HBR.ORG

Harvard Business Review

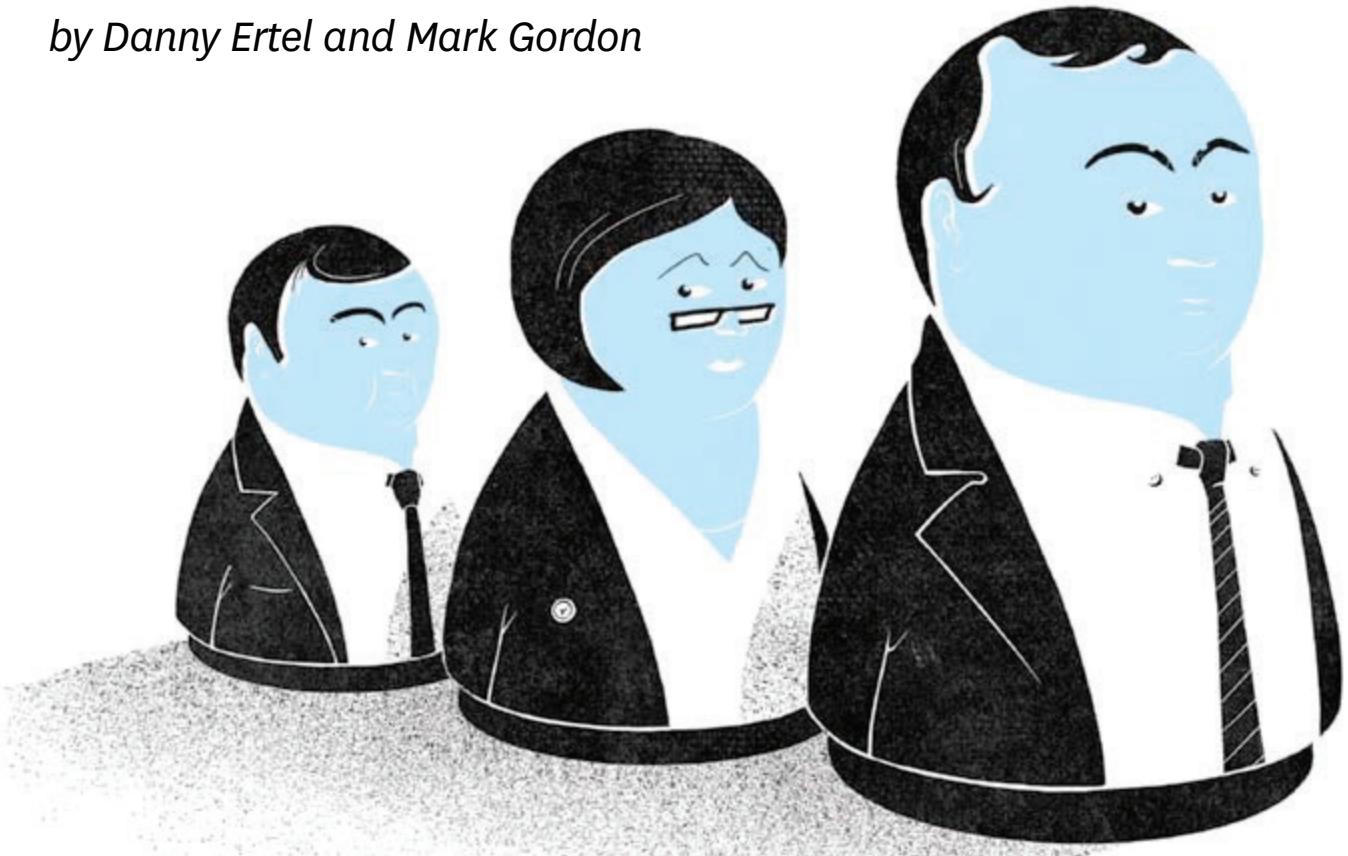
JULY–AUGUST 2012
REPRINT R1207M

Points of Law: Unbundling Corporate Legal Services to Unlock Value

by Danny Ertel and Mark Gordon

Points of Law: Unbundling Corporate Legal Services to Unlock Value

by Danny Ertel and Mark Gordon



Traditionally, big law firms and corporate legal departments have enjoyed a close relationship—one that is based on both trust and regulation. Clients rely on firms to discern legal boundaries and the risks associated with misjudging them; counsel are under a professional obligation to identify and raise potential problems and to handle them competently and thoroughly. Most corporate legal work is outsourced, because it's not cost-effective to employ enough in-house lawyers to meet companies' diverse needs. And work is allocated by in-house lawyers, most of whom started their careers and were trained at law firms.

That close relationship is being disrupted. Company executives are much less patient with the status quo than they used to be; there's a general sense that lawyers and their fees are out of control. It's not just the size of any particular bill that irks executives; it's that they feel they have little influence over what they spend and what they get for it—and that the accountability seems to be much less than what most other business services provide.

Executives now have a lot more choice about how to get their legal work done. They can use technology to support pretrial discovery and automate some basic tasks, bring in high-end temporary lawyers to manage major projects, and send routine processing work overseas. These and other dramatic changes are affecting the practice and business of law across the globe, but particularly in the United States and the UK, where most of the world's largest law firms are based.

It's our belief that corporate legal departments are in danger of missing an important opportunity. Far too many of them are looking for relatively small, short-term savings, and doing so in a way that could critically damage key relationships. Corporations should aim higher. This is a once-in-a-lifetime chance to do four significant things: (1) Assign legal work to the providers best suited to a particular task, rather than paying a premium for one-stop shopping; (2) lower legal costs without sacrificing quality; (3) create greater transparency and accountability; and (4) derive greater value from in-house counsel.

Let's look first at why corporate legal services have been relatively slow to embrace the disruptive change that's in the air.

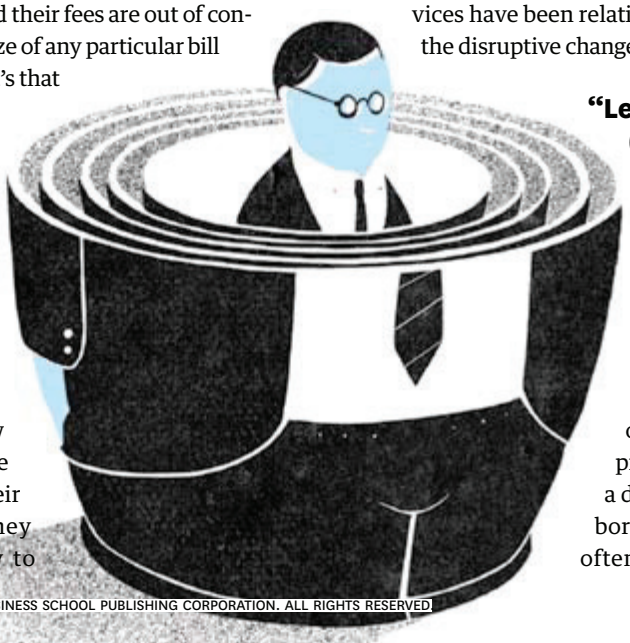


ILLUSTRATION: DANIEL STOLLE

"Legal Is Different" (But Is It Really?)

When your company or your division ends up in litigation, comes under investigation, becomes party to a complex transaction, or simply seeks to improve compliance with a dizzying array of cross-border regulations, you often need outside legal

assistance. At that point you tend to lose control over who is put on the assignment, how long it will take, and what the outcome and the ultimate cost will be. It would be difficult to argue that cost savings should be the top priority at "bet the company" moments, but most legal matters are more routine than that. And even large, complex issues can be divided into discrete tasks, many of which don't require senior-level attention. Think of document review for pretrial discovery, or due diligence for a major transaction: Both can be done more efficiently and just as effectively by other service providers. Why, then, have companies been slow to embrace change in those instances? Three factors seem to hold them back:

Sticky relationships. Companies develop enduring relationships with law firms on the basis of personal and institutional trust. As the general counsel of a *Fortune* 100 company noted in a moment of candor, "I've been here over 10 years. We were using Cravath when I got here; I'm sure we'll be using them after I leave. When it's a board-level matter, you don't want to take chances."

Professional responsibility. Many chief legal officers believe that their most important responsibility is to choose whom to trust to help the company manage various kinds of risk and exposure. The U.S. general counsel for a large global manufacturing company, for example, described his job as being "mostly about triage, constantly assessing situations and deciding whom I should ask to handle them, internally or externally." A chief counsel whose job is framed in this way is not likely to welcome a reverse auction or any other procurement process that focuses on short-term cost savings. Moreover, the rules of professional responsibility under which both in-house and outside counsel must operate place a significant burden on them to represent clients with zeal and to exercise due care when delegating any work. "We're not buying paper clips here" is a common response from the general counsel when procurement groups try to identify less expensive firms.

An adversarial system. The legal systems of the United States and the UK are founded on the premise that a contest between two parties will produce truth and other good things. In such a system, where everyone expects to see winners and losers, the latter can derive little comfort from saying, "Well, I didn't hire the best lawyers, but I did save some money."

What's Changing

At least temporarily, the bargaining power in the lawyer-client relationship has shifted in a way that can lead to a genuine realignment in legal services.

Supply and demand. During the recent downturn, large law firms experienced an unusual decline in both deal-making and litigation activities. In the past a decline in deals was often accompanied by an increase in litigation; until 2008, continual activity enabled the top 100 or so law firms to sustain revenue increases per lawyer and profits per partner over a 20-year period. The simultaneous decline in *both* big-ticket items created significant excess capacity, especially at firms with high associate-to-partner ratios. The resulting layoffs and postponement of starting dates for new hires quite publicly signaled which firms were experiencing a drop-off in work.

This excess capacity is interesting not only because it enhanced clients' bargaining power but also

Idea in Brief

The traditionally close relationship between corporate legal departments and big law firms is being disrupted.

Some of the work that was once assigned almost automatically to firm associates or partners can now be outsourced or automated. It's tempting for corporate executives to react to these new options by asking, "How can we maintain the same service levels at a lower cost?"

But that's the wrong way to frame the issue. Instead, executives should look for ways to:

- create new value by better managing risks and opportunities
- align incentives between the firm and in-house counsel
- allocate work to the best-positioned providers
- maintain strategic, high-trust relationships

because it heightened scrutiny of the billable-hour model. Within the bounds of professional responsibility, lawyers have significant discretion about how deeply to research a particular issue, how many times to rewrite a brief or a loan document, and under how many figurative rocks to look for potential problems with a deal. When a law firm is very busy, its lawyers have every incentive to spend only as much time as is strictly required on a particular matter. When the firm is not busy, and individuals are perhaps worried about whether they have enough billable hours to avoid the next round of layoffs, those incentives may work the other way.

Technology. Over the past 20 years or so, information technology created a problem for corporations by generating oceans of data that had to be collected, preserved, and reviewed in litigation. Failing to produce documents relevant to a lawsuit risked expensive sanctions as well as losses in court. To address that risk, law firms threw armies of young lawyers and paralegals at the problem—a highly profitable solution from their standpoint, but one that has become unsustainable for their clients. Fortunately, technology is also starting to provide solutions, enabling "smart searching" to shrink the stacks of documents that require human review and facilitating the outsourcing of this and other relatively low-value work.

In addition to giving clients more choice about how document searches will be done, the evolution of technology has provided them with greater leverage relative to outside counsel. Some companies have opted to bring technology in-house; others have unbundled certain tasks and negotiated deals with third-party vendors, with whom outside counsel are expected to collaborate.

New competitors, new business models. Over the past few years new types of legal-service providers have emerged. Sometimes these newcomers sell to law firms—providing technology services that enable the handling of large volumes of documents, for example, or providing personnel to help rapidly (but temporarily) expand for a big case. Sometimes they sell services directly to corporations. For example, Axiom provides experienced counsel on a dedicated but temporary basis. (See "The Rise of the Supertemp," HBR May 2012.) Legal-process outsourcing (LPO) providers, many of them overseas, now allow clients to acquire repetitive, lower-value services such as negotiating nondisclosure agreements or maintaining trademark registrations without incurring high fees.

As clients have started to think of legal services as part of a supply chain and to consider who can best carry out which tasks, they have gained some bargaining leverage. At a few companies, internal sourcing and procurement groups have helped negotiate various deals with law firms and other providers. This approach will probably accelerate as legal-services liberalization, which allows nonlawyers to invest in law firms and to provide some legal services, takes hold in the UK and possibly in the United States. More capital will flow into the legal industry, and new business models will emerge. Such innovation should further enhance clients' leverage, at least over the short term.

The downturn led to an unusual decline in both deal making and litigation, creating significant excess capacity at large law firms.

Warning: Wrong Turns Ahead

With excess capacity, technology, and new competitors all shifting power to corporations, it's not surprising that many of them have renegotiated terms with their law firms. In most cases, however, the firms' concessions have come in the form of discounted rates, which are by their nature limited and unsustainable.

Demanding discounts gets one only so far. A discount may ameliorate a couple of years' run-up in rates, but it doesn't change staffing models or technology use; it doesn't bring greater visibility of or control over litigation or deal-making costs; it doesn't require real change in law firms' business models. Furthermore, after a difficult negotiation, a firm's partners may be less inclined to write off some of their own team's inefficiencies than they might previously have been. The final bill, showing the discounted rate but a not-very-well-managed number of hours, may be higher than the client expected.

Haggling for a discount may also damage the relationship, as one side makes demands and the other resists as best it can. Often both sides bluff about their willingness to terminate the association. After such a negotiation, lawyer and client are less well positioned to work long hours together under pressure. If they ever have to negotiate again when the tables are turned—such as during a dawn raid or a huge lawsuit, or when the firm holds unique expertise—the client should expect to pay the piper for the "fun" of the first go-around. (And make no mistake: The tables will turn. Tens of thousands of legal-sector jobs were lost during the downturn, and law school enrollment has dropped for the second year in a row; excess capacity is becoming less of an issue. Indeed, many firms have already started raising their rates.)

Discounts may be the easiest thing to demand, but they are by no means the most valuable. And focusing on them makes it harder to have constructive conversations about efficiency, creativity, or responsiveness. To address the real pain points in how companies consume legal services today, law departments must move quickly past Procurement 101 to more-sophisticated strategies.

A Road Map Forward

We don't profess to have a "theory of everything" on this topic, but we know from our practice that some companies (and law firms) are trying out interesting new approaches and getting many things right. They're driving major savings and improvements in quality, transparency, predictability, and, ultimately, control. The following guidelines emerged from our study of what's working.

Start by thinking about more than expense reduction. It's perhaps not surprising that corporate attempts to improve the legal department's performance usually begin by focusing on how to maintain the same service level at a lower cost. We recommend framing the issue differently: How can the legal team create more value for the company?

Consider the by now well-documented efforts at DuPont over the past 20 years. Under significant

How to Talk About the Hard Stuff

Clients often find it difficult to challenge outside counsel on how a transaction or a dispute will be managed, while law firm partners may view such questions as an attack on their professionalism, competency, or ethics. Conversations about how many depositions to take, or how exhaustively to look for problems, are often abstract and theoretical.

Some of our clients have found a way to bring the conversation down to earth and draw on partners' specialized knowledge at the same time. Here's an example of how: Pretrial review of documents often constitutes 50% or more of the costs of litigation. Suppose that even after some early screening, 40 gigabytes of data (e-mails, spreadsheets, memos) or 2 million pages of documents need review. Start the discussion by asking outside counsel:

Under what circumstances might each of the following be the right choice?

Have the firm's associates review the documents at their usual rates

Use the firm's "staff attorneys" at a billing rate 50% that of associates

Bring in temp-agency attorneys and pass the costs along to the client as disbursement, at approximately 25% of the associate rate

Use an offshore legal-process outsourcer, at approximately 50% of the temp-agency rate

Rely entirely on software tools

Framing the conversation like this helps avoid arguments about whether contract paralegals or offshore legal-process outsourcing providers are "safe enough." Instead it gets everyone talking about what factors would make each choice best for the matter at hand.

pressure to control legal costs and risks because of an avalanche of mass tort cases in the 1990s, DuPont adopted a new model for partnering with law firms for mutual benefit. It started by changing the mix of work done by lawyers and paralegals, encouraging the reuse of standard materials, and consolidating work with a smaller set of law firms. More recently DuPont Legal has taken the model one step further, with what it calls the Recovery Initiative. DuPont Legal has determined that the company's day-to-day transactions present an opportunity to add tangible value. In partnership with business units and the finance function, it identifies ways to recover cash or other value from, for example, intellectual property violations, customer or supplier failure to live up to contractual obligations, and billing problems. Not only has DuPont dramatically reduced the cost of defending the corporation by working with outside counsel to reengineer its processes, but it documented more than $1 billion in gross recoveries during the first four years of the initiative.

Smaller legal departments are also starting to think about adding value rather than just reducing costs. Consider the asset management company legal department that was interested in getting closer to the business and more involved in deal making. Because of the high cost of engaging counsel to review lengthy documentation, the department typically did not begin due diligence until the relevant business unit had determined that it wanted to do a deal. At that point the lawyers' role was primarily to knock down barriers, not contribute to the strategic discussion. When it became clear that some of the due diligence could be done far less expensively by an LPO provider, the legal team was freed to work with the acquisition team *before* a deal had picked up much momentum. This earlier involvement affords the deal team the benefit of the legal department's perspective on the quality of the seller's title, licenses, easements, and permits, and the consequent legal and regulatory risks, before it sends a seller signals about what terms might be acceptable. Lowering the cost also enables the legal department to obtain more-thorough summaries of key documents, making them of correspondingly greater value for the postdeal management of assets acquired.

Align incentives between client and counsel. Attorney-client relationships, privileged in the law and idealized in fiction, are supposed to be built on a foundation of trust. Yet most rely on a zero-sum financial arrangement under which the longer one side works on a matter, the more the other has to pay. Recognizing this, many legal departments are exploring alternative fee arrangements that better align both sides' incentives. One interesting example is the pharmaceutical giant Pfizer, whose general counsel, Amy Schulman, in 2009 created the Pfizer Legal Alliance (PLA), a group of 19 law firms that have agreed to work for Pfizer under a flat-fee arrangement. These firms collectively handle nearly 75% of Pfizer's outside legal work.

Pfizer has done a lot more than impose a new billing arrangement, however. It is encouraging member firms to become more efficient by means of project management tools, a website for knowledge sharing, and the outsourcing of low-value tasks such as initial document reviews. In-house lawyers are changing how they consume legal services—particularly how they specify the deliverables they actually need. Because Pfizer wants to do away with hours as the relevant unit of measure, there is no annual reconciliation of hours with fees.

This approach does not work for everyone. Some of the larger firms have struggled to adapt to Pfizer's still quite unusual model, and two have left the alliance. Unless a firm values predictable annual income and can become more efficient in the delivery of services, it may have trouble making the numbers work. Conscious of the challenges—and committed to building long-term partnerships—Pfizer has invested significantly in governance for the PLA (for example, assigning relationship managers to facilitate communication and monitor work allocation, conducting "Smart PLA" workshops for lawyers across the alliance, and investing in the development of law firm associates). Strategic issues are addressed by a governing body made up of Pfizer senior lawyers and law firm partners. (Many of these practices mirror those of the R&D alliances and comarketing relationships that Pfizer and other pharmaceutical companies have managed for years.)

Pfizer does not disclose exact savings, which it refers to as "substantial." The company does disclose that its legal budget has declined each year, even as the level of activity has increased. But as Ellen Rosenthal, the chief counsel for the Pfizer Legal Alliance, notes, "We were looking for something much more valuable than discounts. Those would have been easy to get. We wanted lawyers to get closer to the business, to deliver more value. We're changing how we practice, and I'm convinced we're getting better lawyering."

How Cisco Decides Who Does What

Cisco's general counsel, Mark Chandler, sorts legal activities by looking at two factors: whether they will pose a high risk if performed poorly, and whether they will contribute to competitive advantage. (This approach is borrowed from Geoffrey Moore's *Dealing with Darwin*, 2005.)

	NOT TIED TO COMPETITIVE ADVANTAGE	TIED TO COMPETITIVE ADVANTAGE
HIGH RISK	**WORK CLOSELY WITH OUTSIDE FIRM** High-stakes litigation Reputation Compliance HR policy	**HANDLE INTERNALLY** Product design, build, and sell Intellectual property strategy
LOW RISK	**OUTSOURCE TO A VARIETY OF PROVIDERS** HR cases Smaller litigation Real estate	**MANAGE VIA SELF-SERVICE, AUTOMATION, OR OUTSOURCING** Routine transaction processing

NOTE ADAPTED FROM CISCO SYSTEMS INTERNAL DOCUMENT

Allocate work according to fitness for purpose. As various providers have come onto the scene to take advantage of what technology and the global talent pool have to offer, clients have begun to realize that some legal processes are divisible. Each component of a legal case or a transaction should be assigned to a provider whose business model and capabilities are best suited to that specific task. The benefits that can be achieved by leveraging specialization—including economies of scale, standardized processes and deliverables, knowledge management and reuse—can dwarf whatever savings might come from squeezing a bigger discount out of a law firm's hourly rate in exchange for greater volume.

Nearly 10 years ago Hogan Lovells, a leading UK law firm working in behalf of Prudential Property Investment Managers, pioneered a model whereby it would retain the complex part of corporate real estate transactions and outsource the routine work to less costly firms outside London. Some other firms, but surprisingly few, have recently created capabilities to handle routine work in lower-cost locations. And for litigation, it is not unusual today to find a law firm parceling out some pretrial discovery tasks to specialized providers.

So how far can legal services be mapped out, specific activities delineated and sequenced, and the work distributed among providers? We do not yet know the answer. LPO providers would say that many if not most legal services include some routine tasks that require only limited legal judgment. Many technology providers would add that some of those tasks can be almost wholly automated. In addition to pretrial discovery, where unbundling and reintegration is becoming routine, more and more firms and in-house counsel are exploring ways to outsource doing due diligence for acquisitions, drafting patent applications and managing IP portfolios, and negotiating limited changes to standardized but high-volume contracts such as simple license agreements.

Cisco's general counsel, Mark Chandler, has developed a framework to help him think about what traditional activities to eliminate, automate, outsource, or retain. (See the exhibit "How Cisco Decides Who Does What.")

Remember that you must eventually reintegrate what you unbundle. Any manager who has moved to a multivendor system of service delivery can tell you it is all too easy for important details to slip through the cracks and for providers to point the finger when problems occur. Fortunately, legal departments can learn from other corporate functions that have gone down this path.

In the early days of IT outsourcing, for example, the lead provider typically acted as the prime contractor—and charged more for taking on that work. Some customers, tired of paying for margin on top of margin, started contracting directly with each vendor, but they soon found that dealing with multiple independent contracts was a recipe for disaster. (In one common articulation of the problem, if you have 10 providers that each commit to 99% uptime and reliability, your network overall is likely to be down 10% of the time.) More recently, companies have started to use a "services integrator"—which can be one of the providers or a completely different entity.

Similar integration capabilities will be required for legal services; what remains to be seen is who is best equipped to provide them. Some legal departments have started to build those capabilities internally. Prudential Financial, NetApp, Oracle, Yahoo, Credit Suisse, and Morgan Stanley have created head of operations roles to bring greater process discipline to their legal departments.

Some law firms have also stepped up, recognizing that if they can integrate services for their clients, rather than resisting the inevitable move toward

"We were looking for something much more valuable than discounts. We wanted lawyers to get closer to the business."

unbundling, they can strengthen their institutional relationships. Orrick, Herrington & Sutcliffe, for example, rose to the challenge posed by Cisco's request for help managing routine compliance obligations and keeping track of the many filings, registrations, minute books, and so forth of more than 100 subsidiaries around the world. Orrick's solution was to identify and customize a new tool to manage the workflow and to put the multiple providers of inputs "on a diet" through more-efficient staffing, standard templates, and fixed fees. The firm delivered an immediate saving of 15% on outside counsel costs, reduced the complexity of managing local counsel around the world, enabled Cisco to reallocate in-house resources to higher-value activities, and committed to an overall goal of reducing costs by 20%. Cisco, in turn, has helped Orrick attract other clients to its Global Corporate Solutions practice.

And finally—don't forget your change-management skills. Lawyers are independent, highly trained professionals. Getting them to alter the way they approach the practice of law is difficult. In-house counsel must be persuaded to develop new relationships with lawyers at firms that have signed on to the company's new model. The merits of relying on LPO providers must be made clear to both corporate and firm lawyers. Alternative fee arrangements require adjustments to how legal services are consumed. (During the first year of its alliance program, Pfizer's in-house counsel had to learn to specify what deliverables they really needed from law firms and to avoid overconsuming flat-rate services.) And until lawyers begin to reuse knowledge instead of drafting unique solutions to every problem, firms' efforts to become more efficient will founder.

Visionary general counsel at DuPont, Pfizer, and Cisco have made a lot of progress on these fronts by transforming how their legal departments view their own role and how they work with outside counsel—which providers to use and what services to stop providing. But each of them will tell you that to lead this kind of change, the general counsel has to articulate the reasons for it, invest in processes and tools, provide training and coaching, and use both carrots and sticks to influence behavior. And each will acknowledge that this is a work in progress.

What you are not likely to hear, because it is not true, is that simply hammering on outside counsel to get discounts would have achieved anything like the value they have delivered.

HBR Reprint R1207M

Danny Ertel and **Mark Gordon** are founding partners of Vantage Partners, a global consulting firm specializing in helping organizations to negotiate and manage complex relationships.

"He is in, but according to security cameras he's shimmying down the drain pipe outside his office window."

CARTOON: P.C. VEY