Developing and Maintaining a Profitable Private Client Practice

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Chapter 1: Changes sweeping the UK legal services market

The UK legal profession has been ripe for reform for the past 30 years. Despite the fees generated by the profession accounting for some two per cent of the gross domestic product (GDP) of the UK for the past 20 years,1 it was apparent many years ago that substantial change was set to take place.

The 'Access to Justice' report written by Lord Woolf in July 19962 highlighted many of the changes required within the profession. This report became the blueprint for the incoming Labour Government’s policy, and indicated how the Government’s Department of Constitutional Affairs was determined to bring about significant change within the profession.

In December 2004 Sir David Clementi finally concluded his wide-ranging review into the provision of legal services.3 The consequences of his findings would bring about the most significant wave of change to affect the legal profession in its entire history.

Clementi was commissioned to carry out a wholesale review of the provision of legal services in England and Wales. His brief was not only to look at reforming the way the profession is regulated, but to consider the very structures the profession uses, specifically in relation to legal disciplinary practices (LDPs) and multi-disciplinary practices (MDPs).

Importantly, the review covered the provision of all legal services and not just those offered by solicitors, barristers and legal executives. The activities of patent agents, licensed conveyancers, will-writers and trademark attorneys were all considered by the review and could consequently be subject to wide-ranging reform.

Subsequently, the Legal Services Act 2007 (often referred to as the Act in this report), which received Royal Assent on 30 October 2007, has reformed the way legal services in England and Wales are regulated, putting consumer interest at the heart of the regulatory framework. The Act set out the framework for proposed reform, which included the setting up of the Legal Services Board and the Office for Legal Complaints, and enabled legal services to be provided under new business structures.

The Legal Services Act was the catalyst for change and this has been further expedited by the length of the current recession.

But despite warnings from numerous experts in the wake of the Clementi review that the proposed changes constituted ‘a wake up call for solicitors’, many have been slow to visualise the new legal landscape. Yet it is becoming clear that the aforementioned recession, and in particular the associated downturn in the housing sector, is having a major influence on the viability of practices that relied on conveyancing for a large proportion of their income. Many of these firms are now commercially unviable, hence the necessity for consolidation through merger.

However, even without this powerful accelerator, the legal market would have been facing serious upheaval, with powerful competitive forces set to be unleashed, and
traditional business models being swept away in what some experts have called the ‘big bang’ for the legal profession.

Finally, Lord Carter’s review of legal aid procurement is regarded by some to be an unmitigated disaster, putting further pressure on those firms providing publicly-funded work.

Why was the legal services market ripe for reform?

A common question is why was the market for legal services – which is large, valuable and, in fact, growing – earmarked for such comprehensive change? The legal services marketplace generates some £29bn of income per annum, of which 10 per cent is exported and a further 10 per cent is legal aid. Although this figure has increased over the past 20 years, the contribution to GDP has remained very similar at two per cent. However, in direct contrast, the number of solicitors serving the market has been increasing at a remarkable rate. In 1987, there were approximately 50,000 practising solicitors in the UK. Twenty-five years later, this figure has trebled. Interestingly, the gender shift within the profession has also been quite remarkable with some 70 per cent of the students now studying law being female.

The consequence of this dramatic growth in numbers is an over-supply of solicitors operating nationally from high-street premises with cost bases which are far too high to be sustainable in the long term. In any highly-competitive commercial environment, we see a downward pressure on fees and a squeeze on profitability. It is this competition that is leading many of these high street practices to be unprofitable.

The average age of an equity partner in a typical high-street practice is now in excess of 60, and many younger salaried partners are no longer prepared to provide the traditional exit strategy for senior retiring partners.

The uncertainty facing legal practices has left many younger fee earners and potential partners prepared to work hard for a good income, but not prepared to invest their cash into equity. In fact, those practices that have converted into limited liability partnerships (LLPs) are also having difficulty in finding members for these, and this suggests that there is little interest in having responsibility. However, 25 per cent of legal practices now trade as limited liability companies, which is tax efficient, a vehicle for potential third party investment and a way to encourage new owners. Planning for exit or succession is a major weakness in many practices, and this will be explored at length later in this report.

The traditional business model of law practices is now under threat, with too many qualified solicitors operating in too many law practices. Additionally, too many equity partners in many of these firms are finding profitability a major issue for them. Of the (approximately) 11,000 law firms practising, over 8,500 of these have four partners or fewer – and this is not a cost-effective method for the distribution of legal services.

A surprising number of solicitors still run their practices as a hobby, not having the necessary skill set to manage them as businesses. Subsequently, we see many law firms not being run as traditional businesses, in that the importance of cash flow and money management has never been seen as a priority. The general lending policy of the banks, which we will examine in the next section of this report, has further exacerbated this situation.

The implications of the banking crisis for law firms

The UK banking industry has faced catastrophic problems, with the first run on banks since the great depression of the late
1920s and a number of the major banks having already been bailed out by the government to avoid collapse. Consequently law firms have, for the first time, experienced a significant hardening of banks’ attitudes towards legal practices. The lending criteria have been raised but solicitors’ borrowings, predominately due to the static interest rate, have stayed flat.

The main banks had traditionally found that law firms provided their greatest return on investment compared to any other industry. Since the early 1990s banks had willingly lent monies to professional practices and, in particular, to solicitors, with little or no regard as to their credit status. The ‘professional’ had always had earning capacity and in the unlikely event that a law firm should fail, the banks assumed they had some security with joint and several liability of all partners, and their abilities to find alternative employment as employed solicitors. Very few law firms had, in fact, failed and therefore, until 2008, most banks did not operate a credit policy with regard to the legal profession.

What the banks did want, however, was access to the significant credit balances in law firm client accounts. The interest rates paid were generally very low and this gave the banks a huge opportunity to reutilise this cash for significant profits. Additionally, charges would be applied for transfers of cash and other ‘added value’ services.

In recent years we have seen a change in this policy as non-high street banks began offering over base rate for client credit balances, thus making their high street competitors pay more heed to the interest they paid on these deposits.

However, following the collapse of UK bank Northern Rock and the downturn in the housing market, this option became far less attractive. With most law firms seeing, at least, a 50 per cent drop in conveyancing instruction work, their client account deposits also fell by the same amount. If a law firm had more than 25 per cent of turnover reliant on conveyancing prior to 2007, then it is likely to be suffering financial difficulties today.

Certainly the lending policies of many of the major banks have been contributory to some of the current problems facing law firms, many of whom are carrying significant borrowings that are unserviceable in the current recession.

For example, many law firms have been given overdrafts, which have been subsequently rolled up into five or 10-year loans, with further overdraft facilities then being granted and the process starting all over again.

It has traditionally been quite usual for solicitors to approach their banks to request additional facilities when required, and to generally have their request accepted. This could be for additional working capital, tax or VAT demands, and even to pay the wage bills at the end of some months.

Why now?

Access to capital will be the real challenge for law firms in the future. Those firms whose business model relied on personal injury work, traditionally seen to be highly profitable, will have greater difficulty in obtaining the funds required to maintain these departments. Firms which have relied on claims management companies (CMCs) or other marketing methods to find them suitable cases are finding their model is no longer workable. One of the key lenders in this sector, Hampshire Trust, began an organised withdrawal from the sector earlier in 2012 leaving a significant gap which the banks are reluctant to fill. The Jackson reforms, however they are watered down, will question the viability of referral fees in
any case making many personal injury firms look very carefully at their ongoing viability.

The two main banks with the largest share of the legal sector are Barclays and RBS (NatWest), which share the custom of over 60 per cent of UK law firms. These banking giants are already seeing the earliest casualties of the present economic circumstances and, as a result, are taking steps to force law firms to act as businesses, rather than hobbyists. Controlling cash flow will be a major issue for law firms in the future, and the traditional ways in which legal services have been delivered and paid for will change for many of those firms that wish to survive.

Many firms, for example, are reluctant to ask for monies outstanding. In one particular instance, a nervous bank reviewing a law firm’s facility discovered that as a result of one family matter with a high net worth client, the firm was carrying over £180,000 of work in progress (WIP) on its own overdraft while it waited for a family property to be sold. This type of casual approach to managing cash flow is no longer sustainable in a law firm. No other industry or profession would run a business in this way.

The problems we are currently seeing mark the beginning of an increasing number of challenges facing the legal profession. Despite the fact that many overdrafts are provided on the basis of ‘instant recall’ — whereby the bank can call in the loan without notice — many law firms do not think that a major bank would call in their overdraft. However if the WIP and debtors clear most of the liabilities, and a law firm refuses to act as any other business would in a recession, then it is not unreasonable to expect that the banks will take drastic action to reduce their liability. The added pressures of tax demands, lease payments and VAT are likely to plunge even more law firms into crisis.

The professional indemnity market has subsequently added to the confusion with a number of key insurers now choosing not to insure smaller practices. Lack of funding for the not insignificant premiums has caused a number of problems in recent years, as established funders have withdrawn from the market for a variety of reasons. Other funders such as Hampshire Trust are withdrawing funding from the personal injury sector.

Consolidation
We are now seeing banks recommending to many law firms that they should look to merge with larger practices, but even this is fast becoming impractical. Some parts of the country seem to have hit a crisis point at the same time with several practices facing the same dilemma. Firms that have high borrowings in both loans and overdrafts, with no security, are facing insufficient work coming in and little opportunity to change their working practices. If the banks choose to take a tough stance with these practices and suggest they look to re-bank within a given timescale, there will be a significant rise in insolvencies.

This report will explore the issues surrounding valuation, merger and consolidation, so suffice to note at this point that many practices currently have an overvaluation of what their firm is worth, and this will cause major issues during the consolidation process. The consolidators wish to pay little or nothing to purchase practices, and sellers, who think they have found an exit route, grossly overvalue their practices when a potential purchaser approaches them. If the two parties cannot agree terms, then we are facing a challenge that the banks may well force sellers into mergers.
What the experts say

It is interesting, at this point, to look at the predictions of two experts, Richard Susskind, law columnist at The Times and Professor Stephen Mayson, Professor of Strategy and Director of the Legal Services Institute at The College of Law.

Richard Susskind’s book, The End of Lawyers, indicates a future in which conventional legal advisers will be less prominent in society than today. Susskind argues that the legal profession needs to undergo a significant transformation to avoid extinction. According to his book, the legal profession will need to react to two market forces: first, an irresistible pull towards commoditisation and second, ongoing development and uptake of information technology, which will become increasingly important for cutting costs and delivering legal services to the web generation of consumers. Susskind concludes that new and different roles in the new world will emerge for adaptable solicitors:

“The challenge I lay down here is for all lawyers to introspect, and to ask themselves, with their hands on their hearts, what elements of their current workload could be undertaken differently — more quickly, cheaply, efficiently, or to a higher quality — using alternative methods of working. In other words, the challenge for legal readers is to identify their distinctive skills and talents, the capabilities that they possess that cannot, crudely, be replaced by advanced systems or by less costly workers supported by technology or standard processes, or by lay people armed with online self-help tools... The market will determine that the legal world is over-resourced, it will increasingly drive out inefficiencies and unnecessary friction and, in so doing, we will indeed witness the end of outdated legal practice and the end of outdated lawyers.”

Professor Stephen Mayson is head of the Legal Services Institute think-tank, which was set up to examine the implications of the Legal Services Act. He believes that changes to the market as a result of the Act will mean that qualified solicitors will only be used for reserved activities, such as probate and litigation.

Mayson has argued in several prominent speeches that the legal services reforms are intended to bring about upheaval in the legal services market, and that law firms will need to restructure and possibly refinance to consolidate, recruit, train and market themselves in a measurable and cost effective way, and to engage in even more sophisticated strategy and management. Mayson predicts that many law firms will be forced to consolidate or go out of business:

“In the context of the market reforms as a whole, however, even many estimates of 800 legal aid firms disappearing might be a significant underestimate. So what scale of consolidation should we project? It’s difficult to be sure of course but here’s my guess for the next five to ten years... the ‘at risk’ group would lose about 3,000 firms and would imply about £1.5 billion of turnover on the move. We probably have twice as many qualified lawyers as that market needs. The number of lawyers has doubled, but the volume of work in reserved activities has not... We have got to get much tighter on what we pay for. The AA and HBOS are doing work on a massive scale. There aren’t that many law firms around that can compete. Are we going to roll over, or think about consolidation?... The one thing that makes an industry vulnerable is the incumbents not changing. Thinking like lawyers could spell the end.”
What will a profitable private client practice look like?

As we have already identified, of the 11,000 or so legal practices currently operating in the UK, over 8,500 of them are run by four partners or fewer, and many of these partners have never been trained in even the most basic management skills. No one questions these partners’ intelligence, knowledge or legal skills, and this goes back to the problem that many firms are being run as a hobby by the partners.

For many years this hobbyist attitude had little impact on legal firms, largely because the banks were prepared to finance law firms with little heed to their management skills and financial acumen. The Legal Services Act 2007 and the introduction of the Code of Conduct 2007, with its business management rule, were meant in part to assist law firms in the management of their practices. However, the ongoing recession has changed that gradual process into a raging sea change within the profession, the like of which has never been seen before.

Many law firms, as we have seen, are currently having to merge to survive, and the numbers of firms that are being asked to re-bank is growing. This becomes even more serious when partners are in denial as to the serious plight of the profession. Comments such as: ‘it’s only a blip!’; ‘the bank will always support us’ and ‘we can sell our practice for its annual turnover’ still abound. Sadly, it’s time for a reality check.

As previously noted, the average age of an equity partner in a typical high street practice is over 60 years, and many simply do not have the appetite to change. However, it is essential that law firms seek assistance and help to instill simple management and fiscal disciplines into their practices, and realise that their most important assets are their clients and their people.

A good law firm will have a strategic plan that is regularly monitored and updated and this will be a plan that all partners agree to implement. That firm will also have strong management and a leader (not necessarily the senior partner) who will take the tough decisions when required. The Act has allowed non-lawyers to become equity partners in LDPs, and financial specialists have proved to be the greatest number of non-lawyers becoming partners in such practices. There are organisations that provide this service on an ‘as required’ basis, therefore not involving a full-time financial director, but still providing the partners and perhaps, more importantly, the bank, with the information they require to support the business.

The use of technology to drive down costs will be another vision of the successful law firm of the future. This does not simply mean case management or practice management systems, important as they are to achieve processed systems, but also the use of voice recognition and document assembly systems that can reduce overheads. Secretarial and support staff need not be replaced or may be re-deployed into more client-facing activities, therefore reducing overheads.

One of the essential aspects of being a good law firm will be care of and attention to the clients. Providing ‘world class service’ will ensure clients not only return with more work, but actively advocate a law firm to others. Some firms are even introducing ‘loyalty cards’ for their private clients, offering these clients various legal expenses insurance products plus discounts for referrals to other clients. Clients are a law firm’s most important asset and need their legal advisers to be proactive with advice and guidance. Providing prompt responses, particularly by returning telephone calls and managing clients’ expectations in terms of
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service, billing and collection of debts will also be of paramount importance.

It is worth considering, though, whether a firm has ‘clients’ or ‘customers’. Customers shop around for service and products, and will go to several suppliers to find the best deal – whether in terms of service, price or quality – and that is the reality of today’s marketplace for many legal services.

Becoming a client-centric, people-focused practice will result in additional cross-selling opportunities, and introducing a performance-based remuneration system for all fee earners and staff will change the culture of the practice. The introduction of costs-delivered targets for all fee earners will not only help with their motivation, but will also assist the partners to deal effectively with underperforming staff. The well-managed firm will not carry poor performance in either fee earners or partners – instead they should be dealt with sympathetically but firmly, and may be removed from the practice.

The growth in online legal documents has been slow to date but this market will expand dramatically in the coming years with the US suppliers Rocket Lawyer and Legal Zoom entering the UK market.

We are now seeing many well-run, progressive practices offering a wide range of insurance-backed services – for example, the offer of probate insurance when preparing a will, insurance-backed employment packages, total legal care packages that include a wide choice of commercial insurance packages, etc.

Fixed fees for most legal work will become more common throughout the profession. In fact, I predict that the vast majority of legal services will be on a fixed fee basis within five years.

A good law firm ensures that any spending on marketing is both measurable and accountable. Many firms believe that advertising and profile-raising are their only means of promoting their practices – yet it is well proven that the only way to ensure sales are achieved is by face to face meetings. Client care, networking and cross-selling skills are fast becoming the in-house courses most in demand by well run law firms.

A good website that is both up to date and informative is an essential tool for a good practice. The vast majority of potential customers use the web to locate a solicitor and traditional methods of advertising, such as the Yellow Pages, are now often used as a means of finding contact details, rather than picking a firm from the many others advertising there.

We have also seen the growth of the legal franchise, with QualitySolicitors taking a leading – some would say dominant – market position. The private equity backed, national legal brand has used advertising, including on television, to raise its profile and indeed that of the profession as a whole – something the Law Society should have done in some solicitors’ opinions.

The conclusion is simple. Law firms that have been run as a hobby by partners will not survive in the current market. It is absolutely essential that law firms accept that change is inevitable and exploit this exciting opportunity.

There will be winners and there will be losers in this period of uncertainty. Those firms that embrace change and deal head on with these challenges will be the winners. The partners in law firms behaving like ostriches with their heads firmly buried in the sand will be the losers in this seismic period of change.

The following chapters look at how to embrace the future, get outside help and rise to the challenge.
References


5. Mayson, ibid.

6. Ibid.

