

The impact of the expansion of the big four on the legal services market and mid-sized law firms

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Abstract

This paper is based on an article by The Economist titled 'Attack of the Bean Counters' published in March 2015, which advances the argument that the Big Four audit firms are the biggest underestimated threat to the legal profession today and the firms most at risk from the expansion of the Big Four in the legal services market are the mid-tier law firms. This is attributed to a number of factors, including their global reach, large client base and more importantly their efficient integration of new legal practices. To interrogate these two assumptions, this paper first examines the basis for the rise of the professions in the society, the 'inability' of these professions to meet client needs which led to liberalization and subsequent penetration of the market by alternative legal service providers including the Big Four. Secondly, it examines the critical success factors for their expansion in the legal market through the adoption of new legal practices, enabling them to provide cheaper integrated services. It is debatable whether the Big Four are the biggest threat to mid-tier law firms, compared to other legal service providers, but what is certain is that they are an underestimated threat. Lastly, this paper concludes that, based on the current demand gap, the Big Four, mid-tier law firms and alternative legal service providers all stand an equal chance of thriving in the legal market based on their ability to provide cost-effective, and differentiated services that solve their client problems in the long-term.

Introduction

The article by *The Economist* titled 'Attack of the Bean Counters', makes two fundamental and thought-provoking statements in regard to the impact of the Big Four audit firms on the future of legal services market (The Economist, March 2015). First, this article quotes Michael Roch of Kerma Partners who alleges that the Big Four accounting firms are the "biggest underestimated threat to the legal profession today."

This is mainly because the Big Four have a wide global reach, large client base, their ability to provide lucrative packages that complement their own practices, and efficient adoption of new legal practices for cost effective and efficient provision of legal services. Their ability to pull a wide array of expertise from across the world makes it easier to serve clients with offices in different jurisdictions.

Secondly, this article also advances the idea that the firms most at risk from the expansion of the Big Four into the legal services market are the mid-tier law firms (Malcom, Wilsdon & Charlie, 2011). This is because these mid-tier law firms have lower profit margins, and their repetitive tasks can easily be standardised and automated by accounting firms. This is also based on the assumption that these law firms will not be able to respond effectively to the market needs of clients who are keen on reducing operational costs including costs of routine legal services.

These statements in *The Economist* can be considered to be far-reaching in light of the various technological advancements and liberalisation of the legal services market in many countries, which have led to the introduction of numerous legal service providers and increased competitiveness.

These competitive forces have led to a process whereby different firms (including incumbents) try to win over customers over a period of time by offering them reduced pricing, better quality, and efficiency. This has been witnessed by the introduction of new legal practices including the use of artificial intelligence, outsourcing, and mass customization in a bid to provide cheap quality legal solutions.

Moreover, regulators have also been keen to ensure that these successfully competitive legal service providers, adhere to professional conduct and increase consumer welfare in the event of market dominance.

Numerous authors have discussed the changes in the legal services market, including Richard Susskind (2017), who in his book, 'Tomorrow's Lawyers' explores the radical challenges occurring in the legal services market leading to the following key drivers for change: clients demanding more services at lesser costs; liberalization of the legal services market; and technological advancements.

He discusses these drivers of change in the context of the changing legal services market but does not discuss this in the specific context of the Big Four. Wilkins and Esteban (2016) in their paper 'The Reemergence of the Big Four in Law' discuss how over the last decade, the Big Four audit firms have quietly rebuilt their legal networks, integrating these services into a new model of "globally integrated business solutions," and aggressively promoted this model in emerging economies in Asia-Pacific, Latin America, Africa, and the Middle East in comparison to the Big law firms.

However, not many authors have explored the impact of the expansion of the Big Four on mid-sized law firms. For this reason, this paper focuses on the effect on mid-sized law firms because it is supposed that the services they offer are more routine and mundane and they might have the available resources to invest in technologies to commoditize these routine legal work.

The Role and Impact of Professions in Society

Professionals, as defined by Mike Saks (2012), are a group of individuals in possession of unique and positive characteristics including distinctive knowledge and expertise. This expertise results from their knowledge obtained in training, and practice.

Richard and David Susskind (2015), expound on this definition by identifying four major similarities of professionals i.e. specialist knowledge, admission dependent on their credentials, their activities are regulated, and a common set of values. Professionals are considered to be important in society since they are at the heart of our social and working lives, educating our children, ensuring spiritual and physical health, protecting our legal entitlements and running businesses which build our economies.

As a result, they are considered to be pervasive, invaluable and indispensable. This is because each aspect of our lives is dependent on their skills, and I would argue that the 'societal costs' of attributed to the lack of obtaining such services beforehand are very high. Their importance in society is the justification for what Susskind calls the 'grand bargain', which entitles professionals to exclude others from providing professional services.

This exclusion is effected through either the issuance of a license (Hughes, 1964), regulatory bargain (Keith & Donald, 1995), a mandate or claim (Schön 1987). According to Winston and Crandall (2011), this 'grand bargain' is maintained in the legal profession by lawyers in politics, who create barriers to entry to keep a low number of lawyers. In Kenya, this is evidenced under the Advocates Act 2012, which restricts unqualified persons from preparing certain documents, limits practice of foreign advocates, and prohibits advocates from sharing of profits with non-advocates.

In addition, the legal profession is one of the most pervasive professions in our society today. It not only regulates all aspects of society, but also, all elements of economic and political life are creatures of law. As a result, the profession has grown to be a stable force in society (Saunders and Wilson, 1933). In the USA, the legal system contributes \$1.8trillion to economy, which is one-third of the economy (Magee, 1992).

According to the Office of National Statistics in the UK (2016), legal businesses (excluding in-house activity of solicitors not in private practice) contributed £25.7 billion to the UK economy in 2015. Moreover, for every one per cent growth of the UK legal services, 8,000 new jobs are created and £379 million is added to the economy. In terms of the influence that lawyers have in our society, 25 out of the 45 Presidents of the United States were lawyers, with the ruling elite in most governments across the world comprising of lawyers.

Despite their value in society, scholars like Peter Huber, Dale Jorgerson and George Priest (1993) argue that various features of the modern legal system including an oversupply of lawyers, increased litigiousness, expanded standards of liability, and growth in governmental regulation have a negative effect on economic growth and competitiveness.

Therefore, to realize maximum value for society, Stephen Magee looked into the relationship between economic growth rates, and population of the lawyers to come up with the 'Magee curve', which determines the optimum number of lawyers required in society. These findings assume that there is discernible correlation between lawyer populations and economic activity.

The Magee curve estimates that 10 lawyers are required per 1,000 white-collar workers. Despite the fact that Charles Epp, challenges Magee's theory by asserting that there are fatal flaws in Magee's data and definitional problems, I would argue that the main flaw with Magee's assumptions is that the increase in the number of lawyers does not necessarily lead to the increase in bad litigation.

The increase in the number of lawyers mainly leads to increased competitiveness in the legal services market as opposed to increasing the amount of frivolous and vexatious litigation. In an ideal situation of perfect competition, this would result in the drop in prices to marginal costs, and productive efficiency leading to 'pareto optimality' (i.e. making society better-off without making someone else worse off). Moreover, this survey by Magee would have been more accurate if it considered some of the non-economic benefits of lawyers like civil rights and social justice.

In addition, the oversupply of lawyers has led to the shift from professionals being protectors of society to professionals being strictly commercially driven entities. This can be traced to the publication by Heber Smith, titled 'Law Office Organization' which emphasized the need for disciplined business execution and economic success of law firms (Smith, 1956). This article published in 1956, highlighted the need for law firms to increase their reputational capital, and maximize profit by increasing the number of billable hours.

The resultant adoption of this model by law firms led to a conflict of interest between societal/ethical interests and commercial success (Heineman, Lee and Wilkins, 2014). Moreover, research by consulting firm Consolio, reveals that lawyers charge high fees for routine non-legal work which make legal services costly, whilst the legal work amounts to only 40% of the billable hours (Remus and Levy, 2016).

As a result, this business model does not reflect the market trends, and more importantly the client's needs of cost reduction.

Liberalization of the legal market

The market gap created by a monopoly of inefficient legal practices and rent seeking behaviour led to the move towards 'de-professionalization' of the legal practice in the early 2000s. New South Wales was the first jurisdiction to allow for the incorporation of legal service practitioners with other non-legal practitioners under the Corporations Act 2001 (Mark and Gordon, 2008).

Later in 2007, Slater and Gordon became the world's first listed of law firm, on the Australian Stock Exchange. Alternative Business Structures (ABSs) were introduced in the UK by the Legal Service Act 2007, which came into force later in 2008 with the first ABSs licensed by Solicitors Regulatory Authority (SRA) in 2012.

The lowering of the barriers to entry, lead to what Michael Porter (1998) terms as threat of new entrants, resulting in the emergence of new players in the legal market who were driven by leaner principles of providing cheaper, faster and better service (Lean Law).

In 2013, Eric Chin, an associate of Beaton Capital introduced the concept of NewLaw, which was a new business model of providing legal services to clients. In this model, there is efficient division of labour whereby the lawyers do the legal work, professional sales personnel market the firm and the firm is corporately owned by shareholders.

The other resultant effect of this market gap is that corporations ended up increasing their own legal capacities as evidenced in the market survey by the SRA (2014), whereby between 2000 and 2012, the in-house solicitor population doubled, reaching 25,600 solicitors and increasing to 18% of the total solicitor population.

According to Ronald Coase (1937), this reduces transaction costs within organization because the costs of obtaining these legal services from law firms was significantly greater than the marginal costs of obtaining these legal services within the organization. On the other hand, the accounting firms developed a multidisciplinary practice especially among tax accountants and lawyers partnering in practice.

In January 2014, PwC Legal gained an Alternative Business Structure (ABS) licence, followed by KPMG Legal in October 2014 and then EY Law in December 2014. By the start of the 2000s, the then Big Five had the largest legal practices in the world by headcount (Australian Law Management, 2015).

Emergence of the Big Four

The Big Four is a term that refers to the four largest accounting firms in the world that provide a wide range of accounting and auditing services including audit, tax advisory, risk assessment, management and business consultancy. They include:

1. Deloitte Touche Tohmatsu (popularly known as Deloitte) was founded in 1845. It has approximately 245,000 employees in 150 countries and revenues of US\$38.8 billion in 2017 (Deloitte, 2018). Each Deloitte member firm is structured in accordance with national laws, regulations, customary practice, and they are legally separate and independent entities;
2. PricewaterhouseCoopers was formed by the merger of Price Waterhouse, and Coopers & Lybrand in 1998. It has approximately 223,000 employees in 157 countries and revenues of US\$37.7 billion for the year ending 30 June 2017 (PWC, 2018).
3. Ernst & Young (EY) was formed in 1989 when Ernst & Whinney merged with Arthur Young. It has approximately 231,000 employees in 150 countries and revenues of US\$31.4 billion for the year ending June 2017 (EY, 2018).
4. Klynveld Peat Marwick Goerdeler (KPMG) was formed through the merger of Peat Marwick International and Klynveld Main Goerdeler in 1987. It has approximately 189,000 employees in 152 countries, and revenues of US\$26.4 billion in 2017 (KPMG, 2018).

The main reason for the success of the Big Four is the fact that, in most jurisdictions where they operate, *every public company is under a legal obligation to prepare financial statements examined and opined by an auditor*. On the New York Stock Exchange alone, there are 2800 public companies listed with a capitalization of about \$19 trillion, and their investors relying on the opinions of these auditors (Peterson, 2015).

After the Enron scandal and the enactment of the Sarbanes-Oxley Act 2000, restricted auditors from providing non-audit services with similar laws were enacted in other countries like China, Germany, Australia, Mexico and Canada (Committee on Financial Services US House of Representatives, 1996).

Wilkins and Esteban (2016) argue that the three main reasons for the expansion of the legal service by the Big Four despite the strict regulations include: gaps in the regulation of auditor independence; changes in the legal profession's regulatory framework; and the organizational evolution of the Big Four. Their global reach evidenced in the image below matches as illustrated in the current attractiveness of the global market for legal services.

This is mainly through the process of 'glocalization', which involves customizing their services for the local markets they operate in while maintaining high global standards of professional conduct (Kim, Pakir and Wee, 2010). As a result, their aggregate market penetration ranges from 4% in China and 6% in Britain to 20% in Germany and 30% in Spain (The Economist, 2015).

Compared to the work of law firms in these regions, research cannot ascertain the quality of work but according major ranking services such as Chambers and Partners and the Financial Times (2012), they are considered to be among best in their respective markets. As a result, it is safe to say that, notwithstanding a harsh regulatory environment and high barriers to entry, these networks have not only survived but thrived.

In contrast, the mid-tier law firms have reactive service problem, whereby the person with the problem needs to know that they have a problem to consult a lawyers and the paradox is that you need to be a lawyer to know when you need a lawyer. The Big Four on the other hand are proactively reaching out to offer integrated systems to ensure that the rules are embedded in the system and no option for non-compliance.

Big Four vs BigLaw in 2014: Lawyers and geographic spread

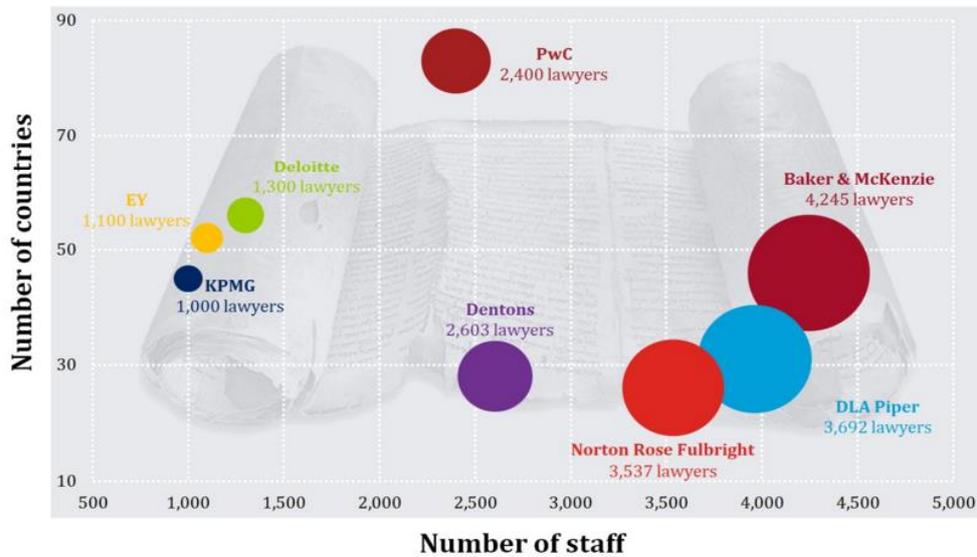


Figure 1: Graph indicating the number and geographical spread of lawyers in Big Four Audit Firms and Big Law firms in the World (Chin, 2014).

Secondly, unlike mid-tier law firms, the Big Four have multiple income streams from various offices, massive pay-outs and the ability to increase chargeable rates despite pricing pressures. This is evidenced by the fact that they have annual revenues of \$120 billion whilst combined revenues of the 100 largest law firms in the world is \$89 billion (Susskind, 2015).

Despite the fact that in 2015, PwC disclosed that they generated revenues of £41 million from legal services, which is less than half of what a typical mid-tier law firm generates (for example, Shoosmiths generated revenues of £93 million last year), these firms are still in the process of implementation of their market penetration strategies (Aldridge, 2015).

On the other hand, mid-tier law firms in the UK, are finding it difficult to maintain profitability over this rivalry in the market. Similar to the work of the Big Four, the work of the commercial mid-tier law firms includes banking law, mergers & acquisition, general business affairs and corporate finance.

According to research by Charles River Associates (2011) in the legal services market share, the work of mid-sized law firms in business affairs comprise of 17% of the market share whilst that of magic and silver circle firms at 19% of the market share. This is a potential area of threat by Big Four who are introducing integrated fixed fee packages.

Moreover, it is worth noting that the figures for litigation of commercial disputes, indicated that mid-tier law firms had a significant market share at 23% compared to magic circle law firms at 14% of the market share. This has not been an area of focus for the Big Four firms who, may only threaten this share of this market through the establishment of robust dispute resolution departments.

Therefore, mid-tier firms can only maintain competitiveness through: (1) efficiency in their legal processes; (2) alternative dispute resolution departments; and (3) focusing on other branches of law (including employment, family, wills and probate, and personal injury).

The **third** reason for their success of the Big Four in the legal services market can be attributed to the **shift in mode of delivery of corporate legal services**. This results in the adoption of non-traditional business methods such as unbundling, outsourcing, and process management in which the Big Four already have significant advantage.

According to Rosen (2002), the Big Four are able to integrate their work into the company's decision-making processes, delivering legal services as consultancy services as opposed to technical and specialized services. This leads to: (1) flexibility and ease of integration in the client services; (2) certainty of processes (3) fixed prices since it is not based on hourly rates.

As a result, according to research by George Beaton (2015), 80% of respondents said that they prefer global firms due to increased expertise or knowledge, or specialised capacity. In addition, 50% also said that they have better/stronger brand and reputation. In response to this rivalry, mid-tier law firms are now offering more fixed fee arrangements.

According to a survey by PwC (2015) on law firms, 38% of total fees are now under fixed fee arrangements amongst UK law firms ranked 51 – 100, compared with only 23% for the top 25 firms. This means that the mid-sized law firms will compete effectively on costs with the Big Four for the routine legal work of clients.

However, a recent survey by EY indicates that staff costs of UK law firms accounts for 40% of their turnover. This means that with their fixed fee agreements, mid-sized firms will still incur higher overhead costs compared to the Big Four firms therefore having low profitability.

Lastly, accounting firms are keen on using their financial resources to leverage on technology. This is seen through their alliances with leading technology companies. In 2014, PwC established a joint business relationship with technology-based giants Google to develop technological solutions for clients.

EY also has an alliance with LinkedIn that is designed to assist in developing better customer relations using social and data analytics. In 2018, EY also acquired RiverviewLaw (one of the leading innovative legal ABS in the UK), to accelerate the expansion of EY Law into the USD3bn global legal managed services market, and in a bid to become a leading disruptor on legal services market.

Despite the fact that we have not seen the impact of these alliances on their global legal businesses, they will definitely give the Big Four a significant competitive advantage in the global market for legal services. On the other hand, mid-sized law firms being at the short end of the digital divide, as compared to alternative legal service providers (Hargittai and Hsieh, 2013).

Therefore, if they are not able to cope with the application of technology to improve the efficiency and reduce costs of providing legal services, their market share will be under

significant threat from the Big Four. At this initial stage, it is difficult to determine the actual effect of this market penetration vis-à-vis other legal service providers (including those using artificial intelligence or mass customization) to be able to prove or disprove the claim that the Big Four is the biggest underestimated threat.

Challenges that might impede the growth of the Big Four as providers in the legal services market.

A major challenge that the Big Four will face in the expansion of their legal services is conflict of interest/ethical concerns. This arises where there is a need to balance commercial interests and the risk appetite. According to Richard Moorhead, ethical indicators for the legal services comprise of a combination of capacity, context and character (Moorhead et. Al, 2012).

From this study, it was revealed that the ethical compromises mainly occur at the context level and not from content or capacity. In the case of accounting firms, this arises from the multidisciplinary nature of delivery of their services. The enactment of the Limited Liabilities Act 2000 in the UK led to the change in corporate structure of the Big Four from joint and severable liabilities of the partners to limited liability partnerships leading to an increase in the risk appetite.

Revenues generated from highly paid non-audit work created incentives to gloss over potential problems whilst auditing their own work. This issue arose with Arthur Anderson in the Enron case, leading to the enactment of the Sarbanes-Oxley Act, 2000. This was also an issue of major concern in the regulators of the legal profession.

As a result, the American Bar Association established the Commission on Multidisciplinary Practice in 2000 to scrutinise the accounting firms' incursion into law. The Association found that multidisciplinary practice was probable if it preserves the core values of the legal profession including competence, independence of professional judgement, confidentiality, and loyalty to the client.

However, this report did not provide any clear guidelines on the avoidance of this conflict of interest challenge. Moreover, certain aspects of the legal profession were not considered including issuance of professional undertakings and indemnity which are very critical in protecting client money, and applicable in corporate/commercial work which is the main target market for the Big Four. This might create significant barriers to entry of this market share, by impeding their ability to undertake these corporate transactions on behalf of their clients.

In the UK, these professional and ethical principles are under the Solicitors Regulation Authority Handbook (SRA Principles 2011, Part 1). These rules emphasize among other principles, independence as was stated by the ABA but also go beyond to include non-economic obligations such as maintenance of public trust and carrying out their role in the business in a way that encourages equality of opportunity and respect for diversity. This notion ties to the original upholding of the special duty professionals owe to the society. This is critical according to research by Maryam Kauchaki (2013), which proved that

professionals who think of themselves as professional are likely be more compliant. Lawyers claim to be the pinnacle of ethicality and this might not be achieved when other professionals provide legal services. This evinced in the report by EY (2014) which found that in-house counsel they are more likely to justify backdating contracts in order to meet financial targets than other executives.

However, it may also be argued that ethics are subjective and depending on people's individual moral compasses. Therefore, in regard to the Big Four, there is need to be cautious to ensure they maintain professionalism and value judgment. However, this should not be exercised in a manner that discourages innovation.

Conclusion

The unmatched revenues, technological integration and ability to bring together cross-functional teams to meet the business objectives of clients gives the Big Four a competitive advantage in the legal services market.

This competitive advantage poses a significant threat to the traditional legal service providers by virtue of Michael Porter's horizontal measures of rivalry, threat of new entrants and threat of substitutes (Porter, 1998). Moreover, with their growth strategies still work-in-progress, incumbents underestimate their ability to pull resources and capture their market share.

Compared to other alternative legal providers, it is debatable, whether their presence in the legal services market, is the biggest underestimated threat, or is significant enough to result in the 'death' of lawyer professionalism by the mid-tier law firms.

However, based on Porter's vertical measure of bargaining power of suppliers (i.e. the legal service providers), scholars like Pearce and Wald (2013) argue that the advocates of death of 'traditional' law firms exaggerate the severity by misunderstanding the full text of "autonomous self-interest" features in external lawyer-client relationships, as well as law firms' internal mechanisms.

This relationship-based model of law firms is purported to sustain lawyers in the ever-changing environment. Traditionally, this would be plausible for the more complex transactions where the price is insensitive, (i.e. because the case is so critical that the price does not matter).

However, considering the high bargaining power of customers, a relation-based capital is not sufficient to sustain the relevance of any legal service provider in foreseeable future. This is because we are inherently selfish beings and will seek cheaper effective alternatives.

The relevant product market under threat in this case is the corporate/commercial sector, in which the Big Four will provide cheap and quality legal services preferred by corporations and multinationals. This is because, according to Christensen, the integrated packages by the Big Four are disruptive innovations that bring to the market a very different value proposition (Beaton, 2013).

However, from the analysis seen above by Alex Aldrige (2015), both the Big Four and mid-tier law firms stand an equal chance of thriving in the product market based on their ability to provide cost-effective, and differentiated services that solve their client problems in the long-term. However, in the geographic market, the global reach of the Big Four place them at an advantage with multinationals.

In conclusion, from the research carried out by the Legal Services Board, there is a disconnect between service providers and clients ('access gap') to the tune of £5 billion (Briggs, 2016).

With liberalization of the legal services market, thus low barriers to entry, what is certain is that innovation, quality and cost-efficiency will be the determinant factors for maintaining competitiveness in the legal market. According to Susskind (2006), "competition that kills you, does not look like you."

Therefore, there is no 'finishing line' in terms of adoption of these new legal practises by law firms, the Big Four and alternative legal service providers, but it is dependent on their ability to leverage on these technologies and business practises to meet client needs.

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