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Arguments Against Fixed Fees, And Why They're Myths

Law360, New York (August 13, 2010) -- As Kathy Young hung up the phone, she felt a huge smile creep across her face. Excitedly, she hurried to the office of her mentor, Harry Oldman, the managing partner of her firm. He was on the phone, but made it clear through his pantomime that he was glad to see her, and that she should wait a minute for him to finish. As Kathy waited, that minute seemed like hours.

Kathy, a freshly promoted partner, had just gotten off the phone with the general counsel of one of her most promising clients — ACME Co. Consistently pleased with her service, the ACME general counsel made Kathy a very attractive proposition.

If Kathy offered ACME a fair, fixed annual fee for legal services, ACME would be willing to increase the volume of work given to Kathy by 50 percent, including matters in new lines of service.

Recognizing the excitement on his young protege's face, on hanging up the phone, Harry playfully asks, "Well, are you going to tell me, or just sit there beaming?" Kathy excitedly, yet eloquently, shared the great news she'd just received, but was greeted with quite the opposite reaction than she expected.

"You had me up until the fixed fee part. Listen, Kathy, I understand that this seems like a big opportunity, and I'm the last one to try to discourage you from deepening your client relationships, but the fact is that fixed-fee arrangements are impossible to implement in practice. They just don't work. There are too many variables, and the risk is too great. I'm sorry, but you'll just have to counteroffer with some sort of an hourly rate discount or something. We just can't do a fixed-fee arrangement and still be profitable."

As a good lawyer, Kathy was not about to give up without a fight, so she quickly began setting the stage to make her case.

"I'm sorry to hear that's your view on the matter, Harry. I've seen a lot of evidence to the contrary, but I know you know our business. Could you indulge me and explain to me the reasons why this won't work?"

At that, the elder partner began to list the reasons for his refusal. "Well, first of all, it's practically impossible to accurately predict our costs associated with the delivering of services for each type of matter. Setting a fixed fee just makes it too risky for us."

Anticipating that this would be one of Harry's reasons, Kathy was quick to offer a response to the contrary. "I understand that is the traditional view, but in fact, through both quantitative and qualitative analysis of historical billing data, it's possible to come to a baseline estimate of many types of matters and potential portfolios. By observing the frequency and average input of time of each category lawyer on a type of matter, you can derive a surprisingly accurate prediction of the resources needed to effectively complete a task."

“Take, for example, the product liability claims that ACME Co. faces in high volume in connection with its personal rocket pack and roller skate products,” she said. “The company encounters scores of these each year, most of which are addressed using a formulaic approach that can be broken down into standard time inputs of specific resources. This makes the costs related to addressing these needs predictable.”

Pausing for a moment to consider Kathy’s response, Harry gave an understated shrug and moved on. “Well, even if that does seem to work, regardless, it’s still impossible to be profitable under a fixed-fee model given unpredictability and matter management implications.”

“That’s another very common and understandable misconception, Harry, and let me tell you why,” Kathy confidently responded. “The more you know what to expect, the more you can control costs, ultimately improving profitability while decreasing the cost to the client, in many cases. By employing proven project management techniques, you can continuously monitor each matter to ensure efficiencies are achieved. This can widen the profit margin even at a lower overall cost to the client, making the firm look good and positioning us to receive more work from the client.”

“This was proven to work well with the sales contracts we developed and manage for ACME Co.’s anvil products, which are produced in Eastern Europe, but which primarily sell in the desert Southwest of the U.S. Each of these contracts slightly vary and take some time to process, sometimes encountering exchange rate issues and other complications,” she said.

“However, I’ve been able to assign junior associates to the routine components of these matters, and only call in the partners in the international trade group when their expertise is required to resolve a potential issue,” Kathy said. “While previously we had partners working on these custom contracts, by monitoring each instance, we can manage the projects accordingly. We’ve even been able to develop standard forms and processes that further increase efficiencies.”

Harry was impressed by his young colleague’s commitment to her point, but as a good lawyer, he wasn’t about to concede. “An interesting prospect, and I’ll admit that project management could potentially be a benefit, but working to hit a fee target essentially incentivizes lower levels of performance because we are bound by downward pressure on our fee deal. Clients don’t want lower service quality.”

Well-versed in the flaws in this particular line of reasoning, Kathy seized the opportunity to leverage this point to support her previous statements. “Interesting that you bring that up. However, when you think about it, fixed fees incentivize higher performance levels. They encourage efficiency of time and resource utilization, which can only be accomplished by expertly managing matters staffed by teams of skilled lawyers. Again, the key is matching the resource with the objective of the client.”

Again, Kathy cites an example of how she’s done this effectively. “To illustrate, we’ve been helping ACME Co.’s Agriculture and Foods division deal with FDA compliance for their bird feed products for some time. While the research on such matters can take a long time, we initially staffed the diligence aspects exclusively with young associates.”

“However, not knowing exactly what to look for, they spent endless hours trying to identify the appropriate statutes across several jurisdictions,” she said. “Then we realized that if we put the chair of our Food and Drug practice to the task of setting up a workflow framework to point the junior lawyers in the right direction, we could get them up to speed much more quickly, and overall, deliver a high-quality output in relatively less time than previously. So here, again, the fixed fee encouraged efficiency as well as high performance, and everybody wins.”

“Boy, you have a good answer for everything, don’t you?” Harry sarcastically replied with a friendly smirk, slightly unsure whether to be annoyed or impressed. “Let’s put this to the test one more time. Say what you will, but you can’t argue with the fact that fixed fees don’t fit into the law firm management structure of using time as a primary performance metric. We can’t get around that!”

In contrast to her previous replies, Kathy decided that greeting this challenge with a positive response is a fitting tactic. “You know what? You’re right, Harry ...” and she paused for a moment for effect.

“But ... ?” Harry quipped, reading her body language and realizing she wasn’t done.

“Well, while it’s correct to say that it doesn’t fit into the current structure, it’s incorrect to say that it can’t. Essentially all we do when recording time is track the costs and associated revenues they generate,” Kathy said.

“Fixed-fee billing doesn’t change that — we will still record our time to track costs, and as I’ve mentioned, we must continue this practice to constantly monitor progress and efficiency. Fixed fees, however, actually make billing easier, because the client already knows what they’re paying, and we already know what we’ll be paid, so it’s just a matter of tracking costs to maximize the margins. Plus, it saves us the time we frequently spend explaining our bills to clients and negotiating additional write-offs and other concessions,” she said.

“Here’s an example of how this can work: We recently had a great experience with this simplified billing for ACME Co.’s Hardware division, and specifically, their sledgehammer product group. After finishing up their patent prosecution work, rather than sending them an itemized bill showing everyone that did anything connected with the work, we simply billed them for the agreed-on amount, and accounting recorded our costs,” Kathy said. “In essence, nothing really changed for the worse internally — we still kept track of time and billed the client—but the end result was that the client was happy, and the process was simplified for everyone.”

As Kathy concluded her rebuttal to Harry’s last point, he sat back in his chair and reflected on the points of her analysis and observations. “You know, Kathy, as easy as it would be for me to just tell you that everything you’ve just said sounds good in theory but doesn’t work in the real world across practices, that would be a disservice to you, the firm, and heck, even the profession, because you may be onto something."

"Now, I’m a little concerned that you’ve been using such creative and innovative fee structures without my input, but I’m pleased, and intrigued, to hear about your success in implementing them," he said. "In fact, I guess this is a situation when it’s better to ask forgiveness than permission.”

Kathy sat across from her mentor and began to realize the magnitude of the impression she had made on him. As she began to savor the feeling of the student becoming the teacher, Harry leaned forward, crossed his hands on his desk, and asked, “So once we set this up for ACME, which client should we approach next to offer to develop a similarly mutually beneficial arrangement? And when are you going to start teaching me how to structure these deals?”

--By William A. Rudnick (pictured) and Keith Maziarek, DLA Piper

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