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Out with the Old, in with the Alternative: A Critical Examination of How Lawyers Can Use Alternative Fee Arrangements to Satisfy Increasingly Powerful Clients

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Abstract

This article examines law firms' need to replace the billable hour with alternative fee arrangements and discusses the ethical and managerial hurdles they will face when making this transition. It analyses the characteristics of client demand for legal pricing models and determines that client demand can only be satisfied by firms that implement alternative fee arrangements. This proposition is supported by research which suggests that alternative fee arrangements optimise firm profitability and enable firms to retain their clients whose bargaining power has been enlarged by technology. Finally, this article provides practical guidance on factors firms must consider when adopting alternative fee arrangements, specifically legal ethics issues and managerial challenges that must be addressed when implementing disruptive innovations. Ultimately, the author intends to highlight the industry-wide misalignment between client demand and the billable hour, and persuade firms to optimise their profitability and chances of survival by adopting alternative fee arrangements.

I Introduction

A *Background*

1 *Context*

Billable hours and legal pricing models have been inextricably linked for the better part of a century. However, clients are disenchanted with the billable hour and strongly prefer alternative fee arrangements

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(‘AFAs’).¹ Clients prefer AFAs because AFAs can be personalised to their legal issues and provide more value and fee certainty than time-based billing models, like the billable hour. However, regardless of client demand, many traditional law firms (‘Traditionalists’) continue to use the billable hour. This is a major risk for Traditionalists as technological innovation is enhancing client bargaining power, making it easier for clients to switch to firms that better satisfy their demand for AFAs. Despite understanding the negative consequences of billable hours, Traditionalists are not adopting AFAs. This suggests that legal ethics and managerial challenges, rather than just ignorance, are preventing firms from implementing AFAs. Thus, this article argues that firms must adopt AFAs to optimise their profitability and defend their market share, and tentatively suggests how they can overcome some managerial and ethical dilemmas associated with this transition.

2 Literature Review

Despite the importance of pricing in a law firm’s value proposition, existing literature does not comprehensively identify why firms must adopt AFAs or discuss how firms can practically transition from the billable hour to AFAs. Available literature superficially discusses the cliched ‘death of the billable hour’ topic,² mimicking the *2017 State of the Legal Market* report which advocated for firms to adopt innovative pricing arrangements.³ A notable exception to this trend in the literature is Ford’s analysis of the effect of innovative service delivery models on legal pricing strategies.⁴ However, all of these articles merely echo Susskind’s criticism of firms for not efficiently servicing clients with legal pricing models and they do not explain the ramifications of sticking with the billable hour.⁵ Critics’ failure to convey the consequences of inaction exacerbates Traditionalists’ complacency with the billable hour model.

This article relies on commentary from legal and commercial theorists. Beaton and Kaschner’s book, *Remaking Law Firms: Why &*

¹ BTI Consulting Group, *BTI State of Alternative Fee Arrangements* (Report, 2016) 7 (‘*BTI Report*’).

² See John Chisholm, ‘The Death of the Billable Hour’, *John Chisholm Consulting* (Web Page, 8 October 2018) <<https://www.chisconsult.com/my-perspective/2018/october/the-death-of-the-billable-hour/>>; See Ryan Bradley, ‘Why the Billable Hour is Dead (or Should Be)’, *Forbes* (Web Page, 26 May 2017) <<https://www.forbes.com/sites/theyec/2017/05/26/why-the-billable-hour-is-dead-or-should-be/#70e8a48c5289>>.

³ Center for the Study of the Legal Profession, *2017 Report on the State of the Legal Market* (Report, 2017).

⁴ Janine Ford, ‘Time to Kill the Bill? – Alternative Fee Arrangements in the Legal Industry’, *Legal Tech Weekly* (Web Page, 10 April 2019) <<https://suits.contractbook.com/legaltechweekly/alternative-fee-arrangements-in-the-legal-industry>>.

⁵ Richard Susskind, *Tomorrow’s Lawyers: An Introduction to Your Future* (Oxford University Press, revised ed, 2017) 21.

How,⁶ requests firms to re-evaluate their reliance on the billable hour and discusses AFAs' advantages.⁷ However, it does not spell out the consequences of ignoring AFAs on firms' market share. The authors' failure to follow up the 'carrot' of improved revenue under AFAs with the 'stick' of declining market share if firms continue to use the billable hour hinders their call for change to how legal services are commercialised. This article seeks to overcome that shortcoming by complementing its discussion of AFAs' advantages with the consequences of ignoring AFAs to prompt major change in legal pricing strategies.

Similarly, Maister has authored articles on pricing strategies in professional services firms.⁸ This article uses his analysis to demonstrate that AFAs enhance profitability.⁹ This is proved by comparing the effects of AFA and billable hour pricing characteristics on firm profitability using Maister's formula, making a compelling case for Traditionalists to adopt AFAs.

Christensen's theory on the innovator's dilemma is also relevant to firms' adoption of AFAs.¹⁰ The innovator's dilemma outlines that a successful company's culture helps it develop sustaining innovations but prevents it from developing disruptive innovations.¹¹ Therefore, this article will apply Christensen's theory to show firms that they must ignore the billable hour's promise of easy profits and instead implement significant measures to deliver AFAs and improve their long-term profitability.

Thus, although there is a gap in available literature, this article will draw on resources from legal and managerial theorists to justify why firms must substantially adopt AFAs into their pricing models to retain their clients.

3 *Significance of this Research*

This research is important because it highlights inconsistencies between the billable hour and client demand. This misalignment negatively impacts Traditionalists' profitability and viability, and will continue to reduce their market share as technological innovation enhances client bargaining power and clients move to firms that better satisfy client demand. This call to action is increasingly pertinent as COVID-19

⁶ George Beaton and Imme Kaschner, *Remaking Law Firms: Why & How* (American Bar Association, 2016).

⁷ *Ibid* 126.

⁸ David Maister, *Managing the Professional Services Firm* (Simon & Schuster, 1st ed, 1993).

⁹ *Ibid* ch 3.

¹⁰ Clayton Christensen, *The Innovator's Dilemma: When New Technologies cause Great Firms to Fail* (Harvard Business Review Press, reprint ed, 2016) 231.

¹¹ *Ibid* xix; see *Section VI(B): Analysis of How Firms Can Overcome the Innovator's Dilemma and Obtain First Mover Advantages when Implementing AFAs* for a discussion of sustaining innovations, disruptive innovations and the innovator's dilemma.

strikes fear of an imminent recession into the hearts of many.¹² If a recession occurs and is similar to the 2008–09 recession, many clients will enact stringent legal expenditure protocols that could only be satisfied by firms that use AFAs with pricing characteristics that this article highlights.¹³ Thus, this article also serves as a roadmap to help firms navigate some legal ethics and managerial issues associated with adopting AFAs.

This article will shine an economic lens on legal pricing models, exploring the billable hour's viability and AFAs' advantages and limitations. As such, it also intends to highlight the continued existence of antiquated practices in the legal industry, like billable hours, and demonstrate that Traditionalists' pricing strategies are only viable if they satisfy client demand. This forms part of this article's broader discussion that legal business models are not *prima facie* correct just because they are used ubiquitously by firms; a lesson that applies to all hallmarks of traditional firms.

B Research Question and Objectives

This article will answer the question: 'Why must firms adopt AFAs to survive in the technological age and how can they overcome managerial and ethical challenges associated with this transition?' This article does not intend to discuss every reason why firms must adopt AFAs or address every difficulty associated with this transition. It merely intends to discuss why technological innovation forces firms to change their pricing strategies and address some universal dilemmas that affect firms when making this transition.

This research question comprises of the following research aims:

- To illustrate the misalignment between billable hours and client demand for valuable, personalised legal services with fee certainty, and identify how AFAs can satisfy this demand.
- To demonstrate how AFAs can optimise firm profitability and how ignoring AFAs can diminish firms' market share.
- To explain the legal ethics and managerial challenges associated with adopting AFAs and suggest how firms can implement this change smoothly.

¹² Jordan Furlong, 'Pandemic I: What We're up Against', *Law 21* (Blog Post, 1 April 2020) <<https://www.law21.ca/blog/>>; Kenneth Rogoff, 'The Next Global Recession Could be Around the Corner', *Australian Financial Review* (Web Page, 3 March 2020) <<https://www.afr.com/policy/economy/the-next-global-recession-could-be-around-the-corner-20200303-p546bo>>.

¹³ Center on Ethics and the Legal Profession, *2020 Report on the State of Legal Market* (Report, 2020) 15 ('*2020 Report on the State of Legal Market*'); ALM Legal Intelligence, *Speaking Different Languages: Alternative Fee Arrangements for Law Firms and Legal Departments* (Report, April 2012) 6 ('*Speaking Different Languages*').

C *Research Methodology and Structure*

1 *Methodology*

This article adopts a reform-oriented and interdisciplinary approach to promote change in legal pricing models. It firstly analyses qualitative research into preferred pricing characteristics prepared by legal industry experts like Susskind, Beaton and Kaschner. Despite most of this research originating from inhouse legal teams and legal consultants,¹⁴ this data adequately reflects client demand because inhouse lawyers are the largest purchasing demographic of legal services, and consultants are well-informed about legal pricing models and industry trends.¹⁵

This article also evaluates quantitative studies of the US legal industry,¹⁶ specifically supply and demand trends for legal pricing models. This data is the most reliable indication of legal industry trends, in the absence of reliable Australian data, and supports this article's argument that the billable hour is not a viable long-term pricing strategy. To accurately depict the survey data, this article assumes the median value of survey responses illustrates data trends. This is an important assumption because the survey responses are skewed towards the Traditionalist model and median values are the most accurate measures of centre (ie, data trends) for skewed distributions.¹⁷

Ultimately, this article's design-oriented methodology enables it to identify the billable hour's viability concerns and suggest suitable alternatives that firms can adopt.¹⁸ This is appropriate because firms are frequently cautioned about the billable hour's issues, but are rarely given guidance on transitioning to AFAs.¹⁹ Through illustrating client demand and the consequences of not abandoning the billable hour, and providing practical guidance on how firms can implement AFAs, this article seeks to change firms' perception of AFAs and influence a minor change in legal pricing models.

2 *Theoretical Framework*

This article applies Maister's theory on firm profitability and Christensen's theory on the innovator's dilemma to discuss the benefits and difficulties of making this transition, respectively. Maister's theory demonstrates that AFAs increase firm profitability by enhancing

¹⁴ Beaton and Kaschner (n 6) 229-42.

¹⁵ Ibid 45.

¹⁶ Thomas Clay and Eric Seeger, *Law Firms in Transition 2019: An Altman Weil Flash Survey* (Report, 2019) ('*Law Firms in Transition 2019*').

¹⁷ Norean Sharpe et al, *Business Statistics, Global Edition* (Pearson Education Limited, 3rd ed, 2015) 84.

¹⁸ Piet Verschuren and Hans Doorewaard, *Design a Research Project* (Eleven International Publishing, 2nd ed, 2010) 33-4.

¹⁹ Ibid 49-56.

recovery rates and shielding firms from the billable hour's negative effect on profit.²⁰ Alternatively, the innovator's dilemma explains how successful companies' cultures constrain their ability to sideline profitable, sustaining innovations, like the billable hour, to invest in disruptive innovations, like AFAs.²¹ Each of these theories are relevant to transitioning from the billable hour to AFAs and have not yet been applied to legal pricing strategies.

3 *Structure*

This article comprises of six sections. Section II briefly discusses AFAs and the billable hour. Section III examines client demand for legal pricing characteristics, specifically their desire for valuable, personalised legal services with fee certainty, and explains how firms can satisfy this demand with AFAs. Section IV analyses AFA pricing characteristics and demonstrates the positive effect of AFAs on firm profitability using Maister's formula. Section V argues that firms cannot ignore AFAs because technology enhances client bargaining power, forcing firms to satisfy client demand for AFAs or risk losing clients. Finally, section VI investigates legal and managerial challenges associated with transitioning to AFAs and suggests strategies firms can use to overcome them. In turn, this article concludes that whilst firms' transition to AFAs will be inhibited by legal and managerial issues, firms must take this step to maximise both their profitability and their chance of survival in an increasingly competitive legal services market.

II An Explanation of Billable Hours and Alternative Fee Arrangements

The key concepts this article will discuss are 'billable hours' and 'AFAs'.

Billable hours are a pricing metric which firms use to calculate the cost of legal services based on production cost, namely the number of hours lawyers need to complete the relevant service. It was introduced to satisfy client demand for an alternative billing model to the then non-descript, single-line invoices that demanded an arbitrary amount of fees 'for services rendered'.²² Whilst the billable hour's proponents claim its sole condemnation is that it disincentivises efficiency,²³ this article's

²⁰ Maister (n 8) ch 3.

²¹ Christensen (n 10) xix.

²² Sarah Boulden, 'The Business of Startup Law: Alternative Fee Arrangements and Agency Costs in Entrepreneurial Law' (2013) 11 *Journal on Telecommunications and High Technology Law* 279, 281; Larry Ribstein, 'The Death of Big Law' (2010) 2010(3) *Wisconsin Law Review* 749, 769; Robert Hirshon, 'Law and the Billable Hour' (2002) 88(2) *ABA Journal* 10, 10.

²³ Douglas Richmond, 'In Defense of the Billable Hour' (2003) 14(2) *Professional Lawyer* 1, 1.

central criticism of billable hours is that it fails to satisfy client demand for valuable, personalised legal services with fee certainty.

Alternatively, *AFAs* are a loose concept meaning either any fee model which is not the billable hour or any fee model which is not based on billable hours.²⁴ This article adopts the former, more expansive definition because fee models that use time-based billing, like risk collars, can still satisfy clients' desire for valuable, personalised legal services with fee certainty, which is *AFAs*' purpose.²⁵ However, this article does not consider discounted or blended rates as *AFAs* because, although they are alternative to billable hours, they do not satisfy client demand.

Ultimately, although many theorists advocate for the billable hour,²⁶ this article contends the billable hour satisfies client demand less than *AFAs* and that firms should transition to *AFAs*.

III An Analysis of Client Demand: Valuable, Personalised Services with Fee Certainty

Clients demand valuable, personalised legal services with fee certainty. Firms initially introduced the billable hour to satisfy client demand for greater oversight;²⁷ however, law is now a mature industry where better-informed clients and reactive markets regulate firms.²⁸ This has reduced the billable hour's utility and caused client demand to shift towards pricing models that are valuable, personalise fee certainty.²⁹ This section will explain these concepts and discuss how firms can use *AFAs* to satisfy these characteristics of client demand.

A *How Subscription Arrangements and Risk Collars Maximise Value*

Clients are pressuring firms to provide higher-value services for the same price.³⁰ Susskind calls this the 'more-for-less challenge'.³¹ It is sparked by inhouse legal teams' need to undertake more work with smaller budgets and enables firms that can offer valuable legal services

²⁴ Beaton and Kaschner (n 6) 261.

²⁵ *Speaking Different Languages* (n 13) 12.

²⁶ Richmond (n 23) 4-5.

²⁷ Boulden (n 22) 281; Ribstein (n 22) 769.

²⁸ Beaton and Kaschner (n 6) 37; LawVision, Legal Executive Institute and Peer Monitor, *The 2019 Pricing Strategy Survey: Law Firms show Signs of Pricing Maturity but Much Work Remains* (Report, 2019) 7 ('*The 2019 Pricing Strategy Survey*').

²⁹ Altman Weil, *2014 Chief Legal Officer Survey: An Altman Weil Flash Survey* (Report, 2014) 13 ('*2014 Chief Legal Officer Survey*').

³⁰ Milton Regan and Palmer Heenan, 'Supply Chains and Porous Boundaries: The Disaggregation of Legal Services' (2010) 78 *Fordham Law Review* 2137, 2138-9; Qian Hongdao et al, 'Legal Technologies in Action: The Future of the Legal Market in Light of Disruptive Innovations' (2019) 11 *Sustainability* 1015, 1016.

³¹ Susskind (n 5) 22.

to gain a competitive advantage.³²

However, before firms try to maximise client value with innovative service delivery models, like automation, they must firstly transform their pricing models to incentivise efficiency and value maximisation. Traditional billing models create perverse incentives for firms to be inefficient and meet billable hour quotas.³³ Thus, time-based billing models prevent firms from selling valuable services profitably because it forces firms to be efficient and efficiency reduces utilisation (ie, billable hours), which is the billable hour's main profit lever. Firms should instead use pricing strategies that incentivise value-maximisation, like subscription arrangements and risk collars.³⁴

1 *Subscription Arrangements*

Subscription arrangements are flat-fee arrangements for prescribed work during an agreed period of time,³⁵ such as unlimited telephone consultations for legal issues.³⁶ Firms are increasingly using subscription arrangements because technology is commoditising legal services, making it easier for firms to deliver them efficiently.³⁷ Subscription arrangements benefit firms because they can be delivered profitably using economies of scale, increasing recovery rates and establishing predictable income channels.³⁸ Conversely, they benefit clients because they give firms access to valuable services for small recurring payments.

However, firms must ensure their subscription service's scope is broad enough to benefit clients and is not merely a gateway for clients to procure additional legal services. This is because narrow subscription services will decrease client satisfaction and reduce client retention rates.³⁹ Therefore, firms should use subscription services strategically

³² Ibid; Altman Weil, *2019 Chief Legal Officer Survey: An Altman Weil Flash Survey* (Report, 2019) 33 ('2019 Chief Legal Officer Survey'); Law Society of New South Wales, *The Flip Report 2017* (Report, 2017) 5; Stephen Mayson, *Business Models in Legal Services: The Meaning of 'Business Model'* (Working Paper, March 2010) 5.

³³ Boulden (n 22) 281; James Spigelman, 'Opening of Law Term Dinner, 2004' (Speech, Law Society of New South Wales, 2 February 2004); *Foyle v Foyle* (2018) Fam LR 52, 68 ('Foyle'); *Law Society of New South Wales v Foreman (No 2)* (1994) 34 NSWLR 408, 437 (Mahoney J) ('Foreman (No 2)').

³⁴ See *Section III(A)(2): Risk Collars* for an explanation of risk collars.

³⁵ Boulden (n 22) 292.

³⁶ 'Easy Access to Legal Help. Become a Member Today', *LegalVision* (Web Page, 2020) <<https://legalvision.com.au/subscription/>>.

³⁷ Richard Susskind, *The End of Lawyers?: Rethinking the Nature of Legal Services* (Oxford University Press, revised ed, 2010) 43.

³⁸ *Speaking Different Languages* (n 13) 29; Kaleb Sieh, *Law 2.0: Intelligent Architecture for Transactional Law* (Public Policy Report, 13 August 2010) 15.

³⁹ Muhammad Alshurideh, Ra'ed Masa'deh and Barween Alkurdi, 'The Effect of Customer Satisfaction upon Customer Retention in the Jordanian Mobile Market: An Empirical Investigation' (2012) 47 *European Journal of Economics, Finance and Administrative Services* 69, 75.

to satisfy clients' desire for value with the intention of gaining long-term clients.

2 *Risk Collars*

Risk collars are incentive mechanisms that overlay billable hours.⁴⁰ They reward firms with premium rates for under-budget work and penalise them with discounted rates for over-budget work.⁴¹ For example, if a client and firm agree a procurement project should take 40 billable hours at \$600 per hour, the parties can agree the firm will receive \$700 per hour if it is completed in thirty hours or less (ie, fees payable for 30 hours are \$21,000 rather than \$18,000 using standard rates) or \$500 per hour if it takes 50 hours or more (ie, fees payable for 50 hours are \$25,000 rather than \$30,000 using standard rates). Therefore, risk collars align clients' interest of obtaining cheaper legal services with firms' interest for greater profits by rewarding efficiency with higher billable hour rates,⁴² making legal costs more reasonable and eliminating the billable hour's perverse incentive to boost revenue with inefficiency.⁴³

However, firms must undertake legal project management (ie, defining and planning legal tasks) before offering risk collars.⁴⁴ Firms that do not understand all possible components of a service will underestimate required work and offer it too cheaply to clients to undercut their competitors. These firms will then be forced to either sacrifice profit to maintain quality or sacrifice quality to maintain profit because they underestimated the work required to complete the task competently. Therefore, firms will encounter difficulties adopting risk collars if they are trying to reduce their administration costs because using risk collars profitably requires detailed planning and legal project management.

Ultimately, firms can maximise client value by using AFAs, like subscription arrangements and risk collars. These arrangements increase clients' legal budget by an average of \$2.7 million annually and improve client satisfaction because clients receive more value for their money.⁴⁵ However, firms must not undermine AFAs' intrinsic value by using subscription services as a gateway to other services or

⁴⁰ Boulden (n 22) 291.

⁴¹ *Ibid.*

⁴² Jim Hassett, 'Risk Collars: A Great Way to Start Offering Alternative Billing', *Legal Business* (Web Page, 3 March 2010) <<https://www.lexisnexis.com/legalnewsroom/legal-business/b/the-legal-business-community-blog/posts/risk-collars-a-great-way-to-start-offering-alternative-billing>>.

⁴³ *Legal Profession Uniform Law 2014* (NSW) s 172; Boulden (n 22) 281.

⁴⁴ Susan Lambreth, *Legal Project Management: Transforming Legal Services* (White Paper, 2011) 1; Beaton and Kaschner (n 6) 166.

⁴⁵ *BTI Report* (n 1) 6.

failing to plan how to deliver risk collars profitably because this will reduce long-term profitability.

B *Using Deferred Fees and Holdback Arrangements to Personalise Pricing Arrangements to Clients' Financial Circumstances*

Clients are not a monolith; they expect legal services to be perfectly customised to their needs.⁴⁶ For example, clients expect legal fees to be tailored to their financial position, including when, and on what conditions, fees are due. Therefore, firms should use deferred fees and holdback arrangements to personalise legal fees to clients' financial capacity and to increase their market share by servicing a greater variety of clients, irrespective of their financial position.⁴⁷

1 *Deferred Fees*

Deferred fee arrangements are agreements between a firm and its client to defer the client's payment of legal fees until a predetermined date or event (eg, date of settlement for conveyancing matters). They are common when dealing with clients who cannot afford legal services, like startups who require assistance with financing transactions.⁴⁸ In return for flexible pricing, firms can charge premium rates.⁴⁹ However, firms should not use interest on fees payable as a compensation mechanism because the maximum interest rate payable on legal fees is two percent above the cash target rate;⁵⁰ a maximum interest rate of 2.25% p.a. at May 2020.⁵¹ Firms should instead charge higher hourly rates, provided these rates remain fair and reasonable.⁵²

Deferred fee arrangements are a great source of competitive advantage because they enable firms to service clients with great need but low financial capacity. However, they can create cash flow problems for firms as they are essentially an agreement to work without payment for the foreseeable future.⁵³ Therefore, before offering deferred fee arrangements, firms must ascertain the probability that clients can pay their fees, set prices to appropriately reflect their risk of not being paid and have sufficient cashflow in case a client's matter drags on for years or clients cannot pay for services after they are

⁴⁶ Beaton and Kaschner (n 6) 113.

⁴⁷ Ibid 113, 128; *2014 Chief Legal Officer Survey* (n 29) 13.

⁴⁸ Boulden (n 22) 280.

⁴⁹ Ibid 294.

⁵⁰ *Legal Profession Uniform Law 2014* (NSW) s 195(4); *Legal Profession Uniform General Rules 2015* (NSW) r 75.

⁵¹ 'Cash Rate Target', *Reserve Bank of Australia* (Web Page, 2020) <<https://www.rba.gov.au/statistics/cash-rate/>>.

⁵² *Legal Profession Uniform Law 2014* (NSW) s 172.

⁵³ Gerry Singen et al, 'Dollars and Sense: Fee Shifting' (2017) 39(2) *Western New England Law Review* 283, 303.

rendered, such as if a startup's financing event fails and it goes bust. In the alternative to setting higher fees, lawyers can take security over client property;⁵⁴ provided the security is not unjust,⁵⁵ unfair or a breach of the lawyer's fiduciary duty.⁵⁶

2 *Holdback Arrangements*

Holdbacks arrangements are hybrid fee models which overlay billable hours.⁵⁷ They enable clients to hold back fees if firms fail to meet mutually-agreed performance metrics, like achieving deadlines and not overstaffing tasks.⁵⁸ For example, a firm helping a client renegotiate its high-interest loan facility could agree that legal fees are reduced by a proportion of interest the client must pay its lender after a reasonable amount of time for the firm to have settled the new facility has passed. Holdback arrangements help firms personalise legal services to clients' needs, driving client demand;⁵⁹ however, they are less effective for small engagements because the cost of establishing performance metrics may exceed their benefit.⁶⁰

Furthermore, holdback arrangements force firms to understand client-specific issues at a high level because holdback criteria can impact a client's obligation to pay fees. In the previous example of a firm assisting a client renegotiate its loan facility, the firm should review its client's credit rating and available security before agreeing to a holdback arrangement because these factors will affect the firm's ability to secure finance. Once the firm understands their client's position, they can negotiate additional fees for unforeseen risks that may occur and carveout some exceptions to the holdback criteria, like excluding holdbacks where an agreement is not reached because the client does not agree to provide reasonable security for the new loan facility. Considering the added complexity of using holdbacks, some firms will find them difficult to adopt, especially if many of the firms' matters are small or have ill-defined performance metrics.⁶¹ Hence, holdback arrangements are a great mechanism to personalise legal services to clients' needs; however, firms must meticulously review their client's circumstances before offering them.

⁵⁴ *Legal Profession Uniform Law 2014* (NSW) s 206.

⁵⁵ *Contracts Review Act 1980* (NSW) s 7.

⁵⁶ *Competition and Consumer Act 2010* (Cth) sch 2 s 23(1); G E Dal Pont, *Riley Solicitors Manual* (LexisNexis Butterworths, revised ed, June 2019) [14,035]; *Re Nelson* (1991) 106 ACTR 1, 18; *Liu v Adamson* [2003] NSWSC 74, [73].

⁵⁷ Crowell & Moring and Association of Corporate Counsel, *Handbook for Value-Based Billing Engagements* (Report, 2014) 16-9 ('*Handbook for Value-Based Billing Engagements*').

⁵⁸ *Ibid* 20.

⁵⁹ Beaton and Kaschner (n 6) 113, 128.

⁶⁰ *Handbook for Value-Based Billing Engagements* (n 57) 18.

⁶¹ *Ibid*.

Ultimately, clients can no longer be effectively served by the one-stop shop of the billable hour and so firms should personalise legal services to their clients' circumstances using AFAs like deferred fees and holdback arrangements.

C *An Analysis of How Fixed-Fee Arrangements Enhance Fee Certainty*

Finally, while professional services are predominantly sold using the billable hour,⁶² most clients cannot predict legal costs purely based on a firms' hourly rate because they do not understand their legal issues.⁶³ This lack of predictability typically associated with legal fees attracts clients to firms that provide fee certainty.⁶⁴ Proponents of the billable hour claim case estimates sufficiently 'allow clients to predict their costs' and therefore firms do not need to use AFAs to guarantee fee certainty.⁶⁵ However, an estimate is only a guideline and does not guarantee the maximum price firms will charge for their services.⁶⁶ Ultimately, the only way firms can provide fee certainty to clients is through using AFAs, such as fixed-fee arrangements.

Fixed-fees are set price arrangements for an agreed scope of work. They are corporate clients' preferred pricing model because they align lawyers' and clients' interests by rewarding efficient firms with high profitability and giving clients greater access to legal services with fee certainty.⁶⁷ Fixed-fee arrangements also enable solicitors to give clients a more accurate estimate of costs,⁶⁸ aligning firms' pricing models with *Legal Profession Uniform Law's* object of keeping clients informed about the cost of legal services.⁶⁹

Critics of fixed-fee arrangements claim they are 'a potential disincentive to zealous advocacy' and encourage lawyers to work less

⁶² Thomas Clay and Eric Seeger, *Law Firms in Transition 2013: An Altman Weil Flash Survey* (Report, 2013) 52 ('*Law Firms in Transition 2013*'); Thomas Clay and Eric Seeger, *Law Firms in Transition 2014: An Altman Weil Flash Survey* (Report, 2014) 40 ('*Law Firms in Transition 2014*'); Thomas Clay and Eric Seeger, *Law Firms in Transition 2015: An Altman Weil Flash Survey* (Report, 2015) 63 ('*Law Firms in Transition 2015*'); Thomas Clay and Eric Seeger, *Law Firms in Transition 2018: An Altman Weil Flash Survey* (Report, 2018) 69 ('*Law Firms in Transition 2018*'); *Law Firms in Transition 2019* (n 16) 28.

⁶³ Ribstein (n 22) 769; Competition & Markets Authority, *Legal Services Market Study* (Final Report, 15 December 2016) 46.

⁶⁴ Beaton and Kaschner (n 6) 12, 133; Bloomberg Law, *A Changing Landscape: Legal Operations* (Report, 2019) 7; Committee on Lawyer Business Ethics, 'Business and Ethics Implications of Alternative Billing Practices: Report on Alternative Billing Arrangements' (1998) 54(1) *Business Lawyer* 175, 180.

⁶⁵ Richmond, 'In Defense of the Billable Hour' (n 23) 4; David Hechler, 'Controlling Costs' (2002) 25(9) *National Law Journal* A27, A27.

⁶⁶ Gino Dal Pont, *Law of Costs* (LexisNexis Butterworths, 3rd ed, 2013) [2.26].

⁶⁷ *BTI Report* (n 1) 7; Boulden (n 22) 290.

⁶⁸ *Legal Profession Uniform Law 2014* (NSW) s 174; Dale Boucher, *Guideline & Direction: Cost Estimates* (Legal Services Council, 11 March 2016) [3].

⁶⁹ *Legal Profession Uniform Law 2014* (NSW) s 3.

to maximise profitability.⁷⁰ However, this risk only arises where a scope of work has too many possible variations and firms should be reluctant to offer broad fixed-fee arrangements. This is because although broad fixed-fee arrangements can increase firm profitability if minimal work is required, they can reduce firm profitability if more work is required than was expected. Further, if a service comprises of substantially less work than expected and is too profitable, the lawyer responsible for designing the arrangement risks breaching its obligation to charge reasonable legal fees and may be subject to financial and professional consequences.⁷¹

If there are too many possible variations in a scope of work, firms should use staged fixed-fee arrangements instead of standard fixed-fee arrangements.⁷² Staged fixed-fee arrangements break down legal services into multiple stages that are only payable if the client's circumstances require them to be performed.⁷³ For example, instead of charging \$10,000 to settle all legal disputes for a client, firms can charge \$5,000 for disputes settled in negotiation, \$10,000 for disputes settled in mediation and \$15,000 for disputes settled in court. This helps firms satisfy client demand for fee certainty and mitigate firms' risk of reduced profitability if matters require more labour than was expected. Thus, firms can use fixed-fee arrangements and staged arrangements to enhance fee certainty.

Ultimately, client demand for valuable, personalised legal services with fee certainty highlights that firms should not just be cutting prices to defend their market share. Clients remain cautious about pricing but they do not perceive low prices as the most important feature of a firm's pricing model.⁷⁴ Therefore, as discounted legal fees trend in the legal industry,⁷⁵ firms must realise that AFAs satisfy client demand for legal pricing models and use them to sell legal services instead of blindly shedding profits.

⁷⁰ Richmond, 'In Defense of the Billable Hour' (n 23) 4; Douglas Richmond, 'The Business and Ethics of Liability Insurers' Efforts to Manage Legal Care' (1997) 28 *University of Memphis Law Review* 57, 83.

⁷¹ See *Section VI(A): Analysis of How Lawyers' Obligation to Charge Fair and Reasonable Fees Can Inhibit their Ability to Commercialise AFAs* for a discussion of lawyer's duty to ensure legal fees are fair and reasonable; *Major Projects Pty Ltd v Sibmark Pty Ltd* [1992] ANZ ConvR 349, 350 (McLelland J) ('*Major Projects*'); *Legal Profession Uniform Law 2014* (NSW) s 172.

⁷² Legal Services Commission, *Fixed Fee Costs Agreements* (Regulatory Guide 9, April 2019) 4.

⁷³ *Ibid.*

⁷⁴ *2019 Chief Legal Officer Survey* (n 32) v; *2014 Chief Legal Officer Survey* (n 29) 13.

⁷⁵ Kim Do, *Legal Services in Australia* (Industry Report No M6931, IBISWorld, May 2019) 22; *Law Firms in Transition 2013* (n 62) 50; *Law Firms in Transition 2014* (n 62) 40; *Law Firms in Transition 2015* (n 62) 60; Thomas Clay and Eric Seeger, *Law Firms in Transition 2016: An Altman Weil Flash Survey* (Report, 2016) 69 ('*Law Firms in Transition 2016*'); Thomas Clay and Eric Seeger, *Law Firms in Transition 2017: An Altman Weil Flash Survey* (Report, 2017) 64 ('*Law Firms in Transition 2017*'); *Law Firms in Transition 2018* (n 62) 68; *Law Firms in Transition 2019* (n 16) 27.

IV Why Lawyers Should Listen to Clients: An Investigation into How Alternative Fee Arrangements Optimise Profitability

Clients understand that the time lawyers spend on tasks is ‘not even a rough [measurement of] value’.⁷⁶ Therefore, firms must redesign their pricing strategies to satisfy client demand. However, redesigning pricing models should not be perceived as a burden on firms. Instead, it is an opportunity for firms to optimise their profitability. This section will discuss Maister’s formula, explain how AFAs increase profitability and discuss why firms must implement AFAs urgently to reap their benefits.

A Explaining Maister’s Profitability Formula

Maister’s formula, depicted by Beaton and Kaschner in Figure 1,⁷⁷ explains firm profitability levers (ie, pricing characteristics that affect profitability). Whilst other profitability formulas exist,⁷⁸ this article uses Maister’s formula because it applies measurable input values that align with AFAs’ effect on firms’ pricing features. Accordingly, this article will use Maister’s formula to communicate how AFAs maximise firms’ long-term profitability relative to billable hours.

$$\text{PPEP} = \frac{(\text{EP}(1+\text{L}) \times \text{U} \times \text{R} \times \text{BBR}) - \text{TE}}{\text{EP}}$$

- PPEP = profit per equity point.
- EP = equity points, which are the number of profit units owned by all equity partners.
- L = leverage, which is the number of fee earners per equity partner.
- U = utilization, which is the number of hours that the firm charges per fee earner.
- R = recovery rate, which is the rate that charged hours (i.e. utilisation) are recovered.
- BBR = blended billable rate, which is the firm’s fee income divided by total utilisation (i.e. U x R)
- TE = total expenses

Figure 1. Maister’s profitability formula.⁷⁹

⁷⁶ Ribstein (n 22) 768.

⁷⁷ Beaton and Kaschner (n 6) 41.

⁷⁸ See Ronald Baker, *Implementing Value Pricing: A Radical Business Model for Professional Firms* (John Wiley & Sons, 2011) 8.

⁷⁹ Beaton and Kaschner (n 6) 41 citing Maister (n 8) ch 3; Ben Farrow, ‘Has the Juice been Squeezed from Big Law’s Business Model?’, *Remaking Law Firms: Why & How* (Blog Post, 24 May 2016) <<https://remakinglawfirms.com/biglaw-profitability-maister/>>.

B *Analysing How AFAs Maximise Profitability Using Maister's Formula*

This section applies Maister's formula to demonstrate how AFAs increase profitability and shield firms from the billable hour's negative effect on profit. By outlining AFAs' benefits and the billable hour's limitations, this section argues that firms should adopt AFAs to maximise profitability.

1 *Recovery Rate*

AFAs can reverse the current negative trend in recovery rates by eliminating client discounts. Optimistic reports claim firm recovery rates in 2019 were 89% of utilisation, declining from 94% in 2017,⁸⁰ and this negative trend is expected to continue permanently.⁸¹ Declining recovery rates are caused by client demand for 'an ever-increasing discount'.⁸² This has resulted in 21%-30% of all revenue coming from discounted fees,⁸³ reducing profits as Maister's formula and existing literature show that declining recovery rates reduce profitability.⁸⁴ However, introducing AFAs can eliminate firms' need to discount legal services, and therefore increase recovery rates, by reducing price elasticity of demand.⁸⁵

Price elasticity of demand is 'the percentage change in quantity demanded' due to a change in price.⁸⁶ High price elasticity of demand suggests demand is sensitive to price change whereas low elasticity means demand is not affected by price change. Therefore, suppliers of highly elastic products must engage in price competition and offer discounts to retain clients whereas suppliers of products with low elasticity can maximise sales with high recovery rates because demand does not change whether they decide to discount or not discount products.

The billable hour is highly elastic because many firms sell it. Thus, firms that use the billable hour must discount their services more to obtain clients. Alternatively, firms can reduce the price elasticity of demand of their legal services if they use AFAs because there are less

⁸⁰ *2020 Report on the State of Legal Market* (n 13) 11.

⁸¹ *Law Firms in Transition 2015* (n 62) 70; *Law Firms in Transition 2016* (n 75) 76; *Law Firms in Transition 2017* (n 75) 83; *Law Firms in Transition 2018* (n 62) 84.

⁸² *Law Firms in Transition 2019* (n 16) 33.

⁸³ *Law Firms in Transition 2013* (n 62) 50; *Law Firms in Transition 2014* (n 62) 40; *Law Firms in Transition 2015* (n 62) 60; *Law Firms in Transition 2016* (n 75) 69; *Law Firms in Transition 2017* (n 75) 64; *Law Firms in Transition 2018* (n 62) 68; *Ibid* 27.

⁸⁴ Michael Mam, Eric Roegner and Craig Zawada, *The Price Advantage* (John Wiley & Sons, 2004) 27; Peter Doyle, *Value-based Marketing: Marketing Strategies for Corporate Growth and Shareholder Value* (John Wiley & Sons, 2nd ed, 2012) 297.

⁸⁵ Beaton and Kaschner (n 6) 119.

⁸⁶ Gadi Fibich, Arieh Gavious and Oded Lowegart, 'The Dynamics of Price Elasticity of Demand in the Presence of Reference Price Effects' (2005) 33(1) *Journal of the Academy of Marketing Science* 66, 66.

substitute products in the market (ie, only 6%-10% of legal services are sold using AFAs).⁸⁷ This will increase the price clients are willing to pay for a firm's services and eliminate firms' need to discount their services to retain clients.⁸⁸

Ultimately, firms, like most suppliers, misunderstand that their invoice price is not their 'realised price'.⁸⁹ They must understand that AFAs reduce discounts and thus, even though AFAs like subscription arrangements may be sold more cheaply than the billable hour, AFAs can be sold more profitably than billable hours.

2 *Inflation and Technology Reduce Profits*

The billable hour is unviable because inflation increases expenses and technology introduces price ceilings on the supply of legal services. These forces are increasingly magnified by global inflation targets and Moore's law (the prediction that technology's capacity will double each year).⁹⁰ Ultimately, growing expenses and declining revenue will cumulatively eliminate profit from firms using the billable hour, reducing the viability of firms pricing services as a multiple of cost rather than pricing services in accordance with their value.

Firstly, inflation increases business expenses and reduces profits. In Australia, the target inflation rate is 2-3% which means expenses rise by approximately 2%-3% annually.⁹¹ This is worrisome for Traditionalists because the billable hour's profit margin depends on low total expenses since labour expenses, which is a firm's largest expense,⁹² and revenue increase proportionately. Therefore, inflation will slowly increase expenses and eat away profitability, as demonstrated through the total expense lever in Maister's formula.

Secondly, the billable hour's revenue is in decline because technology is commoditising legal services, reducing utilisation and introducing price ceilings on the sale of legal services.⁹³ Commoditisation enhances efficiency but also reduces the amount of work firms must complete to provide legal services (ie, utilisation), which is a key profit lever in Maister's formula. Therefore, since legal services can be produced more cheaply with less labour expenses and

⁸⁷ Ibid; See *Section III: An Analysis of Client Demand: Valuable, Personalised Services with Fee Certainty* for a discussion of client demand for AFAs; *Law Firms in Transition 2013* (n 62) 52; *Law Firms in Transition 2014* (n 62) 40; *Law Firms in Transition 2015* (n 62) 63; *Law Firms in Transition 2018* (n 62) 69; *Law Firms in Transition 2019* (n 16) 28.

⁸⁸ Fibich, Gavius and Lowegart (n 86) 66.

⁸⁹ Doyle (n 84) 297.

⁹⁰ Gordon Moore, 'Cramming More Components onto Integrated Circuits' (1998) 86(1) *Proceedings of the IEEE* 82, 83.

⁹¹ 'Inflation Target', *Reserve Bank of Australia* (Web Page, 2020) <<https://rba.gov.au/monetary-policy/inflation-target.html>>.

⁹² *Law Firms in Transition 2019* (n 16) vi.

⁹³ Susskind (n 5) 21.

the current legal services market is very competitive,⁹⁴ the market price for legal services will slowly decrease and a price ceiling on the supply of legal services will develop.⁹⁵ Ultimately, technology's negative impact on revenue will continue to rise exponentially as technological capacity increases each year (ie, Moore's law),⁹⁶ reducing available revenue annually.⁹⁷

Accordingly, firms using the billable hour will experience a profit margin squeeze because business expenses are increasing and available revenue is decreasing. These firms can no longer offset inflation's impact on profit with price increases because they must adhere to price ceilings imposed by technology. Instead, firms must redesign their pricing models with AFAs so revenue generation is not predicated on business expenses. This will enable firms to maximise profitability by improving efficiency. For example, firms could use economies of scale to sell legal services via subscription arrangements, increasing revenue without necessarily incurring additional labour expenses, excepting research, development, and maintenance costs. Ultimately, firms cannot price legal services according to inflation anymore; they must use AFAs that are value-driven and will withstand the hypercompetitive environment of the future.⁹⁸

C AFAs Benefit Firms Which Offer Them Proactively

As discussed in sections IV(A)-(B), AFAs increase profitability and shield firms from the billable hour's deleterious effect on profit. However, firms' slow adoption of AFAs has caused them to offer AFAs reactively (ie, in response to client requests), which has reduced their profitability. Accordingly, firms must design and offer AFAs to clients proactively.

Firms which proactively offer AFAs maintain or increase profitability on 62% to 84% of matters, compared to firms which offer AFAs reactively maintaining or increasing profitability on 37% to 52% of matters (see Figure 2). This disparity in profitability presumably occurs because firms that reactively offer AFAs have not transformed their service delivery models to provide legal services efficiently. Thus, not being prepared to offer AFAs can negatively impact business profitability and viability, and firms must take steps to design and deliver AFAs urgently.

⁹⁴ Do (n 75) 6; See *Section V(B): Technology Enhances Buyer Power* for a discussion about how technology has heightened, and will continue to heighten, competition in the legal services market.

⁹⁵ Matias Busso et al, *The Causal Effect of Competition on Prices and Quality: Evidence from a Field Experiment* (Report, February 2015) 24.

⁹⁶ Moore (n 90) 83.

⁹⁷ Susskind (n 5) 21.

⁹⁸ *Ibid.*

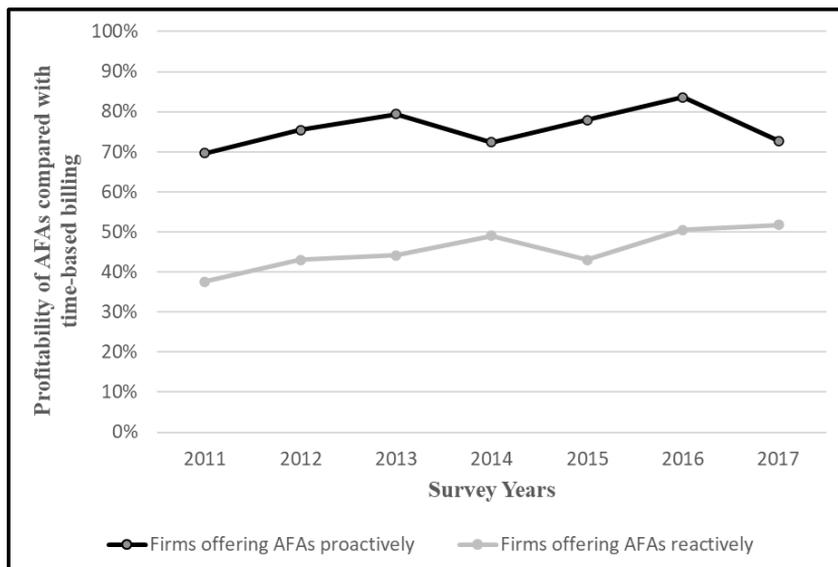


Figure 2. Comparison of profitability under AFAs between firms that proactively offer AFAs and firms that reactively offer AFAs.⁹⁹

Therefore, whilst the billable hour may still be required to service ‘mission critical’ and bespoke legal problems,¹⁰⁰ AFAs’ positive effect on profitability necessitates its substantial implementation in firm pricing models.

V Why Lawyers Must Listen to Clients: Technological Innovation Enhances Buyer Power

Clients were originally subservient to their legal advisers because they did not understand their legal needs and had limited avenues to obtain legal solutions.¹⁰¹ This forced clients to trust their lawyers on all legal disputes and transactions.¹⁰² However, technological innovation has increased competition and, in turn, increased client bargaining power (or ‘buyer power’). Technology has enhanced competition by increasing the supply of legal services and reducing information asymmetry between lawyers and clients.¹⁰³ Therefore, technology has forced firms to satisfy client demand for AFAs to retain their clients.

⁹⁹ Tony King, ‘The Future of Legal Education from the Profession’s Viewpoint: A Brave New World?’ in Hilary Sommerlad et al (eds), *The Futures of Legal Education and the Legal Profession* (Bloomsburg Publishing, 2015) 181, 187.

¹⁰⁰ Ibid.

¹⁰¹ Law Society of England and Wales, *The Future of Legal Services* (Report, 2016) 6 (‘*The Future of Legal Services Report*’); Lord Hunt, *The Hunt Review of the Regulation of Legal Services* (Report, October 2009) 14.

¹⁰² Ribstein (n 22) 753.

¹⁰³ Doyle (n 84) 163.

This section will explain the bargaining power concept, analyse how technological innovation enhances buyer power and argue that enhanced buyer power forces firms to satisfy clients to defend their market share.

A *Explaining the Bargaining Power Concept*

Bargaining power is a party's ability to carry out its own will, irrespective of another party's resistance.¹⁰⁴ The distribution of bargaining power between parties depends on the 'relative importance of' sales and purchases within an industry, which is determined by 'market-imposed conditions ... on negotiating parties'.¹⁰⁵ The next section will explain how technology has fostered an environment of high supply and low switching costs in the legal industry, increasing buyer power.¹⁰⁶

B *Technological Innovation Enhances Buyer Power*

Technological innovation enhances buyer power by increasing competition in the legal services market and reducing switching costs. It increases competition by widening firms' target markets and making high quality legal services easier to produce, increasing service supply and decreasing demand. Alternatively, it reduces switching costs because the internet provides clients with detailed information about firms in the marketplace, simulating perfect information and making it easier for clients to find more suitable legal services. Ultimately, the cumulative effect of technology on the legal services market is increased service supply relative to constant demand and, in turn, enhanced buyer power.

1 *Expanding Target Markets*

Technology enlarges firms' target markets by enabling them to 'communicate and deliver' legal solutions to more prospective clients.¹⁰⁷ This expansion is primarily aided by the internet, which eliminates geographic barriers to entry and lets firms compete in

¹⁰⁴ Sanjay Prasad, Ravi Shankar and Sreejit Roy, 'Impact of Bargaining Power on Supply Chain Profit Allocation: A Game-Theoretic Study' (2019) 16 (3) *Journal of Advances in Management Research* 398, 400 citing Max Weber, *The Theory of Social and Economic Organization* (Free Press, 1947).

¹⁰⁵ Michael Porter, 'How Competitive Forces Shape Strategy' (1979) 57(2) *Harvard Business Review* 137, 140-1; Prasad, Shankar and Roy (n 104) 400 citing Lehman Fletcher et al, *Bargaining Power in Agriculture* (CAEA Report 9, 1961).

¹⁰⁶ Doyle (n 84) 163.

¹⁰⁷ Adel El-Ansary, 'Marketing Strategy: Taxonomy and Frameworks' (2006) 18(4) *European Business Review* 266, 268.

interstate and international markets.¹⁰⁸ However, enlarged target markets also increase competition in domestic markets because it enables international, ‘national and regional firms’ to enter and service clients.¹⁰⁹ Therefore, enlarged target markets increase buyer power by increasing service supply in the legal services market.¹¹⁰

2 *High Quality Services Are Easier to Reproduce*

Technology makes high quality legal services easier to reproduce.¹¹¹ It gives firms access to automation software to supplement their labour force and access to online legal libraries (like Westlaw) to enable lawyers to produce more accurate advice efficiently. However, whilst firms gain significant advantages from technology, it also threatens their viability because it energises three of Porter’s five competitive forces: industry competitors, buyer power and threat of substitute products, enhancing buyer power by increasing supply and reducing demand.¹¹²

Firstly, technology enables firms to better service clients because they can mass customise legal services with automation and artificial intelligence.¹¹³ However, technology also helps competitors better satisfy client demand. This increases the supply of high-quality legal services relative to constant demand as more suppliers sell the same product.

Secondly, technology increases competition because it enables clients to complete legal services internally by giving them greater access to resources, a process called backward integration.¹¹⁴ Backward integration is a risk to firms because it causes around 60%-84% of firms to lose work to clients who complete projects internally,¹¹⁵ such as ‘due diligence, legal research and legal writing’,¹¹⁶ and outsource what they cannot complete to alternative legal service providers (‘ALSPs’). This reduces client demand for legal services relative to constant supply, increasing competition between firms.

¹⁰⁸ Nadeem Akhtar, Syed Azeem and Ghulam Mustafa, ‘Strategic Role of Internet in SMEs Growth Strategies’ (2014) 5(2) *International Journal of Business Management and Economic Research* 20, 20.

¹⁰⁹ Thomas Clay and Eric Seeger, *Law Firms in Transition 2012: An Altman Weil Flash Survey* (Report, 2012) 46.

¹¹⁰ Porter (n 105) 140-1.

¹¹¹ Ribstein (n 22) 761.

¹¹² Porter (n 105) 138-142.

¹¹³ Susskind (n 5) xix.

¹¹⁴ Porter (n 105) 142.

¹¹⁵ Ribstein (n 22) 760; Michael Legg and Felicity Bell, ‘Insourcing – Implications for In-House Counsel and Private Practice Lawyers’ (2018) 45 *Legal Services Journal* 70, 70; *Law Firms in Transition 2015* (n 62) 20; *Law Firms in Transition 2016* (n 75) 6; *Law Firms in Transition 2017* (n 75) 5; *Law Firms in Transition 2018* (n 62) 5; *Law Firms in Transition 2019* (n 16) 5; Regan and Heenan (n 30) 2139.

¹¹⁶ Legg and Bell (n 115) 71.

Thirdly, technology has fostered the growth of ALSPs by expanding ALSPs' target markets and scope of services.¹¹⁷ ALSPs are non-legal entities which offer cost-effective solutions to clients, like document review and e-discovery,¹¹⁸ and capitalise on clients' tendency to unbundle and outsource legal services. This has enabled ALSPs to grow 12.9% annually between 2015 and 2017.¹¹⁹ Like firms, technology has enlarged ALSPs target markets, enabling them to offer services to clients which ALSPs could not physically service previously.¹²⁰ Further, technology has also expanded the scope of ALSPs' high-volume services, enabling them to move into new areas, like contract management, as technology's capabilities have increased.¹²¹ Ultimately, technology has catalysed the rise of ALSPs,¹²² introducing substitute products and increasing competition in the legal services market.¹²³

Therefore, technology has heightened competition between firms, increasing service supply, reducing client demand and, therefore, enhancing buyer power.¹²⁴

3 *Low Search Costs*

Technology has transformed legal services into a commodity that can be compared and purchased on the internet.¹²⁵ The internet simulates perfect information because it enables clients to make more informed decisions about which firm to choose.¹²⁶ This obviates clients' 'special reliance' on lawyers and gives them greater bargaining power relative to firms because they are more aware that different firms and substitute products (like ALSPs) exist.¹²⁷

Thus, technology has enhanced buyer power in the legal services market by increasing supply and reducing both demand and clients' search costs.

¹¹⁷ Center for the Study of the Legal Profession, *Alternative Legal Service Providers: Understanding the Growth and Benefits of these New Legal Providers* (Report, 2017) 15.

¹¹⁸ *Ibid* 1; *The Future of Legal Services Report* (n 101) 14.

¹¹⁹ Center on Ethics and the Legal Profession et al, *Alternative Legal Service Providers 2019: Fast Growth, Expanding Use and Increasing Opportunity* (Report, 2019) 1-2 ('*Alternative Legal Service Providers 2019*').

¹²⁰ El-Ansary (n 107) 268.

¹²¹ *Alternative Legal Service Providers 2019* (n 119) 14.

¹²² *Ibid*.

¹²³ Fibrich, Gavius and Lowegart (n 86) 66.

¹²⁴ Prasad, Shankar and Roy (n 104) 400 citing Ken Binmore, Ariel Rubinstein and Asher Wolinsky, 'The Nash Bargaining Solution in Economic Modelling' (1986) 17(2) *RAND Journal of Economics* 176.

¹²⁵ *The Future of Legal Services Report* (n 101) 41.

¹²⁶ Amanda Jones, *The Economics of the Internet Retail Industry and its Impact on the Business-to-Consumer Retailing Environment* (Report, 2001) 8.

¹²⁷ *The 2019 Pricing Strategy Survey* (n 28) 7; Ribstein (n 22) 753.

C Enhanced Buyer Power Means Firms Must Satisfy Client Demand

Ultimately, technology enables firms to commoditise today's bespoke legal solutions into tomorrow's procedural projects (ie, autonomous or low-labour input solutions).¹²⁸ However, it has also benefited clients by increasing competition between suppliers and enhancing buyer power. Technology's positive impact on buyer power will force firms to either satisfy client demand or lose clients. This will result in complacent firms being marginalised as their clients flock to competitors that satisfy client demand,¹²⁹ leaving the complacent to fight with each other for crumbs.¹³⁰ Thus, firms must react quickly to technology's transformative effect on the lawyer-client power dynamic by offering clients valuable and personalised products with fee certainty so they do not risk losing their clients to other firms.

VI Deconstructing Legal and Managerial Challenges that Firms May Face When Introducing Alternative Fee Arrangements

AFAs are both a source of competitive advantage and ethical and managerial dilemmas. Thus, any sizeable discussion of AFAs' advantages should be complemented with guidance on how firms can navigate legal ethics challenges, such as ensuring legal costs are fair and reasonable,¹³¹ and the innovator's dilemma, a managerial challenge that impedes firms' implementation of disruptive innovations like AFAs.¹³²

A Analysis of How Lawyers' Obligation to Charge Fair and Reasonable Fees Impedes their Ability to Commercialise AFAs

When introducing AFAs, firms must balance their profit motive with their obligation to charge fair and reasonable legal costs.¹³³ This section will discuss the concept of fair and reasonable legal costs and explain how firms can maximise profitability using AFAs without breaching their ethical cost obligations.

¹²⁸ Susskind (n 37) 43.

¹²⁹ Doyle (n 84) 276.

¹³⁰ *2020 Report on the State of Legal Market* (n 13) 21.

¹³¹ *Legal Profession Uniform Law 2014* (NSW) s 172.

¹³² Christensen (n 10) 225.

¹³³ *Legal Profession Uniform Law 2014* (NSW) s 172.

1 *Lawyers' Obligation to Only Charge Fair and Reasonable Costs*

Although legal cost agreements are contractual arrangements,¹³⁴ they are heavily regulated by statute to ensure lawyers' drive for profits do not prevail over their duty to serve the wider community.¹³⁵ The most relevant feature of this ethical framework to designing AFAs is the obligation to charge fair and reasonable fees.¹³⁶ Fairness involves assessing the circumstances in which a costs agreement was entered into 'whereas reasonableness relates to the substantive terms of the agreement.'¹³⁷ To determine whether fees are fair and reasonable, courts consider whether they reasonably reflect the skill of the lawyers, complexity of the issue, labour involved, quality of the work product, client instructions and circumstances of the matter.¹³⁸

Breaching the obligation to charge fair and reasonable fees can have financial, professional and moral repercussions for lawyers. Firstly, if the Court or a cost assessor determines an agreement is unfair and unreasonable,¹³⁹ it may vary the amount of legal fees payable to reflect a fair and reasonable amount, essentially on a *quantum meruit* basis.¹⁴⁰ Alternatively, courts have an inherent power to set aside cost agreements that are not fair and reasonable, preventing lawyers from recovering any fees.¹⁴¹ Secondly, if costs agreements are very unfair or unreasonable, they can also be grounds for professional misconduct.¹⁴² This can result in a lawyer being struck off the roll.¹⁴³ Finally, lawyers have a moral responsibility to help others obtain 'justice under law' because they are the gatekeepers of legal advice.¹⁴⁴ Therefore, charging unfairly or unreasonably is a breach of lawyers' moral duty to their community.¹⁴⁵ Thus, firms must ensure AFAs are not unfair or unreasonable. The next section will discuss how AFAs can cause cost agreements to be unreasonable. A detailed discussion of unfairness is

¹³⁴ Dal Pont, *Riley Solicitors Manual* (n 56) [14,000].

¹³⁵ *Re Foster* (1950) 50 SR (NSW) 149, 151 (Street CJ) cited by *Legal Services Commissioner v Walter* [2011] QSC 132, [19] (Daubney J); *Shapiro v Kentucky Bar Association*, 486 US 466, 488–9 (1988); G E Dal Pont, 'Contextualising Lawyer Overcharging' (2016) 42(2) *Monash University Law Review* 283, 293.

¹³⁶ *Legal Profession Uniform Law 2014* (NSW) s 172.

¹³⁷ Dal Pont (n 56) [15,030.20]; *Re Stuart* [1893] 2 QB 201, 204–5 (Lord Esher MR) ('*Re Stuart*').

¹³⁸ *Legal Profession Uniform Law 2014* (NSW) s 172(2).

¹³⁹ *Ibid* ss 185(1), 199(2)(b).

¹⁴⁰ *Ibid* ss 185(2), 199(2)(b); Dal Pont, *Riley Solicitors Manual* (n 56) [15,100].

¹⁴¹ G E Dal Pont, 'Costs Agreements and VCAT – The Challenge of St Yves' (2008) 34(2) *Monash University Law Review* 261, 267; *Re Stuart* (n 137) 204 (Lord Esher MR).

¹⁴² *Legal Profession Uniform Law 2014* (NSW) s 297.

¹⁴³ *Ibid* s 302(1)(a); *D'Alessandro v Legal Practitioners Complaints Committee* (1995) 15 WAR 198, 209–10.

¹⁴⁴ Dal Pont (n 135) 291.

¹⁴⁵ Chief Justice Spigelman, 'Opening of Law Term Dinner' (Speech, Law Society of New South Wales Law Term Dinner, 2 February 2004).

less relevant to designing AFAs than unreasonableness and is beyond the scope of this article.

2 *How Can AFAs be Unreasonable and What Should Firms Consider When Designing AFAs?*

AFAs are reasonable if their scope of works does not exceed their clients' needs and if their price bears a relationship with their value.

Firstly, AFAs are unreasonable if their scope of works exceeds their clients' need for legal services and take longer to complete than could be completed by a competent solicitor.¹⁴⁶ For example, a fixed-fee purchase of business arrangement that includes comprehensive antitrust advice will be excessive and unreasonable for many small to medium enterprises since such a transaction could not substantially lessen competition and is unlikely to generate a risk of prosecution under antitrust law.¹⁴⁷ Ultimately, firms must not offer AFAs without ensuring the service reflects their clients' needs. This is especially relevant where the arrangement is with an individual as opposed to a well-informed client because courts are more likely to find an agreement is unreasonable if there is a disparity in bargaining power between lawyers and their clients.¹⁴⁸ Therefore, firms must only offer products that their clients need because providing excessive legal services is a breach of lawyers' duty to provide legal services for reasonable costs.

Secondly, whilst judicial criticism for overcharging is traditionally aimed at the billable hour,¹⁴⁹ firms cannot escape the risk of overcharging by using AFAs unless the price of their legal services bears a relationship to its value.¹⁵⁰ AFAs incentivise 'efficient case management' as their profitability commonly lies in efficiency and low labour costs.¹⁵¹ Technically, reduced labour costs should constrain how much firms can charge clients since labour input is an important consideration in assessing legal costs.¹⁵² However, this article argues that reduced labour input does not constrain how much firms can charge if the service's price reflects its value.

Caselaw clarifies that calculating reasonable fees is a market-based determination, not an 'arithmetical calculation'.¹⁵³ For example, the Court in *Aesthete (No 3)* determined that a lawyer's fees are reasonable

¹⁴⁶ *Major Projects* (n 71) 350 (McLelland J).

¹⁴⁷ *Competition and Consumer Act 2010* (Cth) s 50.

¹⁴⁸ *Foyle* (n 33) 71-2.

¹⁴⁹ *Foreman (No 2)* (n 33) 422 (Kirby P).

¹⁵⁰ *Petersen Superannuation Fund Pty Ltd v Bank of Queensland Limited (No 3)* (2018) 132 ACSR 258, 286 ('*Petersen Superannuation Fund*') quoting *Skalkos v T&S Recoveries Pty Ltd* (2004) 65 NSWLR 151, 153 (Ipp JA) ('*Skalkos*').

¹⁵¹ *Handbook for Value-Based Billing Engagements* (n 57) 3.

¹⁵² *Legal Profession Uniform Law 2014* (NSW) ss 172(2)(c), 172(2)(d)(ii).

¹⁵³ *Hudson v Sigalla (No 2)* [2017] FCA 339, [54] (Katzmann J) citing *Foreman (No 2)* (n 33) 422 (Kirby P).

if they correspond with market hourly rates for similarly-qualified lawyers.¹⁵⁴ This is because the objective of a cost assessments is to determine whether ‘costs bear a reasonable relationship to the value and importance [of the legal services]’.¹⁵⁵ Therefore, even though AFAs reduce labour costs, firms can charge prices without respect to the associated labour costs if a service’s value bears a relationship to its price.

Ultimately, introducing AFAs can cause lawyers to risk breaching their ethical obligations. However, these ethical challenges can be surmounted by ensuring that clients are not sold excessive legal services and that legal services are priced based on their value. Thus, whilst legal professional rules impede AFAs’ commercialisation, firms can take very simple steps to adhere to these rules and obtain AFAs’ long-term benefits.

B Analysis of How Firms Can Overcome the Innovator’s Dilemma and Obtain First Mover Advantages When Implementing AFAs

Businesses that normalise disruptive innovations have much greater chances of success than later entrants.¹⁵⁶ This is because they gain a first mover advantage (ie, a surge in market share that companies receive for normalising disruptive innovations).¹⁵⁷ First mover advantages gave early entrants in the disc drive industry a 6-times greater chance of succeeding than later entrants and will enable firms that normalise AFAs to seize Traditionalists’ market share.¹⁵⁸ However, a business’ ability to implement disruptive innovations is impeded by the innovator’s dilemma.

The innovator’s dilemma is a successful business’ difficulty in developing disruptive innovations because it is prejudiced towards developing more profitable sustaining innovations (eg, improvements to existing technology).¹⁵⁹ Disruptive innovations are products or processes that initially perform below required capabilities but can be offered more cheaply or conveniently than existing technology,¹⁶⁰ such as the initially worse-performing, but more convenient, 5.25 inch disc drives that replaced 8 inch disc drives.¹⁶¹ Whilst disruptive innovations

¹⁵⁴ *Aesthete No 3 Pty Ltd ACN 127 464 966 v Gilmore Finance Pty Ltd ACN 104 792 627*[2018] NSWDC 1, [35].

¹⁵⁵ *Legal Profession Uniform Law 2014* (NSW) s 172(2); *Petersen Superannuation Fund* (n 150) 286 quoting *Skalkos* (n 150) 153 (Ipp JA); *Anthony Lenehan v Powercor Australia Limited (ACN 064 651 109)* [2020] VSC 82, [11] citing *Skalkos* (n 150) 153 (Ipp JA).

¹⁵⁶ Clayton Christensen, ‘Exploring the Limits of the Technology S-Curve. Part 1: Component Technologies’ (1992) 1(4) *Production and Operations Management* 334, 347.

¹⁵⁷ Beaton and Kaschner (n 6) 203.

¹⁵⁸ *Ibid.*

¹⁵⁹ Christensen (n 10) 231.

¹⁶⁰ *Ibid* xix, 201.

¹⁶¹ *Ibid* 16.

initially perform worse than sustaining innovations, sustaining innovations to a disruptive technology enhances its performance to a level that better satisfies client demand and is superior to previous technology.¹⁶² Ultimately, to gain first mover advantages, firms must develop disruptive innovations before the disruptive technology's performance satisfies current demand (see the points of intersection marked on Figure 3 with 'X's').¹⁶³ AFAs are a disruptive innovation because they are initially less profitable than the billable hour but can quickly revolutionise a firm's service delivery models and cost structure. Therefore, firms must understand the innovator's dilemma and learn how to implement AFAs before AFAs outperform billable hours and these firms can no longer obtain first mover advantages.

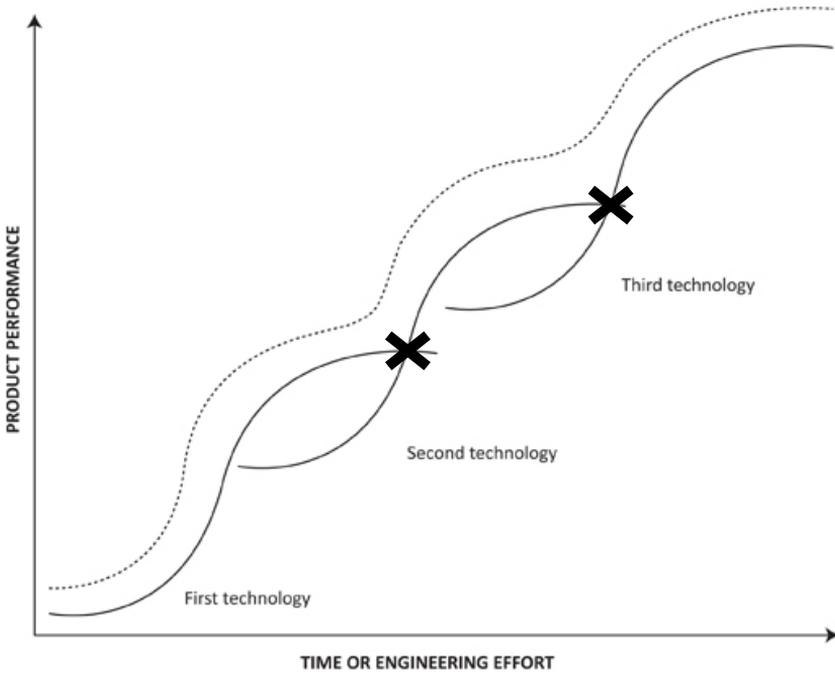


Figure 3. Diagram explaining how sustaining innovations enable disruptive technologies to outperform existing technologies.¹⁶⁴

¹⁶² Ibid 40.

¹⁶³ Ibid.

¹⁶⁴ Christensen (n 156) 340.

1 *Discussion About How the Innovator's Dilemma Affects Firms' Implementation of AFAs*

The innovator's dilemma impairs firms' implementation of AFAs in two ways: market analysis cannot forecast AFA profitability and firms' value networks are prejudiced towards billable hours.¹⁶⁵

Firstly, traditional market analysis cannot predict demand for disruptive innovations because 'markets that do not exist cannot be analyzed'.¹⁶⁶ When smaller disc drives were introduced, market analysis could not accurately forecast demand because consumer products only used larger disc drives.¹⁶⁷ This bias distorts projections of consumer demand for disruptive innovations and paralyses their development as managers are uncertain whether disruptive products will be profitable.¹⁶⁸

Although AFAs are disruptive, firms can gather evidence to support the introduction of most AFAs, like fixed-fee arrangements, because traditional AFAs have been introduced into the market already and existing research confirms that they satisfy client demand.¹⁶⁹ However, firms may struggle to forecast demand for more unique AFAs like risk collars and holdback arrangements because they are less common. Ultimately, AFAs' minor presence in the legal services market reduces the impact of the innovator's dilemma on their implementation; however, firms must understand that this bias will still present itself as reduced demand when they plan how to commercialise AFAs.

Secondly, firms' value networks prejudice them to invest in sustaining innovations, not disruptive innovations.¹⁷⁰ Value networks are the 'context within which a firm identifies and responds to clients' needs'.¹⁷¹ The most relevant feature of a firms' value network to its commercialisation of AFAs is its profit drivers. Traditionalists are currently geared towards being inefficient because they generate profit by expending labour using the billable hour. Conversely, AFAs are most profitable when they are delivered efficiently.¹⁷² Therefore, Traditionalists cannot substantially adopt AFAs without reinventing their service delivery models to incentivise efficiency, such as by adopting a cost structure which is most profitable when producing a large quantity of low-profit AFAs. This will require firms to make substantial capital investments into research and development before implementing AFAs and will deter many from implementing AFAs.

¹⁶⁵ Christensen (n 10) 231.

¹⁶⁶ Ibid 143.

¹⁶⁷ Ibid 145.

¹⁶⁸ Ibid 144.

¹⁶⁹ See *Section III: An Analysis of Client Demand: Valuable, Personalised Services with Fee certainty* for discussion of rising demand for AFAs.

¹⁷⁰ Christensen (n 10) 30.

¹⁷¹ Ibid 32.

¹⁷² Boulden (n 22) 281; *Handbook for Value-Based Billing Engagements* (n 57) 3.

Ultimately, the innovator's dilemma impedes firms' adoption of AFAs. It obscures market analysis of AFA profitability and forces firms to substantially change their service delivery model to deliver AFAs profitably. However, these challenges can be overcome by firms that create a spinoff entity.

2 Analysis of How Spinoff Entities Can Counteract the Innovator's Dilemma

Firms can use spinoff entities to overcome the innovator's dilemma. Spinoff entities, or captive entities,¹⁷³ are small organisations established to develop disruptive technologies independently of the main organisation.¹⁷⁴ If disruptive innovations are developed inside the main organisation, main organisation managers will divert all resources towards profitable sustaining innovations and away from disruptive innovations because they are biased towards short-term profitability over long-term corporate growth.¹⁷⁵ However, this can be avoided by establishing a spinoff entity whose resource allocation process is independent of the main organisation,¹⁷⁶ ensuring the spinoff entity focuses on long-term growth and product quality rather than profitability.

When establishing a spinoff entity, firms must match the growth to risk ratio of the opportunity to the spinoff entity's size and ensure spinoff entity managers are focused on long-term growth rather than short-term profitability.

Firstly, a spinoff entity's size must reflect the growth to risk ratio of the disruptive innovation it develops.¹⁷⁷ Disruptive innovations have smaller and riskier prospects of success than sustaining innovations.¹⁷⁸ Therefore, they 'cannot solve the near-term growth and profit requirements of large companies' and must be developed inside small entities that can get excited about low revenue.¹⁷⁹ If spinoff entities are large, their expenses will outweigh the small successes that disruptive innovations initially command (such as first customer orders) and they will not be perceived as successful. Thus, firms must ensure the entity they use to develop AFAs is small enough to remain profitable with low revenues and be enthusiastic about small wins, because these characteristics are imperative to their development of AFAs.

Secondly, spinoff entity managers must focus on long-term growth, not short-term profitability. Rational managers dislike disruptive

¹⁷³ 2020 Report on the State of Legal Market (n 13) 19.

¹⁷⁴ Christensen (n 10) 102.

¹⁷⁵ Brian Bushee, 'The Influence of Institutional Investors on Myopic R&D Investment Behavior' (1998) 73(3) *Accounting Review* 305, 330.

¹⁷⁶ Christensen (n 10) 176.

¹⁷⁷ *Ibid* 121.

¹⁷⁸ *Ibid* 77.

¹⁷⁹ *Ibid* 121, 135.

innovations because they are less profitable and more risky than sustaining innovations.¹⁸⁰ Therefore, firms must force managers to focus on long term strategies so they concentrate on developing AFAs rather than maximising profitability with sustaining innovations. This can be done by increasing goal congruence: the degree of alignment between business strategy (eg, practice leaders) and corporate strategy (eg, managing partner),¹⁸¹ which can be manipulated with incentive reward schemes.¹⁸²

To incentivise long-term growth, companies should reward spinoff entity managers based on revenue and growth rather than bottom line profit, which is a short-term incentive base.¹⁸³ This will reward product development and not penalise managers for high development costs that are necessary to build disruptive innovations. Hence, firms can incentivise spinoff entity managers to develop disruptive innovations by modifying their incentive plans to reward long-term growth and use a spinoff entity to successfully overcome the innovator's dilemma.

Ultimately, adopting AFAs will introduce a plethora of ethical and managerial challenges for firms. However, AFAs' promise of profitability and long-term survival make this struggle worthwhile. This section has demonstrated that firms must understand legal ethics regulations when designing AFAs and the innovator's dilemma when implementing them. Whilst firms must take radical steps when facing these challenges, they are surmountable and can be overcome through designing and delivering AFAs carefully.

VII Conclusion

In conclusion, Traditionalists' unwavering acceptance of the billable hour is unviable and they will be marginalised by firms who better satisfy client demand with AFAs. This article has explained why firms must adopt AFAs to survive in the technological age and identified practical considerations associated with this transition. It firstly discussed the characteristics of client demand and how it can be satisfied with AFAs. It then demonstrated the opportunity AFAs present for firms to enhance their profitability and the consequences of ignoring AFAs on firms' market share as technology increases buyer power. Finally, it discussed the legal and managerial challenges which many firms must overcome when implementing AFAs. This article's reform-oriented approach has attempted to advance existing literature by

¹⁸⁰ Ibid 77.

¹⁸¹ Kim Langfield-Smith et al, *Management Accounting: Information for Creating and Managing Value* (McGraw-Hill Education, 7th ed, 2015) 533.

¹⁸² Jeff Coates, Ted Davis and Ray Stacey, 'Performance Measurement Systems, Incentive Reward Schemes and Short-Termism in Multinational Companies: A Note' (1995) 6(2) *Management Accounting Research* 125, 128.

¹⁸³ Ibid 130.

explaining why firms should adopt AFAs, using industry reports of client demand, and how they can implement AFAs smoothly, based on legal ethics and managerial theories. Whilst this article has identified why firms must adopt AFAs, this is merely one element of the Traditionalist model which requires reevaluation. Therefore, it requests additional contributors to undertake further research into other hallmarks of traditional law firms so commercial awareness always prevails over tradition in the industry-wide discussion about how firms should deliver legal services.¹⁸⁴ Ultimately, this article has argued the billable hour must give way to AFAs for firms to satisfy increasingly powerful clients, regardless of the ethical and managerial challenges they will encounter on this journey. Without making this transition, firms will struggle to optimise their profitability and survive in the increasingly competitive legal services market.

¹⁸⁴ Andrew Sanders, 'Poor Thinking, Poor Outcome? The Future of the Law Degree after Legal Education and Training Review and the Case for Socio-Legalism' in Hilary Sommerlad et al (eds), *The Futures of Legal Education and the Legal Profession* (Bloomsburg Publishing, 2015) 139, 141 citing Rebecca Huxley-Binns, 'What is the "Q" for?' (2011) 45(3) *Law Teacher* 341, 350-1.