The road not taken: law firms at crossroads

The ‘good old days’ of firms charging high fees and making a fortune are over for most firms, but many partners are failing to respond to modern pressures, writes George Beaton.

The extent and speed of the changes affecting legal services in the past decade well exceeds what has occurred since the big law firm business model was invented in the 1950s. No wonder managing partners, let alone the average partner, are so ill-equipped to grasp the relevance and threats of the trends. Very few have known anything other than utilisation, leverage and time-based billing as the economic basis for planning their futures. The pyramid is being forced into something more like a cylinder for the traditional firm.

No firm has time to wait and see what is going to happen; every law firm and client organisation is being affected. The evidence is ubiquitous, but too many law firm leaders are not strategically focused on the big picture. It is not all gloom, though; opportunities lie in places of which most are not yet aware.

Large law firms

There is a growing tendency to refer to large law firms by the collective noun ‘BigLaw’. This is an apt way of describing firms that are at the larger end of the scale in their jurisdiction. They are structured as partnerships, built on leverage, inherently conservative and by and large still very profitable businesses for those who own them.

Just over 20 years ago a seminal book, Tournament of Lawyers, described the relatively recent phenomenon of the large law firm and presciently suggested the very causes of ‘the spiralling growth of the large law firm may lead to its undoing’. When the book was published in 1991 it seems only academics and some observers of the profession paid attention. Today the authors’ ideas are reality – and too many leaders of large firms still appear oblivious and continue to worry about the wrong things.

There are well over 2000 law firms in the world qualifying for BigLaw status. These firms each have annual revenues ranging from $100 million to more than $2 billion. The great majority of the largest law firms in the world are American; total revenues in the US are more than five times those in the United Kingdom, the country in second position.
Beaton’s analysis of the world law firm industry points to a total size of half-a-trillion dollars. Since the year 2000, annual growth of the industry has been declining, with the sharp drop in growth that started during the 2008-2009 credit crisis masking the fact that the signs of industry maturation existed as far back as 2000. Industry maturity means the demand for legal services is growing no faster than the economy, heralding an era of intensifying competition among incumbents. Real innovation is generated mainly by newcomers; to whom I refer as the barbarians at the gate.

**Industry maturity**

Work has moved in-house, to legal process outsourcers and to new business model firms, and also simply been withdrawn from the market. As a result, demand for traditional law firms’ services has steadily dropped, prompting the respected blogger Adam Smith Esq to write a scary (for law firms) e-book called *Growth Is Dead. Now What?* Combine this with another phenomenon of a mature industry – falling prices – and the story gets worse for BigLaw.

Our reading of the economic trends affecting BigLaw paints a dismal picture for partners. To illustrate this, we modelled a firm starting with annual revenue of $100 million and 2500 equity points on issue. In the model, we assume revenue decreases at 5 per cent each year, lawyer salaries increase annually at 3 per cent for five years and then stabilise, other overhead costs increase at 1 per cent per year for five years and then also stabilise and, finally, this firm holds its equity points at 2500 for each of the 10 years. The result? Profit per equity point halves in less than 10 years.

Some might want to argue no firm will remain inactive for this long. They will say this firm will cut staff, reduce office space and de-equitise. Partners accustomed to incomes of these levels are not going to be passive in the face of a decline of this magnitude. We agree rational business owners will do these things and the result, depending on your assumptions of how rapidly and decisively the firm acts, will be less of a disaster than this analysis suggests.

But will this fictitious firm really be quick off the mark and decisive? We know many firms that are already on this slippery slope in the UK, Canada, the US and Australia, too. And these firms are not acting in any manner that could be described as strategic and decisive. The partnerships are stuck. Some partners deny the forecast. Others believe the ‘good old days’ will return – provided they hold their nerve. And they believe there are sufficient associates in the ranks signalling an interest in becoming equity partners. Such analyses are the fiction of scaremongers, they will say. Time will tell who is right.
Industry restructuring

One response of a mature industry is to restructure, which results in the emergence of new strategic groups, with different types of firms operating in each. Law is no different to other industries; alternative strategies are available. Beaton Capital sees three that are mutually exclusive and listed here in no particular order of preference or inferred recommendation:

1. If it is eligible and not already part of a globalising entity, a firm could join one. This move will buy time because very large – well run – firms have the scale to do two things. They are able to invest more readily than smaller firms in a range of initiatives that will slow down the adverse effects of the mature market. These include using captive or outsourced LPOs and legal service managers and investment in technology and work redesign that adds value to clients and reduces the cost-to-serve of the firm. And, increasingly, these globalising firms serve the world’s largest corporations with large legal services budgets – and the power to force firms to innovate.

2. Alternatively, a firm could progressively reposition itself as a narrowly focused client sector or work type specialist and diversify into adjacent services. This strategy is more likely to lock in clients and talent that would otherwise be attracted to the very large firms because of the superior nature of value proposition.

3. Or your partners could accept that their firm, like very many, will see its profits fall with the tide of the industry to reflect returns to owners closer to market than monopoly levels.

Future scenarios are complex and uncertain. It is worth remembering the evocative lines of Robert Frost’s poem The Road Not Taken:

Yet knowing how way leads on to way,  
I doubted if I should ever come back.

and

Two roads diverged in a wood, and I –  
I took the one less travelled by,  
And that has made all the difference.

The words epitomise the dilemma in which many law firms find themselves today.

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