

# New First Year Salaries Mean More Alternative Fee Arrangements

With each announcement that another firm in another city has yet again raised the starting salaries of fresh-out-of-law-school associ-

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ates, the pressure on in-house counsel to find options to fees based on hourly rates continues to grow. Every day, inside counsel must choose among the following options:

- 1) pay more for the same outside legal services;
- 2) pay the same or less for reduced volume of outside legal services;
- 3) pay the same or less for the same volume of legal services delivered by a lower priced (and perhaps low quality) outside lawyer; or
- 4) secure more value for the same external legal service spend through the use of alternative fee arrangements (“AFAs”)

A recent survey sponsored by Butler Rubin, taken before the most recent salary increases, indicates more inside counsel are considering AFAs (option 4) as a response to continuing growth of external legal costs. The increase in first year salaries should only serve to accelerate that movement.

## Most In-House Lawyers are AFA-Friendly

Almost 85% of the survey respondents consider AFAs a legitimate tool to control litigation costs. Respondents divided equally over whether budget certainty or budget amount was more important. Whichever value dominates, or whether both are of equal importance, AFAs clearly are an effective tool.

The survey revealed an interesting chicken vs. egg problem. When asked why alternative fee arrangements were not occurring more frequently, half of the respondents said one reason was that outside counsel had not approached them about use of AFAs. Nearly as many did not use more AFAs because they lacked experience to see if such arrangements work. This is, of course, similar

to a farmer leaving the fox in charge of the hen house because the fox has never suggested another way of protecting the hens or because the farmer doesn't have prior experience actually removing the fox. But with only 11% of the respondents reporting immunity (so far) from management pressure to control legal spending, it seems likely that inside counsel will overcome the lack of initiative by their outside counsel and lack of experience with AFAs and other tools to control spending.

The survey revealed that nearly 3 in 4 respondents believe AFAs are most appropriate for cost recovery or other revenue generating litigation. Such matters lend themselves to AFAs because standard contingency fee arrangements are easily applied. For example, the outside lawyer gets 30% of the amount recovered—the math is easy and the bogeys to which the percentage is applied are easy to identify. Other types of litigation were perceived as less suitable for AFAs. It appears that the perceived “uniqueness” of the type of case was significant in evaluating a matter's suitability for AFAs.

## Most Large Firms Are Not AFA-Friendly

Litigation remains the chief area where costs can get out of control. Budget discipline is an anathema to most large law firms. There are no law school classes taught on the subject. Beyond that, the very essence of large firms is at war with a disciplined budgeting process. The leverage model results in more highly paid (and highly priced) associates because the large firms depend on large numbers of associates working long hours to support a smaller cadre of equity partners. Beyond that, the incentives created by law firms contribute significantly to the problem. Associates in large firms are judged on the number of hours billed and the quality of work delivered to the partner. A decision to do fewer drafts and submit work product of lower quality, albeit good enough to get the job done, is a sure way to earn a lower bonus in the short run and career suicide in the long run. Associates who join large firms in the first place tend to be risk averse: it is a rare associate indeed who risks both earning and career advancement for the sake of client service

or budget certainty. By the time these associates become partners, they have little or no training in how to create and live by real budgets and likely lack the internal fortitude to change the system by which they made it.

The problems that seem inherent in large firms do not inherently plague smaller firms. Smaller firms have the ability to staff cases to give clients the best bang for their buck (even if that means leaner staffing or staffing more partners on the matter) and to shift compensation and evaluation metrics more easily than large firms. The opportunity to capture high quality business is a huge incentive for doing so. That may explain why more than 6 in 10 of survey respondents believed that smaller firms are more willing to explore AFAs than are larger firms.

### Is Litigation Really A Special Problem?

The large vs. small firm issue aside, the survey revealed that many outside lawyers resist requests for budgets on the ground they cannot predict what will happen in litigation. The fact of an opponent making his or her own decisions is frequently offered as excuse for why budgets can't be set. Of course, this excuse would be utterly rejected in the business world, particularly when coming from someone who purports to be an expert in the area. Any seller knows that raw materials costs may change, sometimes quite unpredictably, but that risk is no excuse for failing to quote and live by a reasonable price. Moreover, when fees are fixed using an AFA, firms work within budgets regularly. And when the need arises, change orders are submitted to insure the budget reflects reality. The key is in setting forth the original assumptions on which a budget is based.

One fear frequently expressed about use of fixed fees in litigation, is that when lawyers hit the maximum number, they will lose interest in a case putting the outcome in jeopardy. If the relationship between the client and lawyer is limited to a single matter, the risk could be real. But clients with significant litigation portfolios know that their best lawyers think of the relationship more broadly than a single case. Few of those lawyers would risk an ongoing "annuity relationship" for the sake of a single case, even if that means the lawyer ends up discounting his fees on a case because he has exceeded budget. Similarly, good clients do not want to see their outside lawyers losing money on their cases when unpredictable events transpire in the heat of litigation.

But even if the relationship is limited to a single case, outside counsel's fee can be structured to prevent the firm from "losing interest in the outcome" by including either a "hold back" or "success fee" that will be paid based on the outcome. The single matter can be broken into phases where a fixed fee exists for a phase. One company creates a hold back by paying 80% of fees due so long as the matter is within budget for a particular phase, but only 20% of any budget overage, with the hold back creating a pool of money that will be paid in a percentage ranging from 0 to 200% based on the outcome, speed of resolution and other criteria deemed important by the Company.

### Conclusion

Use of AFAs seems destined to become more frequent, and in short order. When asked whether AFAs would become more commonplace in the next three years, only 18% disagreed. One need only look at massive savings achieved by business leaders like General Electric, DuPont, Cisco, UPS, FMC Technologies, Sun Microsystems, and others to see that material savings are there for the taking. Companies that commit to AFAs, not to mention tools such as meaningful Early Case Assessment and decision trees can generate material savings. With starting salaries for first year associates at large law firms now exceeding what clients pay their middle managers, it seems certain that more corporate legal departments will be experimenting with and utilizing AFAs in the years to come.

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