Taking Advantage of a Recession:
Seven Strategies for Opportunistic Law Firms

By Nick Jarrett-Kerr and Ed Wesemann

The natural reaction of most lawyers is to deal with an economic downturn 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 economic conditions provide an opportunity ~~to~~ dramatically to enhance their competitive position in a ~~very~~ relatively short period of time.

The Rolling Recession

Lawyers, like everyone else, react to their environment – what they see and hear. When the news media trumpets the bad news of a recession and clients complain about business down turns, law firms assume that economic adversity is on its way and begin to board up their fiscal windows.

In truth, not all law firms are affected by a ~~recession~~ downturn equally or at the same time. Recessions are driven by market conditions, and markets in countries the size of the U.S. or the U.K. have strongly regional influences. Arguably there have only been two ~~prior~~ previous "white collar" recessions. The first was brought on in the mid to late 1980's as a result of bank and lending problems. The second was the "tech bust" early in 2000's. In the U.S, the~~.~~ first recession had its roots in middle America and spread its way to the East and West coasts over the next three years. The tech bust started on the West coast, jumped to the East coast and was rolling toward middle America when 9/11 changed the economic focus of the country. In the UK, the first downturn affected all transactionally focused firms, with regional firms strongly affected by downturns in conveyancing. The UK did not perhaps feel the "tech bust" as acutely as US firms, but a number of firms who grew strongly in the "tech boom" on the back of a distinctive sector focus, then fund that times became tough when the downturn happened. What typically happens in the Uniteid Kingdom commercial law sector is that city firms always seem to feel the pain first but ~~typically~~ generally also recover before the British economy in general.

~~This~~ These trends seem~~s~~ to be equally true with the current "sub-prime" recession. Capital market firms in Wall Street and the City of London ~~city firms~~ are seeing dramatic declines in the volume of their transactional business while middle American and middle ~~English~~ British law firms have been much slower to feel the pinch and, in some cases, are enjoying record years. At the same time, UK firms with volume domestic residential conveyancing (real estate) practices are finding new work volumes reduced to less than half their usual levels in some parts of the country, particularly close to London. If previous recessions are a model, by the time severe declines in legal business spread across the country, New York and London may be well on their way to recovery.

The same rolling nature of recessions seems to be true within practice areas. Transactional practice areas including corporate and real estate tend to be the first ~~effected~~ affected by down turns just as they are the first to enjoy periods of prosperity. In large measure this is because transactions have a relatively short life and corporate attorneys have to replenish their workload on a quarterly basis, if not more often. Conversely, litigation lawyers enjoy two advantages. First, they have a virtual annuity with cases that can last for years. Second, many types of litigation are unaffected by gloomy business news, rises in oil prices or loss of consumer buying confidence. As a result, a fall-off in litigation after current cases roll through the pipe line will probably occur at just about the time that the transactional practice begins its recovery.

Investment Philosophy

If the rolling nature of previous recessions holds true in the current down-turn, it emphasizes the 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~~us~~

While it may seem counter intuitive, adverse changes in economic conditions ~~that results in a decrease in the amount of available legal work,~~ 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 down turn 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 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 ~~and in part this was an i~~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 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 ~~the current~~a benign trading environment ~~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 w~~h~~ere 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 considering 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 two pieces of conventional wisdom in the use of legal human resources. The first is the view that full time employees are required for most legal work in order to satisfy clients' demands for capability and responsiveness. The second 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 ~~recruiting~~ 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 lawyer, the firm can size its work force and its overhead structure to the work available by adjusting the hours provided to part-time lawyers. 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. Extreme Profitability

For many firms the imperative for growth has had a dampening effect on profitability. That is, there is a driving philosophy within all forms of business that bigger is better and firms that are not growing are effectively declining. A bastion of law firm management has been that one should never sacrifice long term benefits for short term profit.

As a result, firms invest large amounts of money in growth through recruiting costs, turnover costs and the financing of work in progress while new lawyers 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 downturn was that many firms found it easier to lay off staff below partner level than coping 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 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 20 percent. 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. Put Teeth in Alliances

Many law firms participate in alliances with other firms through a formal structure such as Lex Muni. The core purpose of most of these groups is for the referral of business, yet the experience of most firms is that the amount of actual referred work barely pays for the cost of membership. Arguably membership provides other benefits including the presentation of a more national/global profile to clients and a place to temporarily office lawyers when traveling. While many firms do not keep track of such things, they suspect that the volume of referred work in most affiliations represents only a small portion of the total work being performed in other jurisdictions.

There are a variety of reasons that many firms find affiliations less than fully successful[1]. Many firms became part of their affiliations long ago and in most alliance a proportion of such fims have failed to develop their practices or specialsims to match the growth of the more successful firms. And with lacklkustre quality control systems in place, weaker firms tend to reamin in their alliances as long as they continuie to make their financial contributions. It is therefore no surprise that a~~A~~necdotal~~ly~~ evidence through conversations with partners in firms shows that are members of affiliations indicate that there is often a distrust of the affiliation partner and their ability and willingness to appropriately serve a referred client. Additionally, many partners have their own referral relationships with other firms that they would prefer serve their clients. Often these relationships have been in place for years and provided them with significant business in the past. They feel that they have no assurance that the formal association will provide them with sufficient work to replace what could be lost from their existing source. Finally, there is often concern about their firm's process for assigning income referrals and they may have a distrust that the work and the origination credit will not be fairly allocated.

Periods of economic uncertainty provide a good opportunity for firms to create strong affiliate relationships at all levels of practice and both domestically and globally. The key to a strong affiliation program involves three keys:

- First and foremost, affiliations with specific firms must be exclusive and both firms must agree to refer all appropriate business to each other (with the exception, of course, of conflicts and other unique circumstances). Although such a requirement might be politically difficult in more prosperous times, an economic downturn provides opportunities for the enforcement of stricter requirements.
- Second, the firm must do real due diligence on firms with which it is entering into an affiliation. A partner in the firm must visit the firm, meet partners to whom the referred work will go and gain confidence in the quality of their work, their client service ethic and, in the case of international firms, their understanding of the urgency that is often attached to work in the United States and the UK.
- Finally, the firm must keep accurate records of work that is referred both ways, the amounts billed for that work and the partners to whom the work was referred.

While some of these actions may not appear to be politically saleable in some law firms, the best affiliate networks among law firms were created during periods when the participants were experiencing economic difficulties. A burning platform is an excellent motivator to make important long term changes.

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 going constantly going toe to toe in client panel beauty parades and attempting to poach each others' lawyers. Law firms used to say that there

[1] See "Seamless Service Across the Atlantic" by Ed Wesemann and Nick Jarrett-Kerr (July 2007) Managing Partner Magazine and available on our website at www.kermapartners.com

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 lightening 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 an 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:

a. The identification of one advantage or distinguishing feature about the firm that the competitor cannot easily replicate. It may be a proprietary computer application, a ~~New York~~strategically placed office, ties to a trade association or any other factor that has value to clients.

b. 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.

c. An aggressive recruitment program of the partners in the competitor whose clients have been targeted.

The combination of the impact of the economic slow down on the competitors 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 of 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. ~~among businesses.~~ 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~~A~~ 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 turn-around during a recession could be identified they might well highlight ~~be~~ a law firm with a newly elected autocratic leader and its back against the wall position financially.

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 turn-arounds 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. MBO's of 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 drag down profitability and resist attempts to reduce overhead costs.

The weaker practices vary from firm to firm but they have one thing in common – they ~~do not~~neither benefit from nor contribute to the main stream 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 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 at the same time attempting to offer higher value expertise driven service. Its 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 will, 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~~these~~ practices often temporarily have more attractive revenue streams than other mainstream practices. This can place them on a more level footing and 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 side 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.~~ to focus on the practices~~. 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 spin off 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 spin off 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 situation. Firms that are able to use economic down turns to prosper are those capable of looking at any situation and take a counter intuitive view of the opportunity presented.