

The LegalBizDev Guide To Alternative Fees



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CONTENTS

Executive summary.....	2
Challenges to the billable hour	4
An idea whose time has come?.....	6
How many kinds are there?.....	9
Hybrids.....	10
Discounts.....	14
Examples from boutique firms.....	17
Examples from large firms.....	20
Accepting risk	22
The cost of doing business.....	24
Value pricing vs. cost-plus pricing	26
Eight steps to succeed with fixed fees	28
Structuring contingent fees	34
Win-win or win-lose?	35
Resistance to change	41
A new business model	44
Predicting the future.....	46
Conclusion and recommendations	49
About this guide.....	54
About LegalBizDev	55

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Executive summary

In a recent survey, seventy-seven percent of general counsel and chief legal officers said that they would like to increase the percent of their budgets spent on alternative fees.

The basic concepts of alternative billing have been around for several decades, and the American Bar Association published its first book on this topic in 1989. But client pressures to use the approach have increased substantially within the last year, due to the economy and to the Association of Corporate Counsel's Value Challenge "to reconnect value and costs for legal services."

According to Altman Weil, twenty-seven percent of in-house departments spent at least ten percent of their budgets on non-hourly arrangements in 2008. This figure increased to forty-three percent in 2009. A 2008 survey from The BTI Consulting Group reported that alternative fees are most commonly used in litigation, followed by mergers and acquisitions work, corporate finance, and labor and employment.

Some experts focus on two fundamental types of alternative fees: fixed and contingent. Others also include a third type: discounted hourly rates. The number of ways that these fundamental dimensions can be combined to create hybrids is virtually unlimited. This guide provides numerous examples of specific fee structures used, including transparent blended rates, hourly rates plus a contingency, retainers, fee caps, safety valves, and risk collars. It also describes how some boutiques are using value-adjusted billing, in which legal matters are billed in the traditional hourly way, then at the end of each matter the client is invited to subtract or to add any amount, in order to reflect the value received.

This guide then discusses the relative merits of several different approaches to structuring contingency agreements and value pricing vs. cost-plus pricing. It also lists eight steps to succeed with fixed fees including identifying the clients and matters that best fit the approach, breaking down large matters into smaller steps, and, most importantly, managing the work after you win. Ultimately, succeeding with fixed fees is an art which requires a great deal of trial and error, and improves with practice.

While many writers have stressed the win-win possibilities of alternative fees, in an Altman Weil 2009 survey only fifteen percent of firms reported that non-hourly projects were more profitable. It is getting harder to protect profits as prices go down and margins get squeezed, but many firms believe that

alternative fee arrangements are an absolutely essential tactic to generate cash flow and to survive in an ever more competitive world.

For many years, law firm work practices, recruiting, and compensation models have all been built around billing more hours. As law firms react to a business model that stresses fixed fees and rewards efficiency, many of these practices will have to change. Just how quickly this will occur, and how far it will go, depends on many factors, including the conservatism of inside counsel who are accustomed to hourly billing.

But there is no question that the profession has entered a period of growing experimentation, in which many law firms are relying on alternative fees for a larger proportion of their revenue. If the growth of alternative fees hits a tipping point, it has the potential to totally transform the legal profession, from the way legal matters are handled to the way lawyers are compensated.

The guide ends with ten recommendations for firms that increase the use of alternative fees, including: Identify internal champions to lead the effort, increase efficiency by adapting tools from other professions, measure success, and act like an entrepreneur, not like a lawyer.

Challenges to the billable hour

In a recent survey¹ conducted by the Association of Corporate Counsel, 60% of general counsel and chief legal officers said that the best way for outside counsel to improve relations is to offer more alternative billing arrangements. 77% would like to increase the percent of their budgets spent on alternative fees.

But there is no clear consensus on how lawyers should use alternative fees, or even on exactly what the term means. Is a blended rate an alternative fee? Some experts would say yes, some no. And there is even less agreement about the risks and benefits of all the variations, including flat fees, contingency fees, retainers, capped fees, safety valves, and other alternative approaches.

This guide was written to help lawyers put alternative fees into perspective, and consider when and how to use them.

Any big picture overview of alternative fees must start with the system that it is an alternative to: billing by the hour. A few years ago, the American Bar Association established a “Commission on Billable Hours” to study the pros and cons. Their final report in 2002² highlighted many disadvantages of hourly billing, including (p. 5):

Simply put, the overreliance on billable hours by the legal profession:

- results in a decline of the collegiality of law firm culture and an increase in associate departures
- discourages taking on pro bono work
- does not encourage project or case planning
- provides no predictability of cost for client
- may not reflect value to the client
- penalizes the efficient and productive lawyer
- discourages communication between lawyer and client
- encourages skipping steps
- fails to discourage excessive layering and duplication of effort
- fails to promote a risk/benefit analysis
- does not reward the lawyer for productive use of technology
- puts client’s interests in conflict with lawyer’s interests

¹ <http://www.acc.com/legalresources/resource.cfm?show=196674>

² <http://www.abanet.org/careercounsel/billable/toolkit/bhcomplete.pdf>

The client runs the risk of paying for:

- the lawyer's incompetency or inefficiency
- associate training
- associate turnover
- padding of timesheets
- results in itemized bills that tend to report mechanical functions, not value of progress
- results in lawyers competing based on hourly rates

Later in the final report (p.8), the Commission focused on the most critical problem:

Hourly billing allows, indeed may encourage, profligate work habits. A cost-plus contract can degenerate into disregard for basic market discipline. So too can the obvious benefit of being paid for working more hours lead, directly or indirectly, to inflating the number of hours worked. Cost-plus can also override scruples about quarter-hour billing increments, which are never marked down, only up.

If the billable hour has all these inherent problems, why does it continue to dominate the legal profession? In part, because it is simple and straightforward, and everyone is used to it. But most of all, in the words of the ABA commission (p. 8), because it "Lets law firms make more money."

The seductive appeal of hourly billing is a problem not just in legal circles, but in every profession. In my experience owning and operating a successful training and consulting company for 24 years, hourly contracts are an addictive habit. Before we started working with lawyers, one of our biggest clients was the US Government and we earned over \$15 million on contracts developing and delivering training programs on an hourly basis.

From the government's point of view, the job we did was good enough to win an award from the US Small Business Administration as the best small business government contractor in New England. But from our point of view, the business model of billing by the hour created a disturbing conflict of interest.

The only way to make more money was to hire more people. The more efficient we became, the less money we made. Our needs were fundamentally opposed to our clients' needs. It was bad for business relationships, bad for work habits, and bad for employee morale.

Nevertheless, we became addicted to hourly billing. Every time we had some success, we hired more people. That increased the number of hours we needed to bill the next month to break even.

When signing new business, sometimes we had a choice between a fixed price contract and an hourly approach. In those days, I always chose hourly. Because I hate risk, and the hourly approach minimized my risk.

A few years after our government contracts peaked, we switched our focus to helping lawyers develop new business, and renamed the company LegalBizDev. Since then, all of our work has been fixed price. The reason is ironic. Lawyers love to bill by the hour, but they hate to pay that way. When we consult with lawyers about how to bring in new business, we want to maximize our chances of success by being able to help and support lawyers whenever a new opportunity for more legal work comes up. But if we billed by the hour, lawyers would be reluctant to call us, because they would know that the meter is always running.

These same fundamental business realities apply to every law firm. As David Sump, now at Troutman & Sanders, wrote in the Newsletter of the Virginia Bar Association³ a few years ago:

The billable hour dies hard, like a cockroach that refuses to check into its own special motel or a rodent that scoffs at the spring-loaded cheese morsel... I must confess that as much as I detest the billable hour, I know that if we bill enough of them each month, there will be money left over at the end of the month to pay my partners.

There are many reasons why the transition from hourly billing to alternative fees has been so slow. Most lawyers will seriously consider alternative billing only when they are pressured to do so by clients and competitors. But in 2009, that pressure is rising.

An idea whose time has come?

The basic concepts of alternative billing have been around for several decades. The American Bar Association's first book on the topic—*Beyond the Billable Hour: An Anthology of Alternative Billing Methods*—was published in 1989. That book is no longer in print, but it has been replaced by several other ABA books. The most recent was published last year: the third edition of *Winning Alternatives to the Billable Hour: Strategies that Work*, by Mark A. Robertson and James A. Calloway.

³ http://www.amazon.com/Winning-Alternatives-Billable-Hour-2nd/dp/1590311175/ref=sr_1_4?ie=UTF8&s=books&qid=1230316424&sr=1-4

The blogosphere and the media began buzzing about alternative fees last fall, in part because of the price pressures created by the economy. As a *Business Week*⁴ article put it in January, companies are “scrambling to protect their bottom lines” and “costs cannot be cut fast enough.”

An article in *Forbes*⁵ noted that lawyers have been especially hard hit; “The sudden lack of liquidity has led to a dearth of transactions, killing demand for many legal services. At the same time, clients facing their own financial pressures are increasingly scrutinizing budgets and demanding more value for their legal expenses.”

The result is that “GCs [are]...dropping law firms, and demanding lower bills and fixed fees from the ones they keep.”⁶

Last fall, the 25,000 member Association of Corporate Counsel (ACC) announced its *Value Challenge*⁷ “to reconnect value and costs for legal services.” As an October 19 *Washington Post* article⁸ put it:

New efforts to jettison hourly billing are being driven by in-house corporate lawyers, who say they have grown frustrated seeing fees to outside firms soar even as they slash their own costs. They said they want more certainty in their legal budgets and worry that outside firms are spending unnecessary amounts of time on their matters.

From ACC’s point of view, the timing couldn’t have been better.

When *The American Lawyer* published its latest survey of 112 law firm leaders in December 2008⁹, sixty-nine percent agreed with the statement, “Due to the advent of new technology and increased commoditization of legal services, many, if not most, AmLaw 200 firms will have to change their business and billing practices.”

The ideas got another publicity boost in January, when Cravath Chairman Evan Chesler published an article in *Forbes* with the provocative title “Kill the Billable Hour,”¹⁰ arguing that:

For reasonable periods of time during the life of a lawsuit, say three months at a time, [lawyers should] identify the client’s

⁴ *Business Week*, January 5, 2009, p. 39

⁵ <http://www.forbes.com/2009/04/29/billable-hour-retainer-entrepreneurs-law-taxation-wharton.html>

⁶ <http://www.law.com/jsp/cc/PubArticleCC.jsp?id=1202428368449>

⁷ <http://www.acc.com/advocacy/valuechallenge/>

⁸ <http://www.washingtonpost.com/wp-dyn/content/article/2008/10/19/AR2008101901397.html>

⁹ <http://www.law.com/jsp/article.jsp?id=1202426433148>

¹⁰ <http://www.forbes.com/forbes/2009/0112/026.html>

objectives, measure, calculate, build in a contingency and come back with a price. Once the price has been agreed upon, the billable hour should be irrelevant.

This central idea is familiar to advocates of alternative fees. But when the chairman of one of the most prestigious law firms in the world says it, that is news.

While many people agree that alternative fees are a hot issue, there is less agreement about exactly which types of billing are alternative and which are not. As ACC General Counsel Susan Hackett put it in an interview with *Corporate Counsel*¹¹:

I don't know what alternative billing will look like. Perhaps you'll see more contract people, more people providing legal products and services that are currently being done by lawyers but probably don't need to be. I think you'll see a lot more focus on technology and how it can move those processes forward. And I hope you'll see a much more vibrant law firm market, one that will have corporate practice spread across a much broader swath of firms than you currently see.

Whatever the change looks like, few seem to think that it will come quickly. When Cravath's Evan Chesler was interviewed in the *Wall Street Journal* blog¹² they asked him to identify "the highest hurdle to achieving a billable-hour-free world." Chesler replied:

One is inertia. People tend to continue doing what they've always been doing. Change requires the application of force. Another is the difficulty of defining what constitutes success. Because in large, complex cases, that's not a question with a simple answer. It's easy to think of it in terms of a jury foreman standing up and announcing who won. But the world is more complicated than that.

When Aric Press interviewed Chesler for *AmLaw Daily*¹³, he asked how much progress Cravath has actually made in getting away from the billable hour, and reported that, "Chesler says that he's been raising this issue with clients and in private talks for the last few years. Thus far, he says that he has 'just a few situations, in the single digits' with clients who have abandoned the billable hour."

¹¹ <http://www.law.com/jsp/tal/PubArticleTAL.jsp?id=1202426214778>

¹² <http://blogs.wsj.com/law/2009/01/07/im-a-trial-lawyer-i-bill-by-the-hour-this-needs-to-be-fixed/>

¹³ <http://amlawdaily.typepad.com/amlawdaily/2009/01/cravaths-chesler-time-to-kill-the-billable-hour.html>

Ron Baker, founder of the VeraSage Institute, has devoted the last several years of his life to “burying the billable hour and timesheets across all Professional Knowledge Firms.” But Baker believes that widespread acceptance of the value pricing alternative (described below):

...could take decades if not centuries, since it involves the diffusion of a theory. I was naive enough to think the ABA Report in 2002 would have an impact, but alas, it fell flat. I’m starting to think physicist Max Planck was right: progress happens funeral by funeral.¹⁴

How many kinds are there?

When lawyers start to get serious about alternative fees, one of the first questions they ask is: how many kinds are there?

That’s a logical question, and indeed was one of the first things I asked when I started studying the topic. My researcher and I spent more hours than I would care to admit listing all the types of alternative fee arrangements that have been reported in the past, and studying the taxonomies experts have proposed to classify them.

In terms of the underlying dimensions, depending on whom you ask, there are either two types of alternative fees (fixed and contingent) or three (if you also count discounted hourly rates). The disagreement about whether blended and discounted arrangements should or should not be considered “alternative” can add considerable confusion to an area that is already confusing enough.

For example, when The BTI Consulting Group reported a survey of the frequency of alternative billing at the 2008 annual conference of the Legal Marketing Association, the percentage they reported included blended rates. But when Altman Weil published a survey of the same topic in November 2008¹⁵, they specifically “excluded not only hourly work but also discounted or blended hourly rates.” And, when a third survey was publicized last May (also by Altman Weil), the press release¹⁶ did not mention whether discounts were included or not, which made it hard to interpret their conclusion that “The use of alternative billing is nearly universal in law firms.” (In fact, this survey referred to non-hourly billing. But readers of the press release could have

¹⁴ http://www.verasage.com/index.php/community/what_a_great_idea/

¹⁵ <http://www.altmanweil.com/LDCostControl>

¹⁶ http://www.altmanweil.com/index.cfm/fa/r.resource_detail/oid/fd6a643c-3b55-4dff-b6aa-e598a590a507/resources/New_Survey_Measures_How_Law_Firms_Are_Weathering_the_Storm.cfm

concluded that the statement simply meant that everyone was offering discounts.)

In a survey of the AmLaw 100 that my company is currently conducting¹⁷, we went with the strict definition and excluded blended rates and other approaches that are strictly hourly. We focused instead on arrangements that are fixed or contingent, in whole or in part. We explain that definition when we recruit participants, and I mention it again as I begin each interview. Nevertheless, as the conversations continue, a few participants inevitably go back and talk about blended rates, because that's the way they think about alternative billing.

Several senior partners we've interviewed have noted that inside counsel generally seem to prefer discounts to non-hourly approaches. As one put it, "Half of the time at least—maybe more—when the client says alternative fee, what they are really saying is 'Give me a larger discount than you gave me before.'"

Unfortunately, many clients and law firms have a vested interest in maintaining this confusion. Saying that your firm is offering "alternative billing" sounds much more thoughtful and less desperate than saying: we are slashing our rates because we need the business.

Most of this report will focus on true alternatives to the billable hour, which are partly or totally fixed and/or contingent. These two underlying dimensions are often combined with each other and/or with hourly rates to form a variety of hybrids.

Hybrids

Firms that are trying to establish standards for their own use of alternative fees often start by trying to list all the different types of hybrids that could be used. This is harder than it sounds.

As Patrick Lamb of Valorem Law put it in a March 2009 West LegalEdcenter panel discussion¹⁸ which I moderated, when you consider all the combinations and permutations there are "a limitless variety of ways to structure fees." And even if you were able to somehow create a list of all the fees that had been used in the past, the next day some lawyer somewhere would invent a new one.

¹⁷ <http://www.legalbizdev.com/alternativefees/survey.html>

¹⁸ http://westlegaledcenter.com/program_guide/course_detail.jsf?courseId=19292256

So if you want to compile a short list of the exact details of alternative billing arrangements that best fit your business, and the risks and benefits of each, you'll have to do it the hard way and create your own proprietary list.

This section introduces a few of the most common and most interesting variations.

Hourly rates plus a contingency supplement the traditional hourly arrangement with a fixed fee which is contingent upon success. In their article, "Alternative Fees for Litigation: Improved Control and Higher Value," James Shomper and Gardner Courson list a variety of ways of defining success, including:

Time of disposition (for example, dismissal or settlement by a specified date), type of disposition (summary judgment, voluntary dismissal), favorable judicial rulings (for example, denial of class certification, forum non conveniens, statute of limitations, preemption, or other dispositive rulings), disposition before fees and costs reach a specified level, and the like...

[A] performance award can be defined in any number of ways, such as a percentage of the fees saved below budget, a multiple of the discounted fees, or a specified dollar amount. The performance award might also be paid in stages rather than on the happening of a single event.

When properly structured, contingencies have the effect of aligning the interests of law firms with their clients. As Patrick Lamb noted, clients are often concerned:

...that the firm will allocate inadequate resources in order to maximize the profit margin (translation—increase the risk of a bad result). The holdback or bonus component based on the result is an absolute answer. Fees are all about the client identifying that which is most important to them—for most the top two are cost and result—and structuring the fee to maximize the firm's incentive to accomplish those objectives while at the same time giving the firm the incentive and latitude to do the work as cheaply and efficiently as possible.

From the law firm perspective, contingencies are becoming less attractive in today's cut-throat environment. According to one participant in our AmLaw 100 survey of alternative fees¹⁹: "Part of the difficulty of doing contingency work is that it makes the most sense for large law firms where there is a potential for a substantial recovery. But what we're seeing now is clients

¹⁹ <http://www.legalbizdev.com/alternativefees/survey>

asking for a contingency where the amount you recover if you're successful is about equal to what you have invested in the matter. 'That's not a win-win, that's just a risk-risk. And those don't make sense.'"

Another hybrid approach is an *hourly fee cap*. Here, hourly rates are charged up to a maximum cap. Beyond that, the law firm agrees to work at its own expense. These arrangements are generally more advantageous to clients than to outside counsel, since the maximum serves as a kind of fixed fee, but the hourly billing also enables clients to pay less. For example²⁰:

[Pfizer awarded] almost all of its U.S. labor and employment work to Jackson Lewis for [2008 and 2009]. In return, Jackson Lewis had agreed to an annual cap on its fees-no billable hours or even flat per-matter fees...

Under its agreement with Pfizer, Jackson Lewis gets any employment-related legal work that comes in the door for... two years, including single-plaintiff discrimination cases, equal employment opportunity matters, class actions, and general advice and counsel. All existing employment cases were transferred to the firm except for [three ongoing matters]. In return, Jackson Lewis is paid one-twelfth of the annual capped fee each month.

But there's a catch.

The firm sends Pfizer a monthly accounting of the time that it's spent on Pfizer matters. An end-of-the-year reconciliation will allow Pfizer to recoup any money left on the table.

Some lawyers see hard caps as the worst of both worlds – you can do worse than hourly, but you can't do better – and refuse to do business this way. Others accept hard caps as an inevitable element of the changing legal landscape. In an April panel I moderated for West LegalEdcenter, Rob Fields of Womble Carlyle argued that in the current environment fees “must be transparent so the client can see that they won and they can defend the cost to their business people.”

Lawyers who agree to work within a cap would be well advised to negotiate a *safety valve* in advance, with both parties agreeing to renegotiate if the fees exceed the cap by a certain number of dollars or hours. When safety valves are used, it will be helpful to send formal monthly reports comparing progress to the cap and the safety valve, and offering suggestions for keeping each matter within budget. Some firms use other terms and related approaches. For example, with one type of *risk collar* the firm would collect nothing extra if the

²⁰ <http://www.law.com/jsp/cc/PubArticleFriendlyCC.jsp?id=1202423790324>

total fee were 101-120% of the cap. But anything over that would be split 50/50, so that the client is also motivated to handle matters efficiently.

A far more radical hybrid is *value-adjusted hourly billing*, in which legal matters are billed in the traditional hourly way, but at the end of the matter the client is invited to subtract or to add any amount, in order to reflect the value received.

Isn't that risky? You bet it is.

But in his article "Creating the Law Firm of the Future," pioneer Ralph Palumbo, reports that it has worked extremely well for the Summit Law Group:

Our experience with value-adjusted fees has been terrific. Our customers have voluntarily paid us tens and even hundreds of thousands of dollars more than our proposed fee in matters where the value of our product substantially exceeded the fee proposed. Other customers have asked us to raise our hourly rates in order to better reflect our value. We even benefit when a customer discounts our proposed fee (a rare event) because we get immediate notice that something is wrong and we have time to fix the problem and save the customer relationship.

An unexpected benefit of our value-based pricing is that it has significantly reduced our accounts receivable. We get our bills out by the tenth of every month and ask to be paid promptly. Most of our customers respond—we believe in part because it's hard to object to paying a fee that the customer can adjust to any amount the customer believes fairly reflects value.

Palumbo says that one key to success was building this approach into the firm's culture:

No lawyer or staff member wants to be embarrassed by having a customer significantly reduce our proposed fee. The result is that our lawyers take more care to work with customers at the beginning of the engagement to define the scope and cost of the legal product to be provided. And they take more care to ensure that the cost of our legal product matches the customer's objectives.

Examples of other types of hybrids will appear throughout this document, particularly in the sections on examples from boutiques and from large firms. But before we get to other variations, we should talk about the types of discounts which many include in the definition of alternative fees.

Discounts

It is unfortunate that that a single term—alternative fees—has been widely used to refer to three very different types of billing: fixed fees, contingent fees, and hourly rate discounts. While the first two represent truly alternative models which can change the very way business is conducted, discounts are an alternative only in a very limited sense.

Some law firms argue that they don't need to discount because they are so efficient at assigning key parts of each matter to less expensive junior lawyers. However, clients do not always agree. One general counsel from a Fortune 500 company (who preferred to remain anonymous) put it this way: "Most of the firms we deal with claim to have junior associates or even paralegals do a lot of the preliminary work with the senior partners performing only a review function. From what I've seen, however, the junior associates and paralegals put in an extraordinary amount of time on a particular issue which adds up to quite a lot of money even though their hourly rate is not high. I've also noticed that many times preliminary work has to be rewritten by more senior attorneys because the juniors just don't have the experience to identify the major issues. At the end of the day, I haven't seen much savings."

In a booming economy in which specialized legal expertise is a limited resource, law firms have all the power, and there is little if any need to offer discounts. According to Hildebrandt International's *Special Client Advisory: Fall 2008*,²¹ the years 2001 to 2007 were a "six year period of unprecedented revenue and profit growth."

Law firms have gotten accustomed to raising rates from this position of power. But in the last year the economy has shifted the balance of power to clients. As a result, every lawyer would be prudent to ask: Do I need to offer lower prices to protect critical client relationships?

If clients love your service as much as you think they do, maybe you can skip the rest of this guide and get back to billing hours. Then again, there's a good chance you're wrong. In a 2008 survey of general counsel, *Inside Counsel*²² magazine asked lawyers to grade their overall performance with clients as A, B, C, D, or F. Forty-two percent of the lawyers thought they were earning an A. But when they asked clients the same question, in fact only seventeen percent earned As. In other words, most lawyers overrated their performance.

When the economy heads down and power shifts to the buyer, it may be necessary to discount rates to hold on to clients.

²¹ http://www.hildebrandt.com/Documents.aspx?Doc_ID=2738

²² http://www.insidecounsel.com/assets/article/1782/July08_Cover.pdf

If you offer a discount too soon, you will simply give away money that you could have kept. Then again, if you wait too long and a competitor offers a deep discount first, you may lose the client before you have a chance to make your offer.

So, like everything else in business, it all comes down to an educated guess.

I think that there's never been a better time for discounting and if in doubt, you should offer a discount.

(In case you're wondering, I've put my money where my mouth is, and offered carefully selected discounts to my own clients this year. If I guessed wrong and gave some discounts that were not absolutely necessary in the short term, I still may be better off in the long term due to strengthened relationships.)

But also keep in mind the advice of Ian Shrank, a partner at Allen & Overy, to proceed slowly: "If you offer a discount, it will always be accepted. If in doubt, open a discussion with the client about its happiness with your billing arrangement (and probably all other aspects of the lawyer/client relationship) and see where the conversation takes you."

In a *volume discount*, a law firm agrees to lower its hourly rates in return for getting a certain volume of work. There are a number of ways to structure such an agreement. For example, a firm could offer a ten percent discount in return for a guarantee of 10,000 hours of work in the next year or for handling all of the client's employment cases. Or the discount could be tied to the actual number of hours as they are billed: one percent on the first 1000 hours, five percent on the next 5,000, and ten percent on the next 10,000.

From a marketing perspective this is an excellent approach. No matter how they are structured, volume discounts represents a true win-win: the client pays less, and the law firm gets more security.

Another approach is a *blended rate*, in which a single middle rate is charged for both senior and junior lawyers. This is far more complex, and may not be a discount at all. Who wins and who loses will depend on the actual numbers in a particular situation.

For example, consider a case that is expected to require 100 hours of senior time at \$500 per hour (\$50,000) and 100 hours of junior time at \$300 per hour (\$30,000), for a total of \$80,000. A firm could offer a blended rate of \$350 per hour, which reduces the predicted cost of the matter to \$70,000 (\$350 times 200 hours).

But now suppose that once the matter is underway, the firm discovers that almost all the work could actually be performed by more junior lawyers. If the senior lawyers only need to spend 20 hours supervising the matter (which would have cost \$10,000 at the original rate of \$500 times 20 hours), and junior lawyers put in the other 180 hours (which would have cost \$54,000 at \$300 times 180 hours), the client who pays the blended rate will actually pay more (\$70,000) at the blended rate than they would have at the non-discounted rate (\$64,000).

Now you could argue that it's still a win-win, because if the firm had not offered blended rates, senior lawyers would have delivered 100 hours out of the 200. The client won by paying \$70,000 instead of \$80,000, and the firm won by charging \$70,000 instead of \$64,000.

From a marketing perspective, that is a terrible argument. In essence, it implies that senior people never should have been doing the work in the first place and the client must agree to be overcharged a little in order to avoid being overcharged a lot.

Blended rates invite gamesmanship, as individual lawyers may be tempted to manipulate predictions to maximize profit. And they encourage the use of more junior level lawyers, even when it may not be to the client's benefit. For example, one article reviewing alternative fees described the experience of the general counsel at Marriott International who was unhappy with his blended rate experience because:

The law firm only assigned to the matter those lawyers whose regular hourly rate was at or below the blended rate, and more senior lawyers were unwilling to engage in significant supervision.²³

So if your primary goal is to offer a client a better deal that will strengthen the relationship, blended rates should be used judiciously, only in cases where the client will get an unambiguous benefit. One way to guarantee that would be to use what is called a *transparent blended rate*: bill the client for actual hours spent at whichever amount was lower, the blended rate or the standard rates of the lawyers who actually worked on the matter.

Despite the continuing popularity of discounting, a purist would exclude this discussion from the term alternative fees. Therefore, the remainder of this document will focus on arrangements which are fixed or contingent, in whole or in part.

²³ http://www.dupontlegalmodel.com/onlinelibrary_detail.asp?libid=96

Examples from boutique firms

A growing number of visionary boutiques are leading the charge to alternative fees. In March 2009, I conducted a panel discussion for West Legal Edcenter²⁴ with the founders of four of the best known firms: Fred Bartlit, Patrick Lamb, Jay Shepherd, and Bruce Raymond.

When it was founded in 1993, Bartlit & Beck had few competitors who even knew what alternative fees were. At 70 lawyers, it is still small enough to be considered a boutique and was named 2009 Litigation Boutique of the Year by *The American Lawyer*. But it is also the largest firm in the world that refuses hourly work and works exclusively on an alternative basis. Bartlit & Beck structures every fee so that the law firm and the client win together, or lose together.

The price for handling a matter can be as simple as a monthly retainer, or it may be based on a set of benchmarks which they have established over 16 years of setting alternative fees. In a March panel discussion, Fred Bartlit said that if other firms would typically charge \$200K for a particular matter “We might do it for \$100K. The difference is held by the client. If things don’t work out and the client loses, we lose too.” If Bartlit wins the case, the client has total discretion to set the remainder of the fee. It could be the \$100K difference held in reserve, or it could be a multiple up to five times that amount. Since the client defines that part of the fee, the payment will be totally aligned with the client’s perception of value.

In order to bid properly on a fixed price matter, law firms must invest time in due diligence up front. Some of these investments produce new work, and some don’t. “We turn down cases all the time,” said Bartlit. In this model, investing in due diligence is part of the cost of doing business.

Valorem Law Group was founded by Patrick Lamb, author of the widely read blog, *In Search of Perfect Client Service*. This Chicago litigation firm which takes its name from the Latin word for value.

The animation that greets users to their web page begins by announcing, “The billable hour is dead.” Then it asks a question “How many lawyers does it take to screw a client?” After a short pause, the answer: “On a billable hour basis, only one.”²⁵

One of Valorem’s most interesting innovations is their “value line adjustment”:

²⁴ http://westlegaledcenter.com/program_guide/course_detail.jsf?courseId=19292256

²⁵ <http://www.patrickjlamb.com/archives/commentary-valorem-launches.html>

On each bill, you have the right to make any adjustment to our proposed fee that you feel is needed. We provide value or you adjust the bill, it's that simple.

We do this to give you the ultimate check on our unwavering commitment to client service, and to eliminate the concern that our level of service will wane once the work we've performed exceeds a given flat rate or capped fee allotment.

Some have said that the Value Adjustment Line is extremely risky. We agree. If we aren't willing to risk our own fees on our service, do you really want us advocating for you?

When Patrick Lamb announced the firm's formation in January 2008, he noted that many of its features, including the value line adjustment were "shamelessly copied" from his friend Ralph Palumbo of Summit Law Group. Palumbo's vision of "Creating the Law Firm of the Future"²⁶ describes his approach to "getting away from the billable hour" and much, much more.

Another firm that takes a position on its web page is Shepherd Law Group, founded by Jay Shepherd in Boston to specialize in employment law:

Hourly billing pits the interests of the client against the interests of the law firm. If a project takes longer to complete — which is bad for the client — the law firm makes more money — which is good for the law firm. And most firms have annual billing requirements for their lawyers, who don't receive bonuses if they fail to bill a certain number of hours. With that kind of pressure, how hard are your lawyers going to try to keep your billable hours down?

The Shepherd Law Group does all its work based on "Up-Front Pricing":

Up-Front Pricing is our approach to helping clients control their legal expenses. You will always know how much our work is going to cost before we do it. It's our solution to the problems of hourly billing.

When I interviewed Jay for the March 2009 panel, he gave the example of a monthly retainer for all of a client's employment policy advice. "The help is unlimited," he emphasized. "Hundreds of times over the years I've said to clients 'Why didn't you call me sooner?' before a matter got bad enough to need legal help." The reason, of course, was that clients did not want to pay an hourly fee if they thought they could get by without a lawyer's input. With

²⁶ <http://www.summitlaw.com/PalumboArticle.pdf>

this retainer arrangement, clients talk to lawyers sooner, and can prevent problems before they occur. “It’s a great way to build client relationships,” Shepherd said. And if it becomes clear to both parties that more help is needed than originally planned, at some point the monthly charge can be renegotiated.

At the start of each matter, you need to scope the work out carefully. As Shepherd said, “Sit down with the client and figure out what you are selling. Sometimes you’re in a rush but it’s important to figure it out up front.” If there is a radical change later, such as a client desire for a motion to dismiss, you can always issue a change order.

Raymond & Bennett, a Connecticut firm that specializes in business and personal injury litigation, is another well-known proponent of alternative fees. For intensive, unpredictable work, they guarantee a budget for one phase of a case at a time. According to founder Bruce Raymond, “this makes it easier for the firm to map out with the client what needs to be done.” The budget agreement often includes an escape clause in case needs change. And when one phase ends, the firm can begin planning the next one from a more realistic starting point.

There are many other lawyers and firms that have announced their commitment to this approach, including:

- Chris Marston, founder of Exemplar Law Partners in Boston “the first corporate law firm in the nation to exclusively adopt a fixed price model.”
- Mark Chinn, founder of Chinn and Associates, a family law firm near Jackson, Mississippi that promises a “method of pricing that is relatively unique to divorce practice and is designed to foster extreme customer satisfaction.”
- Michael Grodhaus, a litigator at the Columbus, Ohio office of Waite, Schneider, Bayless & Chesley and author of the blog, *The Alternative Fee Lawyer*.

In December 2008, Bruce Raymond started an Alternative Fee Lawyers group on LinkedIn. By July 2009, when this guide was written, it had grown to about 300 members, many of them from boutique firms.

Examples from large firms

In an April panel discussion of alternative billing at large firms²⁷, Harry Trueheart, the Chairman of Nixon Peabody (over 800 lawyers), noted that large firms have several advantages over boutiques: they can take greater risks if a client wants contingent or other fee arrangements, and they have a larger knowledge base. This can lead to greater efficiency and better estimates of what things should cost. But Trueheart and other panelists also talked about the special challenges in changing the mindset at large firms.

According to Rob Fields from Womble Carlyle (over 500 lawyers), “The client needs to win on every fee, every time, even though at larger law firms, it’s difficult to wrap our minds around this.” He described a large project Womble Carlyle recently started in which the client can choose whether to pay by the hour or to pay one of several predetermined fixed fees. At the end of each matter, the client gets to pick the lowest price. Of course clients love this, but it imposes significant demands on the firm. “We have to manage our staff closely and focus our resources on what the client values....It gives you incentive to focus.”

Richard Rosenblatt at Morgan Lewis (over 1400 lawyers) agreed that the key to success is “managing the work. Everyone has to keep an eye on the budget weekly or even daily. It requires a new level of discipline and rigor....And we also have to constantly ask are we doing enough?” If a client feels that a firm is cutting corners to save money, the entire effort can backfire.

Harry Trueheart explained that as legal clients move in this direction, “a lot of education will go into this and it’s not cheap. Law firms will pay dearly as we as a profession learn to do this. There will be winners and losers on the economics. But many contractors manage their business this way and lawyers must learn this too.”

For firms that do invest in mastering these new ways of doing business, the payoff could be enormous. When clients leave the billable hour behind, they are more willing to pick up the phone to ask for advice because they know it will not increase the cost. “It invites the client to engage with us and increases the ties that bind,” said Rosenblatt. “We’re now on the same team, and more likely to get the next engagement.” The implication is obvious: “This is an opportunity to get a bigger share of a shrinking pie.”

Seyfarth Shaw (over 750 lawyers) has publicized some of the management tactics that lie behind a successful transition to alternative billing. They got

²⁷ http://westlegaledcenter.com/program_guide/course_detail.jsf?courseId=19666306

interested in the topic through their work for DuPont, a company famous for its commitment to reforming the legal profession through what has become known as the DuPont Legal Model. A few years ago, Seyfarth managing partner Steve Poor and other lawyers went out to dinner with DuPont General Counsel Tom Sager to discuss how to increase efficiencies. Sager's advice was crystal clear: you can have an enormous impact if you do this right, but you should not start down this path unless top management is 100% committed to making it work.

Seyfarth decided to make that commitment in 2006, and started a program to adapt Six Sigma management techniques to the legal profession.

Six Sigma was invented at Motorola in the 1980s, and has since been applied by more than two-thirds of Fortune 500 companies to improve quality and reduce costs. It is built around sophisticated tools and methodologies that force people to get to the heart of a problem, and figure out how to improve business processes and save money. For example, at the start of a large matter, in-house lawyers on Six Sigma projects meet with Seyfarth attorneys to "create a 'process map,' perhaps literally on a huge piece of drafting paper, that depicts all the steps involved in completing a legal assignment." Then they discuss how to "eliminate or modify steps to save time and money."

Six Sigma is not a process for law firms that want simple solutions or shortcuts. Seyfarth started with a pilot test training program for 30 lawyers, and found that "the 'off the shelf' version of Six Sigma created cultural and logistic problems in the law firm setting." So they had to create a "lean" version tailored to law firms.

To date, 75 Seyfarth lawyers and staff members (including every lawyer on the executive committee) have been certified as "Six Sigma Green Belts," which "requires completion of an intensive four month training program, and the successful completion of two Six Sigma projects."

According to Lisa Damon, the managing partner of Seyfarth's Boston office and the head of the Six Sigma program:

Traditionally, lawyers have applied the piecework model: the more they produce, the more they are paid. Through Six Sigma, we are learning how to practice an entirely different way. If you get a group of lawyers and staff into a room to discuss how to make things more efficient, it's very easy to find savings.

So that's what they've done. Seyfarth has collected and analyzed an enormous amount of data about past projects in such categories as M&A transactions, real estate acquisitions, real estate leasing, single plaintiff employment litigation, summary judgments, commercial litigation and more. In each

category, groups of up to 40 lawyers and staff have held meetings over several months to define efficient processes, and establish guidelines for how long each step should take. To date, Seyfarth reports that they have developed proprietary processes which have reduced costs by 13% to 50% on more than 75 legal matters, some of them with alternative fees, and some on an hourly basis.

This data analysis has also helped them to discover some interesting and counter-intuitive trends. For example, many general counsel believe that longer negotiations tend to produce better settlements, because it pays to be tough. In fact, when Seyfarth systematically analyzed data from past cases, just the opposite was true: the less time a case was open, the less clients typically paid.

“Clients love it,” Damon reported. “Not only do they save money, but they also get higher quality legal work. And the effect on morale is unbelievable, because this approach gives lawyers permission to do right by their clients.”

However, firms that use fixed fees are still the exception, not the rule. ACC General Counsel Susan Hackett has estimated that more than 95% of legal work is still billed on an hourly basis. But no one knows for sure, and she also noted in an interview with *Law.com*²⁸ that as part of its Value Challenge, ACC has started “some surveying of firms and corporate counsel, to create a baseline so we can go back in a year and see if we’ve moved the needle on any area.”

Accepting risk

By their very nature, contingent and fixed price arrangements involve risk. And lawyers hate risk.

DuPont has led the movement to change the legal service model for nearly 20 years, and may have more experience with alternative fees than any other large corporate buyer. When DuPont held a conference for its outside counsel in June, an article describing the meeting²⁹ was titled “GCs, Law Firms, and Flat Fee Arrangements: A Matter of Trust.” Much of the discussion focused on risk:

“Law firms...must be willing to put some skin in the game,” said Silvio DeCarli, DuPont’s chief litigation counsel. Too often, DuPont gets alternative fee proposals in which a firm makes money if the company loses a case, and even more money if the company wins. “Law firms too often get the idea that

²⁸ <http://www.law.com/jsp/tal/PubArticleTAL.jsp?id=1202426214778>

²⁹ <http://amlawdaily.typepad.com/amlawdaily/2009/06/success-of-alternative-fees-depends-on-trust.html>

they've got to make money on everything, and a lot of it," DeCarli said. "And that's the tension."

As Valorem's Patrick Lamb has noted, when law firms bid on fixed fees, many start by calculating a predicted "cost" based on the number of hours they expect the matter will require, at their standard hourly rates. But those rates already have a substantial profit margin built in. Then the firms increase the bid, to protect against contingencies. The result is a fixed price bid which is heavily weighted in the firm's favor.

Fred Bartlit has compared this risk-averse mentality to oil companies that invest millions in drilling new wells, knowing from the start that many of those investments will turn out to be worthless "dry holes." But, as Fred put it, "At Big Law, there's no such thing as a dry hole." Large firm lawyers expect to make a profit on every single matter, because every hour is billed to the client. Clients may win or lose, but lawyers always win.

Just as oil companies must accept the fact that they may invest millions drilling for oil where there is none, Bartlit says that law firms must accept the fact that in order to win big you have to be willing and able to sometimes lose.

You would think that if anyone understood the need to take risks, it would be the law firms that have been working for DuPont for years. But even at DuPont's conference for outside counsel³⁰:

Who covers costs when a case takes an unexpected turn was a subject of debate. At the conference, some outside counsel said companies have an obligation to ensure their firms don't lose money if a turn of events isn't due to the firm's negligence. Other outside counsel said it's a risk law firms have to live with.

A few large law firms have started to act like entrepreneurs who understand that the client is always right.

After Rob Fields noted in the April panel that "The client needs to win on every fee, every time" there was a spirited exchange on LegalOnramp, a private website for in-house counsel and others, about the wisdom of this approach. Some lawyers asked EXACTLY how Womble Carlyle structured fees to assure clients "winning every time." Naturally, law firms do not want to publicize the details of their pricing tactics to competitors. But Womble Carlyle's Chief Client Development Officer, Steve Bell did describe how Fields is approaching one ongoing engagement where the fee is calculated three different ways, and the client gets to choose the lowest of the three for each matter.

³⁰ <http://amlawdaily.typepad.com/amlawdaily/2009/06/success-of-alternative-fees-depends-on-trust.html>

[The fee is calculated as] an hourly fee, a fixed fee and a productivity/results based fee. The lawyer does not know which will come out lowest until the end, so all three aspects of the representation (cost, efficiency, results) have to be managed. The client wins because it has certainty about the maximum cost, and also pays the lowest cost. The client can use the fixed fee component to shop the representation against the budgets/ fixed fees of other competitors. The client can also budget with confidence. Some lawyers win and some lawyers lose. Low cost efficient providers win. High cost inefficient providers lose. (This result is Economics 101.) The first two components (hourly and fixed fee) are easy. The third component (productivity/results) is what is hard and new for both law firms and clients. It is also the key to the success of this approach because it is the source of the lawyer's incentive to provide good results.

Will this work in the long run? Of course no one knows. But if I could buy stock in law firms, I'd invest my money in the ones that are focused on maximizing client satisfaction for the lowest possible cost.

The cost of doing business

Alternative fee arrangements can help law firms to survive and thrive in the current economy. Aligning the interests of lawyers with their clients produces more stable long-term relationships, and can help firms improve their competitive position.

But these benefits come at a cost. The process can require significant investments, starting with the day firms plan their bids.

According to Guy Halgren, chairman of Sheppard Mullin³¹:

Many law firms...have a hard time pricing bids that work for their clients and are profitable, too. For example, when a firm is asked to bid on a single-plaintiff employment case, it has to know staffing, plus procedural and other costs. Sheppard Mullin has three alternative-fee 'czars' for transactions, litigation and regulatory practices. These attorneys look for opportunities to utilize alternative arrangements.

³¹ <http://74.125.47.132/search?q=cache:hzn7CTeZL4J:www.jdsupra.com/post/fileServer.aspx%3FfName%3D016cf38c-3134-40a2-8ef1-2b14e05262f7.doc+%22alternative+fees%22&cd=90&hl=en&ct=clnk&gl=us>

Large law firms that have made a commitment to alternative fees have also found that it can take significant effort to convince clients to act. When an Inside Counsel article³² explained how Jackson Lewis won Pfizer's U.S. labor and employment work for 2008 and 2009 on an alternative fee basis, it quoted Pfizer's general counsel as follows:

Jackson Lewis got [the work] because they recognized that we needed to find some alternative to billing by the hour. They actually brought it up before we did.

The article went on to describe all the hoops Jackson Lewis had to jump through before they got the work, including:

[Kevin] Lauri [of Jackson Lewis] evaluated the geographic spread of Pfizer cases throughout the country and identified the best partner in each of Jackson Lewis's 36 offices to head up Pfizer's matters in that location. He also compiled a detailed roster of Jackson Lewis's experts in various areas of employment law such as wage and hour compliance, ERISA, and affirmative action. Lauri put all of this data – as well as information and documents for each existing Pfizer matter handled by the firm – on an extranet site dedicated to Pfizer.

Jackson Lewis brought 19 lawyers...from its offices around the country to...[a] meeting with the client. "Without bringing the entire firm, we wanted to make sure Pfizer knew we were dedicated to the process," Lauri says.

The article does not say what all this cost, but it clearly wasn't cheap. That entire investment would have been lost if Pfizer had decided to continue with hourly billing and multiple firms, or had chosen a different firm for its transition to alternative fees.

Significant new investments in marketing and bidding seem especially difficult at a time like this, when law firms are being forced to cut costs. Some firms have been cutting costs for years. According to Ralph Baxter, the chairman at Orrick³³:

"We've got to adapt to changed times." Orrick has changed its staffing model, hiring less costly non-partner lawyers. In addition, in 2002 it consolidated its 'back-office' in Wheeling, West Virginia, to do all tasks that do not need to be done at the same

³² <http://www.law.com/jsp/cc/PubArticleFriendlyCC.jsp?id=1202423790324>

³³ Personal communication, July 16, 2009.

location as the lawyers in a much lower cost environment. The firm has been re-examining how it performs nearly everything it does, to better understand its costs of providing services and pursue a greater level of true economic efficiency.

Value pricing vs. cost-plus pricing

One reason underlying costs are so critical is that most law firms price their services based on variations of the cost-plus model of pricing, in which the client pays the cost of providing a service, plus a profit.

However, some lawyers prefer an alternative model called value pricing, which, according to Wikipedia, “sets selling prices on the perceived value to the customer, rather than on the actual cost of the product, the market price, competitors’ prices, or the historical price.”

And how do you do that? Value pricing guru Ron Baker, founder of the VeraSage Institute, offers many examples in his books and his blog. But he also believes that lawyers often over-think this step. In a blog post entitled “How to value price: Just do it,” Baker advised lawyers to: “Stop analyzing, stop looking for a checklist, a formula, or detailed instructions like this was a piece of IKEA furniture — there aren’t any....Just do it.”

One of the boutiques described above – Shepherd Law – agrees that ultimately prices should be based on the value to the client, not the cost to the firm. For example, success in a case about a secretary fired for chronic lateness is likely to have a lower perceived value than one for a CEO charged with sexual harassment, and that should be reflected in the fee.

Shepherd is such a strong proponent of this type of value pricing that his firm has “tossed their timesheets” and do not even track their time on each matter. “No client wants to buy time; they buy our services, our results.” This idea too can be traced to Ron Baker’s writing. In one blog post about getting away from the cost plus model, Baker wrote:

If you want to become a better pricer, you have to trash timesheets. You have to do other things as well (project management, key predictive indicators, after action reviews, leadership, etc.), but there’s no doubt in my mind, if you are serious about creating and capturing value, the timesheet must be buried.

I used to not believe this. I used to say, “Keep your timesheets, but use them as they were originally intended, as a cost accounting tool only, but price on value.” I no longer say this, because empirical evidence has changed my mind.

The best pricers across all Professional Knowledge Firm sectors—from accounting and law, to advertising and IT firms—all have one thing in common. None of them maintains timesheets.

I used to believe this is because they became so good at pricing, timesheets became superfluous. But I now believe that they became good at pricing precisely because they got rid of the timesheet, which forced them out of the “we sell hours” mentality and made them obsessed with value.³⁴

When the matter of trashing timesheets was discussed at the March webcast, Shepherd was the only proponent. The other three firms do track hours to establish benchmark costs for handling new matters, and to see how well they did at the end of each matter. Bartlit & Beck refuses hourly work, no matter how high the rate, but both Valorem and Raymond & Bennett have a mix of alternative billing and hourly work. Both do some work for insurance companies, whom Patrick Lamb said will be “the last industry in America to abandon hourly billing.” Bruce Raymond also quoted the example of a big Pharma company who was interested in alternative fees, but needed hourly records to provide empirical evidence. “Show me how it saves money,” this client said, “so I can convince my finance and procurement people.”

Based on my own experience running a consulting firm for more than 23 years, it would be hard to imagine doing away with timesheets. The smaller the company, the easier it would be. But even when I was the only employee when I first started my company, if I signed a contract for a complex or unpredictable job at a fixed price, I tracked my time so I could analyze profit or loss at the end.

In my experience, the more employees I had working for me, the more important timesheets became in tracking productivity and profitability.

Both law firms and their clients have several decades of experience thinking about cost in terms of the hours each matter will take. And there are good reasons for this approach, since ultimately most of the cost of doing the work will depend directly on the number of hours it takes, and the salaries lawyers are paid. In my opinion, asking law firms to throw this experience out the window is counter-productive.

³⁴ http://www.verasage.com/index.php/community/ask_verasage_why_carthage_must_be_destroyed

To get better at pricing, you need to measure which matters produce the largest financial returns, and which people within the organization do. Tracking the time and money spent on each matter is the simplest way to measure that financial return.

Perhaps some day the legal profession will change so radically that value pricing will become the dominant system. But in this economy, most firms will need to focus on the short run, on generating enough revenue to survive and prosper with cost-conscious clients. And to accomplish this, they will need to learn how to win with fixed fees, by starting from a cost-plus estimate.

Eight steps to succeed with fixed fees

If a fixed fee is the best way to get a particular bit of business, this step-by-step process provides a starting point for maximizing success, based on best practices from other law firms and other professions.

Step 1. Identify the matters that are most suitable for a fixed fee

Some legal matters are much easier to handle on a fixed price basis than others. Shomper and Courson note:

It makes sense to start with fairly predictable, repetitive cases; for example, slip-and-fall cases for a retail store chain. Outside counsel should evaluate the cases it has handled in the past and gather pertinent data that will be needed to structure the alternative fee arrangement, such as average case cycle time, amount spent in the discovery phase, success in dismissing cases or obtaining summary judgment, frequency of trial, and cost of trial.

Step 2. If necessary, break down large matters into smaller ones

If it is too risky to quote a single price for a large matter, consider whether a fixed price could be charged for sub-stages, such as separate fixed fees for interrogatories, pretrial motions and/or summary judgment motions.

Step 3. Select the best clients for this approach

From a marketing perspective, there is only one good reason to offer a fixed fee: because the client wants it.

Business development is all about advancing relationships with the right people. So it may be useful to ultimately raise the subject of fixed fees with

each of your clients. At an absolute minimum, a discussion of alternative fees is a great excuse to spend time with clients understanding what they truly want and need.

However, there are also reasons for caution. Do not open the discussion if you are not willing to proceed. You can't put the genie back in the bottle, and once you get a client thinking about fixed fees, it may be difficult to continue on an hourly basis.

If you are just starting to experiment with this approach, you may want to start first with your B and C clients, to work the bugs out of the system. Approach your A clients only when you have a proven track record of success.

Despite the benefits of predictability, some clients will not be interested in this approach. They may be risk averse by nature, comfortable with hourly billing, and unwilling to take a chance on lawyers cutting corners to stay within budget. But every client will appreciate an offer to discuss fixed fees, if only because it shows that you are looking for better ways to meet their needs.

Step 4. Identify factors that drive cost up, and consider how you might control them

Shomper and Courson also note that in fixed fee work it is important for all parties to be aware of the factors that:

...make one case more costly to litigate than another. It may be motions practice in a class of cases in which motions to dismiss or for summary judgment are frequently used. It may be depositions in a class of cases in which gathering the testimony of numerous witnesses is necessary. Whatever the cost driver, inside and outside counsel need to consider it carefully and think creatively about ways to achieve the desired result at a reduced cost.

If depositions are driving the cost of litigation, inside and outside counsel might consider whether fewer depositions can be taken. For example, some third-party witnesses could be interviewed, if willing, instead of deposed, with a resulting lower cost. The cost of depositions can be reduced by making an intelligent and informed analysis of the risk involved in not taking depositions of certain witnesses. Rather than turning over every stone in an effort to find every possible piece of relevant information, the client may be willing to take a small risk of an unpleasant surprise later in the litigation in exchange for cost savings now.

If simple specification of key cost factors can be added to the definition of a fixed fee, it will dramatically increase the chances of a mutually satisfactory

outcome. In addition, a clause as simple as requiring in-house counsel to identify a single decision-maker can avoid an enormous amount of inefficiency and waste.

Step 5. Set the price

Now the moment of truth: what will you charge for this work?

This is the most important step, and the hardest.

Lawyers often ask how to structure fixed fee contracts to eliminate risk. The short answer is: you can't. By their very nature, fixed fee arrangements involve predicting the future. With fixed fees, you must accept the reality that sometimes you will win and sometimes you will lose.

Most firms start from a cost-plus model, in which you “simply” estimate what you think it would cost to perform the work on an hourly basis, and then add a safety margin to cover unexpected developments and profit. The size of the safety margin will depend primarily on your market. The stronger the competition, the smaller your safety margin will be, because you will need to assume more risk to offer a competitive price.

Patrick Lamb has noted that when lawyers do this math in the real world, it often leads to an inflated price rather than a lower one:

To start with, hourly rates include a very hefty profit margin. The lawyers also have no incentive in calculating the fee to be skinny on the hours. The problem is then compounded by “adding a safety margin” (the proper translation of this is “more profit”). So law firms typically come up with a fixed fee that guarantees them more profit under the fixed fee approach than they would get under the traditional hourly system.

What risk has the firm assumed in this approach? None. Well, some might say that ‘what if’ the case turns into a runaway train? Most who quote a fixed fee identify the assumptions on which the fee is based and if those assumptions change, will submit a modified proposal. So, in the end, very few firms assume any real risk.

The thing that makes a winning fixed fee agreement is a quote that is lower than the fee that would be paid under an hourly basis, which then creates a huge incentive for the firm to do the work at a lower cost (and I mean cost in the traditional sense of the word, not

the lawyer sense) so that the firm increases its profit margin.
Client wins. Firm wins.³⁵

When you are preparing a fixed fee bid, the most important goal is to win the work, while bidding a price that makes business sense for your firm. Unless you see the work as a loss leader that opens new doors, you must at least cover your costs. Starting out by estimating the hours the work will take is the key to doing this.

But, as noted above, if you start with the hourly rates clients pay, you will be including both your true cost of doing business and profits. If you then add a conservative worst-case safety factor, the fee is likely to be unreasonably high, and you will probably not get the business, especially as other firms get better at fixed fee pricing.

Another problem is that legal matters are often not simple at all, and many lawyers have little experience trying to estimate costs. As Frederick Krebs, president of the Association of Corporate Counsel put it in a *New York Times* article entitled “Billable hours giving ground at law firms,”³⁶ “Many lawyers may not be good enough businessmen to pick the right price.”

Similarly, Fred Bartlit, founder of Bartlit Beck, wrote on *Legal OnRamp*:

Almost NO ONE knows what tasks should cost done right. I usually ask meetings of General Counsel and other inside lawyers, “What should it cost to prepare for and take the deposition of an economic expert in a \$100 million antitrust case”; I get answers ranging from “\$30,000 to \$500,000 in the same room.” So, to me, we have a dramatically atypical situation facing us: a huge market that is not competitive, that does not foster innovation in business processes, and has NO useful metrics for comparing efficiencies of different competitors or calculating roughly what various aspects of litigation SHOULD cost.

Clearly, the more you know about a situation in advance, and the more control you have over the way it will develop, the easier it will be to determine a reasonable fixed fee.

Ian Shrank, a partner at Allen & Overy, says that the best way to start is to:

Make assumptions about as many objective factors as you can think of, such as the number of months to complete the matter,

³⁵ <http://www.patrickjlamb.com/archives/commentary-the-problem-with-most-fixed-fee-proposals.html>

³⁶ http://www.nytimes.com/2009/01/30/business/30hours.html?_r=2&scp=1&sq=Billable%20hours%20giving%20ground%20at%20law%20firms&st=cse

travel needs, number of meetings, number of drafts of documents, number of depositions. Also include some softer considerations if they are feasible, such as how hard the other side negotiates.

And if both sides agree that the fixed price is contingent on certain assumptions, be sure “to alert the client right away when an assumption is being violated, noting this may result in an adjustment to the fixed fee. This is the single most important rule about fees — no surprises! Always keep the client informed about the progress of the fee.”

In complex cases, it is wise to estimate scope for two different scenarios: the best case and the worst case. If those predictions are too far apart, try again by breaking the matter down into smaller stages, or specifying factors you could control that would affect cost.

But avoid the trap of spending too much time on this step. There is no right answer, so just come up with a reasonable cost estimate, and move on.

Once you master the basics, how can you improve your pricing? Practice, practice, practice.

In his description of “Creating the Law Firm of the Future,” Ralph Palumbo, founder of the Summit Law Group, says:

To be truly innovative, you have to learn to make your mistakes faster...every Summit lawyer has authority to propose any pricing system that the lawyer believes will match the Firm’s incentives to the customer’s goals. If an innovative pricing arrangement works well in one matter, we use it again. If a pricing arrangement doesn’t work, we change it to one that does and don’t repeat our mistake.

So, at the end of the day, when you set a fixed fee, you will have to come up with your best guess, and move on. Then keep the agreement as simple as possible, because fixed price agreements work best in an atmosphere of trust.

Step 6. Protect yourself with a “safety valve” clause or change order

Sometimes, things happen, and costs go up.

The traditional approach to this in most fields is to issue a change order in which both parties agree that the work went beyond the original scope and the client agrees to pay additional costs. Needless to say, this often requires some negotiation.

A better way to go is to start by setting an upper boundary “safety valve” that defines the maximum amount of work that will be delivered within the price.

For example, suppose a firm defines a fixed price of \$30,000 for a matter that you predict will require 100 hours of work at an average rate of \$300. Add a clause that says both parties agree that no more than 150 hours will be delivered for the \$30,000. If the hours exceed 150, both parties agree to renegotiate the price.

That protects the firm from charging less than \$200 per hour (\$30,000 for 150 hours) in the absolute worst case, and also gives the client motivation to avoid unreasonable requests. When a project is bid, it also has a powerful psychological effect, in that some clients will do the worst case math, and perceive the \$200 per hour limit as the true cost.

As the project proceeds, it also takes most of the arguing out of change orders. Both the client and the law firm can review actual hours spent in each phase of the project, compare them to budgeted hours, and discuss what might be changed BEFORE a project goes over budget.

Step 7. Manage the work to a successful conclusion

With hourly billing, there is little need for efficient management. In fact, the less efficient you are, the more money you will make in the short run, as long as the client is willing to pay. But in fixed price work, it is absolutely urgent that matters be completed within budget. This is a totally different mindset, which has the potential to change everything about the way law firms operate, and how lawyers are compensated.

A discussion of the best ways to apply project management principles to legal matters could be the basis for another long LegalBizDev Guide or two. For now, the most important advice is to keep records of the hours worked on each matter, and where you stand in relation to the original budget.

Step 8. Review the results

The best way to learn how to do better in the future is to study the past. When you close each file, meet with all the lawyers who worked on the matter, and discuss how to do better the next time.

When you do a financial review, you may find you’ve done better than you would have with hourly billing, or you may have done worse. But as long as you are covering your true costs of doing business, you will be better off in the long term. If alternative fees help you to keep clients loyal in a very tough economic environment, you are already winning.

Structuring contingent fees

In contingency arrangements, fees depend on success. Of course, this approach has long been used by plaintiffs' lawyers, but it is now becoming more common for the defense.

For example, Duane Morris³⁷ billed on a contingency basis when it defended Eli Lilly in a \$1.4 billion whistle blower suit over allegations of improper marketing of an anti-psychotic drug. An online account³⁸ of that suit noted that:

For at least the last decade, [Duane Morris] has focused about 4 to 5 percent of its billable time on contingency fee or other matters with alternative billing structures. And throughout that time it has cultivated a process for assessing risk and potential rewards. The firm will only take large commercial cases with a minimum fee of \$1 million. There must be a 75% probability of success as determined by the firm's attorneys and contingent fee committee, and an opportunity to get three times the firm's recorded time.

When structuring contingent fees, some prefer very simple approaches, as described in the boutique section above. For example, Bartlit Beck bills a substantial portion of its fee at the end of each litigation. Depending on how satisfied they were with the result, clients may choose to pay the remaining amount of the original estimate, or a larger amount, or a smaller one, or nothing at all. Similarly, the Valorem Law Group includes a "Value Adjustment Line" on every monthly invoice. Clients can add or subtract whatever they think is fair to reflect the value they have received. Each client bases the fee on results and satisfaction, and is the one and only decision maker.

At the other extreme, some clients have developed complex models to mathematically tie rewards to success and results, notably FMC Technologies' Alliance Counsel Engagement System (ACES). As described in an article in the May 2008 issue of *ACC Docket*,³⁹ alternative fees guru Jeffrey Carr "has increasingly applied the ACES model to all outside legal matters [at FMC Technologies] since...2001." In one example:

³⁷ <http://duanemorris.com/>

³⁸ <http://finance.yahoo.com/news/For-Large-Firms-Alternative-law-15342292.html?.v=1>

³⁹ Wolf, Mark & Notestine, Kerry. "Controlling outside counsel costs through an alternative billing model," *ACC Docket*, May 2008, p. 70-84.

The company withholds a portion of the fees incurred by the law firm and at the end of a predetermined period or the conclusion of the matter, the company conducts a performance appraisal of the work done by the law firm....The law firm is rated from one to five with five being the highest score on a number of predetermined criteria. If the law firm scores “average,” or a three, then the company pays the withheld amounts. If the law firm performs better than average, then the law firm receives a corresponding premium on the amount withheld. If the law firm scores lower than a three on the performance evaluation, then it receives a reduced amount on the amount withheld.

The article even includes tables showing how the math worked for a number of matters handled by Littler Mendelson⁴⁰. One table shows their ratings on six scales from an actual matter: understood goals, expertise, efficiency, responsiveness, predictive accuracy, effectiveness. It also shows how those numbers were used to calculate a 1.67% premium on the final fee for that matter. The article goes on to explain that:

Littler Mendelson and FMC Technologies have used this basic ACES concept in three working relationships. These include general employment and benefits advice under a retainer arrangement; project work such as union campaigns, OFCCP audits, or purchase and sale matters; and employment law litigation. The general ACES concept differs in each relationship but is based on the same general model.

Which is better for contingent arrangements, the simplicity of the value line adjustment or ACES’ detailed mathematical precision? Personally, I prefer the simplicity of “less is more.” But it doesn’t matter what I think, it matters what clients think. Large firms must be prepared to offer both simple solutions and complex ones to meet a variety of needs. The client is always right.

Win-win or win-lose?

When a law firm agrees with a client on an alternative fee arrangement, both sides usually see it as a win-win for the long term. That’s why they reached the agreement. But what about the short term? Are fixed and contingent fees a good way for law firms to produce greater short-term profits while clients simultaneously pay less?

⁴⁰ <http://www.littler.com>

Of course, the answer varies from case to case. But when law firms talk publicly about the topic, they often focus on the win-wins.

In an article entitled “Alternative Fees for Litigation: Improved Control and Higher Value,”⁴¹ James D. Shomper and Gardner G. Courson argue that “if properly structured, an alternative fee arrangement should result in a win-win scenario for client and law firm.”

That is an excellent goal, and it is certainly possible in some cases, especially for litigators. For example, when Howrey represented Chinese cell phone battery maker BYD, an article on alternative fees⁴² noted that:

[Partner Henry] Bunsow said Howrey was confident that it could get a favorable outcome defending BYD and felt comfortable agreeing to a hybrid contingency. The terms were that Howrey would charge a discount on its estimate for the trial and receive a bonus if either they prevailed in court or reached a low-cost settlement.

The decision paid off. In 2005, the case settled before going to trial for “less than the value of one day's production” at BYD's battery plant, Bunsow said. That earned the trial team a celebratory trip to China and a cool million-dollar bonus, which bumped the firm's revenue from the case 50% higher than it would've been with plain old billable hours, he said.

Similarly, when the New York Times⁴³ wrote about alternative fees a few months ago⁴⁴, they quoted Carl A. Leonard, a former chairman of Morrison & Foerster and now a senior consultant at Hildebrandt about its profit potential:

In one case...Morrison & Foerster negotiated a fixed fee for defending a company in court, covering work up to the point of a motion for summary judgment.

On top of the fee, if the case settled for less than what the company feared having to pay if it lost in court, the law firm got a percentage of the amount saved. The arrangement made sense when the goal was to resolve the dispute quickly....

Lawyers on the case negotiated a settlement for much less than the client's worst-case number, Mr. Leonard said. “The effective

⁴¹ http://www.dupontlegalmodel.com/onlinelibrary_detail.asp?libid=96

⁴² <http://www.law.com/jsp/article.jsp?id=1184058401567>

⁴³ <http://www.nytimes.com/>

⁴⁴ http://www.nytimes.com/2009/01/30/business/30hours.html?_r=3&pagewanted=2&partner=permalink&expprod=permalink

hourly rate was something like 150 percent of our hourly rates,” he added. “We made money, the client was happy.”

It is especially easy for law firms to win with alternative fees when demand is high. In 2007, David Lat wrote a piece in the *New York Times Dealbook* entitled “When \$1,000 an Hour Is Not Enough,”⁴⁵ explaining that when “the boom rolled on, law firms specializing in mergers and acquisitions increasingly engaged in premium billing, charging fees in excess of their total hourly billings.”

One of the firms Lat spotlighted was Wachtell Lipton whose profits were typically around \$4 million per partner during this period. They had “moved beyond billable hours to the flat fee preferred by bankers.” A former Wachtell lawyer described a typical bill as follows: “there’s a paragraph stating something like, ‘For legal services rendered in connection with Transaction X,’ then a dot leader, then a number followed by six zeros.”

In his blog *Adam Smith Esq.*, Bruce MacEwen offered another reason why very successful lawyers should consider fixed fees:

If financial services comprise a substantial part of your clientele, look forward to their being more heavily regulated than before. With congressional oversight. Care to explain to, say, Barney Frank, why \$1,000/hour is a fair and economically justified rate? Wouldn’t you far prefer to explain why (say) \$750,000 as a flat fee on a \$50-million transaction is reasonable?⁴⁶

Although it is possible to make more with an alternative fee, these days most firms don’t. When Altman Weil⁴⁷ released their Law Firms in Transition survey⁴⁸ in June 2009, they reported that:

When asked about the profitability of non-hourly work, only 15% of firms reported that non-hourly projects were more profitable than those billed at an hourly rate.

At the other extreme, 24% of the 208 respondents said alternative fees were less profitable. When the results were broken down by firm size, large firms did even worse. Six of the firms who responded to the survey had more than 1000 lawyers, and three of them (50%) said alternative fees were less profitable than hourly work.

⁴⁵ <http://dealbook.blogs.nytimes.com/2007/10/03/when-1000-an-hour-is-not-enough/?pagemode=print>

⁴⁶ http://www.bmacewen.com/blog/archives/2008/12/rumors_of_my_death.html

⁴⁷ <http://www.altmanweil.com>

⁴⁸ http://www.altmanweil.com/index.cfm/fa/r.resource_detail/oid/fd6a643c-3b55-4dff-b6aa-e598a590a507/resources/New_Survey_Measures_How_Law_Firms_Are_Weathering_the_Storm.cfm

As discouraging as those figures are, I suspect they seriously underestimate the problem. Asking business people about profits is a bit like asking gamblers about their trips to Vegas. Due to selective memory and selective reporting, you are likely to hear much more about wins than losses.

In explaining the survey's results, Altman Weil's Tom Clay noted: "Most [law firms] still haven't figured out how to structure and staff projects so they are more profitable – which they can be, if done right."

While this is certainly true, in my 24 years of experience running fixed price and hourly projects in my own business, I have found that consistently profiting from fixed fee work is an enormous challenge, and a struggle that never ends.

In the hundreds of fixed fee projects we've performed, the vast majority were a zero-sum game. In the short run, when the project was over, one party did better than they would have on an hourly basis, and the other party did worse.

Fixed price projects generally begin with planning a budget upfront, and then managing the work to keep within that budget as the project proceeds. When my company was billing by the hour, I found it relatively easy to manage employees to maximize profitability. But during periods with a significant amount of fixed price work, it became extremely difficult to juggle dozens of projects with ever changing deadlines in such a way that everyone remained billable, and projects stayed within budget. And during mixed periods, when some of our projects were fixed price and some were billed hourly, it was an absolute nightmare, because employees had to turn their efficiency on or off, depending on the project.

Lawyers have been rewarded for their entire careers for putting in extra hours to analyze every risk from every possible angle. Most lawyers will have a hard time delivering the quality they are comfortable with when they must work within hourly limits. And large firm managers will have an even greater challenge when they try to juggle staff on dozens or hundreds of projects with constantly shifting deadlines. Traditionally, firms expect lawyers to be consistently productive 1600 or 1800 or 2000 hours per year. If firms shift a significant portion of their work to a fixed price basis, many will find those goals unreachable.

At the same time, it is also getting harder to protect profits as competition increases, prices go down and margins get squeezed. In the current economy buyers are the ones with the power. And they often use that power to cut costs. For example:⁴⁹

⁴⁹ <http://www.law.com/jsp/PubArticle.jsp?id=1202425964422>

By working with outside counsel on alternative-fee arrangements, Cisco has managed to reduce its legal fees as a percentage of the company's revenue by more than 20% during the past five years, according to Mark Chandler, Cisco's general counsel.

Similarly, Pfizer has reported:⁵⁰

“substantial double-digit reductions in spending” even though matter counts had more than doubled from 2005 to 2006, and then jumped by close to a third from 2006 to 2007. How did Pfizer keep spending down? “Flat fees, volume discounts, and value-based assigning...”

When both inside and outside counsel talk about alternative fee arrangements, I predict they will continue to accentuate the positive, and focus on win-wins. People will speak most freely about the matters that make them feel good and look good, whether in terms of higher profits compared to hourly rates, or in terms of other benefits. But in my experience as a business owner, when one side wins a revenue concession, the other side loses money, at least for the short term.

In competitive markets, business people expect to invest in new business and to take risks. Pharmaceutical companies invest billions in drugs that never make it to market. But most law firms have done very well for themselves while minimizing risk. In 2007, the average profit per partner at AmLaw 100 firms⁵¹ was \$1.3 million. Change will come hard. As Richard Susskind notes in his book *The End of Lawyers*⁵² (p. 280), “It is not easy to convince a group of millionaires...that their business model is wrong.”

But a few leading law firms have started to prepare for a new and more challenging future. According to a June 2009 *National Law Journal*⁵³ article entitled *Kirkland expands use of special fee structures*:⁵⁴

During the past three years, the firm says it has given away more than \$100 million worth of billable hours, but it hopes to make the revenue back through follow-up work from those clients.

Naturally, Kirkland⁵⁵ did not want to reveal all the details of its strategy to competitors, so the article left readers with many questions. How much of the

⁵⁰ <http://www.law.com/jsp/cc/PubArticleFriendlyCC.jsp?id=1202423790324>

⁵¹ http://abajournal.com/news/amlaw_100_profits_up_partners_down

⁵² <http://www.amazon.com/End-Lawyers-Rethinking-Nature-Services/dp/0199541728>

⁵³ <http://www.law.com/jsp/nlj/index.jsp>

⁵⁴ http://www.law.com/jsp/nlj/PubArticleNLJ.jsp?id=1202431436597&Kirkland_expands_use_of_special_fee_structures&slreturn=1

⁵⁵ <http://www.kirkland.com>

\$100 million “give away” was based on fixed and contingent fees and how much from the types of blended rate discounts that all large firms are forced to offer every day? How many of those dollars represented new out of pocket costs, and how many came from associates and partners simply working more hours for the same base salary? But whatever the answers are to questions like these, the fact remains that a \$1.6 billion firm is making a massive bet that the future will be tougher, and that they need to invest more in client relationships.

We live in a world that is changing rapidly. Large law firms like Kirkland are investing heavily in new tactics, and legal clients like Pfizer are paying less while doubling the work. In this environment, I believe that alternative fee arrangements should not be seen primarily as a win-win way to increase profits. But they are an absolutely essential tactic to generate cash flow and to survive in an ever more competitive world.

As Jordan Furlong, Editor-in-Chief of the Canadian Bar Association’s National magazine noted in a comment on a post in my blog:⁵⁶

It may come down to how we define “winning.” I think a win-win alternative-billing scenario right now might look like this: the client wins because it reduces its outside legal spend, or at least improves its legal cost certainty, and the law firm wins because it gets to keep the client for one more day. That’s not the kind of victory lawyers are accustomed to settling for, but I think they ought to get used to it.

I think Patrick Lamb nails it when he identifies the phenomenon of lawyers seeking a guarantee that they’ll turn a profit no matter what billing structure they use. Essentially, they won’t use a billing system that will reduce or eliminate their profitability under their current structure, and they make it the client’s problem to figure out an answer to that.

This will pass, with difficulty, and the new paradigm eventually will see lawyers rearranging their internal processes to keep costs as low as possible, so as to turn a healthy profit in what will be, if not a full fixed-fee marketplace, at least a marketplace where the default setting for lawyers’ bills is predictability, not unpredictability, as it now is. Lawyers should count themselves lucky if their future doesn’t involve clients dictating legal fees downright capriciously.

⁵⁶ http://adverselling.typepad.com/how_law_firms_sell/2009/06/alternative-fees-part-16-winwin-or-winlose.html#comments

Resistance to change

Many law firms that have made a commitment to the approach are still waiting for definitive proof of the payoff — that more clients will come to them with more business. One law firm told me off the record about an RFP competition that they are currently involved in. The firm had explained their alternative approach, and the client seemed convinced that the total cost of a project was more important than the average hourly rate. But then the procurement people got involved, and the RFP said that whoever bid the lowest hourly rates would win the work.

This sort of mixed message is not uncommon in times of transition. Alternative fees are at the pioneer stage, and there's an old saying in venture capital circles that "pioneers are the ones with the arrows in their backs."

There is no question that law firms can significantly lower client costs by changing their approach. But the jury is still out on whether they can overcome the conservatism of inside counsel who are accustomed to hourly billing. According to Steve Nelson of the McCormick Group, "efforts to embrace value billing are often opposed by in-house counsel, who often fear that value billing is a way for outside counsel to boost fees in a way that can evade effective oversight."

And, as Seyfarth's Lisa Damon put it, "the whole revolution rests with the client....If clients change the buying process, it will forever change the way law firms do business." Damon believes that this is a critical year for seeing whether the change actually occurs, given the pressures of both the ACC Value Challenge and the economy.

Similarly, in the April panel on alternative fees, expert views of the speed of change ranged from guarded to discouraged.

Harry Trueheart⁵⁷ noted that at Nixon Peabody,⁵⁸ "we got involved in alternative fees more than two decades ago. When people started talking about this, we got out in front. We wanted to go with the flow and not resist. But the flow was not as strong as we expected."

Similarly, Fred Bartlit⁵⁹ reported that when he left Kirkland & Ellis to found Bartlit Beck⁶⁰ 16 years ago, he thought that once the benefits became known, change would come quickly. It didn't.

⁵⁷ http://www.nixonpeabody.com/attorneys_detail1.asp?ID=556

⁵⁸ <http://www.nixonpeabody.com>

⁵⁹ <http://www.bartlit-beck.com/lawyers/bio.asp?whichid=B320629299&type=f>

Other experts have offered similar observations. Last November, Law.com interviewed Susan Hackett⁶¹, general counsel of the Association of Corporate Counsel, about the progress the ACC Value Challenge was making in promoting alternative fees. According to Hackett, “Lots of clients’ lips are moving, but their feet aren’t moving.”

On the West panel, Richard Rosenblatt⁶² reported that at Morgan Lewis,⁶³ “we are pursuing alternative billing very aggressively. We offer a veritable smorgasbord of billing options, and we believe that virtually all matters can be structured with alternative fees. The biggest challenge is that clients are nervous about entering new territory. They always ask, ‘Will this cost me more or less than hourly billing?’”

Of course that’s a perfectly reasonable question for a client to ask, and Morgan Lewis has devised several ways of minimizing the risk for both sides. Some of their fixed fee arrangements include “risk collars,” which compare the fixed fee to the actual hourly expenses. In one example, “If the hourly expense is less than the fixed price, we offer a rebate. If it’s more than 20% over, the client gets the first 20% free, but might pay half of whatever is over 20%.”

According to Rob Fields⁶⁴ of Womble Carlyle,⁶⁵ fees “must be transparent so the client can see that they won and they can defend the cost to their business people.”

Unfortunately, in some cases it can be very hard to prove that fixed fees lead to lower costs than hourly rates. For example, alternative fees sometimes represent a paradigm shift in which clients are more likely to avoid legal problems by seeking early advice. But how could you *prove* that problems were avoided and money saved? Ultimately, fixed fee arrangements must be built on a foundation of trust, and trust is not the long suit for many lawyers.

Fields reports that at Womble Carlyle the deals that have worked out the best are the ones that were client-driven. “It doesn’t mean the client has to come with the nuts and bolts of how this works. The law firm may have those answers, but the client has to bring to us a clear idea of what they expect to achieve.”

⁶⁰ <http://www.bartlit-beck.com/>

⁶¹ <http://www.law.com/jsp/PubArticle.jsp?id=1202425964422>

⁶² <http://www.morganlewis.com/index.cfm/personID/18f72783-e860-44ca-8749-012b81bf9d3d/fromSearch/1/fuseaction/people.viewBio>

⁶³ <http://www.morganlewis.com>

⁶⁴ <http://www.wcsr.com/lawyer-bio.php?id=128>

⁶⁵ <http://www.wcsr.com>

In a follow-up discussion on Legal OnRamp,⁶⁶ Patrick Lamb,⁶⁷ co-founder of the Valorem Law Group,⁶⁸ said that:

The reasons clients have been slow to move to alternative billing are complex. Inertia is a factor, as is fear of the unknown, and the fact that alternatives typically require a bit more upfront investment of time. It's easier, in some respects, to just send someone a copy of a complaint and wait for the bills to arrive than to work to find out how serious the matter is and work out an appropriate fee (an exaggeration to be sure, but it illustrates the point). But these obstacles are being surmounted more and more, with push coming from the CEOs and CFOs of the corporate world. One of the things they are finding is that performance actually improves when the payment scheme values experience and results rather than body count. This, more than anything, provides the comfort inside counsel are looking for. So does the fact that most lawyers who use alternatives as the core of their model are typically willing to trust the client when it comes to determining the final fee amount.

According to Caren Gordon, Executive Director of the Legal and Governance Practice of the Corporate Executive Board:⁶⁹

Alternative fees have been slow to catch on for a number of reasons. The most dominant drivers from my observation are that they require more time to set up, more internal research into historical expenditures or conversations with outside counsel about what a matter truly costs, monitoring to ensure that they work, and final determination at the end.

That said, when the structures are perceived by both parties to be more easily deployed (i.e., "We have a method for calculation. This is the way we do business. We provide transparency to you as to up and down side," etc.), we see them gaining traction. The critical component is having aligned incentives, making sure that both parties have the same stake in achieving positive and/or quick, optimal outcomes.

Given the recent downturn, General Counsel are under much more pressure to manage cost with a discipline that re-opens the investigation into how and why alternative fees might work.

⁶⁶ <http://www.legalonramp.com/>

⁶⁷ <http://www.patrickjlamb.com/archives/cat-about-patrick.html>

⁶⁸ <http://www.valoremllaw.com/>

⁶⁹ <http://www.executiveboard.com/>

Jeffrey Carr,⁷⁰ General Counsel at FMC Technologies⁷¹ took a stronger view:

Despite constant whining and complaining from the client, not much has changed. In my view, the reason for inside counsel's resistance is really rather simple – the in house community has abdicated its responsibility to drive efficiency as well as effectiveness because of the widely held belief that law and legal services are somehow “different”. Whether fear, complacency, risk aversion, inertia, lack of creativity or vested interest in the status quo has gotten us to this heinous place doesn't really matter. The question is have we really decided to move?

I submit that we have and that a growing number of in-house counsel are joining the effort. The ACC Value Challenge is perhaps the most visible and important manifestation of that effort and movement – but it's not the only one. Each GC needs to make a focus on value the driving force of the legal function and each and every in-house lawyer needs to engage in open, honest communication with their outside firms about expectations, performance, value and compensation. Absent those actions, the more things change, the more they'll stay the same.

Although progress may be slower than some would hope, many experts believe that this is the wave of the future. As Fields summed it up, “Alternative fees are necessary, a good thing, and inevitable.”

A new business model

When I asked the experts on a March 2009 panel what advice they would give to lawyers who are considering alternative billing, all four emphasized that switching to alternative fees is not a small step or an easy one. Jay Shepherd, founder of Shepherd Law Group, said lawyers find it particularly hard to accept the fact that, “pricing is an art, not a science. You learn from your mistakes....Think of alternative billing not just as a change in your billing,” Shepherd advised, “think of it as a fundamental change in your business model.”

With traditional law firms, whether clients win a case or lose, the lawyers always win by billing more hours. But law firms that rely on alternative fees

⁷⁰ <http://www.fmctechnologies.com/Overview/Officers/JeffreyWCarr.aspx>

⁷¹ <http://www.fmctechnologies.com/>

are working hard to align their interests with client interests. And that means that sometimes, as Valorem Law Group founder Patrick Lamb put it, “if you lose the case, you’ll lose money. You’ve got to accept that.”

This leads to a totally different mindset in which Valorem lawyers constantly look for ways to provide services more efficiently. They even “police each other,” and openly discuss tactics such as who really needs to be deposed, and who doesn’t?

Fred Bartlit, founder of Bartlit Beck, said that there is no simple formula for setting alternative fees, and that “every deal is different.” But his firm structures each fee to maximize the incentive to be efficient. “If I lose, it comes out of my pocket.”

This mindset is familiar to plaintiffs’ lawyers who live and die on contingencies. They’ve learned to be hard-headed business people, and won’t accept a case unless they think they can win. But elsewhere in the legal world, the billable hour model has inevitably led to inefficiencies, because the more hours you bill, the more you make.

In an economy that has clients screaming for lower prices, lawyers would be wise to lower costs. And that means more than just reducing the number of billable hours. When Bruce Raymond founded Raymond & Bennett, he decided to adapt the Wal-Mart model of cutting out steps throughout the process of service delivery, including “becoming a fully digital, paperless office,” eliminating support staff and hiring a mix of virtual associates who work from their homes and traditional “brick-and-mortar” associates. “You have to get a firm set up for alternative fees,” he said, and that starts by cutting costs to the bone. Being scalable with professional and support resources introduces a lean “just in time” concept to law services delivery.

At Bartlit Beck, there is no management committee, and “one guy (Sid Herman) runs the entire firm, from deciding which cases to accept to setting the price and staffing each matter. We have no firm meetings and no conferences; Sid runs everything.”

Bartlit noted that some big firms traditionally hire over 100 new associates per year, and that most leave within a few years. This means a significant portion of the firm’s workforce is inexperienced. “Who cares? Their inefficiency is billable,” he said. “In the future, the ideal firm will be underleveraged with about 50 partners and three associates in training.”

This is such a fundamental change in mindset that Bartlit thinks it will work best in “greenfield” operations, where a new law firm is started from scratch to focus strictly on alternative fees.

Predicting the future

As Nobel physicist Niels Bohr once said: “It is very hard to predict, especially the future.”

Legal gurus have been incorrectly predicting the rise of alternative fees for so long that there is widespread skepticism about how quickly change will occur, or even whether it will occur. When *The American Lawyer* published its Law Firm Leaders Survey in December 2008, they noted that while there was a lot of confusion in the marketplace, “the one thing of which managing partners are certain is that alternative fee arrangements will not unseat the billable hour, even in economic turmoil. ‘Stop writing that story, it’s never going to happen!’ [said] one managing partner of a West Coast firm.”

According to data published by Altman Weil in June 2009, “the pace of change toward non-hourly billing is accelerating.” In 2008 and 2009, Altman Weil asked in-house counsel what percent of their budgets for the preceding year were not hourly. They reported that in 2008, 27% said that more than 10% of the legal fees they paid in the preceding year were non-hourly. That figure increased to 43% of departments in 2009.⁷²

At the 2008 conference of the Legal Marketing Association, The BTI Consulting Group reported a survey of corporate counsel which looked at differences between practices. Using a definition of alternative fees that included negotiated (i.e. discount) rates, they found the greatest use in litigation (35%), followed by M&A work (12%), corporate finance (8%), and labor and employment (6%). When alternative billing was employed, the most common approach was fixed fees (35%), followed by success based contingency fees (16%), negotiated rates (11%), capped fees (7%), and retainers (2%).⁷³

Some people argue that these numbers are bound to continue to go up, because so many legal clients are dissatisfied about the way firms currently operate. As Susan Hackett summed up the problem in an *American Lawyer* interview⁷⁴ about the ACC Value Challenge:

Take a look at the cost of legal services and the fact that they’ve been rising 6, 7, 8 percent a year, for as long as anyone can remember. But the services remain pretty much the same. And at

⁷² http://www.altmanweil.com/index.cfm/fa/r.resource_detail/oid/8bc7ca9a-3e76-45f6-8054-289150d9ef2b/resource/Chief_Legal_Officers_Dont_Think_Law_Firms_Are_Serious_About_Change.cfm

⁷³ For details, contact Michael Rynowecer at mrynowecer@bticonsulting.com

⁷⁴ *The American Lawyer*, May 2007, p. 107; <http://www.americanlawyer-digital.com/americanlawyer/sample/?pg=102>

the same time that outside firms' costs are rising, the in-house law departments are getting better at their efficiencies and at lowering their costs. But they don't see the law firms with any motivation to increase their efficiency.

This cuts to the very heart of the matter. The billable hour model led to enormous profits when the economy boomed. In 2006, for example, the average bonus for a partner at an AmLaw 100 firm was \$1.2 million. Unless the firm was headquartered in New York. Then the average was \$2.05 million.

For many years, law firm work practices, recruiting, and compensation models have all been built around billing more hours. If firms decide to change to a business model that stresses fixed fees and rewards efficiency, many other things will have to change.

As *The New York Times* article put it, "the biggest stumbling block may be the managing partners at law firms, who will have to overhaul compensation structures to reward partners and associates for something other than taking a long time to do something."

Clearly, this would be a huge change. If I managed a law firm, I would do everything in my power to resist it. With hourly billing, lawyers almost always make more money. To succeed with fixed fees, lawyers will require strong project management. But anyone who's ever worked at a law firm knows that most lawyers don't want to manage or be managed.

In an article entitled "Are Law Firms Manageable?"⁷⁵ David Maister argued that this problem will not go away any time soon because:

Legal training and practice keep lawyers from effectively functioning in groups [due to]:

- problems with trust;
- difficulties with ideology, values, and principles;
- professional detachment;
- unusual approaches to decision making.

Not to mention the fact that law firms are partnerships. It is remarkably easy for most lawyers to take their book of business across the street in a lateral move to another firm.

On the other hand, any lawyer who has been on the treadmill to deliver 1,800 or 2,000 or 2,200 billable hours per year knows that the billable hour model comes with steep costs of its own. As one writer put it, "it's like a pie-eating contest where the prize is more pie."

⁷⁵ <http://davidmaister.com/articles/1/92/>

In an excellent summary of the key issues,⁷⁶ Bruce MacEwen quoted Jeff Bleich, president of the State Bar of California:

Strong economic forces will continue to favor billable hours....If a better and equally lucrative alternative existed, it would have been adopted by now. So this will not be an easy problem to solve. But we will eventually reach the outer limits of human endurance and the upper reaches of client tolerance, and if we do not begin addressing the issues now, it will be too late when we do....As a profession, we need to start finding billing methods that will reduce distrust and damage to our client relationships, that will refocus young lawyers on being problem-solvers again, and that will remind us of — rather than distract us from — why we are lawyers in the first place.

If this transition does come, how long will it take? According to alternative fee proponent Jay Shepherd (quoted in *The Washington Post*⁷⁷):

Before the financial crisis happened, I thought in 10 years the billable hour would be on the way out. I now think that will be sped up.

When Fred Bartlit started his firm in 1993 he thought change was coming quickly, but “I quit talking about this five or six years ago because nobody listened.” In the last six months, however, he’s been getting lots of calls as a result of the economy. He quoted management guru Peter Drucker’s belief that a shift to a new paradigm is almost always driven by an outside event. And in 2009, you don’t have to look far to find dramatic outside events changing the legal market. “Clients must cut 25% of their legal budgets,” Bartlit said. “Fewer lawyers are needed. We have to write off all these assembly plants just like General Motors did.”

My prediction is for a growing period of experimentation, in which more lawyers try alternative fees more freely, even when they would rather not. This will continue at least for as long as clients remain under financial pressure. But if it ever hits a tipping point, watch out. Alternative fees have the potential to totally transform the legal profession, from the way legal matters are handled to business models and compensation. And if large numbers of clients insist on them, the firms that only know how to deliver billable hours could collapse as suddenly as Heller Ehrman or Thelen.

⁷⁶ <http://www.bmacewen.com/test2/2008/04/diversity-the-billable-ho.html>

⁷⁷ <http://www.washingtonpost.com/wp-dyn/content/article/2008/10/19/AR2008101901397.html>

Conclusion and recommendations

There is no question that the use of alternative fees is growing. The only question is what your firm will do to adapt to the changing marketplace. This review concludes with ten recommendations, based on what the most successful law firms have learned to date:

1. Don't overanalyze; just do it

Law firms tend to make decisions by committee, which is a great way to delay decisions. In the current economic environment, the firms that act quickly, take risks, and learn from experience will win.

The best way to get started will vary from firm to firm, depending on their culture.

One approach is to publicize short, clear and simple policies from the top. For example:

We will be very aggressive in using alternative fees for defensive marketing to protect relationships with top clients. We will also be moderately aggressive in using alternative fees for offensive marketing, to find new clients. All proposals over \$x that include a non-hourly fixed or contingent component must be approved by _____.

Other firms may need to plan how to drive change and build internal buy-in before making any announcements. Some may be able to make faster progress by simply giving leeway to a few key partners who are enthusiastic about this approach.

However it is accomplished, the important thing is to get started, as quickly as possible.

2. Ask clients what they want

Get out of the office, and talk to your top clients. Listen. Give them what they want and need. That will be a good idea even if the economy improves. And if it doesn't, communicating better with top clients could become a matter of life and death.

If you don't talk to your clients about alternative billing, someone else will. Remember the case of Pfizer which awarded all of their 2008 and 2009 labor work to Jackson Lewis on an alternative fee basis, as described above.⁷⁸ The other law firms that had worked with Pfizer for years lost substantial revenues because Jackson Lewis was the first to offer an alternative fee arrangement.

And as Steve Barrett, the former CMO at Drinker Biddle put it, "once you lose the trusted advisor role, you are on the outside, and it could take five years to get back in." If you have any doubts about what happens to law firms after they start losing large clients, just ask lawyers who used to work for Heller Ehrman, Thelen, Wolf Block or Thacher Profitt, four AmLaw 200 firms that were dissolved in the last year.

3. Identify internal champions

Some lawyers will be more enthusiastic than others about this approach, and some will be better than others at planning bids and managing projects. They should be given the support they need to succeed.

A small number of people can make an enormous difference. As mentioned above, at the 70 lawyer firm Bartlit Beck all decisions about pricing and staffing are made by a single person. In my own experience owning and operating a training and consulting firm for 25 years, I have experimented several times with delegating the authority for bidding to others. I don't do that anymore. Some critical tasks are best handled by a single person.

4. Get off to a good start

Kristin Sudholz, the Director of Practice Development at Drinker, Biddle & Reath, recently suggested several approaches to get off to a good start and sell the concept internally⁷⁹:

- “1. Work with a practice group that has more routine and regular work where the lawyers feel confident of the skill and effort needed, and develop a fixed price.
2. Do a historical analysis of past matters that might be similar to the matter for which you want to propose an alternative fee.
3. Pick a matter and develop and test a fee structure for it and monitor it for profitability. Test on other matters then share your approach with the lawyers.

⁷⁸ <http://www.law.com/jsp/cc/PubArticleFriendlyCC.jsp?id=1202423790324>

⁷⁹ *Strategies: The Journal of Legal Marketing*, July 2009, p. 22.

4. Develop a desktop handbook for the lawyers on alternative fees that lays out the argument for them, best practices, types of fee structures with examples, worksheets, approval process and ideally, a list of people in the firm who can assist them with developing a fee structure...⁸⁰

What is most important is to create a comfort level for the lawyers by increasing their sense of certainty that an alternative fee arrangement will work for the firm and the client.”

5. Increase efficiency by adapting tools from other professions

Other industries and professions have an enormous amount of experience bidding fixed price work, managing projects, and completing work within budget. Many of their best practices have been refined over decades and can be adapted to help law firms increase profitability. I will be writing about exactly how to do this in my blog *Legal Business Development* (www.jimhassett.com) over the next few months, especially about bidding tactics and project management.

6. Define and measure success

Some alternative fee projects will be much more successful than others. You need to be able to quickly identify the winners and losers, so that you can refine your tactics and increase your success rate.

This starts by defining clear measures of success for financial results and for quality, to facilitate comparisons across projects and lawyers.

Measuring the profitability of each matter would be ideal, but may be much harder than it sounds, depending on your accounting system, and especially your treatment of partner compensation. (For example, what percent of partner compensation should be considered a fixed cost of doing business, and what percent should be considered shared profits which are at risk?)

For many firms, the simplest financial measure will be the actual revenue received from each alternative fee matter, divided by the income that would have been received for the same work if it had been billed at standard hourly rates. Some firms may prefer to measure the realization rate or another metric. The important thing is to choose a single measure that everyone will use, and get on with it.

Quality should be measured first and foremost from the client’s perspective, not from partners’ perspective. The client is always right. This report

⁸⁰ Full disclosure: Drinker, Biddle & Reath’s handbook includes a copy of this guide.

describes both simple and complex ways to measure quality, including FMC Technologies' ACES approach. This is another topic I will be writing about in my blog, and another area that is likely to evolve as law firms get more sophisticated in their approach.

7. Evaluate results regularly, and learn from mistakes

Once standards have been set, key people within the firm can evaluate results quarterly or on another schedule, to see what works and what doesn't. In this new more challenging world it is not possible to avoid occasional failures. But it is possible to learn from mistakes and to improve results.

Exactly how this review should be conducted will again vary depending on each firm's culture. While many firms have a tradition of extreme confidentiality, the rest of the world is moving in the opposite direction. Transparency is on the way. The only question is, how fast will you get there?

8. Tie results to compensation

The hardest part of working with alternative fees will be making money. The second-hardest part will be splitting it up.

After several decades of working with different systems for compensating my own employees and studying compensation systems at other firms, I believe that there is only one sure fire way to make someone happy with any compensation system: pay them more than everyone else.

This is especially troubling in partnerships where relative contributions are controversial and where it is very easy for unhappy rainmakers to take their clients to other firms.

So it is easy to predict that compensation will remain a source of controversy, especially for firms whose total revenues are shrinking. But as the world becomes more competitive, it will become increasingly important to assure that the greatest rewards are given to the people who are most responsible for the firm's success, and that people understand how such decisions are made.

9. Don't be penny wise and pound foolish

As the owner of a firm that provides consulting to law firms regarding alternative fees, I can hardly claim to be an unbiased observer on the matter of law firm spending. But we started offering consulting in this area for a reason: we believe that the decisions law firms make on bidding, managing profitability, and managing quality area will have implications in six figures, seven figures, and eight figures, and more. Some decisions may affect the very

survival of your firm. Therefore, prudent firms will recognize the need to invest in this area, whether in terms of outside consultants or internal staff.

10. Act like an entrepreneur, not like a lawyer

It is a mistake to approach alternative billing like a lawyer, trying to craft perfect agreements and close all the loopholes. Approach it like an entrepreneur who is willing to do whatever it takes to bring in new business and can't wait to get started.

Fixed price agreements should always define the scope of what will be delivered. But I have been working on fixed fee contracts for nearly 25 years, and cannot remember a single case where something did not change somewhere along the way. If you hired a contractor to build a new kitchen, and he raised the price every time some minor factor changed, would you use him again? Most successful businesses ignore minor changes in scope, and provide plenty of warning if there is any hint of major changes.

Alternative billing works best in a true partnership, where the parties are willing to work together for their mutual benefit. Lawyers who try to get paid more every time the situation changes will have a hard time keeping their clients.

No one knows how alternative billing will affect law firms in the next few years. The only way to find what works for your firm is to try it. When you win some, do more of that. When you lose some, accept it as the price of doing business. Learn and adapt.

The sooner you start, the more likely you are to beat the competition.

About this guide

Approaches to alternative fees are changing so rapidly that it has been necessary to publish three different editions of this guide within seven months.

The basic concepts and conclusions from the first edition (January 2009) and the second edition (March 2009) remain unchanged.⁸¹ However, the level of detail and sophistication has increased substantially in each edition, based upon newly available information from leading experts about what works for alternative fees and what does not.

This free guide can be downloaded from the Alternative Fees section of the LegalBizDev web page (www.legalbizdev.com), and will be updated from time to time as the situation continues to evolve. Most of the content from this guide originally appeared in Jim Hassett's blog *Legal Business Development* (www.jimhassett.com).



Jim Hassett, the author of this guide, founded LegalBizDev (www.legalbizdev.com) to help lawyers develop new business more quickly by applying best practices from other law firms and from other professions. Before he started working with lawyers, Jim had 20 years of experience as a sales trainer and consultant to companies from American Express to Zurich Financial Services. His background includes:

- Moderator of several panel discussions on alternative fees for West LegalEdcenter with leading experts from Alston & Bird, Bartlit Beck, Haynes & Boone, Littler, Morgan Lewis, Nixon Peabody, Seyfarth Shaw, Valorem, Womble Carlyle, and other firms.
- Currently conducting a survey of alternative fees in the AmLaw 100 which will be published in the Fall of 2009. He will present the results at several professional meetings, including DRI's "Best Practices for Law Firm Profitability" conference in New York, and the 4th Corporate Counsel Exchange in San Diego, an invitation-only forum for senior legal executives from companies across North America.
- Author of seven books, including *Legal Business Development: A Step by Step Guide* and *The LegalBizDev Desk Reference*.
- Author of over 70 articles in the *New York Times Magazine*, *Of Counsel*,

⁸¹ An edited version of the second edition was also published as a three part series in *Of Counsel*, the *Legal Practice and Management Report*, in its March, April and May 2009 issues.

Strategies: The Journal of Legal Marketing and other publications.

- Frequent speaker at firms with 20 to 2,000 lawyers and at the Massachusetts Bar Association, Harvard Law School, the Business Lawyers Network, and at Legal Marketing Association meetings in Boston, New York, Philadelphia, Washington, Savannah, and Vancouver.
- Conducts webinars through West LegalEdcenter, the National Law Journal, The International Lawyers Network, TAG Academy, and the Legal Marketing Association.
- Author of the blog *Legal Business Development* which was selected by TechnoLawyer as one of “the most influential legal blogs” and featured in BlawgWorld.
- Harvard Ph.D. and Adjunct Associate Professor at Boston University.

About LegalBizDev

LegalBizDev helps lawyers to increase business with current clients and to find new ones. We help large and mid-sized firms design and manage alternative billing arrangements in a way that is sustainable, and makes business sense for both sides. We also offer business development coaching, webinars, workshops, retreats, train the trainer programs, books, and CDs.

LegalBizDev is currently conducting a national survey of senior partners at AmLaw 100 firms to explore their perspective on what works for alternative fees, and what does not. The results of this survey will be published in the fall of 2009.

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