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What Law Firms Need to Know to Prepare for the Next Recession

Those that fail to adapt to the changing industry will be hit harder when the next recession arrives.

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Today, in the legal industry's eighth year of economic expansion following the Great Recession, it is easy to be lulled into a false sense of security. "Who knows when the next recession will be?" we ask. "The next recession can't be as severe as the previous one," we tell ourselves. "And if we survived the disastrous effects of the Great Recession, then of course we can handle a smaller one…right?"

This type of thinking sets lawyers up for a very rude awakening. Since 1945, the average duration of a period of economic expansion has been 4.9 years, essentially putting us three to four years overdue for another recession. Moreover, there are strong indications that while the next recession may be milder for the national economy overall, it could potentially hit the legal industry much harder than the national downturn would suggest. Chief among these is the tendency of large corporate clients to forgo entrusting an entire matter to a single firm and instead assigning portions of a matter to a variety of entities, or even sometimes outsourcing high-volume tasks to teams of non-attorneys overseas.

Since the recession ended, these clients have had little incentive to let go of these cost-saving strategies and expectations. This has resulted in the range of law firm services and functions contracting over time—a phenomenon that Thomson Reuters has referred to as "the steady erosion in the traditional law firm franchise"—partially explaining why the demand for law firms' services has remained flat since 2010 despite the overall increase in legal spending over that same period. Indicative of this paradigm shift is the growth and prominence of the legal procurement professional, an individual in a corporation's procurement department whose primary responsibility is to shop around for legal services and decide which firms or alternative legal service providers (ALSPs) to hire.

The tactics used by law firms to survive the Great Recession will not be effective during the next recession. These tactics, broadly, include raising prices; cutting expenses, primarily via layoffs; and slowing or shrinking equity partner ranks. Going forward, however, raising prices will be less effective because of the aforementioned paradigm shift. Higher rates will simply drive business toward cheaper firms and ALSPs, accelerating the continued erosion of the law firm franchise. Layoffs and de-equitizing partners present a different problem. Those solutions are exhaustible, and the expenses and lawyer/partner head counts haven't come close to their peaks in 2007. Law firms can't rely on cuts in those areas to maintain profitability again because there is simply less available to cut.

So, what steps can law firms use to survive the next recession? Instead of speculating, we can take a data-driven approach by looking at which firms have experienced the most success in terms of both profitability and market share post-recession and examining what novel tactics they have employed to achieve that success.

Thomson Reuters Legal Executive Institute released a study in 2017, the "Dynamic Law Firms Study," that tackled that very question. The study gave firms a composited score based on revenue per lawyer, overall profit and hours billed (as a rough analog for captured market share). The firms were then ranked, with the top quartile of firms dubbed the "dynamic firms" and the bottom quartile the "static firms." The difference between these two cohorts is stark: The dynamic firms increased their market share (and corresponding profits) by about 2 percent on average, while the static firms saw their market share shrink by about 5 percent on average. These dynamic firms were the only firms that managed to increase their attorney roster without a substantial decrease in per-lawyer productivity, which suggests that capacity (i.e. number of available lawyers) was not the limiting factor in the failure of other firms to increase market share.

The study made two somewhat surprising findings. First, dynamic firms often gave their clients fewer discounts and pre-bill write-downs than other firms. Second, dynamic firms actually increased their overhead expenses, spending proportionally double what static firms did for business development and coaching and triple for technology-related expenses, which, according to the study, "seems to represent a difference in philosophy … that could be characterized as 'investment versus status quo.'" These findings were true across the board, regardless of size or region, and appear to contradict the traditional wisdom regarding what to do in response to clients demanding more value for their money—namely, cutting prices and reducing expenses.

So what actionable insights can we draw from this? The first and most obvious is that all firms, big and small, must be able to change and adapt, for those that attempt to cling to the status quo will suffer before the next recession even begins. The second insight is that law firms should drive up the value of their services to meet their prices rather than reduce their prices to match their perceived value.

To these ends, there are two basic approaches for law firms. The first is to off-load tasks (especially high-volume, repetitive tasks) that truly do not require attorney time and expertise, even if that means reevaluating tasks that have always been deemed important. The second is to enhance the capabilities of attorneys by allowing them to provide more value when performing the tasks that do need their expertise. It is extremely important to note that both approaches are mutually supportive: The former lets attorneys devote more time to the latter, and the latter allows better high-level strategic decisions to be made about the former. It is impossible to ignore one approach in favor of the other.

Key to both approaches is the re-evaluation of the law firm's relationship with ALSPs. While most lawyers tend to think of independent e-discovery or document review firms when hearing the term, the industry has expanded to encompass a greater variety of tasks, including project management and administrative services, and the drafting and revision of contracts and litigation documents, performed by a greater variety of providers, including automation and artificial intelligence-powered tools and services.

These ALSPs provide an opportunity for firms to incorporate technology into their business model, especially now that ALSPs are leveraging artificial intelligence. Lawyers now have access to commercial tools and services that can actually automate the creation of junior attorney work product in a way that mitigates data security concerns that firms claim prevented them from using other types of ALSPs. Technology plays a key role in the second approach as well, and many of the legal tech products on the market today are decision-making aids that aim to help attorneys make better-informed, data-driven decisions. These tools are typically aimed at either predictions (the likely jury award for a case to assist in settlement negotiations, for example) or assisting with legal research (such as using natural language processing to augment search tools).

Despite the increasing availability and reliability of these tools and services, lawyers have historically been unwelcome to these intrusions in the legal industry, both as a cause and result of the aforementioned "erosion of the law firm franchise." Law firms continue to express lingering doubts about the quality of the output these tools and services can provide and about their value proposition. And, ultimately, it's the client's assessment of the quality and value of the legal services that will determine their price. Firms that cannot see the benefits and value of ASLPs will be left behind and will have a much more difficult time in the next recession.

Perhaps the ultimate solution, however, is one rooted beyond the mere adoption of key technologies by law firms. Perhaps the time has come to reinvent the relationship between client, law firm and ALSP. Instead of viewing each other in a customer and service-provider affiliation, a reimagined partnership would lead to more transparent and mutually beneficial relationships. More specifically, all three parties could openly discuss and identify specific pain points and efficiencies to be achieved, and all three parties could agree on a three-way arrangement that benefits all parties. For example, the client could commit to using the law firm exclusively on a certain type of matter across multiples jurisdictions, and in return, the law firm would provide specific client-centric processes and fee arrangements, all made possible by the third leg of the stool—the technology vendor. The vendor would materially increase efficiencies for the client—all of which lead to better results and costs savings—while simultaneously increasing profitability and client stickiness for the law firm.

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