

GEORGETOWN LAW
Center for the Study of the Legal Profession

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2016 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 Peer Monitor are pleased to present this 2016 Report setting out our views of the dominant trends impacting the legal market in 2015 and key issues likely to influence the market in 2016 and beyond.*¹

Introduction – The Dangers of Success



In the annals of American business, few firms were as successful for as long as the Eastman Kodak Company. Founded by George Eastman (the inventor of roll film) in 1880, Kodak introduced its first camera in 1888 with the memorable slogan: “You press the button, we do the rest.” For a century thereafter, Kodak dominated the market for cameras and film in the United States and much of the world. It revolutionized society by making it possible for ordinary people to record the key events of their lives – events later even rebranded as “Kodak moments” – by removing photography from the exclusive domain of professionals. By 1976, Kodak controlled 90 percent of the film market and 85 percent of the camera market in the U.S. Until the 1990s, it was regularly rated as one of the

world’s five best known and most valuable brands. In 1988, at its peak, Kodak employed over 145,000 workers worldwide. Its annual revenues peaked at nearly \$16 billion in 1996 and its profits at \$2.5 billion in 1999.²

The strategy that propelled Kodak to its long-term success was the “razor blade” business model. Just as Gillette makes money on the blades and not the razors, Kodak sold cheap cameras and relied on customers buying lots of expensive film.³ That strategy worked fine in the age of print photography when Kodak could control 80 percent of the market for the chemicals and paper used to develop and print photos.⁴ But it was not a strategy for success in an age of digital photography. In the 1990s, Kodak dragged its feet on entering the digital market in a serious way. When it did decide to get into the game, it was too late, having lost key market advantage to more nimble competitors like Sony and Canon.

History, of course, has many examples of well-established companies being blindsided by technological developments that oust them from their positions of market leadership. And if that were the whole story with Kodak, it would be just another sad though familiar tale. In the case of Kodak, however, the story is much more interesting because the new technology that ultimately destroyed the company was invented at Kodak itself!

In the mid-1970s, Steve Sasson, a young electrical engineer working at Kodak, assembled a system of electronic components that could capture an image and display it on a screen. In December 1975, Sasson and chief technician Jim Schueckler conducted the first successful test of a digital camera in Kodak’s labs. While the first camera was

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 Director; and from Thomson Reuters Peer Monitor – Justin Hines, Analyst – Client Management & Thought Leadership Benchmarking Analytics, and Evan Tepper, Consultant, Client Management & Thought Leadership.

² “Technology change – The last Kodak moment?” *The Economist*, Jan. 14, 2012.

³ *Id.*

⁴ Peter Cohan, “How Success Killed Eastman Kodak,” *Forbes*, Oct. 1, 2011, <http://www.forbes.com/sites/petercohan/2011/10/01/how-success-killed-eastman-kodak>.

fairly crude by today's standards, its technical significance was plainly understood by the company.⁵ Nonetheless, management response was tepid. As Mr. Sasson put it, "They were convinced that no one would ever want to look at their pictures on a television set. Print had been with us for over 100 years, no one was complaining about prints, they were very inexpensive, and so why would anyone want to look at their pictures on a television set?"⁶ In addition, it was not lost on company management that pursuit of digital photography would, of course, seriously undercut Kodak's lucrative film business, and that digital photography itself would not be as profitable. As a consequence, Kodak essentially chose to ignore the fundamental shift in its market – until it was too late.

Today, the first digital camera made by Mr. Sasson in 1975 is on display at the Smithsonian's National Museum of American History. President Obama awarded Mr. Sasson the National Medal of Technology and Innovation at a White House ceremony in 2009, and three years later, Kodak filed for bankruptcy.⁷

This story of the demise of Kodak is an important cautionary tale for law firms in the current market environment. Since 2008, the market for law firm services has changed in significant and permanent ways. Clients who previously deferred to their outside firms on virtually all key decisions regarding the organization, staffing, scheduling, and pricing of legal matters are now, in most cases, in active control of all of those decisions. Increasingly, clients are demanding more "value" in return for their legal spend, and by value they mean greater efficiency, predictability, and cost effectiveness in the delivery of legal services. What once was a seller's market has now clearly become a buyer's market, and the ramifications of that change are significant.

Clients today are more willing than ever before to disaggregate matters, combining the services of several different service providers in order to achieve increased efficiencies. They are more open than ever before to utilizing non-traditional service providers (including non-law firms) to provide a wide range of services previously obtained almost exclusively from law firms. And clients are far more likely today to retain work in-house, bringing their outside counsel in only where needed to supply specialized expertise or to handle matters on a discrete project-by-project basis.

Law firms have responded to these changed market conditions in largely passive and reactive ways. In the face of client insistence, most firms have taken steps to improve their budgeting capacities for client matters, adopted financial systems to facilitate alternative fee arrangements, accommodated the outsourcing of certain functions (like document review and e-discovery), and implemented some processes for project management. To date, however, very few firms have been willing to engage *proactively* in the consideration or implementation of the kinds of operational changes that would be required to respond effectively to the changed expectations of their clients.

The reactions of the law firm market to the rapidly changing environment in which firms operate parallels in some respects the story of Kodak. The current challenge in the legal market is not that firms are unaware of the threat posed to their current business model by the dramatic shift in the demands and expectations of their clients. Instead, as in the case of Kodak, the challenge is that firms are *choosing* not to act in response to the threat, even though they are fully aware of its ramifications. There are many reasons that may lead firms to make this choice, but one of the primary ones is surely that, like Kodak, many law firm partners believe they have an economic model that has served them very well over the years and that continues to produce good results today. They are consequently reluctant to adopt any changes that could put that traditional business model at risk. While that might appear to be a viable short-term strategy, the danger is – again like Kodak – that this effort to preserve their past and current success could result in law firms failing to respond to trends that over time could well challenge their traditional market positions. There is already growing evidence that those trends are well underway. It remains to be seen whether most firms will be able to avoid the dangers posed by their own success.

5 Steve Brachmann, "The Rise and Fall of the Company that Invented Digital Cameras," IPWatchdog.com/Patents & Patent Law, Nov. 1, 2014.

6 "Kodak's First Digital Moment," *The New York Times*, Aug. 12, 2015,
http://lens.blogs.nytimes.com/2015/08/12/kodaks-first-digital-moment/?_r=0.

7 *Id.*

In the sections that follow, we will look in more detail at the trends that are reshaping the market for law firm services and will offer some additional observations on the reasons that many firms seem reluctant to make the operational changes needed to respond to changed market conditions. We begin, however, with a review of the performance of U.S. law firms in 2015.

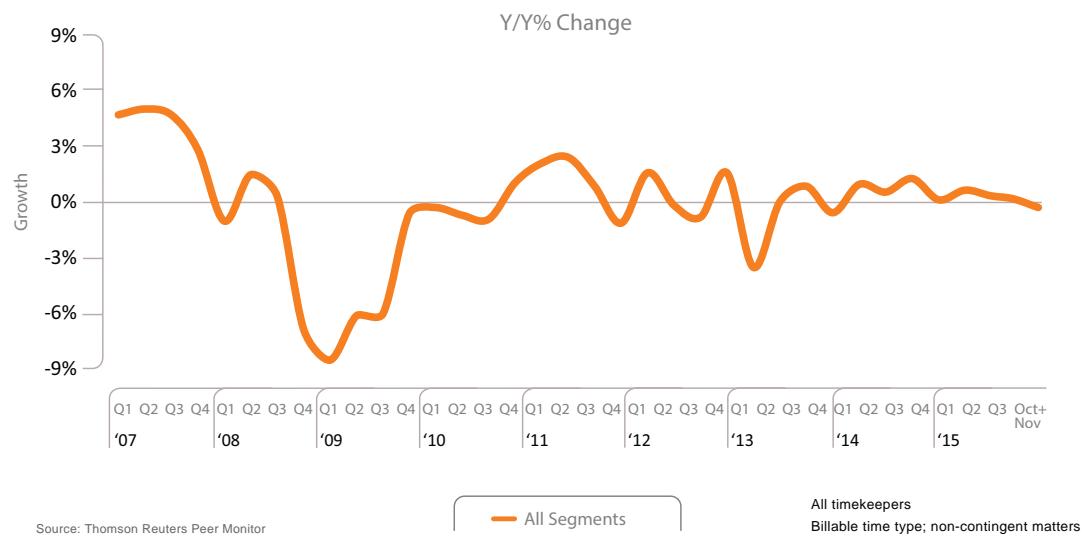
Current State of the Legal Market - By the Numbers

In what is rapidly becoming the “new normal,” it appears that 2015 will go down as another overall lack-luster year in terms of law firm financial performance. While the picture obviously differs from firm to firm – and a few firms achieved remarkably good results – in the main U.S. law firms continued to experience very sluggish growth in demand, coupled with negative growth in productivity, and continuing downward pressure on rates and realization. Indeed, there is now some evidence of a drop-off in the growth of “worked rates” – i.e., the negotiated rates actually used by firms in work for their clients – which, combined with declining realization, has led to a sharp decline in collected rates.

Demand Growth

Demand for law firm services, as tracked by Thomson Reuters Peer Monitor,⁸ was essentially flat in 2015. As shown in Chart 1 below (which tracks performance on a year-over-year basis through November 2015), this continues a pattern seen over the last six years (with the exception of a brief uptick in 2011 and a sharp negative turn in 2013). It contrasts markedly with the 4 to 6 percent annual growth in demand seen in the legal market prior to 2008. Among different segments of the market, Am Law 100 firms reported the strongest relative strength in demand growth, followed by midsize firms, and Am Law Second 100 firms.

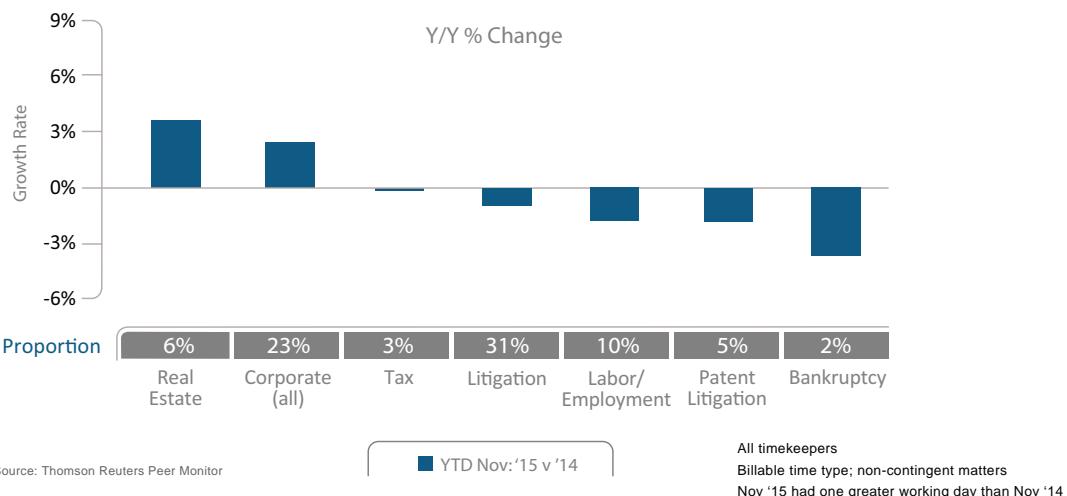
Chart 1 - Growth in Demand for Law Firm Services



⁸ Thomson Reuters Peer Monitor data (“Peer Monitor data”) are based on reported results from 143 law firms, including 48 Am Law 100 firms, 42 Am Law 2nd 100 firms, and 53 additional midsize firms. For present purposes, “demand for law firm services” is viewed as equivalent to total billable hours recorded by firms during a specified period.

As indicated in Chart 2 below, while there was some year-to-date demand growth in corporate and real estate practices, other practices experienced negative growth, including litigation and patent litigation, which together account for more than a third of all work across the market. This negative growth in demand for litigation services has been part of a trend that has been fairly consistent since the beginning of the recession in 2008.⁹ During 2015, the overall decline in litigation demand was driven entirely by Am Law Second 100 firms, as both Am Law 100 and midsize firms reported slightly positive litigation demand growth.

Chart 2 - Demand Growth by Practices



Productivity

During 2015 (through November), the number of lawyers in U.S. firms grew by some 1.3 percent, slightly less than the 1.4 percent growth rate in 2014. Although this rate of growth is modest, given the flat growth in demand, it resulted in a decline in productivity¹⁰ across the market. This result, as well as the interplay of headcount and demand growth factors on productivity over the past four years, can be seen in Chart 3 below.

Chart 3 - Balance of Demand and Capacity

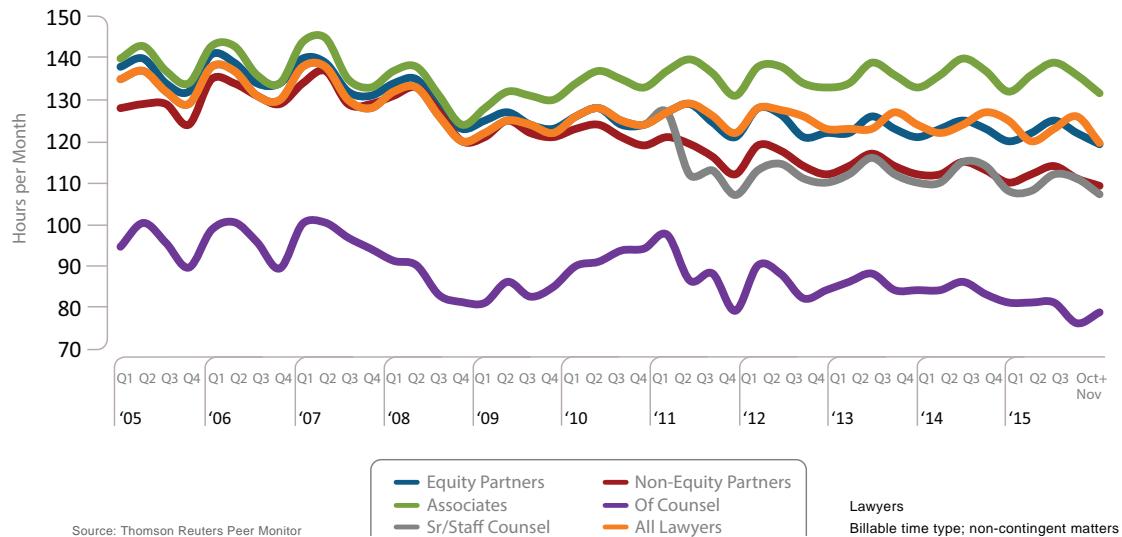


⁹ Demand growth in litigation practices did turn positive for a brief period in late 2011 and early 2012, but then returned to the downward trend seen since 2008.

¹⁰ Productivity is defined as the number of hours (billable time only) worked by lawyers divided by the total number of lawyers.

As shown in Chart 4 below, this negative growth in productivity reflects a trend that has persisted for the past several years. As can be seen, 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.

Chart 4 - Productivity (Hours per Lawyer) by Category



Rates and Realization

During 2015, law firms continued to raise their standard rates, though by a fairly modest 2.7 percent. This is reflected in Chart 5 below that shows rate growth across the market from Q1 2005 through November 2015. Although, as can be seen on the chart, the pace of rate increases has clearly slowed since the pre-recession period before 2008 (when rate increases of 6 percent a year were not uncommon), client pushback to such increases has continued to mount. This has resulted in plummeting realization rates over the same period, as indicated in Chart 6.

Chart 5 - Rate Progression

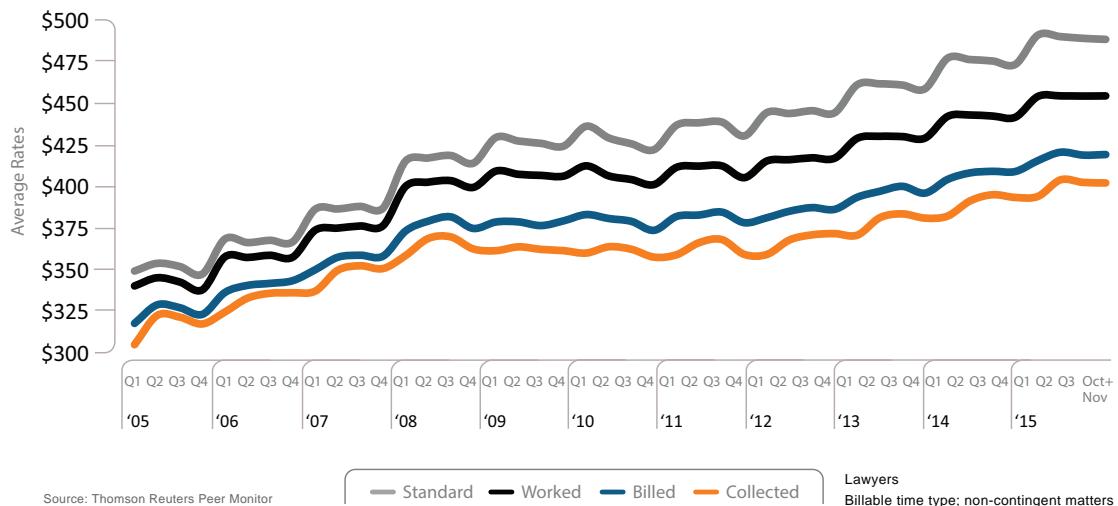
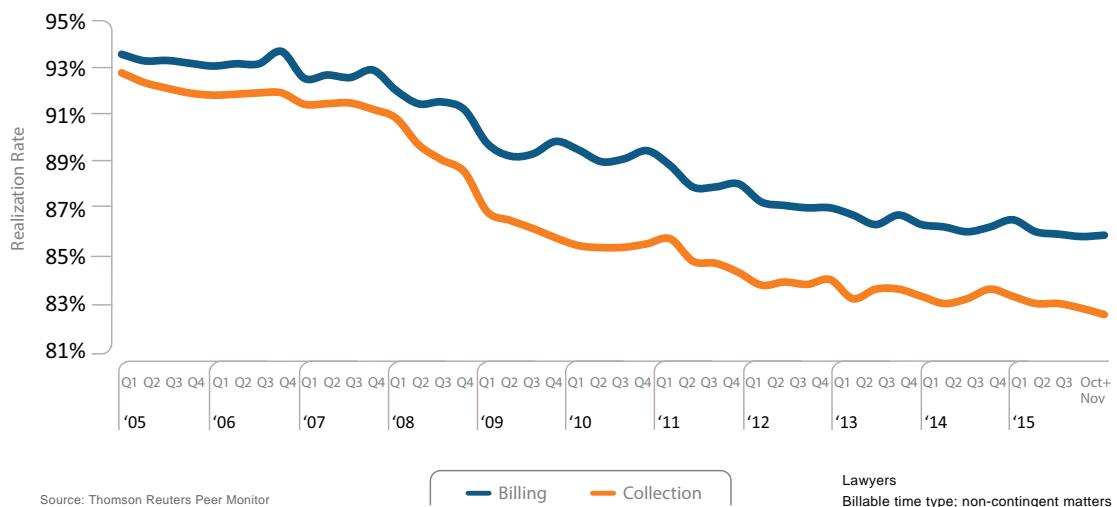
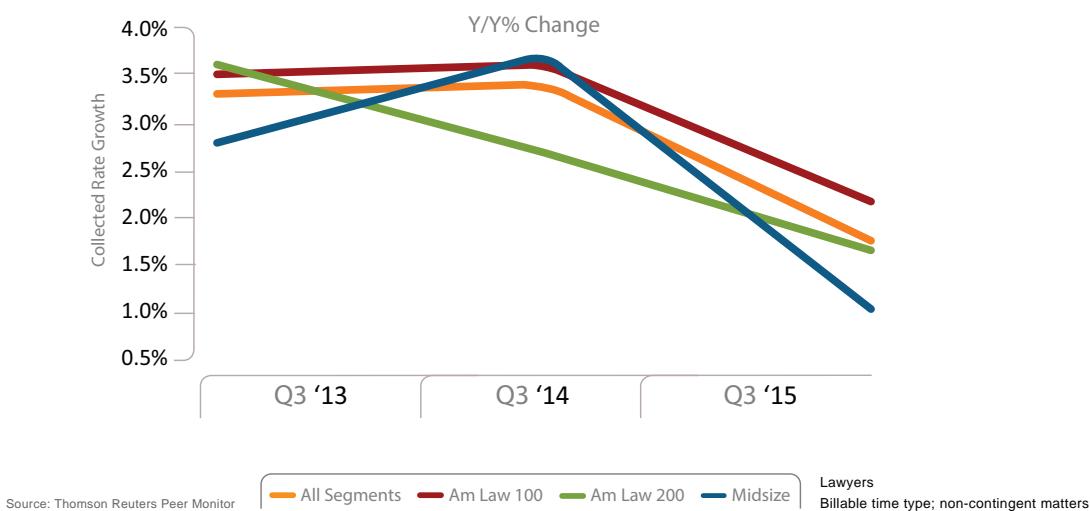


Chart 6 - Billed and Collected Realization against Standard



To some extent, despite sluggish demand growth and falling realization rates, law firms have been able to maintain their profitability levels over the past few years by their annual rate increases, even despite growing client resistance. Over the last couple of years, however, the rate of growth in worked rates – *i.e.*, the rates actually charged for work performed – has slowed considerably. Indeed, in October 2015, worked rate growth hit its lowest annualized level (2.5 percent) since February 2011. At the same time, as indicated in Chart 6 above, realization has continued to move downwards, hitting an all-time low in October 2015 as well. This combination has resulted in a formidable one-two punch as firms have seen their rate increases limited at the same time that their realization rates are dropping. As shown in Chart 7 below, that has resulted in a sharp slowdown in the growth of collected rates across the market.

Chart 7 - Collected Rate Growth



Expenses

During 2015 (through Q3), firms continued to do a good job in managing both their direct and indirect expenses as can be seen in Chart 8 below.¹¹ The levels of such expenditures are dramatically lower than in the pre-recession period and have remained essentially flat for the past three years. Chart 9 shows more detail in terms of specific categories of indirect expenditures. As can be seen, year-on-year increases in most categories in 2015 (through Q3) were fairly modest, with the notable exception of outside services, recruiting, and professional costs, but the three latter categories combined make up just over 4 percent of overall indirect expenditures.

Chart 8 - Expense Growth

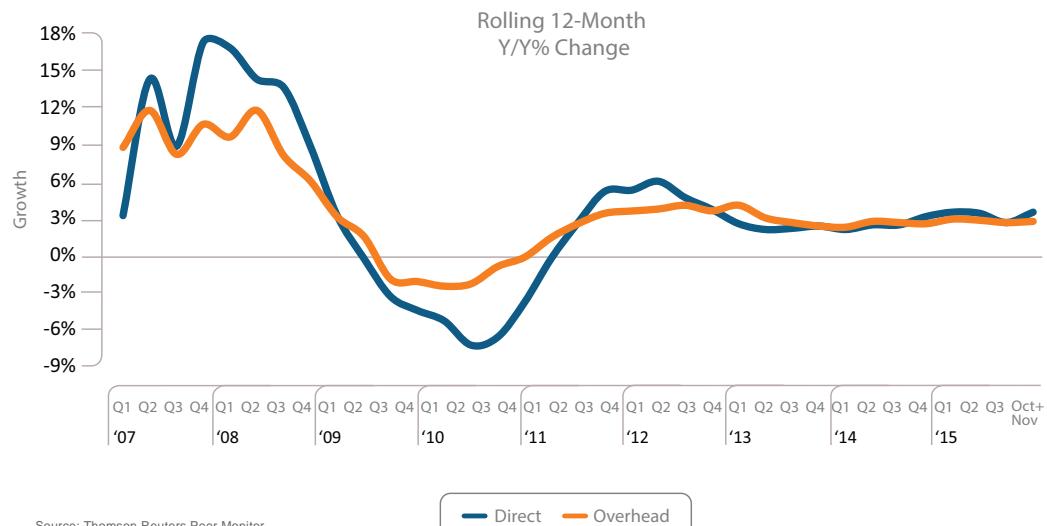
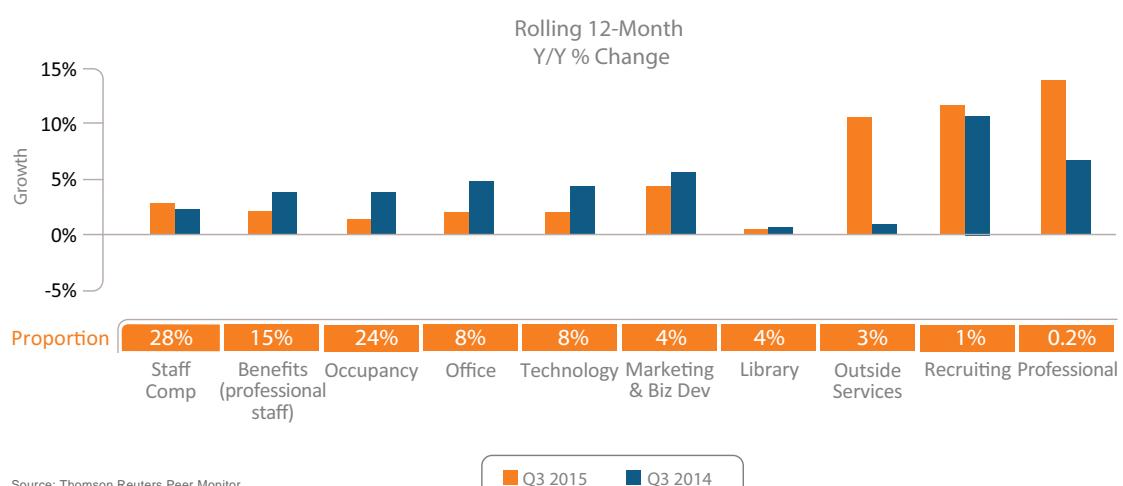


Chart 9 - Overhead Expense Detail



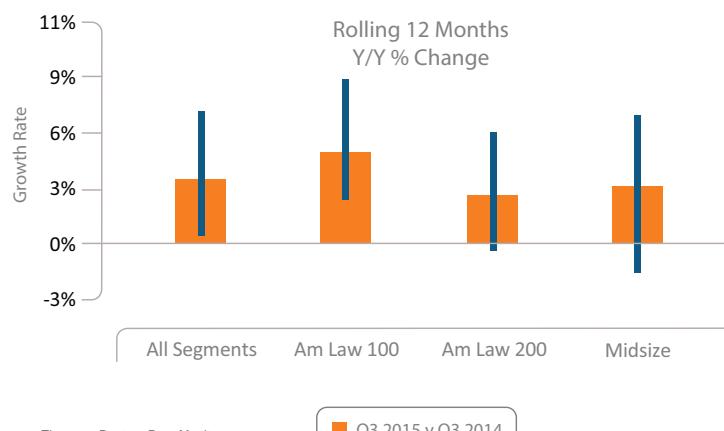
¹¹ Direct expenses refer to those expenses related to fee earners (primarily the compensation and benefits costs of lawyers and other timekeepers). Indirect expenses refer to all other expenses of the firm (including occupancy costs, administrative staff compensation and benefits, technology costs, recruiting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

Revenue and Profits

Charts 10, 11, and 12 below show the growth in overall revenue, revenue per lawyer (“RPL”), and profits per equity partner (“PPEP”) on a rolling 12-month basis through Q3 2015, for all law firms in the Peer Monitor data base, and for the three segments of firms – the Am Law 100, the Am Law Second 100, and midsize. In each case, the blue vertical line indicates the range of dispersion of results in a particular category.

As indicated by the charts, across the market as a whole, firms increased their overall revenue by 3.5 percent in the past year, increased their RPL by 2.8 percent, and increased PPEP by 4.6 percent. Am Law 100 firms led other segments in overall revenue growth, but midsize firms (somewhat surprisingly) led in RPL and PPEP growth. It should be noted, however, that in the latter case the range of dispersion was quite large (indeed more than a 25 percent spread from top to bottom) suggesting that, while some firms in the group did exceptionally well, a large number of others performed exceptionally poorly. By contrast, the range of dispersion in PPEP growth among Am Law 100 firms was much narrower (only about 15 percent from top to bottom) indicating that more firms in this category performed closer to the average for the group.

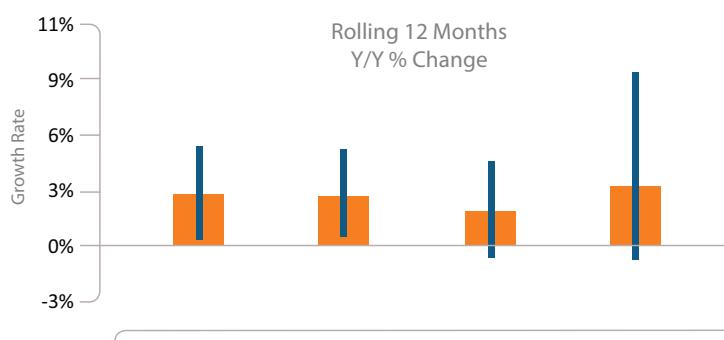
Chart 10 - Revenue Growth



Source: Thomson Reuters Peer Monitor

Q3 2015 v Q3 2014

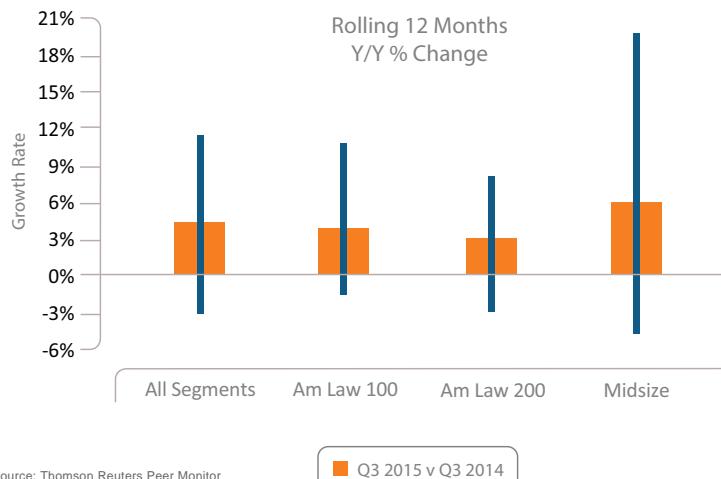
Chart 11 - Revenue per Lawyer Growth



Source: Thomson Reuters Peer Monitor

Q3 2015 v Q3 2014

Chart 12 - Profits per Equity Partner Growth



Shifting Competitive Landscape – Growing Segmentation across the Legal Market

The essentially stagnant growth in demand for law firm services (as described above) – a condition that has more-or-less persisted for the past six years¹² despite signs of strengthening in the economy as a whole – reflects to some extent a slow but ongoing erosion in the law firm percentage share of overall legal market spend. This in turn is evidence of a continuing segmentation of the market for legal and legal-related services, a segmentation that may over time adversely impact the financial performance of many law firms.

As we have noted in prior Reports,¹³ at least since the onset of the recession in 2008, law firm clients have increasingly demanded more efficiency, predictability, and cost effectiveness in the delivery of the legal services they purchase. In the main, however, law firms have been slow to respond to these demands, often addressing specific problems when raised by their clients but failing to become proactive in implementing the changes needed to genuinely meet their clients' overall concerns. As a result, increasingly clients have chosen to "vote with their feet" by reducing the volume of work referred to outside counsel and by finding other more efficient and cost effective ways of meeting their legal needs. This trend continued to be evident during 2015.

Decline in Law Firm Share of Total Market

In recent years, law firms have lost "market share" of overall legal spend to corporate law departments (as a result of decisions by corporate general counsel to keep work "in house") and to alternative service providers.¹⁴ In its 2015 Chief Legal Officer Survey of some 258 corporations, Altman Weil found that 51 percent of respondents reported increasing the internal budgets of their law departments, while only 25 percent reported decreased in-house spending. By contrast, 44 percent said they had decreased their outside counsel budgets, while 32 percent reported increasing them.

¹² There have, of course, been variations during the six-year period, with demand growth jumping in the first half of 2011, only to collapse again and become negative in 2013. It is fair, however, to describe the growth in demand as fairly "stagnant" over the full period. Source: Thomson Reuters Peer Monitor Analysis.

¹³ See 2014 Report on the State of the Legal Market (the "2014 Report"), at 7-9, and 2015 Report on the State of the Legal Market, at 7-8.

¹⁴ The "alternative service provider" category spans a wide array of non-traditional law firm service providers, including legal process outsourcing firms, legal staffing firms, accounting firms, technology consulting firms, and many others.

Significantly, every Altman Weil survey since 2011 has found more law departments decreasing their spend on outside law firms than increasing it.¹⁵ Looking forward, 40 percent of respondents indicated their intention to decrease their spend on outside counsel within the next twelve months, while only 20 percent predicted an increase.¹⁶

At the same time, corporate clients have been increasing their spend on alternative service providers, also to the detriment of law firm market share. During 2015, 16 percent of the respondents to the Altman Weil CLO Survey reported that they had increased their budgets for such outside vendors.¹⁷ While such expenditures currently represent a relatively small portion of overall law department budgets – 6.1 percent in 2015 – the outside vendor slice is growing. In 2012, it accounted for only 3.9 percent of law department spending.¹⁸

The increased market share of outside vendors reflects a proliferation of non-traditional providers of legal and legal-related services. Once regarded as an insignificant sliver of the overall legal market, such non-traditional providers have now established a firm foothold in several service areas once dominated exclusively by law firms. This market shift is documented in a lengthy report recently issued by the Center for WorkLife Law at the University of California, Hastings College of Law.¹⁹ In it, the authors identify five different models of new entities that are reshaping the delivery of legal services in certain segments of the market: (i) secondment firms that provide lawyers to work on a temporary or part-time basis in client organizations; (ii) law and business advice companies that combine legal advice with general business advice of the type traditionally provided by management consulting firms; (iii) law firm “accordion companies” that provide networks of trained and experienced lawyers to meet short-term staffing needs in law firms; (iv) virtual law firms and companies that typically drive down overhead by having attorneys work from their own homes; and (v) innovative law firms and companies that typically offer specialized services under special fee arrangements or service delivery models that differ significantly from traditional law firms.²⁰ The report describes 44 such new model firms currently operating in the United States and Canada. While many of these organizations are relatively small, some are not. Axiom Law, for example, a law and business company based in New York with 14 offices worldwide, has over 1,200 employees.²¹ And Bliss Lawyers, a secondment firm based in Boston, has a national network of some 10,000 lawyers.²²

While many of the alternative service providers described above are focused on the lower, more commoditized end of the legal services market, some have successfully penetrated the higher end by offering highly experienced lawyers to assist in specialized areas of practice. This focus on specialized services is the same approach being taken by the large accounting firms. In the late 1990s, these firms attempted to diversify from auditing and tax services by expanding into both consulting and law. The foray into the legal market was temporarily cut short by the Enron scandal that took down Arthur Andersen and resulted in new regulatory restrictions like the Sarbanes-Oxley Act. Over the past decade, however, changes in the legal market have prompted the large accounting firms to move back in. As explained in a recent article in *The Economist*:

The recession following the 2008 financial crisis prompted businesses’ general counsels to rebel against the padded bills they get from the law firms they use. In the same decade, several countries passed laws opening up their legal industries. Britain and Australia authorised ‘multi-disciplinary practices’ . . . , which let attorneys share profits, without restriction, with members of other professions.

15 Altman Weil, Inc., *2015 Chief Legal Officer Survey: An Altman Weil Flash Survey*, Nov. 2015 (“Altman Weil CLO Survey”), at iii and 17.

16 The 39.9 percent predicting a decrease in spending compares with 26.2 percent who predicted decreases in 2014 and 29.1 percent in 2013. *Id.* at 4.

17 *Id.* at 18.

18 *Id.* at 21.

19 Joan C. Williams, Aaron Platt, and Jessica Lee, *Disruptive Innovation: New Models of Legal Practice*, Center for WorkLife Law, University of California, Hastings College of Law, 2015.

20 *Id.* at 2.

21 *Id.* at 33-34.

22 *Id.* at 31-32.

So, the Big Four moved back in, buying small law firms, poaching partners from others and recruiting on campuses. With the flexibility to offer discounted, fixed fees, they started to win lots of corporate legal work. In recent years the quartet's combined legal revenues have grown at double-digit rates.²³

In some jurisdictions, the accounting firms have actually acquired and control law firms, while in other places they have formed collaborations or offer legal-related services that do not constitute the formal practice of law.²⁴ Their strategy has not been to offer a full range of legal services, but rather to focus on specialized services that complement the services their organizations already offer – e.g., immigration, labor and employment, compliance, commercial contracts, and due diligence activities. One consultant has estimated that, measured as a proportion of the combined revenues of the ten largest law firms in each country, the aggregate market penetration of the Big Four accounting firms into the legal market currently ranges from 4 percent in China and 6 percent in Britain to 20 percent in Germany and 30 percent in Spain.²⁵

The combined effect of all of these forces has been a slow but steady erosion of the market share controlled by traditional law firms. Not surprisingly, the erosion began at the lower end of the market with legal process outsourcing firms skimming off routine but lucrative document review and e-discovery functions. It has now spread, however, to more middle-market activities as alternative service providers have amassed networks of experienced lawyers to assist clients through secondment arrangements and have developed increasingly sophisticated software to streamline “pattern recognition” functions traditionally performed by lawyers (such as the drafting of standardized documents or the review and management of contracts). In some cases, the services of non-traditional providers – particularly highly qualified specialists – are being called upon in connection with the most important matters of corporate clients.

This is not to suggest, of course, that law firms are on the brink of extinction. Firms at the highest end of the market will always be sought out for critical bet-the-company work. And there remains a substantial market for firms that can provide highly professional and creative services to help clients navigate their way through difficult disputes, create new and innovative financing vehicles, or provide bench strength for handling a large and complex litigation or transaction. But the range of activities that *only* traditional law firms can undertake will continue to narrow as alternative service providers become more expansive in their capacities and as software development increases the automation of once heavily labor-intensive activities. To prosper in the newly segregated market, law firms will need to seriously address the inefficiencies and unnecessary costs that have become deeply embedded in the way most firms operate. As *The Economist* noted: “[L]aw firms that are sub-scale and inefficient risk ruin. The Walmarts and Amazons of professional services are at their gates, and the legal industry’s halting pace of creative destruction is set to accelerate as a result.”²⁶

Growing Segmentation within Law Firm Market Share

In our 2014 Report on the State of the Legal Market, we noted that “there is now strong evidence that the U.S. legal market has segmented into discernible categories of highly successful and less successful firms, and that the performance gaps between those categories have been steadily widening.”²⁷

23 “Lawyers Beware: The Accountants Are Coming after Your Business,” *The Economist*, Mar. 22, 2015, <http://uk.businessinsider.com/lawyers-beware-the-accountants-are-coming-after-your-business>.

24 Accounting firms are currently permitted to own and control law firms in Australia, Britain, and Mexico. In China, France, Germany, Ontario (Canada), Italy, Japan, and Spain, while accountants cannot own law firms, they are permitted to work collaboratively and share costs with them. *Id.*

25 *Id.* quoting Michael Roch of Kenna Partners. Roch describes the Big Four accounting firms as “the biggest underestimated threat to the legal profession today.”

26 *Id.*

27 2014 Report, at 11.

As we noted, this trend has been evident within both the Am Law 100 and Am Law Second 100 firm categories:

The top Am Law 100 firms are largely New York-centric, with market-leading practices that can command premium rates. The leading Am Law Second 100 firms are more dispersed geographically, are smaller than the average Am Law Second 100 firm (both in total numbers and in equity partners), and have intensely focused practices that command much higher rates from excellent clients. In each grouping, however, the difference in performance of these high achieving firms is so significant from others in their size category that there is every likelihood that the emerging market segments could begin to harden, forming effective barriers to entry that would make it far more difficult for other firms to move into these elite classes.²⁸

This market segmentation trend continued during 2015. In its analysis of the 2015 Am Law 100 list, *The American Lawyer* noted that the gap between the highest performing firms and others included in the Am Law 100 ranks has continued to widen. For example, the 25 largest U.S. firms now account for more than half of all Am Law 100 profits, more than doubling their percentage from the first Am Law 100 list published some 30 years ago. Moreover, the \$5 million gap in average profits per partner reported in 2015 between the most profitable firm in the Am Law 100 and the least profitable firm is the largest in the history of the Am Law 100.²⁹

The widening gap between high performing firms and lower performing firms has also been confirmed by Citi Private Bank Law Watch. In a study of 163 law firms conducted in August 2015, Citi compared the dispersion of financial performance (as measured by various indicators of firm profitability) of firms in 2009 with their performance five years later in 2014. The analysis confirmed that performance dispersion between quartiles generally widened, particularly *between* the first quartile firms (as measured by profitability factors) and the second quartile firms. But the study also found that performance dispersion *within* each quartile increased as well.³⁰

While there are many reasons that some law firms outperform others – including historic location, practices, and client base – there is now mounting evidence that firms that have responded proactively to changing client expectations by making strategic changes to their lawyer staffing, service delivery, and pricing models are outperforming their peers in terms of financial results. In its 2015 Law Firms in Transition survey of some 320 U.S. law firms, Altman Weil found that firms that had made these strategic changes were consistently more likely to see increases in gross revenue, RPL, and PPEP than firms that had not.³¹

More specifically, the Altman Weil Law Firm Survey found that some 77 percent of firms that made significant changes to their lawyer staffing models reported increases in their PPEP in 2014, compared to only 56 percent of the firms that had not made such changes. Similarly, some 76 percent of firms making significant changes to improve the efficiency of their legal service delivery models saw increases in their PPEP, as compared to only 61 percent not making such changes. And 75 percent of firms that made significant changes to their pricing models reported increases in PPEP, as contrasted with only 66 percent of firms that had not changed their approach.³² These same changes also impacted firm financial performance in terms of growth in gross revenues and in RPL, though to a somewhat lesser extent.³³

28 *Id.* at 12.

29 Chris Johnson, "Rich and Richer," *The American Lawyer*, May 2015, at 98, 101.

30 Presentation by Dan DiPietro, Managing Director/Chairman, Citi Law Firm Group, at Thomson Reuters COO/CFO Forum, New York, Oct. 29, 2015.

31 Altman Weil, Inc., *2015 Law Firms in Transition: An Altman Weil Flash Survey*, May 2015 ("Altman Weil Law Firm Survey"), at iv.

32 *Id.* at 26, 54, and 58.

33 Among firms making strategic changes to their lawyer staffing models, 73 percent saw increases in gross revenues in 2014, compared to 66 percent of firms not making such changes; and 77 percent reported increases in RPL, compared to 60 percent of firms that did not embrace such changes. *Id.* at 26. As to strategic changes in service delivery models, 76 percent of firms making such changes had increases in gross revenues, as contrasted with 66 percent of firms that did not adjust their models; and 76 percent of firms using new models saw increases in their RPL, as compared to 62 percent of firms that did not make such adjustments. *Id.* at 54. For firms that adopted significant changes in their pricing models, 75 percent reported increases in their gross revenues, compared with 70 percent of firms not making such changes; and 74 percent experienced higher RPL, as contrasted with 67 percent of firms not embracing new pricing models. *Id.* at 58.

The findings of the Altman Weil report are supported by a smaller but more detailed survey conducted in September 2015 by Thomson Reuters Peer Monitor. That survey collected data from 34 Peer Monitor firms on specific operational changes made to respond to client expectations for more efficiency, predictability, and cost effectiveness in the delivery of legal services. Breaking the respondent firms into two categories on the basis of their overall financial performance, the data were then analyzed to determine the frequency with which upper-tier firms had pursued the various operational changes as compared to lower-tier firms within the last three years. The analysis showed that, while lower-tier firms had not implemented any changes with significantly more frequency than the upper-tier firms,³⁴ the firms with better overall financial performance had outpaced the lower-tier firms in several important categories, including the following:

Operational Change	% of Upper-Tier Firms Implementing	% of Lower-Tier Firms Implementing
Technology: Use of software that allows firm lawyers to monitor the progress of matters, resource commitments, and budget status in real time on a matter basis	71	47
Technology: Efficient and easily usable knowledge management system that provides lawyers with ready access to the firm's prior work product	71	59
Technology: Document review software using predictive coding based on a "seed sample" of documents provided by firm lawyers	71	35
Technology: Client "self-help" tools that allow clients to perform tasks directly that previously required active participation by firm lawyers	29	12
Technology: Use of project management software	53	35
Technology: Use of e-learning systems	65	29
Outsourcing: Use of third-party service providers for non-legal research	24	6
Insourcing: Use of special units/divisions within the firm for due diligence	41	12
Insourcing: Use of special units/divisions within the firm for non-legal research	35	12
Insourcing: Use of special units/divisions within the firm for non-legal drafting	24	6
Strategies: Use of a detailed project budgeting model	76	59
Strategies: Incorporation of project management/ profitability results into lawyer evaluation/ compensation process	59	35
Staff Support: Use of administrative staff to assist firm lawyers in project/matter billing	94	76
Staff Support: Use of administrative staff to assist firm lawyers in client/practice/matter profitability improvement	76	65

While neither of these studies is conclusive, both strongly suggest that firms that are proactive in pursuing new strategies to meet the concerns and expectations of their clients are more likely to achieve stronger financial results than those firms that merely react to specific client demands. That is, of course, not surprising. What is surprising is that more firms do not seriously pursue the operational changes that would make them more competitive in the current market.

³⁴ The only operational change that lower-tier firms implemented with significantly more frequency than upper-tier firms was a program of regular visits to significant clients by key management other than lawyers providing the services. The survey found that 82 percent of lower-tier firms had pursued this strategy, as opposed to only 53 percent of upper-tier firms. On the other hand, 53 percent of upper-tier firms reported using a regular program of client interviews by in-firm staff other than lawyers providing the services, a strategy adopted by only 35 percent of lower-tier firms.

Fixation on Growth versus Market Differentiation and Profitability

In the face of the significant shifts in market dynamics that have impacted the legal industry since 2008, perhaps the most noticeable trend has been an apparent fixation on growth, as many firms appear to have adopted growth as their primary strategy. Law firm mergers and lateral acquisitions have surged in recent years. Indeed, through December 3, 2015, Altman Weil reported there had been 84 mergers involving U.S. law firms, the largest number since the consultancy began tracking merger activity nine years ago.³⁵

As we have noted in previous reports³⁶ and as other observers of the legal market have pointed out,³⁷ growth as a strategic goal is not always a wise course for law firms to pursue. Above a certain size, there are no real economies of scale in the law firm business model, and law firms – unlike high tech enterprises for example – get no benefit from a “network effect” where having more users (or clients) inherently increases the value of the product or service being offered. Moreover, as repeated analyses have demonstrated, there is no correlation between firm size and profitability.³⁸ Unfortunately, as law firms grow (particularly through mergers and large acquisitions) it all too often means that they face even greater challenges in offering fully integrated, quality services and become even less differentiated from their competitors. It is certainly arguable that most firms would be better served by strategies focused on responding more seriously to the expectations of their clients, tending to the profitability of their organizations, and differentiating themselves on the basis of the quality and efficiency of their service. This is not to say that growth is necessarily bad but rather that a fixation on growing market share through mergers and large acquisitions can have downside risks, not the least of which is diverting energy and attention away from making the difficult operational changes that are required for firms to remain competitive in the current legal market.

The problem, of course, is that making significant operational changes – e.g., implementing new staffing models, redesigning legal work processes, or adopting new pricing strategies – is hard and inevitably runs into stout resistance from partners or principals who see no reason to change methods that have “always worked before” (the Kodak-like “danger of success” trap that we previously described). Such resistance is common in all organizations, but it can be especially strong in law firms for a variety of reasons, two of which loom particularly large.

First, most law firms remain locked in a “billable hour mentality” that makes it difficult for their partners or principals to think creatively about alternative approaches to legal service delivery, a problem that is not just (or perhaps even primarily) about alternative fee arrangements. Most firms of any size today are accustomed to using fee structures that are not controlled by billable hours,³⁹ but most still retain the billable hour as their key metric for other purposes. Lawyer evaluation and compensation systems usually incorporate a heavy billable hour component. Indeed, many firms still tie bonuses for associates and other lawyers to billable hour targets. Additionally, billable hours still remain the basic building block for matter or project budgets in most firms, and the “profitability” of matters is often assessed with primary reference to how close billings come to matching the “full value” of established hourly

35 Source: Altman Weil MergerLine™, <http://www.altmanweil.com/index.cfm/fa/m.home/bl/1/dtYear/2015/altman-weil-merger-line-for-2015.cfm>.

36 See 2014 Report, at 9-11.

37 See, e.g., M.P. McQueen, “Growth Won’t Solve Your Firm’s Problems: Harvard Business Prof,” *The American Lawyer Daily*, Nov. 23, 2015.

38 *Id.*

39 The Altman Weil Law Firm Survey found that, in 2014, over 93 percent of the 320 respondent firms used at least some non-hourly based billing, with 28 percent of firms reporting the percentage of firm revenues attributable to such billings as 6 to 10 percent, 24 percent of firms at 11 to 15 percent of revenues, 12 percent at 16 to 20 percent of revenues, and 12 percent at over 20 percent of revenues. Altman Weil Law Firm Survey, at 62-63. Moreover, it should be noted that the survey probably understated the real impact of client-imposed alternative fee structures. If one were to ask (which the survey did not) what percentage of the respondent firms’ revenues are covered by client-imposed budgets with meaningful caps, the percentages would be significantly higher – no doubt well over 50 percent. Indeed, law firm management consultants Fairfax Associates have noted that “[i]t is not unusual for firms to have 80% of their revenue from fee arrangements based on something other than standard hourly rates.” <http://www.fairfaxassociates.com/insights-series/2015/2/20/finally-time-to-deal-with-pricing>. Although budget/cap arrangements may not technically be “non-hourly based,” they are clearly not hourly fee arrangements in the traditional sense.

billing rates. The latter practice reflects the common – though often mistaken – assumption that work *must* be profitable for a firm if full hourly billing rates are being charged.

It seems doubtful that law firms will ever be able to respond fully to client expectations for more efficient and cost effective delivery of legal services unless and until the stranglehold of the billable hour mentality is finally broken. The most obvious alternative is, of course, to implement rigorous cost and profitability accounting systems, as used in most other businesses. And, in the law firm context, that requires the evaluation of costs and profitability at the matter level. In building project budgets, firms should calculate the actual hourly costs (not billing rates) for all lawyers and other staff required to deliver the anticipated services – factoring in both direct and indirect compensation costs – and should then add additional costs associated with the work including an appropriate allocation of firm overhead. Such an exercise would provide an opportunity to consider whether certain costs might be reduced by down-sourcing or outsourcing particular activities, by changing the assumed staffing mix, or by improving the work process in other ways. The hourly cost rates, as finally determined, would be the primary component of a project budget and would become the key metric for determining the firm's ultimate success in managing the project and in achieving an acceptable level of profitability.

While matter-level profitability assessment has been adopted in some firms, it has been strongly resisted in many others by partners and principals long accustomed to thinking primarily in terms of the billable hour. Up to this point, firms have been able to tolerate this resistance primarily because of their continuing ability to raise rates on an annual basis. As previously noted, however, client resistance to rate increases has mounted steadily since 2008. This is reflected in growing demands for discounts, plummeting realization rates, and a noticeable slowing in the growth of collected rates. It is also reflected in clients "voting with their feet" (as described above) as the law firm share of the overall legal market has begun to contract.

A second reason that many law firms find it difficult to embrace significant operational changes relates to the amount of decision-making authority conferred on firm leadership to undertake such changes, whether in response to client expectations or in order to improve the firm's overall economic performance. In its 2015 Law Firm in Transitions Survey, Altman Weil asked the 320 respondent firms to rank on a one-to-ten scale the extent to which their firms conferred on their leaders decision-making authority to drive change efforts. Among the respondents, 15 percent reported their delegation of such authority as "high" (i.e., ranked as a "9" or "10" on the scale), while 28 percent assessed their delegation as "low" (i.e., ranked from "0" to "5" on the scale). Comparing the financial performance of these firms from 2013 to 2014, the survey found that 76 percent of the firms rated "high" in delegation of authority saw their RPL improve, 14 percent more than the "low" delegation firms; 74 percent experienced growth in PPEP, 11 percent more than the "low" firms; and 74 percent had increases in gross revenue, 9 percent more than "low" delegation firms.⁴⁰ While not conclusive, these results certainly suggest a correlation between the degree of decision-making authority conferred on law firm leaders and better economic performance. Unfortunately, however, in many firms the idea of granting significant decision-making authority to firm leadership is viewed as inconsistent with the "democratic values" of the partnership structure.

For historic reasons, partnership (or its equivalent in professional corporations) is by far the most prevalent form of governance structure for law firms of all sizes. While this form made sense when firms were much smaller and less complex, it is questionable whether the broadly participatory decision-making style reflected in the traditional partnership model can work as effectively in today's law firm environment. *The National Law Journal's* list of the 350 largest U.S. law firms in 2015 showed an average size of 421 lawyers, with the smallest firm on the list having 116 lawyers.⁴¹ *The American Lawyer's* 2015 Am Law 100 list disclosed 23 firms with over 1,000 lawyers, 22 firms with over \$1 billion

⁴⁰ Altman Weil Law Firm Survey, at 6, 8. Equally interesting, only 9 percent of "high" delegation firms experienced a decrease in RPL, as compared to 22 percent of "low" delegation firms and only 15 percent saw a decrease in PPEP, as compared to 28 percent of "low" firms. *Id.*, at 8.

⁴¹ See <http://www.nationallawjournal.com/id=1202728576002/Chart-The-2015-NLJ-350>.

in gross revenues, and five firms with over \$2 billion in gross revenues.⁴² Many of these firms reported scores of offices spread across dozens of countries. With such large and complex organizations, it is imperative that key strategic and operational decisions be entrusted to leadership teams empowered to act with broad authority on behalf of their firms.

This is not to suggest that firm leaders should be given a blank check, that they should be permitted to function without oversight, or that they should operate without transparency. Indeed, the sad story of Dewey & LeBoeuf is a powerful cautionary tale of what can happen if management is left unchecked. But it *is* to argue that law firm partners must understand that the exercise of their “ownership” rights can no longer entitle them to exercise a veto over every key management decision or to approve in advance changes in firm operating systems or models. Other professional service firms (including accounting firms and consulting firms) have made adjustments to their governance structures to make them more responsive to the demands of their market environments. Law firms need to do the same. This is important not only to enhance such responsiveness, but also to enhance the likelihood that decisions will be made with an eye on the long-term viability of the firm rather than the short-term interests of individual partners.

As the law firm management consultancy Fairfax Associates noted in a publication a year ago:

While the traditional partnership model has served law firms well historically, it may be time to rethink the structure and function of the partnership. Firms should be asking themselves what it means to be a partner and how to ensure that partners contribute as true owners of the business. They should also consider if their current partnership model is most appropriate in terms of governance, management and financing. While the current model may continue to work well for some firms, others may need to rethink how they apply the partnership structure more effectively and still others may want to consider alternative structures. Ultimately, in order to sustain growth and competitiveness for talent and clients over time, firms need to look ahead and think about new approaches to structuring the provision of legal services.⁴³

Conclusion

Few observers of the legal market would disagree that, at least since 2008, the market has changed in fundamental ways. Not only has demand growth slowed dramatically, but the competitive dynamics of the market have shifted as well. Clients who once deferred to their outside law firms on all key decisions impacting the legal services they purchased no longer do so. Instead, clients increasingly demand that outside counsel offer more efficient services with more transparency into both work processes and costs. Clients are also more prepared than ever before to disaggregate matters, to retain work in-house, and to bring in additional (even non-traditional) service providers – all in an effort to reduce costs and improve efficiency.

One overall impact of these market changes has been the slow but steady erosion of law firm share of clients' total legal spend. That erosion, combined with sluggish growth in overall legal expenditures, has resulted in a dramatic increase in competition in the market for law firm services. As firms have scrambled to meet this new competitive challenge, the market has noticeably segmented, with a relatively small number of firms emerging as highly successful while most others continue to struggle with the unrelenting pressures of an increasingly unforgiving market.

Thus far, most firms – even those performing at the lower end of the economic scale – have been able to maintain some semblance of stability by bolstering their PPEP through an intentional thinning of

42 See “The Am Law 100” (Special Section), *The American Lawyer*, May 2015.

43 Fairfax Associates, “Time to Rethink Partnership?” Dec. 15, 2014, <http://www.fairfaxassociates.com/insights-series/2014/12/15/time-to-rethink-partnership>.

their ranks of equity partners, aggressive expense management, and annual rate increases (albeit smaller increases than prior to 2008). Now, however, the effectiveness of those levers is beginning to wane. In most firms, there isn't much additional trimming that can be done in the equity partner ranks. (Indeed, some firms are now moving away from two-tiered partnerships altogether, citing the need to give non-equity partners more "skin in the game.")⁴⁴ Expense management has been quite successful over the past several years, but with annual expense growth in most firms now hovering at around 3 percent,⁴⁵ there isn't much fat left. As for annual rate increases, as previously noted, under mounting pressure from clients, there has now been a discernible slowing in the growth of worked rates, combined with a continuing decline in realization. All of which is to say that the economic pressures felt by most firms are not likely to dissipate in the foreseeable future.

Under these circumstances, it would seem that more firms would be actively embracing the need to change their basic operating models – to design and implement new approaches to staffing and legal work processes, to explore new opportunities for collaboration with other service providers, and to adopt and market innovative strategies for the pricing of their services. While a few firms have been proactive in pursuing these opportunities, the vast majority has not. Like Kodak, they have been locked in a kind of denial driven inertia, a belief that somehow the model that brought them past success will see them through now as well. As with Kodak, their approach might work for a while, but ultimately the firms that succeed will be those that not only understand the dynamics that are driving the current legal market but also have the courage to make the changes necessary to respond to them.

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⁴⁴ See, e.g., Susan Beck, "Baker & Hostetler Votes to Nix Nonequity Partner Tier," *The American Lawyer Daily*, Sept. 11, 2015.

⁴⁵ Source: Thomson Reuters Peer Monitor.



2016 Report on the State of the Legal Market

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