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Why is the traditional law firm business model under pressure?

Undercapitalization is challenging the sustainability of the traditional law firm business model.

Law firms are increasingly investing in technology and talent to meet clients' and general counsel's changing expectations. Since the global financial crisis of 2008, clients increasingly value the delivery of tangible results and are less likely to feel duty-bound to remain loyal to a law firm if they believe they'll secure better value for their money elsewhere. Meanwhile, inescapable investments and increasing operational costs are reducing profit margins. Undercapitalization is increasing across the sector, driven by two key pressures: technology and talent.

The technology takeover

Technology continues to disrupt law firms' delivery models. Sources suggest that approximately 80% of law firms' revenue comes from 20% of their clients, and technology is enabling firms to maintain these business relationships by delivering new capabilities with greater efficiency.

Firms are increasingly using artificial intelligence (AI), predictive analytics, automation and clustering models to drive relationships. Technology also enables firms to streamline their operations and limit their overheads. On average, 80% of decisions can be made by an AI model. By leveraging this technology, firms are able to save thousands of hours a month and either utilize this time by providing new services, or redistribute resources elsewhere.

While technological innovation brings opportunity, it also brings disruption. Although law firms have historically maintained a monopoly over profitable transactional work, technologically-capable challengers, such as alternative legal service providers (ALSPs), are increasingly claiming the revenue for these services.

> *"Larger law firms with higher revenues and more disposable capital are better positioned to respond to these challenges by investing in the necessary technology. For smaller law firms, the choice is mainly between developing specialist services to target niche markets or become generalist. While specialist experience and knowledge on a niche area enables firms to charge a higher price, general practice suffers the impacts of large overheads and decreasing value for generalist services."*
>
> George J Wolf, Jr. - Managing Director, Law Firm Advisory Team, Aon

Law firms that are slow to invest may find it more financially burdensome than it would have been to raise capital for acquiring competitive systems previously. The rapid pace of technological development means many late investors may never catch up.

The millennial handover

Undercapitalization is affecting the next generation of leaders. As existing partners approach retirement and enjoy the benefits of unfunded partner retirement plans, the next generation are responsible for generating the capital to fund these schemes. Meanwhile, retaining earnings to invest in technology and develop future talent is critical for sustainable success, adding additional pressures to find new ways of utilizing the business model.

As firms prepare for the handover from the baby boomers to millennials, there is also a need to replace the departing knowledge and experience. Millennials are acutely aware of their role in building a sustainable future for the firm. Where previous generations have typically valued stability, millennials aren't afraid to job-hop to gain the skills necessary for rapid professional development. This demand for development opportunities, alongside expectations of flexible arrangements, access to advanced technology, and high diversity and inclusion standards, are forcing firms to innovate at speed.

Experts suggest the law firms best suited for future growth are those that embrace change. If business leaders decide to ignore the changing values and expectations of the next generation, they risk losing out on top talent and innovation that are critical for sustainable success.

Consolidation is a growing trend in the legal sector. Although internal development programs, technology, and competitive benefits are key ways that firms are limiting their talent turnover, increasing undercapitalization is limiting the investment opportunity for many firms. Lateral M&A activity enables firms to acquire the necessary talent and technology, but at a cost.

> *"Larger firms are typically better positioned to invest in mergers or acquisitions. Diminishing market share and limited capital add new dimensions to the uphill challenge facing mid-sized law firms."*
>
> George J Wolf, Jr. - Managing Director, Law Firm Advisory Team, Aon

Looking ahead – prepare for the future

In the current economic and practice environment, even well-managed firms are now likely to need increasing levels of partner-contributed capital to combat the challenges of technology and talent innovation. In this period of accelerated innovation and opportunity, it's critical to consider the challenges your firm will face over the next 6 to 12 months.

Reacting instead of preparing for issues may mean it's already too late. Action needs to be taken before technology becomes too expensive and key staff move laterally, potentially taking 10-15% of the business with them.

Working with a specialist risk management and consulting team enables firms to benefit from an external and objective perspective to identify issues before they negatively impact the firm. Bridging the generational gap can be challenging, and the need to bring consensus amid a clash of diverse values and priorities is critical to move forward in a systematic and financially sustainable way.

If you'd like to discuss any of the issues raised in this article, please contact **George J Wolf, Jr**.