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I. The business case for the outsourcing of core legal service functions

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1. Introduction

Market-driven disruption of the competition for legal services, accelerated by the economic uncertainties of the COVID-19 pandemic, is causing many traditional law firms, of all sizes and practice specialties worldwide, to take a closer look at the strategic business case for outsourcing internal legal service and support functions that previously had been assumed to be managed best in-house. Outsourcing of these traditionally internal functions is becoming increasingly important for smaller firms.[2]

Why should a law firm consider shifting an essential function in the production and delivery of a legal service – what we describe as a core legal service function – to an outside vendor? As this report examines in depth three areas of outsourced legal process operations – patent research and analysis, cybersecurity and large-scale document review – a strong theme emerges: sustainable profitability, which is the ability to deliver high-quality legal services, often in volume, at a price that is competitive but also profitable.[3] Outsourcing of a core legal service function can have not only positive effects on the main forces that drive and determine the profitability of a practice group or an entire law firm, but can also yield two advantages that can be compelling: lowering the operating cost of the production of a legal service; and raising the level of quality.

2. What should be outsourced?

As the subsequent chapters of this Special Report emphasise, a well-informed outsourcing decision requires more than a superficial understanding of the processes by which a supplier produces a service that is delivered to a law firm and of some of the issues that the vendors must manage in order to deliver a consistently high-quality, cost-effective product or service. In most jurisdictions, almost any legal process, just like almost any administrative function, can be outsourced, even the formulation of legal advice or the presentation of a legal opinion (consistent, of course, with local regulations on the unauthorised practice of law). This Special Report focuses on three types of outsourced core legal services functions, each one of which is at the heart of the way in which law firms practise their profession and deliver expert services and products to clients. Each one of these three areas can serve as a useful case study for the application of the principles and methods that this Special Report recommends to address three critical issues inherent in outsourcing:

- Which core functions will produce the best return on our investment in outsourcing?
- What factors should we consider when selecting an external service provider?
- What risks must we be prepared to manage?

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3. Sustainable profitability as an intellectual framework for well-informed decisions

Outsourcing core legal functions of a law firm – especially ones that are costly, labour intensive, or prone to errors that require corrective rework – has become an essential consideration for most law firms that want to improve and sustain their profitability in a legal services market that is changing swiftly, often in fundamental ways, and becoming more intensely competitive. Understanding the factors that shape the profitability of legal services – often called the *Six Classic Drivers of law firm profitability*[4] – can help law firm leaders and managers to develop specific, realistic objectives to be obtained from outsourcing a core legal function, as well as manage risks and avoid disappointments. These six factors are:

- Pricing – are you charging a high enough fee?
- Productivity – are your fee-earners utilised fully with billable work?
- Realisation – what percentage of your billable work produced is actually collected?
- Cost management – how efficiently and effectively do you manage operating costs?
- Staff compensation – are your fee earners producing at least as much as they are paid?
- Leverage – is your ratio of work produced by associates to work produced by partners high enough to be profitable?

The impacts of outsourcing a particular core legal function, in terms of its positive effects and risks on each of the six drivers, collectively constitute the business case for, or in some cases against, the decision to outsource. This same analysis can also serve as a highly effective risk management plan for the outsourced function:

- by alerting a law firm's management team to the possible risks in terms of financial performance, professional indemnity and reputation;
- by providing 'early warning signs' that a problem is emerging; and
- by allowing the firm and the vendor to take proactive steps to mitigate the risk when it arises or to avoid its potential consequences altogether.

The authors have observed that the most frequent benefits to profitability that outsourcing of a core legal function can produce are with respect to four of the Six Classic Drivers of profitability:

- staff costs;
- productivity;
- leverage; and
- realisation.

3.1 Lower staff costs

As discussed in subsequent chapters, a well-informed outsourcing of a core legal function can produce positive results, directly or indirectly, for each of the Six Classic Drivers. In most instances, the cost of one full-time equivalent (FTE) of outsourced services can be significantly less than the total cost of having the same services performed by one similarly qualified full-time in-house employee.[5] The benefit that is obvious to most law firms considering outsourcing is to reduce staffing costs, especially at the lawyer level, which are usually the largest single element of the fully-loaded operating cost of a law firm. Fully-loaded operating cost is, essentially, how much it costs a law firm or a practice group to produce one hour of legal services. Even for matters that are not billed at an hourly rate, fully-loaded operating cost remains the most accurate and reliable baseline measurement for managing profitability. This is the case in most legal services markets in the world, especially where the practice areas and service lines of some law firms are being squeezed between higher price sensitivity and fiercer competition, which lowers revenue and increases operating costs, especially in lawyer and staff compensation and benefits.[6]

3.2 Improved productivity

One frequently overlooked potential benefit of outsourcing core legal functions that are typically performed by lawyers and highly skilled paralegals is the potential positive impact on the productivity of the people whose work is outsourced.

Productivity is not limited only to the number of hours that produce or contribute to the production of billable work. The value of the work produced – measured in collected fees – should also be considered. By shifting lawyer and paralegal time and effort from the outsourced tasks to higher-value ones, in terms of their fee potential, the outsourcing can produce a substantially higher fee yield per fee-earner hour. Sometimes this effect on overall profitability can be greater than any potential net savings in salaries and benefits which could result from eliminating redundancies.

3.3 Improved leverage and greater partner fee productivity

The concept of leverage is changing in law firms worldwide.

The traditional definition of leverage was expressed in terms of staffing ratios, such as the ratio of the number of associates to the number of partners. A common assumption – actually more of a rebuttable presumption – has been that a ratio of four associates to one partner was usually profitable, especially with fixed-fee work.[7] This is consistent with the general rule that legal work should be delegated down to the least expensive person who can do it competently. Delegation also has the added benefit of freeing partner time for higher-value activities, *"In most instances, the cost of one full-time equivalent (FTE) of outsourced services can be significantly less than the total cost of having the same services performed by one similarly qualified full-time in-house employee."*

such as higher-priced legal services that require a partner's expertise and personal attention, or business development.[8]

The more useful concept in today's law firm, however, is workflow leverage, which measures the ratio of work performed, usually measured in 'billable' hours, rather than just staffing ratios. Workflow leverage provides a more accurate picture of how the work of a law firm actually flows and is performed. This is more useful for purposes of identifying opportunities to improve leverage than staffing ratios because many law firms typically under-delegate work. There are various reasons – and in some cases weak excuses – for low workflow leverage, the most common ones being the assumption – sometimes erroneous but often accurate – by partners that 'there is no one competent to do this work' or that 'it is quicker and easier just to do it myself'. Low workflow leverage, when examined, can be a strong diagnostic indicator of opportunities to make substantial and lasting improvements in profitability.

How does outsourcing affect leverage? The simple, but frequently overlooked, answer is that it can provide another dimension and destination for delegated work (ie, out of the firm). Because the cost of most outsourced core legal functions is less than the fully-loaded operating cost of performing these functions in-house – even at the least expensive level of staff that is competent to do the work – it can extend workflow leverage dramatically, with a resulting improvement in profitability.

3.4 Quality and realisation

Realisation describes how much of a firm's labour is realised in the form of cash receipts. Does every hour of billable work produced ultimately result in an hour's worth of fee revenue? Close attention to realisation rates is, for most law firms, the most powerful way to improve the profitability of a practice without any significant increase in staff or operating costs. Every pound that a law firm does not have to write off is almost pure profit.[9]

Analyses of fee write-offs and write-downs, both before and after invoicing, will usually reveal that defects in quality assurance constitute a leading reason for this lost revenue.[10] Part of the attractiveness of outsourcing large-volume tasks – with their very large potential for errors – is that the primary responsibility for quality assurance is also outsourced to an organisation that is better structured for, and more experienced in, the high levels of accuracy and reliability that are required to meet customer expectations the first time and every time. This is a theme that runs through the next three chapters. In some instances, the reductions in fee adjustments and write-offs, and the resulting increase in revenue, by themselves can substantially offset the costs of outsourcing the function.