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Our 2010 Legal Market Outlook: Strategic Thinking for a Fragile Recovery

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The signs of economic recovery have been emerging for several months. GDP expanded 5.7% in the fourth quarter, Citi Private Bank's recent confidence survey finds guarded optimism returning among larger law firms, and Smock♦Sterling's own fourth quarter law firm survey found the same. Yet, without a doubt, the broader economic recovery is fragile.

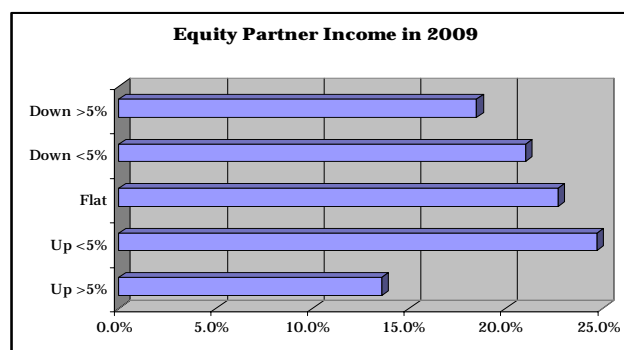
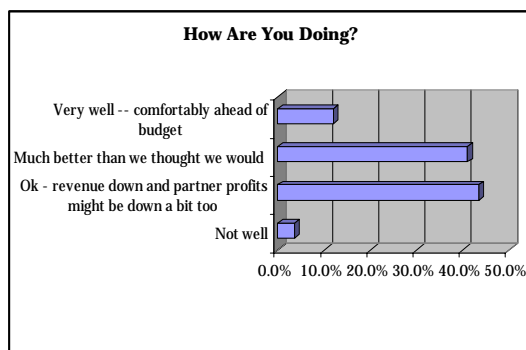
- Employment has stopped plummeting, but growth has not emerged and no one really knows when it will.
- Manufacturing is up, but is largely buoyed by replenishment of inventories that were drawn down to historic lows.
- The stock market has recovered from its deepest depths, but gyrates day-to-day in a range it found several months ago.

Importantly, most law firms' clients are necessarily cautious. Current profits are hard won and costs are still being tightly controlled. So, while law firms have likely weathered the worst of their own storms in comparison, their clients are still sailing into gale force winds.

In response to these factors this monograph offers an outlook for the legal industry for 2010 – with an eye toward the most critical strategies for this fragile recovery. In the following sections we take a quick look back at 2009 and the results it brought to law firms, assess where the legal industry really stands in this first quarter of 2010, and offer advice and strategies for law firm leadership for the balance of the year.

A BRIEF LOOK BACK

Perhaps the most charitable thing that can be said of the past year is that it was not as bad as law firm leaders expected as the year began. Regular readers will recall that we surveyed mid-size law firm leadership during the fourth quarter of 2009, as the year was drawing toward a close. Leaders were asked, "how are you doing" and the results were modestly encouraging and more than half (about 60%) saw partner income either flat or up. Fewer than 20% of mid-size firms saw profitability off more than 5%.



As the largest Am Law firms begin to report 2009 results, it is becoming clear that among the large firms, revenues were down – in most cases modestly – but, many managed the cost side (and/or the equity partner ranks) in ways that preserved PPEP. While a few firms suffered mightily, most were able to cut costs sufficiently to avoid dramatic profit erosion. In fact, our discussions with client after client in the first few weeks of 2010 indicates that cash collections generally exceeded expectations and partner income turned out markedly better than even October 2009 projections.

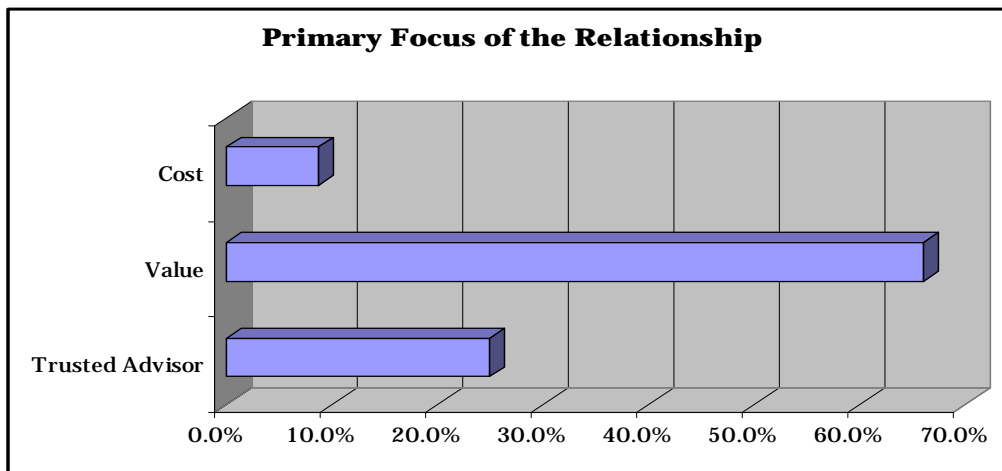
A review of cost cutting strategies reveals two obvious conclusions. First, firms emphasized cost reduction tactics that were least painful to the partners. Second and more importantly, the range of cost cutting strategies represented a mixed bag – some steps have permanently improved law firms' cost bases (e.g., capacity reductions, salary structure adjustments, etc.) and some are, quite frankly, unsustainable (e.g., cutting CLE travel, eliminating firm meetings, etc.).

In an environment with substantial turmoil, Law.com found lateral partner movement in the Am Law 200 spiking in 2009. Lateral partner moves increased 11% in 2009. Some of this movement undoubtedly reflected firms forcing partners out. However, much of it represented opportunistic hiring on the part of more optimistic firms. Litigators moved more than any other group of partners – and they were clearly busy in 2009. Thus, one can only conclude that partner mobility will remain a strategic issue.

The responses to the recession we find most encouraging, however, are steps that enlightened firm management took that enabled them to break free from long established patterns. Far too many firms, for far too long, have followed one another off the proverbial cliff – on starting salary increases, hiring practices, summer programs, and many other costly business practices. So, we were happy to see firms take steps such as:

- Cutting entry level pay as a response to salary compression in the associate ranks (rather than bumping up mid and senior associates) and, simply, to excise associate costs;
- Abandoning lock step pay scales from entry level to senior associate ranks – recognizing that merit based raises are possible and rational, particularly after associates have been in the firm for a couple of years;
- Turing away from the strategy of hiring large entry level associate classes in anticipation of attrition – a necessary change, as associates and non-equity lawyers stopped leaving for “greener pastures.”

Finally, law firms came to the bracing conclusion that client demands for greater value (value = results ÷ costs) were serious and were not going away. Susan Hackett, General Counsel at the Association for Corporate Counsel, had been a voice in the wind in the mid-2000's with regard to value. But, the ACC Value Challenge and the emerging ACC Value Index has put a very bright spotlight on value – and law firms ignore this trend at their own peril. That recognition of the importance of value was underscored by responses to our late 2009 survey – nearly two-thirds now believe the primary focus of their firms' client relationships is on value.

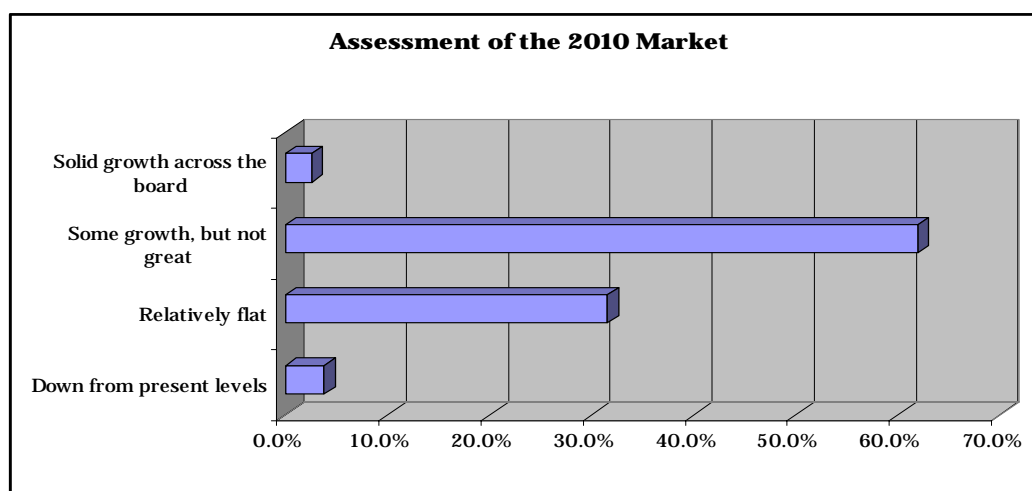


This drive toward value is accruing to the benefit of high quality mid-size firms that are able to deliver first rate work with leaner staffing and more competitive rates.

WHERE WE ARE TODAY

In most years, law firms and lawyers are melancholy at the prospect of closing the books on a year. Wiping the slate clean for a new year usually means resetting all the key performance metrics (billings, originations, hours, etc.) to zero – preparing to run the race yet again. And after a strong year, going back to zero is daunting. But, with the year just completed, we suspect many welcome the opportunity to start fresh.

We see unmistakable signs of optimism emerging across the spectrum of law firm leadership. The Citi Private Bank “*Managing Partner Confidence Index*” found Am Law 100 managing partners’ confidence rise above the benchmark 100 level for the first time in over two years. The Am Law 200 index remained over the 100 benchmark for the second quarter in a row. And, Smock Sterling’s own law firm survey (of firms comparable to or slightly smaller than the Am Law 200 firms) showed similar levels of guarded optimism.



While some practices are expected to remain slow for the foreseeable future (e.g., real estate, securities, and M&A), others are expected to be quite busy. Diversified law firms have solid reasons to take a positive outlook for 2010, as their strong practices are expected to more than cover for the revenue erosion attributable to lagging transactional practices. Further, as the banking system and the broader economy continue to heal, M&A work and capital raising activities should begin growing again in the second half of the year.

We believe important lessons have been learned and law firm leadership is poised to inject these lessons into their management practices going forward.

- The diversified economic model pursued by most firms (the so-called full service business law firm model) is remarkably resilient.
- Quality and value trump size for all but the most obviously “*bet-the-company*” matters or cases – a lesson with significant implications for all firms.
- Firm culture and shared values matter – in an environment of continued partner mobility, shared values (the “*soft*” side of management) can serve as important glue to keep key people in place.
- The emergence of real and meaningful breaks from established management precedents has opened the door to genuine strategic thinking (i.e., to doing different things differently from the competition, rather than merely trying to do the same things better).

STRATEGIC THINKING FOR THE RECOVERY

We believe there are several critical management practices that law firm leaders should embrace and pursue in 2010.

Assess the Competitive Environment and Adjust Your Strategy

The competitive environment has changed substantially. The next few years will witness a re-ordering of the competitive landscape and most firms' primary strategies are clearly out of date. Smart firms will use 2010 to take affirmative steps, such as:

- Understanding your own firm's external environment (i.e., client expectations, competitors' strengths and weaknesses, industry driven opportunities, etc.)
- Translating that understanding of the external environment into a solid assessment of what the implications are for your firm
- Articulating a strategic direction and directly allocating resources that:
 - Capitalize on and leverage your firm's unique strengths;
 - Capture winning market positions (i.e., aligning strengths against the opportunities and/or competitors' vulnerabilities).

Ultimately, strategy development should be about finding ways to be different from the competition – that are of real value to clients and prospective clients.

You Cannot Save Your Way to Prosperity

Most well managed firms took important steps in 2009 to bring costs and capacity in line. Many of these cost reductions were overdue and should be viewed as permanent adjustments of the cost base. However, future profit growth is not going to be a function of ever declining costs. Furthermore, some of the cost reductions taken in 2009 will not be sustainable over time – even in the nearer term.

On the contrary, the time has come to climb out of the bunkers, tell your partners that the artillery barrage is over, get back to aggressively selling the strengths and quality of your law firm and your lawyers, and invest in those areas/strategies that will better serve your clients and contribute to continuing profit growth. If you have partners who are still consumed by excessive pessimism, point to the objective evidence that counters that pessimism (some of which was outlined above).

Remember that costs are only one element in a law firm's economic model. Attention needs to be given to all five of the below profit drivers.



Put Your Emphasis on Client Value

In our view, the ACC Value Challenge is an exercise in common sense. The process calls for a three step mantra – Meet Talk Act. Frankly, law firms that have employed client service teams (a strategy Smock♦Sterling has advocated for years) have been taking this approach proactively – at least with their largest clients. Beyond client service teams, we recommend a variety of strategies and tactics that can advance your focus on client value.

- Take a look at any recent response to an RFP your firm sent to a prospective client and ask yourself, “*are we doing all the great things we are offering this prospect for our existing clients?*” If your answer to that question is a sheepish “no,” it is time to revisit your service levels for existing clients – and, importantly, how you communicate with them.
- Do not equate rates (whether they are up, flat or discounted) with value. Some areas of practice are more rate sensitive than others. But, value is a function of the results a firm achieves for its clients relative to the total cost associated with delivering those results. Value is purely in the eyes of the clients – so, ask them directly what you are doing well and where you can improve.
- Understand that alternative fee approaches is a very broad topic – there cannot be a one-size-fits-all approach. But, if you want to get serious about alternative fees (and it is probably wise to), we recommend taking a few steps.
 - First, make certain that you have a clear understanding of your cost structure and how different approaches to pricing relate to that cost structure.
 - Then, when a client expresses an interest in pursuing alternative fee structures, ask them directly what their objectives and motivations are for seeking an alternative to hourly rates.
 - Some will be interested solely in saving money – in which case simple solutions will likely work (e.g., blended rates, discounts, etc.).
 - Some will be keenly interested in greater predictability – which leads to an entirely different set of alternatives (e.g., fixed prices for projects or blocks of work, flat monthly charges to handle blocks of recurring work, etc.).
 - Still others will be seeking to align risks and rewards with their outside counsel – these situations will call for creative approaches to risk sharing where there are genuine upside and downside fee levels, tied directly to pre-defined outcomes (e.g., success premiums, quasi-contingent fee arrangements, etc.).

Good Management Includes Measurement, Monitoring, and Accountability

The more often law firm profitability is reported on a per equity partner basis, the greater the pressure to ensure every equity partner contributes positively to profitability. Firms have been “*managing the denominator*” for quite some time – long before the recession. We believe that partner level accountability is entirely appropriate. However, that means that firms should be as unambiguous as possible with regard to stating performance expectations for partners. If the standards are clear, consequences (both positive and negative) for performance to or divergence from those standards should not be controversial.

That said, over the next 10 years, the legal industry (and other knowledge intensive businesses) are expected to face serious labor shortages. To avoid an outright price war for people when those shortages hit, firms are well advised to consider alternative career paths for non-partners. The future will not be strictly “*up-or-out*” and firms that can retain a knowledgeable middle tier (at a cost advantage) will be able to deliver greater value to clients.

Finally, as we [discussed in some depth here](#), we believe the Balanced Scorecard provides a reasonable set of categories for setting targets and measuring results at the firm and practice group level. While your firm may want to reach beyond the standard categories, the four core areas that lend themselves to measurement, monitoring and accountability are:

- Financial outcomes (profitability and the underlying drivers of profitability);
- Client outcomes (driven by perceptions of value and measured in ways that align with the firm's approach to client relationships)
- Legal service delivery (focusing on ensuring efficient, high quality processes)
- People and their capabilities (building deeper and broader knowledge bases and ensuring that knowledge is leveraged to solve clients' problems).

Execute on Management Fundamentals

At the risk of sounding like broken records, we cannot emphasize strongly enough how important it is to execute on the fundamentals of good law firm management.

- Ensure every practice (and every person in the practice) understands the valuable role they play in the firm – and is executing against that understood and agreed to role. Consider using some variation on practice portfolio management as a tool for clarifying those roles.
- [Take practice group management to the next level of effectiveness](#) – and give your practice group leaders the tools and support that need to succeed in that migration up the learning curve.
- Allocate time and energy to existing client relationships – it is the best source of work (both continuing work and new work via cross-marketing).
- Ensure that you not only have a clearly defined strategy, but that it is communicated and executed on a continuing basis. You can never over-communicate about strategy and direction. And, you will rarely be faulted for actually doing what you said you were going to do.

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As always, we welcome your feedback, your questions, and your interest in the strategic management of law firms. We look forward to hearing from you in the coming weeks and months.

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 become 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).

Roughly 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 – something none of our primary competitors do. Our three partners (the authors of this monograph) are, unquestionably, the most experienced “*first string*” of any consulting firm serving the legal profession.

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