

SMOCK

LAW FIRM CONSULTANTS

NO CHICKEN LITTLE, THE SKY IS NOT FALLING

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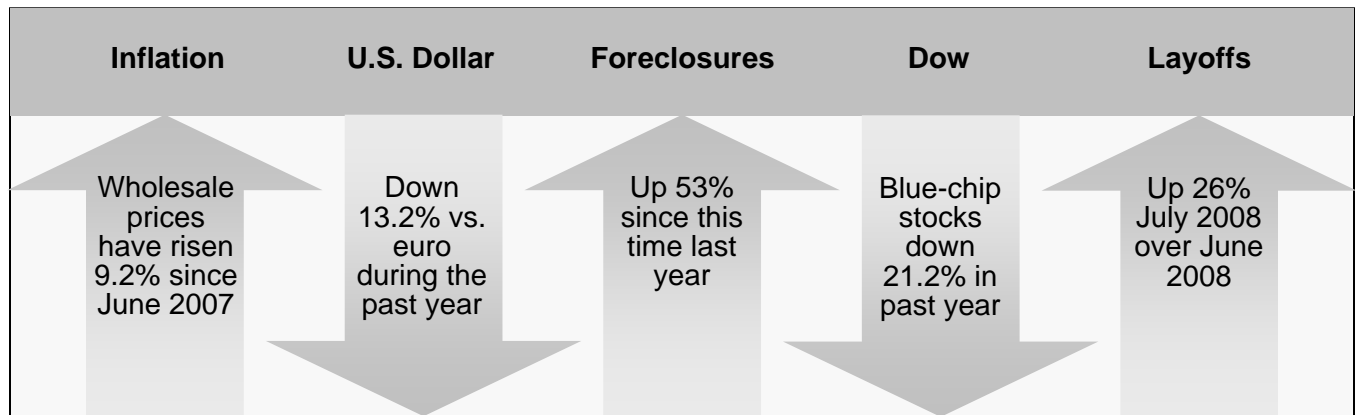
A few weeks ago, John Smock met with a client who pointed out that he had recently attended a presentation in which another law firm consulting firm described the present and future of the legal marketplace in very clear "doom and gloom" terms. Our client expressed some concern, because things (economically) were going very well at his firm and his perception was that they were going reasonably well at his primary competitors. We were taken aback by that and we took it upon ourselves to talk to clients and friends over the succeeding weeks – as we visited various cities/markets on client assignments – regarding how they thought they were doing and how they thought their overall markets were doing.

The bottom line on the response to our questions is very straightforward – **despite the doom and gloom of some prognosticators, most business law firms are having a reasonably good year in 2008.** Most firms will not break the bank or set records this year, but client activity is generally strong, sufficient opportunities are in the pipeline, partner income will either increase or be flat (not a bad thing in down economy), and they certainly do not see doom and gloom.

This monograph presents the current economic environment that law firms face; discusses, in more detail, how firms are doing; talks about the future (which we believe is bright); and given today's market, suggests what law firms should do to survive and prosper.

YES, IT IS ROUGH OUT THERE

There is no question that our nation's economy is going through a very rough patch (as is the world's, because it is now a global economy). We hear daily the reports about mortgage foreclosures, rising and falling oil (and gas) prices, massive write-offs by major financial institutions, and the growing number of jobs at risk. Shown below are some examples of recent less than positive economic trends.



And, these problems are not going away.

- Alan Greenspan, among a growing number of others, is predicting at least two more years for the real estate market to correct itself.
- The energy crisis has been with us for a long time and it certainly is not going to go away, particularly given the inability of our government to develop any sort of coherent energy policy.
- The woes of the auto industry (which employs and supports a large part of our economy) continue with many experts predicting that at least one of the big three will declare bankruptcy in the next few months.

Law firms have not been immune from these pressures.

- Just recently, Cadwalader Wickersham & Taft (a Wall Street firm with a large position in mortgage backed securities) laid off 96 attorneys firmwide (including 20% of its London office). This followed a cut of 35 attorneys in January, when it said that *"the firm was confident there would be no layoffs in the future."*
- In May, Sonnenschein Nath & Rosenthal laid off 37 lawyers (6 partners) and 87 administrative personnel as a *"response to a slowdown in legal work due to the economic downturn."*
- Partners at large New York firms, once able to draw advances against expected annual profit, have been getting push back and limitations from the financial institutions who were always eager to advance the money. One prognosticator predicts that partners at some very large firms (read New York) can expect their take to drop as much as 15% this year.
- Becker & Poliakoff, a south Florida real estate specialty firm recently hit all of its attorneys with a 12% pay cut.
- There is the universal admission that the payment of receivables, as always happens in an economic slowdown, has begun to lag. That was the stated reason for Becker & Poliakoff's decision to cut salaries 12%.
- Legal recruiters have stated that the market – particularly when it comes to lateral associates – has definitely shifted from a seller's market to a buyer's one.
- There is a great degree of trepidation and concern among law firm leaders and managers – there should be. There is no question that the legal economy is considerably tougher now and good leaders and good managers need to be both sensitive to the winds of change and cautious regarding major strategic decisions.

But, the overall economy in which law firms practice must be viewed from both sides. Yes, there are considerable negatives, but:

- The level of negativity by the media regarding the economy is probably unheralded. You can almost watch the salivation and suppressed glee when business reporters talk about a potential recession. For example, one of the most significant statistics quoted by the media (and the most misinterpreted) is the percentage increase in foreclosures. Yes, foreclosures are up, they reflect the economy. But, the overall percentage of foreclosures as a percentage of outstanding mortgages remains very, very low – so any increase, statistically, is a significant percentage change.
- And, there is not yet a recession (as defined by the government). The economy grew by 1% in the first quarter of 2008 and by 1.9% in the second quarter.

GIVEN THIS ECONOMY, MOST BUSINESS LAW FIRMS ARE DOING JUST FINE

While the legal marketplace ultimately reflects the general economy, law firms have a major advantage in that some of their practices run counter-cyclical to economic cycles and when financial/managerial problems exist in their client base, that often leads to **more rather than less** legal work.

- While there is always variance in performance among firms (i.e. – at any given point in time, some firms will do better than other firms), most general business law firms are having an acceptable to great year in 2008. Their attorneys are busy, the work continues to come in, and projections are that performance will be up considerably (a few), be acceptable (the majority), or be flat (a minority). Very few firms that we have spoken to are facing an unusually difficult 2008 (that is, a potential drop-off in partner income). This may change in the last few months of the year, but probably not by much.
- The major problems for some law firms have already been experienced. Those firms with a good bit of work in mortgage backed securities and other securitizations, (like Cadwalader) have taken it on the chin, but the operative word is *"have."* As our partner, Peter Giuliani, describes it, *"if there is a law firm crisis, it is a Wall Street crisis not a Main Street crisis."*

In fact, there are some very solid positives that can be taken from the present environment.

- We know of no firm with a growth strategy that has backed away from that strategy. They may be going about it more cautiously, but growth is still at the top of their lists in executing strategies. Further, we have seen no fall-off in combination/merger discussions – those discussions are not being delayed by the economy. In some cases, the economy may have served more as a catalyst for discussions to commence and/or get serious.

- Further, there is a human resources benefit. The highly paid associates are doing considerably less grousing and appear more content to have a secure position that pays them the kind of money that a law firm position does. This happened before with the tech bubble burst – law firms raised associate salaries well after there was sufficient justification to do so (primarily because the other firms did so) and the agitation by associates dropped off considerably, once they recognized then the difficulty of the economy outside of the legal marketplace. In this regard, it is expected that associates salary increases will be flat for the next couple of years.
- Some practice areas are booming – energy, life sciences, and anti-trust, to name a few. And, the long awaited increase in bankruptcy work is starting to hit.

THE NEAR AND LONGER TERM FUTURE OF THE LEGAL MARKETPLACE IS QUITE BRIGHT

While firms need to be sensitive to the dangers of the economy, there are a number of forces and outside influences converging on the legal marketplace that, we believe, underscore a very strong future for business law firms.

- The November election will benefit business law firms – no matter who wins, only more so if Obama does.
 - Virtually all political experts agree that the Democrats will increase their majority in both houses in Congress and will be in a considerably more advantageous position to pass their desired legislation and to provide payback to the special interest groups that have supported them, like organized labor.
 - Corporations, businesses, and financial institutions are going to be the bad guys – they will face more regulation, oversight, and probably indictment. Legal needs will increase across the board – from regulatory and compliance advice to white collar criminal defense.
 - It is safe to assume that, as a result of legislation, organized labor will have an easier time organizing than it has to date. Labor practitioners will be back in the forefront of law firms and the very good labor lawyers could be the *“legal stars”* of the next decade.
 - Tax practices will increase dramatically in size and importance. Corporate and individual tax issues will multiply and the complexity will likely increase. One legal expert has predicted that *“tax issues will be the key driver for political and economic activity for at least the next half-dozen years.”*
- The economy and competition are forcing firms to make or accelerate changes that they have delayed.
 - Management effectiveness is now a differentiator – the better managed firms (those with a solid strategic direction and the resources and will to execute that direction) are doing and will do considerably better than those without.
 - Firms will accelerate getting out of non-profitable, non-strategic practices – in a time of economic pressure, it is difficult to justify some of the practices that many firms are in.
 - Sanity will return to associate salaries. Washington based Howrey (which has a clear track record of being a trend setter) has just abandoned their lockstep pay for associates. Associates will no longer have a guarantee of a pay increase with each passing year – their increases will be based on performance. As the Firm’s Managing Partner said, *“if we are going to pay those salaries, then we better have people that are up to the task and well trained.”*

WHAT SHOULD LAW FIRMS DO

We believe that there are six key things that law firms can do to deal with this present legal economy.

- **First, recommit to effective management** – at the firm and practice levels. The *“evolution”* that a number of firms have had underway (for too long) to get to good management practices must be a stepped up to *“revolution.”* Many, many firms still sub-optimize their management effectiveness – the marketplace will not allow it now and in the future.
- **Focus on executing the strategic plan** – in other words, do what you said you were going to do and be who you intend to be. A down economy gives a strategically focused firm an opportunity to dramatically improve its position, increase the bonds between the firm and its people, and attract additional people who fit that direction. Abandoning the strategy and *“hunkering down”* until the storm passes is not the way to deal with this marketplace.

- **Cull the practices** – now is the time to ensure that the firm's complement of practices is the complement that the firm believes it needs to be successful now and, very importantly, in the future. That does not mean getting rid of the less than profitable practices and only keep the more profitable ones. It means making conscious decisions which practices fit the firm's strategy and will be necessary to meet the needs of the clients it serves and desires to serve in the future. Carrying a non-strategic, under-performing practice serves little purpose in the present economy and could be truly damaging.
- Also, **cull the people** – many firms have underproductive partners and associates who do not have a future with the firm and drain resources from what the firm is trying to do and whom it is trying to reward. Now is the time to make those tough decisions about people – they are difficult, but essential. We repeat what we have said before – *"every dollar paid to an unproductive partner above what he or she is worth is a dollar not paid to the productive ones."*
- In a down economy, it is important to **fix the compensation processes** – for partners, associates, and staff. You need to ensure that you are rewarding what is important to the firm's survival and prosperity. The Howrey example of redoing its associate compensation is an apt one – associate compensation needs to be changed to reflect varying performance and get out of the socialistic/lockstep environment that currently exists. Partner compensation systems should also be reviewed and, if needed, adjusted.
- **Increase the focus on and the resources devoted to marketing and business development** – marketing in law firms is too often seen as a cost rather than an investment and, as results do not meet expectations, marketing is cut. In downturns, effective marketing is even more important than the good times. Cutting or gutting the marketing program will not only not work, but may accelerate downward trends (similar to the physicians in colonial times practice of *"bleeding the patient"*)

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These are just a few of our thoughts regarding the present environment. We believe the legal marketplace is a healthy one and that the negatives discussed previously are not going to prevent the continued growth and prosperity of well-managed, strategically focused law firms. We hope your 2008 reflects the positives we discussed.

Please call us if you have any questions or comments.