

## PRICING & FEE NEGOTIATION FOR LAW FIRMS CLIENT PERSPECTIVES

### Executive Summary

- The process of moving to alternative fee structures has involved many years of lobbying by clients and is a process of continuing evolution.
- Hourly rates are still widely used but mainly where clients are given no choice in the matter.
- Since the global economic crisis began, clients have found that they can no longer afford to tolerate the uncertainty of after the event, time based billing. Economic imperatives have enabled them to argue more forcefully with their firms and law firms in turn, many of whom have experienced a sharp drop in business in certain key specialisms have been forced to take action.
- Clients, having sampled alternative billing are unlikely to acquiesce in a return to hourly rates once the economy improves.
- Clients, even those representing large corporates, are individuals and they look for tailored billing solutions which represent good value as they perceive it. One size fits all billing does not appeal.
- Alternative billing structures are predicated on deep, long term client relationships. Even if fees on particular matters are reduced, better client relationships lead to increased revenues and profits for law firms.

### 1. Standing in the Client's Shoes

#### 1.1 The Corporate Client

##### 1.1.1 The Budget Process

Heads of legal, referred to here as General Counsel or ("GC"), in common with other department heads in any company, charity or Government department are required to produce an annual budget in advance of each financial year.

The head of department will forecast the likely programme of work for the year ahead and will endeavour to obtain fee estimates from external advisers before entering negotiations with the Finance Director, Divisional Director, Treasury or equivalent (referred to here for simplicity as the "FD"). It is often a bruising experience and particularly so for the GC, who tends to be the principal buyer of legal services in an organisation and who will be berated by the FD for previous legal fee over-spends and most likely a failure to obtain any kind of meaningful estimates for the next year's anticipated work.

The reason that the GC comes off so badly is that the FD can't understand why the GC can't provide accurate forecasts in line with the other departments.

Barry Matthews, Legal Affairs Director of ITV's brand and commercial unit, interviewed in the Law Society Gazette,<sup>1</sup> describes it well:

"Every year, I have to sit down with my divisional MD and give him my legal spend budget. I've got to forecast that... and if I can do that with a global budget, surely the law firm can do it at the outset of the job."

He continues,

<sup>1</sup> Law Society Gazette, 15 October, 2009

“Your bankers will give you a price, your accountants will give you a price, but the lawyers say ‘we’ll tell you after we’re done’. If everyone else can do it, why can’t they?”

The GC may find his budget arbitrarily slashed if he cannot produce objective justifications for his proposed numbers and he may be accused of poor management. He is likely to feel aggrieved that his law firms haven’t helped him through this difficult process despite their interest in ensuring that he continues to provide them with fee income.

### 1.1.2 The Rise of Procurement Professionals

Increasingly, corporate clients are involving procurement professionals both in the selection of law firms and in fee negotiations.

There are 3 main reasons for procurement professionals to be brought in:

- Corporate policy
- Process improvement and
- Cost cutting agenda.

#### **Corporate policy**

A company that involves its procurement team in the selection of law firms almost certainly requires all major purchasing and contracting to be orchestrated via the procurement team. The in-house legal team is often the last bastion of resistance to the involvement of procurement. The GC will distinguish his purchasing decisions from those of the department in charge of purchasing widgets and will cite the importance of law firm relationships which can’t be boiled down to money alone. However, there generally comes a point beyond which the FD will no longer tolerate resistance. This will often coincide with another failure by the GC to stick within his legal budget or to obtain binding fixed fee quotes for planned work. His claims of a solid working relationship with a firm or of a “partnership approach” ring hollow against this back-drop.

#### **Process improvement**

There is no doubt that procurement teams bring a more rigorous, process driven approach to the selection of firms and the negotiation of their fees. Law firms will all be aware of the vast increase in the number of invitations to tender and requests for proposal that they are now required to respond to in order to win new clients or even retain old ones. Much of this is driven by the professional procurement approach. Whether this change is for the better is a moot point but it seems to be here to stay. There were certainly flaws with the old system whereby firms were instructed on the basis of “who you know” or because the GC used to be a partner there. GCs tended to form long term relationships with a few firms and didn’t want to rock the boat or considered it ungentlemanly to question the fees.

#### **Cost Cutting Agenda**

The involvement of procurement professionals is also designed to further the cost cutting agenda. With 90% of GCs now under pressure from their FDs to provide better value<sup>2</sup>, this pressure is very real and favours the involvement of procurement professionals with their extensive fee negotiation experience.

#### **The Best Defence**

Law firms generally complain bitterly of the hoops that they are forced through by procurement teams and the wasted time, effort and resources spent on failed bids where it transpired at the end of the day that they were never truly in contention. They are also, rightly wary of the salami

<sup>2</sup> Financial Times, 18 March 2010, survey by Eversheds and RSG Consulting

slicing negotiating tactics that can render their work unprofitable. The best defence to the march of the procurement professional is to work with your client to deliver good value, predictability and transparency.

## 1.2 The Private Client

Private clients fall into two principal categories:

The first comprise individuals who engage law firms on very rare, ad hoc occasions such as the purchase of a home, following an accident, during a divorce or in the event of an employment dispute.

The second category may be high net worth individuals or business people who interact on a regular basis with law firms as part of the management of their affairs.

Members of the second category will vary considerably in their level of expertise and comfort when instructing lawyers. Some will behave much as the occasional user in the first category whereas those at the opposite end of the spectrum will behave with the sophistication of a corporate client (although it can be noted that fees hurt more if you are paying for them yourself).

The focus of this section is on individuals who are not accustomed to regular dealings with law firms.

Clients in criminal cases are excluded from the scope of this paper.

### 1.2.1 State of Mind When Engaging a Law Firm

The events that send a private client into a lawyer's office are often stressful or emotionally charged. The client may need advice urgently and has often not had time to think in advance about whom they are hiring and their expectations from the lawyer beyond legal advice or successful conclusion of a transaction or resolution of a problem. The law firm will probably have been recommended by someone and the client may think:

*"if it's good enough for Bloggs, it's good enough for me".*

In any event, the client is often vulnerable and not in a good frame of mind to assess whether they will be receiving value for money.

If the client has little experience of engaging lawyers, they will not have educated expectations of what to expect in terms of fees, other than a fear that the fees will be unaffordable - based on anecdotal evidence and the multiplicity of "lawyer jokes" with which we are all familiar.

### 1.2.2 Client reactions to terms and conditions and client care letters

Of course, the solicitors' Code of Conduct laid down by the Solicitors' Regulation Authority contains various safeguards to protect the client in these circumstances.<sup>3</sup>

The law firm's terms of business and client care letter will set out the basis on which the firm will charge. Despite being carefully drafted in plain English, how many clients, actually read, much less understand these terms?

The Law Society certainly recognises that many do not. Here is an extract from one of their practice notes<sup>4</sup>:

<sup>3</sup> Code of Conduct 2.02 et seq

<sup>4</sup> Law Society Practice Note, Client Care Letters, 3 July 2008

"Many clients complain of being given large documents containing lots of legal language in small print by their solicitors. Often these documents are not read or understood"

Client care letters tend to leave rather a lot of "wriggle room" for the firm too. A typical example might read as follows:

"In addition to time spent, we may take into account a number of factors including any need to carry out work outside our normal office hours, the complexity of the issues, the speed at which action has to be taken, any particularly specialist expertise that the case may demand. In property transactions, in the administration of estates and in matters involving substantial financial value or benefit to a client, a charge reflecting the price of the property, size of the estate or value of the financial benefit may be considered. It is not always possible to indicate how these aspects may arise..."

Even if the client has read the terms, they may not understand the full implications such as the probability of these "extras" occurring and their likely quantum. If it's not possible for the law firm, with its years of experience to provide a genuine pre-estimate of likely charges then how is the individual client supposed to know what to expect and whether they can afford to engage the law firm on their behalf?

The Law Society again recognises this risk:

"The failure to provide adequate costs information is one of the areas most likely to result in a client complaint."

A law firm may need to go further than simply meeting its regulatory obligations to avoid complications and disputes further down the line.

## 2. Types of Fee Structure

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The following section looks at the different types of fee structure available and how these can help meet clients' needs. The advantages and disadvantages of each from the client's perspective will be examined below.

The most prevalent types of fee structure are:

- Time based (hourly/blended/discounted/capped) rates
- Fixed rates
- Retainers
- Shared risk reward and
- Value billing.

### 2.1 Time Based Rates

Time based billing, where the client is billed in accordance with the time spent by fee earners on a given matter is, today, the most familiar and widely used method of billing, for both private and corporate clients, although it was, in fact, only introduced in the 1980s.<sup>5</sup>

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<sup>5</sup> Evolution or Revolution? The New Lawyer-Client Relationship, a report by Jomati Consultants LLP, June 2010

There are a number of variations on the theme of hourly rates. Fees may be discounted or the fees of senior and junior lawyers may be blended into a single charge-out rate but all are based on the same principle of paying for the time taken to complete the work.

For the client, there are some attractions to using hourly rates but these are very limited. The justifications given are that hourly rates are:

- Familiar and
- Comparable.

Both arguments are flawed. Paul Gilbert, a former General Counsel, in his book, "One Prick to Burst a Bubble" writes that:

"knowing somewhere is an accident black-spot doesn't make it safer to drive there"

The argument against comparability is that whilst Firm A might charge £300 per hour and Firm B might charge £400 per hour, the total bill will depend on the number of hours of work undertaken (or commonly, that the firm chooses to bill for) and not on the hourly rate. Therefore Firm B could send-in a lower bill despite having a higher headline rate.

The most significant criticisms of time based billing from the client's perspective are that time based billing:

- Encourages inefficiency and
- Is unpredictable making budgeting impossible.

Detractors of time based billing are numerous and have written voluminously on the subject. Paul Gilbert again, this time in his book, "Head2Head" writes:

"Can you really think of any other purchase decision that is made on the basis of an uncertain outcome, an uncertain price and an uncertain incidence of when the price has to be paid?"

## 2.2 Fixed Fees

Fixed fees operate on the basis that the law firm and the client agree a set price for a piece of work to be undertaken at the outset of the matter and this fee will be charged regardless of the time spent by fee earners on the matter. Fixed fees are becoming increasingly common in work for both private and corporate clients. Residential conveyancing, for example is usually carried out for a flat fee. ITV, under General Counsel, Andrew Garard made waves in 2008 by appointing a new panel of law firms all of whom were required to operate exclusively on the basis of fixed fees.

Fixed fees deliver to General Counsel the much sought after benefit of certainty. According to a consultancy, Winmark, in their Looking Glass Report:

"General Counsel crave simplicity, clarity and predictability"

However, this benefit is eroded if the parties are forced to re-negotiate the fee as the project evolves and grows, known as "scope creep". The best ways to avoid scope creep are to plan the matter and its resourcing carefully in advance but also to know you client well, their needs and their ways of working. This has led a number of clients to comment that fixed fees work best in an environment where there is a strong relationship between the law firm and client. An example is Sapna Bedi Fitzgerald, Head of Legal Services at LSL Property Services<sup>6</sup> who says of the fixed fee system:

"it provides greater certainty and helps manage business expectations, but it's not suitable for all types of work and it depends

<sup>6</sup> Law Society Gazette, 15 October 2009



on the strength of the relationship with external advisers. You also need to be careful when setting fixed fees so that both parties understand the scope, because there is nothing worse than getting to the end of the deal to find the “fixed” fee has in fact doubled. Both parties need to be clear and upfront about their expectations.”

### 2.3 Retainers

A retainer is an annual flat fee which is agreed in advance. There have been a number of high profile instances of large corporates agreeing retainers with their law firms. A good example is the Pfizer Legal Alliance under which 19 law firms have each agreed that all their work for the year should be covered by one pre-agreed annual fee.

Pfizer expects to generate very substantial financial savings of ten to fifteen percent of current legal spend, amounting to between fifty and seventy five million dollars but Pfizer’s General Counsel, Amy Schulman points out<sup>7</sup> that cost savings are only part of the story:

“If all I was interested in was saving money, I probably could have gone to any law firm in the country right now and said ‘give me a 10 or a 15 per cent discount’ ...and in this economic climate, they probably would have”

Pfizer, in fact, expects to derive multiple benefits from the Legal Alliance. One of the Alliance members described the aims of the Alliance as follows<sup>8</sup>:

“It’s all designed to find a mutually agreeable way to promote strategic thinking and give the client predictability and stability”

which is another way of saying that the Legal Alliance / retainer structure, requiring trust on both sides and good communication, is a way of promoting the much vaunted “partnership approach” that clients often say that they are seeking.

As with any system, there are some potential down sides, even for the client. There is no doubt that setting the terms of a retainer is more time consuming than agreeing an hourly rate and there is likely to be a steep learning curve and some mistakes made along the way which the parties will need to work together to correct.

### 2.4 Shared Risk & Reward

There are many different ways of operating a shared risk and reward fee structure. Their common feature is that fees increase if the matter is successfully resolved or concluded and decrease, sometimes to zero, if the matter is unsuccessful. One of the most prominent types of shared risk and reward is the conditional fee arrangement which has been used in both personal and commercial civil litigation since 1995. In the commercial sphere, other types of shared risk and reward include deal success fees, payment in client equity - which was particularly in vogue during the dotcom boom of the late 1990s or determination of fees in accordance with an external factor impacting the client’s profits such as the price of oil.

The rationale behind success fees is that the successful and happy client is better able to and more willing to afford fees than a client who has lost a deal or case and may be facing financial loss. A loser will not

<sup>7</sup> Corporate Counsel, 21 December 2009

<sup>8</sup> William Ohlemeyer, Partner, Boies, Schiller & Flexner, quoted in Corporate Counsel, 21 December 2009

want to throw good money after bad. The law firm should also be strongly incentivised to perform well as they may have a significant financial interest in the successful outcome of a matter.

DuPont's Coumadin litigation is an apt illustration of a shared risk and reward scheme which worked well for both the client and its firms. DuPont's firms were paid a fixed amount for the six month discovery period. The firms were paid seventy percent of the agreed fee each month and the balance of thirty percent was held back by DuPont. The firms could earn the thirty percent plus a multiplier of up to three times that figure at DuPont's discretion. DuPont's Corporate Counsel, Justin Miller has said<sup>9</sup> that:

"The [30%] holdback was an incentive for the firms to work on what really mattered to me...the holdback made the firms efficient...the fee structure rendered the focus."

The downsides of shared risk and reward structures are, however, considerable for the client with excessive success fees coming in for most criticism.

Lord Justice Jackson, in his review of civil litigation costs dated December 2009 noted with dismay that fees to lawyers operating conditional fee arrangements were sometimes more than one thousand per cent of the damages awarded in the claim.<sup>10</sup>

Litigation clients in particular are also likely to have to cede control of proceedings in return for entering a conditional fee arrangement.

## 2.5 Value Billing

Put simply, value billing refers to determining the amount of a bill in accordance with the value of the information or service to the client rather than the time expended by the professional in providing the services.

Value billing can take many different forms. Some professionals argue that any type of billing which is not based purely on hourly rates is a form of value billing; so a success fee, as described above, could be considered to be a form of value billing as could adding a premium to the usual hourly rate to reflect the urgency or importance of a matter.

Typical factors which might be taken into consideration when determining a value based bill are:

- Speed of delivery
- Degree of hand holding required by the client
- Amount at risk
- Cost savings to be generated for the client and
- Importance of the matter to the client.

The one certainty is that "value" is a totally subjective notion. Therefore what is value to one client may not be value to another. Value billing requires a tailored approach which takes into account the individual preferences and needs of the client and, once again, the better the relationship with the client, the more reliable and successful the value billing scheme.

The criticisms of value billing are that the term is sometimes used as an excuse to bump up fees rather than to reduce them but, in fact, it should operate both ways and clients should receive lower bills for more commoditised work as a reflection of this.

<sup>9</sup> [www.sugarcrest.com](http://www.sugarcrest.com), articles, How to Boost Business and Profits with Creative Pricing

<sup>10</sup> [legalweek.com](http://legalweek.com), 14 January 2010

The other difficulty is that it can be difficult to determine or measure value, and clients themselves don't always know what they want to achieve from value billing. The simplest way round this is for the client and law firm to discuss that client's priorities and an understanding of the types of work which are likely to be most specialised, important, urgent and appreciated are likely to flow from there.

David Maister, a law firm management guru says<sup>11</sup>:

"There's no secret trick to value billing. Just figure out a way to be more valuable. If you are, you'll get paid more."

## 2.6 Most Commonly Used Fee Structures

Having examined the various alternative billing structures available and noted the advantages and disadvantages of each from the client's perspective, it is instructive to look at the prevalence of each type of billing method.

Despite predictions of the demise of the hourly rate, recent research<sup>12</sup> shows that 98% of General Counsel still pay on the basis of hourly rates, at least some of the time. However, 91% also use fixed pricing, 35% use success fees and 28% use value pricing. Therefore, very few General Counsel rely on hourly rates alone and the proportion of work done on the basis of hourly rates is declining.

Further research conducted by Acritas and the Law Society's Commerce and Industry Group<sup>13</sup> found that one third of clients interviewed were considering sharing more risk through an increasing use of success fees.

Whilst the hourly rate is not dead yet, alternative billing methods are most certainly gaining ground and clients continue to press law firms to offer them alternatives to the hourly rate.

## 3. Criteria for Successful Fee Structures

The criteria for successful fee structures can be boiled-down to the following three essentials:

- Certainty
- Value and
- Relationship.

Each one is examined in turn below.

### 3.1 Certainty

Certainty is absolutely essential to being able to operate within budget and doing so is fundamental to all law firm clients, from an individual anxiously awaiting pay-day to the largest of corporates and government departments. The biggest failing of billing on a pure hourly rates basis is that it makes budgeting so difficult. Fixed fees, and retainers most clearly deliver certainty but shared risk and reward and value billing models can also deliver more predictability than pure hourly rates if they have been well planned and the parameters have been set out by mutual agreement.

<sup>11</sup> David Maister, [blog/230/Value-Pricing](http://blog/230/Value-Pricing)

<sup>12</sup> Winmark, Looking Glass Report

<sup>13</sup> Reported in the Law Society Gazette, 15 October 2009



The biggest danger is presented by "scope creep" where a fee that had been fixed ends up being renegotiated as the nature of the matter changes. CMS Cameron McKenna, in their 2010 report on the future of fees<sup>14</sup> note:

"A huge volume of fixed fees are renegotiated at the end of a deal based on scope creep."

Such forced re-negotiation can at one stroke, wipe out all the good will generated by the firm's agreement to enter a fixed fee arrangement. Alternatively, the client may refuse to pay any additional sum beyond the agreed fixed fee leaving the firm to carry the financial hit. Clients bear some of the responsibility for scope creep but the onus rests with the law firm, to:

- Spend time at the start of the relationship agreeing the scope
- Determine the amount of the fixed fee with some precision by reference to historic files and available resources
- Define the limited circumstances under which the fee might have to be re-negotiated and
- Resource and project manage each matter in order to stay within budget.

Sam Ford, a director at Barcap<sup>15</sup> explains the difficulties presented to his organisation by scope creep:

"it's very hard to unpick where they actually over run because they weren't keeping a proper eye on it - where was their genuinely additional work? If there was additional work who approved that, or was it just that it took longer and everyone agrees that is OK? Unpicking all that is almost impossible"

As Paul Gilbert asks<sup>16</sup>, how can it be that with:

"Fifty years of data on thousands of files, we still don't know the length of a piece of string?"

## 3.2 Value

As long as they can remain within budget and the final bill is predictable, many clients agree that it is more important to receive "value for money" than to achieve the absolutely cheapest price.

Barry Matthews at ITV for example, says:

"I don't want to come across as saying that price is completely king. What you don't do is sacrifice quality for the cheapest deal."

The provision of so called "value added services" such as:

- Newsletters, legal alerts and guides
- Training
- Intranets
- Free advice help lines and
- Seconddees.

Can all create the impression in the client's mind that the client is obtaining better value for money.

<sup>14</sup> CMS Cameron McKenna, The future of fees: your route map to value

<sup>15</sup> Interviewed by Firm Sense 14 October 2009

<sup>16</sup> Paul Gilbert, One Prick to Burst a Bubble

Value, as mentioned earlier, is very subjective but the key, as Winmark conclude is for firms to:

“develop pricing structures that create a clearer economic link between how much they cost their clients and the value they create for their clients’ businesses”

### 3.3 Relationship

The importance of strong relationships between law firms and clients can’t be overemphasised and is the subject of the next section set out below.

## 4. The Importance of Good Client Relationships

### 4.1 Pre-requisite for Departure from Hourly Billing

With the exception of highly commoditised work, any method of billing other than standard hourly rates relies on having deep, long term relationships with your clients.

In order to agree discounts, up-front fixed fees and retainers a law firm needs to know:

- Likely volume of business from the client
- How the client likes to work e.g. lots of partner time versus allowing delegation to more junior staff
- Hands-off or hands-on client approach – which may increase or decrease the firm’s workload, depending on the client’s individual style
- Responsiveness levels required
- Likely volume of business over the year and
- Likely types of business over the year.

Bradley Lerman, Associate General Counsel at Pfizer describes the process as follows<sup>17</sup>:

“It’s a more time-consuming process than the traditional process. It requires trust on both sides and open communication. It cannot succeed if it’s one sided”

Barry Matthews from ITV adds that ITV’s fixed price only panel system has:

“pushed our external advisers to better understand us and the jobs they’re working on, because otherwise, they can get it wrong.”

As a result of working closely and collaboratively together in order to agree alternatives to hourly rates, firms and clients find themselves achieving a true “partnership approach” which is often spoken of by clients as the “holy grail” of law firm: client relationships.

<sup>17</sup> Corporate Counsel, 21 December 2009

## 4.2 Benefits to Law Firms

All the law firm clients quoted in this paper expect to derive cost savings on a matter by matter basis from their use of alternative billing structures or from their negotiated discounts but it is not only clients who benefit from reaching these arrangements and from the resultant closer relationships with their law firms.

There are myriad benefits for the law firms too. These can be summarised as follows:

- Greater share of wallet or the possibility of becoming a sole supplier of legal services
- Loyalty from the client as the firm becomes embedded with the client and the agreed pricing structures deliver "stickiness"
- Ability to earn performance bonuses so that effort and merit continue to be recognised and rewarded
- Internal cost reductions as the firms are forced to adopt more efficient working practices and
- Clients as law firm champions, providing testimonials and referrals.

The net effect of each and every one of these benefits is that law firms are able to generate increased revenues and profits. The position is summed-up well by Alan Weiss, author of the best selling "Million Dollar Consulting"<sup>18</sup>:

"The longer you take to develop strong relationships, the faster you are able to create high-worth, high fee projects".

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This paper was first prepared for a CLT conference on pricing and fee negotiation for law firms held in 2010.

## CONTACT

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If you would like to discuss any issues raised in this paper, please contact Sally Dyson on +44 (0)207 681 4181.

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<sup>18</sup> Alan Weiss, responding to David Maister's blog at <http://davidmaister.com/blog/230/Value-Pricing>