Evolution or Revolution? The New Lawyer-Client Relationship

A REPORT BY JOMATI CONSULTANTS LLP, JUNE 2010

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About this Report

'Evolution or Revolution – The New Lawyer-Client Relationship' is the second in a series of reports on key issues facing the legal sector, published by Jomati Consultants LLP. Future reports will focus on the challenges faced by barristers in England & Wales, as well as what will be the new practice areas of the future.

The first report was 'The Next Wave: Globalisation after the Crisis', published in March, 2010. If you would like a copy of this or any other report please visit our website, www.jomati.com.

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Introduction

"Evolution – (noun) a gradual process in which something changes into a different and usually more complex, or better, form."
The American Heritage Dictionary

It has been clear for a number of years that something has been changing in the relationship between law firms and their clients. Certain patterns of law firm behaviour that are beneficial to law firms, but not the client, are being questioned. The financial crisis, which saw a drop in legal activity and companies seriously targeting legal spending, pushed these issues up the agenda. Even general counsel (GC) who were not aggrieved at law firm billing practices and fees now felt under pressure from their companies to do something. Law firms found they had to listen to GC's complaints and react accordingly if they wanted their work.

This report asks the question: how far-reaching are the changes taking place and what will be their impact? We spoke to many leading GC and the managers of major law firms and the variety of views was impressive. Some of the more evangelical inhouse experts talked of 'a paradigm shift' or a 'revolution', stating that the billable hour was 'dead' and that 'things will never be the same again'. Yet, some other GC seemed disconnected from the debate and almost blasé to its impact.

Some firm leaders see this 'push back' as a brief anomaly caused by market forces, where the 'boot is on the other foot' for a little while, but soon the balance of power will swing back in favour of law firms and the 'transactional' ways of *de facto* price-rises and time-billing will dominate. Other partners seem to think the world has indeed changed and are embracing improved IT, insourcing and outsourcing, fixed fees and annual service agreements as 'the new normal'. For example, one CEO at a leading US firm says: "Partners in denial on this put at risk their firm by thinking this is a fad. We embrace this unstoppable trend and we will use it to drive the business."

So where are we? Is this revolution? Or is this a fad? After weighing the evidence we would say neither. It is an evolution in the relationship between lawyers and clients. The currents that are now sweeping through the legal sector have built up over a long period, at least over 20 years. Equally, many of the elements to this evolution, such as fixed fees and commoditisation, have been around for a very long time too, it is just their importance and proliferation has built to the point where law firms will need to change the way they do business.

The same prefiguring would go for improved use of IT. Ever since a firm digitalised a legal document the possibilities of the near future were set in motion. Ever since a client considered using a panel, the movement toward co-operative partnering and service agreements was set in motion. And ever since law firms started using paralegals to handle process-level legal tasks the first step was taken to the commoditisation of legal work and development of new means of production.

We would say then, this is not about a war between buyers and sellers, nor a passing trend, nor a knee-jerk reaction to the crisis. It is about logical, ineluctable innovation best characterised as evolution. And this is change that you want to be part of.

Chapter One: Getting Noticed

1: Law Firm Profits and Legal Costs

Legal costs are being noticed by businesses today like never before. What had once been a relatively small sum in absolute terms, even if it is only around 0.3% to 0.4%[1] of company revenue, has now grown into something quite sizeable and needs controlling. For example, Microsoft spends around $900m on its overall legal needs, Novartis spends between $300m and $500m, and Motorola around $150m on external legal needs[2]. That is not small change, even for a Fortune 500 company. As one GC explains: "In 2000 no-one paid attention to what legal cost, what the GC cost. It was below the radar and the numbers were low. Law firm costs were low too. There has been an expansion of cost. Internal and external cost is huge now and it's become very noticeable. It's meaty and a manager must pay attention to the numbers." The reasons why legal spend is now 'noticeable' whereas before it was less so are multiple:

- Banks and companies have grown in size and complexity, especially due to international expansion and the globalisation of capital flows.
- Legislation and regulatory hurdles, both at home and internationally, rarely diminish and usually continually increase.
- Companies' use of legal services has widened far beyond only handling litigation or the most complex transactional needs into all facets of a business's behaviour, as well as expanding to manage legal risk, compliance measures, and executive liability issues, as well as non-legal areas such as preventing brand damage.
- The cost of 'purchasing legal services' has increased rapidly, especially since the late 1990s. (Table 1). Internal legal spend has also increased[3].

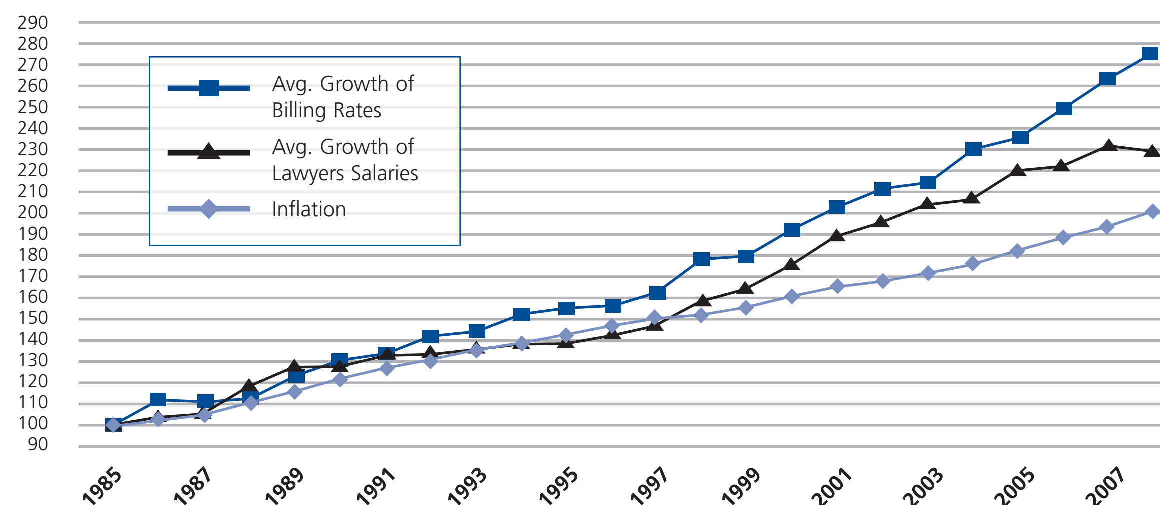

Table 1: Indexed growth US billing vs US lawyer salaries[4] vs US inflation

A company can do little to reduce the impact of the first three drivers. A company cannot do less just in order to face less legal risks or costs. They cannot sensibly go forward as a business with the 'blinkers on' and not spend money on lawyers as they traverse the increasingly complex legislative and regulatory global landscape. To do so now, in a world where legal 'backing' for any decision is second nature, would be seen by shareholders as negligent, if not downright reckless.

[1] See Appendix A.
[2] All spend data from The Lawyer or Legal Week, see Appendix A.
[3] See Table 4, Chapter Three.
[4] Altman Weil, Survey on Law Firm Economics.

What can be reduced then? The main negotiable element is the actual price paid for legal work, of which the majority is almost always externally sourced. And it may sound surprising to those not in the legal industry, but major law firms have not usually had to discuss the price of their services, nor have GC asked, if they felt 'their company could afford it'. Companies have clearly been, at least historically, very poor buyers of legal services even if they used 'good' firms. This has contributed to today's scenario.

The pricing philosophy of law firms can sometimes appear to be: increase until you reach the pain threshold. That pain threshold may have now been reached whether price hikes were cost driven or otherwise. A scan of the numbers for US law firms shows that between 1997 and 2007, i.e. before the financial crisis, partners put up their rates on average by 4.9% each year and associates had their rates put up for them, by 5.4% each year[5].

This perennial, almost de facto, fee hike on billable hourly rates, when added to the overarching growth in legal needs, as well as improved management in law firms and the use of leverage, has led to a remarkable growth in law firm profits, especially among the most advanced firms in the US and UK (see Tables 2 and 3).

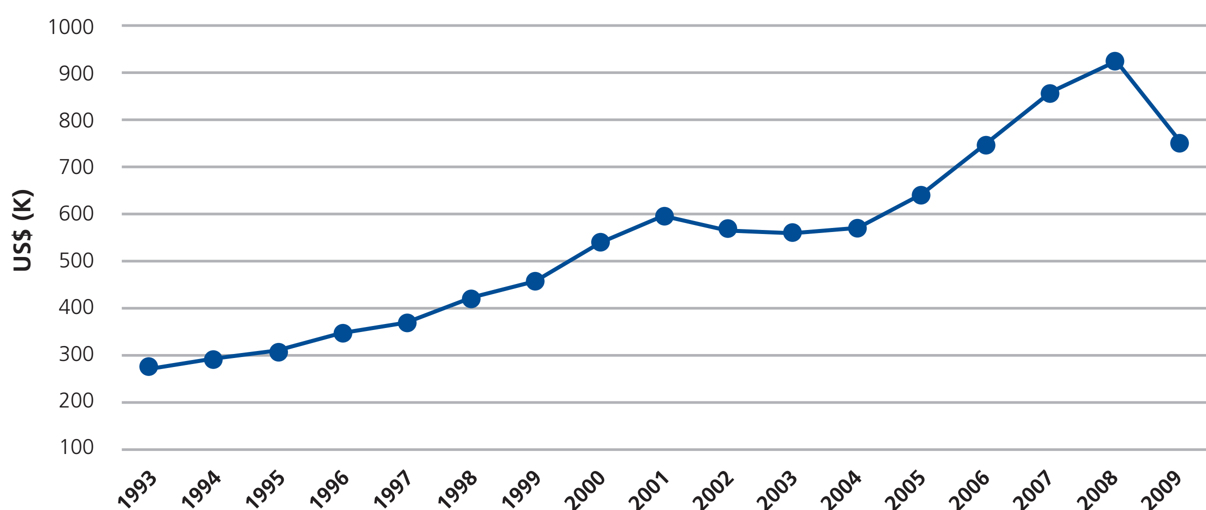

Table 2: Average PEP among top 50 UK law firms from 1993 to 2009[6]

At the peak in 2008 the average profits per equity partner (PEP) for a partner in a top 50 UK law firm was approximately $930,000 (£609,000), or treble what it was in 1995. US law firms also trebled PEP over the same period, although the end result is far more impressive with figures going beyond $1.7m on average in 2008, reflecting the huge size of the American legal market – the largest in the world at around $255bn.

[5] Altman Weil Survey of Law Firm Economics.

[6] Data from Legal Business "UK Top 100".

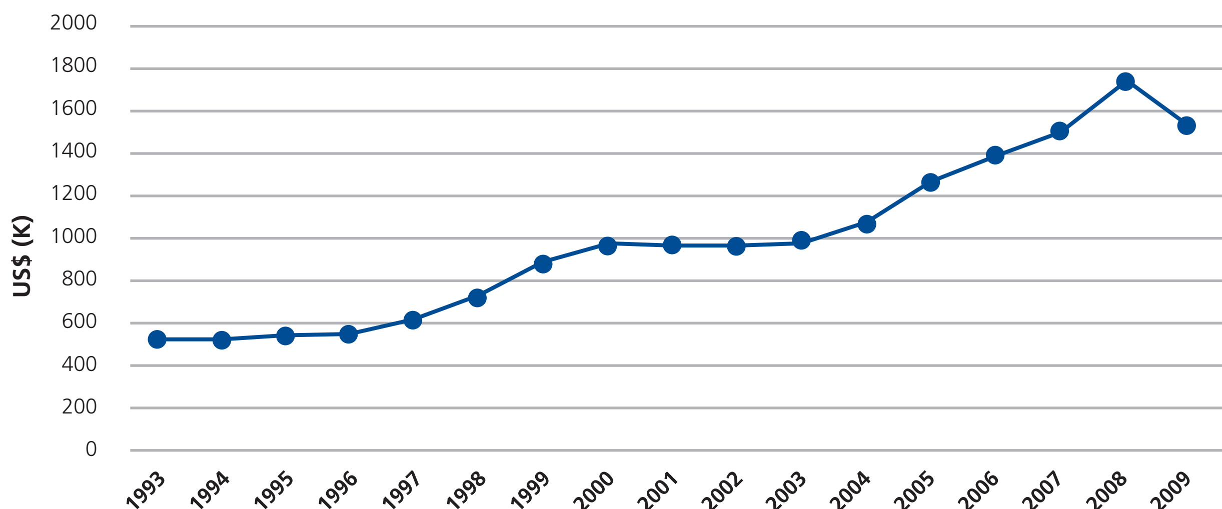

Table 3: Average PEP among top 50 US law firms from 1993 to 2009[7]

In the UK, equity partners in the top 50 UK law firms saw a Compound Annual Growth Rate (CAGR) in profits per equity partner (PEP) of 8.4% between 1993 and 2008[8]. If one extends the data to include 2009 and the impact of the credit crunch, then the CAGR still remains very healthy at 6.4%. The owner-managers of US law firms also did very well with CAGR for PEP of 8.3% from 1993 to 2008[9].

Let us also consider this particular transformation of pricing: in 2003 the lower end price tag for an hour of a Magic Circle partner's time was $570 (£375), just five years later in 2008 it was $912 (£600) – a 60% rise[10]. There may well have been good reasons for this, such as increased salary costs, however this does not reduce the impact on clients.

This income level was a product of the market and the techniques used to boost profits. It may not be so easy again to return to these levels of PEP growth. We could even see a dropping back of PEP for some firms to the days before the 2004-2007 bubble. Partners may also not have such an easy ride in the future as pressure to keep profits high builds an increasingly exigent performance-based culture designed to weed out equity partners that don't pull their weight. Such tough measures have already been introduced in many firms for associates where lock-step, seniority-driven pay is replaced by performance-based pay. Lawyers will still make considerable income, but those looking for an 'easy ride' will become far fewer in the future.

For the clients, the next big question is this: if the cost of buying legal services has gone up by so much have we seen a comparable increase in the value of that service? In most cases the answer is simply, no, even if some of these price rises were unavoidable. Clients really want to feel they are getting value for money. Moreover, they are now using their buying power to ensure their demands are heard.

As mentioned, the financial crisis of 2008 and 2009 brought this issue to the fore as GC had Finance Directors going over their numbers like never before. Not only were they looking at the external spend, but the inhouse legal spend too. Combined, the figures were substantial. "Surely we can reduce this spending?" was the refrain from other parts of the business. Other departments, from accounts to building maintenance had to work on a budget and when contractors were used had to show procurement protocols were used, so why not legal? After all, legal advice is not something beyond human comprehension, nor so esoteric that it is immune from the normal processes used by business to buy services.

[7] Data from American Lawyer 'Am Law 100'.
[8] Data from Legal Business 'UK Top 100'.
[9] Data from American Lawyer 'Am Law 100'.
[10] Jim Diamond, Hourly Rates Survey, UK.

In 2008 and 2009 it appeared that something had changed. Partly in response to the backlash, but also due to the steep reduction in demand, law firms froze salaries and cut hourly rates. They talked up their openness to 'alternative billing' and a certain amount of market-soothing, self-flagellation took place.

Has this been enough to end client worries? Is the matter closed now? No, not at all. First, firms are already starting to raise salaries again – signalling an almost inevitable rise in rates too. Secondly, the cost in itself is not the only issue, but rather a symptom of a wider problem: the 'transactional' relationship between lawyers and clients.

2: It's Not Just About the Money

Clients are not only worried about rates, they are concerned about the entire relationship between external lawyers and themselves. The huge profits generated by law firms and the constant price rises up until the crisis, one could argue, are just natural economic responses to a growing market. That may be true, but they have served to accentuate a sense that things have gone astray, at least from the point of view of some GC.

What GC are worried about is:

- That many law firms do not want feedback from clients, even though closer, tighter relationships with better analysis of what the law firm did may help improve processes and service, resulting in a better relationship.
- That law firms tend to avoid sharing the risk of carrying out legal work with their clients, i.e. they are happy to do the work because they will get paid for it regardless of whether this work greatly benefits the client or what implications these costs will have for the client.
- That law firms tend to be inefficient[11] in how they work, offering clients first and foremost, billing systems that encourage an open-ended 'taxi meter' style work culture.
- That law firms tend to believe they should be allowed to be unpredictable, both in what resources they will give to a certain job, in how much time they will take to complete a job, and how much it will – or should – cost.
- That some law firms tend to see relationships with clients as 'transactional' rather than co-operative or value-driven, where the objective is to market, win work, deliver work in a way that suits the law firm, bill and then move on to the next job as soon as possible.

Clients also worry that law firms don't quite understand what overspending on legal fees means to them. It is not the money in itself that annoys them, but the sense that the lawyers sometimes don't really care. To be fair, this has not been a great issue in the past. But, now it is. Consider this example, a GC in a 4% margin food manufacturing business overspends $400,000 on 'Big Law' legal bills. This overspend requires the company to sell an extra $10m of product to produce the net margin necessary to pay the lawyers.

If its products sell for $1 each that would translate to 10 million more units needing to be sold to cover the cost overrun – with all the costs and planning complications that would involve. That is to say, this is not just about the cost to the client in simple monetary terms, but the wider business impact large, unpredictable and open-ended costs have.

Few GC today would want to have to explain such a predicament at a board meeting in a company that has laid off hundreds and outsourced swathes of jobs to reduce costs. In such a scenario the GC looks a little 'unhelpful' at best. Blaming the law firm may also not carry much weight in the board room. After all, the Finance Director is likely to turn to you and ask: "What? You mean you didn't even have a budget? What kind of a manager are you?"

[11] In a highly leveraged practice, using billable hours with no cap could be very profitable for a law firm. It may also greatly annoy the client. But, it is up to the client to act.

Chapter Two: First Steps

1: The Convergence Trend

The current 'push-back' of clients toward law firms has been a long time building. Its roots go back to an early, innovative period of reorganisation of legal spend and purchasing in the early 1990s with the development of the panel.

The panel system, inspired by DuPont in 1992, which itself went from using 340 law firms to around 30, led to a period of convergence that saw many law firms losing out on advisory roles, especially during the 2000s. Since then there has been a downward trend in the number of law firms used by businesses, and generally an increase in the size and scope of major law firms. Many companies now seek to have main panels of no more than four or five firms, with one or two extra specialists kept on for particular areas or countries. Some have reduced this main panel figure even further (see below). For the firms this provides a form of 'licence to trade', or 'pre-qualification'. However, in many cases the firms must still pitch for work once on a panel and there often remains strong competition between the panel members both for work and on price.

Today the number of major British or American companies or banks that use dozens of law firms at least for UK or US legal work has diminished significantly. Rationalising the number down based on performance and capability criteria now seems second nature to many GC. The convergence trend can therefore be seen as an ancestor, or forerunner, of the current movement to improve value and efficiency within the inhouse sector. The panel system also contains within it a number of issues that clients and law firms are still grappling with and are worth considering:

Pros	Cons
Should enable client to better leverage its 'buying power'	Requires strict policing and regular performance monitoring to avoid complacency
Reduces the quantity of inhouse bureaucracy as uses less firms	A panel that would not 'kick off' law firms could become toothless and counter-productive
Speeds the selection process and allocation of work 'Proves' a procurement process is taking place	Can simply become a sop to the procurement department with little real impact on legal spend or budgetary predictability
Should build stronger, mutually beneficial, bonds between panel firms and the client	In its rawest form promotes antagonism between the panel firms, not co-operation that benefits the client
Should help move away from transactional mind-set of firms to one more of co-operation	

As can be seen the fundamental issue is a balance between creating a system that truly reflects a company's buying power, with that of building a positive, more co-operative relationship. The potential failure of the system comes when either, or both, the GC and the law firms involved, pay the panel lip-service but previous norms of behaviour never really change. To some extent the current debate is about taking these thoughts further, and filling in the gaps left over from what a panel is capable of.

However, before moving onto the main developments of the current debate, we should point out that not all companies are up to date with panels – even now. It may surprise some US lawyers that panels are still relatively rare in parts of Continental Europe, and even some major UK businesses are only just catching up with the idea. For example, Centrica which owns among other businesses 'British Gas', the former State-owned natural gas supplier, and worth around $33bn, is now setting up its first major panel[12]. This variance is indicative of the state of the inhouse legal sector, where in some quarters the debate is raging, and in others there seems to be a polite, but slightly baffled, curiosity over the sound and fury generated in the legal media.

2: The Next Step: Service Agreements

Taking convergence a step further has often been discussed by inhouse lawyers and brings us closer to the current debate. Finding a single firm, or at most a handful of firms, to sign up to a long term service agreement has been seen as one way forward. Some firms have already explored this strategy, others are looking at it more seriously now. The benefits of such a system are:

- Block contracting in this way not only enables lower costs, it helps to improve processes and systems by allowing more feedback between firm and client.
- Immediate sharing of risk by the law firm in terms of fees.
- Enabling a far more predictable system for estimating and fixing costs.
- Far greater commitment to the client than would often be the case.
- The opportunity to learn about the legal and business needs of the client are greatly expanded, in turn helping the client and the firm.
- The opportunity for the client and external firm to become 'symbiotic', i.e. working together for a common good, as well as common financial benefits.
- Building trust that will grow over time.
- Building a platform which can lead to the 'service' firm handling more and more complex 'one-off' matters for the client too.

Critics of such systems say they simply force the service firm to make a major commitment of resources, and risk potential loss of income, without guarantees of gaining 'interesting' work in the future. Equally, for a client, if this service arrangement goes badly, then extricating oneself from such a wide-ranging 'contract' could be painful, especially as other advisers may have been put out in the cold to make the service agreement work. But, there are no risk free solutions to legal purchasing.

One example of a group of firms with a service agreement is that of Pfizer's Legal Alliance[13], which has made advisers bid to join the ranks of a group of 20 law firms that are expected to work together to help the company. They agree to a capped annual flat fee for all legal work they will do for the company. The company can still go outside the alliance if it wants to. Also, if work goes beyond the fees cap, then there is flexibility here too.

[12] The Lawyer, 12 April, 2010, 'Centrica Invites Bids for Places on First Panel'.

[13] The American Lawyer, 21 December 2009, 'No More Baby Steps'.

Although the flat fee is significant, and will help the company save money, what is more important to its longer term impact on the market is the removal of a 'hit and run' mentality for the advisers. The flat fee and calling the group an 'alliance' rather than a panel of competitors points towards a new sense of risk sharing and co-operation. The focus moves to doing a good job, not trying to push fees up and making sure the right firm does the right job, rather than panel firms fighting over it. The firms also benefit from smoother cash flow as the fee is paid out across the year.

There have been other examples and variations on this theme. One UK-based firm, Eversheds, and one company, Tyco, made great strides with a variant to this approach back as early as 2006, although the fee structure involved a mix of flat fees, discounted rates, per project fees and risk sharing elements[14].

The initial deal saw Tyco use Eversheds for a wide range of legal work around the world under a 'basic contract' and reserved the ability to use other firms when needed for certain specialised matters. The firm reported this led to a 27% reduction in legal spend at Tyco[15]. Not only that, the agreement led to a 60% drop in the number of disputes in its litigation portfolio due to better co-ordination of legal matters. Unsurprisingly, after working together so closely, Tyco found it was giving more and more work to Eversheds that was outside the 'basic contract'. Despite plenty of scepticism in the market at the time, Eversheds seems to have made this relationship work. The firm has developed similar agreements with a number of other clients.

At the start of 2010 DLA Piper became 'preferred provider of legal services' to Kraft Foods, the world's second-largest food company, following a competitive bid process. Effective 1 January 2010, DLA Piper will handle the day-to-day legal needs of Kraft Foods' international business units on a non–exclusive basis. A statement at the time[16] from Kraft Foods said: "Our primary objective in this process was to drive down costs for international day-to-day legal services without compromising on quality or service. By building on our existing relationship with DLA Piper, we can consolidate the number of law firms we use, and thus obtain better value for Kraft Foods."

But Tyco and Kraft are not alone. In 2009 Orrick[17] formed an agreement with Levi Strauss to handle all its legal work worldwide for a fixed annual fee. Some IP work will remain with one other specialist firm, but unless Orrick doesn't have an office where the job is, it is expected to win the work. The agreement was designed to offer the client cost certainty, alignment of interests and lower costs as well. Again, what matters is the change in mind-set to the firm being on the same side as the client, and not just a seller of services. One could say the medium of the relationship is the message. That is to say, pitches tend to be transactional in style, while alliances and service agreements tend to be co-operative, mutually beneficial and long-term.

[14] The Lawyer, 15 January 2007.

[15] Eversheds.com, 'How we work with you - case studies'.

[16] DLA Piper, Press Release, 23 November 2009.

[17] The Recorder, 24 November 2009.

Chapter Three: The Rise of the GC

1: The Next Generation of General Counsel

An integral part of the changing relationship between clients and law firms is the role of the GC or Chief Legal Officer (CLO). What a couple of decades ago may have been a job primarily about ensuring the company didn't get sued, or if there was a major deal to choose the right kind of legal expert, has now become a far wider role. From compliance and risk assessment issues, to helping with non-legal business or brand protection issues at the top table with the C-level executives, the GC role has grown. They are also far more concerned about cost management. A recent survey in the UK also found that 90% of GC were "under pressure from their Finance Directors to provide better value, efficiency and cost reductions"[18] for both inhouse and externally sourced legal work, while 73% of GC were trying to be more efficient at resourcing legal work[19].

Gone too, for the most part, are the days of older partners from long term relationship law firms moving across to quietly work out the remainder of their working life as the GC of their client. Many GC have spent their lives in the inhouse world, while those partners that do 'change sides' rarely see the move as a 'winding down' period before retirement.

From what we have seen, the new generation of GC are energetic, questioning, wide open to debate and looking to make their mark on the legal sector. Many are also less than pleased with the way things were done in the past. Their approach is similar to ambitious executives in any key sector of the economy and many relish the growing responsibility that is being thrust upon them. The growth in responsibility also has in turn seen a comparable rise in the salaries and compensation inhouse lawyers can now earn (see table 4).

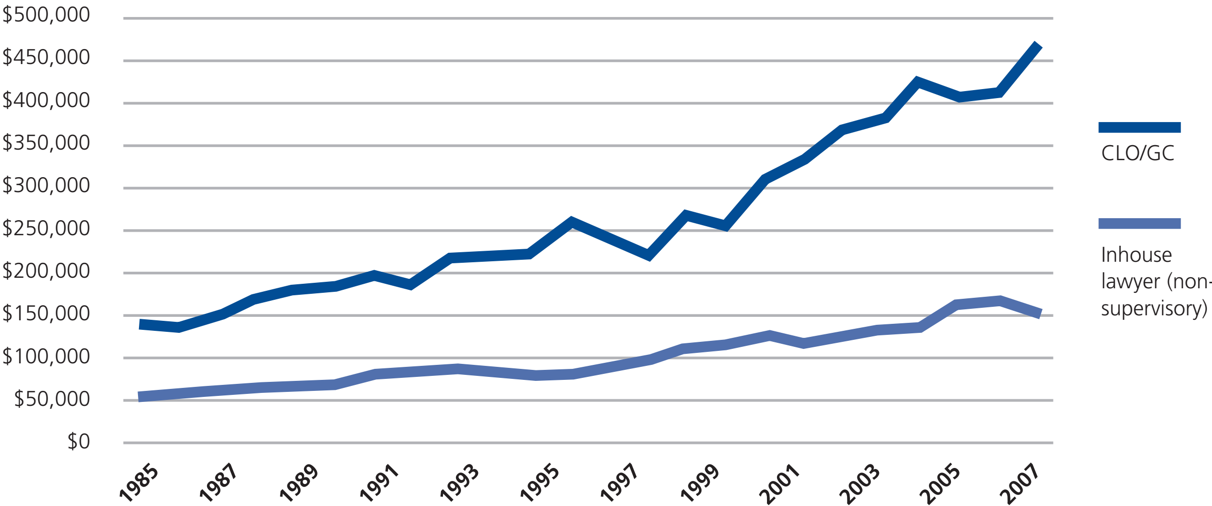

Table 4: US Inhouse Lawyer Average (Median) Salaries from 1985 to 2008[20]

As can be seen the GC role and more junior inhouse roles have both seen a trebling of salaries. GC in particular saw a rapid rise from the late 1990s that looks remarkably similar to rises the external lawyers have experienced. The increase in pay, often with GC and CLOs having major share options in their companies, has underlined the financial

[18] Financial Times, March 18 2010, survey by Eversheds and RSG Consulting.

[19] Ibid.

[20] Altman Weil Survey of Law Firm Economics 2009.

responsibility of their jobs and the status that comes with it. GC we spoke to added that showing an ability to contain and predict costs had become a variable element in their compensation. One added that getting such matters wrong could lose them their job. It could be said GC now have more than enough incentives to push-back in the relationship with law firms and many are acting accordingly.

Another development is the growth of inhouse teams, in part a side effect of an increasingly powerful GC culture that demands an increasingly large inhouse team around them. However, the dominant drivers mentioned in Chapter One remain, that businesses have greater legal needs, especially those that have gone global. While some inhouse teams for smaller, domestic companies remain countable on a single hand, others such as Barclays, which now makes around 50% of its income abroad are now into the hundreds of inhouse lawyers. There seems to be no sign that this trend will decrease in the long term, even if in the short term there have been inhouse staff cuts due to the crisis.

As can be seen in table 5 below, there is a general growth in the size of inhouse teams, usually with at least 30% of GC planning to increase the legal function each year.

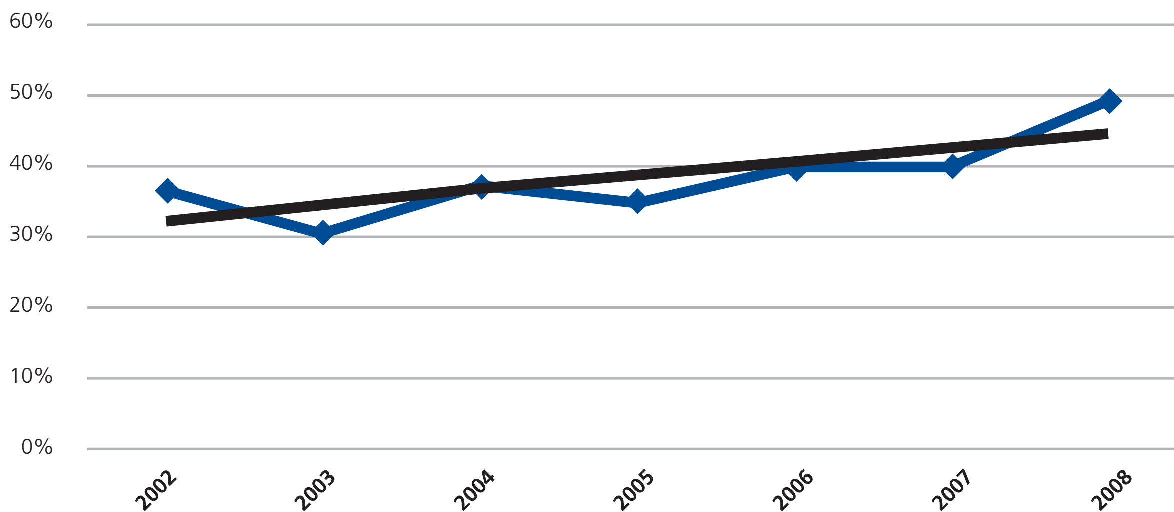

Table 5: Percentage of Chief Legal Officers seeking to increase the inhouse team[21]

This long term growth trend in turn makes the legal function an even larger cost-centre, as well as requiring even greater management and financial skills from the GC. Long gone indeed are the days when just having been a law firm partner was sufficient to qualify to lead a legal team. Now an MBA, a good understanding of financial planning and experience in project management, may not go amiss. To this list of skills one could add an encyclopaedic knowledge of the company's legal issues, the firms it uses, and the ability to negotiate as well as the best procurement expert. To be a GC can no longer be seen as a less demanding role than that of a 'Big Law' partner and they certainly don't want to be talked down to, as happened in the past.

[21] Altman Weil CLO Survey. Black line denotes overall upward trend.

2: Who Shall Guard The Guards?[22]

Law firms, at least in the US and UK, have an enormous amount of information at their finger tips, not just about their clients, but about each other. Scan the legal media and you will find the kind of competitor intelligence that some other industries would rarely obtain. This transparency is a good thing. Partners and junior lawyers can quickly gain a sense of whether they are being treated and compensated well compared to rivals. Strategic successes and failures are often aired for all to see – and can be learned from. Firms can also quickly get a feeling as to how they compare to other law firms they may be competing with. This is all for the greater good and keeps the market healthy.

Businesses have directories to tell them which individual lawyers are well-regarded, and by looking at various websites they can discover a firm's rank, for example, by M&A deals done, or the ethnic balance of a firm. They can also find where it has offices and what practices they offer compared to others. They have plenty of quantitative knowledge. But, they have still lacked sufficient qualitative knowledge. Until very recently, the clients did not have so great an ability to compare the value and performance delivered by law firms, apart from the first-hand knowledge each general counsel would have built up over time from using certain firms, and often with just a handful of key partners they may have known. This is now changing. Given the lack of information clients have so far shared in a formalised way between themselves the creation in 2009 of the Association of Corporate Counsel's (ACC)[23] Value Index is an important development (see table 6).

ACC members score law firms using a five point scale (1=Poor, 5=Excellent) in these areas:
• Predictable Cost/Budgeting Skills
• Efficiency/Process Management
• Results delivered/Execution
• Understands Objectives/Expectations
• Responsiveness/Communication
• Legal Expertise

Table 6: The ACC Value Index

The ACC has 25,000 members in 70 countries, and the Index asks them to rate the law firms they use on six criteria, plus adding the question: "Would you use this firm again?" There is also room to make additional comments.

It is worth noting that 'legal expertise' is seen as just one of the six factors, whereas performance and project management issues make up the majority of the key indices. This clearly shows what inhouse lawyers are focussed on now. The Index also encourages a sense that first, there is a transparent choice of law firms, and second, that the buyers need not be scared of finding new service providers due to lack of knowledge. It also puts an onus on the law firms to show value to clients.

What the Index doesn't do is compare the firms on price, which is perhaps letting the firms off lightly. However, one can extrapolate from the information provided and the kind of work a firm may be doing to understand the value delivered.

[22] 'Quis custodiet ipsos custodes?' A quote from Juvenal, in relation to the dilemma of entrusting just one group to oversee things. It begs the question: should clients accept law firms' methods and practices without first making use of their own 'competitor intelligence'?

[23] www.acc.com.

This ‘empowering’ exercise by GC worried some law firms – and it was rather a worrying sign in itself that sellers of a service should make such a fuss about the buyers daring to talk to each other. They especially didn’t like the idea that clients were ranking firms without the firms getting to see the data. But why shouldn’t clients do this? Law firms don’t own the clients, they have a free choice. In an age of consumer rights such an attitude from law firms appears troubling. Yet, despite being in the right, the ACC has since agreed to let firms see the index[24].

Although the ACC has not gone down the road of looking at pricing or cost, in pure financial terms, some companies have made great progress in this regard. One pioneering GC at a large European company explained that he and his team had now filtered six years’ worth of billing data in order to come up with fixed prices for most kinds of legal work the company used. In short, they know what everything should cost. This is what most other businesses in the world would do, they analysed the data, searched for meaningful patterns and standardised the results to define discrete legal products or processes they paid for. Ironically, many experienced GC know this information already – and finding and organising this data is now easier with the rise of e-billing software and analytics packages. The challenge for many is that they don’t formalise this knowledge to give them objective bargaining power with firms. This GC however, has made a mission of using facts and data to empower himself.

When a law firm pitches for work this GC can tell them in what cost range a piece of work should be. The figure will not be arbitrary, nor the result of a one-off enforced fee cut, but a studied result of previous billing behaviour and firm performance. If the firm goes over budget, the GC might not accept excuses about unpredictability, or work being unique. Some law firms aren’t happy about this development. One managing partner from a major firm described such cost-focussed GC as ‘being bullied by the Finance Director’. However, it seems doubtful a wise GC would see it this way. They may even consider such an attitude patronising.

Finally, web-based forums primarily for inhouse lawyers to discuss professional ideas and exchange experiences are growing. These are especially important as they help counter balance the weight of law firm-dominated media and information sources. One example would be LegalOnRamp.com[25], which although with generally US-led content, has participants from over 40 countries and around 6,000 inhouse participants. Not everyone is taking part in such forums, but many GC are and those with messages about change now have both a platform and a lay audience around the world to share them with on a daily basis. They also help GC feel more connected to a wider world and not isolated inside their company with only the external firms to look to for guidance.

[24] Legal Week, 9 February 2010, ‘ACC allows law firms access to controversial client reviews’.

[25] The US publication ‘US News & World Report’ is also set to launch the ‘America’s Best Law Firms’ ranking in October 2010, (www.usnews.com, 28 January 2010). This will focus on quantitative data and include peer reviews by other lawyers. The big question will be whether this becomes simply another list of numerical data with some hagiographic comments on partners, or whether it will analyse and feedback on how law firms bill, perform, deliver value and connect with their clients, as the ACC Value Index does.

Chapter Four: Value and Commoditisation

1: When Time Isn't Money

How clients allow themselves to be billed is a growing issue. It seemed to have a huge fillip when the financial crisis hit in 2008-2009. One of the more noteworthy contributions to the recent debate over fixed and success fees versus the billable hour was that of Evan Chesler, presiding partner at Cravath Swaine & Moore. In a self-penned article in Forbes magazine, January 2009, entitled 'Kill The Billable Hour' he stated: "The billable hour makes no sense, not even for lawyers." He went on to give the example of how he was happy to pay for his kitchen to be refitted with a fixed price rather than pay the contractor for his time.

He added in the article, that as a litigation lawyer, when asked to handle a case he should: "Identify the client's objectives, measure, calculate, build in a contingency and come back with a price. Once the price has been agreed upon, the billable hour should be irrelevant. The client will no longer be surprised by a whopper bill and met by the standard (albeit true) explanation that 'litigation is unpredictable'"[26] One might add that if it can work for litigation, then it should be able to work for more discrete projects such as producing a Non-Disclosure Agreement, or the legal documentation for a standard finance agreement.

This was not the first and it won't be the last comment on the problems involved in using time units to bill a service. Nor, as mentioned earlier, are 'alternative fee arrangements' anything novel at all. In fact, lawyers who have been practising for 30 years or more remember when the billable hour was introduced in the 1980s as a 'new' way to ensure the client got a transparent bill. Of course, this meant the client was:

- Paying for the time to complete a task.
- Permitting inefficiencies that could easily, or unwittingly, lead to higher costs.
- Implicitly promoted the benefit of highly leveraged, open-ended, cost-plus ways of working.
- By sticking to time-based billing it was undermining the use of IT to speed processes such as document formation.
- Unnecessarily forced to penalise those firms that worked fast and lean and got the job done for a lesser cost, but with the same results.
- Forced to wait 'in the dark' for the final product and the bill to come back.

Law firms have responded by offering all manner of variations on the straight billable hour such as blended rates or discounted rates – but the real irritant, namely time, is still there. Also, in some cases hybrid time systems do not even deliver what they set out to do – reduce costs. Some partners we spoke to said they found that when they offered discounted rates the lawyers in the firm made very sure that nothing was written off and in many cases the final bills were the same as when using the standard rates. This is hardly a good advertisement for transparency and mutually beneficial relationships. It also emphasises that despite a lot of hot air being expended on the subject, how clients allow themselves to be billed does matter.

[26] Forbes Magazine, 12 January, 2009. 'Kill The Billable Hour' by Evan R. Chesler.

2: Why Fixed Fees Matter

Another alternative to time-based billing is a success fee or proportional fee. Firms have been doing this for some time and copying the investment banker strategy of taking a percentage of the deal. Some think this system will see more favour in the future as it avoids time. Interestingly, some GC don't like this approach either because it can appear disproportionate to the work done – even if it gives a more predictable billing outcome. One GC told us of an example when a well-known M&A firm was told to either drop its insistence for what would have been a massive success fee on a merger, or be let go. The figure involved was just too much to swallow. The firm quickly dropped its fee plan and went back to billable hours, which was perhaps not the best option either.

But there is another way forward and its importance goes to the core of what lawyers do and how it is perceived, the fixed fee. The fixed fee may sound innocent enough, after all, is it not just billable hours repackaged? This may be true, but moving to a fixed pricing system does something else alluded to above, it makes legal work, i.e. a service, into a discrete product. To take it further, it turns the abstract into something concrete – a commodity. This commodity with a fixed price can be far more easily compared to others of a similar kind. As processes improve in making this 'product' efficiencies will increase and clients will expect costs to come down.

Table 7: The Impact of Using Fixed Fees

Despite having been able to produce the same product for less a firm may well say: 'We want to raise our rates on all fixed fee work by 5% this year.' But the client could reply: "Why does it now cost 5% more to produce something you have already created many, many times for us? Has it become more complicated?" The firm can justifiably argue overheads and salary costs have risen, but the client is now well-armed as it enters into the pricing discussion. The client will be expecting the unit cost of this 'product' to reduce over time, not rise. GC may well demand that their legal advisers steadily become more efficient and show that they are learning how to improve processes. Clients that work with firms offering fixed fees may also want to see whether the law firms are passing on any of the cost savings the improved processes have provided. Of course, some firms may not want to pass on their savings gained from better processes. It is a free market and they can do that if they wish to. However, competitor firms that believe they can pass on some of the process savings and still run a profitable business will be at an advantage.

What is most surprising about the fixed fee debate, is that they are not the rule already in the legal sector. Many other sectors went this way years ago – and none of them have ever looked back. For example:

- Dental and medical care – few people pay their doctor or dentist by the hour any longer. You choose from a menu of fixed fees, whether this is for a gold filling, or a CAT scan. Cost-plus is still an element, but there is open competition on price and perception of value.
- The defence and airline industry – manufacturers have moved away from a cost-plus model to fixed fees. This reduced margins and encouraged consolidation to gain greater economies of scale. The focus was then on contract variation and future servicing to provide additional profits. There was also a move for buyers to reward performance, such as early delivery. This helped remove inefficiencies in the production system. Efficiency became profitable as it was incentivised. A study from Deloitte in February 2010[27], also found that client after-care was an extremely profitable business to be in, and not just a burden as some manufacturers had once thought.
- Construction – most Government and local Government agencies now contract via a fixed fee procurement process. In the UK it is actually a statutory demand that Government entities seek proof of value and multiple bids.
- Corporate Travel Agencies – in the late 1980s[28] corporate travel agencies such as IVI Travel stopped charging clients a commission on each element of their travel plans, e.g. the cost of a hotel, or plane ticket, and instead moved to charging a fixed fee for the work done by the agency for the client. This helped remove from clients' minds the idea that agencies were booking the most expensive trips in order to grab a bigger commission.
- Recruitment Consultants – while many still take a commission on each candidate, some recruiters are now charging a flat rate, fixed fee for their services[29]. In return they demand a commitment from the client to a long term relationship, which is also mutually beneficial as knowledge is shared and needs understood.

Why should much of what the legal sector does be any different? In fact, one may say that the movement to discrete legal products has already started. If one were to buy a house in England & Wales, you may find the solicitors offering a fixed fee for conveyancing regardless of how long it takes you to complete the move, or how many letters will be sent back and forth to the seller's solicitors. In some cases they will make a loss in terms of the effort expended. Other times – and one can bet they have considered this very carefully – they will make a profit. If the buyer wants to compare their price against others they can. If the buying and the selling of residential property can be broken down and analysed and prices for the various parts of the process 'modalised' then there is surely no obstacle to the same process being rolled out for all manner of legal work?

3: What is Value?

GC say that the first issue they face as buyers of a service is value to the client, and the number on the bill comes second. This makes sense and reflects wider patterns of service buying in the economy. But, this does not mean GC are ignoring cost. Cost remains part of the equation. What they mean is: "Don't think we buy legal services just on price." But then, who would? Many lawyers tend to agree with the value first idea too – but not necessarily for the same reasons. Some lawyers make use of the 'value' argument in defence of billable hours, of unpredictable fees, or a lack of transparency. They state that what they do is 'expert', 'tailor-made', 'high-value' work, which should not be reduced to questions of price. But, this is akin to the 'No one ever got fired for using IBM' argument and has plagued the inhouse sector for years.

[27] Deloitte, Feb 2010 report, "These events have created a global customer support & sustainment industry with profit margins up to 10 times that for the original equipment." This suggests long term 'partnering' with clients is far more profitable than aiming for one-off profitable projects.

[28] New York Times, June 2, 1989, 'Big Travel Agency Moving to System of Fixed Fees'.

[29] For example, Aaron Wallis recruitment agency.

One can understand why lawyers like to push the IBM argument – it is one of the best marketing lines ever created by the service industry. But, in many cases this argument is simply wrong and inappropriate. In other cases they may have a point. There are indeed some areas of work where you need a Nigel Boardman[30], where the matter really is 'rocket science', where it is life and death, and price is immaterial – if you have the money. This is the fundamental problem then: when is advice so valuable that price or the way work is produced have little, or no, importance? That is to say, when would the GC's job be on the line over their choice of firm, or the lawyers chosen to carry out the work, if the deal went wrong? Consider the pyramids below. They describe what kinds of work law firms do, and how clients and firms see this work product differently.

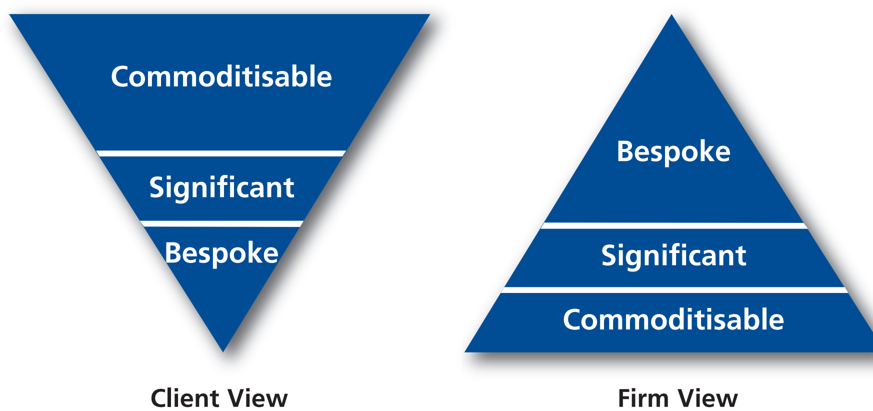

Table 8: The Relative Views of the Value Pyramid for client and law firm

As can be seen, law firms tend to believe what they do is more unique than clients do. Clients are not ignorant of the fact that firms do some very bespoke, and life or death, work for them. But they also know a lot of it is not anywhere near being unique or groundbreaking. The value argument is therefore not so simple. Law firms should also be aware that when it comes to putting a value on a service it is what the client thinks that matters, not what the seller thinks. Clients know what is valuable to them, and that is the only yardstick that matters.

Some firms are well aware of this fact. They know, as do the clients, that a merger, for example is made up of many different elements, each of different value and complexity and needing different forms of labour and production to complete them. As you carefully take apart the deal one finds that the total amount of work that really is 'bespoke' is in fact rather small. The commoditised element may in fact be rather large. The problem is that this differentiation is often glossed over. If GC want to react to this, and more and more do, this should have an impact on both fee levels and the way the client is billed. For example, GC may demand fixed fees for the process elements of the deal.

[30] Talismanic partner of UK's Slaughter and May, famous for his legal skill and business acumen.

Chapter Five: The Means of Production

The other fundamental change in the way businesses see expenditure on legal bills is a growing interest in how they can use technology, geography and 'industrialisation' to alter the means of production in their favour. Below are three key strands to this development, IT-led production, use of offshoring and the use of onshoring, that is to say using legal capability in the home country, but with a lower cost model.

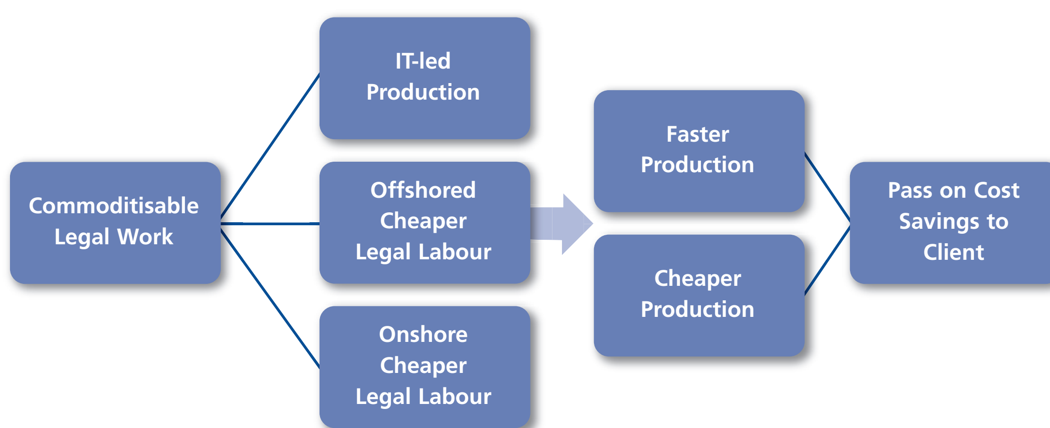

Table 9: How new production methods for law firms could save clients money

These three methods, all of which are poised to have a major impact on the legal industry are described in more detail below. What unites all three routes is the expectation the client will benefit from lower fees, at least per unit or case, due to lower production costs.

1: IT - The Legal Sector's Spinning Jenny[31]

'Legal IT' has become an 'industry' in itself with a myriad of companies and software now available. What started as simple time-keeping software, diary planning and document management systems has gradually evolved to cover electronic discovery for litigation, especially in the US, as well as complex Knowledge Management systems that feed a firm's combined wisdom and experience right to where it is needed as cases and queries come up. Although that 'gradually' is in fact in the space of about 20 years – not even half a lawyer's working life.

But, the real prize is yet to come – wide-scale autonomous production. Given the speed of development so far we would not bet it will never happen. But, Luddites should not panic just yet, given that even a relatively simple legal interaction such as a conveyancing is still scarily complex for a computer to handle. A large proportion of legal work will remain very much in the realms of human control for years to come.

[31] The Spinning Jenny was a multi-spool spinning wheel and a significant step in the 'Industrial Revolution'. It was invented in 1764 by James Hargreaves in Lancashire in the northwest of England. The device dramatically reduced the amount of work needed to produce yarn, with a single worker able to work eight spools at once. This move toward cheaper production was so unpopular for hand-loom workers that by the 1810s 'Luddite' riots began to break out, destroying machines that had undermined their production methods and, more importantly, their income. The term 'luddite' derives from the 18th century folk hero Ned Ludd, who destroyed two textile machines in 1779.

What we will see instead is two-fold. First, the most simple closed-circle, 'form-filling' type legal documents and processes will be automated. For example, Cisco Systems pioneered the way after it automated its Non-Disclosure Agreement for its own employees – and that was five years ago[32]. The employees do not need to see a lawyer and just follow the steps to fill in the digital form. A small number of law firms have also experimented with this idea by offering clients the opportunity to form-fill via their websites to create simple documents such as term sheets and LPO service agreements.

Second, we will see a further development of the hybrid system we have today where information, standard forms, perhaps primed to feed in the best responses or offer best alternatives, plus some vital human input, combine together.

Again, not all law firms are happy about these developments, nor do they always seem keen to pass on cost savings they make in the process. Rather the idea is to do things more quickly, which allows the law firm to take on more matters, hence making more money. Some partners ask, quite fairly: 'Why should we invest so that we can save our clients money? We are a business. We seek to maximise profits.' As one managing partner of a global firm explains: "The sheer cost of going down this road is massive." He stresses that the cost of taking it further is in the order of "tens of millions".

But, can you think of an industry where technology improved production techniques and then did not carry on trying to improve? Or one where competitors didn't use this technology to try and beat rivals on price, or the speed of production? Neither can we. From dentistry to architecture to accounting, technology has had, and continues to have, an impact. A service business that does not embrace technology and use it to benefit the customer is taking a major competitive risk. It may well be expensive: but what choice do law firms have? Legal will be no different, and in fact may be harder hit, due to the essentially 'textual' nature of the end product. But, this is not an entirely negative development. Its impact will be balanced:

Pros	Cons
• Clients will be extremely pleased to see costs and production times greatly reduced for standardised work. • The IT investment will be paid back over the long term. • Combining improved IT with making better use of fixed fees, increased volume, moving production centres to cheaper locations to lower overheads could help support margins and boost income and profits. • Even though IT tends to undermine time-based billing, improved efficiencies and project management could still mean better profits when used with alternative fee arrangements.	• The IT investment cost will be large. • The savings made in production time, and the reduced use of human labour i.e. associate leverage, could reduce the fees that law firms can charge if they remain tied to the billable hour. • Competition from other firms with better IT-led production methods could create added pricing pressure.

If law firms are still not convinced they want to invest to help their clients save money then the big question is: what is the opportunity cost? What will it cost a law firm to not go down this road? What would be the impact of rivals, or

[32] ABA Journal, September 2005, 'The Cisco Way'.

perhaps clients, or even new entrants[33] to the legal market, taking this technological step? Ironically, it may well be the clients who can best afford to invest in such legal technology, after all, if legal is such a cost centre for them, why not take the matter in hand? It does not seem too fanciful to see some of the world's largest technology companies going down this road, or at least forming a major legal IT-driven joint venture with a third party.

2: Offshoring: Location, Location

Offshoring has existed since the 1980s, when what in those days were called 'transnational' corporations realised everything from manufacturing mechanical parts to handling telephone services could be done more cheaply abroad. For the legal industry the idea of offshoring is far more recent, only really taking off in the last five or so years. Some might say it still hasn't really taken off – despite advantages in economic terms (see table 10). One obvious reason for this is that it pays law firms to keep commoditisable work to themselves at home. If you charge 'Big Law' associates out at cost-plus hourly rates, even with the high overhead and salary costs a firm needs to pay, a firm can make a very good profit if there is sufficient business volume. Why undermine your own profits by encouraging clients to use LPOs or other centres abroad?

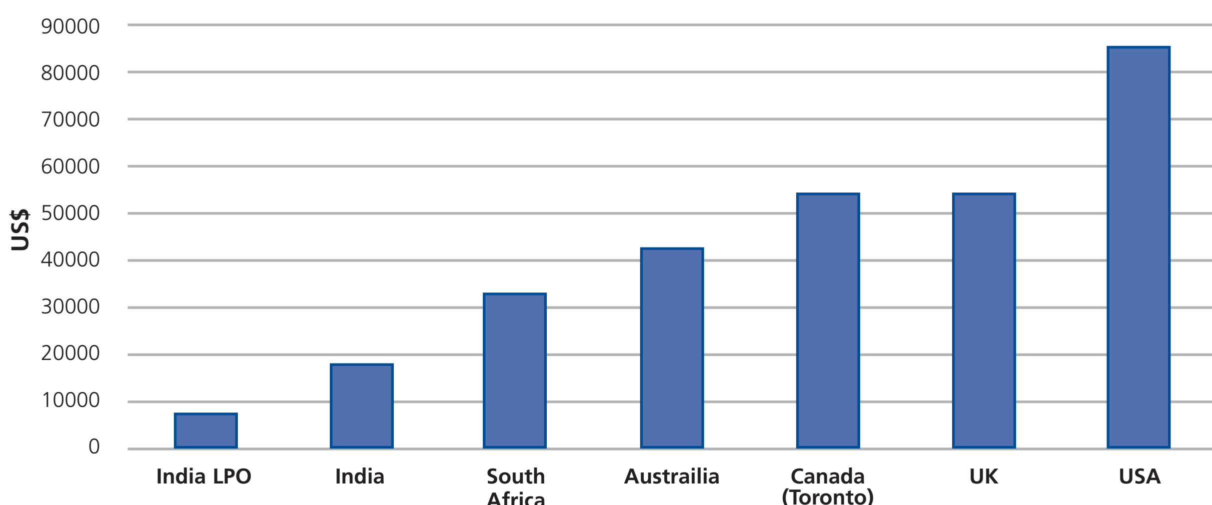

Table 10: Average first year salary in law, plus an Indian LPO salary[34]

Clients have been slow to move on this too. Despite what seem to be clear benefits, GC are not banging the table and demanding their legal work be moved abroad. Distance is not really a factor either, as sending a document via email is instantaneous anywhere in the world. One could even argue a spread of process centres in different time zones is a great benefit to a law firm or inhouse legal department.

But, it is when you look at the different cost basis that the benefits really stand out. An Indian LPO worker is making a tenth or less of a UK first year associate. While, an India law graduate within an Indian law firm is still making around three or more times less than a first year in the UK. Business premises are cheaper too.

[33] New entrants refers to non-legal businesses entering the UK legal market after October 2011, following the Legal Services Act 2007. Large outsourcing companies, well versed in improving production methods, could well invest heavily in the 'next generation' of IT to gain significant production advantages over 'traditional' law firms, especially for process-driven work. See below.

[34] Various Sources: Indian Salaries – The Times, Jan 2010, South Africa – MyWage.za, Australia – Michael Page Financial Survey, Toronto – Toronto Law School, UK – AGR Survey on Pay, US – Altman Weil SLFE. Averages will naturally be far lower than the top end market rates.

Perhaps one of the most headline grabbing LPO deals was that of mining giant Rio Tinto that agreed in June 2009 a major outsourcing deal with CPA Global. This saw CPA take on a proportion of the company's legal document review and drafting, and was expected to reduce legal spend by 20%[35]. So far other big names such as, Microsoft, Canon Europe, Sun Microsystems, Bupa, Carillion and Novartis, among others, are also using Indian LPOs. It is important to note that it is the companies themselves that have been proactive and taken cost-saving into their own hands. This cost-reduction has not been driven by the law firms pro-actively arranging to send process work to LPOs for their clients. But the trend is hardly widespread – nor are the LPO agreements for all of the companies' process work, rather just a fraction of it. Interestingly, Clifford Chance has set up a business process unit in India too, which it owns, outside of New Delhi in Gurgaon[36]. It has around 300 people handling purely support matters such as legal research, plus a smaller team of around 40 Indians focussed on process elements of 'legal' work. The Indian employees from Gurgaon are sent to Clifford Chance offices for training and this is done to ensure clients get global firm quality. Baker & McKenzie also has a considerable cost benefit from running a sizeable support centre from its office in Manila in the Philippines.

This sounds promising, although not the tidal wave of offshoring often predicted, nor is this LPO work covering much more than the simplest legal tasks. In most cases this isn't complex legal work being sent to India – not that it could be due to local sensitivities[37]. Will the picture change rapidly now? Possibly not, at least not for India. Forrester Research before the financial crisis believed that $4bn-worth of LPO work will be carried out in India by 2015[38], which is by far the largest centre for LPO work in the world. A chunk of this is related to e-discovery, primarily for US litigation where discovery had previously led to major costs for process work being racked up by American law firms at home and which clients could no longer stomach. The rise of email and electronic document discovery, and the use of computer-based key-word searching, also meant that such work did not require highly trained legal staff to carry out the work and could more easily be sent to lower cost centres. But, even if it is fairly limited, the figure may still sound a lot. Yet, the US legal market alone is considered to be worth $255bn[39]. That means only around 1.5% of the US market is set to be cannibalised by Indian LPOs.

Overall, India's outsourcing sector appears rather limited, at least for legal work, and may not see the tsunami of growth many predicted. The next question is: where else could be the future centres of outsourcing? Four conditions are required to find the optimum location:

1. The legal talent is of equivalent quality, but at a significantly lower price compared to the source of the legal work.
2. The country's lawyers or paralegals are regarded with trust and clients have no doubts about using such lawyers.
3. The country's bar rules permit foreign law firms to operate there, in case Legal Process Work (LPO) spreads into what regulators would call 'practising law', and,
4. So that if the outsourcing law firm wanted to set up a joint venture with an entity in that country, or create their own business there, they could do so, and send partners to oversee the operation.

[35] The Law Gazette, 18 February 2010.

[36] Clifford Chance's LPO operation is also known as 'OSC Export Services Private Limited', (www.oscesl.com) and describes itself as a company that 'specialises in providing IT-enabled services to overseas organisations - we support management and administration processes'. It also has one client – Clifford Chance.

[37] Legal Week, 26 March, 2010, 'Indian law group names City leaders in call for action against foreign firms'. Soon after the Bombay High Court ruled in December 2009 that foreign firms could not practise the law in India, a new case was brought by the Bombay Lawyers Collective against 31 foreign law firms and one LPO, for allegedly breaking rules on legal practice.

[38] Law.com, January 23, 2008, 'Legal Outsourcing to India Is Growing, but Still Confronts Fundamental Issues', (plus, New York Law Journal).

[39] Datamonitor.

If one looks at table 10 and then considers Common Law countries where you would be more than happy to send New York-based work, or English-based legal matters then Australia, New Zealand[40] and South Africa look promising. In the case of Australia, in particular, you have an over-lawyered market[41], where many associates have spent time either in the US or UK with major law firms. The jurisprudence, at least on standard commercial matters, is relatively close. There is also a significant cost saving, but with no worries about the quality of the lawyers. Australia's legal talent also permits clients or law firms to go far beyond basic LPO work and move to a far more full-scale legal capability. One leading Australian firm, Minter Ellison, has just launched such a project using its New Zealand arm. The 'LPO' will handle matters such as due diligence at a considerable saving compared to UK City rates, one of the key markets it is targeting.

These are still early days for offshoring, but the need for law firms to reduce the production costs will not go away – and may increase. Seeking out foreign markets that can do what is done at home, with the same quality and assurances, but cheaper, may well be the way of the future.

3: Onshoring: Home Sweet Home

A recent survey of clients found that many believed it was better to 'onshore', using LPO-style lawyers in the same country, than to send work out as far away as Asia[42] - which in effect means to Indian LPO centres. Although, just over 30% said what country the work was sent to "was not a factor".

It may be wholly illogical to believe that work done abroad, or in a developing country, is more risk-prone than work handled in your home country, but some people clearly believe this. It is of course rather ironic as the business and legal press regularly report stories of lawyer misconduct and failure in high status locations such as London and New York. Conversely, and after a long search, we could find no story of an LPO being sued by a client for its faulty legal work, or for example, an LPO worker being charged with insider dealing – as US and UK lawyers are from time to time[43].

However, keeping work in your own country may have some benefits. For one, all the work done in the same jurisdiction will come under the same Bar and regulatory rules, including those on legal privilege. Also, if you do have to physically attend the location where the work has been sent then travel times are far shorter. Rightly or wrongly, businesses also tend to trust in the service providers they know locally. Finally, just because work is done within the borders of the client's home country, doesn't mean it cannot be cheaper – not everywhere is as expensive as the City of London or Manhattan Island. For example, Microsoft has extended its outsourcing deal with LPO company Integreon[44] – but is not sending all the new work to India. The LPO will send eight contract specialists and legal staff to a Microsoft office in Fargo, North Dakota, one of the less expensive parts of the American Mid-West for wages and real estate.

This approach has seen some early adopters, such as Orrick in the US, which has for some years used its own base in West Virginia to handle some of its support work at a lower cost. Then consider UK bank RBS, which is understood to be considering shifting process-focussed work that normally goes to the major global firms, to firms with lower costs[45] - some of which could well be placed outside London.

[40] The Lawyer, 17 May, 2010, 'Minter Ellison New Zealand base offers LPO service'.

[41] 215 people per lawyer in Australia, compared to 303 people per lawyer in US. Jomati research.

[42] The Lawyer, 22 March 2010.

[43] Legal Week, 21 May 2009, 'FSA Launches Insider Trading Case Against Two Lawyers', of which one was a London partner in a major US law firm.

[44] Legal Week, 7 April 2010.

[45] The Lawyer, 8 March 2010.

UK firm CMS Cameron McKenna is also understood[46] to be rapidly building up a lower cost production centre outside of London in its Bristol office. Previously a regional office, the provincial base will now steadily grow in lawyer numbers, affording the essentially London and international firm to produce what it did before, but at lower costs to itself. The firm has also announced a planned $890m deal to outsource support functions to Integreon over ten years, again reducing the overall cost base of the firm[47]. Another UK firm, Olswang, is understood[48] to be planning to handle more legal work from its Reading office, a town outside of London, where salary expectations and office costs are lower. It is understood the firm will handle real estate litigation and management work, as well as employment matters from this lower cost base. The logic behind this is believed to be that the London HQ could focus on higher level matters – which will merit a higher fee. In general, such strategies would mean: low margin work to low cost centres, and high margin work to high cost centres.

Meanwhile, a senior partner from a major US firm appears to be taking on the same strategy with the development of 'a staff attorney business unit'. This will he says "be a lower cost unit, not using full associates, nor with a fancy office". He adds the dress code will be more relaxed, for example staff could wear jeans, and the working conditions will be more flexible. It will also be based outside of New York, but not too far away, in a nearby State where the general costs for property and salaries are lower. The motto will be: one firm – multiple ways of working.

Predictably, not all law firms are in favour of this. Predictably too the argument against this change is based on defending their margin. One senior partner at a leading firm says: "How long before the clients start to ask for the high quality work to be done at the low cost rate that is offered outside of London?" But, he may have some good company on doubting the multiple offering strategy. David Maister[49], one of the pioneers of professional service firm management, wrote in 1993: "Experience has shown that it is difficult, if not impossible, for one part of the firm to create a strong 'frontier expertise' reputation when the firm is already known as a low-cost provider."

However, if a single client needs two very different grades of work done by the same law firm, then why shouldn't it work? Don't law firms already offer a wide spectrum of legal abilities and products, ranging from the unique insight of a famed senior partner, down to trainees and paralegals that handle rote answers to standard legal matters? Do clients refuse to use a firm because its partners and associates have different levels of experience and capability? No, not at all. What would stop a client using a firm's junior lawyers, or lower cost lawyers, would be if quality was lacking. But, quality does not diminish just because cost is low. A firm could have an excellent team of paralegals, who work very efficiently, don't make mistakes, but are still focussed on process work and are relatively low cost. We believe if you can maintain quality, then multiple offerings will work – in fact clients may soon demand as much.

[46] The Lawyer, 26 February 2010.

[47] Legal Week, 14 May, 2010, 'Camerons set to outsource entire back office with Integreon deal'.

[48] The Lawyer 15 March 2010, 'Olswang set to move work to the regions'.

[49] David Maister, 'Managing The Professional Service Firm', Simon & Schuster, 1993.

Chapter Six: Principles of the New Relationship

If all of the above is to have a continued and growing impact on the relationship between law firms and their clients, especially the larger, more institutional ones, then this will also have an impact on the way law firms operate.

Below are four key principles that will guide law firms though this period of changing client relationships: the open acceptance that a proportion of all law firms' work is commoditisable; that innovation and not automatic price rises will be the way that law firms may increase profits; that law firms will have to focus on selling on value to each client; and accept that different means of production used in parallel, or a multi-tier approach, will become the norm for many firms.

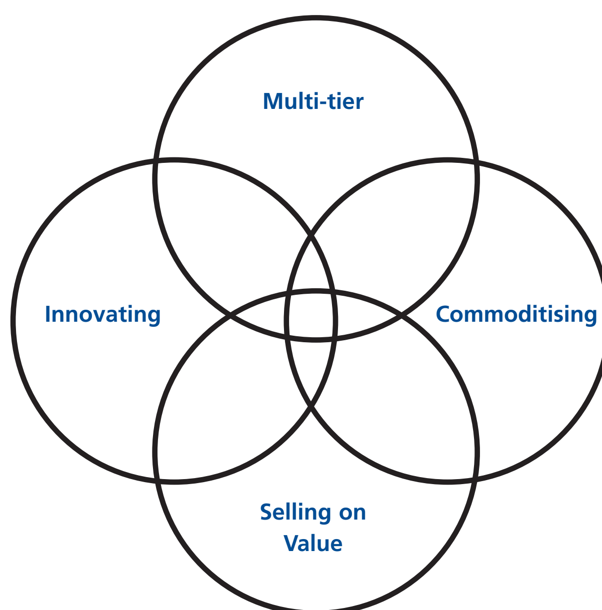

Table 11: Four Principles for law firms working within the New Client Relationship

1: Commoditisation

Commoditisation has always existed in the legal world. As soon as someone came up with the idea of a standardised legal document then we had entered the realms of delivering a discrete legal product, where the added value was not to be counted in the document itself, but in delivery, service, and any additional value that came with it.

Law firms have operated in this semi-commoditised environment for decades, what has changed is that the clients are now far more aware of what can and what cannot be produced in a cheaper way.

Commoditisation no longer just refers to 'that low level work that quality firms are not interested in'. The term could also mean: 'That process work, contained in even the most sophisticated legal work, which can be done more cheaply and efficiently by using different production means.'

These production methods will include using more IT, project management skills, unbundling an assignment into its constituent parts, offshoring and onshoring. They will also mean making far greater use of fixed fees for anything that can reasonably be seen to be repeatable – and which the client has seen repeated before with a similar outcome. This may mean lower profits per job.

The critical business question for law firms is then: do they seek to increase the volume of this lower margin work to keep revenues high, or do they simply accept that part of their offering has been 'devalued' and they must find a way of delivering value in a different way?

There are risks and benefits to both approaches. Following commoditisation too far and one could undermine the firm's brand for quality work. But, to refuse to downgrade work that can no longer be sold as 'key' or 'bespoke' risks alienating clients and leaving the door open to rivals that are prepared to do so.

2: Innovation

Directly linked to the issue of commoditisation is that of innovation. As one global law firm senior partner explained: "If we just went on commoditising what we do, and did not innovate, there would be nothing left of us." In short, to commoditise, but not to develop products that can be sold as having 'added value' will transform a firm very quickly from a top level player to one best known for process work.

The response to the future higher levels of commoditisation is therefore an equal increase in innovation of new legal skills and products. But how to do this? Keeping up to date with what is happening in terms of legislation, or proposing legal products that may be valuable in the future is a good start, but most quality firms are already well-advanced down this road. Using better Knowledge Management systems and extranets are also already well developed, and not really an innovation. So how can you credibly innovate in a way that will make a difference?

Although it cannot be the response for all law firms, building a global capability is certainly one way of adding value to your offering, primarily because so few law firms can do this. As shown in our previous report, 'The Next Wave: Globalisation After The Crisis'[50] the number of firms with credible practices that cover the US, UK and rest of the EU, as well as the Middle East and Asia is very small. Firms that can offer a global, quality capability that no one else has have an opportunity to charge more for it.

Further practice creation may also be an important area of innovation. Seeking out the practice areas of tomorrow and cornering the market for credibility in these areas before other firms do, may become even more vital[51]. It is clear that law related to: the environment; investment into the last remaining developing markets such as across Africa; international regulatory trade, finance and banking issues; energy; and the movement from a Carbon-economy to a renewable-driven economy that will touch everything from the automobile industry to infrastructure, will all be important.

[50] Jomati Consultants LLP report, March 2010.

[51] Jomati Consultants LLP intends to cover this area in a full-scale report at the end of 2010.

3: Selling Value

Law firms will have to make a greater effort to actually show how they add value, especially for any work where there is considerable pricing competition. This is of course a very complex area, and perhaps more an art than a science as deciding what is 'value' to a client will vary greatly. As mentioned earlier, value can still not be divorced from cost entirely. One could argue that even for life or death work, if a client was offered absolutely equal value from two firms, and one was slightly less expensive, which client would not 'save their life' and make a cost saving too?

However, proving your value to a client is a lot harder than it first may sound. Telling a client you are a great firm may just not be enough these days in a world of fierce competition. One way firms have attacked this problem up to now is to offer the best possible service, to 'super-please' the client into coming back. But, it seems that now everyone has upped their game and pushed their client-friendly partners to the front.

What if GC start to ask: "Your service is equal to the other firms I deal with. You are as friendly and as professional too. How then is what you give me any more valuable than what this other firm gives me?" Such a question may be easy to answer if the client is talking about board-level legal strategic genius, but far less so if they are talking about day to day legal matters that they just need to get done.

The answer seems to be that the first thing law firms need to do is identify what a GC of a certain client means by value – as for each it may well be different, and then make every effort to provide that and prove it. For some this may well be related directly to cost, or it may be the assurance of having a famous or respected legal brand advising them. To others it may mean something else entirely, perhaps the long term impact on the company's litigation case load? For others it may be the ability to show strong project management skills, budgeting and efficient use of human resources. It will vary enormously. The key is that selling a slick service, or that you have X-number of lawyers, or Y-number of partners ranked in Chambers, may not be enough on its own, as now everyone can offer that, or at least enough to undermine your offering and make it seem bland.

4: Multi-Tiered Production

If a firm accepts that it will need to find new means of legal production, make use of IT to automate processes and make use of lawyers in non-HQ locations in order to reduce cost, then a far more multi-tier approach will be needed. The head office may well find they need far less associates in the expensive HQ in New York or London than before. Equally, associates will see increased pressure to divide into different tiers, with performance-based tracks laid out for those heading to the partnership from an early stage and those likely to stay at a process level. For some firms associates falling into the latter category may be employed 'off-centre' and in a lower cost base, or moved there after a couple of years. There could be a range of tiers, from HQ, to onshore process teams, to offshore paralegal and LPO-level work. All of these different tiers could still be owned by one partnership and marketed as one offering to clients that appreciate a quality 'one stop shop' with different capabilities.

Chapter Seven: New Models

1: The New Model

Will the impact of new means of production, new forms of relationship and new pricing structures lead to today's top law firms creating a new model? Yes, but this new model will not necessarily look so different externally. Partners will continue to be the owner-managers of most of the world's leading firms and they will keep up their strong focus on boosting PEP and excellent client service. There will be leverage that will support a volume of work and IT will help these lawyers to do their job, rather than replace them. The facade of many firms will be the same, but internally they will be different. We are likely to see:

- Even tougher performance demands on becoming and remaining an equity partner. Management will move to make exiting a partner far easier and faster[52]. Although the ability to bring in new clients will remain important there will be an increasing reward for developing existing clients and deepening relationships. Truly original legal skills and practice innovation that make the firm's offering more valuable will be especially rewarded. The equity will be for those who can be creative or long-term client-developers and not just a reward for service or for one or two years of big billing.
- Despite the challenge of using salaried partners their use will continue as firms demand a tier of 'middle management' that can service day to day, fixed-fee needs of clients and manage processes. However, performance criteria here will also be toughened up and it will cease to be used as a space inside law firms for dumping de-equitised partners, or those that just don't 'fit'. Rather it will be carefully populated with those senior lawyers whose skill-set best aligns with daily service needs. Such skills will include superior IT and project management expertise. Few may seek, or perhaps should, proceed to equity status. However, remuneration will match their value to the client.
- Greater diversification of leverage, with more pronounced tracks and specialised training, for those seeking to become equity partner, salaried partner, or remain process-focussed associates. The use of performance-based pay and far tougher advancement metrics will reinforce this, effectively making it a self-selecting process. There will also be diversification of location of leverage, with those destined to remain in process work operating from lower cost sites, or there will be greater use of outsourcing.
- While some firms will reduce leverage to focus on value-added work, others will expand leverage to capture commoditisable work. However, even value-focussed firms will need a means of handling the commoditisable elements of their deals.
- Firms will invest in project management experts, perhaps non-lawyers, who can improve a firm's billing, IT and process practices. While they may not negotiate directly with GC, they will be an invaluable support to client-facing partners as they calculate and plan the best ways of delivering the service clients want, at a cost the firm will still manage to make a profit on.
- The larger law firms will continue to move toward having less clients, but more valuable and more co-operative relationships with those clients. Such interaction will coincide with greater use of service agreements, tighter panels, more fixed fees, and sharing IT and knowledge management systems with clients.

Overall, we would say that this is a new model, although it should perhaps be seen as a 'next generation' law firm that has evolved from today's law firms to become 'the new normal'.

[52] Using performance metrics will also become especially important due to the challenge of age discrimination legislation.

2: Virtual Firms

Virtual firms have been around for some years, mainly since improved IT allowed them to exist in the late 1990s and early 2000s. But, we may be seeing more of them in the future as clients seek high value expertise without the extra costs that larger law firms add to their bills. In a virtual law firm the office has gone, at least apart from a small administrative and HR centre. In many cases, the leverage has gone too, with virtual firms having a tendency to be dominated by partners, or at least those lawyers capable of autonomous action and client service.

A virtual firm therefore:

- Massively reduces overheads because there is no office, or just a small IT and HR centre, and very little support staff or leverage – the greatest cost elements for any lawyer.
- Greatly increases the ability of the firm to reduce its billing rates to clients – or to keep more of the margin as profit.
- Would be best suited for value-added advisory work where process work is not the focus of client demand.

A virtual firm should not be confused with a legal 'agency', whereby lawyers are sent out to jobs to work inhouse wherever and whenever needed, acting more like contract lawyers. A true virtual firm is not an agency, it really is a working partnership operating externally to the clients, it just does not invest in property, junior staff, or other fixed costs.

Some may dismiss this as a fad – just as tele-working was predicted as 'the future' in the 1990s[53]. But, there do seem to be more lawyers 'going virtual'. Such firms include in the UK: Keystone Law, Lawyers Direct and Excello Law. In the US there are also, among others: Axiom, Rimon Law Group, Virtual Law Partners and FSB Legal Counsel. The latter firm explains the strategy on their website[54]: "FSB put the traditional law firm structure in a clean room and dismantled it. This new law firm 2.0 model discards costly inefficiencies such as expensive overheads, inexperienced attorneys, and the multi-layered approach to delivery of services." This model does seem to have many positives, although its lack of leverage may deter clients from using it for major transactional deals or those with plenty of process work. However, there is no reason why such virtual firms cannot team up with other firms, or outsourcers, to handle that process element. Such an approach, given appropriate management by partners, could result in considerable cost benefits for clients and make virtual firms far more prevalent in the future.

3: Specialist Firms

We may see an increase in niche or specialist firms. These may see partners with a particular expertise banding together to offer low-leverage, super-high value work to clients that appreciate quality advice, and enjoy not having to work with a large, inefficient legal provider – at probably higher prices. Also, at least in the UK, because of the Legal Services Act 2007[55] we may see such partners also joining together with barristers, or other expert professionals to form high-level advisory businesses. Although there has been a tendency for such niche firms to focus on non-core issues such as

[53] Despite tele-working not becoming the norm, many businesses continue to make use of it. Professional service firms are especially suited to this style of working as professionals do not always need to be in the office and can come into a 'HQ' only as and when needed, greatly reducing overhead costs for the business and commuting time for staff.

[54] www.FSBlegal.com.

[55] The Legal Services Act 2007, has allowed some non-solicitor professionals to become partners in law firms as long as they remain under 25% of the partnership, these are termed Legal Disciplinary Practices (LDPs). However, it is planned that from October 2011 licences will be granted for Alternative Business Structures (ABS) whereby non-lawyers may own and operate law firms. While, from 1 April 2010, the Bar Standards Board of England & Wales permitted barristers to work together in partnerships and become 'managers' and 'shareholders' in LDPs.

IP, or professional liability, there is no reason such niche firms could not take on corporate and finance work too. Leverage could be brought in, as and when needed, via relationships with law firms or outsourcing companies that can handle the process work of such deals. With a renewed focus on proving value, clients may well find such advisers appealing, who would not be 'cheap', but equally would not carry many of the costly overheads a large law firm would today.

4: Non-Lawyer Ownership

One likely source of new models for the future delivery of legal services will be the UK's Legal Services Act[56]. If there was ever a time to reinvent the law firm from scratch then it is now. Although it should be noted such opportunities are not currently available in the US due to local bar rules on non-lawyer ownership. The Act offers everything from multiple professions partnering together, to external investment and non-lawyer ownership of legal providers. What would such new models entail?

- These 'firms' will be purpose built to serve a very specific and well-targeted client base with a precise set of practices.
- Technology and lean staffing will be paramount. These providers will be focussed on cost reduction, fixed fees, process management and maximum use of IT for internet-based interfaces, document formation and product delivery.
- The value proposition will not be in the firm's legal genius but in its speed, cost-effectiveness, responsiveness and use of IT, as well as its brand.
- There is no reason why a client that uses an LPO, or has a service agreement with a large law firm, would not also look to a 'new entrant' to handle, for example, all of its finance documents, or all of its M&A due diligence.
- The aim will not be to distribute the maximum possible earnings back to the senior lawyers that work there as partnerships do today, but rather to re-invest significantly each year to grow the business and expand market share. Significant sums may also be spent on advertising to build the brand.

Another aspect to the Legal Services Act is law firms will be able to take private equity capital to go on a growth surge or invest in the latest IT they could not normally fund. Polls suggest there is interest among UK firms[57] for external investment, however the challenge will be to match the return on investment that private equity would demand.

[56] Of course, solicitors in the UK and lawyers in the US, often forget that barristers, the advocates of the English & Welsh legal system, are not usually partners. They usually share the costs of chambers but remain self-employed. However, in 2010 rules were changed to allow barristers to form partnerships, although it is expected few will take this up due to conflict issues (see above).

[57] The Lawyer, 3 May 2010, "A survey by Vantis in association with the Managing Partners' Forum (MPF) revealed that 88 per cent of managing partners and senior partners think firms will take advantage of the new opportunities for external investment".

Conclusion

Despite a number of vested interests saying otherwise, the lawyer-client relationship is changing. That some lawyers and GC say that nothing significant is happening is understandable. GC that have not moved with the times, that prefer the simpler, less pressurised environment of not worrying about the costs they are racking up, clearly don't want to listen to more progressive GC who seek to redefine how clients purchase legal services. Equally, some law firms believe change can only hurt them, even if such views may be counter-productive in the future. After all, up to the crash of 2008 things were going very well for equity partners, seeing their take home 'pay' rise year on year by leaps and bounds. Inefficiencies in the system have favoured them, even if not intentionally, so too have former billing methods and clients' apparent unwillingness to 'push back'.

While it suits some GC and law firms to believe this is all a fad, it also suits some people to say that the legal world now operates under different rules and only their 'new' ideas make sense. We would say the legal world's rules will stay the same, but behaviour will evolve. Fundamentals don't change – the challenge is not to forget this even when the market heats up, or crashes. What we are seeing is an evolution in the sophistication and awareness of the clients and a corresponding threat and opportunity for law firms to respond. There are also new production methods developing, such as offshoring and better use of IT that will have an impact. These 'changes' have been a long time coming and have an inevitability about them that mirrors the 'industrialisation' of business processes around the world.

To put it simply, legal bills have risen in gross terms to the point where companies have 'taken an interest' and naturally seek more efficient, modern, means of delivering their legal needs. This has also meant greater scrutiny of the value delivered, the price of that 'value' and the overall workings of the relationship with external lawyers. Why this didn't happen before was again simple, the figures involved were smaller and the pressure on GC was not there. Many GC went along with the status quo because there was no need to change. As one GC of a global bank told us: "We have been utterly complicit in all of this." But, times change.

GC that fail here will probably not be in their posts in the years to come. Law firms that refuse to budge on time-based billing, or reject transparency on what is clearly commoditisable, who prefer a 'hit and run' transactional relationship to one of long term partnering, may suffer. Some firms, no doubt those that focus on the highest-end, most specialised work, will be more immune than others. Equally, those firms that manage to innovate fast and far enough to compensate for the reduced margins they will experience on standardised legal products, will also cushion the blow, and may get far ahead of their competitors.

Fundamentally, all those within the legal sector need to see what is happening and prepare for change in how they do business. Whether it be in terms of the new models we considered above, or investment in technology and new production methods, there will be important structural and strategic decisions to be made that will have a lasting impact on both the clients and the law firms. Having a strategy in place for these changes may not protect you from all the challenges ahead, but it is surely the best place to start.

Appendices

Appendix A: Legal Spend

Company	*Turnover*[58]	*Net Profit/(Loss)*	*Net Profit Margin*	*External Legal Spend*	*% of Turnover (Approx)*	*% of Profit (Approx)*
RBS	$44bn	($2.9bn)	(Loss)	(Total spend $304m)	NA	NA
Novartis	$44bn	$8.4bn	19.1%	$250m (average)	0.6%	3%
Motorola	$30bn	($4.4bn)	(Loss)	$150m (estimate)	0.5%	NA
Microsoft	$58bn	$14.6bn	24.9%	(Total Spend $900m)	NA	6%
Virgin Media	$6bn	$213m	3.7%	$10.5m-$15m	0.2%	6%
Bloomsbury Publishing	$131m	$11.6m	8.8%	$150,000-$300,000	0.2%	2%
Cisco	$36bn	$6.1bn	17%	$80m	0.2%	1%
Rio Tinto	$44bn	$5.3bn	12%	$90m	0.2%	2%
BT Group	$32bn	$372m	1.2%	$60m	0.2%	16%
Aegis Media	$2bn	$96.3m	4.8%	$2.3m	0.1%	2%
Premier Foods	$4bn	$37.8m	0.9%	$4.6m (average)	0.1%	12%

Table A: Indicative Snapshot of Legal Spend vs Turnover and Profit[59]

The table above is a rough estimate of what companies spend on external legal needs, in relation to the turnover and the annual profit. As can be seen, the legal spend is a small percentage of the turnover, around 0.3% to 0.4% as a median figure.

The sums involved though are not small and run into the hundreds of millions for some of the world's largest businesses. Even for smaller ones the sums are still significant, especially if one considers legal spend as a percentage of the profit. This is doubly important for those businesses that have a relatively small profit margin, such as 5%. As can be seen, some companies are spending the equivalent of over 10% of their profits just on law firms. Or to put it another way, consider how much a company's profits could be improved if they could reduce legal spend.

Although the above figures need to be taken with a pinch of salt, they still indicate that legal spend is 'noticeable', at least if one is prepared to look at it, as many Finance Directors now are.

[58] All data for 2009, apart from Motorola which is 2008. Please see Disclaimer.

[59] All data taken from The Lawyer and Legal Week, as well as company reports. In some cases it was not certain whether spend data referred only to external legal spend, or total legal spend including the inhouse function, therefore these figures should be seen as indicative, rather than precise. Please see Disclaimer.

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