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For all its legal worth

Providing inhouse services to another part of the organisation can leave some departments struggling to prove they're an asset not a cost. Telstra's legal department has been working on a solution.

BY RYK BLISZCZYK

The CEO says the legal department must cut its budget for the year. But, after two years of budget cuts, it's difficult to imagine where the next cut might come from, especially given the new responsibilities in regard to corporate governance. You would like to make a case that further cuts will harm not only the legal department but the company as a whole.

But that's tricky. For years, inhouse legal departments (and other service departments including HR) have been grappling with the question of how to quantify their value. Traditional measurements have been based on best-practice models, comparing one department to others similar, with a focus on cost.

But what about the value of the services? In particular, how do you measure indirect value—the lawsuits that were never filed or the efficiencies gained because your inhouse lawyer knew so much about the company?

Telstra has been working to develop a new way to quantify the value of its legal and regulatory department's key functions. The department has more than 55 attorneys providing services to business unit managers and executive management. There are also relationships with approximately 12 outside law firms. With such a large staff, the department wanted to demonstrate it was not evolving into a significant cost centre, but rather adding strategic value.

The easy part was identifying direct value—for example, savings achieved by using inhouse services instead of outside firms, which tend to charge high fees to cover liabilities and costs. The difference between an inhouse attorney's salary and an outside lawyer's salary was measured. On pure accounting comparisons, the effective internal hourly rate for legal work was less than the effective external hourly rate.

Another source of direct value was the savings gained by inhouse lawyers managing outside counsel. Inhouse counsel are often able to give more focused instructions, have a clearer understanding of the issues and have the appropriate information that outside counsel require. They are also capable of managing external legal spending more aggressively than business managers. Derived from interviews with external lawyers, an average savings value was calculated.

With indirect value, after interviewing key department staff and external suppliers, it was clear that most of the value added by the legal department came from leveraging the department's intellectual capital. Intellectual capital is the unique knowledge gained from working within the company and indicates the ability to more accurately assess risk and understand the commercial imperatives behind an issue, as well as the company's decision-making process.

It was found that intellectual capital contributed more than 80 per cent of the total benefits the legal department provided. Telstra's intellectual capital was composed of three elements: the annual increase in value of proprietary corporate knowledge among inhouse staff and attorneys; the use of this knowledge in generating successful outcomes in litigation and commercial initiatives; and the 'x factors'—elements that add value but were not quantifiable. These included the difficult items to value usually described anecdotally, such as corporate memory or providing proactive advice at a business meeting.

While Telstra won't share final quantifications of its intellectual capital—that's part of its own intellectual capital—it will reveal how some of the core values were calculated.

A fundamental assumption of the study was that there is a distinction between the work that inhouse and outside counsel do best. In measuring the value of a legal department, the focus was on the unique value—the unique contributions of inhouse attorneys not just the value any lawyer could provide. It is this unique value that is strategically important to the parent company.

In every legal department, a vast amount of proprietary corporate knowledge is stored in the heads of lawyers and staff, and tucked away in files. To quantify this intellectual capital value, an estimate was made of the market value of Telstra's attorneys if they could freely sell their services to competitors. This included the market value to competitors of a Telstra attorney with Telstra-specific corporate knowledge and intellectual capital. Legal recruiters were consulted to help determine this value, and subtracted from it the salary of the inhouse lawyer. The difference represented a proxy for the individual's unique intellectual capital value.

It is one thing to possess unique knowledge about a company, and an entirely different thing to put it to use.

To determine the value of leveraging knowledge, the legal department's successful settlements for 2000–01 were analysed. If a matter had extended over several years, an average annual value was calculated. Three major litigations had been settled in the time frame, and the difference between the total value of the claims and the final settlement figures was looked at.

Then, what the outside lawyers had done was separated from what the internal lawyers did. The recent litigations were compared to previous cases with like issues to determine unique value.

For small claims, the approach was similar. Three years ago, small claims payments represented 11 per cent of claims made compared with five per cent for the current year. The difference represented the value the team added.

The 'x factors' include corporate memory, cross-company perspective, avoidance of threatened or potential litigation, risk identification, management and minimisation.

While not ascribed any quantified value in the original study, subsequent analysis demonstrated that 'x-factors' contribute strategic value in the form of time savings, avoidance of cost of mistakes and avoidance of loss of customers.

As a result of the study, Telstra's legal department developed a new strategic perspective on how it adds value to the company. It also allowed the department to reduce costs by answering the difficult question of what to insource and what to outsource and, allowed for a strategic rebalancing of the mix of work between inhouse and outside lawyers.