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Strategic Management Consultants

THE CURRENT ECONOMIC ENVIRONMENT – WHAT LAW FIRM LEADERS ARE SAYING

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This monograph summarizes what we have heard from law firm leaders in meetings focused on the legal marketplace and the economic environment in their offices over the past eight weeks.

Included are a brief background, what these law firm leaders had to say, and Smock◆Sterling's observations.

BACKGROUND

Smock◆Sterling's partners have been meeting with law firm leaders in cities across the country for the past eight weeks or so. We have had two reasons for these meetings.

- First, we have been concerned about the overwhelmingly negative media coverage of law firms' responses to the economic marketplace – coverage almost exclusively focused on layoffs at the attorney and staff levels.
  - The media has been closely tracking layoffs at "*major firms.*" Their count (in round numbers of both attorneys and staff) is 1,500 layoffs in January, 2,000 in February, and 3,500 in March.
  - But, there has been no coverage of the many firms that have not laid off lawyers and staff.
  - Also, we found that we strongly disagree with the tone and specifics of the written responses, interviews, and presentations that our competitors have made on the economy – altogether too negative and not justified by the facts (e.g. – we do not agree with their doom and gloom projections on partner income reductions in 2009).
  - The erroneous impression left is that all firms can do is "*hunker down,*" fire staff and associates, overly control cost items (e.g. – McDermott Will cutting out free coffee in the reception area), and wait for the market to come back.
  - We wanted to gain our own "*reality check*" by directly finding out from law firm leaders what was fact and what was fiction.
- Secondly, we recognize that, like our clients, we must address the economic environment by getting out of our offices, not waiting for the phone to ring, and seeing (personally) clients and friends to remain current on the issues they are concerned about.

Thus, in client trips or new business calls to a wide range of cities, all three Smock◆Sterling partners tacked on an extra day or half day to see the leading law firms in those markets (those we have served and those we have not, but would someday like to). We clearly did not find the level of negativity that the media is convinced exists and we also heard strong opinions on a wide range of issues relative to the present state of the legal market that we felt should be shared – first with those we spoke to and then with the broader legal marketplace.

WHAT LAW FIRM LEADERS HAD TO SAY

Following is a summary of the issues, comments, and concerns expressed by the law firm leaders we met with.

2008 Results Generally Better Than Expected

Most firms had 2008 results better than they had expected – in the last quarter, extra efforts were put against cash collections and they produced results. A few firms had record years – either due to contingency fees or just solid work in their key specialties throughout the year. some firms did have a falloff in partner income – but, these declines were not considered a harbinger of a failure of the underlying business model and were, in many cases, caused by tangible one-time events (e.g. – collapse of a major client, large case or cases settling, etc.).

2009 Is Off to a Reasonably Good Start

Most firms are reasonably busy (and, to many, surprisingly so) through the first three months of the year. Some practices – primarily those that are transaction related – are clearly down (although our most recent interviews indicated the beginnings of activity in this area). But, other practices are up to way up and many of the people in these practices are unusually busy.

Interestingly, many of the people/firms we talked to who stated that 2009 was off to a reasonably good start thought they were unique (the same can be said for the good results experienced in 2008). The overall impression that many expressed was that most law firms are in real trouble (primarily as a result of the media harping on layoffs). It just is not true – while these are challenging times, the vast majority of firms are not in trouble.

- There are legitimate and justified concerns about 2009. Will this work hold up? Will transactions (and the financial liquidity needed to support them) come back? Where will we be in December 2009? There are no clear answers to those questions.
- But, the economic downturn did not start at the first of this year. It can be traced to the mid-September 2008 Lehman Brothers bankruptcy and AIG bailout. And, the broader economy has been in recession since late 2007.
- Most savvy firms cranked in unusually conservative assumptions to the 2009 budget. So, many are ahead of budget (either very comfortably or just a little bit) through the first three months of 2009.
- Some of the business conditions that have been reported about law firms do exist.
    - Associate turnover has dropped dramatically and that fall-off has created real dilemmas relative to capacity and hiring plans.
    - Accounts receivable are growing and *"cash is king."*
    - Firms are seeing better and better resumes from potential lateral partners (generally, resumes from people that have been forced out of other firms) and that creates unique opportunities to bring in people who fill critical gaps.
- The *"elephant under the rug"* is associate salaries. There are real questions as to what firms will do about salary schedules and practices. Some are afraid to make any moves (*"what will the other firms think of us?"*), others are cutting associate salaries now, and others are looking at options for completely restructuring this major cost item.

Lower Rate/High Quality Firms Are Sitting in a Strong Market Position

Corporate counsel have been preaching the *"value"* mantra (which we define as results/cost) for the last few years. Now they really are acting on it. But, for that short term, it is not as much about *"value"* as it is about *"cost."*

- A number of the firms we talked to – generally well regarded larger medium sized firms not based in a major legal market center – have found that their work has picked up dramatically for major companies – often on a national basis – because of their rate structure and matter/case staffing patterns.

- Also, some of these firms not only provide lower rates, but alternative and desirable fee arrangements. They are finding their work increasing dramatically because clients are finally coming around to the value and predictability that well thought out alternative fee structures can provide.

There is no question that corporate counsel are awarding work to firms that had not been in the mix previously – based on what they charge. High quality/affordable rate firms are in a considerably stronger market position than they were before – in fact, ten years ago, the so called *"experts"* predicted these firms would cease to exist.

<u>The Intensity of Cost Pressure Is in Direct Proportion to the Relative Competitive Rate Level</u>

We spoke to a full spectrum of firms – from very large higher rate firms to smaller specialty firms. We found – not surprisingly – that the level of cost pressures from their clients and the amount of time they were spending dealing with this issue were directly proportional to their relative position on the rate scale. The higher rate firms were under more intense pressure (and demands) to cut rates and cut costs. That pressure exists – to a degree, for all firms – but is much less for firms with lower rates.

<u>Higher Rate Firms Recognize the Need to Clearly Demonstrate Value</u>

The higher rate firms that we spoke to clearly recognize that their major effort in this downturn has to be ensuring that their clients see the value in the services they provide and in the relationship itself. They are visiting their clients and paying major attention to enhancing all important client relationships. Cross-selling effectiveness has emerged from the shadows to become a major strategic effort for most of these firms.

In the short term, the market advantage will go to the lower rate firms (assuming acceptable quality), but in the longer term the overall focus will return to value. Those firms with the platform, skills, reputation, and resources – and who produce results – should have the longer term advantage – at least for high risk, high complexity and/or high visibility matters and cases.

<u>But, Cutbacks and Layoffs Are Out There</u>

While a number of firms that we talked to had not had any visible layoffs and were trying to avoid them, some had announced or made layoffs and others were considering them.

- Some leaders honestly admitted that these layoffs were long overdue and performance related ("*these people were just not cutting it*") – the current economy has provided cover to do something they had not had the courage to do before.

- Others said that they had not wanted to lay people off – but the level of business in certain practices (and the near term prospects) called for it. It was – simply – a business decision they could not avoid.

- One managing partner explained it well – "*we are the only industry that carries our wounded with us.*" The economy is causing a rethinking of the concept of indefinitely carrying these wounded.

- Certainly expense cutbacks have been made by most firms – retreats, partner meetings, and travel appear to be the first to get the axe, as well as some deferrable software and hardware upgrades. Managements have the clear impression that their partners are opposed to any spending of any kind on any deferrable items.

Some firms made the comment that we paraphrase – "*this is an economic downturn, what do you expect?*" We echo that – if business is down and the primary cost to a law firm is salaries and benefits (which it is), then layoffs are generally unavoidable if business turns down. In fact, until transactional work picks up (which we feel may be initially occurring), one can assume that the cutbacks will continue.

What has gone unreported in the media are significant layoffs of partners. There are two key points here.

- Partner layoffs are being done – but not visibly. Most do it by quietly asking some to leave, changing partner status (the dreaded word, de-equitization), or accelerating retirement.

- But, these partner "*layoffs*" or "*changes*" are recognized as being well short of what is probably needed. As in prior downturns, the sword falls more slowly on partners – some might argue that is as it should be – others would say that underproductive partners are where layoffs should start.

Most Firms Holding the Line on Salaries and Rate Increases

While many firms did raise rates at the start of the year (usually not by much), many others have held the line. Also, the level of standard rates may be a moot point, because of the discount pressure from clients, particularly the larger ones. In any event, the realized rates are not rising this year.

Most firms we talked to were also holding the line on associates and staff salaries. A couple have asked associates to take reductions, based on their levels of work or productivity. One major client of ours was in the media for asking associates – who were not meeting budget – to take a 20% reduction in compensation (a move we believe makes sense, as opposed to layoffs). A very few firms have lowered the associate starting salary (and, thus, the whole pay structure) – they are few in number, but others will follow them.

That "*elephant under the rug*" mentioned earlier – what to do in the future with associate salaries – underlies all discussions of associate compensation. Firms do want to make fairly revolutionary changes – but most are afraid (and, to some degree, rightfully so) to shoulder the risk of being first.

Some Mentioned the Lack of Responsiveness to the Current and Continuing *"Assault on Business"*

We heard an important comment from some firms – that law firms were too hung up on the economic downturn to recognize and respond to the perceived "*assault on business*" coming from Washington. Recent events, such as the President's sacking of the GM CEO and the congressional reaction to the AIG bonuses, as well as the sponsoring of onerous legislation – like the Pay for Performance Act of 2009, signal a dramatic shift in the relationship between private business (the clients of most of our law firm clients) and government. Couple that with the populist desire to restrict executive pay and widespread anger associated with Wall Street bailouts and there is a real threat to law firm clients' autonomy.

- While politics do play a part, this is not a Democratic and/or Republican thing, but a perceived seismic shift in our nation's economy and the role of private industry.

- The concern voiced to us was that law firm partners were too concerned with the elements of the downturn – layoffs, client pressure on rates, and what to do with associate salaries – and not concerned enough with the impact these major changes will have on business law firms' clients and their survivability as private entities.

- The thought offered is that outside law firms – working in concert with their clients' in-house counsel and management – have to be the lead players in defending the interests of their clients and their clients' shareholders.

- Law firms' websites often speak of being in the "*solutions business*" for their clients – now is the time to clearly demonstrate it.

An Often Unspoken, But Underlying Dynamic – Fear

This downturn is unique – in its scope and in what will or might come out of it. Most firms we talked to did not mention the fact that, simply, their partners were quite fearful of the future – but some did fess up to this underlying fear.

- While the "*hunker down*" mentality can be expected (it has occurred in past recessions), some feel that its source is a "*general fear of the unknown*" across the firms' partner ranks.

- The unwillingness to pursue already agreed upon strategies (another way to say "*hunker down*") is often described in the following way – the Managing Partner says his/her Board/Management Committee will not let him/her do it and members of the Board/Management Committee say that the partners will not let them do it. No one will make a move – thus inaction becomes a virtue.

One Managing Partner told us that "*the race may not be to the swift, but to those with the guts to get up and run and not stand still.*"

One Key Point That Virtually All Agreed On – There Are Significant Opportunities Out There

While a variety of concerns were voiced, there was close to unanimous agreement that significant opportunities exist and a plethora of opportunities will present themselves in the near to medium term future. These opportunities include:

- **Significant growth in key existing practices** – litigation, bankruptcy, labor and employment, environmental, and government affairs (the practices most often mentioned, but there are more)

- **A bounce back in transactions** – when credit is freed up (some feel that has already begun to happen)

- **Enhancing client relationships** – through creative approaches to cross-selling and demonstrating value (and sanctions of those partners who will not cross-sell)

- **Attracting new clients** – through providing a clearly visible higher level of value (or lower costs)

- **A buyers' market for people** – an opportunity to upgrade the associate base and add partners/practices that fit the Firm's strategy ("*very good laterals are readily available*")

- ***"Hunker down"* by competitors puts them at risk** – those truly hunkering down are not focusing on their clients or opportunities, so they and their clients are vulnerable to moves by others

- **Establishing a business model and structure for the future** – including creating a sustainable leverage model (associates and paralegals), weeding out those not fully committed to the firm's strategy, resolving associate pay issue – just to name a few.

SMOCK◆STERLING'S COMMENTS

Our comments follow – based on what we heard from the wide range of firms we talked to. In many ways, they are similar to our suggestions in prior monographs on the legal marketplace – but, it is probably true that these things need to be said again – and again.

Most Doing Better Than They Thought They Would

The legal marketplace is suffering some dislocation – but not to the level many/most thought or believe. While prudent management is called for, the opportunities are significant and it behooves well managed firms to focus on those opportunities, not the concerns.

Focus on the "*Recovery*," Not the "*Recession*"

Our advice is to focus on the "*recovery*" and what each firm needs to do to take advantage of that recovery. That may include broader strategies such as targeted marketing of practices that add real value and can be expanded, acquisition of high quality smaller firms that did not successfully diversify, major revision of associate and/or partner compensation and reward structures, and, very importantly, ensuring that all partners (bar none) are committed to the level of effort and focus needed to be successful in the future. While we believe in a very diverse partnerships, little or no diversity should be allowed in commitment and level of effort.

Shift Focus on What Will Be Needed to Be Successful in the Future

This includes doing those things that will fit with or meet future client needs including:

- An approach to and support of alternative fee structures

- A strategy for protecting clients in the expected and continuing "*assault on business*," as regulatory regimes shift dramatically

- A restructuring of the practice group structure to better align with client and market needs.

A Corollary – Where Possible, Clean House and/or Upgrade

This is the time to make the Firm stronger, more client focused, and more closely committed to the same direction. It is also the time to ensure that all partners, associates, and staff are capable of and committed to the same positive future of the firm. Judicious pruning is not the same as laying people off, it is preparing the firm for a better future.

The Importance of Effective Day-to-Day Management

This recession, as others before it, has underscored the importance of effective day-to-day management. Such items as fiscal hygiene (timely and effective billings and collections), the timely and productive use of relevant management data (e.g. – the accurate measurement of cross-selling results), quick response and timely decision making, and effective internal communications are always important – but more so in a downturn. One firm stated it well – "*we are managing 2009 as if it were composed of twelve distinct fiscal periods – we are successfully through three with only nine more to go.*"

Address the Associate Salary Conundrum

This environment is perfect for addressing the associate salary issue. Now is the time to evaluate the current structure and make revisions (possibly revolutionary) that will ensure that associates are fairly paid for performance, but also ensure that each firm is not caught in a mode of copying its competitors and engaging in policies/practices that just do not make fiscal, strategic, or managerial sense.

Follow Industry's Example – Increase the Velocity of Sales Calls

Smock◆Sterling serves commercial clients as well as law firms. We strongly encourage our law firm clients to take the sage advice of one of our most experienced manufacturing executives.

When asked how his company was doing, that executive noted that things were all right at his company and his backlog was holding. But he did say that he had called all of his people together and said – "*this is my fifth recession as CEO of this company and there is only one tried and true way to deal with a recession – increase the velocity of sales calls – it enables you to hold business in the downturn and increase your customer base for the recovery.*"

We believe there is a lesson for law firms. Those that get their partners out of the office and have them call on present and potential clients will do considerably better (by a lot) than those that wallow in the "*hunker down*" mode.

This completes our update of law firm managers' views of the economic environment. We look forward to your comments and questions.

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Smock◆Sterling Strategic Management Consultants is a strategic management consulting firm with broad experience in serving the nation's leading law firms. Founded in 1991, we have grown our reputation and client list to where we are considered one of the leaders in providing high quality, high value strategic management services to the legal profession in five areas (strategic planning, mergers and combinations, practice group management, law firm economics, and strategic management issue resolution). Although 75% of our work is for law firms, the remaining 25% is for top management in a variety of industries, which keeps us grounded in the thought processes and trends of the broader business marketplace. Our three partners (the authors of this monograph) are, unquestionably, the most experienced "*first string*" of any consulting firm serving the legal profession.

We should add that we are particularly skilled in helping our clients focus on that "*recovery*" and develop the strategies and actions essential to achieving long term strategic, financial, and professional success.

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