2011

Law Firms in Transition

An Altman Weil Flash Survey

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Law Firms in Transition 2011

The Altman Weil **Law Firms in Transition Survey 2011** finds confidence high among US law firm leaders in firms of all sizes. Overall economic performance is rebounding, with two thirds of all firms surveyed reporting increases in gross revenue in 2010 and nearly three quarters reporting increases in revenue per lawyer and profits per equity partner. Standard hourly billing rates are up significantly this year, with firms reporting or planning a median 4% increase in billing rates for 2011. Continued reductions in overhead costs and the strategic shrinking of firms' ownership ranks are contributing to profitability.

However, if firms are finding their feet again post-recession, it is on new ground with a number of new factors in play. And although large majorities of law firm leaders seem to recognize those changes, it's not yet clear whether they will be able to manage them effectively.

Conducted in April and May 2011, the survey polled managing partners and chairs at 805 US law firms with 50 or more lawyers. Completed surveys were received from 240 firms including 38% of the 250 largest US law firms.

Economic Performance and Pricing

When asked about 2010 economic performance, 66.5% of firms reported an increase in gross revenue in 2010 compared to 46% that experienced revenue growth in 2009. Revenue per lawyer was up in 73% of firms, compared to 47% of firms in 2009, and profits per equity partner were up in 73% of participating law firms compared to 56% in the prior year. Rounding out the positive economic picture, 53% of firms reported overhead cost reductions in 2010 – a majority of firms but less than the 69% that reduced expenses in 2009.

Ninety-five percent of firms surveyed have increased or plan to increase their billing rates in 2011. The median increase will be 4% – a number that holds across all firm size categories. Additionally, 97% of firms expect their effective realized rate to increase or remain the same in 2011.

Although annual rate increases are rising again – from a median 3% reported in the 2010 survey – most firms recognize that rates alone can no longer be relied on to drive profitability. Pressure from clients to control costs and more price-based competition will make achieving efficiency and productivity gains key to growing law firm profitability at a pace significantly higher than inflation.

Alternative Fee Arrangements

Alternative fee arrangements (AFAs) are used by 95% of all law firms, and by 100% of firms with 250 or more lawyers. The amount of non-hourly billing in 2010, measured as a percentage of revenue, increased in 58% of all firms, and in 81% of firms with 250 or more lawyers.

Despite the prevalence and growth of alternative fees, only 12% of firms reported that non-hourly projects are more profitable than hourly billing. An additional 37% reported them to be about as profitable as projects billed on an hourly basis.

Two thirds of law firms reported that their use of AFAs is primarily reactive in response to client requests, while only a third offer AFAs proactively as a means of creating competitive advantage. Firms that are proactive in their pursuit of non-hourly business were more than twice as likely to report higher profitability on non-hourly projects compared to firms that are reactive.

Clients are not monolithic in their desire for alternative fees. But firms that preemptively think through issues of internal efficiency, including project management, knowledge management, new technology resources, and staffing and outsourcing options, will be prepared to deliver projects more profitably under client-initiated AFAs or to offer such arrangements to clients and prospects.

A majority of firm leaders expect current pricing trends to be permanent. Fifty-seven percent expect smaller annual billing rate increases going forward; 75% of all respondents believe there will be more non-hourly billing in the future; and 90% think more price competition is a permanent market change.

However, taking all of that into consideration, only 16% of firm leaders expect permanently lower profits per partner.

Partners and Partnership

Cuts of equity and non-equity partners will continue in 2011, but at a reduced pace from 2010. Overall, about one third of all law firms reported removing non-equity partners in 2010 and more than a third removed equity partners. In 2011, 17% of firms plan to cut equity partners and 21% expect to cut non-equity partners.

Large firms were much more likely than smaller firms to reduce their partnership ranks in 2010 and are more likely to do so again this year. In firms with 250 or more lawyers, 56% cut equity partners and 61% cut non-equity partners in 2010. Twenty-seven percent plan to make cuts to their equity partner ranks in 2011 and 48% will reduce their non-ownership tiers this year.

Firms are taking additional steps to control the number of owners. Twenty-seven percent of firms de-equitized partners in 2010 and 16% will do so in 2011. Thirty-two percent of firms made fewer partnership offers in 2010 and 18% will do so in 2011. Larger firms are more likely to take these actions than smaller firms.

In 2009 and 2010, law firms cut personnel from the bottom up, with non-lawyer staff and associates taking the brunt of reductions. This year, cuts will be fewer and more evenly distributed. Many firms will take a hard look at unproductive and under-productive partners and make strategic cuts to improve firmwide productivity and profitability.

Fifty-seven percent of firms expect to have more owners in their law firms five years from now; 27% predict that their total number of owners will remain unchanged; and 15% expect to have fewer equity partners in 2016. For non-equity partners, the five-year outlook is similar: 51% of firms predict growth in their non-equity tier, 30% believe their number of non-equity partners will remain about the same, and 10% of firms expect to employ fewer lawyers in this category in 2016.

Sixty-eight percent of all firm leaders believe that fewer equity partners will be a permanent trend in the profession, up 5 points from 63% last year.

Although the majority of leaders still anticipate growth in their own firms, these numbers seem to indicate an attitudinal shift in a profession that has long been wedded to the ‘growth imperative.’ The idea that getting bigger will always equate to getting better is no longer as prevalent. Firms realize that any move to get bigger must be paired with a strategy to improve the firm’s competitive position and performance.

Law Firm Growth

Law firms are combining cuts of underproductive partners with selective growth, according to the survey. Again this year, the top two growth options firms will pursue are the acquisition of laterals and the acquisition of groups. Ninety-two percent of all law firms, and large majorities in every firm size category, plan to acquire laterals in 2011. Sixty-seven percent will also work to acquire groups of lawyers.

When asked whether lateral partners hired over the last five years were still with their firms, law firm leaders reported a median retention rate of 90%. The retention rate varied inversely with law firm size, with smaller firms reporting greater retention. Firms with 1,000 or more lawyers had the lowest median retention rate (78%), while firms with 50-99 lawyers reported the highest median retention rate (98%).

Firm leaders also estimated what percentage of lateral partners were contributing at the level the firms had anticipated when the laterals were hired. About a quarter of law firms reported that more than 80% of their laterals are meeting expectations. Another forty percent say that 61%-80% of their laterals are contributing at a satisfactory level. The balance of firms had success with 60% or less of their lateral partner hires.

Clearly many law firms can improve their return on lateral hires. Considering the time and money firms invest in the process, a baseline benchmark for lateral success should be at least 80%. In the future, we expect firms to devote more attention to the specifics of lateral portfolios, including detailed profitability analyses, and to manage their recruitment, integration and cross-selling efforts more rigorously.

After a two-year slowdown in the law firm merger and acquisition market, 23% of firm leaders indicated that they will try to acquire a law firm in 2011. An additional 19% are considering an acquisition. In firms with 250 or more lawyers, 42% will pursue a suitable acquisition in 2011 and 19% more might do so. When asked about a merger of equals, 6% of all firms and 9% of firms with 250 or more lawyers indicated they would pursue that growth option. As with the addition of laterals and groups, the key to successful mergers and acquisitions going forward will be the sophisticated analysis of potential productivity and profitability in the newly combined firm.

Associates

Things are looking up for associates in 2011, with 87% of law firms planning to add associates to their ranks in 2011. Overall, only 18% of firms plan to remove associates this year, down from 42% in 2010. In firms with 250 or more lawyers, 36% plan to remove associates in 2011, compared to 61% that did so in 2010.

Looking at a five year horizon, 78% of firms expect to have more associates in 2016; 14% think they will have the same number; and, only 4% predict that they will have fewer associates in 2016 than in 2011.

Associate programs are still under some pressure. Last year 45% of firms reduced or discontinued hiring first-year associates; this year 22% plan to do so.
Sixty-two percent of firms shrunk summer programs in 2010 and 33% will shrink summer programs this year.

Forty percent of law firm leaders expect that reduced first-year classes will be a permanent change in the marketplace. Forty-five percent expect leverage to be permanently reduced in US law firms.

However, those associates who are hired and retained should expect to see their salaries bounce back. Only 18% of law firms surveyed think reduced associate salaries will be a permanent trend, down from 32% that thought so last year.

The future of law firm associates is far from resolved. Most firms would like to continue the traditional (and profitable) associate leverage they enjoyed in the past. The challenge will be to find the right balance of work volume, billing rates, training, development, evaluation, and compensation – all in the context of a longer, narrower partnership track.

Non-traditional Resources

Use of contract and part-time lawyers is on the rise in law firms. In 2010, 31% of all firms added contract lawyers and 28% added part-time lawyers. This year 21% of firms plan to add contract lawyers and 19% will add part-time lawyers. The survey found staffing trends varying with firm size, with larger firms much more likely to add lawyers in these categories.

Overall, 44% of firms used contract lawyers in 2010; 59% will do so in 2011 or are considering it. Sixty percent of firm leaders expect that the increased use of contract lawyers will be a permanent trend, up from 52% last year.

Outsourcing of legal work is very slowly gaining traction in the legal profession, particularly in larger law firms. Only 4% of all firms outsourced legal work in 2010 and 5% plan to do so in 2011. In firms with 250 or more lawyers, 8% outsourced legal work in 2010 and 11% will do so in 2011.

Despite limited adoption to date, 41% of all firms believe that outsourcing legal work will be a permanent part of the new legal market. Seventy percent think that competition from non-traditional (including non-lawyer) service providers is also a permanent trend.

Law Firms in Transition

As the economy stabilizes, the imperative for change in the profession may seem less urgent to some law firms. We asked firm leaders to assess the pace and permanency of recent legal market trends as well as their level of confidence in meeting the challenges presented by change.

Twenty-two percent of firm leaders believe that the recent recession was a game changer from which there's no going back. An additional 44% see it as a permanent accelerator of trends and expect the heightened pace of change to continue. But a third of respondents are not convinced: 28% feel that the recession was only a temporary accelerator of existing trends; and 6% (all in firms under 250 lawyers) think it was simply a disruption.

Leaders expressed considerable confidence in their firms' ability to keep pace with change. On a scale of zero (not at all confident) to ten (completely confident), firms indicated a median confidence rating of eight, consistent across all firm sizes.

Firms were asked to identify areas where they were most concerned about their preparedness to deal with change. The top issue, identified by 47% of all firms, was the retirement and succession of Baby Boom lawyers in their law firms. The second, third and fourth areas named were all economic issues: continuing growth in profitability (44%), erosion of demand (35%), and pricing pressures (35%).

Systematic improvement in practice efficiency was fifth on the list of concerns, identified by 27% of responding firms.

The focus on practice efficiency was identified by 94% of all law firms as a permanent change in the profession, topping the list. Other top trends include more price competition (90%), fewer support staff (88%), more commoditized legal work (81%), and more non-hourly billing (75%).

Perhaps even more interesting than the trends at the top of the list is the one at the bottom. Despite their acknowledgement of numerous economic and competitive trends that are exerting pressure on the traditional law firm business model, only 16% of law firm leaders believe that lower profits per partner will be a permanent change in the profession.

How do firms plan to continue to increase their profitability year after year? The survey yields some answers: Firms intend to improve efficiency, do more work with fewer lawyers, and manage the number of owners to control the denominator of the PPP equation. Additionally, they plan to invest in new lateral partners (and their books of business) while removing underperformers. Firms will also pursue the traditional avenues of business development and client relationships as investments that they expect to yield significant returns. Will these strategies be sufficient to restore profitability trends to pre-recession levels? Time will tell.

Conclusion

Is law firm confidence merited in 2011? A lot will ride on how quickly the marketplace changes going forward. The large majority of firm leaders are banking on a manageable pace of change, and they may very well be correct.

Undeniably, however, some significant changes are gaining momentum.

The traditional law firm profit model is under siege. Firms that relied on ever-increasing volumes of work and unchallenged annual billing rate increases must learn new ways to work more productively and deliver high value to clients at lower overall cost. There will be more scrutiny and accountability for lawyers at all levels. Client work and books of business will be assessed and valued based on their contribution to firm profitability.

Growth will no longer be a magic bullet. Firms that streamlined their ranks in the last few years will begin to grow again – but strategically.

There are a variety of non-traditional lawyer staffing options that can be utilized creatively to improve a law firm's bottom line. More firms are experimenting with contract lawyers and part-time lawyers, and there are many talented candidates available to fill these roles. Outsourcing legal work is another option for firms to consider as more routine work is commoditized and even complex matters are disaggregated into high- and low-end parts.

Practice efficiency and process improvement are simple ideas – but are not easy to execute effectively. Firms must begin the long process of implementing organization-wide changes in how lawyers practice. Legal project management, knowledge management, flexible staffing, alternative delivery models, new technology and a willingness to look beyond the status quo will all be required.

Law firms that plan and act strategically and proactively to deal with change, and that creatively co-opt prevailing market forces, will be well positioned to compete in the new legal economy – no matter how it plays out.

Survey Methodology

Conducted in April and May of 2011, the survey polled Managing Partners and Chairs at 805 US law firms with 50 or more lawyers. Completed surveys were received from 240 firms (30%), including 38% of the 250 largest US law firms. The full survey is available online to download at: www.altmanweil.com/LFiT2011. Special reports based on law firm size ranges are available exclusively to survey participants.

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Thomas S. Clay is a principal of Altman Weil, Inc. With 30 years 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.

He is Fellow of the College of Law Practice Management (COLPM) and has served as a Judge for the College's InnovAction Awards which recognize outstanding innovation in the delivery of legal services worldwide. He is a member of the COLPM Futures Committee. In 2008, Mr Clay was named as one of the "100 Legal Consultants You Need to Know."

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Prior to joining Altman Weil, Mr. Seeger was an independent consultant to law firm and corporate executives. He served as strategic planning officer of an AmLaw 200 law firm for four years. Previously, he performed market analysis for a global manufacturer, holding leadership positions in the industry's trade association, and served in budgeting and planning capacities for a major university.

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