Making Fixed Fee Retainers Work, Financially and Ethically

BY RON POL

A small business created a hugely successful lottery outlet adjoining a big supermarket. Part of a multinational chain, the supermarket refused a lease renewal, presumably requiring room for expansion. Seeking space elsewhere in the mall, the small business found that the supermarket had been granted a lottery license.

The day after the lease expired, the supermarket and adjoining lottery outlet continued as before, now under the big company's ownership. On national TV, the supermarket protested its actions were legal; therefore, it said, fair and reasonable. Lawyers sometimes also equate "legal" with "fair." The operation of fixed fee retainer agreements provides examples.

Alternative fee arrangements are legion, yet the ones that work best depend crucially on two factors: a joint commitment that the arrangements be successful for both parties, involving genuine fairness beyond legal positioning; and structures that change underlying behaviors. Allow me to explain.

"All you can eat" retainers. A big company typically spent $20 million a year in one area, predicted gradually to rise. One firm offered to perform all that work for a $12 million fixed fee.

Some general counsel might have simply accepted a great deal, but the GC expressed concern: "It's a massive saving for us, but to be sustainable, the firm also needs to make a reasonable profit." The firm replied that it expected to make a loss for the first few years as it concluded existing transactions, but intended to do more than improve efficiencies. They would put resources into training and other proactive exercises designed to reduce the company's legal risk profile and the company's need for legal resources.

Here too, other general counsel might have accepted the deal, saved $8 million annually, and when the underlying level of legal risk dropped below the new benchmark, negotiated a lower price — reflecting the fewer hours then required. If the firm successfully halved the company's risk profile in this area to $10 million, the company could renegotiate the fee to that price. After all, why pay a $2 million premium after the firm manages to cut its time cost?

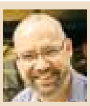
Yet this misses the point. In reality, the GC was delighted to continue paying $12 million a year. The firm might eventually receive a $2 million "premium," yet the real counterfactual was not the new $10 million "time cost" benchmark, but the more than $20 million that would have continued to be paid before the firm's innovation changed behaviors to help reduce the company's risk profile. The company was saving more than $8 million a year on legal fees alone, not to mention the associated management time. Both parties were better off. If the company tried to chisel away at the firm's share of the rewards, or if at any stage the firm thought it might, the benefits would evaporate. In those circumstances, why would any firm bother changing the status quo?

Indeed, the managing partner of a major law firm shared his frustration that in-house counsel often seek alternatives to hourly rates, then demand hours and rates information as well, forcing the firm to accept the lowest figure — whether that be the agreed retainer ("as we agreed") or time cost ("it would be unfair to pay more than your time cost"). The firm has now all but given up trying to be innovative.

Multiple transaction retainers. Another company was involved in hundreds of tribunal cases annually. They measured (more expensive) partner time on each transaction, which they thought should be around 20 percent. Fees differed between $2,000 to more than $10,000, and partner time from 20-50 percent. The average cost was around $5,000, which the company proposed setting as a fixed fee.

The company was concerned that partner time on each transaction might plummet, and the firm was concerned for cases that involved more time than the fixed fee. In practice, neither concern was warranted. Almost overnight, partner time dropped to around 20 percent — the firm benefited from increased efficiencies, yet always maintained effective partner supervision. And business unit managers, able to budget with certainty, were delighted.

A year later, the company and firm had another discussion. Increased efficiency had improved the firm's profit margin, whilst the company's legal bill remained the same. At around $4,000 per transaction, the firm's profitability would have been the same as before, so the fee was reset to $4,500; the result



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was that the firm's profitability had increased (with the released partner time profitably devoted to other clients), and the company cut 10 percent of its legal fees. Tellingly, the company didn't slice it back to $4,000; both shared the efficiency improvements in a sustainable relationship of mutual benefit.

Monthly fee retainers. Using fixed fee arrangements to change behaviors is not restricted to supplier behavior. In one example, a supplier providing services for a projected six-month transaction on a monthly retainer found that the client company made decisions much more quickly than under previous hourly rate engagements, and the project was successfully completed within four months. The company achieved its objective and saved a third of the projected cost. The supplier used the time to deliver services to another client, in the knowledge that its first client — delighted with the result to which its own efficiencies had contributed — would call on the supplier's services again, and recommend them to others.

In another example, the client company's repeated delays, scope changes and instructions emanating from multiple people caused a five to six-month project to balloon past a year. At the end of the transaction, the company assessed that the project cost was higher than expected, and told the supplier to waive the last few months' fees. Big law firms and other suppliers, with multiple simultaneous transactions and millions of dollars in fees, will often accede to such demands. Likewise, small suppliers are unable to afford the cost or reputation risk of suing a major company.

"Lawful" is not necessarily "fair," and may signal failure. Like the multi-national supermarket chain forcibly annexing a successful small business lottery franchise, a big company telling a supplier to waive an agreed retainer may be "lawful," yet does not necessarily equate with fair business practice. After all, the exercise of "might" is not necessarily "right," and may signal a failure — by clients themselves — to effectively use alternative fee arrangements.

So, don't be too quick to suggest that alternative fees don't work; often, it's not the fee structure, or the supplier, but how the arrangements have been implemented in practice. The trick to make retainer agreements work is a joint commitment for it to be successful for both parties, and to use the remuneration structure positively, thus helping to change the behaviors of both suppliers and clients.

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