



2013

Report on the State
of the Legal Market

*The Center for the Study of the Legal Profession at the Georgetown University Law Center and Thomson Reuters Peer Monitor are pleased to present this 2013 Report highlighting the trends that we perceived in the legal market in 2012, as well as the factors that we believe will impact the market in 2013 and beyond.*¹

Introduction – Time to Burn the Ships?



As we enter 2013, the legal market continues in the fifth year of an unprecedented economic downturn that began in the third quarter of 2008. At this point, it is becoming increasingly apparent that the market for legal services in the United States and throughout the world has changed in fundamental ways and that, even as we work our way out of the economic doldrums, the practice of law going forward is likely to be starkly different than in the pre-2008 period. The challenge for lawyers and law firms is to understand the ways in which the legal market has shifted and to adjust their own strategies, expectations, and ways of working to conform to the new market realities. While there is certainly evidence that some firms and lawyers have begun to make these adjustments, many others seem to be in denial, believing (or perhaps hoping) that the world will go "back to normal" as soon as demand for legal services begins to grow again.

Legend has it that in 1519, when he and his cohort of some 500 soldiers and 100 sailors landed on the shores of the Yucatan intent on conquering the large and powerful Aztec empire, Spanish conquistador Hernando Cortez promptly ordered his men to "burn the ships." Cortez knew that, unless more tempting alternatives were removed, it would be difficult to motivate his men to take on an empire with a large army that had been in power for more than six centuries. Hence, his bold and decisive order.

The legal market today is an increasingly difficult and challenging environment, one that calls for clear thinking, strategic focus, and flexibility in addressing rapidly changing realities. To an unfortunate extent, however, many lawyers and law firms seem stuck in old models – traditional ways of thinking about law firm economics and structure, legal work processes, talent management, and client relationships – that are no longer well suited to the market environment in which they compete. Perhaps it's time for us, like Cortez, to burn the ships – to force ourselves to think outside our traditional models and, however uncomfortable it might be, to imagine new and creative ways to deliver legal services more efficiently and build more sustainable models of law firm practice.

¹ The Center for the Study of the Legal Profession and Thomson Reuters Peer Monitor gratefully acknowledge the participation of the following persons in the preparation of this Report: from the Center for the Study of the Legal Profession – James W. Jones, Senior Fellow (lead author); Milton C. Regan, Jr., Professor of Law and Co-Director; and Lisa H. Rohrer, Research Fellow; and from Thomson Reuters Peer Monitor – Mark Medice, Senior Director.

In the sections that follow, we describe the trends that we have observed in the legal market in 2012, explore the longer term implications of those trends for the future, and suggest some ways in which lawyers and law firms can better position themselves to deal with new emerging market realities.

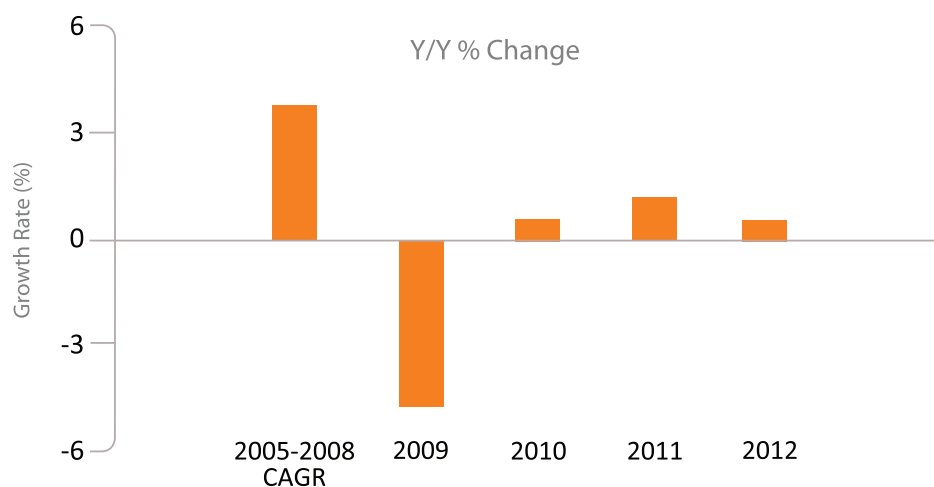
Financial Results in 2012

From a financial point of view, 2012 was another year of only modest growth as law firms continued to struggle with the combined impacts of sluggish demand, declining productivity, falling realization rates, and the need for further expense reductions. While there were some bright spots, on the whole the legal market continued in the financial doldrums.

Demand

Following eight straight quarters of negative demand growth as reflected in declining billable hours, the U.S. legal market turned back into positive territory in Q4 2010 but has been unable to sustain steady and positive growth in demand for legal services.² As tracked in the Thomson Reuters Peer Monitor data base,³ that pattern continued in 2012 with a growth rate of 0.5 percent. As shown in Chart 1 below, however, the present rate remains well below that in the pre-2008 period, when annual demand growth averaged 3.9 percent.

Chart 1 - Growth in Demand for Legal Services



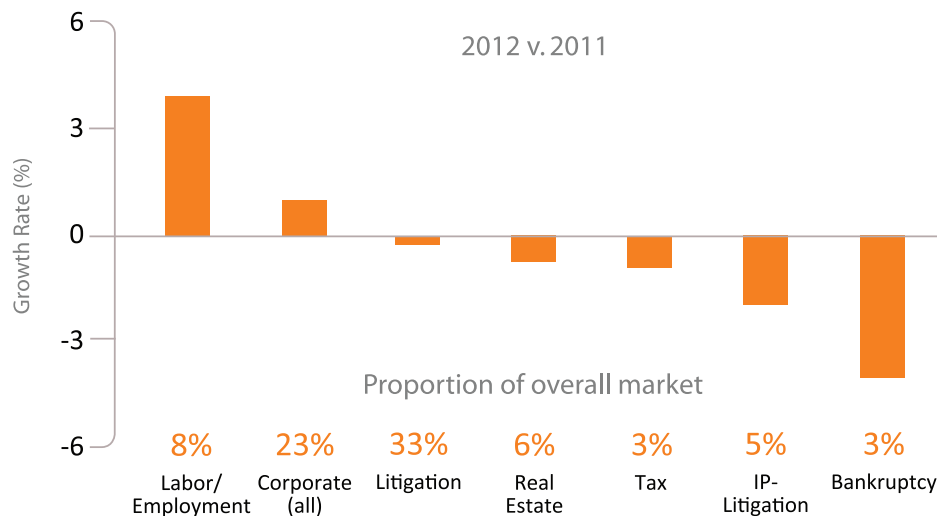
Source: Thomson Reuters Peer Monitor

² Source: Thomson Reuters Peer Monitor. For present purposes, "demand for legal services" is viewed as equivalent to total billable hours recorded by firms included in a particular data base. Q1 demand was 1.5 percent, while Q2 was -0.2 percent, Q3 was -0.8 percent, and Q4 was 1.5, for a full year result of 0.5 percent.

³ Thomson Reuters Peer Monitor data ("Peer Monitor data") are based on reported results from 130 law firms, including 50 AmLaw 100 firms, 45 Am Law 2nd 100 firms, and 35 additional firms.

As shown in Chart 2 below, among various specialty areas, when measured on a full-year basis, labor and employment practices showed the highest demand growth in 2012 (at 4.1 percent), while corporate practices experienced modest growth (at 1.2 percent) and other practices saw declines.

Chart 2 - 2012 Demand Growth by Practice



Source: Thomson Reuters Peer Monitor

The modest demand growth in the United States reflected a similar pattern in the legal markets of the United Kingdom and mainland Europe. In September, *Legal Business 100* reported that, driven by continued sluggish market demand, revenues of U.K. firms in 2012 grew by about 6 percent over 2011 levels⁴ (accounting only for the effects of organic growth as opposed to growth through combinations with other firms).⁵ While 2012 data for Continental Europe is not yet available, *The Lawyer's* 2011 survey of the 100 largest independent firms in Europe found that almost half had achieved less than 5 percent growth in revenues during the preceding year. These organic growth rates are similar to those experienced by U.S. firms and well below the near double digit rates enjoyed by most firms in the pre-2008 period.

The demand picture was different in Asia and Latin America, where high growth national and regional economies continued to drive demand for legal services. As described below this resulted in a significant increase in global merger activity and in the opening of Asian and Latin American offices by U.S., U.K., and European firms. As 2012 drew to a close, however, even the powerful economic engines of China and Brazil had begun to slow somewhat, introducing additional uncertainty into the ability of the emerging economies to drive the global demand growth for legal services to the same extent as in the past.

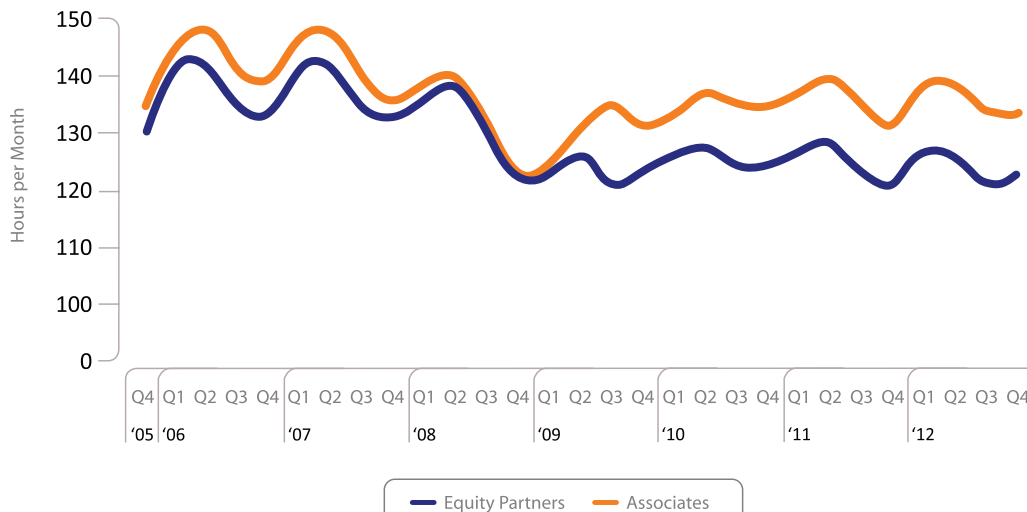
⁴ Most U.K. firms end their fiscal years in April. Hence the comparison of 2012 to 2011 refers to fiscal rather than calendar years.

⁵ The *Legal Business 100* survey indicated that the overall revenues of U.K. firms increased by 14 percent. Much of this growth, however, resulted from merger activity as opposed to organic growth. If the contribution of merger related revenue growth is removed, the resulting "organic growth" figure is 6 percent.

Productivity

During 2012, the number of lawyers in U.S. firms grew by 2 percent, at the same time that (as noted previously) demand grew by only 0.5 percent. As a result, growth in productivity – defined as the total number of billable hours recorded by a firm divided by the total number of lawyers in the firm – remained negative at -1.5 percent for firms in the Peer Monitor data base. This lackluster performance in terms of productivity is not new. As can be seen in Chart 3 below, when measured in terms of billable hours per month per lawyer, productivity has been essentially flat for the past three years.

Chart 3 - Hours per Lawyer



Source: Thomson Reuters Peer Monitor

This constrained growth in productivity is particularly significant if we remember that U.S. law firms imposed substantial staffing cuts in 2009 and 2010. Indeed, firms covered by the NLJ 250 survey reported laying off 5,259 lawyers in 2009 alone – a decline of 4 percent in the total lawyer population and a reduction of 8.7 percent in the total number of associates.⁶ Moreover, even in the three-year period prior to the economic downturn in 2008, productivity growth was essentially flat in all lawyer categories – equity partners, income partners, and associates.⁷

It is also instructive to compare the billable hours per lawyer over the last three years with the comparable figures for the pre-2008 period. As indicated in Chart 3 above, during 2006 and 2007, billable hours for both equity partners and associates were running about 10 hours per month above the averages in the post-2008 period. That of course translates to a difference of more than 100 billable hours per year in both categories and strongly suggests a continuing problem of overcapacity in the market.

6 Lisa Jones, So Long, Farewell, Nat'l L.J., Nov. 9, 2009.

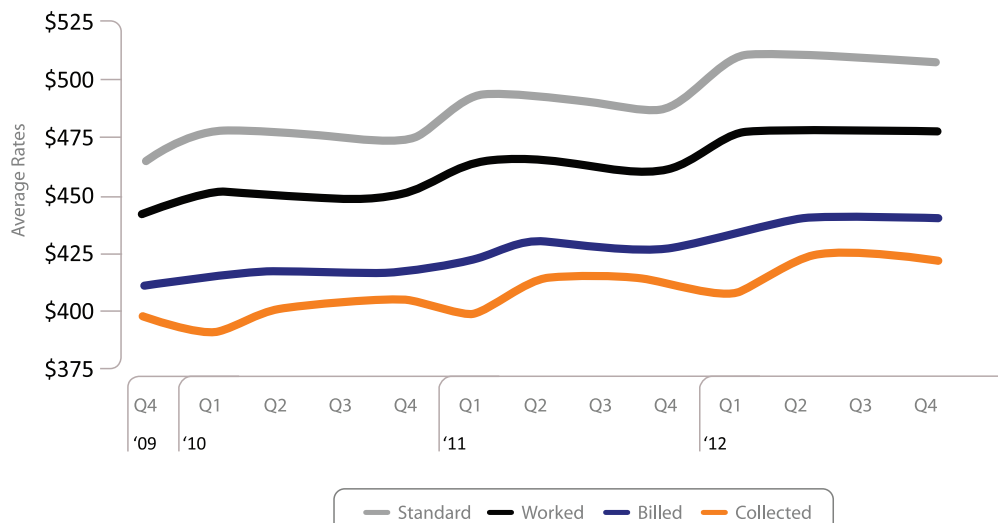
7 Source: Thomson Reuters Peer Monitor.

Similar overcapacity problems have also been evident in the U.K. market. According to the *Legal Business 100* survey, the number of total lawyers in the UK 100 firms grew by 9 percent in fiscal 2012, although some of that growth can be attributed to mergers. Nonetheless, many U.K. firms seem to have increased headcount at a faster pace than could be justified by demand growth, thus leading some to embrace another round of lawyer layoffs.⁸

Rates and Realization

Firms continued to raise rates during 2012 although, as in the past four years, clients continued to push back strongly. As a result, realization rates – *i.e.*, the percentages of work performed at a firm's standard rates that are actually billed and collected from clients – continued to decline, reaching historic lows. The firms covered in the Peer Monitor data base raised their rates on average 3.4 percent during 2012. While this increase was well below the 6-8 percent range seen annually during the pre-recession period, it was consistent with rate trends over the past three or four years. As can be seen in Chart 4 below, during the past three years, firms increased their average standard rate from \$464 to \$507 per hour, an increase of 9.3 percent. At the same time, however, their average collected rate rose from \$397 to \$421 per hour, an increase of only 6 percent.

Chart 4 - Rate Progression



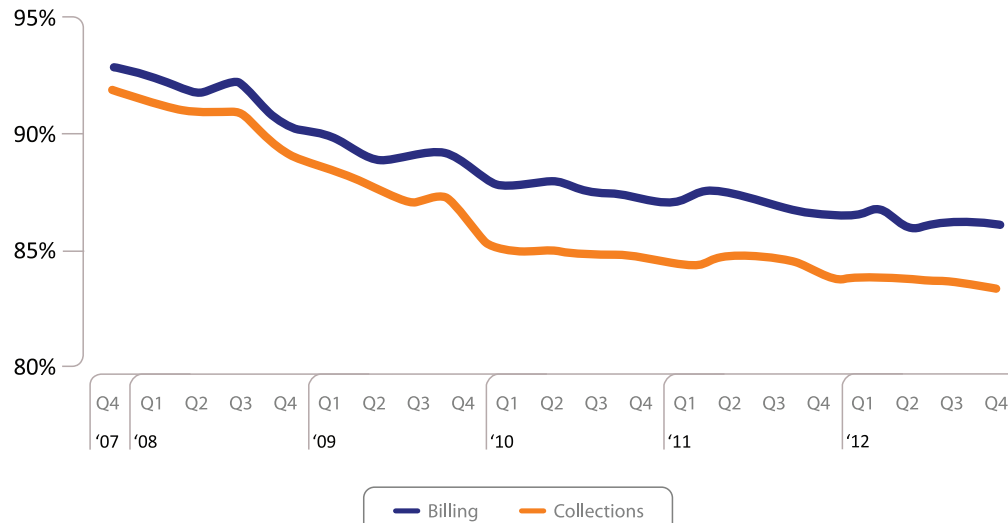
Source: Thomson Reuters Peer Monitor

What this gap between standard and collected rates indicates is that firm realization rates continued to decline in 2012. As shown in Chart 5 on the next page, the collected realization rate against standard for all firms in the Peer Monitor data base now averages 83.6 percent, a figure that is an historic low and some 8 percent lower than the 92 percent level at the end of 2007. Actually, for AmLaw 100 firms, the realization rate is even lower, at 82.8 percent.⁹

8 James Swift, *Focus on Slimmer, Fitter Firms*, *The Lawyer*, Aug. 6, 2012, <http://www.thelawyer.com/focus-on-slimmer-fitter-firms/1013722.article>.

9 The realization rate for AmLaw 200 firms is 85 percent and for other midsized firms covered in the Peer Monitor data base 84.3 percent.

Chart 5 - Billed and Collected Rates against Standard



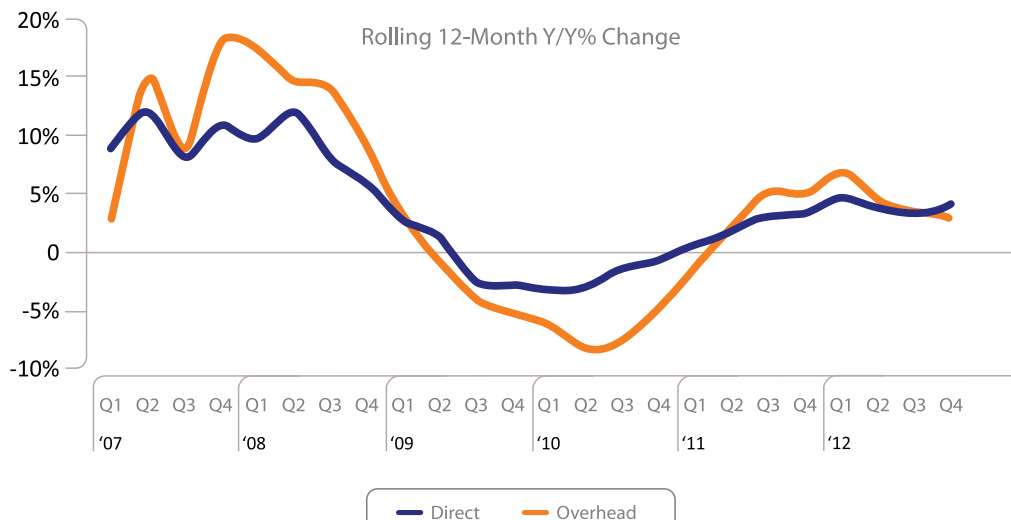
Source: Thomson Reuters Peer Monitor

Expenses

Shortly after the economic downturn began in the third quarter of 2008, most firms took steps to preserve their profitability by sharply cutting expenses, primarily through legal and non-legal staff layoffs. These austerity measures dramatically reduced both direct and indirect expenses¹⁰ until mid-year 2010 when, as shown in Chart 6 on the next page, such expenses began to grow again. This renewed growth was not particularly surprising since many of the expense "cuts" were really only deferrals of expenditures that had to be made sooner or later rather than eliminations of particular programs or activities. As indicated in Chart 6, the expense increases appeared to level out in 2012, perhaps suggesting that many firms imposed additional cost controls in an effort to bolster overall profitability.

¹⁰ Direct expenses refer to those expenses related to fee earners (primarily the compensation and benefits costs of lawyers and other timekeepers). Indirect expenses refer to all other expenses of the firm (including occupancy costs, technology, administrative staff, etc.).

Chart 6 - Expense Growth



Source: Thomson Reuters Peer Monitor

Similar expense pressures were experienced by U.K. firms. According to the *Legal Business 100* survey, during fiscal 2012, average costs per lawyer in UK 100 firms rose 4 percent compared with the previous year.

Profits per Partner

As a result of the combination of continued sluggish demand growth, persistent overcapacity that dampened productivity, client resistance to fee increases, and declining realization rates, profits per partner of U.S. firms in 2012 grew modestly by an average of 3.58 percent. Growth differed by segment, however, with AmLaw 100 firms growing on average by 2.45 percent, whereas other firms grew profits by an average of 4 percent.¹¹ This is consistent with experience in the U.K., where the *Legal Business 100* survey reported profit growth for fiscal 2012 at a modest level of 2 percent over the prior year.

Of course, these results were not true of all firms, and some firms had very successful years despite the lackluster performance of the market as a whole. Nonetheless, from a financial standpoint, the legal market saw only modest gains during 2012.

¹¹ Source: Thomson Reuters Peer Monitor. This result is consistent with the predictions of law firm managing partners and chairs earlier in the year. In April 2012, in a survey of leaders of 52 of the world's largest law firms conducted by Thomson Reuters, 64 percent of respondents predicted that their firms' profit per equity partner growth in 2012 would be in the 1 to 5 percent range. Thomson Reuters 2012 LEB Pre Survey, April 2012. The result is also consistent with market performance in 2011. According to the Altman Weil 2012 Law Firms in Transition Survey of the managing partners and chairs of 238 U.S. law firms (including 40 percent of the largest 250 firms) (the "Altman Weil 2012 Survey"), 48 percent of respondents reported their firms' profits per equity partner increasing by 4 percent or more during 2011, 23 percent reported an increase of 1 to 4 percent, and 29 percent reported profits as either unchanged or declining. Altman Weil 2012 Survey, at 11. Interestingly, almost 48 percent of respondents also indicated that they believed that a slowdown in the growth of profits per partner will be a permanent trend in the legal market going forward. *Id.* at 13.

Other Highlights of 2012

Apart from the financial performance of law firms, there were other developments in 2012 that are worth noting because of their potential to alter the shape of the legal market in the future. These included the rapid continuing pace of globalization, the shifting economic and demographic realities resulting from persistent overcapacity, and the growing pressures on the traditional partnership model of law practice.

Growing Pace of Globalization

Despite (or perhaps partly because of) the challenging economics of the current legal market, 2012 was a banner year for global expansion of U.S. and international law firms. There were 96 cross-border mergers announced during the year, substantially more than in any prior year. Some of the mergers either announced or becoming effective in 2012 were very substantial, including the combinations of:

- U.K.-based Ashurst with Australia's Blake Dawson;
- Australia's Mallesons Stephen Jacques with China's King & Wood;
- SNR Denton with Canada-based Fraser Milner Casgrain and Paris-based Salans;
- Norton Rose with Calgary-based MacLeod Dixon;
- Norton Rose with Fulbright & Jaworski (effective June 1, 2013);
- London's Herbert Smith with Australia's Freehills;
- K&L Gates with Australian-based Middletons; and
- Canada-based Fasken Martineau with Johannesburg-based Bell Dewar.

In addition, U.S. law firms in 2012 continued a very aggressive global expansion through the opening of new offices around the world (some, particularly in Singapore and South Korea, designed to take advantage of recently relaxed practice restrictions by local bars). There were 56 such foreign offices opened by U.S. firms during 2012, with 28 in Asia (primarily in South Korea and China), 15 in Europe (principally in Germany and Russia/CIS),¹² 6 in the Middle East and Africa, and 7 in Latin America and the Caribbean.

This aggressive global expansion obviously reflects strategic judgments on the part of many firms that a more credible and comprehensive global footprint is needed to serve the needs of their international clients. It may also reflect a decision to focus more assets in regions such as Asia, Latin America, and the Middle East, where economic conditions appear more conducive to growth at least in the near-term than in North America or Europe.

Problem of Overcapacity

The continuing effort of law firms to address declines in demand and productivity through the "downsizing" of their legal staffs was starkly evident in 2012. In July, the National Association for Law Placement released the results of its annual survey,¹³ showing that just

¹² Much of the activity in Europe occurred in the wake of the demise of Dewey & LeBoeuf, as various U.S. firms picked up former Dewey offices in that region.

¹³ NALP's Employment Report and Salary Survey for the Class of 2011, as reported in the NALP press release *Median Private Practice Starting Salaries for the Class of 2011 Plunge as Private Practice Jobs Continue to Erode*, July 12, 2012.

49.5 percent of law school graduates in 2011 had obtained jobs in law firms – a figure that compared with 50.9 percent for the class of 2010 and 55.9 percent for the class of 2009. Moreover, of those graduates who did find jobs in law firms, nearly 60 percent were in smaller firms of 50 or fewer lawyers. That compared to 53 percent for the class of 2010 and 46 percent for the class of 2009. The proportion of new jobs in firms of more than 250 lawyers decreased from 33 percent to slightly over 21 percent in just two years.¹⁴

The overall employment rate for the class of 2011 graduates was 85.6 percent (as of June 2012), a figure that was 6.3 percentage points below the recent historic high of 91.9 percent for the class of 2007. For those who were employed, however, only 65.4 percent obtained jobs for which bar admission was required – a figure that drops to 56.7 percent if part-time jobs and jobs lasting less than a year are excluded. Overall, almost 12 percent of reported jobs were part-time. And the number of graduates working for "legal temp agencies" rose dramatically to about 2 percent, the highest level since NALP began tracking that category in 2006.¹⁵

Principally because of hiring cutbacks by larger law firms, the increase in the number of non-partner track positions in large firms, and (in some cases) salary reductions, the median starting salary for 2011 law school graduates fell 5 percent from the 2010 level. That represents a 17 percent decline in median starting salary since 2009.¹⁶ The median starting salary for graduates entering private practice fell over 18 percent from 2010, and an astonishing 35 percent since 2009.¹⁷

Moreover, law firm downsizing has not been limited to reductions in the associate ranks alone. Many firms have continued to raise their expectations for economic performance by their partners and to weed out those who don't meet the new standards. As recently reported in the *Wall Street Journal*, some 15 percent of the roughly 120 firms surveyed by Wells Fargo Private Bank's Legal Specialty Group say they intend to cut partners in the first quarter of 2013, continuing a three-year trend. Also, 55 percent of the 113 managing partners and firm chairs responding to a recent *American Lawyer* survey said they planned to ask one to five partners to leave the firm in the coming year, and 5 percent reported that they planned to cut between 11 and 20 partners in 2013.¹⁸

14 *Id.*

15 *Id.*

16 *Id.* The mean salary for 2011 graduates fell 6.5 percent compared with 2010. Since 2009, the mean salary level has declined almost 16 percent.

17 *Id.* On a brighter note, the median salary for government jobs has remained unchanged since 2009, at \$52,000. For judicial clerkships, the median salary of \$52,000 was also unchanged from 2010 but up \$2,000 from 2009. And for public interest organizations (including legal service providers and public defenders), the median salary rose from \$43,000 to \$45,000.

18 Jennifer Smith, *Law-Firm Partners Face Layoffs*, in *Wall Street Journal Online*, Jan. 6, 2013, <http://online.wsj.com/article/SB10001424127887323689604578>.

Pressures on Traditional Partnership Model

Certainly one of the most dramatic events in the legal market in 2012 was the well publicized collapse of New York's Dewey & LeBoeuf, a firm that dissolved after a 100-year history. While the story of that collapse is in itself an interesting cautionary tale, it may also be symptomatic of a deeper and more serious problem – the growing pressures that have been building for some time around the traditional partnership model used in most law firms.

During the past four years of the economic downturn, it has become increasingly obvious that many law firm partnerships have experienced mounting stress relating to compensation, the reductions in the ranks of equity partners, the treatment of lateral partners, and the management of partner expectations. And the combination of all of these factors – coupled with a growing sense of disenfranchisement – has resulted in partner morale problems in many firms.

As firms have struggled with sluggish demand growth and low productivity, they have increasingly raised the bar for admission to their equity partnerships and (in many cases) increased the number of lawyers in non-equity partnership positions, sometimes through so-called "de-equitizations." Among AmLaw 200 firms, 169 reported having two-tiered partnerships¹⁹ in 2011, an increase over the 166 reported in 2005 and the 146 reported in 2000. Similarly, the percentage of AmLaw 200 lawyers who are equity partners dropped to 25 percent in 2011, down from 34 percent in 2005 and 36 percent in 2000.²⁰ Further, an analysis of the AmLaw 200 survey data from 2006 through 2012 shows a compound annual growth rate ("CAGR") of 1.2 percent for equity partners and 7 percent for non-equity partners. Increasingly, a lawyer's ability to generate significant business (often called client originations) has emerged as the critical dividing line between equity and non-equity partners.²¹

Not surprisingly, as a result of these changes, the compensation gap between equity and non-equity partners is growing rapidly. According to the MLA Partner Compensation Survey, equity partners now average about 2.5 times the total compensation of their non-equity colleagues. During the past year, the compensation of equity partners jumped some 11 percent, while the compensation of non-equity partners was essentially flat.²²

At the same time, there is anecdotal evidence that spreads in compensation between the highest and lowest paid partners (even within equity partner ranks) have widened in recent years. Traditionally, such spreads were typically in the 4:1 or 5:1 range, but they have now increased to 6:1 or 7:1 and in some firms have gone much higher still.²³

19 A "two-tiered partnership" is one that includes both equity and non-equity partners.

20 Source: AmLaw 200 surveys, as reported by Fairfax Associates in September 2012.

21 In the 2012 Partner Compensation Survey conducted by Major Lindsey & Africa among partners in AmLaw 200, NLJ 250, and Global 100 firms in the U.S. (the "MLA Partner Compensation Survey"), 74 percent of respondents noted that originations were a "very important" factor in determining compensation in their firms; 65 percent perceived it to be the "most important" factor (working receipts being the next closest at 21 percent); and 55 percent of respondents said that originations are becoming more important in the compensation process (up significantly from 24 percent in 2010). MLA Partner Compensation Survey at 7-8.

22 MLA Partner Compensation Survey at 8.

23 Based on information obtained from consultants by the Center for the Study of the Legal Profession.

These increasing spreads reflect in part the perceived need by firms to keep major "rainmakers" happy at a time when lateral movements of partners have become increasingly routine.²⁴

Such lateral movements themselves have been an additional source of friction in many firms, as there is a perception that laterals are often paid disproportionately more than "home grown" partners for similar "books of business." In its latest Lateral Report in February 2012, *The American Lawyer* indicated that, in the twelve months ending September 30, 2011, there had been 2,454 lateral movements of partners among AmLaw 200 firms, a 22 percent increase over the prior year.²⁵ And there is some evidence that lateral moves typically result in increased compensation. In the MLA Partner Compensation Survey for 2012, of 930 lateral partners who were queried, some 62 percent reported that their compensation had increased as a result of their lateral moves, a figure that compared to 57 percent in 2010.²⁶

All of these factors have combined in the past few years to create growing morale problems in many firms, particularly among "home grown" service partners who perceive themselves as essential to the quality of legal services delivered by their firms but who lack the origination credits to be regarded as significant rainmakers. Such partners often complain that they also feel increasingly disenfranchised as partners – removed from the power centers of their firms and often treated more like corporate employees than partial owners of their organizations. While few firms experience these morale issues to the same extent as Dewey & LeBoeuf, the feelings are increasingly common across the market.

To some extent, declining morale reflects a failure of firm leadership to set and manage partner expectations. This was, of course, stunningly obvious at Dewey, where firm management failed to disclose a substantial number of partner compensation guarantees to rank-and-file partners. But unrealistic partner expectations – particularly during a period of serious economic downturn – can impact almost all firms. To take but one example, the MLA Partner Compensation Survey reported average compensation for all of its 2,228 respondents at \$681,000 in 2012, up 6.4 percent from 2010.²⁷ One could argue that this figure is fairly impressive, particularly four years into the worst economic crisis the legal market has ever seen. And yet, 58 percent of the same respondents expressed dissatisfaction with their compensation levels, with 47 percent saying they should be earning 11 to 20 percent more and 27 percent saying they should be earning 21 to 30 percent more.²⁸ This at least suggests that there are many partners with unrealistic economic expectations.

24 Interestingly, during the period of limited revenue growth since the onset of the current economic downturn in 2008, the most highly compensated partners in firms have often suffered disproportionately from the constrained growth in their firms' profits. This is because more junior partners have continued to enjoy compensation increases simply by moving up through the compensation ranks. The partners at the top, however, often have nowhere to move and have thus seen their compensation decline as a result of compression throughout the compensation system. While such reductions might be acceptable in the short term, when they begin to last four or five years, the partners at the top become more vocal in their complaints, and their firms often respond by increasing the overall spreads in their compensation systems.

25 *The Lateral Report 2012*, *The American Lawyer*, Feb. 1, 2012, <http://www.americanlawyer.com/PubArticleFriendlyTAL.jsp?id=1202477103222>.

26 MLA Partner Compensation Survey at 12.

27 *Id.* at 7.

28 *Id.* at 28.

Longer Term Implications

The economic performance of the legal market in 2012 and the other developments of the past year as described previously are all part of an evolving pattern that signals significant long-term changes in the legal services market both in the U.S. and around the world. In the sections that follow, we have set out some of the implications of these longer term changes for lawyers and law firms. What they all have in common is the necessity for rethinking old assumptions, for reconsidering previously accepted models of the ways in which lawyers and their firms work, and for exploring new approaches to meet changing market realities. They all require us, in other words, to "burn the ships" and to be open to new ways of thinking and operating.

A Changed Market Reality

It would be tempting to think that all of the dramatic changes in the legal market over the past four years are attributable solely to the economic downturn that has shaken the developed world since 2008 and that everything will go "back to normal" once economic stability and growth return. From this point of view, one would argue that the crisis in the legal market has been driven entirely by a precipitous drop in the overall demand for legal services and that we will be able to get back to business as usual as soon as demand returns, as it surely must. Unfortunately, however, this argument oversimplifies both the causes and the likely effects of the changes we are seeing.

While it is clearly true that the economic downturn has been the proximate cause of much of the disruption we have seen in the legal market, the recession alone does not tell the whole story. Even in the boom years of the decade preceding 2008, other important market forces were at work gradually building toward an inflection point. The financial crisis of 2008 may well have accelerated those forces – and perhaps even exacerbated them – but these underlying market shifts would sooner or later have resulted in fundamental changes in the legal industry even absent an economic crisis.

Among the underlying market forces that have been most important in driving change, several deserve special mention. These include:

- The growing availability of public information about law firms and their capabilities, practices, clients, earnings, and profits that has driven an ever more competitive and efficient market for legal services over the past three decades;²⁹
- The inexorable drive toward the commoditization of legal services that has impacted the work of lawyers at all levels;³⁰

²⁹ The explosion of publicly available information about the business and practices of law firms around the world over the past several years has been staggering. It includes the proliferation of publications like *The American Lawyer*, *Managing Partner* (in the U.K.), *Lexpert* (in Canada), *Australasian Legal Business*, and *LatinLawyer* (in Latin America); as well as the growing number of third-party rating agencies like Chambers.

³⁰ For a particularly informative description of the impact of commoditization on the evolution of legal service, see RICHARD SUSSKIND, *THE END OF LAWYERS? RETHINKING THE NATURE OF LEGAL SERVICES* ("Susskind"), at 27-36.

- The growth of enabling technologies that has accelerated the drive toward commoditization, tended to level the competitive playing field between large firms and smaller ones, and changed legal staffing patterns by simplifying tasks that were previously labor intensive; ³¹
- The emergence of non-traditional service providers that are creating new forms of competition in the legal market; ³²
- The changing roles of in-house general counsel and corporate law departments that have increasingly displaced outside law firms as the primary "trusted legal advisors" to corporate CEOs, often relegating outside counsel to specialized advice only; ³³
- The impact of globalization that has resulted in growing challenges for firms seeking to serve the needs of their clients on a worldwide scale and, over time, will result in a significant shift in global economic activity; ³⁴ and
- The collapse of an unsustainable economic model that drove law firm growth for a decade essentially on the ability of firms to raise their rates 6 to 8 percent a year with little regard for the economic impact of their decisions. ³⁵

The combination of these factors with the effects of the economic downturn of the last four years has resulted in at least two critical shifts in the market for legal services. First, there has been a shift from the seller's market that traditionally dominated the legal industry to a buyer's market that will likely remain the prevailing model for the foreseeable future. What this means is that all of the critical decisions related to the structure and delivery of legal services – including judgments about scheduling, staffing, scope of work, level of effort, pricing, etc. – are now being made primarily by clients and not by their outside lawyers. This represents a fundamental shift in the relationship between lawyers and their clients.

Reflecting the increasing power of clients to define the terms of the attorney/client relationship, this shift has resulted in a new emphasis on efficiency and cost effectiveness in the delivery of legal services. Although obviously not true in all cases, clients increasingly make decisions to hire outside lawyers on the basis of how efficiently, cost effectively, and predictably they can deliver the services the client requires, with quality being taken as a given. As a result, to an extent barely imaginable only a few years ago, firms have found themselves increasingly locked in procurement processes where clients are asking hard questions about schedules, staffing, work process efficiencies, and cost.

31 For a description of the growing impact of enabling technologies, see Susskind, at 59-145.

32 These include not only legal process outsourcers (like CPA Global and Pangea3) but also innovative new law firm models (like Axiom and the VLP Law Group) and new service offerings from traditional law firms (like Morgan Lewis & Bockius' innovative eDiscovery Practice and Berwin Leighton Paisner's Lawyers on Demand).

33 For a description of this changing role of the in-house lawyer by Ben Heineman, the former General Counsel of General Electric, see Catherine Dunn, *The In-House World According to Ben Heineman*, Corporate Counsel, April 9, 2012.

34 The International Monetary Fund predicts that the composition of world GDP will shift dramatically over the next four decades. Specifically, the IMF forecasts that the percentage of world GDP attributable to North America will shift from 22 percent (in 2010) to 11 percent (in 2050), while Western Europe shifts from 19 percent to 7 percent, Developing Asia shifts from 27 percent to 49 percent, and Africa shifts from 4 percent to 12 percent. Source: IMF World Economic Outlook.

35 Careful analysis shows that, even in the boom years prior to the current economic downturn, the financial success of law firms was driven primarily by annual rate increases that bore little relationship to what was going on in the broader economy. Indeed, in the decade prior to 2008, such increases averaged 6 to 8 percent per year at a time when the national inflation rate never exceeded 4 percent. The cumulative impact of these increases over time created a trajectory that was simply unsustainable.

The second critical shift in the legal market in the last four years has been the dramatic increase in competition among firms. In the pre-recession world, when the demand for legal services was growing at a healthy clip of some 4 percent a year, most firms could grow and prosper simply by capturing a reasonable share of the new business being generated. Since 2008, however, the reality has changed. In a period of shrinking or sluggish demand growth, the only way (short of a merger) for a firm to capture market share is to take it from another firm, a circumstance that inevitably results in a ratcheting up of competition in the market. Given current economic trends, it appears likely that the legal market will remain in this state of heightened competition for at least a few more years. Moreover, even as the demand for legal services begins to grow again, it is likely (as noted below) to come back in significantly different ways – ways that may not lessen overall competition among firms.

To adapt successfully to these new market realities, firms will need to be much more strategically focused than in the past. In a significantly more competitive environment, it will be critical for firms to understand their unique strengths and to identify what differentiates them from their competitors. It will also be critical for law firm leaders to focus on how their firms can respond effectively to client demands for more efficiency and cost effectiveness in the delivery of legal services. That will mean, among other things, a willingness to abandon the traditional "one size fits all" mentality that has often dominated legal management thinking and to adopt more flexible approaches that can tailor staffing and leverage, technology support, work processes, and pricing models to meet the needs of particular clients in particular situations.

Fortunately, there is evidence that many law firm leaders understand the realities of the changed market and the imperative for their firms to act decisively to address them. For example, more than 90 percent of the managing partners and chairs surveyed by Altman Weil in its 2012 Law Firms in Transition Survey said that the recent recession served as a "permanent accelerator of trends that already existed" or as a "game changer" for the legal market. And a substantial majority now sees trends like increased pricing competition, more commoditization of legal work, more non-hourly billing, fewer equity partners, more contract lawyers, reduced leverage, and smaller first year classes as permanent trends going forward.³⁶ However, a substantial majority of respondents also had much less confidence that their partners understand or appreciate the challenges of the new legal market.³⁷ And some 60 percent indicated that, thus far, law firms have shown only a low level of seriousness about changing their legal service delivery model.³⁸ This latter view was also confirmed by an Altman Weil survey of corporate chief legal officers in 2011, with the exception that the corporate CLOs ranked law firm seriousness even lower.³⁹ Plainly there is more work to be done.

³⁶ Altman Weil 2012 Survey, at i-ii, 1-2.

³⁷ *Id.* at 6.

³⁸ *Id.* at 8.

³⁹ *Id.* at 10.

Growing Market Segmentation

As large markets become more efficient from a competitive standpoint, they tend to become more segmented, with individual providers focusing on those parts of the market that they can serve better than others. In the past few years, we have begun to see the emergence of such segmentation in the legal market in several different ways.

First, there has been a noticeable segmentation among law firms themselves, as some firms have staked out market positions as providers of high end financial services or general corporate services on a global basis, while others have opted for specific industry concentrations (e.g., in the energy or technology or insurance sectors) or specific practice areas (e.g., as labor and employment or IP or litigation boutiques) or specific service levels (e.g., as providers of low- to mid-value litigation or general representation for major companies in particular geographic areas).

This segmentation among firms has been bolstered by an increasing willingness on the part of clients to "disaggregate" matters – both litigation and transactional – by parceling out different parts or phases of matters to different firms depending on expertise and an ability to deliver cost effective services.⁴⁰ It has also been driven by an increasing willingness on the part of clients to entrust matters (or sometimes parts of matters) to mid-sized or smaller firms that are more price competitive than their large firm counterparts. On the latter point, there is considerable anecdotal evidence that work has moved from large firms to mid-sized and smaller firms, and Peer Monitor results for the last four years also suggest that this may be the case.⁴¹

Another kind of segmentation that has become more evident in the past four years has been the growing inclination of clients to handle more matters or phases of matters in-house and to use outside counsel only for those aspects of matters that require special skills or larger teams of lawyers than are routinely available in client law departments.⁴² This has been coupled in practice with a growing willingness of clients to partner with non-traditional service providers (like legal process outsourcers) for some aspects of work previously sent routinely to outside law firms. This has been especially evident in the outsourcing of discovery work in major litigations, but it has occurred in other areas as well.

40 Milton C. Regan, Jr. & Palmer T. Heenan, *Supply Chains and Porous Borders: The Disaggregation of Legal Services*, 78 *FORDHAM L. REV.* 1477 (2010).

41 Peer Monitor data indicate that mid-sized firms outside the AmLaw 200 have actually fared better than their larger counterparts over the past four years in terms of demand growth and productivity. Some of this difference in performance is undoubtedly attributable to the fact that high end financial and corporate work of the sort traditionally handled by AmLaw 200 firms was particularly hard hit in the recent recession. It is also possible, however, that there has been some shift in work by clients from larger to smaller firms.

42 According to the 2011 HBR Law Department Survey of some 219 companies worldwide, corporations were substantially increasing their reliance on in-house legal staffs to handle continuing growth in legal demands. As the editor of the survey observed, "Law departments are recognizing that they can do more with less by building up their in-house capabilities. . . . We are hearing from our consulting clients across industries that they are limiting the use of outside counsel to high profile or specific areas of expertise rather than to support the growing volume of work. With the rising cost of outside counsel, we expect this trend will continue." HBR Consulting Press Release, *Law Departments Increase Internal Staff and Keep More Work In-House, According to 2011 HBR Law Department Survey*, Oct. 7, 2011. While HBR's 2012 survey covering some 260 companies showed a rebound in outside counsel spending, it also noted that in-house capacity had continued to grow, as 57 percent of respondents reported an increase in the total number of lawyers working in-house. HBR Consulting Press Release, *Legal Spending Returns to 2009 Survey Levels, According to 2012 HBR Law Department Survey*, Sept. 27, 2012.

What all of this means is that, even as the economy improves and the demand for legal services increases, some of the services traditionally provided by law firms will likely *never* return – at least not in their prior form. And that in turn suggests that, to be successful in the new market environment, firms will need to be much more flexible in their work processes and much more open to partnering with their clients in finding innovative ways to address legal needs. As John Collins, Deputy General Counsel of the Royal Bank of Scotland, put it in describing his own company's efforts to change its approach to working with outside counsel, "Law firms understand what we're proposing and we've started to see moves in the market but firms are yet to get fully on board and embrace it. . . . The legal profession isn't immune from process re-engineering: it needs to flex and keep changing and law firms need to embrace that change if they are to remain competitive."⁴³

Market Overcapacity

Prior to the current economic downturn (*i.e.*, in the years prior to 2008), when demand for legal services was growing at almost 4 percent per year, productivity growth in the legal market was essentially flat.⁴⁴ That, of course, suggests overcapacity in terms of the number of lawyers available to perform the work at hand. In the four years since, with demand growth negative to flat, the overcapacity problem has become even more serious. The problem has several dimensions.

First, as previously noted, since 2008, law firms have cut back significantly on their hiring and have gone through several rounds of layoffs of both legal and non-legal staff. Firms have also begun to move toward more flexible staffing models, expanding their use of non-partner track associates, staff attorneys, and contract lawyers. Going forward, it is likely that firms will remain conservative in their hiring policies even as demand begins to grow. As a result, firms will probably be relatively smaller in terms of the number of partners and traditional partner-track associates and relatively larger in terms of the number of other lawyers and non-lawyer professionals.

These trends are confirmed in the 2012 Law Firms in Transition Survey conducted by Altman Weil. Based on responses from 238 U.S. firms, that survey found that:

- A quarter of the responding firms reduced or discontinued hiring first-year associates during 2011, and 40 percent shrank their summer associate programs – both highly significant numbers considering the cuts made in prior years;
- Only 21 percent of respondents indicated they intended to hire more first-year associates in 2012 than they did in 2011;
- Some 55 percent of responding firms expected smaller first-year associate classes will be a permanent trend going forward (compared to only 40 percent expressing that view the previous year);

⁴³ As quoted in Hildebrandt Institute BLOG, *The New Normal: Collaboration between Corporates, Law Firms and LPO Providers*, Nov, 15, 2012, hildebrandtblog.com/.../the-new-normal-collaboration-between-corporates-law-firms-and-lpo-provider...

⁴⁴ See note 7 *supra*.

- Of the respondents, 58 percent also believed that reduced associate leverage is a permanent trend (up from 45 percent the previous year);
- Nearly a quarter of the responding firms said they intended to increase their number of non-partner track associates in 2012;
- More than 80 percent of the firms planned to maintain or increase their number of contract lawyers and paralegals in 2012 (in many cases to take on work previously performed by partner-track associates);
- Some 66 percent of respondents believed that increased use of contract lawyers is a permanent trend in the legal market; and
- Looking five years ahead, respondent firms expected more reductions in partner-track associates than in non-partner track associates or paralegals.⁴⁵

But the overcapacity problem being experienced by law firms is also part of a larger trend – that of excess capacity in the legal market as a whole. As one seasoned observer of the market, Bruce MacEwen, has pointed out, for the next ten years it is likely that American law schools will be graduating over twice as many new lawyers as will be needed to fill the legal jobs available.⁴⁶

While excess capacity in the market is certainly not good news for young lawyers or, for that matter, for law schools, it provides an environment in which law firms should have the flexibility to redesign their staffing models to respond to client demands. By embracing alternative approaches to staffing – including increased use of staff attorneys and non-partner track associates, contract lawyers, and part-time attorneys – firms can create more efficient and cost effective ways to deliver legal services. To do so, however, will require abandoning the traditional model of a law firm consisting only of partners and partners in waiting (i.e., partner-track associates).

Simply stated, the traditional law firm staffing model – enforced through "up or out" policies – assumes that the only lawyers worth having are those capable of rising to the top and becoming equity partners. While most law firm leaders would probably agree that this approach no longer makes economic or structural sense, it still has strong emotional appeal to many law firm partners. It is probably for that reason that firms have been slow to implement real changes to their legal staffing policies, changes that would create genuine career tracks for non-partner lawyers, provide a comprehensive approach to professional development at all levels, and build respect within their firms for the professional capabilities of lawyers who make important contributions but may never become partners. Firms that emerge as successful in the new realities of the legal market will likely be those that find ways to "burn the ships" and fully embrace such real changes for the professionals in their firms. The result could be more sustainable models of law firm practice that both respond to market realities and provide more meaningful professional opportunities for everyone.

45 Altman Weil 2012 Survey, at v.

46 Using projections from the U.S. Bureau of Labor Statistics, MacEwen points out that between 2010 and 2020 the U.S. economy will produce 218,000 job openings for lawyers and judicial clerks, or a bit less than 22,000 openings per year. (These projections include filling the slots of retirees and other job force departures as well as new job openings.) At the same time, U.S. law schools graduated 44,004 students in 2010, 44,258 in 2011, and 44,495 in 2012 – enough new lawyers to fill 61 percent of all the available jobs for the next decade. Bruce MacEwen, Adam Smith, Esq. BLOG, *Growth Is Dead: Part 2 – Excess Capacity*, Sept. 10, 2012, <http://www.adamsmithesq.com/2012/09/growth-is-dead-part-2/?single&print>.

Changing Partnership Models

Even before the current economic downturn, there was considerable debate within the legal profession about the evolving management structures of law firms and the extent to which the changes that were occurring either threatened or enhanced concepts of professionalism. Needless to say, the past four years have, if anything, only further polarized that debate. In its most stark form, the debate is often characterized as whether the practice of law should be a "profession" or a "business," a grossly oversimplified dichotomy since law practice has obviously been both for a very long time.

It is undeniable, however, that the governance and management structures of law firms have changed significantly over the past 20 years and that the market shifts of the past four years are likely to continue that trend. It is also true, as previously noted, that these changes – coupled with the adverse financial impact of the economic downturn – have resulted in increased stress levels and growing morale problems in many firms, as large numbers of partners have felt themselves increasingly disenfranchised.

Some observers have opined that the legal market (at least as regards large law firms) is moving inexorably toward a corporate model of essentially top-down management, in which practicing lawyers will become little more than fungible employees. In our judgment, that prediction is not well founded, but it is true that firms are struggling to strike a new and appropriate balance between models that provide necessary centralized management and structures that preserve the essential independence of professional judgment.

In recent years, there has been considerable academic attention devoted to this problem, with some of the more interesting work focusing on the idea of organizational archetypes – overarching concepts addressing patterns of organizational structures and management systems and the ideas, beliefs, and values that underlie them. The approach has been used to analyze the evolution of professional organizations including accounting firms, architectural firms, hospitals, and law firms.⁴⁷

Using this approach, one group of scholars has described a "P2" form of organization as the archetype of the classic professional partnership.⁴⁸ In the P2 organization, "[a] partner is an owner of the firm, is involved in its overall management, and is a key production worker."⁴⁹ The work requires the exercise of professional judgment that is "not amenable to close bureaucratic control," and control therefore "has to be exercised not through standardization of routines but through standardization of skills."⁵⁰ Professionals in P2 organizations resist the use of detailed cost accounting and financial targets to manage behavior.⁵¹ And such "professional organizations have a strong service ethic and a strong concept of community involvement and responsibility. Partnership implies a career commitment, which is inconsistent with financial myopia and tight accountability."⁵²

47 For the application of organizational archetype analysis to law firms, see David J. Cooper, Bob Hinings, Royston Greenwood, & John L. Brown, *Sedimentation and Transformation in Organizational Change: The Case of Canadian Law Firms*, 17 ORG. STUDIES 623 (1996); Ashly Pinnington & Timothy Morris, *Archetype Change in Professional Organizations: Survey Evidence from Large Law Firms*, 14 BRITISH J. MGT. 85 (2003).

48 Royston Greenwood, Bob Hinings, & John L. Brown, "P2-Form" *Strategic Management: Corporate Practices in Professional Partnerships*, 44 ACAD. MGT. J. 725 (1990).

49 David Brock, *The Changing Professional Organization: A Review of Competing Archetypes*, INTL. J. MGT. REV. 160 (2006).

50 *Id.* at 732.

51 *Id.* at 735.

52 *Id.*

The structural features of the P2 form reflect a distinctive understanding of what it means to be a professional. It includes concepts like participation by the full partnership in governance decisions, the provision of services by professionals exercising relatively unfettered discretion, and the use of collegial structures as the basis of organization – all designed "to respect professionals' desire for autonomy, to maintain the principle of partnership, and to promote acceptance and cooperation."⁵³

During the period of relative stability in the legal market, the organizational features of the P2 model and the understandings that supported them were aligned and reinforced one another. As the external market began to change, however, competitive forces drove modifications in the structural features of law firms that resulted over time in a misalignment with the underlying ideas, beliefs, and values of many law firm partners. As a result, some scholars argue that law firms are now moving toward a new organizational archetype, that of the managed professional business ("MPB").⁵⁴

Unlike the P2 archetype that stresses the role of lawyers as professionals applying their specialized expertise on behalf of clients who are "relatively ignorant about their needs,"⁵⁵ the MPB model "shifts the view of the client to someone, often corporate counsel, who wants demonstrable value for money, and takes legal expertise for granted."⁵⁶ The MPB model also shifts the meanings of both "professional" and "partner."

The attributes which sociologists of the profession used to identify as the hallmarks of a professional, such as education, vocation, esoteric knowledge, self-regulation, and civility, have been replaced, or at least augmented, by an interpretation that stresses punctuality, style, dynamism, financial success, and entrepreneurialism. The meaning of the term "partner" has also changed [away from an emphasis on autonomy]. In the MPB, a partner is a team player, one who trusts the leadership and works for the common good, for example by transferring work to the person in the firm who is most competent or short of work.⁵⁷

In our view, this analysis of the contrasting structures and underlying values of the P2 and MPB archetypes sets out a useful way of thinking about the tensions at work in many law firms today. Plainly, to be successful in today's world, most every firm of any significant size must respond to the changing competitive realities of the market by centralizing many of the decisions previously made in more collegial ways and by embracing a consistent strategic vision that is uniform across the firm and that drives decisions and actions in all of its practice areas. At the same time, a firm must preserve the essential qualities that nourish and support great lawyering, including structures that preserve the independence of professional judgment and the autonomy of lawyers to act in the best interest of their clients. This requires striking a delicate balance between the P2 and MPB models, and different firms will find it necessary to strike that balance in different ways. The important point is that finding the right balance requires deliberate effort and an appreciation for the competing values underlying each model, and getting the balance right forms an essential part of the glue that holds great law firms together, even in turbulent economic times.

⁵³ *Id.* at 750.

⁵⁴ See David J. Cooper, Bob Hinings, Royston Greenwood, & John L. Brown, *Sedimentation and Transformation in Organizational Change: The Case of Canadian Law Firms*, 17 *ORG. STUDIES* 623, 626 (1996).

⁵⁵ *Id.* at 630.

⁵⁶ *Id.* at 630-31.

⁵⁷ *Id.* at 631.

Conclusion

The year 2012 was one of continuing challenges for law firms and their leaders throughout the world. The persistent economic downturn that began in mid-2008 continued into its fifth year and, while demand growth for legal services has begun to increase modestly, it is likely that the market faces many more months of relatively slow growth. For 2013, we project that most firms will continue to struggle to maintain profitability as the combined effects of slow demand growth, declining realization rates, and persistent overcapacity will continue to eat into profit margins. We do expect to see some growth in revenues and continued rigorous efforts to manage expenses, but overall we anticipate that there will be only modest growth in profits per equity partner in the current year – probably in the low single digit range.

Moreover, it is now increasingly clear that, even when more normal growth returns, the market will be very different from the way it looked in the pre-2008 period. Building on underlying forces that were present even in the pre-recession period, the economic downturn served as a catalyst that has changed the legal market in fundamental ways, not the least of which has been the shift from a seller's to a buyer's market for legal services. With that shift has come growing client insistence on efficiency, predictability, and cost effectiveness in the delivery of legal services, a reality that has required a fundamental paradigm shift in law firms themselves. The new, more intensely competitive market has also required law firms to refocus their own strategies and to take steps to manage their businesses more effectively. From aggressive expense controls to improved work processes and from alternative pricing structures to more expansive staffing strategies, firms have scrambled to address the challenges of the rapidly changing market.

The good news is that many firms have begun to see positive results from these efforts, and almost all law firm leaders now acknowledge that fundamental changes are occurring in the market that require different responses than in the past. The challenge now is for firms and their partners to be willing to think outside the traditional models – to "burn the ships" if you will – and to be willing to try new and creative ways to deliver the high quality and responsive legal services that their clients want, using effective business models that serve both financial objectives and professional values.

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