Growth Strategies for Law Firms

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ALL LAW firms should consider growth and what exactly it means to them at some stage. Many law firms consider growth to consist of adding turnover to their bottom line – usually by an arbitrary figure of, for example, 10 per cent across the practice. But what does this actually mean to each department, to each department head, to fee earners, and to staff? Does it mean individuals work 10 per cent more hours to produce 10 per cent more fees at their existing hourly rate?

The assurance can be made to those who have been planning for the growth strategy of their firm that this method simply does not work and the model is unsustainable in the current market. In the halcyon days pre-2007 this method worked because market conditions allowed it to. Firms nowadays no longer predict such growth without a proper strategy. Or do they?

The answer is a resounding yes for those firms who are currently performing well and who have kept profits per equity partner at extraordinarily high levels despite the economic climate. However, increasing turnover by 10 per cent is not only unachievable, it is also unsustainable in the short and medium term.

Law firm growth is unachievable without having a clear vision or strategy for the firm. The current market conditions are only part of this need for clarity over the future direction of any firm. Couple the economic conditions with the legislative changes affecting the legal profession in the UK, and firms are experiencing the biggest changes to the legal market place for 300 years.

The Legal Services Act 2007, the Legal Aid, Sentencing and Punishment of Offenders Act 2012 (LASPO), and other legislative changes were designed by the UK government with the view that all lawyers were charging an extremely high hourly rate for their services.

Growth will mean different things for various law firms. Obviously the current size of a firm will dictate to some degree the growth strategy they will be able to embark upon in future. The local high street solicitor who provided a plethora of legal services is becoming a dying breed. There are currently approximately 8,000 practices that fall into the four partners or less category and which are male dominated with an average partner age exceeding 60 years.

The majority of these aging practices do not embrace change – they are comfortable with the traditional ways of working and with charging their clients in six minute blocks of time. In cases such as this there is little change in attitude and adaptability towards changing the structure of their practice, and, with both aging clients and staff, these firms are doomed to fail.

It is predicted that there will be largescale consolidation amongst these firms and, sadly, a number will actually become insolvent. The number of law firms is dropping, and although the SRA deny crisis talks with a high number of firms, approximately 2,000 of the current crop of traditional high street
practices could be in danger. This does not necessarily mean that the numbers will drop significantly, as there are in fact over 100 applications for new firms each month.

For some firms, part of their strategy for growth may include either picking up the work of the ailing firms by stealth or to acquire these practices as going concerns. Growing by stealth takes considerable time and effort, and a better policy could be to acquire the clients and assets of these firms. A later chapter will explore the threats and opportunities such a strategy represents, but it must be an attractive portion to many progressive firms to grow their business by acquiring other practices. Firms are encouraged, if this becomes part of their growth strategy, to ensure they have help in avoiding the obvious pitfalls of such a strategy such as successor practice rules, TUPE etc. and numerous other difficulties in forming a merger strategy.

A large number of sizable firms have just started to address the difficult issue of growth. For those who are still performing rather well the question needs to be asked as to how sustainable their business model is for the future. The male dominated age issue applies equally to larger firms. When 20–30 per cent of the current partners are looking to exit in the next couple of years it places a huge strain on the remaining partners to meet their capital repayments, replace the work they currently generate through existing well-established contacts, and ensure that there is significant access to working capital from the existing partners, the bank, and from potential third party investment to allow a smooth transition.

The traditional exit model was to promote salaried partners using lock step formulae to purchase equity over a period of time. There are two specific challenges to this model. First, the banks are reticent to lend to younger partners against future profitability. In fact the banks are extremely nervous about their exposure to risk within the legal profession – the demise of Halliwell and more recently Cobbets has left an uncomfortable feeling with bankers exposed to the high risks that some firms represent. Firms associated with property and certain disciplines, such as personal injury work, also carry a high professional indemnity insurance premium.

The most significant change in the provision of legal services is now here; hundreds of years of tradition and latterly the partnership model are now challenged as they never have been before. The growth of smaller independent practices is now one of the greatest challenges. There are circa 11,000 independent law firms, over 8,000 of them with partners with an average age exceeding 60 years. The majority of these firms have no succession or exit plans and no younger partners wishing to purchase equity in the practice. Not surprisingly, these partners have failed to plan for their future and are now facing some very difficult challenges ahead. The questions they are faced with is whether to continue to trade, although their turnover is dropping, their profits per equity partner are less and less each year, they are just managing to operate within their bank facility, they have no younger people prepared to purchase equity, their clients are also ageing, they do not understand the concept of client care, and they are facing pressures from fixed fees. Obviously not all firms fall into this category but many still do not have the vision or strategy for what their firm should look like in five years’ time.

Is it too late?
There are many challenges facing the legal profession, and access to working capital
is becoming even more of a major issue. This will be increasingly so as up to £300m is removed from the legal aid budget from March 2013 and as the effects of the Jackson Review ripple their way through the profession. If firms face an uncontrolled failure then the SRA will have to intervene to protect the clients whose affairs would otherwise be at real risk.

There are a number of fundamental differences between an intervention by the SRA where the intervention agent is seeking to protect the clients’ interests and that of an insolvency process which protects the interest of creditors and employees. Whilst the circumstances of the demise of Blakemores have been well documented, what happens next will be paramount in the future lending policies particularly when a charge is placed over the assets of the practice, including debtors and work in progress to secure the working capital needs of the firm.

In a formal insolvency, an insolvency practitioner is appointed and a process is followed, often over several years, establishing the true and realisable value of the debtors and work in progress resulting in a percentage pay-out to the creditors in due course. It depends on the extent of the insolvency as to how much that percentage in the pound is recovered and distributed.

In the case of a firm such as Blakemores there are literally thousands of files that all need urgent attention to protect the clients’ best interests. In an insolvency it is normal practice for these files to be heavily discounted to encourage firms to take on the work. Often the WIP on personal injury cases is only realised when the file is concluded at a percentage of the value recovered.

The immediate challenge in Blakemores is that there is no formal insolvency, at this time, of the practice which operated as a Legal Disciplinary Practice (effectively a partnership with non-solicitor members). Therefore employees cannot claim on the government redundancy fund and firms interested in taking over files will have no party to negotiate with in order to agree a discount or earn out basis for the files. They will have to give the usual solicitor undertakings on conduct of the files but how will an eventual liquidator react to their transfer?

Any lenders having security over the WIP and book debts will expect to realise the value for these specific cases yet if these are discounted to, for example, 30 pence in the pound (as was the case in Cobbetts) to protect the clients’ interests, who will be expected to make up the difference? How are the realisations allocated? Do they go to the intervention agent to cover costs or to the secured lenders? This is as yet untested territory.

The result could end up in litigation and the banks and specialist lenders will question the value of their security in such cases. If the SRA win the profession may have fewer costs on these cases but the dilemma will then move to firms facing the need for funding, particularly on personal injury and clinical negligence work, where the banks and specialist lenders will surely question their policy regarding such cases. This further exacerbates the challenges law firms are facing with the referral fee ban and the reduced fees through the portal.

The impact of Cobbets, Atteys, and now Blakemores are all high profile in their respective specialist and geographical areas. These are the early casualties in a fundamental shift in law firm survival.

It is more essential now than ever that law firms both operate and are run as businesses.

All change

The Legal Services Act did not sweep through the profession like a tsunami as
some had predicted, but rather as a gentle stream of increasing intensity that slowly but surely has begun to erode the foundations of the profession.

This has been somewhat surprisingly due to the recession and the attitude of the banks. The firms who survived found their banks to be unhelpful in increasing their facilities. Firms would often demand that their bank would increase facilities for whatever reason. In the good old days, pre-2007, banks lent accordingly. Law firms rarely went bust and these temporary increases in overdraft were considered the norm. The amount of clients’ money sitting in law firm client accounts was staggering and the banks (mentally at least) would offset the client account monies against bank borrowings for the firm. Additionally, with interest rates running at an average of 5 per cent, the banks would pay a premium to gain access to these funds. Firms made a substantial bottom line addition to their profits in unearned interest from client accounts. With base rates now stagnated for several years at 0.05 per cent there is no room for manoeuvre.

The lack of commercial and private client lending has also had an impact on this phenomenon; mortgagees and general lending is over 50 per cent down on pre-2008 levels. In many cases, and in other industries, the banks would have taken a more vigorous approach to dealing with ‘problem cases’. Many more firms would possibly have become insolvent had the banks adopted a more aggressive approach to law firm management as they did in the last recession back in the early 90s. Law firms were well protected in those days because interest rates peaked at around 15 per cent and it was the clients’ money that helped keep them afloat. At stagnant 0.05 per cent base rates there is little room for movement over the past three years or for the foreseeable future.

Gone are the days when a law firm would telephone their bank manager and insist on an increase in their facilities and would generally get what they wanted with little or no questions asked. That may be because the bank manager did not understand the position based on the simple fact that hardly any law firms ever went bust. The profession was full of elder statesmen who provided their bank manager with no management information whatsoever. Many of the partners did not know the true position until their accounts were completed at year end – no way to manage a business one might say.

Balance sheets could often show WIP and debtors that had only a 65 per cent chance of recovery – WIP unbilled for four years plus and debtors that had no intention of paying debts going back three or four years. Let’s put this down to the lack of management skills within law practices realising that their balance sheet and therefore their attractiveness to their banks were greatly enhanced by keeping these figures as they were. The true position was probably substantially less.

Most bank managers have now gone through Lexcel training and have a far greater understanding of valuing WIP, in particular for those firms involved in personal injury work where a simple RTA could take 15 months to settle yet the work was being purchased in from a claims management company for various up-front fees that needed funding. Couple that with an organised withdrawal of the specialist lenders for this type of work, and it is easy to see why many firms have reached a financial cross road.

Legislative enforcement
Not only has the Legal Services Act begun this change, but other legislations such
as LASPO are a further challenge to the working methodology and future direction of many firms.

Outcomes-focused regulation (OFR) will have a far greater cost and consequence than firms realise. The appointment of COLPs and COFAs was only the first step and even this caused a problem for many firms. Over 1,000 law firms either failed to appoint their COLP or COFA within the designated time scale or had their appointment rejected for various reasons including bankruptcy and criminal convictions for fraud.

The cost of compliance will become a burden which could be too much to bear for smaller practices and this could force merger talks. Talk of consolidation in the legal sector has existed for some time and this could just be the catalyst to move this inevitable process forward.

**Shut up shop and go home?**

Of course not, there is an exciting opportunity for firms who plan accordingly and set out a strategy for their firm. There may well be a high number of traditional firms that may eventually merge, become insolvent, or close down, but will there be an equal number of new firms to replace them? The USA has circa 460,000 legal practices and 412,000 of these are sole practitioners servicing their local community. Is this the model that will follow for the UK market? There are currently 100 new applications per month for new law firms – predominately sole traders operating as a limited liability company utilising the internet and managed offices for their premises. They can obviously compete favourably with their high street competitors with little or no overheads with a following that earns them a decent living. Many partners in rural and regional practices earn less than an average teacher so this can dispel the myth that all lawyers earn huge sums per annum.

The stark reality is that only a few of the partners in top 100 firms earn the profits per equity partner seen in the press. Therefore many new entrants will accept a lower income for a work/life balance.

**Is this a threat or an opportunity?**

The UK legal market represents an income of £29 billion which is approximately 2 per cent of the gross domestic product (GDP) in the UK and this has been slowly increasing despite the double or even triple dip recession that the UK has faced. How many industries can boast the same, albeit slight, increase in national turnover?

Simply put, whether or not the current market conditions are a threat or an opportunity depends on the firm and the actions they take. By reading this report it is hoped that firms will find the inspiration required for the challenges ahead.

**Reference**