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OUR 30TH YEAR

Chief Legal Officers Are Questioned — And the Answers Are “Costs” and “Compliance”



Daniel J. DiLucchio

By Daniel J. DiLucchio

Despite the promise of an improving economy, astute corporations continue to address their business fundamentals, positioning themselves to capitalize upon the economic recovery as it accelerates. This corporate focus on economic fundamentals translates into specific mandates for the corporate law department. According to a recent survey of chief legal officers¹ (CLOs), the three most important law department management issues that they will face in the near term are:

- budget constraints;
- cost control; and
- staffing issues.

Cost control and budgets were named three times more often than any other near-term issue. Law departments are no longer mysterious areas where costs are considered unmanageable. The corporate legal function is now viewed by chief executive officers (CEOs) like any other non-revenue producing staff function. Costs must be controlled — both internally and externally. In today's world, CLOs must satisfy the CEOs' expectations to manage legal costs and staffing.

It's All About the Money

Cost management issues continue to be the topic of discussion between in-house and

outside counsel. Fifty-nine percent of CLOs surveyed indicated that they have fired or were considering firing at least one of their outside law firms. This percentage is up 4.2% from the 2002 survey and is above 50% for the fourth year running. The number one reason given for terminating a relationship was “cost management issues.” There continues to be a high level of frustration by in-house counsel with law firm billing “surprises” (unexpectedly high bills for work performed), perceived lack of value for cost, billing mistakes and extreme expense charges. Some law firms continue to frustrate in-house counsel by charging high hourly rates and then attempting to pass on charges such as internal law firm deliveries (moving files from floor-to-floor in a firm!) and other such add-ons.

The other top three reasons for terminating a relationship with outside counsel were “lack of responsiveness,” “overworking projects” and “mishandling one or more critical matters.”

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Chart 1, to the right, provides a three-year longitudinal snapshot of CLOs' thoughts regarding law firm relationships. It appears that the frustration level with law firm services continues to be high for in-house lawyers. These concerns are fueled by a lack of responsiveness, high fees, and lack of value for costs. The survey data clearly suggest that there is an ongoing problem that is not being addressed.

When asked about the most innovative practice proposed or instituted by outside counsel, CLOs again focused on their number one issue, cost control. CLOs ranked fee arrangements as the number one innovative practice — although only 22.6% of the survey respondents were able to identify any innovation at all. The CLO Survey result is consistent with the results of the Altman Weil 2003 Law Department Management Benchmarks Survey, which reports that of 183 reporting companies, 33.9% continue to pay all of their fees to outside counsel based on hourly rates. Only 27.9% of the reporting companies pay from 1% to 10% of their fees on billing arrangements other than the hourly rate, and only 10.9% pay from 11% to 20% of their fees based on other than hourly rates.

As cost pressures increase, law departments are also exploring other methods to manage costs. One traditional method for controlling costs has been the make/buy decision. Law departments constantly analyze whether they should internalize more legal work since, traditionally, legal work could be performed more cost effectively by inside counsel, or whether they should "buy" the services from law firms. Chart 2, to the right, reveals that 17.3% of the CLOs plan to decrease their use of outside counsel in the next 12 months while only 15.8% of the CLOs plan to increase their use of outside counsel. This is a significant change from 2001 when 86% of the

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Chart 1

Have you fired or are you considering firing, one of your law firms this year?

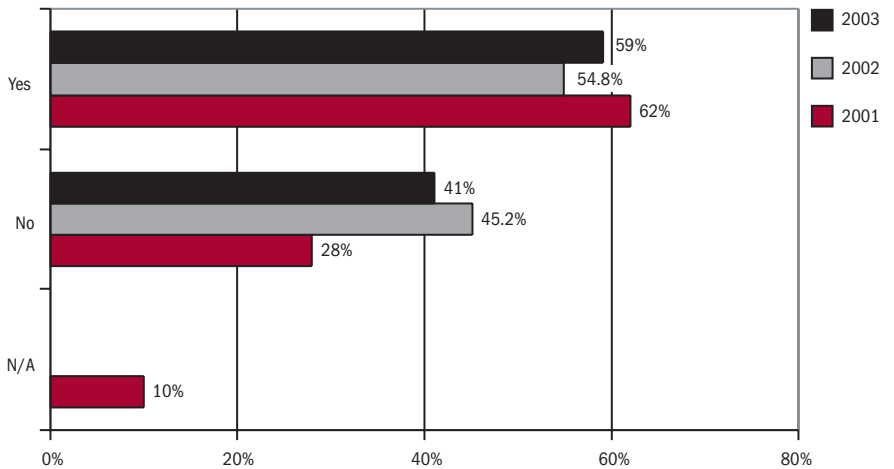


Chart 2

Within the next 12 months, do you plan to increase or decrease your use of outside counsel?

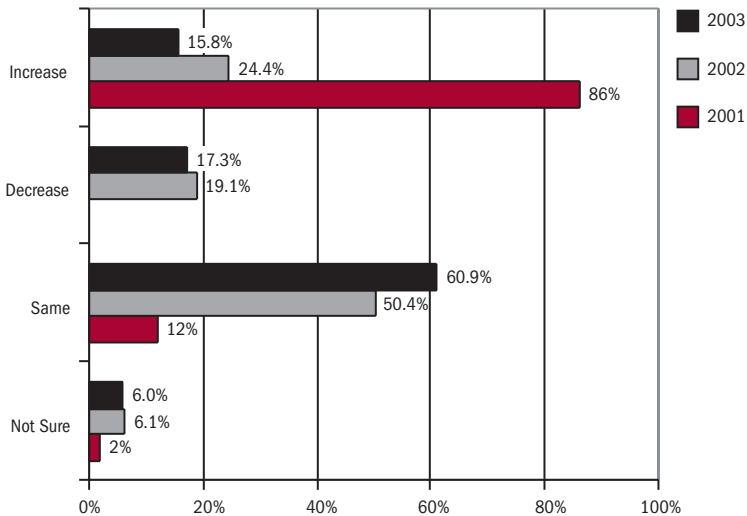
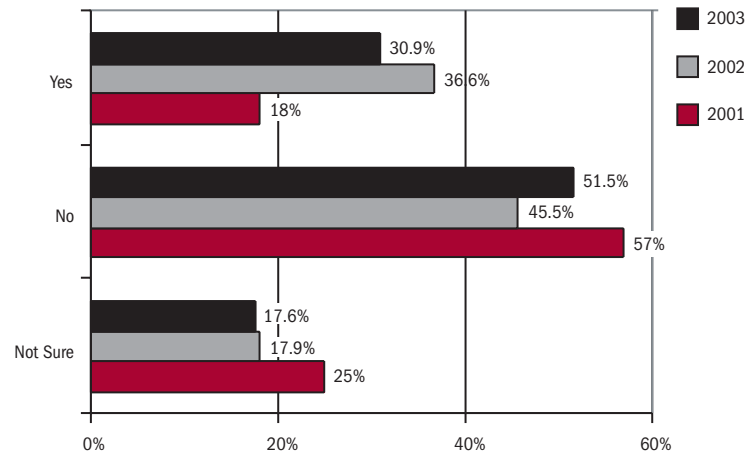


Chart 3

Within the next 12 months, do you plan to extend your in-house legal capabilities by hiring additional lawyers?



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CLOs responding to the Survey planned to increase their use of outside counsel. An explanation for this dramatic change could be the intensity of the economic impact of the recession in 2001. In 2001 CLOs were not anticipating bringing more work in-house since there were hiring freezes in place at the time and they expected to use more law firm services.

CLOs said that the budget constraints they are under mean that they are being held to state-of-the-art standards on shoestring budgets. They are working with headcount reductions, restrictions and, in some cases, hiring freezes. Chart 3 on page 3 shows the CLOs' view of law department growth.

With the intent to maintain or decrease law firm utilization and no plans for in-house growth by at least 50% of the CLOs, it is clear that law departments must find new and creative ways to deliver legal services in a cost effective and efficient manner.

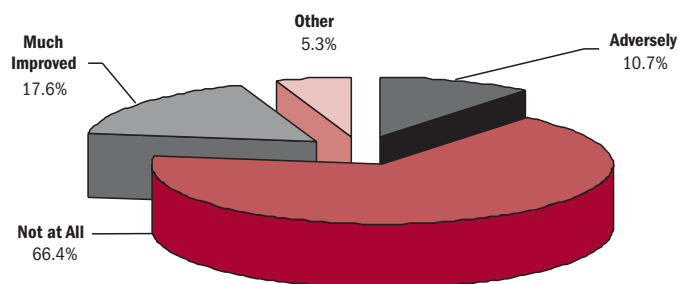
The Impact Of New Corporate Governance Rules

Corporate misbehavior has led to unprecedented focus on corporate ethics and compliance programs. Sarbanes-Oxley has had a direct impact on in-house counsel, their roles, responsibilities and client relationships. The CLO Survey provided an opportunity to assess chief legal officers' thoughts about new corporate governance requirements and their impact on law departments.

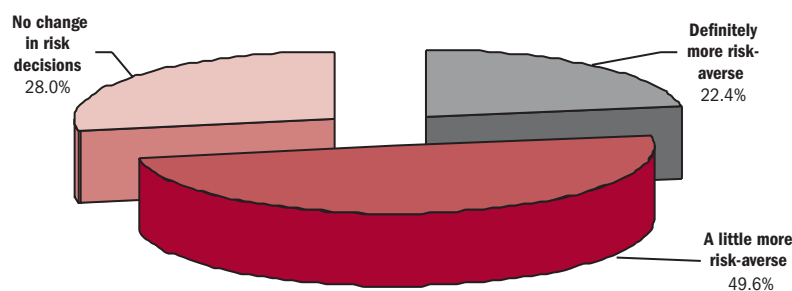
Over two-thirds of the responding CLOs believe that the new corporate governance rules have not affected the CLOs' relationship with senior management. In some cases, CLOs believe that the relationship is much improved (perhaps because roles and expectations have been aired and clarified). Only 11% thought that the relationship had been adversely affected. Chart 4 provides a snapshot of the Survey results:

Chart 4

Have the new corporate governance rules and standards impacted your relationship with senior management?

**Chart 5**

How have the new corporate governance rules and standards affected senior management's approach to risk?



Although CLOs believe the relationship with senior management is still strong, 22% believe that new attorney reporting obligations will make senior managers less likely to seek legal advice for fear of lawyers "tattling" on them. At least one of the CLOs said, "Lawyers are increasingly seen as 'enforcers.' Management is less likely to seek advice for fear that its conversations will be reported to the SEC if the 'reporting out' rules are adopted."

CLOs think that the new governance rules make senior management at their companies either "definitely" or "a little more" risk averse than in the past. The Survey results are shown in Chart 5, above.

The implications of greater risk aversion by senior management could result in a more conservative approach to making business decisions, or significantly more time, money and effort spent in ensuring legal compliance.

In addition to client relationship issues and risk aversion, some lawyers appear to be concerned about

the impact of the new governance rules and standards on their own personal liability. Specifically, 36.3% of CLOs are more concerned about their own personal liability relating to corporate misconduct, while 58% say that they are just as concerned as they always were.

Not surprisingly, when asked to identify the next, most important, emerging client relationship issue that they will face, CLOs named Sarbanes-Oxley compliance as number one. The next two most important issues named by CLOs were "balancing the relationship with the Board and the relationship with the CEO," and "privilege protection."

Conclusion

For the fourth consecutive year, the CLO survey has highlighted, clarified and confirmed some of the trends and changes currently affecting the legal profession. Not surprisingly, in a difficult economy, the number one issue for CLOs continues to be cost control and management. Cost management

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has been a continuing issue with little apparent concrete solution at hand. More recently, the impact of Sarbanes-Oxley on in-house lawyers and their client relationships has also become a critical issue.

Legal cost controls have been discussed for decades; true legal cost control, however, has been spotty. There has been more talk than action about controlling costs by many in-house lawyers. The bottom line for most corporations has been increasing legal fees and double-digit annual law firm rate increases. For those law departments serious about cost controls, the following steps might be appropriate:

- Realize that law firm convergence programs are only the first step in a two-step process. The second step is leveraging purchasing power with the firms that are selected.

- Install and use e-billing technology. This is the best available tool for cost analysis and management. Task-based billing did not meet the hype and expectations, but e-billing has the potential to be the needed management tool.
- Manage the cost of each matter, not just the substantive legal issue involved. Realize that by the time a bill arrives on the desk of an in-house lawyer, it is too late to manage the cost.
- Align law firms with types of matters. Use top firms for strategic legal work and low-cost providers for commodity work.
- Evaluate lawyers, in-house and outside, for their ability to manage costs — it is part of their job.
- If you are still using hourly rates, at least insist on freezing annual hourly rate increases.

The CLO Survey has again provided insight into major trends, and has allowed us to better understand the dynamics of a continuously changing business and legal environment. ♦

¹ For the fourth consecutive year, The Association of Corporate Counsel (ACC) and Altman Weil, Inc. have joined forces to design a set of questions that provide insights into the operation and thinking of corporate law departments. As in previous years, CLOs attending the ACC annual meeting provided input into the survey. The Fourth Annual Chief Legal Officer Survey contains responses from 137 Chief Legal Officers. Survey data were collected at the October 2003 ACC Annual Meeting.

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