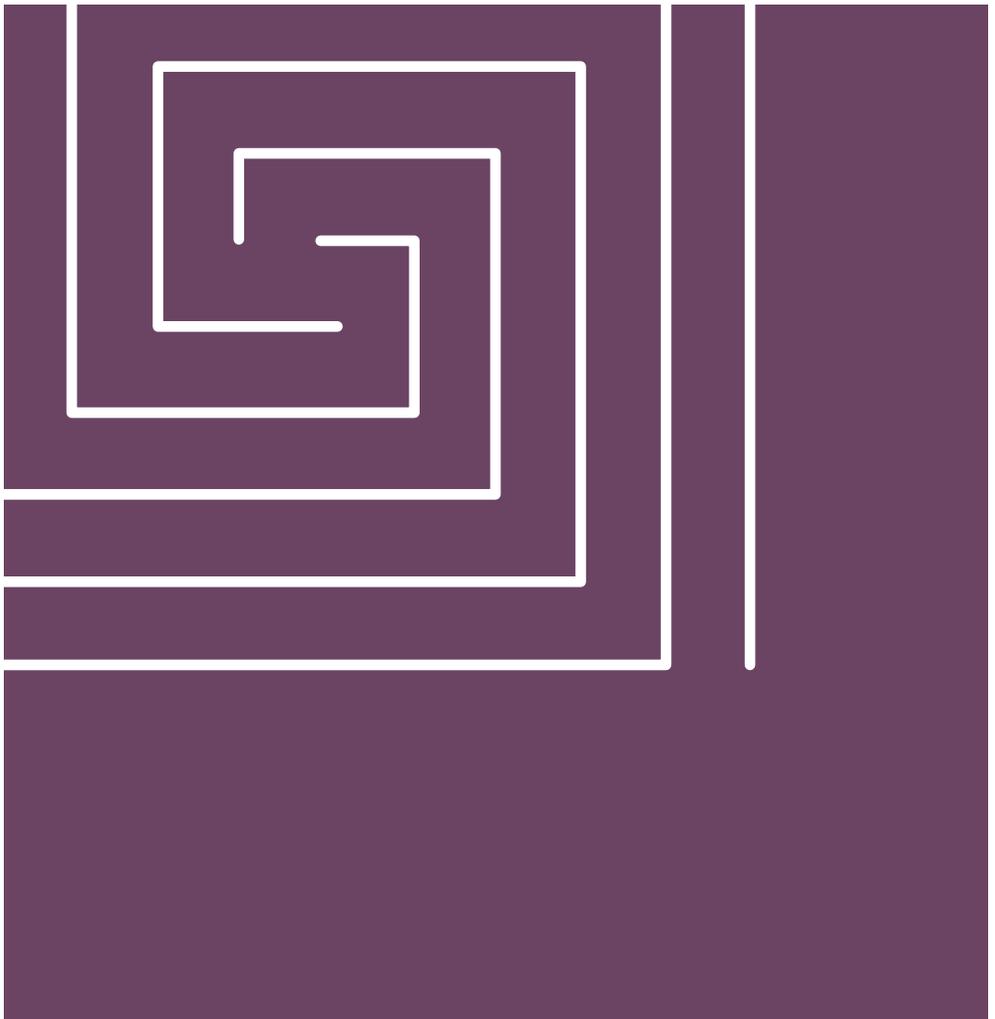




GENERAL COUNSEL WITH POWER? THE IMPLICATIONS FOR LEGAL PRACTICE, LAW FIRMS AND THE GLOBAL VALUE CHAIN IN LAW

NOVAK DRUCE CENTRE INSIGHTS

No. 7



CONTENTS

- 01 INTRODUCTION: THE WINDS OF CREATIVE DESTRUCTION
- 02 EXTERNALIZERS AND INTERNALIZERS:
THE CHANGING FACE OF IN-HOUSE LEGAL DEPARTMENTS
- 04 TOWARDS COMMODITIZATION?
- 06 THE EMERGING GLOBAL VALUE CHAIN
- 08 THE FUTURE ROLE OF GENERAL COUNSEL

**‘THERE IS NOTHING MORE WASTEFUL
THAN DOING MORE EFFICIENTLY THAT
WHICH NEED NOT BE DONE.’**

(Peter Drucker)

Based on the research report, ‘General Counsel with Power?’
by Professor Mari Sako, with an Afterword by Richard Susskind
available at www.sbs.oxford.edu/novakdrucecentre/GCpower.

INTRODUCTION: THE WINDS OF CREATIVE DESTRUCTION

Globalization, digital technology and multi-disciplinary professional knowledge: these pervasive forces are presenting a combination of opportunity and challenge for major law firms. Two key agents of change in particular are transforming legal practice. The first is the changing in-house legal function in corporations and financial institutions where, in a buyer’s market, the general counsel is exerting ever greater power in relation to the external lawyer. The second has emerged in the form of new entrants into the global legal services market. These non-traditional suppliers, including so-called legal process outsourcing (LPO) providers, deliver legal support services from low cost locations, onshore and offshore.

How are lawyers responding to these winds of creative destruction? This report presents key findings from a study of legal service outsourcing and its impact on the legal profession. Based on interviews with 52 general counsel in the UK and the USA from May 2010 to January 2011 in major private and public organizations, its aim is to present a systematic analysis of what is happening in the in-house legal departments of major corporations and financial institutions – the ultimate customer for corporate legal services.

TWO KEY AGENTS OF CHANGE IN PARTICULAR ARE TRANSFORMING LEGAL PRACTICE

EXTERNALIZERS AND INTERNALIZERS: THE CHANGING FACE OF IN-HOUSE LEGAL DEPARTMENTS

In-house lawyers in major businesses are demanding increasing cost effectiveness in the delivery of legal services – demands accelerated by the 2008 financial crisis. How are in-house lawyers reacting to these pressures to do 'more for less'?

Overall, in the last five years the majority of organizations, we found, have increased the number of in-house lawyers, reflecting business growth generally. Only in a small number of cases

has there been a reduction in the size of the legal department despite significant business growth. In financial services in particular, legal departments grew enormously, reaching a peak in 2007 before the financial crisis led to a contraction in lawyer headcount.

Despite finding a common aim to cut costs, our research revealed enormous variation in how corporate legal departments attempt to do this.

TABLE 1: IN-HOUSE LEGAL DEPARTMENTS IN 2010

Sector	Number of in-house lawyers	External to total legal spending
Construction	25–61	20%–83%
Manufacturing	150–314	30%
Energy	10–650	12%–57%
Financial services	80–1068	50%–77%
ICT	2–400	27%–93%
Professional services	11–12	60%
Retailing and wholesale distribution	8–35	60%–90%
Utilities	–	20%
Other sectors	7–72	40%–60%
TOTAL	2–1068	12%–93%

We identified three main types of general counsel:

'Internalizers' with 20% or less reliance on external resources

'Mid-Rangers'

'Externalizers' that depend on external lawyers for 90% or more of their legal resource needs.

Internalizers have taken seriously the following dictum by the management guru Peter Drucker: 'there is nothing more wasteful than doing more efficiently that which need not be done' and have developed a strong in-house legal function that conducts most of the legal work for the

corporation. In one case, the proportion of total legal spending that went to external lawyers decreased from 23% in 2000 to 12% in 2010.

Mid-Rangers, which include investment banks and commercial banks – the biggest spenders on big law firms in absolute terms – are more even-handed in their reliance on external lawyers.

Externalizers fall into two types, whose logic is somewhat different. Type 1 externalizers do not have an active legal department of their own and use external lawyers in place of in-house general counsel. Type 2 externalizers do have in-house counsel but rely heavily on external legal resources and take a proactive stance with respect to managing them.

TABLE 2: NUMBER OF LAW FIRMS ON PANELS IN THE SURVEY

	Five years ago	Now (2010)
Case I	55	14
Case II	60	6
Case III	38	26
Case IV	49	9
Case V	70	20

CONVERGING LEGAL NETWORKS

The overwhelming majority of general counsel in this study noted a trend towards reducing the number of law firms they instruct. In the last five to ten years drastic culling has occurred at some corporations.

This development is supported by more general evidence that between 2004 and 2008 the proportion of external spending by in-house legal departments fell in the US from 67% to 62% and in the UK from 51% to 47%.

However, not all general counsel are fans of convergence. A minority identifies two problems – efficiency and 'false aggregation', arguing that medium-tier law firms are less costly and have deeper jurisdictional knowledge, and that, even when corporations restrict themselves to a small number of firms, these firms in turn go out and hire local counsel anyway.

Law firm panel structures vary from firm to firm and can restrict who can bid for what kind of work. Some firms distinguish between a global panel and regional or country panels, whilst others have specialist practice panels. Yet others have a tiered panel, with high-risk high-value work going to a 'tier 1' panel of global or national firms and lower-risk lower-value work going to a 'tier 2' panel of regional law firms.

In establishing their panels some general counsel strongly encourage lateral communication amongst these law firms in order to forge what they call a 'legal community', 'network' or 'virtual law firm', often hosting an annual conference of their major law firms. However, lateral collaboration amongst preferred law firms is tricky to manage because they are in potential or real competition against each other. The crux always for general counsel is to balance collaboration against competition, in order to induce law firms to work effectively and efficiently.

FIGURE 1: BALANCING COMPETITION AND COLLABORATION AMONG LAW FIRMS



TOWARDS COMMODITIZATION?

‘Commoditization’ is a dirty word in legal practice. Nevertheless, the work of lawyers today may be on the cusp of a commoditization or production-line transformation due to the impact of digital technology, globalization, and new entrants. If so, in legal services, as in other sectors, the following three steps will be required:

1. **Disaggregation and standardization to break down legal work into constituent tasks which are then standardized or modularized**
2. **Process management to ensure the smooth flow of process steps and to eliminate waste**
3. **Project management to separate planning from execution, to define who does what, and to ensure that milestones and deadlines are met on time.**

The decomposition of legal work has been enabled by the use of ICT and process mapping techniques and facilitated by the use of non-lawyers and outsourcing. Task modularity, it might be added, also facilitates organizational modularity, especially where there are only loose knowledge relationships between organizational modules, but such modularity in itself is not sufficient for outsourcing to an independent third party.

The general counsel interviewed for this study fell into three groups. A small group of enthusiasts demonstrated a keen appetite for disaggregation. However, some sceptics stated that there was nothing new in this approach, arguing that for quite some time lawyers have been parcelling out work to junior associates and paralegals. Finally, a ‘wait-and-see’ group was happy for others to take a lead, especially as this approach did not apply to their own area of work.

Litigation represents one of the largest component of external legal expenditure. For this reason general counsel are keen to consider ways of reducing and controlling litigation costs. In-house counsel approaches varied on how best to tackle this. The **craft approach** homes in on the importance of strategy and tactics, led by the in-house lawyer, working closely with counsel from the lead law firm. The in-house lawyer delegates the whole matter to the law firm but expects many of the tasks such as negotiation or legal research to be carried out collaboratively and iteratively.

Under the **automation approach** general counsel focus primarily on automating specific chunks of tasks such as litigation support and e-discovery (or e-disclosure). In recent years, for instance, some firms, notably financial institutions, have intensified competition among their panel law firms by using online auction for discrete pieces of work.

In the **process flow approach**, general counsel establish procedures, in some cases using process mapping, to ensure the smooth flow of legal tasks from the start to the end of a case. It involves in-house lawyers clearly scoping each task and defining who is going to do what at the planning stage. There may be an overlap between the process flow and automation approaches but the two are not identical.

THE WORK OF LAWYERS TODAY MAY BE ON THE CUSP OF A COMMODITIZATION OR PRODUCTION-LINE TRANSFORMATION

FIGURE 2: LITIGATION TASK DECOMPOSITION



A key element in cutting legal work costs – combining process improvements with reductions in billable hours – involves ‘de-lawyering’: the use of non-lawyers to do work that had previously been done by fully qualified lawyers. In-house lawyers, for instance, disaggregate patenting tasks in order to use patent agents to do work previously done by patent attorneys. Similarly, paralegals are increasingly employed to do simple legal research previously done by junior lawyers. Evidence shows that the ratio of lawyers to paralegals is falling steadily, if slowly – from 2.5:1 to 2.3 in the US between 2003 and 2009 and from 3 to 2.9 in the UK.

Perhaps the most significant use of non-lawyers has occurred in contract documentation. In civil engineering, for example, in-house lawyers push routine contract documentation work to engineers who lead projects. These engineers are encouraged to negotiate contracts and deal with clients directly without lawyer involvement. In financial services documentation work is also often delegated to non-lawyers working in the relevant business departments.

Derivatives documentation is a case in point, where the sheer volume of work often creates bottlenecks in workflow. Investment banks are in the business of creating new financial products that are initially complex, low volume and high margin. They commoditize them and turn them

into high volume, lower margin work. Law firms may be involved in the early stages, but when the work becomes a repeat exercise, banks have an incentive to internalize them eventually. In such developments de-lawyering appears to be a cyclical phenomenon and most evident during the mature stage of legal product lifecycles.

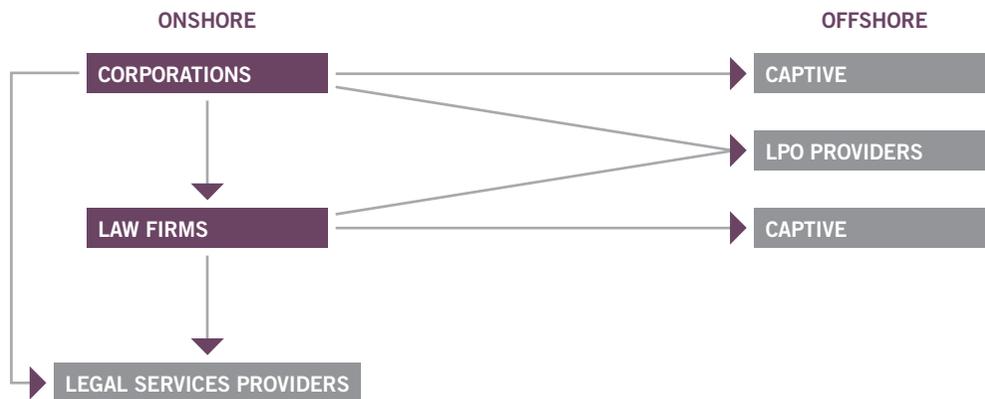
One important question emerging from this study is how disaggregation and commoditization correlate with externalizers and internalizers. Type 2 externalizers tend to use their power to persuade their law firms to take the lead. One general counsel told law firms ‘you’d better unbundle, or else we’ll unbundle for you’. Internalizers, in contrast, are much more systematic about adopting a process flow approach, eliminating waste in the whole matter by taking a lead in disaggregating and in-sourcing litigation support and document review. They also delegate more work down to non-lawyers, and a handful of general counsel, led by internalizers, has appointed directors of legal operations to take the lead in implementing the production-line approach.

THE EMERGING GLOBAL VALUE CHAIN

Once legal work has been disaggregated, the in-house legal department must consider the most efficient and effective way of sourcing each task. In recent years, the portfolio of possible sources of legal service has expanded as new providers and locations have become available. Until recently the only thick pipeline of legal advisory work that mattered was the one connecting the

corporation to the law firm. Whilst this will continue to be important, the corporation now has a more diverse set of sourcing options, including offshoring to a captive in-house legal department, relying on law firms to set up a captive low-cost centre, sourcing from contract lawyers on a project-by-project basis, or going direct to new legal services providers that have a global presence.

FIGURE 3: THE GLOBAL VALUE CHAIN IN LEGAL SERVICES



Despite the emerging models of sourcing legal services shown above, the offshore legal process outsourcing sector remains a mere drop in the ocean, around \$500 million in revenue, or 0.1% of the total worldwide legal market (which was worth around \$500 billion in 2010). So, will multi-sourcing become more extensive and significant in future? In particular, how much value might migrate from transactions between corporate clients and law firms to other parts of the global value chain? The answer depends on who is making multi-sourcing decisions and using what criteria.

In our study most general counsel did not actively seek to source from remote offshore locations such as India. By contrast, those who enthusiastically endorsed new low-cost locations divided into two camps. The first camp is primarily looking for labour cost arbitrage and not much else. General counsel will contract lawyers familiar with English or US law to conduct legal work in a manner that is no different from if it were carried out by lawyers onshore.

The second camp expects to obtain much more than lower labour rates. In these cases, the general counsel is intent on addressing productivity increase as well as labour cost reduction. Some financial institutions, for instance, seek greater efficiency in processing derivatives documentation at greenfield sites, not only by templating and standardizing documents but also by investing in software technology, improving the process flow of work, and exploiting economies of scale. The choice between captive and outsourced offshoring, then, depends in part on the general counsel's views on who has the best package of capabilities in process management and project management. Thus, a 'new location' is often a code for accelerating the implementation of new modes of working, not merely seeking temporary labour cost arbitrage.

Multi-sourcing – including outsourcing and offshoring – requires someone to take a lead in supervising and managing a variety of providers. But who should assume this role? Should it be the law firm or the in-house legal department? The picture that emerges from this study is far from clear cut.

Asked if their law firms used outsourcing or offshoring, some general counsel responded that they did not know, and that it was up to the commissioned law firms to decide. An alternative approach, adopted by a small number of general counsel, was to instruct law firms to disaggregate

and to use a specific LPO provider for chunks of work, such as data room management, 'e-discovery' (or 'e-disclosure'), and contract review. The in-house department would have a direct contractual relationship with such providers. Delegating decisions on what to outsource or offshore to law firms would not work, according to one general counsel, because 'you effectively run the risk of delegating the control of what needs to be done, which inevitably ends up being more expensive'.

Several general counsel expressed the view that, had law firms been willing and able to take an initiative in managing legal projects, they would rather not have stepped in. However, even with such a competency gap in project management skills amongst law firms, these in-house lawyers felt ambivalent about investing in in-house capability.

At least two future scenarios are possible. Under one scenario, law firms will retain a thick pipeline of legal work if they are able to take a lead in filling the competency gap in project management. Under another, law firms might be bypassed – disintermediated – as the general counsel invests in project management capability and engages aggressively in multi-sourcing, including trading directly with new types of legal services providers. Thus, the future shape of legal services value chain depends heavily on the role the general counsel wishes to play in project management.

LAW FIRMS MIGHT BE BYPASSED – DISINTERMEDIATED – AS THE GENERAL COUNSEL INVESTS IN PROJECT MANAGEMENT CAPABILITY AND ENGAGES AGGRESSIVELY IN MULTI-SOURCING

THE FUTURE ROLE OF GENERAL COUNSEL

General counsel tread a fine line between being lawyers and business executives. Over time, the corporate power base of in-house lawyers has expanded, not only because of the short-term impact of the financial crisis but also longer-term organizational trends. The most significant of these is the increasing importance placed by senior corporate executives on the general counsel's role as a joint risk manager. The general counsel's intimate knowledge of the business is therefore seen as indispensable. Significantly, nearly all the general counsel interviewed regularly rub shoulders with the CEO by dint of having a seat on the corporate executive committee.

In this context, how important is the efficient delivery and multi-sourcing of legal services among general counsel's priorities? At one extreme, commoditization – disaggregation and standardization – is regarded merely one of the responsibilities of legal operations directors with support from legal technologists. If this view prevails, re-configuring the legal services market will remain 'a game of inches', a tactical rather than a strategic game.

At the other extreme, general counsel are seen as the guardians of the legal process architecture in their organizations. Such figures delegate much of the day-to-day legal work to other in-house lawyers and focus instead on strategically enhancing the overall value added by the legal department to the business. In this approach the efficient multi-sourcing of legal services will be a key element in an effective legal process architecture.

General counsel's ability to drive sustainable change depends, therefore, on the source and nature of their power. The most transient aspect of that power derives from the buyer's market during the post-financial crisis recession, much of which is likely to evaporate as the economy picks up. By contrast, if general counsel pursue a role of proactively investing in new capabilities such as project management, as internalizer general counsel are doing, they will become a powerful and sustainable force for change.

So, law firms, beware internalizer general counsel! However, an alternative scenario is possible. General counsel with established power bases in corporate managerial hierarchies may not necessarily regard efficient legal service delivery to be on a strategic par with legal risk management. If such counsel come to the fore in the in-house legal function, they may evince little appetite for change and change may come from other catalysts. It is therefore equally possible that we are heading for a supply side revolution with new entrants driving discrete, disruptive change in the way legal services are delivered.

SO, LAW FIRMS, BEWARE INTERNALIZER GENERAL COUNSEL!

The Insights series aims to provide accessible summaries of recent research by members and associates of the Novak Druce Centre for Professional Service Firms at the Saïd Business School, University of Oxford. Each Insight focuses on a particular issue in the management of professional service firms and offers a fresh, up-to-date reading of this issue.

Derived from academic papers and books and written primarily for practitioners, the series is designed to be thought-provoking and challenging yet also highly readable.

To obtain other titles in the series please contact the Centre Manager at novakdruce.centre@sbs.ox.ac.uk

Series Editor: Peter Snow
Academic Editor: Tamar Parush
Design: SampsonMay www.sampsonmay.com

BASED AT OXFORD UNIVERSITY'S SAID BUSINESS SCHOOL, THE NOVAK DRUCE CENTRE IS A HUB FOR ACADEMIC RESEARCH INTO THE MANAGEMENT OF PROFESSIONAL SERVICE FIRMS. ITS MEMBERS WORK CLOSELY WITH TOP PRACTITIONERS TO EXPLORE THE KEY CHALLENGES CONFRONTING THE PROFESSIONAL SERVICES SECTOR.

THE NOVAK DRUCE CENTRE
FOR PROFESSIONAL SERVICE FIRMS

Saïd Business School
University of Oxford
OX1 1HP
Tel: +44 (0)1865 288 949

novakdruce.centre@sbs.ox.ac.uk
www.sbs.oxford.edu/novakdrucecentre