Four Critical Transitions:
Leading Law Firms in the Post-Recession Economy

By
Thomas S. Clay
Altman Weil, Inc.

In 2010, the Rock Center for Corporate Governance at Stanford University issued a report on the future of law firms in the post-recession economy[1], that concluded by saying:

> *"We must acknowledge and respect the forces that created [current market dynamics], and fashion remedies that swim with the tide of economic change rather than rail against it."*

The forces referred to by the authors are those which are exerting an inexorable pressure on the profession to change. I agree with this takeaway which is, essentially: '*Deal with it.'*

Law firms of all sizes cannot escape the pressures for change and therefore must engage in new thinking and new approaches to remain viable, stable and competitive.

In my work with law firms and my collaboration with colleagues who work for corporate legal departments, I see several of these issues rising to the top as areas where law firms will need to focus their transition efforts over the next decade. These are efficiency in service delivery, overhead cost reduction, alternative fees and partnership standards.

Although the need for change seems quite clear, the pace that is required to effectively deal with various pressures is unclear. For example, must a firm move to alternative fee arrangements within the next two years or suffer irreparable competitive disadvantage? I think not.

Must a firm immediately move away from hiring first-year lawyers right out of law school because they appear to have decreasing value, at least to major corporate purchasers? Of course not.

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[1] *Big But Brittle: Economic Perspectives on the Future of the Law Firm in the New Economy*, Rock Center for Corporate Governance, Stanford University, Working Paper Series, No. 87, August 2010.

But these forces are in motion and they are accelerating partly as a result of the recent recession. We don't know exactly how fast firms must change — and that is vexing. However, it is always better to look forward, anticipate the changes that must eventually occur and begin to deal with them before they create a crisis. In fact many firms are beginning to see these issues as opportunities to establish competitive advantage.

A More Efficient Service Delivery Model

A commonly voiced opinion these days is that law firms need to change their business model. I might agree that the model for rendering legal services needs significant consideration and perhaps even an overhaul, but it isn't required in every sector nor must it happen immediately. What is required is for every law firm to examine the way it serves clients and ask the difficult question: "Can we do this more efficiently?" In almost all instances the answer will undoubtedly be "Yes," and, notwithstanding a reluctance to change, the next question should be "How?"

Law firms are struggling with questions of whether to hire new associates, whether to make robust use of contract and other non-traditional lawyers and how to use technology to counteract some of the forces of commoditization.

When viewed in light of law firms' need to maintain profitability levels, it is an inescapable conclusion that reducing professional labor costs, probably significantly over the next five years, is necessary. This includes assuring that work that is deemed to be routine and increasingly less valuable to clients is done at the lowest competent level at the lowest price the market will bear.

To emphasize this point, I relate a conversation that I had with US law school deans when making a presentation at their annual roundtable two years ago. I said that law schools were increasingly producing a product with less market value. You can imagine the reaction I got to that. However, I cited the growing number of corporate purchasers who are not allowing certain lawyers, such as first and second years, to work on their matters, preferring paraprofessionals do the work. Clients are saying "*If you won't become more efficient, we will force you into it with methods like these*."

One dean asked how much a new associate is worth today. My response was that in real terms to do routine work they may be worth no more than a competent, experienced paraprofessional. And in fact that dynamic is only likely to become stronger as commoditization forces increasingly take hold.

So what should a law firm do? They must deal with becoming more efficient now. It's not easy because it involves management attention, personnel decisions, new methods of working, and new ways of thinking. But the pursuit of efficiency is never a bad thing and is looked upon favorably in any economic market.

My estimation of the pace of change in this area is high. The curve is likely to steepen significantly over the next five years.

Overhead Cost Reduction

During and immediately after the recession, law firms focused on cutting overhead costs. Major personnel cuts were made, with the largest cuts in support staff, followed by reductions in associate lawyers. Other overhead cuts were made at unprecedented levels. This was necessary triage to counteract the effects of the recession. It also “saved” many law firms in that they did not have dramatic decreases in profitability and weathered the economic storm relatively well.

However, I believe that too many firms believe that the cost cutting work is done. It is not. Law firms are still too expensive to operate and will need to take some very innovative, and perhaps extremely difficult, approaches to reducing costs even more significantly. New strategies will be needed to improve – or even maintain – profitability.

This may seem harsh, but gone are the days when law firms could raise billing rates each year at twice the rate of inflation or more. That is what allowed law firms to make increased profits year on year and it simply is not going to be possible any longer. Firms also are not going to be able to make large profits on inefficient work. Even if volume returns, the profit levels and margins will not be the same as in the past. These two things will force law firms to reduce overhead costs even more.

By way of example, I recently told a fairly large law firm that they ought to increase their lawyer to assistant/secretary ratios from three to one to eight to one. Most people in the room were aghast. One lawyer said “*How will we get our filing and copying done*?” My response was “*Why are you still filing and copying on paper?*” New thinking at every level is required if progress is to be made.

At the end of the day, law firms that have underlying costs of $150,000 to $250,000 per lawyer will not be able to sustain profitability. Significant improvements in overhead cost reduction will be needed over the next five years and strategies for implementation need to start now.

The pace in this area is compelling. Some firms have begun the transition while others appear to be simply happy that they made it through the recession, generally intact. I believe that the latter will prove to be an unfortunate mindset.

Alternative Fees

Alternative fee arrangements have been around for decades. The percentage increase in their use has been more significant in the last five years than in the previous 25 years. The trend is here to stay. It is not going away. The issue for firms of all sizes to determine is what does it mean to them and their particular clients and what is the appropriate pace of the change in their circumstances.

In my work helping firms to determine how to most effectively conceptualize and install the use of alternative fees, several truisms have emerged:

- Clients are not monolithic in their thinking and are unlikely to become so. The billable hour is not dead and will remain vibrant for at least the next five years. Some clients like hourly billing and will control costs by controlling outside counsel rates.

- There is a cadre of clients that are totally dedicated to moving quickly to alternative fees. Meeting their challenge is a must for any firm dealing with those clients.

- Every firm should gain experience in the area of alternative fees whether they intend to use them as a competitive advantage or simply want to be ready to offer them if requested. When clients ask about alternative pricing, there isn't time to say "*Let me think about it and get back to you*."

What is the pace here? It is totally contingent on individual clients.

I recommend that firms or practice groups take some number of clients, perhaps the top 50, and speak with them about their interest in the use of alternative fees. We have developed a methodology that allows firms to rate their clients' interest from high to low and plot the results on a continuum line. Once a firm has done this, it is easy to see where it needs to focus its energies, what the level of urgency is for that group of clients, or if the firm may have more time to deal with the issue.

The point is firms should not fall prey to hyperbolic rants about moving to alternative fees. Do your homework, talk with clients, then develop a rational strategy based upon the hard facts.

It is important that all firms are educating themselves on this issue and taking the pulse of their clients on a regular basis. Some firms will need to develop this capability quickly. But for most firms there is probably time to proceed at a measured pace and 'do it right.'

Partnership

The final dynamic with which law firms will struggle has, in most instances, emerged quietly. Chronically underproductive partners (as measured by a firm's individual criteria) are finding it increasingly difficult to remain in such a position. In the 'good old days' of extraordinary profitability, many of these partners were able to skate along because there was simply enough money to go around. Now, as managing profitability becomes a very different exercise and there is an increased need for productivity at all levels, underproductive partners will not survive.

Altman Weil's *Law Firms in Transition Survey 2012* indicated that 30% of firms de-equitized partners in 2011 and 26% made fewer partnership offers. In my experience, this is ongoing in most law firms, especially mid-sized and larger firms.

Some see this as mean-spirited or counter to firm culture. I don't. It is the natural working of economic market forces under which all businesses must ultimately operate.

It is hard to predict what the pace of firm actions in this area might be. If firm profitability continues to be flat, as it has been in many firms over the last few years, then the pace will undoubtedly increase. I encourage senior leadership in law firms to deal with this forthrightly, rigorously and humanely. In this area, like the others, take action before you <u>have</u> to.

Summary

These issues – efficiency of service delivery, cost control, alternative pricing and right-sizing the ownership tier - are the ones that I believe are the most important for any firm to deal with in the post-recession economy. There are a myriad of other things that can be in a firm's strategic game plan, but these are clearly the most critical.

In Altman Weil's 2012 survey, 80% of law firm leaders assessed the recent recession as either a permanent accelerator of trends or as a game changer for the legal profession. In firms with 250 or more lawyers, 90% of leaders thought the profession was permanently changed. If they are right, then it is imperative that firms not only address these issues, but match the speed of their response to the pace of market forces.

As Will Rogers is quoted as saying, "*Even if you're on the right track, you'll get run over if you just sit there*."

About the Author

Thomas S. Clay, a principal of Altman Weil, Inc., heads complex consulting assignments in strategic planning, law firm management and organization and law firm mergers and acquisitions. Contact him at tsclay@altmanweil.com.

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