New York Law Journal | LAW.COM

SERVING THE BENCH AND BAR SINCE 1888

WWW.NYLJ.COM

An ALM Publication

NOVEMBER 25, 2020

The All-Terrain Law Firm: Creating Value in a Rocky Economic Climate

Encountering rocky terrain does not mean you're inevitably going to crash. It just means that you need to be using the right piece of equipment to navigate it.

By **Roger E. Barton**

Imagine for a moment that a friend invites you on a rigorous biking trip. Your friend assures you that the trip will start out nice and easy, that you'll be riding on flat, smooth pavement. However, as the trip progresses, you are also expected to pass through mountains, forest, and desert. You will encounter a wide variety of terrains, ranging from gravel and rock to sand and soil.

There's just one problem—you need to buy a bike. You are subsequently given the choice between purchasing either a road bike or a mountain bike. Which do you choose?

On the one hand, road bikes ride very well on flat pavement since this is what they are designed to do. But while a road bike might get you through the first part of your trip without any issues, this type of bike performs poorly in rougher environments. The road bike lacks versatility, is high maintenance, and is temperamental due to several of its structural features. Moreover, a decent road bike will cost you at least $1,000, with upper-tier models setting you back anywhere from $3,000 to $8,000.

Conversely, mountain bikes are designed to ride on pavement *and* to handle various types of terrain over long periods of time. They are generally more comfortable than road bikes and are structured to absorb the shocks of rough terrain without affecting the rider. Mountain bikes also come with hydraulic systems that allow the bike to adapt to varying levels of steepness, along with durable and stable frames meant to endure high levels of stress. You can also get a perfectly suited mountain bike for under $1,000, sometimes even for a couple hundred.


Shutterstock

So which bike do you choose for your trip?

While neither of these options are bad bikes per se, the mountain bike is clearly going to be of more value to you on your trip. It makes the most sense in terms of what capabilities you will need from your bike and in terms of the price measured against the performance. What your decision really comes down to then, is a question of *value*.

So what does any of this have to do with law firms?

The current COVID-19 pandemic and financial crisis is rocky terrain. You'd be hard-pressed to find anyone who would disagree with that. Besides the myriad of public health and humanitarian concerns, the U.S. real GDP contracted 4.8% in the first quarter of 2020, unemployment soared to 14.7% in April, and the stock market saw its sharpest decline in over a decade (*The Economist*, May 2020). And even with the promising news of viable vaccines on the horizon, it will likely still be a while before the business world returns to any semblance of normal.

However, encountering rocky terrain does not mean you're inevitably going to crash. It just means that you need to be using the right piece of equipment to navigate it.

Right now, there are many struggling "road bike" law firms—those that are not able to consistently provide value to their clients—that are losing work during this downturn. But there are also a number of "mountain bike" law firms that, having found ways to consistently drive value to their clients irrespective of outside circumstances, are showing every indication of thriving.

The rest of this article will explore what kinds of firms are best positioned to provide superior value to clients and why this is such a critical consideration in the current economic climate.

Defining Value in the Legal Sphere

Before going any further, it is worthwhile to define just what exactly "value" means in a legal service context. In a colloquial sense, the term "value" is often associated with products that are less expensive. But what true "value" should denote is that the caliber of the product being purchased is in healthy proportion to its price.

When legal service is the product in question, there are multiple ways to evaluate its merit. From a client's perspective, the pillars of *quality, efficiency, client experience, predictability,* and *flexibility* are among the most important. Below are some questions that firms and clients alike can use to evaluate to what degree these standards are being satisfied:

Quality	• Are attorneys knowledgeable and experienced? • To what level are the desired outcomes achieved?
Efficiency	• Are resources allocated effectively? • Is work completed in a timeframe appropriate for the scope of the work?
Client Experience	• Are attorneys responsive and communicative with clients? • Do attorneys take the time to understand clients' businesses?
Predictability	• Do clients receive consistently excellent service? • Are rates and payment arrangements conducive to cost certainty?
Flexibility	• Does the firm use innovation and creativity to meet evolving client needs? • Is the firm adaptive to changing circumstances and market conditions?

While the answers to some of these may not end up being a simple "yes" or "no", they're a good way to begin thinking about the level of value a firm is providing, especially relative to the rates they charge. If a client is simply looking for quality, they'll have no problem. There are certainly hundreds of law firms all over the country with very knowledgeable and capable attorneys. But increasingly, and especially now, clients are demanding more from the firms they retain beyond simply competent work. Incidentally, this creates a tremendous opportunity for firms to differentiate themselves from competitors.

The Import of Value in the COVID-19 Era

As the fallout of COVID-19 continues to affect market behavior, it's helpful to compare current market trends with data collected from the last major recession regarding spending decisions and client attitudes in the legal industry.

From 2007 to 2010, the shockwaves of the Great Recession were altering the spending behaviors and decision-making of general counsel in particular. After 2008, in-house lawyer growth accelerated while law firm growth stalled (*ALM Intelligence*, February 2019). This points to the fact that general counsel were starting to keep more work in-house in an effort to curtail unnecessary legal spending.

And indeed, a survey of general counsel conducted by Altman Weil in November of 2008, found that among corporate legal departments facing budget cuts, 65% planned to bring more work in-house. This tracks with the fact that, when asked about their greatest concerns regarding legal spending in the coming year, general counsel cited "outside counsel costs" and "lack of predictability" as the top two concerns. A whopping 81% of firms flagged these two issues as major concerns going forward. It should come as no surprise then that 54.8% of the general counsel surveyed reported that they planned to decrease their use of outside counsel.

This siphoning of business away from traditional law firms was inevitable considering the circumstances. Amidst the uncertainty of 2008 and 2009, corporate legal departments no longer wanted to pay disproportionately high hourly rates for work that could be done either in-house or by alternative legal service providers (ALSPs)—sources they felt were of better value.

Even before the scope of the current pandemic was fully realized, firms were reporting a loss of business to these other sources. A survey conducted by Altman Weil in early March of this year—just before the ensuing government shutdown—found that almost 70% of firms were losing business to corporate law departments who were bringing more work in-house. Additionally, 30% of firms said they were losing business to new technology tools and 15.5% said they were losing to ALSPs

Of course, a significant quantity of legal work *did* remain in the realm of BigLaw during the recession of 2008. But even for work that could not be or was not taken elsewhere, there is evidence that clients were still pushing for greater value. For example, from 2007 to 2012, while standard hourly rates increased 3% per year, the percentage of rates *not* collected doubled from 8% to 16.4% (*McKinsey & Company*, May 2020). This suggests that even as firms attempted to increase profitability through raised rates, clients pushed back by applying pressure for discounts, write-offs, and write-downs. This increase in uncollected fees served to counteract—at least partially—firms' initiative to raise rates.

Clients are always looking to maximize value when it comes to their legal spending. But as we've seen before and as we're seeing now, when the economy takes a downturn, clients become even more keen on finding value and predictability in the firms they hire.

A recent analysis of legal department invoices by CounselLink in July found that there has been a steady increase in legal fee discounts from March to May 2020, as compared to this same time period last year. The analysis also notes that, historically, the end of the year is the only time that the volume of invoice discounts typically exceeds 16%. For 2020, this 16% threshold was already passed in May. Interestingly enough, in the Altman Weil survey conducted back in March, only 28% of firms said they would offer rate discounts to clients in the event of a hypothetical recession. A month later—when this "hypothetical" recession was realized—this number jumped to 40% when firms were polled again.

In an October article in *The American Lawyer*, a survey conducted by legal analyst Ari Kaplan found that 57% of chief financial officers and other firm executives were willing to reduce bills for clients if they paid early. Furthermore, law firm consultant Tim Corcoran noted that, "During the first quarter of 2020, collection efforts were low—as usual—but the second quarter saw a spike in collections, as firm partners offered discounts or other inducements to commit clients to pay during the unpredictability of the spring."

With many clients struggling with cash flow, firms are finding themselves forced to make concessions in order to better align their rates with what clients perceive as the value of their services. This is not good news for firms that are reliant on increased billing rates to stimulate profitability. The March 2020 Altman Weil survey reveals that, before the economy stalled, 66.5% of firms reported that they had increased billing rates more aggressively in the past few years in order to improve profitability. Of that 66.5%, 82% reported that this method had proven successful so far. Perhaps a more telling statistic is that 58.1% of firms said they were counting on higher billing rates to bolster their performance for the rest of 2020. Among large firms (greater than 250 lawyers) this number was even higher, with 78.6% of firms relying on higher rates to increases profitability going forward.

Firms that depend heavily on increasing rates for their growth are going to suffer during a time when clients are looking to cut costs and derive more value from the services they are receiving. Discounts after-the-fact, while a temporary solution, do little to reinforce a firm's value proposition and can often even serve to undermine it. However, for firms that have figured out ways to strategically and consistently drive value to clients, an economic downturn can present opportunities to stand out from the crowd.

What Kinds of Firms Are Best Positioned To Provide Value?

Like the road bike versus the mountain bike, there are certain kinds of firms that are better suited and better equipped to provide value than others, in large part because of how these firms are *structured*. Firms that are traditionally structured, including most BigLaw firms, employ service delivery models that make it nearly impossible for them to provide value correlative to the rates they charge.

This is due in part to the business model of most BigLaw firms that is based on leverage. This manifests as lower-tier partners and associates having to bill more hours and/or consistently increase rates in order to drive profits to high-earning partners. The result of this is that, even if the client's legal objectives are achieved, they are still left paying fees disproportionate to the value of the services rendered.

Because of this, BigLaw firms had already become impractical as one-stop shops for all of a client's legal needs even before the COVID-19 pandemic. Considering present circumstances, it is even less likely that clients will keep retaining BigLaw firms to do work that can be done elsewhere.

Even for those BigLaw firms that are open to altering their service delivery models, like a high maintenance and temperamental road bike, they are not built to be flexible to meet the needs of a changing environment. The rigidly hierarchical management structure at most of these firms often makes it difficult for meaningful change to be enacted quickly. Excessive red tape and competing loyalties also limit the flexibility of firms to adapt to the changing needs of clients, whether it be through creative pricing arrangements, implementation of new technology, alternative staffing strategies, innovation initiatives, or the like. In the circumstances we currently find ourselves in, where market instability is tied directly to a public health crisis that is changing daily, the ability to be nimble is even more critical.

Consequently, this creates a tremendous opportunity for smaller law firms to deliver value. Those firms that can combine high-quality services with a nimble and flexible business model are uniquely positioned to drive value to clients because they are robust enough to handle complex legal matters, but they are also agile enough to adapt and shift quickly in tandem with evolving client needs.

If properly structured, these firms can differentiate themselves from the general morass of BigLaw firms by delivering a strong value proposition. For example, compensation systems can be designed in a way that encourages efficiency and collaboration within the firm. Non-traditional compensation systems can also leave ample room for creative alternative fee arrangements as they're needed. When partners' compensation is objective, transparent, and aligned with the client's objective to receive value, it eliminates the need for the outdated leverage system responsible for so many inefficiencies. Clients get further value by working directly with experienced partners who can take the necessary time to understand their business operations and objectives.

Firms that employ flat management structures are also inherently more nimble than firms with large ladder-esque hierarchies and executive committees. Flat management gives partners more autonomy over their practices, rates, and fee arrangements. This correlates to greater flexibility when working with clients. On a firm-wide level, agile management allows for quicker responsiveness in uncertain, abruptly changing conditions, which makes it particularly effective in times of economic flux.

While many firms can boast expertise and talent, very few are focused on differentiating themselves in terms of value. In many cases, this is because dependence on the traditional law firm service delivery model inevitably weakens the caliber of value a firm can provide. For savvy clients looking to cut costs without cutting corners, a high-quality firm that prioritizes efficiency, client service, and flexibility is going to be a very attractive option, especially during a period of economic unrest.

Lateral Hiring in Times of Crisis

Clients aren't the only ones attracted to firms that deviate from the traditional model in favor of a more value-conducive one. These firms can be beacons for lateral partners as well.

Historically, the lateral market has been shown to slow significantly during times of crisis and economic uncertainty. During the brunt of the last recession, lateral partner moves totaled fewer than 700 and fewer than 900 in 2007 and 2008, respectively. These numbers stand in stark contrast to the almost 2,000 lateral moves occurring in 2012, when the economy was finally recovering (*Lateral Link*, April 2020).

Not only does lateral hiring stall during downturns, but the rate of lateral leakage (partners exiting BigLaw altogether) increases. From 2007 to 2010, the overall ratio of lateral moves to lateral leakage declined each year. At its lowest point, for approximately every 1 lateral move that occurred, 4 attorneys exited BigLaw altogether (*Lateral Link*, April 2020). By some standards, BigLaw never did fully recover from this mass exodus. As of 2019, the Am Law 50 was still 9% below the number of lawyers it had in 2008 (*ALM Intelligence*, February 2019).

A survey conducted in June 2020 by the National Association for Law Placement (NALP) found that 40% of firms reported a decrease in their volume of lateral hiring from March 1st through May 31st, 2020, compared to this same time period last year. Additionally, legal analytics firm Decipher found that between January 1 and August 31, there have been 10,233 lateral moves among both partners and nonpartners—a 30% drop from last year.

While certain practice areas, such as bankruptcy and data privacy, have seen upticks in lateral movement, lateral hiring on the whole has slowed. Considering the expense, time, and risk associated with recruitment efforts, many firms—especially those that have already had to resort to pay cuts, furloughs, and layoffs—aren't willing to continue lateral hiring in the same capacity as before.

As of Nov. 13, 2020, 143 of the top firms in the country had reported to *Law360* the following measures they'd taken to lessen the financial impact of COVID-19 at some point this year:

Mitigating Measure	# Firms Implementing	% Firms Implementing
Layoffs	30 firms	21.0%
Furloughs	35 firms	24.5%
Pay Cuts/Distribution Changes	76 firms	53.1%
Summer Associate Program Affected	93 firms	65.0%
None of These Measures Taken	2 firms	1.4%

An article from *The American Lawyer* published in August points out that these cost-cutting measures—the layoffs in particular—may also be an attempt by large firms to keep top-tier partners happy as a defense tactic against poaching: "Threatened by hits to revenue and profits, Am Law 100 firms are shedding unproductive partners to feed more money to high performers and prevent other firms from poaching their most valuable talent … Firms in the Am Law 200 are seeking to protect their rainmakers from poaching by the increasingly profitable top 20 firms. Forcing some partners to leave and redistributing the savings is an effective way—at least in the short term—to do so."

Firms that are culling their ranks in a frenzied attempt to retain their top-performing partners are merely managing the downfall, not capitalizing on its underlying business opportunities. It's a survival tactic rather than a growth tactic. Alternatively, a firm that is able to (1) maintain steady work flow; (2) avoid major pay cuts and layoffs; (3) actively recruit laterals; (4) strengthen practice areas; and (5) keep an optimistic outlook is going to retain its current talent, while also appealing to laterals and clients alike. In a time when most firms are cutting back, contracting, and battening down the hatches in order to survive the crisis, a firm that continues to grow and expand is the exception. Going forward, firms that continue to be lackluster in efforts to improve their value proposition will face increased competition and pressure from clients, alternative providers, and other firms that are more value-centric.

This may very well serve as a wake-up call for the legal industry as a whole. Firm leaders—especially those whose firms have struggled significantly in the last several months—may start to rethink the ways in which their firms operate. In another article published by *The American Lawyer* in late July, Jennifer Johnson, the CEO of legal recruiting and consulting firm Calibrate Legal, astutely noted: "I would say the pandemic has given the opportunity to rethink the shape of a law firm. I think it has heightened an awareness that the traditional model may not be what we are going to see as having the most success going forward." While second quarter numbers are better, it is unlikely that we are out of the woods just yet.

There will always be times when the way ahead is rocky and uncertain. That's an unavoidable fact. But the great separator will be between the firms that can adapt and forge ahead into the unknown and those that can only go as far as the paved road lets them.

Roger E. Barton *is the managing partner of New York City-based Barton LLP.*