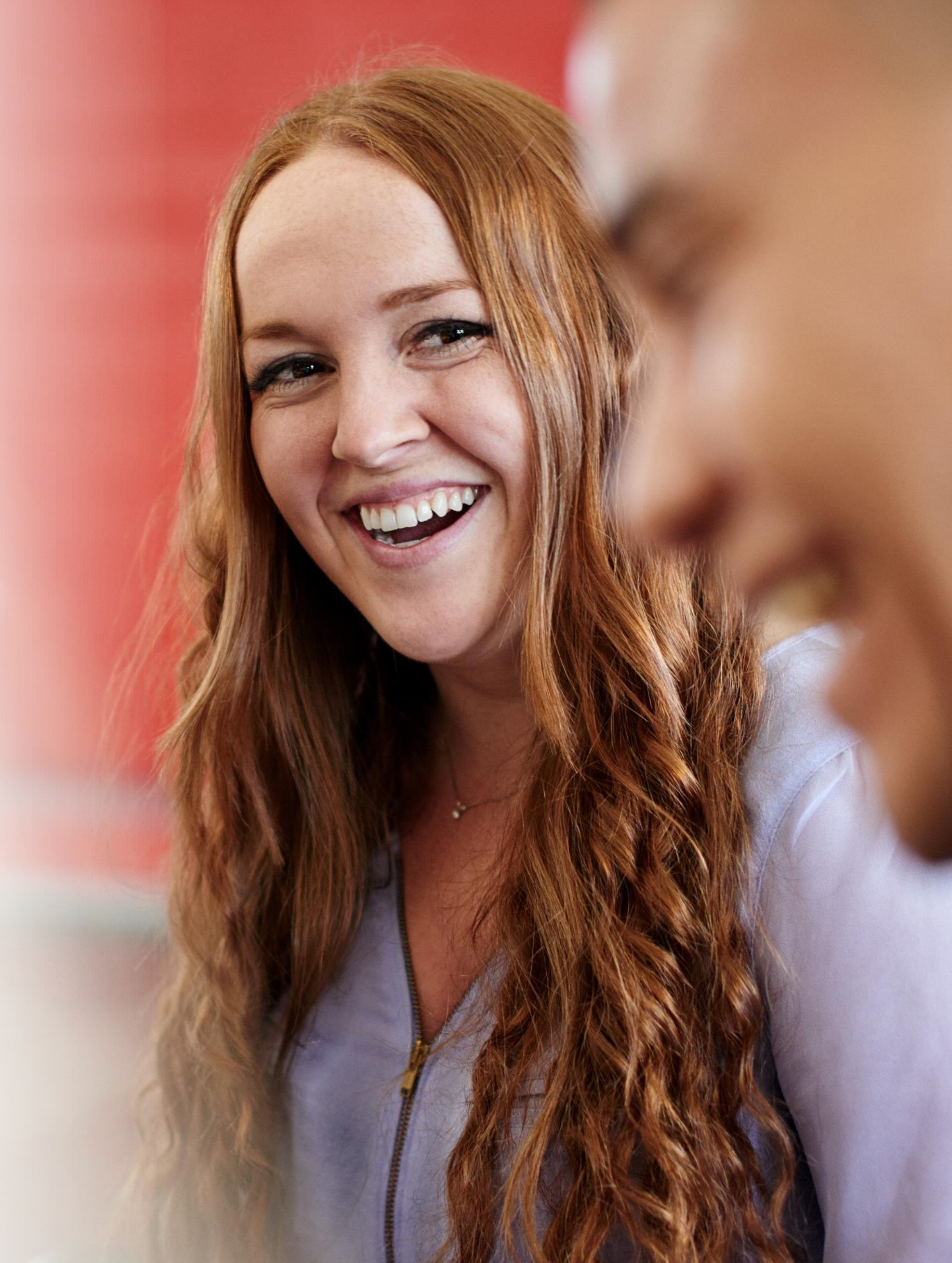
Law Firm
Leadership Series

A new era for law firms

2023

IDEAS | PEOPLE | TRUST

Contents



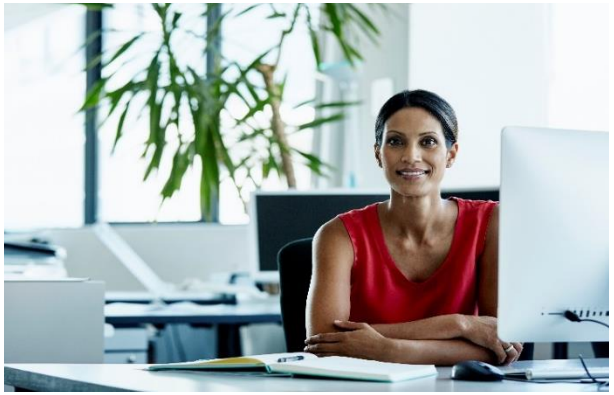
About this edition of the law firm leadership series

The methodology of this edition is based on a series of 13 in-depth, interpretative semi-structured interviews, with senior or managing partners at law firms, in addition to insight gained at an in-person roundtable event. The interviews were semi-structured, so that we could draw useful insights into the health of law firms. As part of our research, we agreed upon anonymity with our interviewees, to allow them to tell us about what is actually keeping them up at night and what they genuinely believe the future holds with a deeper level of candor. We would like to share our thanks with the individuals that participated.

Our partners in researching and preparing this series were Kevin Doolan and Alexis Caught of Strategy Four. We are grateful to them for their expertise and insight.

Article 1 | The three operating models, one year on

The 2022 edition of this series examined how law firms were responding to the evolving market and how they were positioning themselves to compete for both clients and talent. Our research and discussions led us to identify three routes or positions that law firms were taking.



The Pace Setter

At one end of the spectrum are the Pace Setters. These firms are focused on the high-value, lucrative work linked to private equity transactions and other specialist work. They balance substantial financial rewards and pay with considerably higher billable hours. They expect Associates and Partners to meet their clients' demands, come what may, and are less focused on issues such as wellbeing and work/life balance.

Some leaders among the Pace Setter firms have this year reported that their competitive, 'up or out' culture is sometimes creating a negative side-effect. Firstly, their operating model is driving hyper-specialisation with Associates not getting the breadth of experience they need to develop their careers. They are also finding that they are faced with increasingly individualistic, even protectionist attitudes to client relationships and work. This is a problem if they want any of their Associates to develop the client base that they will need to become Partners in the future.

Career Firms

At the other end are what we called Career Firms. These firms responded to the challenge of recruitment and retention by offering a more sustainable and balanced approach to work.

They demand fewer billable hours and offer more flexible working arrangements. These firms hope to retain and incentivise talent by offering better working conditions and career development rather than more transactional financial reward.

Mainstream Firms

Finally, there are firms that sit between the first two groups; the Mainstream Firms. These firms demand more billable hours and offer more financial rewards than career firms, however, they cannot offer the same financial rewards as the Pace Setters. The challenge for these firms is how to compete for talent when other firms offer either better rewards or better conditions and wellbeing.

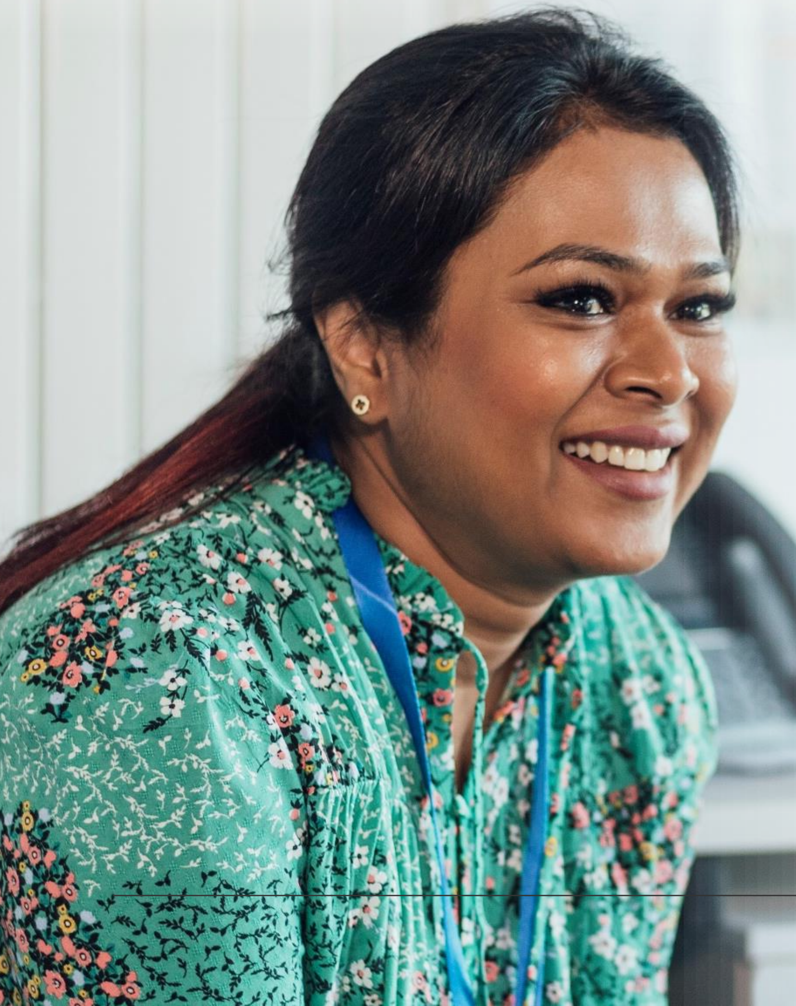
These firms have struggled with the ratcheting up of hourly targets. Some are now finding that Associates and even Junior Partners are simply reporting that they are at capacity when they reach 90% of their nominal capacity. They may still be working more hours than would have constituted 100% capacity a few years ago. Clearly, this is not sustainable or good management.

Last year, the differences between these operating models were brought into stark contrast and exacerbated by a boom in demand and a real talent shortage. The market for talent was in turmoil as many in the industry reconsidered their priorities following the pandemic. The result was a swing in the balance of power towards staff and away from the firms. Firms were forced to re-evaluate how they attracted the talent they needed.

As well as making themselves more attractive employers, law firms were also forced to increase financial rewards, in a way that some felt was unsustainable. One year on, the most important change is that the market has re-balanced, and firms are no longer chasing talent. One Senior Partner remarked that he "could get any Associate he wanted". This has gone some way to reducing the financial pressure on Mainstream Firms competing for talent.

Article 2 | The economic outlook

Regardless of their operating models or their approach to recruitment and retention, all law firms are sensitive to the state of the economy, with the outlook for 2024 not necessarily positive.



The 'Covid margin' has gone

Last year we reported that many law firms had benefited from a Covid margin as a result of the pandemic. Lockdowns and social distancing measures had meant fewer overheads relating to travel and entertaining and more time available for working. Meanwhile, despite lockdowns and the restrictions on economic activity, demand for work was surprisingly strong throughout the pandemic, enabling firms to be very profitable.

With life returning to relative normality, the financial boost has petered out. Law firm overheads have returned to more normal levels. The return of face-to-face meetings and entertaining have meant an increase in the expenses relating to working with clients. The return to working from offices has meant more time spent commuting and less time available for Partners and Associates to work.

A weak economy

The overall outlook for the UK economy is not as positive. A recession may be avoided over the next 12 to 18 months but there is not much optimism when it comes to growth either.

Law firms are usually relatively recession-proof. The increase in demands for services relating to challenging economic conditions such as administrations, restructuring and consolidations can offset the lost business in other areas. However, several specific factors mean that this may not be as true during the next 12-18 months as it has been in the past.

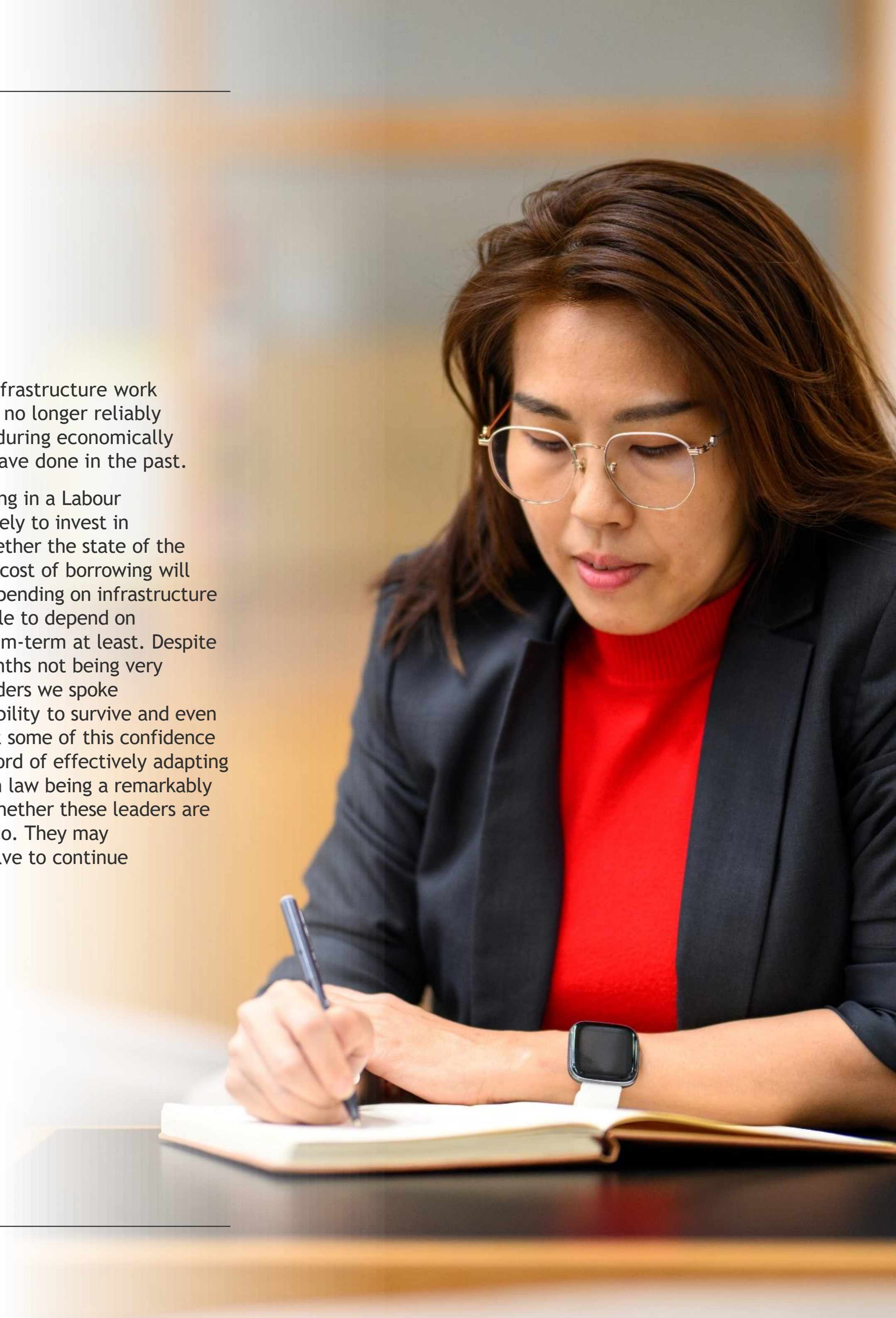
Private Equity and M&A

A significant proportion of law firms focus on servicing the needs of Private Equity and other high-value, specialist work related to corporate transactions and deals. In particular, Pace Setter Firms have purposefully operated to serve this highly lucrative but demanding market. The amount of Private Equity 'dry powder' has meant that this market has long been a reliable source of work for any law firms able to tap into it.

Many law firms also benefited from the boom in corporate deals and PE activity that followed the pandemic. While deals came to a virtual standstill in the early days of the pandemic, markets were quick to compensate as conditions returned to normal.

While there is still plenty of 'dry powder' available for PE firms or houses to invest, high interest rates and tough trading conditions have made investing more challenging. PE investors are simply being more cautious. They are doing fewer deals and taking longer to complete the process as they try to gain assurances that their investments will perform in difficult conditions. This means less money for the Pace Setter Firms, obviously, but also for all other firms that are involved with private equity. If this top tier PE work continues to slow, will Pace Setter Firms begin to encroach into work currently more the purview of Mainstream Firms?

Article 2 | The economic outlook



For many law firms, large infrastructure projects are a valuable source of work and revenue. It may not be as lucrative as corporate finance work, but these are large-scale and long-term projects that provide reliable income. This source of work can become more valuable when other areas of work drop off, for instance, due to a weak economy.

The current economic situation, the precarious state of government finances and the current government's policies have meant that there has not been the same investment in capital and infrastructure projects in recent years. For instance, the government has recently announced it is abandoning the HS2 project's northern extension, undermining investment confidence and weakening the confidence of both home and international businesses in the economic viability of investment into the UK.

This has reduced the volume of infrastructure work available for law firms. Firms can no longer reliably depend on this source of income during economically challenging times as they might have done in the past.

A general election in 2024 may bring in a Labour government, traditionally more likely to invest in infrastructure. The question is whether the state of the government finances and the high cost of borrowing will allow any substantial increase in spending on infrastructure projects. Law firms may not be able to depend on this source of income in the medium-term at least. Despite the outlook for the next 12-18 months not being very positive, many of the law firm leaders we spoke to expressed confidence in their ability to survive and even thrive. There can be no doubt that some of this confidence rightly comes from their track record of effectively adapting and evolving to be successful, with law being a remarkably resilient business. Time will tell whether these leaders are right to feel as confident as they do. They may find that they must adapt and evolve to continue being successful.

Article 3 | Financial health and sustainability

The overall outlook for the financial health of law firms is not as positive as it has been. As we explored in the second article of this series, there are plenty of economic headwinds and challenges in terms of growth and revenue ahead for law firms. These challenges do not seem to pose an existential threat and many of the leaders we spoke to remain confident when they look forward to the next 12-18 months.

To start on a positive note, the labour market has rebalanced. Firms are no longer having to chase new talent or offer significant financial rewards to current staff to retain them. There are signs that inflation is beginning to peak. This will reduce pressure on interest rates, help law firms maintain a grip on rising costs and relieve pressure on working capital by maintaining the cost of borrowing.

However, the less than rosy outlook is compounded by three new developments that will require investment or reduce the financial liquidity of law firms. First, law firms are having to adapt their physical offices to support new hybrid and agile ways of working. Secondly, firms are having to consider how and how much they invest in AI. Finally, the changes in how Partnerships are taxed are going to severely reduce the funds that law firms have traditionally used as working capital.

New offices for new ways of working

Whatever their flexible working policies or their long-term visions for their workforces, law firms are having to adapt to, and cater for, changing workforce expectations. Some degree of hybrid working has become the norm for all firms. Even the firms that have most aggressively sought to return to pre-pandemic working practices, with a minimum of four days a week in the office, have had to accept that the world has changed.

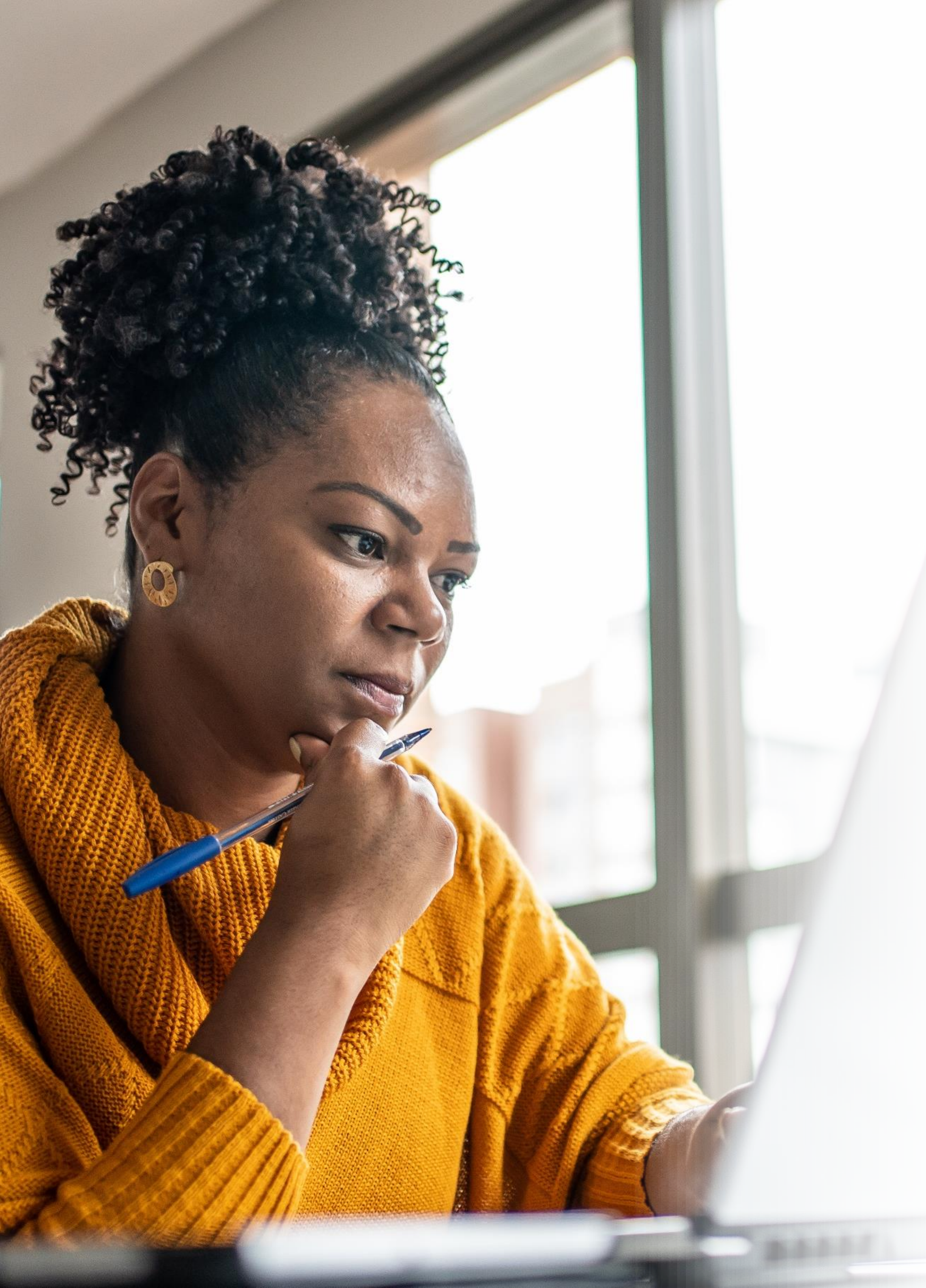
During the pandemic, firms were forced to invest in their IT systems and their technology stack to support completely remote working. They had to ensure that they could continue to serve their clients securely and efficiently through technology. Law firms have had to maintain that technology because their workforces continue to work remotely for significant amounts of time.

As law firm workforces return to using offices, their expectations of the workspaces have fundamentally changed. They use the offices to hold meetings and to collaborate with colleagues. They expect meeting rooms to support hybrid working with participants joining in person as well as remotely. Collaboration spaces to support planning, training and communication activities are also needed to support the activities that must happen in offices.

Law firms have had to invest substantially in their office spaces to respond to these changes. Finding or creating the kind of work environment that meets the needs, and desires, of their workforces is costing law firms. Relocation or refurbishment does not come cheap against a background of high inflation.

Providing the technology that supports hybrid working and hybrid meetings is another significant outlay. Firms are having to provide, and maintain, the right hardware in every meeting room and on every hot desk.

Some of this cost may have been offset by the reduced amount of space needed by firms. Hybrid and remote working do mean that fewer desks are needed, and some space can be released, though not always as much as might be expected. Those collaborative, high-tech meeting spaces also require plenty of square feet. Firms are torn between a desire to bring people into the office to maintain culture and provide a thorough training experience to younger lawyers, and a desire to save money by shrinking their office floorplate. But if firms insist on everybody attending 3 or 4 days a week, how much office space, and, with it, how much money can really be saved?



Article 3 | Financial health and sustainability

Paying for revolutionary new technology

Every firm we spoke to is in the process of investing in AI in some form, with law firm leaders all stating that they cannot afford to ignore the commercial potential of AI. We discuss some of that potential impact and other knock-on effects in a later article in this series. The point here is that AI represents another substantial investment. Law firms are either already investing or are aiming to be 'fast followers'.

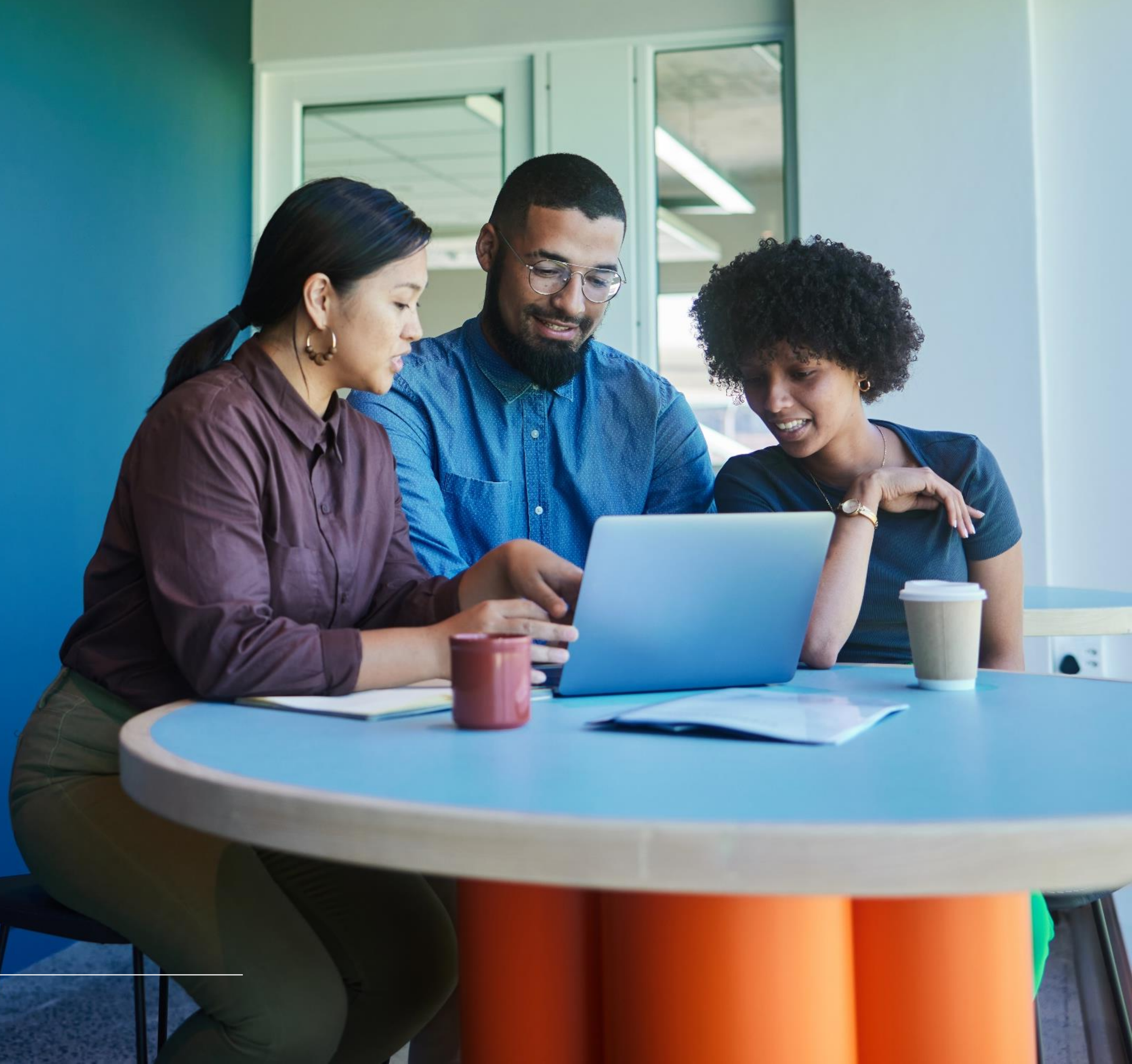
AI technology must be sourced, adapted to the specific requirements of the firm and then implemented. Staff must be trained on when and how to use AI effectively and safely. This is a relatively new market with providers able to charge high prices for their software and services. This is even more true as they can point to a direct impact on a law firm's immediate bottom line. One leader we spoke with shared how the current ticket price of a proposed AI package equated to a doubling of their current yearly IT spend. This poses the questions, how will law firms fund this substantial new investment and the ongoing costs of maintaining and upgrading AI technology?

Changes to taxation and working capital.

HMRC are changing the way partners are assessed on their profits from Partnerships through basis period reform. For an analysis of Basis Period Reform and how it will impact law firms, please refer to our article on Business Profit Tax Changes 2023-2024. Many Partnerships retained tax on behalf of partners and used it as working capital pending it falling due to HMRC. The tax will, for many Partnerships, now have to be paid much sooner.

Partnerships, and individual Partners, are having to provide additional or new working capital to replace the working capital which had been held in tax reserves. Their normal first port of call for any borrowing needs has always been banks. However, interest rates are at a 20-year high and the cost of replacing the missing working capital can be significant. This is more significant because law firms must also fund their investments in new or refurbished offices, and AI. For more information on what Partnerships should do next, please view our additional article on Basis Period Reform.

Article 3 | Financial health and sustainability



Conclusion

We have seen that law firms are facing a few issues that may affect their financial health and resilience with key areas requiring substantial investment and a change in tax regulations hitting working capital. While it would be hard to argue that anything discussed in this article undermines the long-term sustainability of law firm finances, law firms must find effective and affordable means to mitigate the immediate pressures on their finances.

In the end, the solution may simply be more borrowing and taking the hit on higher interest rates. Nonetheless, this may be a difficult moment for some law firms and their leaders may need to make some tough decisions. That may include having to review staffing in areas of the firm where work has dropped off. Inevitably, when demand reduces there is a balance to be had between reducing staff and holding on in the expectation of an upturn. As time passes, the cost of holding on may become more of a concern.

Article 4 | Artificial Intelligence and its impact on law firms

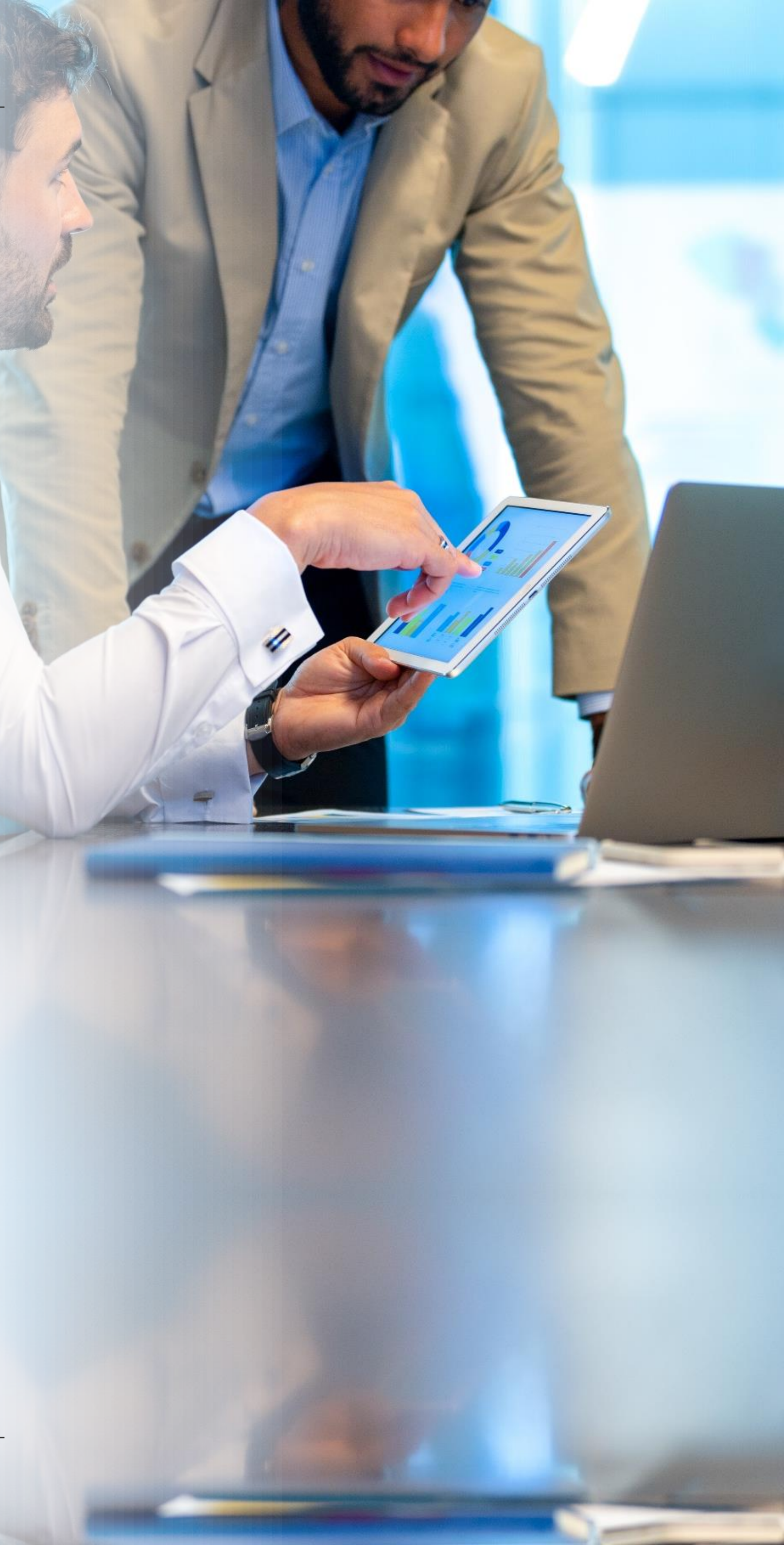
AI is the elephant in the room for many businesses and industries but none more so than for professional services and law firms. The capacity of AI to complete increasingly complex, intellectual tasks quickly, and with improving accuracy, makes it perfect technology for firms in the knowledge economy.

Most law firms are currently grappling with the basics of AI. They are considering which provider or technology partner to work with to implement and develop their AI solution.

Perhaps more importantly, they are asking questions around how much it will cost and then how it can be sold (and charged) to clients. Importantly, there is a paradox in that AI represents a significant outlay to firms, and yet to clients it represents an opportunity for bill reduction and cost savings.

There is now plenty of advice on how to procure and implement AI solutions, and technology Partners will work with law firms to support the application of AI. This article looks at what the wider impact of AI might be on law firms. Will adopting this new ground-breaking technology affect how law firms operate and service clients? Will AI impact on law firm workforces and cultures? Does it have the potential to change those cultures? Career development is another area we think may well be affected if AI is widely adopted and used by law firms. After all, the culture of learning 'on the job' by carrying out relatively simple tasks under the supervision of a more experienced colleague relies on availability of the type of work that AI is able to do. Finally, we will discuss how AI has the potential to change the way law firms charge their clients, both for the better or the worse.

Article 4 | Artificial Intelligence and its impact on law firms



AI and law firm workplace culture

Workplace culture in law firms has been undermined over recent years. The pandemic and subsequent rise of remote working dealt a hammer blow to cultures that were built on long hours spent together in offices. The entrance of new generations into the law firm workforce has also led changing attitudes – many younger Associates no longer accept the long hours that have long been intrinsic to law firm culture. The question is whether AI may undermine law firm culture even further?

Traditionally, both knowledge and culture has been imparted by Partners through ‘learning on the job’. At the start of their career, Associates have been asked to take on relatively simple tasks in support of and under the supervision of a Partner. This usually gives the Associate exposure to the expertise of the Partner and to the firm’s ways of working as well as increasing their technical knowledge. It was the accepted way to develop talent and helped to build culture. It was also the way for Associates to ‘earn their stripes”.

The emergence of AI means that many of the tasks that are used as ‘training’ for Associates may soon be the province of AI. There may soon not be work that Partners and young Associates can collaborate on in a way that promotes a shared culture.

A more diverse workforce?

If AI is the beginning of a seismic shift in the use of technology to deliver work for clients, law firms are going to need new and different skills in their workforce. At the very least, law firms will need technical specialists able to procure and manage digital technologies. Technology specialists and data analysts will need to sit alongside the legal experts to bring together the advantages of the technology and the legal expertise.

Law firms have always employed non-legal staff, but we could see a situation where the technologists are key rather than incidental to delivering for clients. If a significant proportion of the work for clients is being done using AI, the people who can make AI work effectively become more important. They may eventually be perceived as more valuable, and harder to recruit, than some Associates. This would represent a significant shift in relationships between legal and business professional staff. It could also significantly change the culture of the law firms overall.

The challenge will be to create or maintain some form of common identity and culture when a growing proportion of staff are not lawyers and do not have that shared ‘law’ background. Firms will also have to address the reward and career progression incentives for these staff.
The ultimate financial carrot for Associates has always been making Partner. This has been less common for the other professionals working inside a law firm – will that need to change?

Article 4 | Artificial Intelligence and its impact on law firms

AI and billing

We believe that the area that AI could transform beyond recognition is billing. Law firms have always billed by time. When we looked at the varying approaches of Pace Setter and Career Firms, the number of billable hours per year was a key differentiator. When law firms want to increase revenue, the only route open to them is to bill more hours against clients – regardless of whether they increase the number of people or the utilisation rate. Until now, it was often lower value, repetitive work that was billed on fixed fees.

All the work that law firms deliver to clients is done by people, Associates or Partners, and the cost is primarily measured by the time spent on a client or project by those people. AI changes that. Law firms face a situation where, expensive AI has reduced the time that the lawyers take to complete a piece of work. Some proportion of the work will have been delivered by AI technology in a fraction of the time it would have taken an Associate. The time taken to complete the task becomes almost irrelevant.

As AI develops and becomes increasingly reliable, it is reasonable for clients to expect a significant proportion of the work they pay for to have been done by AI. They will argue that as fewer human hours have been spent on the work, the price they pay should also be lower. This will be untenable for the law firms. They will not be able to both invest substantially in implementing AI and charge less for their work as a result.

The only solution may be for law firms to break the link between price and billable hours.

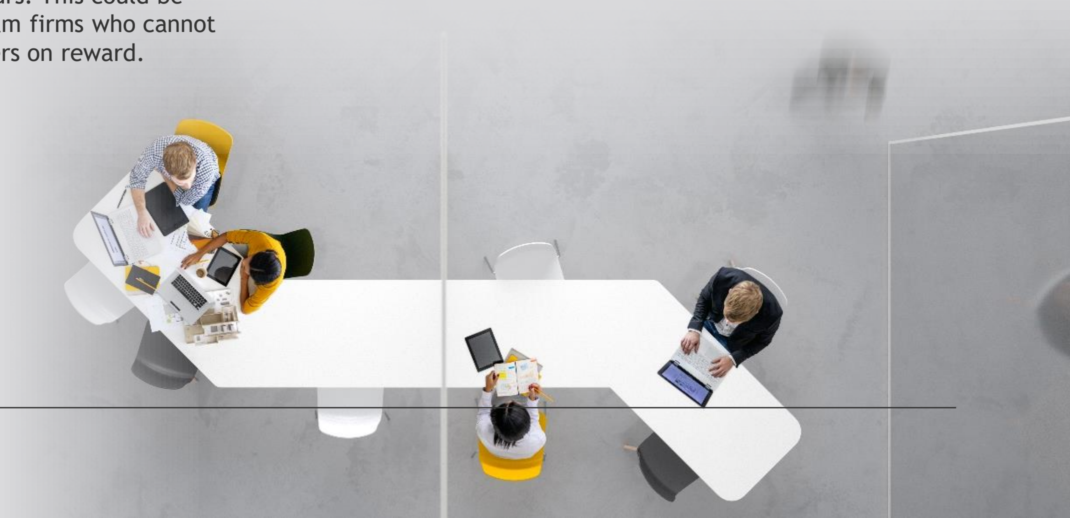
Law firms will need to find an alternative model for billing. One option will be to move to fixed or project pricing based on value. This will not be entirely new; clients have already imposed capped or fixed fees on transactions in some areas of work. But in other areas, this would represent a completely different way of pricing legal services. As well as a new pricing model, this will require a complete rethink of how work is resourced and managed. This is potentially the biggest and most challenging change to law firm operating models.

We think law firm leaders may initially baulk at the idea of changing the pricing model that has stood them in such good stead for so long. However, for many law firms, the changes to their pricing could be hugely beneficial.

Law firms may be able to move away from the ratchet effect that forces them to constantly balance profitability and the wellbeing of their people. Revenue will depend on delivering work efficiently using all digital tools available rather than simply billing more hours. This could be massively helpful for the Mainstream firms who cannot currently compete with Pace Setters on reward.

Secondly, law firms might be in a position to bill according to the value of the work to the client. Pricing by project could allow firms to charge a premium for projects that require a skill set that is hard to find or very much in demand. They might also be able to link the cost of their work to the added value delivered to the client. A high value or high-profile project might then command a premium.

Another trend we saw was the use of AI in other areas of law firms. For example, in creating marketing material and responses to Requests for Proposals; designing financial dashboards that help Partners manage their budgets; helping Partners deliver accurate bills that comply with outside counsel guidelines and reduce the risk of being rejected by e-billing systems. These may be seen as lower risk areas in which to experiment, and we saw several firms exploring AI technology in these uses.



Article 4 | Artificial Intelligence and its impact on law firms

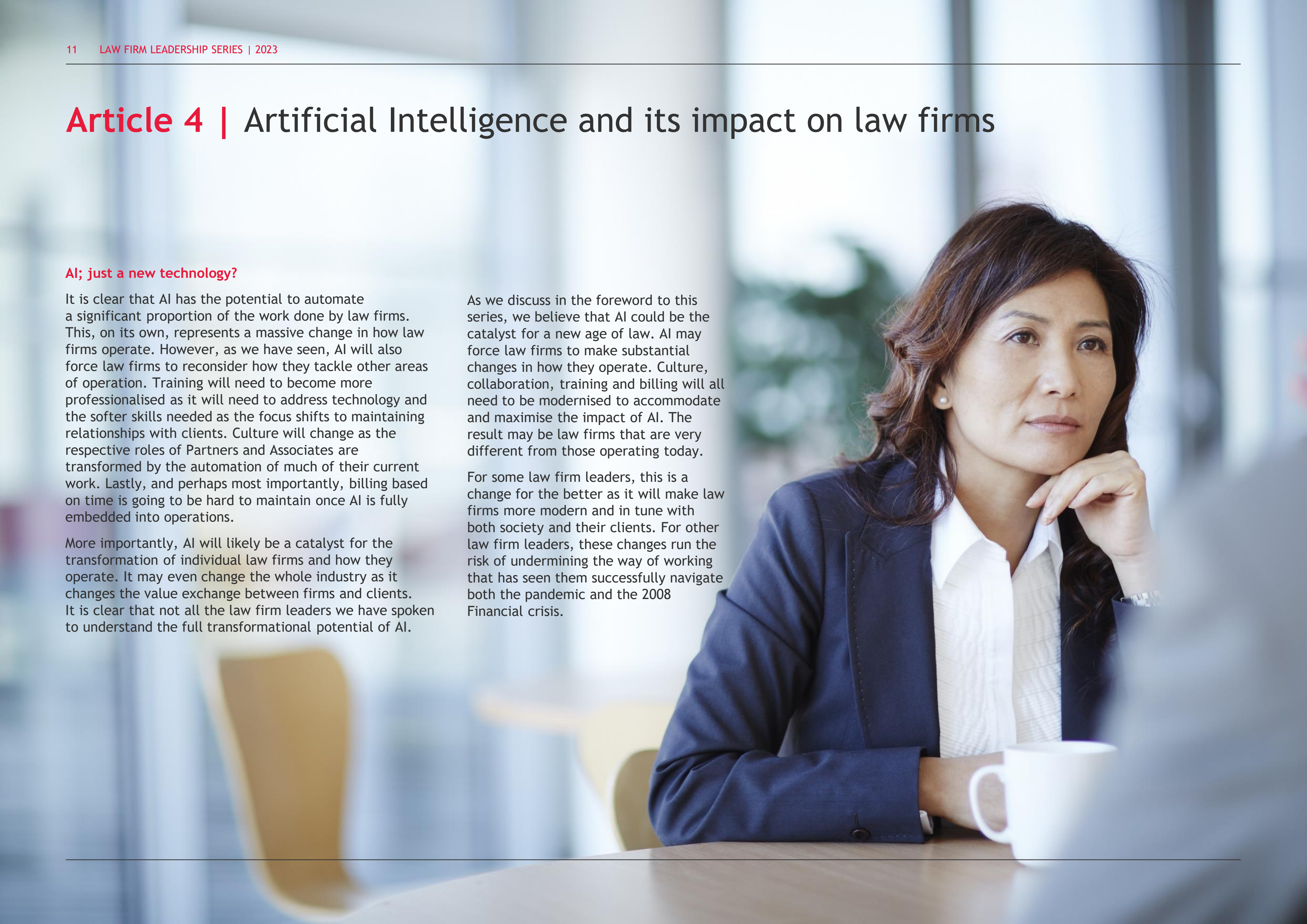
AI; just a new technology?

It is clear that AI has the potential to automate a significant proportion of the work done by law firms. This, on its own, represents a massive change in how law firms operate. However, as we have seen, AI will also force law firms to reconsider how they tackle other areas of operation. Training will need to become more professionalised as it will need to address technology and the softer skills needed as the focus shifts to maintaining relationships with clients. Culture will change as the respective roles of Partners and Associates are transformed by the automation of much of their current work. Lastly, and perhaps most importantly, billing based on time is going to be hard to maintain once AI is fully embedded into operations.

More importantly, AI will likely be a catalyst for the transformation of individual law firms and how they operate. It may even change the whole industry as it changes the value exchange between firms and clients. It is clear that not all the law firm leaders we have spoken to understand the full transformational potential of AI.

As we discuss in the foreword to this series, we believe that AI could be the catalyst for a new age of law. AI may force law firms to make substantial changes in how they operate. Culture, collaboration, training and billing will all need to be modernised to accommodate and maximise the impact of AI. The result may be law firms that are very different from those operating today.

For some law firm leaders, this is a change for the better as it will make law firms more modern and in tune with both society and their clients. For other law firm leaders, these changes run the risk of undermining the way of working that has seen them successfully navigate both the pandemic and the 2008 Financial crisis.



Conclusion

A new vision for law firms?

Our research over the last two years has identified a number of challenges and opportunities that law firm leaders are getting to grips with. Last year's Series proposed that law firms seemed to fit more or less into three categories. The developments we have discussed with law firm leaders, and their responses, have begun to provide us with a glimpse of what law firms may look like in a few years, regardless of where they are currently in terms of operating models.

Throughout this year's Series, we have come back to a number of issues; law firm culture, working patterns, the work/life balance conundrum, the use of new technologies in particular AI and issues around reward.

Across all these issues, we have found a split between law firms that are willing to look at innovative, and sometimes groundbreaking, new ways of doing business and those firms that are being more traditionalist and continuing to rely on the operating models and cultures that have seen them survive financial crises and pandemics.

Culture and working patterns

Any workplace culture has to reflect as well as shape the values of the people. Law firms are now recruiting young people with very different attitudes to work and to work/life balances to previous generations. Some firms want to maintain or bolster their existing cultures and ways of working. The best example of this is firms putting real pressure on their people to return to the office for the majority of the time. They are driven by a desire to rebuild the with long hours of working creating a shared experience.

Other firms believe that remote and hybrid working are here to stay. They are making the new working patterns part of their culture. These firm rely on their work policies on wellbeing and work/life balance to create a different culture.

Training

Most law firms have expected Associates to learn 'on the job'. By working with and for Partners and other more experienced people, the Associates learn all the skills and knowledge they need to develop their careers. This approach is flexible. It allows for Associates to be allocated to meet commercial needs. It also has the substantial advantage of being 'paid for' by the clients. On the other hand, it relies on Partners to be teachers, mentors and communicators as well as experts in their own fields.

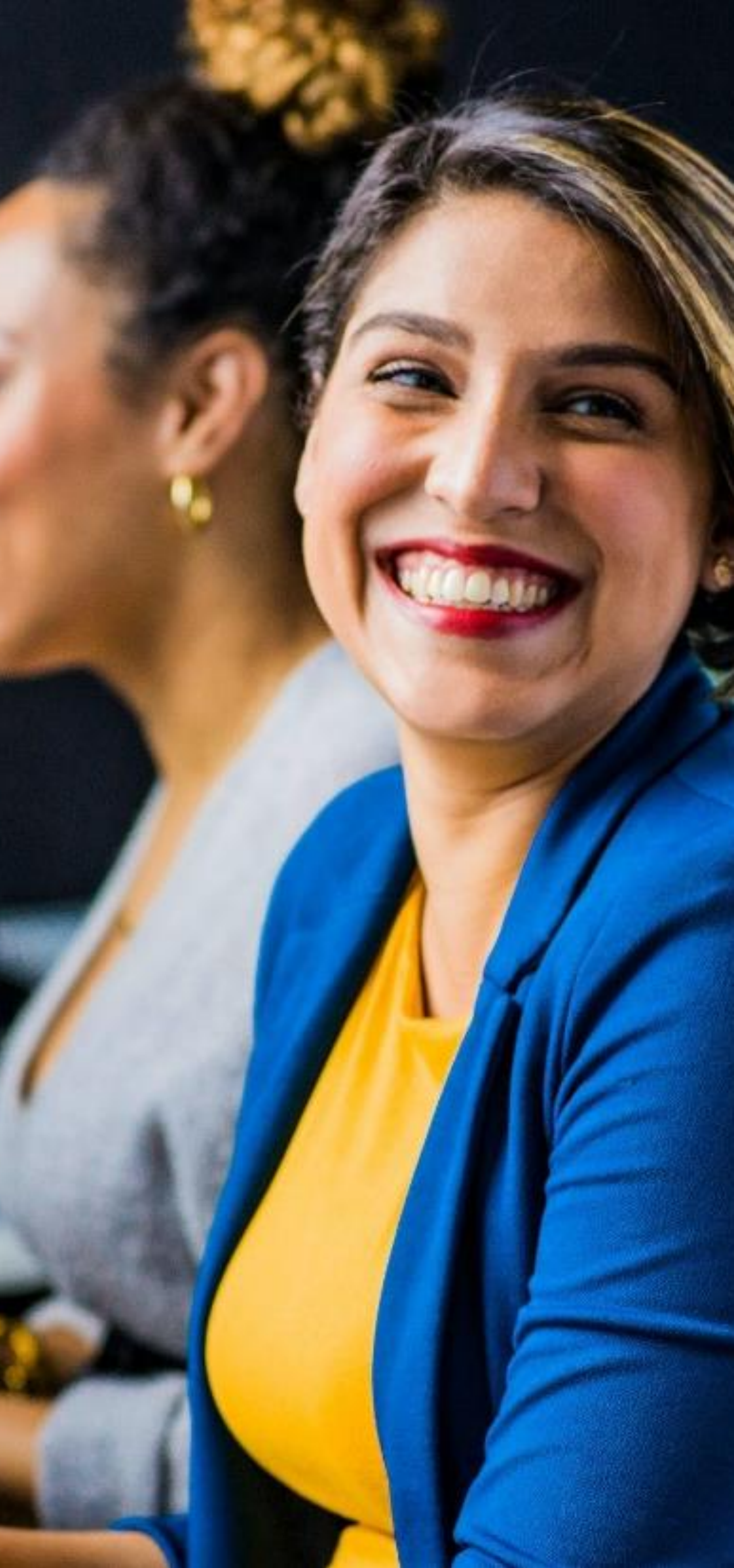
A number of law firm leaders we spoke to want to provide more formal and structured training to Associates. The advantages are that the training is less reliant on the skills of Partners, it is easier to introduce new skills or expertise such as those around technology or 'soft' skills around relationship building. Formal training should also be more comprehensive and balanced. The single biggest downside with this approach is the cost. The firms will have to invest in the delivery of this training and account for the loss of billable time.

Billing

The biggest change that could happen is around billing. Simply put, the impact of AI technology could make hourly billing impossible to maintain.

Law firm leaders must then decide if and how to change their pricing model. They can seek to adapt their current billing to take into account the costs and the savings related to using AI. They will still bill according to time but their rates cards will evolve to reflect the impact of AI and other technologies.

The alternative is to seek to break the link between hours and billing. Law firm leaders that wish to pursue this route will have to convince clients to accept a link between value and billing. They will have to strike a difficult balance between offering competitively priced work and profitability and margins.



Conclusion

Which way should law firms go?

It would be wrong to assume that one model or approach is inherently going to be more successful than the other. We suspect that law firms will modernise where they need to or where they feel willing and able to ‘safely’.

The result will be a spectrum of law firms with some embracing all the changes and beginning to operate very differently while others will evolve more gradually by embracing change in just some areas.

This will change if it becomes clear that one approach is substantially more profitable or sustainable than the other.

From our latest round of research, it is not clear that there is a correlation between types of firm (ie Pace Setter, Mainstream or Career) and attitudes to change and innovation. Each law firm will need to consider its current operating model, its unique circumstances and its client base before deciding if and how to implement changes.

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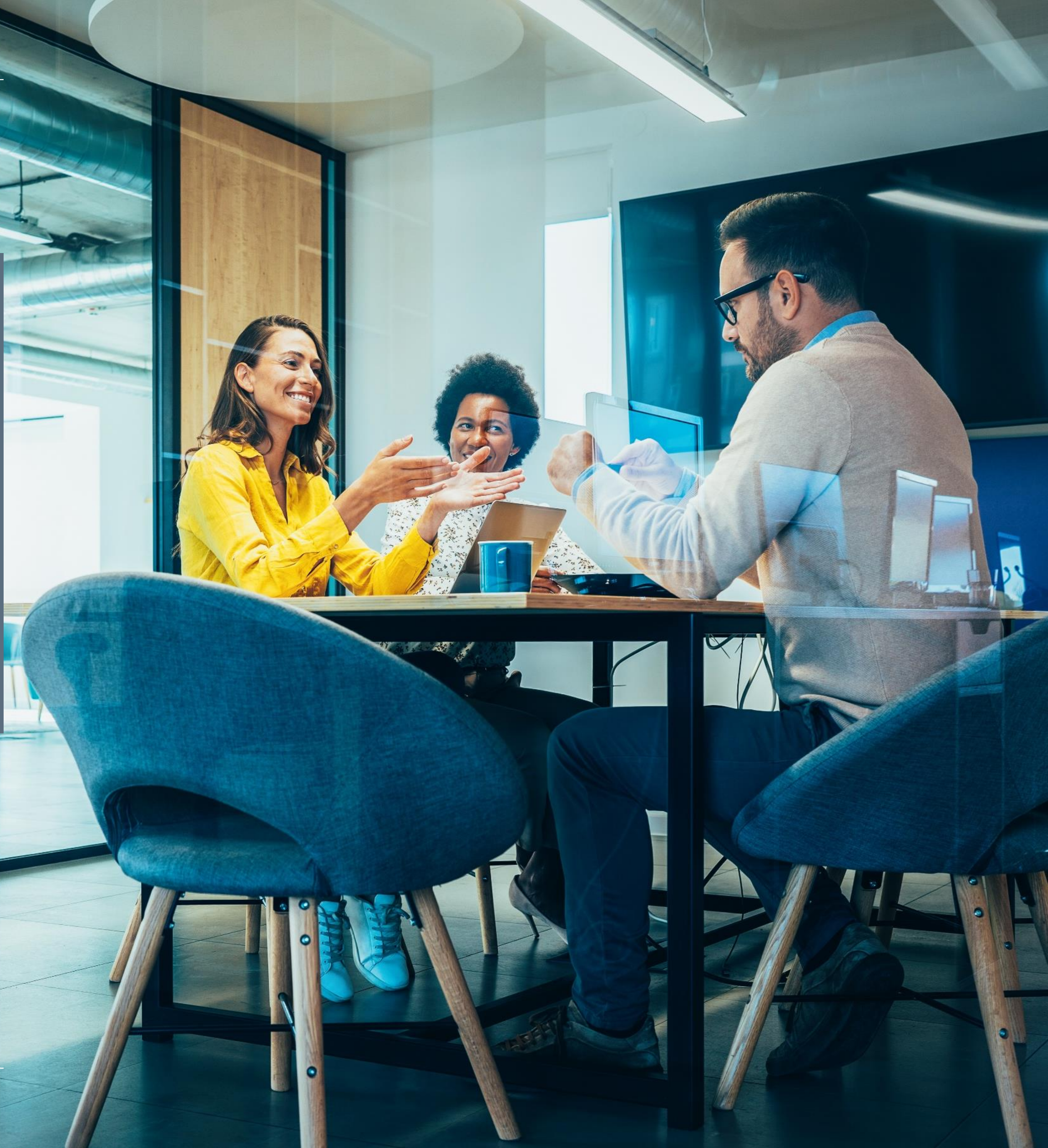

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