside counsel will be somewhat less distinct; they will "converge").

Firms must respond to the pressures created by such programs. To do so successfully, however, they must understand some of the reasons that law departments engage in those efforts. A primary one (and often the only one clearly articulated) is cost. Legal services cost a great deal of money, and the relationship of that cost to the value that the services provide to the company's business goals is often unclear. Sometimes, that cost bears an inverse relationship to the business goals (low-value business transactions entail considerable legal costs, and vice versa). Many in-house attorneys and business executives hold the view that the hourly rate (on which most corporate legal invoices are based) is at least partially (if not mostly) to blame. That perception seems to be, at least to a considerable extent, true. On account of that view, they have long expressed interest in alternative fees.

Despite that interest, however, the hourly rate survives quite well. Surveys consistently indicate that it forms the basis for the bulk of the legal work completed for corporate clients, exceeding 75% in most surveys. Why does it persist?

I think the survival of the hourly rate and the reluctance of attorneys (inside as well as outside the corporate structure) to negotiate alternative fee structures is a function, to a large degree, of an erroneous view or, perhaps more accurately, dichotomous views of what law firms offer and what business executives and law departments want from them. Law firms think that they are in the profession of selling a process, such as counseling. While that clearly constitutes a significant component of what their invoices describe, in truth clients want to purchase something else. Clients want to receive, and pay for, a result. That result might be representation in a lawsuit. It might be the legal work necessary to close a business transaction. Their focus on process, however, causes lawyers to think of themselves as sellers of their time rather than their expertise (despite what they say in their brochures and other marketing materials). The result is legal fees calculated by multiplying time and rate.

If law firms view their output as a result, they can revisit the way in which they price their product. They should be able to apply more imagination and creativity to their pricing. This can enable them to address (and perhaps even anticipate!) clients' concerns in that regard. Fees based on something other than an hourly rate multiplied by the number of hours devoted to a task (*i.e.*, "alternative" fees) can be a basis for them to do so.

The use of alternative fees by corporations has been less widespread than one would expect in light of the dissatisfaction with legal costs and the interest on the part of law departments in aligning the interests of outside counsel and corporate clients. Why does this situation persist? I think that several factors contribute. First, corporations have grown accustomed to paying fees based on hourly rates since they became prevalent in the 1960s, and in-house attorneys have adopted invoice-review approaches based on that fee structure. Second, the alignment of the interests of client and counsel through the fee structure is not easy. Third, corporations are more often defendants than plaintiffs in cases that generate significant fees and can lead to adverse results such as exorbitant jury verdicts. Clients hesitate to try an arrangement that might have unanticipated results by creating incentives for outside counsel to skimp on the quality of legal service in order to keep costs down.

So how would a new way of thinking about law firms' product result in a revolution in client relations? Initially, it would enable firms to view their role for their clients more expansively. The legal work that they undertake is but a means to an end – the end is the completed transaction (*e.g.*, the sale of real estate) or the successful defense of the company's position against a litigation opponent's arguments.

This different slant on how that legal work relates to the clients' business goals should lead to a new way of viewing the fee paid for that work. Essentially, it should cause firms and clients to weigh the value that the legal work adds to the transaction. They would structure the fee arrangement accordingly.

In addition, however, this view of legal work will lead to a new window on the client/firm relationship. It will cause client and counsel to think of the latter as a member of the business team. If the fee is designed in light of the business deal of which the legal work is a component, the business client will consider the attorneys less as necessary evils and more as participants in effecting the business plan. Business executives are likelier to involve attorneys more fully in the design and planning of the means of effecting that plan and its constituent goals. This should lead to a greater level of team attitude among the attorneys and their clients. It should also lead ultimately to more-controlled legal costs (even apart from whatever gains are achieved directly through the alternative fee structures adopted). If attorneys are involved earlier in designing the means of achieving business goals, there might be fewer false starts because legal hurdles that could have been anticipated or avoided by earlier analysis and restructuring do not derail the business plans. Fewer false starts and legal issues that persist in transactions or potential business deals should translate into fewer compliance-related issues in the future. Companies' total legal costs could thereby decrease.

Law firms' view of what they offer their clients also impacts their ability to become true "partners" with those clients in another way. The greater competition in business today (not just for legal services, but more generally) creates a premium on each firm's ability to differentiate its offering positively from those of its rivals. When time is the deliverable, the prospective client looking to select counsel is, in essence, encouraged to compare the billing rates that lawyers charge and use that as the basis for the selection, because there is little other evidence by which to make an objective choice. (Even if the billing rates are not the sole basis for a decision, they certainly play into the decisional process much more than they should.)

Several years ago, Ross Dawson described the distinction between a relationship in which a firm provides its clients "black box" services and one in which a firm engages in "knowledge transfer" with its clients. The latter is a much closer and richer relationship than the former and also better able to withstand the competitive pressures that exist and that are likely to intensify. See Dawson, *Developing Knowledge-Based Client Relationships: The Future of Professional Services* (Butterworth-Heinemann 2000), pp. 5-7, 11.

How can in-house and outside lawyers implement this new way of viewing law firms' service? What steps can and should they take to adopt new methods by which to calculate the firms' fees?

They first must recognize that the client's goals must be paramount in determining the appropriate fee. The apparent simplicity of this statement masks significant difficulty. All too often, the client expresses its goals for the engagement in stark terms, such as "to win" (when the engagement involves litigation, for example). Rather than accepting an initial, facile expression such as that, counsel should engage the client in a more complete, explorative discussion of what the client wants to achieve and how the lawyers' service will or can advance toward that goal.

Once client and counsel agree on what the client wants to accomplish and how the lawyers' work can assist in its achievement, they should discuss the value of that work in the context of the litigation or project. Further, they should explore what sorts of incentives for counsel would align the interests of counsel and client more fully. For example, if swift resolution of a dispute constitutes the client's ideal result, they should design a fee structure that will reward counsel for efforts that accelerate the resolution and that create disincentives (like economic penalties) for excessive delay.

A client may be particularly interested in budget certainty for litigation (especially when that client has initiated the suit as plaintiff, rather than a situation in which it finds itself defending its past actions). In that circumstance, client and counsel might design the fee structure to reward the lawyers' ability to adhere to the anticipated cost of the process. The outcome of the litigation will constitute a significant element of the client's goals, of course, but the fee structure will reflect its interest in that budgetary predictability.

The important point to remember is the primacy of the client's goals for the engagement, expressed in as much detail and subtlety as possible. The fee structure should include incentives that reward actions by counsel that advance those goals and penalize those that frustrate them.

This blueprint for approaching the subject of alternative fee arrangements can only suggest a path. Each engagement contains its own subtleties and idiosyncrasies, any of which might affect the ultimate success of an alternative fee arrangement. The anticipated difficulty of designing an appropriate fee structure, however, should not deter counsel from the effort. Whatever the result of the discussion of possible fee structures, the discussion itself will provide value to both client and counsel. See Sager & Lauer, "The Billable Hour: Putting a Wedge Between Client and Counsel," *Law Practice Today* (December 2003), posted at http://www.abanet.org/lpm/lpt/articles/fin12032.html.

Conclusion

A time-based fee system for the legal profession, like a "black box" type of service described by Ross Dawson, lends itself to commoditization. Such a system makes it easy for prospective clients to use billing rates to distinguish among competitors, rather than differentiate among them on some other, quality-related criterion. Were law firms to engage their clients in the knowledge-based relationships that Ross described, which include knowledge transfer and even co-creation of knowledge by the client and the professional adviser, they would enjoy closer, deeper relationships of the type that they and clients seem to desire.

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