



Feeling the Pinch

How the economic crisis could change your law firm relationships

By Steven Andersen

You know things are rough when lawyers refuse to trot out the usual platitudes. One conspicuous absence in recent months is a certain well-worn cliché. You know the one, about how in bad times clients need lawyers more than ever.

“Like a lot of aphorisms, that only partially hits the mark,” says Martin Lueck, managing partner at Robbins Kaplan Miller & Cierci. “This economic downturn is unprecedented in recent times. As a result you can’t apply mindless generalizations that may have been more accurate in the past.”

There’s nothing like a hard year to cut through the bull, and 2008 was a doozy.

In September, San Francisco-based Heller Ehrman announced it would dissolve after the departure of 15 IP partners to Covington & Burling scuttled a potential merger with Mayer Brown. Before the firm unspooled it had 730 lawyers in 14 offices.

Another Bay Area stalwart collapsed in October. Thelen, with its high-profile construction practice, had struggled with integration issues since a 2006 merger that marked its peak at 600 lawyers. The firm subsequently bled nearly 200 lawyers in a string of decampments and layoffs until a partner-departure covenant was breached and the firm’s credit line was severed.

The venerable Thacher Proffitt & Wood survived the Sept. 11 attacks that destroyed its World Trade Center office but could not overcome its exposure to the mortgage-backed securities debacle. In December, about half its 200 lawyers climbed into a last-minute lifeboat provided by Sonnenshein. The rest were left to sink.

Add to that list the scores of national firms that have fired thousands of partners, associates, counsel and staff. Scarcely a week goes by without some dire news, and industry message boards buzz constantly with speculation about who and how many will be next.

But maybe, just maybe, there’s a silver lining in all this carnage.

As anyone in recovery will tell you, it usually takes a crisis to effect real change. The big lurking question is: Will the current economic crisis, which is shaping up to be longer, deeper and scarier than any downturn since the Great Depression, cause a meaningful change in the dysfunctional, even codependent relationship between law firms and law departments?

There’s hope.

Relationship Re-evaluation

“A crisis is a terrible thing to waste,” says Joel Henning, a legal industry consultant at Hildebrandt International. “While the legal profession generally moves with glacial slowness, this particular crisis may provide necessary traction to achieve significant change. There has been lip service for decades, but this time we may see some results.”

It won't be easy. Inside or out, lawyers are by nature averse to change. Firms are hidebound in traditional business models and vestigial notions about the profession. Meanwhile, their in-house counterparts are often driven by the conservatism that goes with covering one's own hiney. This combination is not the mother of invention.

“Virtually all high-level inside counsel come out of law firms,” Henning says. “It's the dance they know how to do. That has retarded progress in this area. That's why we need to look at the fundamental aspects of the practice of law for big companies.”

There's evidence to suggest a large number of law firms are doing just that.

“There's a big re-evaluation going on,” says Michael Rynowecer, president of BTI Consulting, a professional services research boutique that surveys general counsel on their relationships with law firms. “Law firms are looking at themselves, looking at the economy and asking themselves: ‘Where do we go? What do we do?’”

BTI's research shows the economy is already affecting law firm-client relationships, though not often for the better.

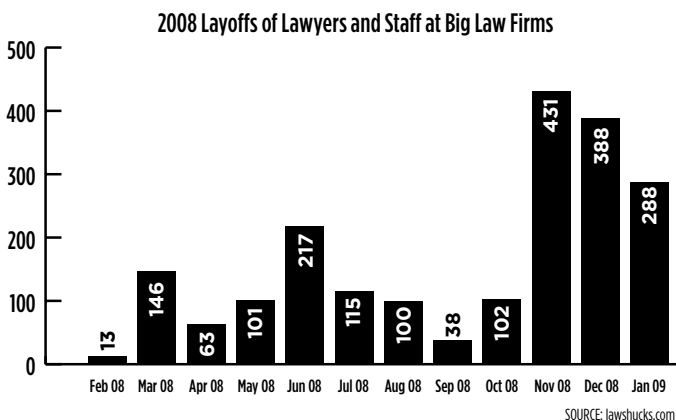
“We've seen about 60 law firms enjoy better relationships with their clients as a result of the downturn,” Rynowecer says. “Hats off to them. But of the 500 or so firms that service the Fortune 1000 companies, that's not a big number.”

Financial stress is exacerbating the tension that has always simmered beneath the surface of the client relationships. Companies are locking down budgets, and firms face rate and hiring freezes, layoffs and declining partner profits as a result. This clearly has law firms' attention.

“I would say that 20 percent to 25 percent of law firms are systematically changing firm-wide as an institution, meaning they have changed their policies on how they approach clients and allocate work,” Rynowecer says. “About 50 percent of firms are making some changes, but on a partner-by-partner or department-by-department basis. The remainder are not making changes and basically swimming against the stream.”

Interestingly, this movement is not determined by law firm size.

“We're seeing some of the largest firms making systematic changes, and some strategic small firms doing the same,”



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Rynowecer says. “We have not found a size cut, and we looked for one.”

Midsized Model

That’s not to suggest that law firm size is irrelevant in this market. Whether they are making changes or not, one market segment is outperforming all others these days.

“Many of the midsized firms are doing quite well, despite everything we’re seeing in the economy,” Rynowecer says. “They tend to be very responsive, very client focused and they understand the risks that are popping up on a daily basis. Typically they can move a little bit faster. They are a bit more flexible in responding to clients. It’s easier for them to enter into alternative billing arrangements.”

They are also well situated to service clients that find themselves unwilling or unable to pay extraordinary rates for routine corporate service. In recent years, a number of firms aggressively raised rates and leveraged themselves with associates in a bid for high-end work and well-heeled clients. That strategy failed along with the economy, and the arithmetic is simple.

In New York, for example, midsized firms bill out their partners at about \$400 to \$600 per hour. The same rate will get you fourth- to seventh-year associates at large, highly leveraged firms. So if you can’t afford the top-shelf partners at the big firms, who will set you back anywhere from \$600 to \$1,200 an hour, it makes more sense to pay a partner at a mid-

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sized firm the same rate you would pay a far less experienced large-firm associate.

“There’s only so much room at the top,” says Bruce MacEwen, founder of Adam Smith, Esq., a blog on law firm economics. “Clients are always going to pay top dollar when they need it, but as you go down the food chain a little bit, it is going to be harder for firms that were aspiring to that top niche.”

Bryan Schwartz, managing partner at the 70-lawyer firm

Levenfeld Pearlstein, puts a finer point on it.

“In the legal business you’re defined by the work you do,” he says. “If you’re honest with yourself and say, ‘We’re not doing the highest-level work,’ then you’re saying you’re not the best. And for attorneys, that’s really hard. That’s where the problem begins. If you don’t know where you’re at and you’re behaving like you’re [a top level firm], that’s OK when everybody’s making a lot of money, but you’re toast when the music stops.”

For the moment, midsized firms have an edge in the market, but it’s a copycat world—when any one model excels, you can be certain others will follow suit.

“I think that you’re likely to see partners at large firms recognize that their firms are huge battleships and they can’t change directions as quickly as the market or their clients demand,” says David Scherl, managing partner at the 115-lawyer Morrison Cohen. “They may spin off and try to service the same clients at a more reasonable rate. It’s a reality check.”

Fixing Fees

If any aspect of the client relationship is ripe for an overhaul, it’s the billing model.

“Hourly billing makes no sense,” says Hildebrandt’s Henning. “It doesn’t really relate to the value of the work done. Ultimately some sort of value billing—not just discounted hourly rates—makes a lot more sense. Corporations are looking very closely at cost. Law firms are looking very closely at how to keep clients. It could lead to a collaboration on this that we haven’t seen before.”

This is not a new idea. Alternative billing arrangements have been touted for years, and while a small percentage of firms and companies have embraced them, they remain on the fringe of the mainstream.

BTI’s research shows the current demand among in-house counsel for fee certainty is the highest in 10 years, but Rynowecer says general counsel remain nervous about alternative billing arrangements other than fixed fees.

“It’s not so much a reluctance to experiment, it’s the concern about lack of definition,” he says. “General counsel love fixed fees. Many law firms say they can’t offer that. The people who are reluctant to engage in fixed fees seem to think that protecting their perceived profit is more important than anything else.”

So despite all the current cost pressure and chatter about fee structures, he doesn’t see many firms shifting to embrace non-hourly fees.

All the firms contacted for this article insisted that they were more than open to alternative billing, but with a caveat.

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"I'm in favor of alternative billing, but it takes two to dance," says Tim Ochsenhirt, chairman and CEO of Roetzel & Andress. "Alternative does not always mean cheap. It doesn't mean one side always wins and the other side always loses. It just means a little bit of certainty, and you win some and you lose some. That should be understandable to inside counsel, because that's what their business does. As a rule, the law firms are afraid they'll underestimate and the clients are afraid they'll pay their lawyers too much."

Ochsenhirt says 15 to 20 percent of his firm's work is billed alternatively, and he points out that there is a higher degree of trust in the relationships that sustain alternative fee arrangements.

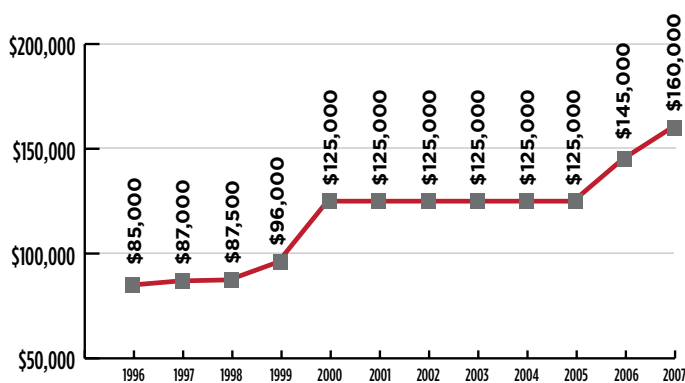
But there's another fundamental problem with non-hourly billing, one that cuts to the quick. Alternative billing arrangements require law firms to manage projects, and themselves, more effectively—something at which they are notoriously bad.

"The issue is not the rate, it's how the matters are managed," Schwartz says. "One of the biggest reasons law firms are so dysfunctional is they don't manage themselves well."

Schwartz says that less than 5 percent of his firm's work is alternative fee. He'd like it to be much higher, but clients won't go for it.

"Would I rather know what my revenues are going to be? Of course I would. If that number was 60 percent, this would be an easier business to run," he says. "If I was an in-house counsel, this is the year I'd want to make my budget. I'd take out the lion's share of the work that had some predictability and say, 'Here firm, I'm going to pay you this much and I'm going to pay you on a monthly basis. It's going to be reasonable for both of us and we'll have a two- or three-year true-up period. So if I get screwed for 15 percent this year and you get screwed for 15 percent next year, we're good."

Median Starting Salaries for First-Year Associates at Large New York Firms



SOURCE: The Association for Legal Career Professionals

"When you have those relationships, that client is more than a client. That client is a part of your business. Unfortunately these conversations don't take place enough, and when I have tried to engage in them, I find that clients are more concerned about what the law firm is making rather than what makes sense for them. Hopefully this environment will add more common sense."

Pruning People

According to a study by the Association for Legal Career Professionals, the average starting salary for associates at large firms in New York was \$85,000 in 1996. By 2007 it was \$160,000.

"Unsustainable trends tend to come to an end," says MacEwen, paraphrasing the economist Herbert Stein. It's an apt assessment. Large firms, forced to compete with investment banks for top talent, steadily ratcheted up associate salaries over the last decade. That could only last as long as the double-digit profit gains that fueled them.



Now many firms face the stark necessity of firing associates, and even partners, to stay afloat. Most experts expect the dramatic level of layoffs in 2008 to continue into 2009 and perhaps beyond, depending on the economy. And a lot of firms must confront the reality that they are not as big players as they once thought.

“There is an increasing segmentation in the legal profession,” says Henning. “The rich are getting richer and the rest are struggling to keep up. Segmentation in a maturing industry is something we see all the time. The law firms at the very top can afford to pay \$160,000 or even \$200,000 starting salaries. But the law firms that have tried to keep up in Indianapolis or Grand Rapids or Reno really can’t afford it, and it’s not in their clients’ best interests anyway.”

It’s not only the large, highly leveraged firms that are feeling the pinch, either. Schwartz says his firm cut 10 lawyers in 2007 as the economy declined. He then hired 10 others in areas strategically suited to a recession.

“Cutting back on paper clips is not going to get you there,” he says. “The only way you can really cut costs is to cut people. We looked at the areas that were showing weakness or people who really weren’t going to be here in a few years. Those are the people that go first.”

Performance Precursors

Only time will tell if the adjustments firms are making are permanent changes or just cyclical necessities. BTT’s research suggests that many firms are starting to treat their

businesses as, well, businesses.

“One of the things we’ve seen is that law firms have really embraced metrics,” Rynowecer says. “We see them measuring things like net effective hourly rate. We see them benchmarking their client satisfaction performance. We see them benchmarking things like billing and collections. Those are proven indicators, if you look at other industries—precursors to improved performance. Those are real opportunities to save money without raising rates.”

There’s also reason to believe that financial pressure on firms won’t let up even if the economy bounces back quickly, as they face new competition from abroad.

“I’m working with firms in other countries that have a lower cost structure and can do work on a global basis,” Henning says. “I think we’ll see those firms competing for work in the United States.”

Then again, there’s the dissenting perspective that the more things change, the more they stay the same—that for all the gyrations and drama, the delivery of legal services goes on, and will continue, more or less as it always has.

“I suspect that [the economic crisis] is not translating into change of behavior in fundamental ways,” says Harvey Anderson, general counsel of Mozilla Corp. “It will force in-house counsel to cut budgets. Firms will respond by lowering rates or changing the way they staff matters. Not to be pessimistic, but I’m not sure this alone will change the way people think about providing service. People aren’t jumping up and down saying, ‘Let’s try this, let’s try that.’” n

Battling Bureaucracy

One of the reasons law firms are so slow to react to market forces is their cumbersome, committee-driven approach. But the best-managed law firms are partnerships only in name, and experts insist it’s inevitable that we’ll see more centralized decision making in law firms.

“I think you will see an acceleration of the professionalization of law firm management,” says Bruce MacEwen, who runs the law firm economics blog Adam Smith, Esq. “These are big enterprises. The notion that you can have somebody with no business background running a law firm in their spare time is irrational.”

Ohio-based Roetzel & Andress has long had a clearly hierarchical org chart. Chairman and CEO Tim Ochsenhirt makes all executive decisions and

constitutes the firm’s entire compensation committee. Garrulous and straight spoken, Ochsenhirt eschews attitude and ego, and is not averse to telling a lawyer, “I don’t think you’re any more important than your dog or cat does.”

A crisis in the firm more than 20 years ago led to the dramatic management solution, but it has worked well ever since.

“Lots of firms would like to have a system like this,” Ochsenhirt says. “Deep down they know it’s a good idea. But if you’re not facing crisis, you won’t get around to it. The main reason is trust—trust is a little on the thin side. Our system requires a lot of trust. It’s a very difficult step for most firms to take.”