



2017

Report on the State of the Legal Market

The Center for the Study of the Legal Profession at the Georgetown University Law Center and Thomson Reuters Legal Executive Institute are pleased to present this 2017 Report setting out our views of the dominant trends impacting the legal market in 2016 and key issues likely to influence the market in 2017 and beyond.¹

Introduction – A Decade of Fundamental Change

The year 2017 will mark the 10th anniversary of the beginning of the “Great Recession,” an economic upheaval that started with the subprime mortgage crisis in 2006 and 2007 and led to the worldwide financial crisis in 2008 and beyond. According to the U.S. National Bureau of Economic Research, the recession technically began in December 2007 and lasted 19 months, through June 2009. It is now widely recognized as the worst global recession since World War II.

While the Great Recession had serious effects for economies and markets throughout the world, its impact on the legal market was particularly stark. The global economic meltdown brought to an abrupt end a long period of unprecedented prosperity for law firms – more than a decade of almost uninterrupted growth² in demand, revenues, and profits.³

Corporate clients, under intense internal pressure to reduce the overall costs of legal services, insisted on taking control of their matters and managing the work of their outside law firms to a degree never before seen. Insisting on the necessity of receiving more value for their “legal spend,” clients increasingly emphasized the need for greater efficiency, predictability, and cost-effectiveness in the legal services they received – *quality, of course, being assumed*.

This basic change in client attitudes, coupled with a broader shift from a “seller’s” to a “buyer’s” market for legal services, has resulted over the past decade in fundamental changes to the legal market itself. These changes are foundational and, in all likelihood, largely irreversible. The challenge for law firm leaders today is how best to adjust to these changes so as to respond to the new demands and expectations of their clients while maintaining the long-term health and success of their firms.

In considering this challenge, there is perhaps a helpful analogy to be drawn from the world of biology. In his seminal work *On the Origin of Species*, published in 1859, Charles Darwin laid the foundation for evolutionary biology with his observations of how species respond to changes in their surrounding environments. Interestingly, Darwin’s conclusions are often misstated to assert that only the strongest of species tends to survive. In fact, Darwin observed that it was not necessarily the strongest of a species that emerged in the process of “natural selection” – nor, for that matter, the largest nor the smartest. Rather, the species with the best chances of survival were those that were the most *adaptable* to changes in their environments.

Obviously, there are problems in trying to apply Darwin’s ideas literally to other fields, as evidenced by the terrible experiments with so-called “social Darwinism.” As an analogy for the challenge faced by law



¹ The Center for the Study of the Legal Profession and Thomson Reuters gratefully acknowledge the participation of the following persons in the preparation of this Report: from the Center for the Study of the Legal Profession – James W. Jones, Senior Fellow (lead author) and Milton C. Regan, Jr. Professor of Law and Co-Director; and from Thomson Reuters – Justin Hines, Analyst – Thought Leadership; William Josten, Sr. Legal Industry Analyst – Thought Leadership; and Joe Blackwood, Jr. Account Executive/Industry Analyst – Thought Leadership.

² The period of rapid growth was interrupted briefly by a short recession in 2000-2001 (related to the bursting of the so-called “tech bubble”), but that recession was fairly short-lived and, in any event, did not affect all firms in the legal market.

³ During this prolonged period, new demand for law firm services routinely grew at 4-6 percent per year, while both revenues and profits per partner averaged near double-digit annual growth.

firms in today's radically changed market environment, however, the survival of the most adaptable seems particularly fitting. At the end of the day, the firms that continue to prosper will most likely be those that are able to adapt most successfully to the evolving demands of their clients and the changed conditions of the marketplace. Those firms that are unable to do so will most likely become endangered species.

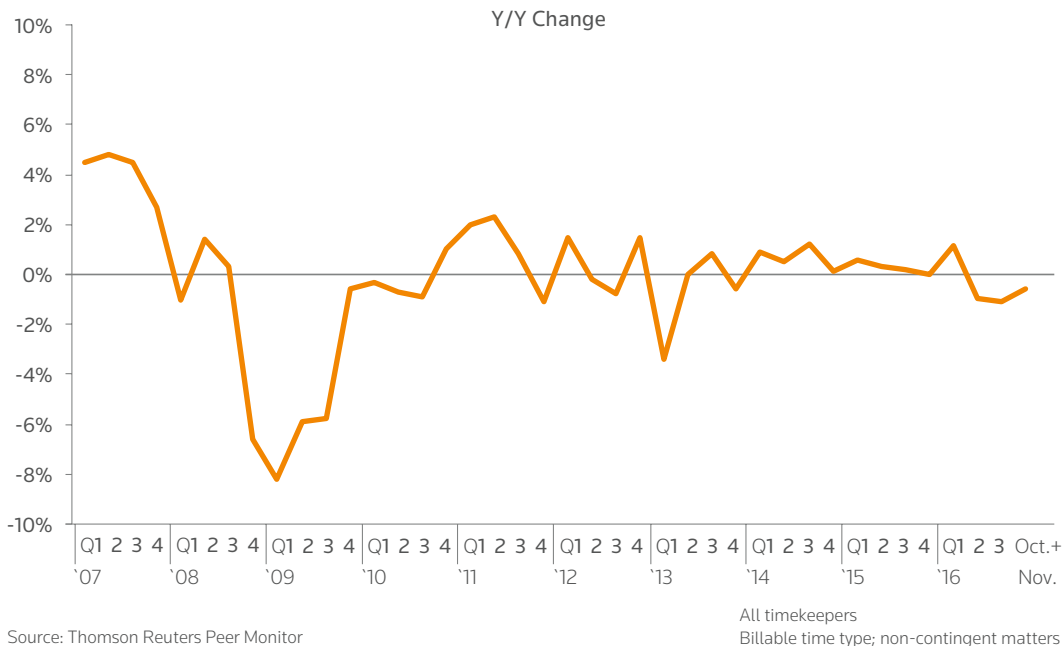
In the sections that follow, we set out the fundamental changes that we believe have occurred in the legal market over the past decade, the implications of those changes for law firms, and the kinds of adaptations we think that firms need to consider in order to remain successful in the decade to come.

Review of the Past Decade – Law Firm Financial Performance

Overall, the past decade has been a period of stagnation in demand growth for law firm services,⁴ decline in productivity for most categories of lawyers,⁵ growing pressure on rates as reflected in declining realization, and declining profit margins. On the brighter side, firms have on the whole done a fairly good job of managing their expense growth, at least during the second half of the decade.

The stagnation in demand growth for law firm services over the past decade, as tracked by Thomson Reuters Peer Monitor,⁶ is shown in Charts 1 and 2, below. As can be seen in Chart 1, following the overall collapse in demand that occurred in 2009, from 2010 through 2016, demand growth – although showing occasional modest peaks and valleys – has been essentially flat. As indicated in Chart 2, demand growth in transactional work has been somewhat volatile, ranging relatively from a negative 4 percent to a positive 6 percent, while litigation growth has (except for one period in 2012) been consistently negative. It might be noted that this softness in demand for litigation services was evident even before the onset of the recession in 2007 and probably reflects client reactions to the exploding costs of litigation tied primarily to the expansion of electronic discovery.

Chart 1 – Growth in Demand for Law Firm Services

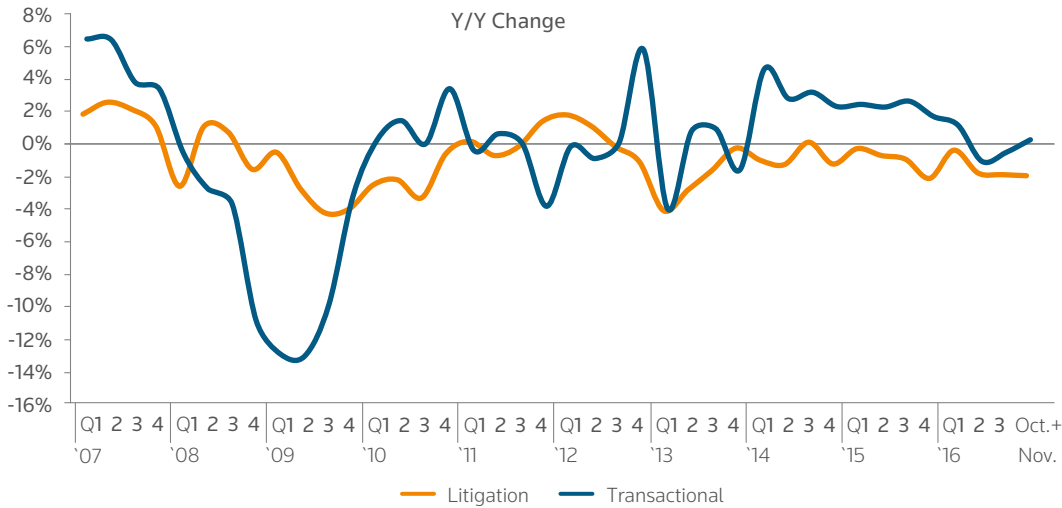


⁴ For present purposes, “demand for law firm services” is viewed as equivalent to total billable hours recorded by firms during a specified period.

⁵ Productivity is determined by dividing the total number of billable hours recorded by all lawyers in a given category over a particular period by the total number of lawyers in that category.

⁶ Thomson Reuters Peer Monitor data (“Peer Monitor data”) are based on reported results from 152 law firms, including 51 Am Law 100 firms, 44 Am Law Second 100 firms, and 57 additional midsize firms.

Chart 2 – Demand Growth for Transactional vs Litigation Services

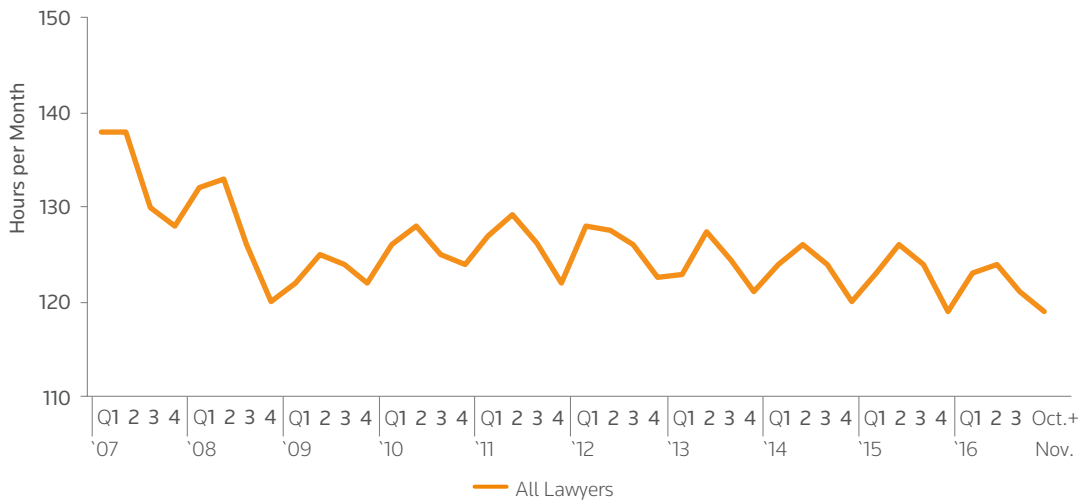


Source: Thomson Reuters Peer Monitor

All timekeepers
Billable time type; non-contingent matters

As to overall decline in lawyer productivity, as can be seen in Chart 3 below, over the past 10 years, the average billable hours worked by all lawyers across the market declined from 134 billable hours per month in 2007 to 122 through the late part of 2016. That equals a reduction of 144 billable hours per year per lawyer. If you multiply that total by the average worked rate (\$463) for all lawyers in 2016, the “cost” to firms of the reduction in productivity over the past decade is currently running about \$66,672 per lawyer per year.

Chart 3 – Billable Hours Worked per Lawyer

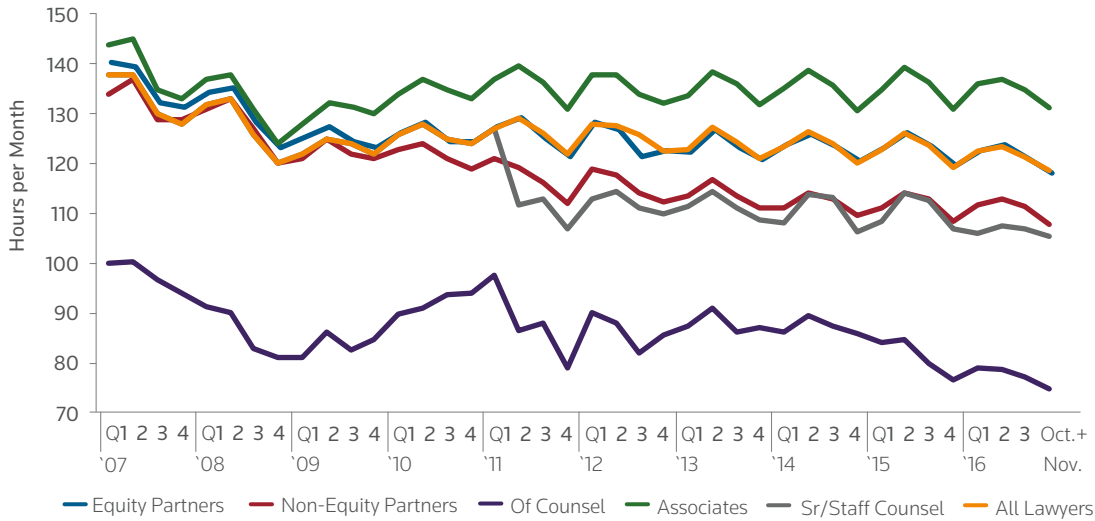


Source: Thomson Reuters Peer Monitor

Lawyers
Billable time type; non-contingent matters

Chart 4 below shows the productivity decline over the last decade broken out by category of lawyer. As can be seen, associate hours have held up better than all other categories, declining only 3 percent over the period, while hours for of counsel and senior/staff counsel have fared far worse, declining some 20 percent each over the decade. Hours for equity partners and non-equity partners declined 11 percent and 16 percent, respectively. These figures, of course, reflect staffing decisions made by firms over the last ten years, including decisions to reduce the overall number of associates and to flatten growth in the equity partner ranks.

Chart 4 – Billable Hours Worked per Lawyer by Category of Lawyer

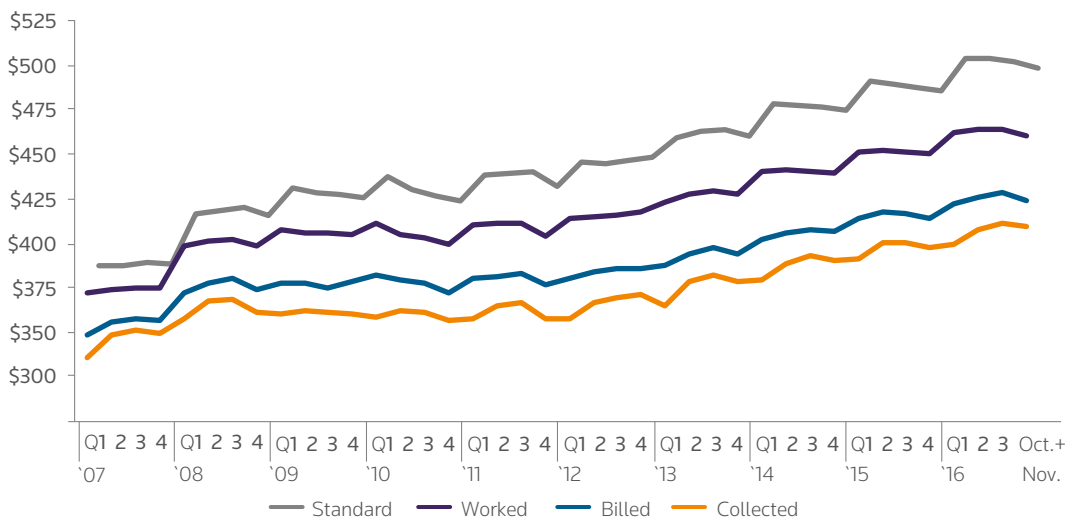


Source: Thomson Reuters Peer Monitor

Lawyers
Billable time type; non-contingent matters

Over the past 10 years, law firms have continued to raise their rates, albeit at a more modest pace than prior to 2008. As shown in Chart 5 below, over the decade, average standard rates⁷ increased some 30 percent, while worked rates⁸ have increased 24 percent, billed rates⁹ 20 percent, and collected rates¹⁰ about 18 percent. As can be seen, the lines on the right-hand side of Chart 5 are farther apart than the lines on the left-hand side. This reflects increasing client pushback to rate increases and suggests that realization rates must be declining. In fact, as shown in Chart 6 below, that is precisely what has happened over the past decade. Since 2007, collection realization as measured against standard rates, has declined 11 percent for Am Law 100 firms, 7.6 percent for Am Law Second 100 firms, and 7.3 percent for midsize firms. During 2016, the average realization rate for all firms has been consistently below 83 percent, the lowest level ever recorded.

Chart 5 – Rate Progression



Source: Thomson Reuters Peer Monitor

Lawyers
Billable time type; non-contingent matters

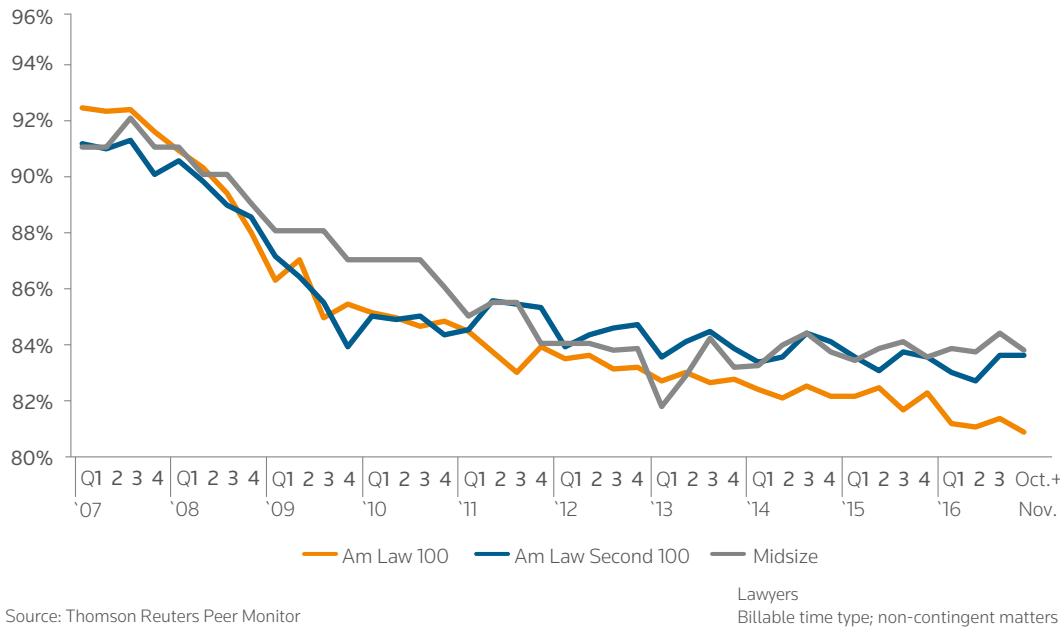
7 Standard rates are a firm's published rates, without taking into account any discounts or adjustments.

8 Worked rates, also referred to as negotiated rates, are the rates that a firm agrees to with particular clients for work on given matters.

9 Billed rates are those rates that a firm actually invoices to its clients, reflecting any discounts or adjustments from worked rates that the firm considers appropriate.

10 Collected rates are those rates reflected by actual payments received by a firm from its clients.

Chart 6 – Collection Realization against Standard Rates

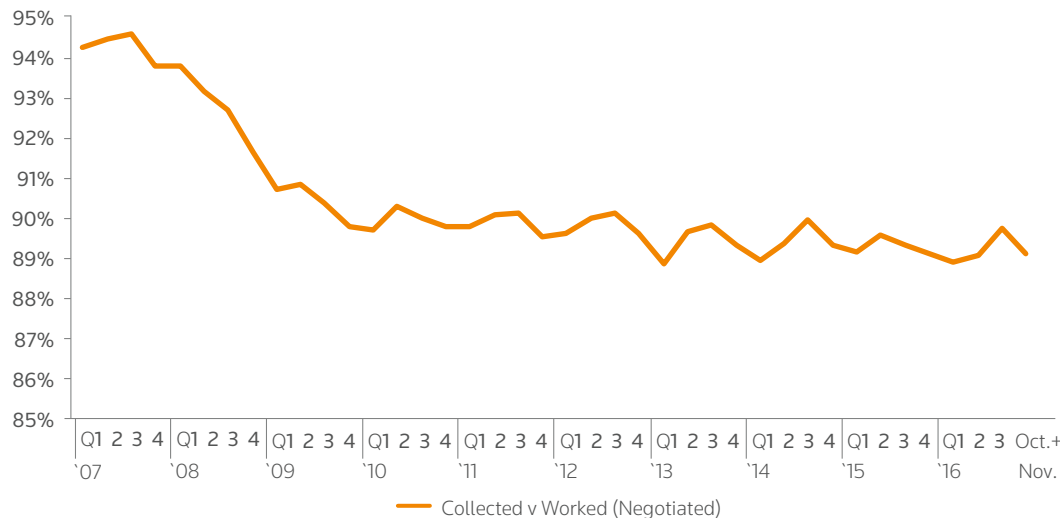


Source: Thomson Reuters Peer Monitor

Lawyers
Billable time type; non-contingent matters

In considering realization rates, it must be noted that comparing collection realization to standard rates undoubtedly produces a somewhat skewed result, since in most firms standard rates have long since ceased to have any real significance for most clients. Like “rack rates” in hotels, standard rates in law firms have effectively become nominal rates that are arbitrarily set and are almost never paid by any significant client. Accordingly, it is perhaps more meaningful to look at the decline in realization over the past decade as measured against worked rates, or the rates actually negotiated with clients. As shown in Chart 7 below, if so measured, while realization has dropped noticeably from a high of 94.6 percent in 2007 to the present level of 89.1 percent, the percentage drop is more modest than that shown in Chart 6 and, in fact, appears to have leveled off somewhat since 2013.

Chart 7 – Collection Realization against Worked (Negotiated) Rates



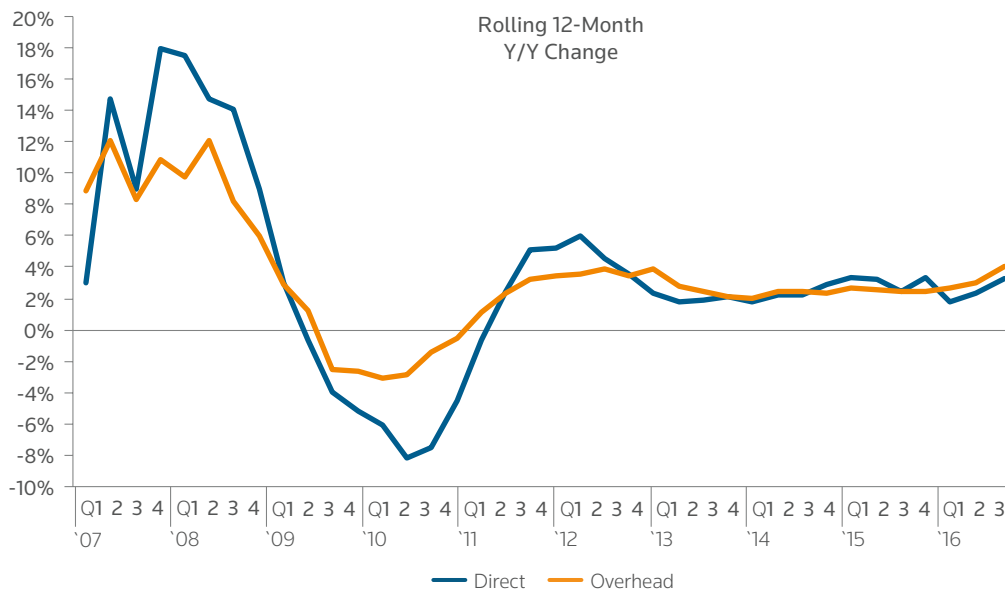
Source: Thomson Reuters Peer Monitor

Lawyers
Billable time type; non-contingent matters

As to expense growth, prior to the onset of the recession in late 2007 and early 2008, firms regularly experienced sharp increases in both direct and overhead expenses.¹¹ Indeed, as shown in Chart 8 below, in late 2007, firms were averaging 18 percent growth in their direct expenses and 10.9 percent growth in overhead, both significantly more than the growth in revenues firms were recording at the same time. Following the start of the recession, growth rates for expenses fell precipitously (especially in 2009 and 2010), characterized by massive layoffs of both lawyer and administrative staffs.

In 2011, expenses began to grow again, ultimately settling into a fairly flat annual growth pattern of 2 to 3 percent from 2013 through the present, outside of a small increase above that range in the second half of this year. This reflects strong expense management in firms in recent years.

Chart 8 – Expense Growth



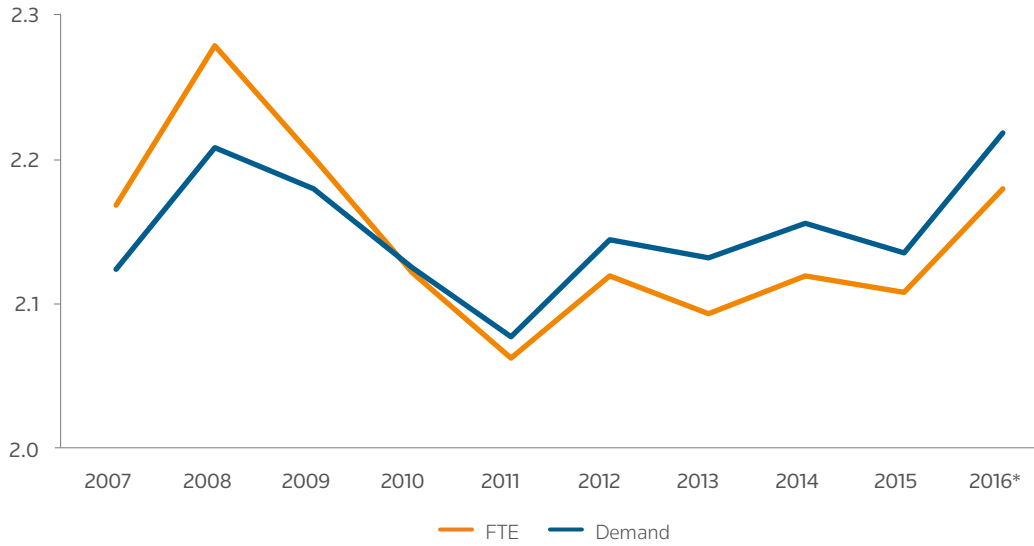
Source: Thomson Reuters Peer Monitor

Two other factors that contribute to law firm profitability – viz., leverage and length of the billing and collection cycles – have, remained reasonably stable over the past decade, as shown in Charts 9 and 10 below. Chart 9 shows changes in leverage¹² over the period as measured in two ways – first, by FTE, showing the leverage ratio based simply on the numbers of lawyers involved; and second, by “demand,” showing the leverage ratio based on the number of billable hours actually worked by the lawyers involved. As can be seen, over the course of the past decade, while the leverage ratios have varied somewhat, the range of change has been quite small. Also, the leverage ratios today are about where they were at the beginning of the decade.

¹¹ Direct expenses refer to those expenses related to fee earners (primarily the compensation and benefits costs of lawyers and other timekeepers). Overhead expenses refer to all other expenses of the firm (including occupancy costs, administrative staff compensation and benefits, technology costs, recruiting expenses, business development costs, and the like).

¹² For these purposes, leverage is defined as the ratio of all lawyers other than equity partners in a given firm to the equity partners in the same firm.

Chart 9 – Leverage (Lawyer to Equity Partner)

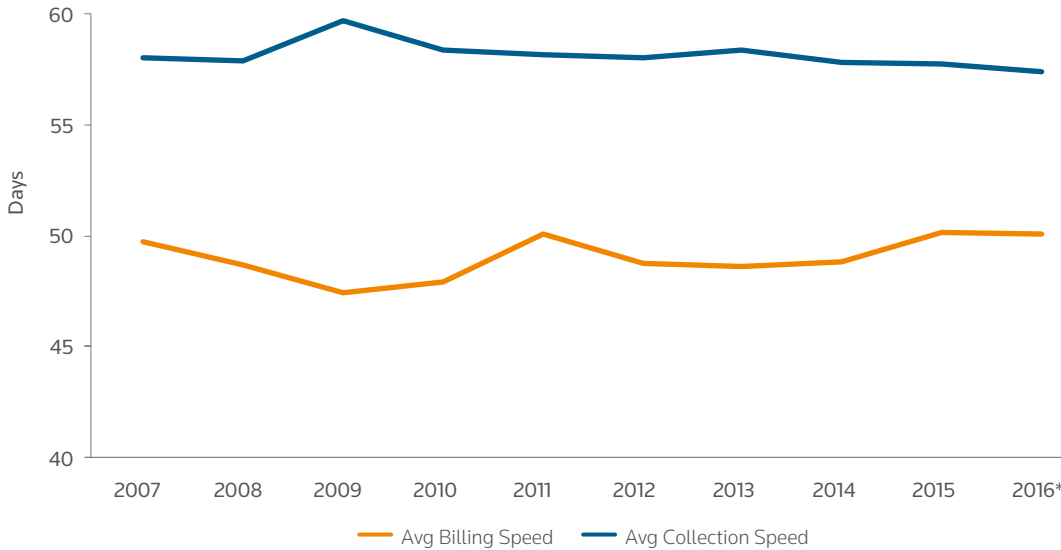


Source: Thomson Reuters Peer Monitor

Lawyers
*Only 11 months (through November)

Chart 10 below shows changes in law firm billing and collection cycles over the past 10 years – i.e., measuring the speed of billings and collections. As shown, while there have been some minor variations, both the billing and collection cycles have remained remarkably flat throughout the period.

Chart 10 – Billing and Collection Cycles

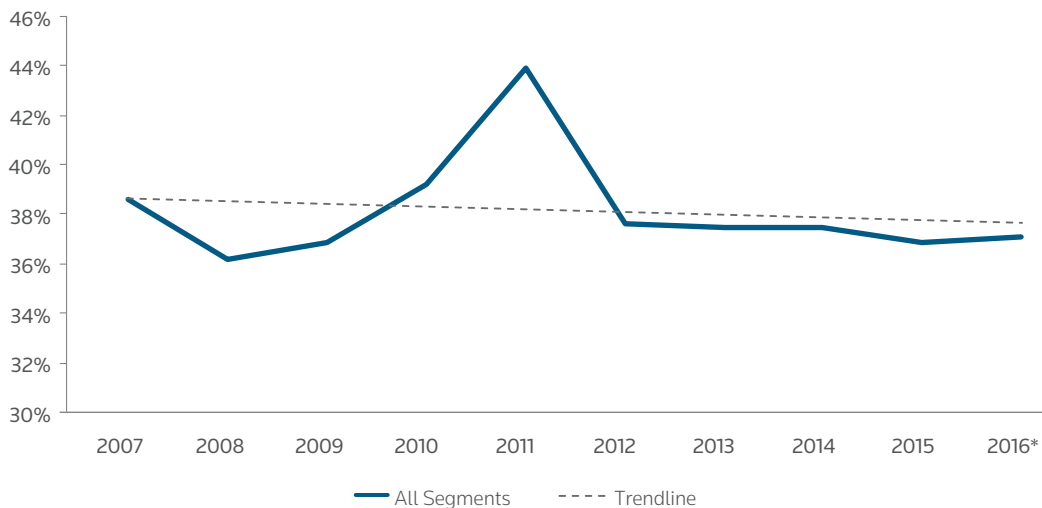


Source: Thomson Reuters Peer Monitor

Billable time type; non-contingent matters
*Only 11 months (through November)

As a result of flat demand, reduced productivity, and client pushback on rate increases as reflected in declining realization, law firm profit margins have been fairly stagnant to declining over the past decade. Although margins did spike upward in 2011 and early 2012, as shown in Chart 11 below, the trend for profit margins has been slightly downward over the entire 10-year period.

Chart 11 – Profit Margin Stagnation



Source: Thomson Reuters Peer Monitor

*Rolling 12 months through Q3 2016 (i.e., Q4 2015-Q3 2016)

From the foregoing analyses, it is apparent that the financial performance of law firms over the past 10 years has essentially been driven by only one factor: rate increases. As we have seen, demand growth for law firm services has been essentially flat, productivity has been declining, expenses have been growing (albeit at a fairly modest rate), and leverage has remained essentially unchanged as have firm billing and collection cycles. In short, the only factor positively impacting revenue growth has been the ability of firms to raise rates 2 to 3 percent a year. While this rate growth has sustained the modest improvements in law firm financial performance that we have seen over the past decade, it is important to note that client pushback to rate increases continues to mount as evidenced by declining realization rates. Accordingly, it is at best an open question whether continued reliance on rate increases alone to drive law firm financial growth will be a sustainable model for the industry in the future.

Review of the Past Decade – Fundamental Market Changes

During the decade since the onset of the Great Recession in 2007, law firms have experienced not only a challenging environment for financial growth (as described above), but also several fundamental changes to the legal market itself. These changes, driven by a broader shift from a seller’s to a buyer’s market and by increased client demands for greater efficiency, predictability, and cost-effectiveness in the delivery of legal services, have forced firms to deal with new market realities and have called into question some of the assumptions that supported the traditional law firm business model.

Death of Traditional Billable Hour Pricing. One of the most potentially significant, though rarely acknowledged, changes of the past decade has been the effective death of the traditional billable hour pricing model in most law firms. This isn’t to suggest that most firms have done away with billing based on hours worked; indeed the majority of matters at most firms are still billed on an “hourly basis.” But focus on that fact alone misses a fundamental shift that has occurred in the market.

This change has been overlooked principally because of a definitional problem. In much of the writing on this subject, the focus has been on so-called alternative fee arrangements or “AFAs,” pricing strategies that are based on fixed-price or cost-plus models that make no reference to billable hours in the calculation of fees. Since other pricing models typically incorporate some reference to billable hours, it has often been

assumed that only AFAs are genuine non billable hour alternatives and every other approach is simply business as usual. That conclusion, however, overlooks a major shift that has occurred over the past decade: the widespread client insistence on budgets (with caps) for both transactional and litigation matters.

Plainly, the imposition of budget discipline on law firm matters forces firms to a very different pricing model than the traditional approach of simply recording time and passing the associated “costs” through to the client on a billable-hour basis. In fact, from a law firm standpoint, a budget approach is in some respects worse than an AFA, since it imposes a fixed price (in the form of the budget cap) but forces firms to “earn their way up” to the fixed price through recorded billable hours (which may themselves be deeply discounted). Moreover, even if the budget caps imposed by clients are subject to renegotiation on some basis, the existence of the budgets themselves may result in self-imposed restraints on partners to push for adjustments. Firms may choose to regard these budget-driven arrangements as billable-hour-based pricing, but they are substantially different from the traditional model that largely prevailed prior to 2008.

Although today AFAs probably account for only 15 to 20 percent of all law firm revenues, budget-based pricing is much more prevalent. Indeed, in many firms, these two methods combined may well account for 80 or 90 percent of all revenues.

Erosion of the Traditional Law Firm Franchise. Driven by strong internal pressures to reduce the overall cost of legal services, clients over the past decade have been increasingly willing to embrace a broad range of strategies to enhance the value they receive for their “legal spend.” A linchpin of these strategies has been a growing willingness on the part of clients to disaggregate or unbundle the services they seek from particular outside providers, and this, in turn, has led to a steady erosion of the traditional law firm franchise.

Prior to 2007, clients would typically entrust an entire transaction, litigation, or other project to one of their outside law firms, and the selected firm would handle all aspects of the matter “from soup to nuts.” While this approach was clearly advantageous for law firms, it resulted in higher fees for clients, partly because firms tended to have many of the tasks involved in the matters performed by professionals who were overly qualified for the jobs at hand. A classic example is using relatively high-priced associates to conduct routine document reviews that could adequately be performed by qualified paralegals or other support staff.

As a result, clients over the past 10 years have been increasingly willing to break particular matters into their constituent parts and to decide, with respect to each part, how the services needed could be provided most efficiently and cost-effectively. Sometimes this has resulted in clients moving certain functions in-house, sometimes in outsourcing certain functions to legal process outsourcers or other non-law firm vendors, and sometimes in moving certain functions to other lower-cost law firms. As to overall coordination, clients may choose to retain that responsibility in-house, may expect their primary outside law firm to assume the role, or may ask a third party to step in.

One significant result of this disaggregated approach is that the client’s relationship with its outside counsel may – and often does – shift from a traditional client/trusted advisor relationship to more of an *ad hoc*, transactional relationship. In the latter model, the outside lawyer becomes less of a counselor with respect to the overall matter and more of a provider of specialized services that the client is unable to provide internally or acquire more effectively elsewhere.

As a result of this trend, the range of services that were traditionally viewed as the exclusive purview of law firms has begun to shrink as new and sometimes non traditional competitors have aggressively vied for parts of the work historically dominated by law firms. This trend helps to explain why demand growth for law firm services has remained essentially flat since 2010 notwithstanding increases in overall spending for legal services by corporate clients.

In its recent *2016 Chief Legal Officer Survey*, the consulting firm Altman Weil reported that, among the 336 corporate CLOs responding to its survey, 35.2 percent planned to decrease their spend on outside counsel during the coming 12 months, while only 21.8 percent planned to increase their spend. At the same time, 37.2 percent of respondents planned to increase their in-house lawyer workforce, while only 8.5 percent planned a decrease. These same trends have remained fairly consistent since 2010.¹³ Additionally, 57 percent

¹³ Altman Weil, Inc., *2016 Chief Legal Officer Survey: An Altman Weil Flash Survey*, Nov. 2016, at 1-2.

of respondents reported that their companies outsource some work to non-law firm vendors (an increase from 43 percent when the question was last asked in 2012). The average value of work shifted from law firms to non-law firm vendors in the preceding 12 months was reported as \$754,644, an increase from the \$496,784 reported in 2012.¹⁴

These same trends were confirmed in a study conducted by Thomson Reuters in early 2016.¹⁵ Among 429 corporate law department respondents, 29 percent reported decreased reliance on outside counsel during 2015, while only 27 percent reported increased reliance.¹⁶ Among the same companies, 24 percent planned to increase their internal law department staffs, while only 2 percent planned to decrease them.¹⁷

If one considers that the core services that can be provided *only* by law firms are fairly narrow¹⁸ and that the range of potential competitors is fairly broad, it seems quite likely that this trend will continue. If so, law firms (at least in the U.S.) could ultimately face the choice of pulling back their offerings to a set of core services or, in the alternative, finding new ways to compete effectively with non-law firm competitors for a broader range of services.

Declining Effectiveness of the Traditional Leverage Model. In the traditional law firm business model, leverage (defined as the ratio of all lawyers other than equity partners to equity partners) was an important factor in driving firm profitability. Organizationally, law firms were envisioned as pyramids in which a large number of modestly paid lawyers at the bottom supported a much smaller number of well-compensated partners at the top. The system worked because the lawyers at the bottom were billed out at an hourly rate that far exceeded their costs to the firm, thus enabling the fewer lawyers at the top to bill out at rates that were far lower than needed to cover their costs.

As shown in Chart 9 above, over the past 10 years, the leverage ratio for U.S. firms has averaged between 2.0:1 and 2.3:1, although the leverage figures vary widely for individual firms.¹⁹ What is often missed in current discussions of leverage, however, is that the effectiveness of traditional leverage as a driver of law firm profitability has been steadily eroding over the past decade as a result of three converging factors. First, in today's increasingly cost-conscious environment, clients are no longer willing to foot the bill for what they regard as the "learning curve" of young lawyers. As a result, many corporate clients have insisted that they will no longer pay for first- or second-year associates working on their matters on the rationale that they are not sufficiently experienced or competent to make a meaningful contribution. Second, in part reflecting these client attitudes but also in an effort to hold their rising expenses in check during a period of limited demand growth, firms have cut back significantly on their hiring goals for associates. This has resulted in a reduction of overall associate ranks during the period. And third, in an effort to bolster their profits per equity partner, firms have held growth in their equity partner ranks essentially flat for several years. To achieve this objective, many firms have increased their numbers of non-equity partners, sometimes even through processes of "de-equitization."

The results of all of these adjustments are shown in Chart 12 below. As can be seen, over the past decade, within the ranks of non-equity partner lawyers, the number of associates with three or more years of experience has decreased slightly, the number of non-equity partners has risen, the number of first- and second-year associates has dropped significantly, and the numbers of senior and staff counsel and of

¹⁴ *Id.* at ii, 5.

¹⁵ Thomson Reuters, *2016 Legal Department In-Sourcing and Efficiency Report: The Keys to a More Effective Legal Department*, Feb. 2016.

¹⁶ *Id.* at 9.

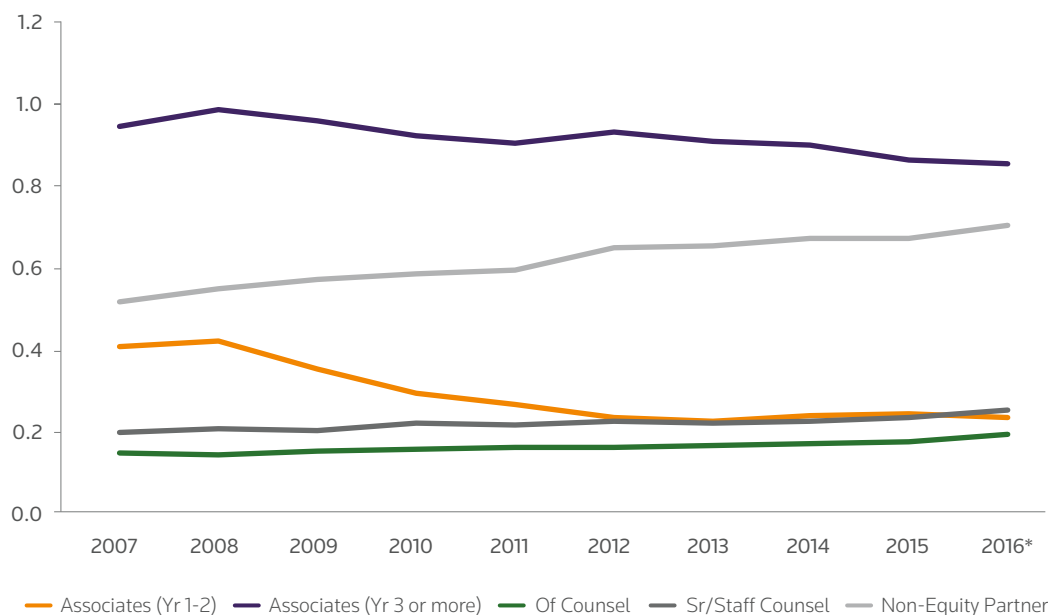
¹⁷ *Id.* at 18.

¹⁸ In the United States, courts have found it very difficult to define those activities that constitute the exclusive "practice of law." While the list varies somewhat from state to state and while there are certainly gray areas, most commentators would agree that the list of activities that, if undertaken by a non lawyer, would constitute the unauthorized practice of law is fairly short. Clearly, only lawyers can appear in most courts or issue formal legal opinions or (at least in some states) prepare wills or trust instruments or hold themselves out to the public as lawyers. But beyond these activities and perhaps a few others, it is not unlawful for a non lawyer to engage in a full range of activities for which clients have traditionally looked to their lawyers – including negotiating or drafting contracts, drafting legislation, doing legal research, completing legal forms, overseeing transactions or other kinds of deals, discussing settlement of outstanding disputes, etc. Of course, in the United Kingdom and several other countries, this whole issue is moot, as non lawyers are legally permitted to offer legal services.

¹⁹ Among the Am Law 100 firms in 2016, leverage ranged from 1.13 (at the lowest) to 8.95 (at the highest). See "The Am Law 100 at a Glance," *The American Lawyer*, May 2016, at 72-81. Although reliable data are not readily available, anecdotal evidence also suggests it's not uncommon to find midsize law firms with leverage less than 1:1.

counsel have remained fairly stable. What this means for law firm bottom lines is that the cost of leverage has gone up substantially, with the ranks of lower compensated lawyers declining at the same time that the number of higher compensated lawyers has increased. This, in turn, has eroded the effectiveness of the traditional leverage model in driving positive financial results.

Chart 12 – Composition of Leverage by Lawyer Categories (FTE)



Source: Thomson Reuters Peer Monitor

Lawyers
* 2016 is through November 2016

Growing Segmentation within the Market for Law Firm Services. Over the past decade, as competition has increased in the market for law firm services, there has been a discernible and growing segmentation of the market into highly successful and less successful firms, and the performance gaps between those categories have been widening. This trend was reflected in the creation by *The American Lawyer* of a new classification within the Am Law 100 in 2014 – the “Super Rich,” a group of some 20 firms that clearly outperformed all others across all key financial metrics.²⁰ But the growing market segmentation that has become apparent over the past 10 years is not limited to those highly successful firms at the very top of the market. It also includes other firms across the market that have managed to outperform their peers on a consistent basis and appear to be achieving better financial results, notwithstanding the overall tepid market conditions that we have previously described.

There are, of course, many reasons that some law firms outperform others – including historic location, practices, and client base – but there are two characteristics that seem to have emerged over the past several years as particularly important in marking firms as likely winners: strategic focus and proactive response to the needs and expectations of clients. As to the first (strategic focus), market trends over the past 10 years tend to support the conclusion that those firms with a clearly defined view of their core practices and client base fare better in the market than firms whose message and brand are ambiguous and who are largely undifferentiated from other firms of their size.

Over the past decade, many firms have responded to the increasingly challenging market environment by opting simply to grow bigger, in many cases without considering other – and perhaps better – strategic options. In the years since the Great Recession, lateral partner moves at big law firms have increased

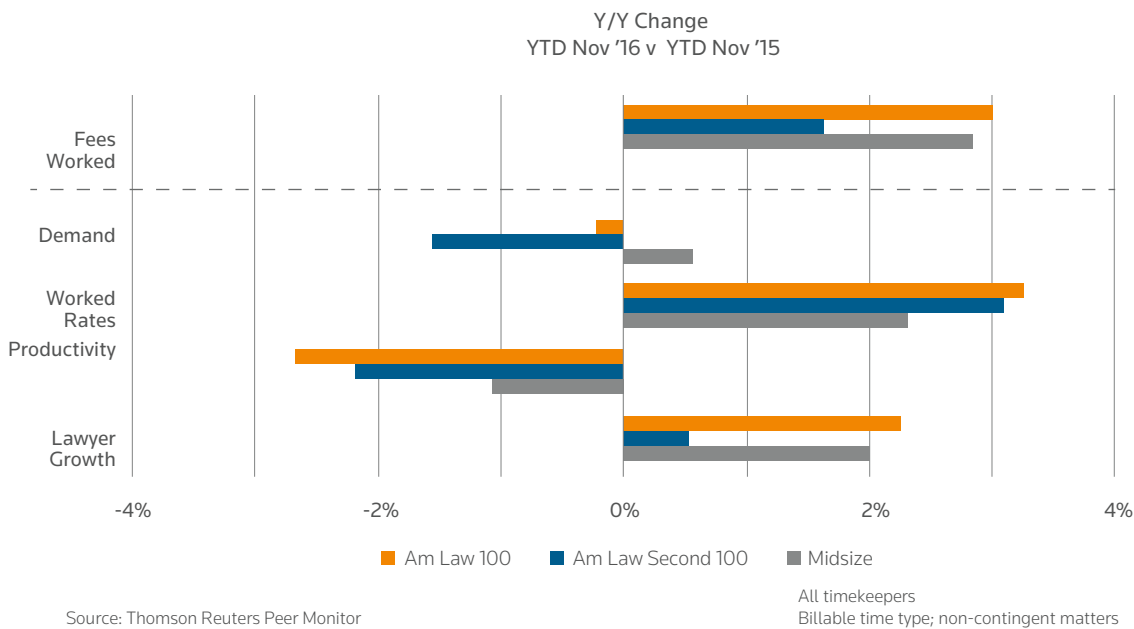
²⁰ The “Super Rich” category consisted of a group of elite firms, all with average revenues per lawyer of at least \$1 million and profits per partner of at least \$2 million. The category originally included 20 firms, but that number expanded in 2015 to 28. Chris Johnson, “Signs of a Slowdown,” *The American Lawyer*, May 2016, at 47.

significantly. Indeed, 2015 was the strongest year for lateral partner moves since 2009.²¹ Law firm mergers have also hit near-record levels, with 2016 closing out just short of another record-breaking year.²²

While a decision to grow larger (through either merger or lateral acquisitions) can reflect a rational tactic if combined with a clear strategy, in previous annual reports, we have pointed out the dangers of viewing growth in and of itself as a viable strategy.²³ Unless driven by a clear strategic vision, simply getting bigger can exacerbate a firm’s problems rather than solve them by making the firm’s focus even more ambiguous and its position in the market even less differentiated.

To some extent this may be precisely what is happening to many Am Law Second 100 firms in today’s market. As shown in Chart 13 below, if one compares financial performance of firms by market segment over the past year, Am Law 100 firms have led in such key performance metrics as fees worked and worked rates,²⁴ even while recording the lowest ranking for productivity; while midsize firms have led in demand growth, have the best productivity ranking (albeit still negative), and have placed second to Am Law 100 firms in fees worked. All this has left Am Law Second 100 firms with the weakest performance in terms of demand and fees worked, as well as the second weakest performance in productivity.

Chart 13 – Key Performance Measures by Segment



These performance results over the past year are consistent with similar trends that have been visible over the past three years. A comparison of the financial performance of Am Law 100, Am Law Second 100, and midsize firms through the first 11 months of the past three years (to keep the comparison periods consistent) shows that Am Law Second 100 firms experienced consistent downward trends in demand growth, fees worked, and lawyer growth, as well as a decline in productivity from the beginning to the end of the period. By contrast, midsize firms saw a consistent upward trend in demand growth and fees worked, as well as an improvement in productivity from the beginning to the end of the period. For Am Law 100 firms, the performance was more mixed, though better than Am Law Second 100 firms in most indicators.²⁵

21 MP McQueen, “The Big Law Lateral Hiring Frenzy Continues,” *The American Lawyer* (online edition), Feb. 1, 2016.

22 Nell Gluckman, “Could 2016 Break Law Firm Merger Record?” *The American Lawyer* (online edition), Dec. 2, 2016.

23 See Georgetown Law Center for the Study of the Legal Profession and Peer Monitor, 2014 Report on the State of the Legal Market, at 1-2, 9-11.

24 Worked rates are those rates that a firm agrees to use on a given matter, typically after negotiations with its client. Fees worked reflect worked rates multiplied by the number of billable hours actually worked.

25 Thomson Reuters Peer Monitor Analysis.

One possible interpretation of these results is that clients, while still directing some types of work to high-end, fairly specialized, premium firms (the Am Law 50), are increasingly willing to move substantially down market to smaller firms (midsize firms) in order to achieve significant price savings. If the large firms in the middle (the Am Law Second 100 and some of the Am Law 51-100) cannot offer sufficient differentiation for their services, clients will have little incentive to change this behavior.

As to the second characteristic impacting market segmentation (proactive firm response to the needs and expectations of clients), in our last year's annual report, we offered some of the growing evidence suggesting that firms that adopt a proactive attitude toward meeting their clients' demands and expectations for better efficiency, predictability, and cost-effectiveness in the delivery of legal services tend to have better financial results than firms that do not.²⁶ Evidence to support this proposition has continued to mount during 2016.

In its *2016 Law Firms in Transition* survey, Altman Weil asked the leaders of 356 U.S. law firms about their practices concerning alternative fee arrangements. Among the 97 percent of firms that bill at least some of their work on a non-hourly basis, 72 percent of respondents indicated that their firms take a reactive approach, addressing AFAs only in response to client requests. Only 28 percent said that their firms were proactive in initiating conversations about AFAs. The key finding, however, was the difference in financial results for firms taking a proactive rather than reactive approach.²⁷

When asked to compare the profitability of non-hourly based and hourly based work, 84 percent of the proactive firms reported their non-hourly based matters were at least as profitable as their hourly based work. This was true for only 51 percent of the reactive firms. Moreover, 40 percent of the proactive firms indicated their non-hourly matters were *more* profitable than their hourly projects, as compared to only 10 percent of the reactive firms.²⁸

Altman Weil summarized these responses in one of the key findings identified in its survey:

Proactivity as a competitive advantage: We see a seven-year trend of compelling success enjoyed by firms that take a proactive approach to alternative fee arrangements. We think this is a good indicator that proactive change in other areas could be equally effective in accelerating law firm performance relative to competitors.²⁹

Long-Term Challenges

Given the significant economic changes and the fundamental shifts in the market environment for law firm services over the past decade as described above, it is important for all law firms to think carefully about the long-term challenges raised by these developments. For the past five or six years (as the market regained some momentum from the Great Recession), it was possible for most firms to maintain their growth and productivity at acceptable levels by implementing a number of relatively "easy fixes." In 2009, for example, firms engaged in a massive layoff of both legal and non-legal staff, in a largely successful gambit to protect short-term profitability. Many firms also initiated efforts to stem the growth of their equity partner ranks, both by de-equitizing some former equity partners and slowing advancement of others into equity status. Almost all firms adopted an aggressive approach to managing their expenses, both direct expenses and overhead. Most firms reduced their associate hiring goals and began more expansive use of contract lawyers to fill peak need requirements without incurring the long-term burden of permanent employees. Some firms experimented with cost reduction strategies like opening firm-wide service centers in lower cost locations. And all firms continued to implement regular rate increases, even though declining realization rates somewhat limited their effectiveness.

While all of the above-described actions helped sustain firm financial performance over the past few years, it is not likely they will continue to be as effective in the future. Further reductions in the ranks of equity partners will, for example, be quite difficult as the growth rate for that category is already near zero, and

²⁶ See Georgetown Law Center for the Study of the Legal Profession and Peer Monitor, 2016 Report on the State of the Legal Market, at 11-13.

²⁷ Altman Weil, Inc., *2016 Law Firms in Transition: An Altman Weil Flash Survey*, May 2016, at v.

²⁸ *Id.*

²⁹ *Id.* at i.

many firms will need to advance more promising younger lawyers into equity positions soon or risk losing them to competitors. Likewise, with expense growth already at the 2-3 percent level, it will be hard for firms to get much more benefit out of aggressive expense management. Indeed, many firms are now finding that pressure is mounting to ratchet up spending for strategic investments in technology, compensation increases for associates (as evidenced by the recent round of raises), and other purposes. Productivity, of course, continues to be a challenge across the market and it is possible that firms could implement further layoffs in some categories, but such actions would undoubtedly have serious morale implications. And, while continuing to raise rates is both a possible and likely tactic, such increases (as noted above) will have diminishing positive effects, particularly as clients continue to push back against every such increase.

What all of this suggests is the need for a longer-term strategic focus in the way that law firms think about their markets, their clients, their services, and their futures. While there are no doubt a number of issues and assumptions that should be addressed in this process, we have set out four below that we think are particularly important.

Need for a New Focus on Profitability. We previously described the effective death of the traditional billable hour pricing model over the past 10 years. Most firms have adapted to that development by adjusting their accounting systems to accommodate client demands for budgets, caps, collars, discounts, and the like. And, in support of these efforts, most firms have developed internal data to allow them to calculate the actual cost of services provided.³⁰ All of which is to say that most large firms now make some calculation of profitability in dealing with pricing and billing issues.

The problem is that, notwithstanding the growing use of profitability analysis for pricing and billing purposes, the traditional billable hour metric continues to dominate other firm processes – not the least of which are evaluation and compensation processes – and remains fixated in the way most lawyers think about their firms' economics. This, in turn, creates a serious mismatch between the way financial performance should be judged and the standards used by lawyers to shape their own behaviors.

To give a simple example, even if a firm determines the appropriate pricing for a given matter using sensitivity analysis to maximize profitability, the chances are (at least in most firms) that the performance of the partner in charge of the matter will, at the end of the year, be evaluated primarily on the basis of the number of billable hours recorded in respect of the matter. From a mathematical standpoint, this is of course ridiculous since the most profitable approach to the matter from the firm's standpoint could well be one that entails fewer and not more billable hours (a reality that many law firm partners would no doubt find baffling).

To cite another example, in many firms today, associate (and sometimes partner) bonuses are still awarded principally on the basis of the number of billable hours recorded during the year. Again, the myopic focus on billable hours as the only significant benchmark of performance not only sends the wrong signals to lawyers about what's really important, it serves as a disincentive to provide services to clients in ways that may be more efficient and less costly while still delivering superior returns to the firm.

To remain competitive in the rapidly changing market for legal services, firms must bring all of their systems and processes (including pricing, evaluation, compensation, resource allocation, and others) into alignment around consistent principles of profitability. Continued reliance on the traditional billable hour approach for all (or even some) of these purposes no longer makes economic, competitive, or practical sense.

Need for a More Expansive Leverage Model. We have previously noted the erosion of the traditional leverage model as a factor in law firm profitability, driven in large part by a reduction in the percentage of associates comprising the legal staffs of most firms. Given the fundamental shifts in the market that have occurred during the past decade, it seems quite unlikely that firms will be ratcheting up their associate hiring goals anytime soon. This does not mean, however, that leverage should no longer be a relevant consideration in law firm strategy. Rather, it suggests the need for a more expansive view of what constitutes leverage in the law firm context.

Historically, law firms have thought of the delivery of legal services as an activity that only lawyers can provide – and, for that matter, only lawyers employed by law firms in traditional roles. This attitude has

³⁰ *Id.* at 66. Altman Weil found that some 67.2 percent of respondents to its 2016 survey indicated their firms have developed such data, a figure that goes up to 90.6 percent in firms of 250 lawyers or more.

made many firms skeptical about re-thinking their legal service delivery models even as their clients have demanded more efficient and cost-effective approaches. To be sure, many firms have increased their use of contract lawyers and added new categories of staff lawyers or counsel in an effort to reduce costs (and thus improve leverage), and these steps have undoubtedly been helpful. What is ultimately needed, however, is a broader reimagining of the overall model for legal service delivery, one that includes paraprofessionals, technologists, information specialists, process managers, and others – in addition to lawyers – as part of an integrated system for the delivery of legal services. This is the model that has evolved in medicine, also driven by the dual objectives of improving outcomes and quality of service while reducing costs. Such a redesigned approach to legal services – combined with a pricing model based on outcomes (results) rather than inputs (recorded time) – could significantly improve both the competitiveness and profitability of those law firms willing to take these issues seriously.

Need for a Clear Focus on Core Practices. As previously described, one of the fundamental market changes that has occurred over the past 10 years has been the erosion of the traditional law firm franchise. Clients have increasingly been looking either internally or to other providers for many of the services that they historically relied on their outside law firms to provide. While this trend started with high-volume, process-oriented work like document review and e-discovery projects, it is now expanding to other activities including contract supervision and management, document drafting and assembly, legal and non legal research, managed legal services, temporary lawyer staffing, managed dispute resolution, and many others. Given the expanding number of competitors in the space and the growing sophistication of technological tools to enhance service offerings, it seems almost certain that the scope of traditional law firm services being offered by alternative providers will continue to expand.

With these developments in mind, it is more important than ever before for every law firm to focus on its core practices and to ensure that it is delivering the highest possible value to its clients in those areas that are critical to the firm's success. This means identifying those aspects of each practice that truly only lawyers can perform – or that are at least best performed by lawyers – and making certain that systems and processes are in place to ensure the effective delivery of those services. It also means making strategic choices since not every practice that a firm has will be a genuinely "core" practice.

As previously noted, the law firms that appear most at risk in the present competitive environment are those whose message and brand are ambiguous and who are largely undifferentiated from other firms of their size. In a market where firms face mounting pressures from both traditional and non traditional competitors, strategic focus and differentiation are critical to survival.

Opportunity for a New Focus on Supply Chain Management. In response to the growing influx of non-traditional competitors in service areas historically dominated by lawyers, many law firms – in addition to focusing on their core practices – have chosen to expand their service offerings into other related areas that complement the firms' existing legal expertise but are beyond the scope of traditional law firm services. While these ventures currently constitute a very small part of the legal market, there has been a noticeable increase in the number of firms willing to experiment with such approaches.³¹

One particularly intriguing opportunity for such expanded services responds to the growing client willingness to disaggregate work among many providers by reimagining a new role of the law firm as the overall coordinator for all of the services being provided to the client. In this supply chain management role,³² the law firm would offer not only the core services that only lawyers can provide but also the overall supervisory function that would ensure that all of the work of various vendors providing services to the client is consistent with the needs of the project, delivered in an efficient and cost-effective way, and acceptable against agreed-upon standards of quality.

31 See Chris Johnson, "Outside the Box: Firms Go Beyond the Law with New Ventures," *The American Lawyer* (online edition), Apr. 7, 2016; Chris Johnson, "Lawyers on Demand Ramps Up Growth," *The American Lawyer* (online edition), May 17, 2016; Nell Gluckman, "Paul Hastings Latest Big Firm to Dabble in Data Analytics," *The American Lawyer* (online edition), Oct. 20, 2016. For a particularly interesting example of one firm's effort to move beyond the traditional legal services model, see <http://www.eversheds.com/global/en/what/services/consulting/managed-services.page>, describing Evershed's new offering of managed legal services through its consulting operations.

32 For a comprehensive discussion of the possible role for law firms as managers of supply chains, see Milton C. Regan and Palmer T. Hennan, "Supply Chains and Porous Boundaries: The Disaggregation of Legal Services," 78 *Fordham L. Rev.* 2137 (2009-2010).

For law firms, this expansion of services represents a logical extension of the activities that clients retain law firms to provide – viz., a reliable assurance that the overall work product that is delivered will conform to the highest standards of quality and ethical norms. To fulfill this expanded supervisory function, however, law firms will have to develop in-house capabilities to monitor and coordinate activities across a project and to provide strategic guidance to the client at key inflection points. This means that firms would need to recruit project management and oversight specialists who could provide the supervisory skills necessary to assure success.

To the extent that firms chose to embrace this expanded role, they would need to consider carefully the implications for internal staffing – including the possibility of empowering non lawyer professionals to engage in client matters in a significant way. Admittedly, this proposal that law firms consider expanding their service offerings to include overall project supervision may be a bridge too far for many firms. But it represents one interesting approach to ensuring that law firms remain central players in the radically changed market for law firm services.

Conclusion

The past 10 years have been a period of dramatic change in the market for law firm services. The decade began with the market in a state of near collapse following the onset of the Great Recession at the end of 2007. By 2010, however, the demand for law firm services bounced back to some extent and, since then, has (despite occasional peaks and valleys) remained essentially flat to slightly positive. Although many law firms have been able to maintain some positive growth in both revenues and profits since 2010, that growth has been driven almost entirely by increased rates. With demand growth flat, declining productivity, growth in expenses (albeit at a fairly modest rate), and increasing cost of leverage (as firms have changed the mix of their legal staffs), the *only* factor that has positively impacted revenue growth has been the ability to raise rates 2 to 3 percent a year. And even that strategy has encountered significant client resistance, as evidenced by steadily declining realization rates. As a result, the overall trend of profit margins across the market has been slightly downward over the entire 10-year period.

These financial results have reflected some fundamental shifts in the market that cannot be ignored:

- The emergence of a buyer’s market in which clients demand greater value for the dollars they spend for legal services and in which value is measured by efficiency, predictability, and cost-effectiveness in the delivery of services;
- The demise of the traditional billable hour pricing model as clients have increasingly insisted on other approaches to the pricing of legal services;
- The erosion of the traditional law firm franchise as clients have been ever more willing to disaggregate work and to allocate responsibilities for different aspects of a single matter to different law firms, in-house lawyers, or non-traditional vendors; and
- The growing segmentation of the market as clients have moved certain work “down market” and have been prepared to reward those firms responding proactively to their demands while punishing those firms that did not.



All of these changes and others have defined a market that is fundamentally different from the one that law firms confronted in 2007. Those firms that are able to adjust to the new market realities, not by putting band-aids on the old models, but rather by engaging in a thoughtful review and (where necessary) redesign of their approaches to client service, pricing, legal work processes, talent management, and overall structure will enjoy an enormous competitive advantage. Those that do not will face an increasingly uncertain future.

To return to the Darwinian analogy, it is fitting to remember that those firms that are most likely to survive and prosper in the new market environment are not necessarily the oldest or the strongest or the smartest, but rather those most able to adapt to the changes around them.

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