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Crisis Leadership:
Three Critical Areas of Focus for Law Firms in the Economic Downturn

by Richard N. Gary

Law firms are under greater stress today than ever before. The economic crisis has reduced transactional activity considerably, and clients are increasingly seeking alternatives to litigation. Resistance to billing rate increases is universal, and many firms have overcapacity in one or more practice areas.

Law firm leadership is a complex undertaking in the best of times; in a crisis, it seems more difficult than ever. But crises have a way of focusing our attention, opening our eyes to pathways that are obscure in less challenging times.

When I became chair of my former firm, Thelen Marrin Johnson & Bridges, in 1992, it was in dire straits. Profits had plunged, partners were defecting at an alarming rate, there was overcapacity in a number of offices and practice areas, collections were soft, and the firm was in default on its credit line with Citibank. But because the firm was in such great difficulty, there was broad support among the partners for aggressive action to address the firm's weaknesses. Fortunately, we were able to turn the situation around. Reflecting back, I now see that, in a very real sense, it was easier to manage the firm when its existence was threatened than when it returned to good health—when options were more numerous and correct choices were less evident.

There is a lesson in that experience. Even though law firms everywhere face formidable challenges, the pathway to survival for most firms is clear—follow a conservative fiscal strategy, communicate effectively and often with the firm's many audiences, and focus with unprecedented intensity on the firm's clients.

Fiscal Strategy

Annual budget. A conservative fiscal strategy begins with the annual budget. In today's economic environment, firms should forecast revenues cautiously, utilizing billable hours, billing rate, and realization assumptions that acknowledge the economy will remain in deep recession. Contingency fees should be eliminated from the forecast altogether and treated as windfalls if and when they occur. This does not mean that firms should anticipate a worst-case scenario, but it does mean that firms should prepare for very lean revenue years in 2009 and 2010.

Next, firms should determine the level to which expenses must be held to produce a level of profitability acceptable to most partners. If this means that workforce levels and accompanying personnel costs must be reduced, so be it. All areas of spending, including leases, must be carefully scrutinized. Widespread layoffs in our industry suggest that most firms are following this principle in their approach to 2009.

The principal purpose of a conservative fiscal strategy is to set modest but realistic expectations—and for the firm to then meet or exceed them. That is especially important in this environment.

Financial leverage. Excessive debt led, in part, to the collapses of Heller Ehrman and Thelen in 2008. Firms should reduce their debt levels and increase partner capital (accounts?) to the extent they can do so without stretching partners' wallets too thin. There are two sources available to firms for this purpose—current-year earnings not yet distributed to partners, and permanent paid-in capital.

Early in the year, when cumulative expenses often exceed revenues, many firms borrow from banks to fund partner draws (can we say payouts to partners?). While I don't advocate dispensing with this practice altogether, I do recommend that firms consider modifying their distribution policies to reduce 2009 partner draw amounts. The most conservative firms distribute only income actually earned, even if partners must wait six months or more into the new year before sufficient profits accumulate to fund partner distributions.

Many firms are also reviewing their permanent capital policies, increasing the amount of capital each partner is required to contribute to the firm in exchange for the right to share in the firm's profits. At most firms, this takes the form of a percentage holdback from current income. Each dollar of additional partner capital reduces the firm's need to rely on bank borrowings to fund operations.

The goal here is to reduce the firm's vulnerability to adverse events by reducing financial leverage and increasing its self-reliance and independence. Heller and Thelen were caught in a downward spiral of partner defections that led to default under their bank credit lines. Had their balance sheets not been so highly leveraged, it is entirely possible that both firms could have worked their way through the crises that affected them.

Communication

Firms have numerous audiences or constituencies—partners, other attorneys, support staff, clients, lenders, and landlords. During times of stress, each of these constituencies is understandably apprehensive about the firm's future. Attorneys and staff are anxious about job security; clients are concerned about not only their own financial health but also the firm's ability to provide legal services on a reliable and cost-effective basis; and lenders and landlords are watching carefully for signs that the firm may be unable to meet its obligations. Firms should develop comprehensive plans to communicate directly with each constituency regarding both general and specific concerns.

There are three important elements of an effective communications strategy—candor, consistency, and frequency.

- *Candor*. Candor and honesty are cornerstones of effective communication. Firm leaders should communicate openly about the challenges the firm faces and what they're doing to address them. Avoid surprises, especially negative ones.

- *Consistency*. Firm leaders must also address the unique interests and concerns of each firm constituency while maintaining a consistent overall theme. Although the short-term purpose of effective communication is to disseminate information, the long-term purpose is to build trust. Consistency is critical in this regard.

- *Frequency*. Finally, firm leaders should communicate frequently with each audience—more often than in normal times. The absence of information in an organization creates a void that will inevitably be filled with false information and rumors. Leaders should keep each audience as well informed as possible and look constantly for opportunities to broadcast the firm's message.

Client Relations

Most firms are dealing with the new economic reality by reducing expenses. And because the great preponderance of a law firm's budget relates to personnel, it is no surprise that many firms have announced layoffs and salary freezes in the past few months. In fact, it is difficult to pick up a newspaper without reading another story about workforce reductions in our industry.

But it is unusual to see stories about efforts by firms to strengthen client relationships. In good times, it is important to seek feedback from clients; in bad times, it is imperative to do so. Direct contact with clients in the form of well-constructed client meetings or interviews demonstrates the value the firm places on client relationships and its concern about clients' satisfaction with its services. It also provides an opportunity to gauge the impact of the economic downturn on the client's business. Such information can help the firm predict future demand for legal services.

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Law firms face unprecedented challenges in today's economy—challenges which were unanticipated and for which no firm was adequately prepared. And yet, with a sound and conservative fiscal strategy, an effective communications program built around candor and consistency, and a renewed emphasis on strengthening client relationships, most firms will survive the crisis and emerge as stronger, more vibrant organizations.

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