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A Growing Problem?

By Ward Bower

Conventional wisdom in management circles has held for decades that professional service firms are "grow or die" businesses. Either the organization grows as a result of successfully serving clients, creating more business and referrals, or it stagnates and dies, shedding talent to other firms that are growing.

Since the recession this premise has been challenged. Altman Weil affiliate Bruce MacEwen of Adam Smith, Esq. authored a book in 2013 challenging this assumption, entitled *"Growth is Dead: Now What?"* A recent study published by the Georgetown Law Center challenged the assumption that bigger firms are more profitable and that in turn drives some of the intense merger activity in the marketplace in recent years. That study pointed out that there is no discernable correlation between firm size and profitability amongst the AmLaw 200 law firms. On the other hand, economic surveys of a broader sampling of law firm sizes have consistently shown for decades that there is a general correlation between firm size and profitability, as evidenced by results in ALM's *Survey of Law Firm Economics*. So what gives?

GROWTH DRIVERS

There are a number of internal and external considerations frequently cited as reasons for law firm growth. In the right circumstances, growth driven by these premises has proven to be successful and has resulted in increased profitability. Some of those reasons include:

- **Successful firms must grow to serve their good clients.** Law firms that do good work and have satisfied clients often find their clients bring them more work and refer others to them, requiring that the firm grow to continue to provide superior client service. Even in a static legal market, such as that experienced since the legal recession of 2009 and 2010, one can find examples of successful firms growing to meet the increased workload provided by happy clients and by referrals from those clients.
- **Growing with successful clients**. Law firm clients that are successful themselves grow and experience increasing legal service needs. Firms that do not grow to meet the increasing needs of growing clients frequently find those clients will move to larger law firms with greater breadth and depth in services, whether or not truly warranted. Growth can keep growing clients happy. It is legitimate and desirable.
- **Growth to serve acquiring clients**. Law firms whose clients become acquirers of other companies frequently encounter dramatic increases in client legal service needs, which must be accommodated or clients might seek larger firms that have the breadth and depth required of an operation of their dramatically increased size and volume.
- **Gaining access to new and bigger clients.** Smaller firms often find it difficult to attract larger clients with more sophisticated legal needs and with willingness

and ability to pay for more specialized services. Through growth, access to "bigger, better" clients can be achieved, often enabling better lawyer utilization and rate increases that in turn improve profitability. This is the rationale behind some of the intense merger activity in the legal market over the past ten years.

- **Gaining access to new geographic markets.** Many mature legal markets are saturated. Indigenous firms may grow to new locations in order to gain access to new markets. This is also a rationale behind much of today's law firm merger activity.
- **Adding practice areas needed by clients.** Law firms unable to meet all or most of a client's needs run the risk of clients using other law firms for those services and possibly being more attracted to them. This may lead law firms to grow by adding new practice areas needed by their clients in order to preclude their turning elsewhere to meet unfulfilled legal needs.
- **Creating career path opportunities for lawyers.** Law firms that are not growing do not provide advancement opportunities for young lawyers without risk of dilution of partner profits. Advancement prospects for lawyers in growing firms generally are much better than for lawyers in static or shrinking firms. Consequently, growing firms experience recruiting advantages not available to firms that are not growing.
- **Market leadership.** Some firms will grow, often by merger, in order to achieve a position at or near the top of their market as measured by lawyer headcount (in many cases the only public indication of size or success of a law firm). Achieving top tier status can result in more opportunity for attraction of quality clients, not necessarily under the assumption that "bigger is better," but that firms would not be among the largest in their marketplace if they were not good. This applies only to firms on the cusp or within reach of market leadership, not firms attempting to become the largest of an otherwise undifferentiated middle tier.

FALSE INCENTIVES TO GROWTH

Increased Profits

Although broad survey data of the law firm marketplace (not just the elite firms) indicates that large differences in size between firms result in large differences in profitability, on a firm by firm basis there is much variation. Many are the examples of smaller firms that make considerably more on a per partner basis than firms multiples their size. As the Georgetown study pointed out, that is true within the limited sphere of the AmLaw 200. It is also true on a broader scale throughout the profession, although demonstrated less frequently.

Bigger is Better

Other than growth to solidly position one as a market leader, thereby availing the firm of better client representation opportunities from outside the jurisdiction, bigger is not necessarily better. Growth from a 500-lawyer middle-tier firm with a national presence to a 600-lawyer national footprint is generally inconsequential. Same for growth of a 20-lawyer local firm to a 30-lawyer local firm where market leaders are firms with hundreds of lawyers.

IMPEDIMENTS TO GROWTH

There are plenty impediments to growth in the 2014 legal marketplace in the US (and elsewhere).

Static Legal Market

Studies conducted by banks that serve major law firms (Citi, Wells Fargo) have concluded that the post-recession legal market is basically static, and is not growing. The clear implication is that increasing revenues will be achieved primarily at the expense of competitors. Firms growing for growth's sake may find it difficult to maintain, let alone improve, lawyer utilization. Reduced utilization generally will decrease partner incomes, on average, if not offset by improvement in other profitability factors (rates, realization, margins, all of which are suppressed in the current legal economy).

Inertia/Partner Protectionism

Another impediment to growth is the hoarding of work by partners to keep their production statistics up for compensation purposes, resulting in less work available to younger lawyers. This is a problem endemic to law firms in the post-recession era. It is especially acute among senior partners looking to extend careers and maximize earnings while they are able to do so, especially those whose retirement accounts were decimated by poor investment performance during the recession and who may not have made timely investment decisions since. It is a serious problem for management of firms where this situation exists.

Leverage Resistance by Clients

Post-recession, there have been many reports of corporate clients who specifically refuse to pay for work done on their matters by first and second year associates, under the assumption that in those circumstances they are effectively paying for the training of those associates. This limits the ability of firms to utilize newly hired lawyers, adversely affecting profitability.

Non-Traditional Providers

Increasingly legal work has been unbundled and much of the work previously done by associates is done by legal service support firms, directly marketing their capabilities to corporate clients. Examples include firms specializing in document review, e-discovery, litigation support, document assembly and the like. Some of them are domestic and others use off-shore capabilities. Some of them make their services available to law firms, and in some cases corporations dictate to outside law firms that they use these capabilities rather than their own ranks of associates, due to cost savings involved.

Non-traditional providers are also represented by virtual law firms (Axiom, Pangea, others) and by companies that provide temporary contract lawyers, usually on a case-by-cases or transactional basis. All of this inhibits the ability of some law firms to grow by adding associate lawyers on the scale that was prevalent before the recession.

GROWTH METHODOLOGIES

For law firms that grow, the options are limited to organic growth, lateral additions and mergers. Organic growth through addition of newly hired law graduates is the traditional means by which law firms have expanded. The impediments listed above have made this a much more expensive and difficult way to grow. Associate classes in major law firms are a fraction of the size they were before the recession. As a result, even large law firms are growing much more slowly than was the case in the past.

Laterals/Practice Groups

Lateral growth at a partner level continues as a means by which law firms believe they can add lawyers and clients simultaneously. But lateral growth is expensive, both in terms of compensation paid to induce partners to move from one firm to another, and in terms of legal search fees. And the experience has been spotty, at best. Some managing partners report that as few as 50% of laterals would be deemed successful, by any economic standard.

Other firms have pursued laterals at an associate level, allowing another firm to train young lawyers and bring them in at the point at which corporate clients are willing to pay for their experience. This clearly is a strategy that will only work in an environment where some firms continue to hire new law graduates. The current significant demand for experienced three- to five-year associates is reflective of hiring moratoria and cutbacks in new graduate hiring during the legal recession and a resulting dearth of experienced associates in law firms of all sizes.

Merger

2013 was a banner year for law firm mergers in the United States. Eighty-eight law firm mergers were reported in the *Altman Weil MergerLine™.* That is up from 60 in each of 2011 and 2012. Early activity in 2014 indicates continuing robust merger activity. Many of these mergers are driven by the growth drivers identified previously in this article. Many of those drivers are legitimate reasons for growing and for growing by merger.

STRATEGY IMPLICATIONS

The strategy implications of the growth conundrum are huge. They require different strategic considerations than the strategic plans conceived and implemented during the "legal bubble" between 2002 and 2008. The legal recession and a slow post-recession recovery of the general economy have changed the legal market forever. Firms must rethink their goals in terms of market position, their value proposition, practice mix, targeted segments, geographic reach and structure/organization. Most plans conceived pre-recession cannot be dusted off and implemented effectively in this new legal environment. A new, fresh look is required.

Some firms will choose not to grow. But this is a short term, defensive position, unless combined with a refocus on practices or markets where the firm can compete with larger firms. Artificial restrictions on firm size without such discipline are likely to endanger long-term competitive position.

Others will choose to grow, but at a decelerated rate. Still others will accelerate growth, often by way of merger.

The difference between post-recession and pre-recession legal economy in America is that strategic mistakes in the newly competitive legal economy may be fatal. Pre-recession, errors could be disguised by more than anticipated success in some other area. Lack of management discipline was not apparent. Today, all of this is transparent and exposed both within and outside the firm.

In the context of the issues outlined above, “grow or die” still applies at some level to most law firms. The difference is that not everyone will be able to grow, and that ill-conceived growth plans will surely fail. This is a world where the law business is truly no different than any other business, and just as competitive, if not more so. Strategic planning has never been more important, and needs to be done objectively, with discipline and focus. Many firms are incapable of doing this, and will suffer as a result. Other firms will get it right, and prosper.

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