Finding stability and growth for your law firm

in a challenging economic environment

WHITE PAPER

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Contents

2023 is proving to be a hard year to forecast. On one hand, demand growth is slowing and the overall economic picture in the United States is unclear. On the other hand, law firms finished 2022 with reasonably good financial results, according to the **2023 State of the Legal Market** from the Thomson Reuters® Institute.

Law firms are looking for ways to build on their financial health and find growth in an environment where they can't count on more work coming their way.

In 2022, while financial results were strong, law firms saw a combination of falling demand and growing headcount. This dynamic resulted in a significant decline in productivity. In fact, hours worked per lawyer dropped to 119 hours per month, which is a low point for at least the past two decades. According to the State of the Legal Market report, the average lawyer in 2022 produced $98,000 less in total fees than a comparable lawyer in 2007.

As law firms grapple with declining demand, overall economic uncertainty, and talent and culture challenges, there is still reason to be optimistic about their financial futures. That is, there are a number of areas within your control that can help you build your financial health and find growth in 2023.

First, keep headcount in line with demand growth. This is a tricky balance to strike, as you want to be prepared to take on new work when it comes, but you also don't want to carry more people than you can keep productive. And while it can be tempting to cut headcount when demand dips, it's risky in what is still a job-hunter's market.

Second, optimize profitability by maintaining strong financial hygiene practices. Make sure you are actually billing for the time you and your associates work. It's tempting to preemptively write down your hours to keep a client happy, but data shows that lawyers often write down significantly more than your clients expect you to.

Third, grow your rates in line with the market. Prices went up for many professional services in the past few years. Are your rates keeping up? Market data and client feedback can help you charge appropriately for your time, offsetting some loss in demand growth.

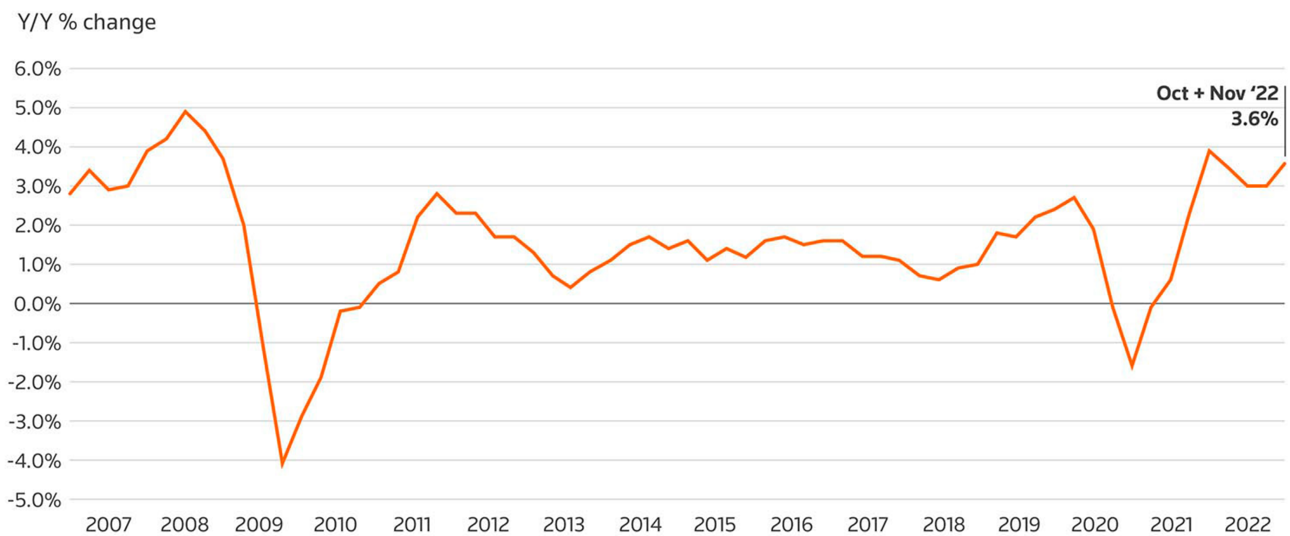
Finally, keep an eye on which practice areas are seeing positive growth and which are sliding. You may be able to offset softness in one practice area by extending into another, more active, practice area.

Smartly combining these approaches can help you manage top line growth and bottom line health for your firm.

Keep headcount in line with demand growth

Lawyer growth spiked in 2021 and 2022 as firms staffed up to meet shifting and growing demand after an initial pandemic-driven decline. Lawyer growth for both years was between 3 and 5 percent, year over year. This is higher than at any year since 2008, the beginning of the Great Recession.

Figure 7: **Lawyer (FTE) growth**



Lawyers (contractors excluded)

Source: Thomson Reuters 2023

According to the State of the Legal Market report, this trend affects all categories of timekeepers and major practice areas as well as firms of all sizes. The report does note, though, that the biggest spikes come from associate hiring and Midsize firms.

Notably, support staff levels shifted over the past two years. "During 2020 and 2021, the total FTEs for support staff declined while, at the same time, the total compensation for support staff and the compensation per role increased," according to the report. "These general trends, if continued during 2022, would suggest that, while firms are decreasing the numbers of lower-level staff, they are increasing staff in higher functional areas while paying the compensation differentials necessary to do so."

Staffing levels went up in recruiting and talent management, practice group operations, executive management, finance, and marketing and business development functions. Firms reduced staff in library and research, administrative, secretarial and word processing, and operations functions.

"Law firms have historically struggled to find the balance between headcount and demand," says William Josten. Josten leads enterprise legal thought leadership for the Thomson Reuters Institute and works with law firms of all sizes to understand how market forces shape their business. "The softening demand is heightening this issue. Law firms don't want to cut headcount now because it's still a long, hard, and expensive process to hire when demand comes back."

That dynamic leaves firms trying to keep the people they have and to keep them busy.

Retain your staff

A **2022 report from the Thomson Reuters Institute** looked at the attributes of firms with lower attrition compared to those with higher attrition.

The firms with low attrition didn't have the highest salaries. Instead, they had a better work environment. "In general, when asked their favorite aspect of their current firm, standout lawyers at Stay firms were more likely to cite factors such as the people with whom they worked, the collegial nature of relationships within the firm, the supportive nature of the firm, and the quality of work they were offered," according to the report. Further, "standout lawyers at Stay firms were also more likely to strongly recommend their firm to a friend as a good place to work; and they were more likely to self-identify as either an innovator or an early adopter of technology."

Firms that kept their employees longer were able to grow lawyer headcount more aggressively without damaging per-lawyer productivity. And corporate general counsel (GCs) interviewed by the Thomson Reuters Institute rated Stay firms more favorably in terms of the service they provided and the strength of their relationships.

Keep your current team busy

The best source of new work is often the same work that's already in front of you. To offset softening demand and slower new client growth, many firms are looking to deliver more work to existing clients. This is a strong business development strategy, but what do you do if your resident experts don't have the capacity to take on the work? This is especially a risk when certain practice areas or matters are in higher demand than others.

You can take this as an opportunity to develop attorneys in different areas of law. The cross training is valuable to them for career development and allows you to optimize their productivity without hiring additional attorneys. **Legal know-how tools** can help attorneys get up to speed quickly in new practice areas and new types of matters.

Attorney hiring will continue, likely at a slower pace in 2023 than the two years before. Hire people into a healthy firm culture with opportunities to stretch into different practice areas, and you are likely to have a more stable, resilient workforce for a shifting demand landscape. This will help you take advantage of growth opportunities as they emerge and improve your bottom line in the near term.

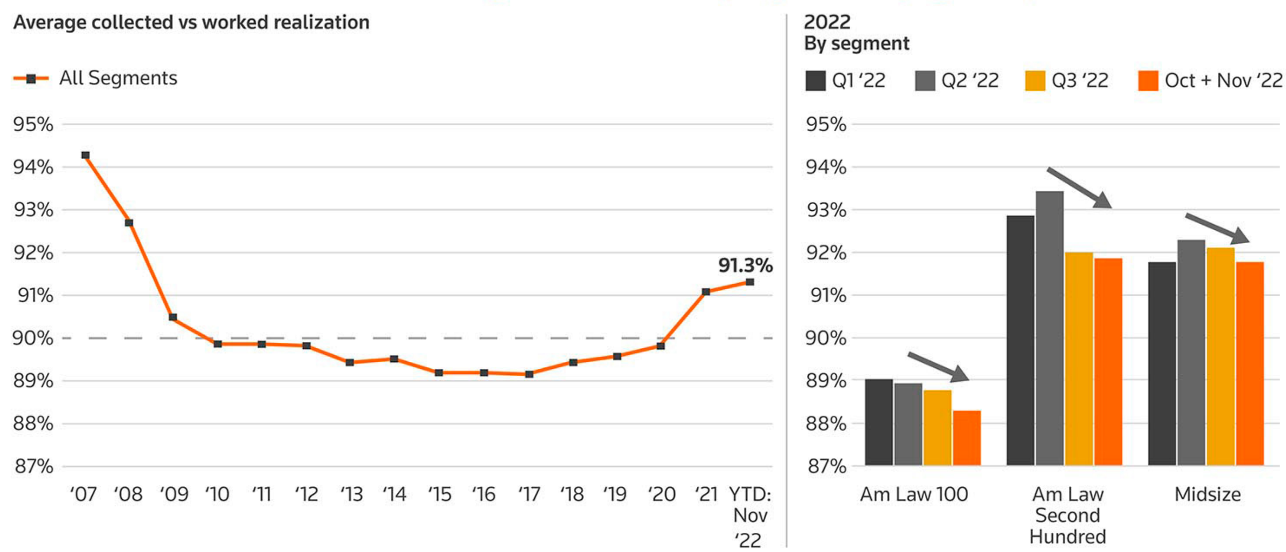
Optimize your profitability

Your realization rate is another crucial factor in top line growth. Are you getting paid for all the hours worked or value delivered? The 2023 State of the Legal Market showed that collected realization against worked rates declined throughout last year after rising steadily for the past two years.

"Particularly noteworthy is the fact that we saw atypical declines during the third quarter of 2022," the report says. "The all-firm average in collected realization normally increases from Q1 through Q4 of every year, but this year we saw a noticeable drop from 91.7% in Q2 to 91.2% in Q3, which continued into Q4."

To offset this leakage, firms can redouble their focus on billing and collections. Write-downs can be significant cause of fee erosion and the declining realization rate noted in the State of the Legal Market report.

Figure 6: **Collection realization against worked (negotiated/agreed)**



Lawyers only. Billable time type.

Source: Thomson Reuters 2023

The **Law Firm Billing Practices White Paper** addresses this challenge in depth. It notes that while every hour spent working on a matter contributes to the firm's "cost of production," firms erase many hours each year. This happens in two steps. First are the silent write-downs, where lawyers report less time than they actually work. Often, these write-downs happen when associates spend time getting up to speed on a new matter or feel they have spent more time than "allowed" on legal research, drafting, or eDiscovery projects. It can also happen when partners spend time correcting or revising an associate's work. They may feel that the initial draft should have been better and don't want to pass that cost on to the client. Silent write-downs like this account for $47,000 per partner per year.

Once the prebill goes to the partners, reflecting these initial losses, we see even greater write-downs, to the tune of $190,000 per partner. While these write-downs are sometimes because of client regulations, caps, or expectations, they are more often because the time spent on a task or matter exceeds the partner's own expectation of how long a task should take. The partner fears the client's reaction and preemptively reduces the bill, rather than having to defend the firm's prices or practices.

This is an important area to address, and law firm leaders are aware of it. Of the respondents to the billing practices survey, 76% felt it was "extremely important" or "important" to reduce the number of hours that are worked but not billed. There are two strategies that can help reduce write downs in law firms: help your associates work more efficiently and help partners feel comfortable defending the firm's pricing.

Help associates present client-worthy work faster

Partners are writing down $19,000 in fees per associate per year because they think the associates are taking too long to complete their tasks. Look for ways to drive efficiency so associates can complete their tasks in less time with more confidence. This might mean more training and mentoring from senior associates and partners. It could also mean investing in technology and content that supports their learning process and speeds their drafting time.

"This doesn't mean your attorneys will bill less or work less," said Josten. "It means that they'll work the same amount of time but be able to bill for more of those hours. And as everyone gets more efficient, if they do have excess time, they can put it toward business development or projects that attorneys are passionate about or initiatives that improve profitability."

Help partners defend your pricing

Partners are putting more downward pressure on realization rates than clients are. Recognizing this is an important first step toward helping partners communicate about pricing and bills. Partners' sensitivity toward billing for work that takes too much time or needs to be redone is understandable. After all, most can remember the great reckoning that came around 2008 when corporate clients started pushing back harder on their bills. Many said they didn't want to pay to train law firm associates.

We're working in very different times now, with different tools and processes that can squeeze much of the excess out of the training process. "Law firms should set rates it can stand behind," says Josten. Get your partners bought into these rates: help them understand how they were set and how to defend them. Then, support them as they communicate these rates to clients.

Raise your rates appropriately

Rate increases are an important source of top line growth. Be sure you are raising your rates in line with the rest of the market and within your clients' zone of tolerance. There are signs that rate growth is not keeping pace with inflation or market tolerance.

According to the State of the Legal Market report,

> Given the growth of inflation since 2020 through the end of November 2022, we saw — for the first time — the annual average rate of inflation (5.0%) exceed the average worked rate increase across the market (4.8%). While that divergence might be tolerated for a while, over the long term it is not sustainable. Depending on how long it takes to bring inflationary pressures under control, law firms could increasingly experience an economic squeeze.

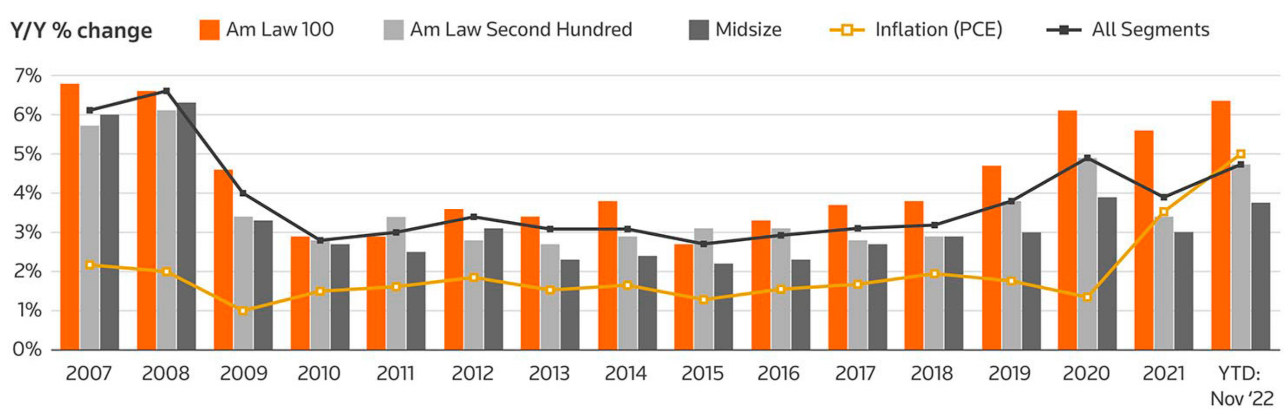
The report notes that firms may not be increasing their rates fast enough to keep up with expenses or inflation. Still, there is sensitivity to raising rates when corporate clients themselves are calculating their risks in a recession. How can you assess how much room you have to raise rates? Look at market rates and talk to your clients.

Research market rates

When did you last look at market rates for firms of your size and in your practice areas? It can be hard to find beyond anecdotal feedback from clients or a moment of generosity from a competing law firm at a networking event. Investigate sources of trusted intelligence to help you know if your rates are in line with the market. If they are wildly below, start making a plan to get them in line with the market. If they're above market, congratulations! Continue with your current pricing strategy.

While rates will vary by location, firm size, or practice area, there are some useful benchmarks in the 2023 State of the Legal Market. "All segments of the market grew their worked rates at a pace exceeding that of 2021 — indeed, mirroring the 12-year high-water marks set in 2020. Through November 2022, firms had increased their rates by an average of 4.8%. Am Law 100 firms led the way with a 6.3% jump, followed by Am Law Second Hundred firms at 4.8% and Midsize firms at 3.8%."

Figure 5: **Worked rate growth**



All timekeepers. Billable time type; non-contingent matters.
Inflation (PCE) measure = Personal Consumption Expenditures Excluding Food and Energy.

Source: Thomson Reuters 2023

Assess your clients' price sensitivity

As you craft your rate growth roadmap, it's worthwhile to test it with clients. While market rate research can help you feel confident about your decisions, road testing with clients can help you make the process smoother.

- Talk to partners about what type of pushback or feedback they've gotten on their bills in the last year. This will help you assess clients' attitudes toward your current rates. (It can also help you and your partners identify opportunities to write down fewer hours, as discussed above.)
- Talk with trusted accounts about their reaction to a proposed rate increase. Be prepared to revise your plan if you get consistent negative reactions that suggest their price sensitivity is far greater than you expected.
- Ask what resources or rationale your clients will need to explain or defend your rate increases internally. They may need to see market data that says they won't get a lower rate at other firms. They may also appreciate seeing that they've been benefiting from below-market rates up until now.

Of course, no client is going to say, "yes, please, raise your rate." But your clients do understand price increases and market dynamics — their businesses have likely implemented price increases too. With some level of client feedback early in your process, you can calibrate the increase and help them prepare for it.

Look for growth opportunities in new practice areas

The demand growth picture was nearly universally bleak in 2022, with Am Law firms seeing big declines in all practice areas. Still, Midsize firms were able to compete in certain practice areas. These included litigation, labor & employment, and intellectual property, according to the 2023 State of the Legal Market report. "Indeed, Midsize firms were the only market segment showing positive demand growth (in their non-transactional practices) during the second half of 2022."

Watch market trends throughout the year and be prepared to extend into new practice areas as opportunities arise. With the right know-how and training tools, your lawyers can take on new kinds of matters rather than refer them out. "It's a time for leaders to remind their partners: 'We're all in this together,'" according to the 2023 report. "Contrary to the natural tendency to hunker down until the danger passes, firm leaders need to engage their practice and industry team leaders to actively work through the challenges that firms face. This should involve a careful monitoring of practice areas and key clients to identify new or expanding opportunities that might emerge from a rapidly changing market. Indeed, periods of turmoil often lead to such opportunities, if firms are capable of identifying and addressing them."

Watch the market, and then **equip your attorneys** to master new practice areas to meet market needs. This practice will help you grow your top line while keeping your team engaged and ready to learn.

While no one can predict the way economic forces will play out this year, there are some basic practices that can help you protect your firm's financial health. Make sure you're getting paid for all your hours worked, if you are billing by the hour. Hire when you know you can keep that new attorney or staff member productive. Make sure your rates are in line with the market and with client expectations — you may be undercharging. And stay open to new practice areas that can help you respond to your clients' current needs. This set of practices will help your firm manage top line growth and bottom line health.

*Getting lawyers up to speed quickly and being able to work in new practice areas present significant opportunities to improve your firm's overall financial health. Thomson Reuters **legal technology** can help your lawyers extend their capabilities and work faster and more efficiently.*

More resources for law firm growth:

- **Forum Infographic: The keys to a growing law firm**
- **2022 Report on the State of the Midsize Legal Market**
- **Mastering a new practice area to meet client demand**

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