

eLawForum

Transforming Legal Services

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Introduction and Executive Summary

Law firms are among the most profitable and least risky businesses in the world. The profit margins of the top 100 U.S. law firms are at least twice those of America's largest publicly traded corporations.

Corporations typically select outside counsel without exposing them to rigorous competition. Corporate legal spending therefore tends to occur in the absence of any organized quality and price competition. By granting law firms what amount to exclusive relationships, corporations have created a sole-source market that sacrifices their ability both to shift risk to their law firms and to reduce legal fees significantly. Insulated from price competition in this closed environment, law firms have kept profitability high by raising their hourly rates while simultaneously dramatically improving productivity through specialization.

Corporations have increasingly attempted to avoid corporate waste by controlling legal costs. Seeking accountability, corporations institutionalized the billable hour, imposing complex rules and auditing. But because corporations accept the sole-source market, law firms play a cat-and-mouse game with the billable hour and cost-plus pricing, hoarding productivity gains and saddling clients with both cost and outcome risks. In search of "discounts" from hourly rates, large corporations fractured their "spend" over hundreds of law firms and created their own internal "law firms"—bringing nearly half of their legal work in-house. This has led to the creation of inefficient bureaucracies to manage legal work.

One company has developed an alternative to the sole-source/billable hour/cost-plus market. eLawForum (www.elawforum.com) competitively sources legal work for a growing number of large corporations. eLawForum makes fixed-fee deals for large aggregations of legal work. This new competitive legal market shifts risk from the company to the law firm, realigns incentives and creates dramatic savings. An analysis of eLawForum's competitions demonstrates that the best law firms are the most cost-effective, that fixed fees work for significant and complex assignments and that corporations choose to stay with their current legal providers about half of the time. By changing the relationship between quality and price, eLawForum has the potential to transform the legal services industry.

The Corporate Legal Market

Law firms are incredibly profitable businesses. Since 1987, the weighted average operating margin for firms in the Am Law 100 is at least twice that of America's 100 largest publicly traded corporations.¹ The 14,867 partners in these law firms divided \$10.1 billion in profit among themselves in 2002. The explanation for this striking profitability is clear: Large sellers of legal services do not face the same kind of competition as their clients do.

Leading law firms are extremely adept marketers. By focusing attention on high-stakes cases or major acquisitions, they emphasize the relative cost of their services to the potentially high cost of the outcome. Success or failure in a "bet-the-company" litigation or a multi-billion dollar acquisition dwarfs the law firm bill. What is overlooked is that most law firm work falls outside this category. The sole-source/billable hour/cost-plus market enables the leading law firms to maintain 40% margins across the board, pricing routine matters the same as significant matters.

In the parlance of disruptive innovation theory, corporations are "overserved" when they pay top-firm rates for routine matters. Corporations have reacted by fragmenting their legal spend in two ways. They have gone "down-market," using smaller law firms that charge lower hourly rates. They have brought routine work in-house, building large in-house law departments. Fragmentation, however, erodes the corporation's market power, creates layers of bureaucracy to administer the multitude of firms and increases the corporation's fixed costs. For the leading law firms, fragmentation means loss of market share.

Specialization

Specialization is the way law is practiced in the corporate legal market. Law departments would not dream of hiring employment lawyers to litigate commercial disputes any more than asbestos counsel would be trusted to handle securities class actions. Law is just as specialized as medicine.

The demographic explosion in lawyers has accelerated specialization. The number of lawyers practicing in the U.S. has tripled during the last 30 years. Today, more than 1 million lawyers practice in the U.S.

Information technology has also accelerated specialization. Large international publishing firms—Wolters-Klower, Reed-Elsevier and Thompson—parlayed the sleepy law

¹ *The American Lawyer* publishes an annual survey of the revenue and profitability of the largest law firms. The Am Law 100 has maintained nearly 40% margins since the survey began in 1987. The operating margins of America's 100 largest publicly traded corporations hovered around 12% during the same period. Some argue that the Am Law margins appear high because Am Law 100 partners receive no salaries, while the cost column of publicly traded companies includes salaries paid to executives and management. However, assuming the average partner's salary is roughly \$200,000, the Am Law 100 would still have profit margins approaching 30%.

library into a \$15 billion-a-year industry. Proprietary information retrieval systems (CCH, Westlaw and Lexis-Nexis) have revolutionized legal research.

The growth of specialization means that most corporate legal work does not involve complex problem-solving. With the right experience, specialists can easily recognize patterns and apply familiar tools so that they do not need to “reinvent the wheel.” Pattern recognition dramatically increases efficiency. Hourly rates assume everything requires complex problem-solving. While few industries have experienced greater productivity gains from specialization, the absence of a competitive market enables law firms to hoard cost savings instead of passing them along to corporations.

The Sole-Source Market

The billable hour is a relatively recent invention. Before World War II, law firms weighed a number of factors in deciding what to charge their clients: The significance of the matter, the skill required, the work done and the result.² Law firms provided little information on the time spent because they attempted to price on the basis of value. In the pre-billable hour era, corporations outsourced most of their legal work and used fewer law firms than they do today.

After World War II, law firms and corporate law departments moved to hourly billing as a way to more accurately measure the value of legal services. The billable hour became the standard system for overseeing and compensating outside counsel. In lawyer-like fashion, strict rules were imposed, specifying in minute detail what could appear on bills. At \$300, \$400, \$500 and \$600 per hour, it seems logical to account for a tenth of an hour. Law department and law firm compensation inevitably became skewed towards those who excelled at the cat-and-mouse game created by the billable hour.

“Make” vs. “Buy”

The billable hour fragmented the corporate legal spend. Against the yardstick of hourly rates, general counsel realized that it was cheaper to hire in-house lawyers than outside counsel—to “make” rather than “buy”. Without taking the fully allocated cost of in-house legal staff into account, outside counsel appear to be twice as expensive.³ Corporations arbitaged this differential by expanding their in-house law departments. Over time, corporate law departments have taken over approximately half of corporate legal work. Today, many Fortune 100 law departments have mushroomed to the point where they rival the size of the world’s largest law firms. Citibank and General Electric, for example, employ 1,200 and 800 lawyers respectively, with a presence in every continent. Thus the sole-source/billable hour/cost-plus business model encouraged corporations to compete with outside suppliers of legal services, reducing the market for law firms.

² Herbert M. Kritzer, “Lawyer’s fees and the Holy Grail: Where should clients search for value?” *Judicature*, 77:4, Jan-Feb. 1994, p. 187.

³ By PriceWaterhouseCooper’s estimate, outside counsel cost at least 56% more than inside counsel. PriceWaterhouseCoopers, “Law Department Spending Survey Trends Analysis Report,” 1999, p. 20.

Most economists would argue that legal services should be outsourced because they are not the core competence of corporations. The fact that corporations “make” rather than “buy” half of their legal services demonstrates that sole-source/billable hour/cost-plus business model turns economy theory upside down.

Going Down Market

The explosive expansion of law departments was not the only way corporations fragmented their legal spend in reaction to the billable hour. After asking incumbent law firms for discounts from their standard hourly rates, general counsel took the further step of searching for lower hourly rates among firms they had not used before. The move “down-market” meant giving more routine work to smaller law firms charging lower hourly rates. The search for lower hourly rates fractured the “spend” of Fortune 500 corporations over hundreds of law firms.

The hidden cost of micro-managing the explosion of incumbent law firms overwhelms any savings lower hourly rates promise. Law departments have been forced to commit vast resources to audit hundreds of monthly bills detailing the hours spent by each partner, associate and paralegal. The auditing function has grown so complex that it has spawned a new industry of outside auditors and software vendors. These outsourced services can account for more than 2% of the corporate outside legal spend.

Wasting Corporate Assets

Corporations have reacted to the fragmentation of their legal spend. In an attempt to regain their corporate market power, they have provided volume commitments to a few law firms in exchange for hourly rate discounts.⁴ Attempting to simplify the problem of managing the proliferation of law firms and legal vendors, they have reduced the number of incumbent law firms to a “pre-approved” list of preferred counsel. The insurance industry has gone the furthest in developing a system of “panel counsel” firms.

Simply aggregating demand in the sole-source/billable hour/cost-plus market does not save money. Reducing the number of firms—what law departments call “convergence”—in return for a 10%, 15% or 20% discount does not translate into legal service cost reductions. The Am Law 100 firms make 40% margins *after* giving discounts. Using approved firms and panel counsel is a form of command-and-control that cements the sole-source relationship.

Finally, the “beauty pageant” has also failed to contain costs. The four or five law firms invited are too few to ensure the best representation for a significant litigation. The winning firm is compensated using the billable hour.

It is extremely difficult to avoid wasting corporate assets within the confines of the sole-source/billable hour/cost-plus market. With one hand, law firms give discounts on hourly rates to their largest clients. With the other hand, they take back what they have given by raising the base hourly rates to which the discounts are applied and increase the number of hours they bill to do

⁴ Zoë Baird, “A client’s experience with implementing value billing,” *Judicature*, 77:4, Jan.-Feb. 1994, p. 199.

the same work. Law firms are masters of the cat-and-mouse game of the billable hour. As long as they respect the procedures mandated by the law department, law firms can circumvent any attempts at cost reduction by controlling the two key variables—the base rate and the number of hours spent.

The Billable Hour Jeopardizes Results

The billable hour fosters an adversarial environment that leads to higher settlements. At the outset of litigation, the corporate defendant has access to more information to evaluate the case than the plaintiff. Yet the billable hour encourages suspension of judgment and exhaustive discovery. This educates the plaintiff and may lead to surprises that expose the corporation to additional liability. The “scorched earth” policy of refusing to negotiate settlement until after the close of discovery and filing of summary judgment motions hardens positions and escalates the plaintiff’s costs that must be factored into any settlement.

The Fixed Fee Alternative

General counsel are recognizing the pitfalls of the billable hour.⁵ In 1993, Daniel Hapke, then Chairman of the American Corporate Counsel Association (ACCA), pointed out that hourly billing pressures lawyers to pad their bills, perform needless work and engage in similar unprofessional conduct. Lawyers are encouraged to stretch out their time rather than seek early results.⁶

Robert Hirshon became so alarmed by the unending drive for billable hours that he made it the focus of his American Bar Association presidency. In 2002, the ABA released a comprehensive study indicting the billable hour on a series of counts. Hirshon explained that the billable hour is “a counter-intuitive measure of value.”⁷ According to a partner of Bartlit Beck Herman Palenchar & Scott, “the only way lawyers made more money was to bill more hours as opposed to doing a better job.”⁸

Corporations have started to focus on alternatives to the sole-source/billable hour/cost-plus market. The ABA study highlights the need for an alternative way of pricing legal services and recommends the fixed fee. “Lawyers should be at least as capable to set fixed fees for most engagements as auditors, construction contractors and even car mechanics are. All of these other jobs have substantial risks of cost overruns due to unexpected difficulties.”⁹

⁵ By 2001, a study by the BTI Consulting Group found that nearly three-quarters of companies were dissatisfied with their outside counsel. *The Strategic Review and Outlook for the Legal Services Industry*, p. 69. “Clients...see no substantial difference between any of the law firms out there. Quality is good, but clients can find it in virtually any firm.” *Id.* at 18.

⁶ Daniel S. Hapke, Jr., “Professionalism, Quality, and Hourly Billing... Are They Compatible?” *American Corporate Counsel Association Docket*, 11: 3, pp. 30-38.

⁷ American Bar Association, “ABA Commission on Billable Hours Report,” August, 2002, p. ix.

⁸ American Bar Association, “ABA Commission on Billable Hours Report,” August, 2002, p. 36.

⁹ American Bar Association, “ABA Commission on Billable Hours Report,” August, 2002, p. 16.

The eLawForum Model

One company, eLawForum, is disrupting the sole-source/billable hour/cost-plus market and replacing it with a competitive-source/all-inclusive fixed fee/total cost market. By shifting risk, aligning incentives, aggregating demand and basing compensation on results, eLawForum delivers dramatic results.

At the heart of the eLawForum process is a “quality competition.” Highly qualified law firms compete and provide their services at very substantial savings. Over the past four years, the business model—built upon the quality competition—has evolved through four stages.

In its first stage, eLawForum did not require law firms to propose fixed fees so that hourly rates remained the dominant compensation structure. Moreover, the cost-plus model allowed the law firms to continue charging for their expenses as well as their fees. Hourly rates do not enable corporate clients to know their legal service cost in advance, nor do they provide a basis for cost comparison. In the end, savings from the discounted, capped or partially fixed compensation schemes were uncertain.

The second stage saw the introduction of the *fixed fee requirement*. eLawForum made fixed fee arrangements mandatory in all competitions. For the first time, it became possible to compare the legal service cost (fees and expenses) of competing proposals. Corporations could budget legal service costs with the confidence of a fixed fee and achieve significant, measurable savings.

In the third stage, in addition to high-stake single matter assignments, eLawForum began to leverage the market power of the corporate client by *aggregating* various legal matters into the same assignment. eLawForum developed sophisticated prospectuses and data sets to assist the law firms in analyzing the complex structures of these new aggregation deals. Third stage aggregation deals typically yielded 50% legal service cost reductions. The 2002 ABA study noted the tremendous success eLawForum has enjoyed with aggregating demand for fixed fees.

The fourth stage added a new focus on management for *total cost*—liability cost as well as legal service cost. While competition drove the fixed fee down to breakeven, a share in the savings over historic liability costs offered the winning firm the potential to profit. Through close communication with the competing law firms, eLawForum identified and priced each risk factor separately and became a strong advocate in selling the deal. In the fourth stage, legal service cost savings grew to *two-thirds* as winning firms bet on reducing liability costs by 25% to 50%.

Case Studies

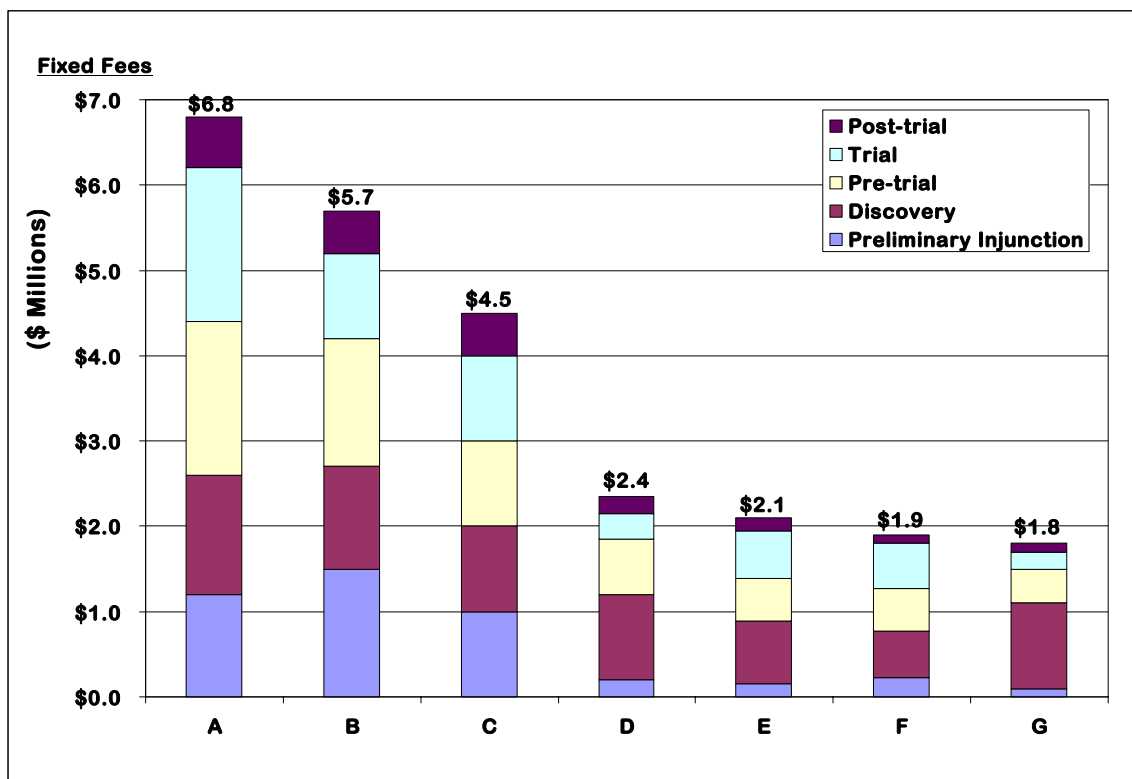
To assess the eLawForum model's impact, we studied 50 competitions over the last four years involving the top 100 U.S. law firms. A consistent pattern emerged. There were always large spreads in the fixed fee proposals of the competing law firms and the results obtained were dramatically below the corporation's budgets. This held true whether the eLawForum competitions were for single matters or aggregations or involved the most complex litigation or routine matters, and existed regardless of the practice area of law (e.g. commercial litigation, products liability, employment/labor/ERISA, class actions, asbestos, M&A, real estate, intellectual property).

The following five case studies illustrate the power of the eLawForum model.

Case Study 1: Single Matter

A representative single matter eLawForum competition involved defense counsel for major patent infringement litigation. There was a \$500 million exposure—a “bet the division” case. More than two-dozen law firms were invited to compete. Seven Am Law 100 firms provided fixed fee proposals. The eLawForum prospectus required the competing law firms to breakdown their fixed fee into five stages: preliminary injunction, discovery, pre-trial, trial and post-trial. This was important because the outcome was likely to be determined in the earlier stages and the corporation was only obligated to pay through the stage where the case was resolved. As illustrated in **Figure 1**, the highest overall bid was \$6.8 million and the lowest was \$1.8 million—a \$5 million spread. There was as much variation in the proposed fees for the different stages as there was overall. In order to win, the corporation’s first choice agreed to reduce its fixed fee to \$1.8 million, almost a 75% savings compared to the highest bid.

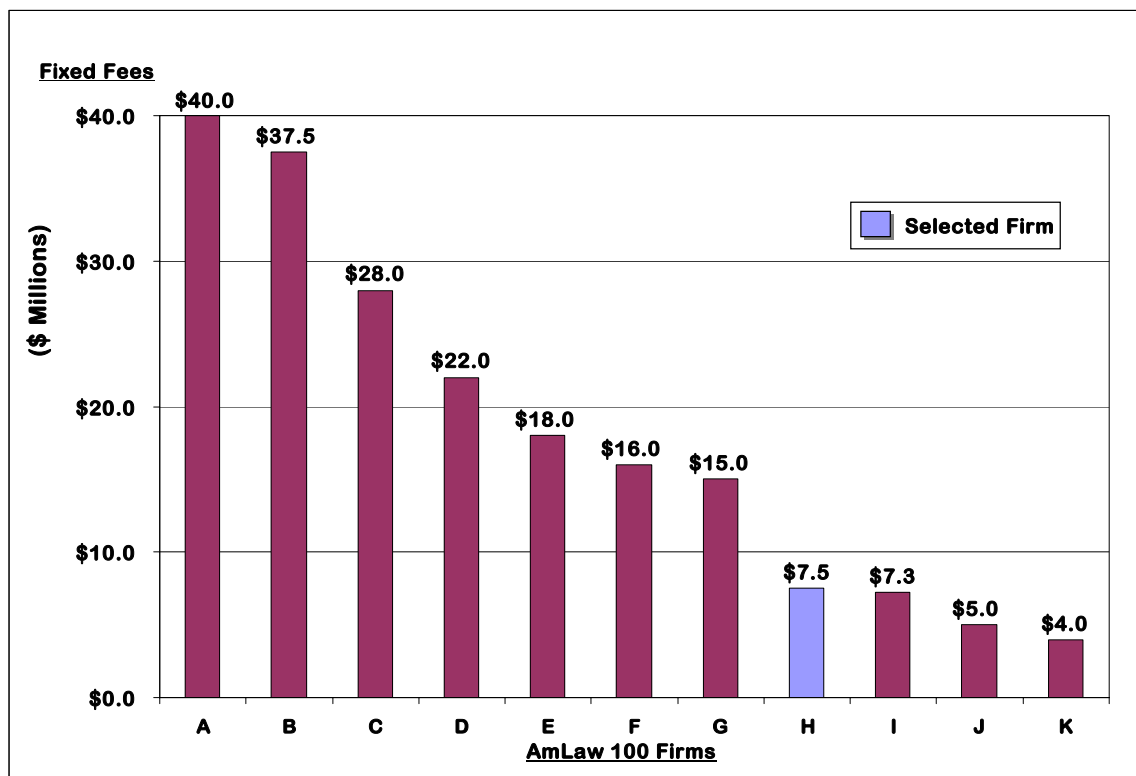
Figure 1: Single Matter Case Study



Case Study 2: Commercial Litigation Aggregation Deal

A representative eLawForum aggregation deal involved selection of commercial litigation national counsel for a Fortune 50 corporation. eLawForum aggregated all of the corporation's new commercial litigation for a two-year period. Thirty law firms were invited to compete. As illustrated in **Figure 2**, the highest fixed fee proposed was \$40 million and the lowest was \$4 million—a \$36 million spread. The corporation retained one of its incumbent counsel for a \$7.5 million fixed fee.

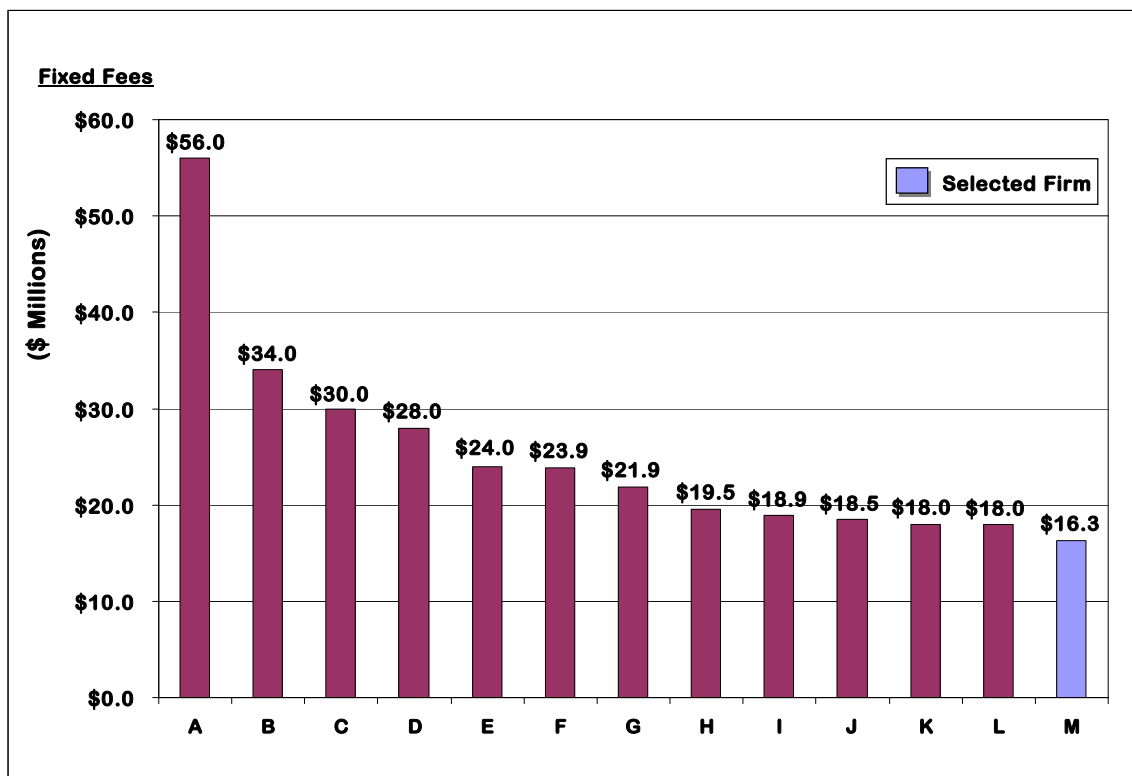
Figure 2: Aggregation Case Study



Case Study 3: Class Action Aggregation Deal

Another representative eLawForum aggregation deal involved selection of class action national counsel for a Fortune 500 corporation. eLawForum aggregated 17 class actions in multiple jurisdictions across the United States. Forty law firms were invited to compete. As illustrated in **Figure 3**, the highest fixed fee proposed was \$56 million and the lowest was \$16.3 million—a \$40 million spread. The corporation saved 50% of its \$33 million budgeted legal service cost.

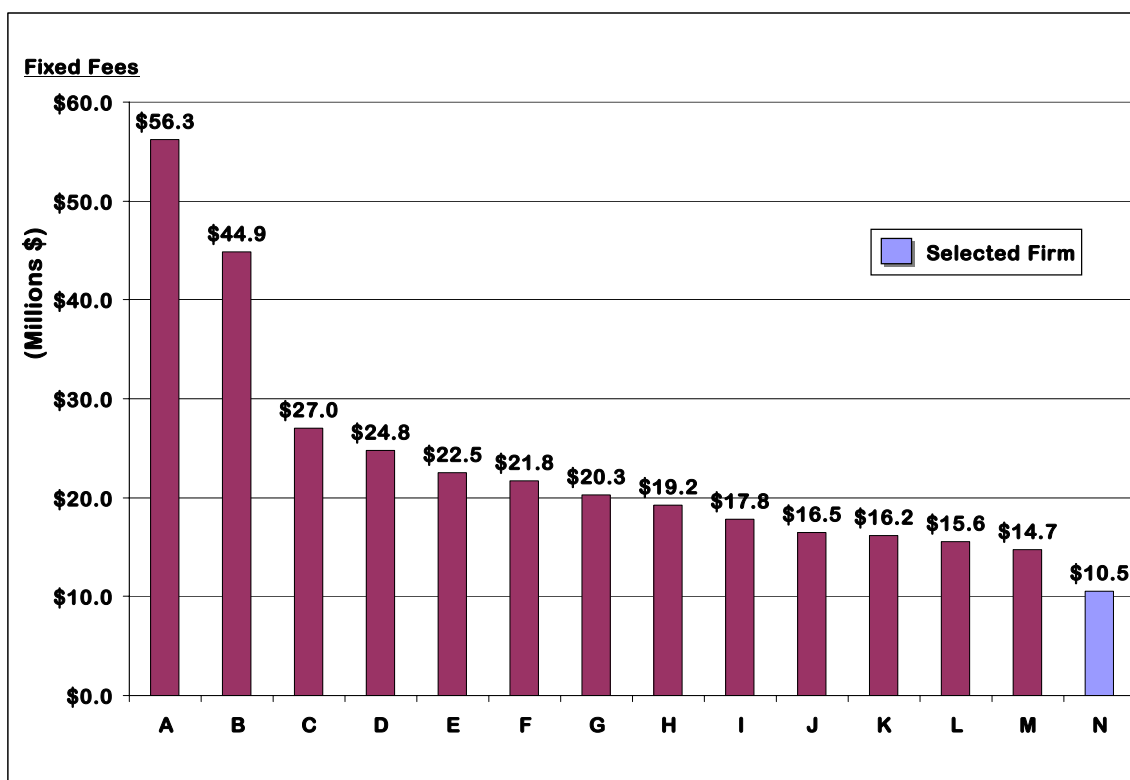
Figure 3: Class Action Aggregation Case Study



Case Study 4: Total Cost Management

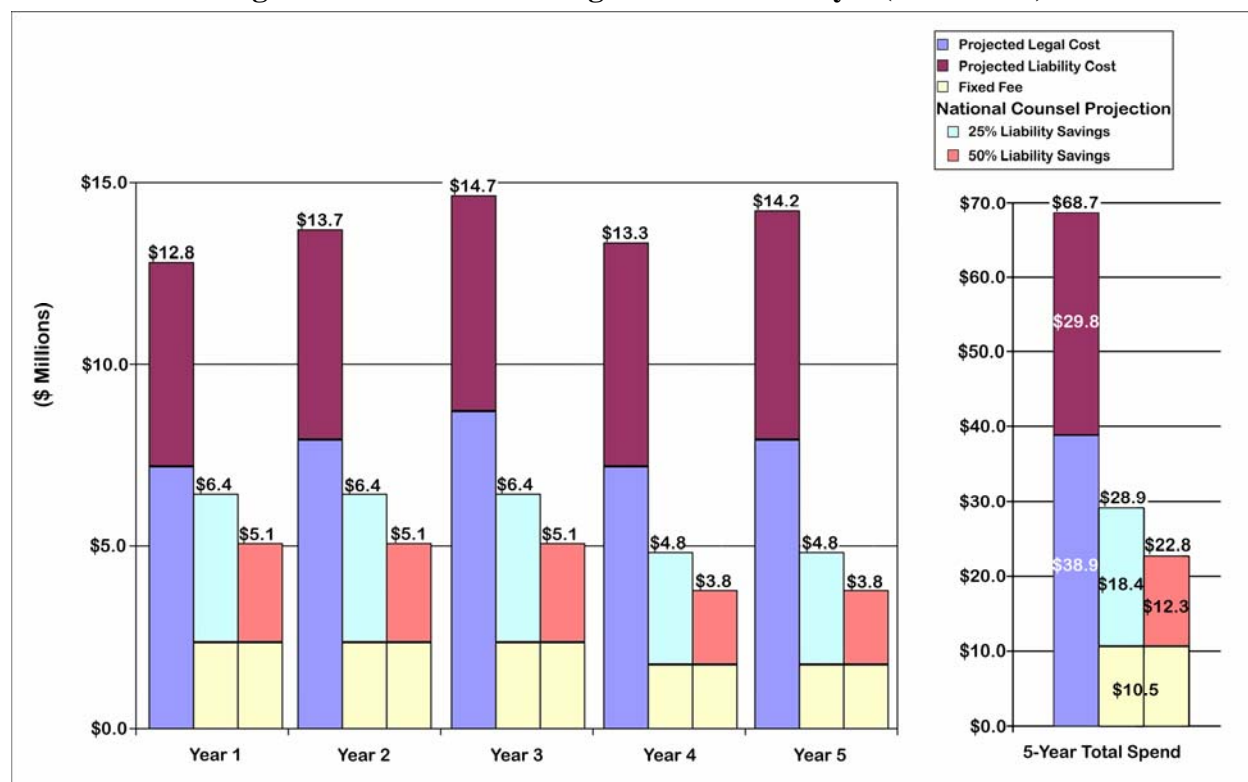
The next two representative stage four aggregation (total cost management) projects demonstrate the benefits of the eLawForum approach. The first involved eLawForum packaging a Fortune 500 corporation's labor, employment and ERISA litigation. The assignment envisioned that the majority of the 450 cases in these practice areas would be future claims rather than existing ones. The eLawForum prospectus stipulated that the fixed fee would be paid in 20 equal quarterly installments. Forty-four firms, including 31 incumbents, were invited. As illustrated in **Figure 4**, the highest proposed fixed fee was \$56.3 million, while the best proposal was \$10.5 million; the spread was \$45.8 million.

Figure 4: Total Cost Management Case Study 1 (Fees)



As illustrated in **Figure 5**, the benchmarks against which savings are measured are what the corporation would have expected to pay for an equal number of cases based on its historic cost—legal service cost (fees and expenses) and liability cost. Against a projected legal service cost benchmark of \$38.9 million, the corporation locked in savings of \$28.4 million. Against a projected liability cost benchmark of \$29.8 million, the winning law firm expects savings of 25% (\$17.5 million) to 50% (\$14.9 million) and, when the final case is resolved, will earn one-third of this liability savings.

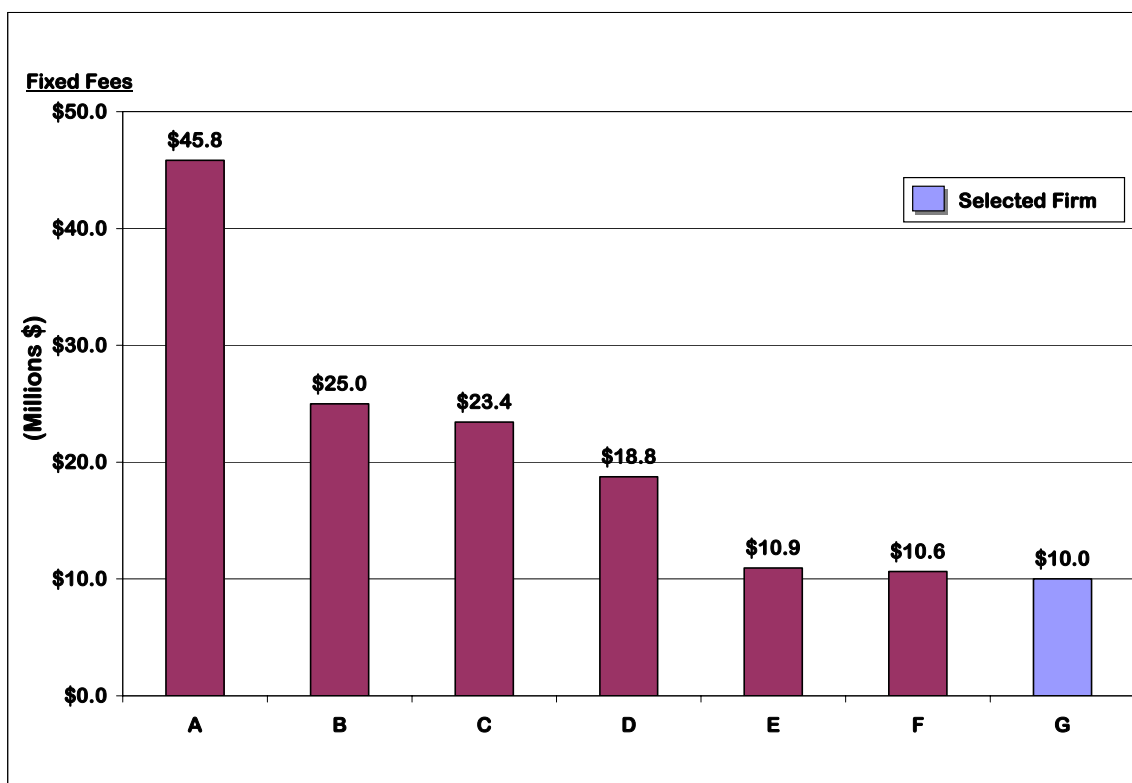
Figure 5: Total Cost Management Case Study 1 (Total Cost)



Case Study 5: Asbestos Litigation

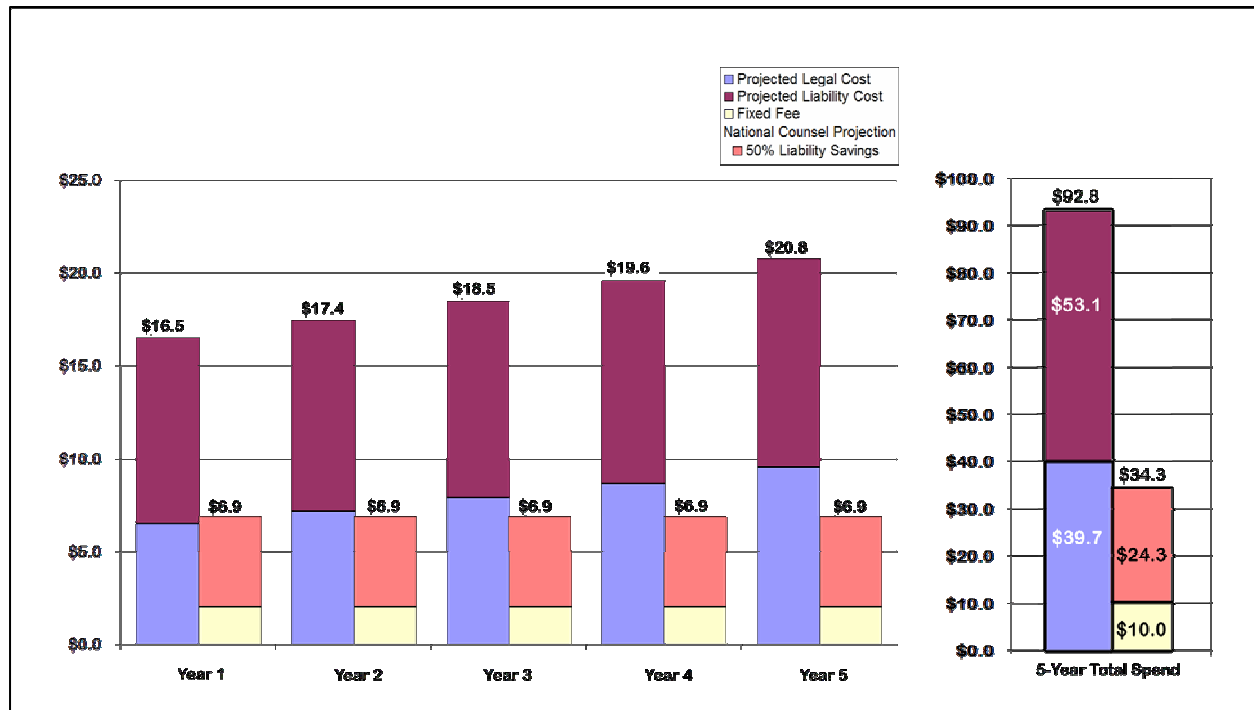
The second representative aggregation (total cost management) involved eLawForum packaging a Fortune 500 corporation's asbestos litigation. The assignment envisioned that the majority of the 625 cases would be future claims rather than existing ones. The eLawForum prospectus stipulated that the fixed fee would be paid in 20 equal quarterly installments. Twenty-nine firms, including 13 incumbents, were invited. As shown in **Figure 6**, the highest proposed fixed fee was \$45.8 million, while the best proposal was \$10 million; the spread was \$35.8 million.

Figure 6: Total Cost Management Case Study 2 (Fees)



As illustrated in **Figure 7**, the benchmarks against which savings are measured are what the corporation would have expected to pay for an equal number of cases based on its historic cost—legal service cost (fees and expenses) and liability cost. Against a projected legal service cost benchmark of \$39.7 million, the corporation locked in savings of \$29.7 million. Against a projected liability cost benchmark of \$53.1 million, the winning law firm expects to save 50% and will earn one-third of this liability savings.

Figure 7: Total Cost Management Case Study 2 (Total Cost)



Conclusion

The 50 eLawForum competitions we studied demonstrate the clear advantage to corporations in seeing a large number of fixed fee proposals. Large spreads and dramatic savings are only possible when a broad field of pre-qualified law firms take part in the competition. The results of eLawForum's process dispel some fundamental myths and concerns of the legal services industry (see box)

The ABA considered eLawForum's results so compelling that it featured one of eLawForum's competitions in its August 2002 billable hour study. As the General Counsel of Nationwide Insurance, Pat Hatler, explained, the eLawForum process focused Nationwide's legal team on "the strategic approach we wanted to bring to these cases. We had to really understand the nature of these cases and to think about them in a different way."¹⁰

eLawForum's four stages of business model development have resulted in progressively greater savings. In the stage three deal shown in **Figure 3**, eLawForum saved its corporate client \$16 million with a 50% reduction in legal service cost. Rather than spread the legal work in a practice area across two or three dozen firms, demand aggregation gives the winning law firm the role of national counsel or national coordinating counsel. In the two stage four deals shown in **Figures 4-7**, eLawForum saved its corporate clients \$25 million and \$30 million respectively in legal service cost. eLawForum was able to move from half to two-thirds legal service cost reductions through combining liability savings-sharing with demand aggregation. Managing for total cost (legal service cost and liability cost) multiplies the size of the deals and generates the greatest savings.

eLawForum's unique business model is supported by enabling technologies. eLawForum invested millions of dollars in developing specialized Internet-based software. Without this platform, it would be impossible to exchange enough data (gigabytes) with the large number of qualified law firms required to create a competitive-source/all-inclusive fixed fee/total cost market. As **Figure 8** demonstrates, eLawForum's business model breaks historical tradeoffs between liability cost certainty and price and between quality and price.

eLawForum's results disprove three common myths:

Myth 1. The best law firms charge the most.

This is true in a sole-source market with cost-plus pricing. The eLawForum competitive-sourcing model reverses the dynamics of the traditional outside counsel relationship. eLawForum's first-time customers are usually surprised to learn that the best law firms are the most competitive. This is logical: The most experienced and capable lawyers are the most confident in their ability to assess risk and work most efficiently.

Myth 2. Competitive sourcing for fixed fees has the most utility for low-end "commodity" work.

The data shows that eLawForum's most frequent and successful aggregation deals involve complex work. The same is true of big-ticket litigation as seen in the "bet-the-division" patent litigation case competition we examined.

Myth 3. Competitive sourcing requires corporations to hire lawyers they don't know.

Of the 50 eLawForum competitions we studied, incumbent law firms won half the time.

¹⁰ American Bar Association, "ABA Commission on Billable Hours Report," August, 2002, p. 34.

Figure 8: Differences between Sole-Source and eLawForum Models

	Sole-Source Model		eLawForum Model
LEGAL SERVICES COST	<i>Low certainty, high cost</i>	➔	<i>High certainty, low cost</i>
	Sole Source	➔	Competitive Source
	Reduces Market Power	➔	Leverages Market Power
	Cost Plus, Billable Hour	➔	Fixed Fee
	Complex Billing & Auditing	➔	Quarterly Billing
	Penalizes Efficiency	➔	Rewards Efficiency
	Costs Rise Faster than Inflation	➔	Costs Go Down
	Corporation at Risk	➔	Law Firm at Risk
	No Economies of Scale	➔	Economies of Scale
	No Infrastructure Investment	➔	Infrastructure Investment Rewarded
	Specialization Benefits Law Firm	➔	Specialization Benefits Corporation
LIABILITY COST	<i>Low quality, high cost</i>	➔	<i>High quality, low cost</i>
	Narrow Field of Qualified Firms	➔	Broad Field of Qualified Firms
	Exhaustive Discovery	➔	Focused Discovery
	Delayed Evaluation	➔	Prompt Evaluation
	Adversarial Environment	➔	Cooperative Environment
	Late Settlement	➔	Early Settlement
	Corporation at Risk	➔	Law Firm & Corporation at Risk
	Fragments Spend "Downmarket"	➔	Aggregates Spend with Top Firm

Success bred success. eLawForum repeatedly innovated to hone its disruptive model. It recognized that fixed fees were indispensable to achieving measurable savings. It used demand aggregation to generate larger savings. Its latest innovation generated still larger savings by providing law firms with the opportunity to profit based on results. eLawForum's success in working out the details of these innovations is seen in the magnitude of the value eLawForum created in the case studies we examined.

As long as corporations have no alternative to the sole-source/billable hour/cost-plus market, law firms can play a cat-and-mouse game, hoarding productivity gains without taking any risk. The emergence of eLawForum's competitive-source/all-inclusive fixed fee/total cost market changes the rules. Corporations now see productivity advances in law firm specialization translated into substantially lower prices. And, as we have witnessed in other industries, a dynamic marketplace will drive yet more innovation and lower prices.