REENGINEERING THE LEGAL FUNCTION

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What are the true benefits of a legal department? The answer most often heard is that we in-house counsel know our clients and their business goals better than outside counsel. As a result in-house counsel can often estimate legal service requirements more confidently and expertly and are better able to ensure that legal decisions fit into our clients' overall business strategy.

If we are honest with ourselves, however, perhaps the greatest benefit is predictability. There is security in knowing the strengths and weaknesses of our own personnel versus risking the unknown (outside attorneys working off-site on our matters). Second, we know what it costs to run our department, including where we can make cuts if budget pressures so require, and how to shift our internal resources to fit client needs. Finally, we have very few surprises with what we do internally.

But if these are the strengths of a legal department, doesn't it behoove us to cultivate them in outside counsel? Likewise, isn't it time we address the fact that both in-house and outside counsel operate under perverse incentives — that is, firms profit by more billable hours and in-house counsel have greater job security if the legal pipeline remains full?

Reengineering and Renewal

Much is written about reengineering and organizational renewal. While the concepts are usually received with high praise and pledges of support, few managers are willing to make the difficult choices required to achieve fundamental reform.

Anyone who has grappled with the daunting task of managing the legal department of a modern U.S. corporation knows there is no single answer for the best way to handle the legal function. Indeed, yesterday's breakthrough may be today's albatross absent structures and processes that are self adjusting, self renewing, and, most importantly, client driven.

The legal department at Stanford was for years a model of `legal departments. It drew upon very bright, highly skilled professionals and included a broad range of substantive talents, such that the office could do virtually everything in-house, looking to outside firms only when target-

ed expertise was needed to supplement in-house capabilities. At one point, the office had an authorized headcount of 26 attorneys and paralegals occupying two floors in a building directly behind the president's office. Moreover, it was known for stability and continuity — more than two-thirds of the attorneys had in excess of 10 years of service at Stanford.

Why, then, did we open the department to bids for outsourcing? For one thing, as the university's funding faced major shortfalls and with virtually all the regular work being handled in-house, reductions in the legal budget could only be achieved by eliminating full-time employees. That was fine up to a point, but since each in-house attorney typically has a number of specialties, it was not easy to eliminate one or two without creating significant gaps in expertise. Likewise, as litigation became increasingly complex, the office required more support not less. Eliminating attorneys to free up dollars for litigation services was not going to be popular either. And what if litigation dropped off significantly the next year? More importantly, once a large litigation unit was in place, where would the incentive be to reduce litigation?

Finally, a number of senior officers of the university thought that a significant change was in order, particularly where high-level expertise was needed. They thought if our department drew upon professionals who handled similar matters on a daily basis for a wide range of clients it might provide more cutting-edge knowledge and offer a more global perspective.

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In addition, we developed a strategic alliance with three firms. The firms work at fixed or budgeted fees. Their attorneys function full-time, or at least on a regular basis, on-site as if they were in-house. All attorneys who regularly work on Stanford matters have university telephone extensions, voice mail, and e-mail addresses. Furthermore, the law firm attorneys who regularly work on Stanford matters now attend what previously had been our weekly internal staff meetings. The goal is for all attorneys — whether in-house or outside — to function as part of a single, unified department.

The remaining in-house attorneys are not seen as supervisors of the outsiders, but as partners. My role is essentially that of managing partner for the consolidated

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enterprise. The partnership goes all ways, moreover. Both the in-house and law firm attorneys are encouraged to juggle workloads among themselves. Matters that cross over the jurisdictional lines of one firm to another are expected to be handled in a routine fashion, without the extra time and cost of attorneys getting to know one another for the first time or needing protective memos and introductory meetings. And all attorneys — in-house and outside alike — now share the common goal of managing and reducing our overall legal costs and exposures.

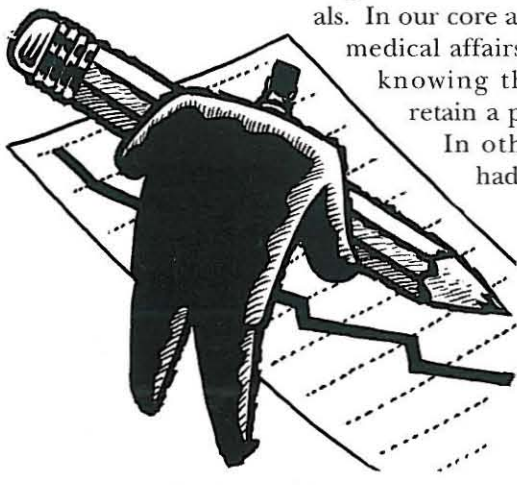
For the rest of this article, I will describe the steps that were taken to achieve this result. At the end I will share my assessment of how the project is going as we finish our first year.

Benchmarking and Goals

In the summer of 1993, shortly after I arrived at Stanford, I undertook some benchmarking exercises and found, to the surprise of many senior administrators, that the university's legal costs were not only equal to those of its peers, but in some cases lower. Nevertheless there was, as I mentioned, a strong desire by many in senior management to see if the legal function could be performed differently to achieve further savings.

As we weighed our choices, including the option of keeping the existing system in place, we established three primary criteria: expertise, elasticity, and economies.

Expertise. We knew that in many of the complex and highly regulated areas of law, the necessary levels of expertise would be achieved only if an attorney handled a wide range of matters and interacted continually with agencies and other leading professionals. In our core activities of academic and medical affairs, we had some comfort knowing that we had and could retain a proper level of expertise. In other areas, however, we had no such certainty.



Elasticity. By employing a large in-house staff, we were faced with the question of whether we could have an appropriate level of elasticity. For example, one year we might have a large number of tax matters, but the next year, our more significant issues might arise in environmental or labor law. One cannot convert a tax attorney to a labor attorney overnight. (In most cases, the tax attorney has no desire to become a labor attorney and might not be good at it even if he or she tried.) We also needed elasticity in the levels of experience being applied to any given matter: some matters might require the senior expertise of an attorney in practice 15 or 20 years, whereas others might only need a new or mid-level associate or possibly a paralegal. Finally, we needed elasticity in our overall budget — that is, to be in a position to either increase or decrease the amount of resources the legal department could bring to bear in a given year without the painful and often debilitating process of hiring and firing personnel.

Economies. Attorneys who are working hard and providing good service need and deserve recognition, including salary increases and bonuses. A time comes, however, when the organization's legal needs have not increased dramatically enough to merit across-the-board pay increases. If the corporation has too many resources on a cost escalator that cannot be stopped much less reversed, it is inevitable that those resources will eventually exceed market costs.

At Stanford we suspected that important economies might be achieved by going to one or more firms that handled the same matters for many clients, knew the industry and substantive areas thoroughly, and thus were able to give answers or generate documents with high efficiency. Indeed, it was not a question of comparing in-house cost-per-hour with the higher billing rates of outside firms, but rather a question of overall cost.

Although there was no predisposition with respect to the outcome, we wanted at least to test our costs against what could be achieved if we outsourced all or a portion of our legal work. Accordingly, we selected 14 law firms to bid.

Some firms were selected on the basis of their strong industry expertise (representation of other universities or medical centers). Other firms were selected on the basis of their strengths in the substantive areas of law we needed (for example, environmental or labor), even if not within our industries.

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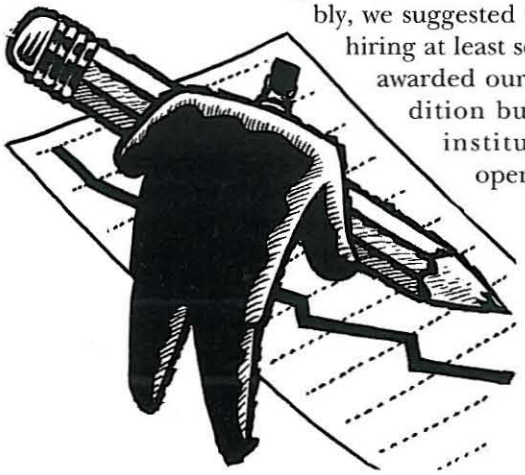
Indeed, we thought there would be advantages to using attorneys not solely involved in higher education or health care and that in some substantive areas it might be useful to draw on expertise developed in other industries. We intentionally selected some firms from other geographic areas, partly to see if there would be a price advantage and partly to avoid conflicts of interest. (For example, we knew we would be active in buying and selling assets related to our medical center, and there could be advantages to using a firm that was not already representing other medical groups in northern California.)

The Bidding Process

We met with each of the firms for a standard two-hour beauty contest presentation and then furnished each firm with what many would consider sensitive and confidential information. We gave them our total budgets for the past several years, showing them how much we had spent in-house and how much on outside counsel, and on what cases. We also showed them the line items for our support functions and personnel costs and how we had calculated those costs.

We decided, however, that the most essential information was what each attorney had in his or her head, so we asked our attorneys to discuss their case loads past and present in an assembly to which all 14 firms had been invited. This obviously was a very difficult step, and in retrospect, we would consider other means of providing the information, although if the presentations were not done en masse, the alternative was a terribly time-consuming and probably more harmful process of attorneys meeting individually with representatives of the 14 firms. At the assembly, we suggested that each firm consider hiring at least some of our personnel if awarded our work: not as a precondition but as a way to preserve institutional memory and open up career paths.



The firms were presented with three levels of bidding. The first level was complete outsourcing. Here a firm would be asked to take over the legal function for the university and the medical center, providing a full turnkey operation: all attorneys and paralegals on a daily basis and for extraordinary matters; a law library; photocopying, messenger service, and other service and supply contracts; and even a general counsel, if they thought it appropriate.

The second level of bids was by component. Here a firm would be asked to provide legal services for specified substantive areas (for example, environmental, labor, tax, etc.), including all litigation that might arise in those areas. Our requirement that litigation be included was intended as an incentive for a firm to act smartly and think strategically in holding our overall legal costs down. We were concerned that if we did not include litigation, firms would see their fixed-price role as a basic housekeeping function, viewing litigation as their opportunity to turn a profit (a perverse incentive built into much of the legal system today). Although the firms struggled with the concept that they would be asked to handle litigation as well as the counseling role for a single price, they eventually came to understand that this was an essential part of the reengineering we had in mind.

The third level of bids was a backup service. Here we told the firms to assume that we had a strong internal staff in a given area (such as academic affairs) and were expecting them to serve as backup partner to our attorneys and be able to answer informal inquiries and brainstorm with them about a case for an hour or two without the meter running.

Evaluating the Proposals

Initially the firms felt that complete outsourcing was the most risky for them, but we urged them to consider the fact that the complete outsourcing approach was probably the least risky from their perspective because they would have total budget control. (This is in fact the model after which legal departments pattern their operations.) Of the 14 firms that made presentations, seven had the capacity to bid on complete outsourcing. All seven did so and several of the smaller boutiques sought to partner with other firms to do the same. All 14 firms submitted proposals for services-by-component and backup services.

Most of the bidders proposed to fold attorneys from the department into their

firms (several proposals for complete outsourcing included plans to hire approximately half the in-house staff, and some proposed hiring a greater number under a more radical profit-sharing arrangement). Most of the proposals for complete outsourcing suggested that we retain a general counsel and one or two other core attorneys, either solely on the university's payroll or on an of-counsel basis with the firm.

All proposals for complete outsourcing and for services-by-component identified criteria for labeling a matter "extraordinary" and thus outside the fixed or budgeted fee. In some cases, firms used a dollar amount; in others, they specified conditions and substantive areas.

In evaluating the proposals, we noted several firms had the potential to reduce our legal costs by approximately 15 to 25 percent while still improving elasticity and expertise. Because many of the firms shared their worksheets with us, we were able to ascertain that these were not lowball bids.

Notwithstanding the economic and other possible benefits of total outsourcing (even with one to three attorneys retained in-house), senior management did not want to become captive to a single firm, at least not at first. Indeed, we concluded that it would be worth giving up some efficiencies by creating a concept of managed competition among two or three firms and retaining a staff to serve our core businesses, preserve institutional memory, and provide future continuity if ever we were to make changes in the selected providers. As a result, we examined the proposals' dollar amounts, expertise, and staffing plans and developed a composite model that drew upon the talents of three designated law firms (plus a fourth firm that worked pro bono) and a core general counsel's staff.

Budgets

Let me turn to the budgeting process we developed and that is now part of the ongoing operation of the office.

We added to the legal office staff a non-attorney who serves as our director of legal services. This person came to us with extensive law firm management experience but now has a much broader role that extends to involvement in the budget process and coordinating client inquiries.

Working with me, the director of legal services developed a matrix of clients and substantive areas these clients would likely need. At the beginning of the budget process, we meet with each of our staff attorneys and ask them to allocate their time by client and substantive area; the law firms make similar allocations. After assigning dollar values to these projections, we get a picture of where legal services might be needed the following year and what the total cost is likely to be. I adjust these num-

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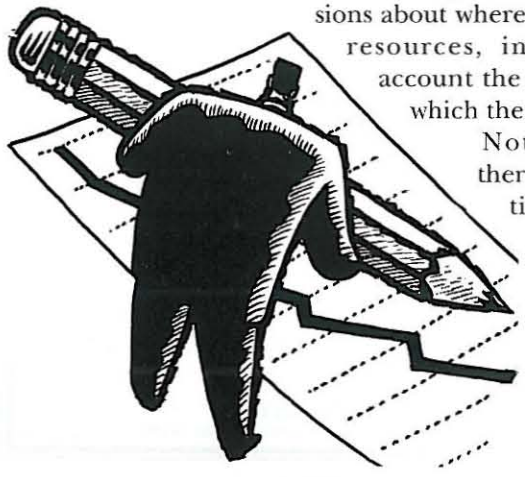
bers based upon my own judgment of where services should increase or decrease, and we take into account what the overall legal budgets are for the university and medical center. We also try to establish a reserve to cover at least some of the unexpected matters that are inevitable in any year. After some fine-tuning, we arrive at a final budget for the fiscal year.

That is only the beginning of the use of the matrix, however. Every month our attorneys and each of the law firms provides a report on their hours, which enables us to compare actual legal services with what was budgeted. (This is what hours initially were meant for: a report of effort, not necessarily value.) Among other things, this process gives us an early warning about where we might be over or under our projected numbers, and in those cases, we typically meet with the attorneys (both on the general counsel's staff and from the law firms) to discuss variances and how we can adjust other activities to stay within our budget. This is becoming an important process for the staff attorneys and notably so for the law firms, who are getting used to the fact that they must operate within budget constraints and that this burden is theirs to share with us.

We also share these numbers on a quarterly basis with our clients, again showing them what our budgeted amounts were and what actual services are. Among other things, this information is helping clients make more educated and focused use of legal resources.

Finally, as we come to the end of a budget year, the same matrices become the starting point for building the next year's budget — again, with input from staff attorneys and the law firms and partnership-oriented discussions about where to increase or decrease resources, including taking into account the overall legal climate in which the university functions.



Note that in all of this, there is a very strong incentive for the law firms to do as much preventive law as possible. With effective preventive law programs, there is a much greater likelihood that the firms can operate within their budgets (that is, achieve profitability while still providing first-rate service).

Evaluation

As we come to the close of the first year of operation after the restructuring, all indications are that the project is working quite well. One important indicator is the campus-wide survey of clients concerning the legal services they received. Only three months into the reorganization, the following areas showed significant improvement in client satisfaction: communicate clearly and concisely (90% of client responses gave a score of 4 or 5, versus 83% the previous year); results meet expectations (up to 87% from a previous 77%); practical and effective advice (86% from 81%); satisfied with outside counsel (85% from 61%); creative solutions (75% from 68%); and anticipate needs and minimize expense (66% from 62%).

There also were areas where scores went down, many of which were predictable and have been corrected since then: is knowledgeable regarding Stanford's policies (scores of 4 and 5 were down to 87% from 93% the previous year); keeps the client informed of progress (down to 67% from 79%); and gives the client a sense that the matter is important to the attorney (down to 76% from 81%).

It has obviously taken some time for the remaining in-house attorneys to feel more comfortable with the reorientation of the office. We have used two different outside management firms to meet with all our attorneys and support staff and with some of the law firm attorneys. The feedback is that most find the new partnership professionally rewarding and challenging. Many, however, are still uncertain about a structure that intentionally has fewer traditionally defined roles.

We are probably at the most difficult stage for the law firms. As most general counsel know, it is not an easy task getting law firms to toe the line in terms of cost control, to say nothing of providing a legal product suited to the needs of a given matter and the client. All too often, corporate counsel has tossed a short question to an outside attorney only to receive a $5,000 memo covering issues far beyond anything that was on our minds or needed to be addressed.

Now the burden is being shared with the

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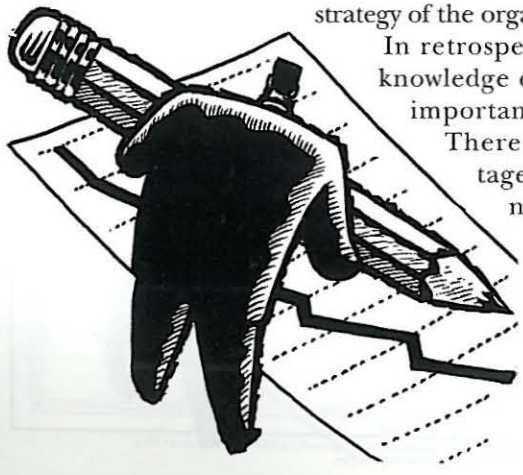
firms to co-manage resources and help make the difficult decisions about the amount of resources that should be brought to bear on any given issue. The ongoing nature of the relationships has made this an easier goal to achieve. Whether one uses the structure we are trying at Stanford or some other approach, I feel quite confident that law firms must learn that they can no longer manage themselves solely on billable hours. Rather, they are going to have to address the same issues being addressed in other industries and consider, among other things, the quality of services provided, the value of retainer contracts managed, profit margins, risk, incentives, and the ability of a limited pool of attorneys to be both front-line lawyers and overall managers (i.e., doing what in-house counsel do every hour of every day).

To help in our communication process, I meet monthly with a representative from each firm to go over the numbers and, more importantly, the quality of service. This is in addition to the weekly staff meetings, where law firm and staff attorneys discuss the work of the office. Once or twice a year, I also try to go to the key offices of each firm and meet face-to-face with attorneys who work on Stanford matters but may not attend our regular staff meetings.

A major task for next year will be to give clients more control of their work. Such a goal is fraught with difficulty and risk. But we are fooling ourselves if we think that by keeping absolute control over the legal function we are ensuring minimal legal exposure for our client. Rather, I see the job of corporate counsel more as facilitating legal services for diverse clients and ensuring that the work being done is coordinated with the overall goals and legal strategy of the organization.



In retrospect, I think a law firm's knowledge of our industry is more important than we anticipated. There are significant advantages when law firm attorneys are sufficiently involved in an industry such that they regularly attend legal and non-legal trade association meetings, read trade publications, understand industry jargon, follow industry court cases and legislative and regulatory developments, and move in and out of industry positions. It also is important that the firm's core business strategy — and its senior management — have as a high priority that the firm be among the top firms serving a given industry.

We have found it a challenge to operate against 30 years of wrongheaded legal culture. Law school education and subsequent mentoring encourage attorneys to be argumentative, nit-picky, issue-spotting, and process- rather than result-oriented. These are not traits that fully serve the legal needs of today's corporate America.

Paul Lippe, Vice President for Business Development and Legal at Synopsis, a major Silicon Valley software company, has tried another way to break the barriers among in-house counsel, outside counsel, and the client. He designated five law firm attorneys as his "virtual associate general counsels" and assigned them the task of overseeing areas such as technology licensing, corporate, international, patents, and government. Lippe, too, has found it difficult to get law firm attorneys to be value-driven and not simply billers of hours. In the report card he prepared after the first 18 months of Synopsis' outsourcing project, Lippe lists many positives, but he also lists these negatives: "only partly plugged into the flow," "not strategic," "not managing results," "not self-initiating," "does not leverage expertise," "no budget leadership," "firms wary," and "no real sharing of responsibility."

Whether outside counsel can make the adjustments needed to achieve the strategic alliances that corporate counsel are looking for remains to be seen. If large law firms cannot make the change, other service providers will fill the gap. We think the approach being tested at Stanford is making good headway. But no matter what approach is used, the goal for corporate counsel must be to reengineer the legal function so that in-house and outside counsel alike have built-in and measurable incentives to reduce legal risk while assuring professionalism, quality, economy, and predictability.

The next five years should be interesting, indeed! ❑