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Five Questions Law Firms Face in 2006

What challenges are ahead for the legal market?

Emma Schwartz
Legal Times
January 6, 2006

Mergers. Firm dissolutions. Associate salary hikes. Last year was anything but docile in the legal market. With ever-increasing competition among firms, 2006 looks to be equally challenging. With that in mind, here are five issues that could be -- or should be -- in the forefront of every managing partner's mind heading into the new year.

1. WILL MERGER MANIA CONTINUE?

Across the country, law firm mergers are changing the legal landscape, as firms seem intent on growing into 1,000-lawyer-plus behemoths to remain globally competitive.

In the nation's capital, the merger wave has taken the form of outsiders snapping up longtime local players. And although Washington, D.C., has more experience with outside law firms than most cities, the consolidation trend isn't showing any signs of slowing. In 2005 alone, the District saw San Francisco-based Pillsbury Winthrop partner with Shaw Pittman, Burns Doane's remnants head to Pittsburgh-based Buchanan Ingersoll and Boston's Bingham McCutchen announce the acquisition of Swidler Berlin.

"There is just more activity than we've seen in a long time," says Michael Rynowecer, president of BTI Consulting Group, which recently released a study on the legal market in 2006.

Consultants say New York remains the choice market, but Washington, because of its importance as a regulatory hub, is increasingly seen as a must-have outpost for firms with national ambitions. And if the mergers by Swidler Berlin and Shaw Pittman are any indication, the District's midsize firms will continue to come under increasing pressure. "There are law firms that are doing really well and ones who are giving up clients," Rynowecer says. "It's harder and harder to just be in the middle."

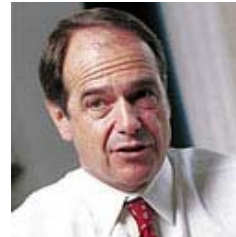
2. WILL COMPENSATION SOAR?

Crowell & Moring lost its securities regulatory group. Swidler's energy practice jumped to Alston & Bird. George Pappas, along with his nearly \$10 million in business, gave up on his longtime firm, Venable, for the more white-shoe Covington & Burling. The lateral market is hot, and firms are losing some of their best and brightest at the drop of a hat -- or a suitcase full of C-notes.

"The war for talent is real," says Ward Bower, a principal at legal consulting firm Altman Weil. "I think, finally, the message is there that the only difference between law firms is people."

For law firms, that means the complacency of recent years concerning talent retention is over. Their best weapon: money. So, say consultants, more and more firms are likely to take a long look at how best to reward partners. Some firms may widen the spread between the highest- and lowest-paid partners. Others may finally make the switch to a tiered partnership system, as Gibson, Dunn & Crutcher did for the first time last year.

Partners aren't the only beneficiaries. For the first time in five years, associates saw base pay for their class rise at firms such as Arnold & Porter, Howrey, and Skadden, Arps, Slate, Meagher & Flom. But the boosts, which averaged about \$10,000 a class, were largely reserved for third-years and above.



Bruce McLean,
managing partner at
Akin Gump Strauss
Hauer & Feld.
Legal Times/Patrice
Gilbert

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Specialized firms like Finnegan, Henderson, Farabow, Garrett & Dunner have gone further. The intellectual property powerhouse increased the salary of first-years to \$135,000 in 2005. Already, a few other IP firms have followed suit.

The move has put other firms on notice. Nobody is certain how quickly this salary competition will peak, but no doubt every firm in town is watching.

"I know management will have to turn to it," says Brian Busey, D.C. managing partner at Morrison & Foerster. "Last year most firms resisted the increases some firms pulled. Maybe this year people won't."

Either way, the scramble for talent has spawned more firm attention to human resources and professional development -- something likely to increase this year.

"Once you invest the time and your resources to bring in new, talented people, you want to keep them here," says Chris White, director of professional personnel at Nixon Peabody.

3. HAVE BILLING RATES TOPPED OUT?

Last year most firms tried to boost profits the usual way: by raising billing rates -- on average, about 6 percent. Mix in some more hours out of your partners, and, voilà, you have a healthy jump in profits. But some firm managers say the fee-hiking binge is overdue to end.

"The string of rapidly escalating billing rates has pretty much run its course," says Bruce McLean, managing partner at Akin Gump Strauss Hauer & Feld. "We're going to have to find different ways to improve profitability."

Although, for the moment, times are good. A recent survey conducted by the *National Law Journal* revealed that about 75 percent of large law firms surveyed in the United States raised their billing rates in 2005.

The move toward containing fees is being driven largely by corporate clients, most of whom are under tremendous pressure to close the spigot on legal spending. That pressure is augmented by increased competition from new law firms and from megafirms gaining a toehold in lucrative practices like intellectual property and securities work.

One option firms are testing more and more: alternative fee arrangements. By creating flat fees or bonuses based on particular outcomes, firms are trying to find ways to hang onto favored clients. At Akin Gump, McLean estimates nearly 20 percent of revenues come from some type of special fee structure.

Not everyone is sold. Lisa Smith, a consultant with Hildebrandt International, says firms haven't figured out how to maximize alternative fee structures and are often merely offering favored clients discounts. John Beisner, D.C. managing partner at O'Melveny & Myers, concurs. "I'm not seeing a lot of those that people get really comfortable with," says Beisner, who adds that his firm will raise rates again. "They need to be tailor-made to particular circumstances, and there is a challenge to find ones that are broadly applicable."

4. CAN COSTS BE CUT FURTHER?

Even as some firms continue to raise rates, they are still looking at other ways to hold down costs.

One development likely to escalate in the coming year: outsourcing.

Firms like Howrey have already tested the waters for some electronic discovery. And there may be opportunities to capitalize on India's inexpensive intellectual assets to offshore preliminary work on patent prosecutions.

But, says Bower, "There is not a lot of confidence yet in the quality of what is coming out."

Another option may be to pare down practice groups. Firms are starting to see a greater advantage in having a few practice areas with more depth and expertise, says Robert Ruyak, managing partner at Howrey. To achieve that goal, many firms are seeking to acquire specific practice groups, such as Ropes & Gray's acquisition of Fish & Neave's intellectual property group or Jones Day's buyout of IP firm Pennie & Edmonds.

But while Ruyak doesn't see Howrey moving toward a model of having just a handful of practice groups, he believes that as firms drop unwanted lawyers, it will "have the effect of making people available for other firms."

And other firms like Arent Fox still believe that by staying small they can give better service -- and rates -- with equal quality.

5. ARE CLIENT RELATIONSHIPS MORE CRITICAL THAN EVER?

There is an ongoing tug of war between corporate counsel and their outside law firms. Companies are shaving the number of outside firms they use, while the firms, in turn, are trying to boost their portfolios with key clients. Which firms ultimately develop relationships with clients and which ones lose out depends largely on one factor: service.

"So much competition is out there, you really have to be customer-friendly," says Douglas Woloshin, D.C. managing partner at Duane Morris.

The overall legal market is buoyant and growing. According to a recent law firm study by BTI, the vast majority of companies are shrinking their in-house counsel team, in part because they believe this will cut costs. For law firms, that translates into a larger market for business. That excludes some of the world's biggest companies, which are growing their in-house teams.

But, say consultants, expect a shakeout between clients and outside counsel in the coming year. Some firms are "going to strengthen their client relationships at the expense of those who don't," says Peter Zeughauser, a principal at the Zeughauser Group.