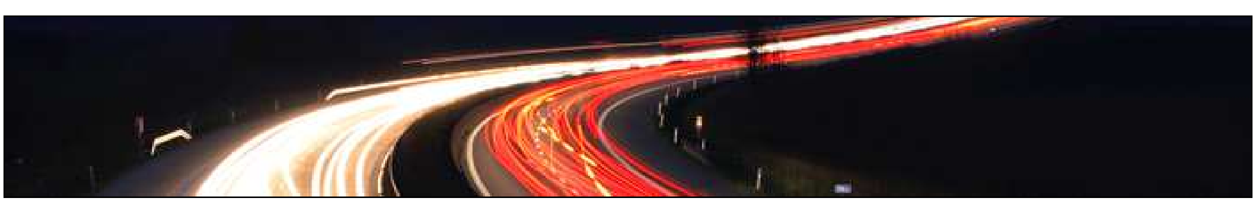
An Altman Weil Special Report

2016

Law Firms in Transition



Altman Weil, Inc.

About Altman Weil, Inc.

Founded in 1970, Altman Weil, Inc. is dedicated exclusively to the legal profession. It provides management consulting services to law firms, law departments and legal vendors worldwide. The firm is independently owned by its professional consultants, who have backgrounds in law, industry, finance, marketing, administration and government. More information on Altman Weil can be found at www.altmanweil.com.

Law Firms in Transition 2016

Are law firms still in transition in 2016? We think so, although the pace of change can seem modest. Despite pockets of true innovation, most firms are choosing to proceed with lawyerly caution in the midst of a market that is being reinvented around them.

Now in its eighth year, Altman Weil's *Law Firms in Transition Survey* continues to document market forces that are reshaping the competitive legal landscape, identify ways in which law firms have responded (or are lagging in their response), and prescribe how law firm leaders can find competitive advantages in a redefined marketplace.

Key Findings:

- **Unreliable demand:** Market demand for legal services has failed to return to pre-recession levels in a majority of US law firms. Many firm leaders remain concerned about how to grow profitability in a market characterized by stagnant or declining demand, intense competition from old and new sources, commoditization, and price pressures.
- **Surplus of lawyers:** Broad overcapacity is creating an ongoing drag on law firm profitability. Overcapacity and underutilization are prevalent among equity and non-equity partners, especially in larger firms. Compensation adjustments are being used in most firms to deal with underperforming partners, and chronic underperformers are being counseled out of their firms.
- **Inefficient delivery of legal services:** Although nearly all firms identified the need to improve the efficiency of legal service delivery as a permanent trend, more than half have not significantly changed their approach to achieve greater efficiencies.
- **Proactivity as a competitive advantage:** We see a 7-year trend of compelling success enjoyed by firms that take a proactive approach to alternative fee arrangements. We think this is a good indicator that proactive change in other areas could be equally effective in accelerating law firm performance relative to competitors.
- **Resistance to change:** The pace of external change being experienced by law firms is not expected to slow in the foreseeable future. The slower pace of internal change in many firms is attributable not to lack of awareness or will among law firm leaders but to low awareness and high resistance among their partners.

Financial Performance and Outlook

Just over two-thirds of law firms reported gross revenue and revenue per lawyer increases in 2015. Profits per equity partner (PPP) were up in 65% of firms. Twenty-three percent of firms saw PPP decrease in 2015 and almost half of those firms were down sharply (4 percent or more).

Many firm leaders are not optimistic about the ability to maintain an upward trajectory on profitability. Nearly half (47%) of leaders believe a slowdown in profit per partner growth is a permanent trend in the profession.

Law firms' financial trajectories are no longer consistent or guaranteed. We know a significant number of firms move in and out of the 'plus column' from year to year, buffeted by a variety of market forces. We also know that a drop in profitability numbers, especially in consecutive years, can trigger key partner departures and create immediate vulnerabilities.

Demand

Only 38% of law firm leaders say demand for services has returned to pre-recession levels in their firms. Another 12.5% expect demand to return in 2016 or 2017, leaving nearly half of all firms that think pre-recession demand is at least three to five years away – if it returns at all.

Most firm leaders (62%) think the erosion of overall demand for work done by law firms is a permanent trend. A combination of market forces have combined to put pressure on law firms' traditional flow of work from clients, including more price competition, seen as a permanent trend by 95% of law firm leaders, commoditization of legal work (88%), replacement of human resources by technology (85%), and competition from non-traditional service providers (82%).

The most immediate threat is coming from law firms' own clients. Sixty-eight percent of firms report they have already lost business to corporate law departments in-sourcing more work, and another 24% perceive this phenomenon as a potential threat. Clients' use of technology that reduces the need for lawyers and paralegals is considered a current threat in 21% of firms and a possible future threat in another 53% of law firms. Larger firms were much more likely to be affected by these competitive threats than smaller firms.

Individual law firms may or may not be in transition, but clearly the market is changing around them. Firms are faced with an evolving competitive landscape and shrinking or shifting demand. Any firm that is not actively planning to meet these challenges ignores them at its peril.

Lawyer Staffing, Overcapacity and Growth

Firms are having trouble keeping their lawyers utilized, with half of all firms (52%) reporting their equity partners are not sufficiently busy. Overcapacity and underutilization are worst among non-equity partners: 62% of firms report their non-equities are not sufficiently busy, including 80% of firms with 250 or more lawyers.

Widespread overcapacity is holding down profitability in 60% of all firms and in 76% of larger firms.

Law firm leaders are split on the strategic value of growth – only 53% of them said growth in lawyer headcount is required for their firm's success, and 60% see fewer equity partners as a permanent trend. Only half of all firms expect to have more equity partners five years from now than they have today.

Law firms are trying to address these issues in a number of ways.

Lateral acquisitions are seen as quick way to buy market share in a low-growth environment, and 85% of law firms report they added lawyers last year who brought new business to the firm. However, 47% of firms lost lawyers who left and took business with them in the same time period.

A majority of firms are practicing basic labor arbitrage – shifting work to less costly lawyers. More than half of all law firms are utilizing part-time lawyers (59%) and contract lawyers (56%) to meet demand as needed. Three quarters of firms with 250 or more lawyers are using part-time and contract lawyers. Only 9% of firms are currently outsourcing legal work, but 52% of firm leaders believe that is a permanent trend in the profession.

The most obvious solution to the overcapacity problem is to cut underperformers. Fifty-four percent of firms report that they dropped lawyers who didn't have enough work in 2015, and 73% of firms are removing chronically underperforming partners.

Almost half of firms (48%) are taking the interim step of de-equitizing full partners, moving them out of the profit-sharing class.

Law firms are acutely aware of their own staffing imbalances and are making efforts to address them, but in too many firms personal, political and cultural obstacles are hindering pragmatic economic decisions. Non-equity partners present the most obvious target for law firm right-sizing, as that class has been allowed to grow larger than current economics and likely future demand can justify.

Law firms simply cannot maximize their effectiveness until they deal with the issue of overcapacity head-on.

Efficiency and Pricing

Despite the fact that 93% of law firm leaders think a focus on improved practice efficiency is a permanent trend in the legal market, fewer than half of all law firms (44%) have significantly changed their strategic approach to efficiency – seemingly a large strategic disconnect.

The only efficiency tactics that break the 50% mark among all law firms are knowledge management (54%) and use of technology tools to replace some human resources (52%). Techniques that really challenge the way work has been done traditionally, like legal project management or reengineering of work processes, are less likely to have been adopted, especially in smaller firms.

Only one third of law firms are making strategic changes in their approach to pricing – a number that has remained basically unchanged since we started asking the question in 2013. There's a stark distinction between firms with 250 or more lawyers and smaller firms here. Fifty-seven percent of larger firms are making strategic changes in pricing approach, while only 26% of smaller firms are doing so.

The one pricing tactic that has been adopted by a majority of large and small firms is developing data on the cost of services sold. Sixty-seven percent of all firms and 91% of large firms are doing this fundamental analysis, which should enable them to structure more customized fee proposals. Sixty-four percent of large firms have added a Pricing Director or staff equivalent, compared to only 12% of smaller firms.

Discounts – the least strategic approach to pricing change – are widespread. A median of 21% to 30% of all law firm fees came from discounted rates in 2015. In larger firms, discounted fees accounted for a median of 31% to 40% of total fees.

Efficiency and pricing are areas that firms can control to meet the changing marketplace and manage challenges and opportunities. In a profession with a deeply entrenched tradition of hourly billing, those firms that find ways to meet clients' changing value demands through better pricing and efficiency measures are better positioned to compete.

Proactive Firms Are Winning

A large majority of firms (88%) report they are initiating conversations with clients about pricing and budgets, and many are surely talking about alternative fee arrangements. In fact, nearly all firms (97%) bill at least some of their work on a basis other than rates times hours.

Among those engaged in AFAs, far more firms are likely to take a reactive approach in response to client requests (72% of firms) than to proactively initiate alternative fee arrangements (28%). Trend data show that the financial results of the two approaches are significantly different and diverge more each year.

When asked to compare the profitability of non-hourly work and hourly work, 84% of proactive firms find their non-hourly projects to be at least as profitable as their hourly projects. This is the case in only 51% of reactive firms. Narrowing the focus, 40% of proactive firms report their non-hourly projects are more profitable than their hourly projects, compared to only 10% of reactive firms. The lesson is that firms that make a rigorous effort to understand and manage a new or evolving market tactic like alternative fees generally succeed in doing so, and enjoy increasing benefits over time.

Why aren't more firms proactive? The greatest obstacles we've observed in our work with law firms are not technical (software, systems, and skills) but cultural and political (resistance from partners).

Why Aren't Law Firms Doing More to Adapt?

The survey sheds light on why we have not seen more dramatic changes in law firms' behavior despite widespread agreement among firm leaders that they face a host of legitimate threats and challenges that will only increase going forward.

Why the disconnect?

When asked why their firms aren't doing more to change the way they deliver legal services, 59% of firm leaders say clients aren't asking for it and 56% say they aren't feeling enough economic pain to motivate more significant change. Many partners are inclined to ask, "Why rock the boat?"

The biggest impediment to change, identified by 64% of law firm leaders, is that partners resist most change efforts. This factor jumped 20 points from last year's survey to become the most frequently identified impediment. Only 4% of law firm leaders rated their partners as highly adaptable to change (i.e., rated 9 or 10 on a 0 to 10 scale). Leaders understand the market situation, but bringing their partners along is not easy.

Part of the problem is simple lack of awareness among rank and file partners. A majority of leaders (54%) say their firms aren't doing more to change the way they deliver legal services because most partners are unaware of what they might do differently. When asked to assess partners' overall awareness of the challenges their firms face in the current legal market, only 4% of leaders rated their partners as highly aware. We find these statistics alarming.

Partners' high autonomy is another factor. In a third of law firms, leaders believe their partners – if forced to choose – would sacrifice some compensation to protect their current level of autonomy. In other words, they would actually pay money to be left alone. Partners in smaller firms are considered much more likely to be protective of their individual autonomy. No surprise, then, that we continue to see larger firms outpacing smaller firms in their implementation of change efforts.

Law firm leaders remain generally confident in their firms' adaptive capacity, with 77% expressing moderate or high levels of confidence that their firms are fully prepared to keep pace with the challenges of the legal marketplace. But keeping pace is one thing; outpacing and outcompeting other firms is another.

If the strategy is simply to keep up with the pack, it misses the point that most of the pack is itself lagging and just a small increase in pace can distance a firm from its undifferentiated competitors. A firm can never get ahead by merely aspiring to keep pace with sluggish competitors. Vigorous pursuit of opportunities has always paved the way for competitive success.

Recommendations for Law Firm Leaders

In leading the firm:

Be a leader. Not just a consensus builder or caretaker or steward. You were elected to set the tone and steer the ship, so do it. If no one is behind you, it might be because you haven't stepped forward into the leadership role you agreed to take on.

Appoint real leaders. No one leads in isolation. Put champions in your leadership seats who understand the direction the market is going and are willing to work with partners and clients to plan and execute market-friendly solutions in the areas of pricing, staffing, efficiency, and the like. Your best leaders may not be the biggest rainmakers or most senior people. Have the courage and business sense to put your most capable leaders in the most important leadership roles, including practice leadership. Good leaders make the people around them better. If yours aren't doing that, consider restaffing the leadership team.

Deal with overcapacity. In practice areas where you will continue to have more lawyers than work and will eventually have to downsize, do it now. Lowering individuals' compensation doesn't address the long-term problem. Employing too many chronic underperformers creates a number of avoidable consequences, including a drain on profitability, blocking up-and-comers, morale issues, and more. Leadership in this area calls for managing attorney headcount more assertively and matching supply to demand.

Drive profitability through your practice groups. Only half of all law firms presently require their practice leaders to manage their groups for profitability, despite 78% of them having the information readily available to do so. In some firms, the ability to manage for profitability at the practice group level may be constrained by the caliber of the practice leaders or political considerations rather than the availability of reliable data. Sophisticated software is usually not necessary to manage people, practices, and matters for greater profitability, just the willingness to do it and a culture that permits greater levels of transparency and candor regarding the underlying data.

Go see your firm's clients. There is no magic formula that will satisfy every client. Each client has its own circumstances, personalities, motivations, wants, and needs. But don't wait for them to tell you what they're looking for – go find out. Ask about their goals, decision processes, how they select and evaluate outside counsel, what they're getting from other law firms that they like, and what they'd love to see from their lawyers if they could get it. Use communication, empathy, and service excellence to differentiate your firm by deeply understanding your clients. This doesn't cost anything, can be done by small firms as well as large, and can be extraordinarily useful.

Use non-hourly billing to your advantage. In the present environment, where the use of AFAs will only increase, where other firms are using AFAs as both a competitive advantage and a means to greater profitability, and where price competition and smaller annual billing rate increases are considered permanent trends, we suggest that a reactive stance in this area is inadequate. Proactive firms are setting the tone by analyzing previous matters, weeding out inefficiencies, nailing down reasonable cost estimates, and coming up with new win-win pricing proposals for clients. Ask why your firm isn't doing the same.

To increase awareness, engagement and action:

Explain <u>why</u> change is needed. Simply sharing the latest trends information is not sufficient. Your partners need to understand <u>why</u> the changes you recommend are imperative. What makes the information legitimate? Why is it important? Why is it relevant to the firm, their clients, and to them personally? Why and how will doing what you recommend be better for them? Why will not doing it be wrong or bad for them? Help them internalize the challenges and take ownership of solutions.

Ask your partners to think through the issues. Retreats provide an excellent forum for your partners to meet in small groups and devise firm- or practice-level strategies that are responsive to client needs and likely to generate competitive advantages in the near term. The slow pace of change in the profession translates into continued opportunities to get out in front of your competitors. Structured exercises in which your partners analyze threats and opportunities and develop rational action plans will stimulate good thinking and help overcome resistance.

Work with those who will work with you. You may not be able to get every partner to agree to create process maps for repetitive matters, shake up staffing models to increase efficiency, and reprice the work. But some will. Rather than pushing against a large, immovable partnership group, choose instead to create well-defined, low risk, short-term projects led by willing colleagues. Share your successes and enlist others to participate.

Share the survey. Use the *2016 Law Firms in Transition Survey* and other resources to increase your partners' awareness of important trends. A complimentary copy of the survey can be downloaded at www.altmanweil.com/LFiT2016.

About the Authors

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Thomas S. Clay is a principal of Altman Weil, Inc. With over 30 years of experience consulting to the legal profession, he is an acknowledged expert on law firm management principles and is a trusted advisor to law firms throughout the United States. Mr. Clay heads complex consulting assignments in strategic planning, law firm management and organization and law firm mergers and acquisitions. He is a thought-leader on the key issue of law firm practice group strategy and leadership.

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The 2016 Law Firms in Transition Survey

Conducted in March and April 2016, the *Law Firms in Transition Survey* polled Managing Partners and Chairs at 800 US law firms with 50 or more lawyers. Completed surveys were received from 356 firms (45%), including 49% of the 350 largest US law firms.

A copy of the survey can be downloaded at www.altmanweil.com/LFiT2016.

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