
Getting Away from the Hourly Rate:

The Counterproductive Effects of Billing Time

Editor's Note: The following is the second of a multi-article series that will continue to appear in upcoming Of Counsel issues.

Whether services are purchased based on an hourly-rate-and-expenses basis or through a creative alternative fee arrangement (AFA), the concept of value serves as the foundation for assigning monetary amounts to be exchanged. Therefore, exploring how different constituents think about value is important.

“Value” has always been a subjective term. In fact, it isn’t a stretch to suggest “value” is in the eye of the beholder. When applied to an intangible such as legal service, though, it becomes even more subjective, since its components are also intangibles. “Value” as seen through the eyes of CEOs, CFOs, GCs, in-house lawyers, or outside counsel can be based on a wide variety of diverse components that may be difficult to align, particularly if there are differing levels of understanding about how legal services contribute to achieving a corporation’s overall strategic objectives.

Defining Value

Professional services differ, as an example, from an automobile, which has a value attributable to its mechanical and physical components (e.g., the steel of the car’s body and engine, the effort required to manufacture its systems, etc.) as well as the value attributable to its pedigree (was it manufactured by Lamborghini, by Volkswagen, or by Yuko?). The latter component of the car’s value is, of course, more subjective than the former.

The efforts of corporate clients to realize greater value from expenditures for legal service needed to accomplish their business objectives triggered the current debate over “value.” (See, e.g., the ACC Value Challenge launched in 2008 by the Association of Corporate Counsel, at www.acc.com/valuechallenge.) Over the years, in-house attorneys have observed the continuing rise of hourly rates charged by law firms, often with little or no economic justification, even as the budgets of corporate law departments have decreased from repeated reductions and constraints imposed by corporate management.

Those in-house attorneys realized more and more that the fees charged by outside counsel often bear only a nebulous relationship to the degree to which those fees contributed to the achievement of their companies’ goals. Thus, the cost of the legal service and the perceived value of that service, at least in the eyes of corporate management and corporate law departments, diverged to an ever greater degree as time passed.

Efforts such as the ACC Value Challenge attempt to establish a more direct relationship between the fees and billings from law firms and the value of the legal service than those clients perceived to be the case in recent years. The issue has been cast as one of determining how in-house counsel view the efforts of their outside compatriots.

In essence, the value of the service is to be determined by the corporate client whose goal constitutes the underlying purpose of engaging the outside lawyer. To the degree

that service enables the client to achieve their goal without imposing a cost disproportionate to that goal, it represents positive value for the client. If, on the other hand, the client achieves its business objective only after spending more on fees than the objective is worth to the business, the client has lost ground from a business perspective.

For the client, then, the value of the legal service can only be measured in relation to its utility in reaching the client's goal. Any other measure possesses an intellectual value but no more.

Unfortunately, outside lawyers see their task as identifying and eliminating all possible risks attendant to the client's situation, even when those risks might be extremely unlikely or very minor in the context of the transaction or the dispute. Whether it results from their training in law school or from their personality types, this approach leads external counsel to spend billable time on matters that, to the business client, will have minimal or no effect on the client's business position.

We believe that the process of negotiating and designing AFAs can lead to better understandings between corporate clients and outside counsel and therefore a closer alignment of needed activities designed to create more value for both parties.

Let's revisit issues related to the use of the hourly rate as the basis for legal services.

Inertia-Driven Approach

Time-based billing serves neither the corporate client nor the law firm well (though for differing reasons). Yet most fee arrangements between law firms and their corporate clients still utilize the hourly rate to compute the amount of fees due the former by the latter. In part, it's an effect of inertia, since the hourly rate has been with us for over 50 years.

The hourly rate's appearance of objectivity and ubiquitous applicability also provides it

with a sheen of legitimacy that contributes to its longevity. Finally, the absence of a clear, well understood alternative has also allowed the hourly rate to overstay its welcome (certainly among corporate law departments).

The persistence of the hourly rate deserves a closer examination. Has the time arrived to move away from it more forcefully? Does its detrimental impact on corporate clients and their law firms finally outweigh its putative benefits?

Negative Impact on Law Firms

What negative effects does the hourly rate have on law firms? We identify at least the following:

- It causes the firms and their lawyers to view their "product" as the time that they devote to their clients' matters. The achievement of their clients' business goals becomes an indirect result of spending time on those matters.
- It leads to the use by firms of internal metrics and measures of their lawyers' contributions to the firms' success that are based on the number of hours that those lawyers bill the clients. The firms consider as more "productive" those lawyers who bill greater numbers of hours than their compatriots within the firms. The number of billed hours counts more for the firms than does the achievement of the clients' business goals.
- The hourly rate distorts the focus of the lawyers in a law firm. Rather than the client and client service, lawyers tend to direct their attention to the work as an end in itself.
- It creates a false sense of ability to manage the work effectively. Instead, firms manage the number of hours, often by reviewing draft bills and marking down the amount of time therein represented if it "feels" like too much. In this way, the firms indirectly manage the efforts of their lawyers. This after-the-fact review of the work does not contribute

to achieving the client's goals or assist the law firm in reaching its own financial and other targets.

- Firms do not know how their work on behalf of distinct clients or on each client's various matters compares from one to the next, other than in terms of the amount of time. Not taken into account are the myriad qualities of those distinct representations that also affect the work and, in that way, the clients' matters.
- In the firms' marketing efforts, hourly rates steal the spotlight from more meaningful comparisons among firms. Clients end up comparing firms primarily on the basis of their respective rate structures rather than on less clear, but perhaps more meaningful measures of the firms' "fit" in their needs for outside legal service.
- Hourly rates serve as the basis of a "cost-plus" method of billing that eliminates any risk for the law firm of efforts failing to achieve the client's business goals. This distorts the economic "contract" between the client and its lawyers, enabling the lawyers to "take their eyes off the prize" when the client expects cost consciousness to play a part in their approach to the work.

Negative Impact on Clients

The hourly rate also detrimentally impacts corporate clients in several ways.

- The only means by which in-house counsel can manage the firms that they retain on behalf of their companies is the number of hours logged by the attorneys in those firms. Unfortunately, despite the development of technology tools that collect, collate, and present the billing data to the in-house attorneys on their computer screens, those attorneys still are able to manage the work of law firms with those tools only retrospectively. By the time an in-house lawyer reviews the firm's invoice, the work has already been completed and the client is able only to mark down the amount of time for which the company will pay.
- With the increased emphasis within corporate law departments on effective management of outside legal service due to budgetary constraints, corporate general counsel have no clear line of sight into the bases for those costs; the only metrics available to them relate to the hourly rate and the amount of time actually devoted to the work. Once again, retroactive review of time-based invoices and fees constitutes the only management tool available to them.
- In-house lawyers share the view of their internal clients that productivity is directly proportional to how quickly and efficiently a task is completed. The less time it takes to complete a given task, the more productive the worker who completed it. Since firms incentivize billing professionals based on the hours billed to clients, the hourly rate format (subject to constraints such as a figure in authority, such as a partner, writing down the amount of time to be billed) works inversely to the common in-house perspective and dis-incentivizes professionals to apply efficiencies learned over time.
- In the absence of other common metrics, when seeking outside legal service, the in-house attorney is able to compare providers most readily on the basis of their respective hourly rates. Whether each provider is the most appropriate selection can be a decision left to ill-defined, subjective determination rarely expressed or agreed to.
- The hourly rate and the invoices based on it have focused the attention of in-house lawyers on the cost of the legal service rather than more meaningful examination of its contribution to the companies' business goals. It has led to phenomena such as well-drafted "outside counsel guidelines" and well-intended audits of legal invoices. Both of these purported safeguards have negatively affected the relationship between in-house and outside counsel because the fee arrangements and the law firms' billings constitute a zero sum game played by counsel and client. For one to gain, the other must lose.

Moreover, because such guidelines regulate items like costs that may (or may not) be passed through to the client by the firm or the manner in which they may be passed through (e.g., with or without an administrative “upcharge”), they do no more than nibble at the edges of the cost structure of the legal service. Whether it pays a charge for faxing material or not, the client’s bill will not vary materially; focusing on the time spent and how well those efforts contributed to achieving the client’s goals would constitute a much more financially meaningful effort by the in-house attorney.

- The need to review invoices full of details about time spent diverts in-house counsel’s attention from the strategic goals of the engagement. They’re inspecting the trees rather than assessing the forest. In other words, time devoted to reviewing invoices is time not spent attending to the substance of the company’s legal needs and, to some extent, time wasted (relatively speaking).
- Because time-based fee invoices require intensive review and authorization by one or (frequently) more in-house attorneys, they often lead to an us/them confrontation. The zero-sum nature of that relationship does not serve the client’s interests well, since trust and collaboration represent such critical elements of how successful client-and-counsel relationships work. The introduction of fee auditors in the 1990s represented a very destructive development in many cases by leading to much second-guessing by those auditors of strategy as well as billings. That is but one way in which time-based billing negatively affects the client-counsel relationship.

Moving Forward

In light of the many deleterious effects of the hourly rate on clients and firms, why not discard it? What underlies its persistence?

In addition to its advanced age, the hourly rate does serve some goals of both clients

and law firms. Those goals, however, were established in a far different economic and budgetary environment and, in the view of many (if not most) in-house attorneys, they have been superseded by the need for greater cost consciousness, greater focus on strategic goals, and the need for corporate clients to realize greater value from their investment in legal service. In addition, corporate law departments have evolved considerably since the hourly rate’s appearance; they have become more capable substantively and much more advanced in the use of managerial techniques.

In order to move successfully from time-based fees and billing to AFAs, though, both clients and their counsel must have a more certain path in view. That has been lacking to this point. Unfortunately, most AFA-oriented discussions by corporate clients and their outside counsel so far have been ad hoc and matter-specific rather than programmatic. As a result, those discussions probably often create challenges and confusion rather than lead to well-designed AFAs.

Is there a better way? While the answer to that question is affirmative, we first must go back and analyze the concept of “value” in the context of legal service. Only then will we be able to chart a course toward AFAs that serves the interests of corporate clients and their law firms. How does this fundamental notion of value determine what client and law firm must actually do?

First, client and law firm should take into account the disparate ways in which they view and value the service that the latter provides in light of factors such as those detailed above. If they don’t do that, the AFAs will have a much lower probability of working than their designers expect or want.

Second, they should design those AFAs on the basis of the respective contributions to the value of the legal service by the various contributors to that service. For example, in some situations or for some matters, a corporate law department will rely entirely

on outside counsel to provide the legal service; for other matters, on the other hand, more of the work will be completed by the in-house lawyers. Sometimes, the client will incorporate the work of service providers that are not law firms, expecting those providers (such as expert consultants or vendors of technology-based services) to work with its law firm.

Which work is performed by the various members of the team should be reflected in those members' compensation and in the structure of the AFA. One should take into account the value of those members' contributions accordingly.

In the next installment of this series, we will examine the respective values of in-house counsel and their external counterparts, how those values differ, and how they are similar, along with the implications of that analysis for the design of an AFA. The series will conclude by delineating a process by which corporate law departments will be able to approach the design and negotiation of AFAs so as to maximize the likelihood of (i) reaching an agreement with outside counsel on an AFA, and (ii) designing an AFA that advances the client's business

goals by creating incentives for counsel that lead in the same direction as the business wishes to go. ■

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