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You Should Go By the Numbers

When the CEO asks about costs, it's good to know what other law departments are doing. Compare total spending, cost per lawyer hour, or even head count.

By Rees W. Morrison

Benchmark metrics help a general counsel know how well his or her law department is managed compared to other law departments. "Is my spending in line?" "Do I have a typical number of paralegals?"

These measures help the top lawyer respond confidently when the CEO asks, "Have you sufficiently narrowed down the number of law firms you use?" General counsel use benchmark data to argue for more hires or bigger budgets, defend the resources they have, and look for clues to improve their department's operations.

Management Matters

Amid the profusion of benchmarks foisted on general counsel, three are pre-eminent. The most important metric—total legal spending as a percentage of revenue—overlaps somewhat with the other two: people (total legal staff per billion dollars of revenue) and costs (fully-loaded cost per lawyer hour). Appreciate that each metric is normalized, so it is stated in terms of units of revenue or lawyer hours. One figure is divided by another figure, which allows large companies to compare themselves similarly to small companies.

All general counsel need these sorts of benchmarks. All managers in legal departments, in fact, need to appreciate the nuances of these three particular benchmarks and to pursue improvement in them.

Total Legal Spending

Among the three essential metrics, this one takes pride of place. Calculated properly, total legal spending expressed as a percentage of the company's revenue should total everything spent by the law department—both its internal costs such as compensation and facilities as well as its external costs such as outside counsel and other service providers.

Usually, little uncertainty arises from the revenue portion of the calculation. On the spending side, however, law departments include a variety of expenditures. For example, some law departments are not charged the equivalent of rent, but all law departments should at least add in an imputed number. To be comprehensive about TLS and thus on the same footing as other law departments, a general counsel who does not control all outside counsel spending or manage all practicing lawyers in a company should add in the missing expenses.

The total should not include settlements and judgments nor fees and costs of directors but it should include all incentive compensation charges as well as intellectual property fees and expenses. The goal is to include all the costs that the law department incurs, whether or not they are officially on the budget of the department.

Once a law department collects its own figure of TLS as a percentage of revenue it ought to obtain comparable figures from similarly situated law departments. Comparative data from one's industry serves as the best yardstick of performance. The size of a law department is not nearly as relevant as its industry. Not that benchmarking against other companies is essential; some law departments might simply set themselves the goal to maintain or lower their current-year figure.

As with all benchmarks, several proprietary surveys have collected data from law departments and are available for purchase. Other options include collecting data from peer companies informally or retaining a consultant to collect and present the information. A general counsel might reach out to peers and swap data informally, or a general counsel might obtain a wider set of data through the efforts of a consultant who can assure all of the participants that their data will be kept confidential.

This all-encompassing figure—TLS as a percentage of revenue—best represents how a law department stacks up against its peers. Most law departments in U.S. companies of $500 million of revenue or more run between 0.25 percent and 0.75 percent of revenue. It subsumes costs and staff, which in turn lets a general counsel make changes to any aspect of the department yet present a single number to be judged against. Since all legal spending is reflected in the figure, whatever changes—whether it's more lawyers hired, better technology installed, improved guidelines for law firms—will be covered.

Barring the exclusion of expenses that ought to be included in the total, a law department's managers cannot manipulate this calculation. The one drawback is that in a particular year, the ups and downs of spending on a major matter may distort the metric for that year. A large acquisition, for example, could bulge the number for spending (and note that even capitalized legal expenses should be included in the total). For this reason, take a two-year average and compare it to your benchmark figures. This technique will smooth out anomalous expenditures. As long as TLS as a percentage of revenue trends at or below revenue growth for your company, your law department can pat itself on the back.

Staff Per Billion of Revenue

The second most important metric for those who want to assess the performance of a law department focuses on the department's total head count. Many people favor lawyers per billion of revenue, but that ratio is not as trustworthy. One reason is that a law department, which has many paralegals and other nonlawyers—in other words, less expensive personnel—looks improperly good on the purely lawyer-based metrics. Better to include all employees of the law department so there is no incentive to distort the mix of personnel. It is quite typical for U.S. law departments to have one lawyer for every nonlawyer (paralegals, legal assistants, administrative assistants, and others). Typical U.S. companies have about 7 to 13 legal staff per billion dollars of revenue.

Even when all employees are counted, this metric permits some manipulation, as a law department can use consultants, contractors, and temporary employees to keep its official head count artificially low. My recommendation is to include in the employee head count those outside service providers who effectively are doing the job of an employee. Further, when a law department calculates its head count, it should translate part-time or new employees into full-time equivalents. Thus, if a lawyer worked half a year, count that lawyer as one-half of the full-time equivalent.

The costs of people account for about three-quarters of a law department's internal budget, so there is considerable overlap between this metric and total legal spending as a percentage of revenue. The difference is that this second metric has to do with the productivity of people. For a given staff size, how does the law department compare to its peers in presumably comparable output?

Cost Per Lawyer Hour

This third key metric allows a comparison between internal costs and external costs. Law firms, too, should grasp these two cost figures.

Here's how you can calculate your department's number. Multiply the number of your in-house lawyers by 1,850 chargeable hours per year. That number is reasonably well accepted as the number of hours in-house lawyers work in a year that they would bill if they were at a law firm. Divide the result into the inside budget of the law department. The fully loaded cost—which should capture the total cost to the company of employing its lawyers—is what the lawyers would have to charge their clients to cover the department's internal costs.

Law firms have to cover all of their costs and profits through their billing rates; law departments calculate a similar number by this method. The effective rate of outside counsel usually runs at about $280 to $320 per hour. By "effective rate" I mean the total of a representative group of bills, as paid by the law department, divided by all the lawyer hours on those bills. Typically, U.S. law departments' lawyers run at about $180 to $220 per hour when all costs are fully accounted for.

Thus, each outside hour is about 50 percent more expensive than each inside hour. Not surprisingly, a typical law department spends 40 percent of its total legal budget inside and 60 percent outside. What that typical ratio says is that roughly the same number of hours are worked by lawyers inside the company as by lawyers outside the company.

What's tricky about fully loaded costs is how full the figure is. From my consulting experience, no law department comprehensively accounts for the cost to its company of maintaining the department. Law departments should include every cost they incur or share in because otherwise the company cannot accurately decide on the relative value of in-house lawyers and outside counsel. Overlooked costs include the cost of litigation over discrimination suits, executive-search fees, security provided for the law department, building and grounds maintenance, and other costs that are not be fully accounted for. Even so, these omissions probably do not add more than $10 per hour.

To make use of this metric, it is not sufficient to keep the gap at no more than 50 percent. The department could retain more expensive law firms and increase its own costs, so the gap would remain constant, but total costs would soar. No, the trick is to keep both costs in line with each other and their total below the benchmark aggregate number. For instance, if your law department costs $200 per lawyer hour and your law firms' effective rate is $300 per hour, the aggregate is $500 per hour. If the median figure for comparable law departments in your industry is greater than $500 per hour in the aggregate, you are doing well.

Armed with this triumvirate of metrics, motivated to track and compare them every year, and possessed of a sophisticated understanding of their strengths and weaknesses, a general counsel is much better positioned to make the necessary management changes and to demonstrate the relative value provided by the legal department to senior executives.

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