

New Directions in Legal Services



EDITED BY LAURA ARMENTANO

Chapter 1:

Why the developments to the competence divide (and not the digital divide) will make or break the law firm business model

By Emma Ziercke, research assistant, and Markus Hartung, director, at the Bucerius Center on the Legal Profession (CLP) at the Bucerius Law School

In 2016, the Bucerius Law School in conjunction with the Boston Consulting Group, revealed in their report ‘How Legal Technology will Change the Business of Law’¹ (the ‘2016 Report’) that legal technology solutions could perform as much as 30–50 per cent of the work currently carried out by junior lawyers; firms would need to redefine key elements of their business model in order to succeed in the new world of legal technology. One year on, we examine whether legal technology has caused law firms to re-write their business models. It is evident that firms are already striving to differentiate their service offering by availing themselves of legal technology, and are benefiting from technology in enhancing their internal processes.

Other aspects of the law firm paradigm, such as revenue models and organisational structure, are reactionary and the signs of change are difficult to establish. Is legal technology driving these adjustments to the model, or are there more subtle forces at work? Some argue that the digital divide between lawyers and their clients is widening² as lawyers gain access to state of the art legal technology, but what about the competence divide? The traditional law firm business model was founded on an information asymmetry, and ultimately an imbalance in expertise, between the lawyer and the client which made defining the customer value proposition relatively straightforward. What will happen as information finds its equilibrium and the competence divide shrinks? To answer this question, we have to go back to basics and ask ourselves what the key attributes of the law firm business model are.

From information asymmetry to the closing competence divide: An elusive aspect of the law firm paradigm

Firms compete on the strength of their business models, but what is the

law firm business model? Experts such as Clayton Christensen³ will stipulate that a business model consists of four key elements:

1. A customer value proposition that fulfils an important job for the client in a better way than competitors' offerings;
2. A profit formula that describes how the organisation makes money delivering the value proposition;
3. The key resources; and
4. The key processes needed to deliver the value proposition.

Although this definition may be the perfect tool with which to analyse the effects of legal technology on a business model, when it comes to law firms, the first key element remains critically elusive: the customer value proposition.

One aspect of the customer value proposition that is most often overlooked is the *asymmetry* on which the very business model is founded. In the same way as doctors are revered for their medical expertise, so lawyers are sought after for their legal expertise. 'Scientia potentia est' ('knowledge is power') and the power resides firmly with the lawyer. The asymmetry in information and expertise permeates the entire business model from the customer value proposition through to the way firms make profit and organise their resources. This divide has begun to shrink, however, not only through the increase in the number of proverbial 'Google' lawyers, but also through the changing market structure which makes information more readily available and moves expertise in-house. What will happen to the model as the asymmetry is redressed and the divide closes?

Legal expertise

Historically, businesses went to law firms because the lawyer had a greater depth of knowledge than the in-house legal team. Nowadays, corporate legal departments are reinforcing their numbers⁴ and, more likely than not, filling them with ex-private practice lawyers. Hence legal expertise and knowledge has moved in-house, and the asymmetry between the lawyer and the client is 'righted'. In the English legal profession, as well as in Germany, the private practice lawyer is likely to be working with an in-house lawyer who was once a highly respected and skilled colleague and who has moved in-house, for one reason or another. Furthermore, the amount of legal information available from resources

other than law firms is growing (see for example the services offered by Thomson Reuters). Thus, the value proposition of ‘fulfilling an important job’ for a client becomes a challenge when the client has at least as much expertise as the lawyer, and the same access to information.

Leverage

The asymmetry does not stop there. Law firms’ profit formulae reside in achieving a sufficiently high leverage (the average ratio of associates per equity partner). A higher leverage translates into higher equity-partner incomes, and thus higher PEP (profit per equity partner). When used as a financial, rather than organisational tool, leverage disregards the quintessence of the customer value proposition. A high leverage (as well as an unrealistically low leverage) is not in the client’s best interests. While a competence asymmetry was the cornerstone of the business paradigm, clients (begrudgingly or otherwise) simply paid their bills. Without the requisite information, the client could not assess whether the matter should be staffed with two associates per partner or five associates per partner. As long as the work was done on time and to budget, the client cared little for ‘how’ the firm organised its resources to provide the service. Now clients are acutely aware of ‘over-lawyering’ and will challenge law firms’ decisions on how to staff transactions, and even decisions on which seniority of lawyer carries out which tasks.

Opacity

Finally, the overall lack of transparency in how law firms organise their resources in order to provide the client with the service previously allowed firms to charge the client based on a simple billable hour formula at the end of the process. Brief narratives describing the work carried out were provided to clients, mostly on request. Thus the information asymmetry was, once again, weighted in the law firm’s favour. With the advent of highly advanced billing systems, clients can now see in real time how much the transaction is costing. Accordingly, the balance of information power has shifted to the client.

How legal technology will change the business of law

A brief recap: The 2016 Report (‘How Legal Technology will Change the Business of Law’) created a snapshot of both big and small law firms’ current business models and identified the new imperatives which will lead to change in the future, namely:

1. Stronger competition from boutique firms in respect of bespoke work, and from legal-process outsourcing providers and legal-tech vendors in respect of standardised work; and
2. Evolving client expectations, which are becoming more sharply focused on efficiency (quicker, more tailored advice), along with a call for greater transparency on fees and more seamless collaboration between internal and external lawyers.

What does this mean for the business model? Beginning with the heart of any business model, the *value proposition*, the job the client wants fulfilled is no longer restricted to pure legal advice. The report revealed that firms will need to offer *additional* services such as legal project management (i.e. professionally led project management), case management tools, legal analytics and decision-support solutions, as well as acting as an outsourcing manager for legal services. Some firms could even become 'legal tech vendors' selling legal technology to their clients or advising clients on purchasing legal technology, and/or finding the appropriate legal outsourcing partner for standardised work.

As the value proposition changes, so must the *revenue model*. The report points out that the billable hour impedes the adoption of new value propositions. A solution would be to adopt partial fixed pricing based on quantifiable success against clearly defined deliverables, as is already common in other professional service industries.

How will the *operating model* change? The report suggested that firms will need to outsource low-skilled legal work and automate high-volume but standardised tasks. Work will be differentiated internally between complex non-standard tasks, and those where legal-tech and legal process outsourcing can be used to advantage. Firms' cost structures will also change significantly as technology becomes a larger element of its base cost along with employee wages.

Finally, the report emphasised that the *organisational model* will need to change in two key ways: firstly there will be a much lower ratio of junior lawyers to partners; secondly there will be different, adjacent roles of project manager and tech manager. The end result is the metamorphosis of the pyramid into a rocket shaped organisation, thus leading to the conclusion that the use of technology will reduce the ratio of junior lawyers to partners by up to three-quarters.

Is legal technology really changing the law firm model?

What has changed since 2016? Are firms already re-inventing their business models? Where are they making the most progress? Taking the traditional business model analysis together with our interpretation of the information and competence asymmetry aspect, we can gain an extraordinary insight into the way business models are evolving.

The value proposition: Complexity and bespoke information

Firms are making the most adjustments with regard to their *value proposition*. Legal technology has offered firms a new tool box with which to design their service offerings. Firms from high-street practices to Magic Circle firms have already begun to provide clients with additional services *outside of* the traditional sphere of legal advice.

Legal project management

Legal project management (LPM) is the primary area in which firms are able to deliver the most value. The legal project management of huge, complex, and international matters, such as class actions (for example, Volkswagen) or M&A (for example, AB InBev/SABMiller) is not only a question of sheer ‘manpower’, but increasingly of high quality, professional project management – resources and expertise which clients are unlikely to have in-house. Thus, even if the information or competence asymmetry is redressed, a *process* asymmetry remains. A transaction that requires regulatory hurdles to be met in over 20 different countries, or tens of thousands of different contracts in different languages to be reviewed, is beyond the logistical capabilities of most in-house teams.

This need can be met in various ways. The firm and its lawyers can simply demonstrate a superior legal process management capability when dealing with complex and multi-dimensional matters, usually by training their lawyers in legal project management (see for example, Allen & Overy or Herbert Smith Freehills). Other aspects of legal project management include offering better ways to collaborate, such as the *Deal Room* (Dentons) or *dealVault* (Norton Rose Fulbright), both of which facilitate document review and sharing between internal and external lawyers. Alternatively, some firms are offering clients integrated tools for project managing, such as Baker & McKenzie’s *iG360* for information governance. Clients can access the tool at any time, online or via an app, and even manage costs through the tool. In addition, firms are providing legal outsourcing managed services such as Berwin Leighton Paisner’s *Lawyers on Demand*, Pinsent Masons’ *Vario* or Eversheds’ *Agile*.

Legal data analytics

Firms are enhancing the value proposition by making *legal data analytics* available to clients. Examples are: DLA's *Cyber Trak* (with Blue Edge Lab) which provides online access to information on cyber security worldwide, but in particular, maps certain standards onto the client organisation's compliance framework to identify areas of compliance and potential concern; and Allen & Overy's *Margin Matrix* (in conjunction with Deloitte), a derivatives compliance system designed to help banks deal with new regulatory requirements. The system codifies the law in various jurisdictions and systematises the drafting based on an automated legal analysis. Such services can overlap with legal project management services, to the extent they replace the need to appoint and manage separate providers across the world. Other examples include Linklaters' *Verifi*, and DWF's counter-fraud service, which analyses for example, fraudulent insurance claims to predict claimants' behaviour and help clients develop strategies to counter such fraud.

Access to information

While legal tech opens a completely new access to justice (A2J) in the business to customer (B2C) area, things are different in business to business (B2B). The righting of the information asymmetry opens up additional ways for firms to grasp the value proposition. Although the client and the lawyer may be on a par with their legal expertise and access to information, we live in a time of information overload with the result that finding a path through the plethora of information is a valuable proposition. Take for example the general counsel of a global company, the sheer magnitude of information that GC would be required to know about overseas regulations and laws makes it impossible to manage. This is where firms are stepping in, and providing their clients with information in a succinct, user-friendly, and tailored way.

The information is presented in different forms; a newsletter, on a website, as a video (see for example CM Murray's Resource Library), through a secure portal, for free, or as part of a subscription. The amount of information can be varied, from simple guides to detailed reports. The service can be merely to keep clients up to date with developments in the law (see for example Hogan Lovells' Brexit Taskforce), or can pull together regulations from all over the world. A prime example of the latter is Baker & McKenzie's Global Merger Analysis Platform, in which merger control rules in 120 different jurisdictions are summarised, together with real-time updates and a report-generating function.

Equally, DLA Piper's Global Patent Tool which summarises patent law and dispute resolution procedures in over 100 jurisdictions, at different levels of detail from country guides to full handbooks, also demonstrates how the righting of the information asymmetry has resulted in firms making the provision of complex information in a user-friendly form part of their service offering.

Law firms as legal tech consultants?

There is little evidence that firms are moving directly into the *legal technology consultancy* arena. Eversheds Sutherland LLP's consulting arm (ES Legal Consulting) has, jointly with Repstor, developed a matter and contract management application, which it markets to in-house legal teams. Otherwise, firms are slowly building up their reputation as users of, and eventually experts in, legal technology. Berwin Leighton Paisner's Talk Tech, is a prime example of this approach. The online portal is run by Berwin Leighton Paisner and brings together general counsels who are interested in legal technology and offers them a platform for discussing experiences, opportunities, and challenges in leveraging legal tech. Finally, some firms are offering adjacent services, such as providing legal training to clients (see for example DLA Piper's Future Legal Leaders).

Revenue model: Client or lawyer managed?

There is less evidence that firms are actually changing their revenue models. Naturally, there is the ostensible trend that more clients are seeking alternative fee arrangements. In the UK for example, GlaxoSmithKline announced last year that over 80 per cent of its law firm fees were now on an alternative fee arrangement basis. Law firms continue, however, to use leverage as an on/off switch for profit, and in a period of financial uncertainty, the trend is towards low leverage. Again, the key issue with the law firm revenue model resides in the shifting information asymmetry; clients increasingly have real time access to 'the clock', and can see at any time how many hours have been worked and what fees have been incurred, leaving the firm nowhere to hide when it comes to inefficient work, poor delegation, or overly high leverage ratios. Client-lawyer collaboration may be increasing, but it is also changing the way lawyers work, and can lead to a swing from lawyers' 'command and control' approach to clients' 'micro-managing'. The 2016 Report noted that firms need to re-consider the billable hour. Despite the dramatic shift in information equilibrium, firms will struggle

to make sudden changes to the billable hour regime. The billable hour has entwined itself in the very fabric of law firm organisation: performance and remuneration criteria, work allocation decisions, promotion criteria, work methodology, appetite for non-client related work (such as know-how, innovation, team management, mentoring, and leadership), organisational structure, working culture, and even lawyers' appreciation of their own self-worth are rooted in the billable hour as the token measuring unit.

Organisation of resources: Early signs?

A law firm's primary resource is its lawyers, and increasingly, its technology base. The 2016 Report predicted that law firm structures will move from a pyramid to a rocket, as more experts are retained and the new roles of legal project manager and technology manager are introduced. It seems to us that the predicted changes have not yet taken place, even not yet begun; at the time of writing, the latest statistics for the profession are not yet fully published, but there are some interesting initial indicators. In the UK, the Spring 2017 trainee retention rates for top City firms were only marginally down on those from 2016 (see reports in, for example, *The Lawyer*), with most firms still being around the 80 per cent mark. Deloitte reported in their quarterly Legal Sector Survey Update that firm headcounts were up around 1–2 per cent, whereas the *Legal Week's* analysis (in conjunction with Smith & Williamson) of firms' 2015–2016 financial accounts revealed a previous 3.6 per cent increase in headcount. Although the analysis did not differentiate between lawyers and potentially 'new' roles, spending on salaries increased last year by 4.8 per cent. It may be too early to tell, but firms do not appear to be in a hurry to convert their pyramid to a rocket.

Key processes: Opacity

The 2016 Report noted that firms may move from handling all tasks in-house to out-sourcing low-skilled work. This is borne out to the extent that top city firms in the UK (such as Allen & Overy and Herbert Smith Freehills) have 'low-cost centres' outside of their London hubs. Others are using data analytics to allocate workflow more efficiently (see for example Ashursts' 'blind' work allocation system), although this is still in its infancy. An increasing number of firms are investing in software programs and artificial intelligence (such as KIRA and RAVN) to provide answers to standardised questions. Some firms are actually

collaborating with clients to produce a tool for standardising routine work for the client's benefit (see for example a simple collaboration between Pinsent Masons and Everton Football Club to create a contract generator for player transfers).

Information equilibrium, but in a dynamic market?

There is evidence that, one year on, firms are already altering their business models supported by legal technology to deal with the shifting asymmetries in information and expertise. Firms are focused on changing the value proposition and are taking advantage of the new toolkit provided by legal technology to do so. Spurred on by the fact that the client knows as much, if not more than the lawyer, firms are focusing on offering legal project management, legal analytics, and bespoke information. The key processes needed to provide the new value proposition are also developing significantly and even being used as a new value proposition in their own right. Changes to the revenue model are more sluggish, despite the fact that the information asymmetry has been corrected and the client has almost become the cost manager. The organisation of resources, like the revenue model, is embedded in law firm organisational behaviour and culture, and firms are therefore slow to adapt.

Is the emerging model robust enough? All things being equal, the new value proposition can be replicated by other firms, indeed by other players. The crux of the problem is that business models are dynamic and depend upon who else is offering the same or similar services. Our analysis is thus only a snapshot, as the success or failure of a business model depends on how it interacts with the models of other players in the industry (on which one would need to dedicate a separate chapter). The competitive advantage obtained by differentiating the legal service offering is only short-lived. What will be the new value proposition? An improved delivery method? An additional service offering? Perhaps a radically different value proposition – the game-changing opportunity to solve a problem for the client that has never been solved before? One thing is clear, firms will need to adapt the operational aspects of their business models much more quickly in order to keep up with the need to constantly offer new and differentiated value propositions, as the competence divide is closed and information continues to find its equilibrium.

References

1. Veith, Wenzler, Hartung et al., 'How Legal Technology Will Change the Business of Law', Final Report of Bucerus Law School and The Boston Consulting Group

- on the impact of innovative technology on the legal sector, 2015/2016. Available at: http://www.bucerius-education.de/fileadmin/content/pdf/studies_publications/Legal_Tech_Report_2016.pdf.
2. See for example the Eversheds/Sutherland/Winmark 2016 Looking Glass Report.
 3. Clayton Christensen, Professor of Business Administration, Harvard Business School and author of numerous articles and books on innovation and business model innovation. See www.claytonchristensen.com.
 4. In fact, early indicators from the Law Society of England and Wales Annual Statistics Report 2016 are that the number of solicitors working in-house has risen to 22 per cent of all practising certificate holders.