REPORT 3: BDO LAW FIRM LEADERSHIP SERIES 2017

NEW LAW FIRM STRUCTURES AND MODELS

BDO

INTRODUCTION

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“Ten years ago, law firm managing partners would have said that law firms would largely stay the same. That’s completely changed.”

This was the view of one of the law firm leaders surveyed as part of our law firm leadership series which also pointed to a range of factors that would have the greatest impact on law firms over the next five years. In the first report in our four part series we delved into some of the wider industry concerns that law firms are experiencing in a rapidly changing economic, regulatory and technology enabled market.

Technology, greater client demands, generational change and legal market consolidation are at the very top of the list of concerns for law firms leaders and in the second report in our law firm leadership series we took a much closer look at how technology is shaping the future of the legal industry. One of the main challenges of technology and innovation is how to fund its investment, particularly within the partnership model, in order to keep up with the competition. These are some of the issues we will examine in this latest report.

Law firms are moving into a new digital age and many believe the current business model will need to evolve, or in some cases, be reinvented. Culture and people will continue to drive a law firm’s identity and success, but the structures that support them may not be fit for purpose.

Who will deliver legal services, and what range of services law firms offer is already changing and will continue to evolve. These shifts are putting pressure on partnership models, how lawyers, other professionals and staff are compensated, and require funding for new investments.

Full service global law firms are already reinventing their businesses as they expand their services into areas outside the law. Many expect the changes over the next five years to be greatest at large law firms with high leverage.

Smaller international and national law firms are also reinventing themselves in arguably the most competitive part of the market. New partnership and funding models are options to help them invest in new technologies and also to differentiate their offering from a crowd of peers.

Are law firm leaders ready to embrace new ways of structuring their firms to invest in future innovation?

THE LAW FIRM LEADER’S SERIES EXPLORES THE THEME OF MANAGING ACCELERATED CHANGE IN LAW FIRMS. OUR NEXT AND FINAL REPORT IN OUR SERIES:

SEPTEMBER 2017: CHANGING CLIENT RELATIONSHIPS
The full series of reports will be available on the Law Firm Leadership Series website

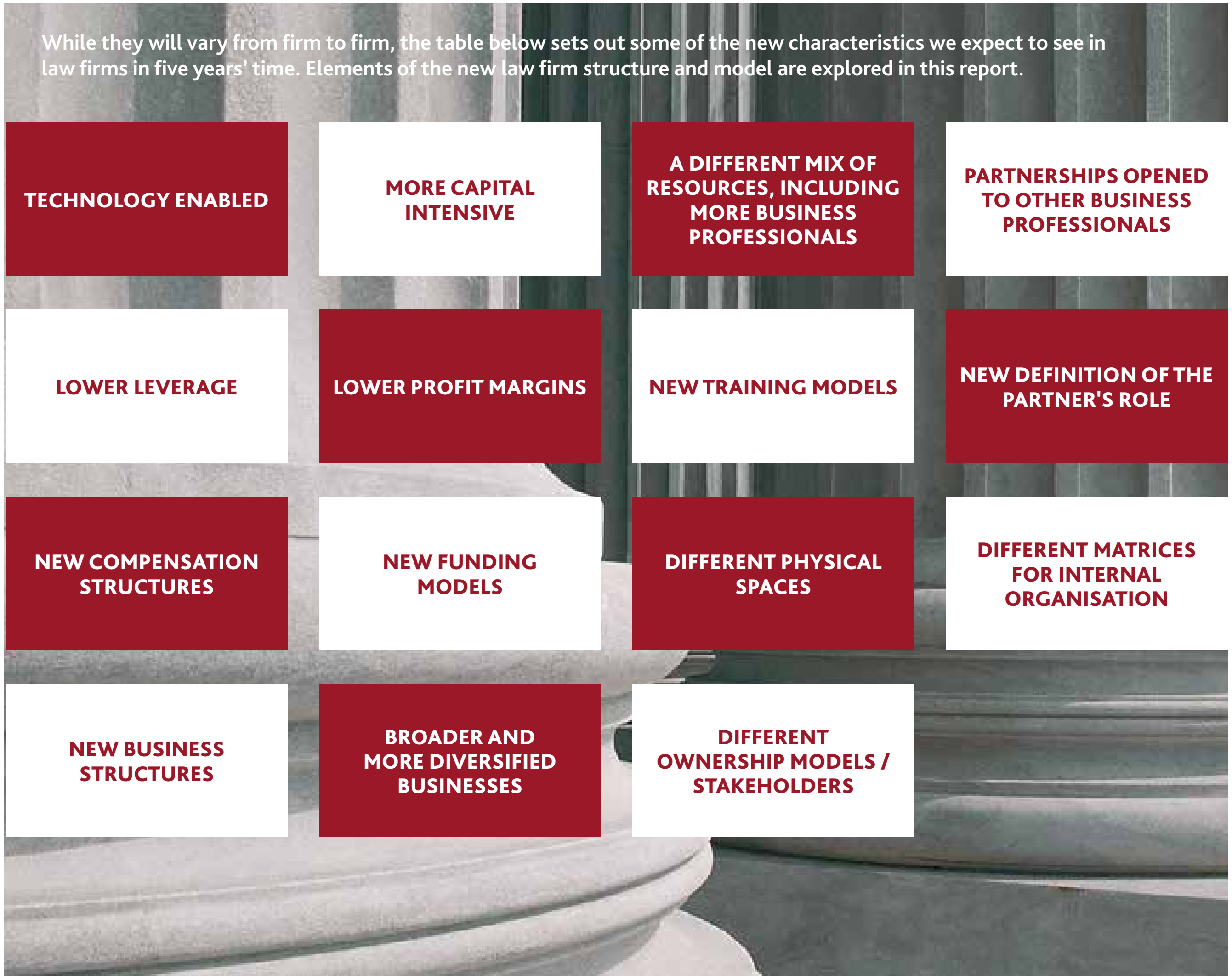
As part of our research, carried out in conjunction with RSG Consulting, we surveyed 50 law firm leaders and held six in-depth interviews with Managing and Senior Partners.

WHAT WILL THE FIRMS LOOK LIKE IN FIVE YEARS' TIME?

Five years is a relatively short time horizon. However, the pace of technological advances means most law firm leaders expect to see their firm structures change within this period.

Different models will suit different types of law firms. We are likely to see a more diverse legal market as firms pursue more divergent strategies. A few may resist change altogether. "In the UK, it's only the specialist boutique firms that won't change significantly" was the view of one law firm managing partner.

The most important driver of structural change is technology. Not only does it require a different investment model and new skills, new tools disrupt the monopoly lawyers have on delivering legal services. Technology will "increase the ability of non-lawyers and clients themselves to undertake tasks previously the preserve of lawyers" said one managing partner. This will, in turn, impact leverage at many firms.



While they will vary from firm to firm, the table below sets out some of the new characteristics we expect to see in law firms in five years' time. Elements of the new law firm structure and model are explored in this report.

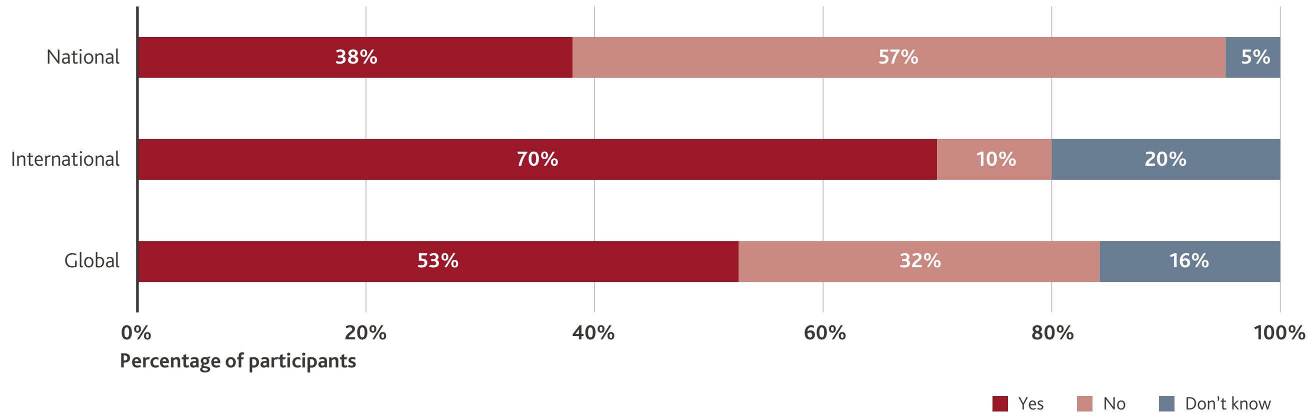
TECHNOLOGY ENABLED	MORE CAPITAL INTENSIVE	A DIFFERENT MIX OF RESOURCES, INCLUDING MORE BUSINESS PROFESSIONALS	PARTNERSHIPS OPENED TO OTHER BUSINESS PROFESSIONALS
LOWER LEVERAGE	LOWER PROFIT MARGINS	NEW TRAINING MODELS	NEW DEFINITION OF THE PARTNER'S ROLE
NEW COMPENSATION STRUCTURES	NEW FUNDING MODELS	DIFFERENT PHYSICAL SPACES	DIFFERENT MATRICES FOR INTERNAL ORGANISATION
NEW BUSINESS STRUCTURES	BROADER AND MORE DIVERSIFIED BUSINESSES	DIFFERENT OWNERSHIP MODELS / STAKEHOLDERS	

NEW COMPENSATION STRUCTURES

Many law firm leaders believe we will see significant changes to law firm leverage over the next five years, and a growing need to enfranchise and motivate people in a range of new roles. Both changes have implications for law firm compensation models.

We asked whether law firm leaders felt their current model would be fit for purpose in five years' time. Responses varied greatly between the leaders of different types of law firms surveyed.

Do you believe current compensation structures and incentives will be fit for purpose in five years' time?



Current compensation structures will not be fit for purpose in five years' time, according to majority (57%) of national UK law firm leaders. Only 38% of national law firm leaders believed they would be fit for purpose, while 5% answered that they did not know.

However, a majority of leaders at global law firms (53%) and international law firms (70%) believed that current compensation structures would continue to be fit for purpose.

THE FUNDING CHALLENGE

> “We start from zero every year, which is a problem. Our internal organisation won’t change, but we need new ways to get funding.”

The related issue of whether the full distribution model, which means paying out the law firm’s full profits to partners each year, will need to change is a greater focus for many law firm managing partners. “We need to get rid of the full distribution model to begin with” said one.

Although, as one managing partner argued, “I disagree that the full distribution model prevents you from investing. We have done it without external investment. You do need to reduce partner profit, but you can do this if you have some scale.”

New sources of funding are also of interest to law firm leaders, but there was little enthusiasm from the largest law firms to take external equity investments. “Bank debt is still cheaper and more attractive than private equity investment” said one law firm leader.

Funding, compensation, and partnership models are interlinked, explained one managing partner, making it a particularly complex problem. “With external funding, the remuneration model must change as you can’t take the full profit out each year” and “to remunerate people fairly, you will need a capital incentives plan instead of a profit distribution model.”

Or as another law firm leader viewed the challenge, “The biggest changes will be about bar rules and the nature of partnerships. The current models prevent us from operating more efficient businesses: the short term, capital out each year model, with hierarchy, status and egos.”

BDO VIEW

WHY IS THE CAPITAL INCENTIVE MODEL NOT MORE ATTRACTIVE?

Where the founders are looking to exit it may be that those benefiting from the receipt of the business deem it reasonable to make a payment to recognise the blood sweat and tears not to mention investment (perhaps in the form of absorbing losses) made by the founders. However, as the generations move forward, paying a previous owner for the business becomes more alien. This also relies on someone joining the business and buying the departing partners interest.

Where private equity are involved the desire is to grow the value of the business so that whilst the ‘partner’ owns a smaller percentage, this smaller percentage is of a bigger pie. Specific businesses may benefit substantially from the investment introduced by PE firms (and expertise) but questions are raised over the viability of a secondary exit and whether the increase in value makes the original dilution and inevitable cut in take home profit worth the punt.

A blank piece of paper of course is also much easier to work – as the culture and history have yet to set expectations, but there is also a question of need at this stage in the development cycle of law firms – perhaps we will see more change if law firms see profit and opportunity decline significantly.

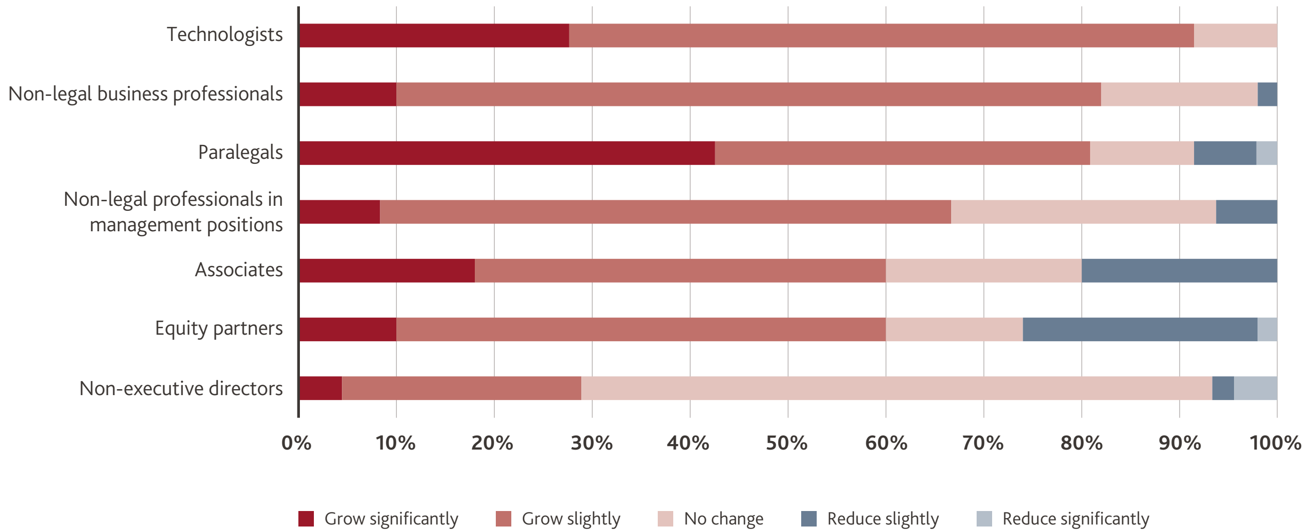
How could an AIM listing help achieve a firm's aims?

WHO WILL DELIVER LEGAL SERVICES IN THE FUTURE?

> “A different type of person will deliver the service.”

Already many large law firms have invested in data consultants, analysts, technologists, project managers and process experts. Most have been tasked with helping law firms improve the way they operate internally, but some now also offer this expertise to help clients improve their processes or implement new technology. In some instances, this is now done on a chargeable basis as law firms move into a broader consulting and advisory space, offering more than pure legal advice.

How do you expect the following groups of people at your firm to have changed in number in five years' time?



The numbers of technologists, non-legal business professionals and paralegals are expected to see the greatest growth at law firms over the next five years. Over 80% of law firm leaders expected the number of people employed in each of these roles to grow.

The trend to increase the number of non-legal business professionals, technologists and paralegals was consistent across the global, international and national law firms surveyed.

Fewer law firm leaders expect to grow the number of equity partners and associates. Growth within these groups was expected by 60% of law firm leaders.

A CHALLENGE TO THE PYRAMID MODEL

The rapidly changing nature of the types of roles in law firms point to firms having lower or different leverage models in the future. More work is being done by paralegals compared to trainees, as they are cheaper. And technology can already replace armies of junior lawyers on tasks such as due diligence and document review which require lower leverage, and with implications for law firm profit margins.

High law firm profit margins have traditionally relied on a pyramid model of a large number of junior associates compared to a smaller number of senior associates and much smaller number of equity partners. The majority of law firm leaders interviewed believed this pyramid model would change to become either:

1. more rectangular, meaning a reduced ratio of associates to partners
2. more diamond like, with fewer junior associates and equity partners, but more experienced lawyers who are not part of the equity partnership.

In both models, access to the equity partnership is likely to become more and more difficult.

The move away from the pyramid model is driven not only by technology, but also by clients who increasingly expect to get their advice from senior lawyers.

As firms will require fewer trainees, and less of the routine work is done by junior lawyers, they will also need to rethink training models. "The rationalisation of the pyramid structure is inevitable. The danger is that it will become more rectangular, which creates an issue for developing the next level of staff" said one law firm leader.

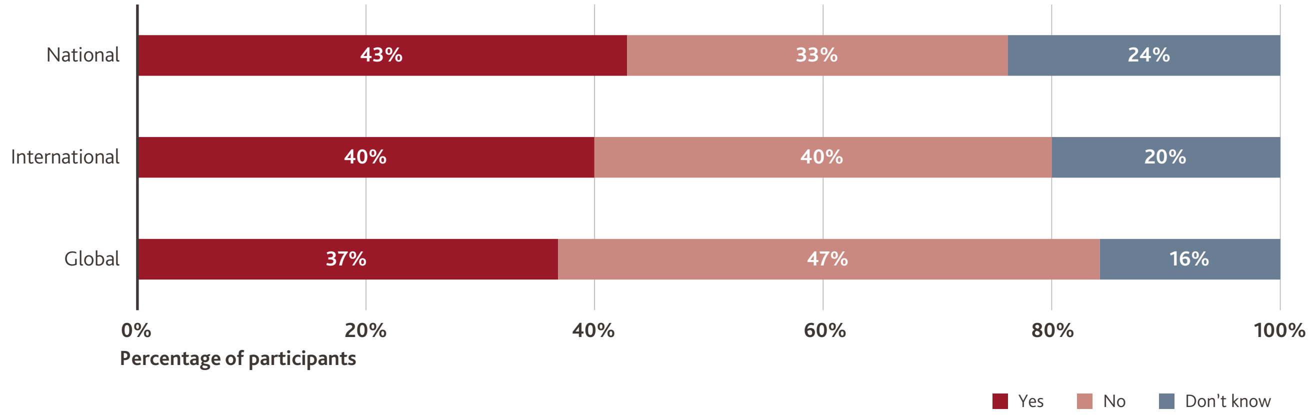
WILL BUSINESS PROFESSIONALS BECOME PARTNERS?

> "The question is: do you make your data analyst part of the equity partnership when they get to that stage? And if not, do they feel valued with influence and authority?"

There is a broad consensus that non-legal professionals will play a more important role in law firms in five years' time, bringing with them both a different skill set and a longer term view. The nature of their work internally and with clients is less likely to be focused on one-off transactions and short-term gains.

However, law firm leaders are almost evenly divided on the question of whether they will want to bring those professionals into the partnership.

Do you expect to want to bring non-legal professionals into the equity partnership in 5 years' time?



Global law firms were the least likely to want to bring non-legal professionals into the equity partnership, with almost half (47%) answering no to the question. International law firms were slightly more likely to want to share ownership of their firms with other professionals, while national law firm leaders were the most likely.

While some law firm leaders see regulatory barriers as prohibitive, for others, the challenge lies elsewhere. "It's not a regulatory issue, it's just culture. We will get there with the right leadership."

In the current culture, partnership continues to be a marker of both authority and success. While many law firms have made their senior business service heads partner equivalents, and some have given them voting rights in decision making, there is still a gulf between how equity partners and "partner equivalents" are perceived.

The solution for one managing partner is not to offer partnership to business function heads, but to tackle this culture and perception within the firm. Instead he wants to make it the norm to have authority without partnership.

ORGANISATIONAL CHANGES

> “[The matrix model] is the worst model except for all the others.”

DIFFERENT MATRICES FOR INTERNAL ORGANISATION

The dominant organisational model within large and diverse law firms is the matrix model. Different law firm matrices have evolved over time to accommodate financial reporting and management along lines which cross geographies, practice areas and industry sectors. Office and regional groups often dominate, while some law firms primarily organise around global practice area groups. To date, the primary purpose of industry sector groups has been to facilitate better knowledge sharing and coordinated marketing and business development rather than hard financial reporting or management decisions.

However we are seeing a continued shift away from practice area reporting lines to more sector and client-focused financial reporting and internal organisation. Still today, very few report profit and loss against sector groups. This is likely to change over the next five years, but perhaps the more radical next step will be law firms organising themselves not just around sectors or clients, but client-solutions such as risk management, or supporting business growth, or reviving businesses in distress.

DIFFERENT PHYSICAL SPACES

The ability to work remotely will have a direct impact on law firm physical spaces, and their second highest expense: real estate. “As we move to more agile and flexible working, our aim is to move to 120% occupancy” said one law firm leader.

For others location will be less important. “In ten years’ time, we may not need an office in London” said the managing partner of a firm that for most of its history has only had an office in London.

BROADER AND MORE DIVERSIFIED BUSINESSES

Many law firms are planning for or are in the implementation stage to set up new adjacent or offshoot businesses. These subsidiary or adjacent businesses are able to offer a range of new non-legal services. Standalone businesses can take on external funding, and give non-legal managers an equity stake, overcoming some of the structural barriers within the main law firm. There are also brand and reputational considerations to separating out technology, or non-legal advisory services from the main law firm, but diversifying can reduce risk and deliver a potential capital upside.

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