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ETHICAL ISSUES AND ALTERNATIVE FEE ARRANGEMENTS: WHAT TO DO AND WHAT NOT TO DO

Few topics in the practice of law have generated as much discussion over the last few years as alternative fee arrangements (AFAs). Most of those discussions focus on clients--their desire to gain some level of control over costs. And, when properly implemented, AFAs not only can benefit clients, but can also improve the overall quality of legal services rendered and, as a result, lawyers enhance relationships with their clients.

AFAs' most obvious benefit is predictability--clients can more accurately budget and plan for legal costs. This, in turn, encourages practitioners to provide legal services more efficiently. AFAs also encourage lawyers to increasingly focus on value-driven client services. Finally, AFAs reinforce the sense of shared commitment towards a client's goals and shared financial risk in obtaining those goals.¹

While the potential benefits of AFAs are readily apparent, the potential risks are often less obvious. Financial risks aside, practitioners face a plethora of potential ethical pitfalls when implementing AFAs. Fortunately, effective practices, from a business standpoint, can serve to resolve the ethics issues. Outside counsel who adopt certain of the practices discussed below will be better able to incorporate AFAs in their practice and be better positioned to grow their practice in the future. In-house counselors who understand the ethical issues that arise with respect to AFAs will be better equipped to implement arrangements that are successful from their employer's perspective.

Defining the Playing field

AFAs have become more prevalent as attorneys and their clients have collaborated to construct creative solutions for managing legal costs. There are numerous types of AFAs, so first we will define the relevant terms and the types of AFAs being considered.

Generally speaking, an AFA is a fee arrangement based on factors other than solely on hourly rates.² The most effective AFAs are customized to the needs of the particular client and matter. As a result, AFAs can come in countless shapes and sizes. Among the most popular ones are the following:³

Flat or fixed fee--a set fee for an entire matter or specified portion of a matter (e.g., \$500 for the drafting of a simple will).

Blended rate--a fee where the same hourly rate is charged for all timekeepers or the same hourly rate is charged for all partners and a different rate is charged for all associates.

Success fee--a result-oriented arrangement where a fee in addition to the agreed-upon hourly rates is assessed upon occurrence of a specified result.

Collar fee--the coupling of a targeted budget number for a particular matter with an hourly rate; the client and attorney periodically review fees against a budgeted amount and make necessary adjustments if fees are outside a predetermined range (e.g., attorneys bill hourly fees, but if the actual fees are more or less than the budgeted total by a certain amount (e.g., 10%) (i.e., the "collar"), the firm and the client share savings below or additional costs above the collar).

Retainer--a fixed fee per month (or some other agreed-upon period of time) for predetermined services regardless of how much time attorneys devote to the matter.

Capped fee--a fee arrangement based on standard hourly rates with a cap on the total amount that can be billed during a particular period of time or on a particular matter.

Portfolio fixed fee--a fixed fee for a number of matters (e.g., all real estate closings or all patent prosecutions).

Performance-based hold back--a fee arrangement based on standard hourly rates where a client pays only an agreed-upon percentage of those rates (e.g., 80%) and then pays additional amounts at certain intervals based either on its own assessment of the attorneys' performance or certain agreed-upon criteria.

Hybrid hourly rate/success arrangement--blending an agreed-upon hourly rate with an additional success fee upon the achievement of certain defined goals.

Ethical Considerations

As with any fee arrangement, AFAs present certain ethical issues. One general ethical concern is whether the financial and business considerations inherent in operating a law firm will interfere with attorneys' ethical obligations to their clients. Other concerns include preserving the client's absolute right to terminate the relationship at any time without penalty and the attorney's rights and obligations regarding flat fees or other fees paid in advance.

Fee agreements that fix or cap the client's fees at a specified amount can tempt an unethical attorney to curtail work after the cap has been reached. For example: a law firm and its commercial real estate client implement a portfolio fee arrangement pursuant to which the client pays the firm \$400,000 per year for the firm's legal services related to all the client's real estate closings. The standard hourly rate for the attorneys on the file is \$400, meaning that it would take 1,000 total hours at the attorneys' standard rate

to reach the \$400,000 annual fee. A potential issue arises when the firm reaches or exceeds those 1,000 hours prior to the end of the year and additional work on the client's files is required.

Because of hypothetical situations such as the foregoing, some clients have become leery of "low-ball" flat fee proposals knowing that the actual cost for the quality of work they expect exceeds the amount proposed.⁴ Clients considering a flat fee arrangement may fear that the firm will "under work" the matter.⁵ On the flip side, some attorneys refuse flat fee work imposed by clients because they fear they will not get paid if additional work is required.⁶

Another ethical issue related to fixed fees is whether a fixed fee payment immediately becomes the property of the attorney or remains the property of the client until earned by the attorney's performance of legal services.⁷ This issue has generated much discussion since the District of Columbia Court of Appeals wisely held that a flat fee is not earned upon receipt but upon the performance of legal services.⁸ The answer to this question affects attorneys' obligations in handling flat fees.

Model Rules

The ABA's Model Rules of Professional Conduct provide guidance on many issues of AFAs. Perhaps most important is Rule 1.5 of the ABA Model Code, which establishes a reasonableness standard for assessing legal fees: "A lawyer shall not make an agreement for, charge, or collect an unreasonable fee or an unreasonable amount for expenses."⁹ This general rule applies to all types of fee agreements.

Comment 5 to Rule 1.5 is especially relevant to any type of fee agreement that caps the client's payment at a specified amount (including fixed or flat fees, capped fees, retainers, and portfolio fees):

An agreement may not be made whose terms might induce the lawyer improperly to curtail services for the client or perform them in a way contrary to the client's interest. For example, a lawyer should not enter into an agreement whereby services are to be provided only up to a stated amount when it is foreseeable that more extensive services probably will be required, unless the situation is adequately explained to the client.¹⁰

Comment 5 imposes a high standard on attorneys using any type of capped fee arrangement because it prohibits any fee agreement that "*might* induce the lawyer improperly to curtail services for the client or perform them in a way contrary to the client's interest."¹¹ On its face, this is a high standard because, arguably, any type of fixed or capped fee arrangement *might* induce any attorney to curtail his or her services after the specified cap has been reached. The Comment goes further, prohibiting such an agreement if it is merely *foreseeable* that additional services will be needed--unless the attorney adequately explains the situation to the client.

The Model Rules contain additional relevant guidance. Model Rule 1.3 requires a lawyer to "act with reasonable diligence and promptness in representing a client."¹² Comment 1 states in relevant part as follows:

A lawyer should pursue a matter on behalf of a client despite opposition, obstruction or personal inconvenience to the lawyer, and take whatever lawful and ethical measures are required to vindicate a client's cause or endeavor. A lawyer must also act with commitment

and dedication to the interests of the client with zeal in advocacy upon the client's behalf.¹³

In addition, Comment 10 to Model Rule 1.7 states that “[t]he lawyer’s own interests should not be permitted to have an adverse effect on representation of a client.”¹⁴ These Rules prohibit lawyers from allowing their financial interests to interfere with or supersede their obligations to their clients. This has implications for AFAs. For example, these Rules govern a lawyer’s conduct where a flat or fixed fee, retainer, or capped fee has been earned in full, but necessary work remains on the client’s matter(s).

Then there is Model Rule 1.1, which requires a lawyer to “provide competent representation to a client.”¹⁵ Comment 1 provides the following non-exclusive list of factors for determining whether a lawyer is “competent” to handle a particular matter:

- “the relative complexity and specialized nature of the matter”;
- “the lawyer’s general experience”;
- “the lawyer’s training and experience in the field in question”; and
- “the preparation and study the lawyer is able to give the matter and whether it is feasible to refer the matter to, or associate or consult with, a lawyer of established competence in the field in question.”¹⁶

Model Rule 1.1 has implications for a lawyer tempted to “push work down” to less experienced attorneys when a blended rate is used. The supervising attorney must ensure that all work is assigned to attorneys with sufficient skill and experience to handle the particular project.

Of course, outside counsel implementing AFAs must adhere to these Rules (and any other governing rules or precedent). The challenge for these attorneys is to provide legal services as efficiently as possible without in any way sacrificing effectiveness or compromising their obligations to the client. The Model Rules provide a good starting point for learning to strike this balance.

Implement Best Practices for Addressing the Potential Ethical Issues Associated With AFAs

The use of AFAs is still relatively new in most practice areas. As a result, some practitioners are undoubtedly attempting to implement AFAs without much, if any, experience doing so. This can make navigating the potential ethical and legal issues difficult. It is critical, therefore, that law firm lawyers contemplating the use of AFAs consider the applicable ethical issues and develop systems and best practices to avoid the potential risks. Outside counsel who embrace and effectively address these challenges will almost certainly reap the benefits, given the nature of today’s legal marketplace.

Best Practices--General Considerations

At the risk of stating the obvious, AFAs must work for both the client and the attorney or law firm to be successful. AFAs must succeed from a business standpoint and must avoid the associated ethical issues. Effective AFA practices that further the purposes and benefits of AFAs while minimizing the ethical, professional, and legal risks should be predicated upon the following: knowledge, experience, trust, collaboration, and communication. Implementing these concepts will assist outside counsel in avoiding the ethical and legal pitfalls associated with AFAs and help attorneys foster a closer relationship with their clients.

Knowledge

In-house and outside counsel considering implementing AFAs should first take time to educate themselves about the various types of AFAs, how each works, their respective benefits and risks, and the types of matters for which each AFA is best matched.

Of course, it is also critical that attorneys considering AFAs understand the unique ethical and legal issues they present. This should include, at the very least, consideration of the governing rules of professional conduct and other bar- or jurisdiction-specific rules. This will help practitioners implement AFAs that meet their clients' needs while avoiding the ethical and legal issues that these arrangements can present.

But being fluent in the various AFAs is not enough. Even if an attorney has an advanced knowledge of AFAs, he or she will not be able to implement an effective AFA without also obtaining an adequate understanding of the client's business, its legal needs, and how the two fit together. The practitioner should then work with the client's in-house counsel or other personnel to select and craft a fee agreement that best addresses the client's needs.¹⁷

The client, too, must be knowledgeable about its fee options. It is incumbent upon in-house counsel to learn various AFA options. Outside counsel should be able to advise the client on the pros and cons of each option for the particular matter at hand. All of this should go hand-in-hand with the attorney's knowledge of the client's business and legal objectives.

Experience

AFAs that effectively meet the client's business and legal needs while balancing the practitioner's need to run a profitable practice should be based, in part, upon the attorney's or law firm's experience in handling similar matters. It is difficult to implement an effective AFA for matters with which the attorney or law firm has little experience.¹⁸

Of course, an attorney who has experience handling similar matters or projects will be better equipped to predict the fees and costs associated with a matter, and to suggest appropriate terms and parameters for the fee agreement. The experienced attorney should look at data collected over time, which includes the

number of hours necessary for completing specific tasks, the associated tasks, and the necessary staffing. Experience and data will put the attorney in a better position to implement a fee arrangement that meets the needs and expectations of both the client and the attorney while simultaneously decreasing ethical risks.

Trust

Trust between the attorney and client is essential for an AFA to work. For this reason, AFAs work best for matters where there is a pre-existing attorney-client or other relationship which has allowed the parties to develop a trust in one another. However, a pre-existing relationship is not a prerequisite ethically or otherwise for a successful AFA. Trust is often intertwined with experience. A client is more likely to trust an attorney who has handled similar matters and has experience and expertise in the relevant area.

Collaboration (Pre-Engagement)

Practitioners should decide upon and implement an AFA in close collaboration with the client. The first step is to work with the client to determine whether an AFA would be effective for the particular matter(s), and which AFAs might work best. This type of collaboration provides an *14 opportunity to develop the client's trust regardless of whether an AFA is eventually implemented: the attorney has the opportunity to listen to the client and learn about his or her business and legal needs and to educate and advise the client on various fee agreement options.

The second step is for the outside counsel to carefully draft a fee agreement in collaboration with the client. The agreement should address the client's needs and goals. It should also clearly define the scope of the representation, the details of the fee and how it is to be determined, and how the matter will be staffed.

Communication (Post-Engagement)

After the representation has begun, the attorney should keep the client informed on the status and the budget.¹⁹ Attorneys should consider a provision in the fee agreement that allows the parties to reassess the agreement at specified points during the representation and to allow for alterations in certain specified instances. This provides both the practitioner and the client with a "safety net" should the matter and the billing not play out as anticipated.

Specific Tips

In addition to the general principles discussed above, the following specific issues should be considered when implementing AFAs:

- For blended rate agreements, consider a tiered system in which there is one rate for partners and one for associates. Some blended rate agreements contain even more narrow tiers,

applying a separate rate for senior partners, junior partners, senior associates, and junior associates.

- For blended rate agreements, the attorney and client should agree upon and understand how the matter will be staffed and how work will be delegated to junior attorneys.
- For flat or fixed fees, consider a “collar fee” or “true-up” provision that would provide partial compensation in the event the actual fees are significantly above or below the agreed-upon fee.
- The fee agreement must allow the client to terminate the representation at any point without any penalty.

Conclusion

Alternative fee arrangements are important tools in the current legal services marketplace. Although AFAs can present unique ethical issues, outside counsel who embrace the solutions to those issues are more likely to succeed in this environment. And in-house counsel who familiarize themselves with various kinds of AFAs and understand the ethical issues confronting outside counsel will be better equipped to structure such arrangements that benefit their employers in the long term.

Footnotes

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¹ See Andrew Nicely & Elisa Kantor, *Malpractice Risks in Alternative Fee Arrangements*, 20 No. 10 Westlaw J. Prof. Liability, March 2011; *Strategies for Alternative Fee Arrangements*, ZG Alert, 1 (Mar. 2010), <http://www.consult.zg.com/assets/Uploads/ZGAlert-AFAs-March2010.pdf> (“The reasons for this renewed interest in AFAs are clear: clients want to drive costs down, they want greater predictability, and they want their lawyers to have ‘skin in the game.’”).

² See J. Randolph Evans & Shari L. Klevens, *Alternative Fees May Lend Solutions*, Daily Report, Oct. 10, 2011 (“Alternative fee arrangements are fee agreements or billing agreements customized to fit the goals and needs of a client and matter based on discussion between a client and its counsel as opposed to the standard hourly fee arrangement.”).

³ See *id.*

⁴ Rebecca M. Lamberth et al., *Alternative Fee Arrangements: Who’s Responsible for Making Them Work?*, 22 No. 2 Cal. Litig. (2009).

⁵ *Id.*

⁶ See Meredith Hobbs, *Lawyers: Flat Fees Pose Ethics Issues*, Daily Report, Jan. 10, 2011.

⁷ For an extended discussion on this issue, see Tyler Moore, *Flat Fee Fundamentals: An Introduction to Ethical Issues Surrounding the Flat Fee After In re Mance*, 23 Geo. J. Legal Ethics 701 (Summer 2010).

⁸ *In re Mance*, 980 A.2d 1196 (D.C. 2009).

⁹ Model Rules of Prof’l Conduct R. 1.5.

¹⁰ *Id.* cmt. (5).

¹¹ *Id.* (emphasis added).

¹² Model Rules of Prof’l Conduct R. 1.3.

¹³ *Id.* cmt. (1).

¹⁴ Model Rules of Prof’l Conduct R. 1.7 cmt. (10).

¹⁵ Model Rules of Prof’l Conduct R. 1.1.

¹⁶ *Id.* cmt. (1).

¹⁷ David T. Brown, *Approaching Alternative Fees*, Chicago Daily Law Bulletin, Nov. 18, 2010 (“[A] firm must maintain the flexibility to work with each client to define the best approach based on its unique business and legal needs, as well as the specific challenges of each case or transaction.”).

¹⁸ *Id.* (noting that “one-time deals (which are more typical at midsize firms) are much harder to predict and control, making it that much more difficult to employ alternative fee arrangements.”).

¹⁹ James A. Comodeca & Scott R. Everett, *Alternative Fee Arrangements: Risk Sharing Requires a Strong Partnership*, The National Law Review (May 3, 2010), <http://www.natlawreview.com/article/alternative-fee-arrangements-risk-sharing-requires-strong-partnership> (“(Relationships created on alternative fee arrangements will only be successful if there is an open and honest dialogue between the parties.”).

85-MAY NYSTBJ 10