

Word count:

For/Against

Are AFAs for You?

Two professionals outline the case for and against AFAs

By Thomas M. Clark and Kenneth P. Carter

The Pros of Using AFAs

First, and perhaps most importantly, alternative fee arrangements (AFAs) are not appropriate for every situation or case type. Factors that must be considered are the culture of the firm and the company, types of litigation involved, volume of litigation, and adequacy of data and information upon which to formulate the specifics of an AFA.

With most AFAs based on volume, there will be cases that will be a windfall for the company and others that will strongly benefit the firm. Through a sufficient volume of cases over time, however, if an agreement is structured and priced appropriately, a fair overall result should be realized by both parties. It is important to have a very clear understanding incorporated within the body of the AFA stating that after a specified period of time has passed, a review will be conducted by both parties to determine the fairness and accuracy of the original assumptions that formed the basis of the AFA pricing. The AFA must be fair to both sides to have a chance at long-term success.

It is true that most companies have an ongoing goal of reducing expenses and fees, but also without sacrificing the quality of legal services provided. I believe there is a significant misperception within the legal services industry that corporations are only interested in AFAs as a mechanism to reduce the costs of litigation. I cannot emphasize enough how inaccurate this assumption is.

The major benefits that can be realized from AFAs are:

- Create enhanced predictability in legal spend.
- Allow the budgeting process for individual cases to be more simple and reliable.
- Provide claims litigation adjusters with a tool to allow them to better understand the mechanics of the litigation process, and thereby allowing them to be a more integral partner with the firm.
- Reduce the average cycle time (age) of litigation resulting in potentially significant timesavings for attorneys and expense savings for companies.
- Enhance the working relationship with outside counsel by eliminating the number one source of friction — the billable hour. AFAs promote healthier professional relationships by allowing both sides to more casually interact without concern over billable time.

- Allow litigators to focus exclusively on the process and strategy of litigation and on what is really needed to successfully defend a case, without considerations associated with billing — requires attorneys to be more efficient and give advanced thought and consideration to planning the defense strategy for new cases which is beneficial to all parties.

Savings can be easily quantified with the right amount of data, both pre-AFA and post-AFA. I implemented a comprehensive AFA program at a national insurance company over a five year period with interesting, and occasionally unexpected results. Our quantifiable savings were delayed because the terms of the AFA were applied only to new cases. This was a lesson learned for the company, as the anticipated positive results did not manifest until approximately six to eight months after the AFAs were implemented.

At maximum implementation, the company was able to have approximately 60 percent of the entire caseload (9,000 new cases annually) handled under AFAs. The other 40 percent of cases were carved out as exceptions to the AFA terms for reasons determined on a case-by-case basis, which were agreed upon by both the claims handler and attorney at the onset of each case. It was also understood that occasionally a case would change during the course of litigation requiring a transition from a fixed “phased” litigation budget to straight time and expense billing. This ability to carve-out specific cases was essential to the success of the AFA program, and helped enhance the relationship between the firms and the company. This alleviated any concerns the attorneys may have had relating to their ability to adequately defend their primary clients on the right cases.

In the example cited above, the quantifiable benefits of the AFA program were significant reductions in total pending cases and also in the average age of cases. After approximately 3 years, pending cases were reduced by 15 percent, the average age of cases decreased by more than 4 months, and total legal expenses incurred by the company were reduced by nearly 13 percent. From the firm perspective, the results were also striking. Most firms received an increased number of cases, eliminated considerable back-office administrative time and effort associated with managing the time and expense billing process, experienced stronger relationships with their insurance company clients and realized additional time to spend with other clients and matters as a result of the increased efficiencies created by the AFA process.

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The Case Against AFAs

While I respect many law firms' willingness to recognize our needs for predictability and cost containment in the litigation process in formulating alternative fee arrangements, I prefer hourly billing for most insurance defense litigation for several reasons.

Hourly billing is more economically efficient.

What we are really concerned with is not simply lower litigation costs, but greater efficiency and value. In order to create an efficient market for legal services, homogenization of trading units, transparency and competition are necessary, if not sufficient, conditions.

In an AFA system, it is not always clear what precisely we are buying. Insurance defense matters are so varied in complexity that it is helpful to break down the cost into homogenized units, namely X-dollars for one hour of legal services. The hourly fee system allows buyers and sellers of legal services to more effectively manage their transactions.

Hourly fees permit better transparency in the true cost of legal services, which can be compared across law firms. AFAs do not always provide law firms the opportunity to be compared on equal terms.

These points ultimately lead to the same end. Hourly rates facilitate law firm competition for the limited demand for their services, and this competition governs price. Of course, law firms compete on effectiveness and expertise as well, but using transparent common units rather than a wide array of AFAs provides a starting point.

Loss adjustment expense management is primarily the insurer's responsibility.

Primary responsibility for managing claim efficiency rests with insurers. A buyer's-side approach to expense control is thwarted by both front-loaded and phased AFAs. Hourly billing allows us to capitalize on opportunities for cost containment on an individual case basis. Inherent in the AFA concept is the idea that we will over pay on some cases and under pay on others, but it will all work out in the end. Purposefully not trying to get it right on each individual case is unsettling.

Fundamental to insurance is the concept that higher risk management costs will be reflected in premiums. To the extent that prior risk-related expenses are predictive of future exposure, it is necessary to accurately allocate costs to individual policyholders. The hourly fee system precisely allocates legal expenses, helping underwriters to properly select and price risks.

Hourly billing facilitates rational case resolution decisions.

An hourly fee system can be better suited to sound decision analysis. For example, in the field of behavioral economics it has been observed that decision makers tend to

incorporate sunk costs into their decision analysis, even when these costs have no bearing on the future outcome of the matter at hand. This is an irrational, yet common, decision making behavior that may be exacerbated by front-loaded AFA systems.

AFA's cannot deliver the promised cost savings.

I am skeptical about AFAs delivering on their promised cost savings. Most AFAs have various exceptions built into their structure. There is a tendency for law firms to request exceptions to the flat fee agreement in those cases where the legal work effort is expected to be large. This is natural, but runs against the idea that each side will “win” in some cases, achieving mutual benefit in the aggregate.

I have observed a tendency toward more complex AFA proposals. Because neither side truly wants to recognize the concept of aggregate fairness, both sides incorporate terms into the AFA contract that will minimize their chance of “losing” in individual matters — defeating the purpose. Lawyers and insurance companies being what they are, AFA contracts tend toward more complexity, exceptions and rules, counterbalancing the potential for administrative streamlining.

It is folly to believe that billing arrangements alone can result in lower legal costs. Law firms are managed by intelligent businesspeople. They will not, in the long run, accept 10 to 20 percent less pay and provide the same quality legal services.

Hourly billing permits better metrics.

Metrics are an important component to managing claims operations. It is best to have a system that permits apples-to-apples comparisons of legal expenditures across law firms. Accurate analysis can only be done if you use common task and time measurement units. This is best accomplished with the hourly rate system.

The hourly system can mitigate some bad faith exposure inherent in the tripartite relationship.

It is a reality of our business that our conduct is subject to intense scrutiny in the form of bad faith litigation. We must guard against even the appearance that we have put our own financial interests ahead of our policyholders'. While AFAs can certainly be defended and are not *prima facie* ethically problematic, we still need to be aware that in bad faith litigation there might be some effort at painting a picture of a cut-rate, one-size-fits-all defense that sacrifices the defendant in favor of the insurer's bottom line.

This issue should be considered in choosing a legal fee structure. The hourly rate system largely avoids this problem as the law firm, frankly, is incentivized to over-litigate, thus ensuring a vigorous defense, while the carrier is partially incentivized toward resolution, thus mitigating trial risk to the insured. This is a different sort of argument against AFAs, not playing on cost efficiency. The hourly system can mitigate some bad faith exposure inherent in the tripartite relationship. For these reasons, I remain a proponent of the hourly fee based system for legal services in the insurance defense practice.

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Pull out

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