

# Marginal Changes to the Bottom Line?

By Nick Jarrett-Kerr

A whole generation of baby-boomer lawyers is just coming up to retirement. When they started their legal careers, making money in the legal profession was relatively easy. Clients treated them with respect, and there was little downwards pressure on fees. At the same time, wages remained relatively low, particularly for support staff. As a result, margins remained high; some lawyers remember quite large law firms operating with profit margins in excess of 60%.

Over the last three decades, however, margins have been inexorably squeezed by the twin forces of client-induced pricing constraints and employee-induced pressures on staff costs. These pressures have resulted in the halving of typical net profit margins over the last 30 years. In response to these challenges, the legal profession has concentrated hard on maximising the traditional profitability model to focus even more heavily on hours, rates, margin and leverage. The client (external) side of the equation is based on the simple but historically effective formula of increasing rates year-on-year at the same time as optimising utilisation levels by getting lawyers to work harder and to be more effective at time-capture. This equation has been amply assisted by the pricing of engagements predominantly on an hourly rate basis. The internal side of the equation has been to force cost efficiencies wherever possible at the same time as building leverage below partner level. Growth in law firm size has also helped firms to benefit from econo-

mies of scale and from leveraging work down to increasingly large teams of trained lawyers working below partner level, but whose charge out rate to the client remains high enough to enable the firm to make substantial profit from them. Thus, clients have experienced in their view extremely high charges for even the most humdrum and process oriented work involved in their engagements and unsurprisingly have been increasing pressure on their law firms to find cheaper ways of doing the elements of work which do not require high levels of legal qualification.

Put bluntly, the long-standing and traditional profitability equation for law firms seems to be fast running out of wiggle room. Unless law firms embrace innovative changes, their profitability could enter a period of long term decline. There are three main reasons for this. In the first place, rates resistance from clients is now overwhelming, and the hourly rate model is steadily being replaced by alternative fee structures such as fixed price, capped fee and value pricing models. Firms are finding it is becoming more and more difficult for them to increase rates year on year, and harder for them to identify and win truly partner-level work for which premium rates can be justified.



The second allied problem is the inexorable increase in the standardisation and commoditisation of legal work which has brought about a steady decline in the standing of lawyers as providers of expertise-driven solutions. This increase in standardised solutions has enabled non-lawyers to attack the traditional markets of law firms both as a result of deregulation (impending and actual) in jurisdictions like the United Kingdom and the steady annexation of legal work everywhere by accountancy firms, surveyors, banks, consultants and other external competitors.

Whilst the rates and commoditisation threat has been in existence for some time, the third reason for the law firm profitability model to creak still further is more recent and potentially even more game-changing. This third and latest challenge is that of Legal Process Outsourcing (LPO). It is becoming clear that large corporations through their legal departments and procurement departments are finding the substantially lower rates offered by providers of LPO services to be extremely attractive. The well publicised arrangement - whereby RTZ is using LPO to cut its legal spend - is an example of this trend. Taken to its logical extreme, LPO presents a huge threat to the whole of the leverage model employed by the larger law firms. After all, under the leverage model, law firms take the profit generated by their sometimes huge and serried ranks of staff lawyers, who will traditionally carry out the more routine processes generated by transactions and disputes. If such routine work becomes

substantially redirected to LPO providers instead of law firms, fewer staff lawyers will be needed and the opportunity to make profit via people leverage becomes more limited.

The strategic response to these challenges will predominantly be contextual rather than generic. Huge 'Biglaw' firms will be most threatened by the double whammy of rates pressures and the leverage challenge of LPO. Their response is likely to include a further focus on globalised brand-building in order to provide augmented quality assurance across the world. Such firms also have the option of remodelling their leverage structures so as to provide their own proprietary LPO models at cost efficient prices. Mid size and regional firms will continue to stress their competitive pricing structures and may find that slimmer pricing differentials between their firms and LPO providers do not threaten their leverage structures in the same way as it might worry their Biglaw rivals. However, the increasing pressures of commoditisation will continue to provide them with big worries. Smaller law firms in low cost centres may find that they are able to offer a variant of LPO to large corporate entities, or to take advantage of 'Mexican Wave' panel arrangements.

Forward-looking firms of all sizes will be able to take competitive advantage from offering innovative pricing structures based on the principles of value billing – so long resisted by law firms.

It is however in the areas both of expertise driven services and experience reliant problem-solving where the biggest opportunities may lie for firms of every shape and size. Clients will continue to be prepared to pay premium prices for unique high level skills (when they are needed) or for 'bet-the-farm' solutions. Emerging and tricky areas of law will continue to need bespoke answers. Cutting edge industry sector knowledge will



always remain extremely valuable. At the same time, clients will continue to value lawyers who use the considerable weight of their experience to provide insight and practical wisdom if it gets the client better results. As Anthony Kronman observed more than fifteen years ago in his book *The Lost Lawyer*, the highest goal of the lawyer used to be “the attainment of a wisdom that lies beyond technique – a wisdom about human beings and their tangled affairs that anyone who wishes to provide deliberative counsel must possess.” Perhaps it is high time for law firms to return to these values and to offer thereby a differentiated competitive edge – the subtle combination of wisdom, prudence, insight and technical expertise.

