Alternatives To Hourly Billing:

A Guide For Lean Enterprises Facing Major Legal Expenses

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Introduction

Typically, attorneys charge by the hour: the more they work, the more they earn. However, this is not the only way to do things. There are a variety of alternative fee structures, including simple flat fees, success fees, and even pay-what-you-will arrangements.

Alternative billing receives more media attention than any other legal cost-control strategy. Thousands of pages have been written on the topic, and it isn't hard to see why. Traditional hourly billing can be a serious problem. It rewards attorneys for overworking simple projects and for pushing low-value work up the food chain to more senior attorneys billing at higher rates.

When you see five attorneys billing for the same hour-long meeting, hourly billing is what makes that possible. When you see twenty-page research memos on minor issues or waste-of-time court filings, the billable hour is a likely culprit. When you see a $500-per-hour attorney drafting anything from scratch rather than delegating the work to a $250-per-hour attorney? The billable hour is to blame, once again.

There are two main ways in which alternative fees seek to prevent these abuses: by capping the amount that an attorney will receive for a particular project, or by tying compensation to the quality of the outcome. Both strategies force attorneys to focus on efficiency, project management, and creating value for clients.

For all the hype surrounding alternative fees, traditional hourly billing still dominates. There are a couple of reasons for this. First, the legal profession is relatively conservative and resistant to change. Attorneys have been billing by the hour for centuries, and old habits die hard.

Second, and more important, hourly billing favors attorneys in ways that the alternatives do not. Even when a budget has been imposed on a legal project, it is usually very easy for an attorney to go over budget without suffering any consequences. If the overage is large enough, then that may prompt an uncomfortable conversation with the client. However, attorneys can always blame the excessive fee on the uncertain nature of disputes or contract negotiations. (Many clients are seduced by lawyers' perceived expertise on legal matters and blindly accept this line of reasoning.)

Failing that, the attorney may blame the other side for making things more complicated than they needed to be. Failing that, the attorney may blame his or her own client. Even if the client remains unpersuaded, he or she is still likely to accept the situation and pay the bill to avoid getting into a legal dispute with (of all people) a lawyer.

Alternative fee structures make it much harder for attorneys to exceed budgets because they shift focus away from the amount of time spent on particular tasks or projects. If an attorney agrees to accept a flat fee, then it does not matter whether it takes ten hours or one hundred hours to do the work. He or she gets paid the same amount either way. Similarly, if an attorney agrees to work for a percentage of any amounts you win in a lawsuit, then that percentage is what he or she receives, whether it is based on an award of $10,000 or $1,000,000.

Attorneys who have never had to work efficiently or focus on results may have a very hard time adapting to this alternate universe. Putting a fixed price on legal services takes practice and forces attorneys to accept a great deal of risk. If they overestimate costs to protect their margins, they will scare clients away. If they underestimate, they may very well end up doing a lot of work for free.

If the alternatives are so unattractive, how do you convince an attorney to abandon billable hours? There are several strategies that can help you to get buy-in. The key is to meet your attorney halfway, limiting risk where you can and creating opportunities for him or her to share in your success. The first two approaches are not very useful for leaner enterprises, but they illustrate how these concepts work in practice:

- **Be an enormous company that can deliver millions in business.** Keeping attorneys busy is a challenge for most law firms. They tend to have massive overhead expenses, and a long idle period can be fatal. A client paying millions in monthly billables can keep an entire firm flush with business. Often, attorneys are happy to cap their upside in exchange for knowing where their next several meals will be coming from. This is a risk-limiting strategy.

- **Be a venture-backed start-up with huge potential.** Back when record companies still relied on album sales, they would market "loss leaders", music samplers sold at a deep discount in the hope that consumers would like a couple of artists enough to go out and buy their albums at full price. A lot of law firms do the same thing with promising start-ups: offer discounted or flat-fee structures early on for small projects in the hopes of winning a lucrative IPO a few years down the road. This is a reward-based approach.

In both of these cases, the attorneys are getting something in return for agreeing to an alternative fee arrangement: certainty, in the first example, and a lottery ticket in the second example. Of course, most businesses aren't GE or an over-hyped mobile app start-up, but there are still ways that a business of any size can structure an attractive alternative fee arrangement that limits attorney risk and/or enhances upside potential:

- **Use alternative fees for straightforward, commodity work.** Some legal projects just do not involve many variables. For example, entity formation, non-disclosure agreements, and software user licenses tend to adapt well to a cookie-cutter approach. In these situations, it is relatively easy for attorneys to come up with an accurate fee estimate. Particularly for very small projects, the attorney's risk will be limited. These are the areas where alternative fees are most likely to be available to you, no matter what your size or legal budget.

- **Hire a progressive attorney who chooses not to charge by the hour.** There are a growing number of attorneys and law firms out there that have abandoned the billable hour. Instead, they have invested in improving project management, overall efficiency, and the accuracy of their budget estimates. These law firms see alternative fees not as a source of increased risk, but as a competitive advantage they hold over their peers. They are in the minority but, if you can find one, they have already created their own incentives for adopting alternative fees.

- **Build a reputation as a loyal, easy-to-work-with client.** Low-ball estimates and ballooning costs are not always the attorney's fault. Often, a client will contribute to the problem through poor records management, unreasonable time demands, and tangled lines of communication. My e-book details how your business can lower your costs by avoiding these pitfalls, and I urge you to put those strategies to use. If you work with an attorney on an hourly basis for a couple of projects and show that you are a great client with long-term potential, then you will have an easier time pushing for a move away from hourly billing. The attorney will see you as less of a risk, and as a valuable client for life.

- **Use a hybrid billing approach so that attorney and client share the risk equally.** Even the least predictable legal projects (complex litigation, sale of a business) have predictable aspects. By working with your attorney to identify areas where an accurate estimate is possible, you can enter into a conversation about setting flat rates only for those stages of the project. This can be presented as a win-win proposition that balances risks and gives you some measure of certainty.

All of my writing on legal expense management takes strategies that have worked well for large companies and scales them down for businesses with limited resources. I do not even cover alternative fees in my e-book because the leanest start-ups seldom have the bargaining power to win those concessions. However, once your business starts paying attorneys thousands of dollars a month, consistently, the possibilities open up a bit. You may not be a Fortune 500 company with law firms falling all over themselves to work for a low flat fee. You may not be backed by a private equity firm with a Sand Hill Road address. But that does not mean you cannot present yourself as an attractive candidate for an alternative fee structure.

The next section contains a brief rundown on the most common alternatives to hourly billing. For some of these structures, the appeal lies in their simplicity. Others are more complicated, but may appeal if you are someone who enjoys "aligning incentives" and getting creative with compensation packages. After summarizing them, I will spend a page or two outlining the potential downsides to alternative fee arrangements.

Alternative Fee Structures Explained

Different alternative fee structures accomplish different goals. At one extreme, they simply limit the total amount that an attorney can charge the client for a particular project. These approaches are all about cost-control. At the other extreme, some alternative fee structures force an attorney to focus on the client's business objectives. These approaches are all about maximizing value. Because there are positives and negatives to these approaches, there are also hybrid structures that attempt to balance cost considerations with achieving value.

The following alternative fee structures are best if you care about cost control above all else:

- **Flat Rate.** Typically attorneys will offer flat rates for simpler, more predictable projects. The client benefits from the cost certainty. However, if the attorney over-estimates the time required, then he or she will get paid more than under an hourly billing arrangement. Attorneys tend to discourage flat fee arrangements for more complicated or open-ended matters.

- **Hourly Billing With A Fee Cap.** Under a fee cap structure, the attorney bills at an hourly rate, but agrees that the total amount charged will not exceed the cap amount. This is, by far, the most client-favorable arrangement. If the cost comes in under the cap, you pay that lower amount. If the attorney reaches the cap, he or she has to work for free until the project is complete. Typically, an eager attorney will offer this fee structure to a new, reluctant client. It signals the attorney's confidence in his or her efficiency and ability to predict how long a project will take to complete. To create some upside value for the attorney, the cap amount may be slightly higher than what he or she might offer under a pure flat rate structure.

- **Flat Monthly Rate.** This is a variation on the flat fee where the client pays a fixed amount every month for however long the project lasts. This approach protects the attorney from working for free on a project that drags on longer than expected. However, the client may end up over-compensating the attorney if, for instance, there are long idle periods while your own attorneys wait for the other side to respond in a contract negotiation, or if there is a long delay in the middle of your lawsuit. Many attorneys offer an arrangement like this for basic small business services, sometimes charging only a few hundred dollars per month.

- **Volume Discount.** Sometimes a law firm will agree to reduce its typical hourly rate if the client agrees to bring in consistent business over an extended time period.

- **Discount Above Cutoff Amount.** As with a flat rate arrangement, attorney time is charged at normal hourly rates up to a certain amount. However, instead of earning nothing for additional time spent on the project, the attorney(s) are compensated at a heavily discounted hourly rate (say, 50%). The idea is to soften the blow for attorneys going over budget. They still are compensated for their time, which makes it somewhat less likely that they will rush and do sloppy work just to get the project completed.

- **Blended Hourly Rate.** This is not a pure cost-control play. It is more about efficient staffing. Instead of charging different rates for attorneys of different experience levels, all attorneys bill at the same rate, which is an average of all their normal billing rates. So, senior attorneys are billing at a lower rate than usual and junior attorneys at a higher rate. This structure encourages senior attorneys to push work down the food chain. However, working this way does not always save the client money. If the junior attorneys are the ones overworking a matter, the client is actually paying more for that work than at the standard, unblended rate. Also, this structure may encourage the use of inexperienced attorneys on challenging tasks that are above their pay grade.

The next few fee structures focus on value rather than cost control:

- **Contingency Fee.** This is the oldest form of value-based billing. An attorney working on a contingency basis collects a percentage of the total amount the client recovers. It is most commonly used by plaintiffs' attorneys in class action lawsuits, where clients cannot afford to pay the attorney up front, but stand to recover very large sums if they prevail. However, it is also possible to use a contingency fee in the context of a business transaction, where compensation is tied to the dollar value of the deal. In some contexts, laws and ethics rules prohibit contingency fees.

- **Reverse Contingency Fee.** Sometimes a business gets sued and knows for certain that it will have to pay money to the other side, the only question being how much. With a reverse contingency fee, the attorney earns a percentage of whatever amount he or she saves the client. For example, let's say the worst case scenario is a $2,000,000 payout and your attorney negotiates a $1,000,000 settlement. Under a 10% reverse contingency fee, the attorney would earn $100,000 for that work. You have to have very reliable information about the possible dollar amounts for an arrangement like this one to work.

- **"Pay-What-You-Will" Billing.** This is the most extreme form of value-based billing. The client pays nothing until the project is complete, at which time that client can pay zero dollars for poor results or reward the attorney handsomely for a job well done. Most attorneys would think a client completely insane to propose such a structure. However, a handful of firms actually volunteer to use this approach, with the objective of building long-term relationships with fair-minded clients. Using this structure requires an enormous amount of trust and planning. If the client short-changes a successful attorney, then the attorney would almost certainly refuse to take on any future projects for that client.

- **Payment In Equity.** This is a controversial fee arrangement that is most common in the venture-backed start-up world. A law firm will serve a stable of start-ups, sometimes in affiliation with an incubator, in exchange for an equity stake in each of them. If one out of those ten client companies eventually goes public, the increased value of the law firm's equity stake will more than cover the time lost working with the nine companies that did not succeed. Aside from the riskiness for the attorneys, these arrangements raise ethical questions and possible conflicts of interest.

- **Partial Value-Based Billing.** This structure involves dividing attorneys into junior staff (who do time-consuming but lower value work) and senior staff (who provide guidance and valuable experience). Junior staff bill at their normal hourly rates with no cap on hours or the total amount of the bill. Senior staff are compensated solely for the value they create, based on meeting certain project goals that are defined at the outset. This approach is very similar to blended rate billing, in that it encourages delegation. However, the junior attorneys are not billing at an artificially high blended rate.

Finally, there are some structures that attempt to balance cost-control and value:

- **Hybrid Billing.** Under this approach, attorneys charge the client fixed amounts for the more predictable phases of contract negotiation or dispute resolution. For the less predictable phases, they charge on an hourly basis. This is an attempt to achieve "the best of both worlds" – some measure of certainty for the client, and some downside protection for the attorney. Of all the alternative fee structures, this one shows the most promise. It requires an honest discussion about budgeting and forces the attorney to stand behind his or her estimates. At the same time, the attorney runs far less risk of doing a lot of work for free. It is an extremely fair approach, and one that a lot of attorneys would have a hard time arguing against.

- **Reduced Hourly Fee Plus Success Fee.** The attorney agrees to charge a reduced hourly rate (say, 70% of his or her usual rate). This is the cost-control element. It does not prevent an attorney from overworking a project, but it does provide some cushion to limit the effect of cost overruns. As for the value element: at the outset, the attorney and client also define "success" for the project. An attorney achieving those goals is rewarded with a lump sum payment that brings the effective hourly rate above the attorney's normal hourly rate. (Instead of getting 70% of the normal rate, the attorney might end up receiving 130%.) If "success" for the project is defined properly, then the satisfied client will not mind paying out the premium fee. In addition to motivating the attorney, this approach forces everyone to define and focus on specific, measurable business goals. It also emphasizes fairness. The attorney still risks losing money on the deal, but also stands to gain a meaningful windfall.

- **Time-Based Success Fees.** In a variation on the basic success fee formula, an attorney may be rewarded for getting a project completed by a certain date. When a business places a high value on resolving a particular matter quickly, it may be willing to share some of that benefit with a diligent attorney. Whether this works as a cost-control measure depends on the situation. If the attorney is billing 300 hours a month to get the work done in half the time, there may not be any cost savings. At the same time, there are only so many hours in the day and, given a tight deadline, the attorney may not have the luxury of wasting time on low-value work.

Some of these fee structures will probably seem attractive to you. Others may seem overly complicated or more trouble than they are worth. However, even the simplest structures are not cure-all solutions to the problems with traditional hourly billing. In the next section, I will highlight a few negative aspects of alternative fees.

Potential Pitfalls With Alternative Fees

When entering into any alternative fee arrangement, it is important to do so with your eyes open. Although these compensation structures solve certain problems associated with hourly billing, they can also have unintended, negative consequences:

1. **The arrangement may end up being unfair to the attorney.** From your point of view, this may sound like a positive, but it seldom is. If you are hiring an attorney, it is because you have a business objective in mind that is almost certainly more valuable than whatever amount the attorney

might charge you for his or her time. If an attorney charging $300 per hour agrees to do a project for $3,000 and that project ends up taking 100 hours rather than 10, then the attorney is only making $30 per hour. This can cause resentment. It can lead to rushed, sloppy work. And it can lead to cut corners that end up costing you more than if you paid the attorney on an hourly basis at his or her normal rate.

2. **Flat fees are not always so flat.** Business objectives change. New facts emerge. Problems that seemed small at the outset may end up being much bigger than expected. Any attorney negotiating an alternative fee is going to require a well-defined “scope of work”. If the project balloons or goes in a different direction, you may end up paying a much higher amount overall. If you are already a few months into the project when that renegotiation happens, you may not have much bargaining power. It can be difficult, expensive, and time-consuming to change horses in midstream, and your current attorney is well aware of that.

3. **It is not so easy to define “value”.** Anyone who has drafted a business plan or tried to calculate return-on-investment knows that it is as much art as it is science. If the deal's value to you shrinks halfway through a negotiation or your lawsuit falls apart, your attorney will figure that out. At that point, he or she is in the same position as an attorney who hits a hard cap or a flat fee halfway through the project. Your attorney may resent the situation. He or she may rush or cut corners, causing the business value of the deal to shrink even further. At the other end of the spectrum, it is easy to be overly generous when setting a fee you may never have to pay. If you give your attorney 30% of the deal value or a large equity stake when you go public, that may end up tying your hands in unexpected ways.

4. **Alternative fees place as much pressure on you as they do on your attorney.** All of these alternative fee structures require that certain ground rules be set at the beginning of the project: scope of work, deliverables, division of labor, people and companies involved. If the landscape shifts, or if the attorney feels your company is the cause of inefficienct project management, then he or she may try to change the terms of the fee arrangement or get out of the deal entirely. At best this can be a distraction. At worst, it can be a catastrophe.

5. **Alternative fees are not suitable for certain projects.** Even firms that have abandoned hourly billing will turn away work that is too unpredictable. It can be due to the nature of the project (a complex lawsuit, a deal with too many moving parts). It can be due to a lack of concrete information about you as a client, or about the value of the project. If a few different law firms have refused to take on the work unless it is billed by the hour, then you may need to rethink whether an alternative fee structure is the correct approach.

Conclusion

An alternative fee structure may seem like a way to stick it to a greedy attorney. However, in practice, it will only work if the arrangement is viewed as a partnership from which everyone stands to benefit. From your standpoint, any alternative fee structure should give you a measure of comfort that your legal expenses will not balloon out of control. It should also help you and your attorney to define project goals early on and focus on achieving them.

At the same time, for an attorney to accept an alternative to lucrative hourly billing, there has to be something in it for him or her. A structure that places all the risk and responsibility on the attorney's shoulders is probably going to be a non-starter. Instead, your business will need to take a fair approach to fee negotiations, do whatever it can to keep the project moving forward efficiently, and create meaningful and achievable rewards for those attorneys who do good work for you. If you do those things, then alternative fee structures become an effective tool for improving legal outcomes for your business.