The Challenges in Negotiating Legal Fees: An Alternative Fee Case Study

Toby Brown
Director of Strategic Pricing & Analytics
Akin Gump Strauss Hauer & Feld
August 2012

Negotiating legal fees is a relatively new thing for the legal profession. Historically firms quoted rates and clients accepted them. More recently an annual "rate dance" has occurred between firms and clients, whereby the firms cautiously raise their rates and then hope clients accept the higher rates. Typically the client pushes back, sometimes even asking for rate freezes. The dance continues until some sort of acceptable rate situation is crafted and billing commences. Sometimes this dance lasts well into the New Year, resulting in high levels of frustration for both clients (not knowing prices) and law firms (not knowing if they will be paid).

Ultimately this rate dance is futile. Law firms struggle to maintain profit margins under reduced rates and clients may not save money. That last point highlights the futility of the rate dance. No one knows whether money was saved or not. Lower rates only result in … lower rates. These should have an impact of fees, but no one is really sure what that impact is.

This frustration is pushing many clients to re-examine the dance and shift the conversation to the fee level. The days of just getting a bigger rate discount may be ending. Clients, under internal pressures, are learning to redirect the dance in to more healthy, proper, fee negotiations.

Of course, negotiating at a fee level requires a much different conversation than the rate dance. At the fee level, things like scope and duration matter. As well, the full goals of the client related to a given matter or even type of legal work need to be injected into the conversation. The legal goals need to be blended with business goals and overall cost control needs. This multi-dimensional conversation is more challenging, especially since lawyers (both at firms and working in-house) are new to this effort. Overcoming this challenge will be key to transitioning to a healthier fee negotiating method.

A central part of this challenge is the transition phase. For most firms and clients they currently live in a bipolar world, with both rate dancing and fee-level negotiations. In this world both efforts are occurring simultaneously, many times in direct conflict. This is evidenced when clients ask for both fixed fees and ghost billing. In the transition, clients struggle to trust either rates or fees and therefore oddly mix them as a check on both of them.

What follows is a Case Study highlighting this transition in a particular piece of the legal market: patent litigation. This type of work is at the forefront of the transition and serves as an opportunity to learn and apply new ways to other areas of the practice. The Case Study examines the impact of the shift away from hourly-based pricing to fee-based pricing in the patent litigation market.

This transition demonstrates the emergence of a three-tier market pricing structure. This alone is significant for fee negotiations. But then the Case Study peels back further layers, laying out the new dimensions fee negotiations have to take in to account, including new and elusive definitions of "efficiency."

Obviously, fee negotiations will be an evolving subject. This paper attempts to initiative the discussion for how firms and clients can better understand the dynamic between rates and fees, leading to more productive fee negotiations.

Case Study on the Evolution of Pricing in Patent Litigation

This Case Study examines the impact in the patent litigation market relative to the shift away from pricing these services on an hourly basis, to one where prices are set at the fee level. The fee level being top-line dollars spent on either an entire matter, or on each stage of a matter.

Two primary impacts have been identified in this case study. First is the impact on market pricing; specifically how a competitive market has driven down pricing. The nature of this pricing has also evolved.

Second, we examine how firms are responding to this change in the way they plan and manage these cases.

After looking at these two impacts, we will extrapolate whether these same phenomena may be replicated in other segments of the legal services market.

The methodology used in this case study is relatively simple. It includes my extensive firsthand experience as a law firm AFA specialist. As well, I have interviewed a number of lawyers who practice in this area, including some litigators who practice solely in this market, and other litigators with a more general commercial practice that includes this market space.

I will start off by stating that I do indeed think the changes occurring in this market are instructive of what's to come in other legal market segments. Although there are some unique aspects to consider, I am already seeing similar transitions begin in other market segments, consistent with the evolution here in the patent litigation legal market.

Impact on Pricing

The first and most obvious result of the shift to fee-based pricing was significant downward pressure on the fee-level price. In an 18 to 24 month period, prices fell approximately 50%. Although dramatic in nature, this drop coincided with the emergence of a more "natural" pricing segmentation. Previously most cases were treated the same for pricing. There were some exceptions for nuisance cases; however, for the most part the same pricing approach was used. Once fee-level pricing emerged, the market started defining three primary market segments; each with a distinct pricing level. These three segments are typical of many markets and are described as follows:

Tier 1 – High stakes matters. This type of work might result from two market players engaging in a patent war (think Apple vs. Google) or any other number of circumstances when a patent represents significant revenue to a client. Here each player has a lot of money at stake and will have low price sensitivity for legal services. This segment is clearly "Bet the Farm" work and might represent 15-20% of the market, and is declining (currently at 10% per one interview).

Tier 2 – Mid-level stakes. These matters will have valid legal claims involving enough money that they require a reasonable legal response, but not at the level of Tier 1. This segment of the market has seen increasing price sensitivity. Two to three years ago the work may have commanded fees near Tier 1 level. In many instances these cases now include multiple defendants, enabling easily identifiable cost savings. This segment: 50-60% of the market and growing.

Tier 3 – Nuisance matters. This tier covers questionably valid legal claims and thus low financial exposure. This segment has high price sensitivity and clients benefit from quick, low cost resolutions. Services for this segment need to be highly leveraged and utilize lower cost personnel. This segment: 20-25% of the market, relatively stable but with occasional spikes (30% per one interview).

An interesting and noteworthy aspect of Tier 2 pricing comes into play with the multi-defendant situation. It appears overall case filings are down for patent lawsuits, however, the number of named defendants is up. This represents a trend within a trend. Clients may have a $1m exposure in a Tier 2 matter; however, the relative financial exposure of co-defendants impacts their fee-level pricing decision. Formal joint defense agreements are now more common in these cases; however, the agreements do not spell out the relative cost load for each participant in these matters.

For instance, in a case where one defendant is clearly identifiable as the primary patent holder (other defendants may be customers leveraging that patent), the identified company, by default, takes a laboring oar in the legal work. Therefore their law firm can extract a higher fee. In other circumstances, the relative position and responsibility for legal work may be determined by the financial exposure of each defendant. Those with the highest exposure take on central roles. Currently these varying roles and the degree of financial participation are decided informally.

This approach has been working; however it will face some challenges going forward. An inherent conflict exists in this model, because players (and their law firms) are financially motivated to settle out as early as possible. As fewer defendants remain involved, they will need to shoulder greater levels of expenses / fees. Clients obviously want to avoid being in a declining pool of participants as their costs will go up. Law firms in fixed-fee arrangements will have the same concern. An informal, undefined approach to the fees and costs will become more challenged as players figure this system out and react accordingly. A possible resolution will be formally defined roles within the Joint Defense Agreements.

Pricing by Stage

For Tier 2 and 3 matters, another pricing mechanism has emerged. Clients have drifted towards fixed fees or fee caps for the overall matter. One expressed concern with this approach is the impact of early settlement. Clients do not want to pay a "Through Trial" or "Through Markman Hearing" level fee when the case may not go that long. So what emerged was a fee-per-stage, usually in four or five stages, with the final stage being trial. A variant of this model is a fee-per-month-per-stage. In this model an expected level of legal activity is agreed upon for each stage and a monthly fee is set for each stage. This approach further limits a client's exposure in a fixed-fee as they only pay for the time the case is active.

Fixed Fees versus Fee Caps

The logical conclusion is that clients would prefer fee caps, as they shift almost the entire financial risk to law firms. Whereas, fixed fees involve a sharing of risks. So far the market has been a mixed bag of the two. My observations are that fixed fees are actually the better option for clients. Fee caps involve more effort by clients in monitoring and directing the work of their outside counsel. Fixed fees (when properly employed) can greatly reduce this burden. One litigator interviewed classified clients in two categories: Group A clients - who feel compelled to manage cases at a high level of detail, and Group B clients - who set a fee and give broader control to their outside lawyers. With in-house legal departments experiencing internal staff reductions, their ability to commit resources in such a manner as Group A are likely limited and unsustainable. Additionally, these types of tasks may not be the best use of in-house counsels' time.

Internal Pressures on In-House Lawyers

A consistent theme heard from clients is that when it comes to fees, their jobs are on the line. Since cuts to legal departments include the reduction of internal staff, this aspect is of special concern. Clients highly value "no surprises" in their fees. In-house lawyers are being held accountable for not going over budget on fees. Once they give a fee/budget number to their CFO, fees above that number weigh heavily on internal performance reviews. This means in-house lawyers are becoming hyper-sensitive to budgets, fee caps and fixed fees as a means for maintaining their positions within their companies. This also explains the willingness to manage outside firms very closely.

Another growing trend is the involvement of "Procurement" or "Purchasing" in the selection of law firms. This trend is not limited to patent litigation, which makes it more worthy of notice. In-house lawyers are getting the command from their leadership to bring Procurement in to drive the process for bidding and selection of outside firms. The results of these efforts have been mixed, since Procurement is new to purchasing legal services. However, this trend appears to be solidifying and unlikely to abate.

Middlemen Emerge

Any market that struggles to set open-market prices is a target for intermediation. And two types of intermediaries have emerged in the patent litigation market. On the plaintiffs' side, the non-producing patent owners (a.k.a. "Trolls") have been in the game for a while. However, recently they have upped their game by going after multiple defendants (noted above in Tier 2). Fee-level pricing makes this a better bet for them. On the defendant side, a new business has emerged that pools patents and patent defense services.[1] Clients pay an annual subscription fee to build a pool of patents they can use in defense of their businesses. This approach is driving down the cost for clients and reducing the likelihood of future claims.

Conclusions on Pricing Impacts

Fee-level pricing has had a dramatic impact on the prices suppliers (law firms) can charge and the type of fees in use. The emergence of a three-tiered market is natural, but may well be in for some more evolution, given the emergence of intermediaries in the market. Currently the pricing appears to be relatively stable, but that may not hold if the suppliers continue to compete on price to get and retain clients.

Impact on Practice Management

With such a dramatic drop in prices and the emergence of a three-tier pricing market, law firms have obviously had to make some adjustments in how they manage their work. What is emerging on this side of the effort is more emphasis on case planning. Given all the discussion in the market about Legal Project Management (LPM) you might expect to see more adoption of formal project management tools and techniques. However, for the time being, the decision making remains with individual lawyers, so few, if any, central infrastructure or project management approaches have been widely adopted.

Case Planning

In the past case planning was about legal strategy. Decision making focused on all the efforts needed to meet that strategy. Now planning takes into account how much resource is available and where it will best be deployed. Internal to firms - teams now ask different questions when deciding how much effort should be made in-line with a legal strategy. For instance, the number of depositions to be taken and which ones is asked. From the client side, greater controls are put in place over which timekeepers can appear on bills and who performs a given task or set of tasks. The level of participation by the client can even go as deep as specifying a specific partner go alone to a deposition. As noted above, this approach takes measurable resources from the client.

Price pressures are driving a new type of planning behavior. Typical adjustments include fewer, more closely managed numbers of timekeepers per matter. It also includes closer scrutiny of

[1] See RPX Corp at http://www.rpxcorp.com/.

tasks performed. However, it appears to still lack a standard, repeatable project management approach.

Lack of Planning

The motivations of law firm compensation plans (rewarding billable hours) runs counter to planning and project management methodologies. As a result, many practices are seeing an increase in write downs (pre-billing) and write-offs (post billing). This is an important point. Attempts at planning and project management may well be crippled by compensation plans that don't reward these behaviors. Lawyers whose compensation is rewarded by spending more time on a project will struggle with plans that reduce those numbers. This will likely create internal conflicts for firms, leading to hoarding and difficulties executing on plans.

Role of Project Management

Obviously this situation begs for some type of formalized project management. This may take some time to appear for two reasons: 1) Clients, and 2) Law firms. Clients are utilizing a diverse range of approaches to driving down costs. Even though a common market pricing mechanism has appeared, each player is struggling with how to respond to it. The result is very inconsistent approaches by clients and even departments and/or business units from the same client.

Law firms have an even greater challenge. Like clients, behavior from firm-to-firm will differ. But practice management behaviors from lawyer-to-lawyer within the same firm will also differ. Law firms typically employ a decentralized management methodology, allowing partners to manage their practices to each client's needs. This decentralized model increases the challenge for firms needing to centralize and standardize on an LPM approach.

An initial and promising first-step is the increase in monitoring capabilities by both law firms and clients. Monitoring efforts will create a first level of accountability and highlight the need with handling lawyers for utilizing project management alongside case management. How can you improve on cost management when you don't know what your costs are?

This monitoring effort could easily be the first step for both clients and law firms, as evidenced by new and expanding tools on the market. Client-side "spend management" applications are beefing up their monitoring and management capabilities.[2] Next generation providers are even entering the market, with examples like Onit.[3] On the law firm side, tools like "Redwood Planning[4]" from LexisNexis and "Engage[5]" from Thomson are examples of products that provide for modeling, planning and monitoring of legal matters.

[2] Examples include: Datacert, Serengeti, Bridgeway and MitraTech.
[3] See Onit at www.onit.com
[4] Product described at: http://www.lexisnexis.com/redwood-analytics/BI/planning-application.aspx,
[5] Product described at: http://www.thomsonreutersengage.com/.

Conclusions on Practice Management

Dropping prices dictate the need for reducing the cost of services. Existing law firm and client practice management tools and methods are inadequate to deal with this changing and challenging environment. Efforts are currently being made to reduce these costs within the given framework and with existing tools, but these efforts can only go so far. There is an obvious need for centralized and standardized project and practice management methods and tools. The decentralized nature of law firms will make embracing these changes quite a challenge.

Overall Conclusions

The transition to fee-based pricing for the patent litigation market is an indicator that the underlying general market mechanisms have changed. Therefore we should expect to see other legal market segments make similar transitions. A primary hurdle for these shifts will be the establishment of a fee-level market pricing mechanisms for each market segment. Likely segment choices will be those with more intense pricing pressures, or those that have more defined processes and tasks (e.g. with rules of procedure, well-defined administrative process, or scope-able projects or tasks). Signs of this type of shift are appearing in a number of other legal markets. How far this shift goes and into how many legal market segments is yet to be seen.