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The Survival of the Fittest

13th October 2008

The current downturn is starting to bite hard on the legal profession following a near 15 year bull run. The position may look bleak and will be brought home when firms prepare their first half figures and realise that the second half will, for most, be worse. However, as always, firms that are well positioned, well run and in a good cash position will use this period of turmoil to improve their market position and to emerge far stronger when markets finally turn for the better.

In the meantime, to spot the likely winners and losers one can look for a range of indicators:

Cash is King. Firms with good cash balances and relatively low debt accompanied by almost obsessive control of work in progress and debtors can survive and flourish in these turbulent times. WIP and debtors are not cash in the bank and some never will be. Bankers want their money back and any available borrowing is much more expensive.

Keep the best and ditch the rest. The gearing model significantly increased equity partner remuneration in the bull market. In a bear market it represents an underperforming high fixed overhead. Put simply, a firm with a 25% profit margin whose fee income falls just 20% will see profits fall 80% in the short term as most costs cannot be adjusted quickly. Firms need to decide which of their people (equity partners, salaried partners, associates and support staff) they want to have in three years time. These people need to be focused on the best work, which produces both short term cash and long term value. The rest are expendable. High salaries make this issue urgent especially as high redundancy costs mean that any cost saving will not materialise for at least six months.

Leadership and Management. Holding a firm together in such a period will require effective and firm leadership and efficient management. Surprises and inconsistent messages destroy trust. Clear and honest contingency plans are needed to adjust costs not knee jerk reactions, which destroy long term value. Good and bad leadership will be clear to see.

Failure is good for the survivors. We have about 13,000 law firms in England and Wales, mostly sole practitioners and small firms. By 2011 at least 3,000 will disappear through merger, dissolution, retirement, insolvency and SRA intervention. The survivors can grow market share, extend geographic or practice coverage and depth and improve their client portfolio. Mergers may be problematic due to premises and employee issues and the poison pill of successor liability for PI claims but the able and strategic will navigate these hazards.

Culture will out. A partnership where the partners trust and respect each other and where the associates and staff trust the partners is most likely to survive. The LLP regime is untested in these conditions. For a general partnership, where all partners are at risk for all of their assets, the possibility of the nuclear option concentrates partner's minds and keeps them focused on a co-ordinated solution (and I bear the scars of this from the dissolution of Garretts in 2002 following the collapse of Andersen). Will partners whose sole exposure is their capital account and current year profit share behave so well if they have an attractive offer from a solvent firm? Rapid spirals of decline of the sort seen in the US with Heller could happen here.

Are the vultures circling? In January 2009 many firms will face their first cash crisis when they have to pay their partnership tax bill. Deferring income distributions and making capital calls will be the next problem. Ghoulish perhaps, but firms in difficulty with some good practices will be a happy hunting ground for strategic predators. This may not be pretty but as Charles Darwin noted in relation to evolution "it is not the strongest of the species that survive, nor the most intelligent, but the most responsive to change".

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