

Reflecting Upon The Impacts Of Economic Adversity

QUESTION:

Managing a sophisticated law firm is not a quarter-by-quarter exercise, but here is what we know after three quarters into 2008: revenue growth has reversed; there is immense profit margin compression (largely due to associate costs); and this slowdown is hitting the most profitable firms the hardest.

Will this economic trough alter the long-term demand for legal services? Some claim that the players may be re-shuffled, but the intrinsic demand will remain the same no matter what happens electorally in November. I'm not so sure!

And will this economic adversity accelerate the consolidation of our profession? Faced with making severe talent cuts, some firms may find their attractiveness to laterals and law students compromised, and their viability as independent going concerns in question.

I would be interested in hearing from your group on what strategic decisions law firms should be considering in light of the challenges in the U.S. and international economies.

RESPONSE:

As we polled our group we concluded that none of our individual crystal balls were very clear given the recent market turmoil (and the collapse of a good number of big M&A, project finance and infrastructure deals), the lawyer layoffs and the recent large law firm dissolution. That said, here are some of our collective views on the two subjects that you raise:

Demand For Legal Services

One of the legal publications reported that while many companies face increasing global competition and flat profits, partners in big law firms generally witnessed their income double every four to six years over the last 15 years. The suggestion was that the legal business has been in unsustainable expansion, largely driven by the boom in financial services. Whether that is entirely true or not, it probably can be argued that partners nowadays expect their incomes to just naturally rise each year and many have now been conditioned to think that the legal business is somewhat immune from the vicissitudes of the marketplace.

What we see is that a lot of wealth has recently been redistributed. A lot of old, "safe", buy-and-hold money resided in financial services stocks, and a lot of that money evaporated. On the other hand, in a volatile market, somebody is making a lot of money. We suspect that, when this is all over, more money will be concentrated in fewer and different hands and more consolidation of business entities will have occurred. If recent events are any indication, the consolidation may occur, of all places, within the ranks of Fortune 100 companies. Whether this is true probably depends a lot on whether the economic bailout

package has its intended effect. If it is true, those law firms one level below the elite Wall Street firms may feel it first.

Conventional wisdom has it that law firms that have, or can move, substantial resources out of the United States are going to do better. If money does not start flowing in the credit markets soon, we fail to see how any economies anywhere in the world are immune from feeling this.

We think the environment is going to be very different coming out of this, and suspect that it may favor the mega-firms with the most resources. We also think that in almost every industry new players are going to emerge and that creates opportunity for everyone.

Action items:

- Stay close to your clients,
- Consider more carefully and favorably than you otherwise might, combinations with other firms and lawyers that make sense strategically without overreacting and running into the arms of a suitor that does you no good strategically, and
- Look for new emerging players who may have capitalized on the current crisis.

Become lean and nimble.

We believe that in hard times (and we think these are and will be the hardest that any of us have ever seen), businesses must learn how to run themselves more leanly and control costs more effectively. That is what economic shake-outs are all about. Businesses that are lean and nimble survive and the others do not. We may very well see fewer and more parsimonious consumers of legal services. Businesses are going to be forced to do things, including purchase legal services more innovatively and cheaply. General counsels are going to have to walk the talk that they have been talking for some time.

Action items:

- Be honest with yourself and your partners about what is happening;
- Adopt a mantra throughout your firm of how can we deliver more value to this client for less money;
- Understand your cost structure and how to control it,;
- Become less tolerant of those who are not "with the program;" and
- Figure out how to price your services more sensibly than you are doing now.

Expect increased regulation.

A dramatic drop in the demand for legal services in our increasingly regulated society seems unlikely. That does not however, necessarily suggest that any increase in demand will be filled entirely or even primarily by outside law firms. The tremendous rise in law firm costs and rates has resulted in more work being brought in-house and in-house positions have become more attractive to both new graduates and experienced lawyers. Both trends may accelerate.

Americans are a litigious society and we have all seen litigation increase in difficult economic times. And with drastic changes in laws will come complex regulations, accompanied and followed by a lot of legal work. We will see more regulation of the ills that have beset us, but maybe not a lot more regulation of those that have not yet beset us. We are very good at the horse-is-out-of-the-barn-but-we-are-not-going-to-let-him-out again

approach to regulation. After 9/11, we set out to prevent the very thing that had already happened, not necessarily the things that might happen. There will certainly be over-regulation in the financial services industries, but the degree of regulation in other industries probably depends more on who wins the presidential election than the current economic crisis.

Action items:

- Continue to do what you do best and not worry about trying to chase the regulatory dollar. If you are not there already, it is too late.

Exploit opportunities.

The state of the economy is a condition with which all businesses must deal. Economic downturns also present opportunities. Carefully identify, and then conceive strategies for your firm to avail yourself of, opportunities for growth, improvement, and expansion.

Action Items:

- Counter-cyclical practices, such as bankruptcy, and practices that are often not much affected by the state of the economy, such as commercial litigation and labor and employment, can help to off-set revenue declines in transactions practices;
- It is likely that unsettled economic conditions also will present opportunities for recruitment of talented professionals from firms that are struggling and for combinations of firms to achieve enhanced market position and greater reach and strength; and
- Avoid compromising your firm's ability to eventually participate in a demand upswing by steps taken to deal with the downturn, such as aggressive reductions in force.

In the final analysis, we are hopeful that the economic trough will not significantly alter the long-term demand for legal services. We do believe that the players will be reshuffled. There are the winners and the losers among firms when clients consolidate. We also think there will be work coming out of the current economic chaos, and certainly the aftermath . . . but not all firms everywhere are going to share in that. Some firms are just going to have a hard time getting through the transactional slowdown that we think we can expect for the next couple of years.

Consolidation of The Profession

There is ample empirical research to prove that every industry consolidates over time. Thus with our profession in a maturing stage, consolidation seems likely to accelerate. That is not meant to suggest there will be only a few national firms but rather that consolidation will occur on a national, regional and even local basis.

We also believe that with advancing consolidation there will be a shake-out within legal market segments. We think that we will see more law firms becoming more substantively specialized and narrowing down to those specialties. Depth of resources within specialties is going to be more important.

Meanwhile, well-managed firms will take this opportunity to market "value" to clients, and to market their platform and stability to laterals. Groups of laterals may be more attractive, and attracted, than taking on whole firms.

Strategically, your leadership has to communicate to partners what your firm is going to try to accomplish during these times, and how it is going to go about doing that. Your partners have to understand that the firm is taking the long view, but doing what is necessary to make the short term as bearable as possible. Communication remains very important.

Action Items:

- Your firm needs to assess your core strengths and weaknesses, your current position in the marketplace and the options which are or could be available to you. In other words, “where you are and where you want to be.” You then need to develop a strategy to get there, probably with professional help and
- In the short term, invest in what you do best, because, when things turn, as they surely will, you will need to be ramped up and ready to roll.

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