What the New Law Firm Looks Like:

The Necessary Reinvention of a Reluctant Industry

By Ronda Muir, Esq.

RMuir@LawPeopleManagement.com
www.LawPeopleManagement.com
www.LawPeopleBlog.com

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> “Gentlemen, we have run out of money. It is time to start thinking.”
> *Nobel-Prize Winning Physicist Sir Ernest Rutherford*

After a blistering year of record downturns in revenues and profits, law firms have been responding by battening down expenses—eliminating summer programs, reducing compensation and bonuses, delaying the entry of new classes, and cutting their ranks, even of partners. And most law firm consultants continue the tradition of nibbling at the edges of true reform by hawking $20,000 quick-fixes.

But the road posts of cataclysmic change are cropping up everywhere. If you are one of those law firms not averting your eyes, here is what the lay of the future land looks like.

NOT NECESSARILY BIGGER

One of the more interesting developments in the law industry over the last couple of decades is the emergence of the mega-firm. Or what might be called the strange case of the temporary triumph of inefficiency.

"Convergence," the short-hand name of the corporate model for managing outside legal fees by reducing the number of preferred firms, was developed originally in the early 1990s by DuPont and fed the ensuing merger frenzy that has driven up the average size and revenues of the biggest firms to behemoth proportions.

However, the bottom line turns out to be just what industry consultants have repeatedly shown, that there is no relationship between firm size and financial performance. “There are no obvious economies of scale or scope for law firms in a merger, where productivity is largely a result of billings by individual professionals,” an analysis of law firm mergers done by Vanderbilt Law School clearly stated back in 2005.

That conclusion is borne out by the financial statistics kept by Dan DiPietro of Citibank’s Law Firm Group, who said flatly at a recent September 2009 conference that “bigger has yet to prove to be more profitable.”

So if bigger is not necessarily more profitable, law firms can start taking steps to simply get better.

Custom Fee Arrangements

The town crier has been announcing that the billable hour is dead for years now—noting its incentive to be inefficient rather than align with client objectives—but its death knell for at least a portion of legal work may have finally come. Traditionally law firms have priced their services based on a cost-plus-margin model— whatever it costs to make a profit the unexamined way, the client will have to pay. And the clients have paid— 6-8% more every year for the past 10 years. At a time of escalating business demand and a limited supply of newly-minted top-tier lawyers, most firms were able to get away with that. But it is a far cry from the typical business model, which determines competitive pricing and then structures costs so that the target prices can be met.

In place of simply billing whatever hours are spent on a project, billing will be based on different types of services carefully separated out—"unbundled"—so that the cost of delivering those services and client pricing can be individually correlated. Firms will critically evaluate their specific legal service offerings based on a true profitability analysis, determining which services they are equipped to produce at the best overall cost and outcome for the client. And lawyers will develop serious project management skills that focus on evaluating and reviewing client goals (both fee-related and outcome-related) and managing matters to reach them.

While firms have flirted on the edges of these concepts for years, Kirkland and Ellis and other firms are now aggressively announcing forays into these "alternative billing" waters—variously called fixed fees, commodity pricing, outcome pricing, contingent fees, success fees—as clients demand from their lawyers what they are able to get from other service providers—reductions, not increases, in cost over time derived from the provider's experience and business savvy.

In the litigation arena, lawyers will have an incentive to make more finely-tuned cost/benefit analyses that help clients determine how to pursue, or whether to simply drop, a matter, and a new type of legal service—dispute avoidance instead of dispute resolution, or what consultant Richard Susskind describes as "erecting fences at the top of the cliff instead of providing ambulances at the bottom"—will become highly valued.

Specialized Multi-Sourcing

As a result of careful practice analysis and pricing, some legal practitioners in more highly repetitious practices such as trademarks and those firms providing specialized services such as document discovery and review will be able to streamline their work processes so as to offer comparable or greater levels of competence at lower rates than their competitors. Some of this work firms will therefore lose to these providers, whom clients will find directly. But your firm could also maintain relationships (either as clients or owners) with a number of these specialized firms for those clients who want to take advantage of your connections and experience and/or who want to make your firm responsible for delegating and oversight, in either case giving you another source of fees.

The analyses of a firm's best value offerings will drive not only its practice and role vis-à-vis other firms and vendors, but will impact its partner/associate mix and tiers, its definition and use of various partner and non-partner "tracks," non-lawyer staff needs, and therefore hiring.

Variable Attorney Staffing Levels

Some consensus has recently arisen on the advisability of using fewer young associates. Savvy General Counsel have forbidden their inclusion on client teams except perhaps with a weighted average billing cap. That client avoidance coupled with the rising cost of associate salaries has driven up the period of time until associates become profitable from less than two years only a decade or so ago to over four years. Young associates have effectively become loss leaders to a firm's hopes for eventual talent dominance, in spite of bouts of raging attrition and lateral free-for-alls. Those associate expenses make it vividly apparent that even high-entry-cost technology that makes a firm less dependent on young associates can be much more cost-effective in the long run.

The advantages of higher leverage were always in question—the most profitable law firms have consistently used lower leverage than the average—and the sudden onset of low market demand has once again made the disadvantages apparent.

But those discussions of leverage are part of the past. The numbers and types of associates that work for the new law firm will vary over time and at any given time depending on the litigation and corporate caseload being managed by the firm, what specific role the firm has been hired to play in each matter—big picture strategizing vs. due-diligence review of reams of documents, for example—and how much of that work the firm performs in-house or outsources to third-party or captive providers.

Because legal work will be more unbundled, and firms hired by a client for a very narrow part of a matter, the firms will in turn hire associates for specific terms at specified hourly or project rates with negotiated notice, confidentiality and separation provisions. Firms will no doubt develop a reliable stable of these contract-type lawyers with respect to a number of types of expertise and will also maintain relationships with outside "temp" providers whom they trust. Conflict rules will be modified (similar to the recent modification of conflict rules with regard to lateral hires) to recognize this new reality. The use of paralegals and other highly trained non-lawyer staff will rise, from which clients will benefit and which law firms may be better able to leverage financially.

When it comes to firms landing and keeping long-term "keepers," the informal free agent system that has been developing for laterals will morph into highly negotiated pay-for-play arrangements with all incoming lawyers, arrangements that firms will have to revisit frequently in order to offer clients the expertise needed to stay competitive. Depending on a firm's needs and approach, these desirables may either be freshly minted law graduates or, more likely for most firms, lawyers who are more seasoned. Associates will build their resume with an eye to what will make them most attractive to the type of practice they are ultimately gunning for. Gen Y's goal of a truly portable career will be realized.

Limited Real Estate

Bigger firms may still want to retain or have access to conference rooms and computers in several spots around the world, but the days of setting aside 150+ square feet on a year-round basis for every one of the firm's attorneys are as good as gone. The surprise to Boomers may be how okay Gen X and Y is with that: they are used to setting up shop wherever there's WiFi, and the flexibility of working when they want to—during the wee hours, while the baby sleeps or through a snowstorm—is tremendously appealing to them. Office intranets, PDAs and remotes will keep everyone virtually connected, so work product should still benefit from the same workplace input as in the old chained-to-the-desk scenario.

Heightened Practice Group Management

Achieving a firm's standard of excellence in different practice groups may well require the hiring, development, application and delivery of very different skills. Firms will decentralize aspects of management so that practice groups are managed as small businesses with unique requirements and standards rather than as a cog in a large, standardized whole.

Hiring and compensating associates differently based on which department they join is already becoming fairly well established. Requisite skills can vary widely. Some practice groups, such as banking and regulatory groups, have work that is more susceptible to routinized production than others, while M&A work, for example, continues to require more personalized and personable legal attention. Non-lawyer staffing requirements for different types of practice are also often radically different.

Merit-Based Compensation

Lock-step compensation will also be a thing of the past: being another year older makes you just that—not necessarily a better, more valuable lawyer. But "merit-based" compensation begs the question: compensation based on which merits?

For associates, merit is likely to mean achieving competencies that the firm, or more specifically the practice group, values in practice skills, such as being able to draft a complaint or conduct a deposition, and in professional skills such as mentoring or leading. Generating realized revenue—whether through origination, billable hours or success fees—will also continue to be rewarded.

For partners, fairly similar factors will likely be part of the compensation consideration, and if a firm is smart, it will also compensate partners (and associates) for involving other appropriate lawyers in a client's matters and for realizing client cost efficiencies. Involving other lawyers increases the likelihood of a client need/lawyer expertise match, reduces exposure to lawyer error or misbehavior, reduces the likelihood of a partner walking off with a client and promotes the firm's client succession goals.

For all "keeper" attorneys, both associates and partners, and even staff, compensation adjustments that are triggered by changes (both up and down) in firm profitability will help focus everyone on the bottom line.

Contingent Profitability

The bad news is that profitability has probably peeked for 2/3rds or more of law firms, i.e. those who will not be creative enough to fashion a more profitable business model. Historically, the stability of the legal product and the reliably increasing demand for services produced no incentive for creative products or business models. But average Profits Per Equity Partner (PPEP) have declined over 7% for the first six months of 2009 compared to the first half of 2008, double the decline of 2008 over 2007, and expectations are that the full year 2009 numbers will be down even more. Productivity is similarly down over 7% for both 2009 and 2008 after holding steady for the prior 7 years. Those declines may gain added relevance from the fact that much more modest drops at both Heller Ehrman and Thelen presaged total collapse.

Now firms will need to develop their own R&D for new products and delivery systems, as nearly all other industries do, in order to increase revenues over time. That requires experimentation, which risks failures as well as success—a whole new arena for lawyers.

Lower Average Compensation

Sorry to say, but over the next 5-10 years average lawyer compensation will suffer a 10-25% decrease from current levels, with only those in the upper stratosphere of gray-haired advice (not necessarily given by those with gray hair) seeing a compensation increase. The average will be hit particularly hard by the impact of contract-type lawyers, working for firms and legal providers, whose compensation will be significantly lower than that of current young associates. The result will be a much greater divergence in individual lawyers' compensation.

While many firms have moved quickly during the last year to reduce fixed associate compensation, reductions in partner compensation are less visible, since they are often dependent on overall firm profits, and certainly less advertised. Yet for many years the percentage increase in starting salaries for associates, though large, has not kept up with the percentage increase in partner profits. If historically high partner income is preserved at the expense of associate salary reductions, the disparity in "sacrifice" may breed further discontent among younger lawyers.

And in the partner ranks, recent statistics from Dan DiPietro of Citibank's Law Firm Group show an already clear slowdown in the rate of making new equity partners—currently a 1.5% increase compared to a 2.5% average increase for the prior years of this decade, already considered low because of a torrent of non-equity partners made in lieu of equity partners during that time. Baby boomers staying on to try to rebuild their financial portfolios account for some degree of the calcification at the top, and uncertain, or declining, overall profitability no doubt also contributes. But the trend will not appeal to perennially younger clients and is likely to breed revolution in law firms. The result? Young turks will leave to start their own firms rather than wait out an uncertain and increasingly less profitable future.

Non-Lawyer Stakeholders

Australia's Slater & Gordon, which went public in May 2007, is the world's first publicly traded law firm and last February reported a 22.4% increase in net profits and 35% increase in revenue over the prior year.

Meanwhile, on the other side of the Pond, a law similar to the one in Australia authorizing the investment in and management of UK law firms by non-lawyers comes into full force in 2011. In anticipation, several investment firms have already raised millions to take minority and controlling stakes in firms that would benefit from outside investment—whether to carry out a merger, develop a new practice area, or fund expanded IT systems.

US law firms, which could use the additional capital, are grappling with the arrival of outside investment in the same way as did the old guard investment banks who confronted public offerings. Also once dominated by private partnerships, the industry began the transition to public ownership 30 years ago. After Merrill Lynch listed its shares in 1971 in what became increasingly obvious as a competitive advantage, financial pressures on other banks mounted until Goldman Sachs became the last major investment bank to make the change in 1999.

Similarly, these non-lawyer investment laws in Australia and the UK will change the entire business landscape of law firms everywhere. "If the English firms can sell stakes in their law firms publicly, that will then give them an advantage,'' says Ralph Baxter, the chief executive officer of Orrick, Herrington & Sutcliffe.

With no quick economic rebound in sight, there will be increasing pressure from partners of U.S. law firms on management to explore, and work to legalize, the option of obtaining public investors.

And if non-lawyers are thus far precluded from investing in US law firms, they are already investing in US litigation. The share price of Juridica, a publicly traded UK fund with over $100 million available for investment in plaintiff commercial litigation in the US, has risen 24% over the first year of trading. Juris, a Chicago firm backed by hedge funds, has realized returns in excess of 20% annually on its investment portfolio in US litigation.

Although shocking to US lawyers, the era of your firm either being in bed with a non-lawyer, or competing with a firm that is, is already a reality.

Enhanced Leadership

What little firms have been able to accomplish over the last decade in the way of motivating the troops and gaining loyalty has been achieved by using the blunt instrument of cash. While the current economic siege makes loyalists of everyone, the firm of the future, lacking the ability to simply pass on expenses to their clients, will have to master the finer art of leadership.

At the same time, building relationships, which is key to exerting leadership influence, will be more challenging: face time will be scarcer due to distant locations, less predictable office time, and more reliance on virtual connection. The largest firms will be the most challenged,

particularly if the biologist Robin Dunbar's contention that stable groups are limited to 150 relationships holds true. These firms will rely even more heavily on practice group leadership. All told, it will be harder to build within a firm a shared sense of identity, values, standards and culture at a time when disseminating those values through identity marketing will be critical for the firm's success.

Highly Developed Training

The importance of frequent and accurate evaluations of lawyers and staff and the effective use of targeted training cannot be overstated. Every person will need to carry their weight in a very specific way, for which they must be exquisitely prepared. Firms will no longer be able to afford to carry talent who is not clearly useful now or will be in the fairly immediate future.

How to Get There

"When the tide goes out, it's apparent who's swimming without a bathing suit," as Warren Buffett has famously pointed out. Many firms' weaknesses have been there for years, but were simply obscured by high revenue and the nonchalance that goes with it.

Recessions can create more opportunity, not less. Now is when you have the time and the impetus from the sense of urgency necessary to rebuild your firm's approach. But it requires an investment. Simply responding with across-the-board cuts in expenses has proved in past recessions to hurt firms in the long run. Those firms which keep spending on talent, marketing, and expanding or refining services during recessions do significantly better than those which make big cuts. They also maintain those gains well into recovery.

There are steps your firm can take to put it on the way to an enhanced future if you take seriously the necessity of change and carefully evaluate a range of options. But gone is the time when law firms can reassure themselves by just doing what other law firms are doing—that only brings the assurance of middle-of-the-pack mediocrity. Now is the time to distinguish your firm as an innovator, an admittedly challenging role for law firms because it is both very difficult and unfamiliar.

The science of paradigm shifts predicts that the last to change are the ones who were most successful at the old system, so the currently most profitable firms are unlikely to be leading the way. And many firms will not be able to transition to a new model without breaking up on the shoals of change—we are trained, after all, to find things wrong with any proposal and we are so good at that we can effectively impede our own progress with our objections. But those firms that do change will reap the rewards only available to the new law firm.

Ronda Muir, Esq., founder and Principal of Law People Management, Inc., is a leading authority on the application of behavioral science to the legal workplace. She draws from law, psychology and conflict resolution to offer business-savvy, psychologically sophisticated assessments of and real-world solutions to the personal dynamics issues that are unique to law firms and law departments. Reach her at RMuir@LawPeopleManagement.com.