Navigating fees

In the second in a series of articles on fee management, founding partner Ori Wiener of Møller PSF Group Cambridge explores the relationship between price, structure and negotiation.

Law firm profitability will become increasingly dependent not just on setting the right rates and structures but also on the ability of its partners to negotiate acceptable terms with clients. These profits will only materialise if matters are executed effectively and in such a manner as to make the most of the agreed fee structure.

Last month's article highlighted how fee management can improve both law firm profitability and client relationships. An additional reason for firms to reassess their approach to fee management is the growing importance of alternative fee arrangements (AFAs). Although some consider any fee arrangement that deviates from a standard billable hour (i.e. discounted rates or blended rates) to qualify as an AFA, true AFAs move away from a time-based approach which is effectively a 'cost plus' system.

The trouble is that the hourly approach has become so deeply embedded in the business model and internal processes of virtually all law firms that it is now part of their cultural DNA and has also shaped partner thinking. As a result, many partners are unable to assess the impact of changes in the rates they charge or the way they manage a matter on their firm's profitability.

Hartmut Papenthin, COO of CMS Hasche Sigle notes that, when it comes to pitching for new work, "most partners have a feeling for what to ask for in terms of fees but not profit. Consequently, they often focus on either the wrong client, matters or issues when it comes to safeguarding profitability".

To help partners and senior management to understand where and how to apply time and effort in this area (particularly the complex relationships between a number of factors that contribute to a firm's profitability), we have developed the golden triangle model (see Figure 1).

Pricing

As noted previously, price is the area that most partners have a 'feel' for, but thinking needs to adapt to AFAs. Under an hourly pricing approach, there is little risk to the law firm if estimates are wrong or the work is executed inefficiently (as long as clients pay).

Under AFAs, in addition to needing an accurate view of the cost of delivering the work required, partners must understand the overall value the work represents to the client. They need to be clear about which features of the service provision the client truly values and is willing to pay a premium for, and which are considered a necessary evil to be done at the lowest possible cost (if any).

Darren Mitchell, Clifford Chance's strategic analysis director, notes that there have been some new developments in AFAs. "We are seeing two different phenomenon following the recession. The first is the spread of AFAs into traditionally high margin areas such as M&A. Combine this with the second trend, which is clients' desire that we deliver on an agreed AFA and not revert to hourly billing at the first opportunity, and you can see why AFAs now loom so much more in partners' minds."

Structure

The adoption of new fee structures for a significant share of a firm's revenues will result in a need to overhaul long established systems, internal procedures and partners' approaches to dealing with a broad range of issues, such as the following.

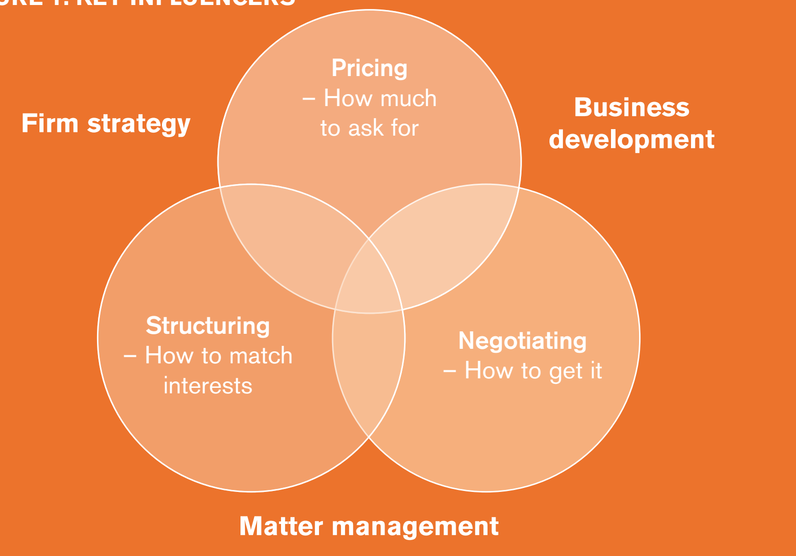
- **Accounting and billing systems.** Some firms have not been able to calculate fees and discounts correctly due to an inability to record and allocate global revenues accurately. Some arrangements have become so complex that they can only be calculated manually.

- **Matter and risk management systems.** A key consideration is whether firms can adequately manage the risks associated with novel risk-sharing arrangements. If not, this can potentially impact on funding costs or the cost of professional indemnity insurance.

- **Performance management systems.** Another issue is whether firms provide the right incentives and feedback on individuals to ensure that success fees are earned rather than lost. How will a firm know which partners and associates have earned these bonuses and how can it minimise behaviours likely to endanger performance bonuses?

- **Partner remuneration systems.** These systems need to adequately handle the differences between partners who generate 'safe' fees and those whose AFAs are associated with higher degrees of risk (including performance bonuses or success/abort fees).

FIGURE 1: KEY INFLUENCERS



Source: Møller PSFG Cambridge & GARA Consulting

Clients and their external counsel may well have very different views on the preferred fee structure for a particular matter or framework agreement. Reaching an optimal agreement will increasingly depend on partners' ability to negotiate skilfully, aligning conflicting interests.

Negotiation

Negotiation doesn't just cover the one-off conversation in relation to fees for a particular matter, but also the whole approach to managing client expectations as well as resolving problems constructively.

Firms seeking to enhance their approach to fee management will need to invest significant resources in raising their partners' fee negotiation capabilities. Little will be gained from developing robust pricing and structuring views if these cannot be successfully agreed with the fee-paying clients.

Partners with skills in this area are needed now more than ever. Mitchell notes that "the increased professionalisation in the selection processes (such as increased involvement of procurement) and cost management means that we have to become more professional in how we negotiate and manage on fees."

Skilful negotiators differentiate themselves in the following ways:

- they prepare properly;
- their preparations include significant amounts of time thinking about the needs and desires of, and the alternatives open to the other side;
- they listen to the other side substantially more than average negotiators;
- they use what they have heard to explore issues, interests and positions collaboratively with their counterparts; and
- they know how to combine integrative (making the cake bigger) and distributive (claiming a bigger share) negotiations.

Impact of strategy

A firm's strategy and its allocation of resources will impact fee management in a number of ways, including:

- service offering, such as commodity vs. premium 'bet the farm' work;
- leverage and the use of outsourcing;
- use of know-how and IT;
- ability or willingness to provide value-added services;
- approach to training associates and partners;
- risk appetite, such as increasing the share of performance or success-related elements; and
- remuneration and performance management systems.

CHECKLIST: NAVIGATING THE GOLDEN TRIANGLE

When looking to raise your firm's ability to manage fees, consider the following:

1. **Build** and make available accurate data on the cost of precedent matters to support partners' cost estimation for new work.
2. **Give** partners the appropriate tools and education to fully understand the firm's financial drivers. No partner should be able to plead ignorance or indifference in this area.
3. **Encourage** business development or client management teams to support partners' understanding of their clients, their decision-making processes and their selection criteria.
4. **Test** partners' understanding of competitors' pricing. This needs to be substantiated, as their understanding is often based on false comparisons or misleading information.
5. **Ensure** partners are clear about which work the firm is and isn't targeting. This will avoid giving confusing messages to clients and support consistent pricing.
6. **Review** billing and accounting systems to ensure that partners have access to all relevant information regarding the state of a matter.
7. **Adapt** risk management systems to flag the potential impact of major cost overruns and the impact of abort fees. Can partners use these to understand their collective exposure to particular risk factors or clients?
8. **Refocus** performance management systems to ensure all lawyers (including partners) receive the appropriate client feedback regarding their performance.
9. **Raise** the quality of matter management processes and resources. This is an area in which most firms lose more money than they think and which is entirely within their own control.
10. **Invest** in fee negotiation and matter management resources and training.
11. **Build** a culture that encourages partners to be ambitious but realistic in their approach and preparations to negotiating with clients and managing matters.

To avoid wasted efforts, it is essential that firms ensure alignment of strategy and gain partners' commitment.

Business development

A partner's ability to prepare and anticipate clients' preferences and options is directly influenced by the quality of the investment made in the relationship and of his/her understanding of broader market trends.

The support partners receive in this area varies widely and is also affected by the objectives set for a marketing or business development department. When partners merely want marketing or BD teams to compile brochures, pull together pitch books, update CVs or provide credential lists, the quality of support in relation to fee management will be limited.

On the other hand, those able to engage with clients, understand their issues and provide intelligent, creative and effective support on fee pricing and structuring are unlikely to have the time to also deal with more logistical issues.

Matter management

According to Stuart Dodds, global head of pricing at Linklaters, "clients' interest in AFAs is prompting not just a rethink on prices but also a reassessment on how lawyers practice and how they can provide more value".

The increasing client emphasis on uncoupling time spent working and fees paid is forcing those in charge of matters to spend more time and effort to consider that:

- only work which is directly needed is carried out. This requires clear agreement with the client regarding what is needed and what can be excluded;
- work (such as precedent research) is only carried out to the level of detailed needed (again subject to client agreement), rather than at the most thorough level possible;
- work is carried out by the most cost-effective lawyers. It may be cheaper to allocate work to experienced senior associates rather than junior associates whose work would need to be checked; and
- only time actually spent on a matter is recorded, but done so promptly.

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There are additional implications. For example, limiting the extent and level of detail for research into precedents agreed with clients could mean that clients may receive answers much more rapidly but, that at the same time, increase the risk that these answers may have to be revised in light of further developments. Such discussions take on a level of commercial risk and project management with which few lawyers are traditionally familiar.

Next month's article will look specifically at how to prepare for fee negotiation. mp

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