Bigger Isn't Better

One-stop shopping at giant global firms has its limits, says GE's former top lawyer.

By Ben W. Heineman, Jr.

THE RISE OF LARGE, HIGH-QUALITY, global corporate law departments started more than 20 years ago. It was aimed, in part, at breaking up the "monopolies" that law firms had with corporations. Using a range of initiatives from requests for proposals to auctions, in-house counsel sought to end these cozy relationships and introduce a measure of competition into the law firm–client dynamic. The mantra of "lawyers, not law firms" was uttered so often that it became a cliché.

Because of these pressures—among others—law firms increasingly focused on becoming more effective business organizations. Some followed globalizing clients and looked to provide cross-specialty, cross-border service, either through acquisitions or organic growth, or both. This trend led to the rise of global megafirms—such as Clifford Chance, Linklaters, Jones Day, Freshfields, Allen & Overy, White & Case, Latham, and Skadden—with about 2,000 lawyers (plus or minus 10 percent), a significant proportion of whom practice outside their home country.

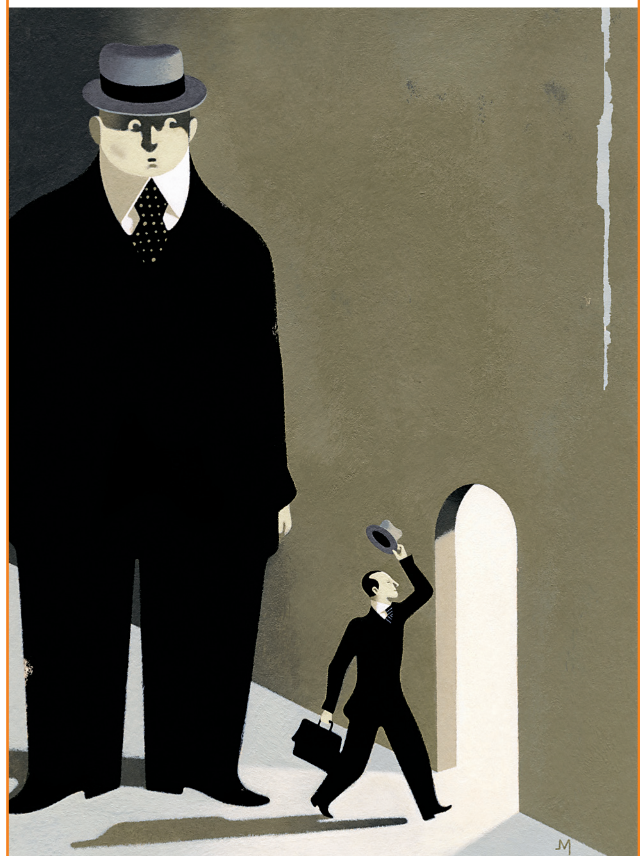
These firms have sought to regain monopoly positions with desirable multinational clients by aggressively asserting that they are a global "brand" in various types of practices (such as capital markets, transactions, litigation, or full service). Until this year's economic downturn, many of these firms had rising revenues and profits per partner. As a result, many have argued that bigger is better and that consolidation for global one-stop shopping is inevitable in the business of law.

As general counsel of General Electric Company's global law department for many years (with approximately 1,100 in-house lawyers), I have been skeptical that the global megafirms, in fact, provide the claimed superior service, quality, or price. Indeed, the relationship between the big law departments and big firms is often bedeviled by prickly issues relating to power, money, culture, and, ultimately, the foundational question of who controls the corporation's legal matters.

These questions have become more salient as the global economy turns down, but big firms' expenses and rates continue to rise. I recognize that GE may not be representative of in-house law departments, even big ones, and that global firms will point to paying clients as the best answer to doubts. I will return to these points at the end. But let me summarize the fundamental questions that potentially separate global law departments and large global law firms. (These questions may also apply to midsize firms.)

■ **DOES GLOBALIZATION CREATE HIGHER COSTS?** When firms expand, especially by acquisition, they are clearly taking on higher costs in people, space, and infrastructure. Yet, how many law firms have detailed, systematic integration policies, which identify "synergies" that can lead to cost reductions? How many have relentless, durable cost control programs? How often do we hear that many of the overseas offices or acquired firms are "loss leaders"? Indeed, global firms may often finance part of their expansion with debt, leading to even higher annual costs and greater risk.

■ **DO HIGHER COSTS (AND INCREASED RISKS)** put enormous pressure on firms to bill more per partner and per matter to cover the huge annual costs of a global firm—even before equity partners take home profits? My GE meetings with big-firm leaders usually began with a stark comparison of differing economic imperatives and worldviews. I had to operate the legal department



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within a budget; they had to bill and collect like crazy for almost two-thirds of the year to feed all the mouths before they made any profit. Billing targets are red flags for clients. For example, didn't these pressures lead to overstaffing, unwarranted markups for paralegals and young associates—work that an inside department could outsource far less expensively—and strong incentives for overbilling?

WHY DO LAW FIRMS take such a narrow view of "productivity"? In simplest terms, a total productivity increase in business is defined as more output with less input. To maintain margins in fierce global competition, the corporation has to lower costs along with price. But for law firms, "productivity increases" mean leverage—more lawyers per partner or per matter—or more hours billed per lawyer. Both of these measurements speak to increases in firm hours and revenues. But, with rising compensation and operating expenses, they do not, in and of themselves, remotely speak to more product for clients with less cost and less price. For the largest firms, with their cost problems and billing pressures, this "productivity disconnect" with clients can be acute. A truly productive law firm could get the same result with fewer lawyers and less total cost (and free up hours for other efficient work for other clients). Indeed, at GE I came to believe generally that small was beautiful, and big was wasteful. Until the big, global firms candidly address the ultimate issue of productivity on a "total cost" (single price) per-matter basis, they will have a hard time being on the same economic page as many corporate clients.

HOW CAN THE VAST GLOBAL FIRMS avoid a large "mediocre middle" and sustain a culture of high performance? Can they hire, teach, and retain the best in a firm with thousands of lawyers ["The Lost Generation?," March]? How can they evaluate and maintain quality control over the large numbers of more senior associates and nonequity partners? How, in fact, on large, international matters with huge staffing, do they have "project management" discipline to ensure quality and avoid billing for unnecessary work, poor work, and rework? Creating a unified culture across boundaries and nationalities, when the international lawyers are not homegrown, is perhaps an even more significant problem than quality control—especially when law firm acquisition and integration planning may be unsophisticated.

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WHY SHOULD GLOBAL CLIENTS buy the specialty cross-sell from name-brand global firms? Acquiring in-house specialists has been an important element in the growth of corporate legal departments. It gives companies the capacity to evaluate and find the best outside specialists and not blindly accept a cross-sell from firms. Thus, for the global law legal department with a high level of specialization, the cross-sell by the global firm is no more compelling than before (and because of cost and quality issues may be even less so).

This is true even for the biggest firms, which seek to profit from a particular practice area, such as cross-border transactions for major clients. Broken up into pieces, transactions, of course, involve different legal issues beyond basic deal questions of price and control: antitrust, litigation, environmental health and safety, improper payments, and a host of other issues relating to myriad national and international laws. If those issues are complex and difficult, it is questionable whether one firm has the capacity to address them.

SIMILARLY, WHY SHOULD GLOBAL CLIENTS buy the cross-border cross-sell from the biggest firms? The global law department may have as much as 50 percent of its lawyers practicing in jurisdictions outside headquarters. These lawyers are often local nationals and are knowledgeable about outside lawyers in Shanghai or Mumbai or Berlin or Tokyo. Sophisticated purchasers of international legal services will not be persuaded by a cross-border cross-sell on the basis of a firm's brand. An antitrust issue under China's new competition laws, environmental due diligence when purchasing Russian assets, a target's improper payment problems in the Middle East, accounting issues in Japan, political issues in Poland—these may be critical to the cross-border transaction and require separate counsel with special expertise. Again, the task of putting together the right inside and outside teams on a major cross-border matter almost always, if properly done, involves far more than simply signing up with a big global firm. This may be especially so because some global firms, such as Linklaters, boast about charging higher rates on cross-border matters.

UNDER NEW ACCOUNTING RULES, won't the requirement that deal costs be "expensed," not "capitalized," increase the sensitivity to the megafirms' high legal costs on cross-border transactions? A Financial Accounting Standards Board rule (FAS 141(R))—and a similar International Accounting Standards Board rule—will take effect in 2009. These rules require that legal costs on transactions be treated as "expenses" in the year incurred, not as costs of the acquisition that can be

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capitalized and amortized over many years (or deferred indefinitely as goodwill). If they weren't sensitive to deal costs already (because they were capitalized), in-house lawyers and business people will become much more so now because all annual legal costs will affect annual profitability.

■ **DO THE INEVITABLE CONFLICTS OF INTEREST** make retaining global firms problematic? For a large multinational corporation with many interests in many countries, it is hard to work through the technical conflicts posed by other clients of a big global firm. But the problem is even more complicated when the firm is on the other side of some general legislative, regulatory, litigation, or political issue, which is not a technical conflict, but is anathema to the corporation. These issues are true land mines, which big firms may not find until they've exploded.

Ultimately, the question for in-house law departments is: Do they want to manage their major global matters—or do they want to cede management to outside counsel? This question of control—who really is directing the specific legal matters of the corporation—affects the answers to many of the questions raised above. The sophisticated corporate purchaser of legal services, with high-quality in-house lawyers, will often choose to oversee the important cross-border matter—whether it's a deal, arbitration, litigation, investigation, public policy issue, etc. The corporation's general counsel may choose to work with smaller, more efficient firms—and piece together the necessary legal team through the smaller firms' few global offices, their ties with local firms, the corporation's own extensive law firm contacts and, importantly, its blue-chip in-house talent.

But some businesses may not have the desire or capacity to be so aggressive. And this doubtless accounts, in part, for the global firms' rising economic numbers prior to the current slowdown. Corporate law departments may not have a tradition of an independent and activist role. Until recently, this was especially so in the United Kingdom and Europe, where many of the big global firms are located. Midsize legal departments may not have the size, resources, and international reach to manage global matters actively. So, too, in the tradition of hiring "lawyers, not law firms," corporate law departments may be attracted to superstar senior partners, and then defer to them on staffing complementary matters that, in some cases, may be as effective and efficient as the alternatives.

At the end of the day, the continued rise of big global law firms will turn, in part, on a related trend. Are the CEOs in large and medium-size international companies (the big firms' targets) willing to invest in in-house legal departments? Are they willing to create global, specialized in-house groups to direct the legal work of the company and save total legal (and business) costs—and play a central role in ensuring high performance with high integrity? These high-caliber departments are a potent counterweight to the global firms, driving them to address hard questions about cost, quality, and productivity. The rise of such departments, in Europe and Asia, not just in the United States, is necessary to ensure meaningful competition among outstanding firms—small, medium, and large; national and international—which has been one of the enduring goals of the "inside counsel" movement, now more than a generation old.

Ben W. Heineman, Jr., former GE senior vice president and general counsel, is distinguished senior fellow at Harvard Law School's Program on the Legal Profession and senior fellow at the Belfer Center for Science and International Affairs at Harvard's John F. Kennedy School of Government. He is also senior counsel to Wilmer Cutler Pickering Hale and Dorr. He writes occasional commentary for The American Lawyer *on developments in the law and the legal profession. E-mail: ben.heineman@ge.com.*

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