

Alternative Fee Arrangements: Value Fees and the Changing Legal Market

PATRICK J. LAMB



Alternative Fee Arrangements: Value Fees and the Changing Legal Market

is published by Ark Group



UK/EUROPE OFFICE

Ark Group Ltd
Paulton House
8 Shepherdess Walk
London N1 7LB
United Kingdom
Tel +44 (0)20 7566 8276
Fax +44 (0)20 7324 2373
publishing@ark-group.com

NORTH AMERICA OFFICE

Ark Group USA
4408 N. Rockwood Drive
Suite 150
Peoria IL 61614
Tel +1 309 495 2853
Fax +1 309 495 2858
publishingna@ark-group.com

ASIA/PACIFIC OFFICE

Ark Group Australia Pty Ltd
Main Level
83 Walker Street
North Sydney NSW
Australia 2060
Tel +61 1300 550 662
Fax +61 1300 550 663
aga@arkgroupasia.com

Commissioning editor

Anna Shaw
ashaw@ark-group.com

Assistant editor

Stephanie Ramasamy
sramasamy@ark-group.com

Managing director

Jennifer Guy
jguy@ark-group.com

UK/Europe marketing enquiries

Robyn Macé
rmace@ark-group.com

US marketing enquiries

Daniel Smallwood
dsmallwood@ark-group.com

Asia/Pacific marketing enquiries

Steve Oesterreich
aga@arkgroupasia.com

ISBN: 978-1-906355-89-0 (hard copy)

ISBN: 978-1-906355-98-2 (PDF)

Copyright

The copyright of all material appearing within this publication is reserved by the author and Ark Conferences 2010. It may not be reproduced, duplicated or copied by any means without the prior written consent of the publisher.

Chapter 1: Dawn of the billable hour

FROM TIME to time, words and concepts invade law firm marketing like wildfire. Client service, a topic near to my heart even before I began blogging about it in 2005, is one example. At first, only a few firms used the term and those firms actually believed in client service. After a while, every law firm was all client service all the time, even though they weren't doing anything differently. They all wanted to 'partner' with their clients, without a clue as to what the concept meant. To them, client service simply meant 'give us more work'. Indeed, most of these marketing wildfires are about talking the talk rather than a deep understanding, application and then execution of the concept.

In 2009, alternative fee arrangements (AFAs) became the latest of these marketing wildfire buzzwords. But something seems different this time. Perhaps the reason for the difference lies in the economy. This downturn was unlike anything any of us had experienced before. Law departments were no longer given a pass on budget cuts, and the cuts were severe. The need for change was beyond anything mere price discounts could cover. And it seems that the changes are permanent. If a law department proves it can perform capably with a budget 30 per cent lower than before, why would anybody expect the budget to increase when the need for the budget cut is not as acute? It is possible that, to use Malcolm Gladwell's term, we have reached a 'tipping point'.¹

Law firm leaders and others are struggling to understand what AFAs mean

for their firms. Is everything the same save the invoice? Is revenue higher or lower? Do we have to change our operations to accommodate this new fee structure? How does it integrate with our standard billable hour system? How do you figure out the price to charge?

These questions are, of course, ones that ordinary businesses grapple with every day. It appears that the business of law is finally catching up with the rest of the business world. For the world of clients, that is a good thing.

How did we get here?

Before discussing what this new world order means, a moment on how we got here is in order. Law, as it turns out, has never really been wholly immune from the economic pressures that influence 'normal' businesses. Like any other service business, it is, by its very nature, a buyer's market. For the longest time, this simple fact did not seem to register with either buyers or sellers of legal services. As a result of the buyer's willingness to suspend their power as buyer, lawyers have only felt immune to a large degree from the economic drivers of other businesses.

In 1958, lawyers were at a similar crossroads. At that time, the private lawyer's payroll expenses had jumped 52 per cent over the prior seven years, and his (yes, then almost all private lawyers were male) rent and other expenses had increased 65 per cent over the same period. His income had increased only 45 per cent compared to income growth of 83 per cent for dentists

and 157 per cent for doctors. Over the prior quarter century, the performance of the profession was even worse. It was considered to be a crisis.

The American Bar Association created the Special Committee on Economics of Law Practice. While the concept of hourly billing was not unknown, it was not common until the Special Committee recommended that lawyers engage in hourly billing: "Time being the lawyer's sole expendable asset, the economic worth of his ability, training and experience is determined by the use made of the hours available for the practice of his profession."

With this one sentence, the ABA's Special Committee launched the billable hour revolution. Often lost at this point is the Special Committee's statement a few pages later: "There are only approximately 1,300 fee-earning hours per year unless the lawyer works overtime."

Lawyers always have been good at finding language they like and ignoring the rest. But think about it – 1,300 hours! How things have changed. Today, lawyers who bill only 1,300 hours are likely to be fired.

By the time I began practising in 1982, the billable hour requirement for most firms was 2,000. That number grew, both as a written and, more frequently, unwritten rule. It was not uncommon to see lawyers bill 2,500 hours and some even billed more than 3,000 hours in a year. One former partner crossed the 3,000-hour threshold regularly and once came close to 4,000 hours. Other firms had similar 'success stories'. And lest there be any doubt, managing partners view lawyers billing hours in this range as geese that lay golden eggs.

The rise of the billable hour's prominence limited the means by which firms could grow revenue. Once the limits of human endurance were reached and no

more hours could be billed without medical intervention, firms could increase rates and they could increase the body count, the number of fee generators. Leverage models were born as was the annual increase of hourly rates. Firms looked to continually increase the ratio of associates to partners. Ratios of 1:1 were less than satisfactory, while the elite firms looked to ratios of 4, 5 or 6:1. But for most firms, there were limits to the leverage that could be achieved, meaning that the only way to increase total revenue was to increase hourly rates. And firms did this with abandon. Between 2000 and 2007, firms increased their hourly rates between eight and ten per cent a year, compared with average annual inflation of 2.5 per cent during that same period. On a more macro scale, legal spend as a percentage of gross domestic produce (GDP) grew from 0.4 per cent in 1978 to 1.8 per cent in 2003. Yet another way to look at the growth in legal spend was cited by Washington research group General Counsel Roundtable: "Corporations spent an average of 0.63 percent of revenue on legal expenses in 2005, compared with 0.52 percent in 2003."²

During the period ending in 2007, the manpower churn was on, and firms gave everything in pursuit of profits per partner, the scorecard by which partners compared firm performance. Lost in this pursuit was any real care about quality, development of associates and the impact of all of this on clients. Firms further divorced themselves from reality by measuring efficiency on how many hours a person worked rather than more standard outputs of production. It became inevitable that someday there would be a reckoning.

The start of change

At the time this report is being written, in-house law departments have been

struggling to cope with double-digit reductions in budgets, precisely at a moment when demands for legal services, both internal and external, are growing significantly. More for less has become the in-house Holy Grail.

Of course, the clients' 'less' comes at the expense of those accustomed to feeding at the trough. Partners and associates alike have been jolted from their complacency. Layoffs – the word firms chose to use to soften the blow of terminations – have become commonplace no matter whether your title was partner, associate or counsel. Even with draconian personnel cuts, many law firms are experiencing significant reductions in profits. The level of anxiety in the profession is at an all-time high.

Those about to enter the profession have become victims of this unprecedented upheaval. Law school graduates from the finest law schools, accustomed to lavish starting salaries and bonuses, have had their employment offers rescinded or postponed. Students in these elite law schools have been shocked as firms have cancelled their entire internship programmes and many have abandoned student recruiting efforts altogether. Their future is bleak as firms confront a period of unprecedented instability.

The hourly rate business model of the past half-century is broken, and clients are starting to realise it. The temperature surrounding alternative fees has been on the rise. Firms are reacting by characterising any work done using anything other than the firms' standard rates as an 'alternative fee'. This means, of course, that firms can characterise a higher percentage of their work as AFAs, trying to make themselves look like something that they are not. Firms have long experience in this type of gerrymandering, and have employed it successfully in calculating profits per partner

or the number of women and minority partners. Clients, for the most part, have taken a more measured approach, but their interest is growing and accelerating when most suffered budget cuts in recent years.

Economist Herbert Stein once said: "If something cannot go on forever, it will stop."³ It does not require an advanced degree to know the boundless rate increases and the growth in legal spending as a percentage of GDP or corporate revenue cannot continue. The anticipated reckoning may now be here. The widespread turmoil in the profession provides an enormous amount of fodder for a book. But a book focusing on what went wrong with the business of law looks in the wrong direction. Instead, the focus needs to be on the opportunities now opening up to those who choose to see them.

References

1. Gladwell, M., *The Tipping Point: How Little Things Can Make a Big Difference*, Abacus, 2001.
2. See www.executiveboard.com/legalandcompliance.
3. Herbert Stein (August 1916 – September 1999), senior fellow at the American Enterprise Institute and contributor to the *Wall Street Journal*.