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Square pegs, round holes: Does the traditional law firm business model fit the needs of clients, or even most lawyers, anymore?

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JUNE 2017

In industry, where a competitive edge is crucial and often achieved through economies of scale, one business stands out as contrary to this basic principle: the law firm.

Generally speaking a law firm — the traditional provider of legal services — becomes increasingly less efficient, less productive and consequently provides less value to a client the larger it gets.

In such firms, high overhead costs and layers of service providers combine with a systemic drive to produce revenue based on leverage. This creates a breakdown of the service delivery model and the client loses. In spite of this fact, nearly 47 percent of the legal spend on outside law firms goes to the AmLaw 200 firms, according to ALM Intelligence.

There are some legitimate arguments for why a significant portion of legal work remains with BigLaw. Some complex international matters require coordination of lawyers across a wide number of jurisdictions. Other matters demand highly specialized knowledge, often in the regulatory context.

Certain litigation or enforcement actions may draw the attention of the public markets, which may find comfort in the familiar name of a large law firm (certainly the board of directors and the general counsel do).

In those instances it is often understandable for the client to pay a premium to be represented by such firms.

However, the majority of work performed by most large law firms does not fit within the categories mentioned above and can be performed by other legal service providers who may offer a more competitive value package than a large law firm.

What is it about BigLaw that can have a negative effect on the client experience and value proposition? Let's start with Law Firm Economics, Business and Politics 101 (a course every law school should teach).

A law firm is a collection of people who work together, most often with the business goal of earning a profit. The law firm has what are known as "fee earners," those who provide their services to the clients in exchange for a fee. The fee earners fall into a few traditional categories: paralegals, associates, of-counsel and partners (nonequity and equity).

Simple enough, but here is where it gets more complicated.

Fee earners are people with only so much capacity in their workday. At the ends of the spectrum, but most especially at the top end, the fee earners are paid in stark disproportion to their own productivity.

So how does that work? The answer is leverage. Those who are at the lower to middle levels of compensation need to drive significant amounts of revenue to generate the profits that flow to the top end.

What I just described is the Economics part of the course. The importance of this as it relates to the client experience is exacerbated by the Business and Political elements.

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The culture (politics) of BigLaw has changed dramatically over the last 10 years. The artifacts in the display cases at the Museum of Old Law are lock-step partner compensation, succession planning with meaningful benefit to the retiring partner, promotion of associates to equity partnership, loyalty of partners to a firm and from a firm to its partners, and even of clients to a firm.

What this creates is a business environment in most law firms where lawyers who control "books of business" that keep others busy have the ability, and are indeed encouraged by the market, to move their practices to firms that are offering a better deal. Ninety-four percent of firms stated last year that they intend to grow their firms by hiring lateral partners.[1]

The impact of this is that to retain the star partners, firms have to pay them more. The ultimate scorecard for this metric is the AmLaw 100 Survey that measures revenue per lawyer and profits per partner.

In a business where increased size leads to disproportionally increased overhead cost and overall inefficiency, the only way to climb this ladder is to get more revenue out of the fee earners and share profits with fewer partners.

In practical terms this means thrusting as much work as possible onto those whose cost (compensation plus overhead) is proportionally less than their level of fee charged to the client,

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hence profit. In most of the BigLaw firms, that means paralegals, associates and junior partners. It also means driving up the rates of midtier partners while paying them proportionately less.

One cannot lose sight of the fact that the most junior of these associates are earning first year base salaries of $180,000 and the average billing rate of a first year associate is about $350 per hour.[2]

Senior associates and junior to midlevel partners are not paid proportionately more, yet their hourly rates are more than twice as much with a much higher realization rate.

Top partner rates have exceeded $1,500 per hour, though one could easily argue that a few hours of regulatory advice from a leading practitioner is well worth the fee.[3] Note as well that some of those high hourly rate regulatory lawyers are also not compensated in proportion to their fees earned.

The ultimate question for the client should be: Does this model drive value for me in most of my legal service needs? I would argue that it does not.

A related question should also be asked by BigLaw partners who are not among those who control large amounts of business, and who run the risk of losing the clients they have because of the firm's pressure on them to increase their billing rates, i.e., profitability: is this a business model that fits the needs of my clients and provides them with value? Likely it does not.

So what is happening in our industry to address this problem? There is an interesting disconnect between what in-house counsel believe is being done by firms to provide innovative solutions and what law firm leaders believe is being done.

In the most recent Altman Weil Chief Legal Officer Survey for 2016, in-house counsel were asked "In your opinion, in the current legal market, how much pressure are corporations putting on law firms to change the value proposition in the legal service industry (as opposed to simply cutting costs)?" Over 70 percent of those surveyed responded that the pressure was "moderate to intense."[4]

Chief legal officers were asked a related question: "In your opinion, in the current legal market, how serious are law firms about changing their … service delivery model to provide greater value to clients (as opposed to simply cutting costs?" Nearly 85 percent said "moderate to not at all serious."[5]

Contrast this with law firms' response to a 2016 Altman Weil survey titled "Law Firms in Transition."

"In your opinion, in 2016 how serious are law firms about changing their legal service delivery model to provide greater value to clients (as opposed to simply reducing rates)?" Nearly 60 percent of the law firms responded that their efforts were "serious to doing all they can."[6]

Notice any inconsistencies? Clearly, law firms need to step up their game in this regard.

Some clients are attacking the problem by attempting to manage how law firms staff their matters and charge for ancillary services. Outside counsel guidelines now frequently state that clients will not pay for first year associates, internal meetings, legal research, secretarial overtime and other items that they believe rightfully belong to a firm's overhead cost. Others are attacking the problem by requiring discounted rates.

The ultimate question for the client should be: Does this model drive value for me in most of my legal service needs?

While these are useful tactics, they are not a strategy and they do not address the systemic problem of how to achieve value from a service provider that is not efficiently structured, and whose business model directs profits to a select few and does not drive value to the consumer of the services.

The reason for this is that the general law firm response to guidelines that shift revenue producers to overhead has been to raise rates — net-net, not a great result for the client (or even some of the lawyers).

There are a few trends that are worth watching: alternative fee arrangements, increased amount of work being brought in house, increasing reliance on technology and legal process organizations, and finally, the rise of smaller firms as legitimate alternatives to BigLaw.

Alternative fee arrangements come in all shapes and sizes. At their core, they are an attempt to move a firm away from charging an hourly rate for its services. The goal of an AFA (or as I like to say, an "appropriate fee arrangement") is to measure a service's value against a desired result rather than a time and materials approach.

AFAs have done a lot to modify how a firm manages a representation. Structured properly, an AFA will encourage a firm to marshal its resources in the most efficient manner to achieve the best result.

As a simple example, a fixed fee arrangement may well be handled exclusively by a senior partner with a paralegal. Rather than employing leverage, the firm is able to achieve profit by expending a relatively small amount of targeted and efficient resources to handle the matter with fewer hours, but at a higher rate of return.

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The client is happy as the overall cost is predictable, potentially less, and if managed well, the product is likely of higher quality.

The increasing trend of AFAs is already having an impact on BigLaw. We are seeing regular incidents of firms shedding attorneys at all levels, but particularly in the associate and nonequity partner ranks. This follows years of reduced hiring for first-year associate positions.

While the demographics of BigLaw are slowly beginning to change, significant difference will take a generation or two at firms whose ability to dramatically restructure their entire business model is akin to turning an aircraft carrier.

Bringing work in house has been on the uptick over last few years, with nearly 40 percent of in-house law departments surveyed responding that they expect to continue to increase their in-house lawyer workforce in the expected incoming year.[7]

This pendulum swings every decade or so, and other than taking primarily commodity work away from outside law firms, does little to dramatically change the landscape of the law firm legal service delivery model.

Chief legal officers surveyed by Altman Weil also anticipated an almost 15 percent increase in their use of legal technology and legal process organizations.[8] Yet, these events do little to dramatically change the nature of the economic structure of BigLaw's business model.

There is an interesting disconnect between what in-house counsel believe is being done by firms to provide innovative solutions and what law firm leaders believe is being done.

One of the more interesting, and I would argue sustainable, changes to the legal service industry is the emergence of the boutique and midsized firms as alternatives to BigLaw.[9]

There still are not many of these firms that have the ability to compete for the work normally handled by BigLaw, but over the last few years there are a number of firms that have been started by former BigLaw partners with the intention of creating a high-quality and efficient alternative for sophisticated legal work.

Over 48 percent of large firms surveyed stated that they view nontraditional firms (which include boutiques firms, AFA firms and partner-only firms) as a potential threat to their business.[10]

Structured properly, these firms with lower overhead and nimble management can drive value to their clients. These firms are not burdened with legacy compensation structures that require extensive use of leverage. They can effectively implement AFAs and can use technology for even further efficiencies.

For clients, there are other advantages to using a smaller firm that may not be readily apparent. Generally a partner will directly work on a client's matters. As experienced practitioners, these partners are likely to be of high quality, and can be efficient and responsive.

The partner you hire is the partner you get and your business is likely to be greatly valued by that partner and their firm. This should result in a pleasant, highly serviced customer experience.

There also are advantages for attorneys. BigLaw's challenges in implementing change, combined with the market forces discussed above, are "encouraging" high-quality BigLaw partners to leave their larger firms and join smaller firms.

This is particularly true for the lawyer who is no longer a good fit in the BigLaw model. Who is that? It is generally a skilled practitioner who has a decent client following, but does not have blue chip institutional clients that keep teams of people occupied with matters that arguably should be serviced by BigLaw.

Often this lawyer is a younger partner who is looking to expand their client-base. Unfortunately such attorneys are under pressure from their firm to increase rates or reduce their compensation (that is, increase profitability), and face pressure from their clients to decrease their rates or at least hold them steady. This challenge is compounded by the fact that their work cannot justify their high BigLaw billing rates.

These lawyers are literally being squeezed out of their firms because they are not as profitable as the firm needs them to be to maintain their AmLaw rankings.

The logical fit for such attorneys is with a firm that has a lower overhead structure, one that has the efficiencies of smaller scale. In many cases, such attorneys can lower their billing rates, employ creative AFAs, make use of quality associates and support staff at a lower cost, and actually earn more money. Their clients are also happy to have a trusted attorney providing them services in a structure that drives value and creates a better customer experience.

The business of law is certainly changing. While the overall spend on outside counsel is relatively flat, the shift is on to work moving away from BigLaw and toward other alternatives.

The law firms that can firmly and efficiently establish their place in the value chain of the legal service delivery model will enjoy continued success. Others that do not adapt, as we have seen, will merge or fail as market forces continue to mount against them.

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[1] Altman Weil, Law Firms in Transition 52 (2016), http://bit.ly/1U9hRNs.

[2] Frank Strong, *Key Metric: The Current Law Firm Billing Rates by Practice Area*, Lexis Nexis Business of Law Blog (Oct. 27, 2015), http://bit.ly/2tJGCKN.

[3] Claire Zillman, *Some Lawyers Are Now Charging $1,500 Per Hour*, Fortune, Feb. 9, 2016, http://for.tn/2rzzFLO.

[4] Altman Weil, Chief Legal Officer Survey 22 (2016), http://bit.ly/2fZA3kD.

[5] *Id.* at 23.

[6] Law Firms in Transition at 13.

[7] Chief Legal Officer Survey at 1.

[8] *Id.* at 3.

[9] Jacob Fischler, 10 Boutiques Giving BigLaw A Run For Its Money, Law360 (July 8, 2015).

[10] Law Firms in Transition at 5.

This article first appeared in the June 2017, edition of Westlaw Journal Professional Liability.

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