

Pay The Lawyers Only If The Deal Closes?

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Should lawyers be paid hourly or based on results? Both methods have drawbacks.

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When lawyers work on commercial real estate or other transactions, they typically charge for their time by the hour. If the transaction doesn't close, the bill is the same as if it did close. Clients who face those bills don't like them. These bills cause maximum pain if the transaction nearly closed and the lawyer kept working on it—running up time and legal fees—until the very end.

Might it make more sense to have the lawyers agree they'll get paid only if the deal closes? That would let a client avoid the risk of having to pay for a transaction that didn't happen. It could in theory, of course, give the lawyers an incentive to cut corners and overlook risks and legal deficiencies just to make sure there's a closing. On the other hand, hourly billing may give the lawyers other bad incentives, such as incentives to be inefficient, overcomplicate transactions, raise spurious issues, and not let those issues die. Any billing system creates its own incentives, both good and bad.

In one recent corporate transaction, a New York law firm agreed it would collect its legal fees at closing. The governing engagement letter didn't set a deadline for the closing. It also didn't say what would happen if the deal never closed at all.

Sure enough, the deal never closed. It died in such a way that it could never come back to life. In the course of doing that, it ran up several million dollars in legal fees. The firm sued to collect those unpaid millions. The client went back and looked at the engagement letter. It said legal fees were due at closing. Noting that no closing had ever occurred, the client refused to pay. The matter is now in litigation (New York State Supreme Court, New York County, Index No. 651428/2023).

From the client's perspective, that sort of arrangement makes a great deal of sense. If transactional legal work is supposed to deliver value in the form of a closed transaction, then the value isn't realized if the transaction doesn't close. The law firm shares the risk of time and effort wasted on activities that don't produce value.

Did the arrangement make sense from the law firm's perspective? If the firm billed at its regular rates but collected nothing if the deal didn't close, then the firm was effectively discounting its hourly fees to the extent of the likelihood that the deal ended up not closing. If the firm priced 10 comparable deals this way, and six of those eventually closed, then the firm would have effectively discounted its fees by up to 40% overall.

In response, the firm should demand a premium if it agrees to this sort of arrangement and a deal actually closes. For example, if the firm can reliably predict that six out of 10 similar deals will close, then to compensate for the four busted deals, the firm should charge a 66% premium on the six deals that do close.

Of course, it's impossible to predict the likelihood of closing for any particular deal, hence it's impossible to calculate what premium the lawyers should charge to compensate for the risk of not getting paid at all. So they'll probably overestimate the premium to compensate for the uncertainty. That dynamic, plus client resistance to paying a premium on legal bills that the client already regards as too high, may drive the attorney-client billing relationship back to the use of simple hourly fees with no contingency tied to whether the transaction closes.

In some contexts, though, it may still make sense to adjust legal fees based on whether a closing occurs. For example, if a law firm handles a steady diet of very similar transactions involving very similar counterparties and deal structures—such as a steady diet of mid-market acquisitions, loan closings, or leases—then the client and its counsel might very well agree to a discount for deals that don't close and premiums for deals that do.

The discount doesn't need to be 100%. The premium doesn't need to be so dramatic either. Such an arrangement would help ease the client's pain for deals that don't happen. And the law firm would share in the satisfaction of deals that do close.

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