AI Will Not Be the 'End of Lawyers' – If They Are Prepared

A Guide for Law Firm Leaders on the Expected Impact of AI on the Large Law Firm Business Model and How Firms Should Prepare

By Jack Bostelman*

Introduction

Large law firms are now moving from "Should we deploy AI?" to "***How*** should we deploy AI?" That thinking should not start with "What do we do now?" Instead, it should start strategically with "Where is the market likely to end up, and what path should we take to succeed in that market?"

AI adoption that really changes the way lawyers work is difficult to achieve, as Am Law 100 firms are discovering. That kind of meaningful adoption is, however, the key to success in the new AI world. Firms that achieve full AI adoption first will likely take market share from the others. The top couple dozen Am Law 100 firms have been capturing ever-higher percentages of Am Law 100 total profits. While that trend should continue, the composition of that group may change based on AI adoption rates. Firms successfully adopting AI will retain their top positions or be vaulted into the top; lagging firms will fall out of the top or further behind in the bottom group.

This article explains how AI adoption works, how it can ultimately shift the billable hour to fixed fees, and how AI adoption rates by firms will determine market-share shifts that could potentially force lagging firms into combinations or failure. This article also identifies key risks and opportunities that leaders should address, such as how to avoid the AI adoption gap and how to take advantage of a market where AI adoption rates across firms will vary. Finally, it describes actions firms should take now to accelerate AI adoption, including techniques to incentivize lawyers to incorporate AI in their practices.

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A. Will Your Firm Fall Into the AI Adoption Gap?

AI adoption follows a four-stage progression. Firms that progress the fastest through these stages will be the most competitively positioned. Stage 3 – institutionally driven adoption – is the most challenging. Firms that have trouble completing that stage are considered to have fallen into the AI Adoption Gap and will face competitive challenges. **We believe a high proportion of AmLaw 100 firms, perhaps a majority, are currently working through the AI Adoption Gap.**

1. The four stages of AI adoption

Each of the four AI adoption stages represents progress in a firm's evolution toward full AI adoption, sometimes referred to as being "AI native". No stage should be skipped.

Stage 1 ***Still Considering***	**Stage 2** ***Voluntary Experimentation***	**Stage 3** (the most important) ***Prescribed Adoption***	**Stage 4** ***AI Native Practice***
The firm has not yet made a general-purpose or legal-specific AI tool available to its lawyers. Leadership is monitoring the landscape and evaluating options but has not committed to a firm-wide tool or approach.	The firm has made one or more AI tools available but sets no expectations for use. Adoption is self-directed. There is no structured training, no use case guidance, and no institutional push to embed AI into legal work.	The firm sets goals for lawyer AI use and takes a multi-pronged approach to driving use case discovery and sharing within and across practice groups. The institution, not just the individual lawyer, owns the adoption agenda. Success metrics are being developed. Value pricing for AI-assisted work is also often being explored.	AI use cases and agentic workflows are standardized within practice groups and used by a majority of lawyers. AI is woven into how legal work is delivered. Success metrics are being tracked. Value pricing and other AFAs are regularly used for AI-assisted work.

Stage 1 – Still Considering. Firms should move as expeditiously possible through Stage 1, evaluating the tools to adopt. While there are many tools, the choice of specific tools is not as important as getting started. Most lawyers' use of AI will proceed slowly enough that a few feature differences in the tools will not make a difference. Many firms adopt a general

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purpose chatbot, such as ChatGPT Enterprise or Claude, and a legal-oriented tool, such as Harvey or Legora.

Stage 2 – Voluntary Experimentation. It will take some time for Stage 2 to run its course, where lawyers adapt to the art of prompting and become comfortable with what AI can do and what it should not be asked to do. Training can go only so far; hands-on use is the only way a lawyer will develop a sense for AI's potential and its limitations. This experimentation stage is necessary before the firm can proceed to the critical Stage 3, so it is best to begin as soon as possible. Our sense is that most AmLaw 100 firms are in Stage 2 or further.

2. Avoid the AI gap

Stage 3 – Prescribed Adoption. This stage is where AI starts to make a serious economic impact. A top-down push for AI adoption can convert experimentation into institutionalized change. If a firm approaches Stage 3 successfully, profits will be protected or improved. There are two risks in the transition from Stage 2 to Stage 3, though.

Risk #1 – Getting stuck in Stage 2. The first risk is that the firm gets stuck in Stage 2. It takes a concerted effort by firm leadership to make the move to Stage 3. Firms that are stuck in Stage 2 or struggling in Stage 3 are in the "AI Adoption Gap", where they are paying for expensive AI tools but their lawyers are not yet significantly changing the way they work. Competitive pressure on fees increases from other firms that are further along in embedding AI. Without the ability to perform work more efficiently at the lower fees, margins and profits will be adversely affected for these slower firms.

Stage 3 is challenging because:

- The lawyers have to think about how to break down what they do into parts where AI can assist and parts that humans must perform. Analyzing and restructuring their workflows is generally not something lawyers are used to thinking about, especially at the detailed levels required for AI adoption.
- There is no one-size-fits-all template for using AI. Each practice group must discover on its own how to embed AI in its work.
- Most of the work discovering where AI can assist must be performed by partners and senior associates, because they have the best understanding of the work. Yet these are the lawyers who are the firm's scarcest resources, and can be the most reluctant to make the needed hands-on effort.
- Metrics to measure success (*i.e.*, improved efficiencies due to AI) need to be developed. Mere usage of AI tools may not be the same as **impactful** usage. Hours

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per matter closed in a year and matters per lawyer closed in a year are conceptually appealing metrics but probably are also greatly affected by non-AI events, making period-to-period comparisons of AI success impractical. Developing practical metrics will require time and effort.

- There is a renewed importance on knowledge management to "feed" the AI: precedent collections, matter experience data, contract playbooks, how-to guides, etc. The many firms that are lagging in KM will need to build these resources.
- AI adoption is a big change management effort, and lawyers are often resistant to change.

Techniques to promote change are discussed later in section "E. Techniques To Improve AI Adoption in Stage 3 and Avoid the Gap" on page 13.

Risk #2 – Sticking with the billable hour. The second risk in the transition from Stage 2 to Stage 3 is that the firm makes substantial progress in embedding AI in its core work, but does not move quickly enough to adopt fixed fees. In this situation a firm still billing by the hour must chase increasingly more new work to bill the hours saved (*i.e.*, capacity released) through the massive efficiency improvements brought by use of AI. Chasing this volume of new work eventually becomes unsustainable. As a result, revenues and profits ironically decline due to the efficiency improvements coupled with hourly billing.

Avoiding AI is not a practical alternative for avoiding these risks. Firms that avoid AI will be left in the dust as other firms adapt to AI and reduce fees but maintain profits by using fixed fees.

Stage 4 – AI Native Practice. In Stage 4 the firm has woven AI into how its legal work is delivered, achieved dramatic efficiencies, instituted tracking of AI adoption metrics, and succeeded in billing most of its AI-assisted work at profitable fixed fees. We are not aware of any AmLaw 100 firm that has yet reached Stage 4.

B. Will Your Firm Be Ready for the AI Tipping Point?

1. What is the AI tipping point and when will it occur?

AI will make large law firms more efficient but will not immediately put an end to the billable hour. Firms will initially make other adjustments to maintain revenues and profitability. As AI efficiencies increase at a firm, though, it will be compelled for the reasons described below to switch to fixed fees for AI-assisted work in order to preserve

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profits. At some point, though, enough firms will have switched to fixed fees that the market reaches a tipping point. When that happens, the lagging firms will be forced to move to fixed fees to protect their market shares and fixed fees will become the predominant billing method among the AmLaw 100 for AI-assisted work.

The tipping point will occur when these conditions have been met:

- A critical mass of early AI-adopter firms have reached Stage 4 by embedding AI in most of their work and trading on their reputations to successfully charge this work on a fixed fee basis without shadow hourly billing; and
- A sufficient amount of fixed fee work from the early adopters is completed that legal departments become comfortable they have adequate data to evaluate fixed fees across firms. In other words, they are able to compare work based on unit costs for tasks rather than hours.

We envision the "critical mass" being a dozen or so of the top 25 firms. At that point the remaining top 25 will need to move to fixed fees to protect their market shares, and the fixed fees of the top 25 will have become so low that the top firms start taking market share from the lower tier firms. This will force the lower tier firms into charging fixed fees, or merging with firms that have successfully transitioned to AI with fixed fees, or going out of business.

We believe a "sufficient amount" of fixed fee work history would exist after legal departments of a couple dozen large clients of the early adopter firms have accumulated two to three years of fixed fee data. These clients also work with the lower tier firms and will be in a position to leverage this data to evaluate many of the lower tier firms' fees as well.

2. Why will the tipping point occur?

The market realities are that the billable hour is ultimately not sustainable to address the tremendous efficiencies AI will produce. As firms become more efficient and charge lower hourly fees, they can for a while use the saved hours to take on additional work, thereby preserving their revenues and profits. This may succeed at the outset when AI is used for only 10% of firms' work. At some point, though, firms will use AI for more of their work, AI-driven efficiencies will become greater and the number of firms using AI to this extent will increase. There will simply not be enough additional work to replace those saved hours across firms. Yes, under the economic principle of demand elasticity, client demand for

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additional work should also increase as fees for given pieces of work are reduced due to fewer hours being required. But that demand increase is very unlikely to be enough to offset the saved hours when AI efficiencies reduce the required hours by five- or ten-fold. Also, client law departments will be reducing their outsourcing of legal work due to their own use of AI. In theory law firms could try to compensate by raising hourly rates, but the optics of five- to ten-fold rate increases would likely prevent that tactic. As a result, the saved hours from use of AI become lost hours, and fixed fees are the solution.

The fixed fee for a given matter will be lower than today's hourly-based fee. In a rational world, the market will determine the fixed fee at a point that shares the value between law firm and client.

To be clear, "fixed fees" in this context means billing on a fixed fee basis without providing shadow billable hours. Currently clients often request shadow billable hours for fixed fees because they feel that is their only means to confirm they are getting sufficient value for the fee. Providing hours, however, essentially converts the fixed fee into an hourly fee with a cap because the client may be willing to pay only the hourly fee if it is lower than the fixed fee. That is riskier for the firm than hourly fees because the client benefits from efficiencies but the law firm bears the risk of time overruns. In a true fixed fee, the law firm, not the client, benefits from efficiencies, which is the whole point of that billing method.

Early adopter law firms will try to gain competitive advantage by moving to fixed fees that are lower than the hourly fees of lagging firms, yet still profitable because of the extent of the firms' AI use. These firms will be the ones that can trade on their reputation to replace hours as the trust factor to avoid providing shadow hourly fees and the implicit downside discount they represent. Perhaps some high-profile corporations will partner with these early adopter firms with the expectation of redefining a more competitive market for legal services. As real-world fixed fee data is generated, perhaps shared through the major billing platforms or a disrupting new entrant, that data will ultimately be the trust factor that supports fixed fee billing across all firms.

3. What does the law firm billing model look like with fixed fees?

Moving to fixed fee billing will alter the law firm hourly billing model, which states that Profits per Partner equals the product of four variables: Average Realized Rate, Margin,

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Utilization and Leverage. Those variables are tracked by management and to some extent become levers for managing the firm. The modification for fixed fees is relatively straightforward, though.

The billing model for fixed fees replaces Average Realized Rate with Average Budgeted Rate and adds a new variable, but preserves Margin, Utilization and Leverage. The new variable is Execution Efficiency Factor, which is a measure of success against ***budgeted hours***, with 100% being on budget. Execution Efficiency is computed as budgeted hours divided by actual hours. An Execution Efficiency below 100% is eroding profitability and above 100% is improving profitability. The new concept called "budgeted hours" is the number of hours the firm **expects** the task to take at target 100% efficiency. Thus, for fixed fees Profits per Partner equals the product of five (not four) variables: *Average Budgeted Rate*, *Execution Efficiency Factor*, Margin, Utilization and Leverage. How the fixed fee billing model differs from the hourly billing model is explained more fully in the Appendix on page 16.

C. Key Risks About AI's Effect on Large Law Firms

Predicting when the tipping point may arrive is less important than being prepared for what follows. In considering how best to prepare, large law firms will want to consider these risks:

1. AI adoption rate across firms – lockstep or wildly different?

If most law firms adopt AI at the same pace, match each others' efficiency-driven fee reductions and make other adjustments to preserve profitability, then firms should be able to retain their respective market shares, except for losses to a few early adopter firms. On the other hand, if there is much disparity in the rate of AI adoption, as seems likely, the firms moving faster will capture more market share. The bottom group of firms may be left having to merge with more successful firms or folding their businesses. The safest approach for firms is to adopt AI as rapidly as possible.

2. Extent of increased demand for legal services when prices drop – enough to offset work "lost" to efficiency gains?

As AI improves efficiency, fees for the same task billed by the hour will decrease and, we believe, lower fixed fees for the task will ultimately replace hourly fees. In order to preserve

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revenues when prices fall, one strategy is to take on additional work with the saved hours. But will enough additional work be available? Lower prices will stimulate demand to some extent. Some may doubt that demand will increase with lower prices, and that legal departments will simply reduce their budgets. This has not, however, been the experience when prices reduce in other business sectors. It is true, though, that legal departments may take some work in-house using AI tools, which would reduce demand. In any event, as noted above in the tipping point discussion, we believe the demand increase will not be enough to replace all the saved hours across all firms. The unknown, though, is the size of the demand shortfall. The larger that shortfall, the more market share the early AI adopter firms will take from the slower firms through lower fees. Again, the smart strategic move is to embed AI in the firm's work as soon as possible.

3. Associate leverage – can it be maintained or will it reduce?

There is much speculation that AI will result in law firms needing fewer junior associates and that the leverage model will be upended. That will be true only if firms cannot redeploy their current associate capacity to use up the hours "saved" by utilizing AI. Fully utilizing current capacity depends on two factors:

- **Finding additional work.** As discussed in the previous section, early adopter firms will be best positioned to obtain sufficient additional work because they will lead on price competitiveness.
- **Preserving the associate seniority ratio.** If the AI-assisted work can be handled by the same associate seniority levels as before AI adoption, the existing associate leverage ratio for that work will be preserved. If, however, associates of greater seniority are required, fewer junior associates will be needed and the leverage ratio will decline. Many commenters jump to the conclusion that junior associates will no longer be needed because their work is less complex and more likely to be handled by AI. But associates at some seniority level will still be required for organizational oversight and specific checking of AI outputs. A case can also be made that because AI tools will be incorporating institutionalized knowledge, such as precedents and playbooks, the human work can now be performed by more associates of ***lower*** seniority. Firms will need to experiment in Stage 3 to understand how associate seniority needs will play out. This generally remains an unknown.

Firms forced to reduce associate leverage may seek to partially offset the revenue loss by increasing hourly rates for advisory work by partners and senior associates. Market forces

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will determine the limits of this approach. It seems unlikely, though, that these hourly rates could increase enough to offset the effect of five- or ten-fold AI efficiency improvements.

The formula for the law firm billing model (see Appendix) dictates that if associate leverage declines, profits per partner will also decline, all other things being equal. But increases in another financial lever, Average Budgeted Rate, could offset that effect. Average Budgeted Rate is the fixed fee analog of average realized rate. It is the blended assumed hourly rate used to set the fixed fee by assigning budgeted hours to the matter's tasks for various fee-earner seniorities. In other words, higher fixed fees could offset a decline in leverage. If it turns out that leverage does decline in the future fixed fee legal market, this effect should be applicable across firms, and firms would presumably respond by offering fixed fees that are high enough to retain profitability.

4. Associate training and mentoring

Whether or not associate leverage changes due to AI adoption, associate training will need to change. Associates at all levels, and even partners, will be gaining less hands-on experience when AI begins to perform more of the work. Firms will need to devise a way to replace this lost on-the-job training, such as through more hands-on workshops and enhanced mentoring by senior lawyers. Effective associate training, as contrasted with on-the-job learning, has generally not been a strength of large law firms. The firms that find ways to address this training need will have an advantage in terms of associate leverage (by being able to push work down to more junior lawyers for a given task) and work quality (with better trained associates making fewer mistakes that need to be corrected by senior review).

5. New roles for lawyers – "legal engineers"

AI vendors and law firms are hiring for roles blending substantial subject matter legal experience with practical knowledge of how AI works. These roles, often referred to as "legal engineers", are filled by former associates and sometimes partners. This work, which is typically not client-facing, involves engaging with regular partners and associates to speed adoption of AI into their workflows.

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These roles:

- can accelerate AI adoption within firms,
- provide an alternate career path for associates, and
- are generally highly compensated and represent an additional cost of AI.

Another decision for firms during Stage 3 is the right number of legal engineers to deploy to balance improved AI adoption with cost. Also, AI vendors to law firms are hiring large numbers of former law firm lawyers for these roles, creating scarcity of this specialized talent and driving up its cost. The risk here is whether a firm can fill enough high quality legal engineer positions, either through internal resources or external hiring. A further risk, discussed in section E "Techniques To Improve AI Adoption in Stage 3 and Avoid the Gap" on page 13, is whether the firm can effectively deploy those engineers to facilitate AI adoption.

6. Higher AI expenses

The cost of AI is high and may well increase. Firms will feel pressure to acquire more AI tools and AI vendors are predicted to reduce their pricing subsidies and raise token costs as their businesses mature. Even firms that chose to "own" rather than "rent" AI will face significant capital costs and investment in personnel to develop and maintain their AI systems.

These AI expenses will reduce profitability unless another financial lever offsets them, such as an increase in fees. The need to offset AI expenses will be another factor limiting the extent to which fixed fees in a rational market will drop from pre-AI hourly fees for a given task.

7. Develop New Services, but Not at the Expense of AI Adoption Progress

AI creates the opportunity for firms to offer new services to clients based on their existing expertise. For example, a firm could offer a basic self-serve AI-powered system to answer straightforward questions in an area of law in which the firm specializes. This system could be offered free to the public as a way of introducing the firm's expertise to users who may also have more complex needs and become clients. Or the firm could create an AI-

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powered system that could address more sophisticated questions or legal needs, and sell access on a subscription model.

While these new services create additional revenue sources and can provide competitive advantages by differentiating the firm, firms should not underestimate the effort required to (1) capture the relevant know-how from the firm's existing work product and the minds of its practitioners, (2) develop and test the system, (3) maintain the system's content, and (4) provide user support for the system, whether users are internal or external. Firms having the largest profit pools will have the resources to develop new client services while still making major progress towards firmwide AI adoption and avoiding the AI adoption gap. Most firms, however, will need to maintain the focus of their resources on AI adoption and should forgo major commitments to developing new services until they are further along in firmwide AI adoption. If instead they over-commit scarce resources to developing new services, they are at heightened risk of staying in the AI adoption gap and losing market share to competitors.

D. Re-ordering of the Leading AmLaw 100 Firms

Currently a group of about two dozen firms accounts for more than half the total profits of the AmLaw 100. This trend towards concentrating increasing profits in a top group has been occurring for many years. The trend continues because firms with bigger profit pools have more resources to invest in important lateral partners and in AI and other infrastructure, and greater resilience to weather external forces such as associate salary increases that must be matched and adverse external economic events. AI adoption will not stop this trend, but it does have the potential to re-order the firms that are in the top and bottom groups.

The top firms will continue to have the advantage if they use their inherent strengths to adopt AI, but could lose their positions if they do not. The same profit pool strength that allows these firms to invest in human talent also allows them to invest in AI adoption, and even to develop new AI-powered tools and services without sacrificing general adoption, as previously discussed in section C.7 "Develop New Services, but Not at the Expense of AI Adoption Progress" on page 11. Also, the financial negotiating strength that comes from a large profit pool may allow them to prevail sooner with clients in establishing fixed fees

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without shadow hourly bills. Top firms that press these advantages may solidify or improve their top positions. Conversely, those that do not could find themselves slipping out of the top.

While each year there is some change in the firms comprising the top group, lower tier firms that move fastest to adopt AI have a path to the top group that they have not seen in decades, and the firms in the top group who move too slowly to adopt AI are at a commensurately greater risk of slipping out of the group.

E. Techniques To Improve AI Adoption in Stage 3 and Avoid the Gap

The challenges to achieving AI adoption, which can lead a firm to fall into the AI Adoption Gap, were discussed in section "A.2 Avoid the AI gap" on page 4. The solution to those challenges involves both devising the vision for effective AI use at the firm and persuading the firm's lawyers and business professionals to realign their work with the new vision.

In addressing AI adoption, firms should focus on the middle 80% of lawyers (the average users), not the 10% who are early adopters and not the 10% who are the biggest laggards. Using AI effectively is a learned skill, but more akin to riding a bicycle than learning a legal concept. To "learn" AI the average lawyer needs to spend hands-on time using an AI tool, ideally under the guidance of an AI engineer in solo or small group workshops. It is not intuitive to the average lawyer how to effectively use an AI tool. Only after a period of trial and error will that flash occur where the lawyer "gets" the feel of using AI and understands what the tool is good at and what it should not be used for. Also, there is a common misconception that more junior lawyers will be quicker at learning how to use AI. We have found that the speed with which a lawyer catches on does not correlate with seniority. In fact, senior lawyers have the advantage of knowing more about the tasks involved in their practice and which ones may benefit from AI.

With that context, below are some examples of approaches to developing the AI vision and motivating the lawyers to realign their work to it:

Developing the Vision

- The messaging and the reality should be that senior leadership strongly supports the firm's AI adoption efforts and will make resources available, but the practice group leaders "own" the AI adoption initiative.

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- The vision needs to be developed in such a way that the firm's lawyers feel their voices are included, such as by including as members of the vision-defining team partners and senior associates who are internally recognized as thought leaders.
- Because of the granularity into which lawyer workflows must be broken down and analyzed for suitability for AI use, working teams from each practice group should be tasked with identifying where AI can most effectively be used in the practice. The working teams should be primarily comprised of partners and senior associates, because only senior practitioners will have the perspective to define how the work is performed.
- The practice group working teams should include "legal engineers" – internal or external former practicing lawyers who understand how to use AI tools for legal work and can facilitate brainstorming meetings and assist test design for AI use cases. There is often a shortage of effective legal engineers within a firm, so the firm will need to develop strategies for efficiently using that resource, such as working with practice groups in rotation rather than the entire firm at one time, or bringing in equivalent outside engineers.
- The vision should recognize that metrics for measuring the impact of AI adoption need to be developed and that data for establishing fixed fees need to be generated.
- The vision should emphasize that knowledge resources, such as precedent collections, matter experience data, contract play books and how-to-guides, should be developed or enhanced in each practice group as a way to incorporate the firm's expertise into the AI-assisted workflows.

Applying the Motivations

- All lawyers should be given access to AI tools as soon as possible, encouraged to experiment with the tools and asked to use them on client work. Experimentation is a necessary step for lawyers to get comfortable with the tools, and also may jump-start development of the use cases needed for the firm's AI adoption vision.
- Identifying the specific AI tools as soon as possible, whether legal-specific, general-purpose or both, is more important than arranging elaborate testing to find the "best" tools. The reality is that the tools keep leap-frogging each other in features and performance and most lawyers will not immediately use the more advanced features that differentiate the tools.
- Focusing all the firm's AI support resources initially on one or two pilot practice groups could be a good learning experience for those managing the firm's AI adoption process. Also having two successful practice groups can motivate other groups to want what their colleagues have achieved.
- Lawyers should be held accountable for meeting the AI usage expectations of the vision. For example, expectations should be set that effective AI usage will be a qualitative factor in lawyer performance reviews. Ultimately performance against AI usage metrics (once developed) should be incorporated into those reviews.
- Billable hours credit should be provided for AI experimentation and use case development work. This sends a clear message to the lawyers that the firm is serious about its AI initiative.
- The practice group working teams should be held to regular status reporting meetings, to prevent drift.

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- Use cases should be shared within each practice group as they are developed and periodic full-group meetings held to build awareness.
- Successes should be shared firmwide to promote the vision and inspire others.
- Early AI adopters may generate good use cases, but should not be expected necessarily to be effective internal promoters among their colleagues. This is because it may actually be more difficult for the early adopters to relate to the regular users in terms of what it takes to get those users up to speed with AI usage. The early adopters may also be more focused on applying AI to their own practices than taking the time to help others learn effective use of AI.

F. Assumptions Behind the Predictions

Most of the analysis leading to the above predictions involves logic and application of basic economic principles. There are also a few assumptions, which are believed to be reasonable but for clarity are listed below:

1. AI can greatly improve the efficiency of delivering legal services

While there appears to be a consensus that AI has the potential to improve efficiency of delivering legal services five- or ten-fold, this remains an assumption. While firms have generally not yet achieved these results, the assumption seems reasonable in light of the number of very substantial firms that have publicly declared their belief in this order of magnitude of efficiency improvement and the extent to which AI models are continually improving.

If this efficiency assumption turns out to be false, then the predicted tipping point of large firms moving to fixed fees may not occur and hourly billing for legal services would probably end up remaining much as it is today.

2. AI costs will increase but not exorbitantly

The costs of AI will affect the extent of AI efficiency gains. An exorbitant cost increase could offset efficiency gains to an extent that the tipping point to fixed fees does not occur, with the same consequences described for the previous assumption: hourly billing remains.

G. Conclusion

While the timing and details of how AI will affect the market for large law firm legal services remains uncertain, in all likelihood the market **will** change. The firms that succeed in adopting AI the soonest will be best positioned to compete. That includes reexamining

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current AI plans in light of the risks outlined in section C “Key Risks About AI’s Effect on Large Law Firms” on page 8 and reconsidering the approach to executing that plan in light of section E “Techniques To Improve AI Adoption in Stage 3 and Avoid the Gap” on page 13.

Firms that fail to act will not merely fall behind but could find their very existence threatened.

H. Appendix: Law Firm Financial Model for Fixed Fees

This Appendix explains how the fixed fee billing model differs from the hourly billing model, including the relationship of increased efficiency to improved profits in the AI context.

1. Hourly vs. Fixed Fees Compared

The theoretical distinction between hourly based fees and fixed fees is that hourly fees place the risk of time overruns on the client and fixed fees place that risk on the law firm. Conversely, the benefit of time efficiency for hourly fees accrues to the client and for fixed fees accrues to the firm.

In practice, though, hourly fees are often accompanied by a fee estimate (soft cap) or an explicit cap. In those cases the client benefits from efficiencies, while the law firm bears the risk of time overruns. Thus, hourly fees with a cap is a riskier scenario for the law firm than fixed fees.

To protect against overruns, law firms are therefore often incentivized even with hourly fees to define scope, track actual hours vs. budget and execute fee change orders when scope expands. Law firm discipline in managing hourly fee overruns varies, though. Maintaining that discipline is even more important for fixed fees, because there generally is not even a theoretical option to negotiate a new fee in the event of overruns.

While fixed fees are developed internally within the firm using estimated hours, expectations with the client should be established that neither the budgeted nor actual hours will be disclosed. Otherwise the fixed fee in practice will operate as an hourly fee with a cap.

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2. Efficiency Incentives

Law firms with capped hourly fees have a direct financial incentive to become more efficient only when the cap is reached. Below the cap the benefits of efficiency accrue entirely to the client in the form of lower fees. Indirectly there is efficiency pressure to the extent competitors' greater efficiencies force fees down, but becoming more efficient in the hourly fee scenario is revenue-neutral if new work is undertaken to use up the saved lawyer hours and revenue-negative without new work. In contrast, with a fixed fee (and no shadow hourly billing) improved efficiency reduces the firm's costs without affecting the fee, thereby increasing profitability of the work.

3. Fixed Fees in the AI Context

To benefit from efficiencies created by AI-driven work, and avoid the revenue downsides of increased efficiency in the hourly context, law firms will need to move to fixed fees for at least the AI-driven work, a previously discussed in section B "Will Your Firm Be Ready for the AI Tipping Point?" on page 5. Firms will have the option to move their non-AI work to fixed fees or continue to charge hourly fees for that work.

Fixed fees are developed in the same way as estimates for hourly work: The firm estimates how many hours by various seniorities of timekeepers will be required based on the assumptions in the matter's defined scope, computes the hourly fee, and adds a contingency reserve. The result is the fixed fee. The estimated hours are referred to as "budgeted hours" and are used to track actual vs. budget during the matter.

Budget vs. actual tracking is well-known to firms that have implemented legal project management processes. If during the matter actual hours are projected to exceed budgeted hours, the firm needs to take steps to protect itself from cost overruns that will reduce or even eliminate profits. First, the firm should investigate whether scope has changed and, if so, negotiate a revised fixed fee. If scope has not changed, the firm should consider changing staffing to less expensive timekeepers, if practical. To catch problems before they become serious, tracking budget vs. actual should occur as frequently as possible, ideally weekly.

Developing fixed fees for AI-driven tasks differs from developing fixed fees for traditional human work in that there is little to no historical data on which to build. This is because AI-

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driven tasks, however granularly defined, will involve a combination of AI-assisted work and human judgment. The challenge for law firms developing fixed fees for AI-assisted work is:

- estimate the direct usage costs in dollars for AI tool use on the task, and
- estimate human hours (which then are translated into salary costs) for overseeing, checking and applying human judgment to the AI outputs.

The data for these estimates needs to be created through experimentation.

A third challenge relates to fees for human-only tasks. Those will likely be judgment-intensive tasks where AI is not yet sufficiently helpful. In many cases those tasks will be subsets of larger tasks that were tracked. Developing estimated hours for these non-AI tasks, whether to develop a fixed fee or provide an estimate for an hourly fee, will require examination of individual timekeeper data. As an aside, for high-judgment tasks it may be more palatable to the client to price those on a fixed fee basis rather than at an extremely high hourly rate.

4. Law Firm Financial Model for Fixed Fees

The law firm financial model for hourly fees can be readily modified for fixed fees. The hourly model states that Profits per Partner equals the product of four variables: Average Realized Rate, Margin, Utilization and Leverage. Those variables are tracked by management and to some extent become levers for managing the firm.

The model for fixed fees replaces Average Realized Rate with Average Budgeted Rate and adds a new variable, but preserves Margin, Utilization and Leverage. The new variable is Execution Efficiency Factor, which is a measure of success against budgeted hours, with 100% being on budget. Execution Efficiency is computed as budgeted hours divided by actual hours. An Execution Efficiency below 100% is eroding profitability and above 100% is improving profitability.

The new concept called “budgeted hours” is the number of hours the firm **expects** the task to take at target 100% efficiency. Budgeted hours are also used to compute Average Budgeted Rate (billings divided by budgeted hours), which is the blended assumed hourly rate analogous to Average Realized Rate in the hourly billing model.

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The table below summarizes the differences between the hourly rate and fixed fee models. The variables are designed for the firm as a whole but can also be applied to individual matters or practice groups if general expenses are allocated to matters and groups.

Table: Comparison of Models for Hourly Billing and Fixed Fees

Hourly Billing Variable*	How Computed	Fixed Fee Variable*	How Computed	Fixed Fee Concept
Average Realized Rate	**billings ÷ billed hours**	**Average Budgeted Rate**	**billings ÷ budgeted hours**	**Blended assumed hourly rate that is used to set fixed fee by assigning budgeted hours to tasks for various fee-earner seniorities**
		Execution Efficiency Factor (%)	**budgeted hours ÷ actual hours**	**Measure of success against budgeted hours >100% better than budget <100% worse than budget**
Margin (%)	**profits (=billings – expenses) ÷ billings**	**Margin (%)**	**profits (=billings – expenses) ÷ billings**	**Profit margin, same as for hourly fees**
Utilization	**billed hours ÷ # lawyers****	**Utilization**	**actual hours ÷ # lawyers****	**Lawyer capacity used, same as for hourly fees**
Leverage	**# hourly fee lawyers ÷ # hourly fee partners****	**Leverage**	**# fixed fee lawyers ÷ # fixed fee partners****	**More non-partners increases profits/partner.**
	* **Products of the variables in columns 1 and 3 = Profits Per Partner**			
	** **Allocate total # lawyers and # partners to hourly and fixed fee work in proportion to hours each lawyer spent on that type of work.**			

To enable computing of fixed fee metrics, a firm must track budgeted and actual hours applied to each task. This is needed to compute both the Execution Efficiency Factor for fixed fee work and the two Leverage variables for hourly and fixed fee work. Tracking actual hours against budget remains key to managing the work to meet target efficiency. When actual hours start trending toward exceeding the budget, the firm should make staffing changes (to less costly timekeepers) where possible or, if scope has changed, enter into a fee adjustment agreement.

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