Strategy Determines Trends in No-Growth Legal Economy

By Ward Bower

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Growing market share in a declining or static economy or economic sector is difficult. Generally it requires either pirating customers from competitors or combining with them.

The US Economy

Post-recession US economic recovery is anemic, at best. Projected GDP growth for 2011 was 2% to 3%. Actual results were 0.4% in the first quarter and 1.3% in the second quarter. It is likely that growth will barely top 1% for the rest of the year.

Expectations for 2012 are equally gloomy. A recent poll of economists indicated there is a 50% chance of slide into a double-dip recession in 2012.

Corporations are hunkered down. There is some baseline merger and acquisition activity and there have been a few IPOs. However, for the most part, corporations and investors are hoarding cash, not investing or hiring. Uncertainty regarding the national debt, trade deficits and the government's ability to function are inhibiting investment activity.

The Legal Economy

Historically, the legal economy mirrors the national economy, albeit with a time lag of six to nine months. The US economy came out of recession in 2009, but it wasn't until 2010 that the recovery began in the legal sector. And the legal recovery has not been robust, either. Revenue and profit projections for 2011 are in the +/- 5% range. The first quarter of 2011 was robust for many firms, the second quarter disappointing, third quarter mixed. No one is projecting a fourth quarter boom.

Positive results for law firm performance in 2010 were largely attributable to cost cuts implemented during the recession. Many firms saw a decline in revenues but increase in profits due to belt tightening. In many of these cases, there is little room for more cuts without drastic restructuring at all levels. The prevailing leverage-based business model for law firms needs to be rethought.

Corporate clients are seriously seeking reductions in legal fees. Their focus has been on bringing work in-house rather than sending it out, use of alternative service providers (legal process outsourcers, temporary and contract lawyers, etc.), rate pressures, dictating law firm staffing on corporate matters, even directing case or matter strategy. They also are consolidating their legal work in smaller numbers of outside firms. All of those pressures will continue into the future.

In a slow to no growth general economy, the legal economy can be expected to be static, at best. Gone are the days when a rising tide can be expected to float all boats, as in past economic recoveries.

Law Firm Strategies, 2011 and Forward

After two years of hunkering down during the recession, operating in essentially a survival mode, law firm strategies in the post-recession recovery are oriented toward the following:

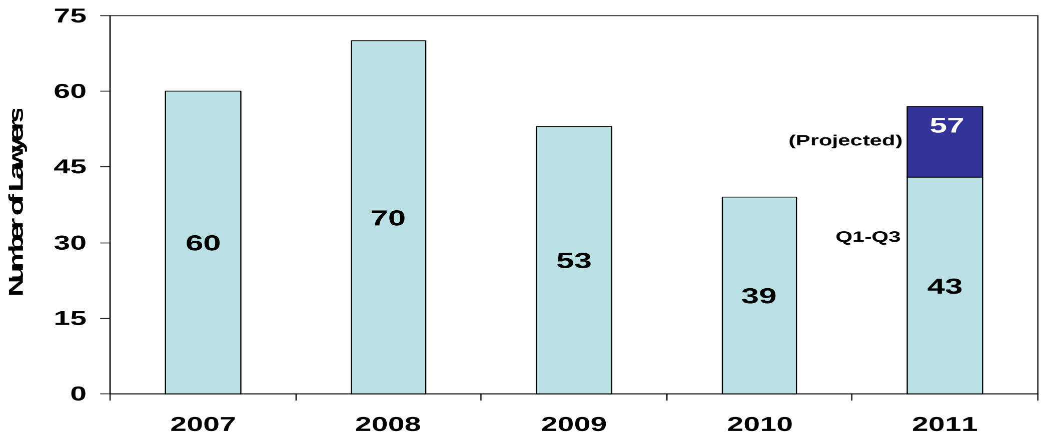
- Keeping existing clients from moving their work to other law firms;
- Gaining access to new clients;
- Gaining access to new markets;
- Positioning the firm to prevail as corporations reduce the number of outside law firms they use;
- Slashing costs;
- Reorganizing at a partner level (de-equitization, implementation of new partner criteria and accountability, etc.).

The impact of implementation of these strategies will define critical trends we see in the legal marketplace over the next few years.

Consolidation

Law firms are employing growth strategies to keep their growing clients from moving to larger firms, to ensure access to large matters that clients might otherwise take to larger firms with greater depth and breadth in practice areas, and to gain access to larger clients as corporations reconsolidate their legal work in a smaller number of outside firms. Much of that growth is by merger. Altman Weil MergerLine shows a 79% increase in the number of US law firm mergers during the first three quarters of 2011, over comparable figures for the first three quarters of 2010. After decreases in the number of US law firm mergers in 2009 and again in 2010, 2011 projections of 57 or more mergers will bring us back to 2007 levels of law firm merger activity.

US Law Firm Merger Activity 2007-2011



Consolidation is evident in the largest law firms, as can be seen in the AmLaw 100. In 2010 the top 10 firms generated 25% of aggregate AmLaw 100 revenues, up from 21% in 2000. Conversely, the bottom 10 commanded 4% of AmLaw 100 revenues, down from 5.5% in 2000. Six of the top ten US firms in 2010 were not in the top ten in 2000. Three of them arrived there as a result of mergers or significant lateral growth (DLA Piper, Hogan Lovells, Greenberg Traurig).

Geographic scope mergers (between firms in different locations) dominate. Of the 43 mergers announced during the first three quarters of 2011, 67% were between firms in different cities. Geographic scope mergers provide access to new clients and new markets. Additionally, they create competitive advantage as corporations reconsolidate work in a smaller number of outside firms, enabling a single firm to serve a corporation in multiple markets. Geographic scope mergers are, for the most part, domestic, although there are an increasing number of international mergers, exemplified by recent trans-Atlantic blockbusters, including Hogan Lovells, Squire Sanders Hammonds, and SNR Denton.

Globalization

Trans-Atlantic mergers are reflective of the impact of globalization on the legal market. US law firms are expanding internationally to be able to serve US-based clients doing business overseas, an essentially defensive strategy designed to avoid losing those clients to foreign firms that have US offices who might offer a one-stop solution to their international clients. Merger is the preferred method to enter international markets, as greenfield operations are expensive to grow to a competitive position and take way too much time and investment. 2012 will see some significant mergers of US national firms with UK firms, and possibly even some US-Australian and US-Asian mergers. In the future, we can expect PRC firms to establish significant US and UK offices to retain work associated with outbound investment by Chinese clients and funds in the US and UK.

Price Competition

Corporate clients are viewing more of their outside legal work as commodity in nature, and giving it to the lowest bidder. They are placing extreme pressure on hourly rates. Even major law firms are discounting some billing rates to keep existing clients and gain access to new clients.

Corporations are also prodding outside law firms to provide pricing alternatives to hourly billing in a search for cost savings and to gain certainty of overall legal fees. In some cases, law firms are using alternative providers, including legal process outsourcers, both domestic and offshore. In some large matters, work is bifurcated, for example in litigation with document review and litigation support functions going to LPOs, while law firms handle trial preparation and courtroom functions. In the future we can expect to see significant effort by corporations to find innovative alternatives to reduce the cost of legal services through the use of LPOs, virtual law firms, and the like.

Cost Reduction

Law firms will respond to corporate efforts at cost reduction by reducing their own costs to enable them to be more price competitive, while maintaining profit margins. Staffing cuts are just the tip of the iceberg. Law firms themselves will outsource, primarily domestically rather than overseas (although UK firms are outsourcing both front and back office operations to Asia and India). Onshore outsourcing by US law firms will enable reduction of both staffing and occupancy costs, the two major categories on the expense side of most law firms' profit and loss statements. Onshore outsourcing by US firms is exemplified by Orrick and WilmerHale operations in Wheeling, WV and Dayton, OH, respectively. Onshore outsourcing by US firms will inevitably include some lawyer functions such as document review and litigation support, to enable them to compete with LPO companies and keep entire matters within the law firm.

Occupancy costs are the second major cost category, after staffing. As leases expire we can expect innovation in space utilization featuring smaller lawyer offices, less "library" space, and workspaces consistent with reduced staffing and new information technologies. Space innovations will also take into consideration increased remote working by lawyers and staff, whether it be from home, client workplaces or on the road. Lawyer offices will become smaller and defined functionally as workplaces, not work and meeting places. Investment in and expenditure on the fit out of new office space will be concentrated in conference centers, meeting spaces, reception and other areas which clients will see, not on the offices and work spaces that house lawyers and staff.

Restructuring

Law firms are rethinking their partnership structure. At the associate level, fixed expenses, primarily associate lawyers, are being replaced by the increased use of temporary and contract lawyers. Permanent staffing will be lean, augmented in peak loads by temporaries and contract resources.

Criteria for becoming or remaining an equity partner and sharing in profits will be adjusted. Lifetime equity partner tenure will become an antiquated concept. Equity partners will be accountable for contribution to the firm on a continuing basis.

Non-equity partner ranks will expand but criteria will be tightened for becoming or remaining a non-equity partner. Any stigma previously attached to non-equity partner status has already disappeared in many firms.

Partner compensation systems will be rationalized to allow downward movement, as well as upward. Seniority will give way to meritocracy.

As baby boomers approach retirement, succession plans will allow for client and leadership transitions. Compensation will be adjusted accordingly. Mandatory retirement policies will disappear. Partner production expectations and compensation will be reduced as client succession is implemented over multi-year spans.

Non-Lawyer Ownership

Implementation of the Legal Services Act in England and Wales, beginning in the fourth quarter of 2011, will be carefully observed by US law firms. Should non-lawyer or corporate investment in one or more major London firms occur, it is possible that capital may be used to attract lateral partners from the London offices of US firms. Should clients follow those partners to London firms, then US firms may become much more interested in seeking regulatory liberalization in the US to level the playing field by allowing for non-lawyer investment in US firms. The issues presented by the MDP (multidisciplinary partnership) debates of the late 1990s will re-emerge, in the context of globalization and allowance of non-lawyer ownership in law firms in the UK. Australia already allows non-lawyer ownership and other jurisdictions are likely to follow in eliminating restrictions on outside investment in law practices.

Shakeout

The shakeout or business failure of firms unable to compete in the new legal marketplace is likely to continue. The demise, in recent years, of major firms like Heller Ehrman, Wolf Block, Coudert Brothers, and Howrey will continue in the future. Economic and competitive pressures in the no-growth legal market which, by necessity, require firms seeking new clients to effectively steal them from other firms, will result in dissolutions.

Conclusion

Consolidation, price competition, cost reduction, globalization, restructuring, non-lawyer ownership and shakeout will be the dominant trends in the slow growth, no growth legal economy of the coming years. These trends are a predictable result of implementation of law firm strategies for continued success, or even survival. Firms that act quickly and decisively to implement strategies for growth, client acquisition, cost control and restructuring will be winners in the new legal economy. Those who dawdle face existential risk. The legal marketplace of the future will not be the kind, generous marketplace of the past.

About the Author:

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