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An independent mind

REVISED WORKING PAPER

BUSINESS MODELS IN LEGAL SERVICES

The meaning of 'business model'

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Professor Stephen Mayson

1. Introduction

As the marketplace for legal services changes in the wake of competition, and as a result of the Legal Services Act 2007, there is increasing talk about 'appropriate business models' for the new landscape. It is apparent, however, that although the same term – business model – is being used, it is not necessarily being used in the same way by everyone. For example, in the emerging debate about new or alternative business structures (ABSs), one often hears such structures, or legal disciplinary practices (LDPs), described as 'new business models'. I do not believe that these truly are business models – any more than partnerships (whether general or limited liability) or companies are: these structures are simply the 'wrappers' within which the true business model is framed. Any one of these structures is, in my view, capable of delivering the *same* business model.

This paper[1] therefore explores the concept of a business model and suggests a definition and application for the legal services[2] market. Hopefully, in this way, we can begin to work towards a common language for a concept in common managerial use[3].

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[1] This revised working paper is based on a paper delivered at the Georgetown University conference on 'Law Firm Evolution: Brave New World or Business as Usual?' in Washington DC, 21-23 March 2010.

[2] Although the expression 'legal services' is used here, it should be read to include those aspects of a provider's output that might better be described as 'products'.

[3] In doing so, I hope to rise to the implicit challenge expressed in Michael Porter's view (albeit expressed in the context of internet businesses) that: "The definition of a business model is murky at best.... The business model approach to management becomes an invitation for faulty thinking and self-delusion" (2001: 73).

2. Definition of 'business model'

The expression 'business model' appears to have been little used before the dot-com crash around the turn of the century. Since then, however, its use has grown rapidly. Despite this, business writers and academics have not so far reached any detailed consensus about its meaning[4]. Many have offered definitions, and there is now a proliferation of possible conceptions and typologies. They operate at different levels (such as strategic, economic, and operational), and cover many facets.

Authors nevertheless do seem to agree on two things. First, a business model is not the same as a strategy. Strategy explains what a firm will offer to its chosen market(s) and how it will do that better than its rivals[5]; a business model describes, as a system, how the pieces of the business fit together[6]. Second, business models fundamentally concern themselves with how a firm creates value in the pursuit of its strategy. To do this, it will need resources and investment, and must ensure that some of the value created is kept by the firm for itself to satisfy its owners' and investors' aspirations for revenue or capital returns.

At its simplest, therefore, a business model could be defined as follows:

> **A business model is an articulation of a firm's core logic for *creating value* and capturing some of it to generate *returns* from its *investment* in and use of *resources*.**

In its simplicity, this definition necessarily makes a number of assumptions; it will also need expanding to make it useful at a practical level. To elaborate the definition, it is necessary to explore in more depth the core elements of a business model: value creation; resources; investment; and returns (for this exploration, see paragraphs 3 to 7). In their articulation, these elements of a business model help, in Richardson's (2005: 5) description, to "link the firm's strategy, or theory of how to compete, to its activities, or execution of the strategy". As he puts it (2005: 19)[7]:

> The business model provides an intermediate logical structure between the firm's theory of how to compete and its activities.... It serves to complete the description of the strategy....

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[4] See, for example, Magretta (2002), who describes 'strategy' and 'business model' as among "the most sloppily used terms in business" (page 92). See also Linder & Cantrell (2000); Porter (2001); Betz (2002); Magretta (2002); Hedman & Kalling (2003); Voelpel et al. (2003); Morris, Schindehutte & Allen (2005); Osterwalder, Pigneur & Tucci (2005); Richardson (2005); Schweizer (2005); Shafer, Smith & Linder (2005); Tikkanen, Lamberg, Parvinen & Kallunki (2005); Malone, Weill, Lai, D'Urso, Herman, Apel & Woerner (2006); Seppänen (2008); George & Bock (forthcoming).

[5] Barney (2002); Mayson (2007), chapter 8. In the context of legal services, a strategy describes the business's target clients, services and geography and incorporates a statement of its intended competitive advantage (see further Mayson, 2007, chapter 4). I acknowledge that I am adopting a resource-based view of strategy (as elaborated in Mayson, 2007) in which competitive advantage is vital, and that this is one of a number of theories of strategy (cf. Hedman & Kalling, 2003: 51).

[6] In this way, a business model provides a link between a firm's strategy and its business plans (cf. Hedman & Kalling, 2003; Richardson, 2005), since business plans should articulate the operational and process support required to achieve the strategy's intended competitive advantage (through the creation of value for clients).

[7] Richardson's view is also consistent with Seppänen's (2008: 19) research that showed that the business model concept is "a mediator between high-level strategies and operations".

> [The] business model framework helps to create a consistent logical picture of how all of the firm's activities form a strategy.

What many writers offer is a categorisation (or 'typology') of the possible types of business model. These, for instance, suggest that there are *n* possible models, and any firm's business model will fall into one of the categories. However, the challenge in this approach is that it runs the risk, for any given firm, that even the closest generic type will not always capture the full depth and complexity of its circumstances.

Rather than take the approach of trying to identify a series of generic business models that could be applied to legal services, this paper adopts a different perspective. Taking the view that a business model is an articulation or 'story' about the underlying logic of the firm's business, the approach advocated here is to identify the core elements of a business model – that is, those elements that any business model must possess in order to articulate a firm-specific model but without needing to base it on any pre-defined generic type.

Articulating a business model is not a one-off exercise. Any business is subject to changes in its external environment and the pressures that this will bring. In this sense, a business model will hold little value if it does not 'fit' with the firm's external environment. The business model must therefore be expected to change to achieve this fit in response to external events and competitors' actions (see further paragraph 9 below).

Further, although a business model is not a strategy, it should nevertheless provide the link between the firm's strategy, its structure and its processes. This will give the model its necessary internal fit. Indeed, when faced with significant external change, too strong a fit internally might prevent the firm recognising and responding to that change[8] – to the firm's detriment.

The benefits of an effective business model arise from encouraging the firm's owners to[9]:

(a) conceptualise the firm as an interrelated set of strategic choices (including recognising that some of the decisions imply trade-offs); this will involve taking decisions relating to the core elements discussed in paragraphs 3 to 7;

(b) seek complementary relationships among aspects and activities within the firm through unique combinations; this will encourage the firm to identify, achieve and maintain a competitive advantage;

[8] Morris, Schindehutte & Allen (2005: 732).
[9] Cf. Morris, Schindehutte & Allen (2005: 733).

(c) ensure consistency across the firm's strategy, structure, economics, growth and exit options; this will make it more likely that the owners' aspirations for the business are met; and

(d) make explicit the strategic and structural choices taken; such articulation is necessary to clarify, test and justify the basis on which the firm is in business.

As Magretta puts it, when used correctly a business model (2002: 90):

> actually forces managers to think rigorously about their businesses. A business model's great strength as a planning tool is that it focuses attention on how all the elements of the system fit into a working whole.

3. The elements of a business model

The premise of this paper is that the concept of a 'business model' is in fact a composite of four, logically interconnected, elements:

(a) the *value creation element* – how the firm seeks to create value for clients or customers; market positioning and pricing are key parts of this element;

(b) the *resource element* – the nature and extent of the resources to which the firm needs access in order to create value and achieve its objectives, and whether or not those resources should be (and can be) internalised within the firm;

(c) the *investment element* – the philosophy and methodology for building and financing the firm, and securing returns on investment; and

(d) the *returns element* – how the firm proposes, over time, to capture for itself part of the economic value created from its investment in and use of resources; in large part, the firm's ability to capture value and so generate returns will depend on where it sits in a chain of suppliers to the ultimate client, and how it generates sustainable profitability.

As an articulation of the underlying logic of the business, a business model can be expressed in any form that suits the user – for example, as an analysis, a diagram, or even a narrative (story).

Each of the four core elements is affected by the others. These elements are generic to every business model: what makes a particular business model firm-specific, and thus more difficult to replicate, is the unique or special application of those elements in the context of an individual firm. It is the movement towards particularisation that will generate greater relevance to any given firm (see further paragraph 8 below).

4. The value creation element

4.1 Introduction

As stated in paragraph 2, all writers on business models agree that value creation is a key component. This raises the need to consider the firm's position in a network of value creation. This positioning is important because:

(a) value can be created in many ways, including internally or externally, and through outsourcing or joint ventures; and

(b) except for the ultimate buyer or client, one firm's cost of supply is the supplier's price (which will affect the returns element considered in paragraph 7).

4.2 Value creation

The creation of value is a key component of a firm's competitive advantage (on the basis that there is no advantage without being different, and there is no merit in the difference unless it delivers some value or benefit to the client[10]). The firm's business model must ensure that this value or benefit is actually delivered.

The ability of any firm to create value depends on three primary factors:

(a) the nature of the market in which it seeks to compete;

(b) the firm's position and credibility in that market; and

(c) the firm's ability to deliver benefits to its clients.

4.2.1 Market: for whom will the firm create value?

There is no business without people to buy. The firm must accordingly have a clear understanding of its market – its size, scope and value – and the nature of the clients in that market. In short, to whom is the firm selling its services, and where in the network of value creation does it sit[11]? With some specificity, this requires the firm to identify, define and quantify its chosen market or markets. For example, a firm might target the retail commodity market, which could include volume services for residential conveyancing, personal injury claims, wills and probate, and perhaps some employment work. Another might wish to target 'high net-worth' clients and owner-managers. Yet another firm might target large corporates and financial institutions, and this potential market will usually need to be further segmented, for

[10] See further, Mayson (2007: 120-132).

[11] This latter question is explored in paragraph 7.2.1 below.

example, by industry sector, turnover, market capitalisation or number of employees.

Each segment is likely to involve different types of clients, needing different legal services, delivered in different ways, by different law firms (and often different types of people within those firms), and using different business development techniques, pricing and overhead structures. Many of the relevant issues then give rise to supplementary questions, such as: How do clients prefer to buy legal services (e.g., in person, as a result of a tendering process, through the internet, as a benefit of an insurance policy)[12]? How much do they spend? How do they assess the value to them of the services bought?

The answers to these questions should be derived by analysing past experience, or from market research or a client survey (or both) carried out by the firm, as part of its research during a strategic review or ongoing activities to stay close to developments in its market(s).

4.2.2 Market position: how will the firm position itself in the marketplace?

Market position is fundamental to creating value for the client (and for generating returns to the firm). It influences significantly the price that the client will be prepared to pay for the legal services in question. It is also important to remember that perception is in the eye of the beholder; in other words, clients determine how services and firms are perceived.

A firm's market position is derived from:

(a) the significance and worth to clients of the services delivered; and

(b) the perceived credibility of the firm to offer those services (given its resources and track record).

4.2.2.1 Value to the client

In simple terms, clients will see value on a spectrum running from high to low. As one moves through the spectrum towards low value, the work tends to become increasingly price-sensitive. The perceived value of the services offered will inform a view of where a firm is understood or assumed to operate, and this will influence the assessment of its market position.

[12] Sometimes, work does not come directly to the lawyer from a client. For example, retail commodity work is often directed to a law firm through a referral agency, such as a bank, building society, estate agency, membership organisation, or insurer. Self-employed barristers, as a referral profession, have long been used to being in this position.

One of the difficulties of value and market positioning is that markets evolve. As a result, services that once were seen as high value might over time become perceived as low or lower value (examples might include property transfers and syndicated loan agreements). It is therefore incumbent on firms to follow the evolution of their chosen market to ensure that they remain in tune with developments and client perception, and that their methods of structure, delivery and marketing remain appropriate. Similarly, there is a lack of uniformity in markets – in other words, the same services might be positioned differently in other locations regionally, nationally or globally.

Further, in relation to the same service, clients might have different perceptions. There is often a tension between price and value. For example, the legal issues involved in child residence mediation might well be the same whether the child's parents are 'high net-worth' individuals or funded by legal aid. The legal issues are the same, and the value in emotional terms could be the same – the 'worth' in every sense, other than economic, is identical. But the price paid for the same input from the lawyer would be different. Clients' ability and willingness to pay is a significant determinant of the firm's market position and strategic objectives. The firm might need to consider structuring and resourcing the delivery of the service differently in order to manage its costs of production.

4.2.2.2 Credibility

Many firms aspire to undertake 'higher value' work – and in pursuing their aspiration necessarily increase the competition and then price sensitivity for that work. For many, though, there might be a gap between aspiration and reality. A firm's choice of intended market position has to be driven by its credibility in four factors:

(a) *Reputation* (of its people, its known client base, and its work): positioning the firm to undertake certain types of service will depend very much on its 'track record'.

(b) *Cost base*: a firm with high-cost office space and other resources will find it very difficult to achieve a sound market position in (say) services perceived to have low value. Equally, a firm with low-cost premises and resources might be hard pressed to be credible in the delivery of high-value services[13].

(c) *Location*: for some types of work, such as initial public offerings, financial derivatives, and government advisory, it will be necessary to be established in the appropriate financial centres or capital cities. For others, such as

[13] Increasingly, however, firms are adopting new business models that challenge this conventional approach: for example, Axiom Legal seeks to provide high-quality legal advice on a low-cost structure: see Maitland (2007) and www.axiomlegal.com.

private client or matrimonial work, it might be necessary to be established in local, accessible, and possibly not too ostentatious, premises.

(d) *Size*: again, for some types of work, the absolute size of the firm will influence its perceived ability to handle some of the larger transactions or important cases[14].

Each market position brings its own requirements, opportunities or constraints for structure, staffing, resources, location, pricing, management, and so on. Because of this, it is difficult to position the firm across the value spectrum: identifying the most appropriate target clients needs tough, informed choices, and might lead to some of the most difficult challenges in adopting the correct business model. In particular, as the perceived worth of legal services reduces, the personal involvement of a partner or senior manager should also arguably reduce[15]: responding with appropriate leverage and support structures, and use of technology, will therefore be critical in maintaining credibility and added value for the client.

4.2.3 Value proposition: how will the firm deliver value to clients?

A value proposition is the firm's internal aspiration for delivering benefits to a client. Competitive advantage is worthless unless it creates value for clients (as well as for the firm: see paragraph 7 below). Value is created from the mix of professional services offered (or deliberately not offered) by the firm, its role in service delivery (e.g., hands-on specialists, volume processing, expert system), how the service is made available to clients (e.g., physical (face-to-face, publication) or virtual (internet), local or remote), and how it is priced. It is important to remember that value for clients is not created by *how* the firm seeks to deliver its services but from the *benefits* that clients derive from their interaction with the firm. If no value proposition can be identified or sustained, effectively a firm is driven to compete on price because this will be the only factor on which a client can distinguish between the firm and other providers.

Sales is the usual measure by which a firm can determine whether or not value creation has taken place – on the assumption that if there is no perceived value for clients in what the firm offers, they will not buy from it. The principal driver behind sales, therefore, is the ability of the firm to create and deliver what are often called 'value propositions'[16]. The process of agreeing a strategy and the firm's intended

[14] This is another area where firms like Axiom Legal are increasingly able to challenge conventional wisdom.

[15] This is often a challenge in the context of publicly funded legal work: the technical nature of the clients' problems might need significant input and expertise from experienced qualified lawyers, and yet the price that the public purse is willing to pay often does not recognise that need.

[16] For approaches to identifying value propositions in the context of legal services, see Maister's (1997: chapter 2) concepts of expertise, experience and efficiency, and the nine generic value propositions in Mayson (2007: 129-132): personal relationship; location or proximity; local knowledge; a high level of specialisation (in service,

competitive advantage should include *identifying* appropriate value propositions; the firm's business model must then ensure that it is capable of *delivering* them.

The effective delivery of any value proposition depends on a firm's ability to acquire, develop or access the necessary resources (see paragraph 5) but – more importantly for current purposes – also on varying degrees of cooperation and dependence. For example, value derived from a personal relationship and attention from an individual lawyer can be delivered entirely by that individual acting alone (as can certain types of specialisation). On the other hand, value derived from the firm's systems and processes cannot be delivered by individuals working alone, and the value delivered then becomes more of an attribute of the firm. The significance of this lies in understanding that value propositions can be delivered at different levels within the firm: as they become more dependent on collective endeavour and the firm's distinct resources, this will increase the likelihood that the firm – rather than individuals – can capture the value created (the significance of value capture is explored in paragraph 7.2 below).

A particular challenge in legal services is that many law firms try to offer a multiplicity of value propositions to their clients. This will inevitably add complexity to the business (and therefore to the business model), which requires more sophisticated management. It also raises the question of whether there is one business (suggesting one business model that underpins the entirety) or several (suggesting a possible need for more than one business model to be isolated and implemented): this issue is explored further in paragraph 8.2.

4.3 Business model evolution

The value creation element of the traditional law firm business model could be said to emphasise specialisation and expertise, the use of highly qualified lawyers, charging for time, and working for any client with the ability to pay the firm's fees. Over time (and consistent with the shift described by Maister (1997: chapter 2), value is increasingly created in different ways (for instance, through processing and the use of technology – and, for some firms, in a multiplicity of ways), using a range of staff not all of whom are legally qualified, fixed fees, or targeted at specific industry sectors. It is increasingly likely in the future that (consistent with the greater influence of 'Generation Y' alluded to in paragraph 7.2.2 below) some services, or elements of them, will be perceived by clients to have little or no value and will have to be delivered without charge.

industry, or client type); coordinated services; resources (including absolute mass); reputation; processing; and legal information engineering.

5. The resource element

5.1 The resource mix

Value and competitive advantage cannot be created or maintained out of thin air. The firm's business model must therefore define the resources and competences required to secure its position in the network of value creation. This will include resources of many different types, such as finance, technology, people, relationships, systems and processes. Not all of these resources will inevitably be inside the firm, and management must therefore consider which resources should be internalised, and which should be accessed on an *ad hoc* basis (e.g., specialist or foreign law advice from counsel or lawyers in other jurisdictions), out-sourced (e.g., overnight creation of documents abroad, or technology support) or through a joint venture (e.g., a relationship with an insurer to gain access to instructions, or an alliance or network for establishing foreign presences).

A firm's resources can be described as a mixture of financial, physical, human, social, and organisational[17]. Of these five types, only financial, physical and organisational belong to the firm[18]. Organisational resources, in this context, include the firm's knowledge systems, contracts and records, structures, routines and processes, culture, collective reputation, and strategies and policies[19]. The important point here is that business models founded on financial, physical and organisational resources that belong to the firm are more likely to lead to it (rather than individuals) being able to capture the value created and so generate returns for the business.

The major challenge in such a conclusion, however, is that no organisation can exist or function without human beings. Human capital (the knowledge, skills and attributes of people) contributes enormously to value creation in business: the question in relation to business models, is the extent to which that human capital is in some way 'attached' to the firm, or independent of it. In other words, how does human capital contribute to the firm's value proposition? Where value is created on propositions that require collective endeavour, the more attached to and dependent on the firm its human capital should be (that is, the more 'firm-specific' it becomes).

Social resources comprise networks of relationships, values and beliefs, norms, and reciprocal obligations. Lawyers often believe that client and referrer relationships 'belong' to them – particularly if they are claiming greater remuneration or making threats to leave the firm. They are usually mistaken. Relationships, by definition, are at least two-way. Certainly, relationships are mobilised through human beings;

[17] In Mayson (2007), these five types of resources are set out and elaborated as forms of capital, and their influence on the firm's valuation is also explored. They are broadly comparable in their totality to Seppänen & Mäkinen's (2007) classification: their 'legal' category would be included in 'organisational', and their 'relational' and 'informational' would be combined as 'social'.

[18] Mayson (2007: 261-263).

[19] Mayson (2007: 154-165).

and those human beings can choose whether or not to mobilise them in the firm's favour. But they – and other facets of social resources – do not belong either to individuals or to the firm. There is therefore a risk in any business model that relies significantly on social resources, since the firm might not be able to ensure that the appropriate resources are available and used to the firm's advantage.

To deliver and capture value, a firm must configure its resources in the right combination (sometimes referred to as the 'resource mix'), ensuring that it has access to all that it requires. This access can arise because the resources are within the firm, or because the firm has negotiated the right to use them as part of an *ad hoc* arrangement, including both one-off contracts (such as instructing counsel) and continuing relationships (as with joint venture arrangements).

In principle, any type of resource could be found either inside or outside the firm. A significant decision in implementing a business model is therefore the extent to which resources should be internalised[20] or remain and be accessed externally. Logically, the more strategically important to the firm and its business model resources are, the more sense it makes to internalise them whenever that is possible to allow greater scope for the firm to capture the value arising from their use.

Where internalisation is not strategically required, then outsourcing would seem to represent a logical alternative arrangement that might, on balance, achieve greater efficiency or cost saving. Outsourcing is in principle a form of supply in the value system, with the necessary implication that the supplier is creating and capturing for itself part of the value in the system. Transaction cost analysis[21] suggests that such an approach would be justified where the overall cost-benefit of a 'spot contract' with an outsourcer is greater than that of internalisation.

5.2 Business model evolution

Historically, the resource element of a law firm's business model was based on employing (and admitting to ownership) mainly full-time qualified lawyers, and internalising as much of the other resources as possible. Pressures on overheads have encouraged firms to look to out-sourcing and off-shoring, and perhaps considering part-time and flexible working and alternatives to employment. The increase in the use and acceptance of lateral recruitment is evidence of a reducing need to 'grow one's own' human capital (or of a perceived commercial imperative to grow more quickly than such organic growth permits)[22]. There is also increasing

[20] The question of internalisation, related to the implications for where a firm chooses to place its boundaries and its 'theory of the firm', is considered in detail in Mayson (2007), chapter 14.

[21] For further detail on transaction cost economics, see Mayson (1997: 111-114) and Mayson (2007: 257-258).

[22] Such a shift usually comes at some cost to the cultural cohesion and identity of a firm, that is, to the value of its organisational capital: cf. Mayson (2007: 162-164).

evidence of, for instance, the substitution of paralegals for lawyers, and of technology for human beings.

Shifts to methods of pricing and ways of working that put a premium on processes, efficiency and case management also encourage firms to recruit either fewer qualified lawyers or at least a more varied mix of staff, with talents in (say) pricing, business development, technology and project management. These shifts in staffing also carry consequences for levels of remuneration and career aspirations that could further undermine the professional partnership paradigm as these new talents expect a broader range of rewards that include share option arrangements.

6. The investment element

6.1 An investment objective

This element describes the owners' ambitions over time, and to the scope and size of the firm, as well as their ability to finance growth and development. Aspirations for the firm's market position, growth and profitability can vary, and are influenced by the firm's owners (and therefore reflect their individual views on life, professional practice, career and entrepreneurialism[23]). Collective aspirations might consequently be challenging to agree, and might also cover a spectrum from modest to ambitious. The business model – driven in part by an investment philosophy – should then differ according to aspiration, and might be more or less formal, sophisticated and unique.

As suggested in paragraph 2 (and revisited in paragraph 8), this paper takes the view that it is not helpful to restrict the range of potential business models by suggesting a limited number or typology of possibilities. However, such an approach could prove useful in relation to investment philosophies.

There appear to be four sets of factors that influence investment philosophy:

(a) *appetite for risk*: the range of appetite (from low to high) might vary depending on whether the business objective is, say, market entry or growth;

(b) *timescale*: whether the investors' horizons are short-term, medium-term or long-term;

(c) *expected returns*: these could vary in nature and focus on one or more of sales (market share), profits (income), capital (growth and/or exit), and resources (acquisition/development); and

[23] In this sense, the investment model could be regarded as part of the underlying 'purpose' of the firm which, as such, has a significant influence on many aspects of strategy and competitive advantage, as well as the business model. These influences can be collectively described as the firm's 'normative environment': for a more detailed treatment, see Mayson (2007), chapter 5.

(d) *ability to raise (and sources of) funding*: the capacity to raise finance is not unlimited, and aspirations might well exceed capacity – leading to a necessary revision of the business model; sources of finance might be internal or external to the firm, and relate to debt or equity.

These factors will combine in different ways to lead to an agreed investment objective. Taking the four principal categories of outputs used to characterise expected returns (i.e., sales, profits, capital, and resources[24]), it is possible to posit 15 combinations of them as outcomes of decisions to invest with those returns in mind. Each outcome can then be described as the result of an investment objective, with an assumed appetite for risk and timescale, as hypothesised in Table 6.

Three of the objectives – start-up, market share, and market entry – have neither profits nor capital as an outcome. It seems sensible to assume that investors in those circumstances would regard such an investment objective as necessarily short term[25]. Without profits or capital returns, the tolerance for continued investment would be assumed to reduce, and the firm would have to move to a different business model that produced better financial returns. In this sense, some of the investment objectives – particularly those with a short-term timescale – will be transitional: if achieved, the investors will move on to another objective; if not achieved, the investors would usually 'cut and run'[26].

6.3 Business model evolution

Legal practice has, until relatively recently, required little capital investment (and produced few demands for capital growth or extraction). The analysis in Table 6 identifies a new world with many more possibilities and opportunities.

Any of the investment objectives described in Table 6 could in principle be financed by internal or external investment, and by equity or debt. In practice, certain of those objectives will be more or less attractive to external investors. Historically, law firms have been constrained by professional regulation to use internal equity and external debt. For the future, following the implementation of the Legal Services Act 2007, the possible mix of internal/external financing and of equity/debt needs to become part of the investment element of a firm's business model. In particular, as liberalisation introduces the possibility of external equity, new choices and variations of traditional business models become possible.

[24] Cf. Betz (2002: 21).

[25] This might be assumed to apply at least to external investors: see also footnote 26 below.

[26] Again, this is almost certainly the case for external investors; however, the evidence from law firms often suggests an alarming tendency to repeat investment in what should have been short-term projects designed to achieve new market entry or greater market share (such as ill-thought-through new offices, practice areas, mergers or lateral hires that have not delivered the expected returns)!

Table 6: Investment objectives

Investment objective	Risk appetite	Timescale	Expected returns
Start-up	High	Short-term	Resources
Market share	High/medium	Short-term	Sales
Short-term income	High	Short-term	Profits
Capital growth	Medium/low	Medium/long-term	Capital
Market entry	High	Short-term	Resources Sales
Sustainability	Low	Medium-term	Resources Profits
Medium-term growth	Medium	Medium-term	Resources Capital
Medium-term stability	Medium	Medium-term	Sales Profits
Long-term growth	Low	Long-term	Sales Capital
Financial return	Medium/low	Medium/long-term	Profits Capital
Diversification	High/medium	Short/medium-term	Resources Sales Profits
Acquisition	Medium/low	Short/medium-term	Resources Sales Capital
Consolidation	Low/medium	Medium/long-term	Resources Profits Capital
Asset return	Medium/low	Medium/long-term	Sales Profits Capital
Market dominance	Medium/low	Long-term	Resources Sales Profits Capital

The ability for a business to generate and capture (or realise) capital value will depend on where the firm is situated in the sequence of value creation and how much bargaining power it has relative to other players in that chain: these issues are explored in paragraph 7.2 below[27].

7. The returns element

7.1 Introduction

Generating a return (in effect, the capture of value by a firm) encompasses a number of dimensions. First, it assumes that value has been created for which clients are prepared to pay – that is, that there is revenue or fee income from which returns can come (see paragraph 4 above). Second, the firm needs to be able to capture that value for itself – in preference to other claimants (such as external suppliers or staff). Third, the firm must manage its resources (cf. paragraph 5 above) and the associated costs in such a way as to optimise its profitability. Although a firm might be in a position to capture value, it could still nevertheless fail to generate returns for itself because of its inability or failure to generate that value profitably. The returns element of the business model therefore fundamentally addresses the question, 'How will the firm make money?' These various dimensions are explored in this paragraph.

7.2 Value capture

If a strategy is a statement of how a firm intends to achieve competitive advantage (see paragraph 2), then a business model must define how the advantage will be delivered – in other words, how (and how much of the) value will be created and captured by the firm to generate returns. It is possible, in a network of value creation and capture, for the firm that creates value not to be able to capture enough of that value for itself. For example, a law firm with a strong track record of delivering results for its clients might find that its profitability is nevertheless below market levels because, for example, its employed staff are able to demand high levels of remuneration or its clients are in a position to negotiate significant discounts. In both cases, value created is captured by players other than the firm itself and so reduces the returns to the firm.

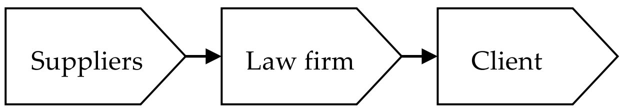
There are two issues to be considered here: first, the firm's position in the process of value creation; and second, the bargaining power of the various claimants in relation to the value created.

[27] The effect of these aspects of the business model on the firm's valuation is explored in Mayson (2007: 215-216, 230-233, 269-271 and 281-287).

7.2.1 The value system

The idea of a 'value system' originates with Michael Porter[28]. The ability to generate and capture value is important to each participant in the sequence of value creation: relative position in the network might therefore determine any given participant's ability to create and capture value. Whether the firm is selling directly to clients, receiving its work through intermediaries (e.g., banks, estate agents, accountants, insurance companies, citizens' advice bureaux), or acquiring it as a result of a tender, beauty parade, auction or panel appointment, potentially affects the value it can both create and capture. The issue here is the creation and capture of value within the value system as a whole. Thus, from the point of view of participants in the system, the ability of one of them to capture value (for example, as an intermediary receiving a referral fee) might not be seen by others (such as a law firm) positively or even as creating any value at all for the ultimate client.

A simple value system for a law firm might be as follows:



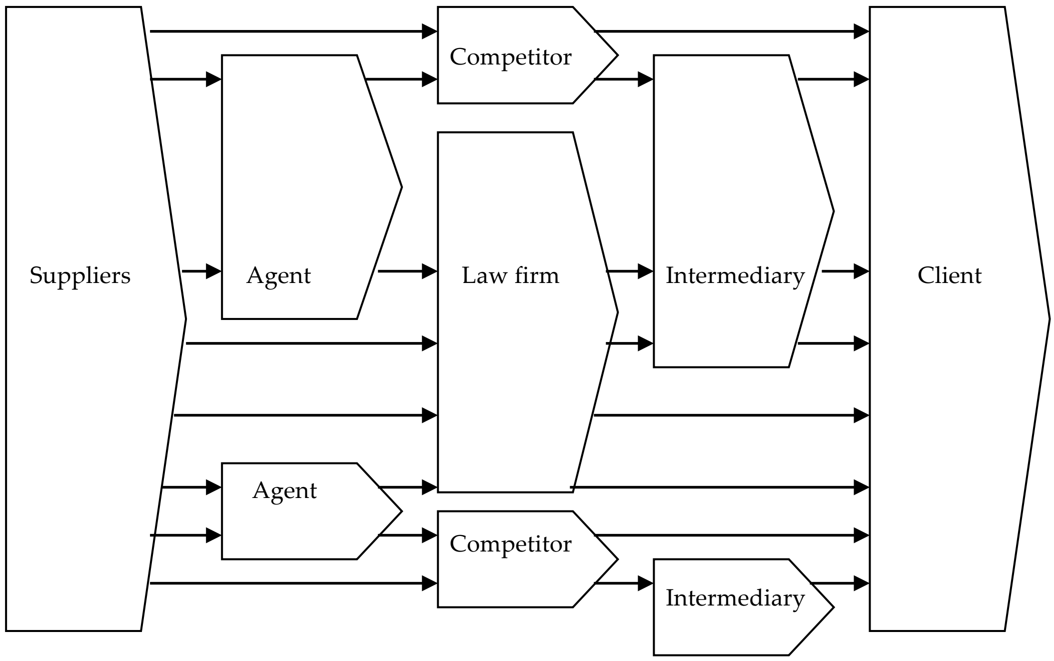
In this context, 'suppliers' includes both those outside the firm (e.g., landlords and utility companies) and those within it (e.g., partners and staff). For the self-employed Bar, one could insert 'Counsel' between 'Suppliers' and 'Solicitors'. Over time, however, this simple, traditional, sequence has become more complex. Intermediaries interpose themselves between suppliers and the law firm: estate agents or property managers on behalf of property owners and landlords; recruitment consultants on behalf of staff; finance companies on behalf of suppliers of technology; and so on. Similarly, intermediaries increasingly position themselves between clients and the law firm as referrers of work[29]: for example, insurance companies with the victims of accidents[30]; accountants with business clients; estate agents with those buying or leasing property; the Legal Services Commission with publicly funded work; in-house procurement departments; and so on. The ability of these intermediaries to charge a fee for their intervention (or the need for their costs of establishment or administration to be covered) adds to the cost of the overall

[28] Porter (1985: 34).

[29] Porter identifies distribution channels as being interposed between firm and buyer (client), but does not mention intermediaries such as referral sources (which, from the firm's perspective, control or influence inbound *access* to work rather than its outbound *distribution* to the ultimate buyer or client).

[30] It is not only the interposition of such intermediaries, or the payment of referral fees that influences the supply chain: the level of premium required from the client, and changes in the scope of insurance cover over time, can also affect the numbers, nature and handling of claims as they are referred on (or not) to law firms, and can also then have a consequential effect on access to justice.

transaction and so, in some way, captures some of the value created[31]. Accordingly, more complicated value systems emerge, such as:



Further, for any given firm, this value system is not static and does not exist in a vacuum: competitors might establish better relationships with an agent or intermediary; Government and regulators might impose a regulatory framework that affects relationships between a law firm and its clients, or between a law firm and referrers[32].

The longer, or more complex, the network is, the more likely that costs will be loaded into the process. Indeed, there might come a point where the final cost is more than the ultimate market will bear (arguably the point now reached by the Government in relation to the public funding of legal aid). The ability of any law firm to capture value, therefore, will be determined in part by how many other 'claimants' there are within the value system seeking a share of the price ultimately paid by the client. The more claimants, the less there is likely to be distributed to any one of them – and the more important their relative bargaining power becomes in securing (more than) their fair share.

[31] Again, one should emphasise that, although value has been created and captured within the value system as a whole, this might not be viewed positively either by the ultimate buyer (because the price will have been increased) or by those elsewhere in the supply chain (because pressure will have been applied to them to control their costs or reduce their prices and so absorb some or all of the additional cost resulting from the intermediary's interposition).

[32] Part of the current debate about referral fees and other arrangements (considered, for example, by Lord Justice Jackson's review of costs in civil litigation, and by the Legal Services Consumer Panel) needs to focus on the effect that such intermediary relationships have on the public and consumer interest in ensuring access to justice, independence of representation, and fair competition for available work. It is possible that value (other than economic) might be removed from the value system by these arrangements such that regulation is required to govern them.

7.2.2 Bargaining power

The mere fact that a firm occupies a certain position in the value system does not inevitably mean that its ability to capture value is predetermined. Whether it is or not will also depend on the firm's relative bargaining power. For example, intermediaries often exercise disproportionate power because they can decide whether or not a particular firm receives any work and, if it does, at what cost by way of referral fee, expected staffing or imposed compliance processes for delivery. A firm must understand this relative positioning if it is to develop and sustain an appropriate business model.

We should also not overlook the bargaining power of clients. The rise in the number of in-house lawyers and the tendency of commercial or public sector clients to keep work for internal disposition, combined with the increasing use of procurement processes (such as tenders, auction and panel appointments), lead to greater client control or influence over the volume, nature, handling and pricing of legal services provided by law firms. Further, there are the changing expectations of a new generation of clients (principally 'Generation Y'), who are more comfortable with technology and social networking. These changing expectations will lead to more remote and virtual relationships with providers of goods and services – and, indeed, to experiences of provision where some services, or elements of them, are offered without charge. The reconstruction of legal services to determine which elements are to be offered in return for a fee and which not could represent a particular challenge to some lawyers and law firms. This dimension of value creation and capture, based on a different dynamic in the relationship between lawyer and client (reflecting, among other things, a shift in bargaining power), should not be underestimated in the design of twenty-first century business models.

But the issue of generating returns in professional services firms does not end there. In the context of business models, it might be thought that the principal concern should be capture by one business relative to another in the sequence of value creation. For instance, estate agents or insurers as intermediaries capture value through a referral fee, at the expense of the law firm undertaking the work. But in the context of professional services firms, even partners and employees can be seen as 'suppliers' in the system: in Porter's terms they are part of the firm's internal 'value chain'[33]. As such, they frequently capture value at the expense of the firm by demanding higher personal rewards that reduce the returns otherwise available to the owners.

This might seem an odd assertion in the context of equity partners since they are rewarded out of net profit. My assertion is that, because of the confusion of stakes being remunerated from the pool of net profit[34], any equity partner who secures an element of personal reward not justified by contribution is effectively reducing the

[33] In Mayson (1997: 74-77), Porter's concept of the value chain is further discussed and applied to law firms.

[34] This is the point first made in Mayson (1997: 140-144) and it is fully articulated there.

amount available to all partners as a return on their collective enterprise – that is, capturing value at the expense of the ownership as a whole (who, in a different business structure, would often be different people or, at least, would be rewarded differently – for instance, through dividends rather than 'wages'). A failure to distinguish rewards to different stakeholders could potentially result in lack of clarity in the business model where assumptions are made about the creation and capture of value. For instance, value might be captured by equity partners which has not been created by them – at the expense, say, of 'proper' rewards for employed staff – resulting in a distorted or unsustainable business model.

The ability to capture value internally seems to resolve to the following:

(a) which 'stakes' are being rewarded (e.g., financier, worker, entrepreneur, shareholder)[35]; and

(b) the bargaining power among potential stakeholders.

In relation to (b), bargaining power within a firm, there are three further factors that determine the relative ability of an individual or the firm to capture value:

(i) the degree of the individual's dependence on the firm or vice versa (e.g., for client relationships or work flows);

(ii) the extent to which the individual identifies with the firm (which for many professional people can be relatively low, with a tendency to identify more with their clients, their team, or – historically, at least – their profession); and

(iii) the credibility of any threat by the individual to leave the firm.

All three factors cover a range from a more personal, self-centred view of the business world to a more collective, firm-centred view. The more an individual is at the personal end than the collective, the more likely it is that this person will capture value at the expense of the firm – that is, will reduce the returns generated for the firm. This ability of a supplier, or group of suppliers, to capture value internally should therefore also influence the firm's view of the appropriateness and sustainability of its business model.

If the intention is that the *firm* should generate returns from the use of resources in the creation and delivery of value, this would suggest that it should depend less on individuals for productivity than they do on the firm. In the context of business models, the conclusion must be that where the firm's value creation relies on value propositions based more on individual than collective endeavour (as described in paragraph 4.2.3), the less likely the firm will be able to capture the value created, and the returns will be reduced. Such a business model might not prove sustainable, except where the ownership of the firm remains in the hands of those individuals on

[35] This issue and its implications for a firm's valuation are explored in Mayson (2007: 281-287).

whom the value proposition depends (which, of course, has been the historical basis of the professional partnership structure). Increasingly, however, to generate returns in the future and within new forms of organisation, the firm must work to connect human capital to teams within the organisation or embed their knowledge and skills in the firm as organisational capital so that the firm can capture for itself some of the value created (see paragraph 5 above).

7.3 Generating profit

Part of the returns element concerns not simply *whether* value is captured, but whether *enough* (or as much as possible) of it is captured. As Magretta puts it (2002: 90): 'Profits are important not only for their own sake but also because they tell you whether your model is working'.

The firm's approach to generating and maintaining profit will depend on various levers of profitability (particularly pricing and the management of fixed-fee work, overhead control, the utilisation of resources, the effective use of leverage, and the management of work-in-progress and debtors). For instance, will money be made on turnover (say, from volume, fixed-price work) or margin (say, from personal, higher-value, services)? What potential is there to derive economies of scale? Further, at any stage in the value system considered in paragraph 7.2.1 above, by driving down the prices of a supplier, the next business in the network can capture for itself some of the value that would otherwise have gone to that supplier.

These days, profit in legal practice is an outcome that needs to be managed rather than assumed, and a law firm must understand the relative contribution of the various drivers of profitability as well as of distinct parts of its business (such as service lines, sectors, clients, and offices) [36].

The firm's business model must therefore establish whether returns are to be generated from a privileged market position allowing it to operate in 'high value' segments with higher margins or premium rates, or from economic efficiency driven more by volume, and the use of leverage, processes and technology.

Profits can also be reinvested in the business. In this way, they can be applied for the acquisition or development of new or additional resources in the expectation of further value creation and capture in the future. The use of profits for this purpose is usually expected to generate a return more quickly than is the case with capital investment.

[36] Further detail is contained in Mayson (1997), chapter 28 and Mayson (2007: 79-86 and 200-208).

7.4 Business model evolution

The returns element of the traditional law firm business model has historically been a revenue-driven model, in more sense than one. Many firms grew turnover with little attention to profitability (which until at least 1990 – and for many firms long after that – was a positive and reliable result). More recently, attention has turned to managing for profit, though still (given that the predominant form of value creation has remained expertise) based on premium, usually hourly or time-based, rates. As a consequence, most law firms have been more dependent on their senior people than those people have been dependent on the firm[37].

As some firms have struggled to maintain profitability, managing for profit has become more important, as has recognising some shifts in business to encourage more innovative approaches to pricing and case management to derive profit from fixed and volume fee arrangements.

Whatever a firm's route to profitability, the distribution of returns has also been founded almost entirely on the owners (partners) deriving income returns in the form of shares of net profit. There has been no separation of the 'stakes' being rewarded out of this mixed pot, and little or no attempt at the creation of capital value[38].

Finally, with the implementation of the Legal Services Act and the introduction of external capital, this element of the business model might well evolve into even more focus on managing for profit, greater differentiation of returns for different stakes and among different claimants, and increased attention on the generation of capital as well as income returns.

8. A typology of business models in legal services?

8.1 An alternative approach

The core elements of a business model outlined in this paper indicate that there are in fact a number of variables to be factored in to choosing an appropriate model for a particular firm. Given the wide variety of ways in which those variables could be configured, there would appear in principle to be potentially an infinite number of possible business models. As indicated in paragraph 2 above, this paper accordingly does not take the approach of trying to identify a series of generic business models that could be applied to legal services.

[37] It would be possible to offer a conjecture that in some major law firms there is an institutional relationship with clients such that no individual is more important than the firm, and thus that the individual is more dependent on the firm than vice versa. Slaughter and May, and Cravath, come to mind.

[38] There are many challenges in creating capital value in law firms (not least the existence of a market for the capital shares created to provide an exit or realisation route for the owners or investors): these issues are explored at length in Mayson (2007). It is also surprising that so few attempts have been made given that tax rates on capital gains are (typically) lower than those on income.

Taking the view that a business model is an articulation of the underlying logic of the firm's business, the approach advocated here is to work through the four elements of value creation, resources, investment and returns in order to articulate a firm-specific business model, without needing to base it on any pre-defined generic model.

To be able to do this and create its own, fully developed, business model, a firm will need to have paid attention to the following issues:

(1) Strategic analysis should have shown where the firm's current strengths and opportunities lie. It should therefore have a good understanding of the nature of its market, resources, and economic aspirations.

(2) The firm's strategy should suggest one or more value propositions – and in particular whether the dependence inherent in the creation of that value lies predominantly with the individual or the firm (or at an intermediate, team, level). The firm must decide whether that proposition is consistent with its position in the value system and its ability to capture value and generate returns – and, if not, what to do about it (such as shift the emphasis or dependence, or adopt a more suitable business model).

(3) Profit will be generated because of one or both of a favourable market position and the firm's economic efficiency. This has implications for creating and capturing value and the specific resources required by the firm.

(4) Resources will be needed to implement the business model. The firm must appraise those resources it already has at its disposal (or to which it can gain access) in the light of the preferred business model. It must decide whether it can, or must, have certain resources within the boundaries of the firm, or whether it can afford or would prefer to, or must, leave them outside and use *ad hoc* contracting, joint venture, out-sourcing, or other arrangements to access them. Where the resources are critical to creating or capturing value, the firm would be best advised to internalise them; where that is not possible, alternative business models should be explored further before a final decision is made.

(5) Finance will be required for the firm. The specific business model should establish what the investment objective is or will be over time, and whether the capital required should and can be provided internally or externally (and, in any case, from whom), and whether by debt or equity, or some appropriate mix of those factors. Whatever configuration of internal and external, and of debt and equity, is adopted, it must be appropriate to the business model (that is, it must be capable of delivering the returns that will be acceptable to the providers of the capital in meeting their investment objectives).

8.2 One business or several?

The question of the appropriate 'unit of analysis' is highly relevant in the context of business models. Where a firm offers different services or products to its market (as is the case in many law firms), the inevitable question in the current context is: does the firm constitute a single business or several? If it is a single business, then its business model must explain and support the totality; if it is several businesses, then perhaps distinct business models are needed for each. If a firm cannot easily, strategically, consistently or logically explain why it is one business, then it probably is not. If it can, then the factor or factors that make it one business should become prominent in the business model[39].

For example, a firm might claim to specialise in the needs of clients in a particular market sector (say, financial services). Although it might offer a range of professional services (such as those supporting regulation and compliance, loan agreements, mortgages, property transfers), each is applied – and collectively they work together – in the context of the specific circumstances of that sector. The market is well defined; the firm's market position creates value through sector specialisation and by coordinating multiple services, supported by knowledgeable and specialised people as well as possibly by processes dedicated to sector needs (such as housing repossession). The key elements of sector specialisation, coordination, and a dedicated, complementary, response should therefore be emphasised in the firm's business model.

Porter made the point that competitive advantage cannot be understood by looking at a firm as a whole[40]. The processes of the creation and capture of value to generate returns could well differ significantly across practice areas. For this reason, it is possible to argue that there might be distinct 'strategic business units' within the same firm, each requiring a separate business model. There is much logic in this view[41]. But where this occurs, there still needs to be some overarching explanation for the firm as a whole, with its portfolio of distinct business units. Indeed, often this overarching explanation is not well thought out, leaving the firm vulnerable to competitors' actions in relation to specific business units.

An alternative explanation, based on the approach set out in this paper, would not be found in distinct *business models*. There is no quarrel with the notion of strategic business units (far from it, since there is great merit in conceptualising and organising a firm in this way)[42]. Rather, each business unit requires a different *value creation element* to explain how, in its market, it seeks to create value, and possibly a

[39] Linder & Cantrell (2000: 5).

[40] Porter (1985: 33); this is also a point emphasised in Mayson (2007: 126 and 128).

[41] Seppänen (2008: 12-13) writes, for instance, that "in a large firm having many businesses, there may be – and typically are – several business models".

[42] Subject to the view that there should be some underlying strategic logic or rationale to connect them within the same firm: see Mayson (2007: 114-117).

different *returns element* to explain how it seeks to capture some of the value created and generate returns from doing so. But then, within the context of a single, integrated, business model, it could still use a single *investment element* to provide the rationale for the collection of business units within the whole. If there is genuinely one business, rather than distinct business models, this view would suggest the use of one business model incorporating different value creation elements (and returns elements) for the component strategic business units. Taking this approach might encourage the firm's investors and managers to be far clearer about how the whole is intended to fit together to create returns for investors, and to flush out and resolve potential conflicts between units or activities (particularly in the allocation of resources).

9. Moving from one business model to another

It is very likely, over time, that a firm will face a need to move from its current business model to another, either to help it face emerging changes in its marketplace or to position the firm to take advantage of new opportunities it has identified[43]. Indeed, as indicated in paragraph 6 above, some of the investment objectives might inevitably be regarded as short-term, transitional, objectives. In these cases, the firm should expect to move to another business model within a short period of time.

In moving from one model to another, it seems logical to suggest that the safest approach to adopting a new model would be to *add* one new output to those existing in the current business model or *substitute* one new output. Thus, for example, a firm following a start-up objective could add either profits or capital and so move, respectively, to sustainability or medium-term growth. Alternatively, a firm moving from market entry could add either profits or capital as an additional output and so move, respectively, to diversification or acquisition. Such incremental shifts would put less pressure on the firm and its management in a period of transition[44]. Making more than one addition or substitution inevitably increases the challenge (and risk) to the business, adds to the investment required, and necessitates a depth of management ability and experience that the firm may currently lack. It also seems reasonable to suggest that a succession of incremental (and therefore more manageable) changes over time will reduce the need for (and higher risks associated

[43] Voelpel et al. (2003) describe the driving forces and discontinuities that tend to lead to the need to change business models. Indeed, they suggest that, in the face of such forces, a firm "should be capable of reinventing its strategy not when it is in the midst of a crisis, but continuously.... Therefore, organizations should constantly attempt to create new business models if they hope to survive and grow in a turbulent and competitive environment" (2003: 8-9).

[44] As Voelpel et al. suggest (2003: 13): "Developing new business models requires the discarding of conventional beliefs and established ways of doing business", which leads them to describe three principal difficulties in achieving change: the limited perspectives of the firm's top management; the need to 'unlearn' the past; and reluctance to 'cannibalise' the existing business (2003: 13-17). Incremental change can reduce these challenges.

with) more radical and disruptive reinvention of the business model that could stem from failing to make any movement earlier.

10. Conclusions

This paper represents a first step in creating a definition of 'business model' appropriate to the legal services market. It suggests that a business model is a representation of a firm's core logic for creating value and capturing some of it to generate returns from its investment in and use of resources. It therefore identifies four core elements in respect of which a firm must make decisions: (i) value creation; (ii) resources; (iii) investment; and (iv) returns.

These choices must be consistent with each other (that is, have internal 'fit'), and create the links for a firm's strategy, structure and processes. They must also be consistent with the firm's external environment (external 'fit'), and provide an appropriate response to that environment and events in it, as well as to competitors' actions.

The approach to developing a business model might therefore be:

(1) Consider and decide whether the firm is in truth one business (with distinct strategic business units) requiring one business model with multiple elements, or a number of discrete businesses requiring multiple business models.

(2) For each business model, articulate:

  (a) the value creation element(s);

  (b) the resources element;

  (c) the investment element; and

  (d) the returns element(s).

(3) Identify whether or not the business model is a transition from or to a different model, and establish the implications of that transition.

There are significant dangers in a lack of clarity about business models. For example, a firm runs the risk of not identifying a business model at all and then failing to implement its strategy; there is the risk of adopting an inappropriate or ineffective model, or of failing to implement a model successfully because of the lack of clarity; and there is the risk of adopting only one method of value creation or generating returns when the business requires a model with complementary or alternative methods within the same investment objective. These risks should not be under-estimated because the wrong business model will be at least expensive and could, ultimately, lead to the failure of the firm.

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