



How law firms were able to post record profits in the most challenging of years

White paper

2020 was described in many different ways throughout the pandemic. Unprecedented. Challenging. Historic. Disruptive. The list is nearly endless. No matter how you referred to it, the weight of the uncertainty (another frequent descriptor) was unlike anything the world had seen in decades. Entire industries shut down for months, and we still don't know what "normal" is going to look like once COVID-19 is under control.

Even with a downturn in demand across nearly all industries, it was unexpected, to say the least, law firms reported record year-over-year profits compared to 2019. So, how did they do it?

In this white paper, we will explore the unique market conditions that dominated the 2020 legal industry, how firms were able to post such impressive results under those conditions, and the role that strategic tech investment played in their success. We will also look ahead to see what firms can expect through the rest of 2021.

A LOOK BACK AT MIDSIZE LAW FIRM PERFORMANCE IN 2020

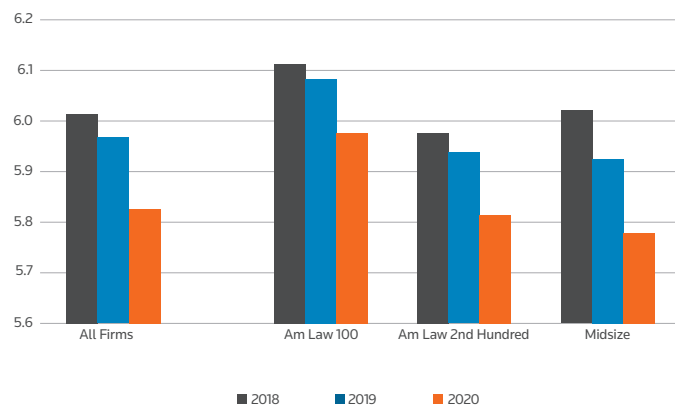
On paper, 2020 appeared to be a tough year for midsize firms. Initially, Q1 looked to be a continuation of a strong 2019. But, as the scope of the pandemic came into focus, it became evident that 2020 would be anything but normal.

Demand for legal services was down

With businesses across all industries forced to comply with government stay-at-home orders and not knowing when they would be able to reopen, there was a lot of belt-tightening going on. This environment could have contributed to the 2.6% drop in demand (Figure 1) for legal services that midsize firms saw compared to 2019 levels.

Demand for the services of midsize firms was lower than demand for the services of their larger counterparts, but not significantly off historic norms. Generally, the larger firms' customers were better off during 2020 compared to the clients of midsize and smaller firms, so it seems natural that performance would follow through to the law firms that serve those customers.

Figure 1



Law firms' response to changing market conditions

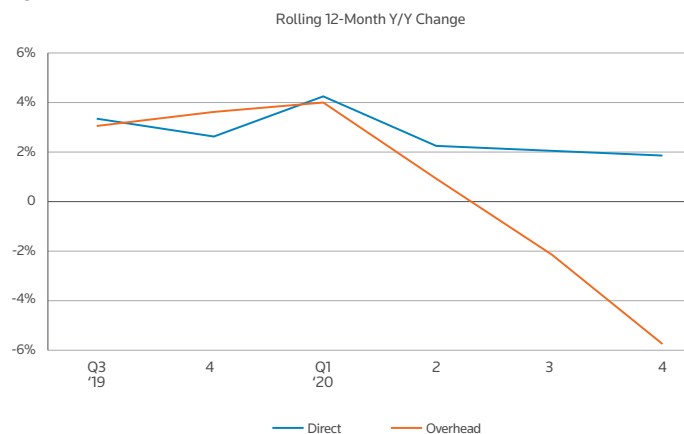
Direct expenses vs. indirect expenses

Direct expenses refer to those expenses related to fee earners, primarily the compensation and benefits cost of lawyers and other timekeepers.

Indirect or overhead expenses refer to all other expenses of the firm, including occupancy costs, administrative and staff compensation and benefits, technology costs, recruiting expenses, business development costs, and the like.

With clients tightening their belts, it's no surprise that law firms were close behind them. After the scope of the COVID-19 crisis became clear in March and April, almost all law firms imposed aggressive cost control measures. In fact, the Thomson Reuters Law Firm Business Leaders Report showed that over 81% of firms stopped or significantly reduced discretionary spending. Midsize law firms held direct expenses at near-zero growth year-over-year and reduced their overhead expenses by 4.5%. (Figure 2)

Figure 2



Where did law firms cut expenses in 2020?

We can leverage Thomson Reuters® Peer Monitor, which uses actual anonymized data direct from law firms' financial management systems, to provide insight into midsize law firms' cost control strategies:

- Staff compensation down 1.3%
- Occupancy down 1.5%
- Outside services down 3.2%
- Benefits down 4.3%
- Office expenses down 22.5%
- Recruiting down 40%
- Marketing and business development down 5%

It's not difficult to imagine that some of these reductions led seamlessly to others (e.g., reduced occupancy leading to reduced office expenses).

There is no doubt that law firms were purposeful in their efforts to control costs at all levels of the business. And there were efforts underway at most firms to control costs in their business operations as well. Many looked at making more efficient use of office and administrative space as well as reviewing support staffing and work processes. In addition, they reduced business travel and increased capabilities around virtual meetings.

Where did they increase spending?

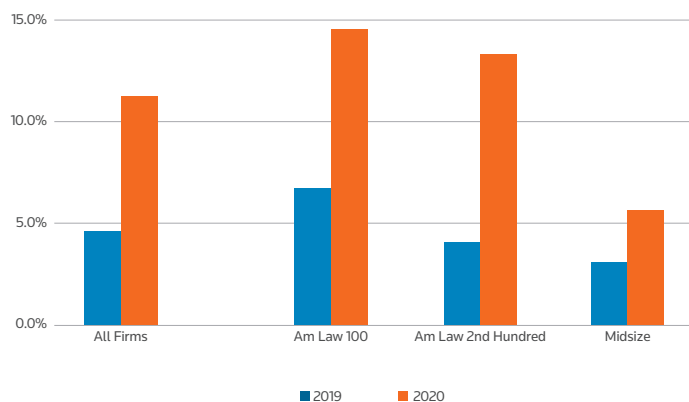
As telling as the list of 2020 spending cuts is for law firms, there are two areas where spending actually increased that are equally compelling. Spending on technology and knowledge management/research were both up 2%.

Making these types of strategic legal tech investments was imperative to the survival of many midsize firms in 2020. Not only did the technology provide the connectivity they needed to navigate the new work-from-home environment, it also set them up for continued success once the new normal is established post-pandemic. Law firm leaders also acknowledged that quality legal research tools were critical to the efficient delivery of legal services and chose to increase their investment in these areas to improve their operations.

NOW—ABOUT THOSE RECORD LAW FIRM PROFITS

One of the key performance metrics that law firms use is Profits per Equity Partner (PpEP). And PpEP was way up across the board in 2020. (Figure 3) Am Law 200 firms reported a year-over-year increase in PpEP of 9.1% and the midsize law firm segment saw a year-over-year increase in PpEP of 5.9%; both new records for as long as Thomson Reuters Peer Monitor has tracked that metric.

Figure 3



With demand down, how were profits at record highs? The actions taken by firms during 2020, combined with the significant reductions in expenses resulting from office closings and other restrictions on business operations, gave rise to very strong growth in profits per equity partner.

The experiences of 2020 underscored the importance of sound financial practices, leading many firms to more rigorous management of timekeeping, billings, and collections. In the most recent Law Firm Business Leaders Report from Thomson Reuters, a resounding 92% of respondents said improved budgeting and cost management of client matters will be a priority. While cutting their own expenses certainly helped, it was the diligent management of client matters that was the real key to higher profits for most firms.

What enabled that level of financial management to happen?

One thing that quickly became clear at the start of the pandemic was the need for firms to take a proactive stance in their planning. The most successful firms seemed to place technology investment at the center of their plans. And most of them focused their efforts in two primary areas:

1. Robust practice and financial management software

Resource management became extremely important to businesses' survival during the pandemic. For law firms, that meant streamlining processes and closely managing the financials.

Some of the key elements of their practice and financial management solutions included:

- Mobile timekeeping
- Reporting and monitoring
- Record access and data insights

2. Cloud-based software allowing for rapid shift to and continued support of remote work

It was a common theme across many industries in 2020: working from home. Businesses that would never have considered remote work historically were suddenly thrust into it without any warning—or any choice. The legal industry was one that had to make a hard pivot.

Some of the key elements of firms' cloud-based solutions included:

- Access anywhere
- Security
- Decreased reliance on internal IT department for maintenance



WHAT OTHER LEARNINGS DID LAW FIRMS TAKE AWAY FROM 2020?

Few business leaders—regardless of their industry—would deny that 2020 was a year filled with new experiences and sharp learning curves. So, what did law firms take away?

Law firm leaders are more open to adopting legal tech

Partners at most firms now have a broader acceptance of the role of technology in the effective delivery of legal services compared to pre-pandemic opinions. Case in point, 84% of law firm partners surveyed by Thomson Reuters Acritas expected their firms to increase investments in technology. While we should not take this as any kind of sign that resistance to change is a thing of the past, it could indicate that the experience of pivoting in response to rapidly changing market conditions in 2020 has created a willingness to at least consider other methods of service delivery.

Data from the Legal Management Resources LLC October 2020 Law Firm General Counsel Roundtables Survey on the Impact of COVID-19 (Law Firm GC Survey) also provides some interesting insight. Among law firm senior risk managers, 81% report that their experiences during the pandemic will cause a significant change in their firms' technology investments and strategy over the next few years. Likewise, 72% of large firm business leaders report that greater use of technology to cut costs will be a priority for their firms in 2021.

Most law firms now acknowledge that remote working can work

Some 81% of senior risk managers participating in the Law Firm GC Survey believe that a significant increase in remote working—as compared to the pre-COVID period—will remain a permanent fixture in their firms' operations.

The disruptions resulting from work-at-home arrangements were less serious than most firms expected. Interestingly, Acritas reports that the proportion of U.S. lawyers who now want to work remotely at least one day a week has doubled from the pre-pandemic period. While 37% of lawyers expressed an interest in remote work prior to the pandemic, 76% now favor the remote work option.

Law firms are more open to new practice models

According to the Law Firm Business Leaders Report, 59% of business leaders at large law firms responded that they either have implemented opportunities for more collaboration or will implement them within the next year. Some 52% also responded that their firms' compensation systems either currently provide adequate incentives to encourage such collaboration or will provide them within the next year.

Acritas also reports that the perception of many law firm partners indicated an improvement in working practices in the remote environment rather than any kind of deterioration. In addition, data from Acritas Sharplegal indicates that a majority of partners themselves now favor working remotely at least one day a week.

WHAT WILL SUCCESSFUL LAW FIRM OPERATIONS LOOK LIKE IN 2021? AND WHAT CHANGES SHOULD FIRMS EXPECT?

As much as law firms had to be flexible in their approaches to dealing with the new conditions brought on by the pandemic, it is beginning to appear that a complete return to the industry's previous normal is unlikely. Some of the changes that they made have the potential to become permanent. And others may be required in a post-pandemic environment.

Law firm professional and support staff ratios

For the past several years, the industry has seen law firms actively reduce their professional and support staff ratios. The fully remote work environment has exposed the opportunities to further streamline their operations, including the size and composition of support teams.

While some roles that were initially furloughed have since been reinstated, others have been eliminated in their new structures. Law firms are planning on reducing the number of administrative staff, paralegals, and hospitality staff they employ, relying instead on technology to perform those duties directly—or making them easier for lawyers to cover.

On the other hand, the industry is likely to see an increase in billing and collections, technology, business development, and pricing staff. Some firms are attempting to keep their current employees and transition them into new roles, while others are starting anew.

Enabling technology at law firms

With technology enabling the legal industry to continue operating in a remote environment, there has been a substantial increase in appreciation for legal tech investment. It would not be surprising to see greater and faster adoption of technology than there was across the industry in the pre-pandemic era.

Historically, the investments that law firms have made in technology have been better than those made by their clients. This includes corporate law department clients, who may face challenges obtaining adequate budgets to invest in new technology. Looking forward, this investment advantage, if used well, will enable firms to continue to position themselves as a compelling option in the efficient delivery of legal services.

Changing financial structures and expectations

Given the success firms have enjoyed this year with the shift in their approach to billing and collections, it's reasonable to expect a continued focus on shortening the billing and collections process. This, of course, is further enabled with the right financial management software.

In their efforts to shorten the work-to-pay cycle, some firms are looking to e-billing solutions. These solutions have proven to be helpful in resolving issues with rejected invoices. In the case study, Seamlessly embedding gold standard e-billing into law firm systems, Howard Vogel, Chief Financial Officer and Firm Administrator at Capehart Scatchard explained, "Sometimes, through no fault of the software, bills can be rejected, for instance, if items are not complete. eBillingHub is a great tool for our collections group to see what the issues are so they can be resolved rapidly, and the bill re-submitted."

On another front, firms will also continue to examine the ways in which they are capitalized, and in particular, some firms can be expected to increase their partner paid-in capital levels. As evidenced by firms' tendencies during the early days of the pandemic, access to liquidity was one of their key priorities. With large firms reporting having enough liquidity to cover four months of expenses on average, the industry saw firms take a number of steps to manage cash flow.

A greater focus on law firm business development

2021 is shaping up to be a highly competitive environment. This will be especially true in practice areas where substantial growth is expected, including bankruptcy, financial restructuring, labor and employment, and regulatory investigations. Growth is also expected in industries experiencing an increase in the need for legal services, including technology, insurance, life sciences, and financial services.

New opportunities will present themselves, but firms will need to focus on how to deepen and broaden relationships with their existing clients. It will be important to examine current clients' businesses to determine whether any of the practice areas or industries mentioned above have or will come into play as a result of the pandemic.

For their part, in-house legal departments are also feeling budget constraints, but there may be a shift back to an outsourcing model as corporate law departments review fixed costs associated with keeping a team of attorneys on staff. They will continue to be strategic in what matters they choose to address, the types of work they keep in-house, and what they send to outside firms and other providers. Despite the downturn, many General Counsels are comfortable with rate increases, and 46.4% expect rate increases in 2021, but there has to be an equivalent increase in value delivered by the firm.

A recent Legal Department Operations Index survey revealed law departments' most urgent priorities. They are focused on enforcing billing guidelines (81%), requiring matter budgets from law firms (42%), and regular reviews of budgets and comparing to actual spending (51%).

The key for law firms is to deliver value for the rate:

- More work product
- Adherence to budget
- Collaboration between the firm and the client's legal department
- Deeper insight into the law firm's activities, strategy, and potential success (litigation analytics)
- And of course, results

An integrated strategy for law departments and law firms can only strengthen key relationships over the long-term.

MAPPING YOUR LAW FIRM'S SUCCESS IN 2021

As challenging as 2020 was on a global scale, many law firms were able to post record results through shrewd attention to financial metrics, early adoption of technology, and a focus on delivering value to their clients. The rest of 2021 will come with its own set of challenges as the world continues to adjust to the impacts of the pandemic.

The need for lean matter management and the ability to respond to the requirements of cost-conscious clients will not go away. The successful firms in 2021 and beyond will continue to optimize staffing ratios, control costs, and embrace the use of technology wherever it can contribute to the firm's business efficiency and delivery of legal services.

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