Apperio

SEE LEGAL SPEND AHEAD OF THE INVOICE

The pursuit of control in legal spending

A survey of 300 in-house lawyers working in private equity and venture capital finds legal expenses are growing – and so too are pressures to control costs

Control means getting more value from legal spend

As global economic dynamics have shifted, so too have narratives in equity markets, including private equity (PE) and venture capital (VC). As I wrote recently for Alpha Week, equity stories have shifted from 'growth at any cost' to 'profitable growth.'

Investors aiming for growth know they can't cut costs and expect growth – but they can make adjustments to drive more value out of the money they've already committed.

This is instructive for in-house lawyers working in private equity and venture capital because the complexity facing equity investing grows every day. For example, there are more challenges associated with compliance and regulations at every level. These developments invariably drive more demand for legal services, not less.

Simply cutting what an investment firm spends on legal would expose it to a risk level that far outweighs any saving. So, the operative word, for in-house legal teams, is control. Control means getting more value for the money spent on legal.

Or as my brilliant friend D. Casey Flaherty put it, legal needs "a higher yield from every dollar we spend."

Yours in legal spend management,

Nicholas d'Adhemar
Founder and CEO, Apperio

Key findings

Apperio commissioned a survey of 300 lawyers who work in-house for private equity and venture capital firms in the US and UK. On average, these organizations manage $9 billion in assets, spend $12 million on outside counsel annually, and employ five in-house lawyers.

The survey was conducted in August and September of 2022 by the research firm Coleman Parkes. Some of the high-level findings include the following:

Legal spending has grown this year – and will grow next year too
64% of the in-house lawyers surveyed said their firm is spending more on legal expenses this year compared to last year. Further still, 66% expect to spend even more next year.

Pressure to control legal costs builds
Nearly nine in 10 respondents (86%) say their organization feels some pressure to control legal costs. That pressure has been building over time as well: 62% say the level of pressure to control legal costs has increased compared to last year.

LPs are scrutinizing legal expenses
84% of respondents say LPs are scrutinizing legal expenses. More than half (62%) said the level of scrutiny LPs have exhibited over legal expenses has increased over the last three years.

Legal expenses are a material concern for investment firms
More than two-thirds of respondents (71%) say their organizations are at least moderately concerned about overall legal costs. Nearly half say legal costs around "house spend," which is often tied to bonuses, is a significant concern.

Top three challenges in controlling legal costs

57% said legal work, and therefore costs, are unpredictable; 46% pointed to a lack of transparency around time, billing and invoices; 40% said they sometimes get billed for unnecessary legal services.

Many investment firms receive higher-than-expected law firm invoices

78% of respondents say they are surprised by the size of law firm invoices at least some of the time. This includes 39% who say these invoices are "always" (16%) or "often" (23%) higher than expected.

Timely, transparent and predictable invoices beat lower legal fees

In-house lawyers working for investment firms prefer timely (66%), transparent (55%) and predictable (47%) invoices from their law firms – over lower legal fees (32%).

Matters initiated without the legal department's knowledge

81% of respondents indicated some matters are initiated without their knowledge. One chief legal officer for a PE firm said they find out about new legal matters from investors.

Fixed fees aren't always fixed

To manage legal spend, 52% use AFAs other than fixed fees; 48% have brought more work in-house; and 44% utilize fixed fees. However, about three-quarters of respondents say fixed fees exceed the agreed price sometimes – including those who say it happens "always" (17%) or "often"(23%).

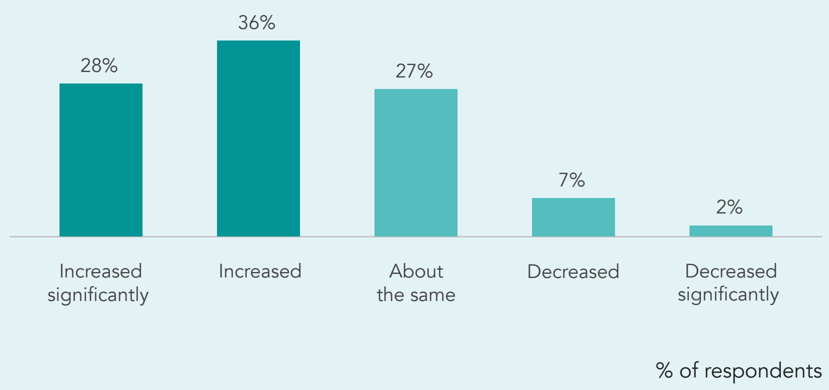
Legal spending has grown this year – and is likely to grow next year too

On average, respondents spend $12 million on outside counsel every year – and employ five in-house lawyers. Most say that number has grown and expect it to continue to rise.

More than half (64%) of the in-house lawyers surveyed said their investment firm is spending more on legal expenses this year in comparison to last year. This includes 28% of respondents who say legal spending has "increased significantly." Significantly was characterized as a change of 10% or more.

What's more, the pace of legal spending shows no signs of slowing. Two-thirds (66%) of respondents expect legal spending to grow next year. Of those, about one in four (24%) say spending will grow "significantly."

Fig. 1. How does this year's level of legal spending for your organization compare to last year?

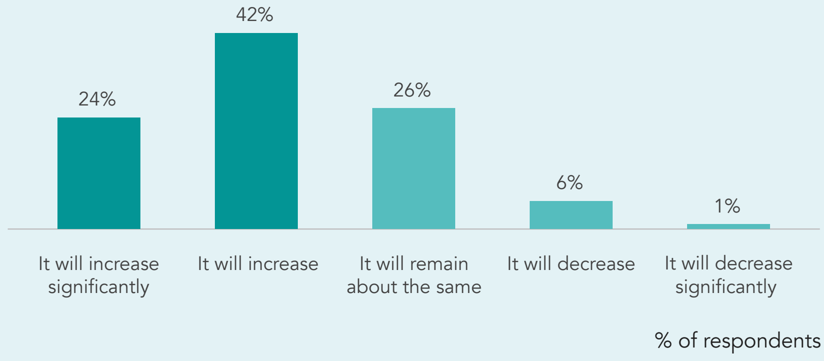


This finding defies expectations, given the pace of investment firm activities that typically require legal services - such as merger and acquisition (M&A) transactions - have slowed. The simple explanation is that business is becoming more complex which adds to the compliance and regulatory risks. In turn, these fuel demand for legal services.

For example, there have been new efforts to impose "bank style regulation" on PE in recent years. In another example, the current US administration has plans to "crackdown on buyout groups" which "could usher in one of the biggest shifts in the history of US competition policy," as reported by the Financial Times.

"I feel like it's going to be complicated to control legal costs this year and next year and it'll take a lot of work, so we need to be on top," according to one associate general counsel that took the survey in open-ended remarks.

Fig. 2. What do you expect to happen to the level of legal spending for your organization next year?



Pressure to control legal costs builds

Increased spending may sound like a plus, but the spending growth comes with some strings attached. The survey found nearly nine in 10 (86%) respondents say their organization feels some pressure to control legal costs. Among this group, 35% say they feel "moderate pressure" while about one-third (29%) feel "significant" pressure.

The level of pressure has grown over time too: 62% of respondents say the pressure to control legal costs has increased (38%) or "increased significantly" (23%) compared to last year. Conversely, just 7% say the pressure decreased.

How can in-house teams reconcile a legitimate need for additional legal services with the pressure to control costs? It's to recognize that control doesn't necessarily mean cutting but rather ensuring the organization is getting the most value out of its legal spend.

"Instead of more with less – the idea that the legal budget should be reduced – we need to reorient the conversation of more for less," said D. Casey Flaherty, the co-founder and chief strategy officer at LexFusion, on a podcast with Apperio CEO Nicholas d'Adhemar earlier this year.

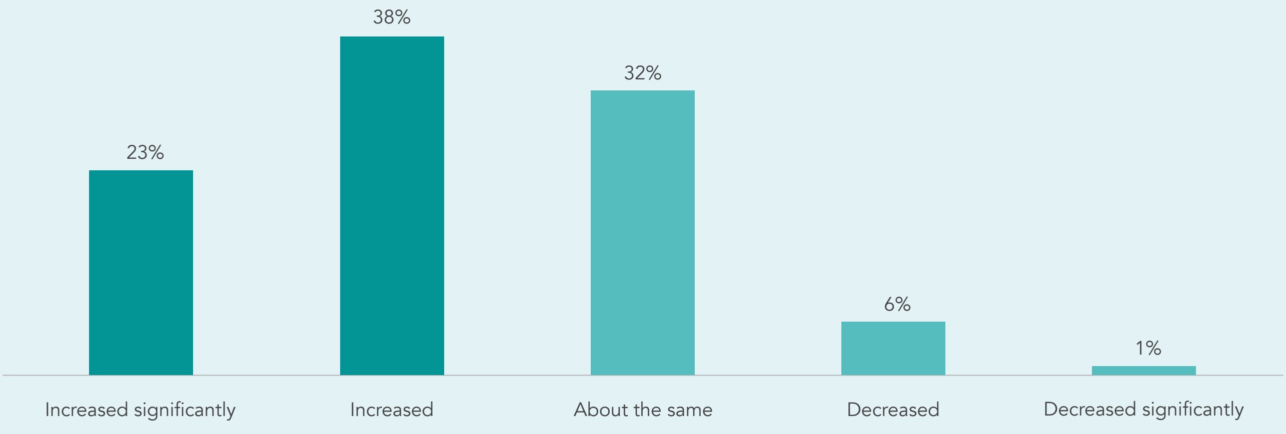
In other words, legal needs "a higher yield from every dollar we spend."

> "Instead of more with less – the idea that the legal budget should be reduced – we need to reorient the conversation of more for less"

Fig. 3. Nearly 9 in 10 (86%) respondents say their organisation feels some pressure to control costs

% of respondents

Fig. 4. Has the pressure to control legal costs increased or decreased in the last year?



% of respondents

LPs are scrutinizing legal expenses

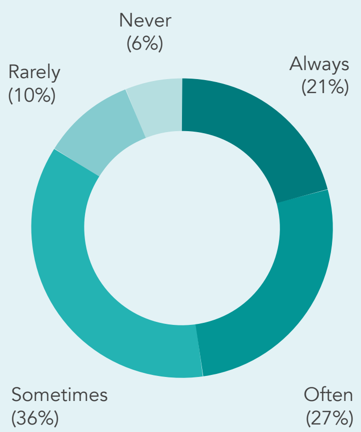
One of the most interesting findings from the survey was the degree of interest respondents say limited partners (LPs) have in reviewing legal costs.

More than eight in 10 respondents (84%) said LPs are scrutinizing legal expenses. Further, about half (48%) said LPs scrutinize legal expenses "always" (21%) or "often" (27%).

The survey results also suggested this is a multi-year trend. More than half (62%) said the level of scrutiny over legal expenses has "increased" (36%) or "increased significantly" (26%) over the last three years.

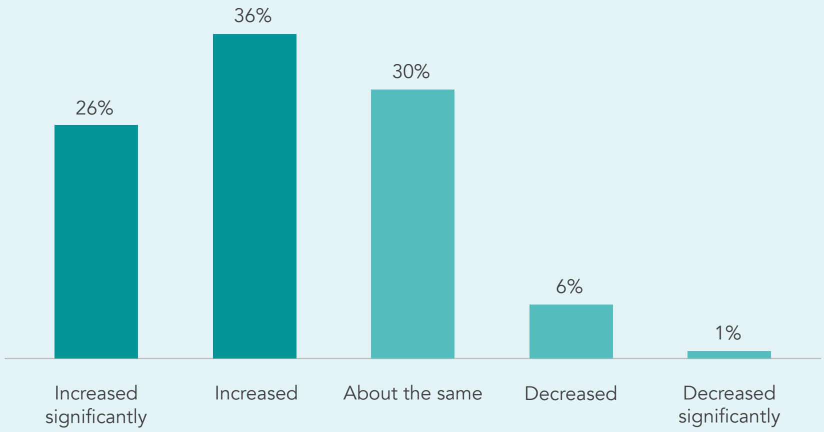
As one respondent, who serves as the senior legal counsel for a PE firm, noted in open-ended comments, "The climate right now is not advantageous to runaway legal spending."

Fig. 5. Do limited partners (LPs) scrutinize legal expenses?



% of respondents

Fig. 6. Has scrutiny by LPs increased or decreased in the last three years?



% of respondents

A material concern to equity investment organizations

Legal expenses are sometimes dismissed as a "rounding error" – especially in comparison to assets under management or the size of the transactions being pursued. However, as the survey demographics establish, the level of spending is not insignificant. Further, some of these costs are absorbed into the cost of running a general partnership.

The survey found more than two-thirds of respondents (71%) say their organizations are at least moderately concerned about overall legal costs – and some big-ticket line items. More specifically, about one in two said their organizations have significant concerns about legal spending in the following areas:

Overall legal spending

47% say "overall legal spending" is a "very significant concern" (20%) or a "significant concern" (27%).

Individual transactions

45% say legal expenses for "individual transactions" such as M&A are a "very significant concern" (18%) or a "significant concern" (27%).

Fundraising

46% say legal expenses incurred during "fundraising" are a "very significant concern" (19%) or a "significant concern" (28%).

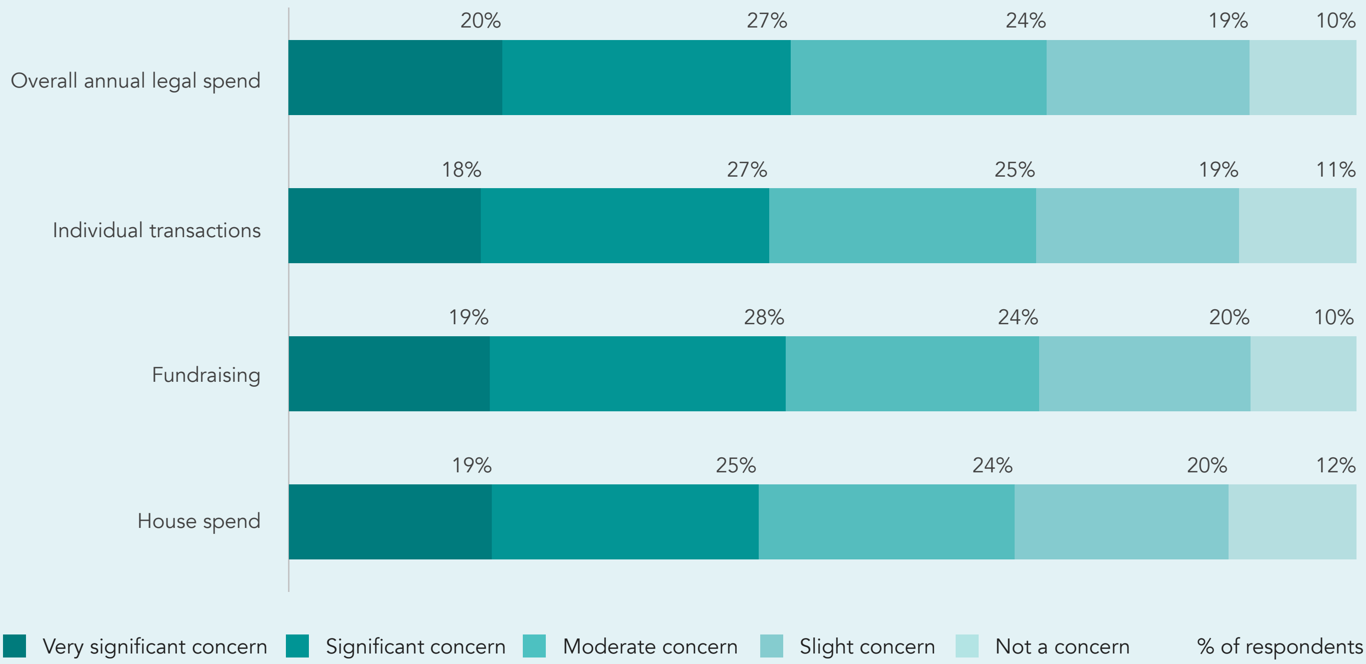
House spend

45% say legal costs around "house spend" – the cost of operating a general partnership – are a "very significant concern" (19%) or a "significant concern" (25%).

The effects of house money on legal expenses can also have a personal impact:

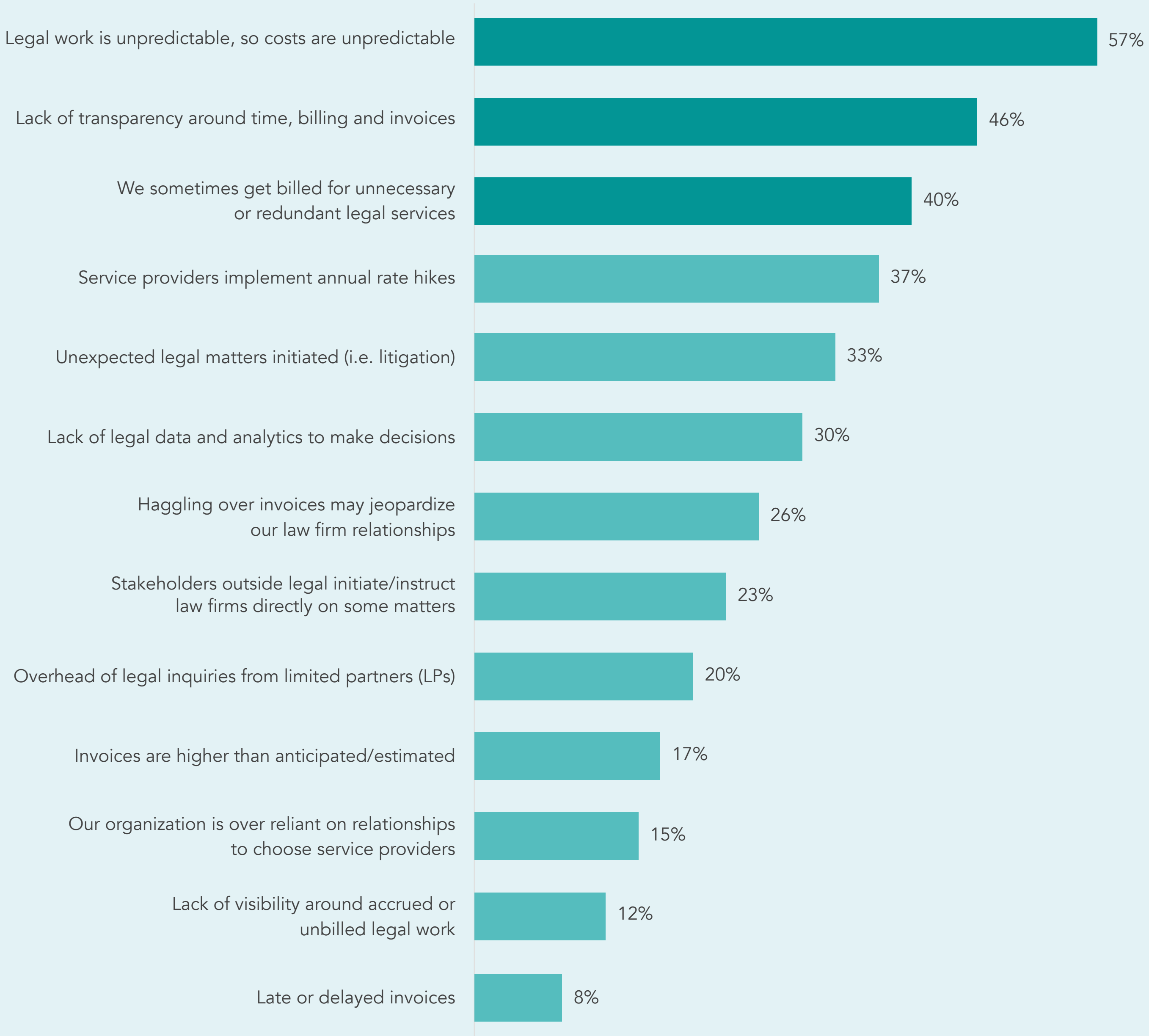
"If I don't control cost my bonus will be much lower," noted a respondent who identified as a legal partner.

Fig. 7. To what extent do any of the following considered a concern in your organization?



Please note: Numbers that do not add up are due to rounding.

Fig. 8. What are the top challenges your organization faces in controlling legal costs?



% of respondents
(multiple selections permitted)

Unpredictable costs, opacity and unnecessary work

Controlling costs sounds like a straightforward exercise, especially for a business that revolves around finance. Yet forecasting legal costs is notoriously difficult. To that end, respondents identified the top three challenges as follows:

57%

said legal work is **unpredictable** and therefore legal expenses are unpredictable.

46%

identified a **lack of transparency** around time, billing and law firm invoices.

40%

said they sometimes get billed for **unnecessary legal services**.

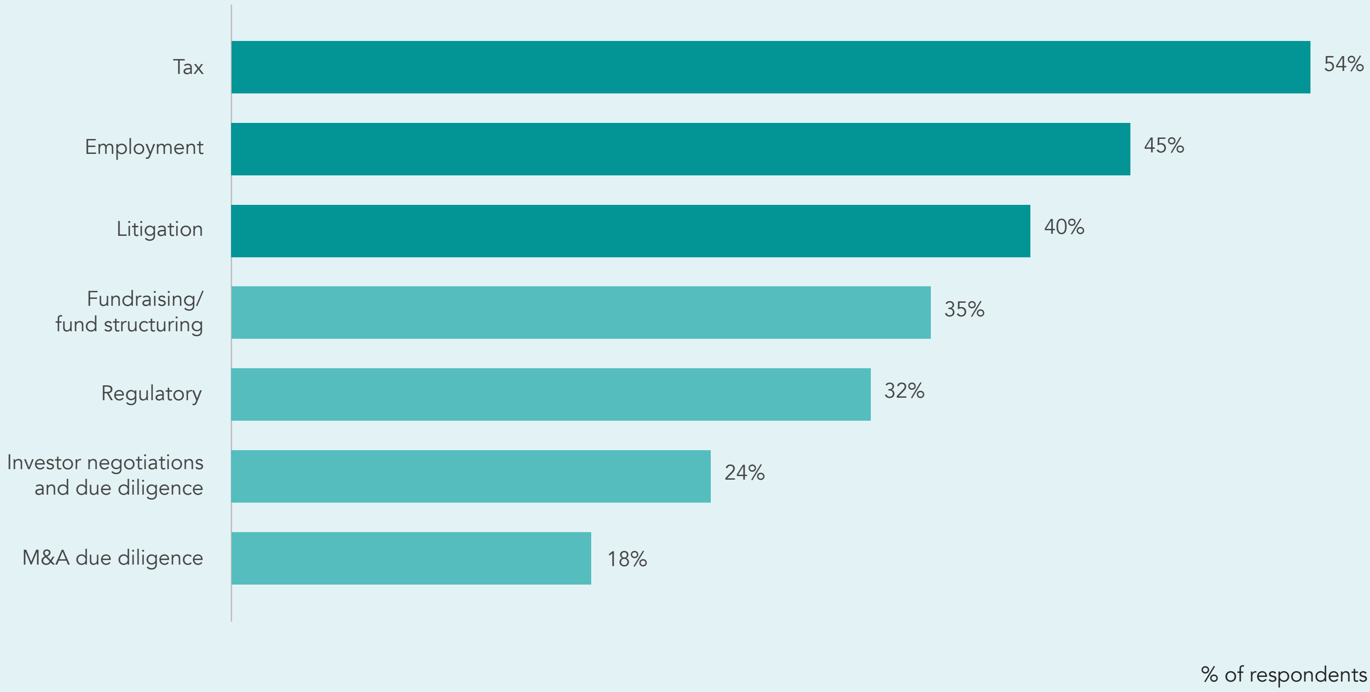
These three challenges are closely related. For example, law firms endeavor to deliver exceptional service and can be very thorough in addressing every possible risk. Because there's little transparency around time and billing as the matter is worked on, both the client and law firm lose track of the time put on the clock. As a result, and in hindsight, PE firms will sometimes find the level of effort billed was more than what they consider necessary.

Law firms are sometimes hesitant to provide a high level of transparency because they worry clients will haggle over every time entry. However, that annual rate hikes (37%) ranked in fourth place on the list of challenges, makes a case that clients in private equity are more concerned with predictable legal costs than they are the absolute price.

(It's worth highlighting, we pressure tested this thesis in a separate question, that's described later in this report.)

Among the matters most likely to go over budget are tax (54%), employment (45%) and litigation (40%). Although the question was worded slightly differently, this finding is a thematic shift from a similar survey of PE firms Apperio commissioned in 2021. That survey found the top matters most prone to cost overruns were investments related to financing, litigation and regulations.

Fig. 9. Which of the following matters are most prone to exceeding estimates?



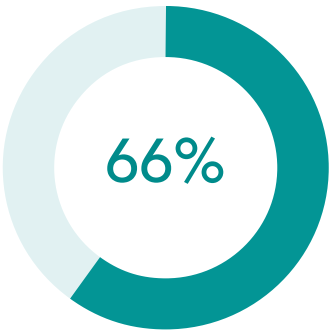
Many investment firms receive higher-than-expected law firm invoices

Matters that go over the budget estimate naturally give way to higher-than-expected law firm invoices. More than three-quarters (78%) of respondents say they receive surprise invoices at least some of the time. This includes 39% that say invoices are "always" (16%) or "often" (23%) higher than the legal department expected.

Bill Priestley, the Chief Investment Partner at Epiris, a boutique private equity firm calls this one of the "bugbears" of legal fees:

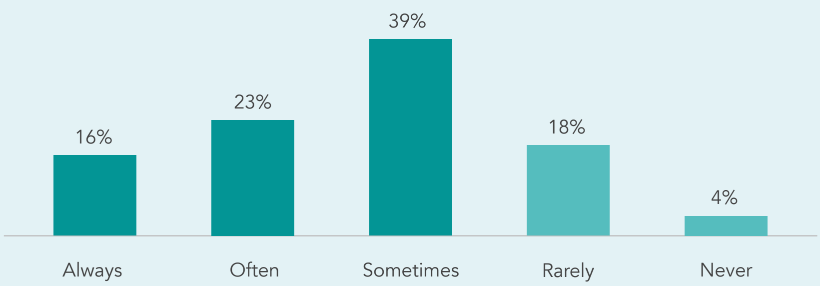
"You'd get a quote for the deal, work on the deal, and then invariably the cost at the end would be considerably more than the quote. You'd then have an old-fashioned discussion and haggle to make the fees more palatable, but it was always relatively unscientific and quite awkward."

This explains in part, why two-thirds (66%) of respondents say they have purchased dedicated software in the last year. However, it's important to bear in mind the limitations of some legal technology solutions in this category, like e-billing. These tools are reactive: it takes an invoice to trigger a response. So, while they have a practical application, they are insufficient alone to fully address a problem like surprise invoices.



Two-thirds (66%) of respondents say they have purchased dedicated software in the last year.

Fig. 10. Do the invoices you receive from law firms ever exceed the estimate?



% of respondents

Timely, transparent and predictable invoices beat lower legal fees

As noted earlier, one question on the survey was designed to pressure test the thesis that in-house teams at investment firms prefer predictable costs over the lowest cost.

When asked, aside from quality or outcome, if you could only select two out of four possible characteristics – timeliness, transparency, predictably and lowest cost – respondents expressed a clear preference for timely invoices:

66%

said **timely invoices –**
you receive invoices within 30 days of accrued billable time

55%

said **transparent invoices –**
you understand what's being billed and why

47%

said **predictable invoices –**
the amount on invoices matches the estimate

32%

and in last place,
respondents said **lowest cost –**
the most economical option

Here again, there's a relationship among the factors cited. Timely invoices require contemporaneous time entries, which is a long-standing challenge for many law firms. This means law firms often don't have an accurate sense of how much time they've logged on the clock for a client until they start the invoicing process. As such, the unpredictable nature of legal work, in some ways, becomes a self-fulfilled prophecy – albeit an avoidable one.

Legal matters initiated outside the purview of the legal department

Some of the problems behind the unpredictable nature of legal costs is related to the organizational structure of investment firms: deal teams want to move quickly on competitive deals and for that reason, are empowered to initiate matters with law firms directly.

This often happens outside the purview of the in-house legal team. The survey found that 81% of respondents indicated that matters are initiated without their knowledge. Nearly half say this happens "always" (22%) or "often" (24%).

So, how does the legal department first learn about these matters?

"The department is informed by a third-party agency," according to one respondent, who holds the title of legal partner at a PE firm, in open-ended remarks.

"Through meetings and discussions with senior management," said another, who is an associate general counsel working in private equity.

"We receive an email from the investors," noted a third, who is the chief legal officer for a PE firm.

This puts in-house lawyers working for investment firms in a difficult position of trying to manage expenses over which they have little visibility, let alone control.

One surefire way to gain better control of these expenses is to centralize all matters and spending through the legal department. This requires some consensus building and change management, but other financial services organizations have found success with such initiatives.

Fig. 11. 81% of respondents indicated that matters are initiated without their knowledge.

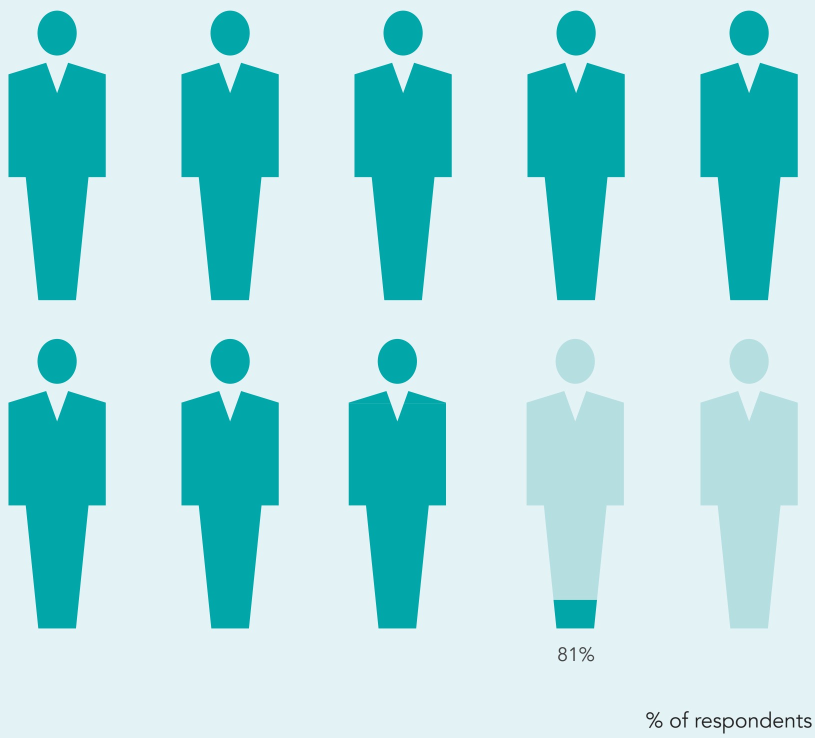
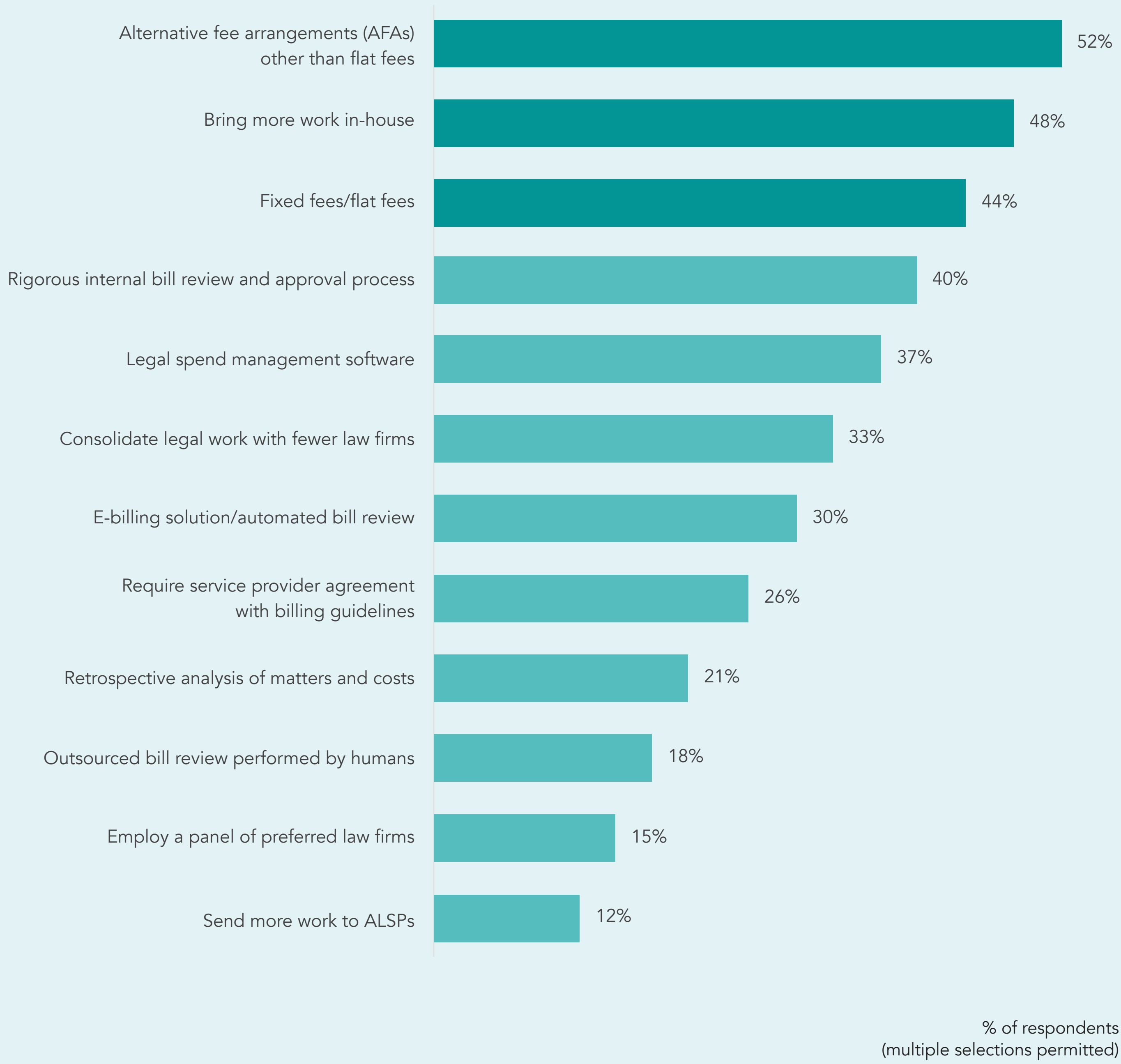


Fig. 12. Which of the following techniques does your organization currently use to control legal costs?



Top techniques investment firms use to control legal costs

Despite the challenges, investment firms do have some options available to tamp down legal costs. The survey revealed the top three techniques used are as follows:

52%

use **alternative fee arrangements (AFAs)** other than fixed fees.

48%

have brought **more work in-house**.

44%

utilize **fixed fees**.

Hold-back agreements are a good example of AFAs other than fixed fees. This is when a law firm holds back a percentage of a fee in escrow until they meet a certain key performance indicator (KPI) they had agreed to with the client. If they miss the KPI – i.e., an invoice fails to match the fee estimate within a certain margin of error – the money goes back to the client.

That investment firms are bringing more work in-house is reflective of a trend in the broader corporate legal sector. This year, 54% of corporate legal spend will be allocated to in-house resources, according to a survey by the Association of Corporate Counsel (ACC).

Finally, a word of caution that a subsequent question on this survey revealed fixed fees quite often are anything but fixed (more detail on the next page).

Some of the other techniques to control costs identified by respondents include a rigorous internal bill review and approval process (40%), legal spend management software (37%), law firm panel consolidation (33%) and e-billing solutions or automated bill review tools (30%).

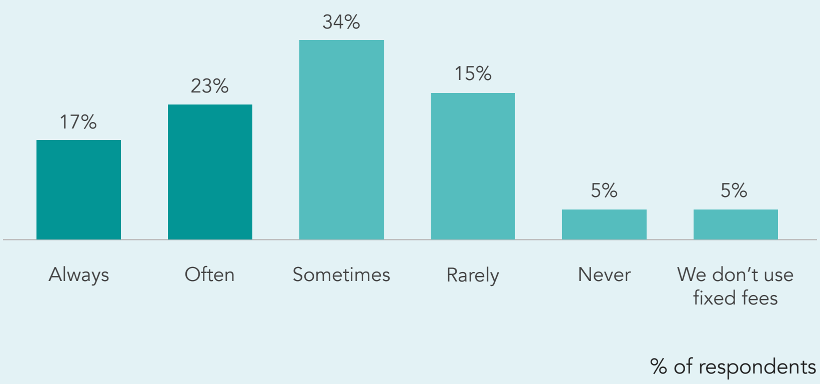
Most of the answers were generally uniform across geographies, except for law firm panel consolidation. More than half of respondents (51%) in the UK (N=100) say they use this technique compared with just about a quarter of their peers (24%) in the US (N=200).

Fixed fees aren't always "fixed"

A big part of the value proposition of fixed fees is predictability. This sounds good in theory, but it doesn't always work well in practice.

The survey found nearly three-quarters (74%) of respondents say fixed fees exceed the agreed price at least some of the time. This includes a significant number of respondents who say this happens "always" (17%) or "often" (23%).

Fig. 13. Do fixed fees ever exceed the initial agreed price estimate?



We asked respondents "why?" in an open-ended follow-up question. Here is a representative sample of responses:

"Because extra work is necessary to gain a whole picture." ~ Associate general counsel in private equity.

"Things increase unexpectedly or not realizing fully what is required." ~ Chief counsel in venture capital.

"We don't price it [matters] accurately." ~ Legal partner in private equity.

"We agree on a course of action and they must advise us if it incurs extra costs before proceeding." ~ Senior legal counsel in private equity.

"Hidden fees." ~ Principal legal officer in private equity.

"They exceed the legal initial agreed price estimate weekly. It's very hard for my business." ~ Deputy general counsel in private equity.

"I'm not sure but I'm working on finding the answer." ~ Senior legal counsel in venture capital.

Fixed fees can be effective in certain circumstances, but they are not a panacea. In some cases, it creates a "zero-sum game" that puts clients and law firms at odds. This is because if the final price is over or under the fixed fee, either the law firm or the investment firm "wins."

Control requires a proactive approach

Legal spending has grown and is poised to continue to grow for the foreseeable future. This growth is driving greater scrutiny from stakeholders inside and outside of investment firms – including general partners and limited partners.

This fact is pressuring in-house legal teams to ramp up their efforts to gain better control of legal spending. Yet as this survey demonstrates, several formidable barriers inhibit such efforts. These range from an organizational structure that permits teams other than legal to instruct law firms directly – to the longstanding problems of opacity in the business of law around WIP, accruals, time entries and billing.

Presently, many of the strategies in-house counsel use to address rising legal spend – such as requesting discounts on surprise invoices – are reactive and occur retrospectively. These also do little to support the legal department's efforts to provide reliable forecasts of expected costs that are on par with forecasts required by peers in other departments.

A better approach is to get ahead of the invoice. This can be done by motivating the organization to centralize its legal spend processes, augmenting those processes with modern legal technologies, and inviting preferred law firms to be part of these advancements from the outset.

Survey methodology and demographics

Apperio commissioned a survey of 300 lawyers who work in-house for private equity (83%) and venture capital (17%) firms in the US (67%) and UK (33%). On average, these organizations manage $9 billion in assets, spend $12 million on outside counsel annually, and employ five in-house lawyers. Nearly 6 in ten (58%) said they are the senior decision maker on legal spending, while the rest (42%) said they are part of a team of decision-makers. Respondents hold titles including chief legal officer, general counsel, and senior legal counsel. The survey was conducted in August and September of 2022 by the research firm Coleman Parkes.

Please note: Numbers that do not add up are due to rounding.

Fig. 14.

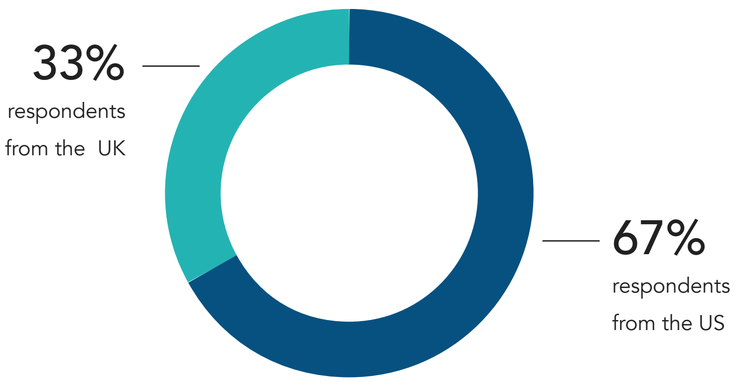


Fig. 15.

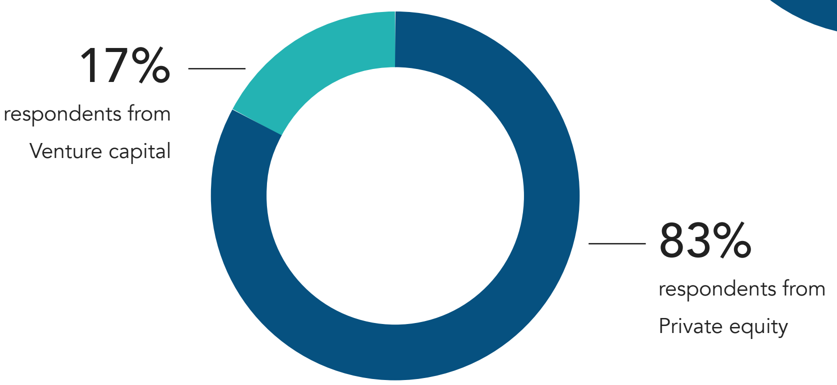


Fig. 16. Which of the following best describes your job title?

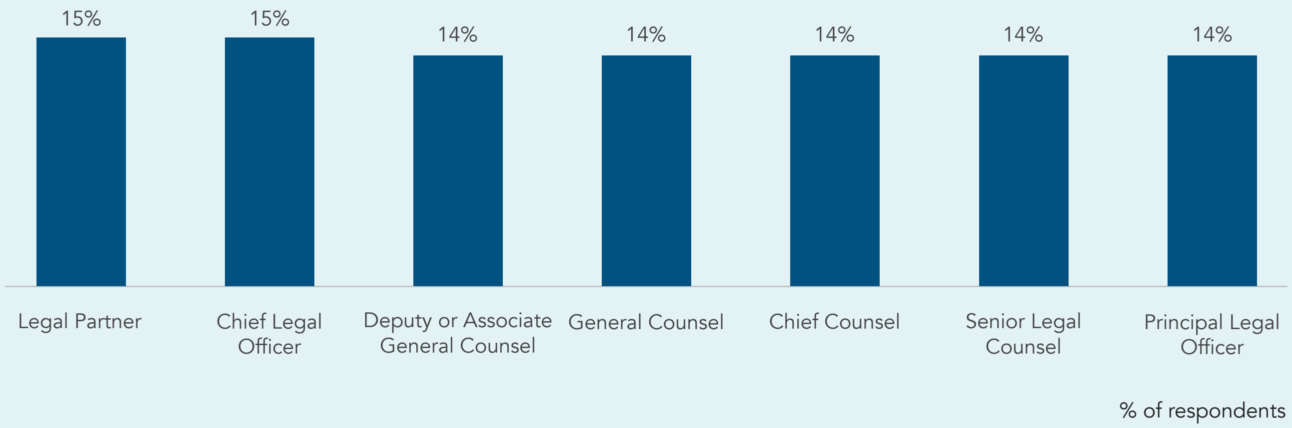


Fig. 17. How much does your legal department spend annually on external counsel?

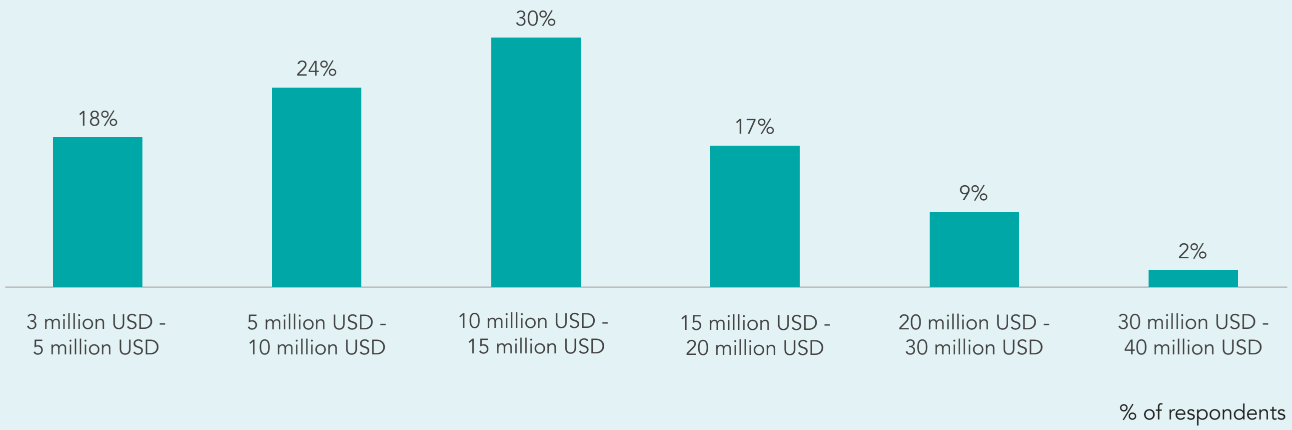


Fig. 18. Which of the following best describes your level of involvement in the decision-making process around legal spend management within your organization?

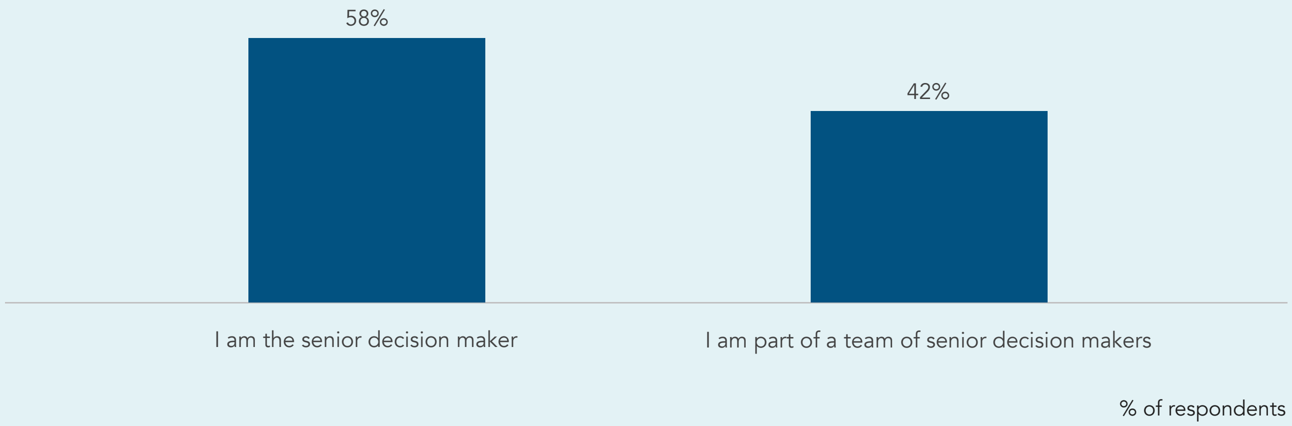


Fig. 19. How many qualified lawyers are employed in-house by your organization?

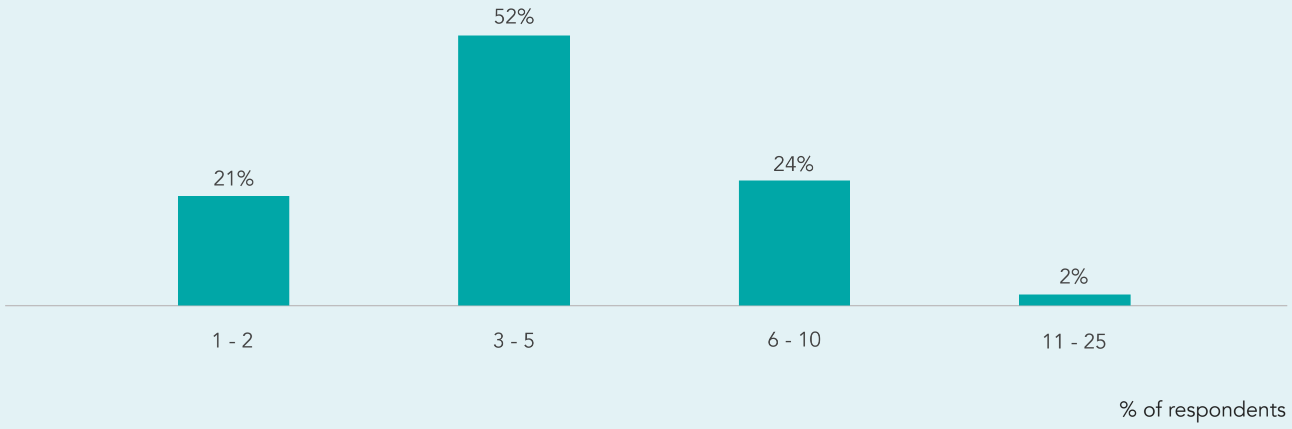


Fig. 20. What is the value of the assets your firm has under management?

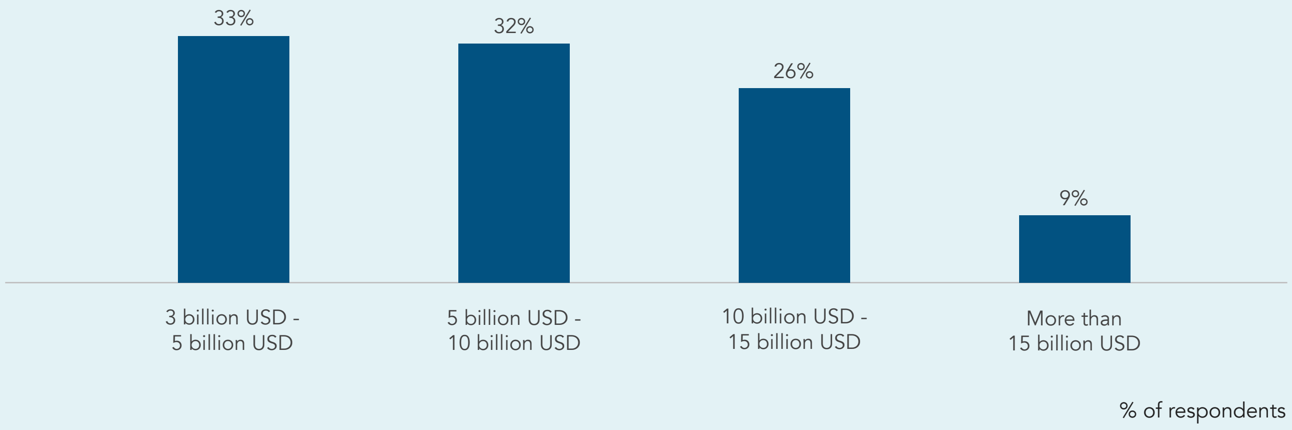


Fig. 21. What is the target 'deal value' (in USD) for companies in which you seek to invest?

About Apperio

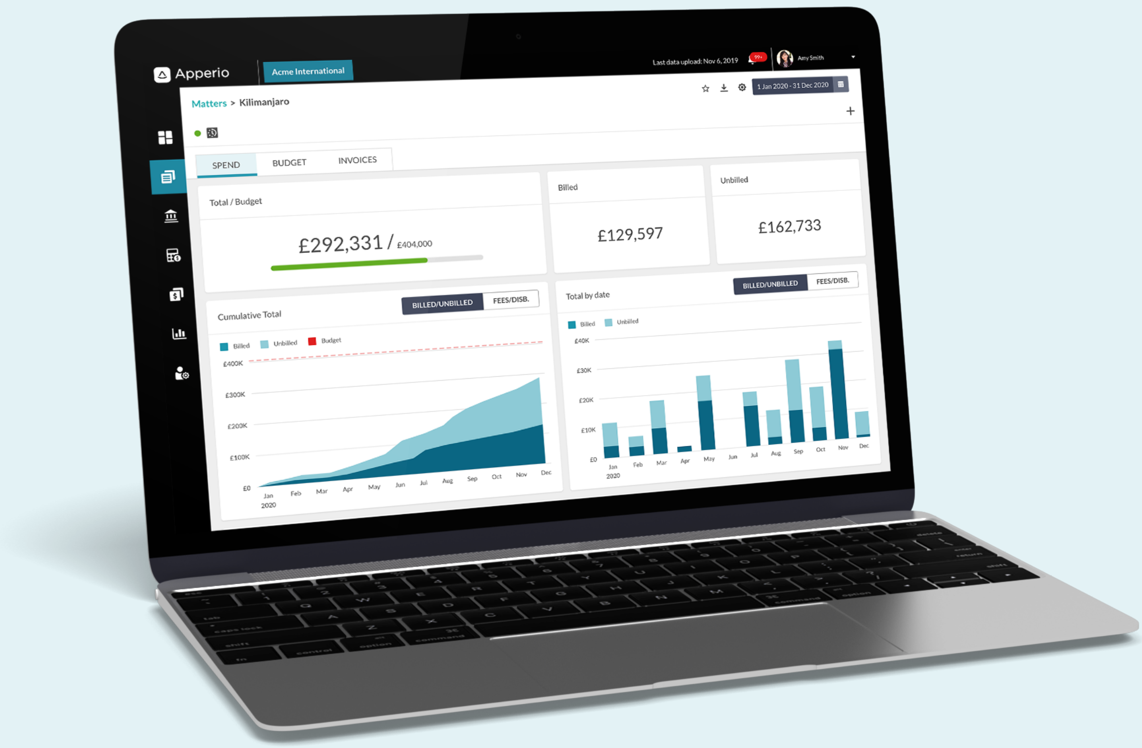
Apperio's legal spend management software provides analytics and real-time visibility on external legal matters. This empowers in-house counsel to control and optimize their spend with law firms, ahead of the invoice.

Rather than relying on data from billed invoices, Apperio works by aggregating data directly from the sources of truth – law firms' time recording systems. As a result, a greater level of granularity and analysis is possible, weeks before an invoice is received.

In-house teams can therefore work proactively with this data and gain confidence from an accurate picture of their spending. In turn, such insights can also improve the forecasting, budgeting and efficiency of the legal department.

Currently, Apperio is used daily by more than 50 in-house legal teams including Epiris, EQT, Phoenix Group, Royal London, Network Rail, and Cornerstone. Apperio is headquartered in London, England.

For more information, please visit Apperio.com or follow Apperio on LinkedIn or Twitter.



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