

Between A Rock and A Hard Place

By Daniel J. DiLucchio and James Wilber

General counsel are finding themselves more and more between the proverbial rock and a hard place. Not the usual rock and hard place of complex legal matters, where they are dealing with high stakes litigation, navigating increasingly difficult regulatory issues, and assuming more responsibility and accountability for compliance requirements and SEC matters. On the legal side of the pressure cooker — the side on which most general counsel are relatively comfortable — it's business as usual.

But on the business side of the legal function is another rock and hard place. The rock includes overall legal costs, law firm fees and expenses, the managing of law-firm relationships, and ensuring premier legal services to the corporation. The hard place is increasing corporate scrutiny of the way the law department manages the business of law. Pressure has been increasing during the past few years — pressure from the CEO, the CFO and business-unit clients, all clamoring for legal cost-control, predictability of legal fees and, of course, reduced legal expenses. This pressure and scrutiny now have reached a point where corporations are asking their global purchasing functions to take an increasingly prominent role in securing legal services, using sophisticated purchasing techniques to do so.

A look at the 2003 and 2007 editions of the annual *Law Department Metrics Benchmarks Survey* published by Altman Weil Publications Inc., an ALM company, offers some perspective on the magnitude of the cost-management problems now facing general counsel and their law departments. The 2003 *Survey* contains information from 199 corporations, evenly distributed between companies with annual revenues of under \$250 million and companies with over \$5 billion. The 2007 edition of the *Survey* contains information from 144

companies similarly distributed in size.

We'll review overall law department costs, breakouts of inside and outside costs, and staffing numbers for all participating law departments and compare those metrics with companies in the highest revenue category — those with annual revenues of \$5 billion or more. Later, we'll look at an industry with metrics that run counter to the general trends.

Changes in Overall Costs

The fundamental cost benchmark employed to determine a law department's financial performance is the company's total legal costs as a percentage of its annual revenues. Total legal costs include both the cost of operating the in-house legal function (fully loaded) as well as outside-counsel costs. This metric provides a relatively accurate comparison from company to company. As Table 1 (below) shows, average total legal costs as a percentage of annual revenues increased over the four-year period from 2003 to 2007 by 16 percent for the largest companies participating in the *Surveys*. Effectively, a corporation with \$10 billion in annual revenues was paying \$24 million in total legal costs in 2003 and \$28 million in 2007.

For all companies participating in the *Surveys*, the four-year increase in total legal costs was 18 percent, or an average just over one-half of one percent of annual sales revenue.

Table 1 – Average Total Legal Costs as a Percentage of Annual Revenues

| Category | 2003 Survey Average | 2007 Survey Average | Increase 2003 to 2007 |
|---|---------------------|---------------------|-----------------------|
| Annual Revenues of \$5 billion and Over | 0.2425% | 0.2803% | 16% |
| All Companies | 0.4942% | 0.5843% | 18% |

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While the percentage increase was more or less the same for the two groups, the actual cost as a percentage of annual revenue for the law departments in high-revenue companies is less than half of that of all law departments reporting. Some of this difference can be attributed to greater opportunities to leverage purchasing power by consolidating the number of law firms employed, effectively using e-billing information and ensuring that, from a pricing perspective, the companies are placing the appropriate legal work with the appropriate outside counsel.

Breaking down this percentage, we discover that the 2007 *Survey* reports that the larger companies of \$5 billion and over spend approximately 44.44% of their total legal ex-

penses inside the corporation. For all companies, 46.79% of their total legal budget is spent inside.

Changes in the Cost of Inside Counsel

As we continue to peel the legal-cost onion, another way to look at the costs of legal services is to analyze the expenses of a fully loaded in-house law department. Analyzing these expenses on a per-lawyer basis allows for company-to-company comparisons.

As we see in Table 2 below, the average inside legal costs measured on a per lawyer basis increased over the four-year period by 10 percent for the largest companies participating in the *Surveys* and 5 percent for all companies. Companies with higher annual revenues have higher per-lawyer in-

ternal costs and have experienced an increase in their inside costs at twice the rate of all companies in the *Surveys*. These changes might be attributed to increases in inside-counsel compensation, designed to compete with outside-counsel compensation, allowing the companies to attract, retain and motivate their in-house attorneys.

Changes in the Cost of Outside Counsel

Total legal costs are composed of both the cost of operating the in-house legal function, as well as expenses related to outside counsel. Table 3 provides information regarding the average changes in outside counsel expenditures as measured on a per-lawyer basis. The per-lawyer analysis is calculated by taking the

Table 2 – Inside Expenses Per Lawyer

| Category | 2003 Survey Average | 2007 Survey Average | Increase 2003 to 2007 |
|---|---------------------|---------------------|-----------------------|
| Annual Revenues of \$5 billion and Over | \$345,685 | \$379,273 | 10% |
| All Companies | \$314,576 | \$330,133 | 5% |

Table 3 – Outside Counsel Expenditures As measured on a Per-Lawyer Basis

| Category | 2003 Survey Average | 2007 Survey Average | Increase 2003 to 2007 |
|---|---------------------|---------------------|-----------------------|
| Annual Revenues of \$5 billion and Over | \$573,446 | \$725,328 | 26% |
| All Companies | \$554,596 | \$581,179 | 5% |

Table 4 – Compensation and Benefits Expense Per Lawyer

| Category | 2003 Survey Average | 2007 Survey Average | Increase 2003 to 2007 |
|---|---------------------|---------------------|-----------------------|
| Annual Revenues of \$5 billion and Over | \$261,627 | \$313,747 | 20% |
| All Companies | \$246,825 | \$277,058 | 12% |

Table 5 – Number of Lawyers Employed

| Category | 2003 Survey Average | 2007 Survey Average | Increase 2003 to 2007 |
|---|---------------------|---------------------|-----------------------|
| Annual Revenues of \$5 billion and Over | 44.37 | 41.45 | (7%) |
| All Companies | 20.31 | 18.10 | (11%) |

Table 6 – Utilities Industry Metrics

| Category | 2003 Survey Average | 2007 Survey Average | Increase 2003 to 2007 |
|--|---------------------|---------------------|-----------------------|
| Utilities Industry – Average Total Costs as a Percent of Revenues | 0.5485% | 0.4946% | (10%) |
| Utilities Industry – Inside Expenses Per Lawyer | \$354,499 | \$326,219 | (8%) |
| Utilities Industry – Compensation and Benefits Expenses Per Lawyer | \$223,125 | \$265,844 | 20% |
| Utilities Industry – Outside Counsel Expenditures Per Lawyer | \$893,491 | \$815,768 | (9%) |
| Utilities Industry – Staffing | 13.86 | 25.13 | 81% |

total outside expenses of the company and dividing that amount by the number of in-house counsel.

As seen in Table 3 on page 4, the average outside legal costs measured on a per-lawyer basis increased over the four-year period by 26 percent for the largest companies participating in the *Surveys*. For the large companies, this averages to be a 6.5% increase per year over the 4 years, which approximates law firm annual hourly rate increases. In comparison, all companies reported only a 5 percent increase. This difference might reflect the significant legal issues facing larger companies, including large litigation matters and significant compliance requirements, fee increases from outside counsel as well as the fact that some smaller companies are doing an effective job of managing their outside counsel costs.

As much as 80% of the inside expenses of a law department are composed of personnel expenses including salaries, bonuses and benefits for lawyers, paralegals and support staff. Table 4 on page 4 demonstrates the changes in in-house compensation and benefits on a per-lawyer basis between the 2003 and 2007 *Surveys*. This analysis allows us to dig deeper into the costs of operating an in-house law department, discovering that over a four-year period, in-house compensation and benefits costs rose approximately 5% per year for the largest companies while all companies saw a smaller 3% per year average increase.

Staffing Changes

Getting the right combination of inside and outside counsel services to handle a company's legal needs is a constant challenge for general counsel — especially as it relates directly to the overall cost of legal services. Table 5 on page 4 shows the average changes in in-house lawyer staffing over the four-year period from 2003 to 2007. Overall, law department staffing at the largest survey participants

(\$5 billion and over) decreased by 7 percent, while all companies participating in the *Survey* showed a decrease in in-house lawyer staffing of 11 percent.

As companies reduce their in-house staffing levels, the legal work must be absorbed by the remaining in-house lawyers, or be sent to outside counsel. Since in-house counsel are generally working to capacity, the overflow work is sent to law firms, thus increasing the outside counsel costs to the company.

Utilities Industry – Counter-Trends

While on average there have been increases in overall legal costs and decreases in in-house lawyer staffing over the four-year period across all companies participating in the *Surveys*, and specifically in the largest of those companies, one industry's metrics trend in the opposite direction.

As Table 6 on page 4 shows, utilities companies participating in the *Surveys* actually decreased their overall legal costs by 10 percent as a percentage of annual revenues. Based on our recent experience and specific benchmarking efforts with Public Utility Holding Company Act companies, this group decreased its overall costs by using a combination of cost-management techniques, including effective in-sourcing, better in-house leveraging of work and alternative fee arrangements.

The percent of total legal spending on inside expenses for the utilities industry is 30.42% of the total legal budget, resulting in a spend of 69.58% on outside counsel, according to the 2007 *Survey*.

The utilities industry also decreased its inside legal operating costs by 8 percent while the average increase for all companies participating in the *Surveys* was 5 percent, resulting in a difference of 13 percent. This was accomplished while maintaining average increases in compensation and benefits equal to

the largest companies participating in the *Surveys*.

While the utilities industry shows significant decreases in spending across the board, the in-house lawyer staffing in that industry shows a significant increase — almost double the 2003 *Survey* average.

Although outside-counsel costs decreased in percentage terms, in real dollars they were, and still are, higher than for all companies in the *Survey*, and higher than for the companies with annual revenues of \$5 billion and over. A significant portion of this difference may be attributed to the highly regulated environment faced by the utilities industry.

Techniques for Addressing Legal Cost Management

Faced with the increases, what tools are available to help companies and their general counsel better manage costs? Some of the more common techniques include the following:

1. Better budgeting
2. Use of e-billing
3. Alternative fee arrangements (not discounts off of standard hourly rates)
4. Management of annual fee increases
5. Getting legal work into the right hands and the right firm
6. Convergence programs
7. Internalizing more work

Each of these techniques can be employed on a stand-alone basis or in combination with others. Companies in the utilities industry used several of them between 2003 and 2007 to actually decrease their overall legal costs. There may be a lesson there for companies in other industries.

For general counsel and their companies, navigating between the business-side rock and the hard place is a treacherous undertaking. Metrics and benchmarking can be the coordinates by which GCs can plot their

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course from the past to the place in the future where their clients want to be with respect to legal costs. The old adage “what one measures, one pays attention to” applies in this case. The benchmarks tell companies and their GCs what they need to focus on and where to apply the techniques that have proven effective at controlling legal costs for companies. ♦

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