

The Edge Effect of the Legal Ecosystem

Alignment Will Be the Catalyst for Successful Evolution

In ecology, the term “edge effect” refers to the boundary of two or more habitats. At the edge of two intersecting habitats scientists find greater diversity of life, including unique species that are specially adapted to the conditions of the zone where the two habitats come together.

Today’s corporate law departments and law firms are in many ways like those adjacent ecological habitats: in their respective legal habitats, each faces different market pressures and has different resulting needs. As in ecology, in the zone where they come together there is an opportunity to evolve new species of service delivery models for the legal ecosystem.

Macro trends in the legal ecosystem

Law departments have evolved rapidly over the past decade because of financial and other market pressures in addition to internal pressures. They are now focused on the next stage of their evolutionary journey – to climb higher on the value chain in their role as advisors to the business. Law firms, in turn, face increasing demands from their law department clients to change how they deliver their services and provide value. For legal organizations that are willing to adapt, there is a clear opportunity to evolve in a way that will differentiate them from the competition.

The law department habitat. Over the past 10 years, law departments have progressed, having experienced a financial crisis and the resulting increased (and now perennial) pressure to “do more with less.” More recently, their evolution has become more nuanced, focusing not only on cost but also on delivering value and more directly meeting the needs of the organization as a whole. This has resulted in the chief legal officer and corporate counsel becoming more involved in influencing business strategy in today’s heavily regulated and complex global market. New issues that today’s general counsel deal with include cybersecurity and data privacy, a web of sometimes conflicting international regulations, global supply chain concerns and much more.

With growing complexity comes increased risk, and law departments are seeing an increasing demand for legal

services. Budgets, however, are not growing as quickly, causing a misalignment between budget and service needs. According to the recently released [2018 HBR Law Department Survey](#), 81 percent of responding law departments expect their legal needs will continue to increase in the next year.¹ To respond to these pressures, law departments have made material improvements in operational efficiency:

- *Work allocation.* Law departments are reallocating work to ensure the right work is being done by the right resources. Having operationalized lower-value work for efficiencies, law departments are now widely leveraging alternative service providers (ALSPs) and offshore resources. This allows law departments to free up internal capacity to bring additional higher-value work in house. Fifty-two percent of the respondents to the 2018 HBR Survey indicated an increase in law department staff and 40 percent expect to add lawyer headcount, both up from last year’s survey results. A legal operations leader at [HBR’s 2018 Legal Lab](#) described this shift as “crossover,” the occurrence when a law department’s internal compensation and overhead expenses are greater than its outside counsel spend.²
- *Outside counsel management.* Law departments continue to refine their outside counsel management programs, emphasizing guidelines, alternative fee arrangements (AFAs) and convergence programs. The Corporate Legal Operations Consortium (CLOC) is driving many best practices in this area.
- *Next generation technologies.* Law departments are implementing and upgrading technologies to automate manual workflows and create visibility into workload and spending. According to our Survey, 49 percent have legal spend analytics solutions and 26 percent plan to implement them. As new technologies evolve, law departments continue to seek ways to more efficiently perform legal work. For example, contract management solutions are currently the most popular next-gen technology (55 percent have implemented them and 29 percent plan to implement them).

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Nevertheless, the most significant law department priority is outside counsel fees. AFAs are still seen as a potential solution to rising outside counsel costs, with 73 percent of Survey respondents actively seeking to increase their use. Procurement and finance departments, which seek to measure the benefits of partnership with specific law firms, suggest that AFAs lack transparency, however. While law firms are in the best position to use strong analytic data to educate their corporate clients about the benefits of AFAs, most firms are not mining and leveraging their data in this way. Therefore, many law departments continue to default to discounts as the best proxy for value.

Law departments' current challenges can be summarized as follows:

- Growing volume of legal work
- Ongoing need for cost control and management
- Increasing regulatory complexity
- Risk management and cybersecurity
- Relatively static budgets
- Need for predictability

The law firm habitat. Law firms are advanced in certain areas and lagging in others relative to their corporate law department clients, but several competitive market forces are exerting pressure that is likely to accelerate their pace of change. These include the following:

- *Increased competition for legal work and the associated value challenge.* In addition to competition with other law firms, firms face competition for legal work from their own clients as discussed above, ALSPs and, more recently, the Big 4 accounting firms. Law firms must find ways to differentiate themselves from their competition by delivering incremental value to their clients, whether through different fee structures, tailored solutions or other innovations centered on addressing clients' most pressing needs.
- *Pressure to improve technology.* Clients want their outside counsel to operate more efficiently and be able to leverage technology to share data. However, pressure also comes from inside the law firm. Younger associates who want alternative working environments expect all the tools and functionality of a traditional office at their fingertips when working remotely.
- *Changes in law firm/corporate client relationships.* In the past, law firms could rely on individual partners' strong relationships with key clients. In our current legal ecosystem, efficiency and value increasingly take precedence over individual relationships. A perpetually active lateral market and related portability of business are also significantly changing historical firm/client relationships.
- *Shifting talent needs.* An active lateral market has created a need for partners whose portable business portfolios are compatible with the firm's practice areas, fee structure and other clients. At the same time, firms struggle to recruit, retain and train diverse talent that meets changing work needs and that no longer always fits the traditional partnership track.

These pressures conflict with the traditional law firm model, which is becoming harder to sustain in terms of compensation structures still heavily influenced by the billable hour system. Law firms have significant fixed expenses, including compensation of all non-equity employees. Yet equity partner compensation is based on firms' earnings, and profits per partner have continued to rise

despite the increasingly competitive market for law firm services, arguably indicating greater regard for short-term individual gains versus longer-term investments in the firm to ensure future success of the collective organization.

Law firms must find ways to differentiate themselves from their competition by delivering incremental value to their clients through different fee structures, tailored solutions or other innovations centered on addressing clients' most pressing needs.

Fortunately, some forward-looking firms are now investing in changes to position themselves for longer-term success. Examples include: developing alternative business models, bringing recurring revenue products to clients, partnering with third parties, co-innovation and other creative ideas.

Law firms' current challenges can be summarized as follows:

- Responding to the value challenge and quest for efficiency
- Responding to market segmentation and new competition from their clients, ALSPs and the Big 4
- Developing a talent pipeline: succession planning and re-examining what it means to be partner
- Technology and security

Moving forward: evolution will require greater alignment

In the current legal ecosystem, both law departments and law firms have an opportunity to evolve. Like the analogous ecological species in the edge zone between habitats, legal organizations must adapt to their common environment and to each other's needs in order to evolve and thrive. This requires legal organizations to focus on aligning in three core areas: (1) strategically, (2) with a customer and business focus and (3) operationally.

Strategic alignment. What makes a law department or law firm unique and how is the organization leveraging that to its advantage? What are the key strategic imperatives? Are they clearly communicated across the enterprise, transcending practice groups, operations, regions and other organizational divisions and business segments? These are questions legal organizations need to address in order to align strategically.

Law departments must examine the scope of the services they provide, directly and indirectly, and their role within the businesses they support. For example, too often, in-house clients "over-index" when assigning matters to outside counsel, defaulting to elite firms for reasons of risk aversion and reputation, even for relatively low-risk matters. Law departments can educate their business clients regarding risk awareness, equipping them for better business alignment in the selection of outside counsel.

Law firms must re-examine their continued reliance on the billable hour system as a fundamental pillar of their business models. For example, leading firms are implementing value-based pricing using historical data (although few firms currently mine and analyze that data) or creating business structures outside the partnership to handle commoditized work.

Customer and business alignment. Alignment with an organization's customers is a clear differentiator. When solutions are specifically focused on the customer's needs, everyone wins. Some examples include:

- *Aligning workloads and transforming service delivery based on resource optimization.* This may involve disaggregation of categories of work or collaboration, forums to engage the business with outside counsel and post-matter debriefing communications that transcend matter teams.
- *Co-creation or co-innovation projects to ensure the voice of the customer is heard.* At HBR, we have had success with programs bringing together select groups of law department and law firm leaders to brainstorm and collaborate to find ways to solve issues collectively.

There are many other opportunities: law departments can hold their own forums to engage business clients with outside counsel, law firms can benchmark operational excellence in cooperation with a small group of progressive clients to ensure they are keeping pace, and more.

Given that we are in a period of rapid change, evolving in a customer-centric manner is the best way to achieve a competitive advantage. Law firms and law departments must be willing to experiment and take measured risks. For example, Chapman and Cutler LLP [recently sold](#) a deal management application to NetDocuments that had been developed by the firm's practice innovations group.³ The application was designed to streamline transaction closing processes and had been successfully used by the firm to create efficiency and save costs.

Operational alignment. Aligning law departments' and law firms' operations with their strategy-specific goals helps them better achieve those goals. Some areas for operational alignment include the following:

- *Data-driven metrics.* A comprehensive metrics program allows law departments and firms to demonstrate their value and make data-driven decisions. Law departments and law firms have an abundance of available data although, to date, [law departments have made better use of it](#).⁴ Critical criteria include a well-designed taxonomy, good data hygiene, and the people and processes to best manage the data. Data measurement and analysis can lead to insights regarding timekeeping, e-Billing and other related information; can guide pricing and development of AFAs (a major opportunity for law firms); can programmatically demonstrate ROI on innovations; and more.
- *Technology enablement.* Technology can streamline operations in a customer-centric manner. For example, law departments are helping their business-side customers leverage various self-service technologies, thereby freeing up lawyers' time. Law firms are

developing stand-alone, product-based solutions that allow for a recurring revenue stream or give clients greater access.

- *Change readiness.* Most importantly, law departments and law firms must be change ready. This requires a heightened awareness of the steps and methodologies needed to successfully navigate change. In addition to understanding change management principles, leaders should cultivate an environment that supports creativity, proactive thinking and continuous growth – for example, by aligning employee incentives with new initiatives and recognizing contributions at each stage of innovation: generation, implementation and the successful outcome of the idea. Leaders further foster a culture that supports transformative innovations by demonstrating executive commitment to and support of any changes the organization undertakes.

When legal organizations align in these core areas, they can naturally evolve and thrive.

Law departments and law firms must align strategically, with a customer and business focus and operationally in order to evolve and thrive in the current legal ecosystem.

Conclusion

Species in diverse, adjoining ecological habitats must find ways to coexist, aligning with the environment and with each other's needs in order to evolve. From HBR's perspective within the legal ecosystem's transition zone as advisor to both law departments and law firms, the same is true for adjoining legal habitats: alignment is critical in legal organizations' next stage of evolution. Law departments and law firms must adjust to the current market environment and understand each other's needs to creatively adapt and successfully evolve, in order to ensure long-term success. Law departments can continue to refine their transformation,

while law firms have the opportunity to “leapfrog” their evolutionary journey.

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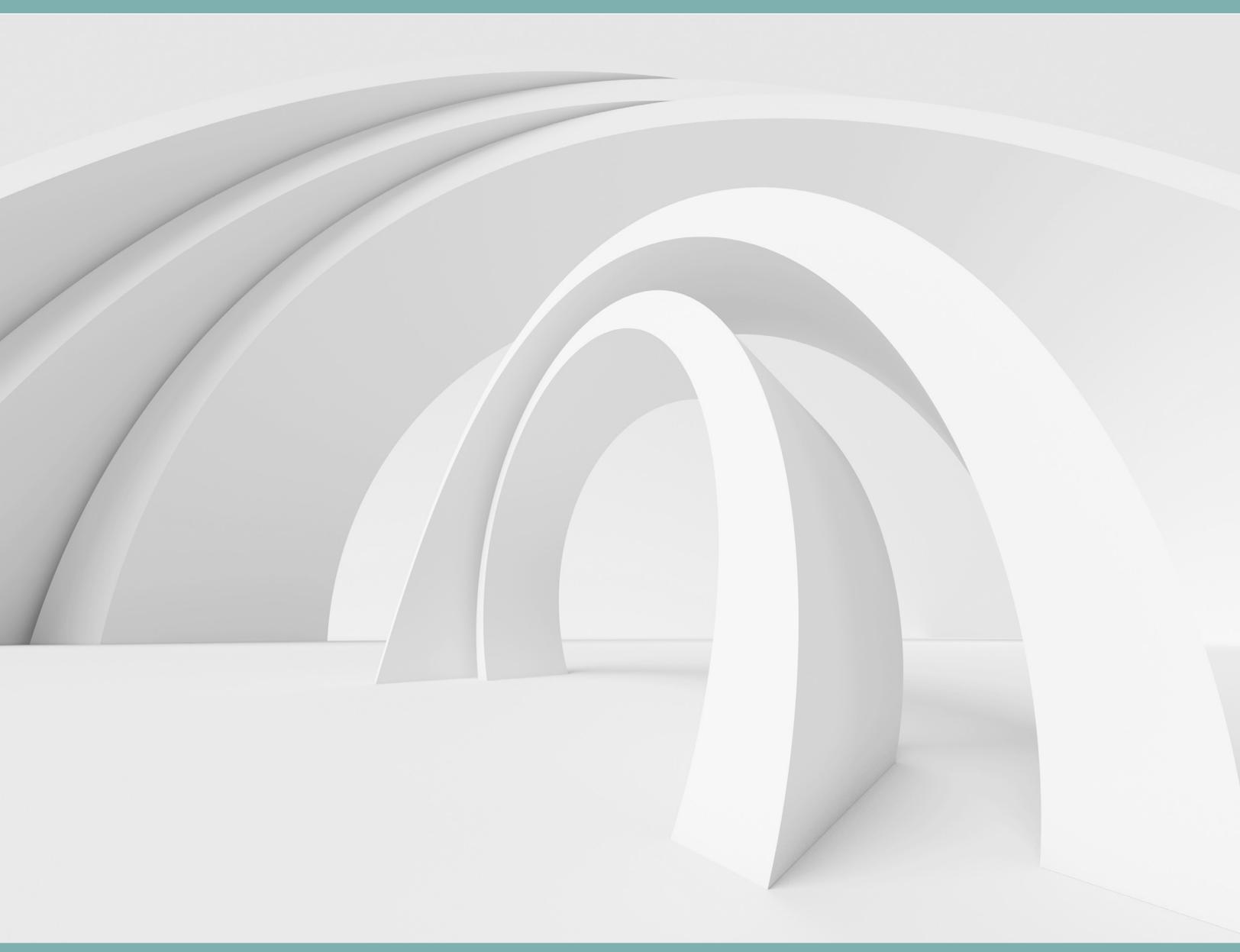
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