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Managing Law Firm Profitability during a Recession

Recessions change the rules of the game in all industries. The legal sector is no exception, and the urgency of change is even greater for law firms than for many other businesses. This recession coincides with the Legal Services Act of 2007 to put unprecedented pressure on law firm margins. To put it simply, with a shrinking economy and the potential for external capital to enter the market and Multi-Disciplinary Partnerships to encroach on the traditional market share of smaller and medium-sized firms, the issue of law firm profitability is more crucial than ever.

Law Economics and Law Politics

Recessions change mindsets. This means that partners are willing to accept and implement changes that would have been unpalatable during prosperous times. Recessions also rebalance the economy, and mean that different services come into demand.

This all means that a recession provides an opportunity to drive through fundamental change that is essential to the survival and prosperity of a considerable proportion of the legal market, and which would otherwise have been impossible.

In a partnership, politics usually defeats economics. In a recession, law economics must defeat law politics.

Step 1 – Managing Cash Flow

Law cash flow is key in the first place - without it bills, staff and partner drawings cannot be paid. At this stage, the bank may become involved (according to The Lawyer, 20 October 2009, 'Around 500 firms have been referred to the so-called intensive care units (ICU) of their banks because they are facing financial difficulties'). Morale is affected and reputations suffer, and staff and clients may even begin to leave. On the other hand, if cash flow is effectively managed then the opportunity is there to overtake less efficient competitors. A strong cash flow situation will leave firms on a sound footing to take advantage of countercyclical service opportunities, drive through internal efficiency changes, invest in the appropriate support and technology, and recruit high-calibre staff.

Establishing appropriate levels of work-in-progress, outstanding debts and disbursements, and implementing a process to achieve these levels is something that an experienced Finance Director or Consultant should be able to achieve fairly quickly. It is, however, something that many law firms have demonstrated themselves incapable of achieving independently in the past.

Step 2 – Managing Costs

We do not advocate wholesale, across-the-board cost cuts where avoidable. Before any cutbacks are made, in-depth analysis is required of the firm's costs and revenues, in order to establish which areas are vital to the business's success, and which are less important. Assessment of client profitability is an important part of the self-assessment process.

The next stage is to reassess underlying cost structures. Law firms have traditionally been described as 'fixed cost operations'. The key to managing costs in a volatile or fluctuating economy is to turn these fixed costs into variable costs wherever possible. There are a number of areas in which this is achievable, although it may not always be a welcome change. However, one of the lessons quickly emerging from the current downturn is the need for flexibility with regard to capacity, in order to avoid knee-jerk cutbacks and redundancies.

There is considerable room within most law firms for flexible staffing arrangements. Part-time and flexible contracts and performance-related incentives in areas such as property reduce liability during a downturn, while leaving room for expansion when the market picks back up. Likewise, technology outsourcing is an efficient and cost-effective way of managing what would otherwise represent significant fixed costs.

Step 3 – Business Services and Counter-Cyclical Opportunities

Analysis of the firm's service offerings is crucial to maintaining profitability in the long-term. Some areas will simply be unprofitable, others suffering in the short-term but with long-term potential, and still others will emerge as strong areas in which investment would be rewarded. Consideration must be given to both the practice and the market within which it operates. This is tied up with Step 2 above, to establish how much capacity different practices require.

A recession will always present opportunities in counter-cyclical areas. Examples in the legal sector include Insolvency, Debt Collection, Employment (Employer and Employee), Corporate Restructuring, Family, Mortgage Repossession, Professional Negligence (valuations), Personal Injury, and Outsourcing Advice. Flexible staffing and technology arrangements can mean that increasing workloads in counter-cyclical practices allow falling revenues in other areas to be offset. This often requires the attention of a Business Development Director, and a Sales and Marketing Manager or Consultant, to put in place a plan and a strategy for achieving it.

Step 4 – Investing the Winnings

The steps above should have facilitated cost savings and cash flow improvements, and highlighted areas in which falling revenues can at least be offset by intelligent business development planning and marketing. However, the key to long-term profitability is to invest the savings wisely. For some firms, this will be difficult as the abovementioned steps will have succeeded in putting them back on an even keel, but margins will still be tight. The necessary investments should be made as soon it is feasible.

Areas that are often neglected by law firms include training, support and technology. One of the keys to minimising (expensive) staff turnover is to ensure that all staff feel adequately valued and supported. This means not cutting back on support when times get tough, and indeed making sure that leverage is sufficient to allow fee-earners to work as efficiently as possible. Technology is also important in supporting fee-earners and support staff. Often, technology requires an initial investment but will pay for itself through

long-term cost and efficiency improvements. This is the case with digital dictation software and IT outsourcing, in order to ensure compatibility. Training is a crucial area for investment, not just for technical expertise, but in the management and ‘soft’ skills that will allow staff to succeed in senior roles
within the firm.

Conclusion

The most important ingredient here is vision. A firm must know where it wants to be in five years’ time, and must work back from that vision to develop a strategy for achieving it. This strategy must be integrated, and must involve a holistic approach to business development. Simply ‘burying heads in the sand’ until recession passes is not a viable option for firms that want to continue to prosper in the 21st Century.

Please feel free to contact us for further advice on Financial Management or Business Development.

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