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Briefing

ALTERNATIVE PRICING

ISSUE 10 | APRIL 2011

The future of fees is here. Is your firm up to the challenge?

Interview

Fees ability

Neil Kinsella, CEO of Russell Jones & Walker, on the future of pricing, alternative business structures and the value of financial knowledge

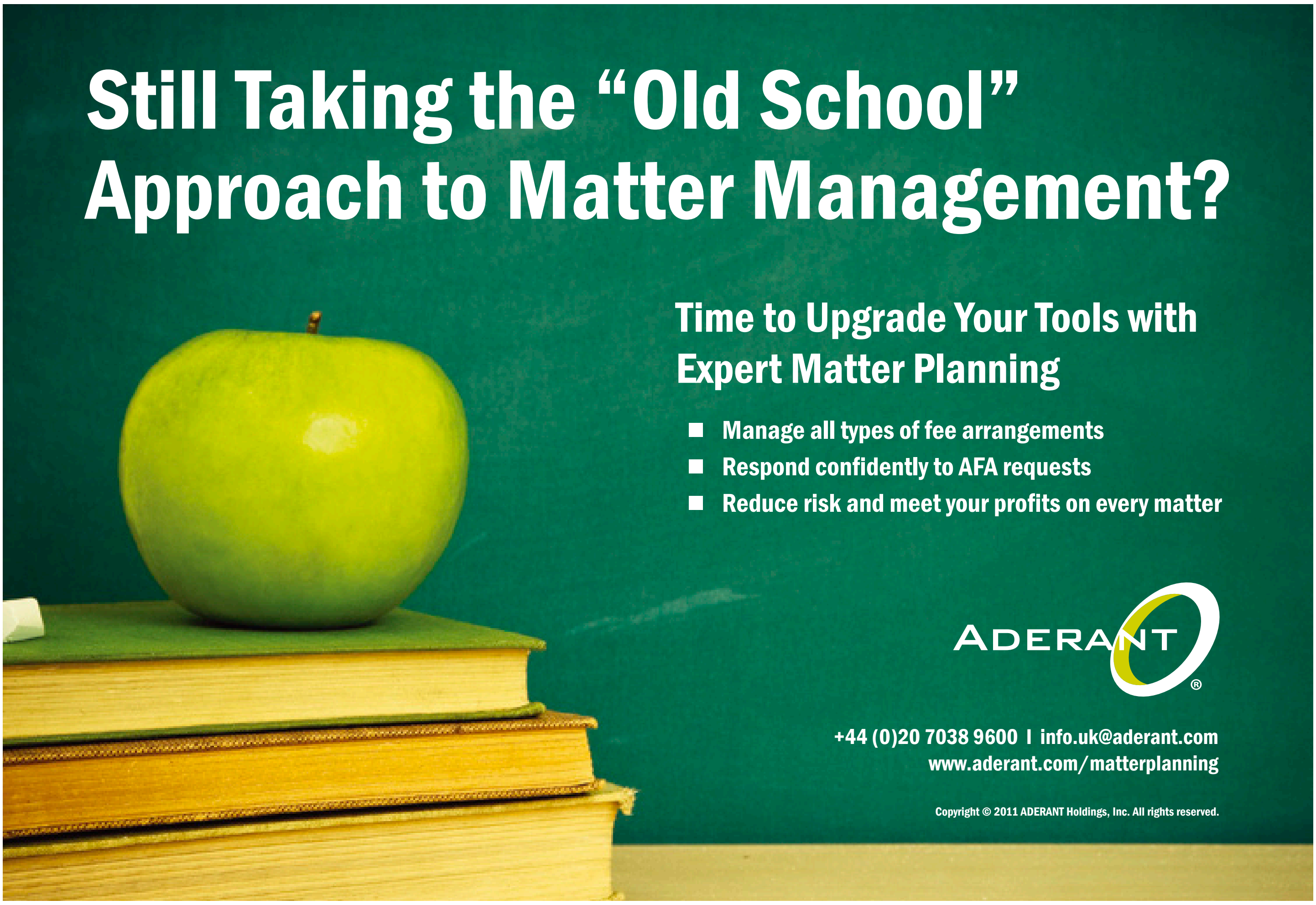
Feature

Alternative future

Clients want them and you know you need to consider them – but what does it take to deliver alternative fee arrangements?

Plus

Analysis by businesses working with law firms, from IT to banking, on which fee models to use, how to plan for them financially, how to profit from them and why firms must change to offer them – now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What's your work really worth?

That's a question firms should be asking on a regular basis, but that's not happening.

Why is it so important? In this post-recession world how the client, the customer, perceives the value you bring to the table has become the only factor you should be thinking about when thinking about the future of your firm.

Of course, 'value' is a subjective thing, and law firms like certainty – but what firms are now learning is that so do your clients.

So, this month we analyse what alternative pricing options are out there, from the world of fixed fees and consumers to value billing and free secondees to commercial clients. We also have insightful analysis on the systems and financial controls you need to run alternative fees from sponsors Aderant and Elite, as well as companies on the ground in banking, IT and business process.

This is a bumper issue of **Briefing** – we hope we've got everything you need.

Do let me know what you think of it; just click on my name to mail me.

Rupert White, head of content and community

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INTERVIEW

Fees ability

Neil Kinsella, CEO of Russell Jones & Walker talks to Rupert White about alternative pricing – and how firms need to change financially to face the future

RJW is a firm that knows a thing or two about fixed fees for demanding audiences.

It has multiple ‘identities’, appealing to different audiences, and it offers a wide variety of legal services, many of which are price controlled by either the justice system or the market. It runs a profitable PI business in Claims Direct, and works for membership organisations such as unions and the Police Federation.

Many of the work types it engages in require a level of ‘cost certainty’ to the client that’s a world apart from your average top-20 commercial law firm – or rather, that used to be the case.

Now, after the recession, the legal world has changed. Clients from corporates and charities to Joe Public want their legal work costed in a more transparent and cost-efficient way – and they want it to cost less, too.

Clients now want fixed fees, and that’s just one colour in the alternative fee spectrum (our *feature on page 9* lays it out in more detail, as do our *analysis articles on page 13*).

So perhaps RJW, an avowedly ‘consumer-oriented’ firm, has something the whole industry can learn from, because the rules for delivering fixed fees to PI claimants are fundamentally the same as those behind delivering alternative fee arrangements (AFAs) to a corporate client: know what work costs to do, break the work down as far as possible to work out which bit costs what, automate where possible, resource the work ‘correctly’ and closely tailor your pitch to the client.

Or, as Kinsella found out when he was a fledgling lawyer, find out if your client wants a Rolls Royce or a Ford Escort – and make sure you find out before you build it.

“The reality is, you need to match the service to the client. If the client thinks they are paying for a Rolls service, then that’s what they should get – but do they need a Rolls Royce service?” This applies to any kind of client, too.

“As a consumer, what you’re concerned about is getting value for money. If you are paying a fixed fee, you don’t necessarily concern yourself with how that was achieved.” Corporate or organisational clients will, or should, he says.

Kinsella says he thinks “transparency is key” to delivering client satisfaction in fixed-fee work – it’s something clients want, but to deliver it you’ve got to be doing the work efficiently.

“I don’t think transparency should be a problem for anybody, in the sense of seeing how you are making a profit. If a law firm is running its work properly – staffing work with the right people for the job, not wasting time and ensuring that all work that can be automated or done efficiently is being done that way – Kinsella says it should be able to say how it’s achieving its fees.

Perhaps some law firms don’t ‘do’ transparency well because clients would revolt when they found out how work is often being done? And might a post-alternative business structure (ABS) world, with more transparent, value-conscious competition around, force the change?

Absolutely, Kinsella says. “That’s the way we are going. When we look at professional services providing a service to us, that’s the sort of question we would ask. If a partner turns up with three assistants and we only ever deal with the assistants, and you get a large bill for the overall service, we ask for it to be broken down as to who did what.”

Some of this transparency has to come as firms start to solve the resourcing side of the equation. Kinsella points out that, “anecdotally, I’m hearing that a lot of commercial firms in the ‘squeezed

INTERVIEW **NEIL KINSELLA** cont.

middle' [in the regions, eg] are finding it more difficult, because national and international law firms are sending their work to be done in regional offices".

"Now, I'm assuming that the client is well aware of that, and the pricing has been done accordingly." Does he actually mean he 'hopes' clients are being told that chunks of their work are being done at lower cost out in the regions, and that the saving is slavishly being passed on to the client? Or does he really mean he assumes so?

He really means it, he says – "It would seem naive of businesses not to ask that question." One has to wonder from that answer whether he believes it, but let's hope he's right.

"There are reasons why you will sometimes do work at lower profit or no profit at all, but you need to know if something is a 'loss leader'."

Lessons in cashflow

Back on home turf for RJW, now that the Jackson reforms will be pressed home, he says, "we're all being driven to be more efficient and more transparent in what we're doing". The Jackson changes will affect every firm with work types like RJW's – and will mean more concentration on whether a law firm is really delivering value to the client, and will also create even more external control on the amount a firm can 'make' from a case.

This should usher in a world in which knowing how much work costs to do, and where efficiencies and margins are, is the norm not the exception.

Hard lessons for RJW in the early years of the last decade taught Kinsella the value of fully knowing a firm's position, both financially and in terms of return on work done, he says.

"To say I [came to understand] cash and cashflow would be an understatement. You then start to look at your business in terms of where are you making money and where are you losing it. Whereas we might have taken a hands-off approach to that in the past, we became very, very aware that cash is king."

Kinsella references a famous urban myth (which may even be true) about the notoriously profligate music svengali Tony Wilson when he wants to explain why firms need to get a handle on the costs of their work: "When New Order brought out 'Blue Monday' they were losing money for every single copy bought, because they had spent so much on the packaging.

"We had an internal mantra: 'No Blue Mondays', and I still think that applies. Many firms still do not understand where they do and don't make money. There are reasons why you will sometimes do work at lower profit, or no profit at all – but you need to know if something is a 'loss leader'."

This is rule number one of offering AFAs to the client: don't take a bath without knowing it, and knowing why.

Rule number two might be: be internally consistent. If you change your measurements every year, it'll be hard to work out if your strategy is working and if the work you're doing is making real profits, he says.

Profits and 'profits'

Kinsella also argues that firms are making a fundamental error in calculating profit: "Most lawyers don't factor in their own salaries, whereas we do." He spoke about this point at a talk in April 2011 that I attended, and I put to him a question I'd received on Twitter about it – that he had confused the notion of a cost centre with that of a business owner. Was that the case?

"I don't think I am confusing the two, I think I'm separating the two out, because most other businesses would factor in the chief executive's salary and salaries for other chiefs.

"When you see profit figures published in the *Lawyer* or *Legal Business* or whatever, the profits that are stated are profits without taking out either salaries or even a notional salary for the people who work in that business. It's an absolute basic of corporate management [to build those costs into profit calculations]." This is the consequence of the well-known producer-manager model – if resourcing is the key to more value for money and delivering work that's more predictable in terms of costs, the calculations have to include those at the top, as well as those at the bottom.

"If you are performing a service and creating revenues yourself within the business, what is it costing to do that? What does it cost to have a partner or owner in the business provide management services?

Not doing this, he says, "gives you a false sense of having a profit margin". "When we do a cost centre analysis, we put in notional salaries for partners so we can see what the profit margin is at the end."

Unfortunately, there seems to be a disparity between what clients want and how much

INTERVIEW **NEIL KINSELLA** cont.

legal services are costing them – Kinsella's question about the big firms farming out their work to regional offices is just one example. What has to change is resourcing, fundamentally.

Who's doing the work?

Changing the resourcing mix in law firms "will happen across the board," he says. "We've got to learn ways [to create, as a sector,] transparency and make sure that people [with] the right training and experience are dealing with a job and how it is supervised. That is a challenge we're still to succeed with."

Technology can do a lot more than it's often being used for, though, he says. He suggests that the way to work out what to automate might be to see what an outsourcer can do with offshored people.

"One of the things some of the outsourcing companies can teach you is how to look at your business and break down what needs to be done, by whom, [and] very often the answer is that technology could do a lot of the things that don't need to be done by lawyer. If you can then allocate work to the right level and get it supervised by the right person, that may well be the better option than the complexity of sending parts of the process abroad."

Alongside the strategy and the resourcing to deliver work at a more certain, cost-efficient level, a firm needs good management information to determine what work is costing, if it's being done effectively and to track delivery to ensure profit targets are hit. This is incredibly important when it comes to AFAs like fixed fee work, and it means changing the way the law firm thinks about billing – the billable hour – completely.

"We break [management information] down into practice areas, practice groups and then we break it down into the individual.

"The way we try to look at our business is that there isn't one single KPI that tells you whether or not you are getting it right, but you start off with the basics – which is if you record your time properly, and only if you are recording everything you are doing can you understand whether or not it is profitable. Otherwise executives can bill according to what they think the particular job might be worth.

"Insisting on full utilisation, and executives recording all their time, gives us an opportunity to see what the realisation of that time is, and the effective billing rate."

To deliver AFAs like fixed fees, which seem to depart from the billable hour ethos, you actually have to get better at time capture, Kinsella says.

"The argument has been put to me that 'If it's fixed fees, why are we bothering recording time?'. But the reason you record time is because only by working out how much you spent on a job can you know whether or not there is a reasonable return there.

"We are selling time – whether or not it is fixed fees, we are selling time – and the only way in which we can work out whether that time is spent fruitfully is by breaking it down into serious, simple units – then we can do a calculation at the end on what did we get back for it? And was that return profitable, bearing in mind the allocation of cost against different parts of the business?"

> **THE KINSELLA CODE**
>
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A corporate future for all

RJW behaves like this probably because it works in a very corporate way. You've got to ask, though, how this was done? Many people in legal wonder whether a 'CEO' is a real thing in a law firm – after all, aren't law firms traditionally run by a committee, regardless of whether there's a CEO?

Kinsella says it works at RJW because the firm ownership handed the direction of the business over – it didn't have it wrestled away. The management team had to establish "a level of trust in the management of the business by a small group based upon transparency and regular reporting, so people can see how the business is progressing and be confident in that".

"It's only once you create that confidence that people will take a step back from trying to be involved in management at every level, and I think we've been reasonably successful in that."

Now, he says, RJW has a constant rolling three-year plan, "which breaks down into where we expect to be from a revenue, profit and cashflow point of view". This allows RJW to predict "how much money, say, the partners either need to put into or can take

INTERVIEW **NEIL KINSELLA** cont.

out of the business, and how much funding we need".

Looking back on the impact that tough times had on the firm, does he think the recession has given a similar shock to the industry as a whole?

"Absolutely." Halliwells is a great example, he says, of the laissez faire attitude to financial control in the industry – "it was unthinkable that a firm like Halliwells might go bust in the past, and what you see with Halliwells is a whole series of decisions which, had there not been a recession, they might have got away with".

Kinsella says knowing how the firm is doing in a very granular way stops this from happening, and RJW even shares this management data with its banks – which generates trust in the firm's capital 'partners' because they know what they're dealing with. RJW also gets "a certain amount of free consulting as well, because you get the banks questioning why you do certain things".

So perhaps RJW is really quite ahead of the curve in terms of understanding the need for transparency, for internal as well as external advantage, alongside a good understanding of the cost base and 'real' profits.

ABSs: the route to growth?

Might this all be pointing at a firm that will become an ABS?

Kinsella says the ABS "is an interesting area, and it gives the opportunity to look at having the right sort of capital structure to put [in place] IT infrastructure, management infrastructure [to help the firm gain scale] – because there is going to be an initial cost of getting that to the right scale and across the board".

"ABSs are an opportunity to begin to behave in a more corporate way and [have the resulting] access to capital.

"My main concern is: what is the depth of capital required to try and achieve our ambitions? We want to be the leading independent consumer law firm, and to achieve that we still have got a long way to go in terms of improving systems, improving training, management – and that is going to require capital. I would see ABSs as a way of bringing law firms in line with the rest of industry."

But where's that money going to come from? If a firm gets into bed with private equity or venture capital, it is more likely than not on a road to a sell-out within a decade – after all, the investors have to have an exit route, a way to gain that return on investment. So what source might a firm like RJW want its capital to come from, and what might it use it for? Kinsella seems to point to more traditional capital funding, and for the simple goal of market dominance.

"Every business requires capital, no matter what," he says, from the traditional source of a partner cash call, to bank capital and the new world of venture capital, private equity and flotation.

"The problem [with private equity] is that you get debt," he says, which might end up affecting whether you can reach your business goals – some of the people lending you money "are looking for an exit rather than just solely developing the business".

The new world of ABSs will also mean a change in the look and feel of staffing in legal service providers, he says.

"Increasingly it is going to be difficult to split the two sides of the business, and you are going to get more professional management into law firms. I don't think there is any reason why lawyers shouldn't also be professional managers – in the United States, a lot of the business leaders come as much from legal as they do from accountancy, and that is something we have to learn.

"I feel strongly that it does make sense for people who understand the business, who understand what it's like to deliver a frontline service, to also be managing it. That can be an advantage – but it isn't the only reason why someone might succeed as a professional manager in a law firm."

Whatever your background, Kinsella says, 2011's changes will create the need for more professional managers.

"It's a chicken and egg thing – more professional business people will mean [their firms] will be the more successful businesses. At the same time, it will be the firms who see the need to [employ those people] that will be successful. Firms that don't do that will, I think, go out of business.

"One thing we can be sure of in the next few years is there are going to be winners and losers – and if you haven't got a real handle on management, you're shaping up to be a loser." ●

ABSs: What's in it for RJW?

"We want to be the leading independent consumer law firm. We still have got a long way to go in terms of improving systems, improving training, management – and that is going to require capital."

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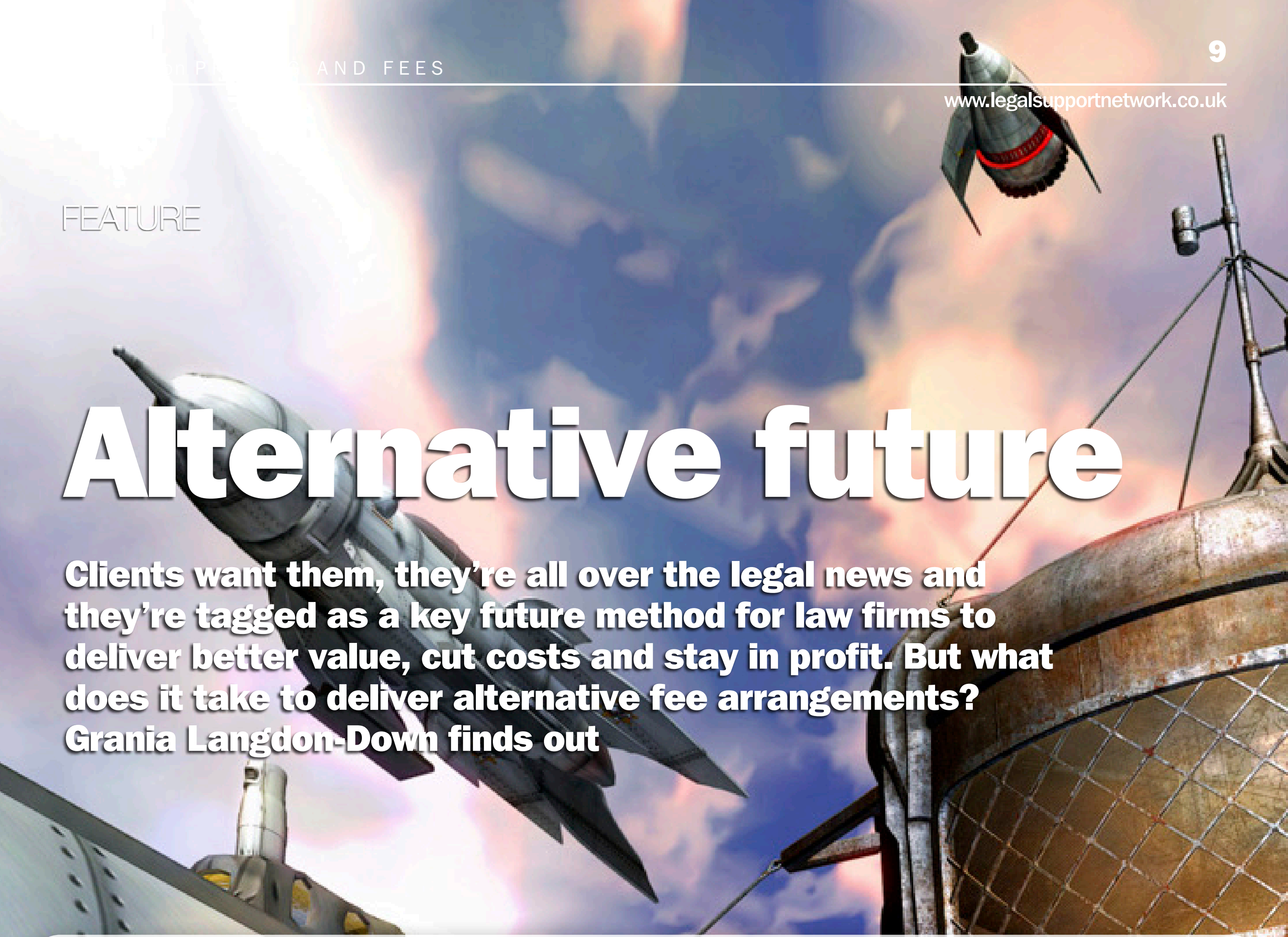

FEATURE

Alternative future

Clients want them, they're all over the legal news and they're tagged as a key future method for law firms to deliver better value, cut costs and stay in profit. But what does it take to deliver alternative fee arrangements? Grania Langdon-Down finds out

Across the world, a shift has happened in law firm billing. Fundamentally this is about making firms more attractive to clients, but what it means changes everything about how a firm works.

It can mean 'pay us if you are satisfied with the work', 'pay us what you think the work is worth', or even 'pay us in kind for our expertise' – these are just some of the special offers on one law firm's pricing menu that are a far cry from the sacred cow of the billable hour.

"Legal functions are in the crosshairs for spend," says Andrew Giverin, a founding principal of niche technology boutique Radiant Law, which launched in January as a "trailblazer" in structuring itself so it can throw away timesheets and price on value, not hours.

"Clients want to work with lawyers who understand their business needs, are prepared to put some skin in the game and stand by a fixed price."

Lawyers find the idea "unsettling", he says, because they have been brought up on the idea that it is all about hours and selling time, when it should be about selling results. But "a system that remunerates partners and associates on how many hours they clock up just incentivises inefficiency".

So as clients press you to work faster, better and cheaper, how do you deliver lower prices and more flexible billing while staying profitable?

Alternative fee arrangements (AFAs) are a big cultural shift for law firms. They've got to learn to plan, staff and manage engagements so that the fee budget meets an agreed timeline and preferred profit margin. That can mean taking on dedicated project managers and pricing specialists – CMS Cameron McKenna is about to recruit its third professional project manager to join its business development team, for example.

And firms should be under no illusions about how easy it is to mess up. Alan Hodgart, managing director of consultants Huron (UK), says that offering fixed price work that's managed the same way as hourly rate work is a sure way to lose money.

He says firms should do three key things to make sure AFAs work out profitably: develop pricing and project management skills within the firm; improve partners' and fee-earners' ability to delegate less complex work; and develop the right technology to automate repetitive work.

Meeting those challenges means making fundamental changes to the way a law firm is staffed, from the legal teams to the back office functions. This also involves a rethink on resourcing, mixing up insourcing, outsourcing and offshoring. Professor Richard Susskind described this as "multi-sourcing" in issue one of **Briefing**, saying it is "probably the most formidable" HR challenge firms have faced.

Who do you need?

Radiant Law, for example, was set up with five principals, no associates, and with the repetitive 'grunt work' offshored to India through legal process outsourcing provider Pangea3. If Radiant needs to scale up, it has a pool of contract lawyers it can call on, plus a list of firms here and abroad that can provide complementary services.

Alternative future cont.

Judith Prime, business development director with CMS, says rates are being cut at every firm from the magic circle down, so every firm has to tighten back office efficiencies. At CMS, this has meant outsourcing HR and the majority of the finance team to Integreon. The firm has also outsourced business analysis.

CMS's 12-strong business development team remains in-house, however, with project managers assigned to specific client relationships to help with scoping and the production of KPIs, so the firm can run competitive teams at competitive rates. CMS has also ramped up its pitch team, with bespoke solutions for each client, and achieves a greater than 50% success rate, says Prime.

"Our biggest challenge in BD is to be numeric as well as creative. You need to be able to model fees, because you have to understand the financial implications of a pitch. What does winning this client at this rate mean to your business? What are your margins and what do these added value services cost?"

There is a big risk in confidence-based fee proposals, for instance – the 'pay us if you're satisfied' model. "Clients really like this [model]," Prime says, "but it requires a huge amount of discipline behind the scenes to make sure there is nothing the client can criticise, because you want the satisfaction fee."

At DMH Stallard, winner of MPF's Financial Management Award for Innovation in Finance last year, accountability for project managing rests with the partners. The firm, which has kept its back office functions in-house, has been using budget templates for each work type for about four years and alternative funding arrangements for about three.

"As you become involved in larger transactions," says finance director Robert Mojab, "you can easily foresee 'scope creep', when the clock accumulates time that is not necessarily recoverable. If the size of our projects doubles, it would make sense to consider having dedicated project managers."

Hodgart agrees with Mojab – given the right planning and project management tools, he says, senior associates and partners should be able to plan an engagement effectively by themselves. "Full-time project managers may become necessary on a multi-location, cross-border transaction running over many tasks, but they will need to be very conversant with the work or they could be more trouble than they're worth."

But while some have embraced the concept of AFAs, others remain resistant. Getting past this buy-in barrier is crucial, says Per Jansson, consultant with Hildebrandt Baker Robbins – and once they're with the plan, lawyers need proper training to run AFAs. "You need the framework for managing the project; IT tools to make the process relatively seamless; and the right people for each task."

Financial considerations

At the heart of any debate over pricing is how firms balance cost with quality.

Jeremy Black, a partner at Deloitte, says legal work is a "strange" product because the person buying it can't always judge the quality of what they are getting. "If it is on a fixed fee, there is the incentive to do it efficiently, but there is also pressure to cut corners.

"You want to avoid becoming like the budget airlines. People went to them because

Three Steps To AFA Heaven

Alan Hodgart outlines three vital changes needed to deliver profitable alternative fee agreements

● Develop pricing and project management skills

Partners must learn how to scope an engagement into component tasks and decide the time each component will take and the level of staff required. This means cost and price estimates can be developed that achieve the required profit margin. You must also list the assumptions in a price and tell the client the moment one is broken, along with its impact on the quoted price.

● Improve delegation

Work must be delegated to lower hourly rate staff, supported by more standard documentation and better supervision.

You need to kill off the view that partner time is free and that profits on their work are therefore the highest in the firm. Partners are the most expensive fee-earners, if the cost of their 'salaries' during the year is taken into account.

● Develop IT automation solutions

Create IT solutions to repetitive work so that labour time and cost can be reduced.

Alternative future cont.

they were cheap, but many now say they would pay more for quality. You need to be clear what you're offering: 'We will be the cheapest' or 'We will provide this level of service and this is what it will cost'."

Prime agrees with Black: "You can price to win work and beat your competitors, but then you have to make it work or you lose money."

She plans to write a paper on the reality of AFAs – which should be worth a read, as she wrote the much-quoted 'Future of Fees' paper in 2010.

"I sense that clients sometimes go for a low quote but end up at the same point as the others quoted. We are doing more analysis internally to check how accurate we are in terms of our initial quotes, with the caveat that the scope may change during the course of the deal."

One trend she welcomes is client procurement teams being involved in pitch documents. "This has brought a fresh perspective about quantifying value in a more objective way and throws down the gauntlet to law firms to manage their services better," she notes.

Getting more value can include offering services such as training and know-how to the client – some big panel pitches ask for secondees to go into the client's business. "The question then is: who pays for them?" Prime says. "The number might be triggered by the amount of fees – some [secondees] eventually will be free to the client. That would never have happened in the past, and it has forced firms to understand their margins a lot better."

> "You want to avoid becoming like the budget airlines – people went to them because they were cheap, but many now say they would pay more for quality."
>
> Jeremy Black, partner, Deloitte

But no matter how innovative law firms are, Prime says clients still want the fall-back position of hourly rates for smaller projects, because they don't want to spend the time scoping to the level where they can ask for a fixed fee.

With no fat left to trim, clear oversight of the deals being offered to clients is then vital – which is a key part for the finance team to play. Jansson describes one firm he knows of that 'suddenly realised' it had three large contingency fee cases on the go at once – luckily it won two, or it would have gone bust.

Mojab winces at that scenario. "Finance has to keep a beady eye on what is happening to WIP and the recoverable element. We have developed electronic systems so we can review all matters line by line every month so that matters don't accumulate a large amount of WIP without us knowing the risk we are exposed to."

The key is getting the right balance of fee arrangements. "You need the right balance of 'Steady Eddie' [work] that is paid monthly, so you can carry the contingent and more innovative matters that are paid in arrears."

So is it just a case of 'win some, lose some'? That's the magic question, Mojab says. "If you are dealing with a contract renewal, some tranches of the work may be more profitable than others, and the client may expect you do some of it at closer to cost than the rest. Finance then has greatest input in analysing the risks of pitching at a level that produces a sufficient return for the firm."

What is clear is that firms need to hone their forecasting skills. A recurring objection to some AFA models is that legal work is too hard to predict – but it's an objection about which Hodgart, for one, is dismissive: "If a law firm is holding itself out as an expert in law, a client is entitled to expect that they can accurately estimate a price."

Alternative future cont.

It's also an objection that prompts a wry laugh from Mojab. "There is always something 'different' about legal. My background is in engineering contracts, where this kind of [prediction] discipline is bread and butter."

And while time is still the key measure, the issue is not how you measure it, he says, but how much you sell it for.

Systems for the new world

Underpinning a move to new pricing options must be IT, focusing on business intelligence (BI) and reporting, management information, forecasting, customer relationship management and engagement planning tools.

Brodies, the largest Scottish-based law firm, implemented a LexisNexis Redwood system as a BI solution about two years ago, and in the last six months the firm has added a pricing model that helps in the tender process.

Pricing used to be a "black art" that happened "in a box" in finance, says Brodies' finance director David Edwards. "Now we can pitch up at meetings and calculate the margins as we go along, so it's clear how much money we will make if we offer a particular deal or how tight the margin will be."

It is part of the firm's DNA that its people are 'finance savvy', he says. "We are very profitable and people want to know what drives the numbers. We use the Elite PMS, but you have to know what levers to pull – that's finance's job. The Redwood suite enables partners to see the accounts received and WIP on their desktops. More importantly, with the pricing mechanism, they see right at the point of making a suggestion what it will do to the profitability of the job."

Brodies has kept back office functions in-house and does not outsource any legal work, but this technology allows them to get the right leverage on a job and monitor that it is staying on track or needs re-engineering.

Radiant Law has invested aggressively in technology, because, Giverin says, "too often, firms are unambitious in how they use technology and end up creating a series of silos where information goes to die". With 12 engagement letters under the firm's belt – most on fixed fees but a couple on retainer – Radiant is building up verifiable data to know exactly the tolerances for a particular piece of work across any client type. "It is not about trying to retro-fit an hourly rate into a fixed price," Giverin stresses.

There will be swings and roundabouts with AFAs, he says – that's part of any business as it builds enduring relationships with clients. "Subject to a sharp kick from my fellow principals, I am quite looking forward to a day when I get it slightly wrong and I tell the client 'It cost us more than we're charging you, but we are sticking with the price', because I think their eyes will be opened by that."

Opened their eyes might very well be. Whether this is so popular when it happens is another matter, as profits may suffer. This leads to the crux of the matter: taking on board all the new pressures flexible billing brings, can firms maintain and grow profitability?

Very much so, says Edwards. "When times were tough, people were accepting tenders at low rates to keep people busy. But you have to go into these things long-term, knowing they are going to be profitable, or be brave enough to walk away."

The challenge is likely to be with cashflow rather than profits, says Mojab. "Law firms have taken out so much cost in recent years that they are now leaner and fitter, so there shouldn't be a problem with profitability."

But the days of simply clocking your time and billing it are over, he says. "Pandora's Box has been opened, and there is no going back." ●

Building partner buy-in

Per Jansson of Hildebrandt Baker Robbins lays out his easy answers to lawyer worries about AFAs

● Who is going to pay for the extra time needed to manage the project?

"It's easy to show that if you spend an extra 5% and get 20% fewer write offs, it will pay for itself."

● Won't it make the work too routine?

"If you get the right checklist, it puts a structure around the routine work, freeing up time for the more interesting, complex part."

● But we're valued by the billable hours we produce...

"There are conflicting incentives if lawyers are required to be more efficient but are being rewarded by the number of hours they bill. Firms need to introduce some criteria around efficiency."

ANALYSIS SPECIAL

From alternative to normal: the new pricing

In this issue of Briefing we've gathered the thoughts of businesses working with law firms to deliver alternative fee arrangements to give you the low-down on what they are, how to offer them, what they can do for your firm and how to deliver them profitably

ANALYSIS **DELIVERING AFAs**

New alternatives

Dan O'Day of Elite outlines some key alternative fee models and what internal oversight is needed to profit from them

The economic downturn took its toll on the legal industry. Law firm billings went down, 'cost containment' became the mantra for business and, as the dynamic between lawyers and corporate counsel continued to unfold, there was one trend that took the spotlight: alternative fee arrangements (AFAs).

AFAs garnered popularity because they offer a new way of doing business – and more law firms now offer AFAs, and more clients ask about them.

There are challenges and risks with AFAs alongside the benefits. There are also many different types of AFA – and each requires data and organisational controls for maximum benefit.

Fixed and capped fees

The most common type of arrangement is the fixed or flat-fee matter. This type of arrangement is popular with clients because it gives them a known cost up front that can be weighed against the benefit of the legal services provided.

An alternative to the fixed or flat fee is capped fees, where the firm bills by the hour until an agreed amount is reached. No more fees can be billed after that – additional work will be done for free.

Therefore, for fixed or capped-fee work to be profitable, it's critical that the scope of what is and is not included be written out clearly in the client agreement. This type of work shifts the risk of overruns to the firm, so a poorly written agreement can expose a firm to significant liability.

Contingency fees

Contingency fees are very common in some practice areas, and are often used when there is limited or no ability for the client to pay. These types of arrangements are often regulated, however, so if the arrangement is a new type, it's worth researching local rules.

These types of matters are also risky, so it's important for firms to limit the nature of cases they are willing to take on contingency. Matters should also be carefully vetted.

Volume discounts

This is the simplest form of alternative arrangement, because it involves discounting the standard hourly rate based on the overall volume done with the firm. This is a great tool for firms to gain more business from a client.

Discount targets are often tiered, and the highest tier should be reserved for new billing targets from the client.

Value-based billing

The most talked about and least common form of AFA in use is value-based billing, in which the fee is based on the value to the client.

The client needs to reveal the value of the services, and the firm needs to agree what would be fair compensation, regardless of the effort involved.

Leveraging AFAs as tools

Alternative fees are tools that the firm can develop and market to gain business and, if managed correctly, increase profitability. There are three steps to success with AFAs:

Metrics: AFAs are about risk management. To understand the risks involved, you need to mine your financial system for metrics and information on similar matters. You need to gather statistics and understand what standard deviations occur with this type of work with mathematical rigour.

Tracking: Law firms need the tools in place to track their alternative fees matters. It is critical that the firms' finance and management teams establish budgets and track actual progress so trends can be identified before it becomes too late to manage them.

Accountability: The most difficult aspect of managing alternative fees successfully is holding partners accountable for their failures. The firm should have a clear policy on how to manage challenges such as cost overruns and associate over-billing.

Law firms are entering a new era of pricing flexibility, but well-managed firms can turn this to their advantage – by knowing what to offer clients to meet their internal budget challenges, while still producing a successful outcome for the firm.

ANALYSIS **DELIVERING AFAs**

Planning matters

David Thorpe of Aderant describes the key questions law firms must answer about themselves before embarking on AFAs

Whatever kind of alternative fee agreement (AFA) might be under discussion, in-house legal departments now expect panel firms to help them manage and control their legal spend more effectively.

The discussion has moved on from ‘Should we offer AFAs?’ to ‘How do we plan and manage them?’. But this change has brought significant challenges, mainly balancing the need to offer competitive services to clients against mounting pressure on profit margins. And achieving greater cost transparency and predictability is just as important as cost reduction as a driver to providing more flexible commercial agreements.

Practice management system (PMS) providers have created specialised applications that allow law firms to model AFA scenarios directly within a PMS.

Through these, firms can benefit from direct access to historic and current time and billing data, fee-earner cost and billing rates and individual fee-earner information. This should mean that any AFA engagement model transitions seamlessly to file opening, carrying with it all its pre-inception data.

But to allow this kind of streamlined delivery of AFAs, firms may have to start from first principles – sophisticated AFA delivery through a PMS should only happen once a firm knows which AFAs it can deliver and what management information is needed to deliver them profitably.

So, some key considerations when entering a bidding process are these:

- Can we access data on past performance on like matters to build a realistic proposal?
- How can we ensure that fixed-fee or other AFA matters are achieving profit targets?
- Are we appropriately staffing and resourcing matters to minimise the costs and risks, while maintaining quality and responsiveness?
- Do we have ongoing visibility into matters to determine if they will meet the pre-set hours, rates and timeframes?

When taking the strategic step to offer AFAs to clients, therefore, a firm must consider some essential components that will allow them to support these engagements effectively.

> “The discussion has moved on from ‘Should we offer AFAs?’ to ‘How do we plan and manage them?’.”

Data capture

Moving away from hourly billing doesn’t mean discarding time recording. If anything, this gains greater importance as a means of monitoring progress against agreed milestones and internal time and cost budgets – but it must become a user-friendly process that captures all information necessary for monitoring WIP.

Determining the internal cost of delivering a piece of work, a function of the time investment and internal cost rates, and balancing that cost against what was billed, ultimately decides whether a matter delivers a profitable result.

Data analysis

When assessing pricing and resource planning for AFAs, you also need a comprehensive analysis of how like work has been delivered in the past.

Combined with the right analytical tools, a firm’s time and billing system should allow a detailed breakdown of historical matter information. High-level data, such as work type, number of hours and total cost charged, as well as the more granular data of phase and task codes and individual cost rates, all need to be evaluated to establish realistic benchmarks. These benchmarks should form the basis of a reliable forecast of time and resources required for future work, and minimise risk in capped or fixed fees.

Matter modelling and management

Armed with the results of the above, firms can create models to evaluate how an AFA will perform. Financial analysts, perhaps even those in new roles like ‘alternative fee project managers’, can build a matter profile based on benchmarks to produce a fee estimate and a projected profit and loss.

Lastly, comparing projected results against actual figures once work has started is a constant process, but it ensures matters don’t exceed budgeted time and cost limits.

ANALYSIS **AFA FINANCIAL MANAGEMENT**

Alternative fees for FDs

Tom Wood of Barclays Corporate analyses some alternative pricing models and the financial capability needed to deliver them

The relationship between the amount clients pay for legal services and the value they receive in return has seldom been evaluated.

But the way law firms have always billed – charging by the hour and issuing a monthly bill – is now under severe scrutiny as clients seek to cut costs and maximise value for money.

Firms are, as a result, facing huge pressure to change the way they work, and it's no surprise that they have been turning increasingly to alternative fee arrangements (AFAs).

Clients now want more cost predictability to help them forecast cashflow. The preferred solution is for firms to move to fixed fees. Of course, law firms need an incentive – compensation in the form of higher fees or to be paid up front.

In complex and/or risky matters, a fixed-fee arrangement can be split into segments – for example, firms can charge one flat fee for an evaluation period, then a second, fixed fee for completion.

In some cases, firms can switch to a performance-based arrangement that splits the risk more evenly between client and firm. In this scenario, a percentage of the firm's fees would be withheld, subject to a performance review. The upside to firms is that they stand to earn bonuses if they perform exceptionally well.

Another kind of AFA is structured payments. Firms can charge their clients on a 'pay as you go' system, based on hourly charges. Clients are charged on an interim basis, rather than having to pay a lump sum at the end of the month, which makes cash flows more predictable for both parties.

Firms can also offer discounts for early payments. Discounting is a common business practice that firms can easily build into their pricing structures and, in times of financial difficulty, straight profitability may be less important than real cashflow, at least for a short period.

Seeing the world of pricing from the client's perspective for a moment, a fee structure that clients can offer firms is payment in kind. This may involve the client offering the firm shares in their business, for example, which was a popular method with dotcoms.

Even the more traditional and widely used fee arrangement of retainers can deliver value, and increase the certainty of cashflow.

Best practice for financial management

When it comes to financial management, clarity on fees and settlement terms in engagement letters is imperative.

Law firms need to be clear about likely fee levels, prompt issuance of their final bill, and the number of days within which payment is expected.

Clients need to feel confident that there is a consistent policy and that they are being treated fairly and the same as any other client – and they will respect firms that are more open from the outset.

It's also important to add the personal touch to credit control. Ensure your credit controllers have good relationships with the accounts payable staff, for a start. It's very important to understand who is responsible for paying the invoice, particularly in large organisations where employees have multiple responsibilities.

Knowing a client's payment process can also work in a firm's favour. If the client has just one payment run a month, know when it is. Also vital is a detailed invoice – the more detailed the invoice, the less likely that payment will be delayed because of queries. Lack of proper credit control makes it harder or impossible to collect late payments, which can have a devastating impact on the firm.

AFAs have always existed in some form, but more firms are realising the benefits they bring in uncertain times.

With more clients wanting cost certainty and a clearer return on their investment, firms stand to gain if they can perform the work efficiently, and therefore earn a premium in receivables. And, by adopting AFAs, firms are also more likely to guarantee payment, which ultimately increases the certainty of their cashflow position.

Email Tom about Barclays Coporate Professional Services

ANALYSIS **DELIVERING AFAs**

Not easy, but vital

Norm Mullock of IntApp says law firms have the tools and skills to embrace AFAs – so why are they finding it so hard to change?

Let's face it – alternative fee arrangements (AFAs) are getting up your nose.

Clients are asking for them, a lot, then backing down, and staff members are investing vast amounts of time in planning, analysing and responding to tenders.

But despite the progress some firms are making, we don't seem to be getting anywhere as an industry. Worse, one could argue that these constant false starts are just hardening the pervasive cynicism around AFAs.

What's going wrong? The answer to that is: we're doing it wrong. The main problem is that we underestimated the effort required.

Clients have a simple need: make buying legal services less costly and more predictable. To meet this need, law firms must do two things: price more frequently on a fixed or nearly-fixed basis, and – critically – lower dramatically the cost of delivering the services provided. But lowering the cost of delivery is the very obstacle to making reasonable progress.

Reducing costs means changing the fee-earner mix or managing the leverage on the matter. So what's really required is to analyse the work being done to identify inefficient, wasteful steps, regardless of who does the work, and only then to push the work to the least expensive resource – including automation. To accomplish this, we need to fundamentally change our approach to the planning and execution around matters.

Two keys to AFA delivery

Fortunately, firms have a lot of experience in process management, having committed to workflow solutions and process mapping for a whole host of processes, and the same analytic approach is required here. Unfortunately, there are some significant data elements missing.

Most firms' applications are matter-centric. The ability to break matters down into greater granularity, called disaggregation or (by Richard Susskind) decomposition, is a prerequisite for reaching these granularity goals that's often missing from those systems.

Another need is a good taxonomy for and a technical approach to matter-typing, so firms can properly compare like (and only like) matters.

Disaggregated matters and good matter-typing both become elements essential to the AFA management process, which can be described thus:

- Matter planning – historic analysis of like matters, resource estimation, pricing;
- Project management – disaggregation, assignment, execution;
- Administration – monitoring and billing.

To do this properly, we must vastly improve our understanding of how lawyers work.

The first step is to make sure there are no major gaps in reported billable time. We need to automate the capture of time, both billable and non-billable, and develop a full analytic approach to the legal practice, including reporting, analysis, benchmarking and forecasting.

Automating time management will further enhance the AFA approach by providing the mechanism for capturing greater detail on the nature of actual work done. If time recording accuracy is shoddy at times, imagine the data quality issues with a manual coding of phase, task, activity, matter type, and so on.

One last thing – a challenge regularly overlooked in the AFA argument is the importance of communication. Until firms can engage clients in detailed conversations, not just about pricing but also about efficiency initiatives in the firm, progress on AFAs will be elusive. Clients will only feel engaged and trust that the firm has their best interests in mind when they're included in project management with progress updates, and we're now seeing tenders specifically asking firms to outline their efficiency initiatives.

Because of the difficulty in getting both sides comfortable with fixed fees, we have landed in a spot where neither side is currently really happy. Discounts to clients temporarily satisfy their nearest term need, but they feel temporary and, more importantly, unpredictable. Clients also wonder whether they could have been paying less for far longer, and where the pricing floor is. To the firm, the discounts erode margins without creating any internal incentives for process improvement.

We have to get this right, but a big part of getting it right is recognising that laying the right foundation is both necessary, and will require a little time.

Click for more on how better time capture helps firms with AFAs

ANALYSIS **SYSTEMATISING AFAs**

Processing fees

Philip Vian of Winscribe outlines some key ways in which business process management tools have helped firms deliver cheaper and better ways to bill

The legal industry is not traditionally known for subscribing to the belief that a more efficient way to perform a task is a better way to perform it.

This largely stems from a legacy business model of charging clients and incentivising solicitors based on their number of billable hours. This model rewards waste and encourages inefficiency as a means of maximising revenue.

But when it comes to alternative fee arrangements (AFAs), firms have a new incentive to be more efficient. However, to offer AFAs profitably, firm staff must work efficiently. This means cutting waste, streamlining work and executing consistently. It also means tracking costs to set AFA rates appropriately, then gauging the overall profitability of delivery.

As a process is broken down into repeatable work steps, standardised and implemented within a business process management (BPM) system, firms can guarantee consistent execution. Consistent execution leads to predictable outcomes. Add to this the ability to associate wages to time spent on predictable task work and you gain insight into your process overhead. You can then accurately predict the costs associated with a task or process.

Armed with this information, the firm can set fixed fees that practically guarantee desired margins. These are the first steps on the path to offering profitably AFAs.

BPM tools help firms identify process improvements as well as standardising work. These improvements can include removing redundant steps or improving the functionality of an electronic form. Changing the flow of work, removing redundant tasks and offloading work from high-cost resources helps streamline legal work, eliminates waste and reduces process overhead. Driving these previously hidden expenses out of a process lowers the transactional costs of performing a task.

To the degree that a firm can take steps to decrease these variable costs, AFAs generating the same level of revenue become more profitable than they would otherwise be. So AFAs can be a truly positive benefit for both firm and client.

Firms can also use BPM systems to manage the AFA approval process. For example: a solicitor proposes an AFA for a client within the BPM system. The system routes the request for review along with any historical data or reports needed as part of the review process. Once approved, the BPM system can update external systems with the new details, if appropriate, and automatically alert key stakeholders.

An additional benefit of systematising the process – including all applicable business rules – is that it guarantees policy adherence.

BPM systems can be a valuable tool in the delivery of AFAs, because they can help firms increase employee efficiency and consistency while lowering operational costs. But although BPM systems make AFAs feasible and can be used to easily track AFA approvals, this is not the work of a BPM system alone.

No individual business system contains all the information a firm needs to determine if it should offer AFAs, when it should offer them, or what the details of the AFAs should be. But much of the information needed to make these decisions is held across the various business systems you already use.

The key role of BPM software in AFA management is its ability to connect business systems and consolidate the information in those systems into one interface. In this way, a BPM system acts as the link that binds your timekeeping, billing, accounting and case management systems together to make AFAs not only possible, but also profitable for your firm.

Contact Philip Vian to find out how BPM can help you deliver AFAs