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LAW FIRM CONSULTANTS

GENERALLY EXCELLENT 2016 PERFORMANCE, VIRTUALLY NON-EXISTENT GROWTH, AND SOME STORM CLOUDS ON THE HORIZON

THE RESULTS OF SMOCK LAW FIRM CONSULTANTS' SURVEY OF THE LEGAL MARKETPLACE

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This document represents the results of Smock Law Firm Consultants' (SLFC) annual review of the national (US) legal marketplace. It is based on interviews of 35 law firm Managing Partners/CEOs and/or Executive Directors/COOs in late December 2016 or early 2017, our impressions from our continuing management consulting assignments in the national legal marketplace, and a review of the recent literature on the topic. Sections of this monograph include a summary of our findings and recommendations; the methodology used; 2016 results and the reasons for those results; 2017 expectations; areas of near-term management attention and effectiveness; longer-term issues/concerns; and SLFC's comments, and conclusions, and recommendations.

Summary of Results

2016 was a very good year for law firms. Nearly 70% of our interviewees felt it was a good or outstanding year - but on the other side, over 30% did not.

- There were a number of reasons given for this generally excellent performance - at the top of the list was a *"focus on profitability."* Other reasons for positive performance included profitable work from solid laterals, increased rates, and overall better management.
- However, while some litigation practices provided a boost to solid results, most firms saw litigation as the primary factor negatively impacting 2016 results. And, the overwhelming percentage of the firms we talked to (whether they did well or not) mentioned that they did so with generally flat headcount (i.e. - little or no growth).

As with most years we have conducted this EOY analysis, expectations for the next year (in this case, 2017) were generally cautious - half the firms interviewed said results would be *"about the same."* The focus on profitability will remain in 2017 as well as improved practice team management, continued emphasis on important management tools (i.e. - budgets, creative use of data, and client feedback). They saw challenges in 2017 including the continuing falloff in litigation work, client pressures on fees and value, continued work being taken in-house, flat demand and no growth, and increased costs (most notably associate salaries).

When asked where their management focus was in the near-term (2016 and 2017), the firms we interviewed brought up a shopping list of generally accepted and effective law firm management techniques. These included the above-mentioned focus on profitability, pricing, legal project management, talent management, practice and industry team management improvements and better teamwork, expanded industry specialization, more client feedback, succession planning, technology, cyber security, effective strategic plan implementation, teamwork, brand focus, marketing (stem to stern), and investing in people (including firm alumni). Some felt *"the Trump bump"* might bring some growth, but they are very cautious as to what the new administration will mean.

We did hear some creative thoughts on longer-term concerns. At the top of the list was growth – law firms are just not growing, which – over the long run – every business must do to survive and prosper. But, as long as they can get rate increases and stay managed for profit, they can keep their partners happy. There were a wide variety of other longer-term concerns brought up including technology changes, continued commoditization, consolidation (mergers/combinations), the continuing buyers' market (*"the clients are in charge"*), generational differences (*"oh, those millennials"*), alternative fee structures and, importantly, conflict between advocating group performance and rewarding individual performance.

As a result of what these 35 firm interviewees had to say, SLFC drew some conclusions. At the top of the list was that **law firm management is leaping rather than crawling forward** (and to us, that is a big change). Our second primary conclusion is that **the future of litigation has become a significant and vexing issue**. Our other conclusions include the perception that the big guys are doing a better job managing to the present environment than the midsize guys (and the small guys); over the past couple of years larger firms have done a better job in dealing with the underperforming partner conundrum; lateral partner hiring seems to be significantly improved; there is still a long way to go with improving practice/industry team effectiveness; too darn many competitive position enhancing mergers are turned down internally (*"I do not want to have move my cheese moved"*); and, finally, there is still significant room for continued improvements in practice/industry team management.

We boiled our conclusions down to five key recommendations that will be expanded on later in this monograph, namely:

- **You better have a growth strategy for the firm's future – internally and externally.**
- **Upgrade the management effectiveness of the practice/industry teams in groups – the ripest near-term area for improvement.**
- **Take a long-term look at the strategic viability of your litigation practice(s).**
- **Get out ahead of the underperforming partner issue – take action not adjust compensation.**
- **And finally, consider revising partner compensation to reward teamwork and group performance.**

Methodology Used

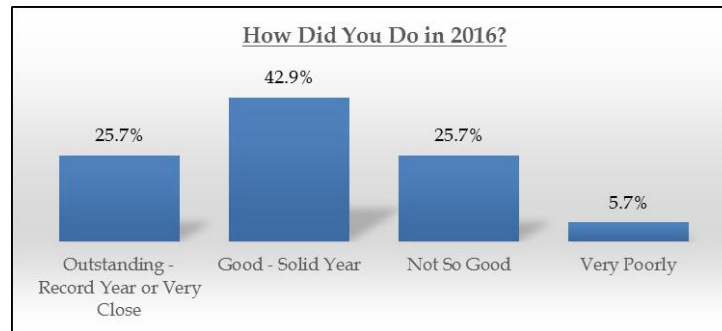
For the last 15 years or so, SLFC has conducted a survey of the legal marketplace and, for the last eight or nine years preceding this year's effort, the format and methodology have been the same – in order to compare statistical results and trends over time.

- The annual monographs we produced as a result of these efforts were well received and, over time, provided a very good comparison of the trends that existed in the legal marketplace (e.g. - the slow but steady rise of AFAs, the annual cautious optimism of respondents knowing full well they were about to raise their firms' rates 5% to 7%, etc.). Although the multi-year trends could be seen statistically, the differences between one year and the next were relatively minor and, in some cases, indistinguishable.
- A few years ago we began augmenting these statistical results with phone and some in-person interviews of a number of law firm CEOs and COOs – in order to gain context and to delve deeper into the specific trends and areas of importance to law firm management. We found that these interviews revealed considerably more detail and insight than merely the comparative statistics – so, this year, we decided to rely solely on interviews and jettison the statistics. We are glad we did.

- Also, the number of surveys done of law firm management by consultants and legal management organizations has grown exponentially (everybody does one now and they do come out - drip, drip, drip - all year long). So, the statistical data is out there if people really want to see it. We decided to do was to focus on what we heard means to law firm management in the near and longer-term future, rather than focus on statistical change.

How Did It Go in 2016?

Last year was, once again, generally a very good year for law firms. As could be expected from the concept of statistical distribution, some did very well and others did not - that is, there is always a "bell curve" of some sort. The distribution of our interviewees' overall responses on 2016 results is shown below.



We specifically asked why firms did well or not so well in 2016 and the responses, while broad-based, were revealing.

For the first time, many firms underscored improved firm management with a focus on profitability as the primary reason for improvement (*"we got pretty good rate increases, but more importantly we managed costs and realization, so that the bottom line grew dramatically"*). The secret appears to have been pushing down responsibility and accountability and providing useful and effective profitability information (even to the individual attorney). Some of those firms that did particularly well in managing profitability also mentioned that to continue to perform well financially, they needed to grow (*"you can only grow so much in profitability from year to year with the same number of people"*).

Although certainly not universal, some of the firms mentioned that they achieved dramatically improved performance from their middle level partners (*"these folks are really coming into their own"*). Also, practices that were not that strong in 2015 - like some of the highly leveraged financial practices - did come back in 2016 producing excellent financial results.

A number of firms interviewed also mentioned that they had a number of good laterals producing expected good financial results this year (*"we took a hit last year in startup costs, but this year that investment has paid off"* and *"our short-term strategy is superior talent acquisition and it is working"*). As will be discussed later, most firms interviewed took a hit in litigation, but others (a minority) had a very good year in litigation and, in some cases, had major payouts from contingency cases that bolstered partner income. Generally, the full range of transactional practices did very well with positive comments about all of them, but the most credit was given to the continuing very viable and profitable real estate practices.

The more positive results came from the larger firms we interviewed (above 400 attorneys) - it appears that these larger firms have moved forward - more rapidly and significantly - in really focusing on profitability and accountability (*"we hold our practice group leaders responsible for budgets and profitability improvement and they performed in an exemplary manner"*). And most appear to have been able to ask for and get increased rates (the secret sauce in law firm finances).

Across the board – whether a firm did well or not so well financially – they did it with generally flat headcount. Most firms did not grow or did not grow significantly in terms of attorneys and timekeepers.

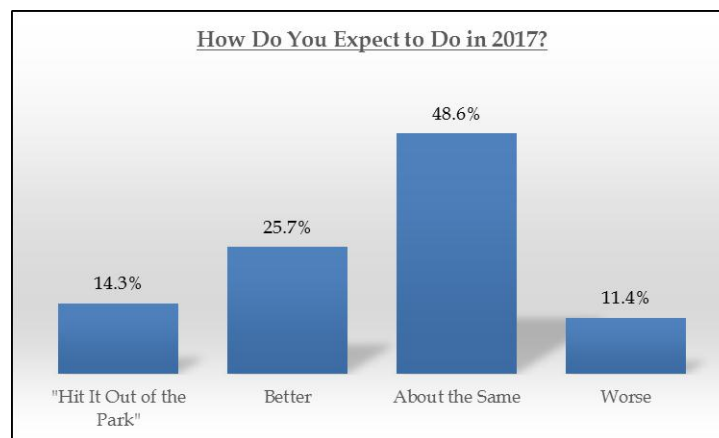
For those firms that did not do well (and there were more this year – percentagewise – than we have had in prior years), there were also a number of reasons. First, some practices just did not do well – bankruptcy has not come back, energy was really iffy (although a number of firms with strong energy practices did well in that space), and some stated that they would have done a much better job on collections. But, the greatest anchor on success was most firms’ litigation practices. Some firms grew their litigation practices; however, most did not do as well as they planned; and some experienced a dramatic fall-off (which directly and significantly hurt their profitability).

Other firms reported that their demand (for legal services) was down and expenses were up – that is clearly not a solution for increased profitability. A few firms also felt that they were investing in people in 2016 (i.e. – the startup costs required for laterals) and expect the financial return to come from that investment in 2017 – *“we are doing a better job recruiting laterals and we expect the results to follow.”*

Interestingly, most firms did not have solid knowledge (or scuttlebutt) on how their competitors did. Those firms that did well thought their competitors did so too and those that did not do well also felt that their competitors did not. So that question did not really provide solid insight to market performance.

What Are the Expectations for 2017?

We asked the firm leaders how they thought they were going to do in 2017. We ask about these upcoming year expectations every year and – year in and year out – most people are pretty conservative/cautious. In other words they do not want to go out on a limb. So expectedly, close to a majority of firms expected about the same level of performance in 2017 as in 2016. The distribution is shown below.



As with 2016 results, a significant number of the firms interviewed will be directly focusing on profitability in 2017 (*“we need to make money on all of our people – not just the most productive few”*). A few firms – a distinct minority – felt that 2017 was a good year to look very seriously at mergers/combinations as a growth strategy. Some of the factors that are expected to influence positive performance increases in 2017 include:

- Increased practice group/team management effectiveness – more leadership, responsibility, and accountability will lead to better performance
- Taking advantage of investments made in people, practices, and offices
- A continuing emphasis on important management tools – budgets, use of data, stated expectations, and feedback – all expect to contribute to better results

- Listening to clients, *“so we can do it smarter, faster, and cheaper.”*

But, there are also challenges that will exert negative pressure on better performance in 2017 including continuing falloff in litigation work (there is real voiced concern about the long term viability of litigation – as law firms have historically known and practiced it); continued and increased client pressure on fees and value; increased incidence of clients taking work in-house (which is also a legitimate long-term concern); increasing competitors’ moves into new markets; flat demand and no growth accompanied by increased expenses; and, finally, the dramatic increase in associate salaries without a dramatic increase in associate performance (or associate rates).

A few of the interviewees felt that there were other factors out there that may dramatically impact 2017. At the top of the list was the unknown impact of the Trump administration. Most of the interviews were completed before the inauguration and the recent spate of executive orders. But, the recent stock market growth (the *“Trump bump”*) and the potential repatriation of offshore profits could lead to the kind of economic boom that dramatically increases law firm performance and growth. Or, as in recent days/weeks, uncertainty may lead to a sell off that might hinder clients’ expansion (and, thus, their use of outside counsel).

Areas of Near Term Management Emphasis

We asked those firm leaders where they were focusing their near-term management efforts and resources (now and in 2017). Below are those areas that the interviewees brought up – sort of a shopping list of agreed-upon effective management areas of emphasis.

- **Focus on profitability** – including increasing client retention and satisfaction; increasing realization; improved measurement and analysis of meaningful management statistics; and specific (i.e. – measurable) expectations at the firm, practice, and individual levels (*“we continue to focus on this, it is paying off, and the resistance to it is finally backing off”*)
- **Pricing** – critical to profitability, ensuring that pricing is accomplished in an effective manner
- **Legal project management** – investing in people (non-attorneys usually), systems, and training to ensure that we are maximizing services to our client, as well as firm profitability
- **Talent management** – the attraction, development, utilization and retention of the best people possible
- **Practice and industry team/group management** – better defining groups, holding leaders and members accountable, keeping everyone busy, and measuring results (*“we have to make this work, or we are not going to grow our bottom line or our firm”*)
- **Industry specialization** – *“making this industry effort really work”* by taking it up a few notches (in terms of development), publicizing positive results, and involving more people
- **Client feedback** – increasing client visits, recording and distributing what clients have to say, and, importantly, clearly responding to and acting on client input
- **Succession** – in terms of client responsibility in firm/group management (*“we have to get the old guys out from both managing our firm and managing our client relationships”*)
- **Technology** – ensuring payback on the enormous investment in technology
- **Cyber security** – ensuring client and internal systems are secure

- **Strategic plan implementation** – having an effective externally focused plan, working that plan, measuring the results, and, if called for, revising the plan and implementation efforts
- **Reinforcing teamwork** – not only ensuring that practice and industry teams are working well together, but solving the conundrum of how a firm can effectively reward teamwork and cooperation rather than just individual effort
- **Brand focus** – defining a firm’s true brand, ensuring that the brand is understood and supported internally, and taking the brand to market (a long-term effort on the part of all in a firm) in ways that differentiate the firm from its competitors
- **Balance** – recognizing that an effective law firm has to be managed with the concept of balance (figuring out how to do A and B well, rather than choosing to do either A or B – Collins’ *“magic of the and,”* rather than *“the tyranny of the or”*) – or, as one managing partner put it, *“ensuring that we do not get way out over our skis”*
- **Marketing** – taking the whole marketing function to the next level where the objective is to get work from current clients and new clients
- **Investing in our people** – to ensure performance and retention, including revised development programs and a focus on alumni relations.

Longer Term Concerns

The final question we asked of the interviewees was about their longer-term concerns – that is, what are the things that you and your firm need to do to address that, at the present time, are a little bit further off in the future. The most commonly heard (from multiple firms) longer-term concerns follow.

- **Growth** – law firms are not growing now (as demand for their services is not growing). Thoughtful law firm CEOs and COOs recognize that their firms will have to get back to growing in terms of size, practices, people, and reputation. Profit is generally now enhanced by raising rates and managing expenses – not by expanding into new industry and product markets. That will have to change – growth is a necessary ingredient to long-term strategic and financial success. A non – growing law firm is subject to the real risk of being marginalized (a fear mentioned often by the interviewees). But, many law firm service partners are not pushing for growth – their personal income is growing annually, whether the firm grows or not – so, they are satisfied.
- **Yes, the future of litigation has become a significant strategic issue.** The falloff in many firms’ litigation practices is a law firm industrywide phenomenon. While many firms have continued to have strong litigation/trial practices and there are still good contingency fee opportunities, the overall trend is clearly down and litigation has become the most significant and the easiest opportunity to bring work in-house for a client.
- **Technology** – not only do law firms have to pay attention to technology in the near term, but some of the interviewees joked that long-term technology may put lawyers and firms out of business (*“when will Watson figure out how to practice law better, quicker, and cheaper than human lawyers can?”*).
- **Continued commoditization of the practice of law** – the last 10 to 15 years have seen a number of legal specialties and services (if not, in some ways, most) become commoditized and this trend to commoditization is expected to continue (as it always will). Firms and their leadership will have to answer their questions as to what services (and attorneys) are viewed by clients as commodities and what should be done about it.

- **Continued consolidation in the legal marketplace** – 2015 was the all-time record year for mergers and combinations. While 2016 was off a bit in terms of completed mergers, there continued and continue to be one heckuva lot of conversations and meetings between firms and their leaders concerning potential mergers. Acquisition of lateral attorneys is currently the preferable growth strategy (as it has been for the last few years), but most firm managers recognize that real growth will have to come from mergers/combinations. A number of the interviewees felt there are two options – either take an active role in these discussions or wait to be called. To most, the former is considerably more desirable than the latter.
- **Margins at risk** – there is virtually no industry (or professional service) that has the kind of operating margin that most law firms do. The marketplace knows that – most general counsel came from law firms and remember their financials and the enormous built-in “*room for error.*” The various pressures exerted by clients will probably result – over time – in the shaving of law firms’ margins.
- **A buyers’ market** – the really big change that came about for law firms in the Great Recession, repeated and accepted as dogma by many of the interviewees, was that the clients are now in the drivers’ seat and the legal marketplace is clearly a buyers’ market. One law firm CEO suggested that while income will remain very high for those lawyers that provide very valuable services (as perceived by the clients), the average lawyer’s income will, over time, be coming down. It is not hard to justify the value of a true “*star,*” but it is becoming very, very hard to justify the value provided by many firms’ mid-level service partners.
- **Length of time for impact** – virtually any strategy takes a while to be implemented and for the impact to be felt – and, that usually extends well beyond a single year. So, many of the interviewees recognize that what they do this year will not see its full financial and market share impact (either positive or negative) until further down the road. Not only does firm management have to be patient, but so do their partners.
- **Dealing with generational differences** – the young attorneys are very different; they have a different view of their work and their chosen profession; and getting continuing and eager productivity is clearly not that easy.
- **Alternative fee structures** – the trend continues and firms have to figure out both how and what to change – and also, the best way(s) to communicate with clients concerning fees and fee structures.
- **Stressing group performance while rewarding individual performance** – most partner reward systems, regardless of how they are structured, still reward activity and/or performance by individual partners. Yet, we are clearly in an age of teamwork and it is very, very hard to fairly reward teamwork in the law firm environment. A number of the interviewees recognized the partner reward systems are going to have to adjust and reward what clients want and what advances the best financial and professional interests of the law firm. Simply put, partner compensation systems are going to have to change to reward group activity and performance, certainly at the expense of the “*Lone Ranger*” partner.

Smock Law Firm Consultants' Comments and Conclusions

Following are SLFC's comments and conclusions, based on what we heard in the interviews.

- **Law firm management is leaping rather than crawling forward.** SLFC's three partners all have more than 40 years experience serving law and professional service firms. We have watched law firm management effectiveness improve over time at a very slow pace – much more like the tortoise than the hare. However, that pace has recently and dramatically picked up – particularly since the Great Recession and now is more like the hare. If you look at both the reasons for positive results and the near-term areas that law firm managements are currently addressing, as mentioned earlier in this document, the collective focus of law firm managers is in the right place or places. Such topics as profitability, increased use of data, legal project management, use of specialty skilled non-attorneys, industry specialization and focus, and group team management, are those “*right things.*”
- **The big guys are doing a better job than the midsize guys (and the small guys).** When you look at this phenomenon of management improvement, it is apparent to us that the larger firms are moving faster than the midsize firms and a well-managed small firm is the exception rather than the rule. The large firms are doing it; the midsize firms are doing it, but facing more partner resistance and doing it slower; and most smaller firms are just not doing it. The intense client pressure started with larger companies (which hit the larger law firms first and comparatively quite hard), so this generalized assertion makes rational sense. The less effective the midsize firms are at improving management to stay competitive, the more they are at risk for acquisition and dismemberment (by the large firms) or considerable downsizing (as happened to a number of midsize firms in 2015 and 2016). Smaller law firms, particularly smaller litigation specialty firms, are in real risk of not surviving the present pressures.
- **Larger firms have also done a better job of dealing with underperforming partners.** Because of client pressure and the need to respond, larger firms have more directly addressed the underperforming partner conundrum. As you go down (smaller) in firm size, the percentage of partners (of the total) that can be labeled underperforming (which we define as multiple years on the dole, living off their partners) rises. In some firms, this problem has become an acute one that threatens continued overall firm performance and existence.
- **Lateral partner hiring appears to be going much better.** A number of firms we interviewed commented that they had dramatically improved their lateral programs and that lateral partners were making a real financial contribution to their firms sooner than had historically been the case. It may very well be that the lateral success ratio has moved up from the historically accepted 25% – but, we would still argue that that the lateral success ratio for virtually any firm is probably still comfortably below 50%. The bottom line is that more and more laterals are making a significant financial contribution to their firms sooner than they had in that past and that there is significant room for further improvement.
- **If practice/industry team management has improved, there is still a long way to go.** One of the greatest industry weaknesses that we have noted over the last few years is that the practice and industry teams and groups are still performing very far below their potential and the level necessary to both protect a firm competitively and truly grow it to a new competitive position. We wrote about this extensively in a prior [monograph](#) earlier in 2016.

- **Too many competitive position enhancing mergers are turned down internally.** It has been and continues to be very difficult to do a strategic law firm merger (not an acquisition - but, a true merger). The greatest obstacle remains internal partner opposition (why would you bother with your cheese being moved in a merger, when your compensation keeps going up?). The amount of time expended in merger activities and the number of firms that have talked to each other are both very large numbers. And, mergers remain the one best way for a firm to substantively grow.
- **And, even with these substantial management improvements, their continuation and expansion is an opportunity rich environment.** There is no question that the competitive pressure, enhanced since the Great Recession, and continuing client pressures require that law firm managements keep improving, as in the continuing improvement efforts that profit-making companies have to embrace.

Smock Law Firm Consultants' Recommendations

Based on the above comments and conclusions, we offer the following suggestions/recommendations for 2017 and beyond.

- **You better have a growth strategy.** The single most voiced across-the-board concern in the legal marketplace is that law firms are just not growing. We strongly suggest that law firms develop and execute a true growth strategy - focused **both internally** (best addressed through industry and practice team/group growth - bootstrapping) and **externally** (through judicious consideration and pursuit of strategic mergers/combinations). That growth strategy should be broadly understood and supported throughout the partner group. And once you develop it, you have to execute it.
- **Upgrade the management effectiveness of the practice/industry teams and groups.** You can have very little impact on improved profitability and management on a firmwide basis. The practice/industry teams and groups (in reality, the service delivery organization of a law firm) are where you produce profit and, very importantly, enhance and grow profit. This cannot be done until you appoint, train, encourage, and reward the team leadership. Full disclosure is in order, we recommend this every year and most firms tend to ignore it, but it remains - in our collective mind - still the ripest area for improvement.
- **Take a long-term look at the strategic viability of your litigation practice(s).** There is no question that litigation is the area undergoing the most significant change in the legal marketplace and perhaps the area of law firms' greatest downside risk. Firms with substantive litigation practices (and that is really the vast majority of law firms in the United States - regardless of size) need to determine how this litigation falloff has and, possibly, will affect their business. It is probably good to do some benchmarking of those firms that have really developed effective litigation practices that have weathered the recent turmoil.
- **Get out ahead of the underperforming partner issue.** Firm management and its practice/industry groups need to deal with the underperforming partner issue. Many firms have, but many, many firms have not. Underperforming partners has become the "*third rail*" (touch it at your own risk) to many law firm managers. There are lots of approaches to dealing with that issue, but merely reducing compensation is not one of them. It is a difficult topic and is covered in a [monograph](#) we wrote a couple of years ago.

- **Consider substantively revising partner compensation to reward teamwork and group performance.** You cannot expect maximum group performance (financially and operationally) unless you specifically recognize and reward it. This means that many, many partner compensation schemes either have to be tweaked or dramatically redone and there are not a lot of models for doing it right. But, the need is there and that revision and adjustment is necessary.

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About Smock Law Firm Consultants

Smock Law Firm Consultants is a focused strategic management consulting firm serving law firms (our primary industry concentration), other professional service firms, and commercial entities. We help law firms address and resolve those key issues that have a major impact on a firm's near term success and its long term direction and focus. We focus on seven key areas of practice - (1) **strategic planning** at firm and practice levels; (2) **strategic plan implementation and execution**, in essence, helping clients do what they said they would do; (3) **mergers and combinations assistance**, helping identify, negotiate and implement combinations; (4) **practice team/group management**, helping the practice team concept achieve its potential; (5) **law firm economics**, helping our clients improve profitability and deal with longer term financial issues; (6) **operational excellence**, improving both the effectiveness and efficiency of firm operations (i.e. - process improvement); and (7) **strategic management issue resolution**, assisting in resolving issues of vexing management concern (e.g. - partner compensation).

We believe there are three factors that clearly set us apart.

- The primary success factor for any consulting firm are the results achieved by our clients - in both the near and longer term. Our client references speak directly to those results.
- Our *first string* and, actually, our **only** string (Smock, Giuliani, and Fiebert) is, simply, **the most experienced group of senior consultants serving the legal profession**. These three partners bring a collective relevant experience of greater than 135 years and **each** has greater than 40 years of varying but relevant experience in law and professional service firm management.
- We tailor our approach to every consulting assignment to the unique needs and requirements of the client. We are known for our **originality and creativity** in doing that and for our scrupulous avoidance of promoting *law firm management dogma*.

Again, thank you for either participating in our survey, being interviewed, or considering its results.

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