

## *From AFAs and VBFs to VRQs and OOFs . . .*

### **Toward Fee Arrangements More Closely Calibrated to Value**

As in-house lawyers prod outside lawyers and the legal profession to jettison the hourly rate as the primary basis for fees paid by businesses to their external legal service providers, they must inevitably face the question, “What will replace the hourly rate?” To date, the term usually used to define what they seek is “alternative fee arrangement.” That nomenclature conveys a very significant truth: They wish—they crave—to replace something with another thing that is not the replaced thing, but which itself has not yet assumed shape.

In 2008, the Association of Corporate Counsel launched the ACC Value Challenge “to reconnect the value and the cost of legal services.” ACC determined not to provide a single definition of “value” in the ACC Value Challenge, opting instead to exhort ACC members to discuss the issue with their outside legal service providers. That would allow members to develop their own definitions of the term to suit their companies’ needs.

In the context of legal service, of course, the term “value” has not had as clear cut or easily measurable meaning. As one commentator wrote slightly more than one year after ACC launched the ACC Value Challenge, “[m]uch remains confused and unclear about that term” (R. Morrison, “Making some sense out of the value gap,” *The National Law Journal*, Nov. 9, 2009).

While a single definition likely proves elusive (at least at this stage of the dialogue within the profession), we can identify some traits or characteristics of higher-value

legal service that could help forge a working definition. These traits—let’s call them “value-related qualities,” or VRQs—may not comprise a definition in the pure sense of that word. They may, however, allow in-house and outside attorneys to learn a shared language to help all the company’s legal counsel provide service that more closely mirrors its value-related needs and expectations. Perhaps, in light of the variation among client perceptions of value, we should not seek a single definition of value but, instead, a framework or approach with which to construct a context-specific definition of the term.

VRQs should enable in-house and outside lawyers to collaborate to determine fee structures that more closely align outside counsel’s interests with those of their clients. Simultaneously, VRQs can provide the basis for more specific measures of the success of those arrangements and other aspects of the client-counsel relationship, including some that are less tangible.

In light of the confusion and uncertainty surrounding the concept of value, how can we successfully approach the challenge of defining and delivering high-value legal service? We must start with the basics, recognizing that value does not exist in a vacuum and is not an immutable constant like the speed of light. Rather, it represents the relationship between the “cost” of something and the “benefit” that one enjoys from it. In this way, the ACC Value Challenge really represents an effort to help ACC members “recalibrate” value and cost rather than to “reconnect”

them. A connection between value and cost has always existed, but that relationship has become more attenuated and unsatisfactory as in-house attorneys frequently experienced the cost outweighing the benefits. As a result, they came to perceive the hourly rate as an incentive for outside counsel that does not coincide with clients' interests in assuring cost-effective service. The "cost" may include more than out-of-pocket expense, and the "benefit" may be expressed in other than monetary terms.

I identify some VRQs in the next section of this article. By focusing on these more discrete factors that, in one or more combinations and to one degree or another, equate to or affect value so as to increase or decrease it (or, at least, clients' perception of value), in-house or outside practitioners can begin to determine how they can actually increase value or prevent its decrease to the benefit of the client. They can start to devise practical steps that enable them to implement and measure the VRQs.

All of those factors and considerations have relevance to the discussion and measurement of the value of legal service and of the attorneys who create, deliver, and manage that service. VRQs can also provide a framework for discussions about, and the design of a fee arrangement to support, the client's value-related goals as discussed below.

### **Clients Realize Value from Legal Service and Lawyers in Different Ways**

Client needs naturally provide some guidance toward developing a definition of "value." Here are a few examples of the value of legal service and the lawyer(s) who provide that service that matter to corporate clients to one degree or another. It is not a definitive list, and these VRQs may matter to a client or different clients in varying combinations and to varying degrees, perhaps determined by the particular legal matter at hand or by the professional orientation of

the outside legal service provider performing the service:

- Cost control
- Expertise
- Cost
- Consistency of effort or treatment
- Predictability
- Speed of resolution or completion
- Reliability
- Convenience
- Security of data and other information
- Certainty of resolution

The legal service value will also vary with the professionals performing that service, as some VRQs may relate to the professionals performing the service rather than just to the service itself. In other words, in-house counsel understand that different law firms deliver different value propositions. Such variance can affect the combination of VRQs that matter to the client in a particular set of circumstances. A law firm that is capable of successfully defending a bet-the-company case, for example, will be very highly valued by that defendant client upon victory regardless of the cost of that defense. In this instance, cost resides lower on the client's list of VRQ priorities.

That same firm, on the other hand, might be the worst choice to defend that same client against a simple slip-and-fall accident claim because the resulting costs will far exceed those justified by the nature of the matter and the risk presented, even if success is virtually assured. In the first circumstance, that firm might deliver very high-value legal service, while its efforts in the second situation might represent negative value to the client.

The value of in-house counsel and the value of outside service providers also differ for a variety of other reasons. Those differences relate to the various ways in which the two roles interact with the clients. (In this usage and context, "clients" refers to the corporate personnel who transact a company's business and receive legal advice and service

from the in-house and outside attorneys in the course of conducting that business.) Those interactions, in turn, reflect the strategic strengths of the respective lawyers. Some of those strengths relate to the attorneys' organizational positions, while some relate to their personal attributes, skills, and expertise.

Putting aside for our purposes the individual strengths and talents of individual in-house lawyers, the value of inside counsel is directly related to the numerous facets of the role itself. Those facets include: close and daily interaction with corporate personnel on matters relating to the ongoing business; institutional memory and understanding of corporate history and operations; commonality of perspective with that of operational personnel; and interests and incentives closely aligned with those of internal clients due to compensation plans, hierarchy, and authority-sharing, among other things.

Outside counsel bring their own distinct strengths to the table. A law firm exists because of the lawyers that comprise it, and its activities and perspectives revolve around those lawyers' activities and perspectives. Accordingly, the law firms are or should be designed to help their lawyers succeed in their representation of clients. Investments by the firm generally are guided by that goal alone. By contrast, a law department, as a unit within a larger organization—the goal of which is to do business—must justify its needs for resources (*e.g.*, personnel, technology, etc.) and compete with other units for their allocation.

Outside lawyers must maintain their memberships in appropriate organizations and their licenses to practice before specific courts and agencies in order to represent clients. A law department, on the other hand, often operates far from where the company does business and where its transactions, disputes, negotiations, and litigation occur, so the in-house lawyers' memberships and licenses may be inappropriate for at least

some of the matters that are entrusted to the department and for which licensure is necessary. Many law firms also include a broader array of legal specialties through their constituent lawyers than a law department typically does. All of these differentiators between in-house and outside counsel can be relevant to fee discussions and related issues.

In-house counsel possess an advantage over outside counsel that relates directly to the subject of cost. As a rule, the direct cost of in-house attorneys is lower than that of outside attorneys. Due to reduced overhead through office sharing with other corporate departments, as well as lower direct staffing costs, members of law departments usually cost the company less than their external counterparts when measured on an hourly basis. This calculation takes into account related costs and compares that all-in charge to the rates that law firms typically charge for the time spent by lawyers with comparable expertise.

The benefit that a company derives from the legal service can flow from several sources. Some transactions, such as real estate-secured loans, simply cannot be effected without addressing legal matters, so the legal service is integral to the business goal itself. The resolution of business disputes typically involves the disputants' lawyers, though in many instances companies can and do resolve their differences without much lawyering. Concluding such transactions and disputes so as to advance one or both parties' business interests constitutes the benefit realized.

In other situations, the legal service may be less central to the business activity but, by expediting that activity, or preventing complications, or by taking advantage of opportunities that exist by virtue of statutory or regulatory structures, the legal service can serve an important supportive role in achieving the business' goals.

What sort of "costs" might a client realize or incur in the context of legal service?

(These costs include some that are directly related to the purpose for securing legal service, such as litigation, rather than just as a direct result of the legal service itself.) While some of the costs will be hard”costs (actual out-of-pocket expense), others will be less measurable but just as real. They include:

- Legal fees
- Transaction-associated costs
- Expert fees
- Reputational harm
- Diversion of corporate executives’ attention from the business
- Heightened regulatory scrutiny
- Poisoned business relationships
- Distraction of company personnel aware but not primarily involved in the matter

When assessing the value of the legal service, one should account for as many costs associated with the matter as possible. The ultimate determination of the value of that service should reflect its impact on the client’s position. Taking into account both costs and benefits realized from the representation, the legal service provided value to the client if that position has improved. If that position has deteriorated, the legal service may have subtracted value from the business or the transaction.

### **Developing a Workable Definition of “Value” for Purposes of Designing a Fee Arrangement**

When developing a framework with which to define “value” in the context of legal services, we cannot lose sight of the fact that, ultimately, the determination of that value is the client’s to make. The primary determinant should consist of the degree to which the legal work contributes to the client’s achievement of its business goals for the assignment. Inasmuch as the client retains counsel in order to achieve those goals with minimal law-related complications, the value of that service must be measured in the same context. Ultimately, then, value lies in the eyes of the client or, for in-house counsel,

the internal clients with whom they work (S. Lauer, *The Value-Able Law Department* Ark Group 2010, p.4).

An article that appeared in the ACC’s *Docket* in 2003 illustrates this point well in its discussion of an in-house lawyer who is “task-focused” working for a chief executive officer who is “goal-focused” (R. Pol, J. Hansen & R. Hansen, “Increase Legal Department Value,” *Docket*, Oct. 2003, p.98). Unless one or the other recognizes that they’re aiming toward disparate ends, their relationship will suffer, with the CEO obviously in a position to survive any collision between their approaches. Similarly, if a law department’s or law firm’s view of the value it provides the company—and the value of the legal service it manages or completes on the company’s behalf—does not closely align with the view held by senior corporate management, especially the CEO, one needs no crystal ball to envision the likely outcome.

For each client, each law-related matter or project represents a distinct, often vastly different, set of issues and risks. Each client’s appetite for risk varies from those of other business organizations, and the legal service provider must take the client’s specific appetite for risk into account when delivering the legal service. A client that willingly assumes a high level of risk may opt for legal service that elevates cost control to a higher plane even though “cutting corners” might invite greater legal scrutiny and risk. A client that cannot afford any law-related exposure might be willing to pay some form of premium for the assurance that that will not occur. Satisfying clients with such disparate attitudes on that issue requires a finer calibration of effort by the lawyers.

Understanding how different VRQs matter to the client in a particular set of circumstances can provide the grounding needed to render that calibration. Is cost control the most important aspect of the work to the client at that time? Is a rapid resolution of the issue of greatest concern? Is complete

vindication the only possible outcome that the client would accept?

VRQs can also serve as the basis for a more informed discussion by client and counsel of possible alternatives to the hourly rate as the means of calculating a fee arrangement. Despite a great deal of discussion over the years of the evils of the hourly rate and a recognition that it can distort the common vision of client and counsel with respect to cost control and the budgetary certainties that matter a great deal to clients, the hourly rate continues to serve as the basis for the great bulk of legal fees paid by business clients. (For a discussion of the incentives of the hourly rate that disserve clients, see P. Lamb, *Alternative Fee Arrangements: Value Fees and the Changing Legal Market*, Ark Group 2011, Chapter 2, “You get what you pay for.”)

How do VRQs do so? By enabling counsel to focus on more discrete, more measurable elements of “value” rather than the somewhat vague, nebulous sense of the term as it’s often used. VRQs allow the dialogue to advance in such a way as to allow for their application more meaningfully. Rather than design a fee arrangement that delivers greater but less definable “value” to the client, VRQs

case was very similar to the others, and they were not very complicated matters, either in terms of legal issues or fact patterns. The relative risk to the company from loss of any single dispute was low.

The company agreed to pay its defense counsel a fee per matter that would be greater if it were concluded more quickly because the company had determined that “time is money” and, the longer a dispute remained active, the greater the overall cost of resolution. The firm and client agreed that the firm’s fee would be determined by a combination of the speed of resolution and the amount for which it was concluded. The firm would receive no fee other than what that calculation would yield.

The company knew, on the basis of its experience, that each case would cost approximately \$25,000 total, including both fees and the amount paid to the customer/complainant. It could calculate a cost associated with the continuation of a controversy, so the pendency of each matter carried a known financial impact. The calculation of its firm’s fee would be derived by a matrix such as shown in the chart (the chart could be continued both horizontally and vertically).

<b>Time/Amount paid</b>	<b>\$0 to \$1,000</b>	<b>\$1,000 to \$2,000</b>	<b>\$2,000 to \$3,000</b>	<b>\$3,000 to \$4,000</b>
0-6 months	\$25,000	\$23,000	\$22,000	\$21,000
6-12 months	\$23,000	\$21,000	\$20,000	\$19,000
12-18 months	\$21,000	\$19,000	\$18,000	\$17,000
18-24 months	\$19,000	\$17,000	\$16,000	\$15,000

permit the design of fee arrangements that align the thinking of in-house and outside counsel on particular criteria that, in the client’s eyes, represent ways in which the legal service can yield greater business benefit.

Let’s look at an example of how this might work.

A company experienced a large number of cases related to a certain product line. Each

The left-hand column represents the length of time that it takes to conclude each matter broken down into six-month increments. The top row represents the amount paid to the opponent/complainant upon conclusion of the dispute. The bargain between the company and its counsel was that counsel would receive as a fee whatever portion of the anticipated total expenditure of \$25,000 per case the company did not have to pay the complainant based on a calculation of

the time-related cost of the dispute and the amount paid to the complainant. If a case took an extremely long time to reach a conclusion or the company paid a higher than desired amount to its opponent, the firm would be entitled to a lower fee or even no fee.

The company and its outside firm had designed a fee arrangement that pivoted on two VRQs that mattered most to the company. These VRQs were the “life cycle” of the dispute and, second, a certain, finite cost of resolution for each matter. The resulting fee arrangement was clear in terms of application and easy to calculate and measure. Based on the volume of cases expected, the law firm could anticipate and realize significant revenue by devising efficiencies in the processing of what were very similar cut-and-dried disputes.

Another example of a fee arrangement not based on the hourly rate will elucidate some other aspects of this overall process. A sole in-house lawyer, who serves as the general counsel of a well-recognized organization, looks for outside counsel who operate in a cost-effective and efficient manner. This in-house lawyer evaluates the speed with which the outside counsel resolve matters and if they do so at a reasonable cost. When working with outside lawyers, this general counsel believes you must “push, push, push” in order to maximize the value that the client realizes.

The company had used one full-service firm and a few others for years. It had paid too much, in its view, for their services, particularly with respect to lower-risk matters, so the general counsel determined to pursue a different approach. After some investigation, the client retained a greater number of firms, but firms that were more specialized than those that had previously represented the company. The roster now includes some very small firms (even a few solo practitioners), each of which handles specific types of work.

Even with more firms handling the work, the management burden on the general

counsel is not appreciably greater, since the company had previously dealt with and managed multiple lawyers at one firm. The management burden in dealing with different lawyers at more, but smaller, firms is therefore about the same as it had been before.

This company has been using alternative fee arrangements for several years. In the general counsel’s view, the billable hour promotes and rewards inefficiency, which is the opposite of what the company needs its counsel to do. One law firm that has represented the company for approximately seven years handles all worker compensation matters for a flat aggregate fee paid at the beginning of the year. At the end of the year, the firm and the general counsel review the files handled and implement a “true up” to ensure that the firm is fairly compensated and that the company is fairly billed for the work completed on its behalf. The long relationship between the company and the law firm allows them to trust each other during the year as well as in the “true up.” That arrangement has persisted for approximately five years.

Each month during the ordinary course of business, the firm provides the general counsel details of the time that its lawyers spent on the company’s work. While that amount of time does not matter for purposes of calculating the fee due, the lawyers record their time so that the firm and the company can monitor the amount of effort that goes into the company’s matters. This data is reviewed during the “true up” when the general counsel meets with the firm’s representative.

After that analysis, the company might agree to increase the “threshold” for the fee arrangement (*i.e.*, pay a higher amount for the next year’s anticipated volume) based on the expectation of a continuing increase in volume. Due to the length of the relationship and the dynamics of the fee arrangement, the general counsel is confident that the company receives adequate value. Also during the “true up,” the general counsel attempts to review the time-related data from the perspective of the law firm. The general counsel

wants the firm to succeed, but not too handsomely.

This company “values” budget certainty (a VRQ) consistent with the risk-related profile of its legal work. The fee arrangement elevates that VRQ to preeminence in a way that also pushes the law firm to operate more efficiently. The trust based on the longstanding relationship supports the collaborative effort to review the data annually in order to ensure that both parties avoid undue adverse effects.

### **Designing a Fee Arrangement with VRQs**

How can VRQs support a viable fee arrangement? What benefits will follow?

First, one must determine the various ways in which the legal service does, or can, help the business achieve its goals. Is speed the most critical criterion for a successful transaction? Does budget certainty outweigh all other factors (assuming the necessary quality exists)?

Second, rank the various VRQs so identified as applicable to the situation. Not all VRQs apply in every instance or must be taken into account.

Third, determine how best to measure, for purposes of the fee arrangement, how well the service that was rendered delivers the VRQs.

Fourth, develop a mechanism with which to link the delivery of the VRQs to the fee due counsel.

Fifth, implement appropriate data collection along with tracking and monitoring mechanisms. Apply them rigorously and use the resulting data to manage the work. Use those data to measure whether the fee arrangement’s terms were satisfied and to what extent.

If the fee earned by counsel depends on delivering the VRQs identified by the client,

then the client will, by the terms of the agreement, receive “value” legal service defined by its own “definition” of value service.

A recent book on the subject of fees includes a useful example of how one of the VRQs listed above trumps cost alone and could be used in a fee arrangement designed to meet the client’s value need. “[T]here can be business-specific or matter-specific objectives [for the legal service]. For example, if an employee leaves with trade secrets and time is of the essence, getting a result in hours rather than weeks has great value and could be identified as an objective to be rewarded.” (See P. Lamb, *Alternative Fee Arrangements: Value Fees and the Changing Legal Market*, cited above, at p.15.) Creating incentives in the fee arrangement that reward outside counsel for greater speed in resolution of the matter would be an effective use of that VRQ.

A fee arrangement so structured, which we call an objective-oriented fee (OOF) arrangement, enables a law department to create a set of metrics and reporting mechanisms that will reinforce the specific behaviors encouraged through the OOF. Despite the somewhat whimsical-sounding acronym, “objective-oriented fee” conveys the goal of the fee arrangement better than some alternatives in use. “Alternative fee arrangement” or AFA, for example, which has been in use for some time, suffers for defining the fee by what it is not. It’s an alternative to a fee based on the hourly rate but does not denote what that alternative might actually be.

“Value-based fee” or “value fee” has acquired some cachet of late (P. Lamb, *Alternative Fee Arrangements: Value Fees and the Changing Legal Market*, Chapter 3, “Alternatives to the billable hour,” p.14). That term provides very little clarity, though, and certainly no more than the word “value” itself. By contrast, with terminology like “objective-oriented fee,” the value orientation of a company can exert itself more and more strongly in the activities of its legal team because the central concept is directly

communicated—that those behaviors that gibe with that orientation are the ones that will be rewarded.

VRQs highlight the varying and distinctive ways in which corporate clients realize benefit from legal service. They enable in-house and outside lawyers to discuss the “value” of legal service in a much more focused and collaborative way. The dialogues on that subject that ACC initiated through the ACC Value Challenge (and that it encouraged with its issuance of “Meet. Talk. Act”) would advance to the next level and yield more concrete results.

Moreover, VRQs can serve as a framework with which to construct more effective fee arrangements that truly support and advance clients’ need for higher-value legal service.

OOFs can be more easily designed and more effectively monitored than fee arrangements based on vague, more-malleable concepts of value. The specificity of VRQs can serve as the basis for fee arrangements along with so much more that is vital to the proper and effective management of corporate legal service. ■

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