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Planning for Recovery: Seven Strategies for Opportunistic Law Firms

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Twelve years ago, in the middle of the 2008 recession, Ed Wesemann and I jointly penned an article headed "Taking Advantage of a Recession – Seven Strategies for Opportunistic Law Firms". The current pandemic has many of the features of recession, and so I am revising our article to fit today's situation and context. Sadly, Ed is no longer with us, so I write this edited version in his honour. – Nick Jarrett-Kerr

The natural reaction of most lawyers is to deal with a crisis in the same way they would handle a hurricane – hunker down, don't take any unnecessary chances and try to survive until it is over. Given the risk adversity of most law firms, avoiding action may indeed be the best plan for a firm. But for some firms, adverse conditions provide an opportunity dramatically to enhance their competitive position in a relatively short period of time.

Investment Philosophy

If the nature of previous recessions holds true in the current situation, it emphasizes the long-term importance to law firms of diversification in both geographic location and breadth of practice. Indeed, creating strategy for the business of the practice of law is similar to creating an investment strategy. The importance of asset allocation and diversification are important survival strategies that assure a consistent moderate growth. But, in both law firm and investment portfolio management, the real opportunities come in times when there is the greatest volatility.

Although not for the faint of heart, we can identify seven proven strategies that we have seen succeed for law firms during previous periods of economic adversity. Under the appropriate circumstances, each of these strategies (or a combination of them) can propel a firm's market position and profitability dramatically and result in a sustainable advantage and strongly increased profitability.

1. Change the Focal Point

While it may seem counterintuitive, adverse changes in economic conditions can provide law firms with an excellent opportunity

to change the focus or balance of their practice.

This may be a particularly attractive option for firms that have seen their practices deteriorate through a dependence on increased amounts of commoditized work. Traditionally, most U.S. general practice firms have depended upon their transactional and general business practices to generate spin off work for other practices, particularly litigation. Because in most recessionary periods, transactional practices feel the effect of a downturn earlier than litigation, there has been a tendency in many firms to gradually increase their dependence on their litigation practice. As a result, firms that historically depended on their business practice for 60 to 70 percent of their revenue have reversed the percentage and are now generating the bulk of their revenue from litigation. There are three connected reasons for this shift. In part this was the unintended result of layoffs and reduced hiring in the transactional areas during downturns. Second, some firms intentionally shifted toward litigation revenue streams that are more predictable over longer periods of time than business practices. The third reason was that, whatever the strategy, some practice areas just happened to grow faster than others over time.

However, because business practices spin off litigation to a far greater extent than litigation practices create work for any other practice area, and the size of the business practice has been reduced, the firm must find billable work to keep their increased litigation capability busy. The most accessible source of business is institutional that involves lower priced work. And, a natural tendency seems to be that the more price-sensitive litigation work the firm accepts, the less sophisticated business work it attracts. Unless the firm can adjust its business model to reduce costs and change the way it practices in order to increase leverage, there will be a deleterious impact of profits.

A recession however provides a firm the opportunity to invest in counter cyclical practices, i.e., practices that are either doing relatively poorly in a benign trading environment (but do better when times are tough), or those which perform consistently in all trading conditions. This can be accomplished aggressively through the lateral hiring or training of an increased number of lawyers in such practice areas as merger and acquisition, securities and real estate, or it can be done more subtly by limiting the growth and matter intake of litigation work.

This shift in focus need not be limited to practices; it could also involve a shift in the type of client. We know of one British firm that shifted its focus from business clients to public sector work during a period when the government was retrenching and other firms were seeking to move away from the public sector. By establishing themselves as a dominant firm in government work, they traded greater economic stability for slightly lower rates by downplaying their declining corporate practice.

2. Change the Staffing Model

As firms consider downsizing their associate, paralegal and support staff when the volume of work is declining, the natural tendency is to eliminate any special considerations designed to enhance diversity objectives. That is, the first people to be laid off tend to be the part-time, job share and telecommuting employees to the benefit of full-timers. This, of course, plays into three pieces of conventional wisdom in the use of legal human resources. The first has always been – at least until the 2020 pandemic – that all full-time workers need to work most of the time from conventional offices, usually in city centres. Currently, however, working from home has become a necessary and attractive option with some professionals positively relishing the freedom from travel and he empowerment to control their task lists without overbearing intervention and disruptive instances of haphazard delegation from their bosses. The second is the view that full time employees are required for most legal work in order to satisfy clients' demands for capability and responsiveness. The third is that non-traditional work schemes are costly fringe options that benefit societal objectives and can only be sustained during periods of great prosperity. When things get tough, it's back to the bread and butter staffing model.

Some firms have found that the advantages of alternative staffing models far outweigh the negatives, particularly the flexibility they provide during periods of economic change. The use of part time staff provides greater flexibility of availability to mesh with volatility in the amount of work available. In periods of recession, the primary objective of most firms is to keep their partners busy. If there is not enough work to go around, firm practice managers must wrestle with laying off associates who have been expensively recruited and require a generous amount of severance pay, or filling associates' plates with work though the under-utilization of partners.

However, if a firm uses the recession to reconstruct its business model away from the full-time, office-bound associate and non-equity partner and toward part-time and telecommuting lawyers, the firm can size its work force, its need for premises, and its overhead structure to the work available by adjusting to a more dispersed work-force. And the modest overhead associated with the support of a part-time or telecommuting lawyer (even if the lawyer is required to routinely spend some period of time in the office each week) is more elastic to workforce size than bricks and mortar offices. Effectively, the shift is from the full-time, working in the office lawyer being the norm with alternatives being the exception, to the part-time and/or telecommuting lawyer being the normal operating procedure. A change in the business model could be especially beneficial to firms where there is minimum leverage, perhaps even more partners than associates.

3. Radical Restructuring for Extreme Profitability

For many firms the imperatives are driven to some extent by the notion that bigger is better and firms that are not growing are effectively declining. But this needs big long-term investment which war with the feelings of many law firm partners that short-term profit is more important than investing in opportunities for long-term benefits.

Hence, firms juggle their top line revenue focus with the investment of large amounts of money in growth through recruiting costs, turnover costs and the financing of work in progress until new lawyers come fully on stream and start to fill their pipelines. Since most law firms are desperately undercapitalized compared to other businesses, these costs must be paid through current revenues, i.e., the partners' pocketbooks. Further, growth can, and often does, cause severe deterioration of culture, which organizational psychologists tell us has a significant correlation to profitability. In the U.S., where tax laws drive law firms to account for revenues on a cash basis, the connection is even more direct and, as a rule of thumb, a lawyer added during the second half of a year generates negative cash flow for the year. What happened to a large extent in the UK during the last two recessions was that many firms found it easier to lay off staff below partner level than to cope with the difficult task of shedding partners. The resulting adjustments then adversely affected leverage, and the proportion of sub-partner work carried out by partners increased markedly. As a consequence, many firms which were already over-partnered became even more partner-heavy, and have spent the consequent decade trying to redress the balance.

In a period of enforced recession, when firms are forced to make major temporary adjustments to their staffing and operations in an attempt to maintain existing profitability, the option of taking more severe and permanent steps may be an attractive option. As one firm put it when they reacted to a temporary slowdown that affected a large portion of their most valuable clients: "We decided to *supersize it."* They decided to really make fundamental changes in their firm that would not have been politically viable during normal economic conditions. The firm used the economy to justify the closing of offices, de-equitization and termination of under-productive partners, shedding of almost a third of their client base, and reduction of office space by a significant proportion. The result after two years was a much smaller firm that had a sustainable profit per equity partner that was 60 percent greater than before the recession.

4. Driving Changes in Governance Model

In the current world of professional services, the increasing trend towards a more corporate style of governance seems inevitable. Indeed, we have seen this trend speeding up as the markets for professional services continue to consolidate. The imperative for speedy and commercial decision-making has become much clearer as firms start to weather the 2020 pandemic. Firms need to drive business performance, and the overriding priorities of the management structures of the firm must be directed towards this imperative as well as all other aspects of law firm management. At the same time, the role of the managing partner or CEO is becoming much more 'executive' – less consensus-driven and with greater authority. The authority of the management boards and bodies is also increasing. The interests of partners as shareholders from the management and operational decisions of the organisation are steadily separating. In some progressive firms, we have seen the introduction of external non-executive directors at board level, whilst line management is being strengthened with beefed up roles – and accountabilities – for group and divisional heads.

However, a great many firms have remained trapped in outdated governance models that preserve the rights of partners to hold up or even veto significant decision-making. A burning platform is, however, an excellent motivator to make important long-term changes and the pandemic gives law firm leaders the opportunity to take a long hard look at the firm's overall governance, including decision-making powers, voting rights and the over-long list of significant matters that are reserved to the whole partnership for ultimate decision. The roles and duties of the managing partner, boards and executive committees often bestow great responsibility but little power. Any mandate to enforce performance management on partners is sometimes weak and blurred, and the power to expel underperforming partners is often heavily restricted.

Law firms often have huge problems with their decision-making processes. In the first place, lawyers are infamous for the glacial speed of their decision-making. Analysis can often result in paralysis. Caution and a tendency for risk aversion can often mean that decisions are delayed further and further until everyone is totally satisfied that there are no further avenues to explore, no more analysis to be done. Additionally, the lawyer's desire for perfection leads him or her to seek the perfect solution. Even when decisions are made, they are often reversed on further reflection or when a vital constituency raises objections.

It is, of course, difficult and in some cases impossible to anticipate extreme or asymmetrical events such as the 2020 pandemic, but the risk of disasters – and indeed rogue partners – can be reduced by a robust and well-honed governance system.

5. Kill off Weaker Competitors

As law firms become more competitive, the gentlemanly aspects of the marketplace are becoming less of a factor in relationships among firms. It's hard to maintain a white glove policy in dealing with a competing firm when you are constantly going toe to toe in client panel beauty parades and attempting to poach each other's lawyers. Law firms used to say that there was plenty of work for everyone. Now, in many geographic markets, there is a consolidating number of clients and the only way to get new work for a firm is to go and take it away from the firm across the street.

This new competitiveness becomes even more critical during a period of economic adversity. Just as a lightning fire in a forest cleans out the underbrush so the remaining trees can flourish, recessions are the economies' means of enforcing survival of the fittest within marketplaces. And, for law firms that enjoy a competitive advantage, recessions present an opportunity to create or enforce a dominant position by effectively putting competitors out of business.

There is a complex but amazingly effective strategy that we have seen work in a number of geographic markets in Europe and the U.S. It involves a firm identifying a competitor who is smaller, has less of a reputation, or has recently lost a significant partner or client. The strategy involves three features:

1. The identification of one advantage or distinguishing feature about the firm that the competitor cannot easily replicate. It may be a proprietary AI application, a strategically placed office, ties to a trade association or any other factor that has value to clients.
2. An aggressive business development program that focuses on face to face presentations to the largest clients of the competitor who would benefit from the advantage identified above.
3. An aggressive recruitment program of the partners in the competitor whose clients have been targeted.

The combination of the impact of the economic slowdown on the competitor's financial picture, concerns resulting from the loss of other partners and/or clients and the risk of losing clients and other partners to other firms creates an effective "run on the bank." The win is not only if the lawyers and their clients come to the firm initiating the strategy, but also if lawyers and clients decide to go elsewhere. In either case a competitor has been weakened.

This strategy is sometimes used when a large law firm enters a new marketplace where they have been unsuccessful in soliciting a merger partner. Its effectiveness is enhanced by an economic downturn because it increases the motivation of both clients and lateral partners to leave a firm that is perceived to be in trouble.

6. Consolidation with a Rising Star

Within almost any industry, economic downturns tend to increase consolidation in most industries. Recessions cause instability and businesses equate size with stability. This carries through to law firms and the number of merger discussions tends to increase during recessionary periods. The converse is also disproportionately the case in the legal profession. In times of prosperity the gravitational pull of consolidation tends to lack intensity. Put bluntly, the reason why consolidation has happened less in the legal profession globally than in practically any other professional service sector is due in large part to the innate conservatism and caution of most lawyers coupled with the relative absence of a pressing economic need.

However, one limiting factor in such consolidations tends to be that in a recession it becomes difficult for the participants to project financial performance. As a result, law firms generally take a very conservative view of historic financial performance as the measurement of comparability in merger discussions. This conservatism may, however, be ill founded. There has been a history of firms dramatically improving their profitability during recessions which, in large part, may be ascribed to the incentive that the recession provided for partners' acceptance of management actions (cost-cutting, termination of underproductive partners, billing-rate restructuring, etc.). In fact, if the primary correlative factors in a successful law firm turnaround during a recession could be identified, they might well highlight a law firm with a newly elected autocratic leader and its back-against-the-wall financial position.

The primary targets among firms actively seeking a merger during a down-turn tend to be those firms least affected by the recession – and, accordingly, firms with the most predictable financials and least likelihood to entertain operational change. Such firms, of course, are the most conservative and the least likely to dilute the profitability of the combined firm.

But the most conservative choice often presents the least opportunity for an immediate and significant growth in profitability. Like under-valued stocks, law firms with low profits per equity partner can enjoy amazing turnarounds in performance during adverse conditions if they have the fundamental drivers of profit in place and leadership willing to take action. Firms that successfully grow through consolidation during recessions do so by making judgments based on *what can be* rather than *what has been*.

7. Hiving Off Weaker Practices

For some firms the term “general practice” effectively means “every practice.” This can result in a collection of practice areas that make no sense strategically or economically. During good times firms can afford to sustain such practices because “they are breakeven.” Even where the firm has within its walls a high-volume, low-margin business which does contribute to profit, it becomes very difficult to run the appropriate business model for a volume business alongside the rest of the practice. During economic downturns, non-core practices have two problems. First, the weaker practices can be a mill stone that drags down profitability and resists attempts to reduce overhead costs.

The weaker practices vary from firm to firm, but they have one thing in common – they neither benefit from nor contribute to the mainstream practices of the firm. These are freestanding practices that do nothing to enhance reputation, create new business or generate profits. They keep people busy and generate enough revenue to result in a zero sum after the partners who participate in the practice are paid. In many firms, areas like low-rate tort or personal-injury litigation, or mortgages and loans, are tied to the history of the firm or are sufficiently large that they become the third rail of law firm politics. There simply is no way to get rid of them.

Downturns also accentuate the effects of the operation of Gresham’s Law, particularly in relation to the internal problems associated with the second type of non- core practice – the profitable high-volume, low-margin business operating in a firm which also seeks to do higher value work. According to Gresham’s Law, bad coinage drives out good where both have the same face value. Sir Thomas Gresham, after whom the law is named, served Queen Elizabeth I in sixteenth century England. Gresham’s law says that any circulating currency consisting of both “good” currency and debased money (scratched, worn or even with parts shaved off) quickly becomes dominated by the “bad” money. This is because people spending money will hand over the “bad” coins in their possession rather than the “good” ones, keeping the “good” ones for themselves. This law applies to legal practices offering both low-value commoditized services as well as at the same time attempting to offer higher-value expertise-driven service. It’s not that the commoditized practice is necessarily “bad” as such, it’s just that it is difficult to maintain the two different bases of currency in the same firm without one of them devaluing the other. This is because most practices find it somewhat difficult to vary both their attorney compensation packages and their pricing models as between the two very different types of practices. In short, the low-pricing model and the price-sensitive client may, over time, drive out the higher value services and the more rewarding clients. At the same time, the business model of a volume-based business must by its nature incorporate an overheads structure with lower-than-average rates of compensation, lower qualified case workers and utilitarian budget premises. Although most firms in times of plenty will accommodate a higher overheads structure for their volume business in attempts to ward off Gresham’s Law in the short term, the required balancing act becomes more and more difficult to maintain during a downturn. The blunt message for firms trying to operate at both ends of the pricing spectrum is that Gresham’s Law will get them in the end.

In recessionary periods, however, non-core practices often temporarily have more attractive revenue streams than other mainstream practices. This can place them on a more level footing, which removes some of the defensiveness that is often involved in practice-management discussions. It also allows the firm and the members of the practice to view the issues with greater objectivity than in normal times and permits both sides to make more rational decisions. If a practice enjoys no synergy with the law firm as a whole and is burdened by overhead expenses that the practice doesn’t need, a recession may provide an excellent opportunity for the partners in the non-core practice to create their own freestanding firm. A free-standing firm is able to seek referrals from all forms of law firms because it is a specialized firm not competing in areas outside its practice. Such firms can operate with lower cost structures to match lower billing rates and can control their own recruiting and promotional policies.

A firm can facilitate such spinoff practices with the agreement that they will enjoy a mutual referral policy and assist in the creation of the firm through prompt repayments of capital accounts, operating cash loans to the new firm, and access to technical expertise in office management, IT and financial matters. The result is a spinoff with minimal cost and disruption to the firm and the ability to maintain a satisfied relationship with the partners involved.

Other strategies

These seven strategies are simply ones that firms have been able to use in prior recessions. They may or may not be appropriate under the current economic circumstance and certainly would not work for all firms. However, they point out a principle that is highly instructive to firms seeking opportunities in adverse economic situations. Firms that are able to use economic downturns to prosper are those capable of looking at any situation and taking a counterintuitive view of the opportunity presented.