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## **The Future of the Law Firm in the Twenty-first Century**

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*The past, present and future of the legal profession: How we got here, what we are doing now and what the future portends: continued revolutionary changes.  
The seminal analysis.*

The Rock Center for Corporate Governance at Stanford University recently published what is, at least for me, and likely for any interested reader, what is perhaps the most seminal recent study of large law firms, from both an historical perspective, an analysis of the law firm in the face of current economic conditions as well as some hedged and qualified predictions for what the future holds for the legal profession.

This remarkable piece of scholarly work, authored by Bernard A. Burk, Academic Fellow at the Arthur and Toni Rembe Rock Center for Corporate Governance at Stanford University and David McGowan, Lyle L. Jones Professor of Competition and Innovation Law at University of San Diego School of Law, entitled [“BIG BUT BRITTLE: ECONOMIC PERSPECTIVES ON THE FUTURE OF THE LAW FIRM IN THE NEW ECONOMY”](#) is **required reading** for every law firm manager, and, indeed for every practicing lawyer, both for law firm practitioners and lawyers serving as in house general counsel.

But, until you find the time to do so, you will find this modest piece, relying heavily on the work of Professors Burk and McGowan and some of my prior work with scores of law firms around the country, an essential guide.

A thoroughly researched work of scholarship, relying on a tomes of work of economists, sociologists and an array of highly regarded academics, heavily footnoted (I was personally rather flattered and a bit humbled to find my own previously published work among the myriad notes), it is a compelling work, laying out in detail how we got to where are now, how we got here and where we are going. My own recent [note regarding the deployment of associates](#) in the emerging law firm model certainly pales in comparison to this detailed work.

I encourage you to print the entire piece, read it thoroughly over a quiet evening, a long weekend or an airplane ride so that you can give it the attention it demands.

Professors Burk and McGowan divide their paper in to three sections: The first, describes the golden era of the past 40 years during which the large law firm emerged as a dominant business model; the second provides an analysis of steps taken by law firms or imposed on law firm by current economic exigencies to allow them to survive The Great Recession; and, third, some predictions for the future.

As the authors note, “past is prologue,” an understanding of the historical perspective is essential. While their historical narrative is compelling, here, I will only deal with the here and now and what lay ahead.

### **Where we were**

The second half of the 20<sup>th</sup> Century witnessed the explosion and proliferation of large, very large and mega law firms. Headcounts, billing rates, associate salaries, demand for new law school graduates, demands for legal services partners’ salaries were all on head spinning upward arc. Law firms, perhaps like real estate prices rose 5% annually, and law firms assumed that rate of annual growth would continue inexorably. Accordingly, planning was in material measure seemed easy: Resting on the assumption of continued growth at this level, firms based hiring, real estate and technology acquisitions to keep pace with this continued rate of growth. By the 1980’s the rate of growth increased to 8% and law firms adjusted their planning accordingly. The world was jolted when it realized that 5% annual growth of real estate prices was not a product of divine command. Hence, the housing bubble bust. Similarly, the legal profession suffered

a shock to its system when it too realized that 5% annual compounded growth was not the product of a heavenly decree. The legal services bubble burst.

As the second half of the 20<sup>th</sup> century began, virtually all firms were based in a single city. By 1980, 87% of the country's largest firms had branch offices. In 1968, the largest law firm in the United States had 168 lawyers. By 2008, 23 law firms had over 1,000 lawyers. In 1975, an elite miniscule number of firms had profits per partner edging up to \$100,000. By 2007, 100 of the most profitable firms had PPP averaging \$1,300,000.

At the start of this golden era, law firm partners considered their admission to partnership as a grant of lifetime tenure and a general commitment by each partner to bind with the firm as a lifetime commitment. Lateral partner movement was virtually non-existent. By 1980, lateral partner movement was rampant. Law firm partners were the LeBron Jameses of their era: free agents available to the highest bidder.

My own career path as I began my quarter century of law practice is demonstrative of this pattern. In 1978, as I was being recruited by various law firms, I elected to join a firm considered a titan of Wall Street. It had 70 lawyers and boasted of the fact that 4 of its 20 partners earned \$100,000. Three years later I was actively recruited to join a firm pursuing an accelerated growth plan. Based in New York, Finley Kumble had a branch in Los Angeles and plans to open new branches. It was the 84<sup>th</sup> lawyer in the firm. By the end of 1987, when it imploded, it was the second largest law firm in the world with over 500 lawyers and eight branches.

### **Where we are now**

Among the pertinent points made by the *Big But Brittle* authors, (all completely consistent with my experience counseling scores of law firms, my prior written work, my media interviews and speeches) regarding the radical changes wrought over the past two years are the following:

- **Huge reductions in force.** Since January, 2008, AmLaw 200 firms acknowledged laying off nearly 15,000 personnel, including 5,632 lawyers. We all know that these figures are grossly understated. They do not include hundreds of "stealth" layoffs, in which firms purported to dismiss lawyers for inadequate performance (largely making those

affected almost permanently unemployable again as lawyers), thousands of layoffs in middle market and mid-size firms falling below the AmLaw 200 metric and hundreds more lost by simple attrition.

- **Drastically reduced recruiting and restructuring associate compensation systems.** [We've previously addressed this issue.](#)
- **Increased reliance on value billing.** [My own work on the subject](#), among the most widely read on the issue of Alternative Fee Arrangements describes the concept, its need and application is certainly recommended reading.
- **Proliferation of specialty boutiques.** These firms, largely populated by large law firm refugees, are simply stopgap measures, fraught with peril. In my view the staying power of these shops is in serious question. Those that focus on specialty practice areas in vogue now risk extinction as their wave of demand ebbs as the economy goes in to its next cycle. Those small boutiques which offer a wider array of services may be able to survive based on competitive pricing. However, these boutiques are frequently self limiting; they are typically undercapitalized, function often on an “eat what you kill formula” and lack the diversity of practice that cushions larger firms as particular practice areas ebb and flow. The “eat what you kill” formula, not at all confined to boutiques, is an invidious concept. Those lawyers who prove to be more facile hunters will always be susceptible to overtures from firms which offer a larger bounty for their kill and certainly from firms that offer richer hunting grounds, with practice and geographic diversification. The successful huntsman typically has little institutional loyalty; rather, he or she is motivated only to increase his or her kill and the portion of the bounty he or she can bring home.
- **Lower margin and cyclical work are slipping down the food chain.** Large firms seeking to maintain high profitability are stripping out lower margin work. In my view, supported by the paper's analysis, practices such as labor and employment, estate planning, transactional real estate work, trademark and patent prosecution will

be disfavored at large firms, find homes in mid-size firms where they can be handled more efficiently and at lower cost.

- **Demise of partner lockstep compensation.** Academic economic analyses suggest that large law firm models work well, since practice diversification theoretically allows for evening out the cyclical nature of many practice areas. Thus, theorists suggest that partners would seek comfort in an environment in which downward trending of his or her practice would be counterbalanced by the ascendancy of other practice areas. Accordingly, these theorists suggest that a partner would sacrifice significant compensation enhancements for stellar performance periods, comforted by the knowledge that their compensation would be protected during downturns in their practices because other practices within the law firm would be on the rise. Increased partner mobility, lack of institutional loyalty and the fact that performance based compensation increases or decreases tend to be “sticky” and long lasting all served to bury lockstep compensation.
- **Client and practice diversification.** The last two decades amply demonstrated that client and practice concentrations can easily be fatal. Technology law firms which made considerable fortunes during the dot.com boom have been eulogized. Firms which fed on the securitization feeding frenzy are gone. Firms that made fortunes servicing now gone Wall Street mainstay financial institutions are still largely reeling. In my view firms that rely on any one client for more than 10% of its revenues or one practice area for more than 30% of its revenues are courting disaster.
- **The death of the up or out rule.** In a world once populated only by associates and equity partners, with those associates not being admitted to the partnership being simply terminated, we now live in a world of [associate caste systems](#), counsel, special counsel, senior counsel, contract partners, equity partners and more. Professors Burk and McGowan have an interesting discussion of some law firms that create the illusion of opportunity for associates by engaging in what they characterize “promotion-to-partner” tournaments, often illusory and arbitrary with current supply and demand factors make largely irrelevant. These issues must be viewed with an eye towards the [necessity of maintaining associate morale and job satisfaction](#).

- **Law Firm Branding** There has been and likely always will be an elite group of top tier law firms which always rate the highest in profit per partner profitability and whose client base is not rate sensitive. The divide between these firms and those below this elite status will likely increase in the future. *Nonetheless, law firm branding at every level is vital. Similarly, individual personal reputations and individual reputations of particular expertise also continue to be main drivers for attracting clients.* [We previously reported on the effectiveness of blogging in establishing the bona fides for enhancing and publicizing expertise and reputation.](#)
- **Clients will likely turn to individual lawyers, rather than law firms.** Individual partner qualifications and recognized personal expertise in particular practice areas is a main driver. Many such partners have been successful in parlaying their retention by cross marketing, relying in material part on firm branding.
- **Cross marketing.** Nothing new here; the simple fact is that the most effective marketing is to existing client bases. In only a slightly different vein, internal referral networks are effective stimulators of business growth factors. Plus ça change, plus c'est la même chose.
- **Corporate legal departments have grown increasingly sophisticated both substantively and in numbers at individual corporations.** The result is that these corporate law departments reduced the amount of business referred to outside counsel. Corporate law departments essentially became competitors of law firms for the sale of legal services. In evaluating retention of outside counsel, corporations evaluate “make or buy” decisions the same way they evaluate the acquisition of other goods and services. *The lesson is obvious: make the case that a “buy” decision is economically advantageous as a key marketing strategy.* The “make or buy” calculus is rendered incredibly complex currently; corporate departments have been required to reduce their internal budgets by at least 2% and their budgets for outside counsel by 5% and more. [Elsewhere](#), I have addressed some options to deal with this conundrum.
- **New technology, downsourcing, insourcing and outsourcing are key factors in the new economy.** Much legal work, particularly time

consuming repetitive work is downsource to temp staff lawyers, not only law firms but corporate general counsel as well. Legal process outsourcing (LPO) is more frequently shipped overseas. Smaller firms with high end technology have various competitive advantages for corporate work, both because of the ability to charge lower hourly rates and being more agile in alternative fee arrangements. Concomitantly, lower rates and the cost of technology acquisition obviously also lowers profitability. Nonetheless, as I have pointed out many times, law firms based in cities with lower costs of than in major metropolitan areas will continue to have significant advantages.

- **Show me the money.** Capital is essential for law firm growth and simple survival; it is needed for expansion, acquisition of new talent and technology. Capital was also essential for the typical law firm model in which all profits were distributed at year's end and new cash was required for the firm to function often through the first two and sometimes three quarters of the year. Most law firms typically operated on a cash loss basis for at least the first half of each year. Tightened credit markets have had a profound effect on law firms, particularly as their need for cash unpredictably increased beyond prior norms, since they also had to pay for real estate and technology acquisitions no longer necessary as headcounts and business shriveled. Banks, once delighted to loan bags full of money to law firms and lawyers, have now turned a very cold shoulder. Underwriting criteria have become more dramatically stringent. Compliance with loan covenants is now closely monitored. Vital cash is now extracted by increased partner capital requirements (sometimes even from non-equity partners, who, in essence are now paying to keep their jobs), longer term payouts of capital for departed partners, lowered draws. A new breed of high end litigation funding companies is emerging and servicing AmLaw 200 firms. Seeking equity capital from non-lawyers [does not seem to be a viable option](#).

## **The Future**

Quoting Yogi Berra (“predictions are hard, particularly about the future”) and John Kenneth Gailbraith (“The only function of economic forecasting is to make astrology look respectable”), Professors Burk and McGowan, “with all

trepidation and humility” do make some predictions about the future. Some highlights and some of our own observations.

- **Downsourcing, Insourcing, and Outsourcing will continue to grow.**
- **Market competition for commoditized work, coupled with technological advances work will result in continued price pressure and profitability.**
- **The number of highly compensated associate partner track positions at large firms will continue to decline.** At the same time, those lawyers who obtain such positions will handle more sophisticated and intellectually stimulating work.
- **The number of non-equity service partners will increase.** In my view, this but another iteration of the increasingly proliferating caste systems discussed [elsewhere](#) and above. Equity partnership status will be far more difficult to obtain; developing, retaining and enhancing portable books of business will be increasingly the key to the magic kingdom, as never before. Again, Plus ça change, plus c'est la même chose. *See, also*, Ecclesiastes 1:9.
- **Our system of legal education and training of lawyers will undergo revolutionary changes.** This subject is addressed at length in my book [Navigating the Perfect Storm: Recruiting, Training and Retaining Lawyers in the Coming Decade \(Ark Press, 2010\)](#) and in a different context in some of my [previous essays](#) on the subject.

We continue to work with firms around the country and the world assisting them in navigating these challenging times. Please contact me at [jkowalski@kowalskiassociates.com](mailto:jkowalski@kowalskiassociates.com) or at 212 832 9070, Extension 310 for more information.

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