Managing Into Headwinds

As we head into the second half of the year, economic headwinds appear to be getting stronger. Demand through Q2, particularly for corporate work, is down, albeit only modestly. Citibank's mid-year report indicates a 0.6% average decline in demand. Expenses are on the rise, due to higher attorney headcounts and the gradual shift towards a return to office. We have written before about managing through headwinds, along with the lessons learned from previous downturns, and it is time to revisit that topic.

Before we do, however, it is important to remember that 2021 was a record year for the legal industry. Demand in many practices skyrocketed. While expenses for talent increased, they were partially offset by savings as the return to office continued to be delayed. A segment of the market saw profit increases of 20%-30% and more. We knew at the beginning of the year that replicating those profitability increases would be difficult, if not impossible, for most firms. As a result, it is not surprising firms are seeing a drop in demand coming from such a high level. Keep this in mind when thinking about what management actions might be appropriate, as it is easy to get caught up in negative headlines.

Lessons Learned From the Past

The 2008 and 2020 downturns blindsided many law firms. They both hit swiftly and hard, and law firm leaders scrambled to make tough business decisions. With the benefit of hindsight, we see that some of those decisions were necessary, and some may have been short sighted. Lessons learned from these experiences include:

- Firms that stopped hiring associates in 2008 found themselves with holes in their talent pool once demand began to pick up a few years later. And in 2021, firms spent an enormous amount on salary increases, signing bonuses, and recruiting fees to quickly build or rebuild the talent pool. Many firms are still underleveraged, and the possibility of future talent gaps could be even more significant than previous downturns.
- Some firms cut operations staff to the bone, both in 2008 and early in 2020. While it saved money in the short term, it often set firms back on strategic initiatives and business development. Many firms are operating much more leanly now, so the opportunity for significant staff reductions is far more limited.
- Firms deferred investments, whether in strategic initiatives or capital costs like technology. While this may have been a possibility in 2008, it is a risky move in 2022 or beyond when the practice of law depends heavily on technology, and continued investment in innovation is critical for many firms.
- Further, some firms deferred investments in mergers and lateral hiring. We saw a divergence of approaches in 2020 with some firms shutting down lateral hiring, and others taking advantage of the market to bring in strong talent. Firms that invested in talent in 2020 were much better positioned to take advantage of the increase in demand in 2021.

Responding in 2022

Since the first signs of a potential market slowdown, firms have been keeping a close eye on the 2022 budget and year-to-date performance. Firms established their 2022 budgets in a period of very high demand. Particularly for firms that set aggressive growth budgets, now is the time to take a hard look at the budget, determine how the firm is faring against the budget, and what impact that will have on year-end profitability. Equally important, firms should begin communicating with their partnerships about the range of potential financial outcomes.

While the appropriate actions will depend on each firm's circumstances, firms should consider the following:

Manage Legal Talent

- *Continue strategic lateral partner hiring.* The first half of 2022 has been a very active period for lateral hiring. While lateral hiring typically slows a bit in the second half of the year, growth-focused firms should continue to make strategic investments in laterals. However, given economic uncertainty, firms should also look more critically at the strategic value of lateral candidates and perform robust due diligence. Compensation arrangements should be structured to balance risk and ensure compensation reflects results achieved (after a reasonable ramp up period).

- *Manage associate performance.* Firms should continue to manage associate performance but take a long-term view. Avoid over-pruning or under-hiring. Given lean associate staffing in firms today, retaining top associate talent must remain a priority.
- *Evaluate income partners.* The income partner ranks in many firms have exploded over the last decade. There are likely more opportunities to right size the income partner group than any other category in the firm.
- *Do not ignore equity partners.* Equity partner performance was strong in 2021 – with both productivity and revenue generation materially up for many partners. While maintaining that level may be more difficult in 2022, firms have an opportunity to reset the overall expectations for what it means to be an equity partner.

Invest Wisely

- *Continue to invest in strategic initiatives.* Review your strategy and pick the initiatives which are the top priorities and will most benefit the firm over the long-term. Ensure that you continue to make appropriate investments in those initiatives, both of management time and budgeted expenses.
- *Focus support staff spending on high value activities.* Many firms have focused on reshaping the administrative support team. Invest in people and initiatives that will help drive revenue and profits – technology enhancement, business development support, recruiting/lateral hiring support, pricing and profitability support, and client facing initiatives.
- *Manage space needs.* Continue to look for opportunities to reduce the firm's office footprint as return to office expectations come into greater focus. Smaller offices, office sharing, hoteling, and other design choices to reduce the office footprint should be on the table. While significant reductions may only be possible when leases expire, there may be opportunities to right size leases in the near term.

Focus on Clients

- *Be proactive with clients.* Our interviews with the clients of law firms indicate that they appreciated firms that supported them throughout the challenges of the pandemic. This varies across sectors but can start with anticipating how market changes may impact your clients' business and legal needs. Clients value firms that proactively identify emerging risks and legal requirements, and partner with them to find solutions.
- *Be creative with pricing.* Effective rates have increased over the last year, which will no doubt create some pricing pressure going forward. Instead of turning to discounts, get creative about meeting client budget requirements through alternative pricing, project management, increased efficiency, and cost-effective staffing approaches.

Managing through headwinds can be a challenge for law firms. Leaders who can balance short-term actions with long-term goals will position the firm for success not just in 2022 but in 2023 and beyond.

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