New Client Retainer Models: Backing Away from the Billable Hour

By Ann Farmer

As the head of her firm's recently acquired Levi Strauss & Co. account, Karen Johnson-McKewan, a partner at Orrick, Herrington & Sutcliffe LLP, is handling the broadest alternative fee arrangement that her global corporate law firm has ever undertaken. And she's aiming to make Orrick the perfect fit for the jeans giant.

"They said, 'Can you do it for X dollars?'" says Johnson-McKewan, describing how Levi Strauss—in an effort to curb its legal costs and maximize the efficiency of its in-house legal department, which was spending too much time reviewing bills from the multiple legal firms around the world to which it outsources work—decided to consolidate all of its outsourcing under two roofs. Townsend and Townsend and Crew LLP will continue to manage the company's brand protection work. But Orrick now handles all the other legal matters involved in running Levi Strauss's commercial entity. And they're doing it for one fixed fee paid in monthly increments.

"Even though we didn't know the full extent of the legal work, we figured we could match their proposed figure," says Johnson-McKewan, who finalized the deal last May.

Alternative Payment Arrangements

Fixed fees are just one of many alternative fee arrangements gaining momentum these days. Although law firms continue to survive and flourish using the billable hour as their primary pricing system, with the economic downturn putting the squeeze on businesses, law firms are agreeing to all kinds of alternative payment arrangements. They range from fixed and phased fees, to fee deferrals, contingency fees, disincentive fees, success fees, and a host of other payment models. (See sidebar on page 9.)

"A few years back there were virtually no alternatives to the billable hour," says Susan Hackett, senior vice president and general counsel of the Association of Corporate Counsel, which recently conducted a survey with *The American Lawye*r in which they asked the heads of corporate law departments and law firms about changes in their billing arrangements. The survey went out to all Am Law 200 law firms, the top-grossing law firms in the country. Of the 142 law firm heads that responded, four-fifths said they used flat fees last year and three-quarters said they had negotiated at least one incentive or success fee in that time.

The survey indicated that it was the clients that almost always initiated the new non-hourly billing arrangements. While their use of alternative fee arrangements remains small (about half the general counsels indicated that they

CONSIDER THE FIXED FEE STRUCTURE

1. **Try monthly fixed fees for basic law firm counseling.** Clients can call law firm personnel with basic questions. Define when an item is a separate matter. If something gets out of kilter, revise the arrangement the following month.
2. **Determine fixed fees for specific tasks.** Look at past experiences as a starting point. If estimates in the first few projects are way off, make adjustments. With experience, you'll get better at determining costs.
3. **Employ fixed fees for entire matters.**
4. **Define when a fixed fee shifts off the fixed fee arrangement.** Instead of an immediate full stop when a safety valve is activated, consider a 50-50 split for awhile.
5. **Experiment with the firm taking on a whole portfolio of work at a fixed fee for a designated period.** Among the benefits of a whole portfolio (especially if it includes both counseling and litigation) is how it provides the firm the sort of continuity and work flow to better manage its resources. And the firm has an incentive to keep the client out of trouble, manage litigation resources, etc.

Source: Association of Corporate Counsel (www.acc.com/valuechallenge).

covered approximately 10 percent of their annual outside legal expenditures), Hackett says the findings are nonetheless significant. "That's a monumental change," she says, "because we're a slow-moving profession."

The billable hour concept emerged in the 1950s. Before that, whichever side lost in court usually paid a firm's legal fees. But as deregulation took hold in the industry, billing by the hour was viewed as a more transparent method for valuing and paying for legal services. It also ushered in a more competitive relationship between the firm and its clients. "It was, 'If I win, you lose,' as opposed to firms and clients talking about how both can win," Hackett says.

Hackett adds that the tipping point occurred a couple of years ago when clients found it increasingly difficult to predict their legal budgets. "No matter what, law firm rates went up 7 to 10 percent each year," Hackett points out. "Clients started saying, 'This is crazy.'"

More recently, as the economy bottomed out and businesses started drying up, law firms recognized the need to be more flexible about their fee arrangements. "That brought a lot of people to the table who otherwise wouldn't have come as quickly," Hackett says.

Calculated Risk

Johnson-McKewan says her firm embarked on negotiations with Levi Strauss before the economy tanked. And while she's thrilled to have entered into an arrangement that gives her company proximity to such a sizeable and appealing client, the venture remains somewhat of a risk. For one thing, it will take time to ascertain the full scope and volume of this global apparel marketer's legal needs.

"For us, there are a lot of unknowns. It took a big leap of faith on both sides," Johnson-McKewan adds, explaining that their fiscal agreement includes mechanisms that will ensure her firm additional monies should the workload exceed expected levels. "If it falls below, we give back some of the fee."

When lawyers agree to work for a set fee, the clock, in essence, gets turned around. Instead of the client keeping an eye on the minutes ticking away during legal consultations, it's now lawyers who may feel greater pressure to keep a close tab on the time it takes to provide quality services and turn a reasonable profit for their firm.

"What we really care about is not gross hours, but how effective we are," says Johnson-McKewan, who is based in San Francisco but is taking a close look at where in her vast firm (which has 21 offices in Asia, Europe, and North America) she can tap into the right talent while also saving money. "It's convincing partners to bring in associates and plug associates in whenever possible," she says. "We have very skilled lawyers in Wheeling, West Virginia, that don't cost as much."

Through the years, it's not only clients that have borne the negative brunt of the billable hours concept. As firms began setting billable hour quotas for their lawyers, it became a proxy for power, prestige, and income levels. Many lawyers face penalty clauses if they don't meet the minimum required of them. "I think there is a long-held desire to move away from the billable hour," Johnson-McKewan says. "Lawyers don't like recording their time. Some have left the profession because of it."

Not all firms are embracing alternative billing arrangements, however. Denver and Washington, D.C.–based Steese, Evans & Frankel, P.C., for example, has made it a hallmark to charge lower than average hourly rates. The firm has managed to avoid the rate inflation of recent years by maintaining a low overhead and only hiring experienced lawyers who share a similar commitment to their organizational model. "It works perfectly for us," says Kevin Evans, a partner based in the firm's Denver office. "We have found our clients happy to pay the billable hour."

On the other hand, Carol Osborne's decision to join Holme Roberts & Owen LLP in Los Angeles, where she focuses on complex transactional and business counseling matters, was based in part on the firm's flexibility and pride in creating customized fee arrangements.

ALTERNATIVE BILLING ARRANGEMENTS: A GLOSSARY

- **Fixed fee:** A fixed price for a specific task, reached by agreement between a lawyer and client. Where a legal matter is simple and well defined, lawyers typically charge a flat fee.
- **Risk collar:** An hourly billing arrangement built around a budget for a particular matter. The client pays a bonus if work is completed under budget and/or gets a discount if the work goes over budget.
- **Fee cap:** A maximum amount that a client will pay for services. May apply to an hourly rate, monthly rate, or a specific task.
- **Retainer fee:** A form of prepayment (or down payment), often refundable, and usually based on a lawyer's hourly rate, to ensure that the lawyer will provide certain legal services on behalf of the client.
- **Hourly rate:** An agreed-upon rate per hour for the hours a lawyer works on a client's case or matter until it's resolved.
- **Hold back arrangements:** An arrangement under which an amount of a lawyer's fee is held back to give the client an opportunity to value the firm's performance. The client has the option to release all or a portion of the held back amount.
- **Phased fees:** Flat fees for different phases of a protracted process.
- **Fee deferral:** When a lawyer accepts a low base payment but gets a bonus for a good outcome.
- **Contingency fee:** The lawyer takes no fee at the outset, but is paid a percentage of the outcome or settlement or money judgment in resolution of a case.
- **Disincentive fee:** Penalty applied if a lawyer doesn't meet certain preestablished milestones for resolution of a client matter.
- **Success fee:** Also known as value billing, when a lawyer receives a bonus for a good outcome.

"I do think that the firm thinks hard about the best way to serve its clients," says Osborne, who is a partner at Holme and previously worked as general counsel for San Francisco–based Folger Levin & Khan LLP.

Benefits of Customized Fees

Osborne has already worked out a broad range of alternative financial agreements. She says she's on retainer with several clients, including a solar business and an aerospace manufacturer, because her firm wants those

(Continued on page 14)

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(Continued from page 9)

clients to feel comfortable picking up the phone and calling the firm. She arranged a fixed fee with a northern California startup that doesn't have a lot of cash but wanted her firm to organize an equity fund. For a venture capital investment firm, she works on a fee deferral arrangement. Because this arrangement pays at closing, thereby putting her company's fee at risk, she got her client to agree to a one-time premium billing.

Osborne explains that these kickers, also known as "success fees" or "value billing," are common ways to negotiate better deals based on the quality of legal services provided. "Let's say you told your client that you can get the case dismissed at an early stage," she says. "The client is skeptical. I can maybe get a success fee or value billing based on the achievement of that milestone."

Osborne says there are an infinite number of other ways to customize fees, describing options such as a "fee cap," whereby law firms charge by the hour up to a maximum. A "hold back" is another arrangement, she says, whereby an amount is held back and the client has an opportunity to value your performance and can release all or a portion of the amount held back. "It is risky for the lawyer," Osborne points out. "I always say that whatever you choose must be consistent with your ethical obligations."

Many lawyers, especially those working in Silicon Valley, she says, are willing to take stock in lieu of fees. But that entails a risk. "There's a long time to see the value," Osborne says. "And you can't pay the rent with stock.

"It's hard to have a tough conversation with a client when you're a 15 percent owner," Osborne continues. "Someone could say, 'Oh, you made that decision because you're a 15 percent owner.'" Lawyers are encouraged to check their local Rules of Professional Conduct, which differ from state to state, on what is permissible.

An additional drawback to the billable hour is the stress it places on lawyers to put in long hours at the office, often at a detriment to their families and work/life balance. In that sense, alternative billing arrangements could allow those lawyers who are faster and more efficient to work fewer hours. And women lawyers—who are usually the primary caretakers of their families and therefore often caught up in the need to work flexible or reduced hours—are especially poised to enjoy a shift in this direction.

"I do think women can benefit from alternative fee arrangements," says Osborne, who is currently involved in determining the next partner promotions at her firm, for which several women associates are being considered. She says her committee's focus hasn't been solely on the top-line numbers. They take a close look at the underlying profitability of any revenue brought in by the candidates.

Alternative fee arrangements can also provide women and men lawyers more leeway for attracting new clients. And they can better enhance the feeling that the interests of the lawyer and client are aligned. "They create all these opportunities to sit down with the client and understand the client's objectives, understand the solutions that the client is working toward, and figure out, in a very personal way, how the lawyer can deliver that solution," Osborne says. "I think women will find that that very appealing."

Still, should alternative fee arrangements continue to take greater hold in the industry, it remains likely that billing by the hour will not disappear. "I can tell you that 50 percent of the time, I can propose an alternative, but they want to stick to hourly," Osborne says. "Some clients have a lot of reluctance about changing the model."

Ann Farmer is a Brooklyn, New York–based freelance journalist who covers breaking news for the New York Times *and contributes stories on culture, law, crime, and other topics to publications including* Emmy, DGA Quarterly, Budget Travel, *and others.*

HOW TO DETERMINE A DAILY CONSULTING RATE

- **Daily Labor Costs:** Divide your annual salary by the number of days per year that you work, including Saturdays and Sundays. (Example: $200,000 ÷ 260 days = $769 per working day.)
- **Daily Overhead:** Add up all recurring expenses associated with running your firm (including rent, utilities, insurance, equipment, and assistants) and divide by the number of days per year that you work directly for clients. (Example: $120,000 yearly overhead ÷ 160 client working days = $750 per day.)
- **Daily Profit Margin:** Determine your profit by using estimates from Bill Mooney of William Mooney Associates (a consultancy to consultants) that a consultant usually averages between 15% and 25% of its total expenses. (Example: 20% of $750 is $150.)
- **Daily Rate:** Add together daily labor plus daily overhead plus daily profit margin. (Example: $769 + $750 + $150 = $1,669 per day.)

Source: *Forbes*, www.forbes.com/2006/11/06/bostonconsulting-marsh-mckinsey-ent-fin-cx_mc_1106pricing.html.