New Surveys Send Mixed Signals on Law Firms' Health

Reports this month showed demand for legal services thawing at the same time clients are putting the freeze on their outside legal spending. What gives?

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By Miriam Rozen | February 14, 2018

It's been a month of seemingly conflicting signals when it comes to law firms' financial fortunes.

Thomson Reuters Peer Monitor Index and Citi Private Bank's Law Firm Group both found that law firms boosted revenue in the fourth quarter of 2017, amid a much-welcomed uptick in demand. At the same time, two separate surveys of top in-house lawyers showed that GCs and chief legal offices are scrutinizing their outside law firms more closely, with nearly half expecting to fire their firms this year. Law department leaders also said they're spending a larger proportion of their budgets on in-house legal services rather than on outside firms.

"I think the data and my conversations with law firm chairs suggest that last year—and particularly its last quarter—were better than expected for a large number of firms. That's what I'm hearing and seeing," said legal industry consultant Kent Zimmermann of the Zeughauser Group.

The better-than-expected fourth quarter results and news that companies are reconstituting their outside counsel ranks "are not mutually exclusive," Zimmermann said. But the juxtaposition does suggest that law departments have shifted how and where they spend their money.

Law firms, particularly as they get a few good quarters under their belts, should aim to work more closely with clients in hiring outside vendors like e-discovery experts and predictive coding specialists—and even alternative legal services providers they see as competitors—or risk losing their place at that table, according to legal industry consultants Bruce MacEwen and Janet Stanton of Adam Smith Esq.

"The law firms would want do to this because otherwise they are going to be totally shut out. They will be marginalized," MacEwen said.

First though, they can bask in their fourth quarter results.

According to the Feb. 12 findings from the Peer Monitor Index, which measures the health of large U.S. law firms, the market had one of its strongest quarters in recent years with a growth in demand, rates and productivity. The index rose a sharp 11 points to 60—one of the largest quarterly gains in the index in several years. Rate growth was the most robust—increasing 3.4 percent—the best annual performance since 2014. Demand rose 1 percent, which might not seem like much, except it's the biggest gain in 21 months. Productivity rose 0.1 percent—and that's the first positive quarter in five years.

Those findings came shortly after Citi Private Bank's Law Firm Group released its results on law firms' 2017 fourth quarter, showing similar modest increases among its sample of 189 firms, 81 of which appear on the Am Law 100 rankings, 53 on the Second 100 Am Law Rankings, and 55 niche and boutique firms. Net income growth was "a solid 4.5 percent" and due in part to a small dip in equity partner head count there was profits per equity partner growth of 4.8 percent, wrote John Wilmouth, a Citi senior client adviser, and Gretta Rusanow, head of advisory services for the bank's private banking group for law firms.

Meanwhile, according to data from the Association of Corporate Counsel's Chief Legal Officers 2018 Survey, issued this month, one in three chief legal officers and general counsel terminated their outside lawyers for failing to meet expectations in 2017. The trend could continue into 2018—43 percent of respondents said they planned to end relationships with firms this year. (The survey includes responses from 1,275 CLOs and GCs in 48 countries.)

The same survey showed law department budget distributions stayed almost flat, with spend on outside counsel declining slightly from an average of 40 percent of total budget to 36 percent. Notably, the survey showed that the law departments' "inside spend allocation increased slightly from an average of 53 percent to 56 percent." Companies with less than $100 million in revenue devote nearly 60 percent of their budgets to inside legal spending, compared to 56 percent at companies with $3 billion or more in revenue, the survey found.

Yet another report this month also found law department spending shifting to in-house. According to a study conducted by Acritas Research Ltd., issued jointly with Thomson Reuters, law departments have shifted by 6 percentage points their ratio of legal spending to in-house from outside counsel since 2013. Specifically, 63 percent of law departments' spending was external in 2013, but that dropped to 57 percent in 2017.

Daniel Reed, CEO of fast-growing legal services outsourcing company UnitedLex Corp., said whatever the law firm market does in a particular quarter or how GCs are budgeting in the short term, firms need to look at the big picture: Change is coming.

The industry is seeing "a systemic increased evaluation of legal costs that is not likely to let up," said Reed, whose company inked what is regarded as the first major outsourcing deal with a corporate law department late last year. "Clients are looking for holistic solutions," he said, and they have grown more emboldened about questioning costs.

Along with MacEwen and Stanton, Reed forecasts 2018 will bring collaborations or joint ventures between traditional law firms and alternative legal service providers like UnitedLex, which has financial backing from the private equity arm of JPMorgan Chase & Co.

The financing resources available to UnitedLex and other New Law ventures gives them more flexibility when making technology investments, he said, adding that joint ventures and mergers of alternative providers and traditional law firms will be shaped by clients seeking "fairly thoughtful integration."

"The predicate has to be what is in the best interest for the client," he said.