

Getting out of trouble: The art of managing a successful turnaround

Restructuring a struggling law firm can be a huge undertaking. Yet, if other avenues have been exhausted, going into administration may well protect clients and staff and ensure there is some return for creditors. Clearly, the best advice is to avoid an insolvent situation and effect a turnaround – reacting early to issues as they arise.

Turning around a troubled law firm can be complex. Increasing financial distress, mounting operational challenges or inconsistent cash flows tend to hasten a firm's decline. Issues should be addressed early. If it is left too late, and you run out of cash, you face the real prospect of administration.

Reorganising debts or selling off non-essential assets can put a firm back on an even keel. However, legal practices experiencing more than a spot of financial bother may be forced into entering 'pre-pack' administration. As a last resort it can be a lifeline for failing law firms, allowing the healthy parts of a business to survive – making the best out of a bad situation.

Sometimes seen as a controversial insolvency route, this widely employed solution allows for a quick sale. It also means jobs are preserved and generally results in higher returns for creditors.

Near-term headwinds

Pre-pack administration can also be used as a consolidation solution by struggling insolvent legal practices to sell a firm on to a new, stronger buyer. Although the UK economy has picked up since the financial crisis, there are strong headwinds building for many law firms – especially in the mid-market bracket.

“Unfortunately, there are currently too many law firms,” Steve Cottee, a partner at Pinsent Masons, told assembled guests at Barclays' Professional Practices: Restructuring and Turnarounds breakfast event in London.

“The 'big four' accountancy firms have all set up their own law firms and are starting to win corporate work from mid-market law-firms. US law firms, too, are searching around for UK partners and they see London as good value with Brexit uncertainty and the declining value of the pound.

“In addition, law firms are susceptible to cyber-attack, which can bring monetary losses and reputational damage. There are also the severe legal aid cuts to criminal and family law work, which is affecting these firms.



“And for consumer law firms there are strong headwinds around personal injury reforms, which have resulted in low fixed fees and the inability to charge success fees for this type of work. The requirement to take holiday sickness claims to trial is also causing a number of law firms cash flow difficulties.”

Are you cracking the WIP?

A 2017 survey by PwC found that the average lock-up for UK law firms was 135 days¹. Lock-up is defined as the time it takes to convert work in progress (WIP) and debtors into cash. It means many law firms are not being paid for work until five months after they have started that work – 110 days is viewed as the ideal benchmark for lock-up. Delays make it harder to pay staff and overheads on time.



“Law firms need to be collecting cash better,” warns Cottee, who has experience in all aspects of restructuring in the professional practices sector. “We see profitable businesses fail just because they’re not getting clients to pay the bills.”

Unhealthy cash flows can lead to a law firm becoming financially distressed. This can quickly turn into a cash crisis, which can be tricky to recover from. Firms become insolvent on a cashflow basis when bills cannot be paid as and when they fall due and there is no scope to raise cash on a viable basis

“In the worst situations it can be binary as to whether a law firm survives a really bad cash crisis,” says Philip Watkins, a partner at FRP Advisory, which specialises in turnarounds, transformation and restructuring.

“You give yourself more time if you act early high up on the decline curve; there you have less operational and financial stress and more chances of effecting a turnaround.”

Sparring partners?

The structure of law firms – the majority of which operate either as limited liability partnerships (LLPs) or partnerships – can lead to complications when restructuring solutions and potential mergers are mooted, especially around personal liability.

“Are these partners liable as true partners for the debts of the partnership?” reasons Cottee. “Did they have capital in the business? Did they have a say in decision-making? Were they held out as true partners?”

“Often, you have this dynamic where certain categories of partners are keen to ensure they haven’t got personal liability. You also need to look at partnership agreements carefully, especially notice provisions. Can all the partners leave in one go if a firm gets into difficulties? And is capital repaid immediately to those partners, or is it payable over a two- or three-year period?”

“Ideally, you need to stop the flow of partners and cash going out the door. Waiting-room provisions in partnership agreement will lock partners in.”

There are also off-balance-sheet debts to factor in – partner capital loans, overdrawn current accounts and personal guarantees.

“It amazes me how much debt some firms get into,” says Watkins. “Off-balance-sheet debt often needs dealing with by the successor practice. Partners need to remain solvent, they can’t go bankrupt if they wish to continue to practice.”

With any insolvency of a partnership or LLP, terminal loss relief – where a partner can reclaim tax already paid from previous years – also comes into play.



“It’s definitely something to be aware of when restructuring an insolvent professional practice,” adds Cottee. “Effectively, any terminal loss relief claims will end up back with the partners direct. It’s often used to ensure that these partners are protected from bankruptcy on the other side.”

Administration process

The most common form of administration for law firms is a pre-pack, where assets will be marketed for sale prior to a business being put into administration. If a buyer is found, assets will transfer to a newco and the old legal entity will enter administration in one legal move.

Administration is far from easy. Marketing must be done discreetly; otherwise partners and staff can get wind and leave. Clients, too, may demand their files back.

Costs can be high for successor firms; professional fees, TUPE obligations for employees having to make up shortfalls in client accounts, dealing with partners’ personal liabilities, and ensuring they have the necessary professional indemnity cover in place often means that less is paid for WIP and debtors resulting in smaller amounts being available to creditors.

“You need an educated purchaser,” says Cottee.

“They must get their heads round these additional factors quickly and build these factors into their offer price.”

Administration, though, is preferable to a winding-up – a court order forcing an insolvent company into compulsory liquidation. A winding-up petition will lead to a law firm’s office accounts being frozen, with the very real possibility of client money becoming intertwined.

“For law firms, a winding-up petition is pretty fatal,” says Cottee. “The Solicitors Regulation Authority (SRA) will intervene if client money is at risk.”

Regulatory intervention

The law profession is a highly regulated sector; the SRA has the power to step in if a law firm looks like it is sliding towards an inglorious end. The SRA will appoint intervention agents to take control of client files and accounts. All partners involved in an

intervention will automatically lose their practising certificates.

“It’s fairly disruptive; nobody wants the SRA to intervene – costs can be huge,” says Cottee. Even without intervention, law firms – unlike other sectors – will need to appoint a ‘solicitor manager’ who reports to the SRA on the progress of the administration. The SRA will also want all files archived, not destroyed.

“The SRA is there to protect client interests, which is good, but dealing with a highly regulated sector often means less money being available for creditors,” says Cottee.

Regardless, the success or otherwise of a law firm’s turnaround depends on a step change to that firm going forward.

“It may require a change of management, closing an office or pulling out of a type of work,” says Watkins. “You will also need a realistic plan that has buy-in from all stakeholders, including partners, staff, clients and funders.

“If nothing fundamentally different changes to the way the practice operates, it is very much twiddling the knobs – the chances are you will just carry on down the decline curve.”

Key takeaways

- Legal practices are facing strong headwinds in the marketplace
- Restructuring and turnaround activity likely to increase
- Pre-pack administration is a widely employed solution used by to enable struggling law firms to achieve a return for creditors and protect client files and client monies
- Going down the pre-pack administration route can be a complex process for law firms
- But managed well, clients can be protected and creditors can get some return.

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¹ <https://www.croweclarkwhitehill.co.uk/wp-content/uploads/sites/2/2017/09/Law-firm-benchmarking-2017.pdf>

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