

Alternative Fee Arrangements

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Overview

Clients and law firms sometimes talk about "Alternative Fee Arrangements" (or "AFAs") without understanding what they entail. Best understood, the term describes any arrangement other than payment based purely on hourly billing rates, whether "standard" or "discounted."

Hourly billing is basically "cost-plus" billing. The law firm charges the client based upon its time in the matter (its "costs") and adds an increment to its hourly costs to generate a profit (the "plus"). Hourly rates and detailed time-keeping provide some objective standard for compensating the law firm, and clients understand and accept this.

So why should clients and law firms consider AFAs? Hourly billing focuses more on how each hour is spent than the cost (or value) of the overall engagement. Hourly costs can be uncertain and open-ended. The total cost of the representation may exceed the client's perception of its value, even if the law firm's work was first rate.

Hourly billing may also encourage or mask a failure by the client and outside counsel to manage an engagement effectively. (This can be addressed through the use of a thoughtful budget.) Alternative fee arrangements may force both parties to think harder about the objectives for the engagement and how to achieve them cost-effectively at the very outset when establishing the value and price for the overall engagement. This may encourage a much more purposeful approach by the client and outside counsel to managing the matter from start to finish. This can produce a true "win-win."

Getting to a Win-Win

How is it ever possible to get a "win-win" when one party pays and the other receives? Too often, we view the financial side of the attorney-client relationship as a zero-sum game. This misses the point that, in the best relationships, the parties' interests are aligned when price equals value. In a free-market economy, the existence and successful continuation of corporations (and other business ventures) and the enforceability and value of any transaction depend upon the rule of law. Therefore, high-quality, cost-effective legal services can add great value to any business. Sophisticated clients appreciate this. The trick is how to match up price with value, from the client's point of view.

Faced with the uncertainty in almost any engagement, most clients and outside counsel choose hourly billing, coupled perhaps with an estimate or budget of what the total engagement might cost. Yet, the parties may well arrive at a win-win at the outset of a matter using an AFA. To do this, the client and outside counsel must be comfortable sharing risk. This can be a "plus" because it can enable the parties to commence the engagement on the same side of the table and thus change the mindset they use to approach the representation.

For this to work, the client and outside counsel must devote time and attention at the outset of the engagement to a truly meaningful assessment of the matter. In litigation, this may go so far as requiring an in-depth review and analysis of key documents, interviewing key witnesses, performing basic legal research, and even presenting both sides of the matter to key decision makers inside the client organization, including heads of business units as well as inside counsel. The client should think about the true value of the engagement to the client's organization, taking into account business goals, the value of controlling risk, and the value of anticipated outcomes.

Variations

Against this background, the client and outside counsel can structure alternatives to hourly billing arrangements using one or more of several basic approaches, including the following:

- Fixed or flat fee for a particular matter or series of matters paid in regular installments at the beginning of each month of the engagement.
- Fixed or flat fee for a particular stage or stages of a matter combined with hourly rates for the remainder of the engagement.
- Fee cap for all or part of the matter.
- Upfront non-refundable retainer, combined with a percentage hold-back from standard rates during the engagement, and an agreement for payment of a multiple of the hold-back at conclusion of the matter if the outcome is a "success" (defined in advance), or loss of the hold back if the matter falls short of a "success."
- "Value" based fee, determined by a mutual agreement about the anticipated value of the representation in the context of the client's over-arching objectives, and then staffed.
- Blended hourly rate for any one category of timekeeper or a single blended rate for all timekeepers.

Whenever a fixed fee, flat fee, or fee cap is used, this should be set somewhat higher than the amount the parties' would normally estimate in a "budget" to provide the law firm with some cushion against the exigencies that inevitably arise in every engagement. This is true because budgets

should be subject to modification through some kind of "change order" procedure, whereas fixed fees or fee caps are not intended to have such flexibility.

Although the parties might provide for adjustments to fixed fees or fee caps in very limited circumstances, these fee arrangements should not be made subject to too many conditions, or the parties will be forced to track them against hourly performance, and they might as well then use hourly billing in the first place. Put another way, if the parties agree to use a fixed fee, they should not compare this outcome against hourly billing throughout the engagement and certainly at the end of the engagement because this will only lead to recriminations or "second guessing" that will destroy the intended "win-win."

Absent a bizarre coincidence, one party or the other will always get the better of the deal with any fixed fee. The key to a "win-win," however, is for each party to agree at the inception of the matter that they are thrilled with the agreed-to price as a great way to manage risk and to align the interests of both the client and outside counsel throughout the engagement by essentially taking the tension associated with hourly billing out of the picture.

When to Use Alternative Fee Arrangements

AFAs will be most successful when used by clients and outside counsel who know and trust each other from past dealings. It is also a great advantage if the client has a track record of handling similar matters and is willing to share data about its historic experience. This provides a target for the client and outside counsel to meet or beat, all else equal. Likewise, outside counsel will be best equipped to set a mutually agreeable price if the law firm has extensive experience in handling the kind of matter at issue.

AFAs may also work better with multiple matters. Having a higher volume of matters may better enable outside counsel to achieve greater efficiencies that can be passed along to the client to reduce the aggregate cost of handling all the matters, and it can also help even out risk to both parties across the whole portfolio of matters.

Any law firm that enters into such an arrangement must be absolutely committed to doing what it takes to complete the engagement with the same enthusiasm and quality with which it commenced the engagement even if it gets "upside down" on fees at some point during any one engagement. By the same token, the client must be willing to allow the law firm to keep any "upside" benefit that comes from managing the matter exceedingly well or enjoying the financial benefit of any unanticipated breaks during the course of the representation. This is what risk sharing is all about. If either the client or law firm feels that it cannot emotionally or institutionally handle these outcomes, then they should use an hourly fee arrangement instead.

Advantages of AFAs

What are the advantages of using AFAs? There are many:

- They can provide predictability in legal costs for the client, enabling the client to budget more reliably, even including a regular payment schedule through completion of each matter or a bundle of matters.
- They should limit the client's total cost exposure.
- They encourage law firms to take greater ownership over the costs of the engagement because they own more of this risk.
- They may encourage the client and outside counsel to think more creatively and purposefully about how to manage costs and outcomes for the client's overall legal work.
- They may better align price of the engagement and value to the client.
- They may reduce total legal costs to the client without necessarily reducing profitability for outside counsel.
- They may encourage the client and outside counsel to define "success" from the outset of the engagement and, by focusing on it, to achieve it.
- They should reduce misunderstandings and disputes over legal fees and costs and increase client satisfaction, thus strengthening the relationship between the client and outside counsel.

AFAs: Some Examples

- For a fixed fee, we handled massive regulatory litigation, specifying the attorneys authorized to work on the file, and agreeing that any added team member would charge standard hourly rates. From prior experience, we knew how long the matter would run, and so were able to "cost out" the engagement by determining the opportunity cost for the dedicated lawyers' time for the agreement's duration. By capping the number of individuals committed to the file, we capped both our cost in handling the file, and the client's fees. By using a dedicated team that learned the case inside and out, we avoided duplicated efforts and other inefficiencies.
- We handled an important appeal at standard hourly rates, but with a cap. This gave our firm the opportunity to earn standard rates, provided we handled the matter efficiently enough to remain within budget. At the same time, the client was assured it would pay no more than the capped amount, which we agreed was a reasonable fee for this engagement.

- Several telecommunications clients pay us a flat, monthly fee to help them stop fraud. Our coordinated efforts go beyond merely handling litigation, which we do, to include managing investigators, and working with law enforcement and our clients' fraud departments. This arrangement has removed the financial consideration from our clients' decisions to sue fraudsters, who see that we will take all necessary steps to pursue them. As a result, our clients' fraud-related losses have been sharply curtailed, providing them with a substantial return on their investment, improved customer and employee satisfaction, and excellent public relations opportunities.
- We filed antitrust lawsuits against 12 companies, handling the matters for a contingency fee of one-third the client's recovery. The client paid costs.
- We handled numerous bankruptcy preference claims for a flat fee per matter.
- For a class action matter, we proposed flat fees, with a collar and incentive bonuses, for the first two phases of the case, which included, respectively, initial case assessment and class certification discovery. We based the fee amounts on our prior experience with the same type of matter, and on the findings of our firm's annual Class Action Survey, which provides data on companies' average cost of defending class actions.
- Using historical data based on prior years' work for a large client, we agreed to an annual retainer. We received payment on the first of each month, before we billed. Costs were separately billed, monthly. The agreement assumed no more than three trials, and provided that a fourth trial would not be covered by the retainer and would require the parties to negotiate. The agreement was subsequently modified so that the retainer excludes trials. We now charge a flat fee for trials.
- On behalf of a pharmaceutical company client, we went from hourly billing to a flat, quarterly fee for all work related to 20,000 cases in multidistrict litigation. We were able to make this shift using historical billing data and the understanding we developed as to the scope of services required. The arrangement was subject to exceptions for unanticipated developments, and the quarterly fees were periodically adjusted up or down as cases were resolved.
- An insurance company client pays us a set annual amount per case through the class certification decision. Thereafter, we are paid 90 percent of our standard rate. If cases are stayed for any reason, we revert to an hourly agreement during the stay.

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