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### THE LOOMING RECESSION: THE GLASS MAY BE HALF FULL

By Peter A. Giuliani

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Wow! What a trip! This time last year we were looking at a 13,500 Dow, oil was over \$90 a barrel, and the Fed was continuing to inch up interest rates in anticipation of rising prices. As of this week, stocks have given up almost 35% of their value, oil is flirting with \$40 a barrel and Treasury yields are barely above 0%. No longer are we worried about rising prices. It's *deflation* we fear.

According to *The Connecticut Economic Digest*, most of economic indicators for Connecticut are clustering around the national averages. The Digest goes on to say "*Prospects for the Connecticut economy are ominous for the foreseeable future. Though the state may not have fared as badly as some states and seems to be avoiding the cliff...Connecticut may soon join the rest of the nation in a severe recession.*"

Jobs data for the state's ten major employment sectors are mostly down. Construction jobs have taken the biggest percentage hit – no surprise there – but declines in manufacturing and financial sector jobs are also significant. The only sectors showing job growth are Education and Health Services, Government, and Leisure and Hospitality Services.

If nothing else, this economic crisis will probably forever change how the US banking industry is structured and regulated. Permit me an amusing anecdote: While visiting a large Toronto-based law firm back in September, I remarked that it looks like commercial banking in the US will soon resemble Canada's banking industry, with five giant banks grabbing most of the market share. My host replied that my scenario was dubious because, unlike the US, the Canadian government holds large equity positions in the major commercial banks. It took less than a week for Hank Paulson to prove him wrong.

The reality is that Bank of America and Wells Fargo now own Merrill Lynch and Wachovia. Goldman Sachs and Morgan Stanley are now commercial banks and JP Morgan Chase owns Bear Stearns. (Remember Glass-Steagall?) This changing landscape will dramatically affect how investment and commercial banking work in the future, especially since the Federal Government will be a major investor in the industry. We might well take a look at Canada to see if we can spot any parallels.

As for the tectonic shift in the financial services sector, Connecticut is probably in for more than its fair share of bumps. Even though most of our native large commercial banks have been bought up, we still are heavily invested in three key sub-sectors of the financial industry: insurance, re-insurance and hedge funds.

So far, Connecticut's insurers seem to have weathered the storm better than AIG has, but we do not yet know the full picture. In the "*Sub-prime Crisis*" alone we're months away from sorting out the damage. Mortgage brokers wrote a bunch of mortgages and then sold them to intermediaries, who then sold them to investment banks who then securitized them and sold the securities to banks and other investors, who bought them based upon overblown ratings by Moody's, S&P, etc.

At each step of the way, one or more insurers wrote policies to cover default, errors and omissions, portfolio losses and a host of other bad things. Having written these policies, they laid off some of the heavy risk to re-insurers. Insurance companies also bought some of these securities for their own portfolios. There was also another whole market in credit-default swaps that was passing the risk around outside the regulated insurance industry.

Right now there is a huge game of musical chairs going on as the financial sector tries to sort out who is going to eat what portion of the sub-prime-crisis losses. As we learned from the S&L crisis, this is going to take a long time to resolve. The good news is that it will take lots of lawyer time to get the job done.

If the economic news for Connecticut is bad, recent developments in the legal profession have been stunning. First came the news that Paul Hastings had decided to close up shop in Stamford. Next, venerable Tyler Cooper & Alcorn announced it was dissolving and its lawyers were joining Hinckley Allen (Providence, RI) and LeClairRyan (Richmond, VA). Shortly thereafter, Thelen Reid cratered resulting in a nice acquisition of its Hartford office by the home-town-boys at Robinson & Cole and another pick-up office for LeClairRyan. The latest – and probably most bizarre – event was the collapse of Dreier LLP in the wake of the arrest and prosecution of its founder and sole equity partner. That said, it looks like the former Stamford office of Dreier will be able to reconstitute itself and continue on with a new identity.

I doubt whether we'll see any more dramatic collapses in 2009, but we might. We might also see another big regional combination, like Day Berry and Pitney Hardin, but that too is impossible to predict.

On the positive side, there should be no shortage of work for Connecticut insurance lawyers in helping to sort out the sub-prime crisis. Bankruptcy, loan restructuring and related litigation practices should also be very active.

As long as credit remains tight – and the pundits say credit will probably remain tight for another four to six months – real-estate finance and development, construction, asset finance, private equity and M&A practices will be inactive. But look for increased activity for those who handle construction litigation and who help with projects that have stalled because their sponsors ran out of money.

Recessions are also typically good for patent and IP litigators. This is usually the time when troubled companies turn to litigation as a strategic weapon to protect technologies (defense) and lock out competitors (offense).

With the new Obama administration coming in, look for increased activity in environmental, labor and employment. There are also a few firms outside the state that are forming "*Climate Change*" practice groups to take advantage of the new market for "*green*" products, alternative energy and trading of carbon credits. Tax and T&E lawyers should also see increased work as soon as the new administration gets around to dealing with tax policy.

While Connecticut's lawyers will undoubtedly see some adverse effects from this recession, the effects will be markedly different from the last two recessions. In the last recession – the "*dot-bomb*" and 9/11 recession – the greatest impact was felt by firms with emerging-company and high-tech practices. In the recession before that, we got hit with the double whammy of the S&L collapse and the retooling of Connecticut's defense industry sector in the wake of the end of the Cold War. Oddly enough, it was that recession that affected Connecticut firms the most, as it also coincided with the collapse of City Trust and the sale of our two biggest commercial banks to Boston-based banks.

What should law firms do in addition to hunkering down to ride out the economic storm? First, they should take time to meet with their clients to discuss how their legal service needs are changing, as a result of the recession. This is a good opportunity to learn how clients' businesses work. If firms want to follow Pepe & Hazard's lead in foregoing rate increases, by all means do so. It may not bring in new work from new clients, but it will help solidify existing work.

Next, firms should look carefully at expense budgets and try to eliminate all non-essential spending. Consider deferring technology upgrades where it can be done without affecting client service. That said, it is not a good time to slash the marketing budget. Instead, firms should cut spending on “*indirect*” marketing (e.g., web sites, brochures, etc.) and shift money into “*direct*” marketing, such as one-on-one meetings with clients, referral sources, industry/trade associations, etc.

In addition, this is a great time to get really selective about recruiting and retention. If a firm has a law school recruiting program, it is a good time to cut back on the number of Summer interns and use the money to invest in training and retaining the best lawyers already on board. Unwanted turnover is very expensive, so retention dollars are better spent than recruitment dollars.

Firms should also take a hard look at their timekeeper staffs and cull those who are not making the grade. This goes for paralegals, associates and partners alike. A recession provides a lot of “*cover*” for restructuring the professional staff. That said, firms should not panic and fire indiscriminately.

At the same time, partners should be diligent about driving work to the best associates, where possible. In a down economy, having partners doing associate-level work is not something clients will look positively on.

Finally, partners may have to get used to the idea that their incomes may decline in 2009 and 2010. No other business in the world can sustain consistent year-over-year increases in earnings, and law firms are no exception. The good news is that the last three or four years should have been great years for law firm profits, which should provide some cushion.

Recessions and expansions are generally good for law firms, especially those that have countercyclical practices, like bankruptcy and litigation. What goes up will come down; what goes down will come up. As we ride the ebb tide, we should prepare for the eventual flood tide. Now is the time for patience and discipline.

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