True Value Partnering Institute

Thomson Reuters Institute

Law firm rates in 2023

What's working, what isn't, and how to move forward into 2024

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Law firm rates in 2023

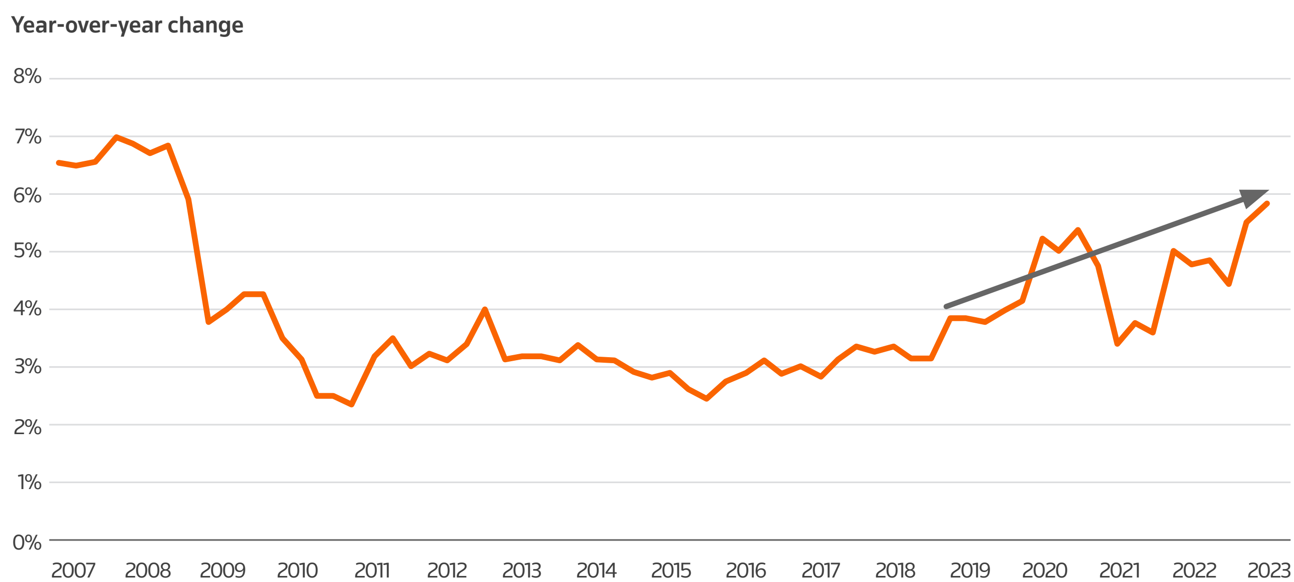
For most of the past decade, the growth in hourly rates for attorney time has been one of the key drivers of the growth of law firm profitability. In fact, when applying the classic *RULES* framework for professional services firms[1] — which stands for *R*ates, *U*tilization, *L*everage, *E*xpenses, and *S*peed of billing — it is rates, and more broadly their impact on driving revenue, that has been the most highly functional lever for law firms to positively influence their profit outlook.

This special report from the Thomson Reuters Institute and the True Value Partnering Institute, offered at a time when many firms are engaging in rate setting for the coming year, will explore not only the current and historical performance of law firm rates, but will also provide insight into other potential pitfalls that may negatively impact the growth of law firm revenue, and ultimately, profitability.

Today's growth in a historical context

Before we can illustrate how significant the recent growth in law firm rates has been, it is important to set historical context.

Figure 1: **Historic worked rate growth**



Lawyers. Billable time type; non-contingent matters

Source: Thomson Reuters 2023

1 See Maister, David. 1997. *Managing the Professional Service Firm*. Free Press.

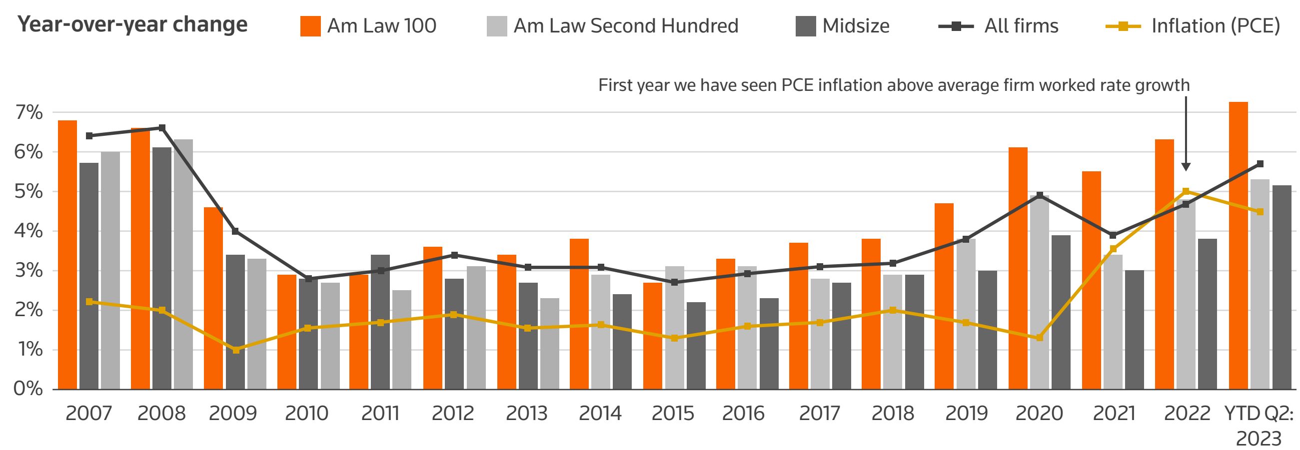
Prior to the advent of the Global Financial Crisis (GFC), law firm worked rates[2] were growing by an average exceeding 6%. There was understandable tumult from the GFC, but rate growth soon stabilized into a pattern of consistent growth ranging from 2.4% to 4.0% all the way until the start of 2020.

It was really the start of the pandemic that marked a turning point. The second quarter of 2020 saw the average law firm post worked rate growth in excess of 5% for the first time since the GFC.[3] Rates cooled again somewhat in 2021 before a dramatic acceleration into 2022 that has continued through to the present.

Rates performance in the post-pandemic era

While rates have long been a key area of focus for law firms, the importance of rate growth has been thrown into particularly sharp relief in the past few years. This newfound urgency can be explained in one word: *inflation*.

Figure 2: **Worked rate growth by segment**



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

Source: Thomson Reuters 2023

Starting in 2021 and continuing through 2022, the market experienced a phenomenon it hadn't seen for as long as this data has been tracked. The typical advantage that worked rates had enjoyed over inflation[4] disappeared for a while; and in fact, worked rates and inflation actually inverted, meaning that the effective real value of law firms' rate increases was essentially non-existent.[5]

2 For purposes of this report, worked rates refers to the agreed-upon rates that clients agree to pay a law firm to engage a new matter. Worked rate growth tracks the year-over-year percentage change in worked rates.

3 Much of the rate growth seen in 2020 was likely the result shifting apportionment of work. More work was being done by partners rather than more junior lawyers, so the average billing rate was elevated. As work shifted back to lower-cost timekeepers in 2021, the pace of rate growth appeared to cool, but this was likely a return to the status quo.

4 For purposes of this report, we use the metric of Personal Consumption Expenditure (PCE) Core inflation 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 as it excludes more volatile items like food and energy prices.

5 For a deeper discussion on inflation and its impact on law firms, see Inflation and the law firm, available at https://www.thomsonreuters.com/en-us/posts/legal/inflation-law-firms.

At the same time, the legal market was experiencing an unprecedented pace of what has been called *demand mobility*.[6] In essence, demand mobility is the shifting of work from one law firm to another, whether as part of a quest for lower costs, greater value, both, or some other advantage. This created a situation in which larger law firms were at risk of losing some share of their client business, while midsize law firms[7] were enjoying an influx of new hours and perhaps were a bit more ready to flex some of their newfound market influence.

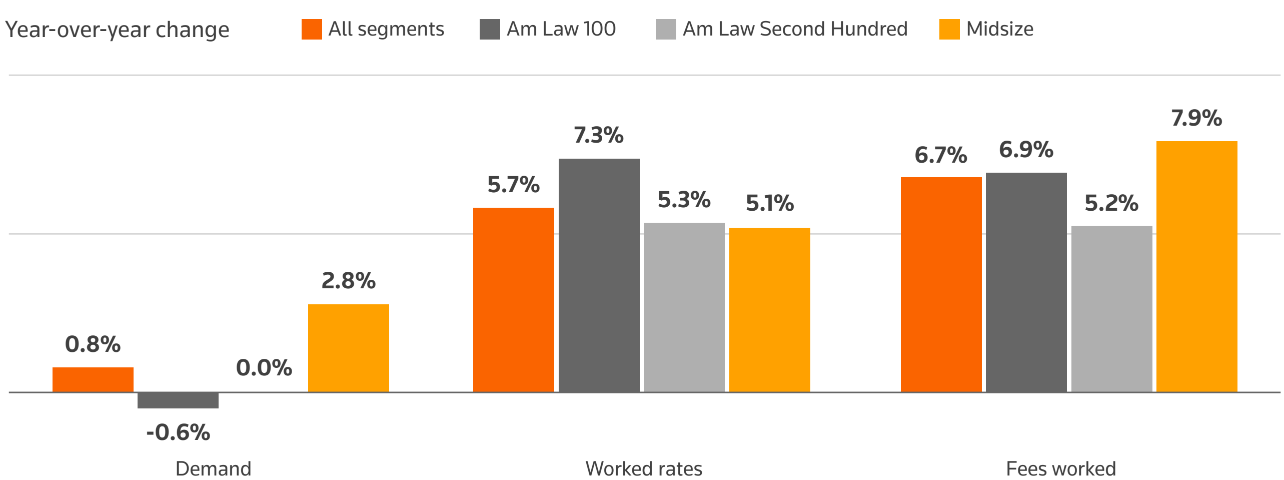
This was the backdrop as law firms engaged in their rate-setting exercises for 2023 — and the results are apparent almost immediately.

Figure 2 (*above*) makes it readily apparent that all three segments of law firms felt the need to push the accelerator on their worked rates in 2023. Am Law 100 firms set a new high-water mark for their rate growth in the first half of 2023, with worked rates growing by 7.3% — a marked not topped even in the heady days prior to the GFC.

Likewise, midsize law firms took a more aggressive stance on their rates than at any point since before 2009. These firms grew their worked rates by an average of 5.1% in the first half of 2023, a sharp jump from the 3.8% pace of rate growth for these firms at year-end 2022.

And for their own sake, Am Law Second Hundred firms similarly set a post-GFC benchmark, albeit with a less dramatic jump than their midsize counterparts.

Figure 3: **Key performance measures**



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

Source: Thomson Reuters 2023

6 For purposes of this report, demand growth is defined as the year-over-year percentage change in the total number of billable hours worked by the average law firm in the data sample. For discussion of demand mobility, see *2023 Report on the State of the Legal Market* at pages 22-26; available at https://www.thomsonreuters.com/en-us/posts/wp-content/uploads/sites/20/2023/01/2023-State-of-the-Legal-Market.pdf. See also, *2023 State of the Corporate Law Department* at pages 10-11; available at https://www.thomsonreuters.com/en-us/posts/legal/state-of-the-corporate-law-department-2023.

7 For purposes of this report, midsize law firms are defined as those law firms classified outside the Am Law 200 rankings. Firms in this category range from those with roughly 40 lawyers to firms with headcounts comparable to Am Law Second Hundred law firms.

Even as 2023 rate schedules took effect, the demand picture continued to shift. Midsize law firms continued to enjoy the benefits of mobile demand, growing their average demand by 2.8% while the other two segments struggled to find growth.

Revenue potential — and therefore profit potential — grew in each segment through the mid-year point, but for different reasons. Revenue potential is tracked via a metric called *fees worked*, an analogue for accrual-basis revenue tracked as the change in the product of hours multiplied by rates.

For both segments of the Am Law rankings, growth in fees worked was dependent entirely on growth in worked rates. Midsize law firms, by contrast, had two factors spurring them on to market-leading growth in fees worked. For these firms, strong growth in both demand and rates put them in a position to capitalize on the potential for increased revenue.

A variation on the *RULES* and its impact on 2023 and beyond

While rates undoubtedly plays an outsized role in driving law firm profitability under the *RULES* rubric, it seems wise to focus on the broader picture of revenue as a substitute of sorts for the first element of *RULES*.

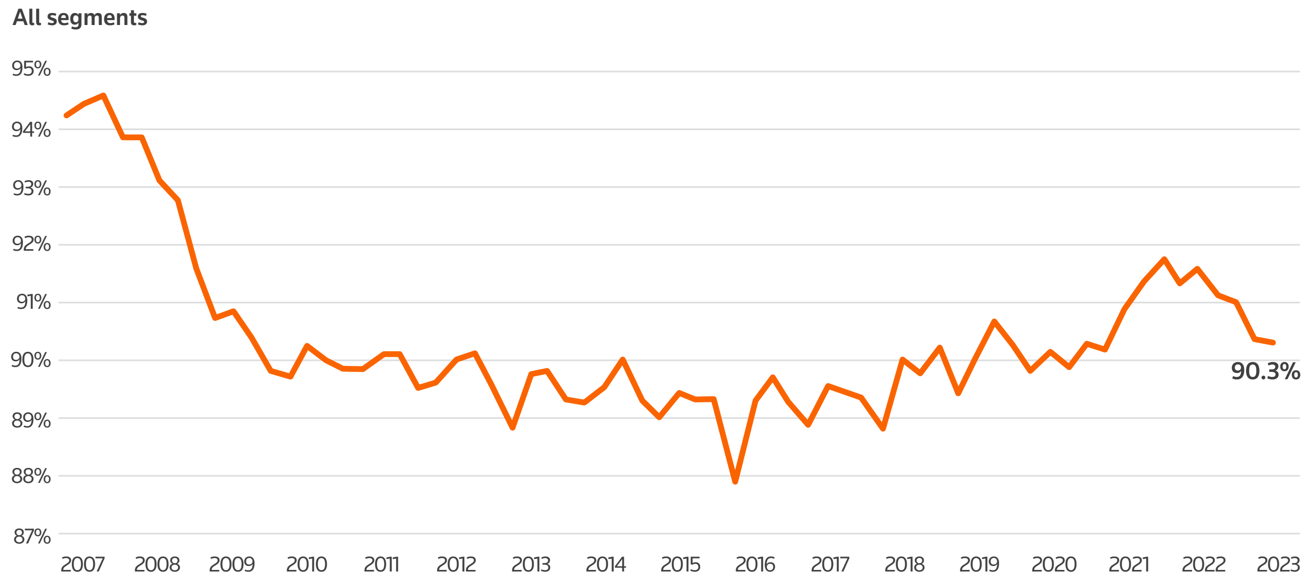
To be sure, rate growth has been a critical driver of revenue growth for many law firms for much of the post-GFC era, a time marked by relatively minimal demand growth. However, rate growth can prove to be an illusory benefit if law firms are unable to actually capture that growth in rates all the way through the client billing process.

Even though it is most common for us to report growth in worked rates, the Thomson Reuters Institute typically tracks rates at four different stages: standard rates, worked rates, billed rates, and collected rates. The latter two are particularly important to the broader revenue picture.

A law firm's ability to convert its worked rates into the rates actually billed to the client is tracked via a metric known as *billing realization*. Similarly, a firm's ability to convert worked rates into ultimate cash collections is tracked via a metric called *collected realization*.

This latter metric — collected realization against worked rates — obviously has tremendous bearing on a law firm's revenue picture.

Figure 4: **Collected realization against worked (agreed) rates**



Lawyers only, billable time type.

Source: Thomson Reuters 2023

For most of the 2010s, collected realization against worked rates hovered between 89% and 90% with a relatively predictable pattern of seasonal fluctuation. Then in mid-2019, collected realization started to tick up consistently above 90%. From early 2020 though early 2022, collected realization consistently improved, only to suddenly sour somewhat in mid-2022 through to the present.

So, what changed?

Understanding the fluctuations of realization

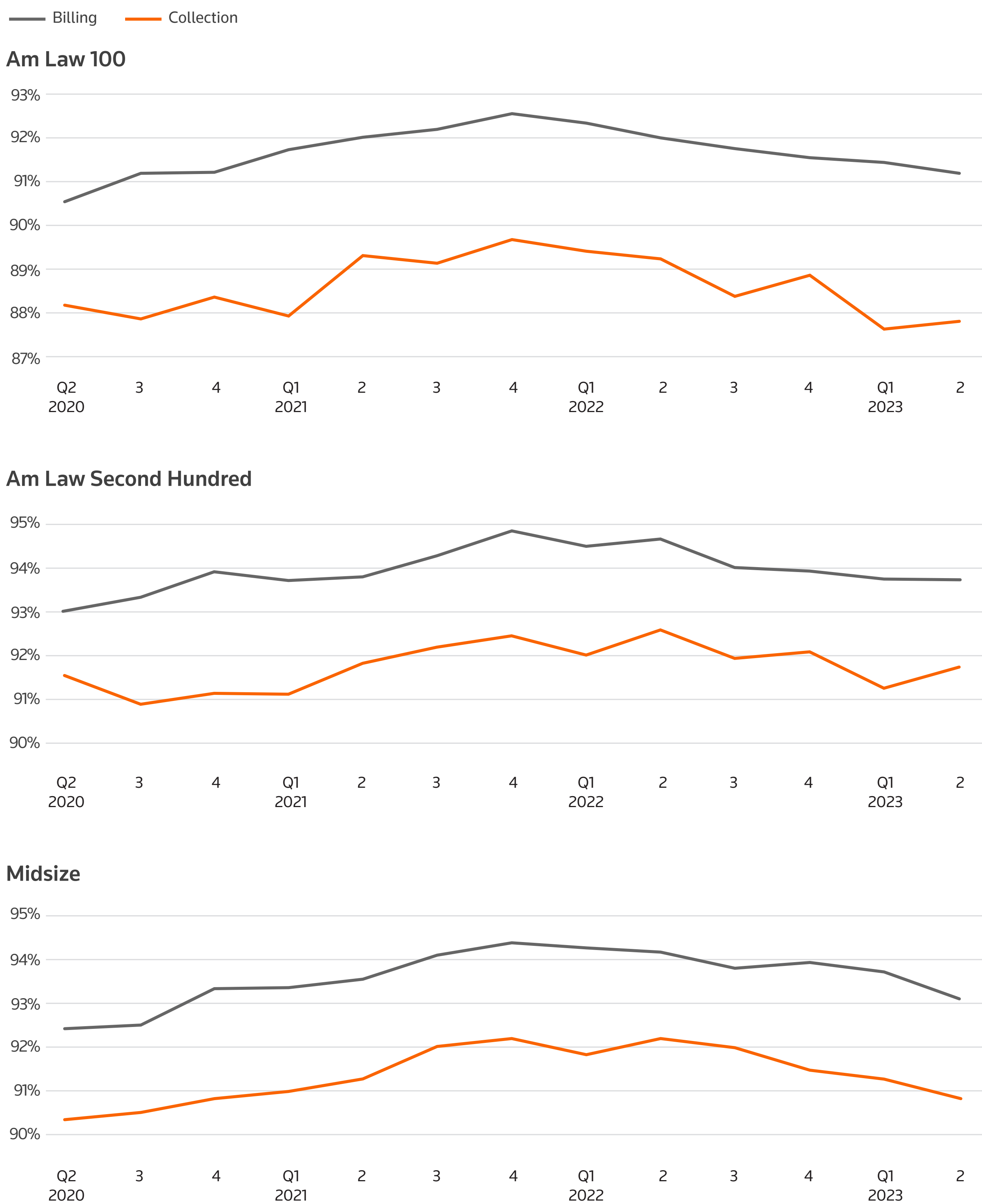
It is tempting to chalk up the fortunes of realization to the whims and behaviors of clients. After all, the legal media is replete with stories of clients pushing back on law firm rates, particularly as many law firms continue to push aggressive rate growth. However, this explanation overlooks a likely more impactful reason.

To better understand the deeper dynamics behind realization, we must more fully explore the broader spectrum of realization.

When looking at declining realization, it is easy to ask, "Why are clients paying less of the rate they agreed to pay?" Examining both billing and collected realization begs another question: "What if the clients never even get a *chance* to pay the rate they agreed to pay?"

Put simply, clients will never be able to pay 100% of the rate they agreed to pay if they're only billed 90% of that agreed-upon rate. Unsurprisingly, clients will take the amount they're billed and work down from there.

Figure 5: **Realization against worked (agreed) rates**



Lawyers; billable time type; non-contingent matters.

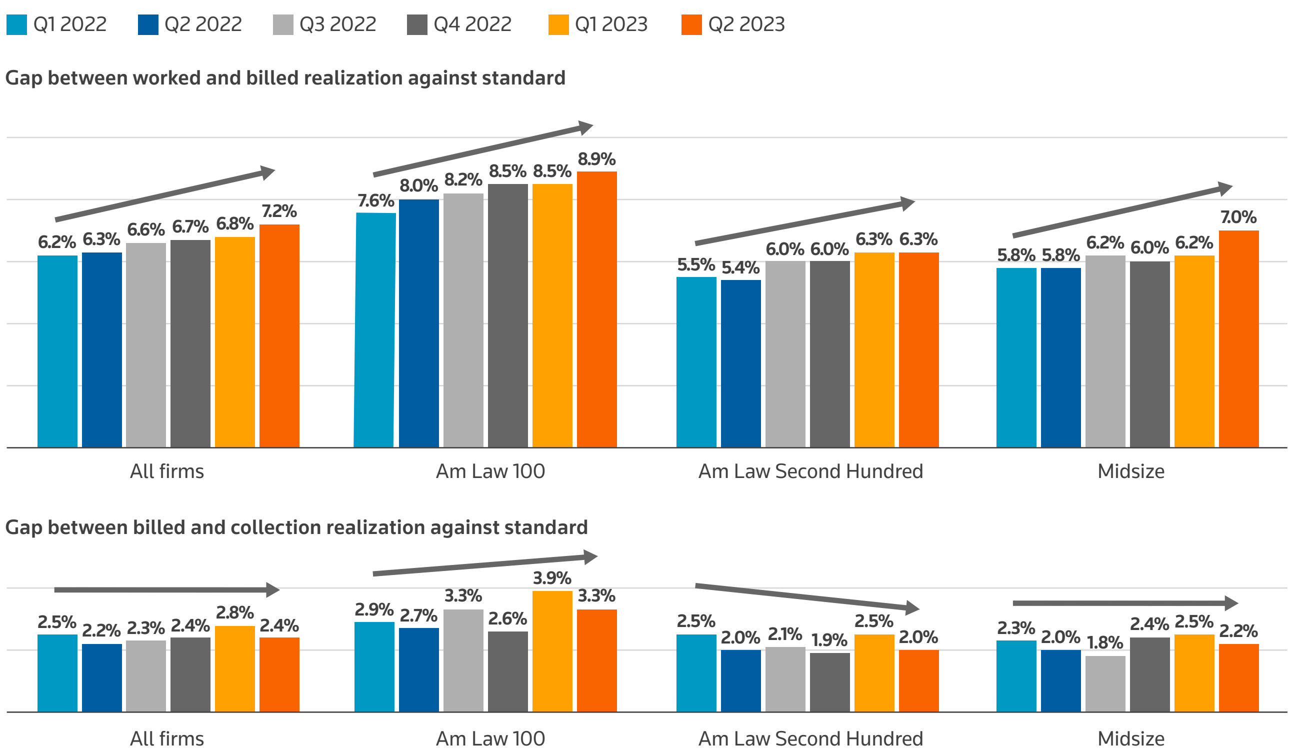
Source: Thomson Reuters 2023

In fact, that appears to be exactly what is happening. Looking at the graphs in Figure 5 (*above*), it's apparent that billing and collected realization tend to travel in rough parallel. There is some periodic variability; but in general, as billing realization improves, so too does collected realization.

In fact, in all three law firm segments, billing realization steadily improved from Q2 2020 through the end of 2021, if not into 2022. It is only after billing realization begins to decline do we notice a commensurate drop in collections. This provides a strong foundation to posit that much of the decline in realization is likely due to patterns and practices within the law firms themselves rather than to external forces.

Without a doubt, clients do push back on the invoices they receive. The key question, however, is whether that is a *primary* driver of declining realization. It appears that, for the most part, the answer to that question is *no*.

Figure 6: Gaps in realization against standard rates



Lawyers only, billable time type.

Source: Thomson Reuters 2023

Explaining the gaps in realization

What Figure 6 (*above*) shows is that the gap between worked rates and billed rates as a function of standard rates[8] has been consistently widening since Q1 2022 for every segment of law firms. Read in conjunction with Figure 5, this explains why we see consistently *declining* billing realization over this same time period.

At the same time, the gap between billed rates and collected rates as a function of standard rates has been mostly consistent, showing that client pushback on billed rates has been likewise consistent. While the Am Law 100 law firms saw a slight uptick in the gap and Am Law Second Hundred firms saw a slight downturn in the gap, neither is large enough to overshadow the much larger trend seen in the gaps between worked and billed rates.

In other words, the decline in realization is happening even before the client is billed.

What drives the gap between worked and billed rates? In short, law firm billing behaviors. The specific answer will likely vary among firms, but the apparent result will turn out to be some combination of a softening of billing discipline following the period of pandemic-era bill hawkishness and an increase in the prevalence of pre-bill write-down activity on the part of law firm billing partners.

Notably, discounts offered to engage work don't enter into this particular analysis because those discounts are already factored into the worked rate before the analysis of the gap between worked and billed rates.

It becomes clear that the decline in realization — rather than being driven by client negotiations or pushback — is much more closely related to law firm behavior.

There is good news and bad news in this finding. The bad news is that much of the decline in realization for law firms, and the accompanying negative effect on the *revenue* portion of our *RULES* analysis, has been due to self-inflicted damage on the part of law firms. The good news, on the other hand, is that this damage is much easier to counter given that it's easier to influence internal behaviors rather than external ones. Put another way, it is far easier for a law firm to place revenue-positive influence on its own lawyers than on its clients.

Much of the decline in realization for law firms has been due to self-inflicted damage.

Convincing clients to act differently when it comes to how they handle their invoices is a daunting task; but convincing lawyers to alter their billing behaviors is much more readily accomplished. In fact, it was done with great success as recently as just a few years ago when realization trended upwards.

8 For this particular figure, we analyze worked and billed rates as a function of standard rates so as to provide a common baseline for both rate figures.

We want to be careful here to state that we are not advising law firms to bill for low-value work that might incur friction with the client. Rather, improving billing practices is a fairly intricate task involving some key steps, including:

- coaching partners and rising partners on how their law firm prices their services — not just the rate structures but the value proposition behind those rates so those partners responsible for reviewing pre-bills feel more confident standing behind them;
- ensuring that law firms begin closely tracking not only how much time is being proactively written down at the pre-bill stage, but also *why* that time is being written down;
- conducting a thorough analysis of the *why* behind the write-downs to identify patterns of tasks or work types that are more susceptible to being written down; and
- looking back at past periods of improved realization to identify both qualitative and quantitative differences in billing practices to determine what changed and how to course correct.

To help with these items, many law firms now employ pricing professionals tasked specifically with helping to improve firm profitability and lawyer understanding of how the firm prices its legal services. The expertise of these professionals can be leveraged to help accomplish these goals and more.

Regarding the third bullet point specifically — areas particularly prone to write-downs are ripe for process improvement. There is a reason this work is being written down more frequently. Lawyers should evaluate how much of the work that is subject to frequent write-downs is really adding value to the outcome for the client. Chances are, it is relatively low-value-added work to begin with. (This is a phenomenon the Thomson Reuters Institute has studied extensively for years.[9])

Among the most common causes of write-downs on a given matter are "correcting or revising an associate's work" and "getting up to speed," whether on a new matter, area of law, or jurisdiction, according to our research conducted of law firm partners and associates. These are not examples of high-value-added work done for a client, rather, they are opportunities to improve how the law firm arrives at final work product by eliminating unproductive worked hours.

Indeed, such improvements can be done without negatively impacting the firm's revenue potential since the time goes largely unbilled anyway. Instead, addressing these issues at their root cause can improve the firm's revenue potential simply because eliminating work that will never be billed anyway creates capacity for more work that will ultimately be billed and paid for.

9 See, e.g., "How law firms can stop rate degradation," available at https://www.thomsonreuters.com/en-us/posts/legal/stopping-rate-degradation/; "How law firms can protect their revenue in 2023," available at https://legalexecutiveinstitute.libsyn.com/how-law-firms-can-protect-their-revenue-in-2023; Law Firm Billing Efficiency and Write Downs Report, available at https://legal.thomsonreuters.com/en/insights/reports/law-firm-billing-efficiency-and-write-downs-report.

Figure 7: **Illustrating the benefit of realization improvement**

Closing the gap between worked and billed rates, and the improvement in collected realization that would potentially follow, can have a notable impact on law firm revenues.

Let's construct a hypothetical comparison for Law Firm A:

2022	2023
Average worked rate **$500.00**	Average worked rate **$528.50** *based on average worked rate growth YTD*
Collected rate **$456.50** *based on Q1 2022 realization rate of 91.3%*	Collected rate **$477.24** *based on current realization rate of 90.3%*
Worked-to-collected gap: $43.50	***Worked-to-collected gap: $51.26***

The higher collected rate seems like an improvement,
but the worked-to-collected gap is widening

Every 0.1% improvement in realization in our hypothetical results in additional cash collections of $5.29 per hour

This might seem minimal, but…

Law Firm A has:
100 lawyers x 1700 hours per lawyer x $5.29 per hour

$900,000 additional collections

Source: Thomson Reuters 2023

The bottom line (pun intended)

Law firms have been quite successful since 2022 at pushing more aggressive worked rate growth, putting them on solid footing for improving revenue outlooks. What likely started as an exercise to try to combat inflation now has set what is looking more like a new standard for rate growth.

However, the opposite end of the revenue picture in our revised *RULES* analysis also needs attention. Declining realization is casting a shadow on an otherwise trendsetting performance.

There may well be a case to be made for pushing for more aggressive rate growth with the intent of sacrificing some small portion of realization. Indeed, looking at Figure 5, that appears to have been a strategy for the Am Law 100 for some time.[10]

There may well be a case to be made for pushing for more aggressive rate growth with the intent of sacrificing some small portion of realization.

Firms looking to take such a strategy must approach it carefully, however. While it is a logical strategy to pursue, it should pursued intentionally and managed carefully. Otherwise, law firms run the risk that more realization may be sacrificed than would otherwise be desirable, particularly if the billing and collection processes are not being closely monitored.

Similarly, just as law firms are setting new standards for rate growth, they should be aware of the standards they are setting for realization. Should rate growth experience another period of cooling, law firms would naturally much rather capture upwards of 91% of the cooler rates rather than 89%.

Law firms that fail to focus on this latter factor run the risk of losing grasp of their most impactful tool — a fuller understanding of rates, from billing to collection — to most positively influence profitability.

10 As illustrated in Figure 5, the average Am Law 100 firm has historically struggled to top collected realization in excess of 80%. At the same, Am Law 100 law firms have consistently posted market-leading worked rate growth. (See Figure 2.)

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