



Perfect Storm...or Perfect Opportunity?

by Rob Fenty and Trever Cartwright, Coraggio Group

A critical conversation has been waiting to happen within law firms. Managing partners have intuitively known that something was awry for several years. Yet, the combination of a distributed governance model and decades of fairly solid economic times have made important strategic or trade-off conversations difficult to tackle within law firms.

With the demise of firms like Heller Ehrman and recent reports about the expected decrease in corporate spending on law firms, managing partners and management committees are wondering whether these warning signs are a combination of strategic mistakes and cyclical economic times or signs that deeper problems exist in the law firm business model.

Our firm has worked with regionally leading west coast law firms over the past several years. This article summarizes our thinking and recommendations to law firm leaders as they face the challenging decisions that lie ahead.

The opportunity...

In the midst of the challenges facing law firms, we first want to remind law firm leaders of the opportunity that comes with increased competition and challenging economic times. When overall market growth slows and competition increases, there is an increasing gap between market leaders and market followers. Consolidation also occurs moving some underperforming firms out of business or forcing a reduction of their practices. These economic windows provide significant strategic opportunities for firms to solidify and strengthen

their positions in specific practice areas and specific geographies.

Leadership during competitive times requires greater focus and a different set of priorities than those that have governed the firm during times of economic growth. When spending shrinks, as we are experiencing now, law firm leaders must remember two things:

1. CLARITY AND FOCUS

Firms must get clear on the areas that create the highest profitability and strategic relevance. In this conversation, firms must clarify their core strategy to compete over the next decade and the underlying strengths or competencies that create uniqueness in that path. This clarity and focus may result in challenging decisions about where to invest the firm's resources for growth and whether to continue in specific practice areas or geographies. Leaders must ensure that the firm has clear strategic context and guiding criteria for not only what decisions to make, but also why specific decisions are being made. Contemplating operating expense or staff reductions without a strategy is a recipe for bad decision-making.

2. INVEST YOUR WAY OUT OF THE RECESSION

A McKinsey study of the 2000–01 recession showed that companies that increased overall market share and leadership in the years following the recession significantly increased their R&D investments during the recession. Rather than trying to cut their way out of the recession, they increased their investments in the areas that would establish long-term leadership. The lesson for law firms: don't spread cuts across the firm in an effort to make the

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firm more competitive. Get clear on the areas and the people that will lead the firm's strategic success and profitability and invest in them.

Leaders must guard against a short-term mentality around decision-making during these times. Firms absolutely will be required to make smart reductions in expenses and even people. However, making cuts based on a short-term need to preserve current year shareholder profitability misses the real opportunity to set the firm up for greater success coming out of the recession. Remember to think both short-term and long-term as you are making your decisions over the coming year.

The challenging signs...

With this opportunity in mind, there are four challenging signs facing law firms, only one of which is economically driven. We believe that the firms that are able to reconcile these four challenges most effectively over the next two to three years will gain a significant advantage in the years to come.

1. OVERALL REDUCTIONS IN CORPORATE SPENDING WILL LEAD TO SOME CONSOLIDATION

The indicators are all around us. A survey of in-house counsel, published by the Association of Corporate Counsel and Serengeti Law, showed that median spending on outside counsel fell by 9.1% last year. In-house counsel predicted future flat or reduced spending. Hildebrandt, after saying early in the year that per partner profits would be up in 2008, recently reversed its prediction saying that they would be flat to 15% down. Keep in mind that most of these studies occurred prior to the real shift in the market over the last month. More concerning than these economic indicators are trends showing an increased shift of legal spending to in-house legal departments. The economic situation certainly means ongoing slowness in work in financial services, real estate and capital markets, countered by increases in bankruptcy, litigation, and specific regulatory areas, such as energy. With all that considered, we expect some consolidation within regional law practices over the coming years.

2. CLIENTS ARE INCREASINGLY PUSHING BACK ON RATES

It's no secret that clients are increasingly pushing

back on rates and fees. Many firms are now experiencing significant reductions in realization rates and significant increases in accounts receivables. Leaders within law firms still generally consider these trends to be economically driven. However, we question whether this is a short-term anomaly or the signs of a larger issue. As a trend, clients are increasingly demanding more accountability around fees, putting more pressure on hourly fee-based pricing arrangements, and requesting flat-rate fees.

The challenge facing law firm leaders is that growth in the existing business model can only be driven by one of two variables: increasing rates or increasing people/hours. We believe that law firms may be experiencing the upper bounds of rates for the foreseeable future. There is also a chance in this climate that increasing rates may actually reduce overall billings in specific areas. Although in-house counsel expect outside counsel hourly rates to increase by ~5% in the coming year, they also expect to reduce utilization of outside counsel by an estimated 10-15%. This becomes a simple price elasticity equation for law firms. If these two indicators are linked, then increasing rates will further accelerate reduced utilization of outside counsel to the detriment of overall law firm billings. This trend combined with our next point raise what we believe is a larger strategic question for law firms.

3. FIRMS ARE EXPERIENCING A GENERATIONAL SUCCESSION

This is certainly not new news. Many law firms are facing a significant succession of leadership over the next five years as senior partners reduce work loads and retire. The significance of this impending transition is a generational gap that exists between junior and senior partners, exhibited in different value structures around work-life balance, the willingness to bill 1,800-plus hours a year, and overall style and approach. Law firms to date have been unable to have a direct and open dialogue on how to successfully navigate this transition, resulting in a paradox. Junior partners are simply waiting for senior partners to leave. And senior partners are unwilling to let go due to a lack of confidence in the firm's ability to succeed going forward. Further,

senior partners have little economic motivation to change the system.

The combination of increased pressure on billing rates and an overall reduction in willingness of individuals to bill high levels of hours creates a fundamental business model challenge for firms. Firms have three options in this quandary:

- a. Increase the number of attorneys and therefore take on higher operating expenses to maintain overall billings.
- b. Increase rates, therefore preserving overall profitability.
- c. Investigate alternative models of pricing and service delivery.

Option (a) works during times of economic growth. However, the minute the market becomes more competitive, profitability per attorney becomes a critical indicator of success. Growth through expansion of attorneys becomes more risky when the overall market is flat or potentially shrinking. Option (b) is a premium pricing strategy that must link with a firm's perceived expertise or strength in specific areas or aspects of their practices. For firms that employ this strategy, we recommend they watch closely whether they are approaching the upper bounds of rates within their markets. Within mid-markets, like Portland or Phoenix, the economic recession may dampen law firms' ability to sustain continued increases in hourly rates. We also believe that the time has come for law firms to examine their fundamental business model and investigate alternative models of pricing and service delivery as a way of creating competitive advantage both during and coming out of the recession.

4. LAW FIRMS HAVE A GLARING LACK OF PROCESS

The existing structure of law firms has some recognized pitfalls. A collection of shareholders with an elected managing partner creates an egalitarian environment where consensus decision-making is required on large strategic investments or changes in direction. This structure, combined with the need for attorneys to maximize billing time, prevent organized conversations around important strategic questions. As a result, firms have a difficult time viewing their forward progress in any other way except the

existing paradigm in which they operate. This is the exact recipe of the old business adage: the elements that create success are the same ones that cause your failure when the market paradigm changes. We believe the legal industry is facing one of those inflection points, which creates both opportunities for firms that will innovate their models forward and significant risks for firms that don't.

Just to be clear, we have not observed a lack of capability within firms to take on these larger strategic conversations. In fact, we believe west coast firms have a unique set of strategic-thinking managing partners that are ready to lead their firms into these conversations. What's missing are agreed upon processes for how firms will engage in these conversations, make decisions and integrate decisions into firm behaviors.

Law firms must also examine their capabilities and processes around cross-firm communications. Lessons from other professional service industries show that market leaders exhibit sophisticated processes for capturing client value drivers, communicating workflow innovations firmwide, testing ideas and processes, and integrating behaviors and improvements throughout the firm. Law firms are significantly behind other industries in their ability to integrate market-driven thinking, process innovations, and communications. For firms to move into a more innovative state in their markets, they need to increase emphasis on process efficiencies around client management, internal workflows and business management.

The required conversations and actions...

We believe that mid-sized, regional law firms are in a unique position to gain strategic advantage in the coming months and years. They have deeper client relationships and a higher level of flexibility than larger national firms to face the challenges that we have discussed. We recommend that law firms directly engage several key leadership conversations in order to create clarity and focus in terms of how they want to move forward.

STRATEGIC CLARITY

We recommend that partners agree to a process to

engage in a conversation that articulates the firm's strategic clarity. In doing so, leaders should confirm the long-term aspiration of the firm in terms of what the firm is about and what is trying to create. Leaders should get clear on the firm's defensible leadership position and its strategy to compete. As a result, the firm will have clarity around the top-level "business" measures and strategic areas of focus that will guide the firm's investments and actions.

FIRMWIDE COMMUNICATIONS AND INFORMATION FLOW PROCESSES

In a period where the firm needs to maximize efficiencies and innovation, the firm must build a stronger mechanism for firmwide information flow around client feedback, workflow efficiencies, and managerial learnings around delegation, performance management and onboarding.

FUTURE LEADER DEVELOPMENT

We recommend that firms look carefully at the idea of proactively developing a top-tier of future leaders around specific competencies of leadership. In challenging times, the gap between top performers and underperformers will widen. Bet on your top performers and future leaders and proactively develop them as part of your investment strategy.

Summary...

Our warning flag for law firms is simple...be careful not to get stuck in the existing paradigm. The environment and market dynamics in which you operate appear to be changing. Now is the time for some honest, direct conversations around who you want to be as a firm going forward, how and where you will best compete and how you will organize for that success.

ABOUT THE AUTHORS

Rob Fenty and Trever Cartwright are founding partners of Coraggio Group. Coraggio Group is a strategy and organizational change consultancy, committed to creating an integrated link between business strategy and people/culture. We work with law firm leaders to articulate firm strategies, build firm leadership capabilities, and manage organizational transitions. For more information about Coraggio Group, please visit www.coraggiogroup.com or call 503-493-1452.