

# The Undeniable Inevitability Of Alternative Fees For Litigation

In early May, nearly 100 general counsel and other senior inside counsel gathered on the Norwegian Dawn, a large cruise ship, for a fascinating program sponsored by Richmond Events and Corporate Counsel, the publisher of this magazine.

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I hosted nearly 40 of these attendees in three roundtable discussions about alternative fees. It was apparent that most had experienced abuses of the hourly rate system and were very interested in using alternative fees.

Before the cruise began, we surveyed the roundtable participants. The data showed the following:

- Virtually all of the in-house counsel were under significant to severe pressure with respect to their budgets.
- Virtually all of the in-house counsel rated the budgets they received from outside counsel as bad to poor.
- Participants believed that hourly rates were too high.
- Most participants believed that hourly rates were interfering with the quality of the relationship each had with his or her outside counsel.
- Most of the participants had experimented with alternative fees, identifying discounts, blended rates and caps as the alternatives most frequently used, but were not using them on a regular basis.
- Litigation is the primary area where these inside counsel wanted to utilize alternative fees.

## The problem of rounding

The general antipathy toward hourly rates and the hourly rate model was palpable. Counsel took turns telling stories about the hourly rate system run amuck. I heard a story the other day about a large, well-regarded Chicago firm which had billed an auto manufacturer 18 hours for an associate to prepare for the deposition of a 9-year-old boy whose father had been hurt in an automo-

bile accident. Aside from wondering why the 9-year-old would be deposed at all, the 18 hours understandably drew the ire of the client. The stories told by my roundtable participants were almost as outrageous as this one.

I took considerable comfort in the enthusiasm of the bashing of the hourly rate system. But when I brought up the concept of "rounding errors" and we walked through an exercise of how much rounding errors cost each participant, I could tell I had scratched a whole new nerve. Most hourly rate bills are expressed in tenths of an hour. Yet most timekeepers record their time weekly or monthly. Only the most conscientious record their time each day. When recording time several days or weeks after the time was spent, how can the timekeeper possibly be precise to the tenths of an hour? Rounding errors are inescapable. For the substantial majority of timekeepers, the lapse of time between the work and the recording of the time will cause a significant degree of imprecision, and, for many, the rounding will typically be rounding up because of institutional pressure to bill more hours. If the error is just one hour per week for a lawyer billing at \$400 per hour, the rounding cost is \$20,000 per year. If the rounding error was an hour per day, the penalty paid would approach \$100,000 annually. Add in a few partners, associates and paralegals making the same rounding errors on your matter, and pretty soon the penalty is meaningful. Obviously not every timekeeper falls prey to the upward rounding error. Firms with lower billable requirements are bound to experience the problem much less, if at all. But the sad fact is that there are few firms who have set low hour requirements, so the overall problem is a significant one for clients. As a result of these and other problems, many in-house lawyers spend hours every month reviewing the bills of their outside counsel. Not only do such reviews tend to create stress in the relationship, but the time spent is hardly the most productive use of inside counsel's time.

## Alternative Fees That Work

During the roundtables, I was frequently asked what

type of fee I believed had the best chance of succeeding. My answer was direct -- a fixed fee with a success kicker, whether in the form of a pure premium or recapturing a hold back or a combination of those two. In my mind, a fee structure should accomplish the following: (1) budget certainty for in-house counsel; (2) minimum revenue certainty for outside counsel; (3) eliminate the "temptations" created by the billable hour model to overstaff, overlitigate and miss resolution opportunities ("But Mr. Client, if we make an offer now, the other side will view it as a sign of weakness"); and (4) maximize outside counsel's interest in the outcome. The simple fixed fee fails on goal 4. Any hourly rate modification - discounts, blended rates and so forth - is destined to fail on each of these goals. Pure contingency fees fail to satisfy goal number 2. But the fixed fee with a kicker meets all four goals. By its nature this arrangement creates certainty and strong incentives for counsel to manage a case as efficiently as is possible, while at the same time maximizing the incentive for a good result. The incentives will cause behaviors to be modified in ways one can never imagine. After much discussion, there appeared to be widespread agreement on this concept.

One issue left unresolved by the roundtable discussions was how to set the fixed fee. Another was what happens if the case settles early or late in the process. While those details are important, the threshold agreement on the nature of the fee arrangement is important. Insofar as these questions are concerned, however, the pricing pressure on the law firm will be considerable, at least until each firm gains comfort in its ability to estimate reasonably the real cost (not the hourly rate cost) of handling a matter, and then building in a suitable profit margin. From the client's perspective, ultimately the focus must be on value received. Insofar as timing of the settlement is concerned, any agreement on the fee should be honored regardless of when the case is resolved. An early settlement does not change the value of the matter to the client, and any change to the promised fee would create a disincentive to settle early, which is precisely the wrong incentive.

#### **Why isn't everyone using this fee structure?**

The roundtable participants provided a number of insights on why alternative fee arrangements are not more frequently used. An Assistant General Counsel described one significant impediment to use of alternative

fees - the risk of public failure. What happens to a rising in-house star when he or she starts using alternative fee arrangements and those arrangements don't work out? Is the loss of stature (or in the extreme case, loss of job) worth it? Another impediment identified was the discomfort of calculating value for the fixed fee component. Just as the hourly rate structure interferes with cost-estimations by outside counsel, it also interferes with the willingness of inside counsel to avoid the feeling that the new system is taking advantage of them too. This only scratches the surface of the internal impediments to using alternative fees. Butler Rubín is beginning a year-long investigation intended to identify the variety of internal impediments to utilizing alternative fees.

#### **What can be done?**

Corporations interested in using alternative fee arrangements should experiment, viewing the experiment as pilot projects, with certain defined goals. Begin on a small matter. See whether the obvious benefit of predictable budgets makes a significant difference for inside budget processes. Calculate whether the cost of handling your cases go down. Judge whether outside counsel was properly incentivized and rewarded for their work. And so on. A list of four or five potential measurables would allow the study to provide meaningful data for future evaluation. Pilot projects that fail aren't that big a deal, but those that pay off can be expanded. But do not stand on the side of the road. The issue is not whether alternatives to the hourly billing system will be tried, but how soon. And, based on the feedback at the recent conference, for many companies, soon is now.

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