



October 22, 2008

To Our Clients and Friends

Over the past several weeks, our economy has suffered from a combination of serious setbacks, any one of which would have been sufficient to rattle the financial markets in normal times. Together, these events have swept away institutions and financial structures that have been in place for many years and have created a crisis of confidence in our financial markets at a level that we have not seen for decades.

In the legal market, the current economic crisis has exacerbated a slowdown in business that has been evident for several months. In most law firms, productivity dropped significantly in the second half of 2007 driven by sharp downturns in real estate, structured finance, and transactional practices. That slowdown continued into 2008, and has been deepened by the current crisis in the financial system. Moreover, despite encouraging recent signs, the current downturn has not yet been significantly offset by increases in other traditionally “counter-cyclical” practices like bankruptcy, litigation, and regulatory work.

To be sure, these effects have not been uniform across the profession. Indeed, we know of a number of firms – including both large national and global firms, as well as mid-sized regional firms – that have remained busy throughout the year and will end 2008 in fairly strong financial positions. Notwithstanding these exceptions, however, the current year will represent a significant downturn for the legal industry as a whole.

In light of these extraordinary developments, we wanted to share with you our observations about the current economic crisis, its impact on the legal market over the next several months, and its wider implications for the way law firms do business.

The Current Situation

The current downturn has brought to an abrupt end the six-year period of unprecedented revenue and profit growth that law firms have enjoyed since 2001. Far from the annual double-digit growth in profits per equity partner that law firms experienced (and came to expect) over the past half decade, we believe that, across the profession, profits per partner in 2008 will on average be flat to a minus 10 percent, as compared to profit levels in 2007. For firms with significant capital markets practices, we expect the decline will be more significant – on average from minus 5 to 15 percent, with a few firms seeing even steeper declines. These results will put a severe strain on many firms and will require steady and level-headed management to calm the inevitable anxieties of partners and others.

Unfortunately, it seems certain that a quick turnaround for the economic crisis will not be possible. Despite the aggressive efforts of governments and central banks around the world to bolster the capital markets and to free up credit, it is apparent that it will take several months to work our way out of the current quagmire. We believe that we are unlikely to see any significant turnaround until late 2009, at the earliest. That said, it is



likely that there will be an up tick in legal work during this period as financial institutions are restructured, as “blame” for the current crisis is sorted out through claims and counterclaims, and as a new regulatory system for our capital markets is put in place. Indeed, we are already beginning to see increases in litigation, bankruptcy, and employment law work related to the economic meltdown. It is also certain that the new administration that takes office in January (regardless of the outcome of the Presidential election) will instigate far-reaching regulatory reforms that will significantly reshape financial institutions and the capital markets and create new legal work, particularly for firms in New York and Washington. It is highly unlikely, however, that any such up tick in legal activity will substantially counterbalance the loss of work that will continue to result from the overall slowdown in the economy in general, at least during the first half of 2009.

The implications of the current economic crisis for the legal profession are significant. Obviously, the widespread restructuring and realignment of financial institutions will disrupt many long-standing firm-client relationships and will inevitably lead to more vigorous competition for work in the financial and capital markets sectors. The general economic slowdown will also adversely impact corporate and transactional practices at all levels for many months to come and may well result in increased resistance to billing rate increases for 2009.

All of this will pose serious management challenges for virtually all firms. For some firms – as evidenced by the recent demise of Heller Ehrman – the challenges may prove overwhelming. We expect to see a significant contraction across the industry over the next several months as firms are forced to lay off legal and non-legal staff, slow down the hiring of new attorneys, restructure operations, and weed out unprofitable practices. We also anticipate additional merger activity as firms struggle to maintain their strategic focus. And, unfortunately, we could see additional law firm dissolutions.

Immediate Management Actions

In light of all of this, we believe that there are a number of immediate steps that firm leaders should be taking to help their organizations weather the current storm.

- First, it is critical to focus on collection efforts now. The year-end collection push is challenging in the best of times, but this year it is likely to be tougher than ever. With the tightening of credit markets, corporate clients will be looking to lengthen their payment cycles at the very time that law firms are trying to meet year-end collection deadlines. For many firms, the problem will be exacerbated by higher than usual debt levels under lines of credit that must be paid down by year end. As a result, many firms will be challenged to meet even their revised net income projections.
- Second, start negotiating your firm’s credit arrangements for next year now. Regardless of what happens in the next few weeks, it is possible that credit may be more difficult to get in 2009 for some firms than it has been (at least until recently) in 2008. It is also likely to be more expensive.
- Third, take a close look at the expense side of your firm’s income statement. In the present environment, you need to look at your expense structure to be sure excess expenses are trimmed, while being careful to preserve items that are strategically important. Firms that take a “slash and burn” approach to expenses will be



seriously disadvantaged when the economic recovery occurs (and remember that recovery in the legal market typically leads recovery in the general economy). You should also review your firm's procurement process, as well as your relationships with existing vendors, to make certain that you are getting the best prices for the goods and services that you purchase. The consultants in our strategic sourcing practice tell us that, in most firms, such a review can result in cost savings in the neighborhood of 25 or 30 percent with little or no adverse impact on operations.

- Fourth, for some firms, excess capacity will inevitably lead to layoffs within both the legal and non-legal staff. It is important to remember that one of the basic problems resulting from the current downturn is that the demand for certain kinds of legal services has dropped dramatically, and many firms now find themselves staffed for levels of work that are not likely to return for some time. If such "excess" lawyers cannot be re-assigned to other more active practices, a firm may have little choice but to consider a layoff. In such cases, firms are well advised to initiate all necessary layoffs simultaneously rather than increasing anxiety by phasing them over time. Moreover, if layoffs are necessary, they should (if possible) be completed in 2008 and charged against 2008 earnings. This will allow firms to have a stronger start in 2009, particularly since it is likely that many firms will go into 2009 with higher WIP and AR. If layoffs are necessary, clear communication is critical to reassure remaining lawyers that the layoffs will not affect them.
- Fifth, use the current downturn as an opportunity to deal with performance issues throughout the ranks of the firm. During the past six years of unprecedented growth, many firms have become bloated with underperforming lawyers who have been demoted or held in place rather than terminated. (A prime example is the swelling of the non-equity partner ranks in many firms through the "de-equitization" of underperforming equity partners.) Whatever the wisdom of this approach during healthy economic times, it is a practice that can't be tolerated in the present environment. For the health and protection of the firm itself, chronically underperforming lawyers (whether partners, income partners, or associates) should be winnowed out.
- Sixth, take a hard look at your firm's practices. This is a time to shore up those practices that are strategically important to the firm's future and to consider paring practices that are peripheral or unprofitable. Similar to their treatment of underperforming lawyers, firms are often inclined to tolerate questionable practice areas when economic times are good. In the present climate, however, trying to maintain practices that are non-strategic and a drag on the firm's overall profitability may be highly ill advised. At the same time, the current downturn may offer opportunities to acquire lawyers who could add significant capabilities to your core practices, and firms should be alert to do so.
- Seventh, stay in close touch with your partners and associates, especially those who are critical to the firm's success. These are, by any measure, unsettling times, and even lawyers in strong and well-led firms are feeling anxious and uncertain about their futures. In these circumstances, it is impossible for firm management to communicate too frequently. In a time of increased external uncertainty, firms need to take steps to reduce internal uncertainty. Partners and associates need to feel reassured that management is on top of the problem and that prudent steps are being taken to position the firm as well as possible. Silence from firm leaders at critical times like the present will inevitably be interpreted as a harbinger of certain disaster.



- Eighth, stay in close touch with your clients, especially those key clients that are important to the firm's future. Now is not the time to save money by cutting back on productive marketing expenses. Your clients are experiencing the same anxieties and uncertainties as the firm itself, and ramping up communication to them will stand the firm in good stead when economic conditions improve. Lawyers have time on their hands, so put it to good use with increased focus on client development, client teams, and appropriate business development training.
- And ninth, if, despite all of the foregoing actions, you find yourself in a position where the worst is possible – *i.e.*, where actual dissolution of the firm looms as a potential outcome – it is critical to address that reality as quickly as possible. Firms on this path can often be rescued – *if* action is taken sooner rather than later. If we have learned anything from years of dealing with firms *in extremis*, it is that failure to confront the possibility of dissolution early and forthrightly almost always reduces options, hardens positions, and increases the likelihood of ultimate dissolution. There are often restructuring opportunities short of dissolution that firms can pursue, but only if they address them in a timely way. Mergers negotiated on the brink of dissolution, for example, are only rarely successfully concluded.

Longer Term Implications

As described above, the current economic meltdown will have significant short-term effects on the legal market. We believe that there are likely to be significant longer-term impacts as well.

As we have noted in previous client letters and advisories, even during the last six years of unprecedented law firm growth, the significant increases in profitability that most firms enjoyed were disproportionately driven by only one factor – the ability to increase billing rates by 6 to 8 percent every year. (Other factors like leverage, productivity, realization, and expenses have not generally been net contributors to profitability growth during this period.) If, as seems likely, across-the-board rate increases will not be possible in 2009, the hit on law firm profitability will thus be particularly severe. Moreover, the current crisis is occurring at a time when client resistance to the level of legal fees has already been mounting. All of this may ultimately require a re-thinking of the basic law firm economic model.

We suspect that, over the next several months, we will see firms looking at a variety of alternatives that, although discussed in the past, have not previously been seriously considered. These could include such items as –

- A serious review of existing associate compensation and evaluation systems, with an increasing number of firms moving away from lock-step advancement to competency-based approaches;
- A re-evaluation of the role and value of non-equity or income partners and of other “permanent” non-partner lawyers, with a view toward redefining those categories in ways that make more economic sense for the firms;



- An exploration of value-based approaches to the pricing of legal work that uses alternatives to the traditional billable hour including, as appropriate, project pricing and fixed fees;
- A re-thinking of the ways in which work is performed in law firms, including consideration of the expanded use of non-lawyer professionals, contract or temporary lawyers, legal process outsourcing, and the like; and
- A significant shift in the dynamics of competition within the legal market resulting from continuing consolidation and realignment of client relationships.

In short, we believe that the present economic crisis may lead many firms to re-think the fundamentals of how they do business and how they deliver value to their clients, and, at the end of the day, that may not be such a bad result. Moreover, it is important to remember that the present downturn in the legal market is caused primarily by reduced demand and that demand will return in time. Although there may be some restructuring in the way that legal services are delivered, the long-term prospects for the legal industry remain very good.

Historically, firms have tended to react in one of two ways to significant economic downturns. Some have taken drastic steps to reduce legal and non-legal staff and slash expenses in an effort to keep their partner profits as high as possible. Others have worked to preserve their cultures and their strategic capabilities by using the downturns to invest in the future of their organizations, even if it has meant some short-term reductions in overall profitability. History has shown that the latter firms have usually emerged as the most successful and stable in the long run.

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As always, we at Hildebrandt stand ready to assist you and your firms in addressing the challenges arising from the current economic crisis. Indeed, we – along with our partner the Citi Private Bank – will be issuing our annual Client Advisory early this year to assist our clients in planning for 2009. As a company with over 30 years experience in consulting to the legal industry, we have seen economic downturns before and have helped our clients work through them successfully. While the current downturn is unique in some ways, we are confident that – with sound management and clear strategic focus – most firms will come through this one in sound shape.

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