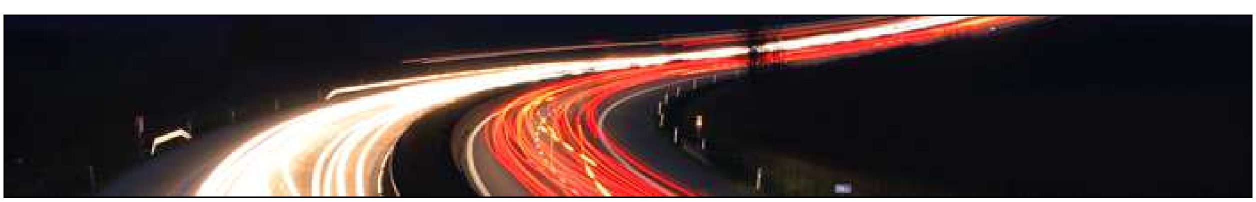
An Altman Weil Special Report

2017
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 2017

Since 2009, when our *Law Firms in Transition Survey* was first launched, we have seen the outlines of a new, post-recession legal market emerge and then solidify. In 2017, there are few law firm leaders who would dispute the permanency of more price competition, a need for greater efficiency, an influx of new kinds of competitors, and the inexorable force of technology innovation.

Law firms are slowly changing – more slowly than we think is wise, but changing nonetheless. Clearly not all change efforts are resulting in overnight success. Some efforts require long-term investments that can be a tough sell with partners. Other initiatives may work quickly, but are one-time fixes that can't be replicated for year-on-year gains. We see firms making only cursory investments where they should be aiming for broader, deeper transformation. And still many partners resist change in all its forms.

Progress will not be linear in most firms, but after nine years of surveying law firms on the challenges of transitioning to a decidedly client-centric, technology-driven market, we see that certain investments are paying off.

This year, we added a new element to the survey to look at which change efforts – those pricing, staffing, and efficiency tactics specifically undertaken to improve law firm performance – are actually producing results. Among the twenty performance tactics we looked at, four of the top five rated most effective by law firm leaders involve alternative lawyer staffing, including using contract lawyers, staff lawyers and shifting work to paraprofessionals.

These changes are being driven by what is perhaps the most immediate and basic threat that traditional law firms face in 2017 and beyond – the continuing erosion of demand.

Oversupply of Lawyers; Decreasing Demand for Services

Decreasing demand for legal services is endemic in the profession. Fifty-two percent of firms report their equity partners are not sufficiently busy, and 62% of firms said their non-equity partners are not busy enough. Lawyers other than partners and associates are not busy enough in 43% of law firms. And in 25% of firms, even associates don't have full workloads.

Overall 61% of respondents said overcapacity is diluting firm profitability. 88% of firm leaders said they have chronically underperforming lawyers. 68% of respondents think fewer partners will be awarded equity status in the future and that this is a permanent trend going forward.

When asked about the reasons for chronic under-performance, 82% of firm leaders identified weak business development skills and efforts as the culprit, while 59% pointed to flat or declining market demand. Firms are dealing with chronic under-performance in a number of ways: by reducing compensation (96%), asking for individual improvement plans (79%), removing chronic under-performers from the firm (73%), and de-equitizing full partners (57%).

While reducing compensation may be an appropriate response to under-performance, it should not be mistaken for a remedial tool. Experience shows that the right response is to make a plan for improvement with a clear timeline, and to remove those lawyers who are not able to turn their performance around. This can be a difficult and painful process, but it is a critical step in addressing a fundamental threat to law firm financial health and long-term viability.

Addressing this issue with increasing pace and more robust implementation will help determine how quickly and strongly profitability can be maintained or increased.

Lawyer Headcount Growth

Despite widespread overcapacity, 56% of law firm leaders still believe headcount growth is a requirement for their firm's success. Virtually all respondents plan to pursue organic growth and the acquisition of laterals in 2017. Two-thirds of firms will also seek to add groups of laterals.

However, we know that more than half of laterals do not meet expectations in terms of books of business brought in and/or personal productivity. Laterals who do not measure up within 24 months of joining the firm should, in our opinion, be subject to reduction in compensation and/or departure from the firm. Unproductive laterals are not only economic burdens but 'culture killers' as well.

Contract Lawyers

Firms are using contract lawyers, staff lawyers and part-time lawyers in an effort to mitigate costs and improve efficiency and profitability. The stigma about the quality of contract lawyer work is gone in most firms, in our experience, and clients find such strategies to be acceptable if not preferable.

Half of all law firms in the 2017 survey said they have significantly changed their staffing strategy since the recession. The use of contract lawyers is the top staffing tactic firms are pursuing and the most effective lawyer staffing technique. The most effective staffing tactic overall is the creation of low-cost service centers for non-lawyer, back-office functions, although only about 12% of firms have gone to this length.

The use of contract lawyers allows firms to flex up and down in response to demand fluctuations without increasing overhead. A firm that has addressed the issue of underperformance and identified a cohesive and productive core partnership should certainly add contract lawyers to its toolkit if it has not already done so.

Alternative Service Providers

Alternatives to the traditional law firm are an important part of the demand equation in 2017, and the largest current challenge in this area comes from clients themselves. Two-thirds of firms report losing business to corporate law department insourcing.

However, there is also a rapidly-growing cohort of Alternative Legal Service Providers – a market recently estimated by *Georgetown Law Center for the Study of the Legal Profession* at approximately $8.4 billion annually.

Non-law-firm providers of legal and quasi-legal services are showing up on some firms' radar, according to the survey. Nineteen percent of firms report those organizations are taking business from them now, and another 40% see them as a potential threat.

Undoubtedly, this growing industry will continue to provide options attractive to many purchasers of legal services, and may be a threat to traditional law firms. But, as suggested in the Georgetown study, it also gives innovative firms "new potential avenues for growth” by providing efficiencies that the market craves and cost reductions that it demands.

Efficiency

Ninety-four percent of respondents in this year’s survey said that a focus on improved practice efficiency will be a permanent trend going forward. But only 49% of law firms said that they have significantly changed their approach to the efficiency of legal service delivery. This represents a frightening disconnect.

Knowledge management is the most frequently used efficiency technique among surveyed firms, but those firms report that is not yielding quick successes, possibly due to poor utilization by partners. Legal project management training is another efficiency tactic that is used relatively widely but has not generated convincing results.

Initiatives like these, which seek to change fundamental lawyer behavior, are certainly the most difficult to execute. But forward-looking firms will not be deterred. Quick wins have obvious value, but long-term investments in behavioral change can be even more important and beneficial.

Firms that pursue thoughtful efficiency initiatives and stick with them will improve internal performance and add value for clients. Firms that do not will experience competitive disadvantage over time. It can cost very little to test-run pilot programs in these areas, and we believe it is an investment worth making.

Pricing

Pricing of legal services is inextricably linked to improving efficiency and providing greater client value. Unfortunately, in our experience, most lawyers are untutored on why and how to have robust pricing conversations with clients, are often reluctant to discuss pricing at all, and are too quick to simply accept discounts whenever asked. These weaknesses lead to decreases in potential profitability.

Only 39% of respondents indicated that their firms have made significant changes in their strategic approach to pricing; 44% said they have not, and 17% said they are considering it.

This year, we asked for the first time whether new pricing tactics have resulted in significant improvement in firm performance. The top three successes reported are: adding a pricing director (44%), incorporating pricing in all planning efforts (39%), and setting margin goals in firm and practice group plans (34%). The majority of respondents indicated it was “too soon to tell” whether each of these efforts would be effective.

An important new question this year asked whether firms are routinely linking discounted, capped and alternative fees to changes in how work is staffed and delivered. Only 30% of law firms said yes.

This is a hugely significant and extremely troubling result that goes to the heart of successful change and illustrates a critical misunderstanding in many firms. The strategic elements of a law firm’s business model are all interlocking gears in the same engine. A firm that does not consider the interaction between scope, staffing, price, project management and margin cannot achieve optimal performance.

Profitability

We are encouraged to see the broad use of profitability data as a management tool to assess partner performance (71%), to analyze the profitability of individual clients (62%), and to manage practice groups (51%). While the use of such data can be difficult to implement (more for political than technological reasons), we believe that ignoring its use is managerial malpractice.

For the first time this year, we asked firm leaders about the use and effectiveness of ten short- and long-term tactics to improve profitability.

The number one thing law firms are doing specifically with the goal of improving profitability is the acquisition of laterals or law firms (cited by 75% of firms surveyed). However, only about half of those firms (53%) report that those acquisitions have resulted in significant profit improvement.

Another profitability tactic that is widely used but is not delivering immediate results is investing more on business development. Seventy-one percent of firms are pursuing this tactic, but it is ranked as the least effective method of improving profitability with only 30% of firms realizing the desired improvement. An additional 65% of firms said it was too soon to tell if the investment would ultimately pay off.

At the other end of the spectrum, moving to smaller, cheaper space is the tactic used least frequently (by only 25% of firms) but most effectively (in 75% of those firms). It is not surprising that actions like cutting staff, cutting under-performing lawyers and cutting low-margin practices and offices have all delivered immediate boosts to profitability.

Many firms are making progress in this area, but all firms should be committed to the disciplined use of all available profitability levers.

Partner Compensation and Business Origination

For the first time we asked, “How important is an individual partner's business origination in your firm’s partner compensation decisions?” The median answer was 8 on a scale of 0 to 10. Origination has been the number one factor in many firms for well over a decade. However, a new factor is fast emerging – the profitability of the originations.

In answering the question “How important is *profitability* of partners' origination in your firm’s partner compensation decisions?” respondents gave a median score of 6. In our work with law firms on partner compensation issues, we see this as the fastest growing criterion that affects compensation. It is also in many respects the most vexing in that firms use different philosophies and processes to calculate profitability. As yet there is no single standard in the profession. However, over-paying people for their books of business is beginning to be rectified, and that is long overdue.

Law Firm Innovation

Half of survey respondents reported that their firms are actively engaged in creating special projects and experiments to test innovative ideas or methods. This is heartening.

Additionally, 49% of firms are currently using technology to replace human resources with the aim of improving efficiency. Many more (84%) believe this will be a permanent trend in the profession.

There are many innovative things law firms can do (some with little investment or cost) to improve service delivery in ways that clients will appreciate. A strategic focus in this area is an absolute necessity at the firm and practice group levels. No law firm can afford to be playing catch-up as clients embrace innovative initiatives from other service providers.

We have included an extensive section of participant responses describing innovations law firms are pursuing in 2017. These run the gamut from technology and data analytics to new business ventures, pricing and staffing improvements, efficiency initiatives, and efforts aimed directly at client engagement and retention.

There should be no argument or surprise that the rise of artificial intelligence (AI), cognitive computing and machine learning has the potential to revolutionize law practice. But few in the profession appear to be doing much about it.

Only 7.5% of firms said they have begun to make use of legal AI tools, and another 29% are beginning to explore their options. The remaining 64% are not doing anything or are not even aware of what is going on in this area. We think at the very least, firms should be keeping a watchful eye on competitors and technology companies that are investing in legal AI solutions. This is coming, and the day is not far off when ignorance will carry a steep cost.

Lawyers are Reluctant to Change

Why aren't law firms doing more to change?

Partners are a big part of the problem, since their cooperation determines in large part whether change takes root in their firm. 65% of law firm leaders say partners resist most change efforts, and 56% say most partners are unaware of what they might do differently.

These findings do not inspire confidence – but neither are they surprising. A reluctance to change is a significant and ongoing challenge in most firms, especially in adapting robust strategies, systems and procedures in the area that clients crave – provision of more efficient legal work at a more cost-effective price.

At the same time, a large majority of respondents (72%) believe that the pace of change in the profession will continue to increase. This is a 12-point increase over six years ago – a significant jump. There is a very concerning misalignment between what law firm leaders believe regarding the pace of change and what their partners believe or are willing to do. That problem must be solved if firms are to make necessary strategic changes.

Although almost all firms engage in strategic planning at both the firm and practice group level, many are doing so without a broad and deep understanding of the environment. This is a cardinal sin and can be catastrophic.

Lawyers are very good at interpreting data and information that is set before them, but they also need to be able to recognize when part of the picture is missing. They must ask and answer the question, '*What don't we know that might matter?*'

Conclusion

The results of Altman Weil's ninth annual *Law Firms in Transition Survey* highlight a number of fundamental problems and challenges that are interfering with law firms' ability to succeed in a rapidly changing and highly challenging marketplace. It also includes some clear direction on what's working in law firms to improve performance and profitability.

Some of this year's results should be disturbing to every lawyer, but opportunities also abound. Law firms that seize those opportunities can create important competitive advantage. We hope they will take up the challenge.

About the Authors

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 2017 Law Firms in Transition Survey

Conducted in March and April 2017, the *Law Firms in Transition Survey* polled Managing Partners and Chairs at 798 US law firms with 50 or more lawyers. Completed surveys were received from 386 firms (48%), including 50% of the 350 largest US law firms.

A copy of the survey can be downloaded at www.altmanweil.com/LFiT2017.

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