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2018 Report on the State of the Legal Market

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The Center for the Study of the Legal Profession at the Georgetown University Law Center and Thomson Reuters Legal Executive Institute and Peer Monitor® are pleased to present this 2018 Report setting out our views of the dominant trends impacting the legal market in 2017 and key issues likely to influence the market in 2018 and beyond.[1]

The Lure of Failing Strategies

During the 1930s, the French government – determined to contain and ultimately thwart any possible invasion by Germany – constructed a massive line of fortresses, blockhouses, bunkers, and rail lines along its borders with Italy, Switzerland, Germany, and Luxembourg. These fortifications, known collectively as the "Maginot Line" (after the French Minister of War André Maginot), were designed to deter any German invasion into the French heartland (particularly into the large population and industrial centers of northeastern France) and to ensure that any invasion that might come would be directed through the Low Countries of Belgium, Luxembourg, and the Netherlands, where it was assumed that French conventional forces would meet and stop any attacking German army. As events unfolded, of course, this proved to be a vain hope.

Although Germany deployed a decoy force along the Maginot Line, on May 10, 1940, the bulk of the German army went around the fortifications and attacked across the Low Countries, while the Luftwaffe simply flew over French border defenses. Within five days, German forces were well into France. On June 14, Paris fell, and on June 22, just six weeks after the German invasion began, France surrendered.

After World War II, the Maginot Line was often criticized as a classic example of an ill-conceived defensive strategy that inspired a false sense of security within the French government, thus leading to inadequate preparations for the invasion that ultimately came. More recent historians, however, have offered a more nuanced explanation for the failure of France's defenses. Noting that, in fact, the Maginot Line did accomplish its purpose of forcing the German military to attack through the Low Countries, these historians have argued that the real problem of the French military was its failure to understand that the nature of warfare had fundamentally changed.

Reflecting its own painful experience from World War I, the French general staff assumed that the next war with Germany would be like the last one – a long-lasting war of attrition in which the two countries would hammer each other until the resources of one or the other were exhausted. From this perspective, the Maginot Line was essentially a "glorified trench" designed to provide the French military with the tools it would need to survive *la guerre de longue durée* (the war of the long duration) and to give time for the superior economic resources of the Allies to grind the Germans down. And the French assumed that the Maginot Line would slow down a German invasion sufficiently to allow French troops to mass in the Low Countries to deter any German force attacking from that direction. What the French military failed to understand, however, was that the German Wehrmacht was operating with a dramatically different playbook.

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, Sr. Analyst – Thought Leadership; William Josten, Executive Engagement Platform Manager – Thought Leadership; and Joe Blackwood, Analyst – Thought Leadership.

Instead of buying into a long war of attrition, the Germans embraced the strategy of *blitzkrieg* (or "lightning war"), in which German troops were committed in force to win quickly via a knockout blow. Key to the strategy was the use of massed armored forces to conduct rapid, mobile operations, all with the help of German air power. While France also had armored forces in the Low Countries (indeed about the same total number of tanks as the Germans), they were committed to battle only in a piecemeal fashion. It can thus be credibly argued that the German invasion worked so efficiently in large part because the French military was fixated on an outmoded – and ultimately failing – strategy.

The story of the Maginot Line is a particularly dramatic example of the consequences of having strategic blind spots. It is not uncommon, however, for organizations of all kinds – including law firms – to remain committed to once successful strategies even as evidence mounts of their failure. In a recent article in the *Harvard Business Review*, Professors Freek Vermeulen and Niro Sivanathan describe this phenomenon and offer a detailed explanation for why it happens.[2] Citing examples from social science research, they argue that "[e]scalation of commitment is deeply rooted in the human brain," and that "people tend to stick to an existing course of action, no matter how irrational."[3] This happens because of "a number of mutually reinforcing biases that collectively explain why people's judgment may be swayed by a prior commitment" to a given strategy or approach.[4] Six such biases that appear particularly important include:

- *The sunk cost fallacy*, in which people focus on the investment already made in a particular course of action and hope that, if the approach is continued, invested costs will be recouped and the prior investment decision vindicated;
- *Loss aversion*, in which people prefer to gamble on the future success of a previous commitment to a currently questionable strategy – even if it means the investment of additional resources – rather than to incur an immediate loss by changing direction;
- T*he illusion of control*, in which people regularly overestimate their ability to control future events, thus reinforcing the first two biases described above;
- *Preference for completion*, the inherent bias of people toward completion of tasks, such as seeing a particular course of action through;
- *Pluralistic ignorance*, in which people who might disagree with a particular course of action remain silent because they think they are the only dissenters and that everyone else is on board; and
- *Personal identification*, in which people perceive that their identities and social status are tied to their commitments and that withdrawing their support for a course of action they previously approved would risk loss of reputation or status.[5]

Summing up, Professors Vermeulen and Sivanathan note:

> In combination, these biases lead a company's decision makers to ignore signals that their strategy is no longer working. It is what Karl Weick, of the University of Michigan, calls *consensual neglect*: the tendency of organizational decision makers to tacitly ignore events that undermine their current strategy and double down on the initial decision in order to justify their prior actions.[6]

This phenomenon of "consensual neglect" seems a particularly apt description of the strategic posture of many (if not most) law firms in today's rapidly changing market for legal services. Ignoring strong indicators that their old approaches – to managing legal work processes, pricing, leverage, staffing, project management, technology, and client relationships – are no longer working, they choose to double down on their current strategies rather than risking the change that would be required to respond effectively to evolving market conditions. Like the French military in the 1930s, they are ready to fight the last war but, unfortunately, not to meet the challenges that are barreling toward them.

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2 Freek Vermeulen and Niro Sivanathan, "Stop Doubling Down on Your Failing Strategy – How to Spot (and Escape) One before It's Too Late," *Harvard Business Review*, Nov.-Dec. 2017, at 110-17.

3 *Id.* at 112.

4 *Id.* at 113.

5 *Id.*

6 *Id.*

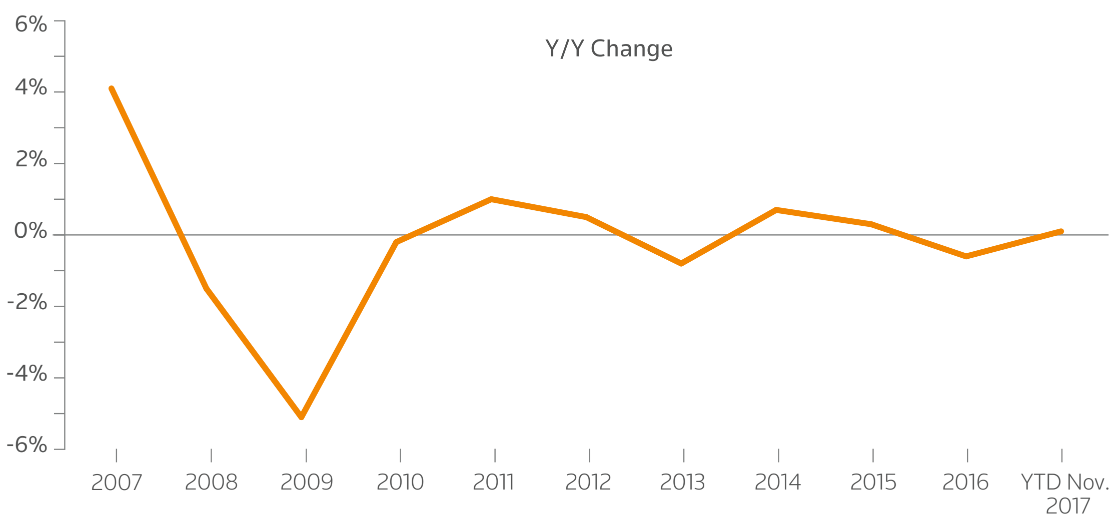
In the sections that follow, we look in more detail at the trends that are reshaping the market for law firm services and offer some additional observations on the mounting evidence that firms are unlikely to achieve future market success using traditional strategies and structures. We also refer to some examples of firms that appear to be breaking out of their traditional strategies and exploring new alternatives to remain competitive. We begin, however, with a review of the performance of U.S. law firms in 2017.

Current State of the Legal Market – By the Numbers

Broadly speaking, it appears that when the final results are in, law firm financial performance in 2017 will represent "more of the same" as compared to results in prior recent years. With only modest exceptions, U.S. law firms have on average continued to see very sluggish growth in demand for their services, continuing decline in productivity, relatively modest increases in rates, continuing downward pressure on realization, and some upward pressure on direct expenses. That said, one interesting difference in 2017 is the clear superior performance of Am Law 100 firms which, unlike in prior years, significantly outpaced both Am Law Second 100 and Midsize[7] firms in a number of key indicators including percentage growth in demand,[8] worked rates,[9] fees worked,[10] overall revenues, and cash collections.

Demand Growth. Demand growth for law firm services, as tracked by Thomson Reuters Peer Monitor®,[11] was essentially flat in 2017. As shown in Chart 1 (which tracks performance on a year-over-year basis through November 2017), this continues a seven-year pattern (with the exception of a brief uptick in 2011 and a slight negative turn in 2013). It stands in stark contrast to the 4 to 6 percent annual growth in demand experienced in the legal market prior to 2008.

Chart 1 – Growth in Demand for Law Firm Services



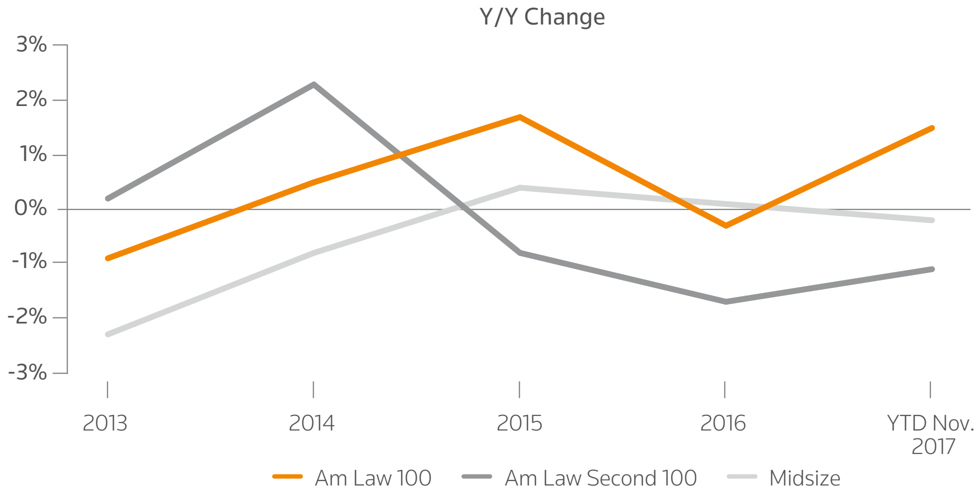
All timekeepers
Billable time type; non-contingent matters

Source: Thomson Reuters Peer Monitor

As previously noted, while demand growth across all law firms was very sluggish, there were marked differences among the three key market segments. As shown in Chart 2, demand growth was slightly positive for Am Law 100 firms, remained flat for Midsize firms and declined noticeably for Am Law Second 100 firms.

7 "Midsize" firms are defined within the Peer Monitor program as firms outside of the Am Law 200; employing an average 146 lawyers.
8 For present purposes, "demand for law firm services" is viewed as equivalent to total billable hours recorded by firms during a specified period.
9 "Worked rates" are the negotiated rates as determined by the matter value. Worked rates are often referred to as "agreed rates."
10 "Fees worked" are worked rates multiplied by demand.
11 Thomson Reuters Peer Monitor® data ("Peer Monitor data") are based on reported results from 168 U.S.-based law firms, including 56 Am Law 100 firms, 47 Am Law Second 100 firms, and 65 additional Midsize firms.

Chart 2 – Historic Segment Demand Growth

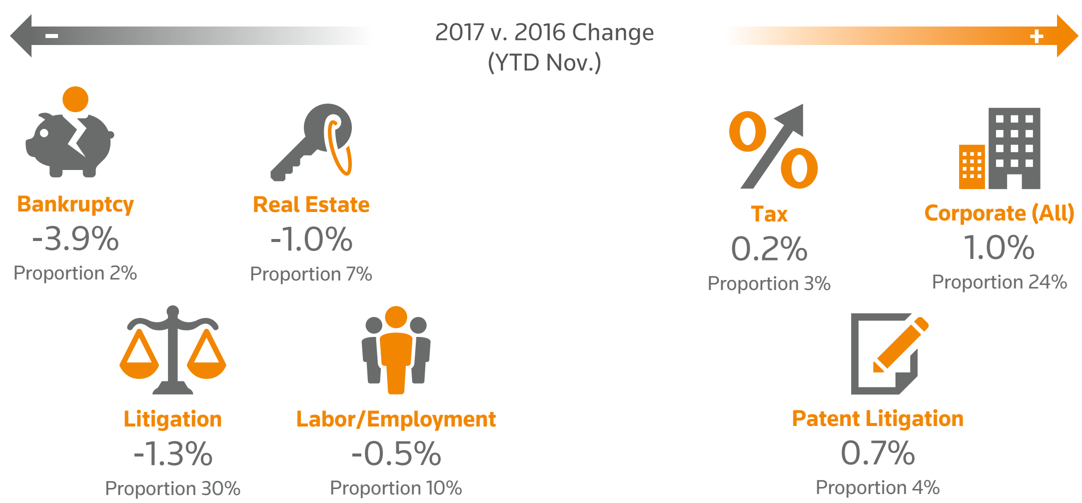


All timekeepers
Billable time type; non-contingent matters

Source: Thomson Reuters Peer Monitor

As shown in Chart 3, demand growth was slightly positive in corporate practices, tax and in IP litigation, but was negative in all other fields. This was particularly significant in the case of general litigation, which represents some 30 percent of all practice activity. Most firms have seen demand for their litigation services decline over the past several years, but during 2017 the pace of that decline accelerated.

Chart 3 – Demand Growth by Practice



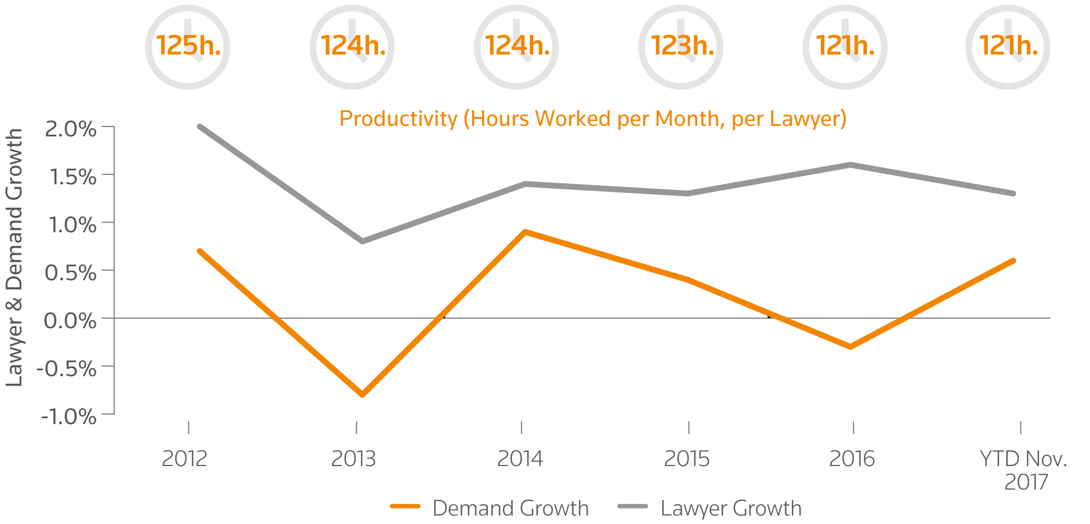
All timekeepers
Billable time type; non-contingent matters

Source: Thomson Reuters Peer Monitor

Productivity. During 2017 (through November), the number of lawyers in U.S. firms grew modestly by some 1.3 percent. Coupled with flat demand growth, however, even this small increase in headcount resulted in a continuing decline of productivity across the market.[12] This result, as well as the interplay of headcount and demand growth factors on productivity over the past six years, can be seen in Chart 4.

12 "Productivity" is defined as the number of billable hours worked by lawyers divided by the total number of lawyers.

Chart 4 – Balance of Demand and Capacity

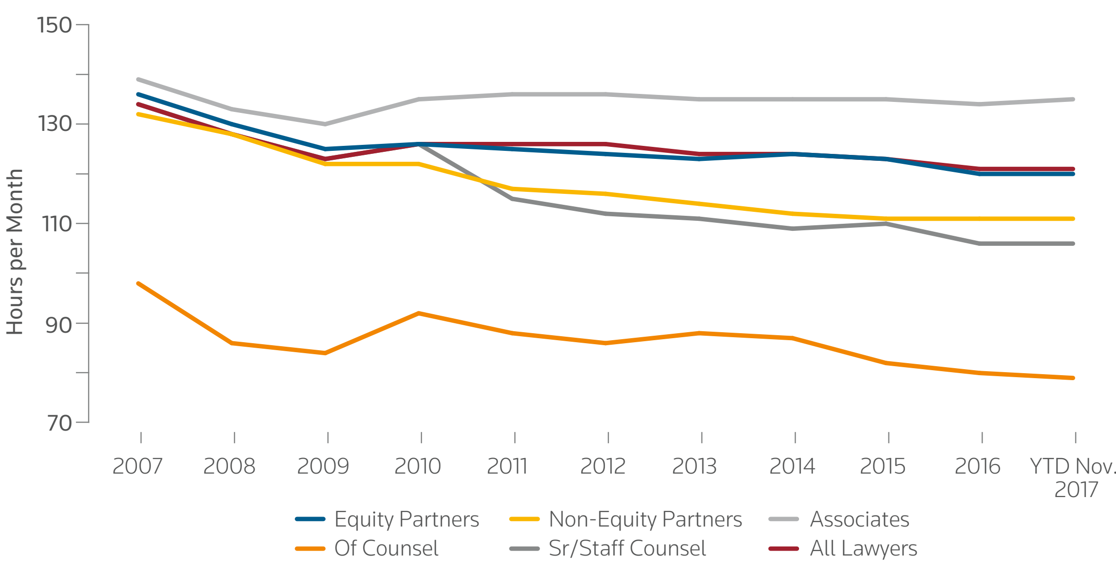


Lawyers; Contractors excluded
Billable time type; non-contingent matters

Source: Thomson Reuters Peer Monitor

This negative growth in productivity reflects a trend that has persisted for several years. As shown in Chart 5, since 2011, there has been an overall downward trend in the productivity of all categories of timekeepers except associates, and the downward trend has been particularly serious in the of-counsel ranks. For all lawyers, the current level of billable worked hours per month is some 13 total hours below the level at the beginning of 2007 (just before the onset of the Great Recession). That represents a total of 156 billable worked hours per year which, if multiplied by the average hourly worked rate for all lawyers in 2017 ($475), indicates that the decline in productivity over the past decade is costing firms about $74,100 per lawyer per year.

Chart 5 – Productivity (Billable Worked Hours per Lawyer) by Category

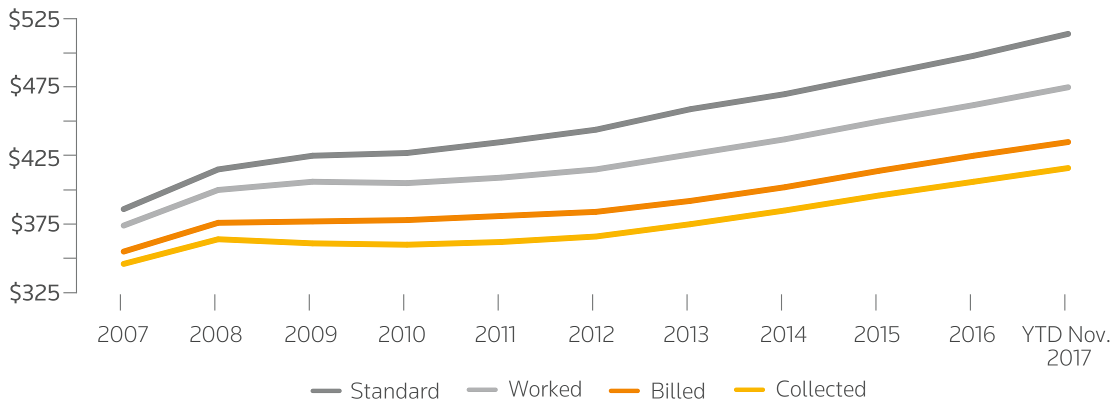


Lawyers
Billable time type; non-contingent matters

Source: Thomson Reuters Peer Monitor

Rates and Realization. During 2017, law firms continued to raise their standard rates, albeit by a fairly modest 3.1 percent. More importantly, their worked (or agreed) rates grew by an average of 3.0 percent. These increases are reflected in Chart 6 that shows rate growth across the market from 2007 through November 2017.

Chart 6 – Rate Progression

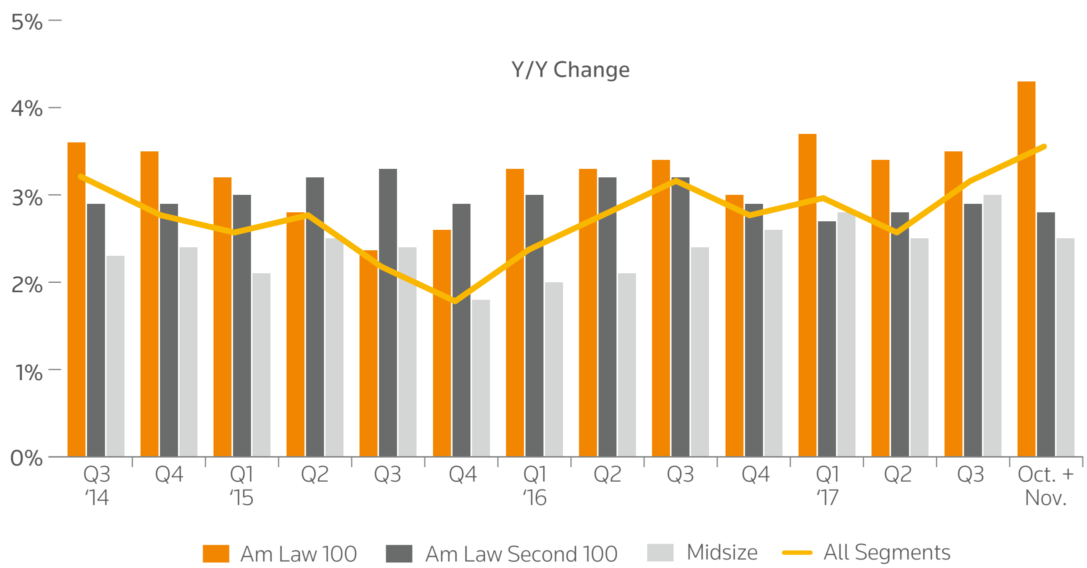


Lawyers
Billable time type; non-contingent matters

Source: Thomson Reuters Peer Monitor

As previously noted, this rate growth was not uniform across the market, as Am Law 100 firms increased their rates by a significantly greater percent than their Am Law Second 100 or Midsize firm counterparts. Also, the ability of firms to impose rate increases varied considerably from one practice group to another. These disparities are shown in Charts 7 and 8.

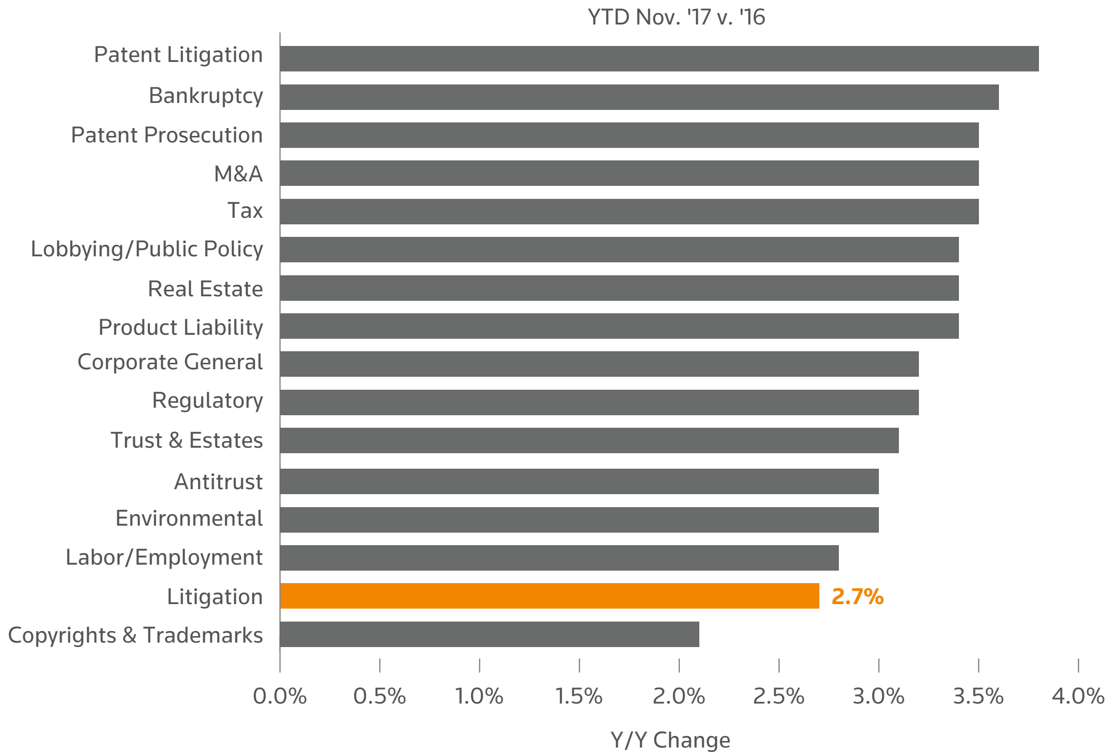
Chart 7 – Worked Rate Growth by Law Firm Segment



All timekeepers
Billable time type; non-contingent matters

Source: Thomson Reuters Peer Monitor

Chart 8 – Worked Rate Growth by Practice

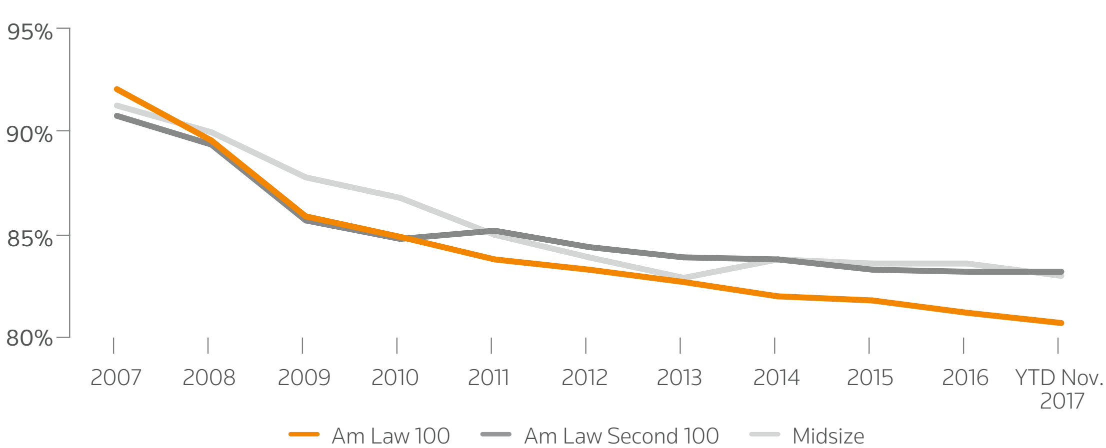


All timekeepers
Billable time type; non-contingent matters

Source: Thomson Reuters Peer Monitor

As in previous years, even the modest rate increases imposed by firms during 2017 were met with pushback from many clients. As a result, as indicated in Chart 9, at least among Am Law 100 firms, collection realization as measured against standard rates continued to decline. If measured against worked rates, the picture was better. Indeed, as shown in Chart 10, realization measured in this way seems to have largely leveled off since 2013.

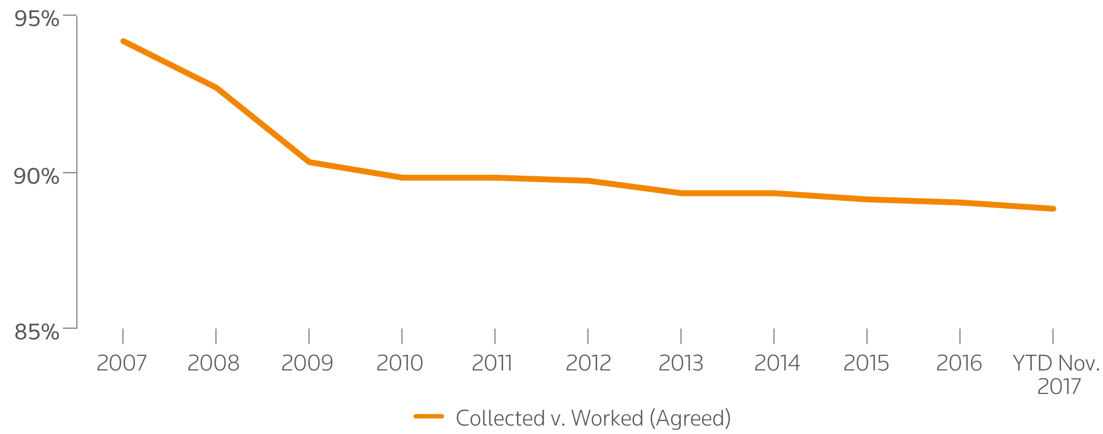
Chart 9 – Collection Realization against Standard Rates by Law Firm Segment



Lawyers
Billable time type; non-contingent matters

Source: Thomson Reuters Peer Monitor

Chart 10 – Collection Realization against Worked (Agreed) Rates

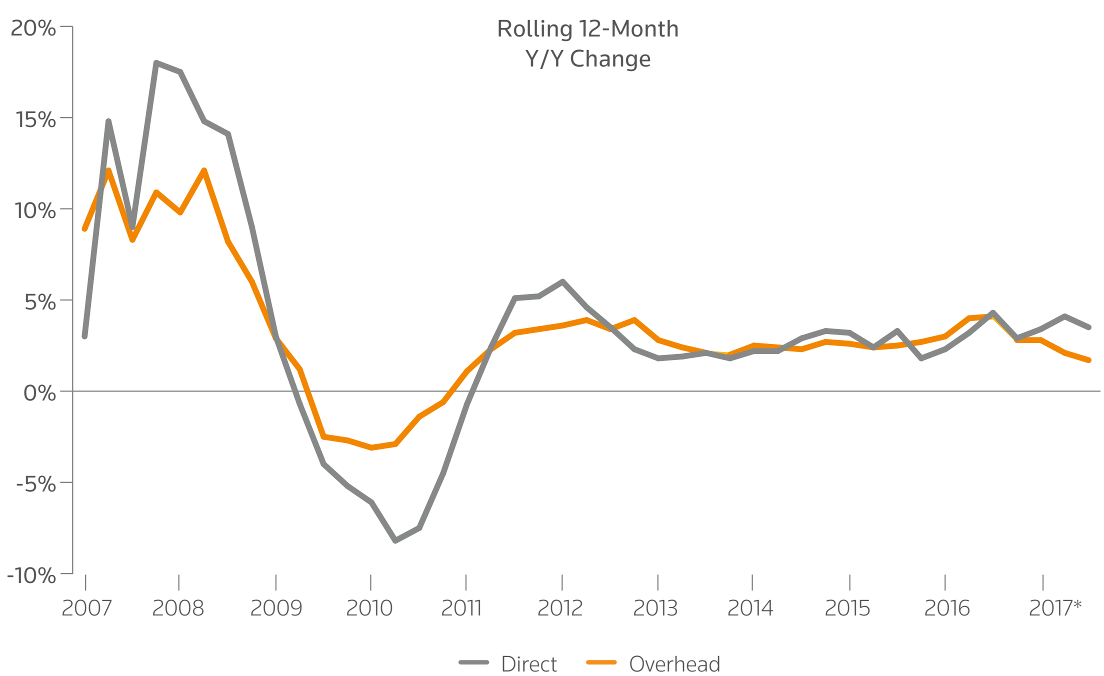


Lawyers
Billable time type; non-contingent matters

Source: Thomson Reuters Peer Monitor

Expenses. As to expense growth, as shown in Chart 11, during 2017 firms experienced a modest overall growth in direct expenses, attributable primarily to the bump-up in associate compensation, especially among Am Law 100 firms. By contrast, there was a modest downturn in the growth rate of indirect expenses.[13] Overall, since 2012, firms have done a good job managing their expenses, in sharp contrast to practices prior to the Great Recession when expense growth sometimes exceeded revenue growth – an obviously unsustainable condition.

Chart 11 – Expense Growth



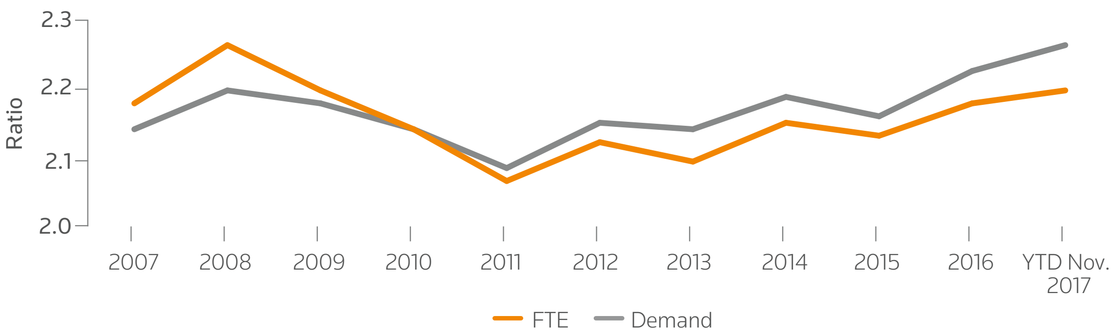
*Rolling 12 months through Q3 2017 (i.e., Q4 2016-Q3 2017)

Source: Thomson Reuters Peer Monitor

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

Leverage. During 2017, leverage[14] across the market remained essentially unchanged. This is shown in Chart 12 which measures leverage over the relevant period in two separate ways – first, by FTE, showing the leverage ratio based 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 indicated, 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.

Chart 12 – Leverage (Lawyer to Equity Partner)

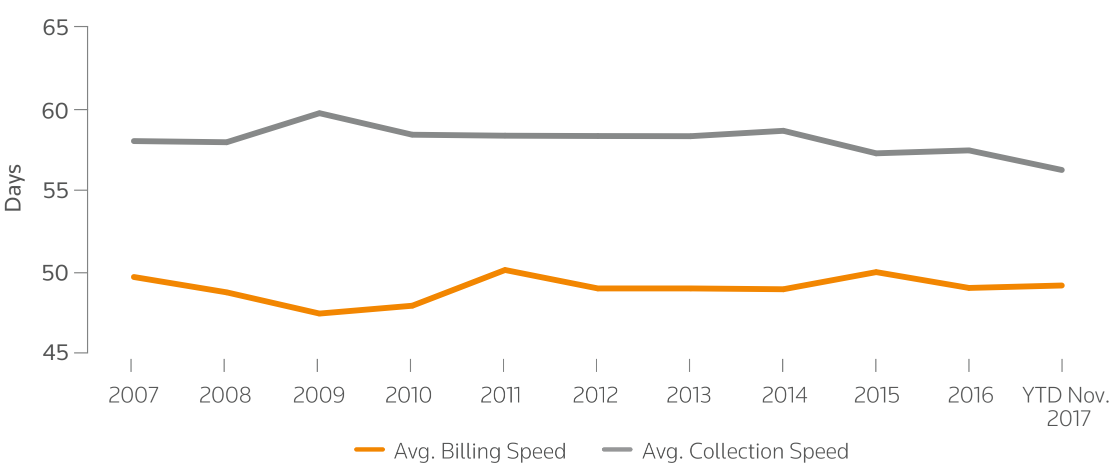


Lawyers (contractors excluded)

Source: Thomson Reuters Peer Monitor

Billing and Collection Cycles. As shown in Chart 13, during 2017, changes in the billing and collection cycles of law firms – i.e., measures of the speed of billings and collections – remained essentially flat, indicating that most firms continued to manage their accounts receivable fairly well despite continuing client pushback on increasing rates.

Chart 13 – Billing and Collection Cycles



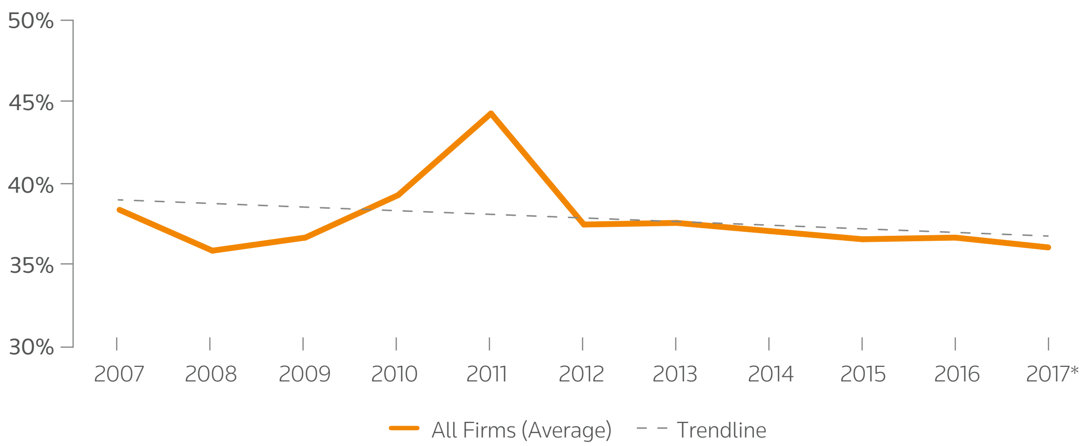
Billable time, non-contingent matters

Source: Thomson Reuters Peer Monitor

14 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.

Profit Margins. As a result of flat demand, declining productivity, and continuing downward pressure on realization rates, law firm profit margins[15] on average across the market were essentially flat during 2017. As shown in Chart 14, since 2007, with the exception of a spike in 2011, the trend for profit margins has been slightly downward over the entire decade.

Chart 14 – Profit Margin



*Rolling 12 months through Q3 2017 (i.e., Q4 2016-Q3 2017)

Source: Thomson Reuters Peer Monitor

A Deeper Look: How Reassuring Are the Numbers?

The statistics on the overall financial performance of U.S. law firms in 2017 – like those over the past five or six years – show an industry that appears to be "holding its own" as it has responded to the seismic shifts in the legal market since 2007. The performance data seem to suggest that most firms have been able to maintain their profitability at acceptable levels through a combination of reductions in headcount, tightening of their equity partner ranks, reductions in expenses, and continuing (albeit modest) rate increases. And, of course, some firms – though certainly not most – have done exceedingly well, even in a challenging market of tepid demand growth.

All of this might sound reassuring, providing some solace to law firm leaders pondering the future of their firms in uncertain times. To interpret recent financial performance data as a clear positive indicator, however, would be a mistake. Indeed, a deeper look at the reality behind the numbers suggests, for the reasons described below, that the market for law firm services is not as healthy as it may appear on the surface.

Declining Growth in Key Metrics. In his analysis of the financial performance of the most successful segment of the market – Am Law 100 firms – in 2016, Nicholas Bruch, a Senior Analyst at ALM Legal Intelligence, observed that, while Am Law 100 firms had on average experienced both revenue and profit growth during 2016, that success was tempered by the fact that the growth rate of several key metrics appeared to be slowing. Thus, growth in revenue per lawyer ("RPL") declined from 3.7 percent in 2015 to 1.5 percent in 2017; growth in profits per lawyer ("PPL") slipped from 6.4 percent in 2015 to 2.4 percent in 2017; and growth in profits per equity partner dropped from 5.6 percent in 2015 to 3.0 percent in 2017.[16] This declining growth was coupled with a noticeable increase in volatility during the same period, as firms experiencing increases in one year would experience decreases in the next, and *vice versa*. In 2017, for example, 60 percent of firms reported a reversal in PPL growth from the prior year. Moreover, the percentage of firms that reported reversals in RPL, PPL, or PPP growth increased in each of the past three years.[17]

15 In the present context, "profit margin" means a firm's net income (total revenue less all expenses but before distributions to equity partners) divided by the firm's total revenue.

16 Nicholas Bruch, "The Am Law 100: Dark Clouds on the Horizon," *Law.Com*, May 2, 2017.

17 *Id.*

The Danger of Relying on Averages. Most analyses of the state of the legal market (including this one) tend to rely on average performance data to assess the economic health of law firms. In many industries, the use of average data is highly informative since key data points tend to reflect a "normal" bell curve. The problem with using averages in the legal industry, however, is that the performance of law firms across industry segments does not reflect the normal distribution of a bell curve.

This point was forcefully made by Bruce MacEwen, the President of Adam Smith, Esq., in his analysis of Am Law 100 data as reported in 2017: "[t]he Am Law 100 is not remotely a 'normal' distribution; it's a power curve, with a few big players, a lot more in the middle, and a long tail of smaller fry. This isn't a technical quibble; it has teeth."[18] He continues, "[c]onsider a few characteristics of this year's Am Law 100: (a) 10% of the group's total revenue is accounted for by the top three firms; and another 10% by the smallest two dozen; (b) 25% comes from the top nine firms and 25% from the bottom 50; and (c) the top three's combined revenue was over $8 billion and the bottom 20's under $7.5 billion."[19] Driving home his point further, MacEwen notes that, in respect of the $3.5 billion in nominal increases in Am Law 100 revenue reported for 2017:

- Two-thirds of the increase can be attributed to only about 20 of the 100 firms;
- Of the 100 firms, 18 reported a decrease in their gross revenue, and 20 reported lower profits per partner; and
- If the 20 smallest firms in the Am Law 100 were to disappear and be replaced by the 20 largest firms in the Am Law Second 100, the overall numbers for the Am Law 100 would move only very slightly – impacting only 1.9 percent of total Am Law 100 revenue.[20]

There is an old cliché that one can drown in a lake having an average depth of only six inches. Relying on average performance data to bolster our sense of well being in the legal market is similarly perilous.

The Slippery Concept of Law Firm Profitability. Many in the legal market have taken comfort from the fact that, even in the face of the most severe recession since the Great Depression, law firms have generally been able to maintain historically reasonable levels of profitability. Indeed, the *American Lawyer*, in its May 2017 review of the performance of Am Law 100 firms, described the average growth in profits per partner of 3.0 percent and the related average growth in gross revenue of 4.3 percent as "solid gains" that were "rather impressive." The problem is that the measure of true law firm profitability is somewhat elusive.

For starters, most law firm performance statistics (including those in the *American Lawyer* and in our own Peer Monitor® data) are reported in "nominal" dollars and not "real" (or constant) dollars adjusted for inflation. And, as pointed out by Bruce MacEwen, this reporting convention can make a huge difference.[21] If the 2017 Am Law 100 data had been reported in constant dollars and had taken account of the head-count growth in the firms, the impressive average gain in gross revenue would have been reduced from 4.3 percent to a *negative* 0.5 percent, and the profits per partner would have fallen from 3.0 percent to only 0.9 percent.[22]

But there is an additional problem as well. Using reporting conventions traditional in the legal market, one could be led to conclude that law firms are among the world's most profitable businesses. As described by Chris Johnson, former Chief Global Correspondent for American Lawyer Media, the average profit margin reported for Am Law's Global 100 firms is 39 percent, with the highest profit margin in the group reaching almost 68 percent – some three-and-a-half times the margin of Apple Inc. and nine times that of Berkshire Hathaway.[23] While such stratospheric profit margins may provide some comfort to law firm partners as well as consternation to their clients, the truth is they are completely misleading.

The skewed results described above result from the simple fact that, when a law firm reports its "profit," it takes no account of the cost to the firm of its equity partners. It simply pays out all of its net income to equity partners and treats the entire amount as "profit." As noted by Johnson:

18 Bruce MacEwen, "But What Do the Am Law Numbers *Really* Show?" *Thomson Reuters Forum*, vol. 3, ed. 2 (2017), at 36, 37.

19 *Id*. at 37.

20 *Id.* at 37-38.

21 *Id.* at 37.

22 *Id*. These calculations reflect an increase in the Consumer Price Index of 2.08 percent from 2015 to 2016, and an increase in headcount among Am Law 100 firms of 2.72 percent during the same period.

23 Chris Johnson, "Why Your Law Firm Isn't Anywhere Near as Profitable as You Think," *The Am Law Daily*, Oct. 6, 2017.

> Compared to companies in other industries, this gives law firms an artificially high profit margin, since from an accounting perspective, equity partners receive no above-the-line salary and therefore represent no cost to the business. It also means that the most popular metrics used to assess law firm profitability – profit margin and average profit per equity partner – are susceptible to distortion by leverage.[24]

To correct this distortion, a firm would need to assign some nominal value to the cost of its equity partners and deduct that value from its net income, thus leaving genuine "profit." The problem, of course, is how to adopt a reasonable standard that would reflect the cost of equity partners to their firms. Although there are a number of potential methods that could be used, one particularly intriguing one has been advanced by Madhav Srinivasan, the CFO of Hunton & Williams. He proposes adding a premium to average nonequity partner compensation based on the ratio of a firm's equity partner profits and nonequity salaries. Using this approach, the average profit margin for Am Law 100 and Am Law Second 100 firms would drop from 37 percent to 13.8 percent, putting it about halfway between the margins of two major professional services firms – Accenture (at 9.9 percent) and Exponent Inc. (at 16.7 percent).[25]

Reduced Capacity to Respond to the Next Downturn. Despite some denials expressed during the heady decade prior to 2008, most observers of the legal market would today agree that law firms are subject to the same unrelenting rules of the business cycle as other sectors of the economy. We are currently in the eighth year of an economic expansion following the Great Recession that started in December 2007 and ended in June 2009. The average economic expansion since 1945 has lasted 4.9 years. Accordingly, the next economic downturn is likely not that far away. When it begins – as it inevitably will – law firms will have significantly less capacity to deal with its adverse effects than they did in 2007.[26]

The 19-month recession that started in 2007 had an immediate and devastating impact on the legal market. The growth in demand for law firm services dropped precipitously from 4.1 percent in 2007 to a *negative* 5.1 percent in 2009, a swing of 9 percentage points.[27] Similarly, average billable hours worked per lawyer declined sharply from 134 hours per month in 2007 to 123 hours per month in 2009, a drop of just over 130 billable worked hours per lawyer per year.[28] Yet, during the months following the start of the recession, most firms were able to mitigate the negative impacts of these developments through the use of several key levers:

- First, almost all firms dramatically slashed both their direct and indirect expenses. Indeed, average growth in direct expenses dropped from 18 percent at the end of 2007 to a *negative* 8.2 percent in early 2010, a swing of over 26 percentage points, while indirect expenses plummeted from 10.9 percent to a *negative* 2.9 percent during the same period. These reductions were driven primarily by staff cuts (layoffs of timekeepers in the case of direct costs and of non-timekeeper staff in the case of indirect costs).[29]
- Second, most firms significantly slowed the growth in their equity partner ranks, in many cases by "de-equitizing" former equity partners and increasing the ranks of their non-equity or income partners. Most firms also reduced their hiring goals and have been adding new lawyers at a slower pace than previously. As a result, the replenishment ratio for equity partners across all firms in the market has been less than 1.0 since mid-2012, which is to say that the ranks of equity partners have experienced negative growth over the past five years.[30]
- And third, virtually all firms have continued to increase their rates on an annual basis, though the rate increases since the recession have typically been in the 2-4 percent range and not the 6 percent range that was often seen before 2008. These rate increases have, of course, been met with continuing client resistance as reflected in the realization rates previously discussed, but they have nonetheless contributed critically to the profitability that firms have enjoyed in the post-recession period.

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24 *Id.*

25 Chris Johnson, "Your Law Firm's True Profitability Revealed," *Law.Com*, Oct. 26, 2017.

26 *See* Hugh A. Simons and Nicholas Bruch, "When Will Disruption Hit the Legal Industry?" The *American Lawyer Daily*, Sept. 11, 2017 ("Simons and Bruch").

27 Source: Peer Monitor data.

28 *Id.*

29 *Id.*

30 *Id.*

The problem is that, when the next economic downturn occurs, the levers that law firms used to mitigate the impact of the last recession are not likely to be as effective. This is in large part because firms would be starting from a significantly lower base than they enjoyed in 2007 – e.g., revenue per lawyer is lower than at the start of the last downturn, the ranks of equity partners can't easily be trimmed much more than they already have been, and there is every indication that client resistance to ongoing rate increases is stiffening and not weakening. All of which suggests that the negative impact of the next downturn could be fairly severe.

In a recent article in the *American Lawyer*, Hugh Simons and Nicholas Bruch describe a "thought experiment" in which they speculate on what would happen if Am Law 100 and Am Law Second 100 firms in a future economic downturn were to suffer the same decline in revenue per lawyer as during the 2007-2009 recession, but were unable to offset such decline through the use of cost reductions and further increases in equity partner leverage. They calculate that, under those circumstances, average profits per partner for these 200 firms could decline by almost 20 percent.[31]

A Broader Look: The Shrinking Market for Law Firm Services

Apart from performance statistics and the capacity of firms to respond to the next downward turn in the business cycle, there is a broader question about the long-term health of the market for law firm services. Since 2008, the overall growth trend for demand for law firm services has (with certain spikes and dips) been essentially flat to negative in every year. This has occurred despite the economic recovery in recent years and despite an overall increase in legal spend by corporate clients. What this suggests, bluntly put, is that law firms have been losing market share and, in fact, that appears to be the case.

In a recent survey of some 300 mostly large corporate law departments representing more than 20 industries, HBR Consulting found that 82 percent of respondents reported a growing demand for their legal services and an increase (albeit modest) in their companies' legal spend as a percentage of total revenue.[32] Participants also indicated, however, that essentially all of the increase in spending occurred *within* their law departments. Internal spending was reported to have increased by 4 percent in 2017, while outside legal spending remained unchanged.[33] Additionally, 95 percent of respondents indicated they were taking measures to reduce their spend for outside counsel, even as 21 percent said they were increasing their use of outside legal process outsourcing ("LPO").[34]

These results are consistent with the findings of Altman Weil's 2017 Chief Legal Officer Survey of some 280 corporate law departments.[35] Respondents to that survey indicated that 56 percent had increased their internal legal budgets in 2017, while only 22 percent had decreased them. In addition, for the first time since 2013, more law departments increased their vendor budgets than decreased them. The only category in which more participating companies cut their budgets rather than increased them was outside counsel spending. Among respondents, 41 percent said they had cut their outside counsel spend, while 32 percent reported an increase. (The survey did note that the differential between decreases and increases in this area has been narrowing in recent years.)[36]

31 Simons and Bruch.

32 The survey reported total legal spend by respondents in 2017 as 0.35 percent of company revenues, as compared to 0.34 percent in 2016 and 0.33 percent in 2015. HBR Consulting, *2017 HBR Law Department Survey*, Nov. 14, 2017 (the "HBR Survey"), at 10.

33 *Id.* at 5.

34 *Id.* at 49. Survey respondents noted that the largest area of work being outsourced to LPOs was contract management.

35 Altman Weil, Inc., *2017 Chief Legal Officer Survey: An Altman Weil Flash Survey*, Nov. 2017 (the "Altman Weil CLO Survey").

36 *Id.* at iii-iv.

In February 2017, a special report on alternative legal service providers was jointly issued by Thomson Reuters Legal Executive Institute, Georgetown University Law Center, and the Oxford Säid Business School.[37] The report, which marked the culmination of the first global survey exploring the growth, activities, and market share of nontraditional service providers in the legal industry, identified five separate categories of alternative legal service provider ("ALSP") – (i) accounting and audit firms; (ii) captive LPOs/law firm affiliates; (iii) independent LPOs, ediscovery, and document review service providers; (iv) managed legal services; and (v) contract lawyers, in-sourcing, and staffing services. As shown in Chart 15, the study identified key players and representative services in each category and, as can be seen, estimated the overall revenues of ALSPs at $8.4 billion. When compared to the $275 billion in total revenues of U.S. law firms or the estimated $700 billion in total global legal spending, the ALSP figure might seem modest. It must be noted, however, that total ALSP revenues have been growing rapidly, that only a few years ago they were at zero, and that virtually all of the revenue represents services once provided by law firms.[38]

Chart 15 – ALSP Market Size by Category of Service Provider

	Accounting and Audit Firms	**Captive LPOs**	**Independent LPOs, e-discovery, and Document Review Service Providers**	**Managed Legal Services**	**Contract Lawyers, In-sourcing, and Staffing Services**
Description	Accounting and audit firms that have a large amount of revenue in legal services. Tend to focus on high-volume, process-oriented work that's complementary to accounting-audit work.	Wholly owned captive operations. Often located in lower-cost regions, focused on high-volume process work.	Perform outsourced legal work under the direction of corporate legal departments and law firms. Typically engaged for matter- or project-based work often proactively managed and globally delivered. Includes e-discovery services and document review providers.	Providers that contract for all or part of the function of an in-house legal team. Typically engaged for ongoing work within scope, proactively managed.	Providers of lawyers to companies on temporary basis. Can range from entry-level document review to highly skilled and experienced specialists.
Key players	• Deloitte • EY • PwC • KPMG	• WilmerHale • Clifford Chance • Eversheds • Orrick • Allen & Overy • Reed Smith	• Thomson Reuters Legal Managed Services • DTI • Mindcrest • QuisLex • Integreon • Consilio • LDiscovery	• Thomson Reuters Legal Managed Services • Axiom • Riverview Law • Elevate	• Halebury • Axiom • Special Counsel • Update Legal • LOD
Estimated revenue	**$900 million**	**$150 million**	**$6,200 million**	**$250 million**	**$900 million**

Source: Alternative Legal Service Providers: Understanding the Growth and Benefits of These New Legal Providers

37 Thomson Reuters Legal Executive Institute, Georgetown University Law Center, and Oxford Säid Business School, *Alternative Legal Service Providers: Understanding the Growth and Benefits of These New Legal Providers,* Feb. 19, 2017 (the "ALSP Report").

38 *Id.*

The potential seriousness of this market realignment is underscored by two recent developments, although many others could no doubt be cited. First, in October, PricewaterhouseCoopers announced that it was launching a new flexible lawyering service as part of its "New Law" initiative. The concept, which is similar to that of Axiom and other legal staffing companies, is to assist corporate clients with their legal staffing needs by providing lawyers on a temporary basis to work on particular projects or to provide extra bench strength for peak requirements. As reported, "PwC expects the service to be used by clients requiring increased resources for tasks such as large-scale contract review, disclosure exercises during investigations, and other implementation challenges driven by regulatory changes."[39]

The second development worth noting was the recent announcement that DXC Technology Co., a Fortune 200 technology services firm, has entered into a five-year contract with UnitedLex Corp., an ALSP, to take over nearly 200 employees of DXC's law department (including some of its senior lawyers) in what is being described as "the first major outsourcing deal involving a law department." Under the arrangement, UnitedLex will have a team of over 250 lawyers and other professionals to handle areas like contract management and immigration, all at a cost savings of 30 percent to DXC. In commenting on the deal, Josh Rosenfeld, a former lawyer at Davis, Polk & Wardwell as well as Heller Ehrman and now an executive at ALSP QuisLex, observed: "This is yet another signal to law firms that companies view their legal work much differently than law firms do. It just re-emphasizes the message companies have been trying to get through the head of law firms that legal services, the way they're being currently delivered, are really inefficient and expensive."[40]

What is becoming increasingly clear is that the market in which law firms are required to operate today may in reality be quite different from the one that most law firm partners have fixed in their minds. So far, the realignment of competition across the legal industry has been limited, but the direction of movement is clear and the pace of change is accelerating. Unless law firm leaders take these market changes seriously, they may well find themselves – like the French generals in 1940 – prepared to meet challenges that no longer exist and outmaneuvered by competitors who are using a completely different playbook.

So, What Can Be Done?

As described above, the challenges facing law firm leaders in today's market are daunting, but the good news is that there are many positive steps that firms can take to address them. Indeed, a number of firms have already begun to do so. To be successful in addressing the new market realities, however, it is essential for firms to listen carefully and respond proactively to the concerns of their clients. And those concerns – at least since 2008 – have been driven by consistent client demands for greater efficiency, predictability, and cost effectiveness in the delivery of legal services. To the extent that these demands cannot be met by their existing law firms, clients have shown themselves more than willing to switch to more responsive firms, to take more work in house, or to transfer work to alternative service providers.

In a recent presentation in London to senior leaders from some 35 major U.S. law firms, Karl Chapman, the CEO of Riverview Law, a highly successful ALSP that offers managed legal services to large corporate clients in the U.K., observed that Riverview Law would not exist if law firms had been more responsive to the needs of their own market. Noting that many law firms already had long-standing relationships with most of Riverview Law's clients and strong brand names to go along with those relationships, Mr. Chapman marveled that a non-law firm start-up like his could so easily displace them. His point is well taken.

39 Alex Berry, "PwC Launches On-Demand Flexible Lawyering Service for Clients," *The Am Law Daily,* Oct. 12, 2017. This initiative is separate from PwC's other announcement in September that it intends to launch a new law firm (ILC Legal) in Washington, D.C. to assist U.S. clients on international issues. Chris Johnson, "PwC to Launch US Law Firm as Big Four Expand Legal Offerings," *The Am Law Daily,* Sept. 21, 2017.

40 Roy Storm, "Big Law Looks On as 'New Law' Gets Closer to Clients," *The Am Law Daily,* Dec. 7, 2017.

Over the last few years, there has been mounting evidence that law firms that *proactively* address the needs of their clients – e.g., by implementing alternative staffing strategies, pursuing flexible pricing models, adopting work process changes, making better use of innovative technologies, and the like – can achieve significant success. In a very interesting and informative study released by Thomson Reuters Legal Executive Institute in November 2017, and based on Peer Monitor® data, the performance of firms across the market during 2014, 2015, and 2016 was analyzed based on their compound annual growth in revenue per lawyer and total profit (net income before distributions to equity partners), as well as their average change in profit margin over the three-year period.[41] The relative performance of each firm in each of these categories was placed into a weighted matrix that resulted in a single composite score. Those firms that fell into the top quartile in composite scores were designated as "dynamic firms" and those that fell into the bottom quartile as "static firms." The study then examined the characteristics of firms in each of these quartiles to determine what might have driven their relative financial success.

Interestingly, size did not appear to matter. Both the dynamic and static groups included an array of Am Law 100, Am Law Second 100, and Midsize firms. Likewise, firm location was not particularly important; nor was a given firm's regional, national, or global footprint.[42] Also, the market-leading performance of dynamic firms was not driven by larger rate increase. Indeed, dynamic firms increased their rates at the same pace as the average for the entire market and only slightly more aggressively than static firms.[43] Nor was leverage a key factor. With only a few exceptions, static firms had greater leverage than their dynamic counterparts (whether measured on an FTE basis or on a demand basis).[44]

So, what did make a difference? The study identified several factors, most of which are relevant for present purposes.[45] First, dynamic firms had a substantially higher billing realization than their static counterparts. This means they offered fewer discounts off standard rates to win business, and they engaged in fewer pre-bill write-downs. This suggests that dynamic firms had better up-front communications concerning pricing with their vclients, a likelihood that is underscored by the differences between the practices of the two groups of firms regarding alternative fee arrangements ("AFAs").[46] Both dynamic and static firms had a comparable percentage of their revenue accounted for by AFAs (slightly less than 25 percent). But there was a substantial difference in how the two groups approached AFAs. Some 75 percent of the dynamic firms responding to a follow-up survey reported they proactively pursued AFAs with their clients, while 70 percent of the static firms said they offered AFAs only in response to client requests.[47]

The importance of clear initial communications with clients on fee matters is probably also reflected in the fact that dynamic firms were generally able to collect their bills somewhat faster than static firms. This enabled dynamic firms to manage their cash more effectively and contributed to some degree to their overall financial performance.[48]

One factor that differentiated between the two groups of firms may be counterintuitive. Dynamic firms increased their indirect (or overhead) expenses in almost every category in the rolling 12-month period ending in December 2016, while static firms cut their expenses in many areas. There were two areas in particular in which the groups diverged by fairly wide margins: (i) marketing and business development expenses, which dynamic firms increased by 4.6 percent compared to a 1.8 percent increase by static firms and (ii) investments in technology, which dynamic firms grew by 3.2 percent while static firms added only 1.2 percent, all on a per-lawyer basis.[49]

41 Thomson Reuters Legal Executive Institute, *2017 Dynamic Law Firms Study*, Nov. 2017 ("Dynamic Law Firms Study"). The Dynamic Law Firms Study can be accessed at http://legalexecutiveinstitute.com/2017-dynamic-law-firms-study/.

42 *Id.* at 2.

43 *Id.*

44 *Id.* at 3-4. The study also reviewed the component categories of leverage to determine, for example, whether dynamic firms might have had fewer nonequity partners, thus potentially skewing the numbers as partners in that category tend to be less productive. In fact, however, dynamic firms actually had a slightly higher average proportion of nonequity partners than static firms.

45 Two factors not discussed in this report were (i) the study's finding that dynamic firms appear to have growing litigation practices that, combined with growing corporate practices, give a powerful boost to overall demand growth and (ii) that dynamic firms have higher productivity among timekeepers, suggesting more success in "right sizing" than is the case among static firms. Dynamic Law Firms Study at 5-6.

46 AFAs are pricing models that take no account of billable hours – e.g., fixed price agreements, portfolio pricing, cost-plus pricing, and the like.

47 Dynamic Law Firms Study at 7-8.

48 *Id.* at 11.

49 *Id.* at 9-10

These differences in investments by dynamic firms in both business development and technology suggest a philosophy of active engagement that is also reflected in the details of the expenditures. Dynamic firms reported that increased expenses in business development were designed to facilitate more client interactions and direct client meetings, business development coaching for lawyers, and brand development. Dynamic firms said their technology investments were focused on improving workflow efficiency, as well as enhancing their ability to assess profitability and better analyze data.[50]

The findings of the Dynamic Law Firms Study are consistent with other studies and surveys that have been conducted in recent years.[51] And there are hopeful signs that many firms are getting the message. For example, Altman Weil reports that, of the 386 U.S. firms participating in its 2017 Law Firms in Transition survey,[52] half say they have significantly changed their staffing strategies since the Great Recession, 49 percent report they have significantly changed their approaches to enhancing efficiency in the delivery of legal services, 39 percent claim to have made significant changes to their pricing models, half report they have created special projects and experiments to test innovative ideas or methods, and 49 percent indicate they are using technology to replace human resources with the aim of improving efficiencies.[53] Over the past year, the legal press has reported on specific initiatives in a number of firms that bear out these findings.[54]

All of that being said, however, there is still much work to do to achieve real, transformative change across the market. As Altman Weil notes:

> Law firms are slowly changing – more slowly that we think is wise, but changing nonetheless. Clearly not all change efforts are resulting in overnight success. Some efforts require long-term investments that can be a tough sell with partners. Other initiatives may work quickly, but are one-time fixes that can't be replicated for year-on-year gains. We see firms making only cursory investments where they should be aiming for broader, deeper transformation. And still many partners resist change in all its forms.[55]

The stark message emerging from the trends discussed above is that the market for law firm services is being transformed – by clients, by law firms that "get it," and by alternative service providers – and that the pace of change in this transformative process is accelerating. Firms that respond proactively to these changes have every prospect of doing well. But firms that choose to ignore them may find themselves trapped in outmoded strategies and operating models that (like the Maginot Line) will fall well short of their intended results.

50 *Id.* at 10.

51 *See, e.g.,* Georgetown Law Center for the Study of the Legal Profession and Thomson Reuters Peer Monitor®, *2016 Report on the State of the Legal Market,* Jan. 2016, at 12-13.

52 Altman Weil, Inc., *2017 Law Firms in Transition: An Altman Weil Flash Survey,* May 2017 ("Altman Weil Law Firms Survey").

53 *Id.* at iii-vii.

54 *See, e.g.,* Roy Storm, "Dentons, in Latest Growth Bid, Launches In-House Consulting Service," *The Am Law Daily*, Nov. 15, 2017; Ian Lopez, "Clients Not Ready to 'Talk to a Robot,' but Jackson Lewis Bets on Automating Compliance Tasks," *The Am Law Daily*, Apr. 22, 2017; Roy Storm, "Seyfarth Shaw Puts 'Software Robots' to Use in Automation Push," *The Am Law Daily*, Feb. 7, 2017; Katelyn Polantz, "Hogan Lovells Expands into Public Relations Field," *The Am Law Daily*, Feb. 1, 2017.

55 Altman Weil Law Firms Survey at i.

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