The Legal Intelligencer

Back to Article

Law Firms Feel Pressure From New Breed of Competitors

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10-26-2010

The legal industry is falling apart. Not in the sense pundits meant when they gave that diagnosis in 2008 as firms were hit with the harsh reality of the recession.

Rather, the industry is moving away from a monolithic provider of legal services -- the law firm -- to a fragmented service platform where the competition isn't just a broadening array of law firms, but legal process outsourcers and other non-law firm legal service providers as well. "Law firms are really being circled by these things," consultancy Adam Smith Esq. partner Janet Stanton said.

Firms have to decide where they want to compete and how, and what fits in their business model, she said.

Not only are LPOs and other firms that are adapting their business models a source of increased competition for law firms, Edge International consultant Jordan Furlong said, but so too are clients who are increasingly bringing more work in-house.

"The overall marketplace for legal services is fracturing," Furlong said. "It's unbundling and specialists are emerging. Legal work will go to the provider best designed for that particular work in terms of personnel systems and mindset."

By "mindset," he means firms that focus on doing only the high-end, bet-the-company work and those that do more of the commodity work.

"Law firms are just going to have to decide what kind of work they want to compete for," Furlong said. "Law firms can't be both the bet-the-company law firm and the commodity law firm. I don't think that's sustainable anymore."

Both Furlong and Stanton said there will be a trend toward boutique firms on one end and large, global firms on the other with little in the middle.

The pressures from LPOs are real, they said. Law departments simply have to find ways to get what they need done for less money and they are slowly starting to realize that the quality isn't lost when using an LPO, Furlong said. Both Furlong and Stanton pointed to the increased hiring by many LPOs of seasoned, high-quality attorneys to do this work.

"I think this is permanent, which is rare," Furlong said. "Trends come and go all the time. This one I think is here to stay. I think it's driven more by clients than by lawyers, but mainly just by the marketplace."

LPOs have been created in direct competition to law firms with a goal of serving law departments and others are looking to get law firms as clients. Sometimes clients hire the LPOs and other times law firms do. On the whole, it seems the bulk of LPOs are servicing law departments and are being hired directly by law departments or by law firms at the express direction of their clients.

Stanton said she is increasingly seeing a move to master contracts in which law departments use a certain provider for all of a type of service and demand that their law firms hire that provider to do that work on their matters.

Many LPOs began by offering e-discovery or document review services, and that is work that will never come back to the law firm, she said.

"How many years ago did BMW stop making car radios?" she asked. "It's gone, it's not coming back."

Firms can either find a way to provide those same services economically or they can give it up, she said. LPOs aren't going to stop there. Stanton pointed to depositions as just one other area LPOs might look to get into.

A GNAT IN AN ELEPHANT'S EAR?

Despite talk of change during the recession, there was a complaint from law firms that clients weren't all that interested in changing how business was done. Furlong said general counsel can be conservative themselves and hesitant to pull the trigger. But as market forces make LPOs a more attractive option economically for some matters and general counsel test the waters and realize this might be a realistic alternative, the shift will start to happen more and more, he said. But some general counsel aren't sold yet.

Roy Hibberd, general counsel of Berwyn, Pa.-based Dollar Financial Corp., said his department looked into outsourcing a few years ago to have a company handle a number of similar contracts. After doing a pilot program, he said he thought the work was good but the nuances weren't being picked up. Hibberd ended up bringing in contract lawyers to do the work instead.

In the last few years, however, Hibberd said it has been interesting to see the increase with which he has been pitched by outsourcing and offshoring companies. The pitch is often to cut out the law firm and have these companies do the work directly, he said. It's ultimately up to the general counsel whether to use the companies. It may make more sense, Hibberd said, for a pharmaceutical company with consistent, similar litigation, for example, to use outsourcing services than for his company.

Not all law firm leaders, perhaps unsurprisingly, agree LPOs are a threat.

"I wish LPOs nothing but the best, but they are a gnat in an elephant's ear when it comes to K&L Gates," the firm's chairman, Peter Kalis, said. There is more talk than action when it comes to LPOs, not only from the media, client community and LPOs themselves, but from major law firms whose overhead is "grotesquely swollen" because the bulk of their lawyers are in New York or London, he said.

"If you, within your platform as a law firm, can localize a lot of back office services and more routine-type services for clients in low-cost venues, you can achieve the same sort of outcome without risking attorney-client privilege, without worrying about transporting certain IP across national lines ... and without having the long-distance management problems that always characterize those sorts of relationships," Kalis said.

He said he finds it difficult to ever consider a company that does not provide the same attorney-client privilege guarantees as law firms a threat. And Kalis said he finds the idea that clients are competition "simpleminded." There is always an ebb and flow between overall workload passed in-house and to outside firms. What clients find valuable one day might become commoditized the next. That is nothing to fear, but rather an ongoing challenge for firms to reinvent their value proposition, he said.

Kalis said his competition is other law firms -- law firms of all breadths, depths and geographic reaches depending on the type and scope of work at issue. What has changed over the last decade is the traditional relationship between specific companies and specific law firms, he said. Those relationships are being challenged by the value proposition of other law firms, creating fewer safe harbors for firms that are part of the old regime of relying on institutional client loyalty.

"That development is great for law firms that are willing to continuously re-examine, repackage and re-articulate their value propositions," he said.

NUMBERS TALK

The LPOs are increasingly capitalizing on the void left by firms that haven't adapted their value proposition.

David Perla, co-CEO of New York and Mumbai-based outsourcing company Pangea3, said 80 percent of his business continues to come from law departments. There is interest from younger partners at law firms who realize the market is changing and from firm management who want to be educated about outsourcing when clients ask about it. But Perla said he isn't sure whether law firms will make any major institutional changes in this regard.

Pangea3 will see a few million dollars in business this year from a law firm that brought the company work the firm's client simply wouldn't pay for young associates to handle.

Far and away, Perla said, the revenue and profit engine for his company is document review for litigation and government investigations. There is always a law firm working with Pangea3 on these matters, but the company is still most often hired by a law department. That is the one area where Perla said he could see law firms become more directly involved in the hiring.

The second-biggest revenue driver is corporate services, including contract drafting, review and revision; and mergers and acquisitions due diligence, he said. There is no law firm middleman in that situation, Perla said.

Pangea3 also handles intellectual property analysis, patent preparation, prosecution and IP asset management. The client mix there is much more diverse, with law firms using Pangea3 and not viewing the company as a threat, he said. The final component to Pangea3's business is risk management and compliance. That includes everything from managing committee minute books and SEC filings to business intelligence. Typically a company's chief compliance officer would hire Pangea3 for this work, he said.

Perla said he always guesses the 80-20 split will shift, with more work coming from law firms, but it never does. Because law departments are picking it up so rapidly and law firms are relatively slower, he doesn't see that ratio shifting soon.

There's also a regional aspect to the business. Going directly to a law department in Philadelphia or Pittsburgh is a tougher prospect than going to New York or San Francisco, Perla said, because there is a closer bond between Pennsylvania clients and law firms than in other markets.

Though some are hesitant to embrace LPOs, numbers speak volumes. Perla said his company's slowest year in terms of growth was in 2009 when it grew 60 percent. Pangea3 just finished the first half of its fiscal year and had revenue greater than the full 12 months prior. He said the company is on track to grow 250 percent this fiscal year. Pangea3 wouldn't disclose its revenue, but media reports showed the company earned more than $8 million in 2008.