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Alternative Fee Arrangements in Complex Litigation

The Case for Value Billing

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BY OVERTON THOMPSON III AND DAVID RUE

Alternative fee arrangements (AFAs) are about value, a benefit legal departments are increasingly pressured to bring to their companies. When hiring an outside lawyer, clients are not looking for “hours,” and they certainly are not looking for tenths of hours. They seek value.

So how does a fee arrangement with outside counsel best ensure that value? That is easy in certain scenarios, such as in a “plaintiff’s case” where a company is seeking to recover a sum of money in damages. In these cases, value can easily be captured through a straight contingency arrangement— if the case is successful, and damages are recovered, the outside lawyer receives a percentage of the recovery.

But what about on the defense side? According to the ACC Chief Legal Officer 2017 Survey, 97% of CLOs outsourced complex litigation to law firms in the previous year, once again assuring litigation’s status as the most outsourced legal matter. Because there is typically no pot of gold for the company to share at the end, however, capturing value is even more challenging in a complex defense case where quantifying savings is not easy. This article looks at available AFAs when outsourcing a complex litigation matter on the defense side, including a real world case study on an approach that has worked well for one of our clients.

AFAs Are a Win-Win for Legal Department and Outside Counsel

It is hard to dispute the potential benefit of an AFA, both for legal departments and the law firms they hire. First, and foremost, firms are incentivized to make AFAs work because increasingly they lead to improved communication and higher levels of client satisfaction. When the fee is aligned with the value the company receives, the legal department wins. AFAs can also lead to a more predictable fee than straight hourly billing. Predictability, again, is a win for the legal department.

These wins for the client also make AFAs a win for outside counsel because they can lead to a better attorney-client relationship. Uncertainty can be the most dreaded element of litigation for many legal departments, both related to the outcome and cost. Because AFAs can be more predictable, those tense conversations over unexpected bills can be avoided. They create a new dimension to the relationship because of the shared ownership of the risk.

Approaches to AFAs for Complex Defense

For a complex defense case, there are a number of different AFAs that can be used.

1. *Blended Rate Arrangements*

In blended rate arrangements, one weighted average rate is charged, regardless of seniority. This arrangement does encourage efficiency, but it is flawed in that it still involves hours, does not bring predictability (by itself) and does not allow outside counsel to take risk with the client.

2. *Fixed Fees*

A fixed fee can either be employed for the entire case, or can be broken down in phases. Legal departments benefit from fixed fees because they are very predictable. However, there can be downsides. First, there is a lot of risk if the case does not go as planned. The outside firm could suffer a significant financial loss without the possibility of a reward for a good result. In turn, the client may have concerns that the firm will not put enough resources in the case if the fee is fixed. On the flipside, the client may also be concerned that the firm may receive an undeserved gain if the case resolves quickly.

3. 'Collar' Arrangements

Another possibility for handling a defense case is a "collar" arrangement where outside counsel is paid the same fixed amount as long as the hourly-based fee is within a certain percentage of the agreed fixed fee. If the hourly-based fees are less than the lower collar, outside counsel receives a share of the savings as a bonus. If the hourly fees exceed the higher collar, the client receives a discount from the hourly rate. This approach helps to ameliorate the legal department's concern about a windfall to the firm and the lawyer's concern about taking a significant loss if the time expended greatly exceeds the fixed fee.

4. *Pure Contingency*

When handling a defense case on a pure contingency basis, the outside lawyer and the company agree on what the potential loss could be in the case, and the lawyer is paid a percentage of the amount the client "saves" off the potential loss at the end of the case. However, determining this fee in a case where the loss is not clearly quantifiable can be difficult and, as a result, these arrangements are rare.

Holdback Arrangements: Incentivizing Results, Efficiency and Predictability

While the above AFAs have their pros and cons, there is another arrangement that works particularly well in defending complex litigation. This approach uses a "holdback" to incentivize results and a phased budget to incentivize efficiency and predictability. In this approach, an agreed upon percentage of fees generated within a budget is set aside to create a pool of fees which can be used to encourage optimal outcomes.

This fee arrangement has a number of benefits, including bringing a large degree of predictability due to a strong incentive for the firm to stay within the fixed budget for the case. At the same time, some of the potential downside of a truly fixed fee is alleviated because the firm will receive at least a portion of the amount over the proposed budget. This fee arrangement also encourages efficiency. Specifically, it encourages firms to push tasks down to the team member with the lowest billing rate who is capable of doing the work. Finally, it incentivizes great results and allows the firm and the client to share some of the risk.

Holdback Arrangement in Action: A Case Study

A holdback arrangement would work particularly well in the following scenario: a dispute involving post-closing consideration in a purchase transaction. The seller sues a company (the outside firm's client) demanding damages for failure to pay certain earn-out payments allegedly owing under the purchase agreement, despite seller having failed to satisfy the conditions necessary to receive the payment. The amount at stake is relatively modest and can't sustain an unbridled approach to defending the case.

Holdback Arrangement

At the beginning of the case, the firm would prepare a budget for each phase of the case — written discovery, document production, depositions, experts, mediation, motion practice, trial prep, trial, etc. Per the agreement, the firm would charge 80% of the time expended in the case as long as the firm was within the budget; and 20% is "held back." If the firm exceeds the budget for a particular phase of the case, it would only bill the client for 50% of the excess, and the remaining 50% would not be added to the holdback.

The outside firm would then reach an agreement with the client regarding the possible outcomes of the case. If the firm loses (however that is defined), it gets nothing more and the client retains 100% of the holdback. If the firm gets a satisfactory (but not great) result, it receives the entire amount of the holdback. If the firm gets a great result, it earns the holdback plus a success fee, which is calculated as a multiple of the holdback (around 1.5 or two times the holdback, depending on the result).

To make holdback arrangements work, it is critical for law firms to carefully manage the case and carefully manage costs. For instance, for document review, outside counsel may consider using a variety of alternative legal service providers who provide excellent work at less cost. Technology can also lead to significant savings, particularly using technology assisted review software for reviewing large quantities of documents.

It is also important, particularly in a long, complex matter, to make good decisions on what actions outside counsel will, or will not, take in the case. Oftentimes, outside counsel feel the need to file every possible motion, fight every fight, take every possible deposition, etc. While this may be necessary in a particular case, many times it is not. Not every battle needs to be fought if the outcome does not really advance the ball toward the desired outcome. The key is to ensure that outside counsel and in-house counsel will be close partners and decide together the case strategy relative to the value.

Conclusion

In appropriate cases, the use of the holdback approach outlined herein can be especially bene cial for both outside counsel and in-house legal departments. Outside counsel should use their pricing strategy team to help create the budget and engage their project management resources to manage the matter and track the performance of the budget as the case progresses.

Accounting teams are vital to tracking fees in the budget and reporting the amount of the holdback as it accumulates. In-house legal teams are essential in assuring that the scope of work outlined in the proposed fee arrangement meets expectations as the matter gets underway. Then, outside counsel and legal departments can work together to deliver value to the organizations they serve.

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