

Organizing Corporate Legal Services: Theory vs. Practice

by

James J. Cook

ISBN: 1-58112-230-6

DISSERTATION.COM



Boca Raton, Florida
USA • 2005

Organizing Corporate Legal Services: Theory vs. Practice

Copyright © 2004 James J. Cook
All rights reserved.

Dissertation.com
Boca Raton, Florida
USA • 2005

ISBN: 1-58112-230-6

**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
2004**

Approved by:

Donald W. Griesinger, Ph.D.

[Original approved and signed by
Donald W. Griesinger, Ph.D., on
April 3, 2004]

**© Copyright by James J. Cook 2004
All Rights Reserved**

We, the undersigned, certify that we have read this dissertation and approve it as adequate in scope and quality for the degree of Doctor of Philosophy.

Dissertation Committee:

Donald W. Griesinger, Ph.D., Chair

David Drew, Ph.D., Member

Kathryn S. Rogers, Ph.D., Member

NOTE: The original of this dissertation was approved and signed by Professors Griesinger, Drew and Rogers on April 3, 2004.

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

ACKNOWLEDGMENTS

I would like to express my gratitude to Professor Donald W. Griesinger, Chair of my Dissertation Committee for his patient guidance in the preparation of this dissertation. I am also grateful to Professors David Drew and Kate Rogers for serving as members of my Dissertation Committee.

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.

TABLE OF CONTENTS

ABSTRACT	iii
DEDICATION	v
ACKNOWLEDGMENTS	vi
LIST OF TABLES	x
CHAPTER 1: INTRODUCTION.....	1
ORGANIZING LEGAL SERVICES	2
Theoretical Bases	3
Transaction Cost Economics.....	4
Agency Theory.....	6
The Trust Factor.....	7
CHAPTER 2: RESEARCH FOUNDATIONS.....	8
TRANSACTION COST ECONOMICS.....	8
Uncertainty.....	11
Asset Specificity	20
Frequency.....	25
Reputation.....	27
AGENCY THEORY.....	28
Form of Principal/Agent Contract.....	32
Situs of Work and the Availability of Information	35
THE ROLE OF TRUST.....	37

RECAPITULATION OF HYPOTHESES.....	40
CHAPTER 3: METHODOLOGY	43
SURVEY INSTRUMENT; OPERATIONALIZING THE HYPOTHESES	44
Reliability/Internal Consistency of the Survey Instrument	45
Pretesting of the Survey Instrument.....	48
Limitations and Constraints	49
Statistical Methodology	50
CHAPTER 4: SURVEY RESULTS	51
Frequencies	51
Correlations.....	57
Correlations and the Hypotheses.....	67
Regressions	103
CHAPTER 5: HYPOTHESIS TESTS	116
INTRODUCTORY COMMENTS	116
Hypotheses 1, 1a and 1b	119
Hypothesis 1c.....	123
Hypothesis 2a.....	124
Hypothesis 2b.....	125
Hypothesis 3.....	127
Hypothesis 4.....	130
Hypothesis 5.....	134
Hypothesis 6	136
Hypothesis 7.....	137
Hypothesis 8	139
Hypothesis 9	140
SUMMARY OF HYPOTHESIS TESTING RESULTS.....	145
CHAPTER 6: THE DECISION TO BUILD IN-HOUSE EXPERTISE.....	149
CHAPTER 7: CONCLUSIONS AND RECOMMENDATIONS.....	164
THE INTEGRATION ISSUE.....	164

The Uncertainty Hypotheses	164
The Asset-Specific Knowledge Hypotheses.	166
The Frequency Hypothesis.....	166
The Reputation Hypothesis.....	167
The Trust Hypothesis	168
THE TYPE OF CONTRACT ISSUE	169
THE SITUS ISSUE.....	172
RECAPITULATION OF DATA-SUPPORTED CONCLUSIONS.....	172
Litigation, a Special Case.....	174
IMPLICATIONS FOR PRACTICE.....	177
Importance of Tracking In-House Attorneys’ Activity by Task	178
Importance of Tracking Outside Counsel’s Activity by Task.....	179
Avoiding In-house Tunnel Vision.....	180
Retention of Asset-Specific Skill Holders.	181
Dealing with the Risks of Opportunistic Conduct	182
RECOMMENDATIONS FOR FURTHER RESEARCH	186
Why have Organizations Chosen Their Current Models for Sourcing Needed Legal Services? Is there a “Best Practices” Way to Organize?.....	186
Are there Special Circumstances Surrounding Legal Services Which Mitigate the Concerns Underlying TCE and Agency Theory? Do Lawyers Fall Within an Exception to TCE and Agency Theory?.....	188
REFERENCES	191
APPENDIX.....	194

LIST OF TABLES

TABLE	PAGE
2.1	Types of Uncertainty for the Organization..... 13
2.2	Types of Uncertainty for Outside Counsel.....16
3.1	Hypotheses and How They are Operationalized46
3.2	Reliability Analysis.....48
4.1	Distribution by Industry51
4.2	Distribution by Annual Revenue.....52
4.3	Distribution by Annual Legal Expenditures..... 53
4.4	Distribution by Percentage of Legal Work Done In-House53
4.5	Percentage of Respondents Who “Agree” or “Strongly Agree” That They Prefer to Do Specific Types of Legal Tasks In-House.54
4.6	Percentage of Respondents Who Assign 50% or More of Specific Kinds of Legal Work to Outside Counsel55
4.7	Percentage of Respondents Who “Agree” or “Strongly Agree” That They Prefer to do Specific Types of Legal Tasks In-house Measured by Frequency Such Work is Dealt With.....56
4.8	Percentage of Respondents Who Actually Do More than 50% of All Legal Work In-house as Measured by Frequency with which Certain Types of Legal Work are Dealt With58
4.9	Percentage of Organizations Where 50% or More of Specific Types of Legal Tasks are Done by Outside Counsel as Measured by Frequency Such Work is Dealt With59
4.10	Correlation Between Level of In-house Expertise (Question 1) and The Frequency Specific Types of Matters are Encountered (Question 12)60
4.11	Correlation Between Level of In-house Expertise (Question 1) and Level of In-House Asset Specific Skills ((Question 5).....61

4.12	Correlation Between Level of In-house Expertise (Question 1) and Uncertainty as to the Time Required to Handle a Matter (Question 2)	62
4.13	Correlation Between Level of In-house Expertise (Question 1) and Respondents Engaged in “Manufacturing” (Section II, Part A).....	63
4.14	Correlation Between Level of In-house Expertise (Question 1) and Respondents Engaged in “Technology” (Section II, Part A).....	64
4.15	Correlation Between Level of In-house Expertise (Question 1) and Respondents Engaged in “Financial Services” (Section II, Part A).....	65
4.16	Correlation Between Preference for Handling Matters In-house (Question 11) and Percentage of Work Done by Outside Counsel (Question 15)	66
4.17	Correlation Between Uncertainty as to the Time Required to Handle a Matter (Question 2) and Preference for Handling Matters In-house (Question 11)	69
4.18	Correlation Between Uncertainty as to the Time Required to Handle a Matter (Question 2) and Percentage of Work Done by Outside Counsel (Question 15).....	70
4.19	Correlation Between Uncertainty at the Outset Regarding Outcome (Question 3) and Preference for Handling Matters In-house (Q11).....	72
4.20	Correlation Between Uncertainty at the Outset Regarding Outcome (Question 3) and Percentage of Work Done by Outside Counsel (Question 15).....	73
4.21	Correlation Between Outcome Measurability Difficulty (Question 4) and Preference for Handling Matters In-house (Question 11)	75
4.22	Correlation Between Outcome Measurability Difficulty (Question 4) and Percentage of Work Done by Outside Counsel (Question 15).....	76
4.23	Correlation Between Unique Asset-Specific In-house Expertise (Question 5) and Preference for Handling Matters In-house (Q11).....	77

4.24	Correlation Between Unique Asset-Specific In-house Expertise (Question 5) and Percentage of Work Done by Outside Counsel (Question 15)...	78
4.25	Correlation Between Outside Counsel’s Unique Asset-Specific Expertise (Question 6) and Preference for Handling Matters In-house (Q11).....	80
4.26	Correlation Between Outside Counsel’s Unique Asset-Specific Expertise (Question 6) and Percentage of Work Done by Outside Counsel (Question 15)...	81
4.27	Correlation Between Frequency with which Matters are Encountered (Question 12) and Preference for Handling Matters In-house (Question 11).....	83
4.28	Correlation Between Frequency with which Matters are Encountered (Question 12) and Percentage of Work Done by Outside Counsel (Question 15).	84
4.29	Correlation Between Outside Counsel’s Expertise (Question 7) and Preference for Handling Matters In-house (Question 11).....	86
4.30	Correlation Between Outside Counsel’s Expertise (Question 7) and Percentage of Work Done by Outside Counsel (Question 15)	87
4.31	Correlation Between Use of Outcome-based Contracts (Question 14) And Extent to Which Outside Counsel is Perceived as Acting in Accordance with the Organization’s Best Interests (Question 9)	89
4.32	Correlation Between the Ease of Measuring How Successful A Result Was After a Matter has been Concluded (Question 4) and Use of Outcome-based Contracts (Question 14).....	90
4.33	Correlation Between the Organization’s Level of Monitoring of Outside Counsel (Question 13) and Use of Outcome-based Contracts (Question 14)	92
4.34	Correlation Between the Organization’s Level of Monitoring of Outside Counsel (Question 13) and Percentage of Legal Work Done by Outside Counsel at the Organization’s Offices (Question 16)	93
4.35	Correlation Between the Extent to which the Organization Views Outside Counsel as Always Handling the Organization’s Confidential Information with Great Care (Question 8) and Preference for Handling Matters In-house (Question 11).....	95

4.36	Correlation Between the Extent to which the Organization Views Outside Counsel as Always Handling the Organization’s Confidential Information with Great Care (Question 8) and Percentage of Work Done by Outside Counsel (Question 15)	96
4.37	Correlation Between Outside Counsel Being Viewed as Always Acting in the Organization’s Best Interests (Question 9) and Preference for Handling Matters In-house (Question 11).....	97
4.38	Correlation Between Outside Counsel Being Viewed as Always Acting in the Organization’s Best Interests (Question 9) and Percentage of Work Done by Outside Counsel (Question 15)	98
4.39	Correlation Between the Extent to which the Organization Views its Outside Counsel as Always Treating the Organization Fairly (Q10) and Preference for Handling Matters In-house (Question 11)	99
4.40	Correlation Between the Extent to which the Organization Views its Outside Counsel as Always Treating the Organization Fairly (Q10) and Percentage of Work Done by Outside Counsel (Question 15).....	100
4.41	Correlation Between Level of Monitoring of Outside Counsel (Q13) and Preference for Handling Matters In-house (Question 11)	101
4.42	Correlation Between Level of Monitoring of Outside Counsel (Q13) and Percentage of Work Done by Outside Counsel (Question 15)	102
4.43	Multiple Regression Analysis Predicting Preference for Handling Anti-Trust/Trade Regulation Matters In-house (Question 11).....	104
4.44	Correlation Matrix for Variables in the Regression Equation Reported in Table 4.43	104
4.45	Multiple Regression Analysis Predicting Preference for Handling Commercial Contracts In-house (Question 11)	105
4.46	Correlation Matrix for Variables in the Regression Equation Reported in Table 4.45	105

4.47	Multiple Regression Analysis Predicting Preference for Handling Intellectual Property Matters In-house (Question 11).....	105
4.48	Correlation Matrix for Variables in the Regression Equation Reported in Table 4.47.....	106
4.49	Multiple Regression Analysis Predicting Preference for Handling Labor and Employment Law Matters In-house (Question 11).....	106
4.50	Correlation Matrix for Variables in the Regression Equation Reported in Table 4.49	106
4.51	Multiple Regression Analysis Predicting Preference for Handling Litigation In-house (Question 11).....	107
4.52	Correlation Matrix for Variables in the Regression Equation Reported in Table 4.51	107
4.53	Multiple Regression Analysis Predicting Preference for Handling Tax Law Matters In-house (Question 11)	107
4.54	Correlation Matrix for Variables in the Regression Equation Reported in Table 4.53.....	108
4.55	Multiple Regression Analysis Predicting Preference for Handling Securities Law Matters In-house (Question 11)	108
4.56	Correlation Matrix for Variables in the Regression Equation Reported in Table 4.55.....	108
4.57	Multiple Regression Analysis Predicting Percentage of Organization’s Anti-Trust/Trade Regulation Legal Work Handled by Outside Counsel (Question 15)	109
4.58	Correlation Matrix for Variables in the Regression Equation Reported in Table 4.57.....	109
4.59	Multiple Regression Analysis Predicting Percentage of Organization’s Commercial Contracts Handled by Outside Counsel (Question 15).....	110
4.60	Multiple Regression Analysis Predicting Percentage of Organization’s Intellectual Property Matters Handled by Outside Counsel (Question 15).....	110

4.61	Correlation Matrix for Variables in the Regression Equation Reported in Table 4.60.....	110
4.62	Multiple Regression Analysis Predicting Percentage of Organization’s Labor and Employment Law Legal Matters Handled by Outside Counsel (Question 15).....	111
4.63	Correlation Matrix for Variables in Regression Equation Reported in Table 4.62.....	111
4.64	Multiple Regression Analysis Predicting Percentage of Organization’s Litigation Handled by Outside Counsel (Question15).....	111
4.65	Correlation Matrix for Variables in the Regression Equation Reported in Table 4.64.....	112
4.66	Multiple Regression Analysis Predicting Percentage of Organization’s Tax Law Matters Handled by Outside Counsel (Question 15).....	112
4.67	Correlation Matrix for Variables in the Regression Equation Reported in Table 4.66.....	112
4.68	Multiple Regression Analysis Predicting Percentage of Organization’s Securities Law Matters Handled by Outside Counsel (Question 15)	113
4.69	Correlation Matrix for Variables in the Regression Equation Reported in Table 4.68	113
4.70	Multiple Regression Analysis on Requiring the Organization’s Outside Counsel for Intellectual Property Matters to be Based at the Organization’s Place of Business (Question 16).....	114
4.71	Correlation Matrix for Variables in the Regression Equation Reported in Table 4.70.....	114
4.72	Multiple Regression Analysis on Requiring the Organization’s Outside Counsel for Litigation Matters to be Based at the Organization’s Place of Business (Question 16).....	114

4.73	Multiple Regression Analysis on Requiring the Organization’s Outside Counsel for Securities Matters to be Based at the Organization’s Place of Business (Question 16)	115
4.74	Correlation Matrix for Variables in the Regression Equation Reported in Table 4.73	115
5.1	Frequency Certain Types of Legal Matters are Dealt With.....	119
5.2	References to “Expertise” in Answer to Question 17	122
5.3	Correlation Between Level of In-house Expertise (Question 1) and Level of Outside Counsel’s Expertise (Question 7).....	133
5.4	Comparison of In-house Expertise and Outside Counsel’s Expertise in Regression Models Where Both Appear.....	134
5.5	Multiple Regression Analysis Predicting Use of Contingent Fee Contracts with Outside Counsel for Intellectual Property Matters (Question 14)	135
5.6	Correlation Matric for Variables in the Regression Equation Reported in Table 5.5.....	135
5.7	Percentage of All Respondents Who Either “Seldom” or “Never” Use Outcome-based Contracts with Their Outside Counsel.....	136
5.8	Census of Correlations Testing Hypothesis 9.....	142
5.9	Entry of Variable 8 (“Handles Our Confidential Information with Great Care”) into Integration Regression Models.....	143
5.10	Entry of Variable 9 (“Always Acts in Organization’s Best Interests”) into Integration Regression Models.....	143
5.11	Entry of Variable 10 (“Always Treats our Organization Fairly”) into Integration Regression Models	144
5.12	Entry of Variable 13 (Level of Monitoring of Outside Counsel) into Integration Regression Models)	144
5.13	Summary of Hypothesis Testing Results.....	146
6.1	Multiple Regression Analysis Predicting Organization’s Level of In-House Legal Expertise.....	151

6.2	Factors Cited by Seventeen Interviewed Corporate Counsel as Underlying their Organization’s Decision to Build In-house Expertise	161
7.1	Presumptions Underlying the Nine Integration-related Hypotheses.....	165
7.2	Matters Affecting Degree of Integration.....	170
7.3	Presumptions Underlying the Three “Type of Contract” Hypotheses.	171
7.4	Search Engine Results for Word Combinations Including “Litigation”	174

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.