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Put Eggs in One Basket?

Many law departments believe it makes sense to consolidate their outside firms to save money. But that might be a poor strategy in the long run.

By Rees W. Morrison

For law departments in the past decade, convergence—that is, consolidating the number of outside firms used in order to save money—has been all the rage. Many departments have dramatically reduced the number of law firms they retain. The convergers expect a number of benefits from a smaller panel of key firms. Those firms, they believe, will know the company better, impose less of a management burden in keeping track of transaction costs, offer better billing terms, and contribute special services.

But I think convergence may be coming apart. Let's take a look at some of the cherished beliefs behind convergence.

Let's first expose the claim that convergence builds institutional knowledge in the key law firms. The idea of institutional knowledge depends on a certain stability. Turnover in large firms is so high, however, that many of the associates who work on a law department's matters will depart within a few years.

IN-HOUSE COUNSEL

In addition, no law department wants to pay outside counsel to "learn about the company's business." Whatever learning is picked up—the essence of institutional knowledge—therefore, becomes sporadic, idiosyncratic, and isolated. Add in ear-popping obligations for billable hours and there's the obvious question: How much time is left to learn much about a client's business? Consider also that lawyers in different practice areas have little training or incentive to share among themselves insights about a common client. Finally, the velocity of changes in the business world erodes the value of the bits and pieces of accumulated understanding.

The second claimed benefit, administrative ease, involves what economists refer to as transaction costs. Whenever an in-house lawyer has to select a law firm, get to know its lawyers, and track a new billing format, there is some inefficiency. That's a transactional cost. Even if the transactional burden of working with hundreds of law firms was palpable, today there are many tools to minimize the stress.

As more law firms bill electronically, for example, transaction costs will decline because there will be less need to review invoices. Besides, even if one firm were handling all of a department's work, the best practice is to obtain a monthly invoice for each matter and review it. Other tools include extranets, which allow firms and departments to communicate more efficiently; early case assessments, which should reduce the length of time that lawsuits linger; and fixed-fee arrangements, which reduce the need for oversight because the law firm now has an incentive to manage efficiently. Each of these, in different ways, attacks the putative scourge of management and administrative hassle.

Furthermore, it's plausible that a boutique needs less managing on the matters that it specializes in than a large firm that assigns significant work to a fourth-year associate.

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More fundamentally, it is likely that each in-house lawyer has her own small group of favorite firms. Multiply that typical number by all the lawyers who manage outside counsel and it appears that the law department uses too many law firms. But in reality, no one lawyer has a heavy transaction burden. And loyalty to incumbent firms, which dominates even in an era known for cut-throat hiring, lets each lawyer reduce transaction costs to an insignificant level.

Next there is the myth that coalescing work with a few firms leads to cost savings. Convergence efforts often mean using large firms. After all, if a large volume of work goes to one firm, especially if that work crosses specialty lines, bigger firms have an edge. But the big-firm billing rates undo whatever savings the firms might offer. Think of the economics this way: How grateful should a law department be to negotiate a 10 percent discount from a blended lawyer rate of $400 an hour if an accomplished, veteran partner at a smaller firm bills $300?

Furthermore, discounts are rampant nowadays. If many firms give them, how much more blood can come from the stone? If a firm has agreed to a 15 percent discount, can it go much higher for twice as much work?

The Trophy Client

If your revenue accounts for a significant portion of a law firm's billings, or even the largest chunk of a major partner's billings, you will be treated with respect and deference and given extra effort. The huge firm—think of the 17 firms in the nation with more than 1,000 lawyers—that handles your law department's $2.5 million per year will treat you differently than the 50-lawyer firm for which your fees and work make you a trophy client.

A law department probably obtains better service when it is a major client of a moderate-size firm, than when it is a line item for a megafirm. For example, Richard Lavers, general counsel of Coachmen Industries, told one magazine: "Our philosophy is we want to be one of the most important clients for the firm. A company our size isn't that important to the megafirms."

Concentration of spending makes more sense than convergence of spending. If a law department lavishes 80 percent of its outside-counsel budget on 10 percent of its law firms, that is a high degree of concentration, even if the department pays 300 other firms the remaining 10 percent.

A law department that chooses 20 law firms to handle all its work will necessarily spend more on those 20 firms than when the department used 50 or 100 or however many firms. But if that department spreads its spending evenly among the 20, it will not gain the benefits of concentration.

Let's also puncture the balloon that converged firms will throw in additional benefits. Sure, it's nice if a law firm can provide an extranet or offer some CLE training or throw in some freebie, quick answers. But those extras can't replace excellent legal service delivered cost-effectively, or make up for its absence.

The putative benefits of convergence aren't enough to make a difference. In fact, there are additional drawbacks to convergence.

So-called partnering arrangements, the cousin of convergence, can deteriorate. A law department that selects a few primary firms presumably wants long-term relations—a partnering relationship. But with that marriage, destructive forces can build. Short-term benefits work at cross purposes to long-term strength. For example, discounted fees by the firm repel the best associates from working on that client's matters. In addition, strong, trusting relationships spawn corner-cutting. In other words, the go-to firm starts cutting quality or over-billing the credulous law department. As everyone becomes comfortable, complacency on both sides can dull the sharpness of an arrangement.

Convergence flies in the face of our common-sense notion that no firm can be good in all (or even many) practice areas. The law department with few firms to choose from will have to either train the firm in some areas of law or accept mediocre service. One-stop shopping generally forsakes quality for convenience.

One also hears that larger firms have more capital and, therefore, can take larger risks and, perhaps, try out innovative billing arrangements. This is probably true to some extent, but large firms also have bureaucratic and cultural inhibitors. Executive committees must agree; new-matter committees have to weigh in; political agendas have to be accommodated; guarantees to other clients that they are getting the best pricing (the most-favored-nation guarantee) must be resolved.

What also happens is that in-house counsel (and often clients) resent being torn from their favored and trusted firms and forced to use unknown lawyers in a newly selected firm. Convergence is always imposed top down; it doesn't bubble up as the choice of the lawyers who work side by side with the law firms.

Unbundling also cuts away at the big firms' advantages. If you have a vendor handling discovery, a small firm doing first-pass document reviews, contract paralegals and an offshore provider doing legal research, and an in-house-counsel discovery group gathering most of the documents, the department is diverging. The management approach is different: Converge and obtain all the services you need with a few law firms, or diverge and find the best answers from a combination of vendors. As law departments become more savvy, especially as the spotlight of cost savings shines hotly on them, they will look more favorably on unbundled services.

To prune a company's roster of law firms is prudent, especially if the cuts are made based on thoughtful evaluations of the firms' relative performance. Over the past decade, however, crowds of law departments have carried high on their shoulders the blind champion of convergence: Reduce the total number of law firms paid.

Now, though, the convergence sheen may be tarnished by high costs, modest knowledge buildup, trivial extra services, and a plethora of other problems. With new management tools at their disposal and a rigorous scrutiny of convergence, progressive law departments may want to resist the urge to converge.

Rees W. Morrison is the co-head of law department consulting for Hildebrandt International. He hosts the blog www.LawDepartmentManagement.typepad. com. He can be contacted at rwmorrison@hildebrandt.com.

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