Organizing Corporate Legal Services: Theory vs. Practice

by

James J. Cook


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ORGANIZING CORPORATE LEGAL SERVICES: THEORY VS. PRACTICE

by

James J. Cook

A dissertation submitted to the faculty of Claremont Graduate University in partial fulfillment of the requirements for the degree of Doctor of Philosophy in the Graduate Faculty of Executive Management

Claremont, California
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Approved by:

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Abstract of the Dissertation

Organizing Corporate Legal Services:
Theory vs. Practice

by

James Jay Cook

Claremont Graduate University 2004

The principal question addressed is the extent to which American organizations source legal services they require in a manner consistent with transaction cost economics and agency theory. Transaction cost economics (TCE) is an interdisciplinary undertaking which joins economics with aspects of organizational theory and contract law. TCE views frequency, uncertainty and asset specificity (the extent to which assets have little utility or value except in the context of a particular transaction or relationship) as key variables in determining how a transaction will be structured. Agency theory focuses on identifying the most efficient contract form for a relationship taking into account certain assumptions of self-interest, bounded rationality, risk aversion and the cost of verifying what the agent is doing.

A survey was sent to full-time in-house general counsel to collect data on actual practices in sourcing legal services for seven different areas of law: antitrust/trade regulation, commercial contracts, intellectual property, labor/employment, litigation, securities and taxes. The survey instrument’s questions also covered key elements of
TCE and agency theory, including uncertainty, asset specificity, frequency, law firm reputation and law firm trustworthiness. In excess of three hundred fully completed surveys were returned.

The survey data were subjected to statistical analysis including multiple regression. The analysis disclosed the locus of the requisite expertise (i.e., either in-house or at an outside law firm) to be the principal determinant for sourcing of needed legal services; the first variable to enter each regression equation dealing either with preference for doing the work in-house or the percentage of work assigned to outside counsel was the variable for the level of in-house expertise. Other survey data, and information obtained in interviews with corporate counsel, showed that in-house legal expertise is generally created and maintained for types of legal matters an organization continually (or at least frequently) encounters. Asset specificity aspects of TCE appear consistent with actual practice. Hypotheses based upon TCE’s uncertainty element were supported only to the extent the data confirmed that uncertainty is dealt with by aligning expertise with the task. Hypotheses relating to other aspects of TCE and to agency theory were not supported.
DEDICATION

To Chris, for her love and support
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I also extend my thanks to the twenty corporate counsel who participated in the pilot study and to the hundreds of corporate counsel who took the time to participate in the research.
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CHAPTER I
INTRODUCTION

The purpose of this dissertation is to inquire into the current practices of large American organizations in the sourcing of legal services and to examine actual practices as they relate to transaction cost economics (TCE), agency theory and the roles of trust and reputation effects. There is no published research which examines legal services sourcing in this context. By exploring these issues it is hoped that managers may benefit from a better understanding of the factors which affect boundary choices and that researchers may benefit from additional empirical data assessing the predictive value of TCE and agency theory and the impact of trust and reputation effects.

Large American organizations typically require extensive legal services. Lawyers are called upon to draft contracts with suppliers and customers, to file lawsuits, to defend lawsuits, to prepare the documents for corporate mergers and acquisitions, to file for patents, to assist in writing employee handbooks, to render tax advice and, generally, to advise, represent and advocate in the seemingly countless areas where state and federal law impact the operations of the organization. The need for lawyers and their services is not likely to decline. Our society grows increasingly complex. Far more laws are enacted each year than are repealed. The reach of government agencies continues to expand. The courts extend existing rights and develop new ones. Fifty years ago an employer might likely have guessed that “carpal tunnel syndrome” was some type of claustrophobia.
Most employers now know it describes one of the repetitive stress injuries which have, in just the past few years, led to a multitude of new state and federal ergonomics regulations. Many other areas of law have also arisen, or greatly expanded, in the past few decades: the rights of minorities and women, pension protections, environmental laws, privacy rights, the rights of disabled individuals, international pacts on tariffs, consumer protection, etc. Henry Ford probably did not foresee that someday the government and the legal system would regulate the emissions of every Ford automobile engine, would circumscribe the very reasons for which Ford could fire an employee and would require the preparation of an extensive environmental impact report for every U.S. smelter, mill, mine and factory he might want to build, open or operate. History has left livery stables in its wake. And blacksmiths and wagon makers. But while Japan is proof that not every modern society requires the services of a large number of lawyers in order to prosper, in the United States all present signs suggest that our society will continue to provide work for a large and ever increasing number of legal professionals.

ORGANIZING LEGAL SERVICES

In many respects the options for organizing legal services are similar to those for information services, facilities maintenance, parts manufacturing, order fulfillment, etc. An organization is generally free to choose between using outside sources, producing the good or service in-house or developing its own unique hybrid combination of outsourcing and internal production. Legal services are no different. At one extreme an organization can rely entirely on its own staff attorneys for all of its legal services. Conversely, an organization can rely entirely on outside law firms to fulfill all of its legal services needs.
Or, as is quite common, an organization can concurrently rely both on in-house and outside counsel to provide needed legal services. There are variations, as well, in the situs where the legal work is done and the type of contract entered into between the organization and its legal counsel.

These organizational choices, once made, are by no means static. In recent years many organizations have chosen to do more of their legal work in-house. Other organizations have chosen to require outside counsel to work at the organization’s offices. Others have shrunk or even disbanded their in-house legal departments in favor of greater reliance on outside law firms. In a global economy where change is said to be the only constant, well-managed organizations realize that to compete and succeed they must continually endeavor to adapt themselves for maximum efficiency. While cost is an important measure of efficiency, other factors also affect the organization choice. Cost alone cannot dictate how an organization’s in-house food service is structured; the food in the company’s cafeterias should be varied, tasty, well balanced, offered at reasonable prices, etc. Similarly, cost alone cannot be allowed to dictate how a company’s legal services needs are sourced. The legal services must be timely delivered, must meet the organization’s quality standards, must protect the company’s proprietary information, etc.

**Theoretical Bases**

Two theories which address structural choice-making by organizations appear to be particularly applicable to the question of how an organization will organize its legal activities. Those theories are transaction cost economics and agency theory. A brief introduction to those two theories is set forth below. A more comprehensive analysis is
set forth in Chapter 2.

**Transaction Cost Economics**

Transaction cost economics (TCE) is an interdisciplinary undertaking which joins economics with aspects of organizational theory and overlaps extensively with contract law (Williamson, 1981). The fundamental assumption of TCE is that commercial transactions will be organized in the most cost efficient manner. Two types of costs are taken into account: production expense and transaction costs. The objective, according to TCE, is to economize on the sum of production and transaction costs (Williamson, 1979). Two key assumptions about human behavior affect transaction costs, bounded rationality and opportunism. “Bounded rationality” describes our limited ability to collect, store, process and communicate information. Opportunism is the tendency of some persons to take unfair advantage when they perceive they can get away with it. According to Williamson “economizing on transaction costs essentially reduces to economizing on bounded rationality while safeguarding the transactions in question against the hazards of opportunism” (Williamson, 1979).

TCE views frequency, uncertainty and asset specificity as key variables in determining how a transaction will be structured. As transactions become less frequent market contracting becomes a more costly alternative to internal governance. Under TCE theory the absence of the safeguards afforded by frequent transactions in the marketplace will cause organizations to tend to internalize the production of a needed good or service rather than expose themselves to the risks of opportunistic conduct by an outside party in
an infrequent transaction - provided, of course, the organization can competently produce
the good or service at an acceptable level of production expense notwithstanding the
presumed absence of any economies of scale due to limited or infrequent production.

Where substantial investments have been made in assets which have little utility
or value in any other context (i.e., asset specific investments), TCE predicts that the
organization will also tend to protect itself by vertically organizing the activity within the
firm (or by protecting itself contractually.) An example would be a machine uniquely
designed for stamping fenders for certain Ford cars. To modify that machine for
stamping General Motors fenders would be very expensive (Anderson, 1985). An
automobile manufacturer will typically protect itself by vertically integrating the stamping
function within the firm. An example of human asset specificity would be an IBM
salesperson who, through extensive training and experience, has learned the IBM
corporate culture, the IBM method of selling and the unique features of IBM products
(Anderson, 1985). In the legal services context, an example of human asset specificity
might be an in-house attorney with many years experience at a state-chartered utility who
has unparalleled expertise with respect to the utility’s complex charter and can recite the
details of every important legal proceeding in which the powers granted to the utility have
been challenged or interpreted. To prevent the loss of key employees with asset
specificity of unique value to the organization, an employer will typically seek to protect
itself with employment contracts, the use of deferred compensation, stock options,
retirement benefits and other arrangements which provide an incentive for the employee
to remain with the employer.