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## ***Getting Away from the Hourly Rate ...***

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### **Clearing the Hurdles**

*Editor's Note: The following is the first of a multi-article series that will appear in upcoming Of Counsel issues.*

The measurable stock in trade of a lawyer is the time that she or he devotes to resolving a client's problem. While other attributes of the lawyer's work might bear more directly on the quality of his/her "product," that measurability has led to the use of expended time as the predominant basis for calculating legal fees. That usually appears in the form of an "hourly rate."

The hourly rate leads to greater fees for lawyers who spend more time at the assignment, which is one of the strongest objections voiced by in-house attorneys to such time-based fees. Assume that two equally competent attorneys are pursuing similar goals on behalf of distinct clients (or even more starkly, two attorneys laboring on behalf of the same client). If each is paid on the basis of the number of hours "clocked" for the client, the attorney who spends twice as much time on the task is paid twice as much if their hourly rates are equal. It is so even if the additional time results from inefficiency rather than just increased diligence or zeal.

Then there are the low-value administrative activities that generally attach themselves to the hourly rate process. Once the firm has collected the previous month's timekeeping records and, hopefully, applied technology to the data in the form of initial screenings or audits, often times there are manual reviews performed by more senior lawyers in the firm before invoices

are transmitted. Once the invoice is received by the client, another stream of review processes take over that may include a review by technology, by the attorney managing the billed matter, and, depending on the amount of fees in question, possibly by that attorney's supervisor.

Wouldn't it be great to eliminate those hours of 'administrivia' and invest them in the practice of law?

### **Pyrrhic Victory**

Whether or not attorneys who are paid by the hour intentionally spend excessive periods of time at the job, the conclusion of many in-house attorneys is that time-based billing simply provides wrong incentives to lawyers. Particularly in the current, cost-conscious era, the corporate client often is interested in the cost of achieving a result almost as much as the result itself. Spending too much to reach a goal is often a Pyrrhic victory. There is little consolation in a bankruptcy proceeding from realizing that you achieved your litigation aims while exhausting your capital.

In-house lawyers have other perspectives as well, of course. Many view the billable hour as nothing more than an accounting convention. It is not a measure of the quality or value of the legal service provided during that time. It is, however, a ready measure of how much of the service is provided and, for that reason, it became a substitute for a more precise measure (which has been unavailable to this point).

While conceived as an accounting convention, the hourly rate became more and more common and the entire attorney-fee concept began to reflect the hourly rate. In-house attorneys (even when they might have recognized the imprecision of the approach) became accustomed to the low-value activity of reviewing invoices in which law firms itemized all the time that they devoted to the work. In other word, in-house counsel grew accustomed to the time-based billing paradigm despite its shortcomings.

*With the increasing fluidity of the legal profession and the greater restiveness of clients, the hourly billings of law firm members are becoming an impediment to development of a more appropriate internal measure for law firms to apply in determining relative compensation of their attorneys.*

For law firms, the hourly rate is also a convenient proxy for other more precise measures of what they provide their clients. If a law firm's revenue is determined by the number of hours its professionals bill to its clients, then the number of hours billed by the various members of the firm can be used to determine the relative "productivity" of those attorneys as well. (We put that word in quotation marks because, for most businesses and for in-house attorneys, greater productivity means spending less time at a task or otherwise consuming less of one's assets to achieve the same result. Not for law firms, which view greater client billings as equating to greater productivity.)

With the increasing fluidity of the legal profession and the greater restiveness of clients, however, the hourly billings of law firm members are becoming an impediment

to development of a more appropriate internal measure for law firms to apply in determining relative compensation of their attorneys. So for law firms too, the negative impacts of the hourly rate manifest themselves more and more clearly.

## Corporate Law Department Perspective

As a result of those forces, there is a great deal of interest among corporate law departments in alternative fees. By "alternative fee," we mean a fee that is calculated on a basis other than simply the amount of time spent in the course of the engagement. In other words, alternative fee means any alternative to a time-based fee.

In-house attorneys are naturally interested in minimizing the costs of legal service. Even if they are unable to reduce those costs, their companies' managements expect them to control fee expenditures much more affirmatively. They are also interested in fee arrangements that avoid the misaligned interests created by the hourly rate. In essence, the client's goal in seeking an alternative fee is often to create incentives that will cause the outside attorney to think of the cost effectiveness of the representation at the same time as she or he thinks about the quality of the representation.

Another goal of an alternative fee is to provide a risk/reward ratio that will lead to compensation for the attorney that is neither too low nor too high in light of the task and the business goals accomplished. Finally, and this last goal is closely related to the previous ones, an alternative fee is successful (in the mind of the client, at least) if it can redistribute to some extent, between the client and the firm, the risk of an unsuccessful engagement by making counsel's remuneration more tied to achieving a successful result for the client, however that client might define success in that regard.

The search for alternative fee arrangements (AFAs) is therefore part of a larger effort to

identify an alternative, and more accurate, means of measuring what a company has received when the legal service is complete. Corporate management is no longer content with the answer that the task is complete. Executives want to be sure that the task was efficiently resolved and that the cost of the service was commensurate with the role that it played in achieving the company's business goals.

## Law Firm Perspective

Why might law firms be interested in AFAs?

At first blush, the hourly rate appears to represent the best invoicing mechanism that they can find. It constitutes an objective measure of the amount due the firm. It is a simple method of calculating the legal fee for a service. It also simplifies the calculation, within the firm, of the members' relative contributions to the firm's profits. Finally, it eliminates any risk that the attorney will not be compensated for time spent on clients' assignments and, instead, places that risk on the client.

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AFAs might seem to represent an unattractive option for law firms. That may not, in fact, be so.

The legal market is extremely competitive. There are increasing numbers of lawyers in most jurisdictions. Moreover, many corporations have taken to reducing the number of

outside firms they deal with on a day-to-day basis, a process often called "convergence." As they do so, the fewer "slots" available on their lists of approved outside firms are subject to more and more competition. And it's not simply a question of eliminating one or two slots at a time—in what is tantamount to a legal service game of musical chairs. Rather, the reductions in the numbers of firms retained by companies are sizeable.

For instance, several years ago The Prudential Insurance Company of America reduced the number of firms on its list of approved counsel from approximately 950 to only 270. That company then proceeded to award approximately 60 percent of its anticipated annual need for outside legal service to only 80 law firms. The DuPont chemical company reduced the firms to which it assigns most of its legal work to 34 firms, which it refers to as its primary law firms. (Over time, that number has fluctuated as DuPont's legal department reassessed the company's need for outside legal service and reviewed the performance of the company's existing service providers.)

Other companies have reduced the number of firms on which they rely for most work. Among the more recognizable ones are AT&T, Chrysler Corporation, and Union Carbide. One insurance company reduced its list of counsel from approximately 4,000 firms to only about 2,000. It's clear that competition for corporate legal work will intensify further as such efforts multiply.

Further, many companies have recognized that they can reduce their reliance on outside service providers by increasing the size of their law departments. Generally speaking, in-house attorneys "cost" less than do outside counsel, assuming that the need for their services will continue at a certain level to justify the staffing increase. The same work completed by an in-house attorney requires a lower outlay while the in-house attorney may also be able to save the company money by simultaneously managing the work still being undertaken by outside counsel more assiduously.

In such an environment, firms find that it is important to distinguish themselves positively from their competitors in as many ways as they can. AFAs can be an excellent means of doing so. AFAs also represent an approach that is particularly responsive to the clients' goals as described above.

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Even beyond that, however, many firms are finding that AFAs can result in higher profit margins. At first, many lawyers fear that abandoning the hourly rate as the measure of their fees will lead to reduced profit margins as clients squeeze their firms for fee concessions without compensatory benefits. That is not necessarily the result.

Law firms find that working within an AFA can cause them to approach assignments differently than they might have otherwise done so (in terms of staffing, tactical decisions, etc.). The result often is that the firms' efforts are much more targeted and effective, so the amount of time devoted to a project or assignment might be less than would have been the case under an hourly rate arrangement.

The law firm might even take a different, innovative approach to the assignment that is more efficient and effective if the firm has "skin in the game." The result is that they may actually find that an AFA often leads to an effective hourly rate that is higher than they would otherwise charge.

Finally, an AFA can allow a firm to very effectively demonstrate to its client that it

shares the client's goal of winning the case (if litigation is the context). Since the firm's fee can depend (at least to some degree and in some fashion) on achieving victory in the lawsuit or success in a transaction, the firm and client have parallel priorities.

## Aligning Interests

Aligning the distinct (and to some degree inconsistent) interests of the client and counsel, which should be the goal of any fee arrangement to which they agree, requires that the client and its counsel fully understand their respective interests and goals and that each respects (even if it does not share) the interests of the other. This partnership must be in place at the start of the engagement to which the fee arrangement will apply. AFAs must be rooted in a mutually beneficial and respected partnership between the two parties.

*Anticipating possible changes in circumstances in order to avoid pitfalls puts a premium on the fortune-telling abilities of the firm and its client.*

The alignment of interests must also persist throughout the engagement. In some contexts, the in-house and outside lawyers tasked with forging an effective fee arrangement may be able to predict at the start how the arrangement will operate going forward and plan accordingly. The more complex a matter is or the longer it likely will persist, though, the more challenging such a prediction will be.

Anticipating possible changes in circumstances in order to avoid such pitfalls puts a premium on the fortune-telling abilities of the firm and its client. Unless a firm employs capable prognosticators, it should opt for an alternative approach. Luckily, an approach is available that is well within the firm's grasp. That approach incorporates good and

timely communication with the client on an ongoing basis.

Why do those aspects of the approach matter? First, if circumstances anticipated by the firm and client don't occur or they change materially, they may undercut the applicability or wisdom of the agreed-upon fee arrangement. In such a case, those parties will need to re-examine the assumptions underlying the arrangement and decide whether they should and can renegotiate the arrangement and, if so, how to do so.

The goal in those discussions would be to ensure that the interests of the client and its counsel remain aligned, since the changed circumstances will adversely impact the alignment that they had established at the start of the engagement.

### **A Dubious Proxy**

Corporate law departments must ensure that the cost of the legal service that their companies purchase from outside providers is proportional to the overall corporate objectives for which the service is deployed.

Though it did serve, to some degree, the interests of both in-house and outside counsel when first conceived decades ago, the hourly rate has several negative impacts on the costs of legal service and on the relationships between in-house and outside lawyers that have become more apparent and less acceptable.

The most significant impact derives from the fact that the fee borne by the client will bear no relationship (other than, perhaps, an entirely fortuitous one) to the value of the legal work delivered because the fee is determined solely by reference to the amount of time devoted to the work. The efficiency or inefficiency of the lawyer(s) whose work is covered by the fee will have a greater impact on the size of the fee than the value that the work bears to the client's need.

Another significant effect of the hourly rate is that it leads to a zero-sum game in terms of the financial component of the relationship between the client and the outside lawyer, insofar as the client simply wishes a lower fee and the lawyer prefers a higher one. A client that tries to control the costs represented by the time-based fee can only do so by reducing the amount of time for which it pays or by negotiating a reduced hourly rate, often after the time has been expended.

*The hourly rate has had adverse effect on the relationship between the client and the outside lawyer and it is a subject that both in-house and outside counsel have frequently tried to avoid in the past.*

Each of these approaches leads to less reward for the outside lawyer without changing the dynamics of how that lawyer works and the effort devoted to the assignment by that lawyer. In short, either the lawyer or the client "pays" for the lawyer's time.

The hourly rate has had adverse effect on the relationship between the client and the outside lawyer and it is a subject that both in-house and outside counsel have frequently tried to avoid in the past. If a client does not want to grant the lawyer and law firm *carte blanche* to bill inordinate amounts of fees, that client, as mentioned earlier, is oftentimes forced to police counsel by after-the-fact invoice review to assure the accuracy of rates, timekeepers, and agreed-upon activity.

A more acceptable approach would be a prospective, forward looking discussion between the client and counsel to insure alignment as to anticipated activity, fees, resources, and costs for the period in question. Under either approach, however, the



hourly rate undermines the relationship between counsel and client.

The time has come for in-house and outside counsel to develop a structure for developing an AFA (or, more accurately, AFAs) that reflect the client's goals and the value that the legal service provides to the client more precisely than the time spent by counsel on the assignment. The hourly rate does not serve corporate clients well in that regard. It increasingly disadvantages firms as well.

In future installments of this series, we will explore the value propositions of in-house and outside counsel, how those propositions complement each other, and how those value propositions can provide the basis for approaching the subject of AFAs for both in-house and outside counsel.

This exploration will lead us to a process that both parties will be able to apply in a consistent, effective manner. The result of all

their effort should be more widespread use of AFAs that reflect the client's needs more directly. ■

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