

Expert Q&A on Alternative Fee Arrangements

While the billable hour has been the most common fee arrangement for legal services for more than half a century, recent years have seen alternative fee arrangements (also called AFAs, appropriate fee arrangements, or value-based fee arrangements) gain in popularity. Nonetheless, there seems to be considerable confusion as to how to best select, design, implement, and manage AFAs. Practical Law asked *Steven Lauer of Lauer & Associates* and *Kenneth Vermilion of The Vermilion Group* to provide guidance on how law departments can make the most of AFAs.



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What is an AFA?

The acronym AFA is shorthand for alternative fee arrangement. The word alternative is used to indicate an arrangement other than time-based (or hourly) billing, which is by far the most common billing arrangement in use today.

For some time now, many have suggested that a time-based billing model does not often provide clients with good value compared to the cost of the legal services provided. Many in-house attorneys have identified time-based billing as a prime source of the friction in the relationships between corporate clients and the law firms that they retain for their work. This led the Association of Corporate Counsel to issue its famous ACC Value Challenge, which, among other things, encourages law firms and clients to reduce their reliance on traditional hourly billing and develop billing models that focus on charging for the value provided, rather than for the time spent on a matter. Accordingly, AFAs are also often called value-based fee arrangements.

For several reasons, however, we prefer the term appropriate fee arrangements instead of alternative or value-based fee arrangements. First, the word alternative does not help explain which fee structure will best serve the client's needs. Similarly, the word value is too vague to provide guidance to those attorneys interested in designing AFAs. We feel that this lack of clarity has contributed to slowing the movement away from time-based billing. Further, the acronym AFA has become a part of the legal vocabulary, and that acronym is preserved in the term appropriate fee arrangement. Regardless of what they are

called, however, proponents hope that AFAs will improve the relationship between the cost of legal services and their benefit to the client by more directly calibrating the cost of legal services to the business benefit realized.

How is the ideal form or type of AFA identified?

There is no single ideal form or type of AFA. The ideal AFA aligns the attorney's efforts with the client's business goals for the engagement and its value definition for the work. That definition consists of a particular constellation of what we call Value Related Qualities (VRQs), which will vary from client to client and from matter to matter.

Therefore, the question comes down to determining what fee arrangement is most appropriate for the specific matter. That simple statement masks some challenges that may not be obvious. For example, it is not always easy to determine what fee arrangement is appropriate and how that fits in relation to the goal of greater value. In fact, a particular matter or group of matters might lend itself to several possible AFAs, the most appropriate being dependent on the client's goals for the matter and other factors.

Many attorneys seem to think that a fixed-fee arrangement is the primary and most acceptable form of AFA. Undoubtedly, a fixed fee constitutes an alternative to time-based billing. It may even be the best AFA in a given situation. However, it may be wholly inappropriate for certain types of matters.

For example, in litigation involving a potential significant loss, a reasonable client would not want its attorneys to put much weight on how close the law firm is to the preset fee when deciding what steps to take with respect to offensive discovery or protective motions. Those decisions should be based on the objective benefits of the substantive steps under consideration. A fixed fee in such a situation might work against the client's interests and lead to an unacceptable course of action or even an adverse result.

Do AFAs offer any real advantages over traditional time-based billing?

A properly designed AFA offers considerable advantages over time-based billing. First, an AFA will establish a relationship between the fees paid by the client and the client's business objectives. Under a traditional hourly billing model, it is not uncommon for companies to pay legal fees that are disproportionate to the company's goal in the matter. As is often stated, one should not spend \$100,000 to defend against a slip-and-fall claim that will not result in liability of more than \$5,000. While that adage may not be true literally, it does convey the angst of many in-house attorneys who must manage their clients' legal affairs with law firms paid by the amount of time devoted to those matters.

AFAs better calibrate the costs and benefits of legal services. The relationship between the assignment (and the legal services required to complete it) and the amount of fees paid for those services must be an acceptable one or the company might as

well proceed without the attorneys. AFAs also afford the client an opportunity to develop a clear line of sight so that it can more effectively measure the value of legal services and evaluate legal work in a way that transcends the simple accounting methodology of the billable hour.

Are there any drawbacks to implementing an AFA?

Implementing an improperly designed AFA or one that does not fit the matter in question can lead to unexpected and undesirable effects. If the incentives built into the fee arrangement cause the attorneys to pursue objectives that are inconsistent with the client's interests, the client will regret having used that arrangement.

This means that the identification of the proper type of AFA and the careful design of its details require increased attention. What might be an appropriate fee arrangement for one matter might be entirely inappropriate for another matter, even for the same client. An AFA should probably never be used "off the shelf." Understanding this can help the client avoid an outcome that is worse than expected.

What are some of the mistakes law departments make when implementing AFAs?

The most common mistake is believing that a single type of AFA, such as a fixed fee, will serve in almost any situation. The second most common mistake may be the failure to conduct a full analysis of the company's goals for the engagement and the relationship between the engagement and the company's overall business objectives. Third, a lack of understanding of the company's value definition with respect to the legal services can lead to disaster.

It is also important to understand value from the viewpoint of outside counsel, since that perspective is also integral to the successful implementation of an AFA. The collaborative development of an AFA is essential to its success for both the client and outside counsel.

What steps should a law department take to maximize the success of an AFA?

The first and most critical step is to analyze the company's overall situation with respect to its legal work. Part of this analysis should include understanding the company's risk appetite. A law department can then:

- Review the specific dispute or transaction.
- Evaluate the company's goals for the matter.
- Determine how the legal services might advance the company's business objectives most effectively and efficiently.

This will provide insights into how the law department and its outside counsel might design the fee arrangement to best achieve those objectives.

The company's relationship with a trusted law firm is also critical to the success of an AFA. This relationship allows for the open and honest dialogue that leads to a plan that can accommodate

different scenarios, complete with assumptions, articulated budgets, and project management considerations.

Both the law department and its outside counsel should monitor the engagement and maintain flexibility to make adjustments to realign incentives, if necessary. Perhaps most importantly, a law department would be wise to conduct a “post-mortem” at the end of any engagement to learn from the experience, incorporating best practices into the next engagement while eliminating the inevitable mistakes.

How can a law department ensure that it is paying the “right” fee for the work?

As discussed above, the right fee arrangement may differ from matter to matter and from client to client, because so much depends on the client’s objectives and risk tolerance. However, a good starting point is for the law department to determine what it has paid for similar matters in the past. This provides a range of fees it has paid for similar work.

The law department should also identify the factors that contributed to any significant deviation from the norm. In this way, the law department can establish benchmarks and understand how different practices, events, and even attorneys might influence the final fee. The importance of taking advantage of the data in the law department’s possession cannot be overstated.

What is preventing AFAs from gaining greater traction and where is that resistance most felt?

The biggest impediment to greater use of AFAs lies in the absence of a consistent approach or method for identifying the appropriate type of AFA for a specific engagement and for the proper design of an AFA once the attorneys have identified the right type.

Law departments seek fee arrangements that deliver greater value to the client than time-based billing. All too often, however, attorneys will disagree on what value is in that context and how to achieve it.

What is the first step in designing and implementing an AFA?

The first and most important step is to develop the client’s value definition. In doing so, the client should determine:

- Which aspects of the legal services matter most.
- How those various aspects relate to each other and their relative priorities.
- Once identified, how the VRQs relate to the required legal services.

This approach recognizes that value consists of several elements that together define what the client seeks.

Examples of VRQs include:

- Predictability of outcome or cost.
- Consistency.

- Data security.
- Speed of resolution.
- Reliability.
- Absolute cost.

The use of VRQs to determine value is a better and more achievable approach since VRQs are more quantifiable and measurable than the abstract concept of value. If budget conformity represents the most desirable VRQ for a law department, for example, that law department can measure easily how often its law firms (and each law firm individually) meet its budget estimates for its matters. The law department can use the data to create AFAs based on that VRQ and also to evaluate the law firms’ relative competency in that regard. Since the same VRQ can appear in multiple types of matters, it can also serve as a way of evaluating those various matters, despite their differences, in a consistent manner.

Should a law department take the initiative in suggesting an AFA or should it rely on outside counsel to propose a fee arrangement?

It is far more common for law departments to take the initiative in proposing AFAs. When asked, however, law firms can be quite creative in proposing AFAs. Accordingly, we suggest that a law department give due consideration to a suggestion from outside counsel that the company consider an AFA.

By virtue of its existence, a law department is responsible for the management of its company’s legal affairs. This includes responsibility for managing those affairs in a cost-effective manner. In light of that responsibility, one might even suggest that a failure to consider and pursue AFAs can constitute a dereliction of that duty. Moreover, since the “C” suite of executives in a company increasingly focuses on the costs of legal services, including the costs of both internal and external resources, it is in the interest of the law department to address this topic proactively.