



Legal Strategy 101: It's Time for Law Firms to Re-think Their Business Model

Published : April 29, 2009 in [Knowledge@Wharton](#)

The global financial crisis is reshaping many businesses -- and tradition-bound, top-drawer law firms are no exception. While the legal industry had begun to face the need for change before the current economic downturn, the crisis is accelerating trends that will alter the structure and operations of law firms going forward.

The sudden lack of liquidity has led to a dearth of transactions, killing demand for many legal services. At the same time, clients facing their own financial pressures are increasingly scrutinizing budgets and demanding more value for their legal expenses.

In the short term, firms are laying off lawyers and support staff, delaying new hires and, in some cases, closing their doors. Fundamental characteristics of the industry are also being called into question, including fees based on billable hours and the partnership structure of law firms. "There were signs before the crisis that the business model had to evolve. The crisis is just making it more urgent," says Wharton management professor [Olivier Chatain](#).



This is a single/personal use copy of Knowledge@Wharton. For multiple copies, custom reprints, e-prints, posters or plaques, please contact PARS International: reprints@parsintl.com
P. (212) 221-9595 x407.

The sudden and steep drop in business has been particularly hard on law firms because of their structure, according to Chatain. A typical law firm is owned by its partners, who are supported by the work of many associates. Law firms refer to the ratio of partners to associates as "leverage." In good times, the arrangement produces strong profits, but when revenues fall, highly leveraged firms can find it particularly difficult to sustain all those associates. As a result, if revenues at a law firm decline 10%, profits can fall 30%, Chatain says. "These firms are very sensitive to downturns. [Because] the partners have to break even every year, they have to do immediate cost-cutting to make sure they adapt their overhead and expenses."

In response, firms have been forced to take harsh measures, says Robert J. Borghese, a Wharton lecturer and principle of the Borghese Law Firm with offices in New York and Philadelphia. "Most large firms are leveraged up for big deals. With no big deals coming through the door, there's not a lot of work for associates so firms have to delever [cut] employees. There's definitely going to be a sea change in the law industry as a result of the credit crisis."

Beyond staffing, Borghese says firms face pressure from clients to move away from a payment model based on hourly rates. "Billable hours will always be here, but you will see more of a movement toward retainers and fixed fees."

GE's Online Auction

More clients these days are trying to negotiate flat fees for services so they have a better sense of what their legal expenses will be upfront, says Chastain, adding that the industry has not always relied on charging by the hour. Prior to World War II, a fee based on hourly rates was the exception in legal pricing. Clients "want to have more value for their money, and that means the hourly rate may not be the best way to set prices. This is something law firms are not comfortable with. The whole model with many associates working for the partners is predicated on associates billing a lot of hours."

While the financial pressure on law firms is now acute, Chatain says the industry faces more challenges over the long term as clients begin to pay more attention to the value they receive from their lawyers. Some clients have become more aggressive in pitting firms against one another. For example, in the

United Kingdom, General Electric staged an online auction process to select legal representation.

In the United States, the Association of Corporate Counsel (ACC), which represents in-house lawyers who typically hire outside law firms for specialty work, has introduced a new set of [guidelines for law firms and corporate counsels](#). The guidelines are designed to make both sides work to keep costs in line with the value of the legal services provided, while assuring a fair return to law firms. The arrangement is similar to the types of agreements made famous by Japanese automakers and their suppliers that create value throughout the supply chain. The suppliers, in this case law firms, agree to provide their services at a fair cost, though perhaps not necessarily the lowest cost, and client companies agree to provide a steady stream of business.

The ACC also has drafted a [sample covenant](#) for companies to share with their legal providers that outlines specific steps the two sides could agree to take. For example, the covenant calls for clients to define objectives in the engagement, pay bills promptly and understand that budgets may need to be revised for unforeseen events. Law firms would agree to learn the client's business and strategic objectives, give honest feedback on whether the client's objectives in a matter are realistic and attainable, and use appropriate staffing to pursue a case.

Susan Hackett, general counsel of the ACC, says the new approach to value is necessary because law firms had become so expensive that their fees often outstripped the value of the problem they were brought in to resolve. "You can have many lawyers and paralegals all billing on a matter worth \$50,000 of exposure adding up to a grand total of \$250,000. That's crazy."

According to Chatain, the traditional model was designed to provide clients with top legal advice because of the brutal winnowing out of associates along the path to partner. Anyone who made it to partner was likely to be extremely talented and hard-working. In recent years, however, he says younger lawyers have been less interested in the traditional route because of the long odds and personal hardships of becoming a partner, diminishing the likelihood of getting the best and brightest at every step of the process. "There's a concern that maybe it's getting harder to keep the best employees within the firm. These trends were there before the crisis; the crisis is only making it worse."

In-house Legal Staffs

According to [Stephen Burbank](#), a law professor and former general counsel at the University of Pennsylvania, the legal profession has been slow to innovate, but is now beginning to explore new business models.

In recent years firms have experimented with outsourcing legal work to India and other low-cost countries, but that strategy has not been very successful, Burbank says, adding that companies are turning to "in-sourcing" -- or building up their own in-house legal departments -- to do work that had been done by expensive outside firms. He points to Cisco and the Ace insurance group as examples of companies that have created large, multidisciplinary legal departments handling everything from regulatory matters to environmental issues.

In-house departments, adds Hackett, can use less expensive employees to do some routine work, such as creating files or managing documents that do not require the specialized skills of a high-priced lawyer.

Chatain says another emerging model is the "virtual" firm, which acts as an intermediary between clients and lawyers who have left big firms in order to work on a freelance basis. An example is Axiom Legal, a New York based company that hires lawyers for temporary assignments. Axiom clients include Google, Dow Jones, NBC and General Electric.

Axiom lawyers used to work in big firms and are well-trained, but didn't want to join the "whole rat race," according to Chatain. The clients receive service similar to a major law firm at less cost. "Almost everyone is happy," says Chatain, except for the traditional law firm, "which is unhappy because it actually trained the lawyers."

Burbank says law firms are hampered from creating innovative business structures by their own regulations that prohibit anyone who is not a lawyer from owning shares in a firm. He argues that this rule, supported by the American Bar Association and state supreme courts, which oversee the regulation

of law firms, has protected firms from competition, but also stifles innovation by denying firms a way to offer more flexible services at lower cost. This prohibition has kept law firms from being able to tap the venture capital or equity markets, leaving them dependent on debt financing, which has been difficult to attain in the current environment.

Non-lawyer Ownership of Firms

Meanwhile, law firms in Europe and the United Kingdom are now undergoing a period of rapid deregulation following passage of Britain's Legal Services Act of 2007, which allows for alternative business structures and non-lawyer ownership of firms, Burbank notes. "It is quite conceivable that within 10 years, you will have a largely deregulated legal profession in the U.K. and Europe. Given the phenomena of globalization, it's hard to imagine this won't put incredible competitive pressure on large American law firms."

Chatain has researched the effect of competition on law firms in the United Kingdom in a paper titled "[Extracting Value From Client Relationships: Expertise and Client-Specific Scope Economies in the UK Legal Market.](#)"

Burbank is participating in a project supported by the University of Southern California's Gould School of Law to encourage research into innovation in legal organizations and business models. [The Southern California Innovation Project](#) (SCIP) has already identified several key areas in which law firms might initiate change. They include pursuit of growing lines of business for lawyers, such as the regulation of privacy issues and of fields with extreme uncertainty -- including nanotechnology and biotechnology.

Aside from plaintiff's lawyers, Burbank says, most lawyers are not entrepreneurial by nature and have long been shielded from competition. "They have a monopoly, and that is how they have survived."

He points out that the regulation, in part, protects individuals from dishonest or unprofessional lawyers. However, he argues that the regulations should be tailored to the type of client being served. "Individuals need more protection against their lawyers than a sophisticated corporation," Burbank states. "We don't have that flexibility and every time you make a proposal for fundamental change in the regulation of the legal profession some lawyers come out waving the flag of the individual. They may have the best motives in the world, but the result is that law firms have little incentive to innovate."

Joseph Ryan, an adjunct professor of management at Wharton who teaches in a specialized management program tailored for Reed Smith, the international law firm headquartered in Pittsburgh, says law firms need to learn to think strategically. Partly because of the nature of their work, law firms tend to be focused on the problem at hand, rather than larger strategic goals, he suggests. "The way a lawyer sees things is more analytical than synthetic. They don't connect the dots."

Ryan says that with today's new financial pressures, law firm managers must think beyond individual transactions and build deep relationships with clients to anticipate their needs rather than reacting simply to cases that arise. He suggests that other service firms, such as advertising agencies and consultants, have done a better job of relating to their clients in this way.

Beyond Rainmaking

Law firms also tend to celebrate individual rainmaking partners, but no one individual can supply the kind of comprehensive service today's clients demand, Ryan adds. While "rainmaking is virtuous," he says, "strategic account management is a team game. The question is how do you let the rainmaker continue to grow the business and discover the needs of the client, but integrate other people from the firm into the team?"

Ryan cites three levers to building strategic thinking into a law firm. The first is defining a process for allocating resources which could result in more effective collaboration across practice and geographic areas. A second lever is clearly articulating the firm's competitive advantage and value proposition. The third is developing an honest assessment of talent within the firm and making the most of that talent.

Mark Dembovsky, a London-based partner at Reed Smith and the firm's chief strategist, worries that the current crisis and its drastic staff reductions may prevent firms from building practices that will be

sustainable into the future. "I see the lemming principle [at work]. There is a lot of panic and, to me, that's a big worry because what happens in a year's time when the market turns around and firms must recruit? It takes a while to build up your practice. Those law firms that have the guts to do it are using this opportunity to build up certain practices that they might not have otherwise done because of the competition for lawyers."

Despite his concern that firms may be overreacting now, he agrees there is no question that law firm management must learn to think and act more like corporate business leaders. He says part of the problem is that in the current law firm structure, most partners serve many functions, in addition to providing legal expertise to clients.

The partnership structure is a plus for firms because it creates a collegial environment, Dembovsky suggests. But unlike a corporation with professional managers, a law firm's shareholders -- its partners -- are also expected to run the business day-to-day. "Therefore, they have great difficulty letting go and allowing other people to take on responsibility for finance or strategy or human relations." In many firms, he notes, the highest fee producing lawyer is viewed as a good lawyer and is automatically chosen to run the practice group, whether or not he or she is an effective manager.

Only in the past 10 years have law firms begun to think about bringing professional managers into parts of the firm which are often run by committee -- without an individual responsible for directing any part of the business. The challenge for law firms, he says, is to find a new way to introduce professional lines of responsibility and management without destroying the firm's collegial and consensual nature -- which inspires trust and, in the end, benefits clients.

"One mustn't knock the partnership structure," he says, "but one needs to see how to build on top of that structure to maintain the positive elements of a partnership with the positive elements of a well-run corporation."

This is a single/personal use copy of Knowledge@Wharton. For multiple copies, custom reprints, e-prints, posters or plaques, please contact PARS International: reprints@parsintl.com P. (212) 221-9595 x407.