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Exploring the Impact of AI on the Economics of BigLaw

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FELLOWS

> “Decisions have to be made for the way the world is, not the way we’d like it to be.”
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> - Charlie Munger, Berkshire Hathaway

Advice to BigLaw Firms: AI investment decisions should focus on profitable revenue, competitive advantage, and improved legal outcomes.

This article explores the economic impacts of Generative AI/large language models (AI) in the legal service industry, specifically for larger law firms, a.k.a. BigLaw. We will start with some premises we feel are very likely and then build on that.

FIRST PREMISE: AI WILL MATERIALLY IMPROVE THE PRODUCTIVITY OF LEGAL WORKERS.

AI is poised to achieve this in most service industries, but we believe the impact will be particularly profound in the legal sector. To clarify, instead of using the legal industry's unconventional definition of "productivity," we are using the traditional economics definition, which describes the reduction in the labor required to produce a specific output. This translates to fewer billable hours needed for the legal industry to generate a document or legal outcome. Several studies have already demonstrated that AI will bring about this transformation in the legal sector.

The legal services industry has yet to experience an innovation that significantly improves productivity. Some innovations have yielded the opposite result. For example, word processing and document management systems increased the time required to create final documents, allowing for increased document iterations during the drafting process.

SECOND PREMISE: AI'S PRODUCTIVITY ENHANCEMENT WILL RESULT IN A DECLINE IN REVENUE AND PROFIT MARGINS PER ENGAGEMENT FOR LAW FIRMS IF BIGLAW'S RELIANCE ON THE BILLABLE HOUR DOES NOT CHANGE.

The revenue decrease is self-evident. The margin decrease will occur because AI disproportionately impacts non-partner hours, the billed hours yielding the highest margins. One model from the Legal Value Network last August suggests that a 5% reduction in partner hours and a 20% reduction in non-partner hours will lead to a 13% decrease in revenue and a 7% decrease in profit margins. This implies that profits will diminish even if a partner generates more work.

This second premise also holds true due to the overwhelming amount of legal work performed on a time and material basis (a.k.a. billable hours). Material increases in productivity for most industries (e.g., Manufacturing or Agriculture) produce an increase in value. Suppliers primarily realize this value as it lowers production costs while prices remain constant. This increased value typically benefits workers, leading to higher real wages. However, in the legal industry, which relies on billable hours, it is far less likely that the suppliers (law firms) will realize the increased value. Without a change in the underlying business model of firms, the new value will flow to clients in the form of lower fees per matter.

SPECIAL NOTE ON THE SECOND PREMISE: AI IS EXPENSIVE.

The primary technology for this is already quite costly. While it will likely become more affordable over time, this reduction will take time to happen. Secondly, implementing "use cases" for this technology will require significantly adding and allocating human resources beyond lawyers. Firms will need to create new roles to manage this, which will require high-demand and high-priced skill sets. To that point, CIO magazine recently reported that posts for generative AI jobs increased roughly 1,000 to 1,500% from year-end 2022 to year-end 2023. We include this special note to emphasize that productivity increases will come at a premium price.

One final point to highlight here: this is a ***new*** technology. It does not replace any existing tech firms may have. It may augment some current systems, but overall, it will constitute an additional technology expense for firms, resulting in higher overhead costs .

THIRD PREMISE: LAW FIRMS WILL MAKE THESE INVESTMENTS.

We are already witnessing a frantic rush among law firms as they scramble to grasp this new technology. We see no reason for this momentum to stop or even decelerate. On the contrary, we anticipate that the pace of adoption will accelerate.

One reason for this is that AI investment in a legal practice will not be a one-time occurrence. For instance, a firm aiming to enhance agreement drafting efficiencies in an M&A practice won't stop there. Subsequent use cases within an M&A practice will drive ongoing efficiency improvements, resulting in progressively lower revenue per engagement and likely further erosion of leverage, impacting profitability. However, this iterative approach will likely lead to better legal outcomes for their clients.

Moreover, another aspect to consider is that the underlying technology will evolve rapidly. In addition to accumulating more use cases, the evolving tools will gain new capabilities. As these two attributes accelerate, the combined impact on service offerings will increase significantly, but at a cost.

OUR ECONOMICS QUESTION

What happens in a service industry that primarily bills by time when productivity significantly increases, as in the case of AI? The only answer is that revenue per engagement and profit margins will decrease. Furthermore, this will occur when costs rise due to the significant expenses associated with these new technologies.

From a fundamental economic standpoint, we currently observe a relative equilibrium in the BigLaw legal market, wherein the number of lawyers at BigLaw firms meets the existing demand for services from BigLaw clients.

In the BigLaw legal services market, the macro demand curve is relatively flat, indicating that it is price inelastic, more commonly understood as price insensitive. Clients have minimal discretionary legal spending. When faced with litigation or an acquisition, they must purchase legal services. This demand curve has historically remained stable and will likely continue to rise as legal regulatory complexities increase.

We assert that our current supply curve follows a typical pattern.

So, what will occur in this scenario is that the supply curve will shift outward because it will require fewer lawyers to fulfill the same demand. We should clarify that most analyses of the legal market describe demand in a non-economic term; it is generally defined as the number of hours BigLaw firms provide to their clients (which is a supply metric). In the context of our discussion, economic demand refers to the number of legal outcomes clients will procure. It is widely recognized that this number will continue to rise, as previously mentioned. The disconnect lies in the fact that increased productivity will require fewer suppliers to meet this demand.

Outcome #1: Competition among suppliers (law firms) will intensify.

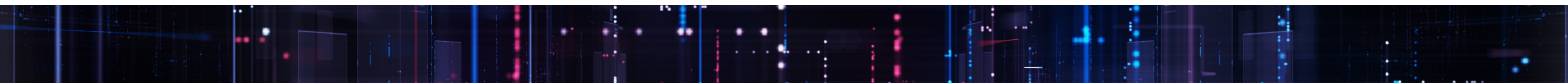
With decreasing revenue per engagement and declining margins, firms will aggressively seek new client work. Some may argue that this will lead to a reduction in prices, and it will, but not at the billing rate level. Instead, we propose it will occur at the project or engagement level. Firms will have two primary options for acquiring this work from their peers. First, by winning it through competitions, and second, by recruiting the business-generating partners from those same peer firms.

Outcome #2: Following Outcome #1, competition for business-generating (BG) partners will escalate. The already competitive market for lateral partners will become more intense. This will likely drive up compensation for these types of BG partners, furthering the disparity in partner compensation within firms. Down-market firms will face more significant challenges in attracting BG Partners with larger and more profitable books of business. Up-market firms will poach talent from firms in the tiers just below them or from peer firms when financially feasible.

As a corollary to the previous point regarding BG Partners, we anticipate that non-BG or insufficiently productive BG partners may encounter growing difficulties. It's worth noting that many firms currently have an oversupply of these non-BG partners, exceeding their actual needs. This is substantiated by industry reports showing that lawyers in this category typically bill the fewest hours. These factors collectively contribute to significant and escalating challenges for this group of partners within BigLaw firms in the future.

Separately, there will likely be less demand for entry-level and junior associates in the future as AI will handle many of their traditional tasks.

Before we proceed further, let's dig a bit deeper into AI. Firms will have numerous opportunities to deploy this new technology. We categorize



these choices into three broader categories. The first is the Back Office, where AI will enhance the productivity of the firm's business services staff, potentially affecting areas such as business intake, website content generation, billing, and collections. These investments are expected to yield a return on investment (ROI) for firms. While we will not go into more detail in this article, firms should calculate and understand the expected ROI before making these AI investments.

Next is the Middle Office. We define this as the administrative tasks performed by billable timekeepers, which AI will also disrupt. This encompasses tasks such as time entry, bill review, or even professional development. Again, this is not the focus of our paper. Still, AI has the potential to accelerate the skill development of lawyers, significantly expediting their acquisition of various legal skills.

Lastly, there will be Front Office options. These involve use cases where timekeepers engage in client work, and this use of AI is the focus of this whitepaper.

MARKET PLAYERS REACTIONS

So, what would a rational (economically) firm do to address this challenge?

To determine this, let's investigate the expected outcomes.

First Outcome: Revenue per engagement will decline, and profit margins will decrease due to reduced leverage (non-partner hours).

A rational firm's response would be to pursue additional engagements actively. As previously mentioned, they will need to capture market share from their competitive firms to achieve this.

Another rational reaction would be for firms to focus their use of AI on their economic strengths: practices and industries they are "known for" and which are also profit generators. By doing this, firms will be better positioned to pull work from competing firms, as their price-per-engagement will be competitive. Additionally, they can develop a significant competitive advantage by generating valuable metrics from their AI usage. For instance, one example would be gaining a deeper understanding of various clauses used in a particular document type.

However, we generally witness a less strategic deployment of AI, often characterized by haphazard implementation choices.

Firms cultivating competitive advantages will be well-positioned to secure business from other firms. Consider two incumbent firms providing services to the same client on a specific type of work. An up-market firm with higher rates can win work from the down-market firm by showcasing costs per engagement that match or fall below the down-market firm's figures. This allows the client to engage a more skilled firm while effectively managing costs. Furthermore, we would like to emphasize that current research demonstrates that AI not only enhances productivity but also elevates the quality of outcomes, which constitutes a primary factor in how clients select outside counsel firms.

What we envision might resemble this: We anticipate a cascading waterfall effect in which up-market firms can capture a significant share

of their client's business. These firms will first target work from their direct peers who have yet to invest in AI strategically, and subsequently, they will target work from down-market firms. Down-market firms, in turn, will seek to replicate this pattern by capturing work from lower-priced firms.

The implication for more down-market firms with weak commercial practices (e.g., needing a coherent strategic approach, including a rate strategy, pricing and LPM functions, business-focused practice management, and strategic lateral programs, etc.) will find themselves at a distinct disadvantage and increasingly vulnerable. Without a strong commercial focus, their financials will not support strategic AI investments or implementations, leading to both talent (BGs) and client defections, resulting in an inevitable, albeit slow, decline.

THE NEW DEMAND CURVE(S)?

As firms continue to invest in AI, they will exert downward pressure on the price-per-matter, potentially for an extended period. This may shift client behavior from pricing based on inputs (hourly rates) to pricing based on outputs (fee-per-matter). This shift becomes possible because legal departments can clearly demonstrate cost savings to their company leadership without relying solely on rate discounts.

If and when this transformation occurs, new demand curves will emerge increasingly granularly, categorized by practice type and service offering. While the overall demand for legal services will persist in its upward trajectory, specific types of work may become segmented. This segmentation will introduce downward pricing pressure at the matter/fee level. These more price-sensitive markets are likely to drive down prices across the industry, resulting in more steeply-shaped demand curves at the macro level.

Another way to view this segmentation is to consider the value level of legal work being performed on the client. Drawing inspiration from Jae Um, we categorize BigLaw legal work into three distinct segments: Cream, Core, and Commodity. Cream legal work represents the highest sophistication and risk in the market. Clients demonstrate minimal fee sensitivity for this type of work and are willing to pay premium rates. However, the amount of Cream work has been declining and will continue to do so as clients increasingly disaggregate their work by risk and sophistication.

Core work constitutes the run-the-business legal tasks. While some price sensitivity is associated with this work, it typically accounts for the most significant portion of a client’s legal spend. It encompasses the work that holds the highest importance for the legal department’s internal clients, enabling the company to operate, develop its products, and bring them to market.

Commodity work resides at the lower end of the spectrum. It is essential for the company’s continued operation but is highly price-sensitive and carries minimal risk.

We anticipate that rational firms will prioritize AI investments in Core practice offerings. We foresee the Commodity level being outsourced to ALSPs. Cream work, representing the highest sophistication, will likely await market developments.

If firms concentrate their AI investments, they could gain a genuine competitive edge (and grow market share) in specific practice areas. These advantages will encompass both pricing

competitiveness and superior outcomes. One possible consequence of this shift is that firms may specialize more in AI applications. This opens a realm of intriguing possibilities to explore. For instance, could partners migrate to firms with specialized AI capabilities aligned with their practice areas? “Platform shopping” may take on an entirely new dimension.

Related to this, the value of BG Partners will continue to rise, leading to heightened competition for laterals in an already frothy market. Only firms willing and financially able to offer competitive compensation packages to these partners will succeed in attracting and retaining them. Rational firms must develop far more strategic lateral hiring programs modeled after M&A functions in other businesses.

SOME GOOD NEWS

Market opportunities that will emerge for firms, consistent with the comments above, will be in the Core segment. However, this won't solely involve capturing work from other firms; it will also revolve around how they do so. Firms will be capable of harnessing the efficiencies generated by AI and converting them into portfolio offerings. Consider a scenario where a firm heavily invests in AI for transactional practices, using these capabilities to extend their reach lower into the transaction space by streamlining processes for groups of matters. Clients will reap the benefits of reduced costs per matter from more experienced firms. In contrast, firms will enjoy the advantages of recurring revenue derived from more significant and “stickier “revenue engagements.

As mentioned earlier, once a firm invests in practice-based Gen AI, it will be compelled to continue augmenting that investment to maintain its competitive advantage. The deeper they dive into these investments, the more challenging it will become for a partner to leave the firm. The toolsets will be distinctive and not easily replicable by another firm. Thus, partners contemplating a move will need to weigh their decision carefully. Moving firms could jeopardize client relationships if they cannot replicate the efficiency and quality output generated by the AI investments at their new firm.

RESULTS

Firms strategically investing in AI will position themselves more favorably to capture and retain market share. In contrast, firms that make haphazard investment choices must help maintain their standing with clients. Clients will reap the benefits of reduced costs stemming from engagements with highly skilled firms.

Moreover, clients are making it clear they expect their outside counsel to employ AI in their offerings, specifically to reduce costs. So again, law firms will not be able to dodge these changes.

OTHER (IMPORTANT) CONSIDERATIONS

Profitability

In conventional business markets, companies relentlessly pursue profitability, which remains the primary force behind most business decisions. Competitors that do not share the same commitment to profit often find themselves trailing behind. We anticipate a similar dynamic unfolding in the legal industry. However, a potential caveat lies in the fact that very few law firms possess the means or the will to effectively measure profitability, raising questions about their ability to make well-informed business decisions. We posit that those firms capable of measuring profitability will gain a competitive edge in the market. This trend may already be evident in top-of-the-market firms that continue to outpace their competitors financially at an accelerating pace. Regrettably, our collective experience suggests that most firms need help to measure profit accurately and, therefore, hobble their ability to make sound business decisions.

Of course, savvy pricing is a critical component of profitability. As these new developments bring increasing margin pressure, firms that cannot effectively price their services with the guidance of a professional pricing team will find themselves at a significant disadvantage.

Moreover, the criticality of the commercial functions within a firm will significantly increase. We define commercial functions as those that contribute to a business's financial and operational hygiene. In addition to pricing professionals, these include Practice Management, Legal Project Management, Lateral Partner Acquisition, and other similar areas. In short, firms must become more intentionally and professionally managed businesses, which is anathema to many lawyers.

To be crystal, lawyers need to accord these business professionals the respect they are due. Otherwise, they'll leave for more welcoming pastures.

Effective leadership

Leadership is pivotal in determining how effectively firms respond to market changes. Firms led by strong leaders capable of nimble decision-making are in a far better position to make intelligent choices regarding AI within their firm's overall strategy. However, a significant challenge is that most law firm leaders serve in a part-time, temporary capacity within the firm's leadership structure. They hold positions such as Managing Partner (MP), Management Committee (MC) members, Executive Committee (EC) members, or Practice Group Leaders (PGLs), and their tenures are often fleeting. Many of these leaders have limited experience or training in managing multi-million or even billion-dollar organizations.

Moreover, they serve at the discretion of the partnership, which tends to resist changes that do not directly benefit their individual circumstances. Consequently, most decisions made by leadership often meet stiff resistance from partners. For perspective, the Managing Partner of a "Silver Circle" firm in London described US law firms as "management lite." As a result, law firm leaders who wish to implement strategic decisions must invest considerable time in persuading the partnership and, subsequently, in addressing their concerns.

Compensation systems

This continuing increase in competition for both client work and BG partners is bound to exert pressure on the current law firm business model. From this perspective, it seems unlikely the model will not change. It will be forced to. One example of this will be how compensation for BG partners evolves. Given that most comp systems primarily reward billed hours versus profitable business generation, we don't see how compensation systems will be able to continue unchanged as billed hours become less relevant. At some point, BG Partner comp will force these systems to bend past their capabilities, leading to a crisis requiring change. At this point, we will not guess what the comp systems will change to, but they will need to shift comp rewards toward profitable business generation above "working."

ANTICIPATING THE AI TIPPING POINT

We predict that a select few firms will pioneer AI implementation in strategic practices or industries through intentional efforts or serendipitous discoveries. Once this breakthrough occurs, it will unleash a transformative wave. These forward-thinking firms will rapidly secure a competitive edge, enabling them to capture market share and attract business generators (BG) from their competitors. As this momentum builds, the ripple effect will compel other firms to respond with similar AI investments. Once a critical mass of firms joins this technological race, it will become an ongoing contest, forcing firms to continually invest in AI to maintain their competitive positions.

WHAT NEEDS TO BE TRUE?

With all that in mind, we decided to take a step back and look at this issue with a clean slate. We are very fond of a framework in "Playing to Win" by A.G. Lafley and Roger L. Martin (one of the best books on strategy). Part of their strategic framework is the question of "what needs to be true" for a strategic initiative to be successfully executed. So, we asked ourselves what needs to be true to implement an AI strategy at a law firm successfully.

Again, we're focused on the Front Office functions, where firms engage in client servicing with AI-driven or -informed solutions.

As discussed, the cost structure would be increased. AI technology is expensive. Firms will need to decide whether to "rent" or buy (or build it themselves).

The changes in the business model will call for changes in the revenue model. As discussed, pricing based on outputs would likely be welcomed by clients, as might portfolio pricing, due to their much higher degree of predictability. However, this requires a robust financial infrastructure and solid actuarial data to develop viable pricing models, which are generally lacking at many law firms.

Even for firms that choose to rent AI tech, in-house capabilities would need to be substantially augmented to include those who can (1) deploy, implement, and tune those technologies, (2) serve as client-facing project leaders, and (3) act as a dedicated sales force to generate a sufficient revenue stream. In fairness, part of these incremental personnel costs could be offset by a reduction in the associate and non-BG cohorts. As such, the employee mix would shift more towards business professionals rather than the 1:1 (lawyers: business professionals/staff) generally seen at law firms now.

Of note, these are not jobs where a J.D. has the remotest relevance. They require text preprocessing, tokenization, topic modeling, stop word removal, text classification, keyword extraction, speech tagging, sentiment analysis, text generation, emotion analysis, language modeling, and more.

We must emphasize how in-demand qualified folks in this space are and will continue to be. Virtually every industry competes for these individuals, and law firms must find ways to overcome their inherent disadvantages in appealing to and retaining these folks. The first impediment is financial. As we all know, firms are restricted from sharing ownership beyond lawyers. Other industries will be able to offer profit-sharing and stock options. How can law firms compete?

As importantly, these folks cannot be treated as second-class citizens, as is often a highly unwelcome experience for many business professionals at law firms. These folks will continue to have myriad options in and beyond the law and will not countenance "upstairs/downstairs" treatment.

In closing, we are genuinely curious to witness how and how rapidly law firms will adapt their business models. The current structure, which allows partners significant autonomy and latitude, appears unsustainable. However, we acknowledge the substantial pressures to maintain this model. Firms making early adoptions may gain a significant market advantage, prompting others to follow suit. This remains to be seen.

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[1] Greg Lambert also provided editing support for this paper.