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INSIGHTS

Managing in an Economic Downturn

In the second and third quarters of last year, economic advisers warned of a potential mild to moderate economic downturn in 2020 or 2021, and in light of those concerns we wrote our July Insight, Managing in a Downturn. At that time, no one anticipated the rapid series of events which have impacted the world over the past 4-6 weeks and the global recession we will likely face over the coming months.

At this moment, most law firm leaders are appropriately focusing on the immediate response to ensure business continuity during the global pandemic. Given that the pandemic is having a dramatic impact on the financial markets and many sectors of the economy today, law firm leaders will soon need to direct their attention to long term decision-making in light of unavoidable business interruption, a possible decline in demand, and the resulting impact on firm financial performance.

Lessons Learned in 2008 and Beyond

As noted in our July Insight, there are lessons we can learn from the 2008 downturn. Much like 2020, the 2008 downturn blindsided many law firms. It hit swiftly and hard, and law firm leaders scrambled to make tough business decisions. As demand dropped, firms responded by cutting expenses, deferring investments like technology, cancelling firm retreats, reducing headcount (particularly associates and staff), and cancelling summer associate programs and even incoming associate classes. As clients became increasingly price sensitive, firms reduced billing rate increases and increased discounts.

While many of these actions will be required again in 2020, firms learned lessons last time that are worth considering before making the same mistakes this time. These include:

- Firms which stopped hiring associates found themselves with holes in their talent pool when demand began to pick up a few years later. Further, some associates from that period were bitter about the way they were treated, and firms suffered from retention issues as a result. With leverage lower now than it was during the last recession, the possibility of talent gaps could be even more significant.
- Firms focused much of the rightsizing on associates and staff rather than partners. As a result, average partner productivity has declined c. 10% or more from pre-recession levels, and rate pressures have exacerbated performance gaps as firms' staffing mix became more partner heavy. Many firms still struggle with underperforming partners.
- Firms cut business development staff and expenses to the bone. While it saved money in the short term, it may have reduced revenue generation opportunities in the medium term. It particularly impacted income partners and younger partners, who were given fewer BD opportunities, which again had longer term consequences.
- Firms deferred technology investments. While this may have been a possibility in 2008, it is a risky move in 2020 or beyond when the practice of law depends heavily on technology and continued investment in innovation is critical for many firms.
- On the flip side, some firms took pride in NOT making tough staffing decisions. As a result, some of those firms struggled with underperforming lawyers and staff, and high expense burdens compared to other firms who had streamlined operations. In a number of instances, the lack of difficult decision-making had long term consequences, as these firms fell further behind competitors and peers over the subsequent years.

Since firms are running more leanly and efficiently today than they were ten years ago, most firms will not be able to use these steps to preserve profitability to the same extent they did in 2008. So where should firms focus today?

Responding in 2020

The good news is that remote working and effective technology, at both the client and firm level, may mitigate some of the near-term impact of the pandemic. The length and depth of the longer-term impact is more of an unknown. While the appropriate response will depend on each firm's circumstances, firms should consider the following:

Focus on Clients:

- *Be responsive to your clients.* In the short term, this means helping them with their own pandemic responses to the greatest extent possible. Clients value firms who partner with them. Firms are even more attuned to client service today than a decade ago, but there may be more you can do to enhance value to your clients during this difficult time.
- *Proactively identify alternative pricing opportunities.* Given the existing pressures on pricing, the price pressures going forward are likely to be far more intense. Get creative about meeting client budget requirements through alternative pricing, service delivery, and staffing approaches – without waiting for the client to demand it.
- *Continue to invest in client relationships.* Get creative about delivering value added services that tie your firm to the client. That might entail using excess capacity to deliver in-house CLE programs or secondments, partnering with clients on diversity initiatives, or working with clients to assess their own operational efficiency.

Manage Cash Flow and Expenses:

- *Rethink the budget.* Most firms have a budget in place for 2020. Now is a good time to take a hard look at the budget and develop worst-case, best-case, and in-between scenarios for revenues and expenses. Evaluate what steps you need to take to manage to each scenario and begin communicating with your partnership about the range of potential financial outcomes, which may well include a decline in partner profits.
- *Consider cash flow*. As part of the budgeting exercise consider your cash flow. Do you need to reduce partner draws or take other steps to manage cash? Collections in Q3 and Q4 will likely be down relative to prior year results. Avoiding a year end cash crunch requires careful planning now.

Evaluate Staffing Needs:

- *Consider lateral hiring.* The first half of the year is typically an active period for lateral hiring, and this year is no exception. However, given economic uncertainty and a greater financial risk profile, firms should look more critically at the strategic value of lateral candidates and do adequate due diligence. Compensation arrangements should be structured to balance risk and ensure compensation reflects results achieved (after a reasonable ramp up period).
- *Carefully assess associate needs.* Rightsizing the associate pool may be required and appropriate. However, given lean associate staffing in firms today, cutting associates, beyond normal performance management issues, may not be as easy as it once was. Take a long-term view and don't overprune or underhire. As part of the assessment of associates, consider the overall legal staffing mix. Can staff attorneys be used to do work more cost effectively for clients?
- *Evaluate income partners.* The income partner ranks in many firms have exploded over the last decade. There are likely more opportunities to rightsize the income partner group than any other category in the firm.
- *Don't ignore equity partners.* Partners who have underperformed before a downturn are unlikely to suddenly start performing at a high level during a downturn. Addressing equity partner underperformance issues now will alleviate compensation tensions likely to arise at the end of 2020 and into 2021.

Invest Wisely:

- *Reassess space requirements.* As law firms develop a far greater capability to support lawyers and staff working from home in the coming weeks, firms will begin to overcome the technical and cultural barriers to remote working arrangements. For many firms, it is likely that remote working will stick and become far more common even after the pandemic and recession subside. Recognizing that this may be a longer term play, firms should start planning now for lower occupancy requirements and seek to right size leases to shed space and the associated expenses.
- *Redirect spending on support staff to high value activities.* Downturns often serve as opportunities to reshape the

firm's administrative support team. Make changes to things like secretarial ratios that are harder to do when times are good. The remote working experience may facilitate this transition. Consider using some of the savings to invest in people and initiatives that will help drive revenue and profits - business development support, pricing support and client facing initiatives.

- *Look for ways to bring partners together.* Many firms have already had to cancel partner retreats due to the pandemic. Going forward, looking for opportunities for the firm's partners to get together and engage in the business of the firm has significant value and should not be eliminated. Consider an in-office event as an alternative, or even virtual retreats.

We don't know exactly what the coming months will bring, or the impact it will have on law firms, but now is the time to develop your plan so you can act quickly and decisively when it is needed.

London

Principal: Giles Rubens
giles.rubens@fairfaxassociates.com
44 (0)20 3633 3943

Washington

Principal: Lisa Smith
lisa.smith@fairfaxassociates.com
202.365.4180

California

Principal: Kristin Stark
kristin.stark@fairfaxassociates.com
415.215.9294