After the Golden Age: The New Legal Era

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About this Report

This is the seventh in a series of reports published by Jomati Consultants LLP examining key issues facing the legal market.

The next report, to be published in summer 2012, will focus on Africa and examine the opportunities and challenges Western law firms face in developing capability and serving clients there.

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Introduction

"Golden Age – (noun) – an untroubled and prosperous era."

The American Heritage Dictionary

Looking back on the period before the 2008 Crisis it is hard not to conclude that the legal market was experiencing a 'Golden Age'[1]. This era has now passed and may not return.

In this Age, partner profits rose year on year by often more than 10%, and sometimes even 15%. Even when there was a recession law firms seemed to bounce back rapidly. Since the mid-1980s revenues and profits climbed rapidly, the number of partners swelled, offices grew and there was a flourishing in demand for expert lawyers across the US, UK and all the major markets of the world. Lawyers had never been richer, more in demand, and more able to charge what they wanted and work how they wanted. And it looked like it could only get better.

But many law firms never asked why this now lost habitat was so benign? Why was it that clients rarely balked at their legal bills? Why was it that even when a General Counsel (GC) placed a firm on a panel very little changed in terms of the fees you could charge or how work was produced? Why did there seem to be no ceiling to fee increases or the expensive associate leverage you could use? Perhaps, and as with the same logic that triggered the Crisis of 2008, legal fees, like house prices, could only increase without consequences or turning point?

Now, of course, such views look naïve. Nothing goes up forever. No market is a simple two dimensional progression. Markets are complex and feedback, though it can be delayed, always re-enters the system at some point. It's a lesson both clients and law firms are learning, and it is not going away. Large banks and corporates are not about to stop seeking legal advice from the best law firms, but they will probably never again give firms carte blanche to either charge how they want, or produce work in any way they want, especially for non-critical matters.

As we explore in this report, the ramifications of this apparently simple, but market-changing shift in the supply and demand equation, from compliant client to active and questioning client, will alter the legal market forever. In this new world the client knows about unbundling process work from large deals to send to regional firms for lower costs; or using legal locum providers; or joining up IT and legal document systems to speed production; and most of all about applying a true procurement model to buying legal services. In this regard law as a sector is coming of age.

In this report we examine how we got here, what this will mean for law firms, what new forms of legal production may rival traditional systems, and how law firms can react positively to these challenges, such as embracing globalisation in order to keep growing profits and revenues. Ultimately, this report heralds a new era where the challenges will be many, but where the most adaptive and far-sighted law firms will find new, perhaps even better, ways to prosper. Those that adapt may then consider that moving out of the Golden Age was not a negative step, just the beginning of something new.

1 'Golden Age' was coined by the Ancient Greeks to represent a benign environment which was now lost. For us, the new era will not be so benign, but it is not necessarily a signal of decline, but rather new conditions.

Chapter One: The Beginning of a New Era

As Good As It Gets?

In the financial year 1986 average profits per equity partner (PEP) in the AmLaw 100 were $325,000. By 1995 they had reached around $470,000, a healthy if not especially huge climb of around 44%. But then things improved very quickly and the average remuneration of equity partners rose to $1.4m by the 2007 peak of the last economic boom.

While the difference between the mid-80s and mid-90s in average PEP[2] was just $140,000, the difference between PEP in the mid-90s and 2007 peak was a difference of $910,000, which is a remarkable rise in remuneration over such a short period.

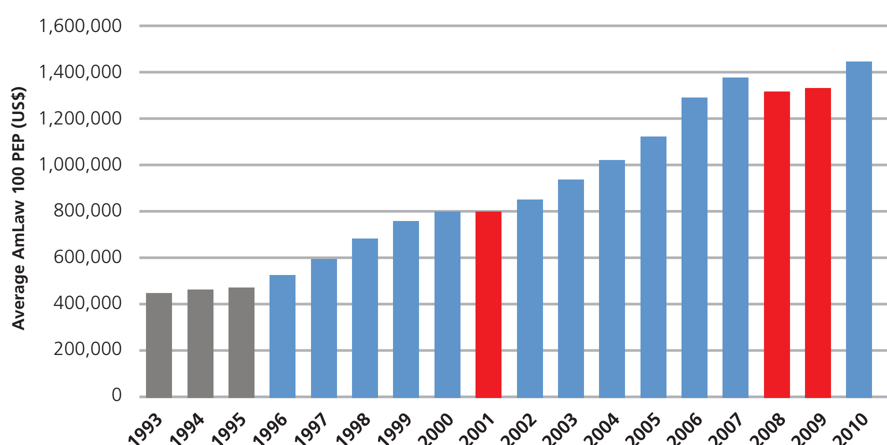


Table 1: Average PEP of the AmLaw 100 from 1993 to 2010. Grey shows the relatively low growth period of the mid-1990s and red shows the years where PEP was below a previous high point.

Whether one looks at this period over the last decade or further back to the 1980s, most people would regard such a profitable era as a Golden Age. To some, such a rise for doing the same service industry job, ostensibly in the same way, may even sound unlikely. But, it happened[3].

This increase in average partner remuneration was far higher than inflation[4] and was all the more notable because clients were buying a product that had remained largely the same[5] in substance and quality. A key factor was that demand for commercial legal services had greatly increased and this was the primary cause of greater profits at law firms. Even so, the legal product was largely made the same way, even if more of this legal product could be made more quickly, and far more cheaply, because of improvements in IT. The sunk costs of having bought the same item from a supplier for many years rarely re-materialised in cheaper, more efficient processes resulting in price cuts for the law firm client. This was in stark contrast to most other parts of the economy where companies have been under huge pressure not only to continually invent and offer new, innovative products, as well as keep improving the quality of their products, but to reduce the cost to the client too. Suppliers to the motor industry, major supermarkets and fashion retailers are expected by their customers to continuously innovate and reduce the cost of their products

[2] Many have pointed out that PEP does not give a complete picture of a law firm's financial health. That is true. But, it remains the metric the owners of law firms, i.e. the equity partners, most care about. See Chapter Two.

[3] A very similar picture exists among UK law firms. See Appendix A. Also, among the more elite US and UK firms PEP rose to around $3m.

[4] If PEP had tracked US inflation from 1995 to 2007 it would have risen to around $600,000.

[5] Legal advice naturally evolves with time, but between the 1990s and late 2000s how commercial lawyers in London and New York drafted a contract had not undergone a radical change, even if Governments and regulators had greatly increased the quantity of regulation lawyers and clients needed to consider.

notwithstanding increases in raw materials and energy prices. For these sectors such an approach has been the norm for at least the last 10 years. In this respect, the legal sector had been insulated from the pressures that applied to other sectors of the economy. In many respects the legal sector is now fully exposed to these pressures.

The corporate, funds and real estate boom of the 2000s fuelled by cheap money pushed up demand for legal services to its highest ever levels and made asking questions about adviser fees secondary to getting deals done. We have already written extensively on the future market conditions to 2020[6], but suffice it to say, the West will not soon see the same kind of financial leverage driven explosion of economic activity it saw from the mid-1990s to 2008.

In terms of client culture we will also see no rapid return to the past. Clients are talking about procurement issues now like never before. A contributing factor, aside from the growth in demand, to the inflation in legal costs was the previous lack of reflection on how legal services were procured and GC are addressing that. The market is therefore learning, even if this learning curve is not going to be pleasant for many firms.

Despite the apparent writing on the wall, some partners still optimistically side with Zhou Enlai's famous summing up[7] that: "It is too soon to say." They can point to the fact that financial data for law firms has improved somewhat – at least relative to 2008 (see table 2). But we should not delude ourselves that this growth was generated by clients permitting large fee increases or a major surge in work.

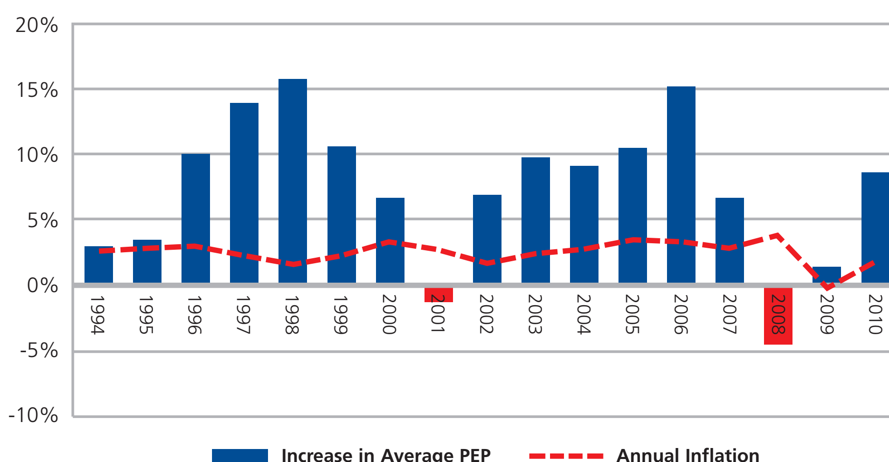


Table 2: Average PEP growth vs US inflation, AmLaw 100 law firms. Red is negative.

There was some healthy increase in work flow, but the 2010 recovery in PEP was also driven by cost-cutting and the removal of underperforming equity partners. It appears that culls of partners, at least in offices in the West[8], are becoming more widespread now[9]. PEP also rose noticeably because the previous two years had been so poor. Firms working their now fewer associates even harder than previously was another factor that increased productivity.

6 'New Frontiers: Law Firms in 2020' Parts One, Two and Three (2011), please see jomati.com 'Reports'.

7 Zhou Enlai, was the first Premier of the People's Republic of China, from 1949 until his death in 1976. His comment was heard during a discussion with President Richard Nixon and at the time believed to refer to the French Revolution of 1789. However, more recent historians believe he was referring instead to the Paris riots of 1968, of just a few years earlier. (Financial Times, 10 June 2011.)

8 It should be noted that many firms, even those that are seeking to trim equity partner ranks, are continuing to increase partner headcount in growth markets such as Asia.

9 For example, Legal Week reported 8 December 2011, that global firm Linklaters was intending to ask to leave or de-equitise up to 35 equity partners. This follows a similar exit program in 2009 where more than 35 partners were understood to have left the top tier firm. However, it is by no means alone in such exit programmes.

For those still not sure whether we really are entering a new era and feel we will soon roll back to where we were in 2007 here are a series of factors[10] which we believe suggest that there is no turning back:

- The client push-back and general awareness of inefficient work production is increasing in strength and this new culture is gaining ground among GC, rather than showing any sign of weakening.
- Although PEP has rebounded in 2010 this was partly the result of staff cuts, associate lay-offs, de-equitisation of partners, outsourcing of back office functions and a reduction in spending on major projects such as IT. These cuts cannot be repeated on the same scale again.
- Although clients are permitting rate rises, they come with caveats about how work is produced, which undermines some of the potential to benefit from them.
- More enforcement of fixed fees and the demand that law firms share more of the risk. Hourly billing continues to face criticism too, although the demise of the hourly rate is still many years away.
- Increasingly tough panels: generally smaller and even if not smaller then increasing pressure to show a commitment to a client's cost and production concerns.
- Increasingly higher demands for 'value added' services from law firms. In other words services rendered for free which the law firm must then cover, such as secondments of associates, inhouse training and product development.
- Careful deconstructing of external legal costs by GC and efforts to tether new fees to previous costs for similar matters by benchmarking. This process has also been greatly supported by the use of client focussed billing software.
- Associates and key non-lawyer staff are still expecting salary rises and bonuses[11] – and that despite fee pressure law firms must pay these bonuses to retain the best associates or risk a flight of talent to rival firms.
- Many fixed costs, from travel budgets to property prices in prime business locations are still rising, even if deal activity is not.
- Growth in low-balling on tenders, aggressively priced offers on fixed fees and all-in-one deals for a single annual fee in order to retain the client.
- Although cheaper and new forms of production are developing quickly, retaining that cost saving inside the law firm rather than returning it to the client is hard to accomplish.
- New forms of production, from Legal Process Outsourcing (LPO) to non-lawyer 'new entrants' such as online document producers undermine fees at the process end of the market among law firms. This in turn softens prices up to mid-level work too.
- The continually mounting cost of following key clients as they globalise.

Combined together these changes create a solid case for pronouncing the end of what was one of the most benign periods for law firms and the beginning of a far more challenging one. This does not mean decline for the major commercial law firms, far from it. Overall legal demand will grow on a global basis. The challenge for today's firms, so wedded to the practices and client expectations of the past, will be to turn the new market conditions into an advantage. That some will fail here is certain. That others will understand the new rules of 'the game' and use them to remould their business model is also certain. But, accepting the rules have changed is perhaps the most significant step of all.

[10] We will examine these issues in more detail in the following chapters.

[11] A recent study of law firm finances by Citigroup found that over the first three quarters of 2011 law firm expenses increased by 5%, driven by higher salaries and other operating expenses. AmLaw 17 Nov 2011.

Chapter Two: Impact of the New Era

Increasing Divergence among Law Firms

Faced with a distinctly new climate the most strategically agile firms will put significant distance between themselves and the strategically static firms. This gap over the next decade will be even more pronounced than it has already become (see table 3). As one can see there is a growing gap between the AmLaw 100 firms. If the market can widen so greatly during what has been the most benign period[12] for law firms in recent history, consider what a far tougher regime for the legal sector will mean. More firms will be left behind and strategic failures will lead to partner departures and law firm collapses. We may also see more rescue mergers designed to head off a future collapse.

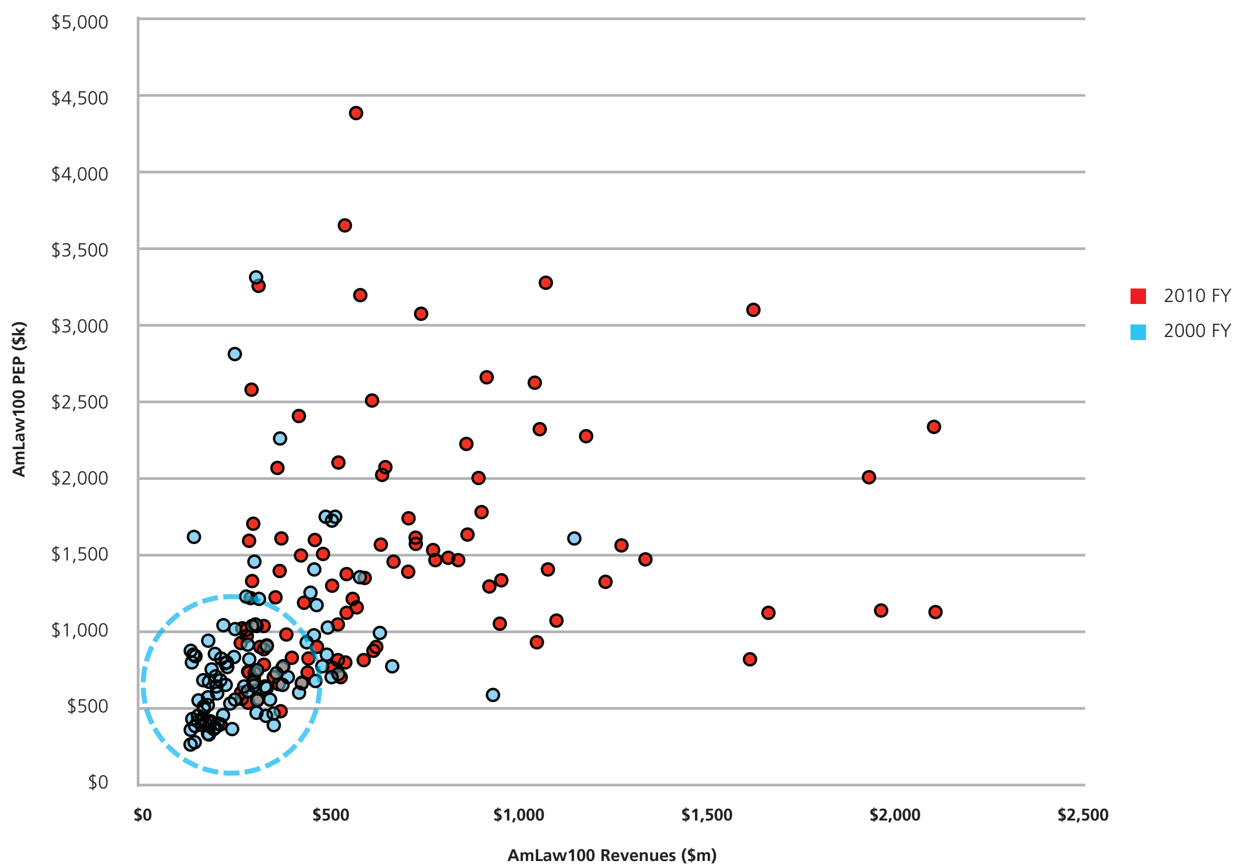


Table 3: Dispersion of AmLaw100 firms in 2000 (blue) and 2010 (red) financial years (FY) using Revenue versus PEP. The blue circle is where the majority of firms clustered in 2000.

As can be seen, in 2000 the vast majority of AmLaw 100 US law firms were clustered together in what appears to be a relatively tight knot – a form of law firm nebula. Ignoring outliers, their average PEP was between $250,000 and $1m, and their revenues were between $200m and $600m. By 2010 this relatively tight knot had pulled apart. If we ignore the extreme outliers, one can see PEP ranging from $500,000 to $3.25m and revenues between $250m and $1.7bn. If one includes the outliers, then the picture is even more dispersed.

What is worrying is that despite many of these law firms adopting strategic plans to grow revenues and profits during a booming market, a substantial number still seem anchored to the same segment of the AmLaw 100 they were in 10 years ago. Meanwhile, the total number of outliers, that is to say the firms that have clearly broken away from the pack, has greatly increased from around eight firms to around two dozen in 2010. It would not be an exaggeration to

[12] Up to 2008/9.

say the market is splitting apart. As noted, in a far tougher and more complex environment for lawyer/client relationships and the costs of production, those failing here face perhaps for the first time in decades a real risk of being completely left behind.

By 2020 some elite firms may see PEP rising far above the $5m level. Some of the largest global firms will see their revenues move to $4bn-$5bn, especially if we see mergers of the larger UK and US firms occur, perhaps with large Chinese firms too, in order to build 'super global' firms that can offer clients a worldwide choice between deals in the dominant international legal forums of English or New York law and cover China, and other major markets too.

Behind these are a wide variety of other firms heading out of the profit-dampening undifferentiated core of large US firms. While not global or elite, they are pursuing international strategies, or high end niche tactics such as focussing on litigation above all else. Such firms may fail to put a significant distance between the pack and themselves, or bridge the gap with the globals and elite, but at least they have direction and that may well take their partnership with them.

The remainder are a far less differentiated group, still stuck where they were[13], and will be increasingly prone to greater price competition as national clients see less good reasons to instruct one national firm over another, especially as clients slowly lose some of their traditional or hometown links to certain advisers. A recent American Lawyer, Law Firm Leader Survey[14], underlined this point after finding many firms were finding it extremely difficult to differentiate themselves from rivals. This pressure was encouraging many to develop new billing strategies, de-equitise partners and outsource process work to meet client demands. However, the problem is many firms in this group are attempting the same tactics at the same time, or not applying the tactics with sufficient rigor, and so they continue not to stand out because the changes are too small. Law firms in this segment[15] face a testing time. When all a client's regular law firms appear to be the same, the buyer is left with little to differentiate on except for price.

Price competition is always a huge challenge for a professional services provider. Instead, a service provider will always want to make the client consider the intangible aspects of their product (more about this below). The law firms that cannot change the subject from price, or answer that question quickly and convincingly and then move on to a more profitable debate, will be the ones that face the most competitive pressure and greatest difficulties in boosting PEP in the medium to long term.

This pressure will mount as GC increasingly learn to wield their huge buying power, something they have always had, but have often previously failed to use. As the European GC of Chartis, a subsidiary of AIG, Chris Newby, said[16] recently in an exemplary statement on how clients now see legal services: "I want to be able to say to firms, 'if we give you x millions in work you'll give us a discount'." What simpler or more direct example of clients using their buying power can there be?

AIG is not just a voice in the wilderness either when it comes to confronting the old taboo of the price of legal services. Vodafone's GC, Rosemary Martin, was recently[17] quoted as saying: "Beyond dealing with legal and corporate reputation issues, cost is the number one item on my agenda." Vodafone, a $74bn revenue global company, is clearly not impoverished nor the kind of client major law firms should ignore because the GC cares about price.

[13] The idea of 100 major US law firms of similar performance is a thing of the past. In another 10 years, after the effects of globalisation of law firms and the bifurcation in performance, differences will be even greater.

[14] 'The Law Firm Leaders Survey 2011', AmLaw 1 Dec, 2011.

[15] Despite at least a decade of investment in law firm branding, marketing and pepping up websites, a large group of AmLaw100 firms, and UK top 50 firms, remain remarkably undifferentiated to buyers of legal services. In a more consumer level environment most would simply blur into each other. Fortuitously, long standing client relationships with certain contact partners prevent a state of 'brandlessness' taking over. But, this may not last and offers scope for new and compelling brands to emerge more easily than they could in other sectors, such as accounting and investment banking.

[16] The Lawyer, 24 October 2011.

[17] Quoted in a report produced by UK law firm Nabarro LLP, 'General Counsel: Vague About Value?' 2011.

Failing here, whether by the inability to compensate for the loss of margin or the loss of clients for refusing to be open on costs may have the same result: static or falling PEP relative to your competitors.

Increased Pressure on Profitability

As increasing profits becomes more difficult some law firms will face additional pressures that could ultimately signal their demise. Falling PEP[18] relative to that of one's peers[19] can decide the fate of a law firm surprisingly quickly, especially in the US where partners can effectively move at will. Ten per cent of AmLaw 100 law firms have collapsed since 2000.

Number	Name of AmLaw 100 Firm	Date of Collapse
1	Graham & James	2000
2	Brobeck Phleger & Harrison	2003
3	Arter & Hadden	2003
4	Coudert Brothers	2005
5	Testa Hurwitz	2005
6	Jenkins & Gilchrist	2007
7	Thelen	2008
8	Thacher Proffitt	2008
9	Heller Ehrman	2008
10	Howrey	2011

Table 4: AmLaw 100[20] law firms that have collapsed since 2000[21].

In many cases these were large firms with long histories. Others avoided this 'dead pool' and didn't collapse, but had to carry out huge retrenchments and the closing or spinning off of offices to survive. Others, perhaps sensing the future outcome was a year or two away, merged before it became apparent there was a crisis and ensured the partners did not panic and seek to depart.

The catalyst for the crisis in most of the firms in the table was an apparently unresolvable PEP drop. The specific reasons why each firm's PEP dropped dangerously was different for each. But, briefly, these firms' managements pursued a strategy or made financial decisions that failed, which in turn triggered a drop in PEP, which led to an exodus that quickly unravelled the firm. As seen in table 5, the PEP spiral once it reaches a point of no return can rapidly tear a law firm apart. It was interesting to note a recent US survey[22] found 58% of managing partners expected only a 5% increase in profits this year. Meanwhile, a minority expected far more. This appears to suggest increasing pressure on the majority of firms, while a minority will move further away from the rest.

[18] While PEP may remain the key indicator for equity partners it needs to be recognised it is not always an accurate metric, at least when mentioned publicly. US law firms, such as LLPs, are not required to publish accounts. The gap between the lowest paid partner and the highest at many firms can also be extremely large, making a firm-wide average misleading.

[19] What some partners think of as peer firms can sometimes be very different from what the market thinks.

[20] Of course, every time a law firm collapses, or is taken over, its space in the AmLaw100 is taken by another. One effect of this is that AmLaw200 firms slowly creep up into the lower end of the 100 ranking as natural selection and consolidation removes more established names from the top 100 firms.

[21] Notable US firm Altheimer & Gray also collapsed in 2003, however, despite its international coverage it was not in the AmLaw100. At the time of its collapse it was ranked 145 by revenue.

[22] Law Firm Leaders Survey, 1 Dec 2011, American Lawyer.

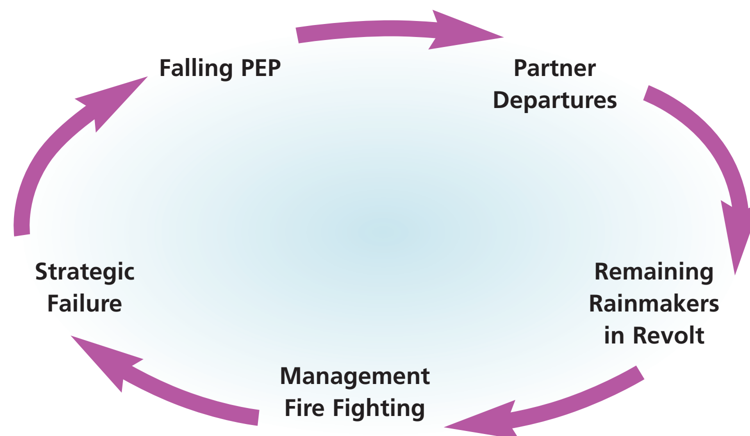


Table 5: The feedback loop caused by falling PEP.

Understandably, firm collapses gain more attention than any other kind of law firm decline. But, beyond these supernovae there are plenty of law firms in relative decline that don't receive market attention. These firms don't over-expand with bank debt and then explode when a key strategy fails: they just drift or go in strategic circles. Meanwhile their peers move ahead with a clear direction, increasing the gap between partners who once saw each other as peers, thereby increasing tension over PEP and a sense of dissatisfaction. That is to say, even while partners appear to be working as usual and clients still instruct you, the firm is still going backwards relative to its peers.

Perhaps the most striking aspect of the legal market is that so few law firms collapse given the lack of structural 'glue'. After all, a business owned entirely by individuals who sell their knowledge and can leave at any time should be an extremely fragile organisation. Yet, there remains a high level of commitment to their firm and perhaps inertia among lawyers, which is perhaps linked to the profession as a whole. This of course may change in the future. It is likely that the levels of competition between firms in this new era will be far greater and more akin to the destructive competition seen in most other sectors of the economy. That in turn will see more firms building market share via merger, takeover and mass team hires. The AmLaw 100 (and UK top 50) is still surprisingly unconsolidated (see Appendix C). Perhaps over the next 10 years we will see the level of consolidation other industries have seen? If so, most firms will want to be the stronger party in any future takeover trend that sweeps the legal market.

Chapter Three: Pricing

Pressure on Rate Rises

Significant annual hourly rate rises have been a standard feature of law firm profitability for over 20 years. But, we may not see a rapid acceleration in hourly rate rises for some time to come. Whether we are in a booming market or not in the future, such leaps may well not be tolerated by clients. That said, many law firms have still sought to increase their rates since 2010. Research by Altman Weil[23] found that nearly all law firms it surveyed increased their rates in 2011, although not by high levels. The median rate was around 4%, up from 3% in 2010. Given that inflation averaged 3.5% over 2011, and when overall increases in fixed costs are accounted for, such a rate rise merely prevents law firm billing rates from declining in real terms. In some cases a firm may seek a 4% rise, but a major client with considerable buying power may only accept a 3% rise. Such may be the new conditions firms have to work under.

Also, clients may seek discounts and write offs on some of the hourly work. They may also demand part of the process, or lower level, work be paid for as a single fixed fee. Interestingly, the Altman Weil survey also found 88% of law firms reported fixed fees proved to be less profitable than charging by billable hours. At the same time a recent client survey[24] found that nearly 70% of clients would prefer fixed fees if possible, and only around 15% sought chargeable hours. Clearly there is going to be a growing challenge for law firms to increase profits in the coming years.

The headwinds that will subdue the benefits of raising rates are going to be long-lasting. In a lower fee rise environment the following factors will become increasingly profit destructive, but also unavoidable:

- The battle for talent remains fierce and the top associates and graduates still command rising salary rates, and still expect bonuses.
- Fixed costs, although they have been targeted for reduction, remain high. Factors such as transport and energy costs, though perhaps once seen as negligible continue to rise swiftly, eating up margin in small but significant amounts.
- Fixed fees, as noted above, can remove the benefit of hourly rates rises especially if a client insists on a fixed fee for a piece of work done earlier, or the previous year, now becomes the 'standard price'.
- Inflation, though again once seen as negligible, will mean rate rises below a certain threshold deliver at best static fees in real terms.

The New Supply and Demand

When asked why rates rose so fast and so high, many lawyers respond that the answer is a simple one: supply and demand. As activity increased client demand increased for legal services and so prices rose too. This was indeed largely the reason and a service sector so intimately linked to corporate activity will always be both positively and negatively exposed to any changes in the economy.

There were also other factors that played a part in this growth in profits. These factors detailed below were part of what now appears as an extremely benign relationship between clients and law firms, which has distinctly changed since 2008. This matters because when economic activity picks up again in the West we cannot therefore assume we will see the same levels of profit growth over a sustained period as we saw in the 2000s. The factors included:

[23] Altman Weil, Law Firms in Transition, 2011.
[24] Legal Week, CSR Report, December 2011.

- **Early panels[25] were limited in effectiveness** – despite the purpose to gain greater 'value' for the client by enforcing a closer relationship, panels were not acting as a brake on bills. Instead they were primarily a quality filter that weeded out those with poor service, insufficient interest in the client's problems or gaps in geographical coverage or capability. Although useful, this was a simplistic approach, ignoring factors such as a key panel member's willingness to refer process work to a regional firm, to build their own process offices, or use LPOs, or agree to more collaborative fee structures, such as risk-sharing, fixed and success fees.
- **Lack of oversight on costs** – although procurement teams, even during the boom years, were poring over bills for everything from travel costs to IT, they were not spending significant time examining legal bills, in part because this was regarded as outside their scope. Also, the use of panels by GC acted as proof something was 'being done' about legal procurement, even though in reality little was done that influenced total expenditure.
- **GC's analysis of 'value' was non-specific** – without spending time to benchmark legal costs, GC's search for 'value' lacked objective metrics. Because of this the hunt for 'value' would remain semantics. This position also tended to unconsciously favour brand over price and allowed the psychological trap of the 'IBM factor' to lead decisions.
- **'You shouldn't buy on price'** – this belief has long circulated the legal market, just as the IBM cliché has. But, given the choice between two relatively equal service providers (of which there are many) and one offering a more collaborative, risk sharing and in short, a less expensive service, a buyer may be well advised to take the better priced offering. The anti-price argument preyed on the idea that high cost equates to high status and quality, therefore less expensive legal products were necessarily worse legal products. However, this argument entirely omitted the fact that a more efficiently run law firm can be equally as good quality, but less wasteful of a client's money.
- **Lawyers buying services from lawyers** – far from 'poachers turning gamekeepers' some GC who had moved inhouse from large commercial firms were not putting to use their knowledge of how work was produced to drive down costs. But this is changing rapidly. Indeed, a growing number of GC are today 'home grown' inside the inhouse sector and have no allegiance to any particular law firm. The old deference and long standing loyalties to certain firms created by institutional relationships have never been more under threat.
- **Spending other people's money[26]** – employees, even if very senior ones such as a GC, can rarely feel the same way about buying services for their company as a private individual would, especially when that purchase is to help insure their company's future.

Today, there is a new breed of GC. They do not so easily accept arguments such as the IBM factor. They are more methodical about how they procure legal services. Panels are not just about quality control, but price control and using buying power to enforce the kind of behaviour from firms that clients want to see, such as risk sharing on fixed fees.

While a number of partners do still retire from law firms, or make lateral moves, to become GC of companies they once served, this may reduce in time. A growing number of the new breed of GC instead have spent a large part of their careers inside companies, rather than private practice, and therefore have little invested in any particular law firm. Such GC see themselves as an integral part of the senior leadership team of their organisation. As such they understand the financial and operational pressures facing the business and wish to run a business-focussed legal function. Failure to

[25] Though, even now some large companies still do not operate a panel, when it is an essential step in developing a systematic approach to legal procurement.

[26] Public or private companies have a duty to their shareholders and investors. Yet, this duty can become difficult to define when it comes to legal costs. A GC spends their budget to protect their company. Despite this, companies are now asking: "What is an excessive legal spend? Can we protect ourselves legally as well as before and still spend less?" In this context GC are now under a double duty to shareholders, to protect the company and also to rein in legal spending. Excessive legal spending may now result in a GC losing their job, but we are not yet at the stage of shareholder law suits against companies for wasting millions of investors' money on excessive legal spending. Though, shareholder litigation evolves over time, and in the long term we may one day see such a case.

provide a proactive legal service to the business and to effectively manage the legal budget are now career limiting to inhouse lawyers and law firms that fail to appreciate this and maintian a lack of transparent pricing or producing bills significantly more than originally agreed and budgeted for will no doubt lose favour, and increasingly lose work.

Ultimately, law firms will have to catch up with the rest of the economy in terms of how they maintain buyer/seller relationships. The majority of businesses endeavour to create new products every year for their customers, they seek to improve the quality of these products each year too, and as much as they can they seek to reduce the price of those products. Moreover, their customers expect this and failure to deliver here is a competitive disadvantage. Some may argue that law is not akin to a manufacturing business and does not respond to what many would regard as the attributes of normal competitive behaviour elsewhere in the economy. As clients grow in sophistication they will expect, as many do already, that their lawyers respond to the same innovation and price dynamics most other businesses operate by, and have lived with for many years.

Process and Bespoke

One could assume that the above changes automatically signal lower profits in the future. But, not so. What law firms will see is a bifurcation in law firm fees for different kinds of work. Partners will have to plan their budgets on the basis that rates are heading in two directions at the same time: flat or lower for process work, and increasingly higher for the most complex and international work (see table 6). Complex deals that involve process work, as almost all do, will effectively be unbundled into variously priced segments. To some degree there has always been an awareness that some kinds of process work, such as discovery, can be done more cheaply. The use of paralegals is also not new. What will change, and is changing, is the scope of what is regarded as process work. Inevitably, as GC examine in more detail work performed for them by external law firms and the cost of its production, they will seek to negotiate down the price of work they deem to be commoditised or commoditisable.

They will also demand far greater use of fee-earner classes such as paralegals, contract attorneys and special process units of associates located outside of the main commercial centres. Law firms may at first not welcome such a step. However, if clients are cutting down the level of fees they will pay for process work, then unless a firm allows its profit margin to be reduced it will need greater leverage at the lower 'production levels'.

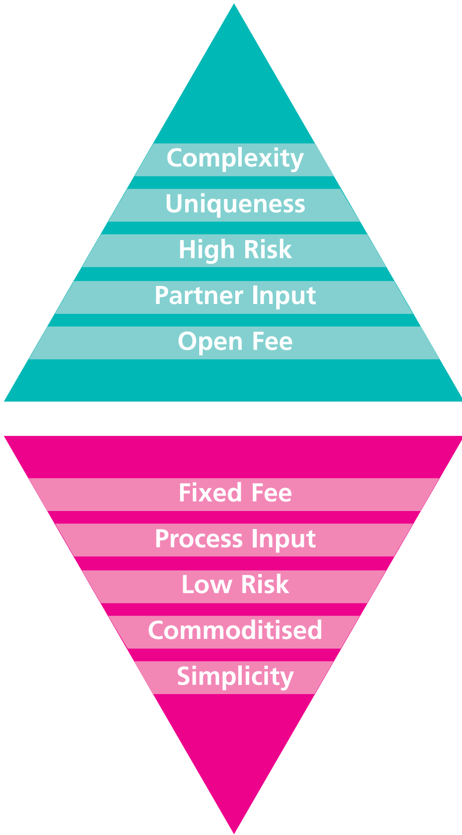


Table 6: The Bifurcation of Law Firm Fees, simultaneous upward and downward price forces.

This cuts right through the traditional model of law firm production, but is the reality now for a growing number of large clients. It would be unrealistic to believe this will not eventually become standard practice among all large clients over the coming decade, at least in the West.

Law firms will therefore have to be as good at producing process work at low costs and understanding how to use alternative means of production as they will need to continually improve their high-level, bespoke and deal management skills in order to gain the richer portion of client fees. Like luxury clothing companies that have their stitching done in China, apparent brand contradictions will become standard operating procedure.

Chapter Four: Alternative Means of Production

When Law Firms Ruled the Earth

No one is expecting the top commercial law firms to cease to be relevant because of new means of production. They will not be replaced by automated online software, or a call centre in India. The most valuable core of bespoke legal production will remain in the hands of equity partners and talented associates employed in the same offices where the partners work. But, likewise, few people are seriously expecting the previous, less differentiated, means of legal production to remain intact. The absolute monopoly of the 'traditional' law firm model is over, that is certain. Moreover, we are only at the beginning of this new era.

Liberalisation of ownership, practice and production are already here. In some countries[27], such as the UK, the world's second largest legal market, and in Australia, a smaller but increasingly important Asia-Pacific market, non-lawyers can already own law firms. In the US the first serious challenge to non-lawyer ownership bans is now taking shape (see more below). Also arriving is the dis-aggregation, or unbundling, of legal work into separate production lines and a host of innovations such as locum lawyer providers like Axiom and DIY commercial document suppliers such as LegalZoom.

None of these on their own are a knock-out blow to 'traditional' law firms, especially not the top end of commercial law firms. But, we still are in the infancy of the modern legal market. If one compared law to banking, then we are entering the 1980s[28] in terms of structural development and new client interfaces and platforms. Despite the huge growth in law firms over the last few decades in size, production has not changed in any substantive way. We are in effect an entire generation behind other financial service industries.

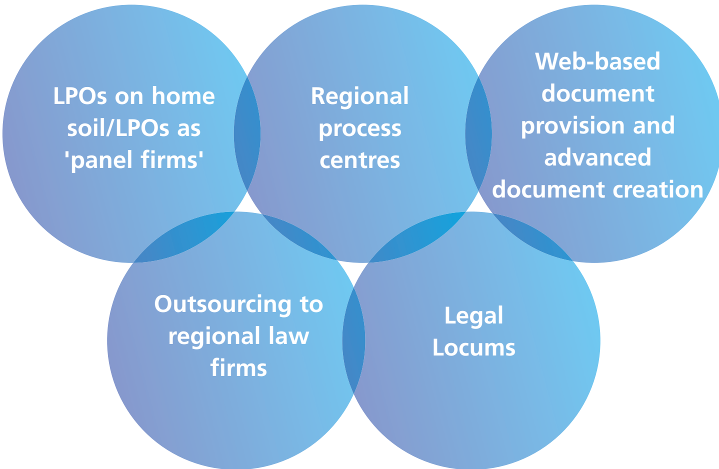


Table 7: The Multiple Alternative Means of Production – could they all merge together one day into a formidable network of different capabilities to manage process work?

[27] Italy has also taken the first steps to allowing external ownership of law firms following Government proposals made in November 2011. Spain already allows a degree of external ownership.

[28] One could compare the current situation among law firms to investment banks in the 1980s just as ownership and practice regulations were liberalised and new IT began to take hold. This did not spell the end of investment banks, but was the beginning of the end for many financial services businesses that failed to embrace the changes. This was especially seen in the UK. This liberalisation, far from destroying the financial sector, gave it an enormous boost even if some patricians of the banking world fell along the way.

Imagine a future hybrid legal entity that combined: Google's search engine capabilities; the case law data of Thomson Reuters; automated document production and form filling software; and the client-friendly platform of a RocketLawyer (see table 7). To that one could then add the potentially tens of millions of dollars in investment such an entity might receive. If such an entity can be created, and we do not see any reason why it should not in the coming years, then you have an incredibly powerful and compelling offering, not just to the man in the street who needs a will, but with the right engineering to large corporates too. To this 'networked' legal production system one could then introduce a BPO for support services and affiliated law firms for either mid-level or higher level work.

What one ends up with is the equivalent of today's universal banks, like Citigroup, or one of the Big Four accountancy firms, that span a huge segment of the market in terms of capability. However, these new legal entities are not MDPs[29], they are purely focussed on delivering legal services. They are formed as any complex entity would be, with different units focussed on different forms of production, overseen by a central nucleus of senior lawyers with project management capabilities.

Unimaginable? Not at all. On nearly every front the standard model of legal production, which has been with us for decades, is under pressure. Even the most elite firms in the world are not immune. For example, Slaughter and May, one of the world's leading law firms by any estimate and with average PEP of around $3m[30], is now asked[31] to offer clients the use of LPOs in order to help cut their bills on the process work elements of the large and highly complex deals the firm is famed for handling.

But, let us take a step back for a moment, and unbundle this potential future network into its constituent parts:

LPOs

LPOs are now doing far more than just low level data trawling. In the UK, Integreon is now providing paralegals to the global law firm Linklaters. Some of these are employed in a provincial 'Legal Services Centre' in Colchester, a small town within easy reach of London, but far enough away to have a fraction of the office costs. According to press announcements, the paralegals will be "working on document review, due diligence and other transactional support for major clients". We also understand that some clients are now going to an LPO first to ask for a quote on how much a piece of process work would cost before then approaching a law firm. By doing this they arm themselves with additional leverage in price negotiations with law firms. A recent survey[32] also found that 37% of law firms were now sending some work to lawyers 'managed by third parties', i.e. some form of outsourcer.

Yet, after a powerful start, LPOs have still struggled to achieve all that they could, in part this is because clients fear sending work to India when it can still be done in the UK and US. The main fear is over professional privilege, as well as the perceived even if not real risk of lower quality work being produced if done in a developing country. Possible professional liability exposure is also a concern for law firms. After avoiding these facts for some years, LPOs seem now to have accepted clients' concerns and are changing direction to build up capability in the West where confidence in such services is more easily gained. Early examples of Western growth include:

[29] We should not be so sure that MDPs are a non-starter either. If European Commission proposals made in October 2011 to demand the large accountants spin off their audit arms ever come to pass, then the remaining non-audit business would have good reason to merge with law firms. Note, it was the audit aspect of the Big Four that was the stumbling block to MDPs operating in the US after Enron, not the non-audit functions.

[30] The Lawyer UK 200, September 2011.

[31] The Lawyer, 4 October 2010, "CPA Global and Exigent in the frame as magic circle firm bows to client pressure on fees."

[32] The Law Firm Leader Survey, 1 Dec 2011, American Lawyer.

- Pangea3 (bought in 2010 by legal information giant Thomson Reuters[33]) – has opened an office just outside Dallas, Texas, with room for 400 people[34].
- Integreon – currently has around 500 employees in the US, and plans to have 600 by the end of 2011[35].
- UnitedLex – 240 employees in the US, but announced plans to open a 24,000 square feet, American HQ in Kansas with substantial room for growth[36].

One other factor that can work against LPOs is that clients spend a lot of time getting to know the law firms they send work to. These relationships are built on trust and in some cases professional friendships. Adding an LPO into the process can be an extra complication for some clients who would prefer just one legal service provider handled an entire matter. That said, this is not the case for all clients and LPO companies hope they can overcome this.

It should also be noted that LPOs are supporting law firms by reducing their cost base by taking over the non-legal process work in the US and UK. For example, in a deal worth around $750m (£480m) Integreon has taken over[37] the operation of a large part of CMS Cameron McKenna's back office functions, covering: finance, human resources, information technology and procurement.

Locum Providers – By taking an old idea, that of the contract or 'temp' lawyer who works inside law firms on an ad hoc basis, and selling it directly to the client rather than to the law firm a whole new model has been created. Legal businesses such as Axiom Legal, which now has 700 people[38] in the US, UK and Hong Kong, sidestep the intermediary of the external law firm and send their lawyers to the client directly. They handle everything from discovery to managing complex contract matters. As these businesses have few overheads the cost to the corporate is less than engaging an external law firm. There is significant room to grow here.

Outsourcing to Regional Law Firms – A number of law firms are now referring process work to the offices of regional law firms to handle instead. This is for obvious cost reasons. Some may feel there is a risk here that the regional firm eventually may 'steal' your client. Others may fear such a step sends out a dangerous message about your capabilities. For some clients there is also the additional challenge of having spent time choosing one law firm for a particular matter only to see it refer out part of that work to yet another firm. Also for the referring law firm there is the issue of overall responsibility and risk to reputation should something go wrong at the regional firm where work has been referred to. This is therefore not a risk-free solution to managing the pressure on process costs.

Process Units – These can be operated as an integral part of the firm, or in joint venture with another entity such as an LPO. Many lawyers today do not want to be partners. Operating from a process unit may be a positive step for some. Such associates may also remain in their role for an entire career if they wish, removing the wasteful 'promotion by tournament' system that best suits only those destined to become partner. Examples of this are the development of Herbert Smith's and Allen & Overy's centres in Northern Ireland, where office and labour costs are significantly less than in London. Meanwhile, UK firm Eversheds is understood[39] to have decided to put on hold plans to develop a process capability with Accenture and has instead begun to examine building its own process unit.

[33] The global legal information (and to some degree legal software) business is dominated by two companies: Thomson Reuters (WestLaw) and its rival Reed Elsevier (LexisNexis). Bloomberg is seeking to increase its presence in legal, but is a long way behind. As can be appreciated, the impact of such companies developing their own large scale LPO operations should not be underestimated.
[34] New York Times, 2 June 2011.
[35] Ibid.
[36] Ibid.
[37] Integreon Press Release.
[38] Axiom website, November 2011.
[39] Legal Week 8 Dec 2011, 'Eversheds mulls low-cost service after joint LPO bid falls through'.

Document Production Companies – While companies such as LegalZoom or RocketLawyer, which recently received investment from Google, are clearly operating at the High Street and small business end of the market, they will begin to have an impact on prices at the mid-level market segment if they can grow and gain credibility. Document production companies aimed at the High Street also encourage larger clients to ask questions such as: "If consumers can receive this kind of service at a cut-price, why can't we?"

External Ownership in America: One Step Forward, Two Steps Backward

Although external ownership has been a major debate in the UK for some years, we have generally not considered it in relation to the US. This was due to strong opposition voiced by some in the profession and a sense it would never happen in America. However, things are changing to some degree and it now seems appropriate to consider the likelihood of non-lawyer owners in the US.

The American Bar Association (ABA) has examined the issue and has recently[40] stated it does not support allowing US law firms to accept external investment. It has however, suggested that all US law firms be allowed to have non-lawyer partners if their role is primarily to support the delivery of legal services and so may become Legal Disciplinary Partnerships (LDPs). This is still dependent upon an ABA ethical rules change and then each State Bar individually permitting this. This would bring the rest of the US into line with Washington DC where non-lawyer partners are already allowed in limited numbers. In this regard the US has taken a bold step toward liberalisation of the profession and simultaneously reiterated its opposition to permitting external non-lawyer investors.

At the same time US firm Jacoby & Meyers, the firm which won the key Supreme Court case permitting lawyers to advertise, is now litigating in New York, New Jersey and Connecticut in order to change local Bar rules on external ownership. Experts estimate that the firm may need at least three years for a definite response from the courts, and possibly a lot longer. The end game would be the case going to the Supreme Court, where a ruling against external ownership could kill off the idea for many years to come. Despite the odds, some legal experts believe that the case ultimately may succeed, thereby permitting US law firms to structure and fund themselves as UK and Australian law firms already can.

The Jacoby & Meyers case[41] states, among others points, the following arguments:

- The ban on external investment is 'an antiquated ethical proscription impeding law firms' ability to compete in the global marketplace'.
- It restricts public access to affordable, quality representation.
- It prevents 'critical sources of funding' for law firms.
- That 'access to capital ensures access to civil justice' – and this is denied by current rules.
- The present system 'perpetuates economic inequity at every level of the practice' of law. The small firms cannot compete as they have no funding and the large firms may in the future not be able to compete against firms based in the UK.
- That, overall, there is no compelling legal argument as to why there should not be external capital available for the development of law firms.

[40] 5 Dec 2011, ABA 20/20 Commission, quoted in the American Lawyer Daily.
[41] As publicly registered in a 1 May 2011 complaint, filed in the US District Court, Southern District of New York, on behalf of Jacoby & Meyers by fellow US law firm Meiselman Denlea Packman Carton & Eberz.

The firm adds that this failure to provide a solid legal reason for stopping external investment on the part of the various US Bars and their Attorney Generals, creates: a violation of the separation of powers (i.e. that the Bar should not get involved in what should be executive and legislative decisions about economic issues); an excessive burden on interstate commerce (as small firms cannot grow or serve their clients when they expand); and a violation of the First Amendment of the United States for Free Speech and Freedom of Association.

We are clearly not at the end of the argument yet and the eventual outcome remains unclear with strong arguments and feelings on both sides of the issue. Either way, US law firms look set to be allowed to become LDPs and this is a distinct move away from the traditional model of most American partnerships.

Chapter Five: Cutting the Cost

Slow economic growth in Europe and the US combined with pricing pressures and challenges to the ability to use associate leverage to generate profits, all point to one outcome: the need for cost cutting. But, this is easier said than done, at least over the long term. How can you keep cutting costs without damaging your internal systems, client service and morale? To this we can add the law of unexpected outcomes, which has a tendency to produce new and far more complex problems than the one we have just solved by using a sometimes blunt budgetary axe.

Below are strategies law firms are using to meet the cost challenge and some of the consequences management may need to grapple with.

Support Costs

At a certain point, and there is no scientific answer to this, cutting staff damages total financial performance and adds unwanted risk to a busy legal practice.

A more radical solution has been to outsource the back office support function to a company that is an expert at running such services in an efficient way. There have been several examples of this already. As noted above, one notable example in the UK was by CMS Cameron McKenna, which agreed a $750m deal with the LPO, Integreon, to take over the roles of around 200 staff. Also as noted above, Herbert Smith and Allen & Overy have built their own process centres in Northern Ireland, resulting in significant cost savings for their support functions.

But, a possible result, critics argue, is that morale may suffer because of staff cuts in the main offices and the firm's reputation for being a convivial work place may suffer too, especially if staff pay and conditions change for the worse. The counter argument is that support staff can be frustrated by having lawyers as employers, as lawyers are primarily good at legal services, not managing large support functions. A better run operation led by a dedicated outsourcer may produce greater job satisfaction and clear career progression. It will also let lawyers focus on their day jobs.

Another large and growing cost has been IT. But now, cloud computing offers some cost savings[42]. A law firm's data and software can be held remotely rather than on site via an expensive server system that needs constant support.

Junior Fee Earners

As clients demand more process work is handled by LPOs or paralegals, or at specially discounted volume rates, then having so many relatively highly paid young lawyers becomes a challenge. If clients will not pay for junior associates, or in the case of the UK, what are called trainees[43], then law firms may permanently want less of them. Cutting here is obviously a huge upfront saving. But, this also means:

- Fee earners in the higher ranks might outnumber the bottom of the leverage pyramid.
- When the market improves and departures of junior lawyers increase again far smaller junior associate numbers may be difficult to cope with.
- By reducing the total intake you reduce the possibility of finding the right partner material to ensure the future of the firm. Not all rainmakers reveal themselves when junior lawyers, but take some years to mature.

[42] Legal Week, 3 Nov 2011. Field Fisher Waterhouse, a UK law firm of around 140 partners had "190 internal servers", and has turned to technology provider Virtustream to operate a cloud computing system instead. The firm estimates it will save $640,000 over five years. To put that in context that is only the combined salary of a single junior associate over four years at a top US law firm. Although, at least the associate is directly earning fee income, something the IT system is yet to do – but perhaps may one day.

[43] In England junior lawyers must complete two years at a law firm as a trainee, where they can be billed out to clients, usually for process work, before they qualify as a solicitor. After this they pursue the same associate track as an associate would in the US.

- The firm is forced to hire in associates laterally at a more senior level to fill gaps, which increases the numbers of associates not brought up with the firm's culture or training. But, this may be preferable to high up-front training costs.
- Training costs are pushed down to other law firms that do not cut intake, increasing their cost burden, and perhaps triggering them to cut too. If played out across the whole market, with each firm passing the cost to another, this could have a negative effect on the entire junior lawyer employment model.

One business in the UK now seeks to meet this challenge. Accutrainee[44] recruits trainees and seconds them to law firms so they can gain their requisite two years of training. The trainees spend time at a number of firms, widening their experience, but still qualify as if they had remained at one firm. The law firms that hire them for a number of months have a far more flexible and reactive flow of junior lawyers, but can reduce their annual intake to meet their demand. Because of the need to hire junior lawyers at least two years before they become trainees, which in this case is two years before they become associates and fully qualified practitioners, UK law firms face considerable pipeline inflexibility in terms of hiring junior leverage. This need to commit to a certain number of trainees far in advance of their becoming fully-fledged solicitors can see firms caught out by rapidly changing economic conditions.

During the recent financial crisis some UK law firms that had hired substantial numbers of trainees based on high growth expectations then found themselves in a situation where the number they could take on as trainees and as junior solicitors was suddenly diminished. In the US where first year associates come directly via post-graduate law school and the Bar exam, there is less pipeline pressure. Although UK firms may have commitments to fund law school students these do not begin to work inside the firm until two years after they are recruited and these serve two years as trainees before they are qualified lawyers.

Partner Exits and De-Equitisation

Those chosen for departure will most likely be the poorest performers relative to the rest of the partnership. Their exit will also give an automatic boost to PEP (after the payment of severance costs) because of a smaller denominator. Even if a new class of partners join that year they may be at a lower point in the remuneration system. Overall, PEP is likely to rise.

This strategy works, but, the majority of the partners have to decide what kind of culture they want. Though, to be a leading global firm today gives little choice. Equity partners at such firms have to give a huge commitment and perform strongly, otherwise rainmakers will leave. One might also say that in a market segment that serves the world's largest companies and handles their riskiest and most important legal matters, equity partners at this level need to perform at the highest levels too. The legal market is very large still and there is room for lawyers that want a less frenetic pace, just not remunerated at $2m to $3m a year. An alternative strategy has been to de-equitise partners so that they become salaried partners and can remain in the firm. This can work, but firms need to consider whether large numbers of downgraded partners, who have effectively lost their ownership stake in the firm, is a good idea or even a sustainable strategy.

What is certain is that regular equity partner culls are now with us to stay, not just for during recessions. They may not be every year, but we can expect firms to be looking to carry out systematic 'pruning' every two to three years in addition to any departures due to retirement. Law firms will increasingly need to develop or improve appraisal systems for partners so that aims are clearly set out and performance targets can be measured. Management will also need to pay closer attention to the overall goals of their equity partners. Simply responding that their goal is to remain in the partnership and serve the clients that come to them may not be a good enough answer anymore.

[44] Accutrainee.com.

Merger and Economies of Scale

Under the traditional Golden Age law firm model a merger purely to gain economies of scale was an unlikely strategy. The driver for merger had always been about bringing together a greater wealth of legal expertise, often in a wider range of locations, in order to help service clients and retain a greater share of their legal spend. This client-focussed approach remains the primary reason for merger. But, in these new conditions, economies of scale are becoming an increasingly important secondary driver. The following would be affected by economies of scale:

- Back office costs could be shared. A doubling of the total lawyers in a firm does not necessarily mean a doubling in the number of support staff.
- Fixed support costs such as IT are cheaper in larger firms relative to revenue generated.
- The more partners in a firm the smaller the cost per partner of supporting firm costs and of paying for future investments, such as foreign offices or process units.
- Buying power is increased in general and this helps reduce supplier charges.

In a market where revenues and profits may not be able to rise as rapidly as they have done in the past, reducing operating costs via merger synergies, which will also deliver an improved platform to serve clients, may make increasingly good sense.

As panels grow smaller there will be a greater need to offer clients a significant and wide-ranging capability, at home and abroad. Failure to do so may mean being left off key panels. Also, there will be a need to build major brands with size and scale in a market that is still filled with undifferentiated law firms increasingly indistinguishable to the new breed of GC. While neither of these is directly linked to reducing costs, both will have significant impact on the ability of a law firm to improve its financial position over the long term.

Chapter Six: Profiting from Globalisation

Globalisation: What Clients Want

One strategy to increase high margin work is to focus on cross-border matters. As discussed below, such work is often complex and high risk, reducing to some extent client resistance on fees. But, are sufficient levels of globalisation occurring for more than a few law firms to benefit from this? Some partners may agree with contrarian economists[45] who argue globalisation is overdone, or that nations today can still stand alone and don't need global trade. But, we do not think globalisation is hype. Domestic markets will always consume a significant proportion of any service provider's 'product' or investor's capital, but what is truly significant is the growing levels of both inbound and outbound investment between countries, which in turn necessitates advisers capable of handling cross-border work. Consider Foreign Direct Investment (FDI) tables 8 and 9.

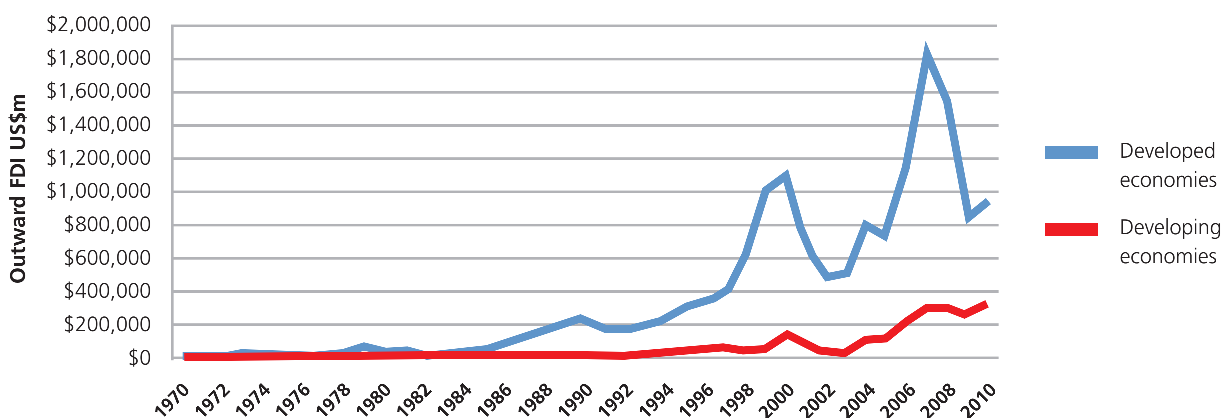


Table 8: Outflow of FDI from developed and developing world. UN data. Current US$.

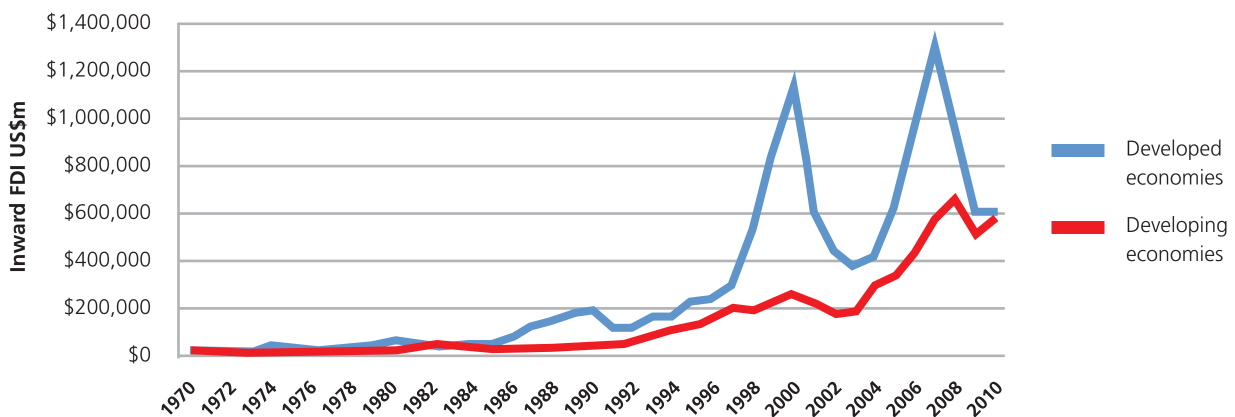


Table 9: Inflow of FDI into developed and developing world. UN data. Current US$.

[45] Pankaj Ghemewat of the IESE Business School in Spain states: "We live in an age of semi-globalisation at most." His argument is that the majority of goods, services and investment are absorbed domestically – therefore globalisation is not happening as we think it is. But, domestic consumption of domestic goods will naturally always be higher – what matters is that the total value of cross-border investment and trade is accelerating because the demand for resources, capital and services across borders is growing.

This United Nations data, collected since 1970, shows a vivid picture of what is happening to our world. As one can see, initially there was relatively little FDI in the 1970s, no wonder then that there were also few global professional advisers. Although one contributing factor here may have been exchange controls which remained in many countries until the 1980s, including the UK, and which would have diminished the free movement of capital and acted as a barrier to global investment.

The data tells us two other things. First, capital is being invested in ever growing quantities across national borders. And second, that developing economies are now investing an increasingly high level of capital abroad themselves, see table 8. Also these figures are generally accumulative, that is to say the increasing capital that is invested each year stays where it is: abroad. This further ties nations, investors and shareholders around the world into an ever tighter net of mutual interest and interconnecting legal issues. The 2008 drop in investment abroad during the financial crisis also underlines just how interlinked we are. This drop should not be seen too negatively. Developed nations in 2008 still received more foreign investment during the Crisis than they did back in the 1970s. In this regard there does not appear to be any going back.

The drivers for this cross-border investment are multiple. One driver is the global demand for natural resources[46], which due to the unequal dispersion of minerals and hydro-carbons around the Earth often necessitates cross border development. Another driver is the growth of global retail and service companies, for example American household name Heinz[47] saw over 20% of 2011 revenues coming from emerging markets and this is set to grow steadily. The global development of banks, private equity funds and hedge funds in order to tap growth markets add to the compelling picture of a world incessantly interlinking and trading and investing more and more closely. Globalisation should also not be seen as a so-called 'disruptive' development, even if its impact on manufacturing that cannot modernise is significant[48]. It simply adds a new and vibrant layer of economic activity upon and between nations' domestic trade and consumption.

Despite this, some still argue that globalisation is not necessarily something their law firm needs to consider. They add, investing in offices abroad is just a cost and in tighter economic times it is better to preserve and distribute as much profit as possible, not invest it. They point to the success of a handful of elite New York law firms with few lawyers abroad as proof that following clients across borders is not necessary[49]. If the likes of Wachtell Lipton Rosen & Katz, which does not have a single lawyer outside of the US, or New York for that matter, can produce PEP of $4.5m then surely building abroad is pointless, perhaps even counterproductive? But, the market for legal services is not so simple, nor so parochial.

In a legal market valued at $255bn, in a location such as Manhattan, arguably the global centre of commerce, then there is room for one or two small elite firms that have the ultimate trust and respect of the CEOs of America's largest banks and listed companies and handle only the most complex of what are already a mass of complex legal matters.

[46] As our recent Jomati reports 'New Frontiers: Law firms in 2020 Parts One to Three' amply show.

[47] Harvard Business Review, Oct 2011: 'The CEO of Heinz on Powering Growth in Emerging Markets'. By way of example, Heinz recently bought a ketchup and sauce company in Brazil, Coniexpress, for $494m. In 2010, it acquired 49% of Cairo Food Industries for $62m giving it access to the tens of millions of people across North Africa. It is likely that this relatively small purchase will be worth many times that by 2020.

[48] The key argument against globalisation is that wage arbitrage destroys manufacturing in rich countries. This is true, but only under certain conditions. If a national economy can develop new manufactured products that no one else can make, rather than seeking to artificially keep production costs of old, over-commoditised products high then one has a different situation. Though, investment and support for such growth is a huge challenge. One might add this is exactly the same kind of challenge law firms now face, although the battle is not between national economies.

[49] The Economist, suggests in a 15 Oct 2011 article that law firms that globalised have not increased profits as quickly as those US law firms that stayed predominantly at home. However, this is a very skewed analysis, as few of today's major firms would have increased profits significantly if they had not globalised. Under the same logic global airlines would be better off just doing local flights, when in reality if they did so they would go out of business and never make the total revenues, nor profits they seek.

This tiny minority of lawyers will find that any movement from their location is profit dilutive, even to move to another State, let alone another country. One might say they are faced by a benign problem: that it is impossible for them to offer anything more to their clients without hurting themselves. For the other 99% of law firms the argument is the opposite: how can they offer a better, more complete service which will secure more of their client's legal spend and allow them to cross-sell work between multiple practices?

Over the last 20 years for many lawyers in the US this initially meant building national law firms. Next it will mean building a new wave of international law firms[50]. Some US law firms have already done this. But, the leading UK firms faced this problem some time ago, given the far smaller size of the UK domestic market and acted upon it. Clients saw this problem even earlier, and law firms generally have chased to keep up with international expansion, and perhaps always will.

Globalisation is an Antidote to Commoditisation

As process work faces increasing price pressure, and as there will always be more domestic law firms that can provide the same level of service and expertise for domestic legal matters, law firms will need to either move up the value chart to protect their margins or significantly remodel their business. Those seeking to move up the value chain need to understand the GC's risk pyramid, (see below). The top of this risk pyramid is where the highest fees are generated and where firms can avoid the downward gravity of commoditisation and price competition.

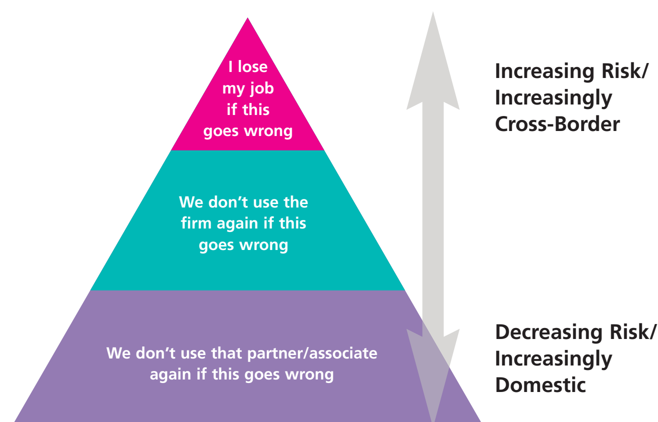


Table 10: The Risk Pyramid – as experienced by a GC when considering which law firm to use, with each stage based upon the outcome for failure or significant error.

For example, high level advice on US and EU anti-trust issues in relation to a multi-billion dollar cross-border foreign takeover is most likely to fall into the top of the risk pyramid for the client. Risk is ultimately what drives clients to seek the help of lawyers. If there was zero risk from a corporate action then there would be little or no legal input. Conversely, the higher the risk the higher the quality of legal advice is needed, both for success and to ensure that the GC is not seen to have failed in their job description. The next question then is: if you are not an elite White Shoe law firm or super niche how do gain access to the market of advising on the highest risk matters?

[50] This development has been examined in greater detail in an earlier Jomati report: 'The Next Wave: Globalisation After the Crisis', (2010). See Reports, Jomati.com.

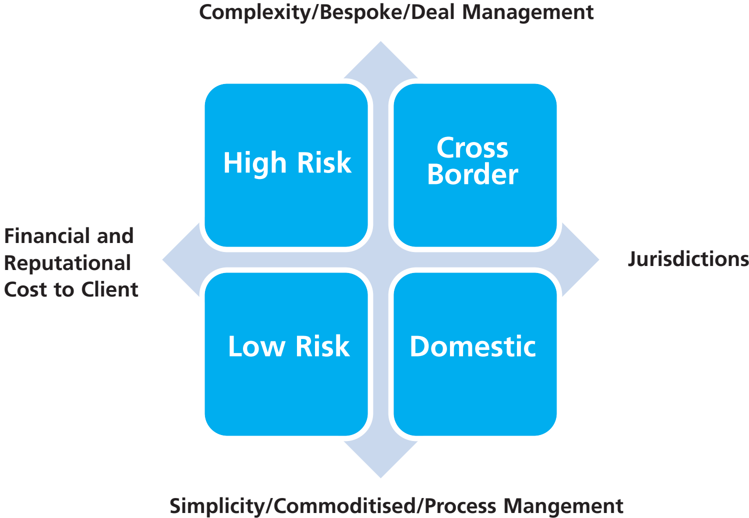


Table 11: Risk Matrix for considering the strategic offering of a law firm.

We would argue that when a client transacts across borders and needs joined up legal advice on multiple jurisdictions it is increasing the risk to itself and the chances that something may go wrong. In uncharted territory a GC will naturally not have a good knowledge of the legal framework or regulatory issues that they may face. Their need to trust in a firm's good judgment on foreign legal matters increases exponentially. In such cases, GC are far less likely to feel fee pressure, even if erosion of fees may still occur on the process aspects of the matter.

For law firms the challenge is then to build international capability that helps serve the needs of its clients' cross-border business. In this respect, having foreign offices is of little use in itself if they focus primarily on serving domestic needs in each country. The objective is to increase the number of matters each office plays an active part in every time a client seeks a law firm's help. If an office's revenues are domestically ring-fenced then you have not created a capability that will help to increase margins by helping on risky, cross-border matters, you have just constructed a local law firm at your own expense.

In conclusion, we would argue in favour of investment and expansion in order to embrace and, to be frank, to exploit, globalisation. But, a firm is not building a stamp collection. It is building an integrated network where each node increases the overall benefit of using your firm to the client.

Chapter Seven: A New Architecture for Law Firms

Evolutionary Acceleration

To appreciate just how much law firms may change in the future we need to grasp how radically they have evolved to the present day. Trace the legal profession's historical roots back far enough and one arrives at an individual, perhaps responsible for administering oaths or appearing in court[51]. This remained the pattern for literally hundreds of years. Very slowly these individuals joined together to share costs and by the late 1800s were forming small partnerships and the kind of 'firms' that we recognise today. Yet these were still tiny compared to the large and complex entities of the 2010s.

To give an idea of how fast the legal industry has changed in the last 100 years consider this: in 1900 there were around 100,000 lawyers in the US. In 1960, despite a surge over the preceding decades in population, huge economic and corporate activity, increases in personal wealth and growth in legislation, there were still only 275,000 lawyers in the US. Then, from 1960 to 2010 the number of US lawyers grew to over 1.1 million[52]. The top firms have also grown into relatively huge firms, and that growth has especially accelerated in the last 20 years.

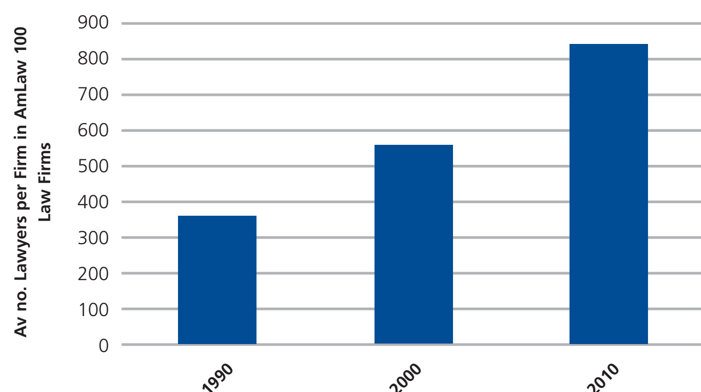


Table 12: Average number of lawyers per firm in AmLaw 100, 1990 to 2010 (financial years).[53]

Part of this growth has come from consolidation in order to build national law firms. Another driver has been international expansion, adding fee earners abroad to firms that could not realistically expand the domestic share of their clients' legal spend any further and needed to follow clients outside of the US. Despite this growth it is still worth considering that the top 100 law firms in the US total around 80,000 lawyers – not even 8% of the total number of lawyers in the US[54].

[51] Even that is not so simple in the UK, where in England & Wales, barristers, a separate profession with its own entirely separate code of conduct and regulator, traditionally handle advocacy before a judge.

[52] University of California, Santa Barbara data.

[53] Understandably, the total number of lawyers has grown too, see Appendix B.

[54] This is very different in the UK, where the top 100 UK law firms employ around 41,000 lawyers in the UK and around the world. In England & Wales there are around 120,000 solicitors. If we assume that the majority of those 41,000 are based in the UK, then we are still looking at the Top 100 UK firms having a far larger presence in the UK, than Top 100 US law firms do in America, at least by number. The top 100 UK firms also make up 60% of all revenues of the UK legal industry. In the US the Top 100 is far smaller at around 25% of total revenues generated by US law firms. (Data: The CityUK and Datamonitor). One last point worth noting is that 1% of all US lawyers produce 25% of the American legal sector's income – quite an incredible figure for a service industry depending on individuals to provide the product for the clients.

There are also at least 240,000 paralegals in the US[55] - nearly as many as there were licensed lawyers in 1960, even though they cannot 'give legal advice'. And there is now a whole new tier of lawyer, known as legal 'scriveners'[56] who are not even paralegals and work at document creation websites. They work for sites such as LegalZoom and are small in number today. But they will grow. Law suits will occur[57] against these legal 'scriveners', but they are not going away.

The overall message is that the Western legal market has grown hugely. The layering, or one might say proliferation, in the specialisation of legal labour that we are seeing also points to a market that is maturing and stripping out production costs as demand becomes more sophisticated, and cost pressures and competition increase. These forces are in turn reshaping how law firms will be built in the future.

One relatively new law firm in the UK, Plexus, which has grown from nothing to a $160m-plus revenue firm in ten years is already pioneering the way. Its graduate recruitment scheme naturally attracts those seeking to become dedicated lawyers, but it is also offering recruits the alternative option to become 'team co-ordinators' and 'technical analysts'[58]. The firm, which may be an early mover in becoming an ABS too, believes that 'law firms' need more than just lawyers who can give legal advice, they need people that are able to manage the processes and systems that large legal services businesses also require.

The New Law Firm Architecture

Although firm size and the sheer level of legal manpower in the market have changed massively over the last few decades, the greatest changes to how a law firm operates are happening now. We believe there will be distinct differences between the law firms of the past and the law firms of the era that is now taking shape. We will see a new architecture for law firms.

Attributes of the Law Firm of the Past

- Seeks to produce nearly all legal work itself, no matter what the cost to the client.
- Seeks to 'own' all leverage and hence grows rapidly by headcount.
- Opaque production model shrouded in subjective terms such as 'value'.
- Able to dictate terms of production to the client, and the client accepted this.
- Inefficiency in production is profit generative.
- Operates in a world without competition except from other law firms using fundamentally the same business model.
- Using IT, but primarily to improve internal systems and client relationships rather than reduce the costs of production.
- Only law firm partners can own it.
- Focussed on finding new work and doing it, rather than managing and growing existing client links or services.
- Non-collaborative either with client or other law firms/legal service providers the client may want to use.
- Surprise total bills sent at the end of the production process are standard.
- Hiring strategy focussed on finding the rainmakers of the future.

[55] ABA data in 2008 – therefore likely to have risen given need to use lower cost production.
[56] www.legalzoom.com/peace-of-mind-popup.html.
[57] For example, the case Janson v. LegalZoom.com, Inc., in the United States District Court in the State of Missouri, the Plaintiffs' alleged claims related to LegalZoom's offering of legal self-help products over the Internet. This case is understood to have settled 23 August 2011: ABA Journal.
[58] The Lawyer, 25 Nov 2011. 'Plexus gives graduates the chance for alternative career in law'.

Attributes of the New Law Firm

- Accepts it cannot produce all 'legal product' itself, or at least not using the traditional means of production.
- Does not seek to own all leverage and so does not grow so rapidly on a national level (although global expansion will still add increasing size and scale).
- Becomes in part a procurer, co-ordinator and manager of others' legal production, as well as continuing to produce high end work itself.
- Develops a strong focus on assembly and project management of legal work.
- Seeks to be transparent about its costs, thereby gaining the trust of the client and cementing a long term relationship.
- Collaborating with other law firms, perhaps less expensive ones with greater process capability, or at least better priced capability, to deliver what the client wants.
- Using IT, not just to communicate, but to speed the production[59] of documents using predictive software that is linked into a firm's Knowledge Management systems, as well as drawing on legal information from case law suppliers.
- Looking for where a piece of work has been repeated and seeking to reduce the costs in that 'production bottle neck' by improving systems.
- Even in good economic times, open to the economic pressures of clients.
- Boundaries between the firm and other suppliers, such as LPOs, blur.
- Costs can be observed in real time through extranet and estimated bills usually agreed up front by mutual use of benchmarking software.
- Hiring strategy focussed on finding project managers as well as future rainmakers.
- Strong focus for some on international work.

This is a different architecture for a law firm than the one that existed in the 1990s. Some might say this is industrialisation, but it is more subtle than that. The new architecture is about a more mature, complex and market-driven design. It is also forged in a more transparent culture where the client can see 'into the machine' and observe the parts working and thereby more accurately measure the cost and the efficiency of the service delivery.

One thing that won't change will be the demand for quality. Scores of client surveys have affirmed what all service providers have always known: that quality is paramount. But you score no points for this now; you can only lose if you don't deliver it. It will not be enough to say: "We are high quality." The GC may reply: "Of course you are. But that doesn't concern me as high quality is expected. What concerns me is how you work, who you use to produce that work, and what it will cost me. Moreover, how much say at the start, middle and end of the process will I have?"

In which case will your firm be open, pragmatic and risk-sharing? Will you treat the client as someone who has a right to demand you make things more cheaply yet at the same quality, or will you treat the client as someone who shouldn't ask such a question? Our new environment will therefore demand a new client relationship and in turn a new firm architecture and culture to go with it. These are the new rules of the game.

[59] For example, one global firm noted one frequent piece of work that once took up to eight hours of associate time had now been reduced to around 30 minutes due to a particular IT application.

Conclusion

What will life be like for major law firms after the benign world of the Golden Age? Is the new world described above all negative? Are we faced with a legal industry that is becoming ever more difficult and where the prize of succeeding is no longer worth the effort? Some lawyers may feel this way. They may feel indignant that their clients now pore over their bills and ask them to explain their 'production methods'. Firms may feel aggrieved that clients are going to continually pressure them on fees, or force them to collaborate with LPOs, or other law firms. They may not like the legal sector now having to operate under the same economic rules that most other industries have operated under for years: continual improvement of product and never ending competition on price, plus the need to reduce the costs of production each year while maintaining or improving quality. Other lawyers may not like the idea that their clients are increasingly investing abroad and that they need to invest part of their profits to fund foreign growth, or need to merge abroad.

To those lawyers that don't like the way this new era is shaping up we can only say, good luck, because the changes we have outlined will inevitably grow over this decade and become the 'new normal'. Talk of the need to adapt can be overdone sometimes. Evolution is not so black and white; there are many ways that different types of law firm models will be able to operate in this changing environment. Nevertheless, key changes such as client push-back on fees, increasing efforts to more systematically procure legal work and examine its means of production are inevitably going to mean change is required in how most law firms operate.

Old models won't crumble overnight, but they will be under strain and some aspects of firms will have to change. One might say the new architecture of law firms will not mean tearing down the whole building, but rather retrofitting it with new designs and extensions. If one were going to build a new law firm from scratch for this new era, one would probably not build it in the same way as the great firms are shaped today. But, management must work with the firm they have, not the one they might design with a blank sheet of paper. The challenge will be to move with the times, whilst taking the partnership along too, and keeping your cultural values while offering clients ways of producing legal work in ways few partners would have even considered a top law firm would offer just a few years ago.

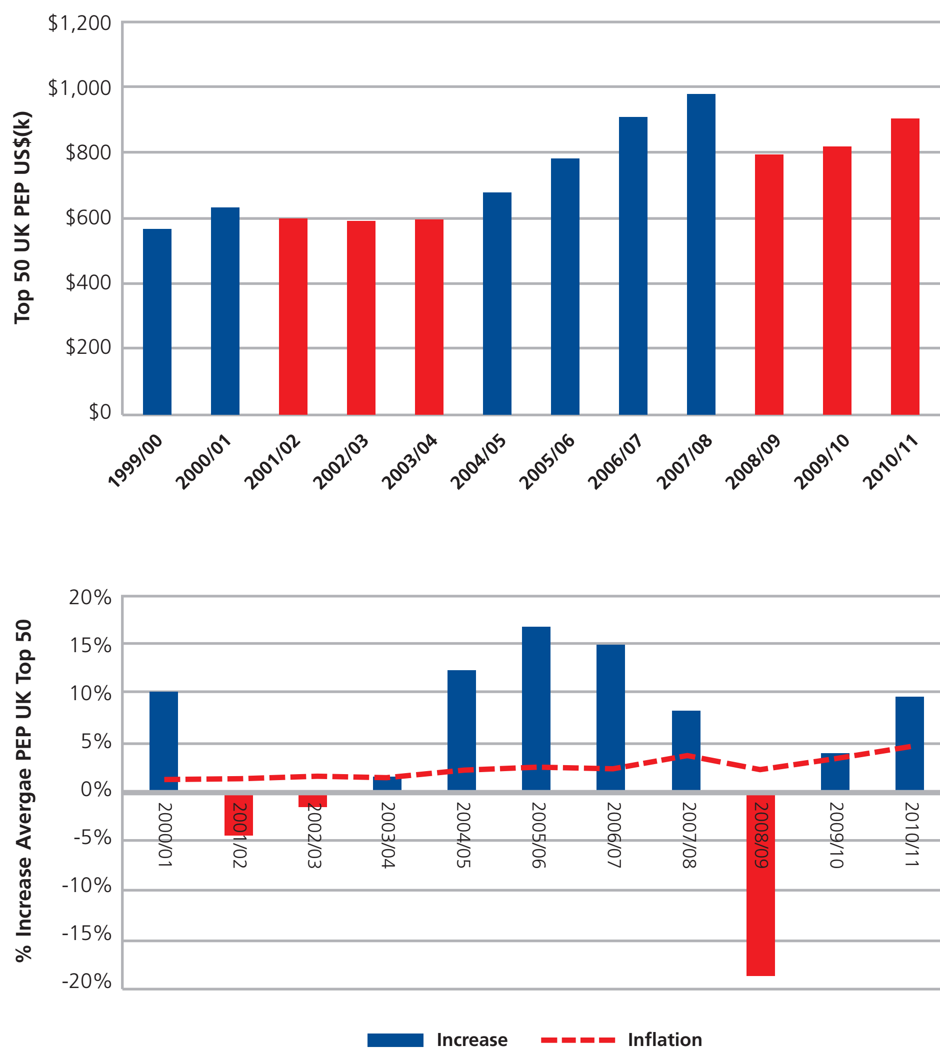
We don't believe the future is a negative one. But it will be challenging. Law is an industry that is only now coming of age, just as so many other financial and service sector industries came of age in the late 20th century. In law's case it has just taken a little longer than the banks and accountants to get here. But now that it is here, this movement will not fade away.

We can look back with nostalgia if we want to. But, the truth is that the legal sector has been in a state of perpetual flux for decades, and will remain so. The change now is just a lot greater and happening in a far shorter time span. Recognising that the legal market is changing is the first step toward changing yourself as a lawyer, and your law firm. Some may still not want this, but our view is that being in tune with reality is going to be a much better option than being left behind.

Ultimately, this new era remains a period of great opportunity. Law firms that grasp this may see profits not even imagined in the Golden Age. Firms will also become larger and more complex, with more ways of producing legal work than ever before. We hope that management will turn these new rules of the game to their advantage and make this new era the most exciting period ever to be in charge of a law firm.

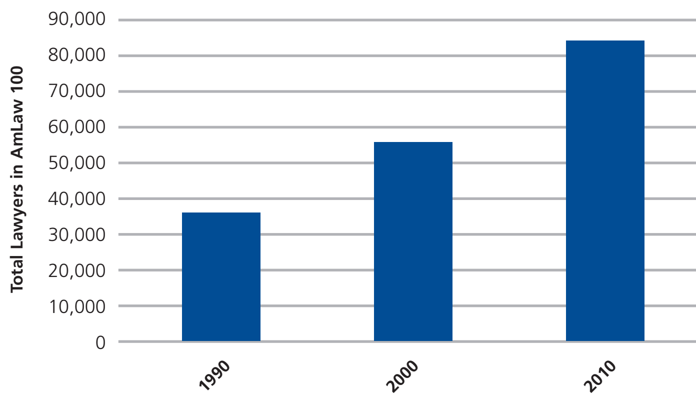
Appendices:

Appendix A: UK PEP Changes



Source: The Lawyer and Legal Business.

Appendix B: Growth of US law firms

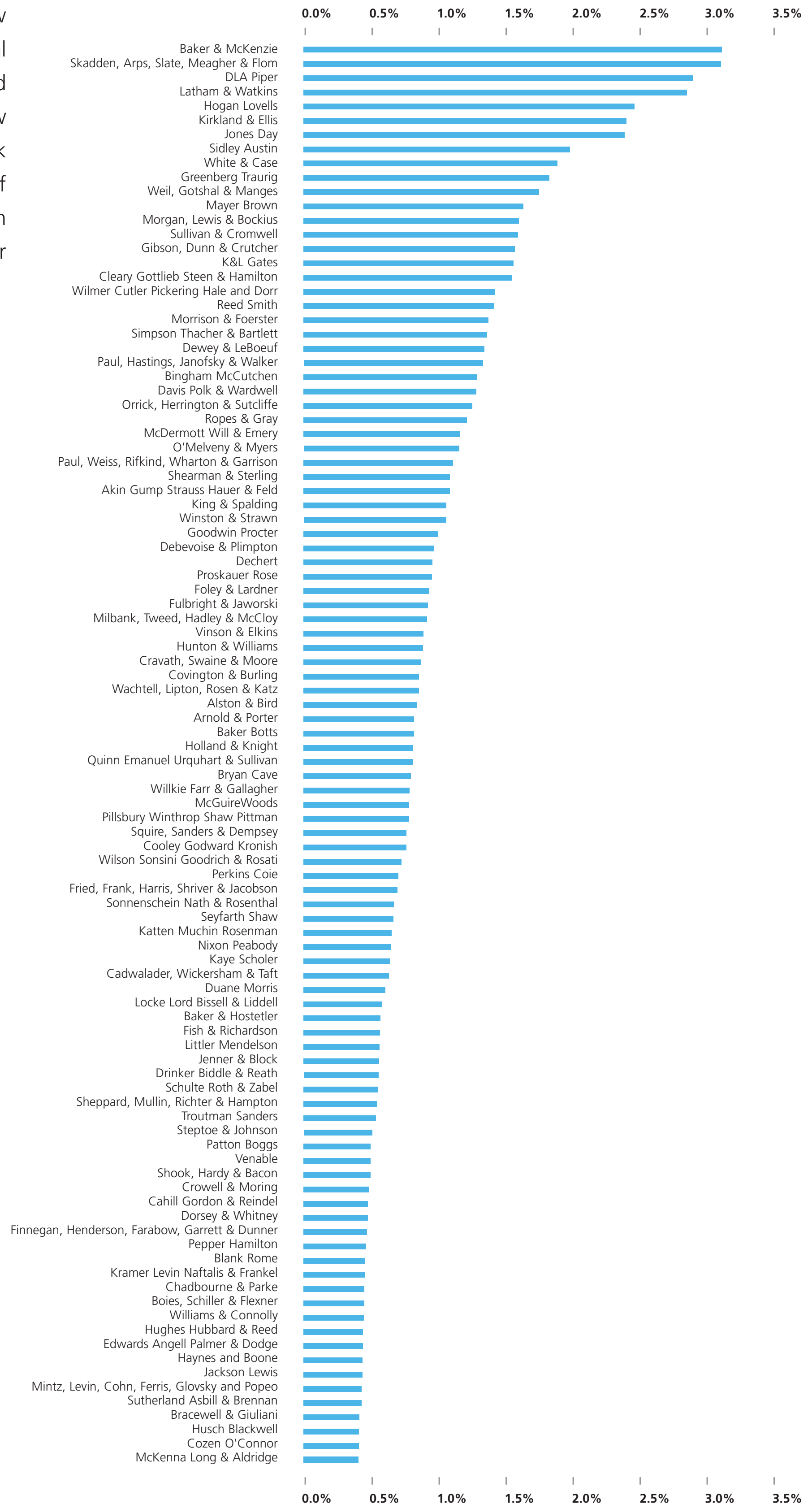


AmLaw 100 lawyer numbers have more than doubled over the last 20 years, although this does include lawyers working in US law firms who are permanently based abroad. Total lawyers in the AmLaw100 in 2010 were around 83,000. This may seem a large number, but given that the US population is over 300 million, this is a relatively small number of people advising the majority of the nation's largest banks and corporations. Perhaps what is even more surprising is that in 1990 the top 100 US firms totalled just 36,000 lawyers.

Source: AmLaw 100.

Appendix C: Market Share Among AmLaw 100 Law Firms

Market share by revenue of AmLaw 100 firms, defined as share of global spend on the 100 largest US-based law firms. The data includes law firms' international network revenues, not just US revenues[60]. If you excluded non-US revenues, then consolidation would be even smaller than it is already.



[60] For example, Baker & McKenzie derives around one third of its revenues from the North, Central and South American region, the rest comes from outside the Americas, while in comparison Skadden Arps derives over 80% of its revenues from the US (sources: American Lawyer).

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