

SMOCK♦STERLING

Strategic Management Consultants

THE LEGAL MARKETPLACE IN 2007 – RIP VAN WINKLE WOULD NOT RECOGNIZE IT!

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Smock♦Sterling Strategic Management Consultants takes a step back once a year to assess the legal marketplace (where we spend close to 75% of our time) – the status, the trends, and what our clients (and, for that matter, all firms) need to do to survive and prosper.

This year, we decided to step further back than just year-to-year trends and examine the market from a multi-year perspective. The analogy of Washington Irving's Rip Van Winkle – who went to sleep for twenty years and awakened to a dramatically different world – is apt. If you were to go back to 1987, fall asleep for twenty years, wake up, and view the legal management 2007 landscape, you would see dramatic change that the year to year view does not illuminate as clearly.

- Twenty years ago *"Managing Partner"* was a title, not a position; marketing was considered (at best) to be unprofessional; management was perceived to be a non-value added activity; and the complaint that *"we are a profession, not a business"* was often heard.
- In the last twenty years, the legal management environment has radically transformed itself in many ways from a hybrid business/professional business model to a highly competitive, highly lucrative performance focused business model.

WHERE ARE WE TODAY?

For the last twenty years (while Rip was asleep), virtually every law firm management article (or consultant's brochure or website) has opened with the obligatory preface – *"in this increasingly competitive legal industry environment."* Interestingly, this rote statement has truly come home to roost – the legal industry is considerably more competitive than it has ever been and that competitiveness is accelerating.

- Most good business law firms and their partners are very, very successful – particularly when measured by profit per equity partner (PPEP), which has become the primary (and, unfortunately in many cases, the only) barometer for success.
- This remarkable record of financial success has spawned dramatically increased competition for the best clients, the best work, and the best people (witness the recent jump in associate salaries – now cascading through the industry in the aptly titled *"war for talent"*).
- But, even in early 2007, much of the recent success (again, as defined by partner profitability) often remains a function of attorney rate increases – not better management, internal discipline, or successful external strategic initiatives. Simply put, the last six years (since the associate salary jump that preceded the dot.com crash) have seen significant rate increases for business law firms – much of which has directly dropped to the bottom line. Though clients have complained and are complaining about those increases, most have accepted and paid them.
- It has become generally true in the legal marketplace that *"if you can diversify your practices, hire and retain good people, charge and collect competitive rates, it is virtually impossible not to make very good money."* It is very hard to say that about any other industry segment.
- But, this remarkable run of good fortune for the industry is perceived by most well run firms and their managements as about to run out. It is clear to them that future successes and gains will be harder to attain and will not be a function of the *"rising tide lifting all boats."*

TRENDS IN THE LEGAL MARKETPLACE

Continuing and Significant Consolidation

The trend to legal consolidation continues apace – with the last year witnessing significant combinations (e.g. – Reed Smith and Richards Butler, Bingham McCutchen and Swidler Berlin) and significant cessations of major mega-merger discussions (e.g. – Orrick and Dewey Ballantine, Bryan Cave and Squire Sanders). This indicates that there are considerable and heated combination discussions going on as we write – 2007 will probably see an increased number of mergers, acquisitions, and combinations.

- There are legitimate reasons for combinations – such as size becoming a more important factor in outside counsel selection and in attracting and retaining talent; significant growth giving a combined firm a different and upgraded playing field; client base consolidation (in all industries); and the fact that many larger law firm mergers have worked, as defined by increased PPEP.
- It has become evident that, if a firm intends to achieve significant growth, it can only get there two ways – through a relatively large combination or by focused growth through market leading practices. Of the two, the relatively large combination route is quicker and, usually, easier to do.
- But, significant opposition remains within most firms to large scale mergers or combinations. They do not want to merge, they only want to acquire – in the long run a statistical impossibility for many. This opposition often consists of high performing partners who are worried about their cheese being moved and underperforming partners who are rightfully threatened. And, mergers/combinations always create opportunities for nimble, smaller firms – there are lucrative gaps in the market that can be filled by creative firms and practices.
- We expect that the merger/combination trend will continue in the near future. The average deal will be larger, all of them will still be focused on moving up the food chain, and, very importantly, the process will take, on the average, less time and be less painful, as firms get better at it.

The Profit Imperative

We mentioned the importance that has been placed on profits per equity partner as the prime (and often, the only) measure of law firm success.

- As consolidation, globalization, and other trends continue, Smock♦Sterling sees the industry segmenting further with entrenched (and highly successful) competitors cementing themselves in the upper echelons of the legal industry.
- The most successful major law firms will not necessarily be the largest, but they will be among the most profitable – with the most sustainable market positions (based on practice areas, client relationships, and scale in key locations).
- Market trends are creating discernable tiers across the Am Law 200.
 - There were 11 firms with profits per equity partner at or above \$2mm (ten of those are indigenous to New York) in 2005. Beyond that, there are nearly 50 more firms with profits per equity partner at or above \$1mm. We expect that 2006 results will up that number.
 - Within the Am Law 100, the median compound average growth rate (CAGR) of per partner profits was 9% from 2000 to 2005. There were 14 firms in the Am Law 200 whose profit growth over that period exceeded 100% (that is, more than doubled).
- There are different strategies at work among the firms that have captured outsized profit growth. Some have aggressively managed the denominator – de-equitizing partners and/or carefully restricting new entry into the equity ranks. Others have focused intensively on their most profitable areas of practice – cutting unprofitable areas. Still others have grown dramatically – geographically and/or in number of lawyers – while restricting new entry into the equity ranks.

The result of this partner profit growth and the singular focus on it is that PPEP has become the prime gating mechanism for lateral candidates' consideration of a firm, evaluation of potential merger candidates, and, unfortunately and misleadingly, the professional worth and competence of a firm.

Costs Are Rising

The most visible cost increases are associate salaries with the recent increase to \$160,000 plus bonus in New York. It says something when an entry level professional in an organization is paid nearly as much or more than the pinnacle of the profession (a Supreme Court justice).

- One could argue that the top New York firms keep upping the ante (as Reagan did with the old USSR) to force those who cannot compete out of the high end market space.
- With all top firms trying to recruit a very finite group of roughly 1,600 or so top tier students annually from top tier law schools, this “*war for talent*” keeps escalating.

But, associate salaries are not the only increasing costs. Technology investments, space, marketing costs, and increased need for non-billable time from key attorneys (e.g. – practice group management, marketing, mentoring, and client relationship development and maintenance) are also increasing.

Escalating Pressure on Rates and Fees

Every law firm client of ours – whether their practice focus is international, national, regional, local, or specialty – complains about the continuing pressure on rates and fees.

- Clients are pushing back and, in some cases, pushing back very hard. Continuing rate increases are getting harder to achieve (but, most firms are still getting them – it is just that the effort to do so is now much more difficult).
- But, those pressures (and, remember, clients are under the same cost pressures – both internally and externally) are causing clients to develop radical approaches to controlling legal costs – shifting work to smaller firms in smaller cities (with a lower rate base), going offshore (yes, to India), and dramatically lowering the number of law firms they retain.

Partner Issues Still a Concern

Law firm managements still spend a good portion of their time dealing with partner issues – the primary ones are under-productivity, partners not behaving as owners, and promotion to equity partner.

- While the underproductive partner is a problem in every firm – its negative impact is greatest on the many permissive partnership cultures that are struggling to retain (sometimes unsuccessfully) their star many performers. Permissive cultures are most strongly embraced by underproductive partners – the culture protects them and justifies or excuses their lack of production.
- We define the issue simply (and often to the chagrin of those underproductive partners) – if a firm overpays (and coddles) underproductive partners, it is underpaying productive partners – and while the unproductive partners may not know that, the productive partners surely do.
- Too many firms have too many partners who do not behave and contribute as partners (our experience has been that there is fairly strong overlap with the unproductive partners). There is a simple rule that applies here – *“if you do not act as a partner, you cannot be one.”*
- Admission and/or promotion to equity partner is dramatically tightening. There are both good reasons and bad for this – **good**, because firms are recognizing that equity partners must do it all (bring in the work, do it, delegate, and develop people) and many lawyers (even good lawyers) cannot do it all and **bad**, because the desire to keep the number of equity partners small (the denominator) to influence PPEP drives equity partner decisions.

Teamwork, Collaboration, and Groups Are Winning

It has taken a long time and it may be too early to declare victory, but the concept of teamwork and group service to clients (and in business/practice development) is triumphing over the Lone Ranger (the partner who hoards his/her clients and does virtually all of the work). This is good, because the clear trend in American (and global) business is to teamwork and collaboration.

- Clients served by multiple partners and multiple practice groups have much higher rates of long term retention – as definitively confirmed by third party research.
- The Lone Ranger is dying off – but, in those firms where he/she still exists, not without a fight.

Diversity – a More Critical Two-Part Challenge

It is an accepted fact that firms that successfully hire, develop and retain women and minorities are and will continue to be increasingly attractive to corporate America.

- Societal change continues to challenge traditional career paths and motivations and retention of female attorneys is a significant challenge for law firms. As female attorney hiring (as a % of all associates to match their majority status among law school graduates) continues to grow, this retention issue becomes greater and greater.

- But, the most significant challenge is the intensely competitive environment for talented minority lawyers – requiring effective recruiting, retention, and promotion to succeed. It has become an “A List” criterion and larger firms generally do it better than smaller ones.

WHAT DO SUCCESSFUL FIRMS NEED TO DO?

We believe there are a number of management approaches and cultural attitudes that firms will need to adopt to be successful in the future. These include:

- A clear strategic direction focused externally and on their strategic growth needs – not on internal management and partner compensation
- A culture that clearly emphasizes “*running this place like a business*”
- Effective practice group organization and management of those groups as “*true business units*” (i.e. – managing each practice to achieve targeted financial contributions) and the understanding of the importance of strategic growth at the practice level to improved profitability
- An understanding of what level of growth is necessary to achieve the stated strategic direction and, if strategic growth is required, a defined merger/combination process (assigned responsibility, resources, and agreed upon steps) to carry out that process effectively and simply
- A focus on and clear strategies to achieve improved and competitive partner profitability – simply put, successful firms **must** be competitively profitable with the firms with whom they primarily compete
- A partnership of committed, fully engaged partners/shareholders as owners – no deadwood, no protective culture
- Partner/shareholder compensation systems that meet three essential criteria – first, respond to those who bring it in – as the top priority; second, be fair; and finally, align compensation unambiguously with the firms’ strategic direction
- Below partner level, compensation levels, benefits, and professional development and training programs that are comparable to competitive firms
- Consistent professional discipline within firms’ management and among the collective bodies of partners – not the discipline associated with the military, but that required of true professionals (i.e. – the primacy of client service, responsiveness to clients, financial hygiene in terms of billings and collections, and importantly, accepting accountability and expecting it of others)
- A marketing that results in and is measured on directly impacting additional work for present clients and new work for new clients
- Competitive use and understanding of the value of technology in practicing law
- Finally, creative and differentiating human resources policies and programs and internal communication approaches that serve to attract, develop and retain the best people

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Smock♦Sterling Strategic Management Consultants is a focused strategic management and planning consulting firm. In our law firm practice, we focus on five key areas – strategic planning, mergers and combinations, practice group management, law firm economics, and strategic management issue resolution.

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