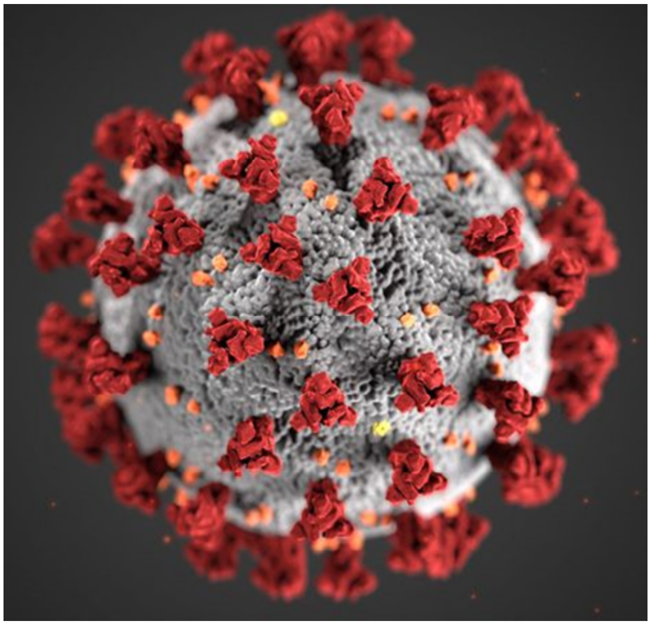
MesaFive

Coronavirus Impact - Client Briefing #3 (March 2020)

This is the third in our series of Coronavirus Briefings for our clients. While firms are still adjusting to the economic pressures created by sheltering in place it is increasingly clear the pandemic will be an ongoing issue for 12 to 18 months. Firms should begin planning now how to redeploy their people and practices in a radically changed business and social environment.



Preparing Now for the New Normal?

As noted in our first briefing the novel coronavirus pandemic has rapidly created the most significant workload and financial downturn in the legal profession, and in world trade, since the Great Depression:

> Over the past few weeks law firms have rapidly evacuated their premises, scrambled to enhance their ability to work from home, assessed and reassessed how workloads and economics are impacted by rapidly collapsing demand, and taken extraordinary steps to reduce the outflow of cash relative to the reduction in production and revenue. Fortunately, the lessons from 2001 and 2008 are still fresh enough in firms' minds that most are acting quickly and effectively, even if reluctantly, to adjust short-term economics.

As noted in our second briefing, the impact of the pandemic downturn is far more varied than is discernible from the press, primarily because most law firms don't want the publicity of being either the worst managed or most insularly profitable firm in the profession. While most firms are still experiencing weekly compounding reductions in production, some have experienced only minor declines in productivity, while for others the drop has been as much as 86% of total workload in just the first two weeks.

Beyond the variations in demand due to practice specialties, part of the reason for the widely varying impact among law firms has to do with how they are financially structured:

- After the 2008 recession many firms increased their capitalization levels, to the point that total contributed capital balances now often range from 25% to 50% of average annual income. It is clear in this downturn that heavily capitalized firms have been more capable of taking their time to assess the effects of the downturn, more capable of keeping lawyers and staff paid in full, and less susceptible to a survival mentality rush to lay off lawyers and staff. While few partners love to make capital contributions, we have always advised our clients that it is much easier for partners to contribute capital in a methodical, well planned manner far in advance, than it is for most partners to forego significant income with only a few days' notice.
- Some firms continue to use bank debt as an alternative to partner-contributed capital. In recent weeks many such firms have rapidly drawn down credit lines in order to buffer themselves from the rapid economic effects of the downturn. But doing so is a short-term tactic at best, as such firms will likely face a delayed challenge as their credit lines are used up without a corresponding buildup of firm revenues.
- Some firms have relied on delayed distribution of year end profits as an alternative means of operational financing, but the reality is that partners in such firms are still accustomed to the predictability of anticipated cashflow. While delaying distributions may help *the firm* with cashflow, it will come as a shock to partners who have structured their lives in such a way to receive profits in the months after year end.
- Many of the firms that have quickly determined and announced they won't need to do layoffs tend to be firms that are the most financially conservative: They have a history of using debt only for long term capital investments (e.g. technology). They have a long history of paying partners only when and *if* cash is collected (a practice which makes partners keenly aware of the need for rapid billing and collections, resulting in these firms having the most impressive cash flow and high realization rates).

What's Next and How to Prepare

At MesaFive we constantly remind ourselves: People who predict the future are notoriously wrong, and those who get predictions right are typically more lucky than consistent. So rather than predict the long-term future let's look at what we already know about the midterm outlook and how we are helping a number of our clients prepare for the next 12 months, based on what epidemiologists tell us about the likely progression of the coronavirus.

Much has been written about the apex or curve of the pandemic. Given how much time has passed leading up to the apex, the experience in Asia and Europe tells us that an equal or longer period of infection will remain in place on the other side of that peak, and that second or third waves will be likely. Epidemiologists warn that if the US softens its myriad of Shelter-in-Place orders by early June, work and social life will need to be vastly different until a vaccine is developed, or until effective antivirals emerge. Without those developments the pandemic will be repeated with potentially worse consequences. Yes, the world could get lucky and a miracle cure could materialize. But the history of vaccine and antiviral development indicates that it is more likely 12 to 24 months before a realistic treatment is available and implemented on a widespread basis. So, the social and business reality is likely going to look very different than we were accustomed to before the pandemic. What are we likely to experience?

- A mix of state-initiated Test, Track and Treat programs, but each carried out in different ways with widely varying levels of enforcement, since the federal government has voiced a reluctance to enforce a nationwide standard. Several US firms are already studying how other countries have required businesses to cooperate with such programs so that they are better prepared to act quickly, comply with new potential guidelines without delay, and thereby begin generating much needed revenue.
- Many firms are considering how to turn their recent ad hoc efforts to advise lawyers/staff/clients of their exposure to a confirmed coronavirus case in their offices, to a more methodical, well planned process with corresponding workload support.
- A much slower, more gradual return to business than was experienced after the 2008 recession. In just the first few weeks of lockdown the US has already lost more jobs than occurred in all of 2008. And while there was some hope that a rapid decline might make a rapid recovery easier, more and more economists seem to be abandoning that theory.
- An ongoing requirement for social distancing in the workplace, and possibly, the need for rotating or phased shifts of workers to alleviate concentrations of lawyers/staff in law firms all at once.
- A strong reluctance by clients and lawyers to travel (despite being trapped at home for months with pets and half-dressed children and/or spouses walking through video conferences). After the SARS epidemic in 2003, which had dramatically fewer consequences for the United States than the current coronavirus pandemic, airports and airlines report that it took a full year for airline passenger loads to recover to pre-SARS levels. Regardless of any financial aid to the airlines, clients are already reporting that they question whether travel in the future will be as necessary as in the past.

Many of our clients are already reengineering the infrastructure and practice strategies for when the Shelter-in-Place orders are eased but are assuming they will operate in a different capacity for *at least* another year:

- Rapidly assessing which lawyers/practices can continue to work from home, with only occasional appearances in the office, versus those that must return full time in order to have viable practices. What's more, determining what equipment and support can be implemented in the next few months that will make the transition from a temporary work-at-home arrangement into a more permanent structure.

- Planning how they can achieve effective social distancing on a one to two-year basis in existing offices, without risking infections or undermining the need for teamwork.
- Reducing or eliminating Summer Associate programs, since it isn't yet apparent that firms will be back in place by the traditional arrival date for summer associates, or that they will have anything close to sufficient volumes of work to keep existing lawyers busy.
- Preparing for potential cascade failures: For example, if firm workloads are slow to recover and existing lawyers are only operating at 50% or 60% of capacity, can the firm risk onboarding a whole slew of Fall hires (when many of those lawyers tend to have low hours and non-existent profits). Many firm leaders are already assessing the variety of circumstances which could trigger both profit and retention issues that are threatening the financial viability of many young partners, who in many firms are the most profitable group of lawyers in the firm.
- Running assessments with the firm's associates to consider which partners and senior associates are best at remote supervision and more importantly why, and then developing procedures and a training program for all their lawyers to learn those skills. Interestingly an early result is that those who know and embrace technology the best aren't necessarily great at supervising or communicating remotely. While understanding and using technology are critical skills that every lawyer now needs, they still don't make up for a lack of great supervisory and communication skills. And as the leader of one accounting/consulting firm, soon to be major law firm said, "we can run circles around law firms in terms of real training and development of people to work together in teams…that's *our* competitive advantage."
- Many firms are rapidly reassessing the long term profitability of partners, practices and offices. It has been commonplace for firms to rationalize the existence of money losing people/practices/offices because the balance of the firm was so profitable. That's not to say every measurable entity has to be profitable, but too often firms gloss over significant losses out of a fear of internal/external publicity. Ignoring the problem allowed many firms to be sufficiently profitable on a firmwide basis and being silent was an easier, less controversial management approach. The difficult truth is that some practices are better served being on their own, or in other firms with a different market position, rather than stretching the market position of a high expense firm in which they are always an unprofitable element.
- There is a huge difference between being profitable and being financially healthy. Just because a firm is the former doesn't mean it is the latter. Some highly profitable firms have little to no capital, or are overly reliant on debt, or have conditioned their partners to such consistent compensation cashflow (regardless of actual profits) that partners

have no ability to skip even a few months of draws. Just as we saw after the 2008 recession, law firm leaders are already contemplating significant changes to their capitalization strategies, so they don't succumb to future cash flow shocks that may threaten firm viability.

- A number of firms are setting up emergency loan programs, backed by the firm, which can provide financial relief for lawyers and staff facing the prospect of bankruptcy due to spouses being out of work or fixed expenses that can't be restructured quickly enough to avoid financial catastrophe.
- As a contingency plan for a second wave infection in the Fall, several firms are now doing intensive planning to better accommodate the potential that parents will yet again need to spend time at home because schools and childcare could close.
- One subtle, indirect outcome is that many firms may realize they don't need all the people and offices in scattered locations, at least for the stated purpose of servicing clients locally, as they have long suspected. Too many firms have created duplicate but often underutilized, resources in multiple offices and that phenomenon may now begin a period of gradual decline as firms concentrate on their most *talented* resources rather than their *closest* resources. After all, if clients are reluctant to pay for travel and have become accustomed to dealing with lawyers through video, is it worth the hit in income to maintain underutilized offices and practices merely for the sake of appearing to be "national" or "global?"

Last, we are struck by how many in-house counsel are already saying this downturn is much deeper and steeper than 2008, and how it will likely take longer to recover their production and supply chain inventory. In addition, many are already talking about how company leaders are pressuring legal departments for any and every means to cut external expenses, including law firm fees and billing rates.