Law Firm Failure - A Different Dynamic

It is now over three years since we delivered our first seminar on the dynamic of the changing legal market in which we highlighted the eventual extreme squeeze on the middle market – which we termed the 'Gastric Band'. This topic has been taken up by other commentators and been shown to have its counterparts in other markets in the form of the "hollow middle".

The primary focus of attention has been the impact on small to medium-sized firms and particularly provincial "high street" firms, and there are regularly alarms sounded about the imminent collapse of the high street, with predictions of several thousand potential casualties in the coming years.

In fact at the moment these predictions are being confounded and debate rages as to whether this is a permanent return to the good times or a last Indian summer for the old model before the forces of competition bite. For the record, we believe it is the latter. Nonetheless, the revival of the housing market and an increase in recorded completions of over 25% has helped many smaller firms to have a much better year. Let us hope that it does not lead to complacency.

From time to time I am asked where the squeezed middle starts and my answers have always been consistent, but I think probably start at about number 30 in the league tables. Most firms above that point have a range of strengths which will allow them to dictate their own future. Interestingly, both the PwC and Baker Tilly reports suggest that there is a widening gap in performance between the top 25 and the remainder of the top 100.

It was particularly noticeable in one of the recent Association of Partnership Practitioners (APP) seminars that restructuring practitioners identified a specific category of firms at risk, namely the medium-sized full-service firm.

Failing Firms – Symptoms and Remedies

The recently published American bar Association book "The Failing Law Firm – Symptoms and Remedies" by David J Parnell analyses the experience of 42 American firms which have failed in recent years. It gives a potted history of each of the 42 and goes further into analysing the main contributory causes of failure in each case and codifying them.

The main contributory features identified were:

- Lack of diversification;
- Scandal;
- Cultural issues;
- Overexpansion/debt issues;
- Governance and compensation issues;
- Strategy issues;
- Failed merger attempt; and
- Mass defections.

The pattern over the last 20 and 10 years is shown below.

	Last 20 Years	Last 10 Years
No of Firms Analysed	42	17
No of Lawyers	12295	7450
Average No of lawyers	292	438
Average age of Firm	81	85
Contributory reasons for Failure		
Lack of Diversification	7	5
Scandal	8	4
Cultural Issues	15	4
Over Expansion / Debt Issues	10	5
Governance & Compensation Issues	31	14
Strategy Issues	25	9
Failed Merger Attempt	22	8
Mass Defections	33	12

Source: David J Parnell, *The Failing Law Firm – Symptoms and Remedies,* ABA Publishing (2008)

Given the financial pressures on firms and the apparent importance of the debt burden in recent high profile UK failures such as Halliwells, Cobbetts, Blakemores, Manches and Davenport Lyons, it is a little surprising to see that debt issues are a major contributory factor in less than a 3rd of the American examples. However, this may partly be explained by the different accounting requirements. The use of accruals accounting in the the UK requires firms to record a profit based on the generation of work in progress and bills rendered, whereas the American system of cash accounting does not. As a consequence UK firms can be tempted into distributing profits before they have been collected, forcing them into borrowing money to make distributions to partners. This does not apply in the USA.

Governance, Compensation and Defection

The two things that stand out both in the 10-year and 20-year profiles are the predominance of governance and compensation issues, and mass defections. These appear to be very closely related. Governance and compensation issues primarily relate to the increasing divergence in the spread of equity partner remuneration which has gathered pace in the USA since the turn of the century and has reached the point where, in some major US firms, the highest-paid partners are earning over 20 times as much as the lowest. As Parnell and others have pointed out, this is stretching the concept of partnership almost to breaking point.

Research by various specialists, including Mark Brandon of Motive Legal in the UK, has shown that the use of lateral hire partners has increased since the turn of the century. Brandon's research has also shown that it is a distinctly fallible strategy and that up to half of all lateral hires are ultimately deemed to be unsuccessful. Other authors, including Bruce MacEwen of Adam Smith Esq and Ed Reeser, have demonstrated that lateral hiring is:

- A key part of the growth strategy of most large firms;
- Not even a zero sum game due to a large element of transaction costs.

Parnell demonstrates how the lateral market has grown and partnership has become less stable. Previously, partnership was expected to be a long-term commitment and partners could accept the fluctuations in fortune which tend to follow the business cycle over the longer period. This started to be eroded by the publication of league tables of firms' performance, and particularly the ever increasing pursuit of profit per equity partner (PEP). Alongside this, partnership rewards have become increasingly tied to performance, which itself has become far more short-termist.

The publication of league tables has forced home to many partners the opportunities that they forego by staying in an underperforming firm. This puts the firm's leadership in a difficult position. In order to maintain a competitive level of PEP and attract new talent into the firm, they desperately need to hold onto the top performers and the rising stars, whose personal performance may be greater than their position in the lockstep. In some cases, the top performers are easier to deal with in the short-term because they also usually carry considerable political influence and could be accommodated with some changes to the remuneration. Rising stars are much a more difficult issue because any adjustments to their remuneration would impact noticeably on the others, including those with the current powerbase. The rising stars are also the ones most attractive to other firms. Of course, the publication of league tables has meant that it has been easy for the recruitment specialists to target rising stars developing their reputation in underperforming firms.

Time is of the Essence

Above all, managing partners have needed time to improve the performance throughout the firm, but particularly to address underperformance (and by implication over-reward) in the lower performing reaches. Unfortunately, time is the one thing that the increasingly open market does not permit. Unless the firm can find a way to reward the rising stars, the firm will find itself on the wrong end of a sequence of defections. This in turn threatens to leave the firm committed to fixed overheads but without the full level of income with which to pay them – thereby causing the start of a vicious cycle: lower income leading to lower profits, which lead to defections, which in turn lead to still less income and so forth.

Once this dynamic is underway it can be very difficult to reverse. In fact, in many cases the only way to construct a viable solution in the short-term is to seek a merger with a stronger partner. Hence the appearance of the failed merger in the table of causal factors. Managing partners are therefore damned if they do and damned if they don't. If they seek a merger and word gets out in the wider firm, they run the risk of defections at all levels, not just by partners. If they don't seek a merger, potentially they are condemning the firm to a slow and steady loss of the main sources of income.

Open markets are dispassionate and unforgiving. As this dynamic takes hold, firms need to act quickly and decisively (not always a strong point of partnerships). For those firms with some unique attribute or particular market niche it is possible to foresee a vibrant, profitable future by bringing something special to the market. For full-service firms which are good but not exceptional it is hard to see how this syndrome can be avoided as a competitive market develops an increasing intensity over the next 10 years or so.

It was always to be expected that the deregulation of the legal market would bring developments which made the legal sector far more similar to other capitalist enterprises – and of course capitalism is about risk and reward. The star system and the increasing impact of the lateral hire market mean that the legal sector has an additional dimension to deal with, potentially undermining stability.

A Source of Relief

However, there may just be one feature that could reduce instability, at least at partner level. Once a firm hits difficulties, the big risk is of mass defections – which finish the firm off. However, if a partnership does become insolvent the partners are entitled to terminal loss relief, which can be extremely valuable and which can make an orderly reorganisation of the firm possible and economically viable to the acquiring party. Terminal loss relief is not available to those partners who left prior to the insolvency. It may therefore actually be in the best interests of partners in a struggling firm to stay with it to the end rather than to abandon a sinking ship. There has been a certain amount of publicity recently for the case of former Cobbetts partners who have been seriously disadvantaged in this way.

It is unlikely that the forces of competition will abate and that law firm failures can be avoided in the coming years, but it may be that the restructuring can be achieved in a more orderly manner than elsewhere.

It may just be that the bottom half of the top 100 is no safer place than the high street.

Please email barry.wilkinson@wilkinsonread.co.uk