LEGAL FEES IN THE COVERAGE CASE: IDEAS FOR TODAY, REALITIES FOR TOMORROW

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I. <u>Introduction and Abstract.</u>

In an oft-quoted line from Shakespeare, Hamlet notes that some customs of his society were "more honor'd in the breach than in the observance."[2] Only a few years ago, a similar comment correctly could be made about the use of alternative legal fee arrangements in litigation. They were discussed much more than they were practiced. And it is fair to say that most law firms preferred it that way, and still do.

That is changing. The trend in litigation generally towards new fee structures that depart from the conventional hourly fee model is not dramatic or rapid. But it is underway, to be sure. And there are reasons to believe that alternative, and especially "incentive based" fee arrangements ("AFAs") may be particularly suited to many insurance coverage disputes and cases.

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[2] *Hamlet,* Act 1, Scene 4. Hamlet disapproved of the Danish aristocracy's tendency for drunken revelry. He thought it better to breach the custom than to participate in it.

This article examines the current state of play from the perspective of all four—yes, four—stakeholders in the insurance coverage legal fee equation: 1) policyholder counsel; 2) policyholder's in-house counsel; 3) insurer's coverage counsel; and 4) carrier claims leadership.

How closely aligned, or misaligned, are the interests of these stakeholders in fee management? Are there priorities that should be common to all of them such as speed and restored commercial relations? Can alternative fee structures assist in harmonizing those priorities? What does the future hold?

II. Current State of Play: In Litigation Generally, AFAs Are On the Rise.

The term "alternative fee arrangement" entered the parlance of the business of law more than twenty years ago. No one knows for sure, but it probably coincided with apprehension in some corporate legal departments about rapidly rising hourly rates in the 1980's. To many inside counsel leaders, hourly rate increases seemed to be whizzing by like mile markers. The breaking of some barriers—such as when young associates were first billed at, heaven forbid, $100 per hour—were especially sobering to legal departments. The revelation that a Midwestern law firm partner could command—you've got be kidding—$350 per hour was another wake-up call.

At first, most general counsel, and nearly all law firm decision-makers, hit the snooze button. The original template considered by those daring enough to look at alternatives was usually a straight contingency arrangement, often differing from those common in the personal injury plaintiff's bar only in that the client agreed to pick up the tab for disbursements. These were not inherently appealing to either client or firm. They seemed somehow to degrade the image of the corporate law firm, brought up on the perception that professionalism should not consider things like "winning and losing" in setting its fees.[3]

Still, with few exceptions, by the mid 1990's general practice law firms of all sizes had quietly experimented with contingency fees, at least sparingly. They tended to be used in "recovery" settings, for example in environmental cost contribution actions under CERCLA, or in simpler patent cases that could be litigated with just a few lawyers but with the prospect of substantial infringement damages. They were almost never used in the defense context. But the toe was in the water.

As hourly rates, and their companion nemesis, the starting salary for associates, continued to soar after 2000, the pressure for more serious consideration of AFAs

[3] In truth, this was not really the case. In an earlier era—namely all of the time until about 1970—corporate law firms billed for matters *not on any hourly rate basis* but instead on what the firm (usually speaking through a few senior partners) believed the services had been worth to the client and what the client would perceive as "fair". Often these judgments would take into account the outcome of a negotiation or suit, and even the present economic condition of the client. In other words, "value based" fees were the norm, until the rapid introduction of the hourly rate.

became undeniable. A few important purchasers of legal services, including DuPont and Pfizer, became vocal trailblazers. Others followed, though not quickly, or in numbers. No one urged extensive use of the pure contingency fee, and most were firmly against it. But divergent approaches to other alternatives began to emerge. A broad menu of options appeared. They had one thing in common: a diminution in the use of standard hourly rates to price a matter from start to finish.

In recent years, industry advisors on legal management and spending have been tracking the utilization of AFAs. Many surveys have been published. While not in complete agreement, they are nearly so. Broadly speaking, taking into account all of the various permutations that are "something other" than a pure hourly rate computation, the use of AFAs is expanding every year.[4] Interestingly, the studies show that clients are more interested in them than are law firms and that they are used most often when the client, not the law firm, suggests their use.[5]

The trend is not meteoric, but it is meaningful. Nearly all surveys show that over the past five years, companies and law firms report a consistent picture: a little more interest and use each year, with AFAs now accounting for nearly 15% of all large firm revenues nationally.[6] The AFA, especially "true" AFAs involving incentives and risk, is still the exception and not the rule. But most inside legal leaders believe it is here to stay, and will continue to grow in use.[7]

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[4] Many law firms internally consider in their management metrics that alternative fees are *any fees not billed at the published standard rate* for the lawyers involved. This will often lead such firms to conclude that 40% or more of their revenues are being derived from AFAs. It may be that such firms feel this measurement method is useful in presenting themselves to potential clients, because potential clients are often perceived as wanting law firms to be open-minded about AFAs. The author does not consider a discounted hourly rate, or even a "blended hourly" rate for a package of lawyers, to be a true AFA. A discount or blended rate is still an hourly rate in which the total fee is purely the computation of hours worked times the agreed (lower) rate.

[5] American Lawyer Media (ALM) reported in May 2013 that only 3% of law firms surveyed said that they initiated the majority of AFAs with their clients, even though fully half of the law firms said they now "embrace" AFAs in their business relationships. And more corporate law departments said they were satisfied or very satisfied with their AFA experience (83%) than did law firms (66%). See ALM press release, May 9, 2013: "ALM survey finds that corporate clients step up use of AFAs, but fewer law firms jumping on board the trend".

[6] Source: LexisNexis Redwood Analytics 2013, "Evaluating the Profitability of Alternative Fee Arrangements", by Daniel Ronesi. The LexisNexis study attributes this figure to the Citi 2011 Managing Partner Survey. According to Citi, AFAs as a percent of revenue in large firms have grown each year, from 7.6% in 2008 to 13.4% in 2012, the last year for which data is available. Norton Rose Fulbright's 9th Annual Litigation Trends Survey (2013) found that in its sample of U.S. and UK companies, the number of law departments using AFAs in litigation matters was about the same in 2012 as in 2010. But the percentages were substantial, exceeding 50% in each year. And the study infers that 87% of companies spent nearly 30% of all litigation dollars using AFAs.

[7] The author has worked with many large company general counsels. Nearly all believe that there will always be a place for the hourly rate, particularly on "short term" assignments, such as second opinions, immediate compliance advice, and some high-level c-suite counseling. And the AFA is

III. The Coverage Case and the AFA: Strange Bedfellows or a Marriage Made in Heaven?

The answer may depend on the stakeholder. The economic motivations of the players in the usual case are normally not equal.

For carriers, coverage litigation is a part of the normal course of business. It comes with the territory. Carrier relationships with coverage counsel are well developed, and special hourly rates have been accepted and/or imposed.

For policyholders, the same cannot normally be said. Coverage litigation, while much more common for most companies that litigation with other important vendors or customers, is still far from "business as usual". Coverage cases that are litigated are almost always seen as significant by the policyholder, even when viewed by the insurer as routine and unremarkable.

At the end of the day, whether an AFA is attractive in a coverage case usually will depend on:

1. The acceptability to the ***payors*** (the inside counsel decision-maker, the carrier claims leadership, or one of them) of paying incentives or bonuses in return for speed and outcome;

2. The appetite of the ***payees*** (policyholder counsel and insurer's counsel) for the risk of a lesser fee if the objectives of speed and outcome are not achieved in return for the reward of a larger than usual fee if they are; and

3. An honest and ***mutual*** understanding (resonably, but not exhaustively detailed) that neither client nor firm will suffer *badly* in the event of a poor outcome in the case, or if the litigation takes a wildly unpredictable course.

There are certain characteristics that make a legal matter more or less suitable to a fair and profitable AFA to both client and law firm. Your own experiences may

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perceived as unsuitable and unnecessary for some litigation, particularly matters that occur infrequently and are not severe in exposure, because such matters do not warrant the effort involved in devising a suitable alternative arrangement.

cause you to list additional traits, but these are the ones that my advising work has demonstrated to me:

Traits Favorable to an AFA

- Timing and speed of outcome are more important to the client that would usually be the case.

- The client's c-suite is engaged and interested in the matter. Normally (not always) this means that financial stakes are substantial for the client and there is less "fee sensitivity".

- The matter is particularly "binary" in character, having almost the feel of an appeal to be argued on the basis of a record; disputes of this kind are often decided on summary judgment and the risk of protracted litigation is diminished.

- *Truly needed* discovery is limited; or fairly predictable in volume; or can be provided by agreement.

- The matter is of a kind that presents high exposure to the client, but is of low frequency; or is of a kind that is of low exposure to the client, but is of high frequency.[8]

Traits Unfavorable to an AFA

- The client is unsure of what its position on the merits is or should be, because there is a great volume of data and evidence that has not been examined or understood—therefore, the client cannot (at least early in the matter) measure the value of the case, or the value to it of a particular outcome.

- The dispute has low exposure to the client <u>and</u> is seen as a "one-off" or infrequent event

[8] The reason a high exposure/low frequency case is attractive to the client for an AFA is that a large incentive for a good outcome can be justified. If such cases were frequent, large incentives would be prohibitive. The reason low exposure/high frequency cases are attractive to the client for an AFA is that case outcomes are predictable and more easily matched to reasonable incentives that reward counsel for disposing of such cases quickly, rather than allowing costs to outpace indemnity values. This last point, in the insurance coverage context, is much more pertinent to carrier appetite and interest than to the policyholder side.

- As opposed to presenting largely legal issues that could be decided on motions, the case is heavily fact-driven, and will likely require extensive fact and expert discovery.[9]

Obviously, policyholder payors will often have different priorities and will define success with different criteria than will the claims department payor on the other side of the dispute. It is a given that the policyholder, all other things being equal, has as a key priority the fullest possible recovery or determination of coverage. Conversely, the insurer has as key priorities the least payable claim amount, and narrowest coverage determination, all other things being equal. A point that cannot be overstated in assessing the appropriateness of an AFA for one or both sides is that *all other things may **not** be equal* in an important coverage dispute.

Consider the following hypothetical (a reasonable and, in the author's experience, commonly occurring one):

1. A CGL policyholder learns that it faces new CERCLA exposures and contribution claims for environmental clean-ups that far exceed its last-disclosed total for pending environmental liabilities. The difference is material from an accounting standpoint unless enough certainty can come into focus about how much of the new liability will be accepted as covered by the insurers. Of course, it would like to know that a very large percentage of the newly discovered costs will be paid by its insurers. But it would like even more to be able to quantify the known exposures soon, and at an amount that will not make investors skittish. Additionally, one or more of the contribution claims will be coming, or have already been filed, by major customers of the policyholder. It is commercially important to behave honorably toward them. It won't do to say to them, "[w]e'd like to pay, but our insurance company won't pay us."

2. The CGL insurers know that part of the costs will relate back to pre-pollution exclusion periods. And maybe it is the case that if the dispute goes to litigation it will be filed in a jurisdiction that has not yet adopted a position on the coverage trigger that is altogether hostile to the insurers. It would be nice to put that ruling off to a later day. Plus, one or more of the insurers whose policies are implicated would like to be selling a lot more insurance to this policyholder, which is a good risk overall. Yes, it would be satisfying to achieve an outcome where the

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[9] Factual complexity does not rule out a mutually beneficial AFA, however. The success of Bartlit Beck Herman Palenchar & Scott, the Chicago based trial firm that works almost exclusively on incentive-based AFAs shows that they can work in mega cases where facts and issues run deep and wide, so long as the talent is equally deep.

insurers pay next to nothing on the new environmental claims. But other motivators may be at play also.

In the above scenario, one or both sides might well find an AFA to be smart and profitable, and meeting the economic interests of both the payor and the law firm.[10]

For example, the policyholder and its counsel might agree to an AFA in which the policyholder decides what minimum dollar amount in assured future claim costs it can live with for purposes of its disclosure concerns. It agrees to pay a rational up-front or monthly fee to the firm to pursue a negotiated agreement with the insurers meeting that objective, or something close to it. This guaranteed fee is something of a "haircut", but nobody is going to the poorhouse on account of it. If counsel can achieve a deal that meets the minimum desire of the policyholder, it is paid a handsome incentive bonus, so long as it is achieved within 6 months, or some other agreed time frame. If it achieves a deal that exceeds the policyholder's minimum expectation, its incentive bonus is even better. If it is unsuccessful in getting any settlement acceptable to the policyholder, it receives no bonus. It also agrees, in that event, that if it is selected as counsel in litigation over the extent of the environmental coverage, it will do so with the resources selected by the policyholder either under a replacement AFA, or at a discount to its regular rate.

On the other side of the claim, the insurer might agree with its counsel that it will pay the rates it expects under its schedule with the firm, but will pay an incentive bonus amounting to a significant premium (say, 30%) if a settlement acceptable to the carrier can be negotiated within 6 months, or some other agreed period. Speed is being rewarded. It might also agree that if the amount of payable claims is capped by the settlement at X dollars or less (a figure deemed very favorable by the insurer), the incentive premium will be more than 30%. And, by the way, if the settlement also includes a commitment by the policyholder to purchase additional lines of insurance at market premiums at the next renewal date for such lines, counsel's incentive premium will be 50%.[11]

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[10] Of course, it is irrelevant to the appropriateness of an AFA whether one or both sides are using one.
[11] It is well accepted that AFAs do not run afoul of professional rules of conduct unless they are seriously unreasonable. Especially as between sophisticated parties, it seems hard to envision an AFA that would not pass ethical muster. But for a good discussion of ethical issues in AFAs, see *Ethical Issues and Alternative Fee Arrangements: What to Do and What Not to Do,* Richard B. Friedman and P. Michael Freed, NYSBA Journal, May 2012; and *Ethical Principles Applicable to Alternative Fee Arrangements and Related Areas,* Gregory R. Hanthorn, ABA Section of Litigation 2012 Annual Conference, April 18-20, 2012.

IX. Conclusion.

Some companies, and many law firms, remain guarded about the wisdom of AFAs. But the trend seems clear. Clients desire them in appropriate cases, and law firms can do very well under them, if the agreements and the cases in which they are used, are well analyzed. Insurance coverage disputes, often involving principally matters of contract interpretation capable of relatively speedy resolution, constitute opportunities for their positive use.

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