

Thank you. It is indeed an honor to be the keynote speaker for the Lawyers Club. As I told Graham Grady and Randy Hack, who initially asked me to speak, I did not know much about the Lawyers Club, but I certainly do now. Perusing the list of speakers on the website from 2005 to the present and then the list from 1883 to 2005, I was dumbstruck that my name would be added to such a distinguished list. Nonetheless, I agreed to speak and so here I am. I was asked to do 3 things: tell you a little bit about me; tell you something about the growth of the company I work for, Illinois Tool Works Inc., and finally speak about a subject that is important to me as a general counsel and that you might find interesting.

So let's begin with a little bit about me. I am a Chicago native and a product of the Chicago public school system. My story is not one of instant success, but like many people, it took me quite a while to find a place where I could succeed. I was privileged last year to be featured in a Chicago Tribune career path article, and, as a result, had the opportunity to go back over my career and the numerous jobs I held prior to coming to ITW. By

my count, I had 13 jobs, including summer and youth jobs, in my career. I will not go through all of them, but in essence, after flunking out of U of I at Chicago, I had a series of accounting jobs until I was drafted into the Army. When I returned home from military duty, I again had a series of accounting-type jobs until I joined the Chicago Police Department in 1972, where I stayed for 10 years. While working the beat, I completed my undergraduate studies at the U of I at Chicago and obtained my law degree from the University of Chicago. After leaving the Police Department, I began my legal career at the former law firm of Gardner, Carton & Douglas, which is now Drinker Biddle, where I spent 5½ years until I joined ITW in January 1988 as a senior attorney. At ITW I had tremendous encouragement from the then-CEO, John Nichols, and General Counsel, Art Wright, as well as their successors Jim Farrell and Stew Hudnut. Each of them had an enormous impact on my success at ITW.

ITW or Illinois Tool Works Inc., was founded in 1912 by Byron L. Smith, a financier, who placed an ad seeking ideas for a

manufacturing company. He selected 4 individuals who responded to his ad and then founded Illinois Tool Works. The Company made a variety of metal cutting tools to solve various engineering problems. Today, ITW is highly decentralized, a process that began early in the Company's history. As the story goes, Henry Ford approached ITW because he was having a problem with his cars -- the engines were falling out. You can understand how this would occur. The roads in those days were not exactly smooth, and, over time, the screws would shake free from the nuts and there goes the engine. ITW engineers developed the lock washer to alleviate Mr. Ford's problem. Now, instead of incorporating the lock washer, a new product, into its regular tool product line, ITW began a separate division, Shakeproof, which even today focuses on screws and fasteners for the automotive industry. ITW was incorporated in 1915, and shares of the Company began trading on the Midwest Stock Exchange in 1963.

In the early 1980s, John D. Nichols, then a consultant, was asked to assist ITW in finding a new CEO. Well, John looked

around and said, “I pick me.” At this time ITW had approximately 100 or so operating units. One of the major issues facing the Company and John when he came onboard was what to do with all the excess cash generated by ITW’s businesses. Well, I know that it sounds like a great problem to have, but it was a problem nevertheless. John’s solution was to use the cash to acquire more businesses. The Company did a number of small acquisitions, and then in 1986 made its first large acquisition when it acquired Signode, a strapping manufacturer. At the time of the acquisition, Signode and ITW each had approximately \$500 million in revenues, thus doubling ITW’s size. So when I joined the Company two years later, in January 1988, the Company’s revenues were approximately \$1.7 billion. Twenty years later, ITW’s revenues are \$16.2 billion with 825 business units employing some 60,000 people in 52 countries. At the end of 2007, we had in excess of 21,600 active patents and patent applications. In the last ten years, we have completed approximately 370 acquisitions with \$11.1 billion acquired

revenues. The average acquisition size was \$30 million. Approximately half of our revenue today is derived from our businesses outside of North America, and, with the exception of public company deals and deals in foreign jurisdictions, we do these transactions without the assistance of outside counsel. We have eleven attorneys worldwide, including me, eight in our corporate offices in Glenview, one in Troy, Ohio, and two in Paris, France.

I'm often asked how 11 lawyers can service an organization our size without a huge outside counsel budget, and my answer is simple. Our decentralized business model is helpful, but, more importantly, we apply 80/20 to everything we do. The basic concept of our 80/20 process is to focus on what is most important (the 20% of items that account for 80% of the value) and to spend less time and resources on what is less important (the 80% of items that account for 20% of the value). We use the 80/20 process to simplify and focus on the key aspects of our business. So applying that process to our legal department requires us to identify the 20%

of issues that may cause 80% of our legal problems and to apply 80% of our time and resources to that 20%. The other 80% we treat differently, e.g., we may outsource or we may provide online tools or other forms of training to the business units. The point is that we view those issues differently from our major issues.

All of that background brings us to the subject of tonight's discussion: Outside Counsel: Friend or Foe? Let me begin by saying that I don't know the answer, but the fact that the question can be raised demonstrates, at least to me, that there is a problem. The basic problem I am speaking about is legal fees. There are currently any number of articles in circulation regarding legal fees and hourly rates. For example, an April 6<sup>th</sup> Chicago Tribune magazine article cites a recent University of Chicago study that found that at the top 50 US law firms profits per partner have soared by a factor of four from \$310,000 in 1983 to \$1.26 million as of 2004. At the same time, the number of partners at those firms has more than doubled.

An article in the March 2008 edition of *Litigation News* entitled “Corporations Balk at Outside Counsels’ Automatic Rate Increases” discussed how companies like Wal-Mart and Shell are refusing to accept all across-the-board hourly rate increases. Another article in that same issue focused on how corporate law departments are using a variety of vendor management techniques to monitor billing. In a recent speech, Mark Chandler, Senior Vice President and General Counsel of Cisco, stated that “the most fundamental misalignment of interest is between clients who are driven to manage expenses, and law firms which are compensated by the hour.” Another article entitled “The Scourge of the Billable Hour” by Lisa Lerer, which appeared in the January 2008 edition of *Slate* magazine, laments the effect of hourly rates on the legal profession. She quotes Justice Stephen Breyer who wrote “The profession’s obsession with billable hours is like drinking water from a fire hose... “the result is that many lawyers are starting to drown.” When law firms began using hourly rates in the 1950s, associates were expected to bill 1,300 hours a year. Today,

associates are easily expected to bill 2,000 hours annually. While it's possible to bill 2,000 hours and still maintain a reasonable after-work life if you work with 100% efficiency, the reality is you have build in downtime for taking lunch, talking to colleagues, or just going to the bathroom, and once you do that, the associate must work a 12-hour day in order to produce 8 billable hours. And if they don't meet their billable hours, they may be tempted to pad their time! Scott Turow's article in the August 2007 ABA Journal entitled "The Billable Hour Must Die" goes even further, arguing that hourly billing is actually unethical. He states, and I quote, "I have been unable to figure out how our accepted concepts of conflict of interest can possibly accommodate a system in which the lawyer's economic interests and the clients are so diametrically opposed." End quote.

There is no doubt that a conflict exists between the law firm's desire to maximize its profits and the client's desire to do the same. However, this is not a problem unique to the lawyer-client relationship, and yet it is one that law firms are unable or willing to

resolve in the manner other businesses do. As a practical matter, I suggest that the customer-supplier relationship dates back as far as the world's oldest profession, with businesses trying to figure out the value of their product. Now what do I mean by value? I believe that "value" is a relative term that compares the benefit of the sale with the cost of the sale. In other words, value equals benefit divided by cost. I am suggesting that value is relative because there is a great deal of subjectivity in assigning value and/or benefit to any particular item -- whether it's a product or a service. I am reminded of an old joke, but because of my age -- at least that's my excuse -- I don't remember the entire joke. What I do remember goes like this: a lawyer was locked out of his home and desperately needed to get inside right away. As luck would have it, it was a Sunday and he could only find one locksmith open. When the locksmith told him it would cost \$500.00, he was not happy, but decided to pay. Well, the locksmith came out and opened the door in about 5 minutes. The lawyer was outraged that the locksmith would charge him \$500.00 for 5 minutes of work.

The locksmith responded that you pay me based upon what I know, not how long it takes. Now, at the time the lawyer agreed to pay the \$500.00, the lawyer felt that the benefit of getting into his house outweighed the cost and therefore the locksmith's services had value. In general, if the benefit doesn't change and the cost increases, then the value is reduced and vice-versa. So, to increase value, you have to either increase benefits or reduce costs or both. Let me give you another example of how this works in practice. Not long ago, merchandise was sold on the basis of what it cost to manufacture the goods and get them to the customer plus earn a profit. Today, we conduct focus group studies to learn how much a customer would be willing to pay for a certain product with certain features under certain circumstances. Then there is a focus on advertising, and the cost of advertising to generate the sales sought. There are many examples of how this works such as cars, watches, you name it. We have luxury brands, mid-price brands, and low-cost brands. Functionally, each of these products may perform the same; yet you'll pay a lot more for a Rolex or Bentley

that you will for a Timex or Chevy. Now, if we go back to our formula, you'll remember that value equals benefit divided by cost, and that if cost increases without a corresponding increase in benefit the value declines. Law firms, for some reason, believe that cost can continue to escalate without any corresponding change in benefit and that clients will continue to view law firm services as "value added." When our businesses look at imposing price increases on their customers or when our other service providers look at imposing price increases on us, those price increases have to be justified by an event beyond their control, such as a sudden and dramatic increase in raw material cost – an "economic force majeure," if you will. Let me explain. We cannot go to our customers and tell them that we are raising prices because we gave our employees or our CEO a raise. If we want to cover the cost of inflation, employee raises, and other internal cost increases, we have to become more efficient and take cost out of our business. We expect our businesses to increase their productivity by 4% a year without regard to external cost

increases. If a large customer like Wal-Mart or Home Depot demands a price reduction, we may have to take even more cost out of our business. We will work with that large customer to get them to help reduce cost by, for example, changing the number of deliveries, changing the location of those deliveries, or changing the range of products we offer. In other words, we look at our business to make sure we understand what our costs are, then we look at ways to reduce those costs, and many times the customer can help us by changing some of its practices. Law firms, on the other hand, simply, at least to my knowledge, employ no cost-reduction techniques. Oh, I know that they reduce head count -- usually associates -- and more often lately, partners. These reductions, however, are not an attempt to hold down the prices law firms charge their customers. Rather, it's an attempt to maintain their "per partner profit." If it sounds like I am being hard on law firms, I am. I believe that unless law firms begin to recognize that there is a problem, we will not be able to find a solution that allows both sides to continue what has been a long

and profitable relationship. Let me repeat: if our businesses went to a customer and tried to raise prices annually because of inflation or employee raises, I assure you, we would be out of business. Whether law firms abandon annual increases and the hourly rate system for an alternative billing system, to me, is not the real issue. Law firms must begin to listen to their customers who need their help in reducing legal expenses. Look at CEO salaries -- a problem that was not addressed by boards of directors for years -- then, outside constituents began imposing all kinds of new requirements on companies to try and reign in those salaries. Many of those requirements had the unintended consequence of raising CEOs' pay even higher. Finally, it looks like shareholders have gotten it right by targeting directors who fail to take action and instituting campaigns to vote against electing those directors. Now, company boards are paying a lot more attention to the issue. Law firms should take notice. If clients don't get the help they need to reduce their legal expenses, they will have to find a way of their own to reduce those expenses, whether it is bringing more

work inside, offshore outsourcing, fixed fee arrangements, or some other method. It will happen. Law firms can either become a part of the solution, *i.e.*, our friend, or they can continue to be viewed as the problem, our foe.