Evaluating the Profitability of Alternative Fee Arrangements

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Agenda

• Industry and client behavior

• Establishing a basis for approaching AFA's and matter management

• Profitability 101

• Understanding the process around matter management and pricing strategy
Top Ten Issues Facing Legal Industry

- Pricing/fee structure: 71% (Corporate counsel), 160% (Private practice)
- Compensation/salaries at law firms: 50% (Corporate counsel), 48% (Private practice)
- Law firm profitability: 32% (Corporate counsel), 49% (Private practice)
- Layoffs: 143% (Corporate counsel), 39% (Private practice)
- Competition: 29% (Corporate counsel), 28% (Private practice)
- Legal outsourcing: 24% (Corporate counsel), 35% (Private practice)
- Role of associates: 25% (Corporate counsel), 28% (Private practice)
- Law firm management: 26% (Corporate counsel), 28% (Private practice)
- Commoditization/de-professionalism of legal services: 26% (Corporate counsel), 26% (Private practice)
- Integration/use of technology: 20% (Corporate counsel), 22% (Private practice)

* Indicates significant difference
Over the Past Decade...

• Total corporate non-law firm costs increased by 20%...

• ...but spending on large law firms increased 75%!

• 3/4 of GC’s reported 2009 budgets cut — by an average of 12%
  – this trend continued into 2010 and 2011

• Flat spending squeezing law firm billing rates
Post Recession Changes

Source: Altman-Weil Flash Survey
Post Recession Changes

Alternative Fee Arrangements in Large Firms

Trends in AFAs as a Percent of Revenue

<table>
<thead>
<tr>
<th>Year</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>2008</td>
<td>7.6%</td>
</tr>
<tr>
<td>2009</td>
<td>8.2%</td>
</tr>
<tr>
<td>2010</td>
<td>10.8%</td>
</tr>
<tr>
<td>2011</td>
<td>11.8%</td>
</tr>
<tr>
<td>2012</td>
<td>13.4%</td>
</tr>
</tbody>
</table>

Source: Citi 2011 Managing Partner Survey
What Companies and Firms are Starting to Realize

• It is possible to reduce a company’s legal costs (up to 25% or more)...

• ...while increasing quality of the legal product

• Firms maintaining and actually enhancing profitability

• Improving communication!
AFA Profitability

Compared to projects billed at an hourly rate, are your firm’s non-hourly projects more profitable or less profitable?

- More profitable: 36%
- As profitable: 12%
- Less profitable: 32%
- Not sure: 20%

Source: Altman Weil
**Client Behavior**

What changes are you seeing in client behavior?

<table>
<thead>
<tr>
<th>Change</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>More clients requesting discounts</td>
<td>81%</td>
</tr>
<tr>
<td>Clients requesting deeper discounts</td>
<td>55%</td>
</tr>
<tr>
<td>Clients paying bills later</td>
<td>43%</td>
</tr>
<tr>
<td>None of the above</td>
<td>7%</td>
</tr>
<tr>
<td>Other</td>
<td>15%</td>
</tr>
</tbody>
</table>

Have clients refused to pay for 1st and 2nd year associate work?

<table>
<thead>
<tr>
<th>Refused to Pay</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
<td>54%</td>
</tr>
<tr>
<td>No</td>
<td>46%</td>
</tr>
</tbody>
</table>

Have clients asked about your project management practices?

<table>
<thead>
<tr>
<th>Asked about Project Management</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
<td>49%</td>
</tr>
<tr>
<td>No</td>
<td>51%</td>
</tr>
</tbody>
</table>

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Are more or less clients wanting to discuss changing fee structures?

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>More clients</td>
<td>63%</td>
</tr>
<tr>
<td>Fewer clients</td>
<td>-</td>
</tr>
<tr>
<td>About the same</td>
<td>36%</td>
</tr>
<tr>
<td>None</td>
<td>1%</td>
</tr>
</tbody>
</table>

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Has the firm made an effort to align partner compensation with new initiatives?

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
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</thead>
<tbody>
<tr>
<td>Yes</td>
<td>49%</td>
</tr>
<tr>
<td>No</td>
<td>51%</td>
</tr>
</tbody>
</table>

In 2011, what percentage of your matters included an alternative fee arrangement?

| Average | 16% |

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Problems for Law Firms

• Pricing by alternative arrangement is not in most partners’ comfort zone
  – Lack of project management skills
  – Lack of pricing experience
  – Lack of historical information to refer back to
  – Inexact science, can’t completely reduce risk

• Shift in demand curve; leverage is with the clients
  – Increased competition for clients
  – Rage against the billable hour (?!)

• Initial profitability in AFA’s is likely to be below firm norms
“Many traditional law firm business models...are not aligned with what corporate clients want and need: value-driven, high-quality legal services that deliver solutions for a reasonable cost.”

– Association of Corporate Counsel

www.acc.com
What Clients Want

• Efficiency

• Cost predictability

• Transparency

• Targeted advice

• Increased use of alternative fee arrangements

• VALUE
Shift in Demand Curve

• Clients driving firms strategic initiatives:
  – Project management
  – Alternative fee arrangements
  – Matter budgeting
  – Client Teams
  – Technology activists
  – New strategic business products

• Increased usage of RFP’s; price becoming the overriding factor in choosing counsel
  – Non adherence to AFA requests knocking firms off of preferred provider lists
Successful Approach to Matter Planning

• Alternative arrangements are not a novel idea
  – Long proposed but seldom practiced

• Alternative fee arrangements push responsible attorneys to proactively work with clients and learn the tools of matter management

• Do not expect to go back in time!
Two Common Themes

**Position 1**
Clients have more of a bargaining position and we will respond appropriately to their RFPs with alternative arrangements if they require it.

**Position 2**
These are tough economic conditions. We will proactively approach clients about alternative fee arrangements.
## Reasons to Approach to Matter Planning

<table>
<thead>
<tr>
<th>For the Client:</th>
<th>For the Firm:</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Cost Predictability</td>
<td>• Gain in Trust</td>
</tr>
<tr>
<td>• Gain in Trust</td>
<td>• Improved Project Management Skills</td>
</tr>
<tr>
<td>• Savings</td>
<td>• Stronger Client Relationships</td>
</tr>
<tr>
<td>• Confidence internally</td>
<td>• Increase Transparency</td>
</tr>
<tr>
<td></td>
<td>• Revenue Predictability</td>
</tr>
<tr>
<td></td>
<td>• Hour/Staffing/Cost Predictability</td>
</tr>
<tr>
<td></td>
<td>• Competitive Advantage</td>
</tr>
<tr>
<td></td>
<td>• Flexibility</td>
</tr>
<tr>
<td></td>
<td>• Adherence to budget</td>
</tr>
<tr>
<td></td>
<td>• Accountability</td>
</tr>
<tr>
<td></td>
<td>• Increase Profitability</td>
</tr>
</tbody>
</table>
Successful Approach to Matter Planning

• Not every client will want an alternative arrangement

• Every client will be happy to discuss them
Where do you start?
Profitability 101 – The Basics

• How Much Can We Charge?

• How Much Does it Cost Us?

• How Can We Maximize the Spread?
Has the model changed?

1. Standard Value of Production
   - Fee
   - Capacity

2. Utilization
   - Revenue
   - Capacity

3. Realization
   - Direct Costs
   - Contribution Margin
   - Operating Profit

4. Leverage
   - O/H

5. Margin

6. Client Investment Speed (Time Value of Money)
   - Net Income
   - Investment costs

1. Client Investment Speed (Time Value of Money)
Profitability 101 – AFA World

• Estimation, Efficiency, and Project Management

• Risk model has changed

• Controlling the drivers that CAN be controlled has become more important
  – Limit risk where you can
  – Learn from previous experience
  – Learn to say no…quickly
Revisiting Profit Metrics

- Realization vs. profit - why is this still a debate?

- Billable hours vs. efficiency - alternative fee arrangements and discounting have changed this scenario

- Partner to non-partner ratios - what type of work are you doing?

- Indirect costs - you cannot cut your way into profitability!
Firms need a strategic plan and a partner compensation model that supports it

• Gives partners visibility to what is happening

• Gives partners a common goal

• Allows action to improve current situation

• Monitors actions against budgeted/expected results

• Encourages the right behavior!!
**How do you define Alternative Arrangements?**

<table>
<thead>
<tr>
<th>Hourly – Alternative or no?</th>
<th>Non Hourly – “True Alternative Arrangements”</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Hourly-based</strong></td>
<td><strong>Risk-based</strong></td>
</tr>
<tr>
<td>• Discounted hourly rates</td>
<td>• Contingency</td>
</tr>
<tr>
<td>• Volume discounts</td>
<td>• Success incentives</td>
</tr>
<tr>
<td>• Blended rates</td>
<td>(usually coupled with reduced rates)</td>
</tr>
<tr>
<td>• Task-based rates</td>
<td>• Fixed fees</td>
</tr>
<tr>
<td>• Retainers</td>
<td>• Capped Fees</td>
</tr>
<tr>
<td></td>
<td>• Collared Arrangements</td>
</tr>
<tr>
<td></td>
<td>• Hold backs</td>
</tr>
<tr>
<td><strong>Value-based</strong></td>
<td><strong>Risk vs. Value – Debatable and interchangeable</strong></td>
</tr>
<tr>
<td></td>
<td>Many other alternatives and more are added daily</td>
</tr>
</tbody>
</table>

- **Risk-based**
  - Contingency
  - Success incentives (usually coupled with reduced rates)
  - Fixed fees
  - Capped Fees
  - Collared Arrangements
  - Hold backs

- **Value-based**
  - Stage based
  - Hybrid
  - Market priced fixed fees
  - Bundled pricing
  - Pure value based
There is no Perfect Arrangement

- Standard Billing Rates
- Negotiated Rates
- Negotiated % Discount
- Discretionary Discounts
- Capped Fees
- Fixed Fees
- Retainers

- Contingent Cases
- Blended Rates
- Tiered Rates
- Success Fees
- Trial Basis (Hybrid Contingent)
- Other
Overall Matter Management is:

The process of analyzing, communicating, guiding, delivering, and reviewing an engagement from its creation until its conclusion in an attempt to meet three key deliverables:

– Client satisfaction on value

– Client satisfaction on quality

– Acceptable results and returns to the firm

The process starts at the beginning. Mistakes made in estimation, risk identification, and scoping will be felt throughout the engagement and beyond.
A Fundamental Change

- More upfront planning
- Increased management
- Closer monitoring of spending
- Selective standardization
- Accept some risk to lower cost
- AFA profitability requires efficiency
Successful Approach to Matter Planning

• Commitment from leadership
  – Must be “in it for the long term”

• Establish basis for moving forward—what will we measure, and how?

• Implement achievable business processes to build information base
  – Start small and higher level

• Track results, and create a feedback loop
Successful Approach to Matter Planning

• Every matter can have a alternative arrangement

• Every matter should have an alternative arrangement

• If properly managed those alternative arrangements could be more profitable and you have provided the client with predictability and results
- What is the client looking to achieve? Do we need more information?
- What are the key risks? What needs to fall out of scope?
- What are the firm’s legal and business needs?
- Is this core to our business? Should we say no?
- Have we done work like this in the past?

- What are the activities need to accomplish the goals?
- What does the timeline look like?
- What resources do we need?
- Constraints?
- Can we use historical data?
- How do we maintain quality while balancing firm needs?
- How do we plan for trigger events?
- Where can we improve efficiency?

- Are we staying close to the budget and schedule?
- Are we appropriately leading and working with the client and internal team?
- Do we need to adapt to changes?
- Are there key deadlines we need to readdress?
- Do we need to change strategy?
- Are we delivering a quality product to the client?

- Did the actual events fall in line with the plan?
- What is the feedback from the client?
- What is the feedback internally?
- Where did we succeed?
- How can we improve?
- Where can we improve efficiency?
- How will we approach it next time?
Know your Goals

• What is the client looking for?

• What are you willing to accept regarding the profitability of this work?

• Is this core to our business?

• Learn to say no

Plan to win
Know your Goals

• Are the clients’ expectations realistic?

• Look at historical matters with common characteristics
  – Were they managed properly?

• What is the cost of delivering the service?

• What will the volume be?
  – Is the volume target subject to variables?
Model and Prepare

• Best Practices:
  – Ask the right questions to fully understand the scope of work
  – For larger matters break it down by stage of transaction, phase, or sometimes even task
  – Safeguard against unforeseen circumstances (not every risk, but major trigger events)
  – Consider safety valves
  – Use historical information to budget for both a new and existing client
  – Provide clients with several options (if required) that are decision neutral for the firm
  – Make sure there is a complete understanding of what is in scope versus what is out of scope.
Deliver and Track

• Until you analyze hard facts everything is anecdotal

• Track, Track, Track
  – You must track data effectively, especially as you dive into the world of alternative arrangements
  – This requires periodic review of variance of actual performance against the intended delivered plan
  – If possible use arrangement codes in your billing systems to help distinguish AFAs for future analysis
  – **Time recording must be enforced or variance analyses will become meaningless**

• Use information to improve future planning and to ensure proper project management of current engagement
Review

• Post-Mortems - Review of all engagements is necessary

• Use information to improve future planning and to ensure lessons have been learned

• Work with the entire engagement group to determine inefficiencies and where you excelled
  – Track these items
  – Let others know about the experience

• Adjust for the next engagement
Conclusion

• Alternative fee arrangements are a global initiative

• Spearheaded by global companies

• Be it regional or national counsel, the challenge remains the same

• Firms that have developed internal processes to address this growing need are in prime position to take away work from ill-equipped firms

• Knowledge and preparation at the onset of engagements are the keys to success
Conclusion

• Trust is the key—the demand for legal services will increase

• Client motivation—cost certainty or price? These are not the same thing

• Sometimes, the billable hour is the best arrangement

• With proper understanding of margins and reasonable assurance of scope, you are indifferent to the pricing arrangement

• Start somewhere. Only experience will increase a firm’s competence
Questions?

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