



BALANCING THE RISKS AND REWARDS OF ALTERNATIVE FEES

BY RAYMOND E. BAYLEY | As the fallout from the recession continues, clients across the business spectrum are demanding more transparency and predictability in their legal bills. In response, law firms large and small are trying to grasp how they can properly implement alternative fees. While some firm leaders still see these arrangements as dangerous, they should instead be viewed as a strategic move to help ensure the firm's future. The key is learning how to fairly allocate the risks and rewards between the parties.

Using alternative fee arrangements (AFAs) requires clients and law firms to allocate risks and rewards between them so that each party maximizes the risk-adjusted benefits of the relationship. If done well, the client will always receive the best possible service at the lowest possible price and the law firm will always be able to maximize its profits. In well-constructed AFAs, both

parties can and should be winners.

A key hesitation among many firms is the risk factor—but that risk has an economic value. In fact, it's a fundamental principle of financial economics that if one party assumes more risk than the other, then that party's rewards should increase accordingly. This is why some investments cost more or less than others and result in

higher or lower payoffs based on the risks involved. Think junk bonds versus U.S. Treasury bonds. In each case, the parties' risk-adjusted return on the investment is basically equivalent.

The same is true in calculating and structuring AFAs to make them a win-win for both parties. However, to do that, both the law firm and the client need accurate information about what it costs to deliver the services and what the variables are that drive those costs. While there are innumerable ways to structure the actual arrangement, the means and methods by which firms need to calculate alternative fees are almost always the same and can be reduced to several basic steps. Here is an outline of them to help make a firm's transition to AFAs easier.

Identifying Suitable Engagements and Calculating Their Costs

Many types of client engagements are not suited for alternative fees. So how do you determine which ones are? Fairly allocating risks and rewards between the parties is fundamentally an economic transaction—the basis of which is cost. While cost predictability is very difficult to achieve when the billable hour is the basis for calculating fees, achieving predictability is at the heart of successful AFAs.

That's why engagements that repeat themselves (e.g., drafting and negotiating standard employment agreements) or portions of engagements that are discrete and well defined (e.g., depositions or pleadings) are ideal AFA candidates. In both instances, it's possible to define the scope of work and understand the costs required to provide the service with enough certainty that the associated risks and rewards can be fairly allocated.

Given that, here are the essential elements of structuring AFAs that work for both clients and firms:

- Understanding the average or baseline cost of an engagement, or portions thereof
- Understanding the probability that the cost will vary from the baseline during given engagements
- Understanding the independent variables that cause costs to be what they are

The first element, understanding baseline costs, depends on measuring the cost of discrete engagements or portions of engagements. As a general rule, measuring discrete and well-defined activities, rather than several activities in the aggregate, will result in a better understanding of costs because there will be less variance from the baseline each time the activity is performed and fewer independent variables to assess. So, for example, you will get a better understanding by measuring the baseline costs of depositions, motions, pleadings and interrogatories separately than by measuring the total cost of an entire litigation.

Also, the more times you measure an activity, the better and more reliable the measurement will be. Or, put differently, measuring the cost to draft and negotiate one or a few employment agreements, or prepare for and conduct one or a few depositions, will not provide reliable information and, in fact, could be misleading. It would be like measuring the height of one or a few persons and concluding that all people must be the same height! Thus, in this context, the firm must measure enough instances of the same activity in order to determine what it costs to provide a particular service. This also provides the information necessary to determine the statistical probability that the activ-

ity's actual cost will vary from the baseline cost—and by how much.

From there, identifying the independent variables that need to be measured will, naturally, revolve around the type of matter or activities covered in the AFA. For example, variables that affect the cost of drafting and negotiating an employment agreement might include (1) the seniority of the employee's position in the organization, (2) the different types of compensation that make up the employee's total remuneration, and (3) the jurisdiction in which the employment agreement is written. Logically, employment agreements for senior-level executives that include stock options and other perquisites and are written in select jurisdictions will cost more to draft and negotiate than employment agreements for entry-level employees who only receive salary as compensation.

Identifying and measuring these types of variables for discrete activities provides insight into the cost of legal services, so they can then be better understood and controlled. That, in turn, creates opportunities to lower prices for clients and increase profits for the firm, all of which are integral to allocating risks and rewards in AFAs.

Structuring the Fee Relationships

Once you grasp the baseline costs and the variables involved, you can determine the best way to structure a particular fee arrangement. There are all kinds of ways to fairly allocate the risks and rewards between the client and firm so that each can maximize its risk-adjusted return from the relationship.

The risks and rewards are principally economic, with the primary risks being: How much will the client pay for the services and how much will the law firm spend delivering them? The

associated rewards are: What will the client get for its money—i.e., will the law firm meet or exceed the client's expectations—and how much will the firm be paid in return?

Managing those risks and rewards requires having a well-defined scope of work that describes the responsibilities of the parties and a process for managing the changes that inevitably occur in every engagement—both are integral to AFAs. Thus, based on the particular requirements of the client and the engagement, there are many ways to structure alternative fees, including the following:

- Variations of the billable hour, including discounted and blended hourly rates, or daily, weekly and annual rates for individuals and teams
- Price per unit of labor (as just described) with a guaranteed maximum price that may or may not include a savings participation that is shared by the parties
- Price as a percentage of the value of a dependent variable, such as an employment agreement, an acquisition or a real estate transaction
- Price per unit of work, such as preparation of a document or any discrete aspect of a case, including pleadings, document review, interrogatories or depositions, or a patent application
- Price for a portfolio of work, such as enterprise-wide litigation or labor and employment work, which often includes minimum revenue and resource commitments along with associated risk collars (called additional or reduced resource charges)
- Results-based fees, such as fees for a successful transaction or outcome in litigation
- Discretionary fees, often structured as holdbacks and paid on the basis of client satisfaction

Any number of variations or hy-

brids could be implemented, too.

Managing Engagements and Monitoring Performance Indicators

There is, of course, more to be done than simply agreeing on the fair allocation of risks and rewards. If the client is going to receive the best possible service at the lowest possible price and the law firm is going to maximize its profits, both must actively manage their engagements and their relationship. This is especially important because AFAs often impose obligations on both parties that don't exist in billable-hour arrangements.

For example, the client may be required to report on the underlying value of an asset or make a determination about a discretionary fee based on its satisfaction, which may in turn be used to determine how much the firm will ultimately be paid. Or, the law firm may be required to report on costs that have been incurred in relation to the amount of work that has been completed, which may also be used to determine how much the firm will be paid. Both parties have to monitor the key performance indicators that can dynamically modify the allocation of risks and rewards—and they must discuss them frequently. Otherwise, the arrangement may fail for lack of monitoring, reporting or dialogue.

For law firms, it's also critical to monitor and control the costs, and the variables that cause costs to be what they are, pursuant to either an internal budget or a budget that has been agreed-on with the client. Accurately monitoring costs may be difficult, particularly when the AFA is based on discrete portions of engagements that don't readily align with the time and billing systems available to

capture and record costs. Additional systems may be needed to capture and analyze costs, but such investments are well placed when they make accurate monitoring achievable.

Analyzing Results and Improving the Delivery of Services

As law firms and their clients work together in AFAs, there are significant opportunities to collect valuable information that will help both parties evaluate the success of the arrangement and create opportunities for improvements in future arrangements. Data about costs, variances from the cost baseline and the variables that influenced a given cost allows the law firm to further refine the baseline; reduce the probability that the next engagement, or portions thereof, will vary from the baseline; and improve performance by managing the variables that affect cost. In turn, the firm can use that information to further pursue its goal of giving clients the best possible service at the lowest possible price while maximizing its own profits.

The bottom line then is that, while alternative fee billing may remain outside the comfort zone of many law firms, it is far from a zero-sum game. Both sides can and should benefit from the arrangement—but only if there is a fair allocation of the risks and rewards. Firms that properly and carefully design and implement AFAs should flourish under them as well as gain the appreciation of their clients—which is never a bad move. ^{1P}

Raymond E. Bayley is President and Chief Executive Officer of Novus Law. He is the former managing partner of PricewaterhouseCoopers' North American Business Process Outsourcing organization and was a member of the firm's management committee. He is a member of the advisory board of the Corporate Counsel Institute at Georgetown University Law Center.