

Pricing and Negotiating Legal Services

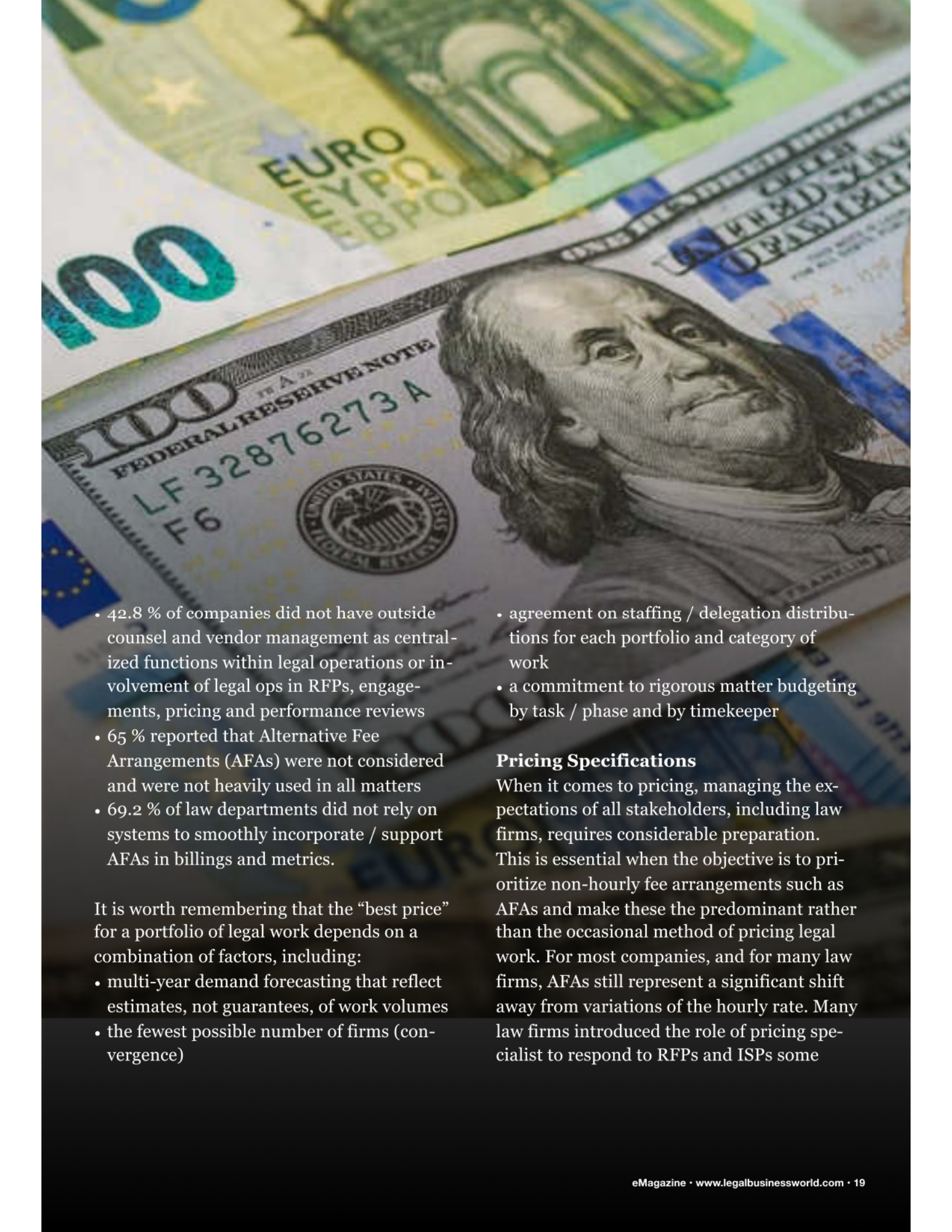
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This is the twenty eighth in a series of articles about how corporate and government law departments can improve their performance and add measurable value to their organizations.



PRICING LEGAL SERVICES

The Association of Corporate Counsel (ACC) released a comprehensive [report](#) benchmarking legal operations in March 2020. The law department maturity model (3 stages) surveys 15 functions, with one of the functions being *External Resources Management*. The findings were telling. Only 11 % of the 316 participants reported they were in an advanced stage for this function. Three of the 13 sub-functions are noteworthy when considering the proportion of companies that had no measures / protocols in place

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- 42.8 % of companies did not have outside counsel and vendor management as centralized functions within legal operations or involvement of legal ops in RFPs, engagements, pricing and performance reviews
 - 65 % reported that Alternative Fee Arrangements (AFAs) were not considered and were not heavily used in all matters
 - 69.2 % of law departments did not rely on systems to smoothly incorporate / support AFAs in billings and metrics.

It is worth remembering that the “best price” for a portfolio of legal work depends on a combination of factors, including:

- multi-year demand forecasting that reflect estimates, not guarantees, of work volumes
- the fewest possible number of firms (convergence)

- agreement on staffing / delegation distributions for each portfolio and category of work
- a commitment to rigorous matter budgeting by task / phase and by timekeeper

Pricing Specifications

When it comes to pricing, managing the expectations of all stakeholders, including law firms, requires considerable preparation. This is essential when the objective is to prioritize non-hourly fee arrangements such as AFAs and make these the predominant rather than the occasional method of pricing legal work. For most companies, and for many law firms, AFAs still represent a significant shift away from variations of the hourly rate. Many law firms introduced the role of pricing specialist to respond to RFPs and ISPs some

years ago, and in many cases to lead the firm's pricing negotiations. Many firms have experience working systematically with dozens of clients on pricing. Their knowledge of law firm economics is sophisticated.

Pricing legal work requires much more than proficiency in AFAs. Companies should possess a practical understanding of law firm economics and the related profitability variables, of law firm cultures, and of law firm compensation systems for partners and associates for the firms that they use.

Unmanaged practice patterns in law firms add at least 10 % to the effective rate. The RFP or ISP should prescribe "optimal staffing distributions" for categories and portfolios of work. Firms should be asked to propose compact and stable teams of senior and junior professionals as well as paralegals to cover the reference period.

Law firm responses to the RFP / ISP should state the extent of their support and the related conditions for the application of these optimal staffing distributions in pricing legal work.

Choosing the Most Effective Alternative Fee Arrangements

Some have said that AFAs should stand for "appropriate" rather than "alternative" fee arrangements. This leaves the door wide open to default to traditional variations of hourly rates. It is also at variance with making non-hourly fee arrangements the predominant albeit non-exclusive approach to pricing legal work. Over the years, corporate law departments have selected pricing that they believed

suitable for individual matters. Nevertheless, today more than 80% of legal work referred to external counsel is still priced on a variation of hourly rates. This is not surprising, since hourly rates require a minimum amount of change to operating practices in the company and in the law firm. This is not the same as cost-effective pricing.

There are three basic categories of fee arrangements and each has variations - hourly fees, fixed and flat fees, and contingency / percentage-based fees. There are hybrids and variations for each of them. For instance, a fixed fee can be combined with a performance fee tied to a result. Designing an alternative fee arrangement that is effective and appropriate for a category of matters - possibly for hundreds of matters with a broad range complexity levels covering a 3 - 5 year reference period - requires a credible demand forecast and a critical mass of work.

Getting companies and their law firms "off the clock" and focused on the company's priorities suggests that the choice of pricing should:

- stimulate *efficiency* in legal work, enough to reduce the hours needed to support a portfolio of matters by at least 10 % over time.
- reward the *effectiveness* of legal work, as measured by the results anticipated by the client
- promote *innovation* initiatives that pass the **S.M.A.R.T.** test and which improve efficiency and / or effectiveness.

Fees for Performance and Innovation

Performance-based fees are a retrospective fee based on value. The performance indicators should be set out in the RFP / ISP and in the terms of engagement with each firm.

Performance indicators typically include results, service levels, efficiency and cost predictability.

A few companies have migrated to a more advanced and simpler form of performance fee with their primary firms because they have been satisfied with service levels, with results and cost management over the years. In such cases, performance tends to be more developmental in nature and can take the form of an Innovation Fee that supplements a fixed base fee. From 10%-15% of the overall legal budget can be reserved to fund innovation.

Specific projects are developed by the law firm and the company – effectively a list of research and development initiatives that benefit the company in the short term. A specific budget is proposed for each project. Under the guidance of the law department, each project is evaluated upon completion. The extent of success determines how much of the project budget is paid to the firm. Some law departments have concluded that the only way that they will make innovation headway is when they pay law firms to help them do so. Nearly 10 years of innovation awards testify to the opportunities for innovation in all facets a company's legal activity.

Costing a Preliminary Allocation to Law Firms It has been nearly 30 years since some companies began to use the procurement process to reduce or “converge” the number of law firms relied upon. Some have completed their fourth or fifth procurement cycle. Convergence is a sourcing strategy that creates a larger share of work for the success-

ful firms. This in turn provides the company with more leverage in price negotiations. In the context of multi-year agreements or multi-national coverage, the law firm has access to a critical mass of work and to a dependable but not guaranteed revenue stream.

Ben Heineman's *The Inside Counsel Revolution* (2016) traced the continuum of practices and relationships that law departments have had with external counsel over five phases. Phase Three refers to the era of “preferred providers” when preferences for key law firms and particular lawyers become explicit. The largest volumes and most interesting work continue to flow to traditional providers, and it appears that relationships and a good track record continue to trump price. In this phase, law departments do not have the analytical tools or they fail to use them to their full potential. They cannot determine how much more they are paying than what they would pay to other panel firms.

Assuming a Phase Four relationship is in place with primary law firms, a company should then commit – but not guarantee – a volume of work for several years in exchange for a fixed price. The company secures budget predictability and the firm has regular cash flow. Provided annual volumes are sufficient, collar arrangements, ranging from 10 % to 15 % are usually sufficient for the firm to secure predictable cash flow and to stimulate efficiency in the law firm.

If follows that fixed fees for a portfolio of work can easily evolve into hybrid fees consisting of a fixed base amount plus a variable portion tied to key performance indicators. It is still only a minority of companies that systematically

firms, with most others preferring a “no news is good news” approach. Heineman discusses the elements of company-law firm partnering arrangement in Phase Five.

Setting aside transitional arrangements with legacy firms which are not retained after a new procurement cycle, companies should prepare a preliminary work allocation of 100 % of the RFP / ISP Scope of Work to the smallest number of firms.

An example follows for a portfolio of 25,000 hours per year covering employment, labor, benefits advice, affirmative action, and strategic advice regarding Human Resources with requirements in 15 states.

Area of law	Firm A Low Cost	Firm B Coverage	Firm C Coverage	Firm D Strategic Relationship and Specialized
Affirmative Action (4,000 hours)	4,000 hours @ \$325 \$ 1,300,000			
Benefits Advice (4,000 hours)				4000 hours @ \$425 \$ 1,700,000
Employment Law (10,000 hours)		5,000 hours @ \$360 \$ 1,800,000	5,000 hours @ \$340 \$ 1,700,000	
Labor Law (3,000 hours)		1,500 hours @ \$380 \$ 570,000	1,500 hours @ \$360 \$ 540,000	
Strategic Advice (4,000 hours)				4,000 hours @ \$675 \$ 2,700,000
Totals	\$ 1,300,000 4,000 hours @ \$325.00/hr	\$ 2,370,000 6,500 hours @ \$364.62/hr	\$ 2,240,000 6,500 hours @ \$344.62/hr	\$ 4,400,000 8,000 hours @ \$550/hr

Preparing a first draft of the costing allows the law department to consider the best balance of cost, coverage, and competence (ex-

pertise). Additional drafts for different allocations will affect the applicable discounts and the overall cost. A preliminary costing should be prepared before the second (or final) round of price negotiations with the successful law firms. In the example above, Firm D would be paid \$ 4,400,000 per year for 8,000 hours.

The 3-year price would be \$ 13,200,000 for 24,000 hours of Benefits and Strategic Advice. The fee would not vary if the worked hours (assuming a 10 % collar) ranged from 21,600 to 26,400 over the three (3) years.

Final Evaluation

A final comparison of prices is carried out after a second round of price negotiations is

completed with the successful firms and after the final/provisional allocation of work is made. Experience suggests that firms are eliminated

- based on the results of the non-financial evaluation
- after a comparative evaluation of prices but before negotiations
- after a first round of fee negotiations
- after a last round of price negotiations and a final/provisional allocation of the portfolio of work

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NEGOTIATING LEGAL FEES

There are many types of successful negotiations for professional services with law firms.

It can be useful for law departments and procurement professionals to have a road map to make the negotiations as effective and efficient as possible. In this case, negotiations are in respect of multi-year portfolios of legal work rather than for single legal matters. The focus is less about the art of negotiating with law firms and more about practical advice in preparing and conducting negotiations.

Building Blocks

Pricing

My last article on *Pricing* advocated in favor of non-hourly fees as the predominant financial arrangement for most categories and complexities of work. It argued in favor of alternative fee arrangements that stimulate and reward effectiveness, efficiency and innovation in legal services provided there is a measurable contribution for each of these.

Provisional allocations and comparative pricing of law firm proposals at different stages of the RFP / ISP and negotiation process are described later in this article.

What to Negotiate

There are specific questions to be asked in the RFP / ISP. These can be expanded for both the financial and non-financial elements. The answers will assist in qualifying firms and accelerating the negotiation process. Consider the firms' written responses to be the early stage of negotiations.

Some of the non-financial elements to discuss with firms include:

- a commitment to detailed matter planning and budgeting to manage the number and

distribution of hours before they are worked by the firm,

- coverage by the firm for each legal specialty, for various levels of partner / associate / paralegal experience, and by jurisdiction,
- the expertise and availability of the law firm's team members at all levels of experience,
- service level guarantees with key performance indicators, covering all offices of the firm as well as the allocation of work by primary firms to secondary firms,
- a relationship partner accountable for all aspects of the firm's professional and financial performance,
- acceptance of the transfer of administrative and management reporting from the company to primary and coordinating firms to minimize the company's investment in infrastructure.

Some of the financial elements to cover with the RFP / ISP and in meetings with firms include:

- the company's preferred staffing distributions by category of work,
- the use of alternative fee arrangements,
- the prices and related conditions/discounts for the work proposed by the firm,
- the stability of prices over the RFP / ISP reference period,
- fees for performance and / or innovation as part of hybrid alternative fee arrangements,
- the admissibility of disbursements,
- the speed of payment and its relationship to price,
- the annual review and adjustment mechanisms based on work type and volumes.

The First Elimination Round

The Project Manager should prepare two reports for the working group. These are useful guides to the other members as they read all the proposals. The reports are a *Qualitative Analysis of the Responses to the RFP/ISP*, including a score for each firm and a *Financial Analysis of the Responses to the RFP* (or ISP). The financial analysis is prepared prior to any discussions with law firms and before any provisional allocations of work to firms.

Experience suggests that working groups should eliminate proposals which score less than 75 % on the qualitative (non-financial) analysis. At this stage, the Project Manager should press the working group to reduce the number of proponents without regard to the financial analysis. It makes little sense to engage with law firms for three or more years when their competitors out-score them significantly on multiple fronts. Law departments prefer a gradual approach to eliminating firms for non-financial reasons rather than on price before negotiations commence.

Provisional Allocations

Law firm proposals should indicate the amount and type of available work that they wish to acquire for each jurisdiction. The law department representatives to the working group will have read the proposals and the reports prepared by the Project Manager. The working group should then be ready to provide the specifications for a *provisional* allocation of work before the first round of negotiations with the remaining firms. For example, they could indicate that the litigation portfolio for a given region be allocated 60 % to Firm A, and 10 % to each of four other firms. The Project Manager can then cost the

allocation using each firm's initial pricing proposal.

None of this information is shared with the law firms. However, it represents the projected legal spend for each portfolio of work prior to the start of negotiations. And it illustrates any gap with the financial targets set out in the agreed sourcing program. Experience suggests that some law departments are reticent to develop provisional allocations. In such cases, the Project Manager can prepare an allocation based on historical usage patterns, the proposed pricing of the firms remaining after the first elimination round, and the results of the financial and non-financial analyses. This allocation and costing should be shared with the members of the working group to serve as a baseline for the first round of negotiations.

Provisional allocations and costing should be prepared after the first elimination round as well as after each round of negotiations.

The First Round of Negotiations

In Person

Law firms invest considerable resources to prepare comprehensive proposals for legal services, especially for multi-year portfolios of legal work. It is recommended that the first round of negotiations take place face-to-face and that two hours be set aside for each meeting, especially if there is a list of non-financial items to cover and if there is to be a departure from the historical pricing model.

Who Should Be Invited?

No more than five individuals should attend from the law firms. At a minimum, these

should include the Relationship Partner, two or three other partners, responsible for primary categories of work such as litigation, and mergers and acquisitions, etc., and the firm's Chief Pricing Officer. The firm should identify its proposed attendees by name and role in the letter accepting the invitation to meet.

The Schedule and Agenda

The Schedule

An agenda should be sent to each law firm 3 to 4 weeks prior to the meeting to ensure the availability of each participant and of each member of the working group. Provided that logistics allow it, primary firms and legacy firms should be met early in the sequence. Three meetings per day are sufficient to allow pre-meeting briefings, tardiness by group members, breaks and lunch, and the end-of-day briefing of the group. Schedule a secondary firm if a fourth meeting is necessary on a given day.

The Project Manager should schedule a half-day preparatory meeting for the working group on the first day of law firm meetings to discuss:

- the two reports, namely The Qualitative Analysis of the Response to the RFP/ISP and The Financial Analysis of the Responses to the RFP/ISP,
 - the costing of preliminary allocations,
 - the roles and responsibilities of each member of the working group, with attention to the questions to be asked by each group member,
 - the agenda and issues particular to each firm,
- the timeline for the conduct of each meeting,
 - the 30-minute end-of-day debriefing session.

The First Meeting

Firms should be discouraged from making a general presentation lasting more than 15 minutes. Any presentation should be customized to the company's RFP / ISP requirements and should address as many of the agenda items as possible. For the sake of efficiency and effectiveness, the first four agenda items and the presentation should be completed within the first 60 minutes.

The financial portion of the meeting should be led by the working group's pricing specialist. Specific changes to the firm's initial pricing proposal are typically requested, and may include

- coverage by jurisdiction
- practice patterns and staffing ratios
- the configuration of alternative fee arrangements
- annual rate and/or price increases
- discounts and related conditions

Firms can rely on a mix of variables to offer more favorable prices for the RFP/ISP reference period. At this stage, the company can suggest a specific target and price together with the relevant conditions, such as volumes and categories of work, that would have to be met by the company to achieve it.

Experience suggests that this level of specificity by the company always yields a better result than asking for a bigger discount.

Many working groups elect to eliminate some firms after the first round of meetings.

There are several reasons:

- some firms were met for legacy business and relationship management purposes but with few chances of work in the future
- a new firm was invited to propose but did not “align” well with the law department members of the working group
- the firm’s responses to the non-financial and financial discussions offered little chance of significant work allocation in the future
- the projections for the cost of services will fall outside of the range acceptable to the company

The Project Manager should request a reduced list of eligible firms from the working group to limit the number of participants for the final negotiations.

Finally, the Project Manager should ask for a revised financial proposal – either as revised spreadsheets or detailed in a cover letter – within 2 or 3 days. The firm should also answer any non-financial questions raised during the meeting. Expect the firm’s Chief Pricing Officer to request access to the working group’s pricing specialist while preparing the firm’s revised prices and terms.

The Final Negotiations

Evaluating the Revised Proposals

Once the revised proposals or letters are received, a summary should be prepared for the working group with a costing of the remaining firms based on the previous allocation, or if a

new allocation is available a revised provisional allocation by jurisdiction and category. The summary may include recommendations from the Project Manager for a different allocation to achieve improved discount thresholds and company targets.

Negotiations

Alternatively, the Project Manager and the working group members may prefer a final round of negotiations with one or more of the remaining firms. Experience suggests that this round is likely to be primarily financial. In-person discussions are not necessary for this. Instead, one representative of the law department, the Project Manager, and the company’s legal pricing specialist can arrange a video call with each firm.

At this point, the company should be prepared to suggest a provisional allocation of work to each firm in exchange for best and final pricing offers incorporating alternative fee arrangements, fees for performance and innovation, limits to annual increases, as well non-financial arrangements. provisional allocations should only be revised once the working group considers each of the law firm responses. Allocations will influence each firm’s resource allocation, pricing, and workflow management all the while remaining provisional rather than guaranteed.

Allocations

Once all the revised proposals and related correspondence are on hand, the working group should meet to review its planned allocations and costing. Adjustments can be finalized at

this stage. The Project Manager can then develop Terms of Engagement / Master Service Agreements with each firm.

Administrative Arrangements

Experience suggests that accelerated terms of payment in the context of non-hourly fee arrangements will leverage a lower overall price. There are examples where anticipated volumes of work are pre-paid and fees reconciled on a quarterly or annual basis.

MSAs and partnering arrangements that cover 3-5 years cannot accurately anticipate the volume and distribution of work for each year. Variations by complexity and jurisdiction are inevitable. Agreements should include annual review mechanisms which are both retrospective and prospective. Adjustment to price may be appropriate when work allocation falls outside an agreed range.

Not all legacy law firms are retained after the sourcing process. It may be necessary to leave certain matters and hours with these firms in the first year while allocating work to successful firms.

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About the Author

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