Law firms in the Great Recession: looking for change in all the wrong places

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The last decade, particularly the last five years during the Great Recession, have generated tremendous change within law firms. Many long-term partners in large law firms poignantly observe that the firm they joined bears little resemblance to the firm it has become.

Most of this change was focused upon internal governance and structure driven by compensation pressures, not upon operating efficiency or delivering change responsive to client demands for a better value proposition for their legal spend. Inside, it is a whole new firm. Outside, clients don’t see much change that benefits them.

Answers are not bold stroke mergers, absorption of chic specialty practices, or expansion to new markets in new locations. Those are all strategies that send the following message to the entire firm: “The future success, indeed survival, of this firm depends on people who are not here now, and are yet to be found.” Is that the message of a successful organization that motivates its membership to move forward with energy, enthusiasm, passion and resolve? Such moves by those occupying leadership roles exhaust the spirit of everyone in the firm and waste financial resources desperately needed to work real change, increasing the difficulty of recovery. For five years, this has been the approach of too many firms.

Legendary business consultant Peter Drucker once observed: “Management is doing things right; leadership is doing the right things.” It is clear that lawyers in positions of management and leadership, and many who advise them, fail to grasp this critical distinction.

Cost cutting remains a major focus. It is not the answer. Only about one third of expenses are typically non-personnel in a law firm. Of those, only about half are eligible for short-to-medium-term adjustment. Take a chainsaw to the one-sixth of costs that are eligible for cuts, and hack 20 percent on average. It only saves, in the best case, a little more than 3 percent from the budget. That isn’t going to move the needle on profits very much, and it cannot be replicated every year.

That means people have to be cut, and that gets into the "rightsizing" discussion. Done masterfully (and judging from industry reports, law firms don’t even do it well), that still only allows a firm to have enough, but not too much, professional capacity for declining market demand.

The key is not whether law firms have been doing the above well or doing it badly. The two primary focus points above are reactive, short-term and marginally beneficial. And buying revenue through laterals and mergers is expensive and problematic, not proactive and visionary. The stark reality is that firms have been doing the wrong things.

The focus on wrong things is evidenced on at least two fundamental levels.

The first level is that there has been abandonment of the "people business" essence of law. This impacts upon the investment made internally, and externally on the oft-discussed price/value proposition for clients. The most precious and essential element of professional practice is identifying, recruiting, hiring, training, mentoring, promoting and retaining those professionals, and the properly skilled staff to support them. Systems, procedures and technologies are all important, but they mean little without having the best professionals, (unless you aspire to a practice where the quality of the professionals is not important).

The cost of each professional is very high compared with most other businesses. Every time a firm loses one, it costs a small fortune. This is an incredibly wasteful yet almost institutionalized feature of the industry. Let's say it costs a firm an unrecovered investment of more than $350,000 each time an associate with less than four full years of service leaves the firm. What does that do to all those cost reductions elsewhere? Capital is important, but compared with manufacturing and other businesses, it is a smaller contributor to the creation of revenue. In law firms, it is people who create revenue. Operating models that treat legal professionals as fungible and interchangeable widgets are inefficient and unpleasant to work at.

To get a feel for just how economically stupid they can be, model a business with an industry average 18 to 20 percent annual associate attrition rate with those costs, and see what devastation it does to the bottom line. Then try cutting the attrition rate in half and running the numbers again. The difference is millions of dollars a year. Adjust the assumptions to fit the firm, but the answer is clear: Hire less, train more, keep them longer. It used to be a firm investment to train people, not a client subsidy. It morphed into armies of young lawyers doing clerical work, with the cost passed on to clients and a profit to the firm. Clients don't let firms do that anymore.

Emphasis on reorganization of law firm structure has for the most part been a cosmic waste of time, energy and money. Going to practice group management models versus geographic management models is but one example. It is nothing more than deciding to play musical chairs by marching clockwise rather than counterclockwise. What is worse, it gives the false impression that the enterprise is actually engaged in doing something that is going to make a difference. Actually, it does make a difference. It gets more people who lack management skills involved in management.

The second level is in the definition of what the "right" things are that firms should be doing: specifically, a very definite, clear and uncompromising definition of a moral "right" thing that is communicated to all and embraced and adhered to by all with rigor. It is through the pursuit and achievement of the "right" thing that the culture of a firm is built, and the team commitment by people to each other and for each other can be framed to achieve everything else that matters in the enterprise.

Without that group commitment to the value-based mission at the beginning of the enterprise endeavor, nothing can be soundly built or grow, and without it applied steadily to the end, nothing of real value can be sustained or survive. Leadership must tend to this culture relentlessly, such that it is embodied in everything the firm does and thus by everyone in what they do.

The defining culture has been abandoned or relegated to just words by many law firms. The absence of meaningful actions that unequivocally demonstrate to everyone in the firm that its culture comes with utmost priority characterizes today’s landscape of struggling law firms.

The two levels are, of course, related. Without the collapse of the second level of firm culture, the erosion of the most critical component of the "engine" of the business would either not have happened at all or would be materially less than it is.

Widening partner compensation spreads, borrowing large amounts on working capital lines to make distributions, dramatically increasing partner capital, tranching partnership status ... do nothing to improve operations. They just preserve distribution levels for a few at the expense of the many.

Next time, we look at extricating ourselves from the struggling business model that is no longer matched to the market for legal services.

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