



2022 REPORT ON THE STATE OF THE MIDSIZE LEGAL MARKET

by

Thomson Reuters Institute

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2022 Report on the State of the Midsize Legal Market

Solid results in a pressure-filled environment

2022 Report on the State of the Midsize Legal Market

The midsize law firm¹ segment in the United States has certainly not been immune to the volatility experienced broadly in the past several years. But the average midsize law firm seems to have staked a position going into the latter half of 2022, leaving them in a better position relative to the market than they were just a few years ago.

We must look all the way back to 2015 to find a year in which the average midsize law firm outperformed its Am Law 100 counterparts in terms of demand growth.² Yet that is exactly the situation found through the mid-point of 2022. While other trends such as dramatically increasing overhead expenses and associate compensation are placing a drag on the financial results for midsize law firms, many other fundamental markers are looking quite positive.

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In this latest edition of the *Report on the State of the Midsize Legal Market*, we will undertake an in-depth exploration of a number of factors contributing to a generally bullish picture for midsize law firms, but we would do well to also acknowledge that numerous challenges remain.

As an example of one such challenge, midsize law firms have generally fared well in terms of attorney attrition.

In fact, research from the Thomson Reuters Institute indicates that midsize law firms make up a disproportionate percentage of what has been dubbed “Stay” law firms, those firms with lower rates of attorney turnover, indicative of those firms being a desirable place for attorneys to work.³ For obvious reasons, this is a positive finding, particularly in light of the fact that midsize law firms tend to have lower associate compensation scales and generally offer smaller raises; the clear implication is that for at least some lawyers, a good working environment is about more than just money.

However, the competition for associate talent has unquestionably impacted the ability of midsize law firms to recruit and retain talent. Sparked by large salary increases by major international firms, midsize law firms have similarly found themselves needing to raise

¹ For our purposes here, midsize firms are defined as those firms participating in Peer Monitor / Financial Insights, but not included within the Am Law 200 rankings. Thomson Reuters Peer Monitor® / Financial Insights data is based on reported results from 168 U.S.-based law firms, including 45 Am Law 100 firms, 50 Am Law Second Hundred firms, and 73 additional midsize firms.

² “Demand” is viewed as equivalent to total billable hours recorded by law firms during a specified period.

³ See “Law firms competing for talent in 2022: Will lawyers stay or will they go?” Available at <https://www.thomsonreuters.com/en/reports/law-firms-competing-for-talent-in-2022.html>

salaries in order to stay competitive. The *2022 Report on the State of the Legal Market* discussed the research of Frederick Herzberg, who in the 1950s posited that paying employees less than what they think they're worth creates *dissatisfaction*, but paying them what they think they are worth is not sufficient to make them satisfied employees⁴ — a sort of “necessary versus sufficient” line of argumentation.

In this way, midsize law firms with lower pay scales must be careful to create firm cultures that provide satisfaction in ways other than cash compensation. There may be a plethora of necessary conditions to create a favorable working culture, which if present, can possibly overcome the allure of a higher salary. But absent these necessary conditions, it becomes increasingly likely that a higher salary will be sufficient to draw lawyers away. And particularly in today's marketplace, every vacancy which must be filled represents a substantially more expensive endeavor than in years past.

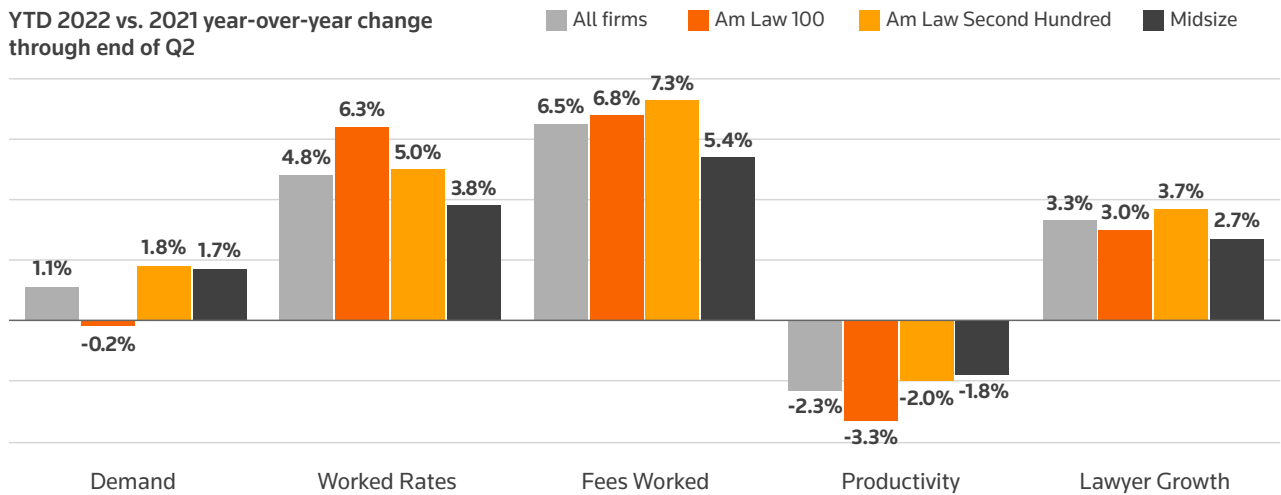
Yet even in the face of some factors which will give wise law firm leaders pause, midsize law firms are on a generally favorable footing upon which to continue the venture into whatever the future may bring.

⁴ See the “2022 Report on the State of the Legal Market”, available at <https://www.thomsonreuters.com/en-us/posts/legal/state-of-the-legal-market-2022/>

A by-the-numbers exploration of midsize law firm performance

While midsize law firms continue to trail their larger firm peers in some key metrics, they are holding their own, if not taking the lead in other areas.

Figure 1: **Key performance measures**



All timekeepers. Billable time type; non-contingent matters.

Source: Thomson Reuters 2022

The average midsize law firm crossed the mid-year threshold in near parity with the average Am Law Second Hundred firm, posting 1.7% demand growth for the first half of the year compared to 1.8% for their slightly larger competitors. And both segments noticeably outperformed their Am Law 100 colleagues.

Worked rate⁵ growth for midsize law firms trailed behind the rest of the market, predictably leading to slower-than-average growth in fees worked for midsize law firms.⁶ This lower revenue potential means that a focus on collections will be key for midsize firms as the year progresses.

However, some areas where midsize law firms trailed their larger competitors actually redound to midsize firms' benefit. Midsize law firms posted the slowest average lawyer growth through the first half of 2022. When offset against strong demand performance

⁵ Worked rates, also referred to as negotiated rates, are the rates that a firm agrees to with particular clients for work on given matters.

⁶ Fees worked is a proxy for potential revenue and measure the year-over-year change in the product of worked rates multiplied by demand hours over a given time period.

this means that midsize law firms actually exhibited best-in-show performance in terms of stemming productivity decline. The average midsize firm saw their productivity decline by only 1.8% in the first half, compared to 2.3% for the average firm across the market.

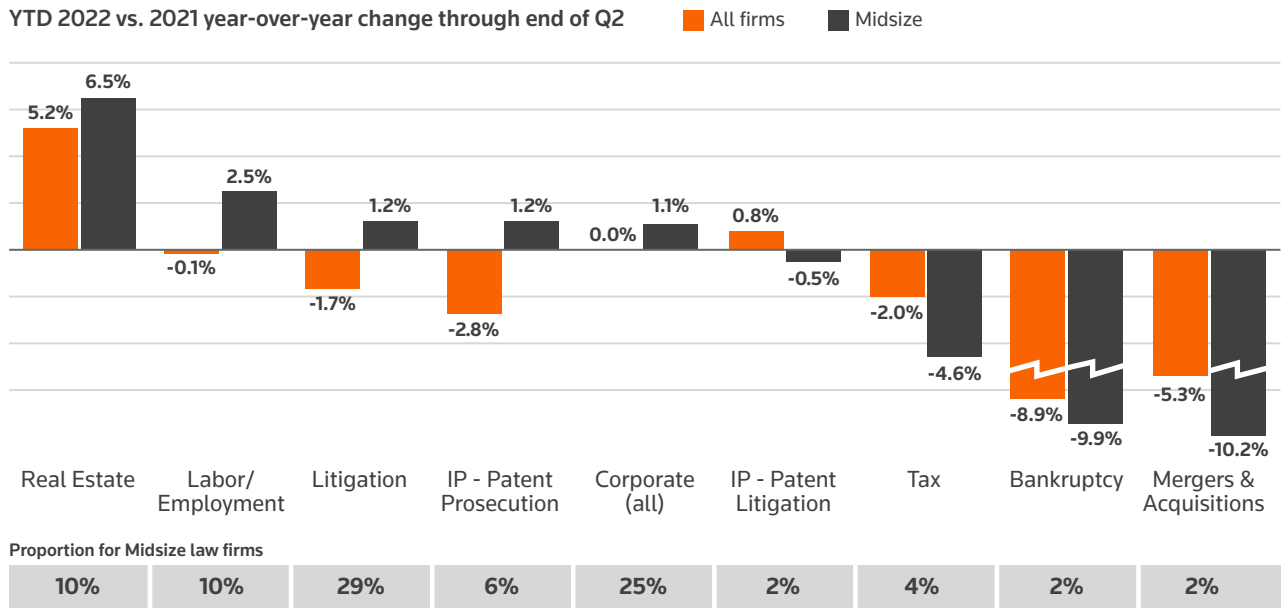
While a 1.8% reduction in productivity may seem like negative news, and long-term, decline in productivity is certainly something to avoid, it can also be viewed as a positive development for at least two reasons. First, there is the phenomenon whereby “less bad is good.” Put another way, being the segment with the smallest decline in productivity puts midsize law firms into a relatively positive competitive position. Second, much of the latter half of 2021 and the first half of 2022 was defined by stories of attorney burnout. Some alleviation of the average lawyer’s daily working burden may help to create some breathing room for lawyers, many of whom have been worked ragged since early 2020. And that, in turn, may help alleviate at least some of the appurtenant attorney attrition and turnover.

Productivity performance, however, is unquestionably dependent on demand performance, a topic worthy of deeper exploration.

Demand for midsize law firm services

The overall picture of demand growth for midsize law firms appears favorable, and there are indications it may become even more so as the year progresses.

Figure 2: Practice demand

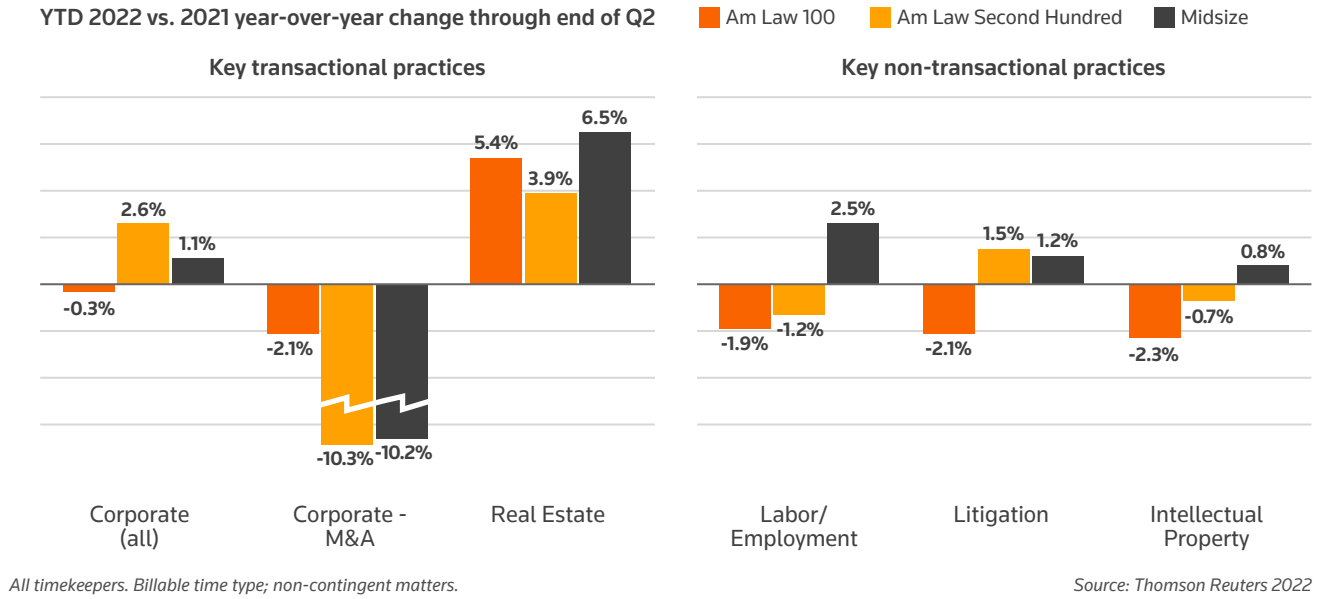


All timekeepers. Billable time type; non-contingent matters.

Source: Thomson Reuters 2022

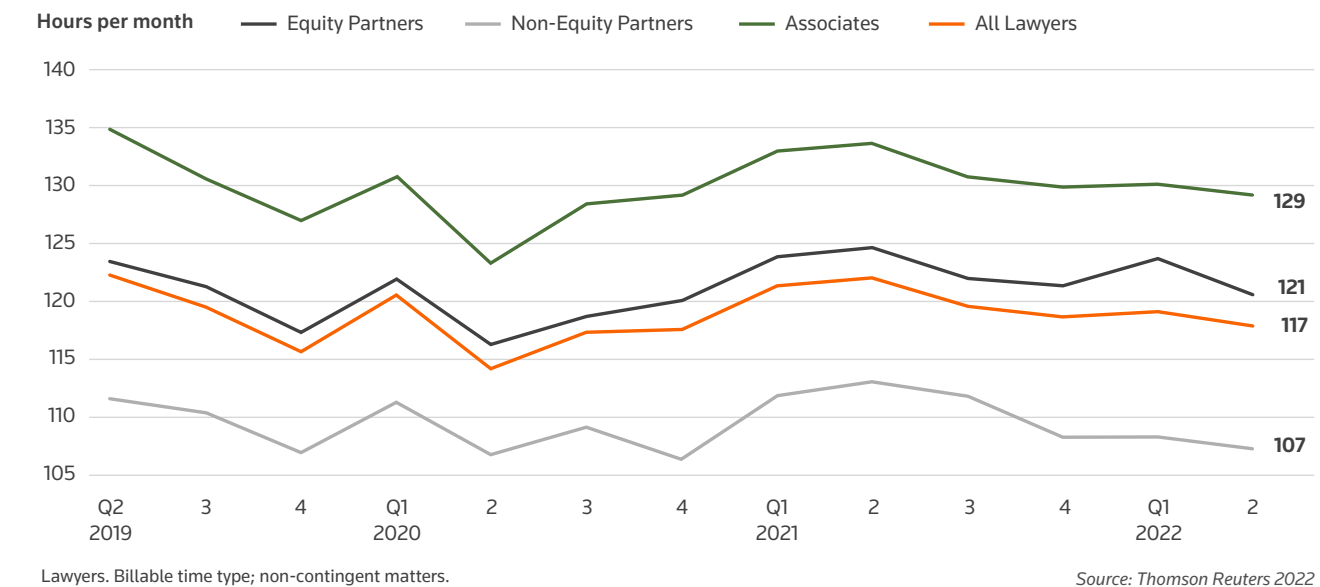
The average midsize law firm outperformed the average law firm in a variety of key practice areas in the first half of 2022. Most notably, while the average firm experienced contracting litigation demand and flat corporate work through the mid-year point, both practices grew for midsize firms (1.2% and 1.1% growth, respectively). This growth, coupled with strong performance by work in the real estate, labor & employment, and patent prosecution practice areas was sufficient to stave off the effects of contractions in patent litigation, tax, bankruptcy, and M&A work.

Figure 3: Practice demand's influence on overall demand in each segment



Comparisons between the practice demand performance of midsize law firms relative to other segments is also enlightening. Midsize firms hold a clear advantage in growth of their real estate practice, but slightly trail Am Law Second Hundred law firms in growth of overall corporate work. Labor & employment growth also compares quite favorably with midsize law firms as the only segment to show growth so far this year. The balance of these practices relative the other segments analyzed demonstrates why overall demand growth year-to-date for midsize firms has been so favorable.

Figure 4: Hours per lawyer



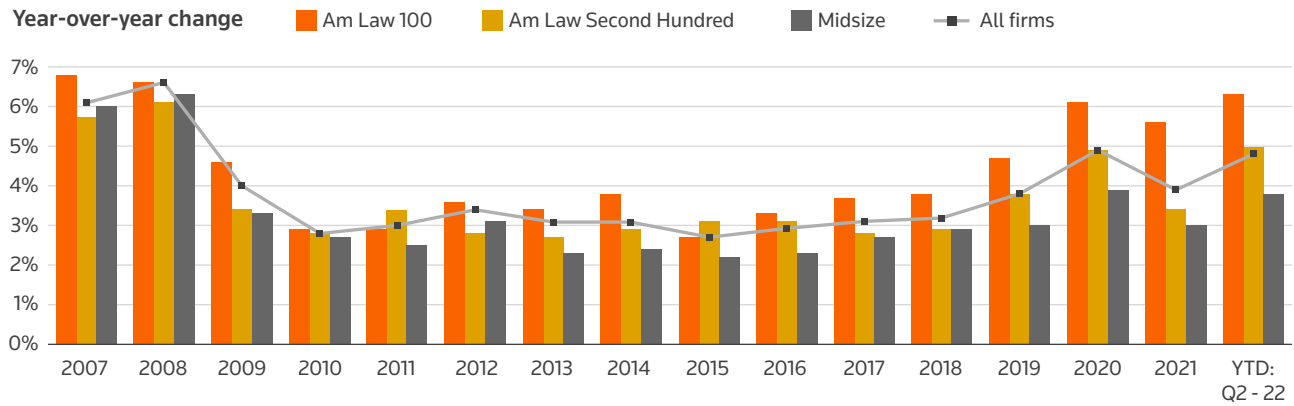
In total, the effects of these practice demand figures are bore out in productivity in terms of hours per lawyer. Over the course of the past 36 months, the average lawyer saw their personal productivity decline by about 5 fewer hours per month compared to the same time in 2019, 117 hours in Q2 2022 compared to 122 hours in Q2 2019. This decline in the average has been seen in every timekeeper class, including associates.

Notably, despite the myriad stories of attorney burnout over the past year, at no point during the course of the past two years were lawyers actually working more billable hours on average than they were in 2019. However, that is not to suggest that burnout is not real or that firm leaders need not be concerned about it. Crucially, if an attorney says they are getting burned out, they are likely telling the truth. And the singular metric of hours billed per month does not account for other factors such as the volume of work being done in those hours, the number of matters handled, the complexity of work being done, or external stress factors beyond the scope of an attorney's work life.

Turning hours into money

Demand hours are a necessary component to a law firm’s continued financial viability, but they are, yet again, not sufficient standing alone. Those hours must be billed at a competitive rate and then collected with reasonable haste so as to maximize the potential realization against the total value of the fee for a given matter.

Figure 5: **Worked rate growth**



All timekeepers. Billable time type; non-contingent matters.

Source: Thomson Reuters 2022

Midsize law firms have, for more than a decade, trailed other segments in terms of the pace of worked rate growth. In fact, after narrowing somewhat in 2021, the gap between rate growth for midsize law firms and Am Law Second Hundred firms has once again widened, and the gap with Am Law 100 firms grew ever larger.

Rate growth represents another dichotomy for midsize law firms. On the one hand, slower worked rate growth can be a positive factor, particularly in a time when clients are experiencing rapidly rising expenses. Being seen as a more cost-effective alternative to BigLaw firms could paint midsize law firms in a favorable light. Indeed, many corporate general counsel have been openly discussing and writing about the efficacy of pushing work to lower-cost providers as a solution to the “do more with less” challenges⁷ the current economy has catalyzed.

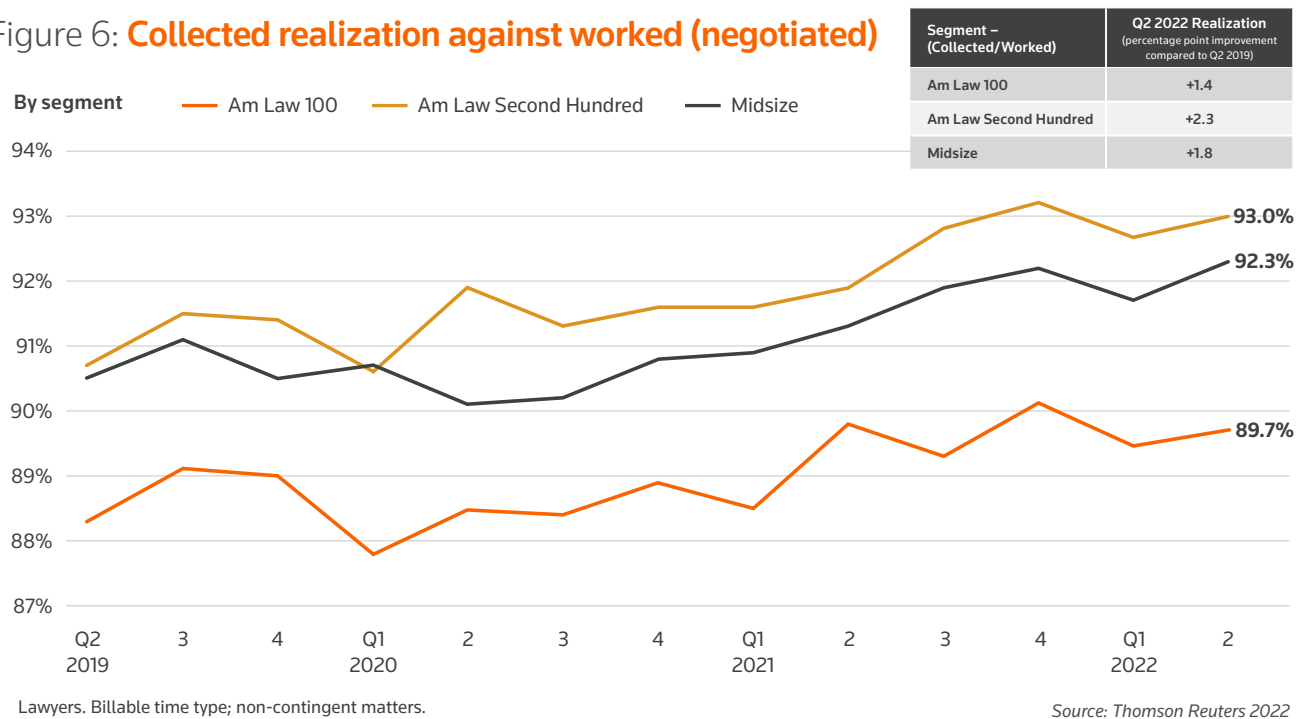
But on the other side of the lower-growth coin looms the unavoidable reality of inflation. Even with the smallest average rate increases throughout the 2010s, the average midsize law firm still enjoyed at least some advantage in terms of rate growth relative to inflation. Today,

⁷ See “Top 5 ways in-house legal teams can do more with less” by Irene Liu & Megha Sharma; Thomson Reuters Institute blog (Sept. 6, 2022); available at <https://www.thomsonreuters.com/en-us/posts/legal/in-house-legal-teams/>.

few firms enjoy rate growth that is outpacing inflation.⁸ The danger for midsize law firms is that their slower pace of rate growth places them at an even greater potential disadvantage relative to inflation. And it seems unlikely that clients will be willing to agree to substantially larger rate increases to place law firms back in favorable positions relative to inflation, as clients themselves are feeling a significant economic pinch.

Rather, it is incumbent upon law firms to adopt other strategies to protect revenue streams and profitability.

Figure 6: **Collected realization against worked (negotiated)**



Key to this effort is growth in realization of the firm’s rates. Historically, midsize law firms have performed well in terms of realization of their worked rates, notably better than the average Am Law 100 law firm. But what is of significance is the notable upward trajectory of collected realization against worked rates since mid-2020. This is a result of two factors: Improvement by law firms in their billing realization,⁹ and a lack of increased pushback on invoices on the part of clients. As a result of these factors, as billing realization has improved due to enhanced firm efforts, collected realization has similarly improved.

But once again, increasing rates and improved realization are necessary, but not sufficient components alone to improved law firm profitability. In addition to the money coming in the door, we must also examine the money that firms are spending.

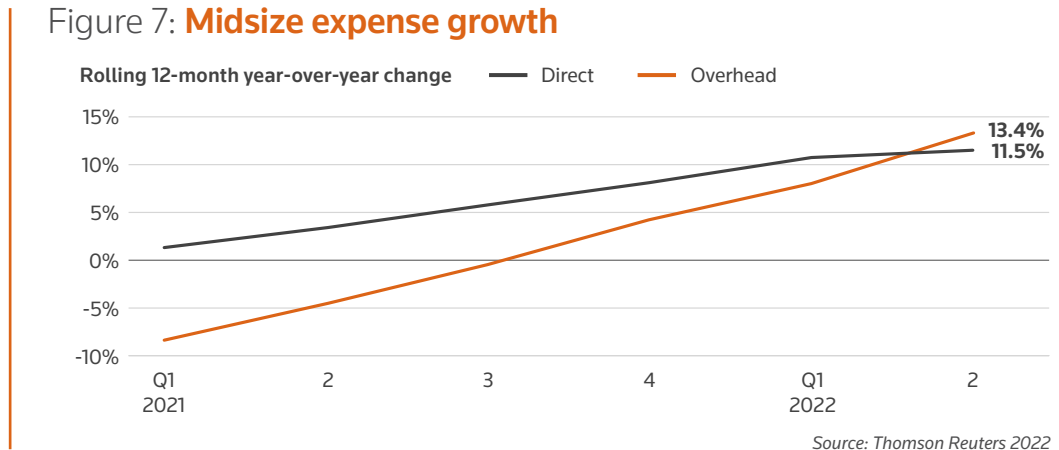
⁸ The Thomson Reuters Institute generally uses core personal consumption expenditure (PCE) inflation for comparison to rates rather than headline consumer price index (CPI) inflation because the data sampling used in the PCE is more robust and it captures more extensive economic behavior than the CPI, while excluding more notorious categories such as energy and food prices. The Federal Reserve relies on the same metric. For Q2 2022, core PCE inflation was 4.7%, while headline CPI inflation was 9.1%.

⁹ Billing realization versus worked rates is the percentage of the value of work billed to clients at the worked rates.

The impact of dramatically increasing expenses

Even a brief glance at the expense growth lines for midsize law firms immediately reveals the dominant trend.

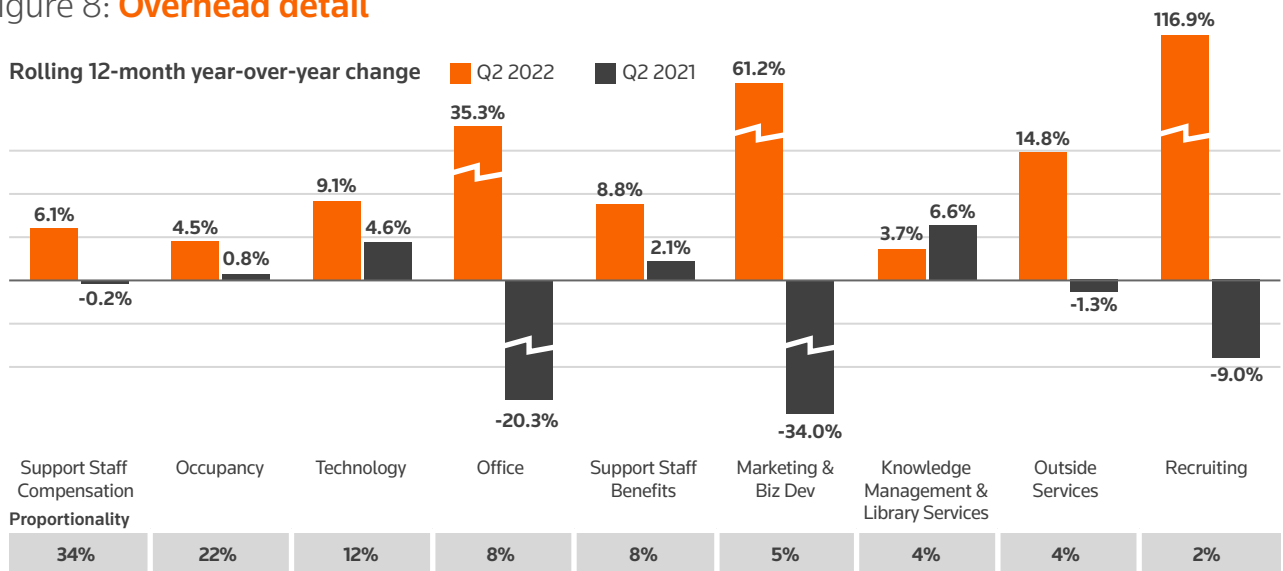
Figure 7: **Midsize expense growth**



Both direct and overhead expenses¹⁰ for midsize law firms have seen dramatic growth so far in 2022.

Overhead expenses stepped back into positive territory in Q4 2021, and have quickly outpaced the growth of direct expenses. For Q2 2022, overhead expense growth, calculated on a rolling 12-month average, reached a new peak of 13.4%.

Figure 8: **Overhead detail**



¹⁰ Direct expenses refer to those expenses related to fee earners, primarily the compensation and benefits costs of lawyers and other timekeepers. 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.

Overhead expenses have grown across the board for midsize firms. Expenses for office, marketing & business development, outside services, and recruiting have grown by double, if not triple digits. The increases in office and marketing & business development expenses likely represent a return to some semblance of “normal” as lawyers return to the office with greater frequency and resume normal activities such as client visits and attending conferences.

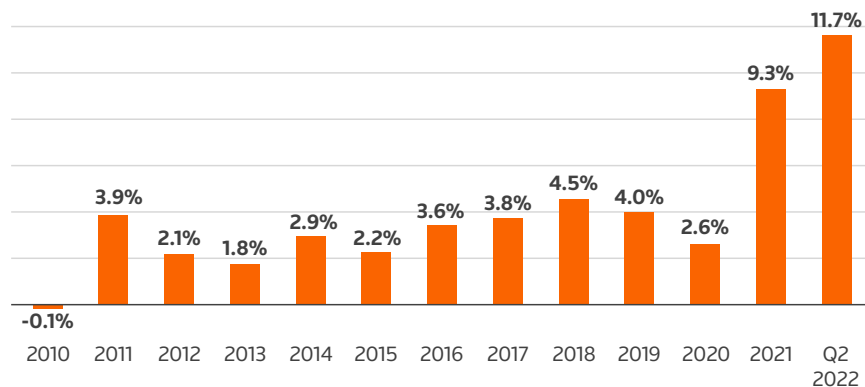
Technology expenses represent a bit of an outlier, as that category did not really experience the pandemic-related slowdown many other expenses did. In fact, investment in technology has been steadily growing year-over-year, including the 9.1% growth posted in Q2 2022. The fact that tech expenditures seem to have not yet plateaued indicates that midsize law firms — which were seemingly playing catch-up early on in the pandemic to implement remote-working capabilities — are now continuing to invest in their tech stacks to build new capabilities and competencies.

Earlier in the report, we discussed the potential challenge midsize law firms faced from any sort of lawyer attrition due to the rising cost of filling vacancies. This is readily apparent in the nearly 117% increase in recruiting expenses in the past 12 months. While recruiting expenses represent only 2% of total overhead expenditures for the average midsize law firm, growth exceeding 100% in even a relatively small expense category can place a strain on a law firm’s finances, particularly when coupled with 6.4% growth in average support staff compensation.

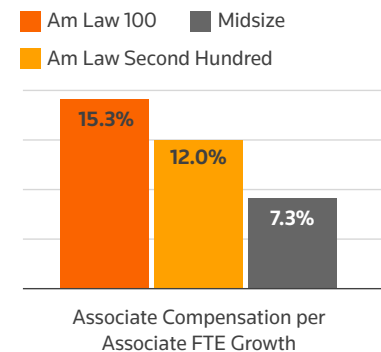
Recruiting expenses alone also fail to capture the other reality involved in finding new legal talent in today’s market – the increasing salary scale.

Figure 9: Associate compensation per associate FTE growth

Rolling 12-month year-over-year change



By segment – Q2 2022
Rolling 12-month change



Associate Compensation Growth: Associate Compensation divided by Associate FTEs

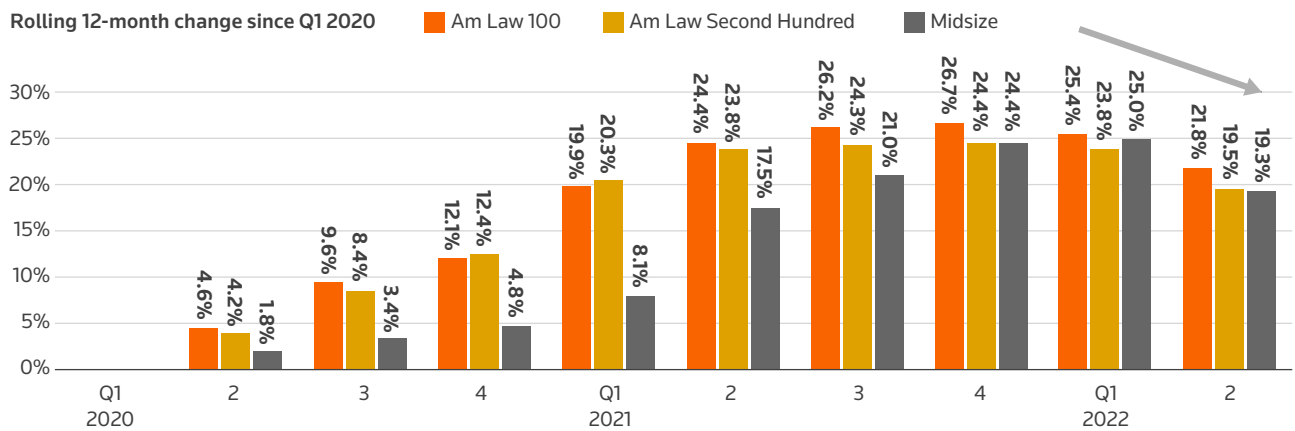
Source: Thomson Reuters 2022

Midsized law firms, thus far, have avoided the bulk of the impact of associate salary increases. While Am Law 100 firms saw their associate compensation grow by 15.3% in Q2 2022, and Am Law Second Hundred associate compensation grew by 12.0%, associate compensation for the average midsized firm grew by a more modest 7.4%. There are indications that growth of associate compensation, and direct expenses more generally, may have reached a sort of plateau. Direct expenses showed relatively minimal acceleration between Q1 and Q2 2022, particularly compared to the rate of acceleration seen throughout 2021. But it is important to note that the potential plateau from Q2 2022 still represents significant growth upon growth, putting many firms in a significant pinch. The competition over law firm salaries seems to have cooled somewhat since early 2022, but another round of salary hikes by large firms could well cause another boost in salaries further down the market.

The picture for firm profits

Demand, rates, realization, and expenses are among the key factors contributing to law firm profitability, and thus far in 2022, the combination of those factors is painting a mixed picture for midsize law firms.

Figure 10: Profit per lawyer (FTE) – change since Q1 2020



Source: Thomson Reuters 2022

On the plus side, profit per lawyer for all law firm segments remained substantially higher in Q2 2022 than the 12 month period ending in Q1 2020. After peaking above 24% in Q4 2021, growth in profits per lawyer has receded somewhat for midsize firms, settling in at 19.3% growth at the mid-year point. While 19.3% growth in profits per lawyer relative to the start of the pandemic is certainly not a bad result, the trendline is concerning. Law firms are remaining highly profitable, but continued solid rate growth and improved realization may not be enough to buoy firm profitability against the influence of softening transactional practice demand and dramatically increasing expenses, particularly if broader economic circumstances conspire to bring down rate growth or realization.

Finding the complicated balance

The period through the remainder of 2022 and into 2023 is likely to involve a complex balancing act for midsize law firms. Many factors are moving in their favor, however, such as:

- Midsize law firms have remained cost-effective alternatives to BigLaw, and corporate counsel have taken notice
- Midsize law firms are more regularly recognized as providers of quality legal services, in many ways on par with larger competitors, particularly for less high-stakes work of which there is typically greater volume
- This has likely helped contribute to the resurgence of midsize firms as leaders in terms of demand growth
- Improvements in how bills are handled internally have led to gains in billing realization, which in turn have led to improvements in collections, helping midsize law firms set a new benchmark for collected realizations
- And although associate compensation has grown, many midsize firms have been able to convey value to their attorneys and staff through means other than just compensation, helping firms to be competitive for talent without having to match the growth in salaries experienced by larger firms

Each of those factors, and likely more, will be necessary components for midsize firms to consider when planning strategy into 2023 and beyond.

As with any consideration of necessary versus sufficient factors, however, those factors that are necessary for success often require balance and management, whereas the factors leading to a poor outcome can be sufficient on their own and require only a lack of attention to exert their influence.

The good news is that none of these are factors with which law firm leaders are unfamiliar. Leaders of midsize law firms will undoubtedly have plenty of challenges to occupy their time. With careful management and a wary eye toward disruptive influences, the positive factors can be brought into balance in such a way that midsize firms can do what is necessary to capitalize on what is, in many ways, a favorable market for continued success.

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