A Year of Shifting Winds – and Some Thoughts for the Year to Come

By Joseph B. Altonji on December 27, 2022

As we enter the final countdown to the end of 2022 – hard to believe another year has come and gone! – there are lessons to be learned from where we've been. This year might go down as the "year of shifting winds" for the world generally and for the legal industry.

Consider where we were a year ago:

- Finally emerging from Covid, and people were tentatively venturing out, albeit cautiously.
- No war in Ukraine, and many people probably couldn't locate it on a map.
- The economy growing at a reasonable pace, though inflation had already jumped to 7.1% from 1.4% a year earlier. Political leaders were only beginning to admit it wasn't "transitory."
- The stock market appeared strong, driven by FAANG stocks, with the S&P hitting its (last) all-time highs around year end. Transactions were everywhere, fueled by cheap money and exuberance.

In the legal industry, we were finishing a record year, featuring:

- Incredible demand for private equity and other transactional practices.
- Litigation on its way back from the depressed Covid levels.
- Associates finishing their most remunerative year ever, having received not just major salary increases and record year-end bonuses, but virtually unprecedented industry-wide midyear bonuses as well.
- Employees with an upper hand, as the main concern of law firm leaders was finding, hiring, and retaining sufficient people to meet demand.
- Strained cultures as firms still had relatively low office attendance, but many were reluctant to ask lawyers to come back, often fearing their people would jump ship to others less willing to push.

Cultural challenges aside, we were heading into 2022 on a major high, with partners expecting record distributions and firms poised to raise rates with impunity.

One year later, the world feels remarkably different. The economy is sluggish at best, and the markets have taken a beating, down roughly 20% for the year as of the weekend, with the FAANG stocks leading the declines. Inflation has pummeled households everywhere, and layoffs have started becoming routine news. The Fed and other Central Banks have pushed up interest rates to fight inflation, leading to a dramatic slowdown in transactions and a much cooler housing market. Most economists and business leaders expect further rate increases and a recession. The war in Ukraine, in addition to all the tragedy visited on that country, changed the perspectives of western leaders and citizens dramatically, in addition to placing significant economic burdens on the U.S. and allied governments and adding to an already growing energy shortage.

Inevitably, the legal industry has felt these changes. We've seen:

- A rapid shift from indiscriminate, above-market hiring to a much more intense focus on performance and profitability. In a repeat of prior periods of excessive "froth," we drove up the cost of the talent just in time for demand to fall.
- Demand for transactional lawyers decline dramatically and layoffs starting. Meanwhile, some increase in demand for additional help in litigation and other areas is emerging.
- Inflation driving up costs, just as demand shifts increase clients' bargaining power.
- Global firms cut offices in Russia and many others gave up clients because of the conflict.
- Some firms came back to the office with some reasonable new pattern, while others continue to suffer from "ghost town" office spaces and continued cultural isolation.

As we enter 2023, law firm leaders – often exhausted by the strains of the Covid era – face challenges unlike those of recent memory. We've forgotten how to operate in weak, inflationary economies as we head into a year where economic uncertainty is likely to continue. Most leaders are taking a cautious approach even while most intend to push rates up materially in response to inflation.

So far, so good, but what else should we be thinking about? While caution is in order, the coming year will also likely present opportunities for those in a position to capitalize. We urge you to view 2023 as a year for carefully considered strategic investments:

- Particularly for mid-size firms and others whose transactional practices were the targets of heavy raids, consider using this opportunity to (cautiously) restock your transactional bench, with a careful eye toward individual cultural fit with your firm. There will be plenty of well-trained lawyers who were never likely to have long-term careers at the name brand shops who would ultimately fit better in a quality midsize commercial firm. You will want them to stay long term!
- Be prepared to seek out and invest in people by moving them to your city but be extremely careful about setting up a far-flung network of scattered people. If you do that, make sure you have a plan for cultural integration, or you run the risk of just "renting" these folks until the next major uptick in demand occurs.
- For those who haven't done it (well) yet, 2023 might be your last real opportunity to reestablish a more natural office culture. We're not talking about everyone back all the time, but rather building a recognition of the value of connection and shared experience. The more time that passes, the harder this will become, but the current shift in market power back in the direction of the employer should make it easier, at least for a while, to get people back. Do it now, while you can, and include the partners!
- Invest in strategic pricing efforts. While inflation will allow (almost) everyone to push up rates, there will be much more pushback and resistance than we've seen in several years. You will need to counter it with serious conversations around value. Equally importantly, your partners will need to build skills to manage these conversations in inflationary times – few of us were active the last time we had these economic conditions.
- For those willing to do the work and make some level of investment, we anticipate more opportunities for a combination with smaller firms. There are many law firms out there that have hung on through the pandemic but have lost critical talent while continuing to age. With the baby boomer generation retiring at an increasing pace, the need for a real succession plan will push more of these to consider "being acquired." As my colleague Mike Short offered in his recent blog, focus on the cultural connections in addition to the economics and look for deals which

can materially deepen your talent pool.

- If you are still using historical direct-assignment support structures, consider restructuring to create more of a cost-effective team approach and work toward better service at lower cost. Take advantage of the pandemic-driven change in how people work to rethink how we support people (NOT just reducing secretary/lawyer ratios!). You will need different skills for the future, and in any case changing times have led to a much-reduced population of people interested in a career similar to that of a traditional "secretary." Start now to prepare for a world of much higher support staff turnover.
- Focus on practice level leadership and management. We can no longer afford laissez-faire approaches to the line management function in our firms. *Everything* about developing and managing lawyers has gotten harder in a world where we are heavily remote. In addition, accountability for performance has never been more important. We need strong practice leaders with the skill and temperament to successfully manage not just the younger lawyers but the challenging partners we see everywhere.
- Re-evaluate your compensation approaches to recognize the shifting demands of different generations (especially around transparency) and the clear differences in profitability of different types of work. Recognize that we may be seeing shifts in practice profitability. How much of a profitability hit will high-value transaction practices take if volume is much lower (and associate embedded costs much higher) and we start seeing material write-offs in busted deals? For smaller and mid-size firms, where do you stack up in market for non-owner (associates, NEP's and staff) compensation? Do you need to reevaluate your structure (not just your levels) to assure you can compete for the new talent you want to invest in?
- Finally, if you haven't done it recently, now is the time to seriously revisit your firm strategy. Conditions have changed dramatically in the last three years and *every* firm should be regularly reflecting on its own place in the world. Perennial questions deserve a fresh look and evaluation:
    - What are we *really* good at, and what can we realistically expect to lead the market in?
    - Do we need to be in all the practices and markets we are in today, or are some diluting our success? Are there places we really do need to be to succeed and be credible?
    - (As explored in my January 2021 blog…) If we have historically been committed to independence, *why*? Is this commitment based on true strategic considerations or historical emotional ones? Is this commitment getting in the way of maximum success?
    - What is our actual culture, and does it help us or hinder us? How do we distinguish ourselves in the market for talent and really stand out?

The next year will be challenging but it also provides all firms the opportunity to reset on some basic topics and build capability through investment. It can also be a treacherous economic year for those not prepared to lead and manage with a strong orientation toward personal performance and accountability. We urge all firm leaders to focus on the opportunities 2023 will present both to invest and grow, but also to reset around some of the basics where needed.

To all our clients and friends, we wish you a strong finish to 2022 and the very best for the holiday season. We look forward to engaging with all of you as we navigate a year of opportunity and challenge in 2023!