

Strategies

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Looking Back on 2009, Looking Forward to 2010

Change Is in the Air



by Peter Zeughouser

The year 2009 will go down as the year in which the greatest upheaval in the world's financial markets since the Great Depression reverberated throughout Big Law. The legal industry began adjusting to the new long-term global economic reality of slower growth in the world's developed economies—the United States, Great Britain and Western Europe—and resilient and more promising growth in the emerging economies led by China, Brazil, India and Russia. For Big Law, the long-term consequences of this shift in the global economy are unclear, but change has been palpable among the world's leading law firms, including the AmLaw 100, 200 and Global 100.

The Year in Review

Looking back on 2009, industry-leading firms lost market share to second-, third- and fourth-tier firms that long had suffered from weak pricing power. According to BTI Consulting Group, corporate spending on legal fees dropped 10.8 percent. Clients in economic distress moved work to firms with lower price points. After years of strong rate increases, top firms felt unprecedented rate pressure. Rate cuts for some work hovered at 25 percent, even among Wall Street firms. Discounts on accounts receivables soared to 40 percent led by Wall Street and City firms. Firms struggled to rightsize. Leverage, the darling of the golden era of law firms, became a dirty word, and deleveraging became the byword of the year. Declining profits at the top of the market resulted in eyebrow-raising lateral departures. Marketing and other staff departments were slashed; 30 percent reductions were common.

Announced lawyer layoffs amounted to more than 3 percent of the AmLaw 200 firms, and silent reductions in the equity and non-equity partner ranks continue to run up the numbers.

The lockstep associate pay scale was cracked at several top firms. Many firms deferred and withdrew offers to first years; some announced they would skip a year of hiring; others extended offers to first years but didn't give them start dates. Some firms cut associate salaries; with the glut of talent on the market, zero attrition held fast. Afraid of leading the market, others held on to starting salaries that were out-of-whack with market conditions.

Firms scrambled throughout 2009 to improve their margins, hold on to desirable talent, shed underperformers and avoid a repeat of 2008 failures such as Heller and Thelen. Believing that rate increases would be tough to get, many firms made a noticeable shift to alternative pricing in their belief that greater profitability is to be had only with improved efficiency and premiums for achieving great results. Evan Chesler, Cravath's presiding partner, proclaimed that he would kill the hourly rate at his firm. Other top-50 firms have announced that they have shifted 20 to 40 percent of their work to flat-fee arrangements, and client behemoths such as Citibank indicate that fully 30 percent of their outside counsel fees have shifted to non-hourly fee arrangements.

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Many pundits pronounced the basic law firm model dead. What they meant is unclear. Some say the era of high-priced associates is over forever. Others say rates will never go up again. Still others say leverage is dead. I don't believe any of these prognostications are true, but there can be little doubt as we turn to 2010 that firms will have to adjust their business models in ways they have previously resisted.

Looking Ahead

What can we expect in 2010? Industry surveys predict that corporate spending either will increase by 4 percent or drop another 4.3 percent. With much of the fat already trimmed from law firms, a 4 percent decline could well translate into a 10 percent drop in profits per partner, which suggests another tough year with more grueling change. The heavily leveraged corporate shops will likely have experienced drops in the 20 to 35 percent range from 2007's all-time highs. Another material drop likely will trigger unprecedented high-end lateral mobility the likes of which the industry never has seen.

To avoid this, smart firms will seek to build their top-line revenue with lateral hires, group acquisitions and mergers and create greater critical mass in the relatively few remaining growth practices: regulatory work and high-end litigation, especially in financial services industry and patent litigation. Inexorable cost pressure on clients will bring more demands for greater discounting, and all but a handful of firms will have to concede. Pricing pressure will drive work to firms in second-, third- and fourth-tier markets, largely as a result of their more attractive (less expensive) rate structures. But firms in these markets will be at risk for being cherry-picked unless they can translate their gains in market share into increased profitability.

Don't believe the pundits who say that leverage is dead. What is clearly stalled and will evolve is the way that law firms create leverage. Historically, law firms have created leverage by maintaining a staff of high-priced associates that is two, three, five or even 10 times the size of the partner ranks, sifting and winnowing the associates as they progress in experience. Compensation for these associates has been on a nearly national lockstep scale. Say good-bye to the lockstep. The market for associate talent is saturated. Associates will work for less, and clients

are less willing to pay \$160,000 a year for newbie associates. For the grunt work, firms will turn more frequently to contract and non-partner track associates.

Two-tier partnerships have been another source of leverage for law firms. Pioneering firms created the second "nonequity partner" tier to get a better look at an associate's ability to develop business. It was supposed to be "up or out." But, equity partners found these uber-associates addictive; they needed no training. Over time, with no skin in the game, too many non-equity partners declined in productivity, blocked opportunities for younger associates and enjoyed the benefits of salary creep. With limited exceptions, in 2010, firms will continue to trim their permanent non-equity partner ranks.

For marketers, declining revenue and price and cost pressures will accelerate market segmentation in 2010, driving smart firms in all segments of the industry to refine their vision and strategies, value propositions, positioning, and branding in an effort to achieve "known-for" status for their core practices. This will enable the winners to compete less on price and more on value. But it won't be accomplished without firms making painful choices about people and practices.

At the time I'm penning this article, corporate work in New York is starting to surge. If it is the harbinger of recovery for the industry, change may come more slowly. None of us should take solace. Whatever the economy brings, the market for legal services undoubtedly will be still more competitive, raising the ante for marketers across the board. There will be no rest.

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