Introduction - The Benefits of Taking a Longer View

Hockey legend Wayne Gretzky once explained the secret to success in his sport by noting that "A good hockey player plays where the puck is. A great hockey player plays where the puck is going to be."

Gretzky’s observation has often been cited for its obvious relevance to the process of business strategy, and it seems particularly apt for law firm leaders in the current environment. In the six and a half years since the onset of the Great Recession, the market for legal services has changed in fundamental -- and probably irreversible -- ways. Perhaps of greatest significance has been the rapid shift from a sellers’ to a buyers’ market, one in which clients have assumed control of all of the fundamental decisions about how legal services are delivered and have insisted on increased efficiency, predictability, and cost effectiveness in the delivery of the services they purchase. This shift in the dynamics of the market, coupled with at best modest growth in the demand for legal services, the decision of many corporate clients to shift more legal work in-house, the growing willingness of clients to disaggregate services among many different service providers, and the growth in market share of non-traditional competitors, have all combined to produce a much more intensely competitive market for legal services than existed prior to 2008.

Over the past five years, law firms have responded to these market changes in a variety of ways. They have become more adept at responding to RFPs and participating in competitive selection processes; they have become more proficient in developing and working under project budgets and in responding to client demands for alternative fee arrangements and they have begun to develop project management capabilities as well as the skills needed to partner with other providers in disaggregated service settings. For the most part, however, these changes have been in response to specific client pressures. They have not generally resulted from law firms themselves taking a longer range view of the changes impacting the legal market and restructuring their services to meet likely client expectations in the future. In other words, to use the Wayne Gretzky metaphor, they represent playing where the puck is and not where it is going to be.

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1 The Center for the Study of the Legal Profession and Thomson Reuters gratefully acknowledge the participation of the following persons in the preparation of this Report: from the Center for the Study of the Legal Profession -- James W. Jones, Senior Fellow (lead author) and Milton C. Regan, Jr., Professor of Law and Co-Director; and from Thomson Reuters Peer Monitor -- Jennifer Roberts, Sr. Analyst, Client Management & Thought Leadership.

2 An "alternative fee arrangement" is generally defined as an engagement in which fees are set without reference to hourly based billing rates.
The importance of this distinction was illustrated recently in a presentation by David Morley, the Worldwide Senior Partner of Allen & Overy LLP ("A&O"), about the strategic redesign of his firm to meet the future demands of a rapidly changing legal market. Speaking at the 13th Annual Law Firm COO & CFO Forum presented by the Thomson Reuters Legal Executive Institute in October, Morley explained that, after extensive consultations with its clients, A&O decided this past summer to redesign itself as a "hybrid firm" consisting of five separate organizations with legal services at its core. The components of the new firm -- which is being designed to provide "hybrid legal solutions for clients" -- includes the A&O law firm, Peerpoint (a contract lawyer service), A&O Consulting (offering hybrid solutions for legal problems), A&O Derivative Services (for on-line legal services), and the A&O Legal Services Centre (Belfast) (for document review services). All components of the new structure are technologically linked to the law firm, and A&O intends to market the components together (as appropriate) in making proposals to clients. The new strategy reflects the firm’s strong conviction that such a hybrid, multidisciplinary approach to legal issues will be essential in the future to meet client demands for increased efficiency and cost effectiveness in the delivery of legal services. It is a good example of playing where the puck is going to be.

Clearly, the strategy adopted by A&O will not be right for every firm, but the process it used -- carefully looking at the way its market was changing and placing strategic bets on the changes it needed to make to remain competitive and successful for the long run -- is a process every firm should follow. Interestingly, most leaders of law firms of any significant size recognize that fundamental change is needed in the way their firms deliver and price legal services, but in practice there remains an astonishing lack of urgency in moving on these issues. For example, respondents in the Altman Weil 2014 Law Firms in Transition survey overwhelmingly agreed that focus on improved practice efficiency will be a permanent trend in the legal market going forward (93.8 percent), as will more intense price competition (93.8 percent), more commoditized legal work (88.6 percent), and increased competition from non-traditional service providers (82.3 percent). And yet, among the same respondents, only 39.4 percent said their firms had changed their strategic approach to achieving efficiency in the delivery of legal services, and only 29.5 percent said they had significantly changed their approach to pricing strategy. The obvious question is why?

In the sections that follow, we will look at the changed market realities that drive the need for firms to take a longer range and more strategic view of their market positions, will review some of the factors that may contribute to the evident resistance in many firms to embrace the changes that the market demands, and will consider the possibility that the resistance to change across the legal market may be at least partially attributable to the way we currently measure law firm performance. We begin, however, with a review of the performance of U.S. law firms in 2014.

3 The results of these consultations have been summarized in a special report, "Unbundling a Market — The Appetite for New Legal Services Models" published by Allen & Overy in May 2014, and available on the firm’s website.
4 A sixth component -- an entity that would offer managed legal services (e.g., the outsourcing of some or all of corporate in-house law department functions) -- was also identified by Allen & Overy as a strategic opportunity, but that component has evidently not been included in the current "hybrid organization" rollout.
5 The 2014 Law Firms in Transition: An Altman Weil Flash Survey (the "AW 2014 Law Firms Survey") included responses from managing partners and chairs of 304 U.S. law firms, including 42 percent of both 2013 NLJ 350 firms and 2013 Am Law 200 firms.
6 AW 2014 Law Firms Survey at 16-17, 22.
7 Id. at 18, 23.
Current State of the Legal Market - By the Numbers

By most indicators, law firm financial performance in 2014 appeared modestly better than in 2013. Demand growth for law firm services finished the year in positive territory as contrasted with 2013 when demand actually declined. As a result, revenue growth across the market was stronger than in the previous year, though persistent challenges remain. In particular, productivity has continued to decline, reflecting law firms’ ongoing difficulty in striking the right balance between headcount and anticipated demand growth. Similarly, realization rates have continued to fall as clients have consistently pushed back on even modest rate increases. And firms have needed to maintain strict discipline to keep expense growth at acceptable levels. Although results differed for individual firms -- and some firms (as described below in our discussion of market segmentation) performed well above market averages -- on the whole 2014 was a year of only modest improvement for firms across the market.

Demand Growth

Demand for law firm services grew modestly (under 0.5 percent) in 2014, as tracked by Thomson Reuters Peer Monitor. As shown in Chart 1 below (which tracks performance on a year-to-date basis through November 2014), while this year’s demand growth is a clear improvement over last year (when demand growth was negative), it does not represent a significant improvement in the overall pattern for the past five years. Indeed, since the collapse in demand in 2009 (when growth hit a negative 5.1 percent level), demand growth in the market has remained essentially flat to slightly negative.

Chart 1 - Growth in Demand for Law Firm Services

As shown in Chart 2 below, demand growth during the past year has been driven by a resurgence of transactional activity, as reflected in healthy growth in general corporate, tax, and real estate practices. Significantly, demand growth in litigation -- which comprises about one-third of all practice activities across the market -- remained negative, as it has been more or less since the beginning of the recession in 2008.

8 Thomson Reuters Peer Monitor data ("Peer Monitor data") are based on reported results from 149 law firms, including 51 Am Law 100 firms, 46 Am Law 2nd 100 firms, and 52 additional firms. For present purposes, "demand for law firm services" is viewed as equivalent to total billable hours recorded by firms included in a particular data base.

9 All non-contingent hours worked.

10 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.
During 2014 (as of November), the number of lawyers in U.S. firms grew by about 1.4 percent or about 1 percent more than the growth rate in demand. Consequently, productivity across the market remained slightly negative.

As can be seen in Chart 3 below, this continued a pattern that we have seen for the last several years. Indeed, according to Peer Monitor data through November 2014, productivity for the market as a whole has been on an overall downward trend for the past 15 quarters. With the exception of associates, where there has been some improvement in productivity, though not quite back to pre-recession levels, other categories of lawyer timekeepers -- including equity partners, non-equity partners, of counsel, and senior/staff counsel -- have consistently remained between 100 and 200 hours per person per year lower than in 2007.

Productivity

11 Productivity is defined as the number of hours (billable time type only) worked by lawyers divided by the total number of lawyers.
Rates and Realization

Consistent with past practices, firms continued to raise their rates in 2014, albeit at a fairly modest level of 3.1 percent. And, also consistent with past experience, clients continued to push back, keeping strong pressure on firm realization rates.

Chart 4 below shows the rate progression as tracked in the Peer Monitor database from the first quarter of 2005 through November 2014. As can be seen, over this ten-year period, firms increased their standard rates by 35.9 percent from an average of $348 per hour to $473 (or an average increase of about 3.6 percent per year). At the same time, reflecting mounting client push back to these rate hikes, the collected rates achieved by law firms increased by a somewhat more modest 28.2 percent over the ten-year period, from an average of $304 per hour to $390 (or an average increase of about 2.8 percent per year). As a result, law firm realization rates — i.e., the percentages of work performed at a firm’s standard rates that are actually billed to and collected from clients -- declined steadily during the period.

As show in Chart 5 below, billing realization fell from 93.5 percent to 86.7 percent over the ten-year period, while collected realization declined from 92.7 percent to 83.0 percent. The latter figure is the lowest collected realization rate on record, having dropped below the previous low of 83.3 percent recorded in Q1 and Q2 2014. To put the magnitude of this decline in perspective, consider that the near 10 percent drop in collected realization means firms are losing almost $10 million for every $100 million in recorded time.
Expenses

Since the beginning of the economic downturn in mid-2008, law firms have aggressively managed their expenses -- both direct and indirect\(^\text{12}\) -- reducing them dramatically from pre-recession levels. As shown in Chart 6 below, the initial cuts in 2009 and 2010 were very deep -- induced no doubt by panicked reactions to the economic crisis -- and were not sustainable over the long term. Consequently, expenses began to rise again in 2011. Since that time, however, firms have done a reasonably good job of managing expenses effectively, with the result that both direct and indirect expenses are now growing at annual rates of less than 3 percent.

Chart 6 - Expense Growth

Profits per Partner

Despite only modest demand growth, flat to slightly declining productivity, and continuing pressure on realization, law firms did see a modest improvement in profits per partner ("PPP") during 2014. For the market as a whole, PPP was up by 3.1 percent over 2013, clearly an improvement over the 1.0 percent growth in the preceding year. The growth in PPP was not evenly distributed however. As can be seen in Chart 7 below, Am Law 100 firms saw their PPP grow by some 5.1 percent, while Am Law Second 100 firms saw improvement of only 3.4 percent, and midsized firms experienced a decline of 0.4 percent in PPP. This is reflective of a growing market segmentation that is addressed later in this Report.

\(^{12}\)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, technology, administrative staff, etc.)
Chart 7 - Profit per Partner (November YTD)

Changed Market Dynamics

The financial performance of law firms over the past year reflects several fundamental changes in market dynamics that have become increasingly evident since 2008. These changes include a shift in the buying habits of business clients, a persistent softness in the market for litigation services, the increasing presence of new non-traditional competitors in the legal services sector, and a growing market segmentation that is rapidly separating high performing firms from the majority.

Shifts in the Buying Habits of Business Clients

Although the general economy began to recover in 2010 from the effects of the Great Recession, we have seen continuing weak demand growth for law firm services. Indeed, from 2010 through 2013, demand growth was less than half of pre-2008 levels. In 2013, business spending on law firms expressed in nominal dollars was $6.4 billion, or 3.7 percent, below 2008 levels. If expressed in inflation-adjusted dollars, however, the picture is considerably worse.

In the ten years since 2004 (years that included four years of the pre-recession boom period), business spending on legal services grew from $159.4 billion to $168.7 billion, a modest improvement of 5.8 percent spread over a ten-year period. But, if expressed in inflation-adjusted dollars, the same spending fell from $159.4 billion to $118.3 billion, a precipitous drop of 25.8 percent.

It is an intriguing question whether or when the demand for law firm services will rebound to anything like pre-recession levels. Some observers argue that such a rebound is inevitable and what we are seeing in the current market is merely a reflection of the fact that law firm services are a trailing indicator of economic activity. Other observers are not so sure, pointing out the demand growth in the boom years just prior to the economic collapse in 2008 might well have been an aberration and that current performance may in fact represent a more normal growth pattern for the legal services market. Regardless of which of these perspectives ultimately proves correct, it is increasingly clear that the buying habits of business clients have shifted in a couple of significant ways that have adversely impacted the demand for law firm services.

14 Id. at 42.
15 Id.
16 According to U.S. Census Bureau estimates, the business sector accounts for about 66 percent of all spending in the U.S. legal services market, or some $169 billion out of a total of $255 billion in 2013. Id. at 41.
First, over the past few years there has been a clear shifting of significant amounts of legal work away from law firms to in-house legal staffs. In the Altman Weil 2014 Chief Legal Officers Survey, some 43 percent of CLOs reported they intend to increase their in-house workforce during the coming year;\(^\text{17}\) over 26 percent plan to decrease their use of outside counsel (with only 14 percent planning to increase such use);\(^\text{18}\) and almost 86 percent said they would shift work to in-house legal staff in the event of a reduction in the use of outside counsel.\(^\text{19}\) Among respondents, almost 40 percent also reported they had in fact shifted law firm work to their in-house legal staff within the past 12 months, and over 33 percent said they had also reduced the amount of work sent to outside counsel.\(^\text{20}\) Consistent with these latter findings, the Association of Corporate Counsel (“ACC”) reported that, among more than 1,200 corporate CLOs in 41 countries responding to the ACC Chief Legal Officer 2014 Survey, 63 percent indicated their companies are now in-sourcing work formerly performed by outside legal service providers.\(^\text{21}\)

And second, there has also been a clear -- though still somewhat modest -- shift of work by business clients to non-law firm vendors.\(^\text{22}\) Almost 17 percent of the participants in the above-referenced Altman Weil survey said that, during the past 12 months, they had outsourced work to non-law firm vendors in an effort to better control their law department costs.\(^\text{23}\) The same respondents indicated that non-law firm vendors accounted for 3.9 percent of their total departmental budgets in 2012, but that figure increased to 6 percent in 2013 and 7.1 percent for 2014.\(^\text{24}\)

Given the laser-like focus of business clients in today’s market on achieving greater efficiency and cost effectiveness in their purchase of legal services, it seems unlikely either of these shifts in buying habits will be reversed anytime soon. Indeed, it seems more likely that they will expand.

**Persistent Softness in the Litigation Market**

Consistent with a trend evident even before 2008, demand growth for law firm litigation services has continued to be very soft -- indeed, flat to negative in most quarters since 2008. This has been somewhat surprising since, in the past, litigation has been a countercyclical practice in most periods of economic distress.

Chart 8 below shows the relative demand growth of litigation versus transactional practices over the period since Q1 2007. As can be seen, with the exception of the period of recession (mid-2008 through Q3 2009) and a brief period in late 2011 and early 2012, demand growth in transactional practices has generally outpaced litigation growth, sometimes by a significant margin. Also of interest, as shown in Chart 9 below, since 2004, litigation as a percentage of the overall practice of Am Law 100 firms has fallen by 1.2 percent per year, and for Am Law Second 100 firms by 0.7 percent per year. Only among midsized firms (i.e., firms outside the Am Law 200) has litigation increased as a percentage of practice -- by 2.4 percent per year.

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17 2014 Chief Legal Officer Survey: An Altman Weil Flash Survey (“AW 2014 CLO Survey”) at 1. The Aw 2014 CLO Survey included responses from 186 CLOs from large companies. More than 93 percent of responses were from companies with more than $1 billion in annual revenues, and more than 34 percent were from companies with more than $10 billion in annual revenues.
19 Id. at 6.
20 Id. at 10.
21 Association of Corporate Counsel Chief Legal Officers 2014 Survey at 2.
22 Legal businesses outside of the law firm that solve legal problems traditionally handled by lawyers through the use of process innovation and technology.
24 Id. at 23.
The continued softness of the litigation market may well reflect client reactions to the greatly increased cost of litigation in recent years, an increase attributable in no small part to the advent and expansion of e-discovery. Simply put, clients may be less inclined to engage in large scale litigation today than in the period before the proliferation of electronic documents. It also seems likely, however, that some of the decline in demand for law firm services in litigation reflects client decisions to redirect certain discovery work previously done by law firms to legal process outsourcers and other non-traditional service providers. This siphoning off by new competitors of lucrative work previously done by law firms may also contribute to the widening profitability gap between litigation and transactional practices.

As shown in Chart 10 below, collected rates for litigation work have simply not kept pace with escalating rates for transactional practices. And, as can be seen in Chart 11, the gap in realization rate between the two types of practice is also significant -- and increasing.
Given the historic importance of litigation in the U.S. legal market — typically accounting for over 40 percent of all practice activities 20 years ago — the drop off in demand in recent years could represent a highly significant market shift. Today, based on Peer Monitor data, litigation (including patent litigation) accounts for about 36 percent of overall billable hours — 35 percent for Am Law 100 firms and 37 percent for each of Am Law Second 100 and midsized firms.

**New Competitors in the Legal Market**

As noted above, there is growing evidence that the market share of traditional law firms is being eroded by the presence of new competitors in the legal services sector. While the overall impact of such expanded competition remains fairly modest today, it is growing at a steady pace and, over time, promises to be even more disruptive to the near monopoly previously enjoyed by law firms in the legal services market.
The proliferation of new non-traditional service providers has been quite dramatic over the past few years. The trend responds to increased client demands for efficiency and cost effectiveness in the delivery of legal services and reflects the growing willingness of clients to disaggregate services among a variety of different firms and providers. Over the past couple of years, the phenomenon has been particularly evident in the United Kingdom as a result of full implementation of the Legal Services Act of 2007, but the trend is also growing in the United States and elsewhere.

Today, the range of new competitors and the services they offer is quite broad -- from the legal process outsourcing ("LPO") services of firms like CPA Global, Pangea3, and Integreon to offerings of new concept law firms like Riverview Law and Redgrave LLP; and from legal talent management services like Axiom to sophisticated document creation systems offered by firms like Koncision and KM Standards, or new dispute resolution systems provided by companies like Fair Outcomes, Inc., Resolution Tree, Raptor Risk Analysis, or Neota Logic.25 We have even seen traditional companies like British Telecom enter the legal market with specialized services targeted at particular practice niches. And, it must be added, the major accounting firms again appear to be aggressively pursuing opportunities in the legal services sector as well.

On the latter point, Ernst & Young -- operating through its legal arm EY Law -- hired over 250 lawyers in 2013, increasing its total lawyer headcount almost 30 percent to 1,100. Also in 2013, it launched legal services in 29 countries around the world -- including Australia, China, Japan, Mexico, and 14 separate countries in Africa. Its legal services cover transactional, commercial, and employment practices, with a strong focus on the financial services and banking industries. The firm's head of global legal services, Cornelius Grossman, noted that "We're building rapidly and ultimately want to be in every mature [market] and relevant emerging market. . . . We want to at least double or triple in size by 2020." 26

It appears that the other major accounting firms are pursuing similar strategies. In February, PricewaterhouseCoopers obtained an "alternative business structure" ("ABS") license in the U.K., permitting its PwC Legal unit to offer legal services in that country.27 And both Deloitte and KPMG have expanded their legal service offerings by hiring additional lawyers in the U.K., Germany, and Asia. KPMG (as well as Ernst & Young) are also reportedly considering use of the ABS model to restructure their legal operations in the U.K.28 And last year, Deloitte Legal opened its own domestic law firm in Shanghai, apparently taking advantage of a quirk in Chinese regulations that allows international accounting firms -- though not international law firms -- to offer domestic legal services in China.29

In short, the market is now awash with new, non-traditional competitors that over time are likely to change the dynamics of the legal services sector in significant ways. The regulatory barriers that for decades have shielded law firms from such competition are collapsing around the world and, even in countries like the United States where formal regulatory constraints remain largely in place, creative "workarounds" are proliferating. Clearly, a much more vibrant and competitive marketplace is emerging.

### Growing Market Segmentation

While the market for law firm services has clearly been impacted by external factors, there has also been an important shift in the internal dynamics of the market that has become increasingly apparent in recent years. Specifically, 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 has been steadily widening.

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25 While currently representing only a modest share of the overall market for legal -- and legal-related -- services, some of these new competitors are growing at impressive rates. One study undertaken by Thomson Reuters in 2012 found that revenues of LPO firms were growing at an average annual rate of about 30 percent, and there is some evidence that even this growth rate may have increased in the last couple of years as LPO firms have broadened their client base from corporate law departments to include law firms themselves. In 2014, for example, revenue growth from law firms for Pangea3 was a staggering 200 percent over the preceding year.


27 *Id.*

28 *Id.*

In recent years, the overall financial performance of Am Law 100 firms has been driven by the extraordinary results of 20 elite, high performing firms -- firms with profits per partner of at least $2 million and revenues per lawyer ("RPL") of at least $1 million. Since 2008, these high performing firms (dubbed the "Super Rich" by The American Lawyer) have grown their revenues by 20 percent, their RPL by 14.4 percent, and their PPP by 31.7 percent. And they have done this with only modest growth, with increases in headcount of only 5 percent and growth in the equity partner ranks of only 4.3 percent.\(^{30}\)

The performance of the 20 Super Rich firms have far outstripped that of other Am Law 100 firms, including the six global mega firms organized as Swiss vereins and the 74 others. The stark differences in 2013 financial performance across these three categories are set out in Chart 12 below. As can be seen, during that year, the Super Rich firms saw increases in RPL of 4.1 percent, as contrasted with -4.7 percent for the vereins and 1.0 percent for other firms; growth in PPP of 5.5 percent, compared with -8.2 percent for the vereins and 1.2 percent for other firms; and increases in compensation of all partners of 4.9 percent, as contrasted with -4.3 percent for the vereins and 0.5 percent for other firms. In terms of profit margin, the Super Rich firms recorded an impressive 51 percent, as compared to 29 percent for the vereins and 35 percent for all others.

**Chart 12 - Comparison of 2013 Performance of Am Law 100 Firms by Firm Type (% Change over 2012)**\(^{31}\)

<table>
<thead>
<tr>
<th>Metrics</th>
<th>All Firms</th>
<th>&quot;Super Rich&quot;</th>
<th>Vereins</th>
<th>All Others</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Gross Revenue</td>
<td>5.4%</td>
<td>4.9%</td>
<td>24.9%</td>
<td>2.2%</td>
</tr>
<tr>
<td>Average Revenue Per Lawyer</td>
<td>-0.4%</td>
<td>4.1%</td>
<td>-4.7%</td>
<td>1.0%</td>
</tr>
<tr>
<td>Average Profits Per Partner</td>
<td>0.2%</td>
<td>5.5%</td>
<td>-8.2%</td>
<td>1.2%</td>
</tr>
<tr>
<td>Average Compensation All Partners</td>
<td>-0.3%</td>
<td>4.9%</td>
<td>-4.3%</td>
<td>0.5%</td>
</tr>
<tr>
<td>Head Count</td>
<td>5.8%</td>
<td>1.0%</td>
<td>31.0%</td>
<td>1.2%</td>
</tr>
<tr>
<td>Equity Partners</td>
<td>4.6%</td>
<td>0.6%</td>
<td>36.9%</td>
<td>1.2%</td>
</tr>
<tr>
<td>Non Equity Partners</td>
<td>7.1%</td>
<td>4.3%</td>
<td>20.5%</td>
<td>3.1%</td>
</tr>
<tr>
<td>Leverage</td>
<td>0.05</td>
<td>0.02</td>
<td>-0.25</td>
<td>0.07</td>
</tr>
<tr>
<td>Profit Margin</td>
<td>38.0%</td>
<td>51.0%</td>
<td>29.0%</td>
<td>35.0%</td>
</tr>
</tbody>
</table>

Source: American Lawyer Media

A similar market segmentation has been evident among Am Law Second 100 firms as well. During 2013, 20 Am Law Second 100 firms substantially outperformed all others and drove the financial results for the entire Am Law Second 100 group. During that year, the gross revenues of these high performing firms grew by 4.6 percent, as compared with only 1.1 percent for the remaining 80 firms; their average RPL jumped by 3 percent, while others gained only 0.8 percent; and their PPP increased on average 3 percent, while other firms saw negative PPP growth at -0.8 percent. The performance of the 20 high achieving firms qualified them for inclusion in the top firms in the overall market (of Am Law 100 and Am Law Second 100 firms) for both RPL and PPP.\(^{32}\)

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.

31 Id. at 33.
Although the legal market has always had winners and losers in terms of financial performance, there was traditionally a fair amount of fluidity, with underperforming firms having a reasonable chance to improve their lot over time. While the full implications of the changing dynamics of the legal market remain to be seen, the segmentation that is now emerging feels somewhat different and more permanent than before.

Resistance to Change in the Law Firm Market

The shifting dynamics of the legal services market underscore the critical importance of law firms taking a strategic and long-range view of how their clients, their practices, their markets, and their competitors are changing. As events of the past year (including the demise of Bingham McCutchen and Patton Boggs) have starkly underscored, today’s highly competitive legal market is very unforgiving, and strategic missteps can have very serious consequences. It is, in other words, more important than ever before that law firms learn to play where the puck is going to be.

As previously noted, most law firm leaders seem to understand all of this instinctively but still express significant doubts about the ability of their firms to make fundamental changes. A substantial majority of the managing partners and chairs of the 304 law firms responding to the Altman Weil 2014 Law Firms in Transition survey acknowledged that the market for legal services has changed permanently in fundamental ways, and almost 67 percent predicted that the pace of change will increase. At the same time, only about 13 percent of respondents expressed high confidence in their firms’ ability to keep pace with the changes in the marketplace (down from almost 24 percent in 2011). And, ranking the seriousness of law firms to implement changes to their legal service delivery models to provide greater value to clients on a low-to-high scale of 1 to 10, survey respondents gave the industry a middling "5". That ranking, interestingly, contrasted to a similar ranking by client CLOs who put the willingness of law firms to change at "3".

If law firm leaders are convinced of the need for their firms to make fundamental changes to their service delivery, work process, and pricing models but seem unable to initiate those changes, the obvious question is why? The reasons are no doubt complex and related to both human nature (our built-in resistance to change) and the inherent conservatism of lawyers (our perception of change as threat and not opportunity). However, the resistance to change may also be rooted, ironically, in the very success that the legal industry enjoyed prior to 2008 and, by at least some measures, continues to enjoy today. We may, in other words, be victims of our own success.

By any measure, the decade leading up to the economic collapse in 2008 was a time of unprecedented growth for the law firm market. With the exception of the brief "tech bubble" related recession in 2000-2001 that adversely impacted some firms (though not all), law firm partners during this period saw their firms’ revenues and profits increase dramatically. Indeed, in the three-year period from 2004 through 2007, U.S. law firms saw their revenues grow at a staggering cumulative rate of 37.5 percent, and their profits per equity partner increase at an impressive cumulative rate of 25.6 percent. Of course, this boom period came to an abrupt halt in 2008, when law firm revenues and profits both dropped precipitously. In early 2010, however, the market began to improve and ultimately reached its current level of positive though very modest annual gains.

33 The identified changes included more price competition (93.8 percent), more commoditized legal work (88.6 percent), more non-hourly billing (81.9 percent), fewer equity partners (74.1 percent), more contract lawyers (71.5 percent), reduced leverage (65.4 percent), smaller first-year classes (60.3 percent), lower PPP/slowdown in PPP (58.3 percent), and outsourcing of legal work (50.7 percent). AW 2014 Law Firms Survey at 2.
34 Id. at 3.
35 Id. at 4, 7.
36 Id. at 12-13.
37 Figures drawn from Citi Private Bank Law Watch reports.
What is often missed in this story, however, is that given the restructuring that many firms have undertaken since 2008, the equity partners in the largest 200 U.S. firms have fared reasonably well, even in the present market environment. In 2013, profits per equity partner in these firms averaged $1.19 million, not back to levels seen in 2007 but hardly disastrous. It is not surprising, therefore, that law firm leaders might have a difficult challenge in convincing their partners of the need to make fundamental changes in their business model or practices. As one observer of the legal market has quipped, "It's hard to convince a room full of millionaires that what they're doing is wrong."

This is not a problem unique to law firms. Indeed, as noted in our Report on the State of the Legal Market last year, whenever a market faces disruptive change -- including the introduction of new forms of competition -- it is often the leading and most successful firms in the market that underestimate or fail to perceive the impact of the change that is occurring. As noted in a 2013 article in the Harvard Business Review on disruptive change underway in the consulting and legal services markets, "The temptation for market leaders to view the advent of new competitors with a mixture of disdain, denial, and rationalization is nearly irresistible. . . . As we and others have observed, there may be nothing as vulnerable as entrenched success." To remain competitive for the long term, law firms -- including particularly successful incumbent firms -- need to focus strategically on how their markets are changing and develop the ability to modify their own operational models to meet the evolving needs and demands of their clients. But past success can be a powerful blinder to the need for change, particularly if it is assumed that only radical change can be successful.

In the wide ranging discussion of the need for change in the legal industry over the past few years, it has sometimes been assumed that the only changes that can be effective are those that require revolutionary new approaches to the solving of legal problems or a radical reinvention of the tasks involved in providing legal services. While it is true that some of the changes on the horizon would have far reaching effects on how law firms operate -- e.g., a shift away from the billable hour as the standard currency of law firm billing and compensation systems or the increased reliance on technology for records searches, document drafting, legal research, and dispute resolution -- it seems unlikely that the basic tasks of lawyers (counseling, negotiating, researching, drafting, litigating, etc.) will change. They are simply part and parcel of how our legal system works. That is not to say, however, that important changes will not occur in the way these tasks are performed.

In 1987, Robert Plath, a pilot for Northwest Airlines and an avid home workshop tinkerer, decided to affix two wheels and a long handle to suitcases that rolled upright, thus creating the world's first Rollaboard. Within a few years, Mr. Plath's creation had revolutionized the luggage industry -- not by inventing an alternative to the suitcase but by making the traditional suitcase more efficient. It seems likely that the kinds of changes we will see in the legal market over the next several years will be of this same genre -- creative ways of improving efficiency and driving down costs in the performance of traditional legal tasks. Conceived of in this way, it might be somewhat easier to convince law firm partners that the changes being driven by the market need not be regarded as a threat, unless of course they are ignored.

There is, however, one additional roadblock to effective change implementation in many firms, and that relates to the metrics firms typically use to measure their economic performance and to guide evaluation and compensation decisions regarding partners. These metrics create incentives and shape behaviors and, to the extent that they measure the wrong things, can lock in inefficient ways of working and produce strong resistance to change.

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38 These restructuring efforts included significant layoffs of associates and non-legal staff, dramatic cutbacks in new lawyer hiring quotas, substantial reductions in both direct and indirect expenses, and a significant thinning of the equity partner ranks.
39 Aric Press, note 13 supra, at 40.
41 Joe Sharkey, "Reinventing the Suitcase by Adding the Wheel," The New York Times, Oct. 5, 2010, p. B6. Actually, Mr. Plath's Rollaboard was an improved and streamlined version of a large "rolling luggage" invented by Bernard Sadow, the vice president of a luggage manufacturing company, in 1970. Id.
Commentators have argued for some time that most law firms do in fact measure the wrong things -- or, perhaps more accurately, fail to measure all of the right things. The metrics used by most firms focus on "inputs" -- primarily billable hours, fee growth, utilization, leverage, and the like -- to determine the "value" being delivered to their clients. We assume, in other words, that value equals the sum of all of our inputs. On any rational basis, however, that's an absurd proposition. Why should a client regard a firm as providing higher value simply because its lawyers clock more hours or charge higher fees? Surely issues like the quality and consistency of work, the timeliness and helpfulness of the advice provided, the efficiency with which tasks are performed, the skill with which projects are managed, or the worth to the client of the results obtained are all far more relevant in the client's assessment of the value that a firm provides on a particular matter. And yet, most law firms measure almost none of these factors.

This lack of focus on client oriented performance measures is exacerbated by the fact that most firms use their current metrics as the bases for performance evaluation and compensation decisions. In most firms, for example, total revenues attributed to a partner are the driving factor in compensation, with comparatively little attention paid to profitability of the work or client satisfaction with the firm's overall performance. Most businesses outside the law firm market would regard focusing on the top rather than the bottom line as bizarre, yet it is precisely such top line focus that drives firm decisions that arguably have the most influence on lawyer behaviors.

A similar disconnect is reflected in the use of profits per equity partner ("PPEP") as the defining metric for tracking the comparative performance of law firms. In recent years, firms have kept PPEP high by dramatically paring back promotions to equity partner ranks, by slowing compensation growth for those who are promoted to equity status, and by de-equitizing or terminating equity partners who are regarded as insufficiently productive. PPEP may thus be an especially poor metric for measuring sustainable profitability because its growth is not necessarily tied to actual improvements in business operations, much less to efficiency in meeting client needs.

At a recent conference sponsored by the Thomson Reuters Legal Executive Institute -- The Law Firm Financial Performance Forum held in October -- participants identified a broad range of additional metrics that firms might consider in measuring their overall performance and responsiveness to their clients. These included, among many others, such metrics as profitability assessments at the matter, client, and practice levels; measures of a firm's market share in particular practices; client satisfaction ratings; measures of repeat business or other expansions of key client relationships; assessments of a firm's "brand strength" in particular markets; measures of "wallet share" for key clients; and use of a client quality index. It was suggested that firms should consider collaborating with their clients to devise metrics that more accurately reflect the value of the firms' services from the client perspective. And it was also agreed that firms should move from a focus on "revenues" to an emphasis on "earnings," a change that would highlight efficiency in the delivery of services.

Unless and until firms are prepared to begin to assess their performance on the basis of these kinds of broader criteria and to hold their partners accountable against metrics that assess ROI from the client's perspective and not just the firm's, implementation of any meaningful changes to their operating or pricing models will remain a challenge. Tom Tierney, the former CEO of Bain & Company, once observed that in professional service firms "if your strategy and your compensation system are not aligned, then your compensation system is your strategy." The old axiom that "you get what you measure" is unfortunately largely true in law firms. So if we want different results, we need to think very carefully about what we choose to measure -- and what we do not.

Conclusion

As we enter the seventh year since the economic collapse in 2008, it is quite clear that the market for legal services has changed in fundamental ways. We now live in a buyers' market in which all of the key decisions about how legal services are delivered and priced are being made or strongly influenced by clients. And clients are insisting on increased efficiency, predictability, and cost effectiveness in the services they purchase from law firms. These are new market realities that are not likely to change for the foreseeable future.
At the same time, the dynamics of the legal market have shifted in other significant ways. We seem locked in a cycle of relatively modest demand growth for law firm services, in which revenues are growing -- albeit quite slowly -- but clear challenges remain. Productivity growth remains a serious issue, as does the continuing decline of law firm realization rates. And firms continue to struggle to maintain expense growth at sustainable levels.

The picture is further complicated by shifts in the buying habits of business clients, which may forebode a permanent ratcheting down of spending for outside law firms; a persistent softness in the market for litigation services, which may reflect a reduced willingness of business clients to pursue litigation options; a dramatic increase of non-traditional competitors in the legal market, a development that over time may significantly erode law firm market share; and a growing segmentation of the law firm market into high performing firms versus everyone else, a segmentation that may be hardening.

Against this background, it is more important than ever that law firms take a long-term strategic look at their primary practices, clients, and markets. The key is not just to react to market realities today, but to understand where their markets are likely to be three and five and ten years from now. In Wayne Gretzky's terms, it's playing not where the puck is but where it is going to be. Firms that are able to adopt this kind of long-range thinking will enjoy a significant competitive advantage in today's rapidly changing legal market.

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