



MPF FEATURED WHITE PAPER

2019 REPORT ON THE STATE OF THE LEGAL MARKET

by

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2019

Report on the State
of the Legal Market

The Center on Ethics and the Legal Profession at the Georgetown University Law Center and Thomson Reuters Legal Executive Institute and Peer Monitor® are pleased to present this 2019 Report setting out our views of the dominant trends impacting the legal market in 2018 and key issues likely to influence the market in 2019 and beyond.¹

The Challenge of Changing Models

When faced with mounting evidence that our traditional way of looking at a problem is no longer satisfactory, most people would agree – at least in the abstract – that it makes sense to examine our underlying assumptions with a view toward possibly changing the model we use to think about the issue. Unfortunately, such openness to change frequently runs counter to our natural instincts. As psychologists have now amply demonstrated, we humans have a tendency to search for, interpret, favor, and recall information in a way that confirms our preexisting beliefs or hypotheses – a cognitive tendency that is referred to as confirmation bias.² And there is some evidence that this cognitive bias can be especially strong among professionals who have been trained to accept a particular point of view and who have a fear of being regarded as illegitimate by their peers for questioning long-established principles.



A particularly good example of this confirmation bias among professionals is provided by the history of ulcer diagnosis and treatment by the medical profession. Historically, it was believed that ulcers were caused by stress and dietary factors. Treatment focused on hospitalization, bed rest, and a prescription of bland foods. Later, gastric acid was blamed for ulcer disease, and antacids and medications that blocked acid production became the standard of therapy. But, despite this treatment, there was a high recurrence of ulcers.

In 1982, Australian physicians Robin Warren and Barry Marshall first identified the link between a bacterium (*H. pylori*) and ulcers and concluded that bacteria and not stress were the cause of the condition. The medical community, however, was very slow to accept these new and “unorthodox” findings. In 2005, Drs. Warren and Marshall were awarded the Nobel Prize in medicine for their discovery. Nonetheless, as late as 2006 (24 years after the discovery of the link between bacteria and ulcers), the Centers for Disease Control and Prevention lamented that many consumers and physicians were still not “aware” of the fact that almost all ulcers are caused by a bacterium and can be treated and cured with antibiotics. And this in a profession that prides itself on being guided by scientific evidence. It can sometimes be very hard to move away from long-held assumptions, even when convincing evidence runs to the contrary.³

The need to examine the available evidence and be willing to consider alternative explanations seems particularly relevant in reviewing the financial performance of the legal market during 2018 – as reflected in

¹ The Georgetown Center on Ethics and the Legal Profession and Thomson Reuters gratefully acknowledge the participation of the following persons in the preparation of this Report: from the Georgetown Center – James W. Jones, Senior Fellow and Director of Program on Trends in Law Practice (lead author) and Milton C. Regan, Jr., Professor of Law and Co-Director; and from Thomson Reuters – Justin Hines, Sr. Analyst – Thought Leadership and Joe Blackwood, Analyst – Thought Leadership.

² Scott Plous, *The Psychology of Judgment and Decision Making* (1993), at 233.

³ For an interesting account of the resistance in the medical community to the discovery of the real cause of ulcers, see Pamela Weintraub, “The Doctor Who Drank Infectious Broth, Gave Himself an Ulcer, and Solved a Medical Mystery,” *Discover Magazine*, March 2010. <http://discovermagazine.com/2010/mar/07-dr-drank-broth-gave-ulcer-solved-medical-mystery>. The article recounts how, in a desperation move, Dr. Barry Marshall actually drank a beaker of the suspect bacterium himself, developed an ulcer, and then took antibiotics to cure himself. Not even that, however, turned around a skeptical medical community. Perhaps one contributing factor was that treatment of recurring ulcers and the drugs related to it – including antacids – was a multi-billion industry at the time.

Thomson Reuters Peer Monitor data⁴ – and in interpreting the somewhat mixed signals that such performance appears to be sending about the current and future health and position of law firms across the market. On the positive side, the past year saw a modest increase in demand for law firm services,⁵ a marked improvement over the past three years, as well as strong growth in worked rates.⁶ Results also reflected a small but positive change in productivity,⁷ reversing the negative growth trend seen in that indicator for the past several years. As a result, the market as a whole experienced healthy average revenue growth of 5.5 percent for the year.

On the negative side, while the overall results described above were positive, it must be noted that they were driven significantly by Am Law 100 firms (and, indeed, within that grouping, by Am Law 50 firms), as well as by some niche firms in the Midsize group. Performance by other firms – including particularly firms in the Am Law Second 100 and some firms in the Am Law 100 and Midsize groups – were well below the market averages. This continues the strong trend toward market segmentation that we saw in 2017 and raises the interesting question of why different parts of the market are performing in strikingly different ways.

Apart from segmentation, there were other financial indicators that were somewhat surprising given the relative stagnation in the market over the past several years. One of the most dramatic was a second round of associate compensation increases that drove associate salaries and bonuses to record levels and that will have a serious impact on the bottom lines of many firms in the coming year. Considering that productivity has been essentially flat to declining in almost every year since the Great Recession, such compensation increases appear – at least at first blush – to be counterintuitive.

A similar observation could be made about the aggressive increase in worked rates seen in 2018. Given the tepid growth in demand for law firm services, the increased willingness of clients to move business to lower cost firms or alternative service providers, and the continuing client push back on rate increases (as reflected in declining realization rates), it is counterintuitive that firms would propose aggressive rate increases or that clients would accept them. But that appears to be what happened.

To make sense of these mixed signals that are reflected in the financial results of the past year, it is necessary to step back and take a broader perspective on the current legal market. If viewed in a more nuanced way, the financial results that we are seeing – including the apparently anomalous ones – may be much more understandable. Such an exercise will require us to jettison some long-held assumptions and to imagine a new model of how the legal market now works. But it may also point us to important insights about steps that firms might take to better position themselves for the future.

In the sections that follow, we take a deeper look at the characteristics of today's legal market and the importance of firms being clear about what segments of the market they serve and how such clarity should drive their strategic decisions. We begin, however, with a review of the performance of U.S. law firms in 2018.

4 Thomson Reuters Peer Monitor® data (“Peer Monitor® data” or “Peer Monitor® database”) are based on reported results from 161 U.S.-based law firms, including 52 Am Law 100 firms, 46 Am Law Second 100 firms, and 63 additional Midsize firms.

5 For present purposes, “demand for law firm services” is viewed as equivalent to total billable hours recorded by firms during a specified period.

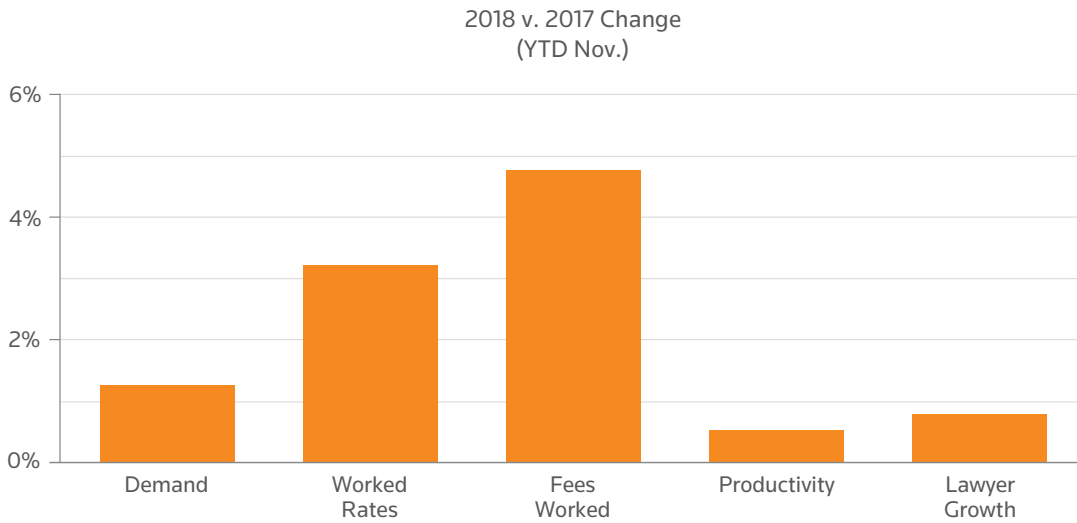
6 “Worked rates” are the negotiated rates as determined by the matter value. Worked rates are often referred to as “agreed rates.”

7 “Productivity” is defined as the number of billable hours worked by lawyers divided by the total number of lawyers.

Current State of the Legal Market – By the Numbers

As previously noted, the U.S. legal market overall showed positive trends during 2018, with a modest but welcome increase in demand for law firm services, healthy growth in worked rates, and even slight growth in productivity. These key performance indicators are shown in Figure 1. Reflecting these positive trends, average revenue growth across the market was up 5.5% percent for the year.

Figure 1 – Key Performance Indicators

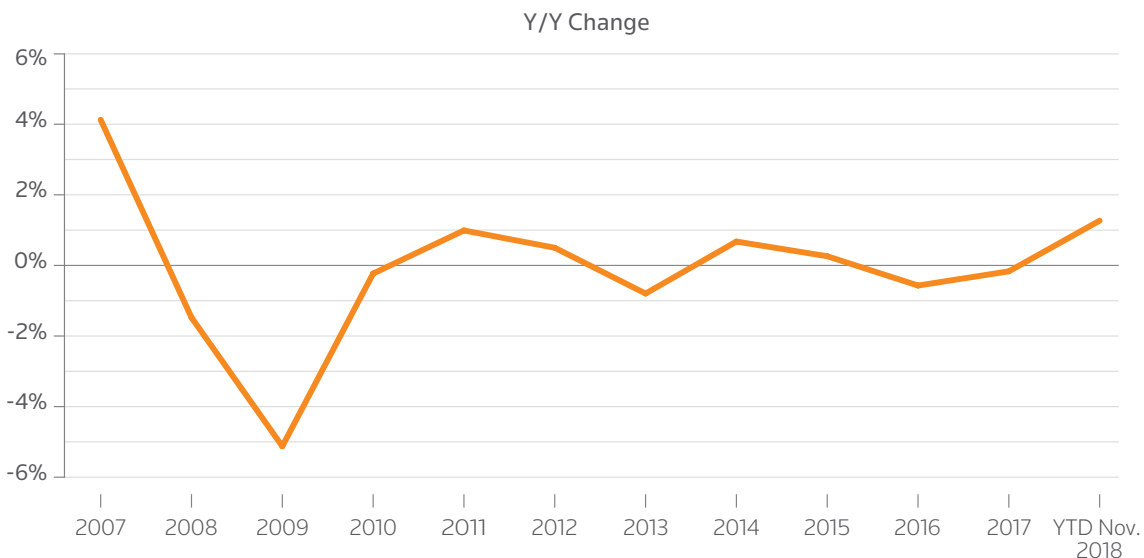


All timekeepers
Billable time type; non-contingent matters

Source: Thomson Reuters Peer Monitor®

In terms of demand growth, Figure 2 shows the course of demand growth for law firm services over the last decade or so, ending with the positive upswing of 1.3% percent in 2018. As can be seen, since 2014, demand has been slightly up in some years and down in others, creating an essentially stagnant growth pattern over the past five years. Whether the upturn in 2018 marks a change in that pattern remains to be seen.

Figure 2 – Growth in Demand for Law Firm Services

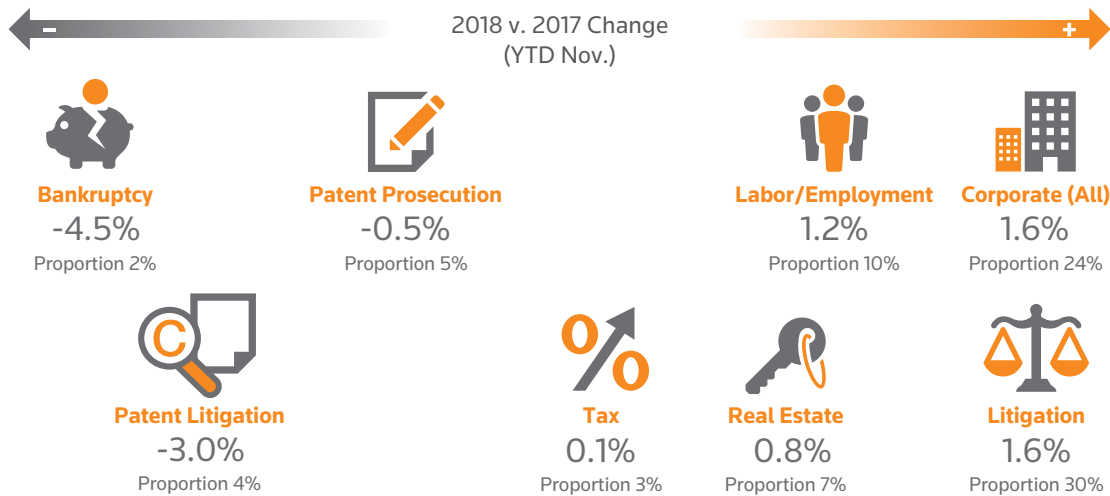


All timekeepers
Billable time type; non-contingent matters

Source: Thomson Reuters Peer Monitor®

In Figure 3, we break down overall demand growth by key practice areas. Of particular interest in the 2018 results is the **positive growth in litigation**, something we have not seen since 2011. This is especially **significant because litigation (with 30 percent of all recorded billable hours) is the largest single practice area** covered by Peer Monitor® data. Moreover, more than half of all firms in the database experienced litigation growth, as did more than half of the firms in each practice segment (Am Law 100, Am Law Second 100, and Midsize).

Figure 3 – Demand Growth by Practice

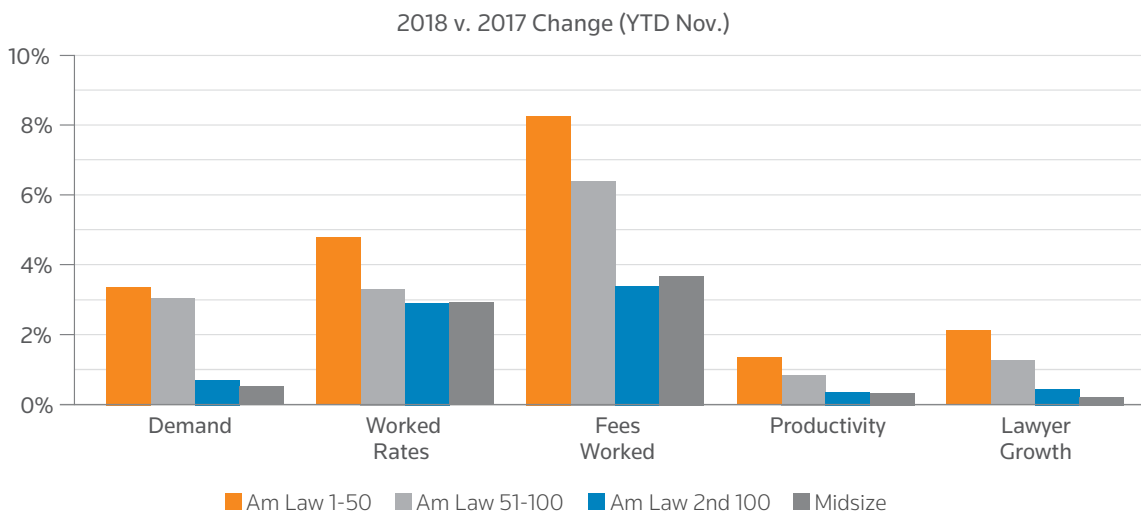


All timekeepers
Billable time type; non-contingent matters

Source: Thomson Reuters Peer Monitor®

It is important to note that, while overall demand growth across the market was positive, as shown in Figure 4, this **growth was driven primarily by Am Law 100 firms**. And, even in this latter category, Am Law 50 firms outperformed others.

Figure 4 – KPIs by Segment

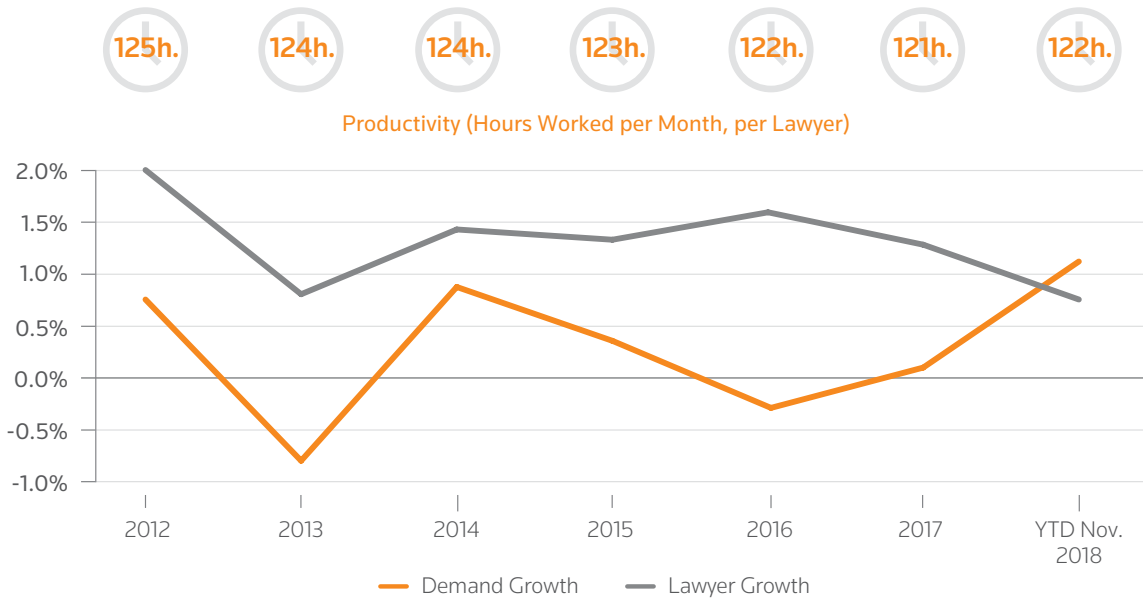


All timekeepers
Billable time type; non-contingent matters

Source: Thomson Reuters Peer Monitor®

Figure 5 shows the relationship between demand growth and lawyer growth in the market over the past seven years, and the impact of the combination of those two factors on productivity. As can be seen, in 2018, unlike in prior years, **overall demand growth rose slightly faster than lawyer head count thus resulting in a modest uptick in productivity**.

Figure 5 – Balance of Demand and Capacity

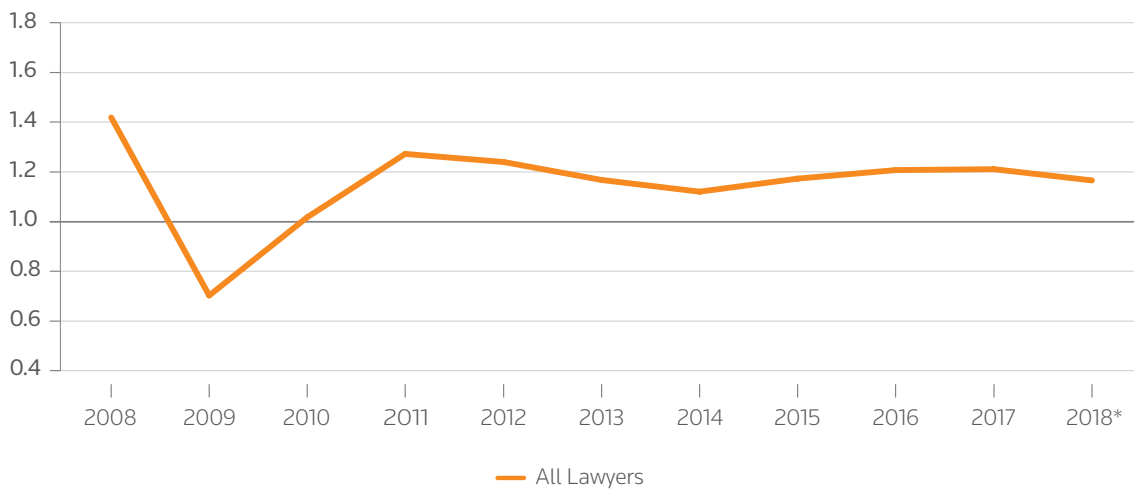


Lawyers only; Contractors excluded
Billable time type; non-contingent matters

Source: Thomson Reuters Peer Monitor®

As regards growth in lawyer headcount, Figure 6 shows the annual replenishment ratio for all lawyers⁸ over the past decade. As can be seen, with the exception of the two-year period at the height of the Great Recession, law firms have grown fairly consistently in recent years. That trend continued in 2018, albeit at a somewhat decelerated pace. But the growth in headcount was not uniform for all categories of lawyers. As shown in Figure 7, headcount has grown consistently in recent years only among associates and senior/staff counsel. In all other categories – including equity partners, non-equity partners, and of counsel – firms have been steadily reducing headcount. This trend also continued in 2018.

Figure 6 – Lawyer Replenishment Ratio

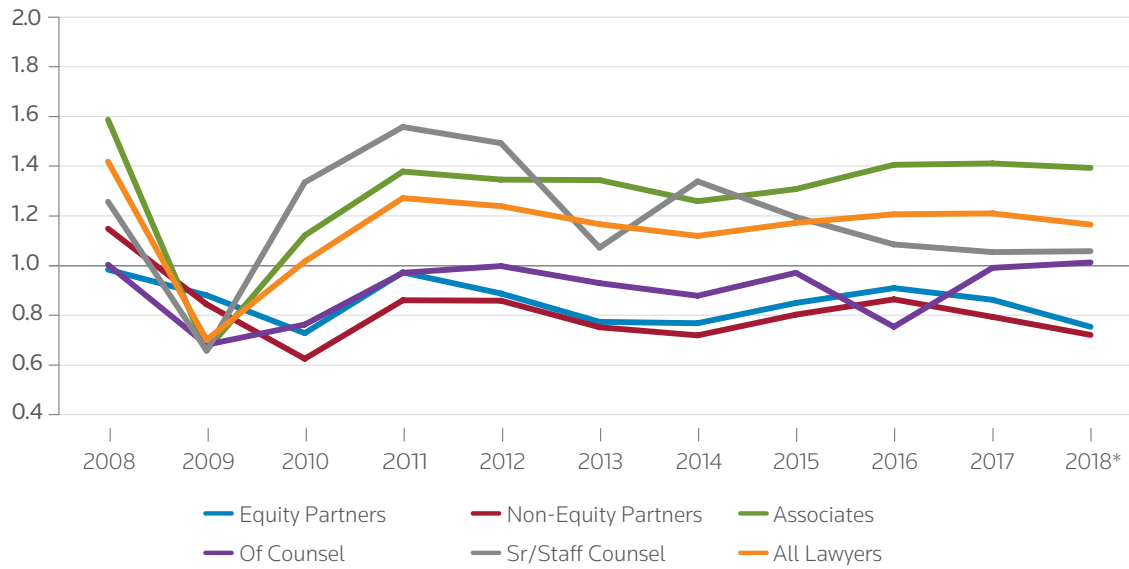


*Rolling 12 months, through Q3 (Q4 2017-Q3 2018)

Source: Thomson Reuters Peer Monitor®

⁸ The replenishment ratio is the ratio of incoming lawyers to departing lawyers. Any number higher than 1.0 indicates that a firm is growing in terms of overall lawyer headcount.

Figure 7 – Replenishment Ratio by Lawyer Category

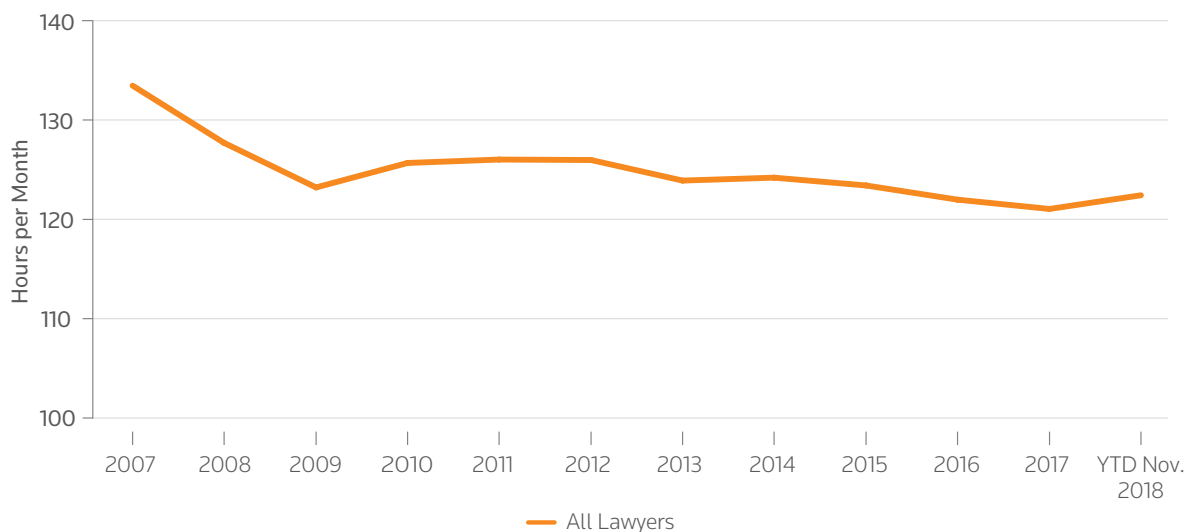


*Rolling 12 months, through Q3 (Q4 2017-Q3 2018)

Source: Thomson Reuters Peer Monitor®

Looking more closely at changing levels of productivity, Figure 8 shows average billable hours worked per lawyer for all categories of lawyers across the market. While the number of worked hours has been reasonably stable in recent years, it is important to note that, compared to average billable hours in the pre-recession years (*i.e.*, prior to 2008), there remains a significant difference. By way of illustration, in 2007, the billable hours worked averaged 134 per month. Through 2018, the average is now 122 per month, or a difference of 144 hours per year from the 2007 level. To see the economic impact of this reduction in productivity, one need only multiply this annual difference by the average worked rate in 2018 of \$489 per hour, to see that the decreased productivity over the last decade cost firms some \$70,416 per lawyer per year in 2018. For a firm of 200 lawyers, that translates to a total cost of \$14.1 million; for a firm of 400 to \$28.2 million; and for a firm of 600 to \$42.3 million.

Figure 8 – Hours Worked per Lawyer

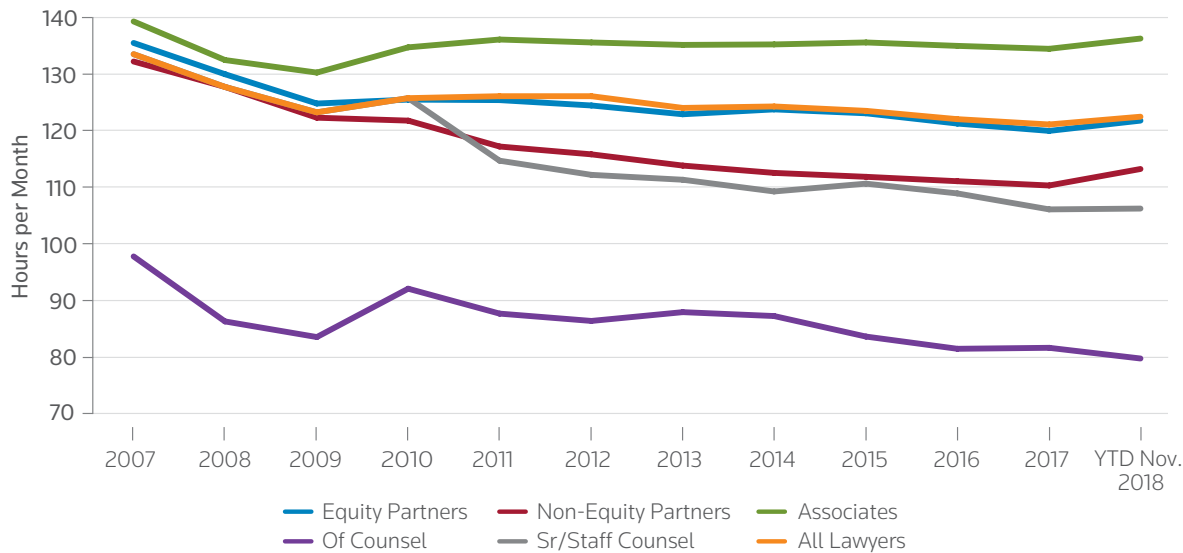


Lawyers only
Billable time type; non-contingent matters

Source: Thomson Reuters Peer Monitor®

In Figure 9, the average billable hours worked per lawyer are broken out by lawyer category. As can be seen, the only category of lawyers with billable hours approximating pre-recession levels is associates, a fact that is hardly surprising given the significant layoffs in associate ranks during 2009 and the reduced hiring quotas imposed by most firms ever since. All other categories of lawyer timekeepers remain down significantly from 2007 levels.

Figure 9 – Hours Worked per Lawyer – By Category

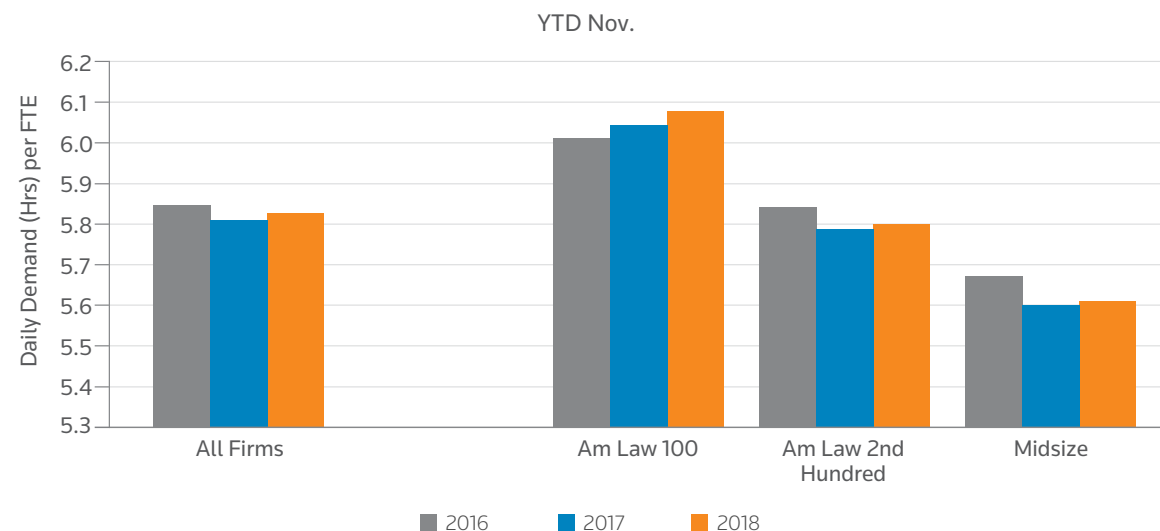


Lawyers only
Billable time type; non-contingent matters

Source: Thomson Reuters Peer Monitor®

As previously noted, financial performance in 2018 was not uniform across the market. Indeed, there were significant differences in performance among market segments. This point is illustrated in Figure 10 which shows average daily demand (as measured by billable hours worked) per FTE for lawyers in the three major market segments.

Figure 10 – Average Daily Demand per Lawyer

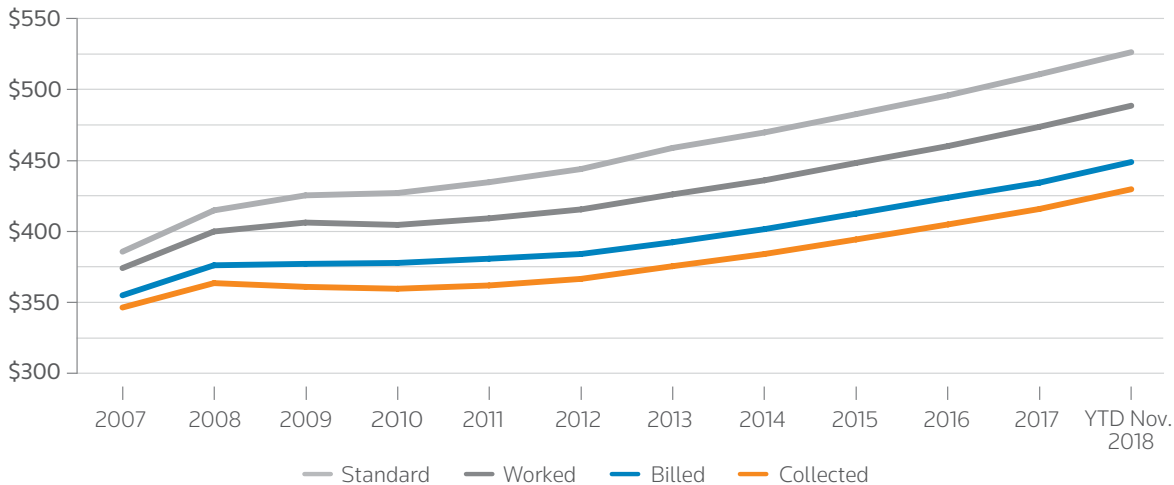


Lawyers only
Billable time type; non-contingent matters

Source: Thomson Reuters Peer Monitor®

As previously noted, firms continued to raise their rates in 2018 in all categories, with some firms pursuing more aggressive rate increases than in prior recent years. These increases are shown in Figure 11, which tracks rate progression over the past decade or so. The chart shows average standard, worked, billed, and collected rates across all firms in the market.⁹ During 2018, standard rates increased by 3.1 percent, worked rates by 3.2 percent, billed rates by 3.3 percent, and collected rates by 3.4 percent.¹⁰

Figure 11 – Rate Progression



Lawyers only
Billable time type; non-contingent matters

Source: Thomson Reuters Peer Monitor®

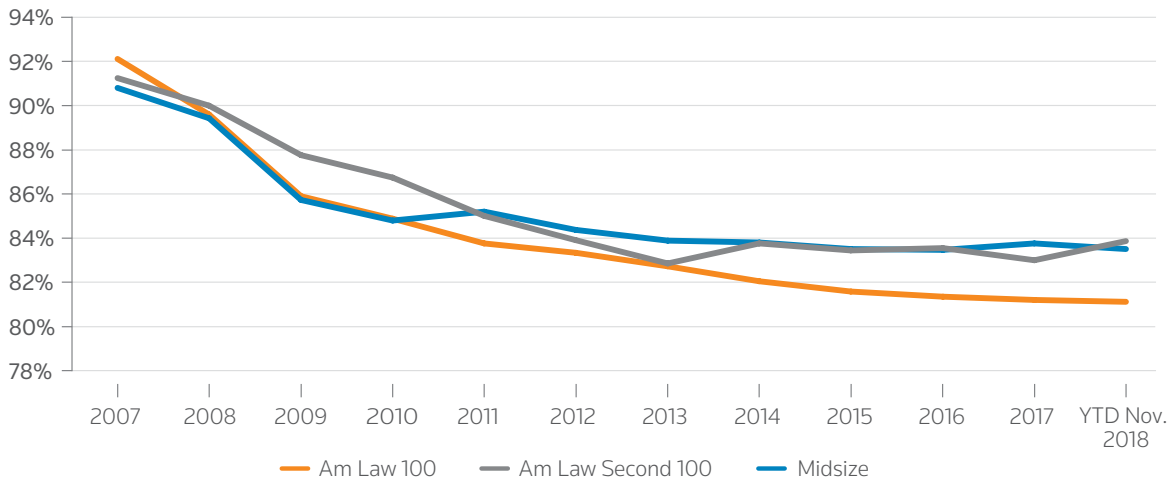
Not surprisingly, as firms continued to increase their rates, many clients continued to push back, as reflected in stagnant to declining realization rates. This was especially true among Am Law 100 firms.¹¹ Figure 12 shows the pattern of declining collection realization measured against standard rates over the past 14 years, broken out by major market segment. As can be seen, realization rates dropped significantly during the Great Recession and have continued to decline, albeit at a more modest pace, ever since. As has been the pattern over the past several years, Am Law 100 firms recorded the lowest realization rates (against standard) during 2018 at 81.1 percent, as compared to 83.5 percent for Am Law Second 100 firms and 83.9 percent for Midsize firms. Not surprisingly, if measured against worked rates, overall realization performance was much better, as shown in Figure 13. Indeed, the realization rate of 89.3 percent for 2018 was on a par with similar rates since 2013.

⁹ “Standard rates” are a firm’s published rates, without taking into account any discounts or adjustments. “Worked rates,” also referred to as negotiated rates, are the rates that a firm agrees to with particular clients for work on given matters. “Billed rates” are those rates that a firm actually invoices to clients, reflecting any discounts or adjustments from worked rates that the firm considers appropriate. And “collected rates” are those rates reflected in actual payments received by a firm from its clients.

¹⁰ It should be noted that these figures cover lawyer rates only. It appears that rates for other timekeepers have increased far more substantially. As reported in the *2018 Thomson Reuters Legal Tracker LDO Index: Benchmarking and Trends Report, 2018 Edition* (the “2018 Legal Tracker LDO Index”) – based on data from over 1,200 legal departments and 62,000 law firms – rates for legal assistants appear to have increased by 15.64 percent from 2016 to 2017, and rates for paralegals by 16.15 percent. 2018 Legal Tracker LDO Index, at 14.

¹¹ In its 2018 survey of 217 legal departments (including 76 corporations in the Fortune 1000 and legal departments from 34 separate industries), Thomson Reuters found that 93 percent of respondents identified controlling outside legal costs as a key priority of their departments. 2018 Legal Tracker LDO Index, at 12.

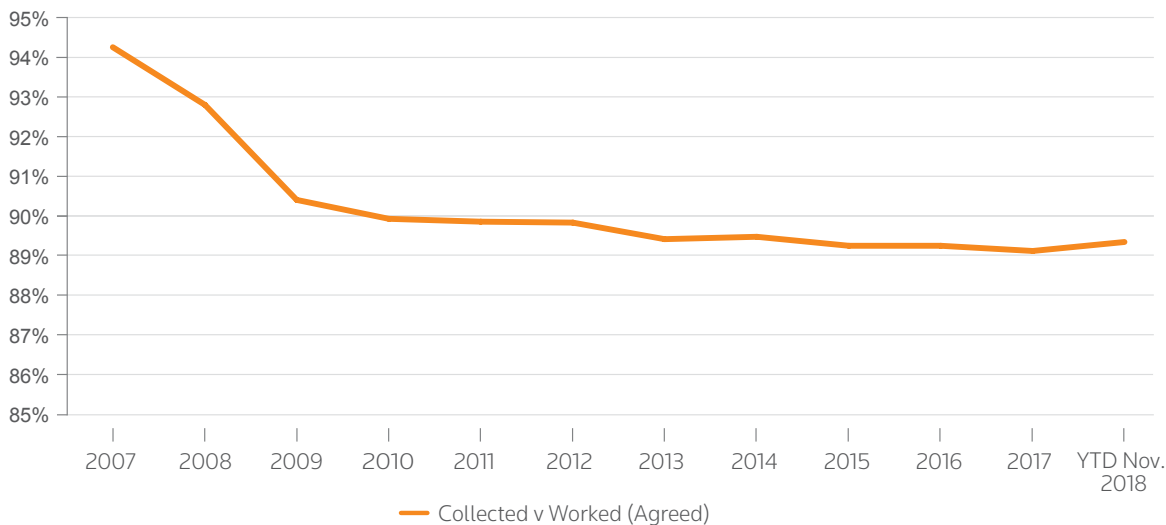
Figure 12 – Collection Realization against Standard



Lawyers only
Billable time type; non-contingent matters

Source: Thomson Reuters Peer Monitor®

Figure 13 – Collection Realization against Worked (Agreed)



Lawyers only
Billable time type; non-contingent matters

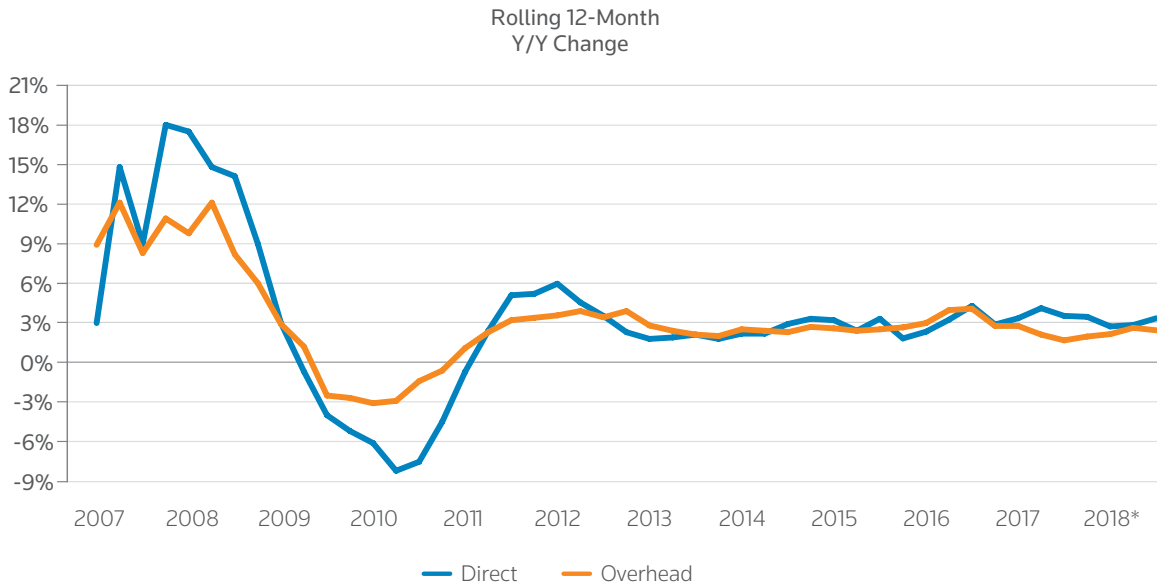
Source: Thomson Reuters Peer Monitor®

During 2018, firms continued to do a fairly good job of managing their expenses, both direct and indirect.¹²

As shown in Figure 14, direct expenses in 2018 grew by 3.4 percent, while indirect expenses increased by 2.5 percent. Both of these were consistent with the patterns seen since 2013, although there has been some uptick in direct expenses in the past couple of years, no doubt attributable to the recent increases in associate compensation.

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, administrative and staff compensation and benefits, technology costs, recruiting expenses, business development costs, and the like).

Figure 14 – Expense Growth

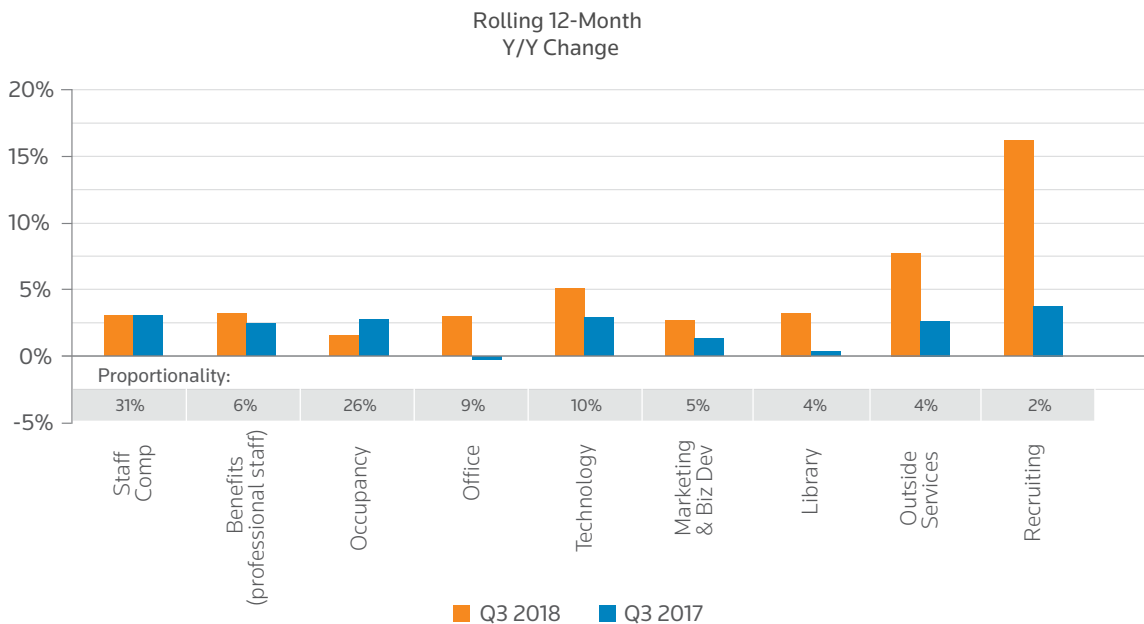


*Rolling 12 months, through Q3 (Q4 2017-Q3 2018)

Source: Thomson Reuters Peer Monitor®

A closer look at indirect expenses shows some interesting developments during 2018. As indicated in Figure 15, firms made significant increased investments in recruiting, and other outside services. There was also a noticeable uptick in office expenses, technology, marketing and business development, and library expenses. Although none of these separate expense categories accounted for more than 10 percent of total indirect costs, collectively they amounted to more than one-third of total indirect expenses. Figure 16 shows the same overhead detail but broken out on a per lawyer FTE basis.

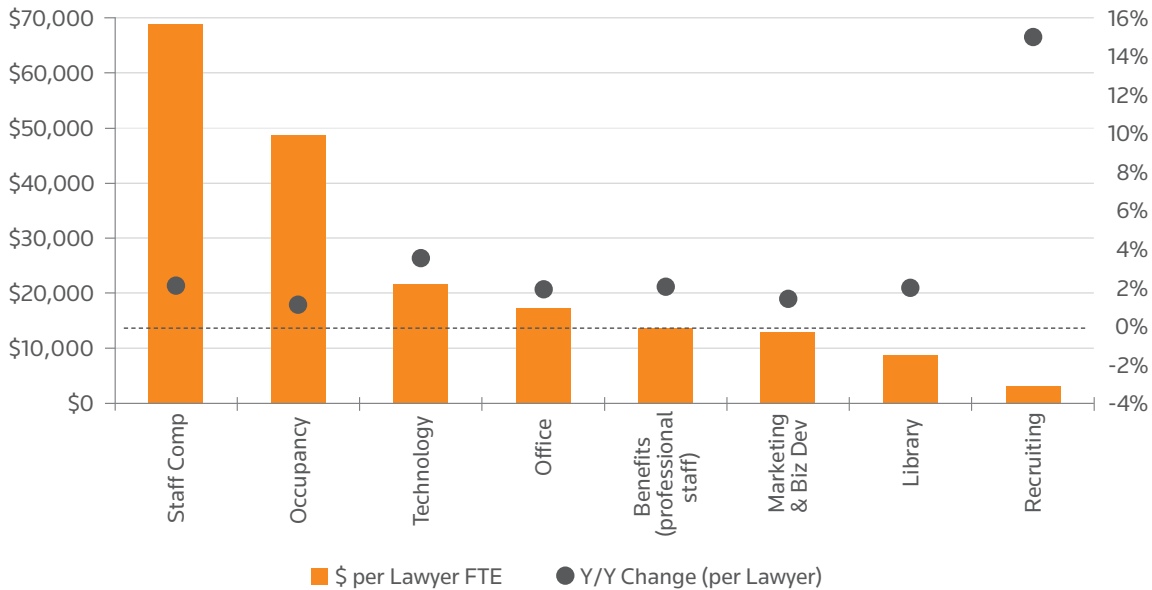
Figure 15 – Overhead Expense Growth by Category*



*Rolling 12 months, through Q3 (Q4 2017-Q3 2018)

Source: Thomson Reuters Peer Monitor®

Figure 16 – Overhead Detail per Lawyer by Category*



*Rolling 12 months, through Q3 (Q4 2017-Q3 2018)

Source: Thomson Reuters Peer Monitor®

In summary, law firm performance in 2018 was certainly better than we have seen in recent years, with overall positive (though modest) demand growth, improvement in productivity, and higher average rate increases than have been the norm over the past few years. At the same time, it should be noted again that performance was not uniform across the market. Indeed, as shown in Figure 17, performance statistics were led across the board by the larger firms in the market.

Figure 17 – Key Performance Indicators by Segment (YTD Nov. 2018)

Metric	All Segments	Am Law 1-50	Am Law 51-100	Am Law Second 100	Midsized
Demand	1.3%	3.4%	3.0%	0.7%	0.5%
Worked Rates	3.2	4.8	3.3	2.9	2.9
Fees Worked	4.8	8.2	6.4	3.4	3.7
Productivity	0.5	1.4	0.8	0.4	0.3
Lawyer Growth	0.8	2.1	1.3	0.4	0.2
Direct Expenses*	3.4	6.4	4.4	3.1	1.2
Indirect Expenses*	2.5	4.5	3.7	2.8	0.7

*Rolling 12 months, through Q3 (Q4 2017-Q3 2018)

Source: Thomson Reuters Peer Monitor®

Changing Market Realities

As indicated by the performance data set out above, the market for law firm services has changed dramatically over the past decade. The changes have altered the underlying assumptions of the traditional law firm economic model and have driven segmentation in new and profoundly important ways. To better understand the impact of these changes, it is helpful to review briefly the assumptions on which the “old order” was based.

The traditional law firm economic model was premised on the assumptions that (i) legal work was labor intensive, (ii) that only lawyers could provide the services required, and (iii) that law firms would control the design and delivery of legal services. It reflected a seller’s market in which all key decisions about how legal matters were staffed, scheduled, conducted, and priced were essentially made by law firms.¹³ The model resulted in a highly leveraged, pyramid structure with inverse pricing – *i.e.*, with a pricing strategy that overcharged for associates and undercharged for partners.

The traditional structure worked very well for law firms. In the years prior to 2008, demand grew steadily, fed by firms’ near monopoly on legal (and legal related) services. Firms were able to raise their rates substantially and regularly, and they charged freely on the billable hour system with only modest client-imposed controls. Real economic competition in the market (*i.e.*, competition based on price and quality of service delivery) was minimized by a lack of available information about how firms performed and charged for their work. The result, for a dozen years or more, was an environment that supported healthy, stable firms that grew at a fairly steady pace.

Though remarkably resilient for a long time, the traditional model, over the past decade, has largely broken apart, driven by a number of factors. *First*, the availability of market information about firms and their practices has grown exponentially, fueled by a wide variety of trade publications, rating agencies, and social media sources. This growing body of competitive information has contributed to the relentless growth in competition across the market. *Second*, the rapid growth of new technologies has made legal work far less labor intensive than it was ten years ago, and that trend will undoubtedly continue. And *third*, the Great Recession that began in late 2007 triggered a number of significant market shifts that have had seismic repercussions in recent years. Those repercussions are reflected in three new market realities that are described below.

Clients Are in Control. Since 2008, there has been a complete shift from a seller’s to a buyer’s market for legal services. In stark contrast to the traditional law firm model, clients are now in control of all key decisions impacting legal representation – from staffing and scheduling decisions to outsourcing requirements, from project management to pricing structures – and they are not likely to relinquish that control anytime soon.

With their newfound power, clients are insisting on more value for their legal spend. And by “value,” clients now mean higher levels of predictability, efficiency, and cost effectiveness in the delivery of legal services, quality being assumed. Of course, these new expectations do not apply in all circumstances. There will always be “bet the company” or other unique cases in which clients will insist on the best lawyers they can find, with no real consideration of cost. But those instances are few and far between. In the vast majority of cases, clients will award work based of their assessment of which firm can perform the work most predictably, efficiently, and cost effectively – again, with quality being assumed.

These new market realities are also reflected in changed client expectations and behaviors. Over the past ten years, clients have become ever more willing to disaggregate matters – *i.e.*, to create virtual teams made up of lawyers from several different firms, in-house lawyers, and representatives of other non-traditional service providers. They are also much more willing to move matters “down market” (*i.e.*, to smaller firms or to non-traditional providers) in order to achieve cost savings. And they have increasingly come to regard their relationships with outside counsel in a much more *ad hoc* and transactional way that views every new representation as unique and subject to competition.

¹³ This is not to imply that clients were not consulted or that clients never raised objections to the decisions being made. It is to say, however, that in most instances law firms were ultimately in control of these aspects of client matters.

Competition Is More Fierce than Ever. In a market characterized by sluggish demand growth, the only way for one firm to improve its market position *viz-a-viz* another is by taking existing market share. That in turn drives increased competition. It also highlights one of the unique vulnerabilities of law firms: the fact that, unlike other businesses, law firms cannot protect their two most critical assets – their people and their clients. In contrast to other business organizations, law firms are not permitted to impose non-compete agreements on their lawyers or to impede in any other way the freedom of lawyers to leave one firm and join another. Similarly, law firms cannot bind their clients into continuing engagements or impose any financial penalty on a client that, for any reason or for no reason, decides to switch its business to another firm. These unique restrictions make law firms particularly vulnerable to shifts in market conditions and contribute to the overall fragility of law firms as organizations.

The largely stagnant demand growth that we have seen in the legal market in recent years has encouraged interfirm poaching of both talent and clients at unprecedented levels, as evidenced by the dramatic increase in firm mergers and lateral partner acquisitions. Mergers have been on the upswing for the past decade but set new records in 2017, with Altman Weil reporting 102 mergers involving U.S. law firms, outpacing the previous record of 91 set in 2015. The 2017 mergers included 15 cross-border mergers, also breaking the previous record of 11 in 2016.¹⁴ Moreover, 2018 seems on pace to set another record, with 79 mergers being reported through September.¹⁵

Lateral partner moves have also increased dramatically in recent years. As shown in Figure 18, ALM Intelligence recently tallied the total number of lateral partner moves in key geographic markets for the period from 2010 through 2017, and the results – taken as reported – are astonishing. In New York, for example, there were 4,445 lateral partner moves, representing 35 percent of all partners in the market. In Washington, the number of moves was 3,759, or 43 percent of all partners. And in two jurisdictions – Chicago and Atlanta – lateral moves exceeded 50 percent of all partners in the market.¹⁶

Figure 18 – Lateral Partner Moves (2010-2017)

Market	Number of Moves	% of Total Partners in Market
New York	4,445	35%
Washington	3,759	43
Chicago	1,926	53
Los Angeles	1,400	45
San Francisco	1,110	42
Boston	904	44
Houston	704	46
Dallas	760	48
Atlanta	629	52

Source: ALM Intelligence

Clearly, the competition for lateral talent is at an all-time high. As one commentator recently observed:

[T]he concept of luring laterals away with money isn't new – it's been going on for decades – and of course firms have always sought to backfill those positions. But, it's never been this aggressive, the profile of the moves has never been this high, and the current market represents an escalation in "capillary action" – the movement of high-powered, apex partners upward in the hierarchy – that is creating a tit for tat scenario and is changing the way that the business of law is being done.¹⁷

14 Roy Strom, "After a Record 2017, No Signs of Law Firm Merger Mania Slowing," *The American Lawyer (On-Line Edition)*, Jan. 3, 2018.

15 Altman Weil, Inc., "Law Firm Merger Market on Record-Breaking Pace," *Altmanweil.com*, Oct. 2, 2018.

16 See David J. Parnell, "The Battle for Talent Is Disrupting the Business of Law," *Law.Com*, Aug. 15, 2018.

17 *Id.*

Firms have responded to this increase in competition in a variety of ways – by enhancing PPEP by reducing the number of equity partners, by increasing spreads in partner compensation, by raising associate compensation to retain promising young lawyers, and (as noted) by pursuing mergers to make their market footprints more competitive. Ironically, these steps have sometimes led to more instability rather than less.

Law Firms Are Losing Market Share. From 2008 through 2010, growth in new demand for law firm services was negative. Since then, demand has been slightly up in some years and slightly down in others, with overall long-term growth being essentially stagnant. During that same period, however, corporate legal spend has been steadily rising. This suggests that law firms have been losing market share. This loss reflects in part the growth of corporate law departments themselves as many departments have increased their in-house staffs to handle a growing variety of matters. But it also reflects the **transfer of work to alternative legal service providers, non-law firms that are increasingly competing for a range of services historically provided primarily by law firms.**

These trends are evident from the most recent survey of corporate chief legal officers conducted by Altman Weil during 2018.¹⁸ That survey found that 53 percent of the 279 participating **CLOs** indicated their departments had increased total spending from 2017 to 2018, compared to only 29 percent that decreased spending during the period. Also, **54 percent of all responding departments increased the in-house portion of their budgets in 2018.** Indeed, the survey found that internal spend represented the largest portion of corporate legal spend, with an average allocation of 48 percent of total budgets being earmarked for internal purposes. This marked the first time that an Altman Weil survey found internal spending taking the lion's share of law department budgets.¹⁹

Altman Weil also reported that, from 2017 to 2018, 42 percent of the law departments surveyed also increased their outside counsel spend, while 32 percent decreased such expenditures. Significantly, this was the first time since 2011 that increases in outside counsel spending exceeded decreases.²⁰ At the same time, respondents remained concerned about achieving the right balance of in-house and outside services to maintain optimal cost effectiveness. As the survey report noted, "This year **36% of all law departments are bringing some work previously done by law firms in-house** to be done by their own lawyer staff instead. They are also making use of contract and temporary lawyers to do in-house work on an as-needed basis, and pushing work down from in-house lawyers to paralegals and other para-professionals."²¹

As to the use of nontraditional service providers, the Altman Weil study observed as follows:

Although non-law firm vendors represent only 6% of total law department spend, 47% of law departments outsource to vendors some work that they once gave to law firms. In departments with more than 50 lawyers, 77% are using outsourcing as a labor alternative. This illustrates the much talked-about "unbundling" of legal services that has become the norm in more and more law departments.²²

In 2016, Thomson Reuters Legal Executive Institute, in collaboration with Georgetown University Law Center and the Oxford University Said Business School, conducted a global survey on the growth, activities, and market share of nontraditional service providers in the legal industry.²³ Based on that survey, **it was estimated that the size of the alternative legal service provider ("ALSP") market in 2016 was around \$8.4 billion in annual revenues. The survey report also noted that many ALSPs appeared to be growing rapidly.**²⁴

¹⁸ Altman Weil, Inc., *2018 Chief Legal Officer Survey: An Altman Weil Flash Survey*, Nov. 2018 ("Altman Weil 2018 CLO Survey").

¹⁹ *Id.* at ii.

²⁰ The Altman Weil findings were broadly consistent with findings in the survey conducted by Thomson Reuters as part of its 2018 Legal Tracker LDO Index. The latter survey found that 68 percent of the 217 legal departments surveyed reported their volume of legal work (as measured by the number of legal matters) had increased in the preceding 12 months. To address this increased workload, 54 percent of the organizations said they have increased the percentage of work handled in-house, and 37 percent have increased the number of in-house lawyers. Some 48 percent of the respondents indicated they have also increased their outside counsel spending. Overall, 65 percent of the responding organizations identified allocating work to firms that are proactive in showing their value as a key priority. Most of the organizations reporting align with data from Acritas finding that the most efficient departments fall within an optimal range of 40 to 70 percent of all work being performed in-house. 2018 Legal Tracker LDO Index, at 7-8.

²¹ Altman Weil 2018 CLO Survey, at iii.

²² *Id.* at iv.

²³ Thomson Reuters Legal Executive Institute, Georgetown University Law Center, and Oxford University Said Business School, *Alternative Legal Service Providers: Understanding the Growth and Benefits of These New Legal Providers*, Feb. 19, 2017.

²⁴ *Id.*

During 2018, a second global survey of ALSPs was conducted under the auspices of the same sponsoring institutions.²⁵ And, consistent with predictions in the 2016 survey report, the 2018 survey found that the ALSP market had grown significantly to about \$10.7 billion in annual revenues, or a compound annual growth rate of 12.9 percent. The 2018 study also concluded that the average growth rate for an ALSP not affiliated with a law firm was about 24 percent per year. Equally significant, the 2018 survey confirmed that the services provided by ALSPs were rapidly moving “up market” to include (among others) such sophisticated work as regulatory risk and compliance, project management, legal research, and corporate due diligence.²⁶ It seems inevitable that, given current market pressures, growth of ALSPs will continue for the foreseeable future.²⁷

Responding to Changed Market Realities: What Works and What Doesn't

Law firms have responded to the changed market realities described above in a variety of different ways, sometimes successfully and sometimes not. Ten years ago, almost all firms slashed their expense budgets. Today, some firms continue to adhere closely to fiscal austerity while others have made significant investments in selective categories – e.g., technology, work process infrastructure, recruiting, and associate compensation among others. Also, in the aftermath of the Great Recession, virtually all firms cut back significantly on their annual rate increases. Today, some firms have moved their rates up fairly aggressively, although many others have not. Similar differences can be seen in the ways individual firms have dealt with leverage, merger, pricing, process improvement, infrastructure, and other issues in recent years.

Given the substantial changes in the legal market, commentators as well as law firm leaders have often struggled to articulate a rational basis for many of these decisions. Is it a good idea in today's market for firms to adopt more aggressive pricing strategies? Should firms address changed client demands by investing more heavily in work process improvements or innovative technologies? Does it make sense for firms to grow their market footprints through mergers or more aggressive lateral acquisition strategies? Does leverage still matter? Should firms seek to transfer as much work as possible to paraprofessionals or other non-lawyers? Is it necessary for firms to continue to ratchet up associate compensation? Needless to say, the stakes are pretty high for firms to find the right answers to these kinds of questions.

To address these issues in a constructive and helpful way, it is necessary to consider the possibility that our model of the legal market needs to be rethought. Given the changed market realities previously described, it is probably accurate to say that there is no longer a single legal market (if indeed there ever was one). There are instead several legal markets – or, perhaps more accurately, a continuum of quite different legal services being offered by different groups of providers, some of whom are traditional law firms and some of whom are not. The services offered at various points along this continuum are subject to very different “rules” related to pricing, staffing, infrastructure and process support, use of technology, drive for efficiency, and the like. Service providers along the spectrum also experience different forms of competition and different competitive threats to their market positions.

To be successful in this environment, it is critical for law firms to understand where along the continuum of services their practices fall and to design strategies that address the challenges posed by their unique market positions. Manifestly, one size cannot possibly fit all. Firms must also be open to the possibility that, over time, their market positions can change, giving rise to a new set of strategic considerations.

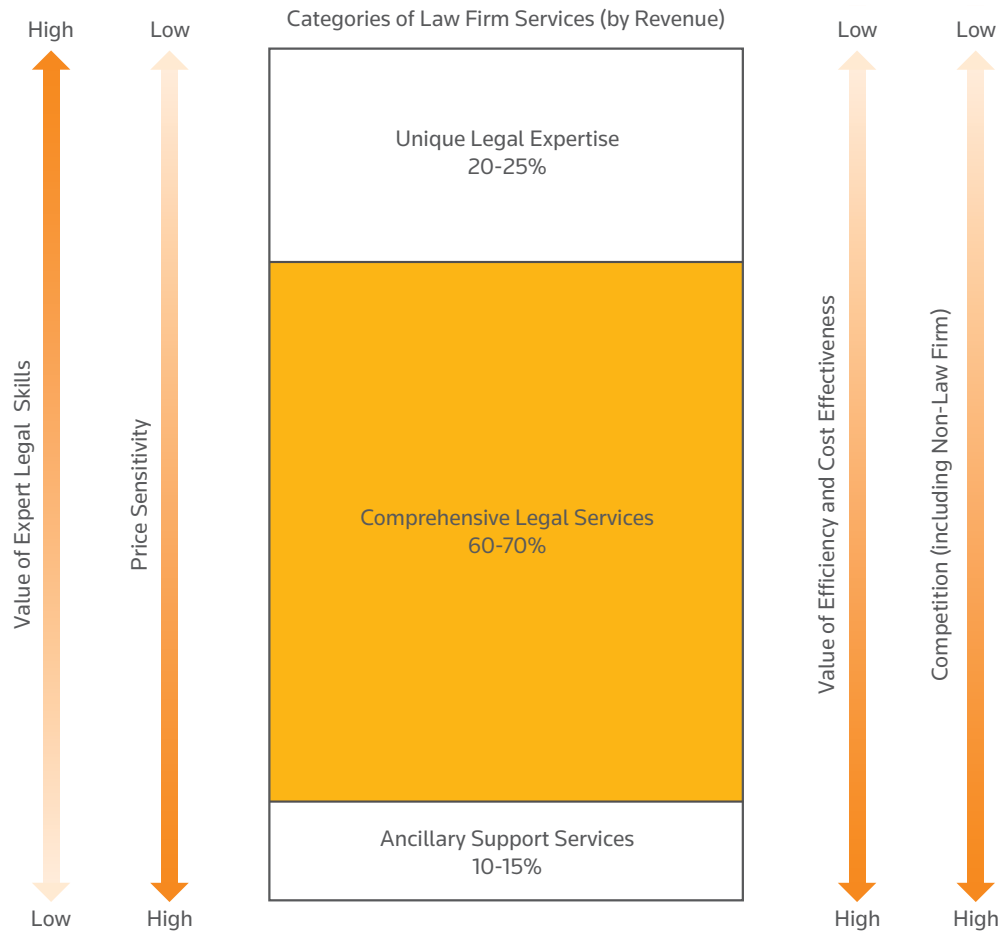
²⁵ Thomson Reuters Legal Executive Institute, Georgetown University Law Center, and Oxford University Saïd Business School, *Alternative Legal Service Providers 2019: Fast Growth, Expanding Use and Increasing Opportunity*, Jan., 2019.

²⁶ *Id.*

²⁷ Interesting recent developments in the expanding market power of ALSPs include the October 2017 launch by PricewaterhouseCoopers of a new flexible lawyering service as part of its “New Law” initiative; the December 2017 announcement that DXC Technology Co has entered into a five-year contract with UnitedLex Corp. for the latter to take over nearly 200 of DXC's law department employees in a broad outsourcing of corporate general counsel functions; the March 2018 announcement of a major outsourcing arrangement between UnitedLex Corp. and General Electric Co.; and the October 2018 acquisition of Riverview Law in the U.K. by Ernst & Young.

Moving from a Monolithic to a Dynamic Market Model. There are, of course, many ways to conceive of a more dynamic model for the legal market, and certainly no model can be a perfect representation of the complex factors at work in such a large and changing industry. Nonetheless, we believe that the model set out in Figure 19 might be a helpful way of imagining the dynamics previously described.

Figure 19 – Dynamic Market Model



The model divides the overall legal market into three distinct segments, though as previously noted, it is more accurate to think of a continuum of services rather than three totally different sets of activities. At the top is a set of services that involves “unique legal expertise.” These are services that, because of their high value to the client or the novelty or uniqueness of the issues involved, require the highest level of legal skills. For these types of services, clients typically rely on law firms and lawyers with well established reputations in their particular fields of expertise, with cost being a distinctly secondary consideration (if, indeed, it is seriously considered at all). Firms with practices falling in this category are not just the well-known, elite Wall Street firms, but also non-New York firms with specialty expertise – e.g., firms with strong private equity practices, litigation boutiques, some IP firms, some well-known regulatory firms, and the like.

The middle set of activities covers what we have called “comprehensive legal services.” These are the day-to-day legal services that clients require to run their businesses, to conduct normal commercial activities, to deal with routine regulatory issues, to resolve disputes that arise in their normal course of dealings, and the like. One commentator has referred to these activities as “run the company issues” as distinct from “bet the company issues” that usually fall under the top tier of services previously described.²⁸ For these types of services, clients

²⁸ Comments of Bruce MacEwen at the Thomson Reuters Legal Executive Institute’s 17th Annual Law Firm COO & CFO Forum (Oct. 26, 2018). The concept of the legal market as a combination of at least two or more distinctly different markets is one that Mr. MacEwen has articulated in any number of blog posts and presentations.

typically turn to law firms that offer broad based practices geared to the scope of services required. Firm reputation is an important selection criterion, although clients are also focused on obtaining services that are predictable, efficient, and cost effective. For that reason, clients with matters falling in this middle set of services are more willing to move “down market” or to turn to alternative service providers as necessary to achieve their overall objectives. This category includes most large U.S.-based law firms.

At the bottom of the model is a set of activities we have dubbed as “ancillary support services.” These are services that were traditionally offered by law firms but which could just as easily – and much more cost effectively – be covered by non-law firm providers. These activities include such services as document review and coding, electronic discovery support, non-legal research, and the like. For these types of services, clients today typically turn to their most efficient and lowest cost options, assuming of course that selected providers can meet basic quality standards.

While sizing these different market segments is obviously challenging, we estimate that services requiring “unique legal expertise” probably account for 20 to 25 percent of overall law firm revenues at the present time. This estimate is based in part on a finding from the Altman Weil 2018 CLO Survey that 24.7 percent of the outside legal fees paid by corporate law departments were “not price sensitive (*i.e.*, for work so important that costs are not an issue).”²⁹ We estimate that “ancillary support services” – *i.e.*, those lower end services that can easily be performed by non-law firm providers – probably account for another 10 to 15 percent of the market.³⁰ That leaves 60 to 70 percent of the overall market in the “comprehensive legal services” category, the segment in which the practices of most law firms fall.

What is perhaps most important about this model is that key characteristics change as services move up through the three identified segments. As indicated by the directional lines shown in Figure 19, as services move up the model, they become much less price sensitive; the relative value of legal talent becomes more important; the drive for efficiency and cost effectiveness becomes less intense; and competition (especially from non-law firm providers) becomes far less significant. This is not to suggest that particular characteristics completely disappear at any level but rather that they tend to be more or less intense depending on where on the model a particular service is positioned. Even at the “unique legal expertise” level, for example, the cost of services usually still plays some role, but the emphasis placed by clients on cost considerations is far less intense than for services in the “comprehensive legal services” category.³¹ Likewise, while the quality of legal talent is a particularly important client consideration for services requiring “unique legal expertise,” it is not an irrelevant consideration for services in the “comprehensive legal services” segment. Rather, it is an objective that receives comparatively less emphasis than say, perhaps, the quality of a firm’s overall work processes and support systems.

Implications of Dynamic Model for Law Firm Strategies. The differences in characteristics of services provided at different levels (as described above) accounts for many of the apparent anomalies in market wide performance data reported over the past couple of years. For example, the back-to-back associate compensation increases seen in 2016 and 2018 – during a period of stagnant to declining productivity across the market – and the more recent aggressive rate increases were initiated by firms with practices primarily in the “unique legal expertise” category. As noted above, these firms compete primarily on the basis of the quality of their legal talent and they operate in an environment where their practices are not particularly price sensitive. Hence, increasing associate compensation (after a number of years of no structural increases) made perfect sense from their perspective,³² as did raising rates more aggressively to help cover the costs of such increases. Neither of these changes were particularly attractive to those firms (a significant majority) that operate primarily in the “comprehensive legal services” category, although many of them tried to follow suit, especially with respect to associate compensation. Similarly, those firms that have been most proactive

29 Altman Weil 2018 CLO Survey, at 40.

30 This estimate takes into consideration the fact that, whatever the cost of such services when provided by non-law firm organizations, costs are undoubtedly higher when these services are provided by law firms.

31 Let there be any doubt that firms at the “unique legal expertise” level still face stiff competition, see Christine Simmons and Gina Passarella, “A Crack in the Wall: Elite Wall Street Firms Are Being Put to the Test,” *The American Lawyer (On-Line Edition)*, Aug. 19, 2018.

32 Indeed, the compensation increases may not have been as startling as they initially appeared. According to an ALM analysis of pay data drawn from the National Association for Law Placement, adjusting for inflation, even the recent increases leave today’s first-year associates with a lower starting salary than their counterparts who started just before the Great Recession. Scott Flaherty, “Despite Salary Hikes, Inflation Leaves Associate Pay Below Pre-Recession Level,” *The American Lawyer (On-Line Edition)*, Aug. 22, 2018.

across the market in reimagining the legal work process, in implementing technologies to improve workflow efficiencies, in seeking alternative pricing models, and the like, have been firms with practices falling primarily in the “comprehensive legal services” category. Again, this makes perfect sense as those are the firms that face the greatest competition from a variety of service providers (both law firm and non-law firm) to deliver their services as efficiently and cost effectively as possible.

This analysis underscores that, to be successful in today’s rapidly changing legal market, it is critically important for firms to make a clear-eyed assessment of where their key practices fall along the broad continuum of services from “ancillary support services” to activities requiring “unique legal expertise.” Since determining its true market position is the essential starting point for every firm’s development of its unique strategy for success, these assessments must be brutally honest. Key questions that should be addressed for each of the firm’s primary practices or services include:

- (i) How truly valuable is the service from the client’s perspective?
- (ii) How novel or unique is the proposed service or the solution required?
- (iii) How important is unique legal expertise in addressing the problem or issue involved?
- (iv) How concerned is the client about efficiency, cost effectiveness, or predictability in the delivery of the service?
- (v) How likely is the client to disaggregate the desired service, *i.e.*, to divide the work up among a variety of law firms or other service providers (including in-house lawyers)?
- (vi) How price sensitive is the matter?

For most firms there will obviously be a mix of answers to these questions for various practices or services they offer. It is important, however, to arrive at a realistic judgment about where the practices or services of a firm predominantly fall so that intelligent strategic decisions can be made. Of course, it sometimes happens that a firm finds a stark contrast between one or more of its key practices –*e.g.*, one practice that is clearly in the “unique legal expertise” category while others fall solidly in the “comprehensive legal services” grouping. In those cases, firms must confront a more serious and difficult question: whether it is possible to develop a structure under which practices with very different staffing, pricing, and support requirements and that are subject to very different competitive pressures can successfully coexist in a single organization.

Once a firm makes a realistic assessment of its market position, it can begin the process of making the strategic decisions required to optimize its competitive advantage. For some firms, this will mean investing in technology to reduce costs or to improve the efficiency of service delivery. For others, it may mean adjusting legal or non-legal staff compensation or changing overall staffing levels. For still others, it may lead to the adoption of different pricing models. For some, it may mean filling practice gaps with aggressive lateral hiring or expanding their market footprints with strategic mergers. Clearly, there is no single, right approach. The strategy for each firm will be somewhat different, depending on its client and practice mix, its market positioning, and its reputation and culture, among other factors. But, as stated above, none of this can be achieved without an honest assessment of the market level at which a firm competes.

In that regard, it’s important to note that the service segments set out in the dynamic market model we describe are not intended as value judgments. Firms can have very successful practices and significant financial success at different places all along the continuum of services described. The key is to have a strategy that works for a particular practice in a given market position, and that, in turn, requires understanding the competitive factors that change as one moves up and down the continuum. In its recently published *2018 Dynamic Law Firms Study*, Thomson Reuters Peer Monitor confirmed that high performing firms could be found among firms of all sizes, geographic locations, practice mix, and market segments.³³ The differences between high performing firms and their lower performing counterparts did not turn on the nature of their practices but rather on their successful attention to traditional issues like productivity, billing realization, investments in critical infrastructure, and profit margins.

³³ Thomson Reuters Peer Monitor, *2018 Dynamic Law Firms Study*, Oct. 2018. This study looked at the financial results of some 157 Peer Monitor firms over a period of three years (2015 through 2017), as measured by growth in revenue per lawyer, overall profit, and profit margin. The study compared relevant factors related to the 39 top quartile firms as so identified with the same factors related to the 39 firms making up the bottom quartile.

It should also be noted that the process of assessing where an individual firm fits in the evolving legal market is an ongoing one because the market is constantly changing. For example, although today we estimate about a quarter of the overall market falls in the “unique legal expertise” category, that segment could well shrink over time as advances in technology reduce the reliance on human judgments in making a wide range of legal decisions. Likewise, as particular services or “products” become less unique and more standardized, they can move down the continuum of services in the model and become more competitive. By way of example, the first time that a law firm put together a securitization, it was a highly innovative financial product that truly involved “unique legal expertise” and commanded very high fees. The 500th time that a law firm undertook a securitization, however, the product was undoubtedly slipping well into the “comprehensive legal services” category with clients expecting highly efficient service delivery, with increased pressure on pricing, and with growing competition from a range of other providers.³⁴ Firms must thus constantly monitor their practices to assure that the work they undertake and the “products” they offer remain services that are consistent with their strategic objectives and services where they continue to enjoy a significant competitive advantage.

The Challenge: Whether Law Firms Are Able to Make the Strategic Decisions Required by New Market Realities. The strategic decision-making process described above may make perfect sense in the abstract. But the question remains whether a majority of firms will be able to make the honest assessments and strategic judgments necessary to compete effectively in the new market for legal services. Sadly, that remains an open question and an especially important one for the vast majority of U.S. law firms whose practices fall primarily in the “comprehensive legal services” category described in our suggested market model.

The problem is not so much that law firm leaders fail to understand the challenges their firms face or the steps they need to take to remain competitive, but rather the resistance that is often mounted by firm partners to the changes that are required. In a recent issue of *The American Lawyer*, Denton’s CEO Elliot Portnoy talks about this problem in the context of law firm responses to the competitive challenges posed by major accounting firms. He describes what he calls the “myth of legal exceptionalism” – the belief that the services provided by lawyers are so specialized that they could never be threatened by accounting firms. The same myth, he notes, is also reflected in the resistance to applying technology to legal issues.³⁵

Unfortunately, what is at work here is a variety of the same kind of professional bias that led physicians to resist – for almost a quarter of a century – the scientifically indisputable fact that ulcers are caused by a bacterium and should be treated with antibiotics. The stark reality of today’s legal market, however, is that law firms may not have the luxury of a quarter century to make the transition to the new realities demanded by our rapidly changing market.



³⁴ This analysis of the tendency of products and services to move down market over time parallels the model suggested by Richard Susskind to explain the impact of technology on particular products and services over time. See Richard Susskind, *The End of Lawyers? Rethinking the Nature of Legal Services* (2008), at 27-36.

³⁵ Dan Packel, “Big Law’s Trojan Horse,” *The American Lawyer*, Dec. 2018, at 22.

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