GEORGETOWN LAW
Center on Ethics and the Legal Profession

Thomson Reuters Institute

2023 Report on the State of the Legal Market

Mixed results and growing uncertainty

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What a difference a year can make! During 2021, the legal market experienced its best financial year since before the Great Financial Crisis of 2007-2008. Most law firms saw unprecedented demand growth in transactional practices and in headcount, the combination of which drove fees and revenues up significantly, resulting in record profit levels and double-digit growth in profits-per-equity-partner (PPEP) across all sectors of the market.

In stark contrast, throughout 2022, growing political and economic uncertainty significantly reduced the market appetite for transactional work. Am Law 100 firms in particular saw their demand decline precipitously. At the same time, law firms continued to add new lawyers at a healthy pace. As a result, productivity declined, even as direct and overhead expenses remained stubbornly high. Rates continued to show healthy growth, although at a slower pace than the growth of inflation. All of these factors combined to pull PPEP down from 2021, though it still remains in a very healthy position historically.[1]

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The financial declines of 2022, combined with substantial uncertainty about the depth and duration of the current economic downturn in the United States and throughout the world, the challenge of returning to the office post-pandemic, the continuing issues of talent and lawyer retention, and the impacts of on-going market segmentation, all set the stage for a challenging year for law firm leaders in 2023.

Times of uncertainty always create anxiety within organizations and a tendency to hunker down to protect against both real and imagined danger. To lead successfully through such periods requires leaders to embrace somewhat different priorities and to be willing to experiment with new ways of doing things. As Peter Drucker put it, "A time of turbulence is a dangerous time, but its greatest danger is a temptation to deny reality."[2]

1 Financial data for this report are provided by Thomson Reuters Financial Insights. Data are based on reported results from 170 US-based law firms, including 46 Am Law 100 firms, 47 Am Law Second Hundred firms, and 77 Midsize firms (US-based firms ranked outside of the Am Law 200).

2 Peter F. Drucker, *Managing in Turbulent Times* (New York: Harper Collins, 1980).

Some lessons in leading through uncertainty

In the early afternoon of August 5, 2010, at the San José copper and gold mine in the Atacama Desert near Copiapó, Chile, 700,000 metric tons of rock (twice the weight of the Empire State Building) caved in, trapping 33 miners deep underground.[3] Two days later, a second rockfall blocked the ventilation shafts in the area where the miners were trapped. Considering the extreme depth of the area where the miners had been working – 2,300 feet below the surface – experts at the scene estimated the chances for a successful rescue at less than 1%. Yet, 69 days later, on October 13, all 33 miners (dubbed *Los 33*) were winched up alive in a televised drama watched by over a billion people worldwide.

The story of how these 33 miners survived their ordeal, persevering against extraordinary odds, holds some important lessons for how effective leaders can help organizations (including law firms) persevere through periods of uncertainty. To be sure, organizations rarely if ever face uncertainties as severe or as consequential as those that confronted the Chilean miners, but it is often in extreme situations that critical leadership traits are most visible.

Although the rescue of the Chilean miners resulted from the efforts of many people – including the work of an extraordinary team on the surface supported by engineers and experts from many different countries – there is no question that a key role was played by Luis Urzúa, the shift foreman who was trapped with the ill-fated group of miners. Urzúa had been shift foreman for several years and was a recognized leader who was trusted by his men; however, the mine collapse landed him in a situation that pushed his leadership skills to the limit. He recognized immediately the gravity of the situation and the extraordinary difficulty of any rescue attempt. Yet he also understood that the chances of survival – however remote – critically depended on how he responded to the situation. The precepts that guided his behavior are instructive for any leader facing situations of significant uncertainty.

Tell the truth – Urzúa recognized from the first moment that telling the truth to the trapped miners was essential. If there was any hope of survival, the men had to be collectively committed to doing whatever was required to enhance their chances, and that meant they had to fully understand the risks they faced. As one miner put it, "Every day [Urzúa] told us to have strength. If they find us they find us, if not, that's that." Things were especially hard for the first 17 days when there was no contact at all with the outside world. But, even after the first probe broke through, Urzúa – who received three daily briefings from the surface — kept the men completely up to date on the progress of the rescue efforts.

3 For more details concerning the Chilean mine disaster, *see* Maureen Corrigan, "The Incredible Story of Chilean Miners Rescued from the 'Deep Down Dark,'" National Public Radio (Fresh Air) (Oct. 29, 2014) https://www.npr.org/2014/10/29/359839104/the-incredible-story-of-chilean-miners-rescued-from-the-deep-down-dark; Rory Carroll and Jonathan Franklin, "Chile miners: Rescued foreman Luis Urzúa's first interview," The Guardian (Oct. 14, 2010) https://www.theguardian.com/world/2010/oct/14/chile-miner-luis-urzua-interview; Jonathan Franklin, "Luis Urzúa, the foreman keeping hope alive for Chile's trapped miners," The Guardian (Sept. 4, 2010) https://www.theguardian.com/world/2010/sep/05/luis-urzua-chile-trapped-miners; Wikipedia, "2010 Copiapó mining accident," https://en.wikipedia.org/wiki/2010_Copiapó_mining_accident.

Require teamwork – In crisis, it's difficult to keep people focused on the team rather than themselves. One of the techniques that Urzúa used to remind the miners that they were all in this together was to insist on collective decision-making. On the first day of the disaster, Urzúa removed his distinctive white supervisor's helmet and announced to his workers, "We are all equal now. ...There are no bosses and employees." With Urzúa's help, the men organized themselves into work shifts, participated in daily prayer sessions, and agreed to ration their emergency food supply into one meal a day of two cookies and a spoonful of tuna fish, augmented by water drained from industrial waste containers. Everything was voted on, and tasks – including relocating the group's sleeping area, mapping the remaining tunnels to which they had access, digging a new well, and many others – were carried out on a consensus basis. After his rescue, Urzúa said that the secret for keeping his men bonded and focused on survival was majority decision-making. As he put it: "You just have to speak the truth and believe in democracy."

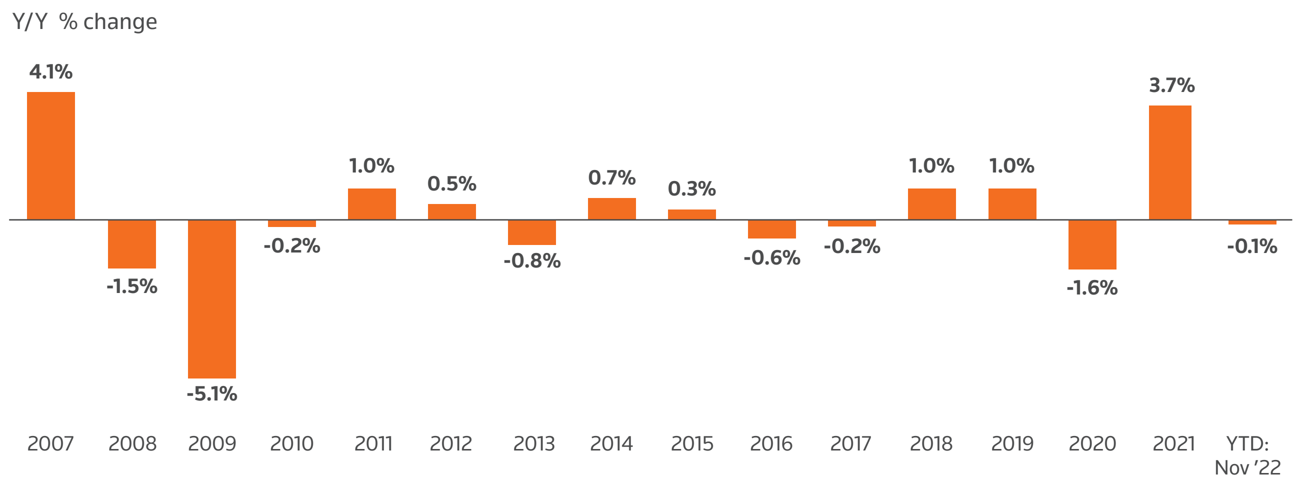
Stay focused – Urzúa, a former football coach, realized that the best way to survive clutch situations is to stay focused on the job at hand and not to overthink the obstacles confronting you. In other words, to enhance your chances of success, focus on the goals and not on the odds. Everything Urzúa led his men to do was focused on getting out and surviving in the interim. Every man had a job. Some mapped tunnels, others dug for fresh water, still others kept living conditions acceptable, while others provided medical care. And one (a preacher who had worked in mining for 33 years) led organized daily prayers and became the miners' pastor. By the end, the miners were so bonded that they asked rescuers if they could all remain on the site until the last man was brought to the surface. Not surprisingly, that last man was Luis Urzúa.

As law firms confront a period of significant economic and market uncertainty, the lessons that emerge from the leadership of Luis Urzúa can provide some useful guidance. But before turning to that discussion, we will look first at the financial performance of the legal market over the past year.

Review of law firm financial performance in 2022

The most prominent characteristic of law firm financial performance in 2022 was the substantial slowing in demand growth that firms experienced throughout the year. On a year-to-date (YTD) basis through November 2022, overall demand contracted by 0.1%. As shown in Figure 1, that result stood in stark contrast to the 3.7% growth rate recorded for all of 2021 (which admittedly was bolstered by the dip in 2020).

Figure 1: **Growth in demand for law firm services**



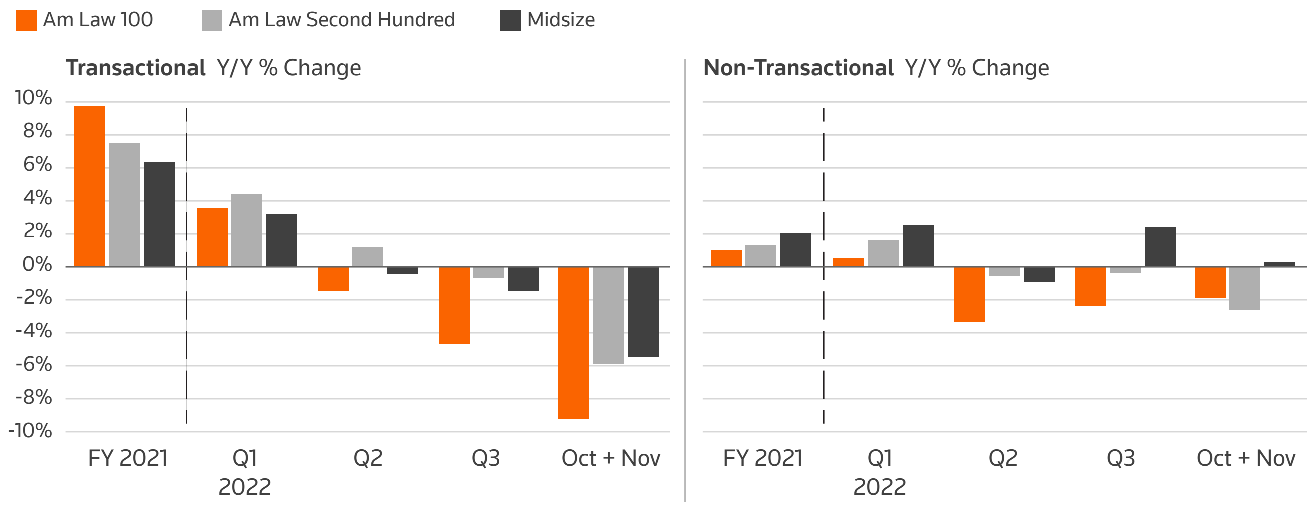
All timekeepers. Billable time type; non-contingent matters.

Source: Thomson Reuters 2023

The collapse in demand growth was driven primarily by a sharp contraction in transactional work that resulted from growing economic uncertainty and fell particularly heavily on larger firms. As can be seen in Figure 2, while demand in all practices declined over the course of the year, transactional practices were hit especially hard. Since these practices include mergers and acquisitions as well as the high-end corporate finance and deal work done by many larger firms, those firms suffered the greatest decline.

One of the more striking features regarding demand in 2022 was its apparent mobility. The Am Law firms saw stark deteriorations in all practice areas, but Midsize law firms appeared more competitive in litigation, labor & employment, and intellectual property, achieving notable growth in these areas. Indeed, Midsize firms were the only market segment showing positive demand growth (in their non-transactional practices) during the second half of 2022.

Figure 2: **Transactional vs. non-transactional demand growth by segment**

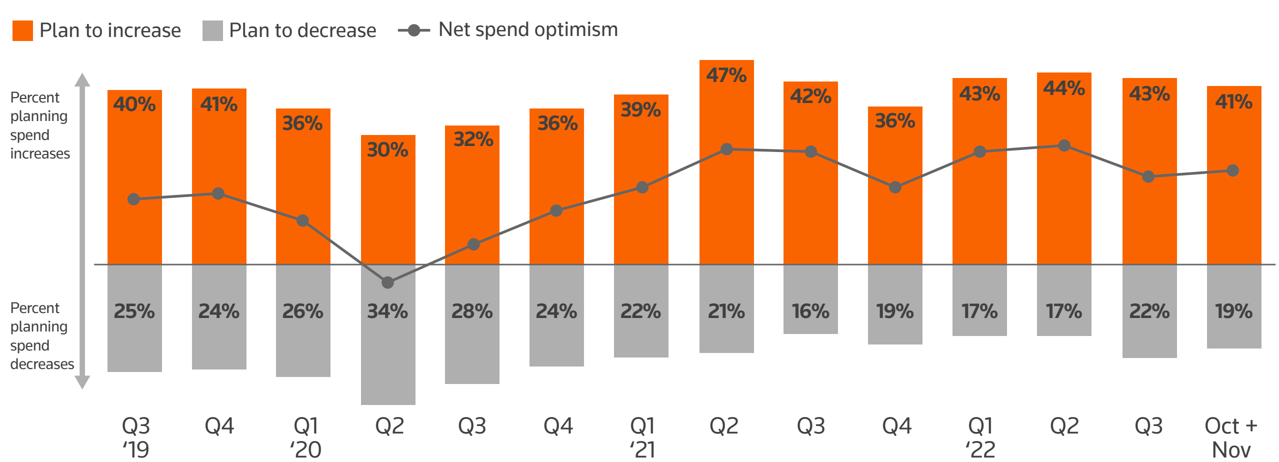


All timekeepers. Billable time type; non-contingent matters. *Source: Thomson Reuters 2023*

This downturn in demand is also visible in the attitudes of clients. Figure 3 shows aggregated data[4] that measure the intentions of in-house counsel to increase or decrease their outside counsel spend on a quarter-by-quarter basis. While net optimism for increased spending grew during the first two quarters of 2022, it started to fall in the second half of the year. At a practice level, increased spending was anticipated in regulatory as well as labor & employment work, while decreased spending was predicted for banking & finance and for insurance. Regarding litigation and M&A work, in-house counsel were polarized, as more respondents both saw spend increasing and decreasing, while fewer saw spend staying the same.

Figure 3: **Buyer sentiment: where is the legal market headed?**

Total legal spend optimism: quarter-by-quarter view ($1B+ companies)



Net spend optimism equals the percent of buyers planning to increase legal spend minus those planning to decrease. *Source: Thomson Reuters 2023*

4 Figure 3 and this paragraph is based on data from Thomson Reuters Market Insights, which provides legal buyer information from around the globe based on annual interviews with around 2,500 legal buyers with revenues above $50 million (US).

The variance in demand among the major segments of the market is plainly visible in Figure 4, which sets out the comparative average daily demand for Am Law 100, Am Law Second Hundred, and Midsize firms during 2021 and 2022. As can be seen, the largest firms struggled to maintain the pace set in 2021, while Midsize firms were the only major segment to approximate the previous year.

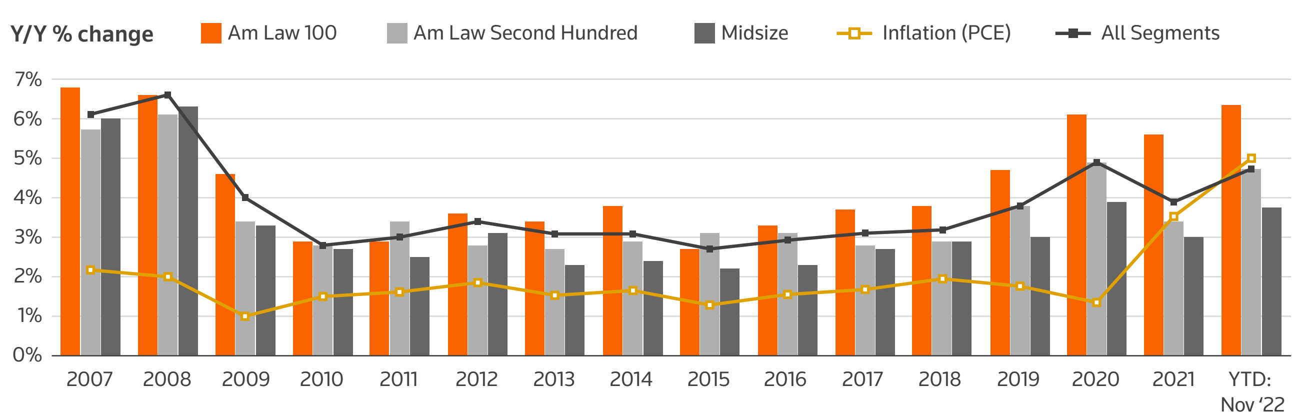
Figure 4: **Average daily demand by segment**

All timekeepers. Billable time type; non-contingent matters.

Source: Thomson Reuters 2023

Despite the drop off in demand, law firms across the market continued to raise their rates fairly aggressively during 2022 and, for the most part, continued to collect the rates they billed. As indicated in Figure 5, all segments of the market grew their worked rates[5] at a pace exceeding that of 2021 – indeed, mirroring the 12-year high-water marks set in 2020. Through November 2022, firms had increased their rates by an average of 4.8%. Am Law 100 firms led the way with a 6.3% jump, followed by Am Law Second Hundred firms at 4.8% and Midsize firms at 3.8%.

Figure 5: **Worked rate growth**



All timekeepers. Billable time type; non-contingent matters.
Inflation (PCE) measure = Personal Consumption Expenditures Excluding Food and Energy.

Source: Thomson Reuters 2023

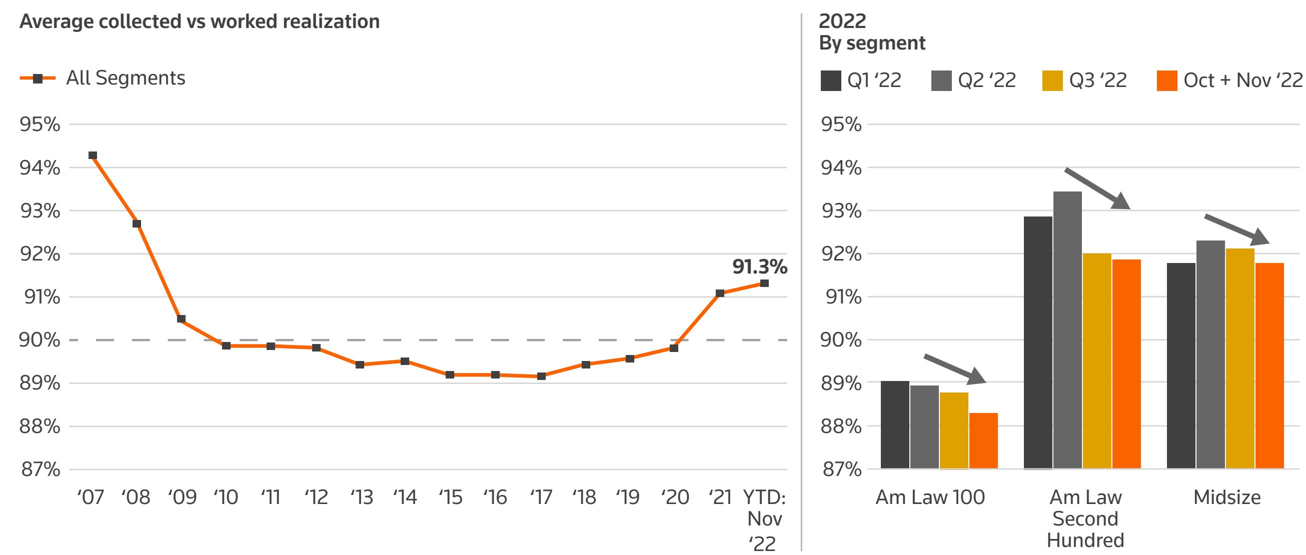
5 Worked rates, also referred to as negotiated/agreed rates, are the rates that a firm agrees to with particular clients for work on given matters.

While the ability of firms to maintain rate growth over the past year is certainly encouraging, there are ominous signs that should also be noted. First, given the growth of inflation since 2020 through the end of November 2022, we saw – for the first time – the annual average rate of inflation (5.0%)[6] exceed the average worked rate increase across the market (4.8%). While that divergence might be tolerated for a while, over the long term it is not sustainable. Depending on how long it takes to bring inflationary pressures under control, law firms could increasingly experience an economic squeeze.

Demand and worked rate growth combined represents fees worked – a proxy for revenue. Through November 2022, fees worked increased by 5.0%, much slower than 2021's 8.1% pace, but on its face still reasonably strong from an historic perspective. The problem is that, during the same period, firms were being simultaneously hit with highly expensive talent costs and the effects of broader inflation. Thus, while revenue generation remained reasonably good, expenses (as we shall see below) were growing at a rapid rate with no obvious end in sight.

A second cautionary word about rate growth as related to realization: As can be seen in Figure 6, collected realization against worked rates, after rising fairly steadily for the past two years, has now begun to level out or decline across all segments of the market. Particularly noteworthy is the fact that we saw atypical declines during the third quarter of 2022. The all-firm-average in collected realization normally increases from Q1 through Q4 of every year, but this year we saw a noticeable drop from 91.7% in Q2 to 91.2% in Q3, which continued into Q4. The drop occurred in all segments, with Am Law 100 firms continuing a near four-quarter decline from their Q4 2021 peak level. This dip may suggest that firms, in the process of

Figure 6: **Collection realization against worked (negotiated/agreed)**



Lawyers only. Billable time type.

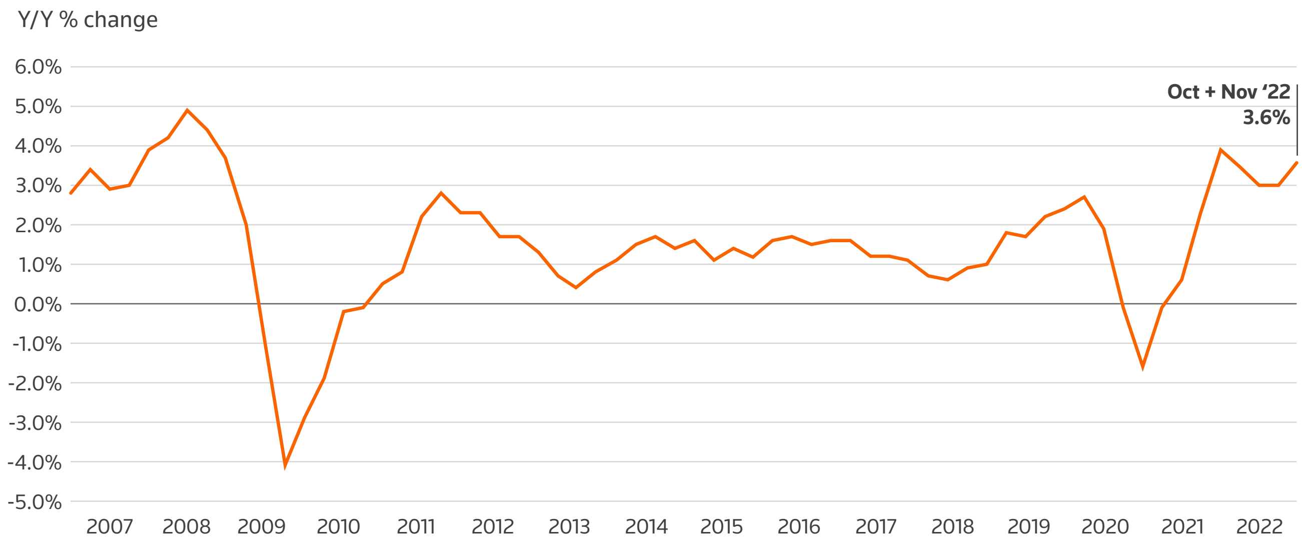
Source: Thomson Reuters 2023

6 For these purposes, we use the PCE Core inflation measure (Personal Consumption Expenditures Excluding Food and Energy) both because it is the standard inflation measurement of the Federal Reserve and because we believe it is the most reliable indicator of the rate of inflation experienced by law firms. https://fred.stlouisfed.org/series/PCEPILFE

trying to return to "business as normal" are losing some of the focus on billing and collections they had developed during the pandemic. But it could also indicate that clients, feeling their own inflationary pressures, may be challenging invoices more frequently and aggressively or simply slowing down their payment cycles. Either way, it is a cause for concern.

Notwithstanding the decline in demand, law firms continued to grow their lawyer headcounts during 2022, showing some slowing from 2021 but still recording a growth rate higher than every other year in the past decade.

Figure 7: **Lawyer (FTE) growth**

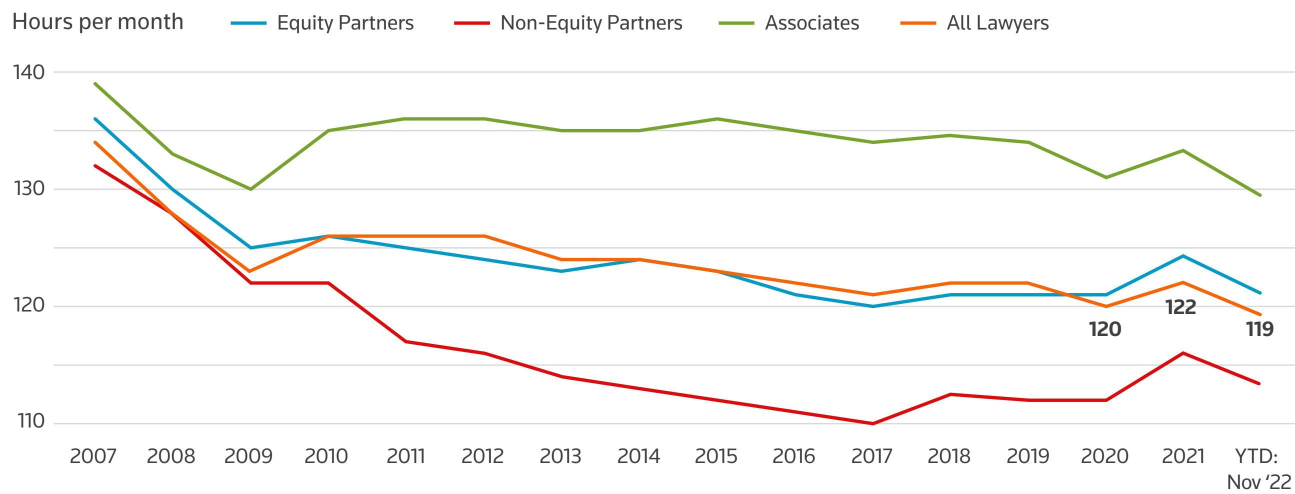


Lawyers (contractors excluded)

Source: Thomson Reuters 2023

Not surprisingly, the combination of falling demand and growing headcount combined to trigger a significant decline in productivity across the market. As can be seen in Figure 8, hours worked per lawyer dropped to 119 hours per month YTD across all lawyers, a low point for at least the past two decades. Using industry benchmarks for worked rates in 2022, this productivity loss means that the average lawyer in 2022 produced $98,000 less in total fees than a comparable lawyer in 2007, based on average rates for 2022.

Figure 8: **Hours worked per lawyer by title**



Lawyers only. Billable time type; non-contingent matters.

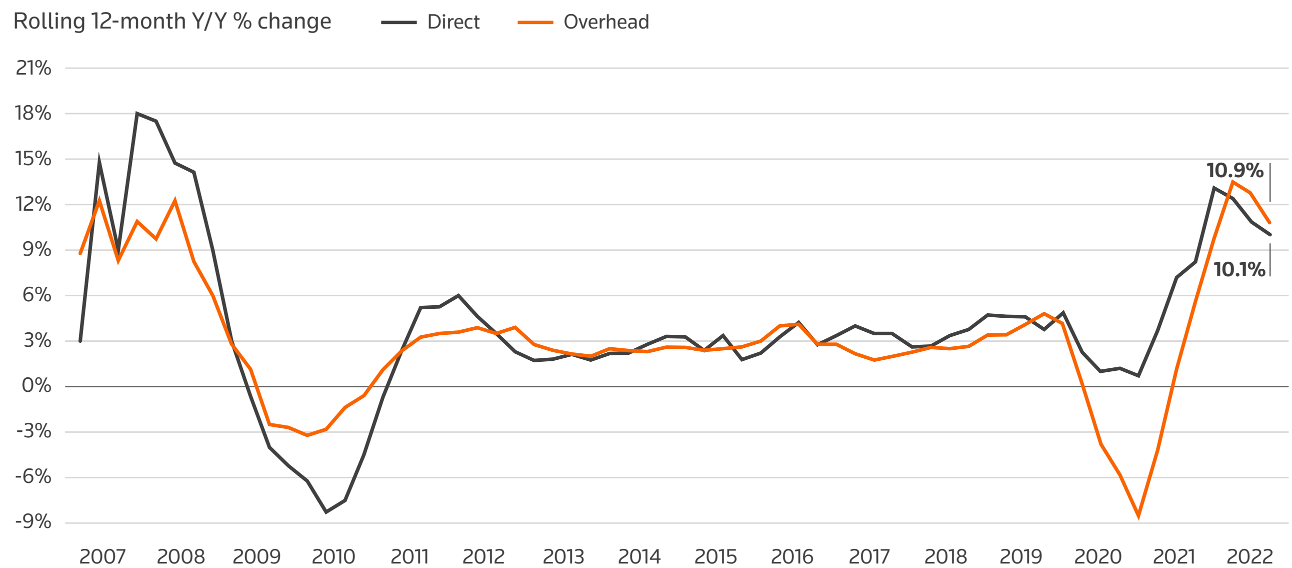
Source: Thomson Reuters 2023

The impact of this decline in productivity can be seen even more starkly by focusing on Q3 2022, which was the least productive third quarter since Thomson Reuters has been tracking such results. This trend continued into the first two months of Q4, affecting all categories of timekeepers, segments, and major practice areas. Unsurprisingly, this deterioration is being driven predominately by associates, Am Law 100 firms, and transactional practices.

Law firm expenses continued to rise sharply during 2022, partly because of the rising competition for talent as well as return-to-office expenses, but also as a byproduct of inflation. As indicated in Figure 9, through November 2022, direct expenses[7] increased by 10.1%, and overhead expenses by 10.9%, both levels being some of the highest we have seen since 2008. In an environment where revenue generation is slowing, such an expansion in expenses is alarming should it continue.

7 For these purposes, direct expenses refer to those expenses related to fee earners, primarily the compensation and benefits costs of lawyers and other timekeepers. Overhead (or indirect) expenses refer to all other expenses of the firm, including occupancy costs, administrative and staff compensation and benefits, technology costs, business development expenses, and more.

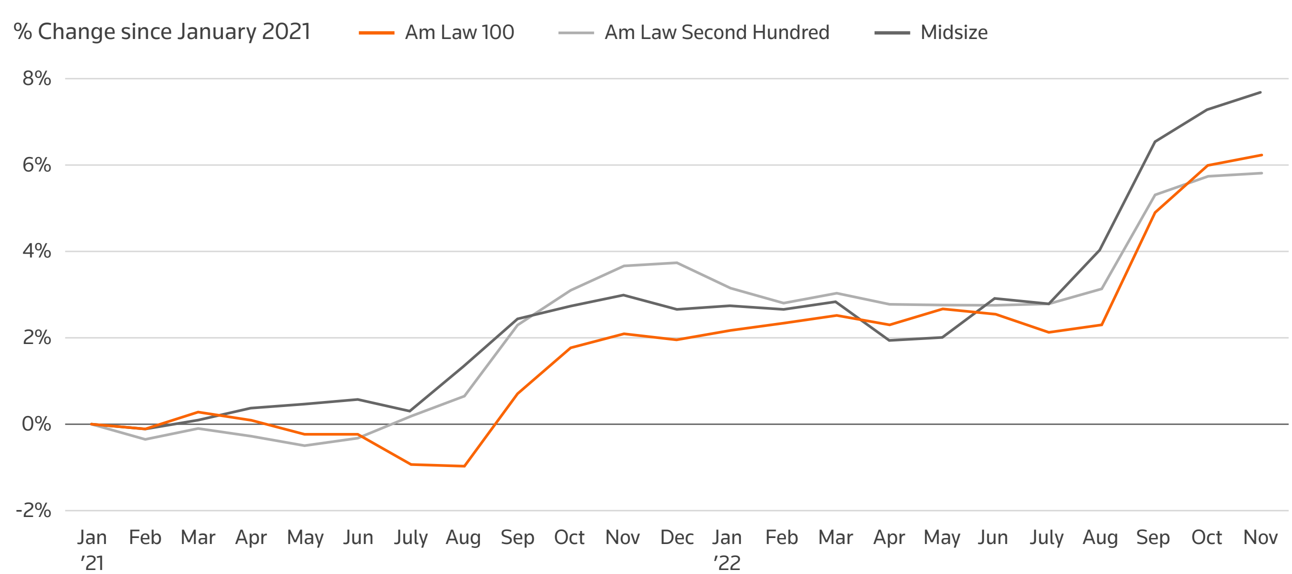
Figure 9: **Expense growth**



Source: Thomson Reuters 2023

As indicated earlier as well as in Figure 10, the heightened pace of lawyer growth over the past two years has been a key driver of the significant growth in direct expenses. Interestingly, during mid-2022, the rate of headcount growth varied more noticeably among segments than it had in previous months compared to the initial headcount in January 2021. As of the end of November 2022, Am Law firms have grown near 6.0%, while Midsize firms topped them at 7.7%.

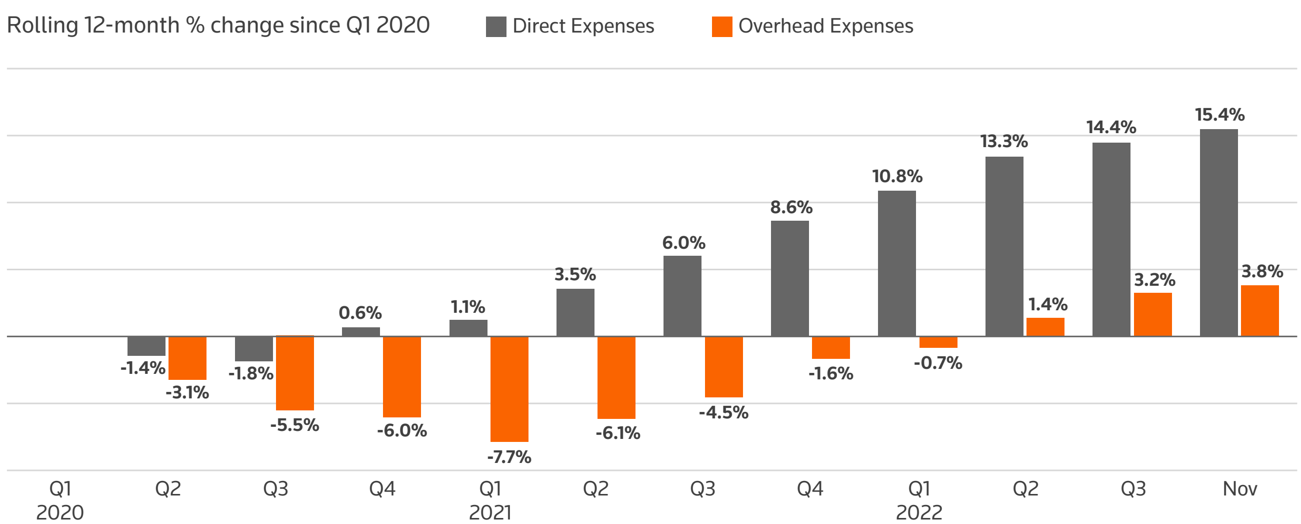
Figure 10: **Lawyer (FTE) growth by segment**



Percentages measures change from each point against Jan 2021 headcount to show change while ignoring baseline effects. *Source: Thomson Reuters 2023*

Expense growth, however, is not purely a result of increased headcount. Figure 11 shows the increase in expense growth since the pre-pandemic Q1 2020, broken out on a per-lawyer, full-time equivalent (FTE) basis. As can be seen, when measured in this way the increase in direct costs is even more stark.

Figure 11: **Expenses per lawyer (FTE) growth by category**

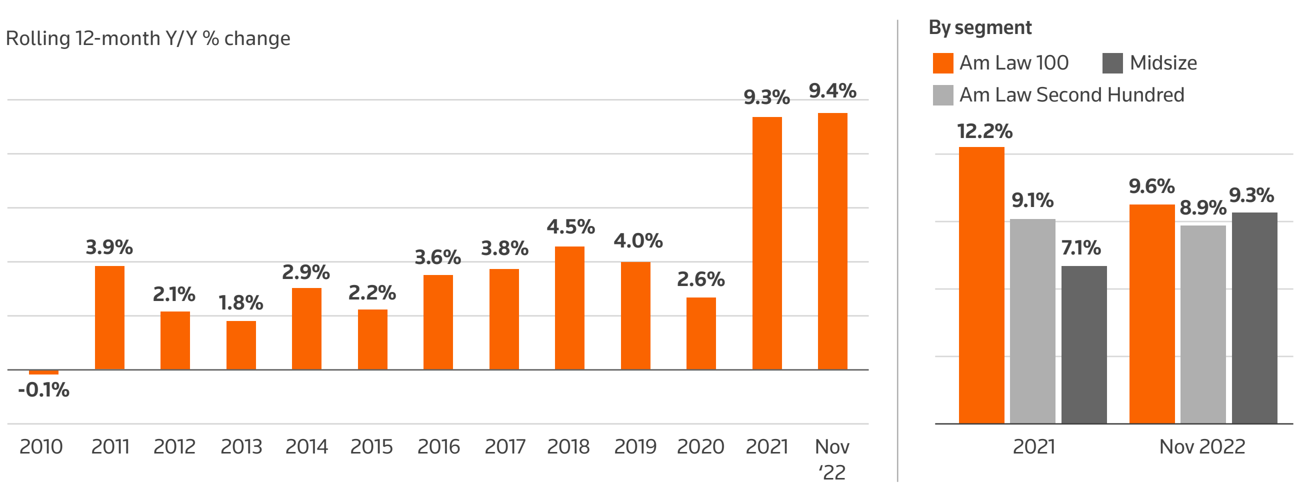


Percentages measures change from Q1 2020 values to show change compared to the last 12-month period preceding the pandemic.

Source: Thomson Reuters 2023

The growth in direct expenses over the past two years has been driven primarily by the significant compensation increases that law firms gave to their associates during the period. These increases have, so far, not been matched by revenue growth on a per FTE basis and are a primary reason for concern going into next year. Figure 12 shows the impact of such associate expense increases on the market as a whole, as well as on the three major market segments.

Figure 12: **Associate compensation growth**

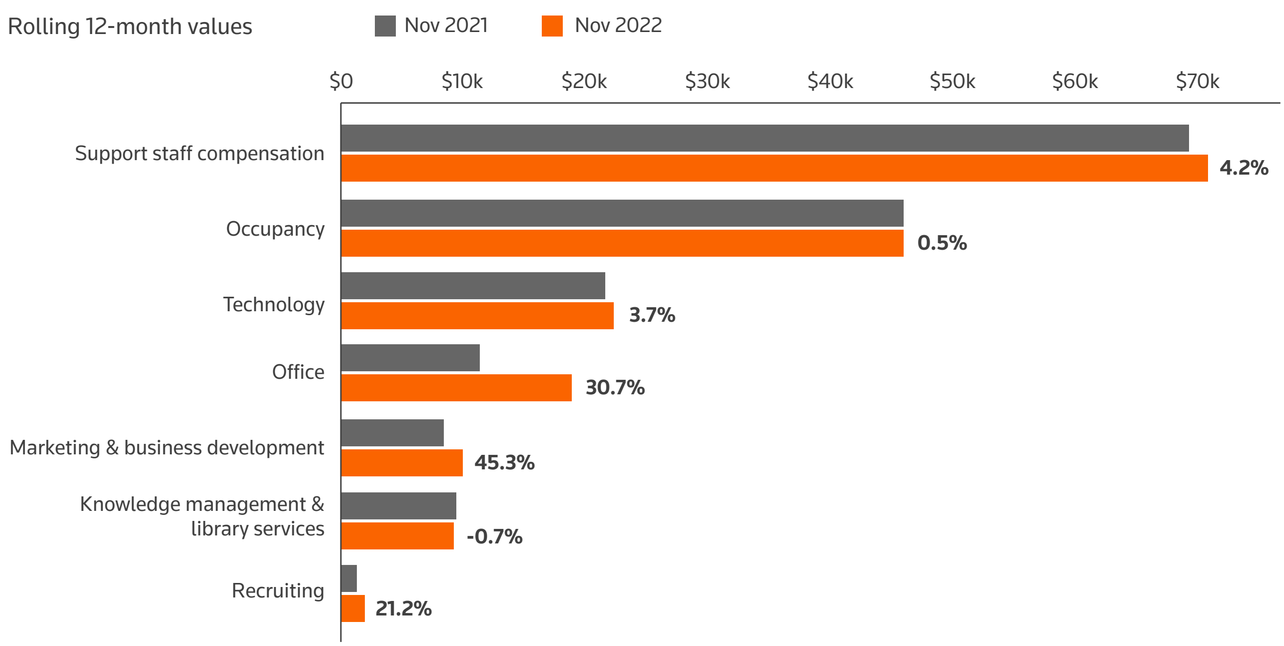


Associate Compensation: Associate Compensation divided by Associate FTEs.

Source: Thomson Reuters 2023

Growth in overhead costs during 2022, if measured on an FTE basis, was somewhat more muted than growth in direct expenses, but it was still notable. Figure 13, which sets out the details of these overhead costs, shows that although the largest portions of overhead expenses are attributable to support staff compensation and occupancy, the fastest growing expenses were related to marketing & business development, recruiting, and office costs.

Figure 13: **Overhead per lawyer (FTE) detail**



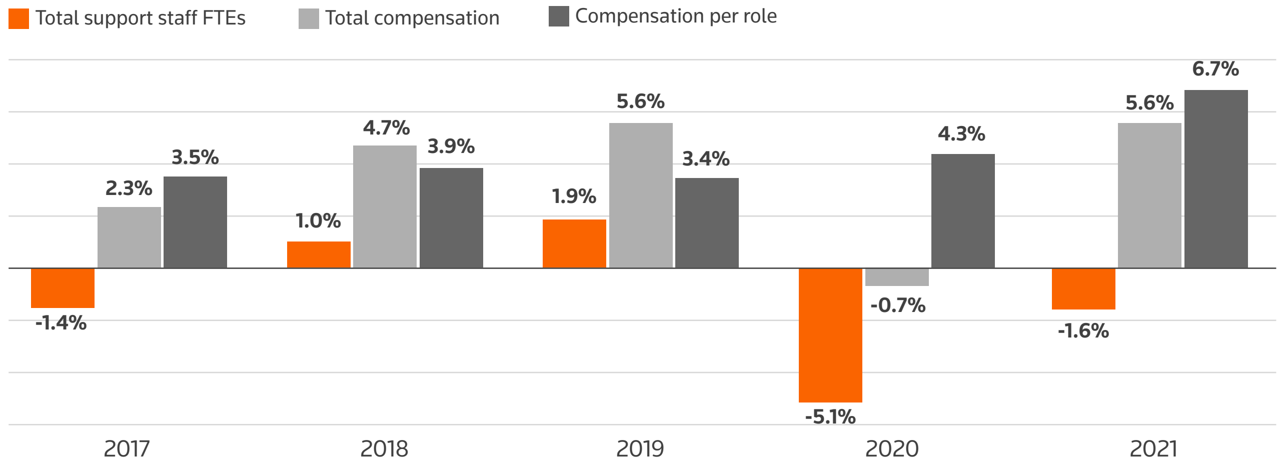
Percentages refer to the change from Nov '21 to Nov '22 in the metric.

Source: Thomson Reuters 2023

The support staff compensation numbers are particularly interesting. During 2020 and 2021, the total FTEs for support staff declined while, at the same time, the total compensation for support staff and the compensation per role increased.[8] These general trends – shown in Figure 14 – if continued during 2022, would suggest that, while firms are decreasing the numbers of lower-level staff, they are increasing staff in higher functional areas while paying the compensation differentials necessary to do so. In fact, as can be seen in Figure 15, firms grew their staff capacities over the period from 2017 through 2021, in areas of recruiting & talent management, practice group operations, executive management, finance, and marketing & business development functions; while, at the same time reducing staff focused on library & research, administrative, secretarial & word processing, and operations functions.

8 Figures 14 and 15 come from the Staffing Ratio Report, an ancillary offering from Thomson Reuters Financial Insights that has a different firm sample than the Financial Insights data seen elsewhere in this report. The Staffing Ratio Report provides far more detailed information on support staff and relevant trends.

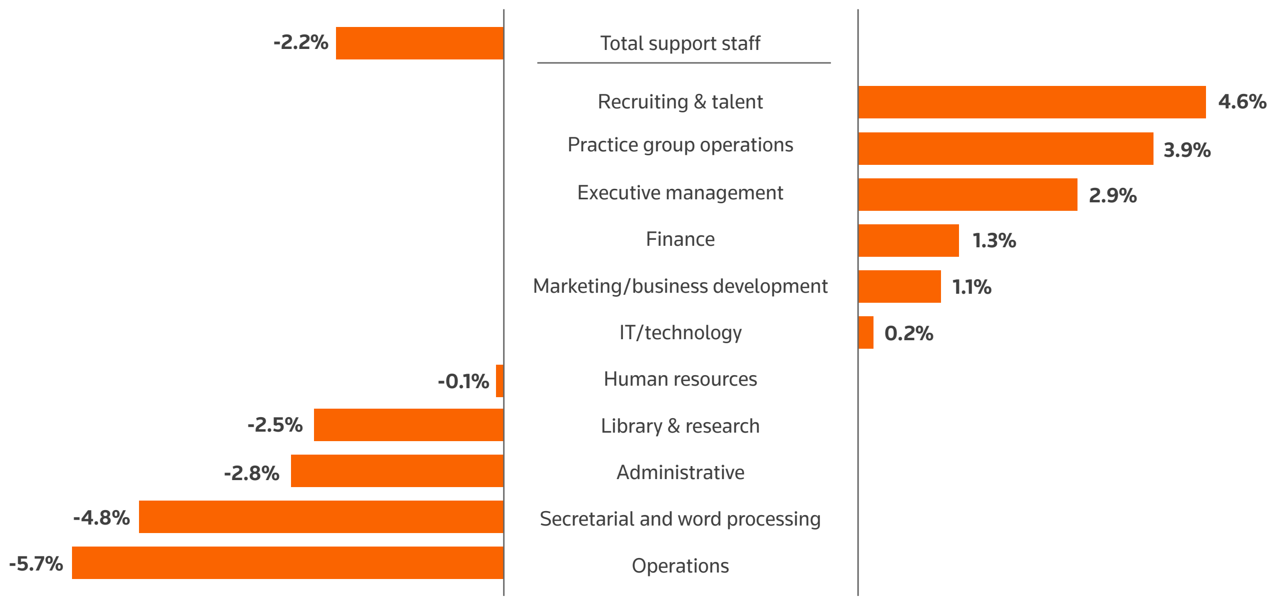
Figure 14: **Support staff FTEs, compensation, and compensation per role growth**



Source: Thomson Reuters 2023

Figure 15: **Support staff FTEs per lawyer growth by function area**

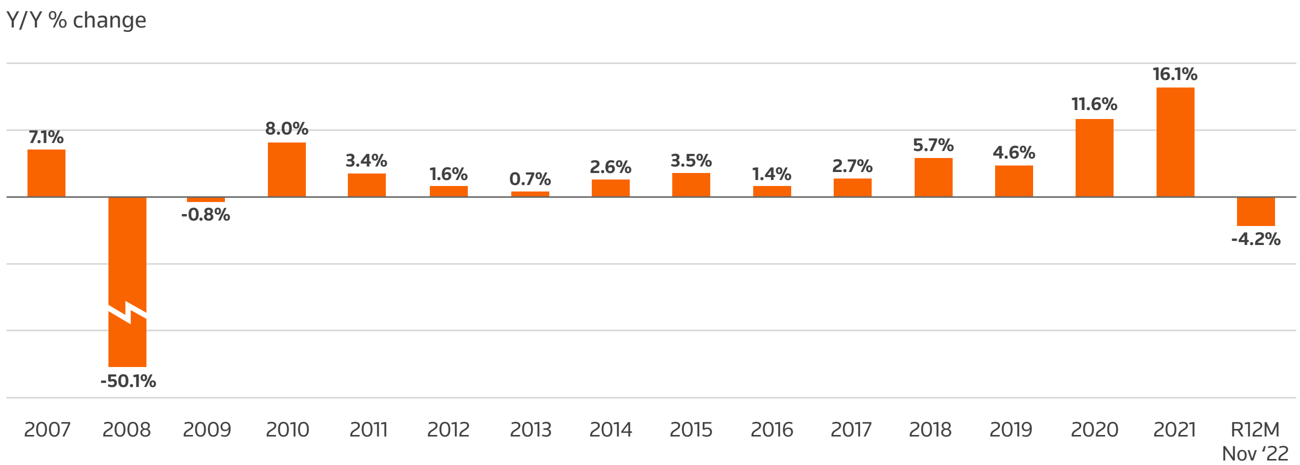
Average annual growth % change: 2017-2021



Source: Thomson Reuters 2023

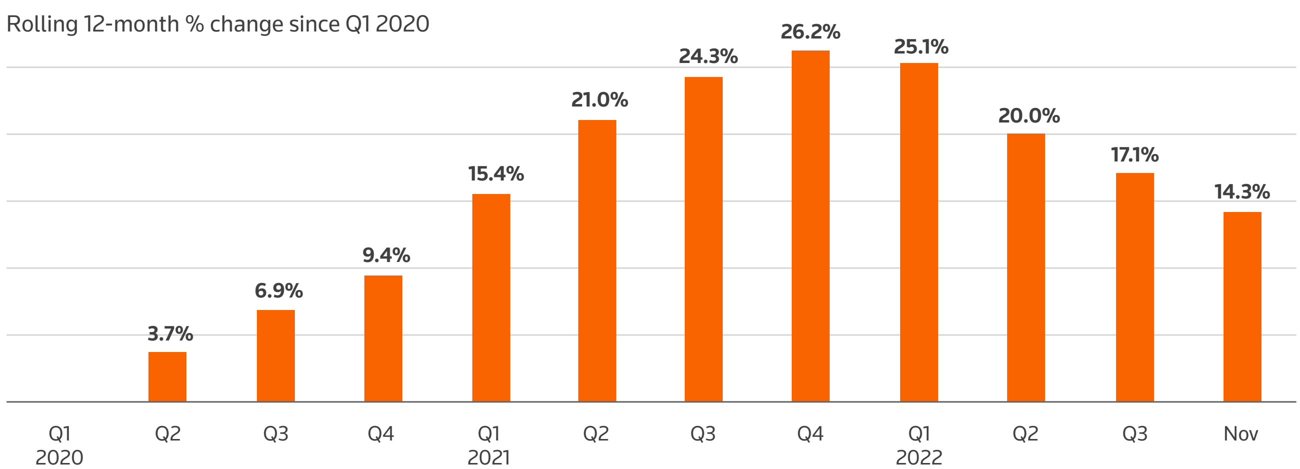
The combined effects of the factors described above are likely to result in a modest decline in PPEP through the end of the year, the first such decline since 2009. While the actual profit figures should still be comfortably high when compared to pre-pandemic levels, if the effects of inflation are taken into consideration, many partners may feel significantly less well off than in 2021. The PPEP growth as of November is shown in Figure 16, while the same measurement, broken out on an FTE basis vs. Q1 2020, is set out in Figure 17.

Figure 16: **Annual profit per equity partner growth**



Source: Thomson Reuters 2023

Figure 17: **Profit per lawyer (FTE) – change since Q1 2020**



Percentages measures change from Q1 2020 values to show change compared to the last 12-month period preceding the pandemic.

Source: Thomson Reuters 2023

Uncertainties for 2023 and beyond

As we have noted, while law firms are likely to finish 2022 with reasonably good financial results, at least as judged historically, the picture for 2023 is more complicated. Firms enter the new year with growing uncertainties about a set of wide-ranging issues, all of which could have significant impacts on their economic and institutional health both in 2023 and beyond.

Overall economic uncertainty – The most prominent uncertainty facing law firms moving forward is, of course, the impossibility of knowing how long the current economic downturn will last, how deep it will be, and what the ultimate recovery will look like. Part of the uncertainty is that the present downturn is driven largely by *externalities* outside the direct control of economic regulators, such as the war in Ukraine, the lingering effects of the COVID-19 pandemic, and the challenges of global inflation. How these issues will be resolved and when, are almost impossible to predict.

It appears that most law firm leaders, while optimistic about a full recovery over the next two or three years, are quite guarded as to their predictions for 2023. In a recent survey of law firm business leaders, the Thomson Reuters Institute reported that more than half expected flat or low growth in PPEP in 2023. That compared to 75% who expected moderate or high growth in PPEP the year before.[9]

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The sentiments of law firm leaders appear widely shared across the broader economy. In mid-October, the International Monetary Fund downgraded its forecast for the global economy stating: "The worst is yet to come, and for many people 2023 will feel like a recession."[10] Although, as previously noted, most firms are likely to end 2022 with very good (if somewhat lowered) PPEP, the clouds on the economic horizon remain very real.

First, firms have continued to grow their lawyer headcount despite a drop in demand that has exerted persistent downward pressures on productivity.[11] This obviously reflects a tough judgment call. Firms remember that during the Great Financial Crisis they reacted somewhat precipitously by laying off large numbers of associates, a move they came to regret when the

9 Thomson Reuters, 2022 Law Firm Business Leaders Report. https://www.thomsonreuters.com/en-us/posts/legal/2022-law-firm-business-leaders/

10 Julia Horowitz, CNN Business (Oct. 11, 2022). https://www.cnn.com/2022/10/11/economy/imf-world-economic-outlook. See also International Monetary Fund, World Economic Outlook (Nov. 29, 2022). https://www.imf.org/en/Publications/WEO

11 Some of the mismatch between headcount growth and productivity is undoubtedly attributable to the fact that firm hiring cycles tend to be quite long, with offers being made months ahead of when new hires actually arrive for work.

economy rebounded in 2010, leaving them short-handed. Furthermore, they must be cautious of the ability of such layoffs to significantly lower group cohesion. One of Urzúa's lessons was that survival requires teamwork. By sacrificing attorneys to protect the bottom lines of partners, many firms risk damaging the firm cultures that they are trying to build. No one wants to replay the post-GFC scenario or undo the culture-building work of the last couple of years, but the ability of firms to "hold the line" will depend mainly on the length and depth of any recession that may occur.

Second, moving into 2023, firms are facing growing internal economic challenges, including expenses that have reached their highest average growth rate since 2008. The primary driver for the growth of direct expenses is associate compensation, which has skyrocketed since 2021, reflecting a fierce competition for talent. The negative impact of these rising expenses was offset during 2022 primarily by firms' continuing ability to raise rates fairly significantly although even those rate increases fell somewhat short of the rising inflation rate.

Regarding growth in overhead expenses, the current category leaders in growth on a per FTE basis are marketing/business development and office expenses, with notable growth in other categories such as technology. Interestingly, occupancy expenses were one of the few categories still remaining relatively flat, becoming a much smaller percentage of revenue.

Looking forward to 2023, firms appear to be counting on rate increases to maintain profitability, but there are signs that clients are likely to be more resistant to further rate hikes. We have already seen evidence of a slowdown in client payments during late 2022,[12] as well as an unseasonal decline in realization rates during the second half of 2022.

If firms are unable to fall back on rate increases as their traditional response to economic challenges, they may face increasingly difficult decisions in 2023 and 2024. Again, this will likely depend on the length and depth of any coming recession.

On the more hopeful side, it is important to remember that the current economic downturn is quite different from the Great Recession of 15 years ago. Today's economic troubles stem from the continuing effects of a global pandemic that essentially shut down much of the world's economy for the better part of a year. While, like the Great Recession, it too necessitated strong government intervention that may have triggered some inflationary results, in other respects, the current downturn is quite different. The 2008-2009 crisis was caused by inherent weaknesses in the financial system itself. This distinction is important because history has shown that recessions triggered by excess liquidity (like the current downturn) tend to be shallower and less damaging than those that are credit-driven (like in 2008-'09).[13]

In the present case, it should also be noted that – unlike the situation in 2008-'09 – a number of underlying elements of the U.S. economy remain strong. These include fairly robust housing and auto industries; balance sheets that are in the best shape in decades across

12 *See* Andrew Maloney, "Law Firms See Payment Delays Amid Challenging Collection Season," LAW.COM (Nov. 29, 2022). https://www.law.com/americanlawyer/2022/11/29/law-firms-see-payment-delays-amid-challenging-collection-season/

13 Lisa Shalett, "How Bad Could the Next Recession Be?" Morgan Stanley (June 28, 2022). https://www.morganstanley.com/ideas/recession-2022-potential-how-bad

households, corporations, and the banking system; a consistently strong labor market; and corporate revenues that appear to be more durable and show a growing share of earnings attributable to recurring income streams.[14] All of these factors are encouraging, but the actual outcome of the current economic crisis remains uncertain.

Challenges of adjusting to a post-pandemic world – A second area of uncertainty confronting firms in 2023 is how to adjust to a post-pandemic world, especially in managing return-to-the-office policies. During 2022, many firms instituted guidelines suggesting that lawyers should be in the office at least three days a week, but the guidelines were essentially voluntary and not backed up by any serious enforcement efforts. More recently, there is evidence that some firms are beginning to tie office attendance to job security and bonuses, a trend that could expand given the excess capacity that many firms currently have.[15] However, the question remains whether such measures are the best way to attract lawyers back or, indeed, whether it is even necessary for all lawyers to return to pre-pandemic office working arrangements.[16] Some research is starting to show that fears of negative impacts of remote working are not necessarily being borne out.

A recent American Bar Association study found that young lawyers feel so strongly about remote work that 44% of them say they would leave their current jobs for a greater ability to work remotely elsewhere.[17] In another recent study, Microsoft surveyed some 20,000 people in 11 countries and analyzed trillions of Microsoft 365 productivity signals in an effort to determine what factors are most important in getting employees to return to their offices. The survey disclosed, perhaps not surprisingly, that the real value of the office is not the place but the people.[18] When asked what would motivate them to come into the office, the surveyed employees had a resounding answer – time with coworkers:

- 85% of employees would be motivated to go into the office to rebuild team bonds;
- 84% of employees would be motivated to go into the office if they could socialize with co-workers;
- 74% of employees would go to the office more frequently if they knew their "work friends" were there; and
- 73% of employees would go to the office more frequently if they knew their direct team members would be there.

This research strongly suggests that firm strategies designed around fostering connections among employees are likely to be more successful than more punitive approaches. But

14 *Id.*

15 Andrew Maloney, "Law Firms Start Tying Office Attendance to Job Security and Bonuses," LAW.COM (Nov. 18, 2022). https://www.law.com/2022/11/18/law-firms-start-tying-office-attendance-0to-job-security-and-bonuses/

16 Andrew Brodsky and Mike Tolliver, "No, Remote Employees Aren't Becoming Less Engaged" Harvard Business Review (Dec. 6, 2022) https://hbr.org/2022/12/no-remote-employees-arent-becoming-less-engaged

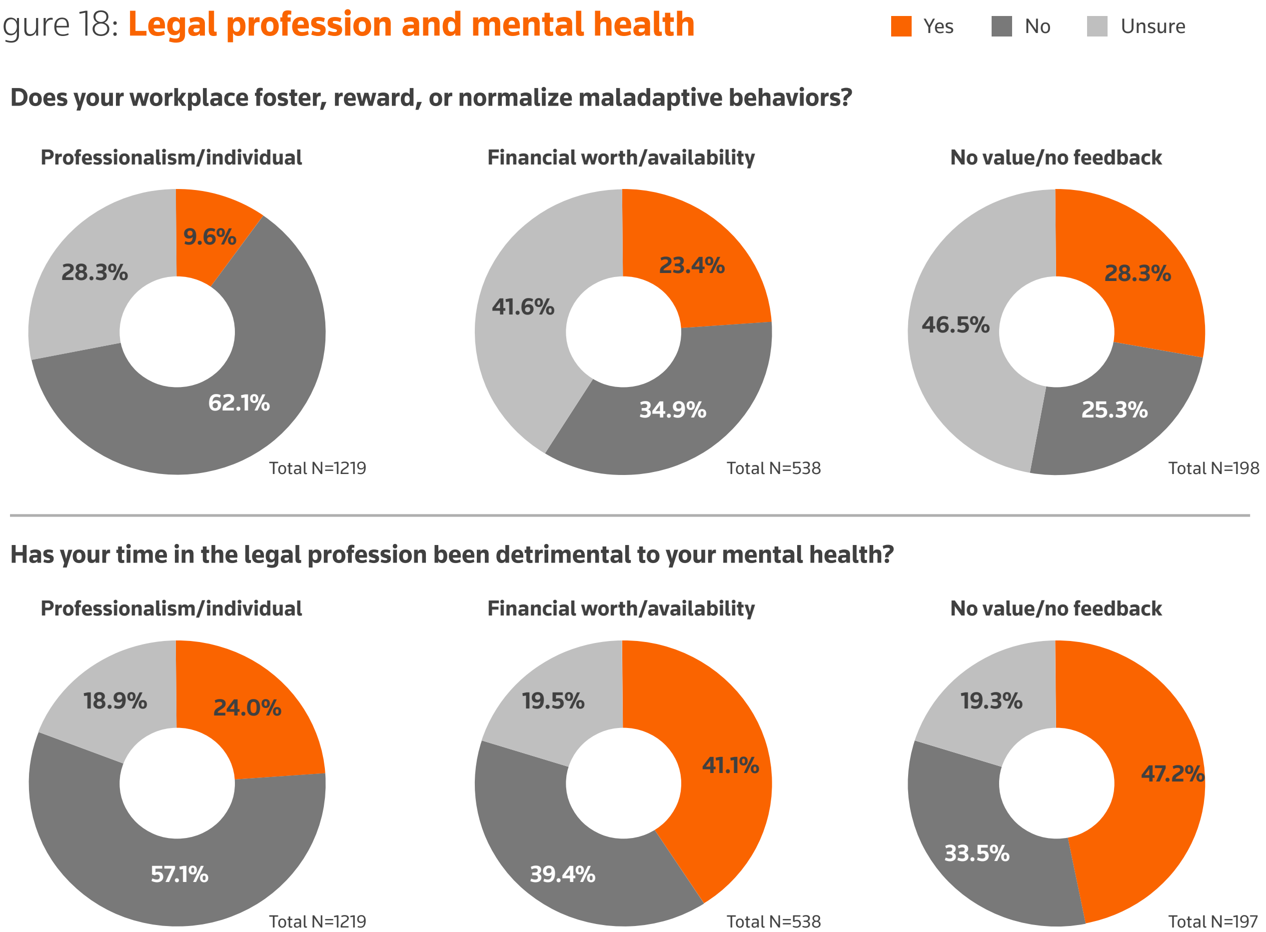
17 Amanda Robert, "Working remotely is now a top priority, says new ABA report highlighting lasting shifts in practice of law," ABA Journal (Sept. 28, 2022). https://abajournal.com/web/article/new-aba-report-highlights-lasting-shifts-in-practice-of-law-and-workplace-culture

18 Chris Capossela, "To Get People Back in the Office, Make It Social," Harvard Business Review (Sept. 22, 2022). https://hbr.org/2022/09/to-get-people-back-in-the-office-make-it-social

a firm's ability to encourage such community building depends importantly on how its employees perceive the firm.

Research published in *Behavioral Sciences* in June 2022 documents this important connection.[19] From a survey of some 2,000 practicing lawyers, the study classified respondents on the basis of how they answered the question, "What do you feel your employer values most about you?" Some 62% of those surveyed responded with "professionalism/individual" items;[20] 28% responded with "financial worth/availability" items;[21] and 10% responded with "no value/no feedback" items.[22] Interestingly, as compared to respondents who defined their firms as "professionalism/individually" oriented, substantially higher percentages of respondents falling in the "financial worth/availability" and "no value/no feedback" categories answered the following questions in the affirmative, as shown in Figure 18.

Figure 18: **Legal profession and mental health**



Source: Krill Strategies, LLC 2022.[23]

19 Patrick R. Krill, Nikki Degeneffe, Kelly Ochocki, and Justin J. Anker, "People, Professionals, and Profit Centers: The Connection between Lawyer Well-Being and Employer Values," National Library of Medicine – Behavioral Sciences (June 2022).

20 For example, "My overall talent and skills as a lawyer" or "Everything, they value my inherent worth as a human being."

21 For example, "My productivity or the hours I bill" or "My responsiveness and availability."

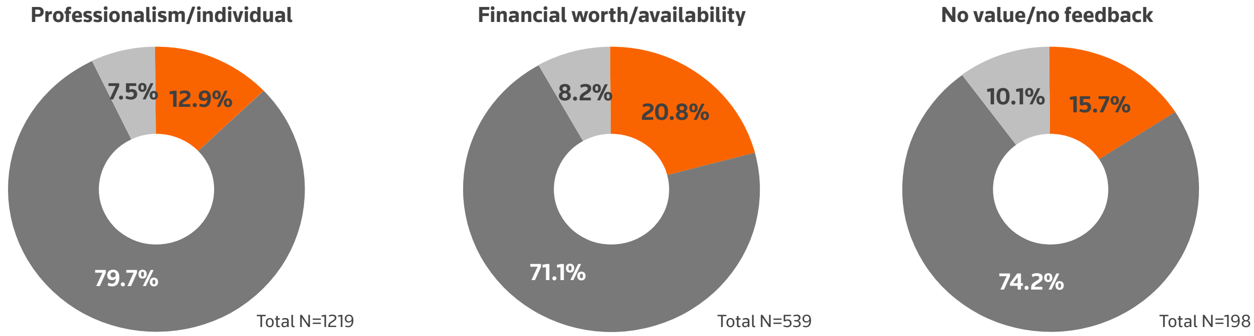
22 For example, "I don't know – I get very little feedback" or "Not much – my employer does not make me feel valued."

23 Reprinted with permission from Krill Strategies, LLC.

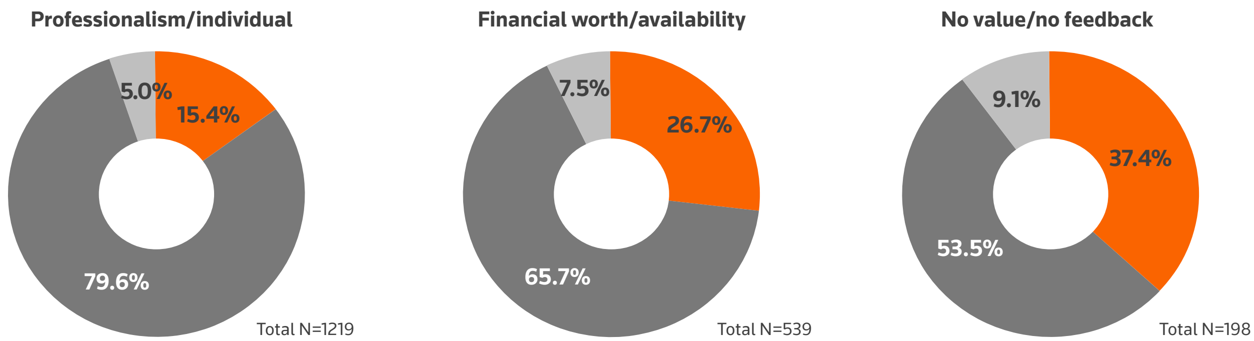
Figure 18: **Legal profession and mental health** *(cont.)*

Yes No Unsure

Has your time in the legal profession caused your use of alcohol and/or other drugs to increase?



Are you considering leaving, or have you left, the profession due to mental health, burnout, or stress?



Source: Krill Strategies, LLC 2022

Patrick Krill, one of the authors of the study has noted that the findings "provide novel insight into the relationship between a primary focus on productivity and the mental health/wellbeing problems in legal employment environments."[24] He also pointed out some of the key findings emerging from the research:

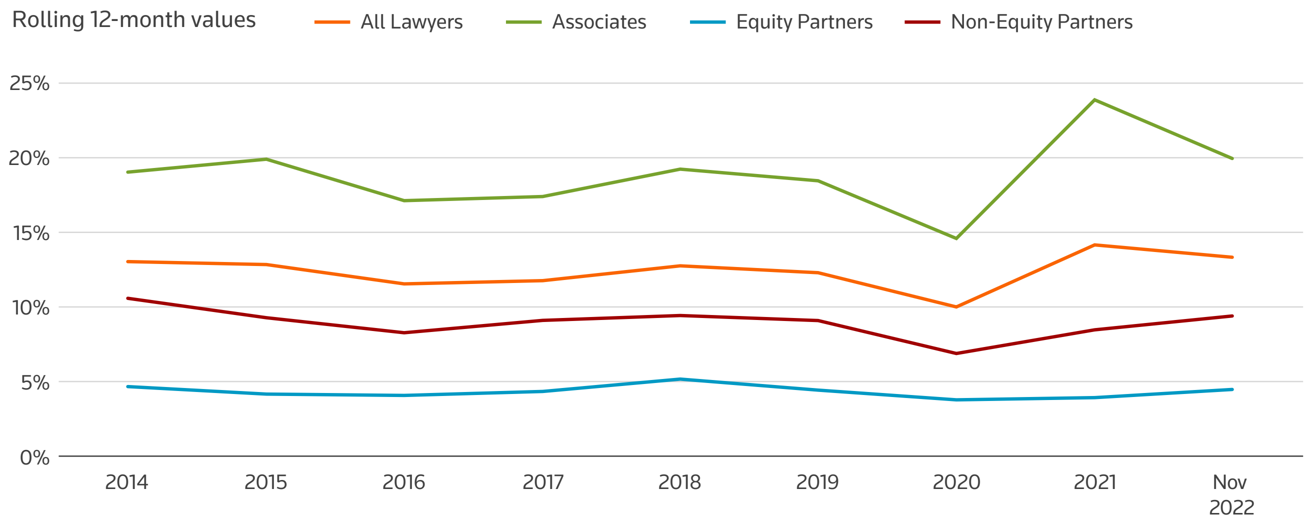
- Younger lawyers, women, and non-white attorneys are more likely to be part of the "financial worth/availability" or "no value/no feedback" less healthy groups;
- The larger the firm, the more likely lawyers are to feel most valued for their financial and productivity contributions, and thus report worse mental health;
- Feeling like you are in a primarily transactional relationship with your employer doesn't lead to the best mental health outcomes; and
- Making lawyers feel more valued for their skills or humanity rather than productivity or responsiveness may improve wellbeing and mitigate unwanted turnover, as well as reduce healthcare costs.[25]

24 Presentation by Patrick Krill to Law Firm General Counsel Roundtable, Chicago, IL (Oct. 21, 2022).
25 *Id.*

Indeed, if there is anything the legal industry's reaction to the pandemic showed us, it's that in the post-pandemic, return-to-the-office environment it is crucial for firms to find ways to convey that they value the talent, skills, and humanity of their lawyers and not just see them for their billable hours. This requires reevaluating training, feedback, and mentoring programs, as well as evaluation and compensation processes. Firms that can successfully embrace a culture that values and respects their lawyers for the skilled professionals that they are, will have a much easier time navigating post-pandemic, return-to-the-office issues.

Talent management issues – In our *Report on the State of the Legal Market* last year, we focused particular attention on the fierce competition for talent that occurred during 2021 and on the turnover rate for law firm associates that appeared to be rising at an alarming pace (24% for associates by year's end).[26] As shown in Figure 19, during 2022, the turnover rate for associates came down slowly (reaching 20.1% by November). It remains, however, at one of the higher levels that we have seen in the past decade.

Figure 19: **Turnover analysis**



Turnover = Lawyers who left the firm divided by lawyers at beginning of the time period.

Source: Thomson Reuters 2023

The persistence of a high associate turnover rate not only poses ongoing economic challenges for firms, it raises an interesting question about whether we have reached a point that calls for a fundamental re-examination of how we approach talent management in law firms of any significant size.

Historically (meaning up to 15 years ago or so), the implicit bargain that law firms made with young lawyers was fairly straightforward. Lawyers agreed to join firms as associates and to

26 2022 Report on the State of the Legal Market, Thomson Reuters Institute and the Georgetown Law Center on Ethics and the Legal Profession (Jan. 2022), pp.14-21.

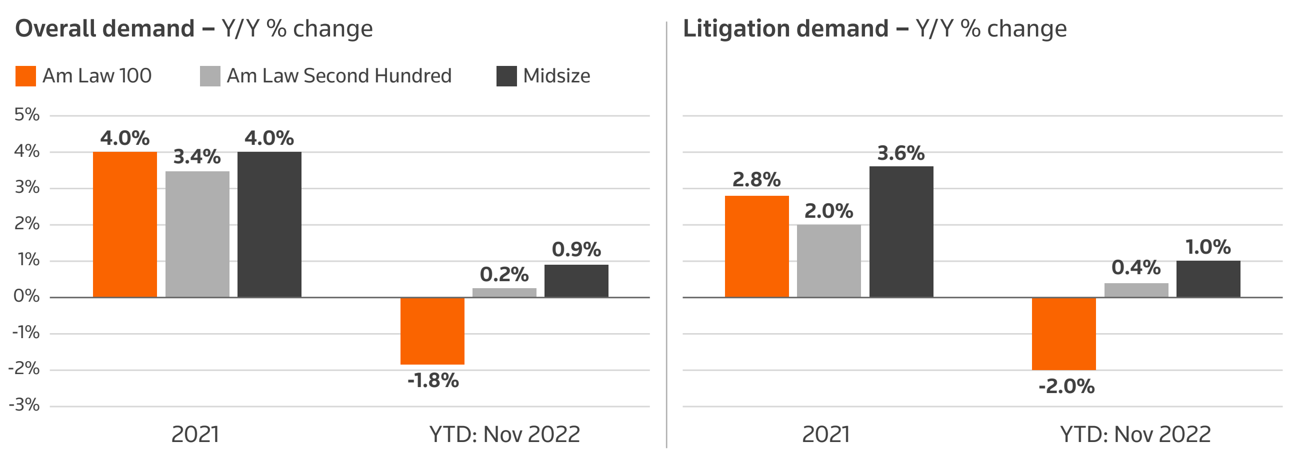
work very hard for a period of years in exchange for the opportunity to become partners and, at least in most firms, the chances of achieving partnership were reasonably good. In more recent years, as firms have grown ever larger and the economics of the market have shifted, the old implicit bargain no longer works.

Today, if firms want to attract and retain young lawyers, they must offer a different proposition – one that guarantees great training and a range of unique experiences that will prepare associates for their next professional role, whether that's as a partner at the firm or some other position. Indeed, some firms have recognized the benefits of retaining good lawyers and have begun to offer alternatives to partner tracks, enabling career progression for associates who either don't want to follow that path or are unlikely to meet the criteria for partnership at their firms.

Some firms, to their credit, have taken steps to move toward this new paradigm for attracting and retaining associate talent. And, research shows that firms that credibly reflect a culture that values lawyers as skilled professionals (and not just for their productivity) tend to have healthier and more loyal employees. The problem is that, in the current economic environment in which firms may be forced to consider lay-offs, it is hard to maintain such credibility, much less to redesign a firm's recruitment and retention model. The challenge for the next year and beyond will be for firms to navigate the tricky process of squaring actions that may be economically necessary with the cultural images they hope to convey both externally and to their employees.

Challenges of growing market segmentation – An interesting feature of the current economic downturn has been the effect that it has had on different segments of the market, unlike the environment in 2020 and 2021. As shown in Figure 20, in terms of 2022's demand growth, Midsize law firms have fared better than Am Law Second Hundred firms and Am Law Second Hundred firms have fared better than Am Law 100 firms. Even within the Am Law 100, Am Law 51-100 firms have fared better than Am Law 1-50 firms.

Figure 20: **Demand growth by segment - overall vs litigation**



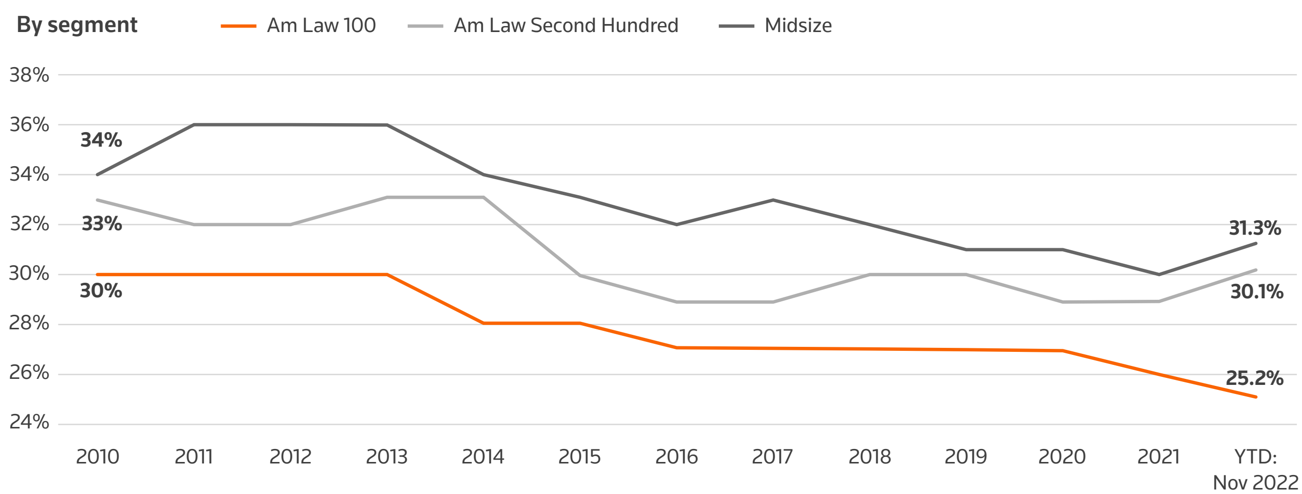
All timekeepers. Billable time type; non-contingent matters.

Source: Thomson Reuters 2023

This disparity is primarily attributable to the fact that the current downturn hit high-value corporate and transactional practices (e.g., capital finance, M&A, and private equity) particularly hard, as corporate clients slowed or postponed deals in the face of economic uncertainty. However, the numbers also point toward another trend that has been underway for some time – the noticeable *re-segmentation* of the legal market as more price-sensitive practices have moved down market to smaller firms capable of delivering quality services at lower rates.

For example, over the past decade, litigation has represented a smaller portion of law firms' overall mix of work across segments. In recent years and 2022 especially, we have also seen a shift as the practice becomes more price sensitive because of e-discovery and other factors, leading to a continued decline in the comparative amount of litigation being handled by the largest, highest priced firms, as compared to firms in the Am Law Second Hundred and Midsize categories, both of which saw an increase in their share of this work in 2022.

Figure 21: **Litigation by segment – historical practice proportions**



All timekeepers. Billable time type; non-contingent matters.

Source: Thomson Reuters 2023

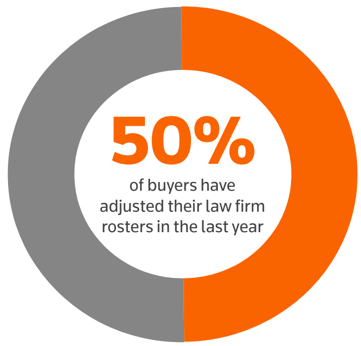
In addition, there also has been seemingly conflicting data from independent sources that shows the 4.8% average worked rate growth that law firms have implemented in 2022 as far greater than the actual effective increases corporate clients have experienced.[27] The most likely way this is possible is if corporate clients are shifting a portion of work from higher-priced firms to lower-cost alternatives.[28] Data from interviews with corporate legal officers support this theory, showing that nearly 50% of clients have substantially adjusted their roster of outside law firms.

27 2022 Legal Department Operations (LDO) Index - Figure 4 (pg. 10) https://legal.thomsonreuters.com/en/insights/reports/legal-department-operations-index-seventh-edition-2022/form

28 "LFFI Q3 analysis: Conflicting rate data helps tell Q3's shifting demand story" Thomson Reuters Institute (Dec. 12, 2022) https://www.thomsonreuters.com/en-us/posts/legal/lffi-q3-analysis-rate-data-demand-story/

Figure 22: **Additional evidence from corporate clients**

Is there a firm you have started using or used substantially more in the last 12 months?



Client Rate Growth Experienced:

Over $10B	'22 vs. '21
Partner	-1.2%
Of Counsel	2.0%
Associate	0.8%
Paralegal	0.4%

From $2B to $10B	'22 vs. '21
Partner	2.9%
Of Counsel	4.5%
Associate	3.7%
Paralegal	3.4%

From $500M to $2B	'22 vs. '21
Partner	0.0%
Of Counsel	2.3%
Associate	-0.2%
Paralegal	3.1%

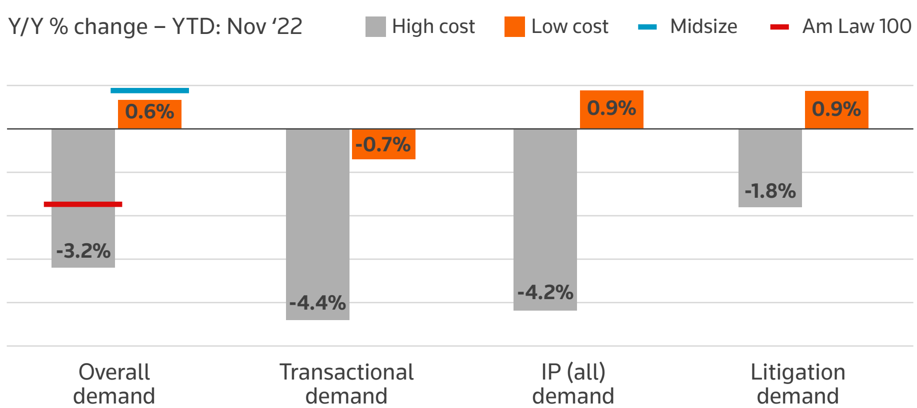
Under $500M	'22 vs. '21
Partner	0.3%
Of Counsel	2.1%
Associate	0.7%
Paralegal	-0.9%

Law firm rate growth = **4.8%**

Source: Thomson Reuters 2023

To dig deeper into the pricing dynamics, we recently identified *high-cost* and *low-cost* firms in the Thomson Reuters database for comparative purposes. High-cost firms were those in the upper 20th percentile of worked rates in 2022, while low-cost firms were those in the bottom 20th percentile. The results in terms of overall demand and major practices are set out in Figure 23. As can be seen, low-cost firms outpaced high-cost firms in all areas of demand growth, most notably in the transactional practice area. Predictably, as demand fell and corporate law departments came under tighter financial pressure, lower cost providers began outperforming higher cost competition. Of particular note was fees worked where we saw neither the high-cost nor the low-cost firms exceed the all-firms average.[29] This suggests that while low-cost firms may have gotten more hours, those hours were not necessarily translating into greater revenue.

Figure 23: **Demand growth – high cost vs. low cost**



Segment	High cost	Low cost
Am Law 100	71.9%	3.0%
Am Law Second Hundred	18.8%	21.2%
Midsize	9.3%	75.8%

All timekeepers. Billable time type; non-contingent matters.

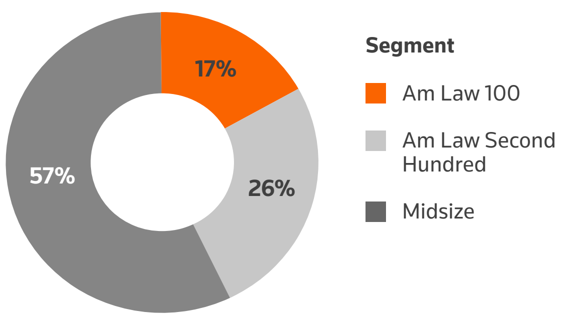
Source: Thomson Reuters 2023

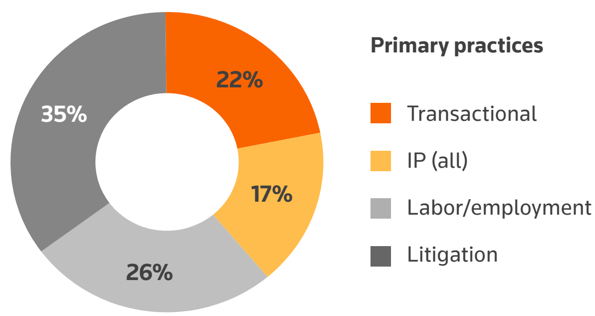
29 All firms saw average fees worked YTD November grew 5.0%, matching low-cost's pace of 5.0%, while high-cost firms grew at a slower 3.1%.

Even looking only at demand, it was apparent that price sensitivity played a large role but did not account fully for the mobility of work. In general, low-cost firms were found primarily in the Midsize segment and high-cost firms were found primarily in the Am Law 100, as most observers of the legal industry would have expected. However, it is notable that both high-cost and low-cost firms collectively underperformed the demand growth figures for their respective parent segments, i.e., low-cost firms grew demand by only 0.6% compared to 0.9% for the Midsize segment as a whole, and high-cost firms saw their demand contract by 3.2% compared to 1.8% for the Am Law 100 as a whole. Given this underperformance, some factors other than simple segmentation must be at play.

To find which other factors might be influencing the results, we looked at different firm subgroups. Among the subgroups, we found that *specialized firms*[30] – such as intellectual property, labor & employment, or litigation boutiques – were competing for demand at the highest level. As shown in Figure 24, the majority of specialized firms are also Midsize firms, but a significant number also come from the Am Law 100 and Second Hundred segments. Specialization also encompasses a wide range of practices.

Figure 24: **Specialized firm demographics**



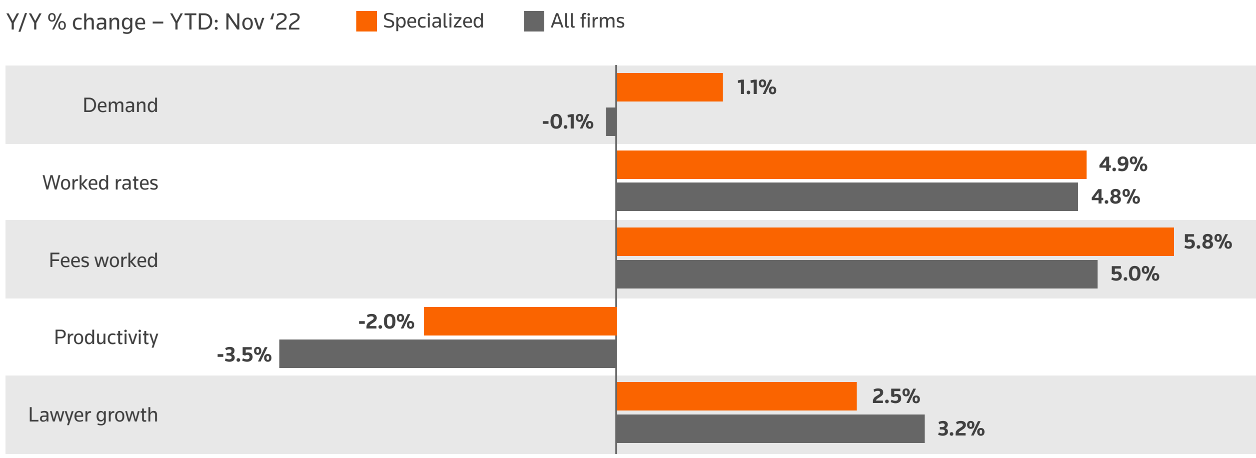


Source: Thomson Reuters 2023

As indicated in Figure 25, specialized firms outpaced all other firms in most key performance measures over the past year, especially in the second half. Measured on YTD change though November 2022, specialized firms exceeded the rest of the market in demand, fees worked, and productivity growth. More importantly, we saw that specialized firms grew demand faster than low-cost firms while maintaining much more robust worked rate increases.

30 The specialized firm group is made up of 24 firms that have 70% or more of their billable hours in a single practice per the Financial Insights database.

Figure 25: Key performance measures – specialized firms



All timekeepers. Billable time type; non-contingent matters.

Source: Thomson Reuters 2023

Due to the variety of specialized firms, we looked into the clients' opinions of these firms and found a multitude of nuanced responses based on the specialized firm's size:

- Am Law 100 boutiques stand out for their specialized expertise and ability to handle needs on a national scope across many different jurisdictions and surprisingly competitive costs is not a strong differentiator for them.
- The specialized firms in the Am Law Second Hundred are where competitive costs come into play as one of the traits being cited for driving favorability to these firms. In addition, their regional coverage also has been cited.
- Midsize specialized firms stand out especially for their competitive costs and their individual lawyers, with clients citing the strength of one or two lawyers at the firms as driving favorability.

These opinions would seem to mean that specialized firms are uniquely well suited to providing high-quality work at extremely competitive prices due to their specialization and workflow efficiency, at least in the eyes of many clients. The notably higher performance of specialty firms over the general market during the current economic downturn hints that clients, while very aware of costs, are willing to pay more for firms if they produce high quality work in efficient and cost effective ways. Clients want the most "bang for their buck," not just the lowest sticker price.

The data also suggest, however, that certain practices are no longer as economically viable as they once were for firms at the higher end of the rate scale. Increasingly, a number of practice areas appear to be moving down market, creating opportunities for smaller or boutique firms and narrowing the range of practices in which the high-priced firms are truly competitive. These shifting market dynamics are only likely to continue in the years ahead.

Lessons for law firm leaders

The uncertainties described above will pose significant challenges for law firm leaders in the coming year and beyond. To push through them successfully, leaders at all levels will have to focus their efforts more effectively than ever before. And, for these purposes, the principles that guided Luis Urzúa in the Chilean mine disaster in 2010 offer some important lessons.

First: Tell the truth – Nothing is more important for leaders in an uncertain situation than to be honest with their followers about the realities of the situation they all face. Uncertainty produces anxiety in everyone and can quickly escalate to uninformed speculation about all of the bad outcomes that can be imagined. A leader's first job is to keep such speculation to a minimum and provide as much reliable information as possible.

Within the context of a law firm at the present moment, that means leaders should help their partners set reasonable expectations for likely or possible outcomes of the economic uncertainties in which firms find themselves. It is much easier to deal with reduced PPEP at year-end if partners have been conditioned to expect it, rather than if the news comes as an unwelcome surprise. Similarly, it is less disruptive for a firm to manage a layoff if the possibility of it has been previously discussed, and if it is handled as humanely as possible.

Further, regarding layoffs in particular, it is very important for firms to tell the truth in public statements. Unfortunately, we have come to expect firms to say that a layoff is less economically driven, and more a sifting out of unproductive associates, as if that explanation is somehow more comforting to clients. Characterizing a layoff as a reduction in force attributable to an economic downturn is far less damaging to the careers of young lawyers caught up in the process than trying to emphasize quality issues associated with departing associates. It is also far less damaging to firm culture.

Second: Require teamwork – Periods of uncertainty can trigger centrifugal forces in any organization, and law firms are no exception. The anxiety associated with uncertainty causes people to naturally focus more on themselves and less on their teams or practice groups. As a result, organizational cohesion can suffer, rendering firms less stable and more susceptible to disruption. Law firm leaders need to counter these tendencies by emphasizing the importance of collective action and by engaging in broad-based consultations with partners and practices across their firms. Simply put, it's a time for leaders to remind their partners: "We're all in this together."

Contrary to the natural tendency to hunker down until the danger passes, firm leaders need to engage their practice and industry team leaders to actively work through the challenges that firms face. This should involve a careful monitoring of practice areas and key clients to identify new or expanding opportunities that might emerge from a rapidly changing market. Indeed, periods of turmoil often lead to such opportunities, if firms are capable of identifying and addressing them.

And third: Stay focused – For law firm leaders, times of uncertainty are also periods when it is critical to stay focused, especially from a strategic perspective. It is also important to remember that a firm's *strategy* is the means by which it hopes to attain a *sustained competitive advantage*. It is not about adopting best practices or doing what your primary competitors are doing. It is about how your firm will *win* in its effort to achieve dominance in a particular practice or with a particular group of clients.

Viewed from this perspective, strategy is not a *product* but rather an *organizational capability*.[31] It is the ability of an organization "to renew itself over and over again,"[32] by constantly monitoring the changing environment in which it operates and making "the most intelligent strategic choices about where and how to deploy… [its] scarce resources in support of… [its] plan for winning."[33]

Law firm leaders who manage to keep this kind of strategic focus during the uncertainties of the time ahead have a much higher likelihood of bringing their firms through the current economic downturn stronger and more prepared to deal with the new market realities that will emerge – whatever they may be.

31 This concept of strategy as an organizational capability is described in detail in Willie Pietersen, Reinventing Strategy: Using Strategic Learning To Create & Sustain Breakthrough Performance, 51-53 (2002).

32 *Id.* at 51.

33 *Id.* at 54.

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