

# ■ Why law firms fail – and how to prevent it happening

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**In uncertain economic times, it's only prudent to think about the resilience of your law firm and what can be done to protect it from the possibility of failure**

A recent report from one of the major restructuring practices revealed that there are nearly half a million businesses in the UK in significant financial distress, an increase of 27 per cent compared with the same period the previous year. Some of those businesses are likely to be law firms. At the same time, last year one of the major accountancy firms concluded that almost half of all law firms had suffered a fall in profits.

Given these warnings and in the light of signs that economic growth is slowing, now is a timely moment to look again at the financial stability of the legal sector and, in particular, to examine the main underlying causes of law firm failures and work out how to avoid them.

A law firm is like any other business – it will fail when the cash runs out. In addition to all the other consequences and human misery caused by a business failure, from the Solicitors Regulation Authority (SRA) regulatory viewpoint, the consequences for solicitors can be dire:

*'We will not tolerate the reckless trading of firms into insolvency and where this happens we will pursue enforcement action under Principle 8, including referral to the Solicitors Disciplinary Tribunal where appropriate'* (extract from a speech of 18 April 2013 by Samantha Barrass, the then Executive Director of the SRA).

The SRA regulatory requirements as to financial stability include:

- **principle 8** which requires solicitors to *'run [their] businesses or carry out [their] roles in the business effectively and in accordance with proper governance and sound financial and risk management principles'*; and
- **outcome 7.4** which adds to the all-encompassing wording of principle 8 by requiring law firms to *'maintain systems and controls for monitoring the financial stability of [the] firm ... and take steps to address issues identified'*.

These mandatory requirements are supported by several indicative behaviours (IBs) in chapter 10 of the Code of Conduct:

- **IB 10.2** – actively monitoring financial stability and viability to identify any risks to the public;
- **IB 10.3** – notifying the SRA promptly of any indicators of *serious financial difficulty*, such as inability to pay a professional indemnity insurance premium, or rent or salaries, or breach of bank covenants; and
- **IB 10.4** – notifying the SRA promptly when you become aware that your business may not be financially viable to continue trading as a *going concern*, for example, because of difficult trading conditions, poor cash flow, increasing overheads, loss of managers or employees and/or loss of sources of revenue.

While no indication is given that the SRA is using the term 'going concern' in a technical accounting or auditing sense, an extract from a 'going concern' statement in the accounts of a limited liability partnership (LLP) law firm provides useful guidance as to the level of financial stability law firms should be aiming to achieve:

*'After making enquiries, the management team has a reasonable expectation that the LLP has adequate resources to continue in operational existence for a period of no less than 12 months from the date of signing the financial statements. Accordingly, we continue to adopt the going concern basis in preparing the annual report and financial statements.'*

## Why do they fail?

While an examination of law firm financial failures will reveal myriad symptoms, the underlying causes of financial failure can usually be summarised in just a few broad categories and the following definition of 'competition' can be usefully used to identify these:

*'a process by which services that people are not prepared to pay for, high cost methods of production and inefficient organisations are weeded out and opportunity is given for new services, methods and organisations to be tried'* (Everyman's Dictionary of Economics)

This definition serves to illustrate a number of the underlying causes of law firm failure (as opposed to mere symptoms), and by applying it we can see why law firms are likely to fail. I would emphasise, however, that financial failures are usually the result of a combination of several of these causes and not just one single factor.

## Strategic level: market risks (including the impact of government legislation)

### Offering services that clients no longer want

Law firms must be sufficiently agile to ensure they position themselves to always provide what their markets want, as well as being able to ride the adverse impact of economic headwinds and government legislation (which can kill a market). The vicissitudes of conveyancing and legal aid work serve to illustrate this. Employment lawyers suffered when new employment tribunal charges were introduced, and now no one knows the financial impact Brexit will have on law firms. If there is no demand for their services, then law firms have to take remedial action, otherwise they will potentially fail.

Law firms should be finding out from their clients and referrers of work what areas of advice they are going to want from lawyers over the next two to five years and then put in place clear and achievable plans to ensure they can meet those needs. What is clear from client perception surveys is that clients no longer want generalist lawyers – they demand specialists – and so building focus within a firm around work

types and client types is critical. At the same time, building client satisfaction (often said to be the only sustainable competitive advantage) is vital for survival and listening to clients will identify what client satisfaction means for them.

### **Offering services where clients only see 'value' for them in terms of low prices**

A legal service may be in demand, but if clients only see 'value' being provided to them by that work being offered at ever lower prices then, unless a firm can reduce its prices to a level that clients are prepared to pay and which will still provide it with an acceptable margin, that law firm is eventually likely to fail.

In this race to the bottom, law firms which have built their competitive offering on commoditised work, low prices and tight margins need to keep extracting more and more 'value' for clients out of diminishing prices. Ultimately, something has to give.

Criminal legal aid, conveyancing, defendant insurance work, wills and now some personal injury, to name but a few, are examples of where downward pricing pressure has caused serious financial difficulty for some law firms and put others out of business. To continue to do such work profitably requires heavy investment in IT and processes and, to stay the course, needs deep pockets. Otherwise such work should be dropped.

### **Offering services using a business model that is not financially viable**

There are also areas of work which at first sight may appear highly profitable but which may lead to financial failure due to the business model they employ. An example is claimant personal injury: that is an area of law that has probably seen more law firm failures over the past 10 years than any other. The underlying reason is that the business model requires a law firm to fund large amounts of contingent work in progress, which may take a number of years to complete and all before the firm is paid. Managing the cash flow pressures involved in that type of business requires high levels of financial expertise, which are unfortunately too often in short supply. Ultimately, banks and other creditors, who see their exposures increasing, take fright or lose patience and 'pull the plug'. And, as regulatory and governmental pressures on the personal injury sector have increased, the financial shortcomings of the model have been exposed, with resultant failures.

### **Operational level: organisations not fit for purpose (including lacking leadership and financial expertise)**

Disruptive change in the legal sector is happening at an ever-faster pace and will not stop. Firms that ignore this will not survive.

Traditional organisational structures which have served their purpose in a slower moving and simpler world are no longer sufficient to meet the challenges facing law firms. They must now, to survive, consider afresh how they organise themselves to meet these challenges.

Law firms must be agile if they are to successfully identify and respond quickly to threats to their businesses (e.g. market risks and government legislation as referred to above: 'Offering services that clients no longer want') and take advantage of opportunities. To be agile, law firms must: focus strongly on change management; have quick response times to threats and strategic opportunities; have streamlined decision-making; and, above all, have people who are open-minded, flexible and prepared to learn new skills and ways of operating.

The following quote from *A Survival Guide to the Stress of Organisational Change* is very apposite here:

*'The organisation is going to change – it must – if it is to survive and prosper. Rather than banging your head against the wall of hard reality and bruising your spirit, invest your energy in making quick adjustments. Turn when the organisation turns. Practice instant alignment.'* (Price Pritchett and Ron Pound, 1997 Pritchett & Associates, Inc.)

How should law firms change to become fit for purpose and survive? Here are some pointers to actions which will directly impact on a law firm's ability to do this.

### **Review what needs to be managed**

This should cover:

- people and their performance;
- functions (including finance, risk, compliance, IT, knowledge management, human resources and business development);
- business strategy (see above: 'Offering services that clients no longer want'); and
- necessary organisational change.

### **Analyse and enhance the effectiveness of current organisational structures (in particular leadership and finance)**

To survive, law firms need to put in place a 'top team' to perform the roles and to streamline their decision-making. This will require, as a minimum, investing in effective leadership and high-quality financial expertise. As law firms grow in size and complexity, there is a corresponding need for enhanced financial expertise.

It may not be palatable to some partners to see what they regard as more 'admin staff' being taken on, but it has been the downfall of many firms to starve the finance function of essential financial expertise. A number of recent law firm failures seem to have come about partly because of financial mismanagement and failure might have been prevented had the firms received (or listened to) better financial advice.

Paying for a high-quality finance director not only makes good financial sense, but, increasingly, banks, which need to have confidence in a firm's financial viability, are pushing law firms to replace those currently managing finance with more suitably qualified and experienced professionals.

Other steps needed to enhance financial performance and stability should include:

- training the firm's people to understand finance;
- measuring and analysing financial performance;
- reporting on what really matters for the business;
- actively managing performance of the firm's workforce;
- putting in place a cash-generation plan linked to sanctions/payments;
- pricing and managing work for profit;
- fully capturing matter-related time;
- managing recovery (realisation); and
- applying zero-based budgeting, especially to people costs, to run on lean burn.

### Change the culture

Law firms must be run as businesses and business-oriented 'cultures' need to be encouraged to underpin financial stability. Unlike a crisis which can force partners to change, just offering 'carrots' to partners to perform differently will usually achieve very little, particularly if they can live comfortably on their monthly drawings.

There also needs to be created an enthusiasm to embrace change. To achieve outstanding financial performance requires a continuous investment in people, services and resources if attitudes are to change and new working practices are to be implemented to re-engineer the way the business is managed.

Innovation is not just about technology – it is often more about the people in the business working differently.

Survival strategies are now needed as law firms are threatened by market forces, government legislation and new competitors with deep pockets and ambitions to match. Complacency is the greatest threat and will lead to more firm failures unless lawyers face up to the disruptive changes now impacting on them and, to paraphrase the sage words of Jack Welch, change before they have to.

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