Client Advisory

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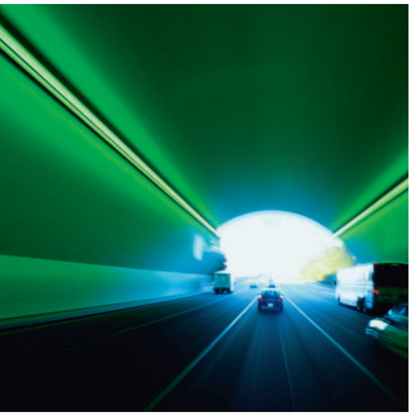
Hildebrandt and Citi Private Bank are pleased to present this 2009 Client Advisory highlighting the trends that we perceived in the legal market in 2008, as well as the trends that we believe will impact the market in 2009.



To Our Clients and Friends

Over the past year, we have watched as the growing economic crisis has spread across the legal market. Although signs of an economic slowdown were evident in the second half of 2007 – as demand in real estate, structured finance, and transactional practices turned sharply downward – the full financial impact of the recession was not felt by most firms until 2008[1] and, even then, the impact was not uniform across the market. Through the first half of 2008, the hardest hit firms were those with significant exposure to the financial markets, and many mid-market and broadly based global firms fared reasonably well.[2] With the collapse of the credit market in the third quarter of the year, however, the economic crisis deepened and began to spread rapidly around the world, with the result that it is now affecting the entire legal industry. One of the unfortunate effects of the freezing of the credit markets was the hoarding of cash by major law firm clients during the last quarter of the year, at precisely the time when cash collections were most needed by the firms. The credit crisis thus worsened what was already a challenging year. As noted below, we now project that, when all year-end figures are in, profits per equity partner ("PPEP") in 2008 will be flat to a minus 10 percent in most firms, as compared to profit levels in 2007. And for firms with significant capital markets practices, we expect average PPEP to decline by 5 to 15 percent, with a few firms experiencing even sharper drops.

In light of these extraordinary developments, firms have turned to fairly aggressive measures to reduce their costs, improve their cash positions, and shore up their capital base. In recent months, firms have imposed strict controls on discretionary spending, cut bonuses, frozen associate salaries, postponed new initiatives, and engaged in a number of layoffs of both professional and administrative staff. Some firms have revamped their partner compensation schedules to slow distributions and improve their cash positions. And many firms have embarked on serious efforts to winnow out underperforming lawyers and unprofitable practices.

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[1] The drop off in demand during the second half of 2007 was offset in many firms by an exceedingly strong financial performance during the first half of that year. Accordingly, many firms finished 2007 reasonably strong, notwithstanding a lackluster second half.

[2] As a result, some mid-market and global firms actually ended 2008 with profits modestly higher than in 2007.

For many law firm leaders and their partners, the current precipitous economic downturn has been particularly jarring because it has no recent parallels. Although the legal market did suffer a slowdown in 2001 with the bursting of the so-called "tech bubble" and the after effects of the 9/11 attacks, that downturn was short lived and it did not affect the entire market. Indeed, many firms not heavily involved in the technology sector fared reasonably well during the period. To find a more analogous situation to the present downturn in the legal market, you would have to go back to 1991 and the economic problems triggered by the savings and loan crisis. But even the 1991 recession was not as deep or broad as the current one, and the impact across the legal market was not as severe.

In other words, the legal market has not experienced anything like the current recession for the last 17 years (if not longer) – the whole professional life of many mid-level partners. Moreover, during most of that 17-year period, the legal market enjoyed unprecedented growth. Indeed, from 2001 through mid-year 2007, the annual growth rate for both revenues and PPEP in law firms was at or near double-digit levels almost every year. It is little wonder that the abrupt changes of the past 12 to 18 months have generated both fear and uncertainty in firms across the market.

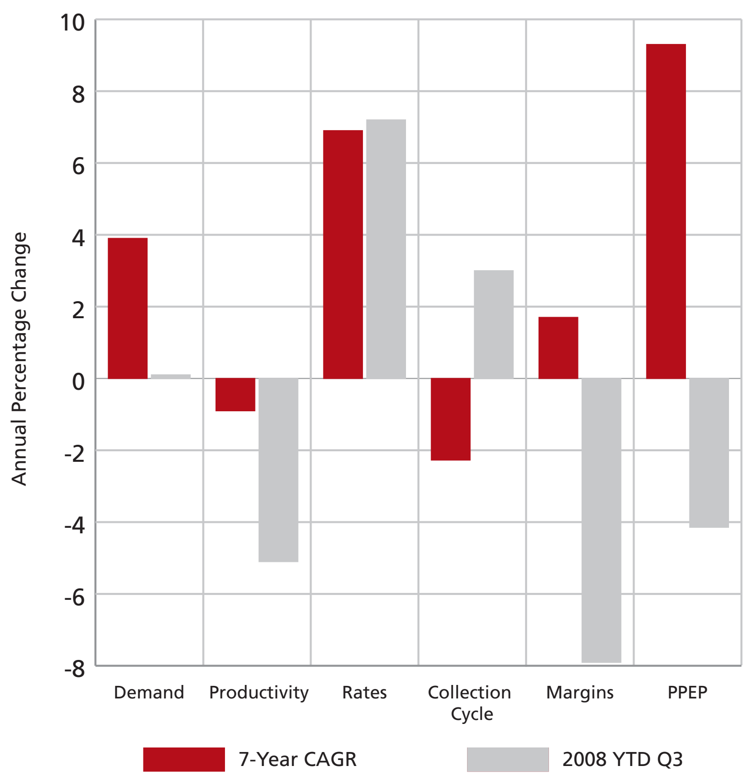
In the sections that follow, we have set out our observations about the performance of the legal market in 2008, our expectations for 2009, and our thoughts about the broader implications of the current recession in terms of how firms are structured, how they perform their work, and how they deliver value to their clients – both now and in the future. As indicated below, we believe that, while most firms will struggle in 2009 and a few will not survive the current economic crisis, others will emerge with structures and practices that are more flexible, more efficient, and more responsive to the needs of their clients.

The Downturn of 2008

The key impact of the broad based economic crisis on the legal market in 2008 was a significant decline in the demand for transactional legal services, in particular in the credit and equity markets, that was reflected in plummeting productivity. As shown in Chart 1, below, the firms included in the Citi Private

Bank *Law Watch* reports[3] experienced effectively no growth in demand (only 0.1 percent) for the first nine months of 2008 as compared to the same period in 2007. This contrasted to an average demand growth of 3.9 percent in each of the preceding seven years. As a result, there was a significant reduction in productivity, to a level of -5.1 percent through the third quarter.

Chart 1 – Key Economic Indicators through 2008 Q3[4]



Source: Citi Private Bank Law Watch

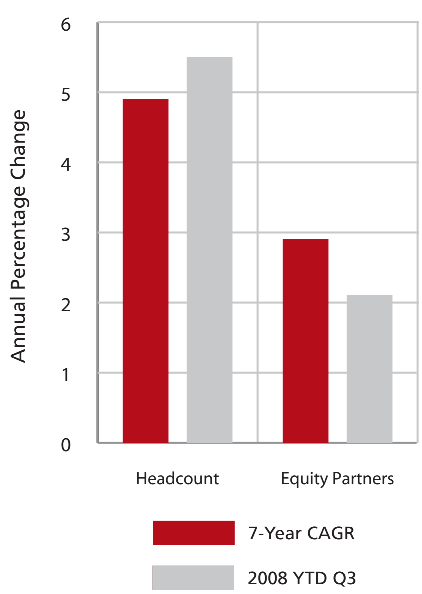
[3] Data used in this Client Advisory referring to the seven-year period prior to 2008 are based on analyses done by Citi Private Bank *Law Watch* ("Citi") in its study, "Law Firm Profitability: Drivers of Superior Performance, 2000-2007." This study reviewed the financial performance of 140 US headquartered firms broadly representative of the industry. Data on 2008 that are attributed to Citi in this Client Advisory are based on Citi's "9 Months 2008 Flash Report," which includes data from 150 firms. Nine-month data are used because Citi's analysis of full-year 2008 data will not be completed until February. Data provided by law firms to Citi Private Bank are considered confidential and, as such, are never reported in a manner that permits the identification of data from any particular law firm. For ease of reference, the source of all Citi Private Bank survey data not more specifically identified in this Client Advisory is given as "Citi Private Bank *Law Watch*."

[4] "CAGR" referred to on this and other charts means "Compound Annual Growth Rate."

Although firms were able to increase their overall billing rates in 2008 and implemented serious efforts to reduce overhead and non-legal staff costs, a continuing growth in overall legal headcount (as described below) coupled with the severe drop in productivity put enormous pressure on margins and caused profits to drop sharply. This was exacerbated by a significant lengthening of the average collection cycle (the number of days needed to turn work in process and accounts receivable into cash). As indicated on Chart 1, through the third quarter, the average firm margin declined to -7.8 percent of its 2007 level, as compared to year-on-year margin improvement of 1.7 percent during the preceding seven years. And growth in PPEP fell to -4.1 percent, as compared to annual growth of 9.3 percent in the 2000-2007 period.

The growth in total headcount during 2008 is shown on Chart 2, below.

Chart 2 – Key Personnel Indicators through 2008 Q3

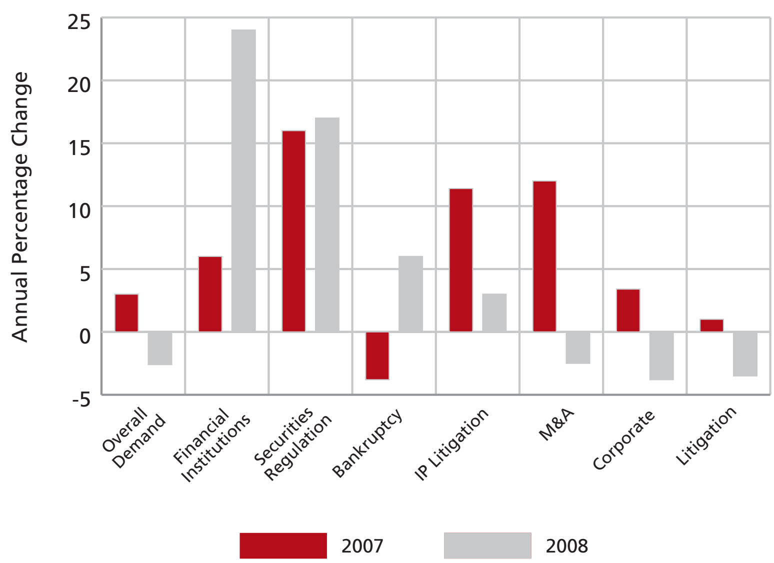


Source: Citi Private Bank Law Watch

As indicated, firms on average increased headcount at a faster rate during the first three quarters of 2008 than during each of the seven preceding years – a rate of 5.5 percent in 2008 as compared to 4.9 percent during the 2000-2007 period. At the same time, equity partner growth dropped in 2008 (to 2.1 percent as compared to the seven-year CAGR of 2.9 percent).

The Hildebrandt Peer Monitor survey,[5] showed an even more dramatic drop in demand for legal services than described above. As shown in Chart 3, below, firms reporting to Peer Monitor experienced a negative growth in demand (-2.6 percent) during 2008 as compared to the previous year (during which the firms had seen a 3 percent growth in demand). The Peer Monitor data, however, break out demand by practice area, and it is interesting to note the 2008 demand growth figures in particular specialties as compared to the previous year.

Chart 3 – Demand Growth by Practice — 2008 vs. 2007



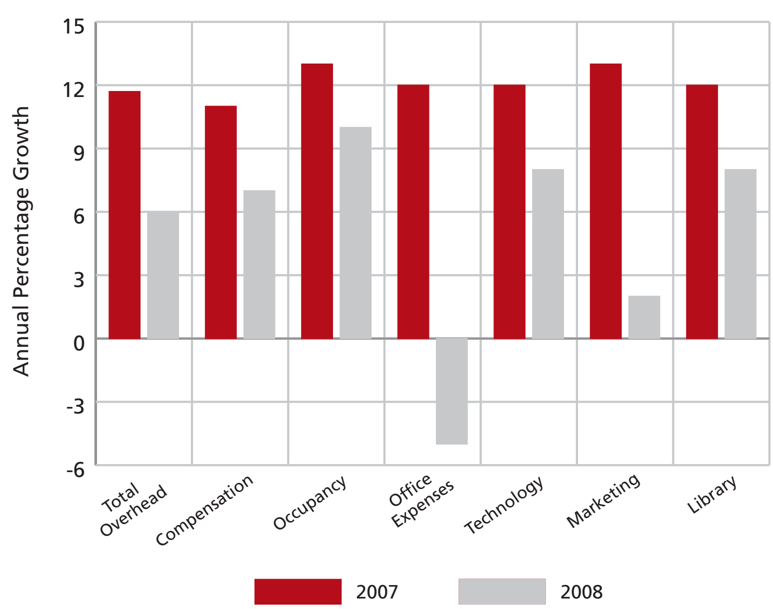
Source: Hildebrandt Peer Monitor

[5] The Hildebrandt Peer Monitor survey is an innovative digital benchmarking platform that is currently used by approximately 100 firms. By accessing the general ledger and time and billing information of participating firms on a monthly basis, Peer Monitor creates financial metrics that allow firms to measure their performance at the firm-wide, practice, and office levels on a much more current and detailed basis than other existing surveys of law firm economic performance. The Peer Monitor data used in this Client Advisory are based on information reported by 74 firms, including approximately 30 AmLaw 100 firms. Data submitted by participating Peer Monitor firms are strictly confidential and are never reported in a manner that permits the identification of data from any particular firm.

Not surprisingly, regulatory work related to financial institutions increased significantly in 2008, and growth in securities regulation work held fairly steady. Demand for bankruptcy services also grew, reflecting one of the countercyclical practices that may be kicking in as the recession continues. Equally not surprising was the significant decline in demand in both the M&A and general corporate fields. The continuing softness in the litigation market – both general litigation and IP litigation – is somewhat surprising, as litigation is a countercyclical practice that often serves to cushion economic downturns.

As noted above, firms did respond to the economic jolts of 2008 with serious cost cutting efforts pretty much across the board. As indicated in Chart 4, below, the firms participating in Hildebrandt Peer Monitor reported that growth in their overhead expenses in 2008 amounted to only 6 percent, as compared to 11.7 percent in 2007. Not surprisingly, the sharpest reductions came in the most discretionary of the cost categories – office expenses and marketing.

Chart 4 – Growth in Overhead Expenses – 2008 vs. 2007

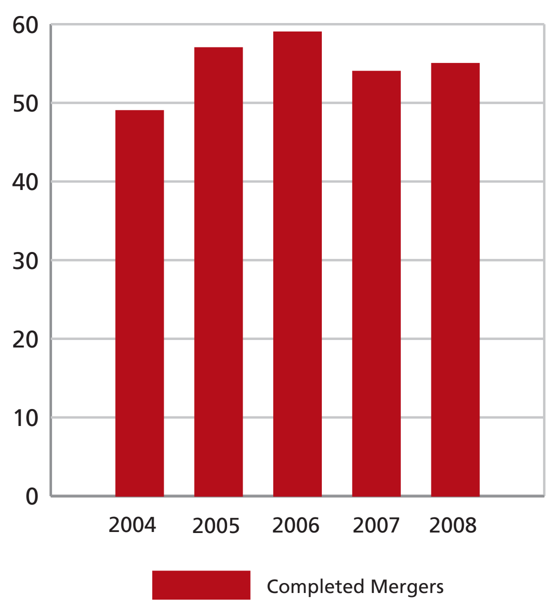


Source: Hildebrandt Peer Monitor

As aggressive as these efforts were, however, they were not enough to offset fully the steep declines in demand and productivity and the growth in overall legal headcount that ultimately drove profits for the year down significantly.

Yet, despite the economic challenges, firm mergers and acquisitions continued apace during 2008, some of them perhaps driven by changing economic fortunes or misfortunes. As shown in Chart 5, below, there were 55 completed mergers of US-based law firms in 2008, a number that was consistent with the pattern over the past few years. There were also seven cross-border mergers involving US firms, a number that was up slightly from the five such mergers in 2007.

Chart 5 – Completed US Law Firm Mergers*



*
Includes all mergers where smaller firm had at least five lawyers.

Source: Hildebrandt Merger Watch

Sadly, 2008 also saw 18 law firm dissolutions, including two particularly high profile ones – Heller Ehrman and Thelen Reid & Priest. While both of these breakups received widespread press coverage and were perhaps inevitably tied to the current economic crisis, it should be noted that the number of firm dissolutions in 2008 was not out of line with those in previous years. Indeed, during 2007, there were 22 law firm failures.[6]

Looking Ahead to 2009

Unfortunately, it is now clear that the general economic meltdown of 2008 will not be reversed quickly, and law firms will have to adjust to a new economic reality. While there could be some improvements in late 2009, most economists predict that a broad recovery is not likely to occur before 2010, and some see an even longer road back to economic health. For the legal market, however, the picture is somewhat more nuanced. As in past recessions, we should in 2009 begin to see the beneficial effects of some countercyclical practices, though perhaps not with the same level of beneficial results as in past downturns. Specifically –

- We expect a slow but measured uptick in financial institutions and legislative work as Congress puts in place a new regulatory system for the US capital markets.
- Similarly, the Obama Administration's plans for a broad economic stimulus package should generate some work for firms with infrastructure or government contracts expertise or with specialty practices in the energy or health sectors.
- We will see some growth in litigation (including white collar criminal litigation) as "blame" for the current crisis is sorted out and as claims and counterclaims are filed, though such growth will continue to be tempered by the determination of clients to hold down overall legal costs and by the growing tendency in the corporate world to settle rather than litigate major controversies.[7]

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[6] During 2006, there were 10 law firm dissolutions; during 2005, there were 12; and during 2004, there were 12. Source: Hildebrandt Market Research.

[7] This tendency, which we believe has been quite perceptible in recent years, is driven by the staggering increases in the costs of litigation – particularly related to the costs of e-discovery – as well as by a recognition on the part of corporate clients of the enormous disruption to business that major litigation can cause.

- There is likely to be expanding demand for bankruptcy and reorganization work, as well as for employment law services, as the economic crisis continues to deepen.
- And some economists suggest that there may be an increase in M&A activity as strong, cash-rich corporations seek to take advantage of the current economic crisis to acquire weaker competitors.

Obviously, these countercyclical practices will help to soften the economic downturn in the legal market, and for some firms they will have significant value. From the perspective of the market as a whole, however, we do not believe that these upticks in activity in certain practices will be enough to offset the contraction in legal work resulting from the stagnation of commercial activity across the entire economy. The simple facts are that the credit markets remain sluggish, consumer confidence has dropped to record low levels, the Federal Reserve has predicted that unemployment could approach levels unseen in half a century, and investors remain very wary. In these circumstances – which are likely to continue for some time – major financings and mergers have virtually disappeared, new capital investments are rare, and large commercial transactions have slowed to a trickle, all resulting in a substantial drop in the demand for legal services.

Putting all of these factors together, we believe that the legal industry will sustain itself better than other market sectors during the current economic crisis, in large measure because of the countercyclical practices described above. It is also true that, when the general economic recovery finally begins, it will be led by the legal market since legal work is a necessary first step to implementation of almost any significant commercial activity from capital formation to asset acquisition. Nonetheless, we expect that the current deep recession will continue to be felt in the legal industry throughout 2009.[8] Specifically, during the current year –

- We project that the legal market will experience flat overall demand, coupled with more modest rate increases than in the prior seven years, heavier discounting, and no uplift from premiums. The net effect will be very modest revenue growth in the 3 percent range, although some firms could experience flat or declining growth.

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[8] It should be noted that, even if there is some improvement in the overall economy toward the end of 2009, it will not provide much help for most firms in terms of their 2009 financial performance. As cash basis businesses with relatively long collection cycles, firms on a calendar based fiscal year would need to see a substantial uptick in demand by October or so in order to improve their year-end performance significantly.

- With modest revenue growth, firms will continue to focus on cutting expenses, with the likelihood that there will be more layoffs in both legal and administrative staffs. We are also likely to see further reductions in bonuses and an expansion of salary freezes.

- Even with these aggressive cost-cutting efforts, however, we expect that expenses will increase at a faster rate than revenues, resulting in further margin compression. The net effect will likely be net income across the industry that is down 5 to 15 percent as compared to 2008, although firms that took aggressive-cost cutting measures in 2008 and continue them in 2009 could perform somewhat better.[9]

In part because of these sober economic projections, we expect that law firm merger activity will likely increase in 2009 and, indeed, may even intensify as healthy firms seek to take advantage of acquisition opportunities arising from current market conditions. We also believe that globalization of the legal market will continue and that firms that are positioned to do so will continue to expand around the world. That said, the global nature of the economic crisis will create a short-term disadvantage for global firms, as declining demand,[10] coupled with infrastructure costs that are higher than those in more narrowly focused firms, causes increased margin compression. Those firms that are newer to the global stage and have not yet established a dominant market presence or reputation will suffer most in this regard, while firms that do local work will fare a bit better. But this disadvantage will be temporary and ultimately will not alter the fact that global firms are here to stay.

In terms of borrowings, we expect that firm indebtedness will increase in 2009. Indeed, Citi Private Bank has reported that its outstanding loans to law firms are up by 30 percent from a year ago, and its loan commitments are up by even more. This increase is driven in part by the lengthening collection cycles that most firms are experiencing and by their desire to have committed credit facilities in place to cover possible cash needs. Fortunately, law firms continue to have better access to credit than most businesses, although the cost of such

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[9] It should be noted that our projection relates to net income and not profits per equity partner. Firms that have taken (and continue to take) steps to "right size" their equity ranks could see improvements in their PPEP for 2009, even if net income growth is flat or somewhat negative. Likewise, firms that carry a significant number of underproductive partners in their equity ranks could see their PPEP decline even if they manage to maintain their net income at or near 2007 levels. If, as we expect, merger and lateral acquisition activity increases in 2009, firms could also see their PPEP decline simply because of the addition of new partners and the inevitable lag time between a new partner's acquisition and any increase in associated revenues.

[10] The first signs of declining demand impacting global firms were evident in the Citi Private Bank *Law Watch Flash Report* for the third quarter of 2008.

credit has increased. Also, banks are imposing more restrictive financial covenants than in the past and are more carefully reviewing the capital structures of potential law firm borrowers. Banks are also looking for broader noncredit relationships with their borrowers, thus making it advisable for firms with multiple banking relationships to consider consolidating them.

A Broader Perspective

As previously noted, many law firm leaders and their partners have never experienced a significant downturn in the legal market and are struggling to put the current slowdown in some kind of perspective. From our standpoint, it is important to remember that the legal industry is a critical part of our economic infrastructure, that law firms are generally faring better than other businesses in the present recession, and that the demand for legal services will rebound as the economy begins to recover. That said, however, we also believe that this recession is significantly different from prior ones and that it could result in some fundamental changes in the way law firms are structured and how they approach their work.

As described above, prior to 2008 – with the exception of a brief downturn in 2001 which did not affect all firms across the market – the legal industry enjoyed 17 years of unprecedented growth and prosperity. As a consequence, law firms have been focused far more on revenue growth and expansion than on controlling costs, methodical marketing, or driving greater efficiencies in the delivery of legal services. Under these circumstances, with revenues and PPEP growing at robust rates, it was often easier to demote or "de-equitize" under-productive lawyers rather than to force them out of the firm or to tolerate unprofitable practices rather than spinning them off or "re-tooling" their lawyers. There was also little incentive to find ways to perform legal work more efficiently when demand seemed unlimited and when clients could be expected to tolerate rate increases of 6 to 8 percent every year for the same services.

The current economic crisis has, of course, put all of this in a very different perspective. Entering an extended period of reduced demand for legal services and with clients more focused than ever on the need to control the overall cost of outside counsel more effectively, law firms face a fundamental challenge to their basic economic model. A recent survey of 2,000 lawyers in the UK found that 69 percent of managing partners and senior partners – and 60 percent of rank-and-file partners – believe that the current economic turmoil will force law firms to make radical changes to their business models.[11]

The seriousness of this challenge is underscored by the fact that, even during the period of record economic growth from 2001 to 2007, the only driver of profitability that was working consistently to support revenue and PPEP growth was the ability of firms to raise their rates significantly every year.[12] Given the strong resistance of clients in the present economic climate to see the overall cost of their legal services increase – and, indeed, the widespread demands from clients for deep discounts or frozen rates on existing work – it seems clear that law firms will need to rethink their own business models if they are to sustain reasonable rates of profitability over the next couple of years and beyond.

It has been said that "a financial crisis is a terrible thing to waste," and it seems to us that the current economic downturn can be viewed as an opportunity to make some fundamental changes in the way law firms are structured and do their business – changes that are not only long overdue but that will also serve the profession well as it emerges from the current recession. Specifically, we would like to suggest four essential considerations that should guide law firm leaders during this crucial period:

- First, it is more critical than ever before that law firm leaders have a clear strategy and that they make decisions based on the strategic vision of where they want their firms to be when the economy rebounds
- Second, law firms should use the current downturn as an opportunity to adjust their associate compensation structures to reflect the new realities of the marketplace
- Third, it is essential for law firms to rethink the structure of their professional staffs so as to be more flexible in responding to shifting demand
- Fourth, law firms must take seriously client demands for more efficient approaches to the delivery of legal services, even if it means doing work in very different ways.

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11 "Senior Lawyers Question Law Firm Business Model," thelawyer.com, Jan. 5, 2009.

12 Based on data from Citi's *Law Watch* reports, across the market during this same period, profit enhancing changes in the other drivers of profitability – leverage, productivity, realization, and expense controls – were generally flat to negative.

The Importance of a Clear Strategy

During times of strong economic growth, it is easy to tolerate unprofitable practices or those that contribute only marginally to a firm's overall strategic objectives. In the present climate, however, trying to maintain practices that are not aligned with a firm's strategy or that impose a drag on the firm's overall profitability may pose special risks. Most importantly, rewarding partners in peripheral or unprofitable practices at the expense of partners and practices that are critical to the firm's future may run the risk of alienating the very people whom a firm can least afford to lose. And make no mistake that, even in the present climate, there will be competitors looking to take advantage of any such misstep. This is clearly a time to find ways to shore up those practices that are strategically important to a firm's future and to consider paring back those that are not. The same criterion should be applied to offices. Firms should take a careful look at those office locations that are strategically important to their core practices and those that are not.

It is also important, however, to keep a clear eye on what your firm's strategy is – or perhaps should be. A successful strategy is really more of an organizational capability than it is a fixed plan, and strategically focused firms are constantly scanning the external and competitive environments to determine how their strategic objectives might need to be revised to adapt to changing circumstances. In a time of serious dislocation and restructuring of major sectors of the economy, this adaptability is more important than ever.

- The present economic crisis has already caused major shifts in ownership structures and client relationships in the investment banking, insurance, and financial institutions industries, and more changes in these and other industries will undoubtedly follow.
- Over the next several months, we will see broad new regulatory systems put in place over large segments of the economy.
- And various stimulus programs will provide advantages to some industries while disadvantaging others.

In these circumstances, it is important for law firm leaders to think carefully about the implications of such changes for their own key practices and to adapt their strategies to maximize their firms' competitive positions both now and later as the economic recovery begins to take hold.

It is also important to learn a lesson from recent history about the dangers of adopting a strategic focus that is too narrow. In a recent Citi Private Bank study of the drivers of superior performance during the 2000-2007 period, it was noted that some of the "superior performers" (defined as those firms with the highest annual PPEP growth) achieved that status by narrowly focusing their practice mix and jettisoning otherwise successful practices that did not meet their narrow strategic or profit criteria. What those firms failed to consider, however, was the potential impact of dropping practices that might provide a buffer in an economic downturn. As the study notes, some of the firms that were superior performers from 2000 through 2007 significantly under-performed the industry in 2008 partly as a result of their having winnowed out practices that could have cushioned the drop in more volatile practice areas.[13] Hildebrandt is currently working with several client firms to be certain their business plans reflect changing market realities.

Adjusting Associate Compensation Structures

The largest expense item in the budget of every law firm is compensation for its lawyers. Flexibility in maintaining the proper size and leverage model for its legal staff, as well as appropriate compensation levels, is thus essential to sustaining every firm's profitability. Obviously, this becomes even more critical in periods of stagnant or shrinking demand. As noted above, during the first nine months of 2008, the firms participating in the Citi *Law Watch* quarterly Flash Reports experienced essentially flat demand (as compared to 2007) but their head-counts continued to grow by 5.5 percent, thus creating mounting pressures on both productivity and margins. Considering the long pipelines involved in the recruitment and hiring processes of most firms, and given the sharp drop off in associate attrition in recent months, it seems likely that these pressures will continue for the foreseeable future.

Given these realities, we believe that it is long past time for firms to move toward more flexibility in the compensation and advancement of associates. While most firms have been fairly aggressive in recent years in moving toward more incentive-based compensation systems for partners and have all but abandoned a locked-step approach to partner compensation and advancement, this has not been the case with associates. In the current economic climate, it is irrational to have half or more of a firm's highly compensated lawyers on largely

[13] A good example of this phenomenon was the decision by many firms over the past several years to pare back or eliminate their labor and employment practices. While it is true that some types of labor and employment matters are rate sensitive, high-end labor and employment work constituted one of the few bright spots in the legal market in 2008.

seniority-based salaries, a reality that has led several firms recently to announce salary freezes for associates in 2009. But salary freezes – however desirable in the present economic crisis – are not a long-term solution to the problem. Firms that have not already done so should seriously consider modifying their associate compensation structures to allow a substantial portion of compensation to be tied to individual performance in support of the firm's goals and strategy.

Firms should also be willing to consider moving away from locked-step associate advancement (and compensation) toward competency-based models. The legal profession is one of the last industries still to cling to this outmoded seniority-based method. In the past year or so, Hildebrandt has helped several large firms revise their systems and adopt competency-based approaches, all with good results. Such systems not only have the obvious benefit of recognizing that different lawyers develop at different rates, but they also allow firms to be more responsive to client concerns – particularly acute in the present economic environment – that they not be "over charged" for younger or less experienced lawyers.

Creating More Flexible Professional Staff Structures

Firms also need to rethink their staffing models for the delivery of legal services. Historically, law firms consisted of only two basic categories of professionals – partners (both equity and non-equity) and associates – and all of a firm's legal work was divided between these two groups of lawyers, usually with the associates performing the majority of the work (at least in a leveraged model). In recent years, however, this approach has proved increasingly inefficient. As matters (in both the litigation and transactional fields) have become more complex, it has been increasingly apparent that some portion of the legal services provided by even large law firms fall into the category of more "commoditized" services. Understandably, clients are increasingly unwilling to pay "top dollar" for a firm's associates to perform these routine legal tasks, and those client attitudes are sure to harden in the current economic downturn.

As a result, many firms have turned to alternative approaches to provide these services. In recent years, we have seen a dramatic increase in the number of "contract lawyers" used in firms (i.e., lawyers hired for a particular project or set of projects without expectation of permanent employment), and that trend seems certain to continue. We have also seen firms expanding their categories of "permanent" non-partner lawyers – typically called staff attorneys, counsel, or special counsel – in some niche areas of practice. This is also a trend that we expect will continue and accelerate, especially as firms develop appropriate management structures to insure the efficient use of such categories of lawyers. Ultimately, having lawyers who can be designated as "senior real estate attorneys" or "senior litigation counsel" or "special international trade counsel" could create career paths other than equity partnership that could improve firm leverage and profitability in the long run.

Over the long term, it is possible that the right economic model for success could well be a firm with relatively fewer partners and associates than today, but with expanded categories of other lawyers (some of whom would be temporary or project specific). Such a model would not only allow firms to be more flexible in responding to client concerns about cost and efficiency, it could also reduce associate attrition by allowing firms to be more selective in their recruitment and more focused in their development of younger lawyers. Critical to the success of any such change, however, will be acceptance by law firm partners of the fact that lawyers in such new categories are not necessarily of lower quality than a firm's associates and that a person can be a highly competent lawyer even if he/she has no desire to be a partner.

Beyond these structural issues, given the tighter profit margins that will probably be with us for some time to come, firms also need to remain focused on winnowing out lawyers who consistently underperform. Over the last several years, many firms became fairly lax about dealing with performance issues, especially among partners. We saw this particularly in connection with the so-called "de-equitization" actions of a number of firms in which demotion from the equity partner ranks became a convenient way to avoid having difficult conversations about performance. Unfortunately, these actions often resulted in the creation of large groups of unhappy non-equity partners who remained as underproductive as before but who, in the process, became serious morale problems for their firms.[14] This is a result that firms can simply no longer afford. In the new economic environment, successful firms will be those that set clear expectations for their partners and other lawyers and regularly winnow out those who persistently fail to perform.

[14] We are not opposed to two-tiered partnerships per se, but we believe they must be very carefully managed. The key is that only highly competent and productive lawyers should be included in either tier of a two-tiered structure. When "income partner" status is used as an excuse for retaining lawyers who should, in fact, be asked to leave a firm, the two-tiered structure can quickly become a serious drag on firm profits and morale.

Developing More Efficient Approaches to the Delivery of Legal Services

One of the most noticeable changes in the legal industry in recent months has been the fierce determination of clients to resist rate increases and, in many cases, to demand discounts or fixed fees, even on current work. Although the most recent round of such demands was clearly triggered by the current economic crisis, we believe that it would be a mistake to assume that these client attitudes will change dramatically, even when the economy begins to recover. It is important to remember that these pressures have been building for some time, exacerbated in recent years by extraordinary increases in the cost of legal services, particularly related to litigation. Corporate law departments were under growing pressure from their CEOs and CFOs to manage the cost of legal services more effectively even before the current economic downturn. With the downturn, the pressure has become even more intense.

As a result, many corporate general counsels are now beginning to think more creatively about how to achieve greater efficiencies in the procurement of their outside legal services. The Value Challenge initiative recently launched by the Association of Corporate Counsel is a case in point. Importantly, this initiative is not focused on rates per se, but rather on the broader question of how law firms can "work smarter" in collaboration with in-house counsel to deliver services more efficiently and in ways that better recognize the value of the services being delivered and received. In our view, these kinds of questions will not disappear even when economic growth returns.

There are also very clear trends emerging in Europe and Asia regarding the use of customized, project pricing for major transactions. This approach reflects common practices in many other industries where fixed-price contracts are used, with the assumption that unexpected events will be covered through appropriate change orders. While we do not expect pricing methodologies in the legal market to change overnight, we do believe that project pricing will become much more common, particularly for large transactional matters.

Another common example of the effort by clients to achieve more efficiency in the procurement of legal services in the past few years has been the growing practice of "disaggregating" or "unbundling" services. Particularly common in litigation, under this approach a client might decide to use one outside firm for discovery and document management, another for depositions, and yet a third for actual trial work. Clients might also require their outside counsel to use (or sometimes even contract with) specific legal process outsourcing vendors. Although posing challenges for firms (particularly in terms of supervision and risk management), clients have insisted on these techniques as a way to control costs by paying less overall than would have been the case had they simply assigned the entire matter to one firm.

Looking ahead, the question is why law firms themselves shouldn't begin thinking in the same way? Why shouldn't firms take the lead in such initiatives by asking themselves where and by whom work on specific parts of a particular project (whether litigation or transactional) could most efficiently and cost effectively be performed? And, in that regard, why should firms necessarily concentrate most of their legal resources in their most expensive offices? Also, why should firms not recruit experienced people (lawyers and non-lawyers) with project management skills and use their talents to organize and manage complex matters? And why should every law firm not, on a regular basis, seek feedback from its clients about the firm's work and whether it is meeting the client's needs and expectations? All of these are approaches that are quite common in other professional service firms and that could certainly be adapted for the legal market.

Obviously, some firms have already begun to experiment with a more efficient service-delivery model, through the relocation of people and resources to centers in lower cost areas, through the use of various outsourcing (and sometimes offshoring) partners, through the use of contract lawyers (as previously described), and through the creative structuring of partnering relationships with their clients. In our view, however, there is much serious work yet to be done to develop effective and sustainable models of service delivery that meet the needs and demands of clients for efficient and cost-effective legal services.

A good place to start for many firms would be to provide serious business development and leadership training for department heads and practice group leaders, as well as for promising younger partners. Such training is not inexpensive, but it can pay huge dividends and have a dramatic impact on profitability. Most firms have only a few serious "rainmakers" and do a pretty poor job of developing new ones. In the present economic climate, many partners have extra time on their hands. Why not use it to develop skill sets and competencies that could serve their firms well for many years to come?

In summary, the current economic downturn in the legal market is likely to be deeper and longer than any we have seen in the last two decades. Even though there will be upticks in certain practices during the coming year, we expect that 2009 will be challenging for most firms. At the same time, we also think – as described above – that the current downturn offers an opportunity to rethink some of the basic assumptions about how law firms should be structured and how they should deliver their services. In our view, firms that remain strategically focused and that are not afraid to "think outside the box" in terms of how they do their business may well emerge from the current crisis stronger and better positioned to compete in the future than before this crisis began.

As always, we stand ready to assist our clients in meeting these challenges. Best wishes to you and your firm for the coming year.

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