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Managing Shrinkage

When we think about the forces reshaping the legal industry, we focus primarily on forces such as the impact of changing client demand trends and innovation in legal service delivery. Much less attention has been given to the internal demographic forces likely to reshape law firms in the coming decade. Our analysis of the aging of many U.S. based law firm partnerships leads us to believe that internal forces within law firms will have just as much - if not more - of an impact on the traditional law firm model over the next 10 years. Partner demographics in many U.S. firms will cause a major reshaping and restructuring of the business, and for those firms intent on maintaining a more traditional model, long term sustainability may require planning and managing for shrinkage of the partnership and ultimately the firm.

What is the risk of shrinkage?

Based on 2016 data, 16 percent of partners will retire in the next five years and 38 percent will retire in the next decade.[1] While this data sounds only mildly disconcerting, our experience indicates that the averages smooth over the more alarming retirement trends impacting some firms. We regularly see firms where the average equity partner age is approaching 60 years old. The risk of shrinkage of the partnership is greatest for firms focused on a more traditional and lower growth model, and particularly those whose partner compensation approach emphasizes partner personal productivity and under-values teaming and development of next generation lawyers. Firms of all sizes have historically struggled with this balance, although small and mid-size partnerships will be disproportionately impacted by the wave of baby boomer retirements. This is particularly true of firms in more competitive legal markets, where lateral activity and competition is high, making it harder to retain high performing younger partners.

In spite of demographics, too many firms appear intent on maintaining their current course. We often hear law firm partners explicitly defend the status quo in terms of external positioning and client service delivery, as well as internal structure, hiring, leverage, and firm composition. Many of these partners are themselves senior, are experiencing peak compensation and are loathe to adjust a model which they believe will serve them well for the few remaining years of their career. Yet regardless of the magnitude of industry change driven by external forces, the reality of partner retirements in the coming decade will force many firms to confront a different looking future. A shrinkage in the number of equity partners will present a number of strategic and organizational changes which if not appropriately planned and managed for could lead to a material decline in a law firm's market position and competitiveness, and potentially even threaten long-term survival.

Can firms avoid shrinkage through succession planning?

For most firms facing a wave of baby boomer retirements, the firm's initial focus should be on succession planning - addressing the broad range of strategic and organizational implications of retirements. Effective succession planning requires that firms evaluate their own specific risks associated with the generational transition of clients, revenue generation, leadership, financial obligations, market profile, referral network, expertise and operational management. While the level of risk in each of these succession categories will vary by firm, there are two core issues which impact nearly every firm with an aging equity partnership – client and rainmaker transition.

Both client transition and business generation or rainmaker capability present outsized implications for the firm's future sustainability. Client relationships represent the core of every law firm's current and future competitiveness, and as a result, transitioning client relationships from senior partners to next generation partners is a critical challenge that must be addressed by any firm with an aging partnership. Those firms pursuing a strategy of opening up client relationships and building teams around clients will be the ones most likely to overcome this particular succession obstacle.

An additional strategy for firms with a high concentration of partners over 55 is the investment in developing and/or replacing

[1] Major, Lindsey & Africa's 2016 Partner Compensation Survey

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senior rainmakers. This will require careful hiring and focused professional development and retention of young lawyer talent (assuming time horizons allow for this longer-term option), or robust lateral partner recruitment. Lateral growth and larger scale partner additions via merger offer the potential to more rapidly shore up the partnership and reduce demographic risk. However, for some firms, lateral growth or merger is a less viable option, due to the firm's geographic locations, a lack of partner support, or the sheer cost and uncertainty of external partnership growth.

For nearly every firm, organic development of young lawyers into equity partners represents a critical path to long term sustainability. Investing in professional development for lawyers across a range of substantive, client development, project management, delegation and leadership skills is essential to helping young lawyers matriculate to equity status. And retaining them through the duration of their careers requires communicating a commitment to their career progress and appropriately compensating their efforts to generate new clients and manage work from existing clients.

Unfortunately, without proper planning and investment, succession efforts often yield mixed results. Client transition is often challenged by the nature of personal relationships and clients' repeated statements that they hire lawyers and not law firms. Also, law firms often wait too long to sufficiently augment aging rainmakers, failing to develop and promote future equities or seek out external growth options. These realities, coupled with a tendency of many partnerships to want to preserve the status quo, demonstrate the likelihood that in future years, traditional law firms may not have invested heavily enough in succession planning. These firms will be forced to confront shrinkage, necessitating careful planning and management of the firm's downsizing over time.

Planning for and managing shrinkage

While shrinkage represents both risks and hurdles, carefully planned and managed downsizing doesn't have to equate to reduced competitiveness, poor performance or even failure. Firms forecasting a decline in partnership and overall firm size will find that shifting from a defensive posture to an offensive strategy is key to preserving profits and maintaining the confidence of the firm membership. This requires careful analysis and planning around the likely changes in the firm model as senior partners retire and the firm's revenue and business base gets smaller, including:

- **Size, staffing model and structure:** With lower revenue, firms will need to align the number of timekeepers and administrative and business staff to support a smaller model. They will also need to evaluate more cost effective and efficient ways to handle certain types of work, including secretarial, research, marketing and business development support, and other non-billable functions. Leadership and management models will also need to be re-constituted, with fewer available leaders and fewer lawyers and staff to be led.

- **Physical space requirements and other overhead:** In light of a reduced size, firms will need to conduct careful and long term planning of space requirements and other operational contracts. Shorter terms on leases will become a business imperative, bearing in mind forecasts of reduced headcount and lower revenue projections.

- **Capital and debt:** As partnership and firm size declines, detailed financial planning around capital repayments, payments associated with unfunded obligations, and debt levels will need to be conducted in order to preserve profitability. To manage capital outflow, firms should evaluate capital repayment policies and timelines to protect cash flow and profitability during retirement waves. Conservative management of both short and long term debt is also critical as partnerships decline in size, in order to avoid further downward pressure on profitability and the perception that future generations have been 'saddled' with past spending.

- **Strategy, practice focus and client base:** In addition to core structural and financial issues, firms facing shrinkage will likely need to rethink where they compete in the marketplace, the services they will provide, and the clients they want to dedicate their more limited resources to serving.

Above all, the remaining partners need to be confident that the downsized firm does have a viable future and is not entering a downward spiral from which there is little realistic likelihood of reversal. How, for example, will internal confidence be maintained? How will clients be reassured and convinced that the firm is not in decline? How will the firm manage the next wave of senior partner retirements? If the remaining partners are confident that challenges such as these can be effectively managed, downsizing may be an option. If doubts exist, they may be better off considering more immediate alternatives rather than from a less favorable position at some point in the future.

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The aging of law firm partnerships is likely to result in material change in the legal industry, and for firms that are currently operating under a 'business as usual' strategy, a wave of retirements could create a need for significant restructuring. Effective succession planning offers an opportunity to address the risks of transition and limit the impact of retirements, however, if succession efforts fail, long term sustainability will require planning and managing for shrinkage.

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