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Can Alternative Fee Arrangements Work for Construction Defect Claims?

I. AFA VARIATIONS & TYPES

There are various AFAs that are being used. The following provides types, descriptions and related legal, ethical and economic issues. Selection of the most efficient and appropriate model depends on the carrier "book" type.

In construction defect matters, carrier books typically fall into the following categories:

- General contractors/ developers only
- Subcontractors only
- OCIPs/CCIPs
- Specific account/custom program
- Book of business

The insurer's "book" category typically affects AFA methodology selection. The most common models are identified below.

A. Capped Fees

Description

Client will pay an hourly fee for the case until the hours collectively reach an agreed upon amount, which then serves as the fixed fee for the entire case, regardless of the number of hours actually worked. Under this arrangement, the client and the law firm agree that the fees to perform specific work will not exceed a certain dollar figure. The law firm may charge its standard hourly rates; however, beyond a certain maximum limit, the client will not pay more money. In summary, this is really just hourly billing with a hard limit.

Example

Client retains law firm for a litigation matter. Law firm is compensated on an hourly rate fee basis but agrees that its fee for the initial investigation will not exceed $50,000. Thereafter, client and law agree to additional "not-to-exceed" fees for each of the subsequent phases of litigation.

Advantages

Client is able to predict maximum costs and shift some financial risk to the law firm. There is no financial advantage to the law firm. It can be a useful alternative to develop clients who must budget their legal engagements. It can reward law firms that know how to leverage their efficiencies and expertise by charging lower fees to clients and potentially gaining a greater client base relative to the competition.

Disadvantages

If the cap is set too low, the law firm has no financial incentive to devote additional time or increased work quality to assure the best outcome to the client. The client must rely upon the law firm's ethical and professional liability obligations to zealously represent the client regardless of profitability. Unforeseen circumstances can lead to conflict with the law firm if additional or higher cost staffing is needed to meet the client's objectives. Any law firm must fully understand the costs of performing the work or risk losing money on the engagement if the work required exceeds the basis for the capped amount. If the law firm misjudges costs or if unforeseen circumstances occur, there is no safety valve provision that allows for renegotiation and revision.

Ethical issues

Although it can be argued that properly negotiated fixed fees or flat rates are per se reasonable, their application can become unreasonable when the amount of the fee is not commensurate with the degree of effort required to do the work. Potentially, some fixed fees can be unreasonable when they seem too high considering the time and labor required, the novelty and difficulty of the questions involved, and the skill requisite to perform the legal service properly. This billing method also carries with it a moral hazard when the fees negotiated are too low: setting up a potential conflict with a lawyer's duty of competent and zealous representation of the client. If the volume of work is guaranteed than the law firm's concern with occasional shortfalls will be eased.

Considerations

Capped fee alternative billing arrangements are best situated for routine or frequent, high volume, commodity work where costs are easy to predict, and surprises are rare. This billing arrangement can be combined with performance bonuses or rewards based on achieving shared objectives (e.g. reducing overall costs, improving cycle time, early resolution, high damages award, etc.). Performance bonuses or awards can help align interests and minimize the disadvantages inherent in this billing method. Ideally, for the protection of both law firm and client, such alternative fee agreements should include provisions for safety valves or reopeners that allow both client and law firm to revisit and revise the agreement should unforeseen circumstances occur.

B. Fixed Fee Per Case

Description

In a flat fee per case arrangement, the parties agree to a set fee that will cover the entire matter from the start to completion. The agreement will cover all work done by the law firm, exclusive of costs, for the client on that matter. Traditionally, this type of arrangement has been utilized for transactional work but has become more common in certain types of litigation.

Example

The client and law firm agree upon a one-time fee for a particular service. In this case it would be a set price for the handling of the case from beginning until disposition. Although the fee may be fixed, the client and law firm must still collaborate on the strategy for handling the matter.

Advantages

The agreement is not based upon hours worked, so that it eliminates the billable hour concern. A client is charged a definite amount per case, so that it knows its legal expense and can budget accordingly. Under this agreement, the client has at its disposal, the resources of the law firm without being

concerned about the individual lawyer's hourly rate. Whether the client consults with a senior partner or junior associate, the cost is the same fixed fee for the case.

For the law firm, it is not subject to billing issues. The agreement is more advantageous with a large volume of cases. Knowing that it will receive a known quantity of matters, the law firm can set a fee that will enable it to achieve an overall profit. Thus, it is less concerned with those cases in which the law firm's time exceeds the flat fee. The law firm also has the freedom to assign the appropriate level attorney to maximize its ability to make the arrangement beneficial. This type of arrangement works particularly well with routine litigation where the format for the litigation is similar.

Disadvantages

From the client's perspective, particularly in the insurer-insured relationship, the greatest fear is that the agreement will provide a disincentive to the law firm's duty to zealously defend a particular client. Consequently, the insurer or the client might not receive the equivalent service it might have received had the insurer or client been paying by the hour. Furthermore, the law firm, although diligent, might be tempted to pursue the path of least resistance, to avoid incurring additional expense and not maximizing the positive return on the case.

Without volume, this arrangement probably is one that is very unattractive. Unless the case is one in which the law firm has a wealth of experience, the appropriate pricing on a one time or infrequent referral may be very difficult to achieve. While the client may be protected from cost overruns, the law firm is not. Should the matter become much more complex than originally anticipated by the parties, the law firm is locked into a fixed fee, which will not be a "fair" return for the law firm's efforts.

Ethical Issues

A lawyer is ethically obligated to zealously defend his client. However, this fee arrangement may prove to be a disincentive to the lawyer to meet that obligation. Another issue may arise, if the written agreement does not specify that the services to be rendered are in exchange for a non-refundable fee. Should a dispute develop between the client and law firm, the client may seek a refund of fees paid, in some states, even if the agreement clearly states that it is non-refundable.

Considerations

This arrangement can achieve the client's goal of receiving value for services and the law firm's goal of a "fair" return for its work. However, it cannot be achieved without an agreement specifying the scope of the work and constant communication between the client and law firm to manage expectations. It probably works best for routine, high volume, predictable cases in which the client and law firm can develop standardized formats. For example, it could work for arbitration level cases or other cases where the exposure is capped by known jurisdictional limits.

C. Incentive Billing Model (E.G. ACES®)

Description

Under the Incentive Billing Model, a law firm is paid a fixed fee plus bonus payment for obtaining predetermined result. Using this model, the law firm receives anywhere from zero to three times the withheld amount based on pre-defined success. Upon retention, the law firm and the client would have to agree on what would be considered a favorable outcome. This does not necessarily mean an early dismissal of the matter or a defense verdict, it could mean an early settlement or even verdict below a certain level, depending on the client's interests. The amount of the incentives is pre-determined by the

law firm and the client. To further encourage optimal effort, the client could offer the law firm a bonus inversely proportionate to the client's loss experience, the smaller the client's payout on judgments and settlements, the larger the bonus to the law firm.

Example

Client and law firm determine what would be a successful outcome in a certain matter. The law firm sends the client its customary invoice and the client pays 80% of the incurred fees. If the law firm is able to resolve the matter within the parameters set by the client at the onset of the litigation, the law firm receives the held back 20%, plus an additional 10% or more as an incentive for having resolved the matter successfully. If, for example, the most favorable outcome possible were an early dismissal, but instead the case is won by motion for summary judgment, the law firm would not be paid the highest bonus possible but would be paid a bonus in between the maximum and the minimum.

Advantages

The bonus structure based on a pre-determined, agreed-upon measurement of success still allows law firms to be profitable while allowing the client the ability to have an accurate estimation of its legal expenses.

Disadvantages

Law firms run the risk of earning less than 100% of its fees if it is unable to reach the pre-determined outcome for the client. In some cases, the incentive may be based upon a subjective finding by the client, which presents the scenario in which the client has its own financial incentive that is at odds with the law firm.

Ethical Issues

Although combining flat fee with incentives protects both parties, the potential application can become unreasonable if both parties fail to come to a meeting of the minds at the beginning of the litigation regarding what a successful outcome would be. This model also has the potential hazard that in many cases "success" would depend on a subjective finding by the client, which otherwise has incentive to not reward the law firm. Conflicts of interest can certainly exist in the tripartite relationship where the insured disagrees with the insurer on the result accomplished, or the law firm may disagree with one or both.

Considerations

Under this method, the law firm has some stake in the game and has greater incentive to achieve the agreed upon goals. It rewards the law firm for meeting the client's expectations but is not excessively punitive if those expectations cannot be met every time. It is important that a strong trust relationship between law firm and client exist, so that the law firms can be certain that success will be properly rewarded.

D. Cost-Shifting Model

Description

Under the Cost-Shifting method, the client and the law firm calculate the average cost of a specific type of case or an entire book, including, but not limited to law firms' fees; expert and court costs; and other litigation costs. From this calculation, the client and the law firm agree upon a set amount of funds that the law firm must use to cover all expenses associated with the matter or an entire case or book.

Example: Single Case

A client retains a law firm for a litigation matter. Upon retention, the client pays a single fee (for example $25,000) which the law firm will use cover the entire litigation. If the total costs associated with the lawsuit, including any settlement or verdict, exceed $25,000, the additional costs will be borne by the law firm. Any money amount under the $25,000 is retained by the law firm.

Example: Entire Book

A carrier requests that a law firm consider bidding on defending an entire book. The law firm analyzes claims and actuarial data to assess past and estimate future claims and related costs. The firm the "bids" on the book. Payments are made quarterly to ensure cash flow.

Advantages

Clients who want cost certainty and who favor an effort to promote more efficient handling of cases are likely to favor a cost-shifting alternative fee arrangement. Under this arrangement, the client is able to maintain a fixed budget for legal fees and shift the risk of an incorrect estimate of costs from the client to the lawyer. It provides a monetary incentive for the law firm to become efficient where reward can be achieved if the law firm can use their resources efficiently.

Disadvantages

The law firm must have a clear understanding of not only the costs associated with performing the work, but also the potential outcome via a settlement or a verdict. More often than not, law firms and clients do not possess the adequate records in order to make an accurate determination of the cost of litigation. This may result in the client either paying the law firm too much or too little. This alternative fee arrangement does not take into consideration the outlier verdict or the irrational plaintiffs; ultimately it could result in the law firm taking a (perhaps severe) financial loss which can cause the matter or an entire book to be abandoned.

Ethical Issues

This fee arrangement may violate the ethics rules relating to the obligation of the client to assume ultimate responsibility for litigation exposure and costs. Under this arrangement the law firm and not the client could be ultimately liable for the expenses. Thus, it would be a violation of Model Rule 1.8(e)(1) and the corresponding state rules, which are generally identical to the Model Rules on this issue, because the client, who bargained for a fixed fee, was not "ultimately liable for (its) expenses."

Considerations

This arrangement has a number of practical and ethical drawbacks that should cause the practitioner to pause before entering into any such agreement. Ultimately, the law firm cannot assure that it will be profitable, and indeed the risk that the law firm will ultimately lose money may color all the decisions from the inception of the case.

E. Hybrid: Hourly/Contingent Model

Description

A hybrid fee structure is an agreement where a portion of the client's legal fees are paid based on an agreed upon contingent fee, and the remainder of the legal fee is paid at a reduced hourly rate. The most popular is the "flat fee plus hourly rate approach" where the law firm offers some form of discounted billing rate with the opportunity for a bonus if it obtains a successful outcome.

Example
Law firm and client negotiated a discounted hourly rate with a "win" contingency which provided for a bonus in the event of a favorable outcome.

Advantages
Hybrid fees allow the client and the law firm to have a better estimate of the potential cost of litigation, with a defined success point for the matter handled.

Disadvantages
This method requires careful analysis of the length and complexity of the case. More often than not, law firms and clients do not possess the adequate records in order to make an accurate determination of the cost of the particular piece of litigation. This may result in the client either paying the law firm too much or too little, with consequent erosion of the relationship.

Ethical Issues
If the flat or fixed fee is exhausted before the conclusion of the matter, then a potential conflict exists between the lawyer's duty to zealously represent the client and the negotiated fee agreement. The law firm must ensure that the scope and quality of the defense is not compromised by the fee arrangement, even if the client (the insured) questions it in hindsight.

Considerations
The hybrid nature of this approach makes it more adaptable to different kinds of cases. Law firms can choose how, if at all, to pair up different methods to suit a particular matter, or genre of file assignment.

II. FACTORS TO CONSIDER WHEN ENTERING INTO AN ALTERNATIVE FEE AGREEMENT

A. Introduction

Numerous types of alternative fee agreements exist. In this presentation, we will identify popular ones, at least being discussed. Each agreement has its advantages and disadvantages. Even the traditional hourly fee arrangement has some potential pitfalls. The bottom line is that each client[1] and law firm can utilize one, some all or none of the alternative fee agreements analyzed in this paper. Whichever fee agreement is chosen the client and law firm must consider the following to make that relationship successful.

An AFA arrangement realigns the risks associated with the number of hours to be worked on a matter to the law firm. These risks may manifest in three settings. First, is the risk of inefficiency, which is largely (but not entirely) within the control of the law firm. A flat fee agreement provides financial incentive to law firms to increase efficiency. Second, is the risk of unexpected litigation. Defense litigation is reactive. The defense lawyer cannot control the work necessitated by court rulings, unexpected events, or adverse party strategies. Traditional logic requires the party who benefits from the defense to pay for the time spent reacting to unexpected events. Flat fee agreements shift this risk to law firms. The third risk is protracted litigation. The threat of expensive litigation sometimes provides incentive to cut the process short through settlement. Flat fee contracts significantly reduce this incentive to the defending carrier, whose fee obligation may not increase if the case does not settle. Indeed, the carrier's incentive may reverse. Having already paid up front, the carrier may decide to maximize its investment in fees by

[1] Depending on the jurisdiction, insurers typically retain counsel to represent the insured. "Client" in this section refers to the entity retaining counsel.

pursuing prolonged litigation in an effort to reduce the indemnity payment. The party with control of the indemnity purse strings also controls the duration of litigation. Traditional logic requires the party with this power to assume the costs associated with exercising that power.

Thus, while flat fees promote law firm inefficiency, they also allow carriers, adverse parties, judges and unforeseen events to cause lawyers to do extra work with no corresponding increase in fees. This translates into the unilateral power to cause law firms to lose money on flat fee files. Therefore, for a flat fee arrangement to appeal to law firms and to succeed, these risks must somehow be managed.

B. Communication

The success of these arrangements requires realistic expectations. A client must be willing to communicate its goals to the law firm. The law firm must be willing to express its concerns and how it will handle the matters under the negotiated fee agreement. Both the client and law firm must communicate their concerns in a forthright manner at the outset, to be able to properly manage the expectations.

Communication does not stop once the agreement has been negotiated. The client and the law firm must be willing to share data, on a regular basis, so that client and law firm are aware of the potential outcomes. This awareness will allow them to address, if desired, any perceived shortcomings in the relationship.

C. Anticipate that the Unanticipated Will Ultimately Occur

In many of the alternative fee agreements, mention is made of "safety valves" or "opt outs." These provisions try to address the notion that, especially in litigation, all factors cannot be anticipated. For example, the client and the law firm might not have foreseen that additional parties would be joined, new developments radically change the risk assessment, new counsel has been retained and the case takes off on a different tangent, the case is consolidated with another case, etc.

An unanticipated development could alter the foundation of the client - law firm relationship. For example, an alternative fee agreement could be conceived, upon a certain volume of work and for whatever reason the volume of work decreases or increases. The unanticipated development can upset the carefully negotiated balance between the client and the law firm.

Regardless of the reasons, the parties to the alternative fee agreement must strongly consider structuring a safety valve or opt out clause to allow the client and the law firm to create an acceptable option for the unanticipated. Quarterly or semiannual meetings between the client and the law firm can aid in addressing the unexpected.

D. Always be Cognizant of the Tri-Partite Relationship

Although the insurer may be "footing the bill," it is the insured's interests that are paramount. Full disclosure to the insured of an alternative fee agreement should be the policy of the client and the law firm. A thorough discussion with the insured of the nuances of any alternative fee agreement is imperative. This discussion will make certain that the insured's interests are not being compromised and that the lawyer can fulfill his or her duty to zealously defend the client.

E. One Size Does Not Fit All

From the variety of alternative fee agreements that we have discussed, it is clear that the clients and law firms must decide which one best fits the case or legal matter. Depending upon the nature of the cases a certain alternative fee agreement may apply for some or all of them or the client and law firm might have to devise several different types of alternative fee agreements. The client and law firm should carefully consider all of the factors before finalizing the alternative fee agreement remembering that what works for a particular case might not work for another type of case.

F. Analyze and Share Your Data

Before entering into an alternative fee agreement, the client and law firm must analyze their data to assess their needs and exposure. With today's technology clients and law firms have at their disposal the ability to assess risk and budget accordingly. Based upon the data, a client can demonstrate the value of a particular type of case in a certain jurisdiction and the range of fees it expects to pay for that result. The law firm must also analyze its data to evaluate whether it can manage a case profitably under an alternative fee agreement.

Of equal importance is the willingness of the client and law firm to share the data. This willingness must exist throughout the relationship, not just when the alternative fee agreement is initially structured.

G. Partners

One of the reasons for the development of alternative fee agreements is a level of mistrust on the part of the clients. They perceived that under the bill by the hour system, that they were not receiving the true value of the services for which they were paying. The clients believed that legal costs were escalating, not out of necessity, but because law firms were operating inefficiently. Without a true partnership, an alternative fee agreement will not achieve the client's goal. The client - law firm relationship must be based upon communication, sharing of information, flexibility to address ongoing issues, and a shared vision. Simply put, trust is a cornerstone of the partnership. Otherwise the inefficiencies that clients believe exist in the current hourly billing system will almost certainly enter into alternative fee agreements. Furthermore, the alternative fee agreements may come under increasing attack as violating a law firm's ethical obligations.

H. Alternative Fee Agreement Must Be In Writing

Any alternative fee agreement must be in writing. The document must cover the objective criteria, such as the refundable or nonrefundable nature of the retainer but also, as much as possible, limit the subjective components of the agreement. Managing the client's and law firm's expectations is critical and that must be captured in the alternative fee agreement.

I. Check Your Jurisdiction

Certain types of alternative fee agreements have raised ethical or other concerns in various jurisdictions. In fact, some type of alternative fee agreements may not even be allowed. Before entering into an alternative fee agreement, confirm that your jurisdiction allows the type of alternative fee agreement that you are proposing with your client. (See discussion below.)

III. AFA: ETHICAL ISSUES & OBLIGATIONS

A. Introduction

Whatever the agreement, a lawyer's ethical obligation to his or her client cannot be compromised. The alternative fee agreement cannot prohibit a lawyer from zealously defending the client.

Most importantly, the lawyer, must not use the alternative fee agreement as a "crutch" to avoid fulfilling his or her ethical duty simply because he or she might not be fully compensated for every hour spent representing the client.

B. ABA: Rule 1.5: Fees

The American Bar Association which creates model rules for most states and national standards has Rule 1.5, which defines the client-lawyer relationship, establishing an ethical framework for AFA's:

C. National AFA Perspective & Extremes

1. States where insurance companies can pay fixed fees to counsel appearing in defense of insureds:

Arizona (Rules of Professional Conduct 1.5 Comment 7 Disclosure of Refund rights for Certain Prepaid Fees (client is entitled to a refund of an advance fee payment even though it has been denominated "nonrefundable" or of similar terms that would imply the client is not entitled to a refund))

Colorado (CBA Ethics Opinion 43 (December 13 1969)(a lawyer retained by a liability insurance carried to defend a claim against the company's insured must represent the insured with undivided fidelity- retention does not create an attorney-client relationship between the lawyer and the carrier); *See also Farmers Group Inc. v. Trimble,* , 691 P.2d 1138, 1141 (Colo. 1984)(Insurer has the right to control the defense of actions brought against insured))

Florida (Florida bar Ethics opinion 98-2 (1998) (an attorney may accept a set fee per case form an insurance company to defend all the insurer's third-party insurance defense work unless the attorney concludes that her independent professional judgement will be affected by the arrangement))

Missouri (Mo. Rev. Stat. Section 484.020 and Mo. Rev Stat 484.919(2); *In re Allstate Insurance Company* 722 SW 2d 947 (Mo Banc 1987) (held that an insurance corporation does not engage in the unauthorized practice of law when its attorney employees prepare pleadings and appear in court in defense of insureds.))

Nevada (Rules of Professional Conduct 1.8 Conflicts of Interest)

New Hampshire (Rules of Professional Conduct 1.8 Conflict of Interest; *But see NH Bar Association Ethics Committee Formal Opinion 1990-91/5, Jan 28* and *7C Appleman, Insurance Law and Practice,* Section 4687 at page 194 (1979)(Requires the fee agreement be disclosed to the client/insured if there is a material possibility the fixed fee may have a financial impact to the insured))

New York (Professional Rules of Conduct Rule 1.6(upon termination of representation, a lawyer shall promptly refund any part of a fee paid in advance that has not been earned.) *Cf Agusta &Ross v. Trancamp Contracting Corp,* 139 Misc 2d 781, 785 (NY Civ Ct 2002)(retainer fees that are meant to retain the lawyer and not for legal services are always earned as long as it is explained to the client); *Rimar v. Continental Casualty Co.* 50 A.D. 2d 169 (1975)- Insured has a right to choose their own counsel and insurer must pay for it whether a fixed fee or hourly, so long as it is reasonable.)

Ohio (Ohio CPR Opinion 97-7 (1997) (fixed fees are allowed if amount is reasonable and adequate compensation so as to insure competent, zealous, and diligent advocacy); Rules of Professional Conduct 1.5 fees and expenses Comment 6A Retainer (attorney must disclose to client that fees denominated "nonrefundable," or similar language, may still be refundable upon early termination of the representation);*See also*, Rules of professional conduct 1.7 Conflicts of interest current clients comment 23- interest of person paying for lawyers service (there is a special notice requirement for clients of insurance defense counsel in Rule 1.8(f)(4), and the arrangement does not compromise the lawyer's duty of loyalty of independent judgement))

Oregon (OSB Formal Ethics Op No 2005-151; *In re Hodges* 313 OR 618,623 (1992)(nonrefundable fixed fee agreements must be stated in a "clear and specific" writing between the lawyer and client); RPC1.5(c)(3) (lawyers must include special explanatory language in any fee agreement which asserts that a fee is "nonrefundable" or "earned on receipt."); *In re Briggs* 318 OR 281 293 (1994))
South Carolina (SCBA Ethics Advisory opinion 16-06 (similar language to Ohio and Oregon where it must be reasonable and earned))
Texas (Rules of Professional Conduct Rule 1.04 Fees: Comment: Unconscionable fees (Texas frames the 'reasonableness" requirement in terms of unconscionability saying they should be made at arm's length and the lawyer should give an explanation of how a fee as calculated); *Burnett v. Sharp* 328 S.W. 3d 594; Tex. Civ. Prac. &Rem. Code Ann. Section 14.003(a)(2); Texas Disciplinary Rule of Professional Conduct 1.15(d))
Washington (Rules of Professional Conduct 1.5 Fees (f) (attorney is obligated to return unearned portion of fees))
West Virginia (*Aetna Casualty & Sur Co v. Pitrolo,* 176 W. Va. 190, 196 (holding similar language to Ohio, Oregon, and South Carolina, adding the insured can collect attorney's fees based on the fixed fee agreement if it is in their policy))

2. States where fixed fees are not allowed in insurance cases:

Kentucky (Kentucky Bar Association Rules of the Supreme Court of Kentucky SCR 3.130(1.5) Fees; American Insurance Association v. Kentucky Bar Association (KY 1996) 971 SW 2d 568 (salaried attorneys cannot defend claims against the insured. Court relied on precedent that stated a corporation cannot practice law.))
Massachusetts (McMurdo v. Getter, 10 NE 2d 139 (1937) (relied on a similar statute as Kentucky that corporation cannot practice law because a retained or flat fee attorney would have the "primary allegiance and obedience to [the] employer rather than to the clients); *See also Opinion of the Justices*, 289 Mass. 607, 614, 194 NE 313.)
North Carolina (Gardner v. North Carolina State Bar 341 SE 2d 517 (court held that counsel could represent nationwide but not their insureds) *See also* Ethics Opinion 682 (1969) and CPR 19 (1974))