Winston and Crandall: The Law Firm Business Model Is Dying

Rules that were adopted to protect the legal profession from outside competition are actually stifling it.

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On Monday night the century-old law firm of Dewey & LeBoeuf filed for bankruptcy—following in the footsteps of other venerable firms such as Howrey & Simon, Heller Ehrman, Coudert Brothers, and Brobeck, Phelger and Harrison. It is easy to think that greedy lawyers are getting their just deserts. But this should not blind us from seeing that there is a better way for America's law firms to do business.

The problems these firms face today are twofold: Large clients are increasingly using in-house counsel to reduce costs, and the public is increasingly taking the do-it-yourself route given the growing access to a variety of legal services and documents on the Internet. The rational response would be for new, low-cost legal firms to start up, and for incumbents to reduce costs and attract new clients by providing innovative services.

But that is happening only to a limited extent because of state licensing requirements and American Bar Association (ABA) rules. Deregulation could open the market and transform the legal industry for the better.

Regulatory barriers have hamstrung other sectors of the economy in the past until the arrival of deregulation. For example, Interstate Commerce Commission (ICC) regulations raised railroad rates for decades after its inception in 1887. But with the proliferation of motor vehicles, trucks began to capture a large share of rail freight traffic.

Then trucks were included under the ICC's regulatory umbrella in 1935, to prevent railroads' freight market share from continuing to erode. But by raising trucking rates, the ICC induced some shippers to buy and operate their own trucks, exacerbating rail's woes. Similarly, Civil Aeronautics Board regulations elevated airline fares, and by the late 1950s—when interstate highway travel was possible—the high fares limited the percentage of seats filled with paying passengers.

The deregulation of transportation that began during the late 1970s enabled motor, air and rail carriers to reduce costs and, particularly in the case of railroads and airlines, to regain market share by offering consumers lower prices and better service.

How have regulations caused the demise of long-established "white-shoe" law firms? Much legal work is performed by associates, who in most states must graduate from a law school accredited by the ABA and pass a state bar examination. This form of licensing significantly limits the flow of new legal practitioners. It also means would-be lawyers must make a substantial upfront educational investment in money and time that must be recouped in high salaries later.

Such salaries can be and are paid because licensing limits competition in the legal profession, and because partners derive much of their own inflated earnings from associates' work.

But when law firms are under pressure to reduce costs, it is difficult for the partners to significantly reduce their reliance on associates without severely affecting their ability to serve clients. Efforts to outsource some tasks have met with only limited success.

While law firms can and do get bank loans, ABA regulations prohibit banks, private-equity firms or other corporations from owning or having an ownership stake in a law firm. This limits a law firm's financing options and raises its capital costs. Dewey's collapse has been attributed to the firm being highly leveraged and unable to attract investment from businesses outside the legal profession.

Law firms are aware of the value that professional business managers can add to their operations. But regulations that prohibit the ownership of law firms by nonlawyers prevent those firms from fully realizing the value of managerial skills and oversight that professional management could bring.

Finally, because regulations prevent corporations from providing legal services other than their own legal counsel, a law firm today cannot realize efficiencies or make more money by merging with a firm outside the legal profession to provide financial and accounting services, for example, along with legal services.

Eliminating regulations on who may provide legal services and who may own and operate a law firm could result in substantial efficiencies. Deregulated firms and new legal entities could reduce costs by hiring a variety of people to provide legal services—some who have completed three years of law school and some who have not.

Such firms would be better positioned to explore the substitution of capital for labor—for example, by accelerating the use of sophisticated Web searches as a substitute for manual document searches, and by using other information technology to ensure that corporate clients comply with government regulations.

New firms not necessarily owned by lawyers would bring new ideas, new technologies, new talents, and new operating procedures into the practice of law. This process has certainly happened elsewhere, the way Freddie Laker and Southwest Airlines brought new operating efficiencies to the airline industry, or the way satellite and cable brought a multitude of new programming to a once-stagnant television industry controlled by three broadcast networks.

As legal fees fell and services improved and expanded, many corporate clients would begin to downsize their internal legal departments. They would go back to relying principally on outside legal help, much as shippers have returned to deregulated for-hire trucking companies and less-regulated railroads. American businesses would reap the economies of specialization and technical progress that a rejuvenated legal-services industry could provide.

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