It’s a New Year, How’s the Market?
The State of the Legal Market and Its Implications for New Lawyers

Columbia University School of Law
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James W. Jones
Outline of Presentation


- Law firm financial performance
- Fundamental market changes

Emerging shape of “new” market for legal services

Implications for new lawyers
A Decade of Fundamental Change (2007-2017)
Tenth Anniversary of the “Great Recession”

- End of a decade plus period of unprecedented prosperity for law firms.

- Shift from a “seller’s” to a “buyer’s market for law firm services.
  - New client insistence on greater value for “legal spend.”
  - Value defined as greater efficiency, predictability, and cost effectiveness in the delivery of legal services.

- Challenge for law firms: how to adjust to new client demands and expectations.
Review of the Past Decade:
Law Firm Financial Performance
Overall, a period of:

- Stagnation in demand growth for law firm services;
- Decline in productivity for most categories of lawyers;
- Growing pressure on rates, as reflected in declining realization; and
- Declining profit margins.

Some good news in management of expenses, at least in second half of decade.
## Demand Growth

### Growth in Demand for Law Firm Services*

<table>
<thead>
<tr>
<th>Year</th>
<th>Q1</th>
<th>Q2</th>
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<td>2007</td>
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<td>2016</td>
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*Y/Y Change*

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

Source: Thomson Reuters Peer Monitor
Demand Growth (cont.)

Demand Growth for Transactional vs. Litigation Services*

Source: Thomson Reuters Peer Monitor

*All timekeepers. Billable time type, non-contingent matters.
Productivity

Billable Hours Worked per Lawyer*

Source: Thomson Reuters Peer Monitor

- Lawyers only.
- Billable hour type, non-contingent matters.
Productivity (cont.)

Billable Hours Worked per Lawyer by Category of Lawyer*

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

Source: Thomson Reuters Peer Monitor
Rates and Realization

Rate Progression*

Source: Thomson Reuters Peer Monitor

- Lawyers only.
  Billable time type, non-contingent matters.
Rates and Realization (cont.)

Collection Realization against Standard Rates*

Source: Thomson Reuters Peer Monitor

- Lawyers only.
- Billable time type, non-contingent matters.
Collection Realization against Worked (Negotiated) Rates*

Source: Thomson Reuters Peer Monitor

*Lawyers only. Billable time type, non-contingent matters.
Expense Growth

Growth of Direct and Overhead (Indirect) Expenses

Source: Thomson Reuters Peer Monitor
Leverage (Lawyer to Equity Partner)*

- Employed lawyers only.
- Only 11 months (through November).

Source: Thomson Reuters Peer Monitor
Billing and Collection Cycles

Billing and Collection Cycles*

Source: Thomson Reuters Peer Monitor

- Billable time, non-contingent matters
  Only 11 months (through November).
Change in Profit Margins

Profit Margin Stagnation*

![Graph showing change in profit margins from 2007 to 2016.](image)

Source: Thomson Reuters Peer Monitor

- Rolling 12 months through Q3 2016 (i.e., Q4 2015 – Q3 2016)
Driver of Financial Performance

Foregoing analysis shows that law firm financial performance over past 10 years has essentially been driven by only one factor: rate increases.

- Demand growth has been flat;
- Productivity has been declining;
- Expenses have been growing (albeit modestly);
- Leverage has remained unchanged; and
- Billing/collection cycles have remained constant.

Only rates have grown, though with increasing client pushback (as shown in realization rates).
Review of the Past Decade: Fundamental Market Changes
Death of Traditional Billable Hour Pricing

- Change rarely acknowledged of a definitional problem – confusion with *alternative fee arrangements* (AFAs).

- Overlooks a major market shift – widespread client insistence on budgets (with caps) for both transactional and litigation matters.

- Although AFAs account for only 15 to 20% of law firm revenues, if combined with budget-based pricing, the figure goes up to 80 or 90%.
Erosion of the Traditional Law Firm Franchise

Growing client willingness to disaggregate the services they seek from outside providers.

Result: a steady erosion of the traditional law firm franchise as clients have moved functions in-house, outsourced to non-traditional providers, and moved work “down market.”

Shift from a trusted advisor to a more *ad hoc*, transactional model.

Trend explains why law firm demand is stagnant even as overall legal spend increases.
2016 Altman Weil survey of 336 CLOs:
- 35.2% planned to decrease spend on outside counsel (while only 21.8% planned to increase);
- 37.2% planned to increase in-house lawyer workforce (while only 8.5% planned to decrease);
- Same trends have been consistent since 2010.

Same Altman Weil survey:
- 57% reported outsourcing work to non-law firm vendors (up from 43% in 2012);
- Average value of work shifted was $754,644 (up from $496,784 in 2012).
2016 Thomson Reuters survey of 429 CLOs:
- 29% reported decreased reliance on outside counsel (with only 27% reporting increased reliance);
- 24% planned to increase internal law department staffs (while only 2% planned to decrease).

Considering that the core services that only lawyers can perform are fairly narrow and that the range of potential competitors is fairly broad, this trend will quite likely continue.
Declining Effectiveness of the Traditional Leverage Model

Over past decade, the leverage ratio for US firms has remained fairly stable – averaging between 2.0:1 and 2.3:1.

But the effectiveness of leverage as a driver of law firm profitability has been steadily eroding.

- Many clients will no longer pay for first- or second-year associates;
- Firms have significantly cut back their hiring goals for associates – thus reducing overall associate ranks; and
- Firms have held growth in equity ranks flat.
Declining Effectiveness of Leverage

Composition of Leverage by Lawyer Category (FTE)*

Source: Thomson Reuters Peer Monitor

• Lawyers only.
2016 is through November only.
Growing Segmentation within the Market for Law Firm Services

Past decade has seen a growing segmentation of market into highly successful and less successful firms.

- Reflected in *American Lawyer* creation of “Super Rich” list within Am Law 100 in 2014.
- But pattern is also reflected in all levels of market.

Two important characteristics have emerged as particularly important in defining “winners:”

- Strategic focus and
- Proactive response to the needs and expectations of clients.
Segmentation: Strategic Focus

- Firms with clearly defined core practices and client bases fare better than those with ambiguous messages and brands that are largely undifferentiated from other firms of their size.

- In past decade, many firms have responded by growing bigger. (Both merger activity and lateral movement are at all-time highs.) But result has often been to make their focus more ambiguous and their position less differentiated.

- May help explain performance in Am Law Second 100 ranks.
Segmentation: Strategic Focus

Key Performance Measures by Segment*

Source: Thomson Reuters Peer Monitor

• All timekeepers.
  Billable time type, non-contingent matters.
These 2016 performance results are consistent with similar trends over the past three years.

Am Law Second 100 firms have experienced consistent downward trends in demand growth, fees worked, lawyer growth, and productivity throughout the period.

By contrast, midsize firms saw a consistent upward trend in demand growth and fees worked, as well as improvement in productivity.

For Am Law 100 firms, performance was more mixed, though better than Am Law Second 100 firms in most indicators.
Segmentation: Strategic Focus

One possible interpretation of these results: clients – while still directing some types of work to high-end, fairly specialized, premium firms (the Am Law 50) – are increasingly willing to move substantially down market to smaller (midsize) firms to achieve significant price savings.

If large firms in the middle (the Am Law Second 100 and some of the Am Law 51-100) cannot offer sufficient differentiation, clients will have little incentive to change this behavior.
Segmentation: Proactive Response

Is now growing evidence that firms that responded proactively to changing client expectations outperform their peers financially.

2015 Altman Weil survey of 320 US firms found:

- 77% of firms making major changes to lawyer staffing models had increased PPEP (compared to 56% of others);
- 76% improving efficiency of service delivery models saw increased PPEP (compared to 61% of others); and
- 75% changing pricing models had increased PPEP (compared to 66% of others).
### Segmentation: Proactive Response

A more in-depth study by Thomson Reuters Peer Monitor of 34 firms confirmed similar results.

<table>
<thead>
<tr>
<th>Operational Change</th>
<th>% Upper-Tier Firms</th>
<th>% Lower-Tier Firms</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Technology:</strong> Use of software that allows lawyers to monitor the progress of matters, resource commitments, and budget status in real time</td>
<td>71</td>
<td>47</td>
</tr>
<tr>
<td><strong>Technology:</strong> Efficient and easily usable knowledge management system that provides lawyers ready access to the firm’s prior work product</td>
<td>71</td>
<td>59</td>
</tr>
<tr>
<td><strong>Technology:</strong> Document review software using predictive coding based on a “seed sample” of documents provided by firm lawyers</td>
<td>71</td>
<td>35</td>
</tr>
<tr>
<td><strong>Technology:</strong> Client “self-help” tools that allow clients to perform tasks directly that previously required active participation by firm lawyers</td>
<td>29</td>
<td>12</td>
</tr>
<tr>
<td><strong>Technology:</strong> Use of project management software</td>
<td>53</td>
<td>35</td>
</tr>
<tr>
<td><strong>Technology:</strong> Use of e-learning systems</td>
<td>65</td>
<td>29</td>
</tr>
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## Segmentation: Proactive Response

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<th>% Lower-Tier Firms</th>
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<tbody>
<tr>
<td><strong>Outsourcing:</strong> Use of third-party service providers for non-legal research</td>
<td>24</td>
<td>6</td>
</tr>
<tr>
<td><strong>Insourcing:</strong> Use of special units/divisions within the firm for due diligence</td>
<td>41</td>
<td>12</td>
</tr>
<tr>
<td><strong>Insourcing:</strong> Use of special units/divisions within the firm for non-legal research</td>
<td>35</td>
<td>12</td>
</tr>
<tr>
<td><strong>Insourcing:</strong> Use of special units/divisions within the firm for non-legal drafting</td>
<td>24</td>
<td>6</td>
</tr>
<tr>
<td><strong>Strategies:</strong> Use of a detailed project budgeting model</td>
<td>76</td>
<td>59</td>
</tr>
<tr>
<td><strong>Strategies:</strong> Incorporation of project management/profitability results into lawyer evaluation/compensation process</td>
<td>59</td>
<td>35</td>
</tr>
<tr>
<td><strong>Staff Support:</strong> Use of administrative staff to assist firm lawyers in project/matter billing</td>
<td>94</td>
<td>76</td>
</tr>
<tr>
<td><strong>Staff Support:</strong> Use of administrative staff to assist firm lawyers in client/practice/matter profitability improvement</td>
<td>76</td>
<td>65</td>
</tr>
</tbody>
</table>

Source: Thomson Reuters Peer Monitor
Similar findings emerged from the 2016 Altman Weil survey of 356 law firms:

Survey found that 88% of firms engaged in conversations with clients about pricing and budgets, including AFAs. But a substantial majority of firms (72%) took a reactive approach to the topic.

Among those firms proactively engaging clients about AFAs, 84% reported their non-hourly work was at least as profitable as hourly projects (compared to only 51% of reactive firms).

And 40% of proactive firms reported their non-hourly work was more profitable (compared to only 10% of the reactive firms).
Challenge: No More Easy Fixes

For the past 5 or 6 years, most firms have maintained their financial performance at “acceptable” levels by several easy fixes:

- In 2009, most firms instituted massive layoffs of legal and non-legal staffs;
- Many firms also dramatically slowed expansion of equity partner ranks;
- Almost all firms launched aggressive expense management;
- Most firms reduced associate hiring goals and expanded use of contract lawyers;
- Some firms adopted other cost-reduction strategies like opening firm-wide service centers; and
- All firms continued regular rate increases.
Challenge: No More Easy Fixes (cont.)

- These fixes are not likely to be as effective in the future:
  - Further reductions in equity partner ranks will be difficult (growth rate is already near zero);
  - Expense growth (currently at 2-3%) will be hard to sustain, as recent compensation increases show;
  - Productivity continues to be challenging; and
  - Rate increases will have diminishing effects as client pushback continues.

- What is needed is a longer-term strategic focus in the way law firms think about their markets, their clients, their services, and their futures.
Emerging Shape of the “New” Market for Legal Services
Changing Models of Law Firms

Traditional law firms are likely to be:

- Smaller – with fewer equity partners and partner-track associates;
- More flexible – with a broader array of non-partner track lawyers;
- More strategically focused around core practices and clients;
- More open to new approaches to legal work processes that rely more on non-lawyer professionals; and
- More focused on profitability and outcomes.
Some law firms will move more toward multidisciplinary practices with:

- Expanded activities that compete directly with non-traditional competitors in the market; and
- Efforts to extend their brand value to a wider range of law related work.

A few law firms will seek to develop a supply chain management model in which they provide overall coordination for client projects in addition to traditional legal services.
Most firms will expand their professional staffs to include a wide variety of law related specialists including technologists, information specialists, process analysts, process managers, project management consultants, risk managers, compliance specialists, supply chain managers, etc.
Changing Perspectives of Clients

- Large corporate clients will increasingly move toward a more *ad hoc*, transactional relationships with their outside firms and away from the “trusted advisor” model.
  - They will continue to grow their in-house capabilities.
  - And they will continue to seek increased value by disaggregating the services they buy among a variety of different service providers.

- Small and mid-size clients will increasingly move toward a managed legal services model in which they will outsource significant portions of their in-house work to outside law firms and managed services companies.
Changing Perceptions of Clients (cont.)

Although corporate clients will likely remain vary of hiring inexperienced lawyers, they will be increasingly interested in finding multidimensional lawyers – e.g., lawyers who have relevant legal training and experience but are also capable technologists or process analysts or project managers.

Corporate clients will also be increasingly focused on risk and compliance issues, interested in “preventive lawyering” as much as in traditional after-the-fact assistance.
The legal market will see the ongoing expansion of alternative legal service providers that will continue to erode the franchise of traditional law firms.

Some law firms will actually participate in this market by creating their own ALSPs – either as affiliates or in partnership with other entities.

This is part of the ongoing trend toward multidisciplinary practices.
ALSP Market Size – By Category of Service Provider

**Accounting and Audit Firms**
- Description: Accounting and audit firms that have a large amount of revenue in legal services. Tend to focus on legal work that is complementary to accounting/audit work.
- Key players: Deloitte, EY, PwC, KPMG, ACCENTURE, BDO, BDO, BDO
- Est. Revenue: $900 million

**Captive LPOs / Law Firm Affiliates**
- Description: Wholly owned captive operations of law firms. Often located in lower cost regions, focused on high volume process work.
- Key players: WILMERHALE, CLIFFORD CHANCE, EVERSHEDES, Orrick, ALLEN & OVERY
- Est. Revenue: $150 million

**Independent LPOs, Ediscovery, and Document Review Service Providers**
- Description: Perform outsourced legal work under the direction of corporate legal departments and law firms. Typically engaged for matter or project based work often proactively managed and globally delivered. Includes ediscovery services and document review services.
- Key players: Thomson Reuters Legal Managed Services, mindcrest, QuisLex
- Est. Revenue: $6,200 million

**Managed Legal Services**
- Description: Providers that contract for all or part of the function of an in-house legal team. Typically engaged for ongoing work within scope, proactively managed.
- Key players: Thomson Reuters Legal Managed Services, Riverview Law, UnitedLex, Elevate
- Est. Revenue: $250 million

**Contract Lawyers, In-sourcing, and Staffing Services**
- Description: Providers of lawyers to companies on temporary basis. Can range from entry level document review to highly skilled and experienced specialists.
- Key players: Special Counsel, Axiom, LJD LAW, Trayford
- Est. Revenue: $900 Million

Source: Thomson Reuters
Implications for New Lawyers
Law Firm Hiring of Partner-Track Associates

- Law firm hiring quotas (for both associates and summer associates) are likely to remain well below pre-recession “normal” levels for the foreseeable future.
  - Productivity growth remains negative in most firms, with current billable hours averaging 144 hours per year below pre-recession levels.
  - And pressures on profitability will remain serious in most firms for the foreseeable future.
  - With tepid demand growth and growing competition from non-law firm service providers, it is likely that hiring levels will remain well below those in the pre-recession period.
If your ultimate goal is a law firm partnership, there are now more ways to get there than ever before.

- Firms are increasingly open to partner candidates with wide varieties of experience – both in law firms and elsewhere.
- The former prejudices against in-house or government experience have faded as lateral movement has increased.
- In large firms, laterals now constitute almost half of all equity partners. So, it is now more possible than ever to start with one firm and switch to another.
- While the bar for equity partnership has been raised at almost all firms, there are more pathways to get there.
Paths to Law Firm Partnership (cont.)

The profession has become more of a meritocracy than ever before. With increased focus on performance, there are more opportunities for new lawyers who work hard and achieve results. Advancement is no longer about “waiting your turn.”
Non-Partner Track Positions in Law Firms

One of the results of the shift toward efficiency and cost effectiveness in the legal market is the proliferation of new categories of lawyers in law firms.

- Firms are experimenting with a wide variety of non-partner track positions – staff lawyers, special counsel, counsel, specialists, etc.

- While the compensation scales and career tracks for these positions remain in flux at the moment, firms will ultimately sort out new attractive talent models.

- These positions will not appeal to everyone, but offer alternative career paths that may be attractive.
In-House Opportunities

One significant result of the recent changes in the legal market is the expansion of in-house opportunities.

Even during the economic downturn, in-house law departments have continued to grow, reflecting in part the growing practice of keeping substantial numbers of matters (or parts of matters) in house.

In-house positions can offer very rewarding and satisfying career paths, particularly given the fact that, in many companies, the corporate general counsel has now emerged as the company’s chief “trusted advisor” for legal matters.

One problem is that most law departments are not interested in entry-level applicants. So, some prior experience will be needed, though there may be many ways to acquire such experience.
Part of the [r]evolution going on in the legal market is the rapidly expanding role of non-traditional service providers in and around legal services. These include –

- Legal process outsourcing firms;
- Legal staffing companies, including both secondment firms working with clients and “accordion” companies working with law firms;
- Legal resource companies;
- Technology companies (including software producers and technology consulting firms);
- General consulting and accounting firms;
- Virtual law firms; and
- Innovative law firms with special services and pricing.
Whole new career tracks are emerging for lawyers among these non-traditional providers. In *Tomorrow’s Lawyers – An Introduction to Your Future*, Richard Susskind identifies a number of them, including –

- Legal knowledge engineers,
- Legal technologists,
- Legal process analysts,
- Legal process managers,
- Legal project management consultants, and
- Legal risk managers.

*And all of these are jobs that really didn’t exist before 2008.*
And Finally

... a thought about surviving in a changing environment.
Thank You!

James W. Jones
jim@legalmanagementresources.com