Value-Based Pricing:

Aligning the Cost and Value of Legal Services

The Evolution of Legal Pricing

Traditionally, lawyers have charged for their services based upon the amount of time spent providing them. This is simple “time-billing” or “hourly-billing,” expressed as P(rice) x Q(uantity), where P is the hourly rate and Q is the amount of time incurred by the timekeeper on a matter. This billing model is sometimes referred to as “task-based billing” in reference to the ABA’s Uniform Task-Based Management System (or UTBMS).

From around 2008, in response to rising cost pressures, corporate legal departments (CLDs) became increasingly interested in cost controls and improved budget certainty. Some brought in specialists with sourcing experience to help, using programmatic methods such as centralized supplier panels to drive savings via discounts to hourly rates. They produced varied results based on how these initiatives were structured and used.

Enter the “Alternative Fee Arrangement” (AFA). AFAs seek to improve cost certainty and link price for work performed to a business output, milestone or outcome, instead of to a time input. In the vast majority of cases, these AFAs are either linked to a specific output (a deliverable such as a contract) or business milestone (such as a phase of work) or management of a portfolio of work (such as all procurement contracts). Common examples include fixed, capped or phased fees.

Time remains at the heart of AFAs, which are predicated on the number of hours it takes a firm to do the work at a specified unit price, albeit re-packaged for the client into a different commercial model. We will refer to them as “time-based AFAs” since they are generated based on time inputs. Time-based AFAs have become a useful tool in the CLD toolbox, helping to re-allocate some of the risk associated inefficiency or unforeseen events to firms. For firms, they may offer incentives to enhance productivity and efficiency, and the opportunity to attract clients with differentiated pricing.

In contrast, CLDs have been slower to adopt alternative pricing based on the value of business outcomes, what we call “value-based AFAs.” Value-based pricing decouples a service’s “inputs” (i.e., billable hours) entirely from price, and instead focuses on value produced from the services, as measured in terms of outputs and business outcomes. Paying for results rather than effort is hardly a new construct in commerce, but use of the concept remains modest for many CLDs.

Despite the interest surrounding AFAs generally, time-based billing remains the dominant model in the legal profession, and is perfectly serviceable for many CLDs in many situations. In this article, we consider the extent to which value-based AFAs offer a viable pricing model which could be explored by CLDs in addition to time-billing and time-based AFAs. We also address common misperceptions as well as offer practical tips for experimentation.

Why Value-Based AFAs—and Why Now

Time-based AFAs are becoming increasingly prevalent[1] as CLDs face shrinking budgets and heightened business scrutiny of their spend. They are increasingly enabled with reliable billing and benchmark data which may equalize the negotiation power in pricing conversations.

Meanwhile, law firms should be able to produce high quality services ever more economically using technology, techniques such as legal project management or lean, as well as new resourcing models. With the rise of a legal services ecosystem comprising multiple new market entrants from alternative legal service providers ("ALSPs") to contract lawyer and technology companies, the supply side is perhaps more competitive than ever. According to "Alternative Legal Service Providers 2021," a research report from the Georgetown Law Center on Ethics and the Legal Profession, Thomson Reuters Institute and The Professional Service Firms Group at Saïd Business School, University of Oxford, **the market for ALSP services reached approximately $13.9 billion by the end of 2019, and 71% of corporate law departments are using ALSPs.**

The intense focus on cost control has both CLDs and firms looking for ways to align interests and value, and reduce costs. AFAs offer a path, with the preferred tools being time-based AFAs. From a CLD's perspective, time-based AFAs may increase price certainty (total envelope of cost) and spend predictability (when and how much will be incurred). That can be a game-changing outcome.

Value-based pricing, on the other hand, can offer a different value proposition and an appealing solution for both buyer and provider. For the former, it may offer cost reduction and paying fair value for services calibrated to the business outcomes required. For the latter, it may offer receipt of a reasonable profit for work performed and experience delivered. However, for many CLDs and their provider firms, striking the right arrangements can present a daunting negotiation process and the potential risks and price drivers can appear elusive to the CLD and the provider firms.

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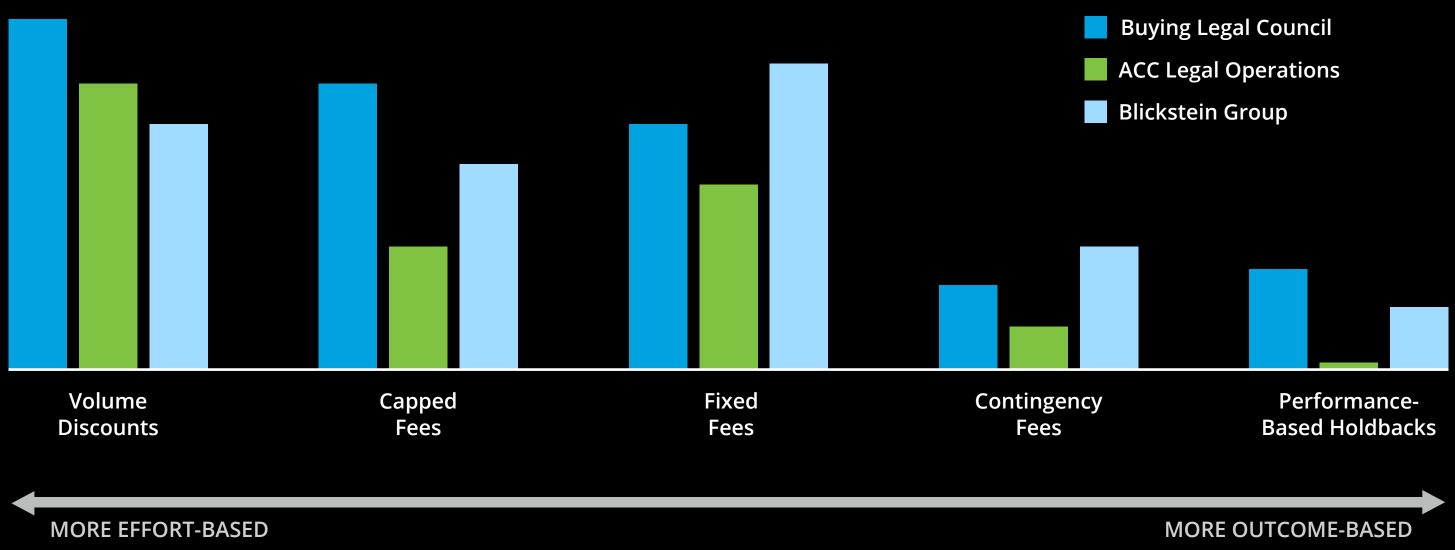
[1] More than 85% of law departments now report having tried fixed fees per matter, up from 69% in 2015. The percentage of law departments that have attempted flat fees to handle all matters in a given area or by matter stages has risen from 54% to 75% and 37% to 63% respectively. (Blickstein Group 2020 Law Department Operations Survey and Blickstein Group 2015 Law Department Operations Survey) 16.8% of all matters now utilize AFAs, compared with 10% in 2020 and a significant increase from 2016 when use was 7% respectively. (CounselLink 2020 Trends Report)

AFAs by the numbers



<10% of departments have **50%+** of their spend on AFAs.

>40% of departments have **<10%** of their spend on AFAs.

75% of departments use AFAs for cost savings, and **70%** for cost efficiency.

60% of departments say law firms are more comfortable with the billable hour, and **40%** of law firms say law departments are.

Sources: Buying Legal Council 2020 Market Intelligence Report, ACC Legal Operations 2020 Report, Blickstein Group 2020 Law Department Operations Survey, Bloomberg Law's 2020 Legal Operations Survey

Time-Based AFAs vs. Value-Based Pricing

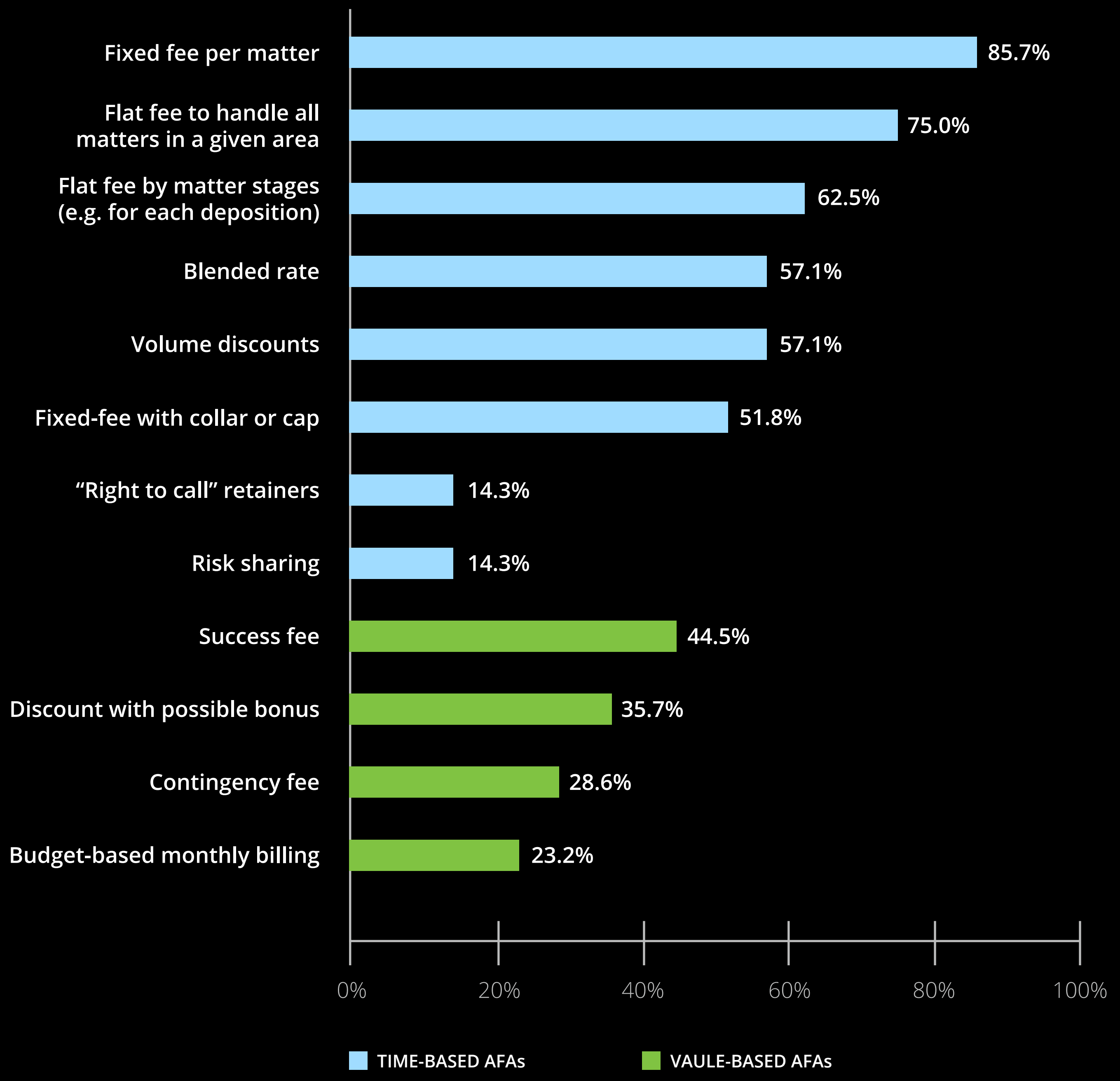
Frequently used time-based AFAs are:

- Fixed fees per portfolio, matter or phase
- Fee caps
- Fee collars
- Blended rates
- Monthly retainers

These AFAs are typically underpinned by specific assumptions which, on flex, may trigger predetermined pricing adjustments or change processes. They offer a suite of different tools which may be used and combined in response to different client priorities. For some CLDs, predictability of spend (periodic burn rate) is preferred, with less emphasis placed upon driving cost reductions. The opposite may be true for other departments, who prize the generation of reductions. Time-based AFAs may offer many benefits to clients by enhancing the firm's attention to productivity and efficiency, and sharing some of the performance risk.

Regardless of their various merits, each of these time-based AFAs belies a calculated estimate of P x Q (the hours needed to complete the work), with the law firm retaining any economic upside from cost underruns while assuming the risk of overruns. They inherently measure inputs, such as the amount of time and effort to complete the work, without reference to value produced. By rewarding effort over results, time-based AFAs may not enhance the alignment of interests between client and firm.

What types of Alternative Fee Arrangements have you tried?



Sources: Blickstein Group 2020 Law Department Operations Survey

Attributes of Value-Based Pricing

Value-based pricing seeks to reward firms for positive results created or negative outcomes avoided, regardless of the time and effort invested to achieve them. In essence, value-based pricing decouples inputs (time and effort) from outputs (units or results obtained). These models generally fall in one of four categories, depending on the values they prioritize:

1. Unit pricing rewards efficiency.
2. Paying based on successful outcome focuses on results.
3. Risk mitigation billing emphasizes proactive problem solving.
4. Fees calculated as a proportion of the organization's overall assets measure legal's alignment with longer-term corporate objectives.

Contingency fees in litigation are one example of value-based pricing. They demonstrate how paying for value can be used to bring the goals and objectives of both the client and law firm into alignment. The firm self-regulates its effort expended in pursuing the desired outcome and the client only pays on achievement of the outcome. Of course, contingency fees introduce a range of other professional considerations for lawyers, and in some jurisdictions, regulatory considerations.

Some CLDs may find that pivoting to focus on value may improve their alignment not only with their law firms, but with the rest of their own organization's objectives. For example, CLDs in companies which prioritize profitability or free cash flow may find benefits from measuring their initiatives based on return on investment, determined by impact on revenue, margin or cash. By tying cost directly to outcomes, these CLDs can move onto the same page with the rest of the business, with the value of their firms' work based on the return on the investment made in it. Other CLDs will continue to prefer time-based billing models, to avoid the risk of paying for effort not actually expended regardless of outcome achieved.

Different Tools for Different Jobs

CLDs juggle multiple competing considerations when assessing the value they create for the business, such as risks mitigated or avoided, volume of litigation managed, contracts negotiated, and business units served. Yet when grading their own performance, they frequently focus on the simplest input metric: legal spend.

As our understanding of AFAs and access to high quality spend data improves, sophisticated CLDs will be in a position to move beyond simple measurement of spend, to be increasingly able to experiment with all forms of AFAs, if they wish, and to treat pricing models as different types of tools in their toolboxes.

In many cases, hourly billing remains a serviceable approach. In other situations, such as at a portfolio or significant matter level, price certainty and predictability may be the overriding objectives, in which case time-based AFAs such as fixed fees may be better options.

For law departments with a focus on proactively avoiding risks or strategically harmonizing legal department objectives with the organization's longer-term goals, the potential opportunities presented by value-based AFAs may be a consideration.

"Initially just for clarity and predictability around billing, we started to employ just some time-based models. And we do have a lot of these in place right now. But as we continue to gather data and as we pull in more information we've had fantastic conversations with our firms, asking 'What does the mutual good look like?' or 'How can we create a win-win here?' We see huge opportunities going forward."

– Brooke Van de Kamp, *Director of Legal Operations, Strategy, and Technology, Johnson Controls*

"It can be a struggle to figure out how to fairly share risks – which sometimes drives us back to hours-based estimates."

– Leeanne Whaley, *Transformation Director for Legal and Co Sec, BT*

The Four Types of Value-Based Pricing Models

While value-based pricing models can take many forms, they generally fall into one of the following four types.

Units Delivered
Often per contract or per single-plaintiff employment matter or patent renewed

Successful Outcomes
Often defensive litigation tied to settlement or judgment (or precedent)

Risk Mitigated
Often litigation avoided via compliance program or reduction in number of employment claims

Client Asset Value
Often offensive litigation tied to recovery amount

Units Delivered

The most straightforward type of value-based pricing is the unit model: payment is set per unit of value, whether that be a contract, a single-plaintiff employment matter, a patent renewal, or other defined unit of work.

If a contract is worth $100 to an organization, how much of that is the organization willing to pay to a law firm to draft, negotiate and execute the contract? Which law firm is willing to do the work at that price point? When law firms are compensated solely on the basis of an input, such as timekeeper hours, they are penalized for using time-saving efficiencies like technology and proactive matter management. The faster the firm works, the less it earns. By contrast, a unit-based approach aligns the aims of the law firm with those of the client. Both sides should benefit from improved delivery models, relieving the typical tension that hourly billing produces. Where there are service gaps, course-of-ordinary feedback discussions and remediation can serve to keep the CLD and the law firm aligned.

Successful Outcomes

A contingency fee in defensive litigation – a fixed fee related to the settlement or judgment amount – is an example of an outcome-centered model. Successful outcome fees can be hard to calculate, but there are simple approaches that can be applied, such as rewards for reductions in case cycle time or bonuses based on timely settlements. Successful outcome AFAs reward law firms for helping a client achieve success, however defined.

Risk Mitigated or Spend Avoided

While risk mitigation may have value, it is also hard to define or quantify. One way to set this value may be by comparison with historical norms and trends, for example, whether the organization reduced litigation compared to previous years, resulting in what cost savings. If a firm can help a client reduce the number of employment or injury claims that must be defended, determining what avoiding those claims is worth and rewarding the firm accordingly can bring alignment of interests.

Models based on risk mitigation may reduce the tension that traditional hourly billing structures produce as the hourly billing model penalizes law firms for preventing problems or solving them proactively, while many CLDs would typically prefer to avoid issues rather than react to them; removing the focus on time rewards their firms for doing just that. This model does put pressure on the feedback loop between CLD and law firm provider to reach consistent agreement on what constitutes risk mitigation or avoided spend.

Value of Client Assets

If a law firm helps a client to enhance the value of the company, to what extent is it appropriate for them to share in that success? This is – understandably – an extremely challenging construct for CLDs. It may be difficult, but it should be possible to link legal fees to the value of client assets, for example, in a company with substantial intellectual property. Could a firm earn a percentage of the licensing fees related to inventions it aided in patenting or trademarks it filed?[2]

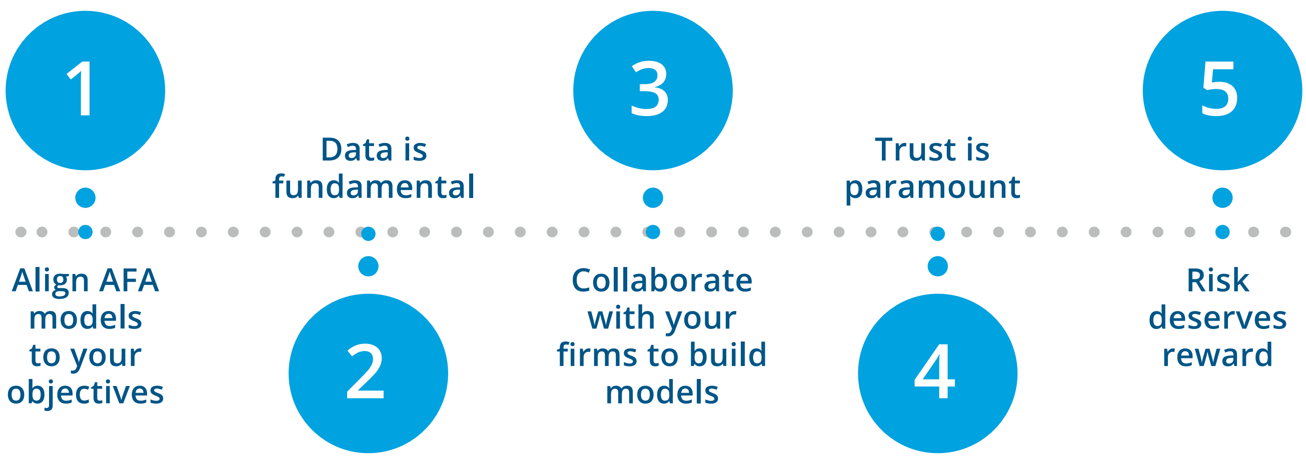
It may be difficult to persuade clients in mature businesses that this is a reasonable commercial approach, as they are less inclined to treat law firms as trusted advisors and more inclined to consider them commodity suppliers that should receive no special treatment relative to other suppliers, who have no expectation of gain sharing. The construct could have application, though, for early-stage companies who need to prioritize deploying operating capital on R&D, sales, marketing and customer acquisition/retention, rather than law firm fees. Such companies may be found especially in the biotech and software sectors.

Again, these approaches can be flexibly designed to meet the needs of the client and the law firm, and it may make sense to start with a hybrid approach. For example, an arrangement that combines a discounted hourly rate with a success bonus based on the eventual outcome can be a way to align objectives without making a wholesale change in the billing model. Value-based AFAs are not all-or-nothing propositions; in many instances it makes sense to identify an incentive that can be attached to results as a starting point for separating legal spend from time invested – and build from there.

[2] These arrangements are always subject to applicable professional regulations.

Implementing Value-Based Billing: Five Essential Elements for Getting Started

Defining value can be difficult and requires a well-informed CLD, with reliable data to aid decision-making. Here are five steps to consider when getting started.



1. Align AFA models with objectives.

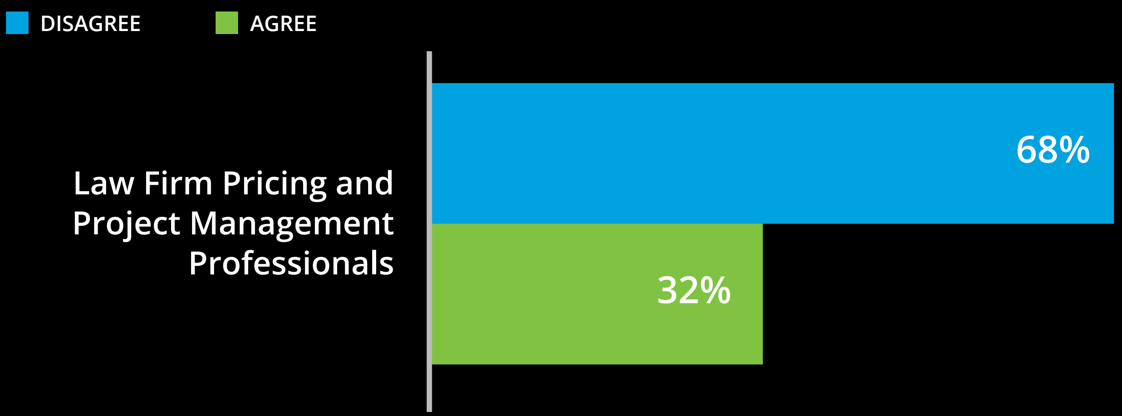
Define value, which then underpins design of the pricing model. Value definition is not always easy and requires CLDs to determine what outcomes truly matter to their organization, and how the CLD and the law firms that serve it can directly contribute to achieving those objectives.

Who is driving the change?

Who should drive the conversation around fee arrangements? Should law firms, as the service providers, suggest different pricing models? Or should buyers demand alternative pricing options – and if so, should that conversation be steered by in-house counsel, procurement, legal ops, or someone else?

Defining value and translating it to a cost is fraught with challenges. It is critical to collaborate to enhance the chances for success.

Our clients do a good job at suggesting alternative fee arrangements that meet their needs



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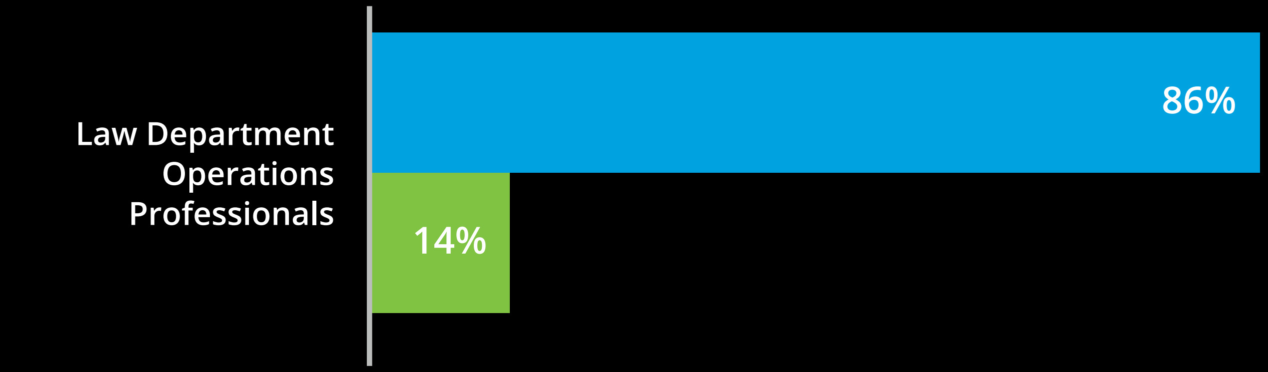


Source: Blickstein Group-Legal Value Network Inaugural Survey of Legal Pricing & Project Management

2. Data is fundamental.

Conventional CLD spend management activities involve collecting input metrics, such as hours, rates and staffing models. These metrics are vital to create visibility of the overall picture, but they are of limited assistance when designing value-based pricing, which focuses on outputs rather than inputs.

For value-based pricing, CLDs need to decide what metrics are needed to measure the outcomes that matter, then collect that data and consider what that outcome is worth.

Not all data is equal; clean and reliable data is essential, and attention should be given to transformation of raw data sets. CLDs, however, may not always be able to produce perfect data and this may make attorneys uncomfortable, but it is not necessarily a reason to abandon the endeavor. Many successful businesses today operate on imperfect data, applying judgment to fill the gaps left by incomplete but directional data. CLDs can do the same.

To accurately calculate the value of a type of work, it should be defined and classified, answering questions such as: in what jurisdiction was the work performed? Did this contract involve a new or existing customer or a new or existing product or service? For litigation, what was the claim amount and the settlement amount? What was the level of reputational risk? If you haven't historically collected this information, your law firms may be a good supplemental data source.

"All of our panel firms have been very open, honest and willing to work with us. They're excited about finding ways that we can work better together."

– **Brooke Van de Kamp,** *Director of Legal Operations, Strategy, and Technology, Johnson Controls*

"It's not about either side dominating the other – it's about realizing that there is a win-win and working out how to achieve it."

– **Leeanne Whaley,** *Transformation Director for Legal and Co Sec, BT*

3. Collaborate with trusted law firms to build value-based pricing models.

A key consideration when experimenting with value-based pricing models is to reduce the perception that it is a zero-sum game. Value-based pricing typically only works where trust can be established, with both client and law firm striving toward a common goal. Instead of one side trying to invent a value-based model that is meaningful to both parties, CLDs may wish to collaborate with trusted law firms to experiment with mutually beneficial approaches, sharing data and insights until a prototype model is ready for experimentation. Collaborating also helps a trusted law firm develop its reporting structure to fit the model under consideration by the CLD. Planning and proactive discussion can reduce extra cycles in trying to get the reporting right, and help the law firm more efficiently meet the CLD's control and oversight requirements.

Contract cycle time is typically a relatively easy place to start. It is often said that "time kills deals" and speed to contract directly correlates with a number of commercial advantages, and therefore value. It is also a discrete metric that's often easy to calculate.

Similarly, settling disputes early can often save money. Building in a reward based on reduction in that one metric by, for example, paying a bonus for every day under the average resolution time. This can immediately align the client's interests with that of the firm, which under an hourly billing model could earn less for settling early.

"We're excited to see how the move toward value-based billing could truly drive innovation in the delivery of legal services."

– Leeanne Whaley,
Transformation Director for Legal and Co Sec, BT

4. Trust is paramount.

Trust is an important factor for effective collaboration. The CLD should trust that the law firms with which it works have the individual and organizational capability to put the CLD (and CLD's clients') goals and needs in line with its own. It's difficult to overstate the importance of trust in establishing a value-based billing approach.

Trust exists at several levels in a CLD-law firm relationship. There is the relationship between the entities, which is managed at senior executive levels in the organization, and then there are individual interactions between responsible in-house attorneys and law firm attorneys. The arrangement between CLD and law firm should be structured so that there is ample feedback at all levels of interaction in order to quickly identify and resolve conflicts that can lead to a lack of trust.

5. Risk deserves reward.

Implementing value-based models may require new thinking for both the CLD and its partner law firms. It can be easy to forget that you are operating under a new paradigm and tempting for both firm and client to want to test whether a "good deal" was achieved based upon the number of hours spent. Since inputs are not the core drivers for value-based pricing, this is likely to be a fruitless exercise, and could erode trust between the parties.

Are You Ready for Value-Based Billing?

We anticipate that alongside the rising popularity of time-based AFAs, value-based AFAs will receive greater attention in the coming years, and will become a tool in the toolbox of CLDs that are willing to experiment with the psychological shift toward paying for value received rather than effort expended.

Doing so would likely foster closer and more enduring relationships with trusted law firm partners through the relentless focus on what is truly important for the client for each matter. CLDs could even experiment gradually by using value-based approaches for discrete phases of complex and large matters, where the overall risk on either party of a misstep is modest.

But is your CLD ready to experiment? A litmus test could be this: Say you've agreed that your firm will handle a difficult litigation matter for a $1 million flat fee. You think it's going to take at least a year to resolve the matter, and you're expecting to have to pay around $10 million as a commercial settlement.

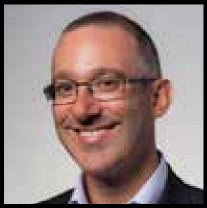
To your surprise, the firm comes back to you just one week later with a $3 million settlement, much lower and much faster than you could have possibly hoped for. You've saved $7 million and a full year of cycle time.

How do you feel about paying the $1 million fee for what could not possibly have been more than a few hours of work?

If you'd be reluctant to write this check as this hypothetical firm didn't put in much time or effort, that just means you are still more comfortable valuing legal services according to a price times quantity paradigm.

If, on the other hand, you'd be happy to write this check based on the outcome, despite the fact that it didn't take much time or effort, then it may make sense to start experimenting with value-based pricing.

Contact us



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