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How small law firms can survive the storm

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The public may believe that lawyers thrive in bad as well as good times. But it is becoming clear that some smaller firms will not survive the turmoil of the downturn.

The largest and most international firms may suffer as their larger transactions and financings dry up but they are big, profitable and well managed enough to weather the storm, even if their profits significantly reduce after 15 years of increased revenue.

Smaller firms with a bedrock of residential and second-tier commercial property conveyancing face many challenges. Fewer transactions and the unavailability of bank debt means 50 per cent less activity. As, in the short term, costs are fixed, this effectively leaves them operating at a loss. Redundancy costs, initially, increase the losses as they try to adjust their headcount to reflect business levels.

If this were not difficult enough, many smaller firms entered the new professional indemnity insurance year on October 1 having to pay significantly higher premiums – up to double if they were heavily focused on conveyancing, with a poor claims history or had been the subject of past disciplinary action. Those that could not find cover fell into the assigned risk pool – anything other than a short stay here is likely to be terminal.

A tight market shows starkly the well-managed firms and those that tightly control costs and their work in progress and debtors. In such a market, clients will take advantage of a firm's poor billing and credit control by challenging invoices and delaying payment, soon reducing cash flow to a trickle. Law firms, too, often treat work in progress and debtors as the equivalent of cash, but they cannot be used to pay wages or rent.

Bankers increasingly are becoming fairweather friends. Credit lines are being reduced with large arrangement fees and margins over base charged for any that is available. Requests for more working capital or partner distributions will ring alarm bells – with many firms facing an increasing cash squeeze. This will become particularly stark at the end of January when the partnership income tax bill needs to be paid. HM Revenue & Customs is unlikely to be sympathetic – Alistair Darling has already spent the money.

With this confluence of pressures, firms can also expect more scrutiny from the Solicitors Regulation Authority (SRA). There have been a record number of interventions this year. If the SRA is not seen effectively to supervise firms, the newly established Legal Services Board will be on its case. Firms must be scrupulous in their dealings with the SRA and their handling of client money if they are to avoid compounding their difficulties.

All is not gloom. As in any difficult market, some will thrive. Mergers may result in larger, better-run and more strategic firms (although some will simply produce larger, more troubled firms), well positioned to benefit when the market turns for the better. Mergers with problem firms will be difficult as the acquirer usually automatically assumes responsibility for the target's professional indemnity claims, which can be the ultimate poison pill.

Law is still a massively unconsolidated industry and many firms have underinvested in IT, recruitment, training, marketing, internal systems and their brand. A degree of consolidation should help to create more robust and balanced businesses capable of surviving this turmoil and then thriving as the markets recover. Identifying these opportunities – and then executing them – will put extra pressure on leadership. They must be careful not to be too preoccupied with fire-fighting, so allowing some great opportunities to pass them by.

Although many firms are focused on short-term survival, they must be prepared for the increasingly changing, client-focused and more competitive legal market that lies ahead. If they are not, the smaller firms that manage to survive the economic downturn risk being swept aside by the tsunami of new and invigorated competition unleashed by the Legal Services Act.

Running a law firm is never easy but, as I know from bitter experience when Andersen exploded and Garretts dissolved, it is far easier than dissolving one.

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