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THE LEGAL MARKETPLACE IN 2008 – TIME FOR THE INDUSTRY TO JUMP OUT OF THE SAUCE PAN

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Each year, as close as possible to its beginning, Smock Law Firm Consultants assesses the legal marketplace, identifies issues, and proposes solutions to those issues. We are not alone in doing this, but have tried to be both creative and original in figuring out ways to get the message across to our clients and friends in that legal marketplace.

To be truthful, the trends we have discussed over the last few years have been fairly similar from year to year – so addressing them in a creative way each year has been challenging. Thankfully in addressing the legal marketplace this year, the evident changes and issues have given us considerable *“meat”* upon which to opine.

The analogy we use this year relates to what our science teachers told us – a frog sitting in a pan of water will stay there as the heat gradually increases and will not jump out even as the water approaches the boiling point. To us, that is a good description of the present state of legal management – it is time for law firms and their managers to jump out of the sauce pan, because the recent changes have been dramatic and significant and the institutional responses – generally – have not been sufficient to effectively address that change. The answer is not to pray that these issues will go away, but to embrace the positive change necessary for the really good firms (regardless of size) to both survive and prosper.

First, let us establish some overall market facts.

- 2007 was another very good year for good law firms. Annual and December collections were very good (from the initial reports we hear from our clients) and partner income again scored another jump.
- While most law firm managers are cautiously optimistic regarding 2008, for the first time in years there is real trepidation out there. People are worried about slowdowns in key practices, client push back (on rates and fees), turnover of key people, rapid escalation of associate salaries, and how all of this will all translate into acceptable financial results. They see significant cutbacks in financial services firms (some just announced as we went to press with this monograph) and wonder if that will happen to the law firms servicing financial institutions.
- While solid performance of the good firms keeps going up – so does the competitive bar. Clients' expectations continue to rise and a number of firms have become quite creative at meeting client needs in truly differentiated ways – stronger relationships, alternative fee arrangements, efficient solutions to recurring legal issues, etc.

But, the present marketplace is a good bit more complex than just those general overview comments – more detail follows.

ISSUES/TRENDS – THE LIST JUST KEEPS ON GROWING

Following are our views of the major trends impacting the legal marketplace – some are old standards and some are relatively new. But, the list – this year – is longer and all are significant.

Clients' Increasing Emphasis on Value

All law firms have experienced considerable client push back on their recent rate increases (in truth, no business can raise its prices 6% to 8% each year and not expect some reaction). However, for the more enlightened clients, that push back in rates is translating into a clear expectation of increased value. In other words, *“if we are going to pay you more, you ought to provide more value.”* While value means different things to different clients, we believe that most rational companies view value in the context of its commonly accepted equation (value = results ÷ cost).

- Historically, it has been easier for clients to deal with the cost side (*“we want a discount”*), but that is changing. In fact, clients are more concerned (from the surveys we see and the general counsel we talk to) with cost predictability. Many have said they need cost predictability first and if the value provided does not measure up to the cost, they will find other law firms. Rates are usually not the issue.

- The value equation is driving different decisions on outside counsel. Examples of recent general counsel comments overheard include *"we are increasing the work given to the good law firms in the non-major cities"* and *"we will never give work to a global law firm – there are no efficiencies there."*

The Time for Creative Fee Arrangements Has Arrived

Two trends predicted by legal management publications and consultants in the 1980s never really happened – the demise of the mid-size firm and the replacement of the billable hour with alternative fee arrangements.

- Although size is a factor in outside counsel decisions (and will remain so), competence, effectiveness, and value are greater issues and a number of well run and focused mid-size and smaller firms continue to prosper in spite of the growth of mega firms. So the mid-size firm is here to stay.
- Alternative fee arrangements – as a major percentage of total legal billings – never really happened, because clients were used to and could manage (they believed) the billable hour and negotiated discounts. But, that is dramatically and significantly changing. A combination of forward thinking clients and law firms are embracing the concept of non-hourly fees and the variety of alternative fee approaches is growing (e.g. – success fees, flat fees, flat fees with bands, retainers for simple/standard legal advice, etc.).

So, the mid-80's prediction regarding the importance and preponderance of alternative fee approaches is turning out to be right – just twenty years later.

Biggest Client Complaint – "Our Attorneys Do Not Listen to Us and Do Not Understand What Our Needs Are"

Yes, clients are putting considerable pressure on rates, fees, and billing methods. But when we talk to clients and ask them about their greatest concern about outside counsel, there is a consistent refrain that their outside attorneys do not listen, do not appear to understand, and, thus, do not respond accordingly. One general counsel stated in a recent presentation we attended – *"I wish they would try to sell us what we need, rather than what they want to sell."*

As firms continue to look for ways to differentiate themselves, listening to what their clients really say (and then acting on it) would not be a bad place to start.

Real Marketing Now More Critical Than Ever

For years, we have criticized the legal profession for spending their limited marketing resources on things that have little to do with getting and keeping clients (e.g. – airport and/or image advertising, sky box rentals at sports stadiums, NPR advertising, and expanding the visibility/reputation of the law firm CEO). The last few years have seen most good firms begin to really use their marketing money more effectively – solid client feedback processes, industry and client/potential client research, targeted contacting, and personal coaching. And, these changes are working.

This is good – because, the rising competitive bar has made effective marketing even more important and valuable and the level of marketing effectiveness becomes another primary opportunity and requirement for differentiation.

Guess What, Most Mergers Are Working

There have been a good number of law firm mergers over the last few years and, both from our experience and the research that has been done, most of these mergers appear to be working and working very well – with *"working well"* defined as increased partner income and improved market position. Law firms have combined, synergies have developed, and management of the resulting entity is often considerably better than management of the legacy firms.

That does not mean to say that a merger is the strategic answer for every firm. While many mergers have worked, many firms – with a clear strategy not to merge – have done very well in their market space and in attracting partners not interested in combinations (not every merger appeals to or works out for every partner in the legacy firms).

Markets Have and Will Continue to Change and Fragment

The markets for specialized legal services have adjusted over time and will continue to adjust.

- There has been a definitive fall off in deal making – either in response to or as part of the overall credit issue. Recent research by McKinsey reveals that this fall off is mostly in the private equity sector. But, private equity has become such an important part of capital formation and wealth development in our economy that it will not be going away soon.
- While some firms' bankruptcy practices are doing well, many are surprised that their bankruptcy practices are not doing better. But, given the current business cycle, we certainly see this year and beyond as strong for bankruptcy practices.
- Intellectual property continues to grow in importance and in the percentage of legal fees paid by companies of all sizes.

We predict that the results of the 2008 election will create new "hot" practices and services (e.g. – regulatory practices invariably see an increased pace following any administration change and demand for labor and white collar litigation will surely increase if the Democrats win).

Human Resources Issues Remain and Will Continue to Remain as Major Concerns

While it is true that equity partner income (in both the US and UK) has risen dramatically over the past seven or eight years, growing the size of the carrot does not necessarily ameliorate a wide range of human resources issues or concerns.

- The most recent increase in associate salaries in 2008 has put more money in associates pockets (as it has rippled, unhindered by reason and rational thought, through the legal profession), but it has not changed associate related issues. In most firms, associate retention, development/training, performance, lifestyle choices, and commitment remain major challenges.
- In spite of the increasing emphasis on diversity in outside counsel selection (for a long time, many general counsel threatened to use diversity in selection – now they are doing exactly that), most firms continue to have considerable difficulty in recruiting and retaining talented minorities and female attorneys. Associate retention rates are not good, but retention rates for minority and female attorneys are even worse.
- In a number of firms there is a real concern that younger partners are not keeping up with the marketing and rainmaking performance and responsibilities of the more senior partners. As those senior partners retire or slow down, the number of effective rainmakers appears to be going down in many firms – even as these firms continue to grow, putting them at real future risk.
- Partners in the "boomer" category are talking about lifestyle changes (slowing down, getting out of the "rat race," etc.) considerably sooner than what is normally considered retirement age and, in spite of their importance to their firms, allowances have not been made for that slowing down. In ten years, law firms will be scrambling to find incentives and new role definitions to hold onto senior partners.

Whistling Past the Graveyard

While many firms (of all sizes) have responded effectively to market changes over the past few years effectively – in terms of setting meaningful strategies and carrying out those strategies – we still see (even in some of the best firms) a number of partners who feel that effective management and management structures, good planning, accountability, and related activities are naturally opposed to the professional practice of law (*"this is a profession, not a business"*). They view strategic planning as a waste of time, feel that consultants have *"screwed up the firm,"* and lump all sorts of ineffective or non-confrontational management practices (particularly those that result in coddling and overpaying underproductive partners) as being part of *"the culture"* – as in *"we cannot do that because of our culture."*

We call this *"whistling past the graveyard"* and, in many cases, the whistlers are really hurting their firms' abilities to deal with major issues. As is often the case, they tend to push the more highly productive, creative, and marketing oriented partners (and associates) closer to the door. We often find this whistling process evidenced by a combination of complacency with what they are and what they have been (a fierce defense of the status quo) and an arrogance (even if faked) that any changes – however slight – will harm the firm and its cultural glue. This is using culture as an excuse for not doing what needs to be done to remain competitive.

More and More Creative and Important Responsibilities for Qualified Non-Lawyers

We have continually commented on the trend of increasing responsibility and competence of non-lawyers in law firms – not just in the COO/Executive Director position, but in marketing, information technology, finance, human resources, and the like. Now that trend has taken a further twist. There are a number of examples – some quite recent – of firms getting considerably more creative in what non-lawyers do and the impact they can have on a firm and its profitability.

- For instance, a number of firms have assigned relatively seasoned managers to support individual or multiple practice groups, so that their practice leaders do not get buried in administrative trivia and detail. Where tried, this investment appears to really be paying off.
- There are other more creative examples – Fenwick & West has hired a non-attorney to manage relationships between start-ups and venture capitalists; Pillsbury Winthrop hired a *"Director of Corporate Social Responsibility;"* and Morrison Foerster hired a new COO, whose prior position had been VP of Business Operations for Hewlett-Packard.

Profits Per Equity Partner Still the Primary Benchmark

A year has gone by since we described the importance the legal market places on *"profits per equity partner"* as the primary statistic used by the market to measure law firm performance and status, as well as the primary gating mechanism when laterals consider firms and firms consider merger partners. A year later that emphasis (which we do not necessarily agree with) remains and, in fact, is probably even more pronounced. Even though there are concerns about what 2008 will bring in terms of law firm performance, the importance placed on this statistic will not waver and not decrease. Firm management ignores it at their firm's peril.

PROPOSED SOLUTIONS – MORE MEAT, MORE GUSTO

It has been our experience – in consulting assignment after assignment – that, while most law firms face a similar set of issues (particularly those who compete with each other), the real difference from firm to firm is not in the issues they face, but in the creative and tailored solutions they develop to address those issues. Thus, while the following suggestions are intended to address one or more of the previously listed issues, how the issues are addressed in each firm will be different. We suggest you look at the following as a buffet table – taking what will work in your firm and passing on what does not whet your appetite .

Run Your Firm Like a Business – That Is What It Is

Probably the most important thing that law firms of all sizes can and must do to address these collective trends is to be run their firm much more like the professional services businesses they truly are (notice, we did not say *"like a corporation"*). Doing so requires extensive and accurate data to make decisions; holding people (with the focus on partners) accountable for their responsibilities and performance; creating and executing a management and administrative structure that facilitates client service, professional development, and profitability; and only staying in business and practices that fit and are playing a defined role in an agreed upon firm strategy.

Some extensive research by the Harvard Business School identified a series of straightforward management practices – regardless of industry and/or size of business – that need to be accomplished if a business entity is going to be successful. While motherhood and apple pie, they truly are worth consideration and focus for every law firm. They include:

- *"A clearly stated and focused business strategy*
- *Flawless operational execution*
- *A performance-oriented culture*
- *A fast, flexible, flat organization."*

All four of these should be part of all law firms' management practices.

Corollary to Running It Like a Business – Effectively Manage the Practice Groups

We just published a particularly perceptive review of the state of law firm practice groups (<http://www.smocksterling.com/images/Unlocking%20Value%20and%20Performance%20Through%20Better%20Practice%20Group%20Mgmt%20%28Nov%201.pdf>). In it, we point out that the performance of practice groups and the practice group concept has generally fallen short of both needs and expectations. However, the need for truly effective practice groups is greater and more critical than ever. Managing a firm through practice groups is the best (and, perhaps, only) way to increase revenue, challenging work, partner/associate morale, and profitability. Doing so requires many of the same things as running the firm like a business – delegation, accountability, data and information, etc.

Do Real, Honest Strategic Planning

By the end of 2007, most firms of any size (say, above 20 attorneys) have made some attempt at strategic planning. Those firms that have both set a strategic direction and successfully implemented it (again, regardless of size) have achieved remarkable success. Further, better performing firms have done it more than once and have become very good at it.

Our strong suggestion is that firms do really solid, honest, and effective strategic planning. This implies an external focus not only on what is happening in the marketplace, but what will happen in the marketplace of the future. It also implies that the strategic plan be a business document, clearly describing the future of the firm for the benefit of its critical stakeholders (owners, clients, and employees). Too often, we see law firms state their overall direction as some variation of *"providing outstanding services to clients."* Services are provided to clients for long term strategic reasons, not merely to provide them – there must be genuine thought given to what distinguishes a firm and its services.

The strategic plan should be developed by representative partners, shared with the full partner group, and communicated throughout a firm. Further, it needs to be reviewed – probably annually – to determine if it is still meeting the needs of the firm and to adjust strategies, activities, and measures.

Less Democracy, But More Information

Over the years, we have worked with a number of law firms who value full democracy – that is, the town hall meeting approach of all partners making decisions and the perceived need for all partners to agree to decisions made by firm management. Many partners rely on this democracy because they do not get information that enables them to trust their management. But, as firms have become larger and more complex (even firms well under 100 attorneys), democracy – where every partner has a say in everything at all times – just does not work. In fact, it tends to put those firms at a real competitive disadvantage.

- Our suggestion is to create a flat, flexible structure where representatives of the partners are charged – with the exception of such major items as mergers, major leases, etc. – with making management decisions.
- But at the same time, firms should dramatically change and improve the way information is provided in law firm partnerships. Information should be expanded and should go well beyond the scope of merely providing financial and operational statistics.

For example, some of our very good clients have invested in the concept of a balanced scorecard. We believe it is an effective way to view broad based law firm management and to communicate results within the partnership. Please view our broader comments on this topic <http://www.smocksterling.com/images/Balanced%20Scorecard%20for%20Law%20Firms%20%28Final%29%20%28Nov%201.pdf>.

Let's Face It, Most Partner Compensation Systems Probably Need Revision/Adjustment

We believe that partner compensation systems must do three things, regardless of whether they are subjective, objective, or some combination of the two – (1) reward those who bring in the work; (2) within the context of rewarding those that bring in the work, be as fair and be perceived as fair as possible; and (3) directly and visibly align with the firm's overall direction and strategies. Most firms respond reasonably well to the first two, but the third is usually not considered.

We strongly suggest that most firms – every three to five years – take a very comprehensive look at their partner compensation process to ensure that it is meeting all three of those objectives. This year, we believe that partner compensation system improvements should have a higher priority than would have been the case last year or the year before.

Take a Broad Based Approach to Clearly Improving and Making More Effective the Firm's Human Resources Programs (for Associates, Staff, and Partners)

Last year, we suggested that firms use human resources programs as a means of differentiating themselves from their competitors (and to improve recruitment, development, and retention). Surprisingly, in discussing our annual trends and issues with our clients, this suggestion got the most pushback, although the broad base of human resources programs deal with the most important asset that a firm has – its people. Even modest reductions in attrition have a enormous positive financial and quality impacts on a firm.

Those firms that really want to be competitive in the future have to take a comprehensive approach to truly developing all of their people. Development is a much broader concept than simply training or mentoring. You are competing in what has become a ferocious war for talent, you need to differentiate what you do for your people formally and informally.

Stop Using Culture as an Excuse to Not Do What Must Be Done

We described the issue of "*whistling past the graveyard*." As we said, those whistlers resist change (of virtually any kind) under the rubric that it "*will destroy our culture*." The way to address the whistlers is for firm leadership to embrace and celebrate what is a firm's true culture and reject the excuses. In some cases, the culture itself has to be adjusted to be more competitive. There are numerous examples of failed businesses that have not been able to change their culture when market conditions change. There will soon be law firm examples.

Develop an Alternative Fee Strategy and Options

Alternative fee structures are here to stay. If a firm does not have an alternative fee strategy and/or structure, it needs to develop one – as soon as possible. We suggest firms research what is being done by competitive firms, contact and discuss with clients as to what they feel is desirable in alternative fee structures, and then develop specific strategies and structures that truly differentiate their own firm – not just copy other firms.

Restructure the Marketing/Business Development Program to Respond to Client/Prospect Needs

The quote used earlier in this monograph of the general counsel stating that "*I wish they would sell us what we need, rather than what they want to sell*" should be a wake-up call. Even though many firms' talented marketing people have shifted the focus away from promotion and fluff to business development and support of the processes of actually bringing in new clients and expanding relationships with present clients, there is considerable improvement that must still be made. We believe any firm can cut to the quick on this need for improvement by focusing on what it is that clients (and potential clients) say they need and is important to them. This implies an effective feedback program, broad based contacts in the community, and solid market research. It is difficult work, requires effort, and is considerably more painful than promotion and fluff – but, it is also considerably more effective.

Try Some New Things – Shake It Up

Too often there is a reluctance to make change and stir the pot and we believe that is one of the reasons (albeit part of a long list) talented people leave a firm. Simply put, the status quo rules – more often than not. We think law firms need to shake it up a bit, try some new things, and succeed in some and fail in others. Examples of such ideas include:

- Establishing an advisory board for the Firm itself or a key industry practice (something we have mentioned for years, but few have tried).
- Establishing a futures committee (possibly of younger, very creative partners) that looks at the future of the profession and the future of the firm and develops recommendations for new practices, new offices, new career development paths, strategic growth, etc.
- Develop a "*fluffless*" annual report that really speaks to advancements the firm has made in the prior year (those advancements focused on better serving clients and accomplishments).

This completes our annual look at trends and their related suggestions/recommendations. We believe 2008 will be a real managerial test and challenge for most firms, but the opportunities are there for continued very positive performance. We wish our clients and friends well this year.

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Smock Law Firm Consultants is a focused strategic management consulting firm serving law firms in five areas – strategic planning, mergers and combinations, practice group management, law firm finance, and strategic management issue resolution. Our three partners – John Smock, John Sterling, and Peter Giuliani are, we believe, simply the best *“first team”* providing strategic management consulting to law firms.