

Going, Going, Sold

When law departments auction off legal business, companies can save money. Here's a guide to choosing the best type of auction and avoiding the traps.

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In their bid to reduce legal fees, many law departments auction off their legal business. In a law department auction, law firms compete to be selected to handle a company's legal work. First, the law department describes the work likely to be needed. The firms then propose how they will handle the work and for what fees. This system has worked well for companies such as Pfizer, Tyco, Ingersoll-Rand, Disney, and Schering-Plough.

As an example, in 2001, Viacom chose one law firm from among 20 competing ones to handle its patent prosecution work and to be one of its top IP litigation firms. On a larger scale and with a different objective, General Electric conducted an online auction in which about 142 law firms competed against one another to provide GE with their lowest rates in seven practice areas.

Most commonly, a law department auction covers a portfolio of matters to be handled over a period of 12 to 36 months. Bidding out a single transactional matter or lawsuit presents more challenges, to both the law department and the bidding firms, than bidding a group. Even so, TXU's law department has adopted a policy that requires outside counsel to bid on any litigation costing \$75,000 or more.

Although auctions are generally a great idea for law departments, it's a good idea to have a clear understanding of the different types of auctions and how to choose the right one. This article describes four kinds of auctions and how law departments should choose among them. Here, also, is advice about putting an end to several problematic aspects of auctions: one-shot bidding, unstated assumptions, the focus on costs, and the winner's curse.

ENGLISH AUCTIONS

The best-known kind of auction is the so-called English auction. Bidders offer increasingly higher amounts until no one goes higher.

The last person to bid purchases what was for sale for the last amount he bid.

In the context of a law department, an English auction could mean that a department sets a budget and firms bid to handle more and more work for that amount. For instance, a law department might say it will spend \$2 million on real estate matters in the United States. The more states in which a law firm agrees to handle all those leases, subleases, and related transactions, the better the bid.

DUTCH AUCTIONS

So-called Dutch auctions (or reverse auctions) characteristically have successive bidders lowering the cost for which they will do something. Among a group of law firms hoping to be hired to handle a company's environmental matters, one says that \$1.5 million a year will be good enough, while another will take the work on for \$1.4 million, but the law department selects a bid of \$1.3 million.

Granted, in auctions for legal work, law firms typically bid lower and lower amounts that they will accept to handle the same bundle of work. From the law department's side, that means the gap between the anticipated cost of having outside counsel handle the matters and the winning bid grows larger and larger.

VICKREY AUCTIONS

The third kind of auction that general counsel should understand is called a Vickrey auction, named after William Vickrey, the British economist who first wrote about this kind of auction.

The law firm proposing to be paid the lowest amount gets the work—assuming all other things are equal—but will be paid the next best amount bid. The idea is that the price the winning bidder pays is determined by the competitors' bids. Of course, other things are NEVER equal. All the law departments that I have consulted to on competitive bids look at many factors in addition to, and more important than, price. They look mostly for experience in the area of law, for example. So if work handling all trademark clearances and registrations for a company ends up with firm Festo, Tertiary & Design

bidding \$2.4 million in a reverse auction, but the next bid was \$2.5 million, Festo wins at the amount of the second-best bid, \$2.5 million.

Both research and theory have shown that a Vickrey auction leads to the best outcome for law departments. A Vickrey auction also diminishes the winner's curse, described below.

CONTINGENT AUCTIONS

Law department auctions can also use contingent bids. Let's say a retailer wants to hire one firm to handle all its product liability cases. The law firm of Palsgraf, Proximate & Cause can say, "If another firm bids \$2 million to handle it all, we will bid \$1.9 million."

Of these four kinds, Vickrey has the strongest backing from academics who have studied the best way to conduct an auction. Contingent auctions add complexity, but they may have a place in the final stages of an auction, where the remaining few law firms can toss a contingent hat in the ring. Dutch and English auctions are most familiar to everyone. I believe it's usually too complicated to explain to law firms the law department's projected cost and have the firms bid larger gaps, as in English auctions. I favor Vickrey-Dutch auctions with a contingency or two available at the end.

PERNICIOUS TRAPS

Regardless of the type of auction a law department conducts, the department needs to avoid five pernicious traps.

Unanticipated major changes in workload. A good practice for a law department if it insists on a fixed fee for handling certain work is to protect both sides with what's called a "collar." A typical collar might be that if the actual fees of the law firm are more than 15 percent above the fixed-fee payment, the law department will absorb 50 percent of the excess. On the other side, if the actual fees come in 15 percent or more below the fixed fee, the law firm will rebate 50 percent.

With a collar, or one of its infinite permutations, both sides feel more comfortable that if the actual workload varies significantly from the projected workload, they will avoid rank injustice.

Single-shot bidding. For many reasons, if your law department lets firms submit only one proposal, no one fares as well. Far better to cull the first round of proposals, eliminate the weaker ones, and then tell the second-round bidders what was bid, although without disclosing which firm bid which amount.

Not that you say, "Firm A bid \$4 million." Rather, you say, "The five bids of the second-round firms were X, Y, Z, A, and B." With that information each firm—knowing its own bid—can recalibrate based on how it interprets the bids of the other firms. What is likely is that the extreme bidders—at both ends—will sharpen their pencils and ponder why their bids were so far out of line. The end result will be better for both sides.

Inflated bids on unexpressed assumptions. One of the crucial causes of wide discrepancies between firms in their bids and a dodgy final arrangement are the assumptions law firms make. For instance, if a company wants one firm to handle all its ERISA and benefits issues, the law department will get quite different quotes if one firm assumes that human resources has a complete database of all compensation plans, while a second firm assumes it will have to create one; or if one firm assumes that the inside benefits lawyer will retire within a year, and the other firm assumes that person will stay on for years and hire a paralegal.

What to do? Ask all the firms to state the assumptions they've made about the company and external events. Then circulate to all contenders the assumptions and how the law department addresses the reasonableness of each of them. It's best to circulate all assumptions to all proposers, so that the information level remains equally high all around. On these hypotheticals the company could describe the existing database and could stipulate that the current in-house legal staff will remain for at least two years.

From my experience of having consulted on seven competitive bids, I cannot stress too much the crucial step of smoking out assumptions. The proposing law firms and the law department should both state as many assumptions as they can and how they are relying on them. For example, "Our bid assumes no more than four investigations in any 12-month period." Only by doing that can both sides narrow the range of uncertainty. Thus, if the law department responds with, "No, assume no more than two investigations," the law firms can more accurately bid on the work.

Whether to disclose hours. If you tell the bidding firms the amount you spent on the type of matters over the past few years, the firms will think in terms of some reduction from that figure. As a consequence, firms will all tend to think in terms of a reduction from that amount. "If MegaCorp has spent \$8 million on average for its M&A work, we'll bid 15 percent less." But if hours frame the analysis, firms with lower billing rates will bid more aggressively.

In other words, if you convert the amounts you have spent into lawyer hours worked, firms will diverge more in their bid amounts, since they have different billing rates. You can convert amounts spent to lawyer hours by figuring out a representative figure for the blended billing rates of the firms that did the most work and dividing that amount into the total spent on the firm.

It's far better to say, "We have averaged 6,500 lawyer hours per year on our patent prosecution work," than it is to say, "We have averaged \$1.625 million."

The winner's curse. The winner's curse has become the memorable term for the likelihood that the highest bidder (in an English auction) or the lowest bidder (in a reverse, Dutch auction) has often bid too aggressively and made a mistake. If six firms propose to handle all of a company's public-debt law needs, and assuming they are all competent and have a solid understanding of the company's likely needs, then the one that prevails has probably overshot the mark. The winner is cursed by having bid too aggressively.

Neither the law department nor the firm is served by a gross error in pricing. The remedy comes partly through a Vickrey auction and partly through multi-round bidding, collars, exposure of assumptions, and describing the work in terms of activities and hours rather than in dollars.

Auctions make sense for law departments that foresee a sizable expenditure, such as more than \$1 million, in the coming one to three years. Knowing the strengths and weaknesses of four kinds of auctions, and some of the common pitfalls, both the law departments and the law firms that they select will do better.

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