

# SMOCK ♦ STERLING

Strategic Management Consultants

***“The pessimist sees difficulty in every opportunity.  
The optimist sees the opportunity in every difficulty.”***  
– Winston Churchill

## **WE ARE OPTIMISTS – WE SEE THE CUP AT LEAST HALF FULL**

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We last wrote about the state of the legal industry in summer, in a monograph that held forth a relatively optimistic view of the future for law firms in spite of some of the economic information available at that time. That monograph was based on a large number of one-on-one conversations with clients and friends across the industry, but our findings (although not necessarily our recommendations) have since been eclipsed by two major events:

- **The liquidity and credit crisis** – which we believe began in earnest on September 15, 2008, the date Lehman Brothers declared Chapter 11 bankruptcy. That date and the days immediately surrounding it included Bank of America’s buy-out of Merrill Lynch, a government bailout of AIG (since expanded beyond the original \$85 billion loan), and what amounts to a government takeover of troubled mortgage giants Fanny Mae and Freddie Mac (which preceded the Lehman bankruptcy by just a few days). Since that initial triggering event, a number of private and government actions have followed (e.g., “brokered” consolidation of banks, government equity injections into the banking system, Federal Reserve emergency loans, etc.).
- **The election of Barack Obama** as the 44<sup>th</sup> President of the United States and the expansion of democratic majorities in both houses of Congress.

This monograph focuses on how we anticipate each of these events will affect law firms. In addition, we will offer our advice on what law firms can do – strategically and operationally – to capitalize on the opportunities these changes will surely bring.

### **IMPACT OF THE FINANCIAL MARKET MELTDOWN**

The most obvious consequence of the liquidity crisis and the resulting financial market meltdown was its impact on the global economy as a whole. We went from a slowdown and likely recession to a shutdown (of credit markets at the least) and a virtually guaranteed recession – some predicting that recession to be deep and persistent.

We expect law firms to experience a number of direct effects – some positive some negative - from the scope and nature of the financial meltdown. First, the **bad news...**

## **Profit Pressures**

Profit growth – at least in the AmLaw 200 – has largely been driven by rate increases throughout this decade (with an assist from those firms that have aggressively managed the denominator to maximize PPEP). But, the era of readily accepted rate increases well above the rate of inflation is over for the foreseeable future.

Given the run-up in AmLaw 200 profitability over the past decade, one might view the flattening we anticipate for the next year or two as an overdue “*earnings correction*” for PPEP. Frankly, we believe this “*correction*” will be modest for most firms – particularly when compared to the severe profit pressures other industries are facing.

One bright spot we see emerging from this profit pressure is the abrupt and nearly complete halt in the (often irrational) growth of associate starting salaries. Recall that the run-up in salaries in the late 1980’s and early 90’s was also stopped by a recession, probably the first to affect law firms directly and which also led to significant layoffs.

## **Layoffs and Cutbacks**

The next recession (2001) did not lead to many law firm layoffs. By comparison, as this new recession has picked up speed, we have already seen a significant number of publicly announced layoffs and staff cutbacks at firms around the country. Some were hit early in the year in response to the downturn in segments of the securities markets (e.g., Cadwalader); others are very recent and intended to position firms for what they anticipate will be a difficult 2009.

The American Lawyer has documented layoffs at roughly 20% of the AmLaw 200 this year. That number reflects only the publicly documented layoffs. We are aware of other firms taking quiet steps to reduce both their administrative staffs and complement of attorneys. The layoffs can be attributed to a few underlying causes:

- **Practice based decisions** – where a downturn in work in a particular practice is viewed as unlikely to rebound in the relatively near term (e.g., mortgage backed securities, real estate development, etc.)
- **People specific decisions** – in which firms take the often difficult steps to separate from underperforming partners (and other lawyers) who are not viewed as having a long term productive future with a firm
- **Planned strategic realignments** – firms using the economic downturn as “*cover*” to exit selected areas of practice (or offices) that no longer fit their strategic direction or platforms
- **Outright business failures** – in which firms (or significant pieces of firms) collapse or exit en masse (e.g., Heller Ehrman, Thelen).

Even in the case of planned realignments, layoffs and cutbacks are always difficult and usually delayed – the current prevalence of these actions indicates how serious the current economic situation is.

## **Significant Law Firm Mergers Will Be More Difficult to Complete**

In a recent AmLaw Daily article, Paul Lippe predicted that “*more AmLaw 200 firms will Heller-ize over the next 18 months than will merge.*” While we believe that this overstates the case, we do agree that completing mergers between major firms will be more difficult in a recessionary economy. There are a number of factors weighing on potential mergers.

- The valuation of qualified defined benefit plans just collapsed. If a plan was modestly underfunded, it is now dramatically underfunded. Combining firms with different positions vis-à-vis defined benefits plans and other unfunded liabilities has just become very difficult.
- A significant hurdle in many combinations (even those that are essentially acquisitions) is making difficult (i.e., unpleasant) decisions regarding who gets to be an equity partner in the newly combined firm. Those tough economic decisions are even more accentuated in this economic environment (see the discussion of profit pressures above). Reason dictates that to make future mergers work, fewer and fewer attorneys will make the equity partner cut.
- The balance sheet of “*new firm*” (the combined firm) better be rock solid, which may mean a capital call on the equity partners of both legacy firms. Banks are going to be loath to finance merger costs in a thinly capitalized, new partnership, particularly in the wake of Heller’s dissolution.
- The current downturn is going to cause some firms’ most important and reliable clients to disappear as independent entities. That will put pressure on firm leaders to make the case for mergers based on client level synergies.

Ultimately, we suspect that the lukewarm and dormant discussions among firms will be even more prone to scrutiny by internal skeptics and cynics. Thus, even some strategically well structured mergers will be more likely to collapse of their own weight.

But, **the cup is half full** – there are silver linings for law firms in the current market meltdown.

## **Innovation and Value Creation**

Viewed through a wider lens, a wave of innovation and creativity should be unleashed as law firms’ reliance on rate increases as the primary driver of law firm profit growth is broken. Firms have not closely examined their fundamental business model for some time – either at the firm level or the practice group level. Current profit pressures could prove to be a meaningful motivating factor leading to better approaches to the structure of law firms and the ways they do business.

- Prahalad and Ramaswamy make a compelling case in *The Future of Competition* (2004, Harvard Business School Press) that tremendous value is created when products or services are developed collaboratively by the providers of those services **and** their clients. They called this process *co-creation*.
  - Actually, this has been the case in the legal industry for at least a generation, as a number of firms or client relations partners have clearly partnered with their clients for mutual benefit.

- The greatest and most valuable service innovations have been a collaborative product of private practitioners and their clients – in the creation of financial instruments, corporate structures, approaches to large scale litigation and other high value services.
- So-called “*relationship firms*” are well positioned to leverage co-creation throughout this downturn. As a result, they may leap-frog higher profit, one-off service competitors relative to both the value delivered to clients and to their position in AmLaw 200 profitability rankings.
- Meanwhile, firms at the top of the AmLaw rankings **must** innovate throughout this recession or they will find themselves in a serious profit dilemma. Clients will have few incentives to pay super-premium hourly rates for most transactions and/or disputes (i.e., the volume of high profit work simply will not be there). At the very least, the growing trend to alternative fee structures will accelerate.

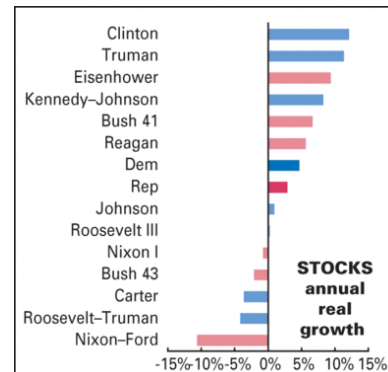
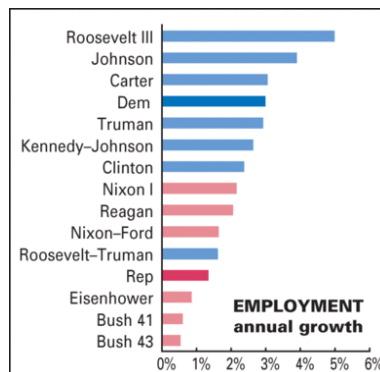
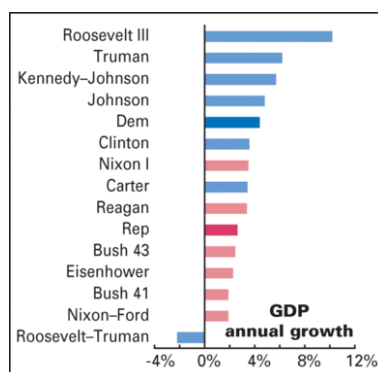
### **A Litigation Boom is Widely Forecast**

In its recent 2008 litigation supplement, *The American Lawyer* identified at least eight litigation sub-specialties likely to grow substantially in the context of the current market environment. That included bankruptcy litigation, antitrust litigation, securities litigation, labor and employment disputes, and intellectual property litigation.

Smock♦Sterling is currently undertaking a large scale research project on the future of litigation on behalf of a major defense bar professional association. While the details of that research will be communicated by our client, we can confirm the findings of *The American Lawyer* litigation supplement. Virtually every lawyer, judge and industry expert we have interviewed anticipates significant growth in litigation over the next few years – in the face of the economic downturn.

### **IMPACT OF THE 2008 ELECTION RESULTS**

While we anticipate the economic downturn will have both positive and negative impacts on the legal industry, we believe the results of the 2008 election will generally have a largely positive impact on law firms. In developing this monograph, we researched the track records of Democratic and Republican administrations on the US economy and found an interesting macro economic analysis by The Liscio Report (see the full write-up at <http://tlrii.typepad.com/theliscioreport/2008/07/presidential-ec.html#more> ). Since the beginning of World War II, GDP growth, job growth and S&P500 performance have been consistently better under Democratic administrations.



Barack Obama struck a serious and pragmatic tone throughout his campaign. He appears to be seeking the best advice available on the economy and has announced that the economy (in the form of a stimulus package and tax reform) is his top priority. That is good news. But, many knowledgeable businessmen and economists believe that some of what Obama promised in the campaign could have a direct and negative impact on the economy and their opinions cannot be ignored.

Regardless of who is right (and it will probably be a mix), specific to law firms we find even greater reason for optimism in the wake of the election. Some of the most obvious up-sides follow.

### **Bailout Package Implementation**

Half or more of the recently passed bailout package will be managed by the incoming administration. That legislation inserts the Department of the Treasury directly into private markets (Note: The Fed has also inserted itself into the private markets in the form of nearly \$2 trillion in loans and equity infusions to date).

- The last time the federal government took this active a role in assisting private markets return to balance was the bailout of the savings and loan industry in the late 1980's and 90's. Who sorted out the assets and institutions during the RTC bailout in that era? Lawyers did – smart, skilled financial service and banking experts from leading law firms.
- We strongly believe that smart, skilled financial services lawyers will be integral to sorting out the current morass of troubled assets and their derivatives.

Further, the global banking industry is being fundamentally transformed – both through government intervention and through the election of former investment banks to seek charters as bank holding companies (see Morgan Stanley and Goldman Sachs). These changes will ripple through surviving private equity and hedge funds as well. With this kind of seismic shift in a global industry, lawyers should have a field day.

### **Health Care**

Obama ran on a platform calling for guaranteed-issue, community-rated health insurance – a reform platform that would lead to significant regulatory change at both the federal and state levels. Most recently, Senator Max Baucus (Chair of the Senate Finance Committee) proposed even more extensive regulatory reform to the health insurance market.

Assuming some type of health care regulatory reform is passed (and signed) at the federal level, we anticipate a strong market for lawyers. That will likely include:

- Substantial work around regulatory compliance at both the federal and state levels – including government relations and advocacy work
- Substantial transactional work as smaller health insurers look for ways to preserve value for their shareholders and/or policy holders (in the case of mutual companies)
- Substantial work surrounding the design, pricing, approval and launch of new health insurance products that respond to the new regulatory environment.

## **Labor and Employment**

While President Obama is unlikely to take any symbolic actions as dramatic as Ronald Reagan's move to fire Air Traffic Controllers, he did express considerable sympathy toward organized labor throughout the primary and general election seasons. An Obama Department of Labor will clearly be on the side of organized labor. Likewise, an Obama Justice Department is likely to be considerably more aggressive in enforcing and supporting employees in civil rights and other discrimination cases.

All of these developments will lead to more work for experienced labor and employment lawyers – potentially at rates above the currently constrained levels. We anticipate a need in many firms to re-invest in developing traditional labor relations capabilities in a younger generation of partners and associates. At many of our clients, labor relations expertise is concentrated in lawyers over 50 – that will need to change over the next few years.

## **Environmental Law**

Substantial federal resources are likely to flow toward green technologies – particularly to renewable energy and low or zero carbon emission technology. In addition, Obama has expressed a strong interest in rebuilding electric transmission infrastructure. Firms that have or can serve energy companies responsive to these emerging federal priorities will be flush with work.

In addition, many anticipate climate change (i.e., carbon emissions) will become an important consideration in environmental regulation. That change will lead to the adoption of a new regulatory regime. Those responding creatively and productively to this regime will be positioned to break free in what has become a highly price sensitive subspecialty in recent years.

## **Litigation**

As is the case relative to the economic downturn, many clients and friends of Smock Sterling have told us that they believe the election of Barack Obama will be good for litigators. Some anticipate increases in corporate investigations and white collar prosecutions. Others anticipate more litigation around employment law, anti-trust disputes, and the other areas noted above. Some simply consider the Democrats to be sympathetic to the plaintiff's bar – and believe that will lead to a fresh round of product liability and tort cases.

## **Antitrust and White Collar Defense**

It is clear that the Washington pendulum will swing from supporting corporate America to seeing it in some ways as the villain ("*those greedy CEOs*"). Antitrust regulation will surely increase and those firms with excellent and respected white collar defense practices will be very busy (and receiving premium fees, because no one wants to go to jail).

Regardless of whether or not you believe Obama will govern from the center (as he has said he will do), there will be significant opportunities for business law firms with practices positioned to respond to the policy priorities of an Obama administration.

## **WHAT SHOULD LAW FIRMS DO?**

This section provides high level recommendations for law firms relative to client relationships, people issues, strategic growth, business development, investment, and basic do's and don'ts as this tumultuous year comes to a close.

### **Client Relations**

Law firms should focus on developing and enhancing stronger, more durable client relationships.

- We remain strong proponents of client teams. In that context, get your client service teams together to talk about how the current financial and political environment is going to affect clients' businesses.
- Approach your best clients to talk about three things, proactively:
  - The fact that you are not raising rates this year (probably a necessity in this current market)
  - The ideas you have relative to how clients can prepare for – and potentially capitalize on – the current environment
  - How you intend to approach the clients' work next year to ensure they are served as efficiently and effectively as possible (i.e., how you are going to save them money and help them through these challenging times)

These conversations should probably not drift to asking for more work. However, your firm will secure more of each client's business if you demonstrate how well you understand the client and their business (and legal) needs and, importantly, you express genuine empathy with their efforts to cope with this difficult economy. In this same context, we recommend that conscientious law firms develop a solid alternative fee structures appropriate to clients' needs.

In addition, where clients face more dramatic change (regulatory or otherwise), adopt a co-creation mindset. By crafting solutions collaboratively with your clients, you will add greater value and develop solutions that are more powerful. The best ideas will be transferable – and could become a source of competitive advantage for your firm and your clients in the future.

### **People Issues**

We believe this period of economic displacement is a good time to adjust the fundamentals of the business model on which your firm develops people and their careers.

- Create some real, non-partner track career options for knowledgeable people who do not aspire to partnerships (and the 60-hour weeks that equity partnership demands). We believe alternative career tracks can be a win-win – profitable for firms and beneficial for professionals not driven to become equity partners.

- Further, interviews with and profiles of the millennial generation (the under-30 lawyers still early in their careers) underscore their interest in and desire for a more balanced work life balance. Unless large numbers of young professionals are systematically lying, many young people are willing to make less money in exchange for a reduced professional commitment.
- This approach also implies a fundamental reexamination of lock step compensation for associates based on their graduating class (modified only by hours or other incentive based bonuses). After a couple of years at a law firm, associates can and should be paid based on their performance, productivity, creativity and commitment.
- Concurrently, we believe it is important to clearly communicate the benefits of equity partnership and what the firm expects of equity partners (both before and after they make it). It is not and should not be only about money – it should be a desirable position.

The pressure to “*squeeze the denominator*” to maintain or grow PPEP will be more intense than ever. But, decisions on who should be an equity partner must be based on clear standards of performance (attracting, serving and cementing expanding relationships with clients). Keeping underproductive people in the equity ranks is a hidden tax on the more productive people and, often, an internal cancer on the Firm.

But, do recognize that you cannot cut your way to prosperity – so, resist the temptation to cut junior people on a wholesale basis to maximize short term PPEP. The mid-90’s were replete with firms searching (often in vain) for experienced mid-level associates – as a direct result of so many firms cutting too deeply into their junior ranks in 1991 and 1992. If cuts must be made, they should be made at all levels of the pyramid – not by slicing off the bottom. It is considerably more advantageous to any firm to keep productive junior partners and senior associates than chronically underproductive equity partners.

### **Strategic Growth**

Yes, it will be more difficult to execute good mergers in this environment – but, despite being more difficult, we believe good mergers will be even more critical as a means to success for many firms. The following three key drivers of good mergers do not evaporate simply because the economy is slow. The key is to find a prospective merger partner of comparable quality (always the most important criteria) that exhibits synergies:

- At the client level (i.e., the combined firm is more valuable and helpful to existing clients than the legacy firm standing alone could be)
- At the practice level (i.e., existing strengths are substantially deepened and/or critical practice gaps are closed)
- At the firm level (i.e., genuine scale efficiencies and/or managerial strengthening results from the combination).

Mergers that are simply forms of financial engineering – or excuses to take the difficult actions a firm should be taking independently – are not justified and will have difficulty gaining the approval of majorities at both prospective merger partners.

## **Investment**

In difficult times, there is a very clear temptation to defer investments to achieve prosperity (as measured in PPEP). Often some very important partners are incessantly arguing to do just that (as long as you do not cut what affects them) – resist that temptation.

There are key investments that must be made – even in a down period – to ensure the future success of a firm. Continue to invest in people, practices, and other high priority items that provide a long term return for their costs.

We have a simple question we ask our clients – is it mission critical (i.e., critical to overall firm success)? If so, the investment is probably even more important in difficult economic times.

## **Marketing and Business Development**

In a down economic period (and in response to the opportunities presented by the results of the election), we believe an increased emphasis on marketing and business development is warranted. That does not necessarily mean more cost. Rather, it is critical to ensure those resources are well focused on activities that directly influence obtaining new work. A good bit of marketing/business development resources are expended on things that are only tangentially related to getting good work – reallocation of that spending can be the source of funds for investment in business development.

## **Other Do's and Don'ts**

Finally, we close with do's and don'ts for times of economic challenge and substantial change.

- Do continue to plan strategically and execute the agreed upon strategic plan at the firm, practice and individual level – avoid a panicked rush to put everything on hold.
- Do address underproductive partner (and other professional) issues – no one wins with a delay.
- Do continue to look for opportunistic acquisitions that may come along. There will be some good opportunities for *"bargain hunting."*
- Do plan for and carefully manage cash flow – avoid unnecessary debt.
- Do increase both the frequency and quality of internal communication to the partners about the finances of the firm. Also, communicate about firm economics with the associates and staff. This latter step may avert unwanted turnover.
- Do ensure that your compensation system is in line with your strategy and with the performance levels of your people. Adjust it if it is not.
- Do develop and offer alternative fee structures that meet clients' needs and fit your firm's economics (n.b., a *"discount"* is not an alternative fee approach).
- Do pay attention to how you staff matters. Delegate work to the appropriate level and supervise matters carefully. This is the key to building profitable leverage.

- Do invest in organizing firm “*intellectual property*” (i.e., form files, drafting systems, proprietary research, etc.) and make sure lawyers know how to use it.
- Do focus more on lateral hiring at the associate level (conversely, do not rely predominantly on law school hiring for junior people – unless you are very good at it and have an exemplary track record in retention/promotion of direct law school hires).
- Do sharpen law school recruiting programs and achieve a healthy balance with lateral associate recruiting. Take in fewer summer associates and use the money you save to invest in training the associates you already have.
- Do not let partners hoard associate level work to keep their hours up. Partners should devote non-billable time to business development, training, mentoring, and practice development.
- Do not, if layoffs are needed, simply cut off the bottom of the pyramid. There are probably redundancies at all levels.
- Do not fire all the marketing and business development people – if they are good, they will help shore-up the revenue side and, if they are not good, they should be replaced.
- Do not fire the internal practice group analytical support (if you have it) – they can help identify the future business models that will ensure the practices remain competitive and profitable.
- A final and very important do – ensure that every practice, office, and partner has a key and understood role to play in the firm’s present and future.

We wish all our clients and friends the best of luck and fortune in dealing with these difficult times. Remember, that glass is **at least** half full.

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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 where we are considered and regularly rated as 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). Although 70 percent of our work is for law firms, the remaining 30 percent is for top management in a variety of industries. 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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