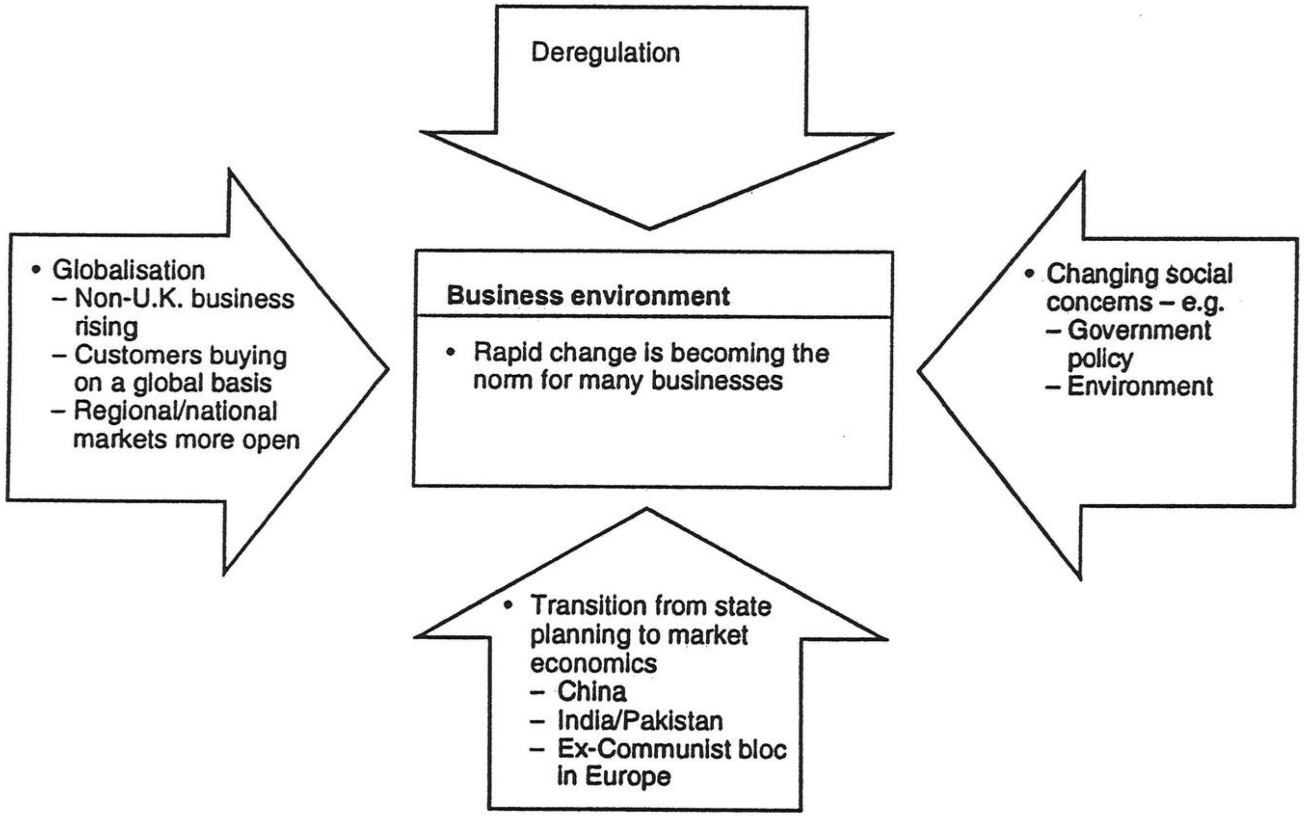
Money – the Link Between Business and Law

Stephen Allott, McKinsey & Company Inc.

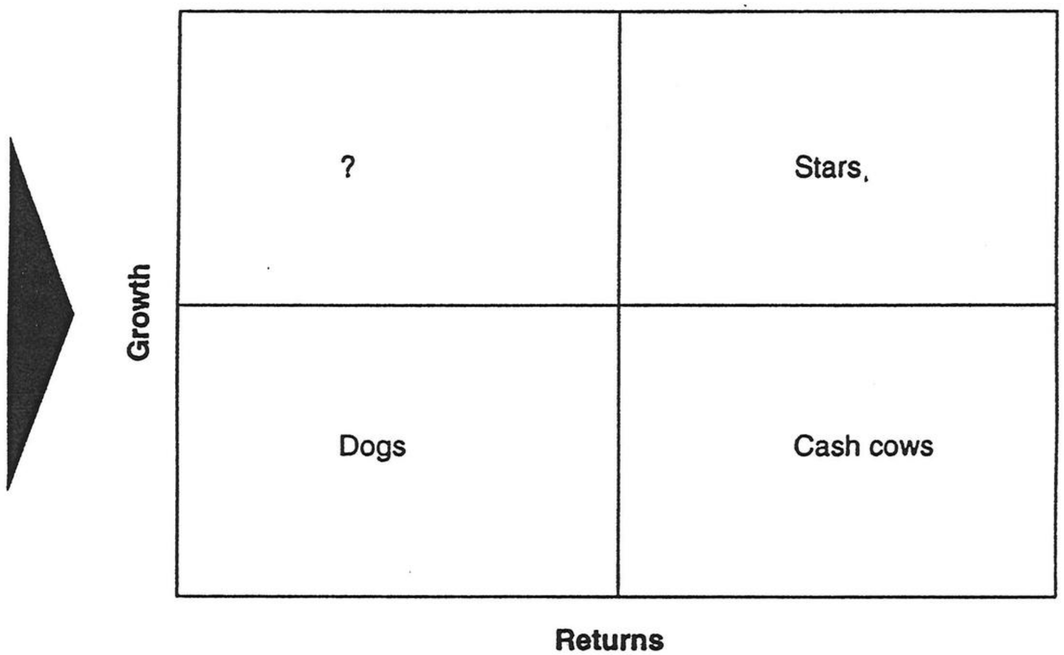
PRESSURES ON BUSINESS



Source: McKinsey analysis

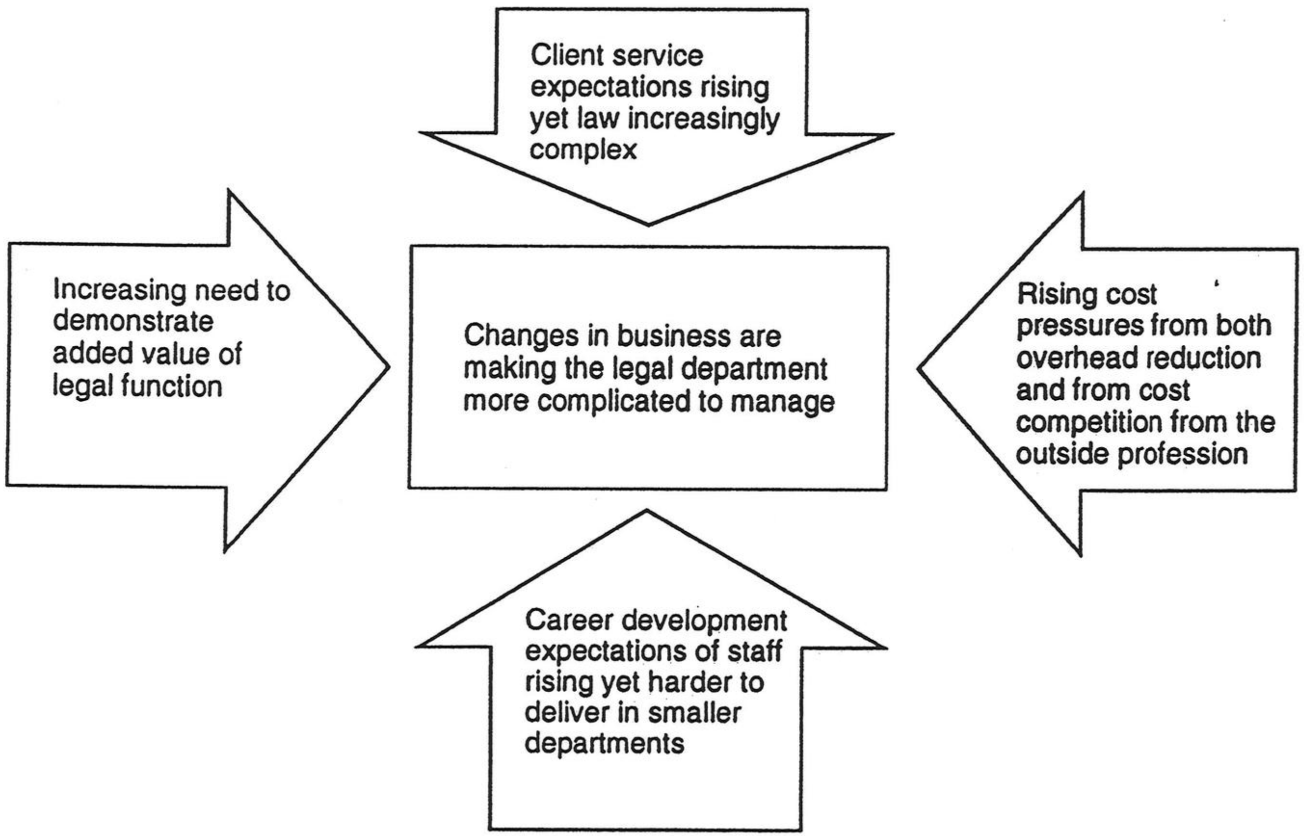
THE GROWTH/RETURNS MATRIX

- What are the prospects for each business?
- How can their prospects be improved?
- Which owner can add most value?
- Which new businesses should we enter and how?



Source: Boston Consulting Group

PRESSURES ON THE LEGAL DEPARTMENT



Source: McKinsey analysis

PRACTICAL ISSUES FOR THE LEGAL DEPARTMENT

ILLUSTRATIVE

Individual level

- Which of the 7 matters in my in-tray is the highest priority?
- What is the appropriate amount of effort to put into this piece of work?
- Which terms can be traded/given away in this deal?
- Which of the 293 Single Market initiatives will my client be interested to know more about?

Source: McKinsey analysis

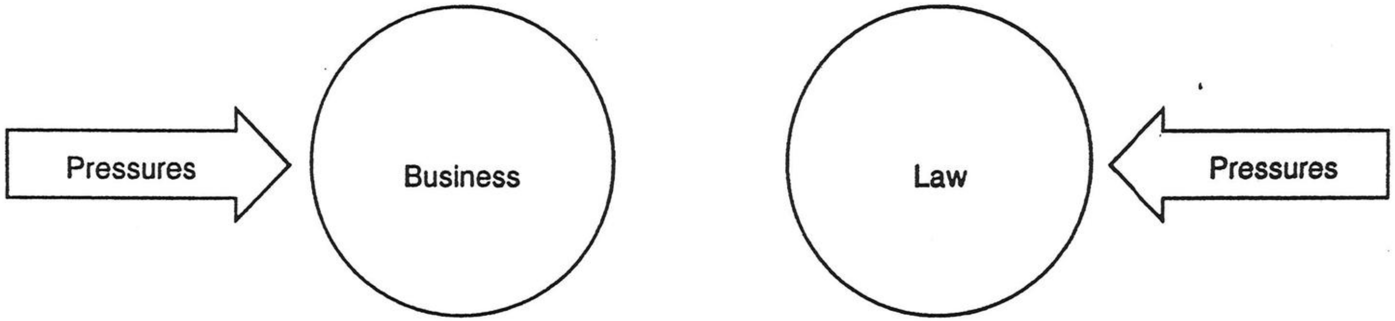
PRACTICAL ISSUES FOR THE LEGAL DEPARTMENT

ILLUSTRATIVE

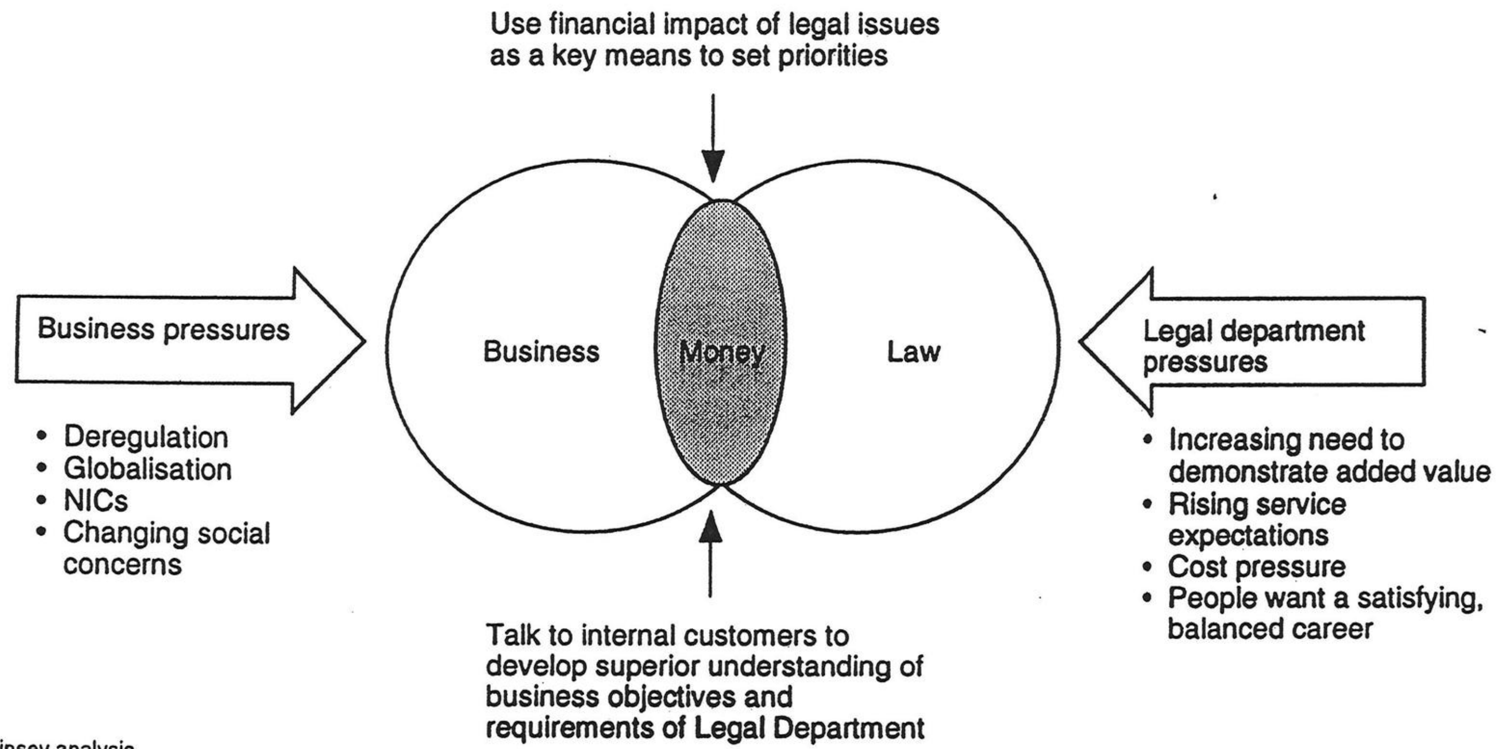
Individual level	Department leadership level
• Which of the 7 matters in my in-tray is the highest priority?	• How many lawyers should be allocated to each business unit?
• What is the appropriate amount of effort to put into this piece of work?	• What guidance should be given as to relative levels of effort required for different pieces of work?
• Which terms can be traded/given away in this deal?	• What guidance can be given as to which terms to trade/give away and which to stick with to the bitter end
• Which of the 293 Single Market initiatives will my client be interested to know more about?	• How can we really contribute to the success of the business?

Source: McKinsey analysis

BOTH BUSINESS AND LAWYERS FACE PRESSURES

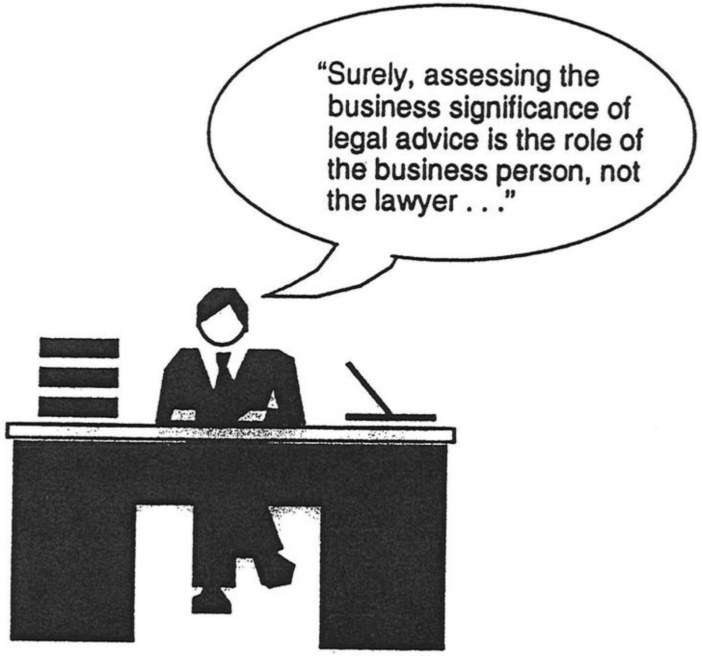


TALK TO THE INTERNAL CUSTOMERS ABOUT MONEY



Source: McKinsey analysis

BUSINESS IMPACT OF LEGAL ISSUES



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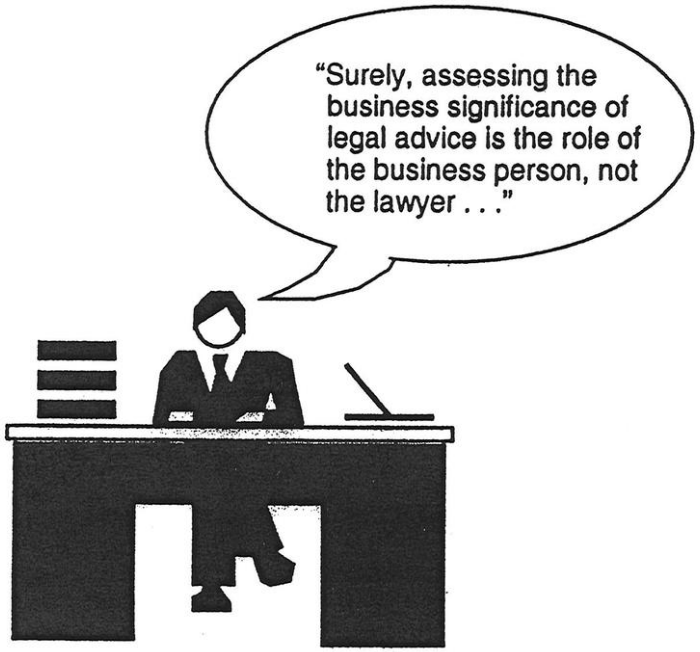
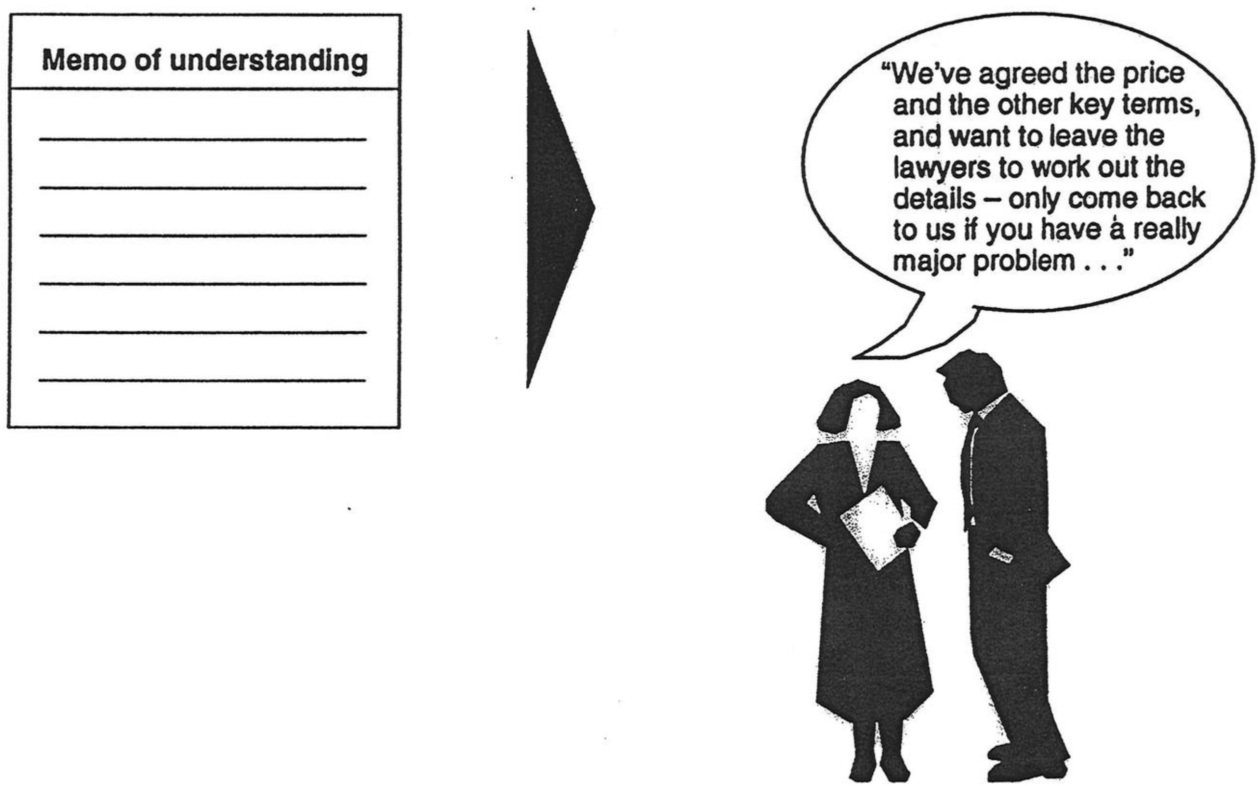


Yes but . . . . the goal is cross functional understanding

- No change in roles and responsibility suggested, merely constructive dialogue
  - Law for lawyers
  - Business for business people
- In practical terms, the aim is cross-functional understanding
  - Business people need to understand legal significance of business decisions
  - Lawyers need to understand the business significance of legal issues
- Cross-functional team working with business-minded lawyers seen as best practice approach

Source: McKinsey analysis

THINKING BUSINESS . . . FIRST STEPS



NEGOTIATING DETAILS – THE REAL ISSUE IS PRICE

Typical details

- Payment terms
- Notice provisions
- Liability for defects
- Liability for loss/damage
- Ownership issues – e.g., of IPR

Source: McKinsey analysis

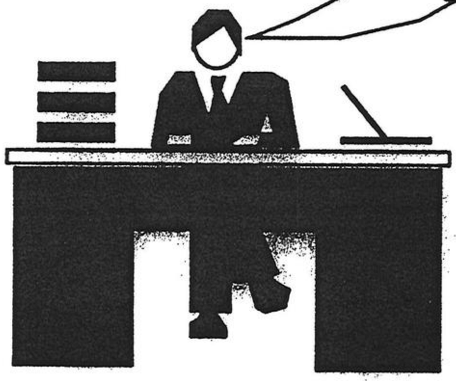
NEGOTIATING DETAILS – THE REAL ISSUE IS PRICE

Typical details	Price impact
• Payment terms	• Delayed payment has a real and obvious cost
• Notice provisions	• Notice procedures may require costly administration to fulfil
• Liability for defects	• Cost of defect rectification is significant
• Liability for loss/damage	• Insurance companies charge a premium for the assumption of risk
• Ownership issues – e.g., of IPR	• Ownership of things is valuable!

Source: McKinsey analysis

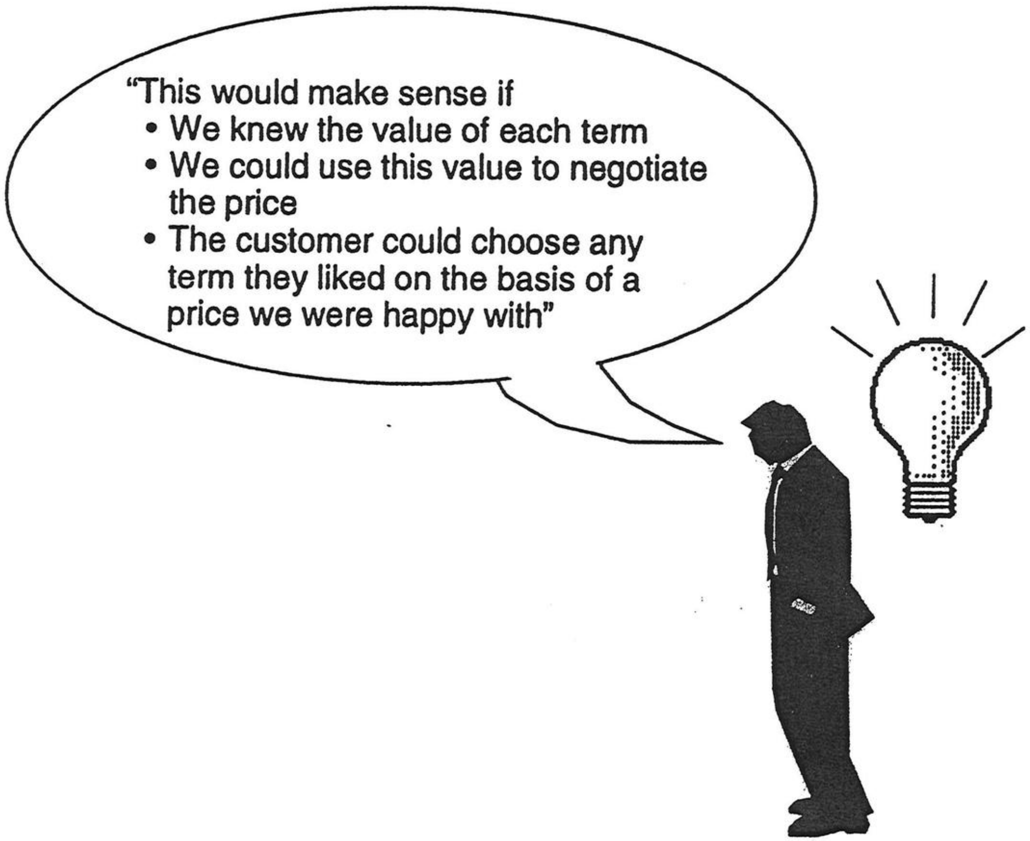
THE REALITY

- "How can I negotiate these terms properly if the price is already fixed?
- How can I trade off terms if I can only guess at the real value of each?
- Is reducing working capital a corporate priority at the moment or should we be offering longer payment terms in exchange for other concessions?
- Is the benefit gained by excluding/minimising liability for defects more than outweighed by the damage to our customer relationships and reputation?
- What is the real probable cost of all the various liabilities which are under negotiation?
- What is the real value of the items of ownership at issue?
- Negotiating this is . . ."



Source: McKinsey analysis

THE IDEA


"This would make sense if
• We knew the value of each term
• We could use this value to negotiate the price
• The customer could choose any term they liked on the basis of a price we were happy with"

BENEFITS OF PRICING INDIVIDUAL TERMS

"You can have (almost) any term you want provided you pay a fair price for it"

- Gives customers exactly what they want – price forces them to choose the terms they really value
- Eliminates wasteful, unfocused negotiation efforts having linked business with law
- Allows the possibility of gaining extra margin if customer is willing to pay more for more onerous but acceptable terms

Source: McKinsey analysis

SIMPLE APPLICATIONS

Situation	Application
• **Selling:** The buyer insists you make a bid which complies with their purchase terms, whereas your prices are based on certain standard terms of sale	• Bid 2 prices and allow the buyer to choose – The price based on the seller's standard terms, but noncompliant with the buyers' terms – The price based on a bid compliant with the buyer's terms

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Situation	Application
• **Selling**: The buyer insists you make a bid which complies with their purchase terms, whereas your prices are based on certain standard terms of sale	• Bid 2 prices and allow the buyer to choose – The price based on the seller's standard terms, but noncompliant with the buyers' terms – The price based on a bid compliant with the buyer's terms
• **Selling**: Negotiating amendments to one's standard terms of sale	• Allow deviations from standard terms of sale, but only on the basis of true valuation of the amendment requested

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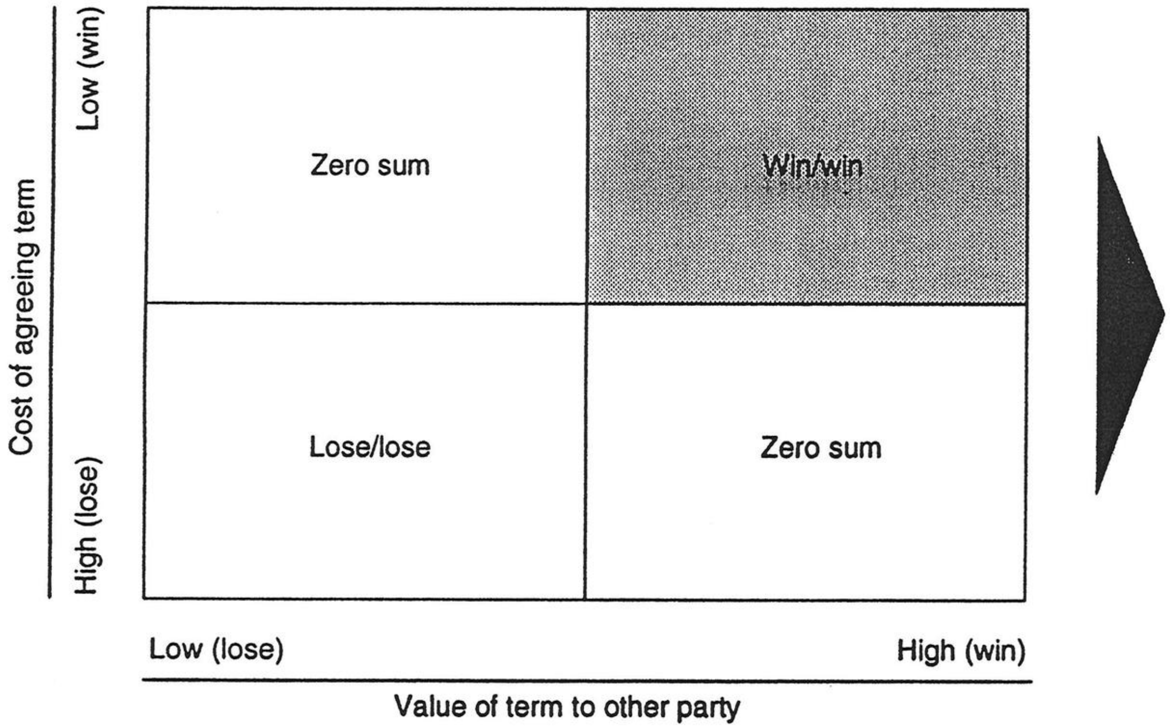
• **Selling:** Negotiating amendments to one's standard terms of sale	• Allow deviations from standard terms of sale, but only on the basis of true valuation of the amendment requested
• **Buying:** Placing a value on one's standard purchase terms	• Identify what changes in terms would allow a supplier to **reduce** their price and arbitrage to see if the reduction offered is more valuable than the internal cost of accepting it

WIN/WIN NEGOTIATION



- Win/win relationships require both parties to benefit

Source: McKinsey analysis

DISCOUNTED CASHFLOW ('DCF') DETERMINES VALUE

Which should you accept?

- £1,000 now
- £1,250 in 2 years from now
- 1 in 300 chance of a £1m liability payable in 10 years' time

* Assumes cost of capital of 12%

Note: Alternative means of financial assessment such as IRR and Payback also used

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- £1,000 now
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	Formula	Present value*
£1,000 now:	n/a	= £1,000
£1,250 in 2 years:	$\frac{£1{,}250}{(1.12)^2}$	= £1,000
Risk of £1m in 10 years	$\frac{£1m}{300 \times (1.12)^{10}}$	= £1,000

* Assumes cost of capital of 12%

Note: Alternative means of financial assessment such as IRR and Payback also used

Source: McKinsey analysis

ILLUSTRATIVE

FACTORS RELEVANT TO PRICING TERMS

- Cashflows
- Timing of cashflows
- Probabilities/risk portfolio size
- Ability to absorb risk (i.e., would £1m wipe you out)
- Indirect costs (e.g., administration)
- Business benefit from positive/negative customer reaction

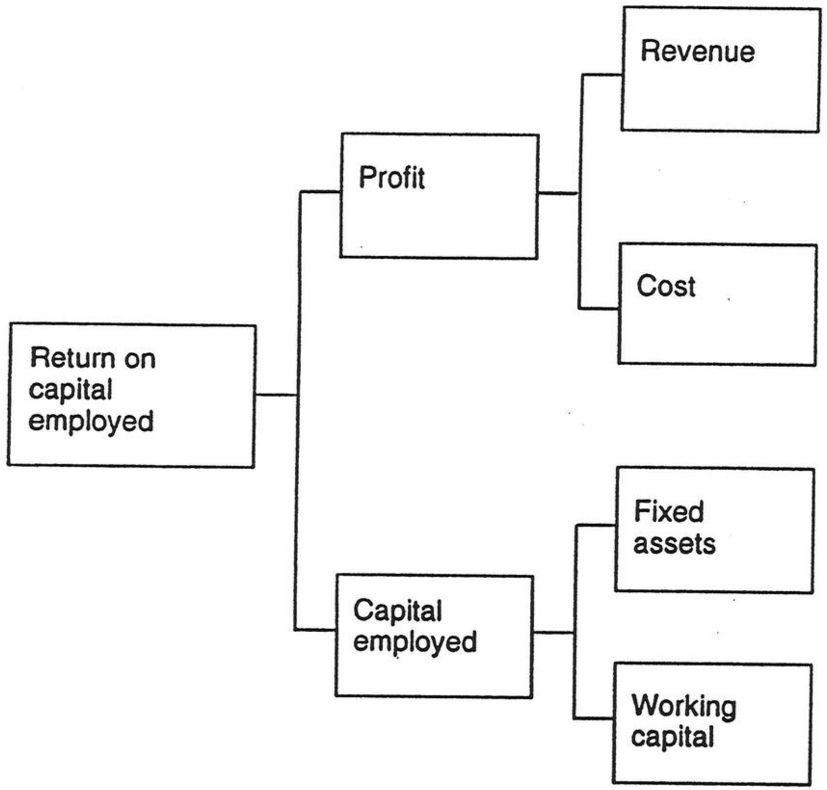
→ A value can be placed on legal issues/work

Source: McKinsey analysis

In principle, the financial impact (on ROCE) of all legal work can be determined

RANGE OF LEGAL DEPARTMENT CONTRIBUTION

ILLUSTRATIVE



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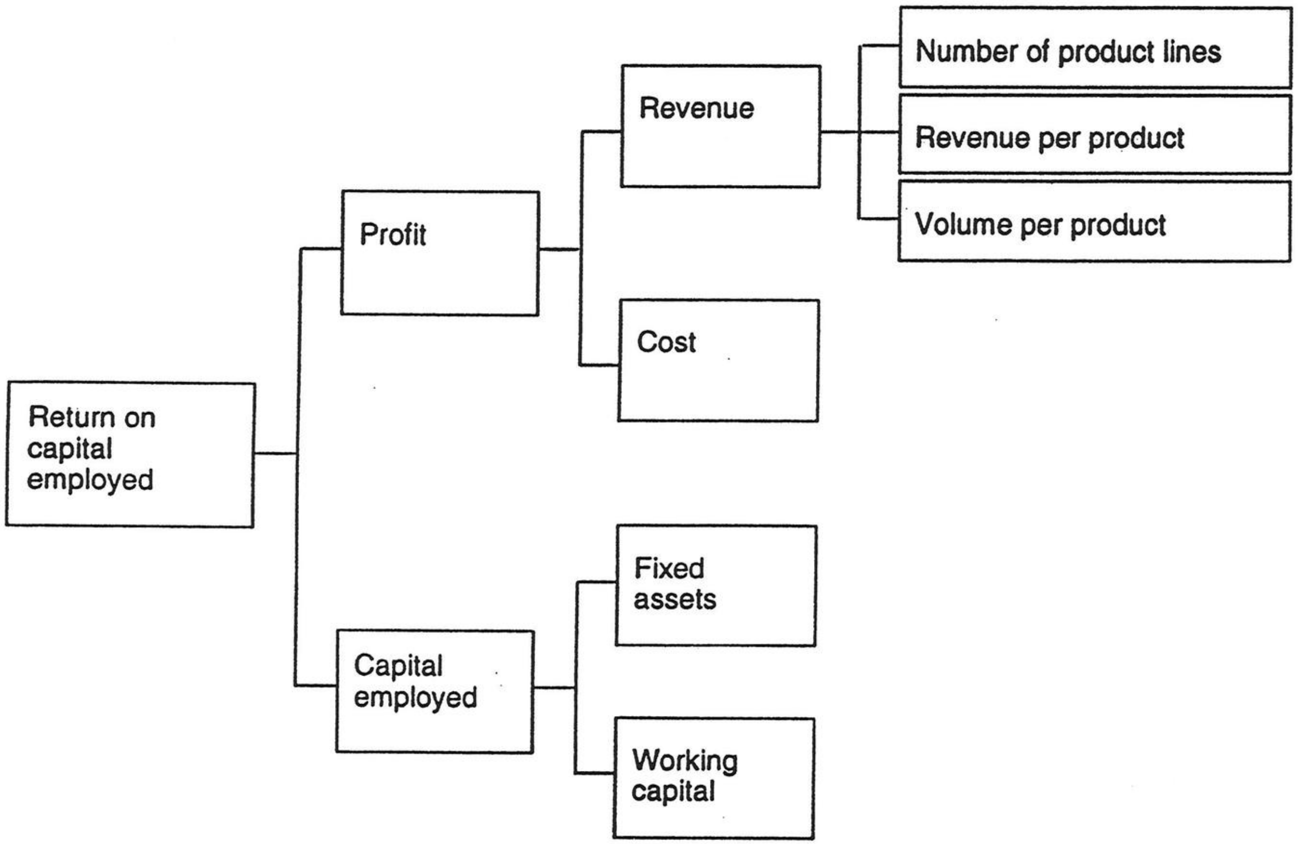

Examples of legal work
- Market entry
- Deregulation
- Licences of right
- IPR
- Pricing behaviour
- Customer negotiation

Source: McKinsey analysis

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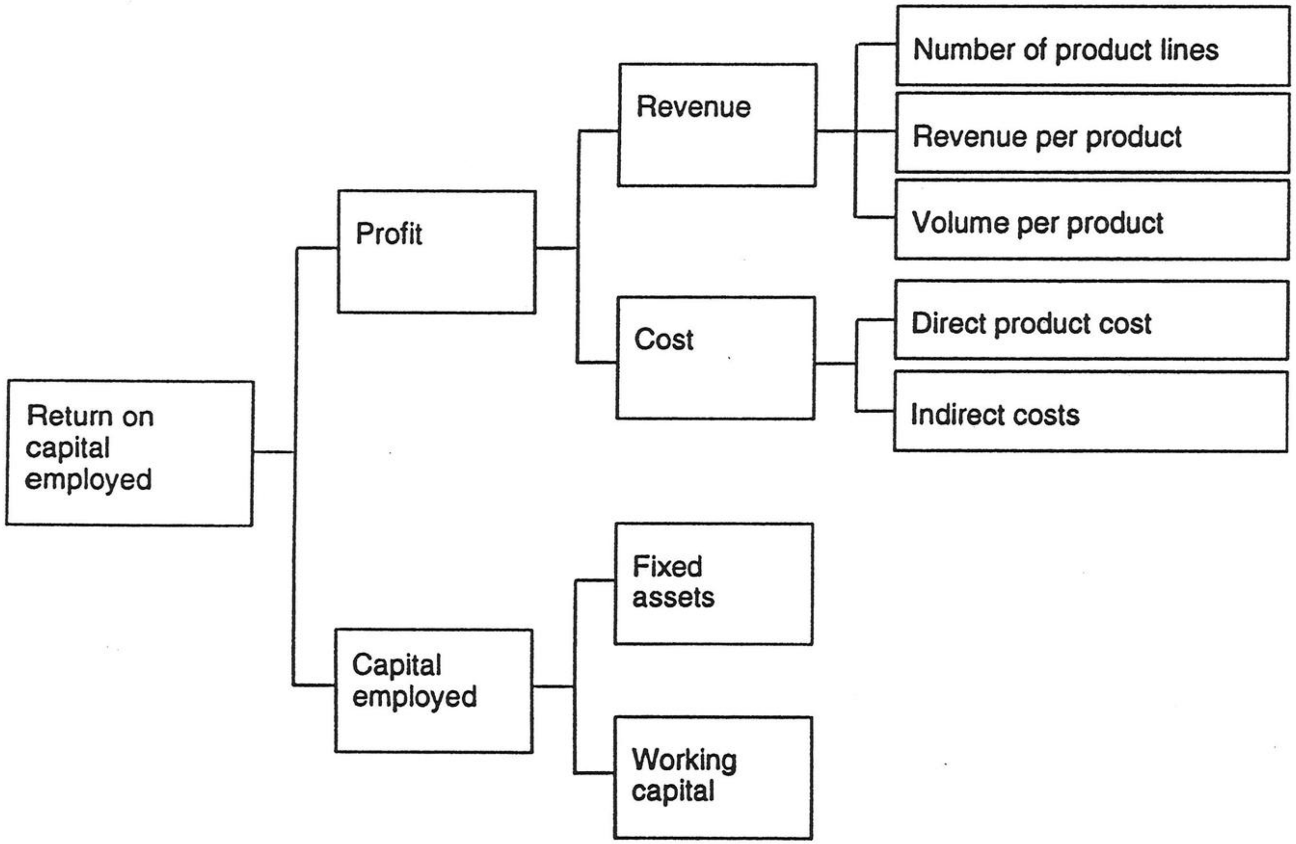

Examples of legal work
- Market entry
- Deregulation
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- Pricing behaviour
- Customer negotiation
- Purchase and manufacturing cost work
- Overhead costs – e.g., lower legal bills

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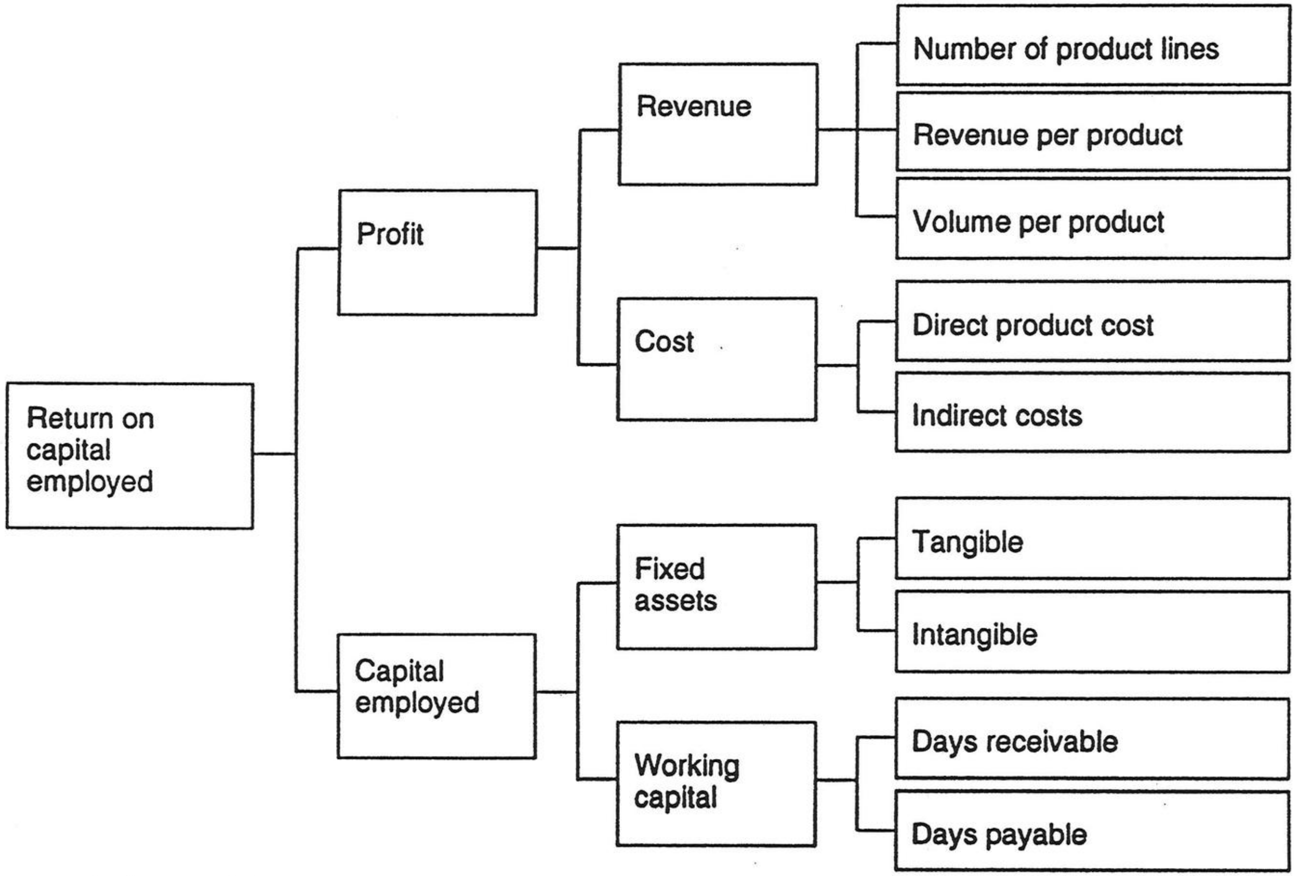
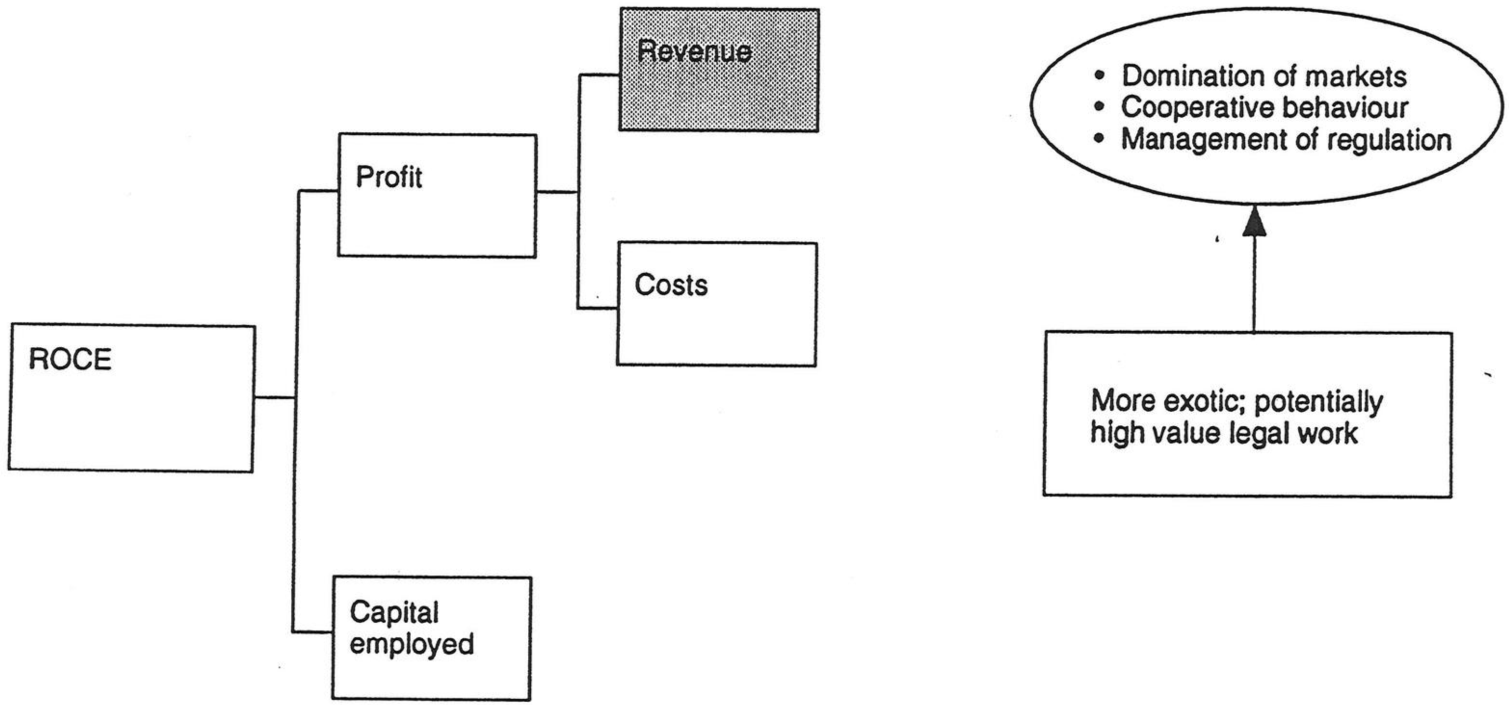


Examples of legal work

- Market entry
- Deregulation
- Licences of right
- IPR
- Pricing behaviour
- Customer negotiation
- Purchase and manufacturing cost work
- Overhead costs – e.g., lower legal bills
- Asset purchases
- Asset protection
- IPR protection
- Payment terms
- Bad debt recovery

Source: McKinsey analysis

ADDED VALUE ON THE REVENUE SIDE

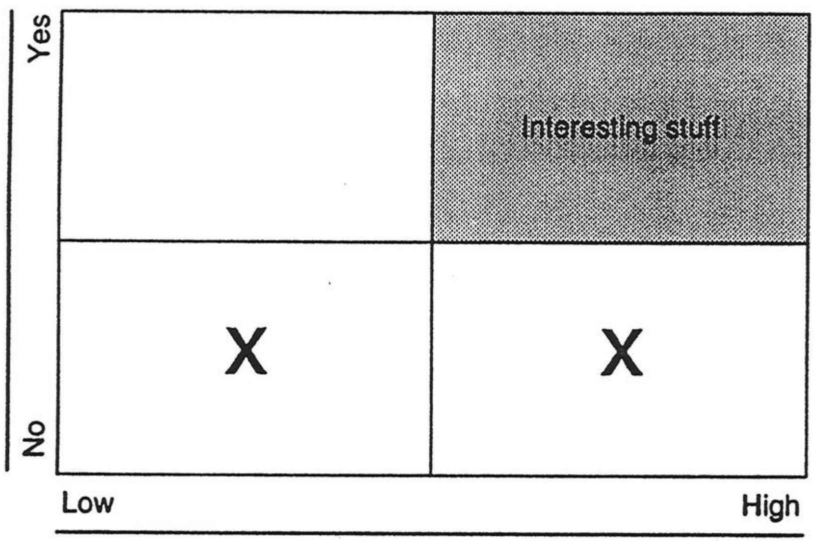


Source: McKinsey analysis

THE HOLY GRAIL

What's allowed

- Lawyers know what's possible, not what things are worth



What it's worth

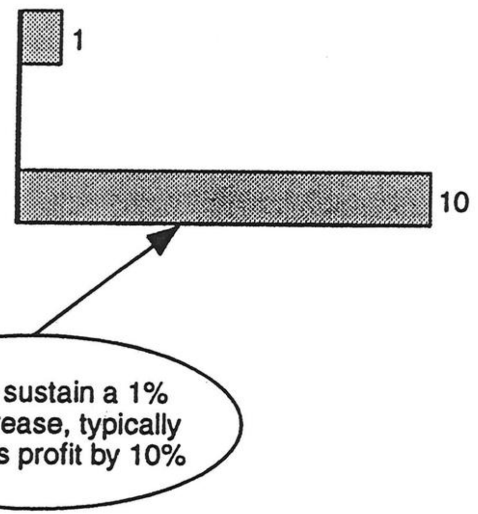
- Business people know what things are worth, but not what's possible

Source: McKinsey analysis

SCALE OF LEGAL OPPORTUNITIES

ILLUSTRATIVE

	Today	Tomorrow	Scale of impact %
Revenue	100	101	1
Cost	90	90	
Profit	10	11	10



Source: McKinsey analysis

WHAT CAN YOU ACTUALLY DO TO PUT THIS INTO ACTION?

- Ask commercial people to try pricing nonfinancial contract terms
- Use valuation of undertakings in competition cases when negotiating with the authorities
- Use valuation of rules/regulations when lobbying the regulatory authorities

HOW ELSE CAN ONE USE VALUATION OF LEGAL WORK?

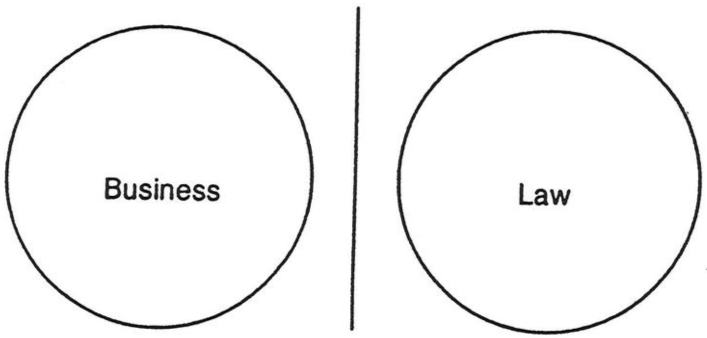
- Reprioritise current workload on the basis of potential added value
  - List current workload/matters/activities
  - Value each one
  - Reprioritise accordingly

- Use the results to demonstrate the department's added value – insist on a value assessment as part of internal reporting in the Legal Department

- Generate new high value added opportunities through discussions with the client
  - Ask the client to explain the business strategy/objectives
  - Brainstorm possible sources of legal department help
  - Prioritise projects and select the most promising

MONEY IS A KEY LINK BETWEEN BUSINESS AND LAW

The old view

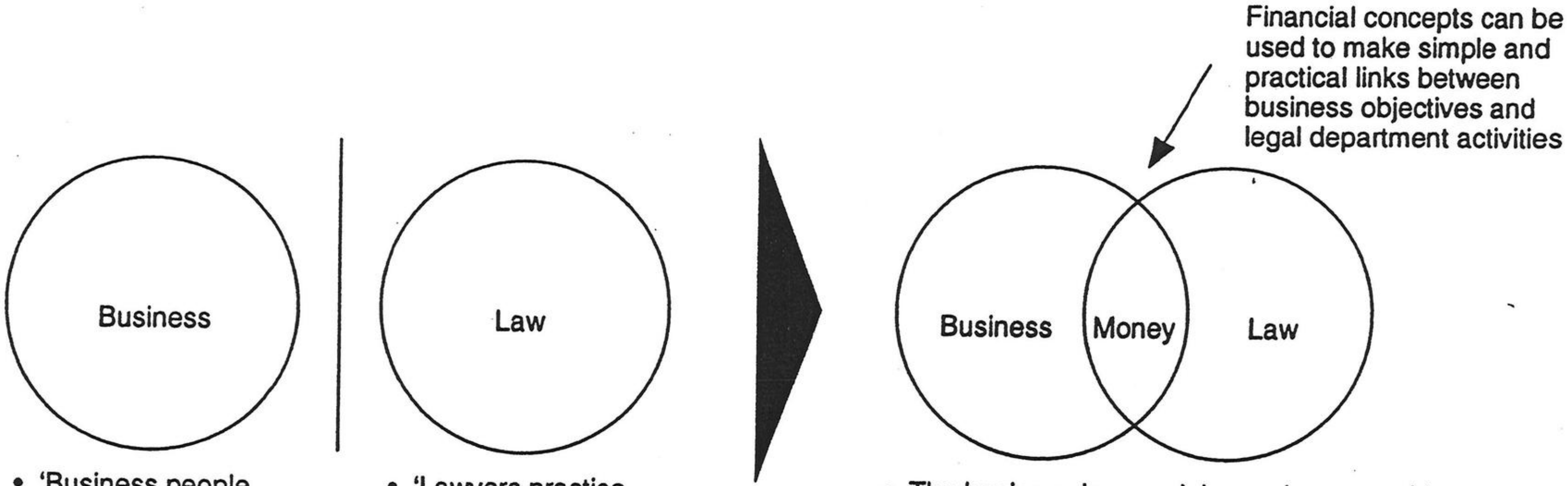


- 'Business people manage the business'
- 'The legal department is an overhead'

- 'Lawyers practise law'
- 'Inhouse lawyers are just like outside lawyers only cheaper'

MONEY IS A KEY LINK BETWEEN BUSINESS AND LAW

The old view | **The new view**



- 'Business people manage the business'
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- 'Lawyers practise law'
- 'Inhouse lawyers are just like outside lawyers only cheaper'

- The business is run by multi-disciplinary teams

- Inhouse lawyers add unique value which is difficult to obtain from outside lawyers

SUMMARY

- Law can be a real source of business benefit
- Dialogue is necessary to uncover and exploit those benefits
- The really powerful sources of business benefit are so strong, like heroin, that their use is controlled viz domination, cooperation and regulation

Money is the link between business and law