

OPINION

■ Financial stability

Peter Scott

It is rather surprising that the Solicitors Regulation Authority (SRA), according to its Risk Outlook 2015/16, no longer views lack of 'financial stability' in a law firm as a 'high priority risk' for a regulator that protects people who use legal services, the operation of the rule of law and the proper administration of justice

The SRA explains that the purpose of its Risk Outlook is to:

- communicate its view of risk in the legal services market;
- demonstrate the priorities to which it will allocate its resources;
- explain how it will control these risks and act in the public interest; and
- help solicitors and firms manage risk.

And in the foreword to the Risk Outlook it states that:

'Delivering our role means striking a sometimes difficult balance – a balance between freeing up firms to do business, to grow and to innovate, and the maintenance of the quality and public protection that is fundamental to the sector.'

I would question how law firms can achieve any of those things if they are not at the same time managing themselves in a manner which ensures their financial stability as required by principle 8: 'run your business or carry out your role in the business effectively and in accordance with proper governance and sound financial and risk management principles'.

Sound financial management to create a financially stable law firm is intrinsic to and inseparable from everything else that requires managing in a law firm, including risk and compliance. On the other hand, if financial difficulty is experienced by a law firm then it is a serious risk on at least three levels:

- as the risk of a law firm failing financially;
- as an underlying causal driver of other risks (including some of the current risks included in the Risk Outlook); and
- as a major factor contributing to inadequate risk management.

Law firms are continuing to fail

The Risk Outlook indicates that there were 394 'disorderly closure reports' in the previous 12 months, although no indication is given as to the nature of such disorderly closures. Over and above such statistics, as the necessary process of consolidation in the sector continues, firms which are struggling financially continue to be 'rescued' by other (often predatory) firms, although these are unlikely to appear in the SRA's figures. And how many 'zombie' law firms are still practising only because they are being kept alive by their bankers? Law firm failures are, unfortunately, likely to continue. How many criminal legal aid firms will go to the wall as a result of the government's tendering process for new legal aid contracts when that saga is finally concluded? Some estimate that several hundred firms could fail as a result. Does the SRA

not regard that as a particularly high priority risk, and what steps is it taking to protect the public?

Similarly, as a result of recent legislative changes, many personal injury firms have already suffered financial failure and others will increasingly find that the future is likely to be bleak for them. Claimant personal injury work can be a difficult financial model to manage from a cash-flow perspective, given the large amounts of contingent work in progress carried for long periods until matters are finished and invoices paid. Unfortunately, some law firms are only now beginning to wake up to the fact that practising law carries with it political risk among all the other risks that need to be managed. Given the potential impact of government-driven changes, should not political risk, which can potentially lead to financial failure, now also be regarded as a high priority risk by the SRA?

What higher priority risk can there be to people using legal services and for the operation of the rule of law and the proper administration of justice than law firms which fail financially, with all the consequences for their clients and the people in those firms that financial failure can bring?

An underlying causal driver of other risks

When I saw the eight 'priority risks' which are set out in the Risk Outlook – all of which are serious issues in themselves and certainly need to be urgently addressed by law firms in order to protect users of legal services – I questioned whether the SRA is necessarily looking at these matters with the correct focus on risk if it is to be successful in ensuring that the legal profession really does come up with appropriate actions to put its risk management house in order.

The SRA's current priority risks as set out are:

- misuse of client money;
- lack of independence;
- money laundering – inadequate systems and controls over the transfer of money;
- information security and cybercrime;
- bogus law firms;
- failure to provide a proper standard of service;
- failure to act with integrity: improper or abusive litigation; and
- lack of a diverse and representative profession.

I would suggest that a number of those risk issues as expressed and commented on by the SRA in the Risk Outlook, while in themselves being serious matters requiring action, do not give sufficient focus to the underlying causes which bring about those risk issues – one of which is financial difficulty in law firms. Several of the risks listed above are likely to be direct consequences of firms' financial difficulties on which the SRA should be focusing to a greater extent.

When you consider one of the SRA's current high priority risks, such as misuse of client money, it is easy to see that there is usually a causal link between financial difficulty and misuse of client funds and no doubt the SRA has statistics to evidence this. Indeed, the SRA provides a case study of a senior partner in a medium-sized firm who, to support his lifestyle when he could no longer afford his loan repayments, made unauthorised withdrawals from client account. If that firm had been generating more cash and profits, that partner would probably not have been in such financial difficulty and would not have resorted to stealing client monies.

The existence of financial pressures on law firms can also have other far-reaching consequences. The SRA rightly identifies lack of independence as a risk issue and says that independence should not be overridden by the promotion of a client's interests, acceptance of a client's terms or a desire to maximise commercial return. It is easy to see how financial pressures can lead a firm to compromising its independence, as well as becoming involved in some of the other risk areas currently identified by the SRA, such as improper or abusive litigation.

A major factor contributing to inadequate risk management

The risk issues created by financial pressures go far wider than the above. At a risk and compliance conference at which I was speaking, I asked the audience how many of them employed a professional risk/compliance manager and only one firm out of the 50 present said it did. The rest said they 'could not afford to!' My response to that was to ask 'Can you afford not to?'

The issue for law firms is how to resource risk and compliance management cost-effectively. Large law firms recognise that managing risk must be treated as a priority and, given that they have the money to do so, they do tend to have well-resourced risk and compliance teams. I do not see the same thing happening in smaller firms. In a firm of, say, four partners (such firms comprise about 85 per cent of the profession), it is unlikely that the compliance officer for legal practice will be spending anything like sufficient time managing the firm's risks because 'time is money'.

The inability, particularly of smaller firms, to generate sufficient cash and profit is almost certainly one of the major reasons for their often inadequate management of those risks now identified by the SRA, including:

- failure to have adequate systems and controls over the transfer of money in relation to money laundering; and
- failure to manage risks that cybercrime presents to clients' money and confidential information.

From my own observations, I see a close correlation between financial strength and effective risk management. What should law firms do now to build financial strength?

On an operational level, firms need to take control of their cash flow to meet working capital needs because 'cash is king'. There is a need to build real capital to replace the shaky foundations of borrowed money. Above all, there needs to be an enthusiasm to embrace change and to invest in people and resources if cash flow and profitability are to be maximised.

On the strategic level, survival strategies are now urgently needed in the case of firms threatened by market forces, government legislation and new competitors with deep pockets and ambitions to match. Only those firms able to develop their businesses to gain a competitive edge over rivals will survive. This will drive further consolidation between smaller firms as they seek to provide the infrastructure now required to run profitable and compliant law firms. Complacency, on the other hand, will lead to failure of the profession to restructure itself, which carries the greatest risk.

Peter Scott runs his own professional consulting practice www.peterscottconsult.co.uk.