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Size Matters – The future for Criminal Law Firms

It may not be obvious at the moment but before long Criminal Law Firms will be looking back at October 2011 as the catalyst to changes that either secured their long term future or led to their demise.

At the start of October we saw the introduction of Ministry of Justice reforms leading to much reduced fees for criminal and civil work followed three days later by the introduction of alternative business structures (ABS's) via the Legal Services Act.

Cuts in fees will hurt firms whatever their size but larger firms will be far better equipped to deal with the financial pain via commoditisation, IT systems, and a smaller ratio of fixed costs to turnover (economies of scale). Indeed, the Government will not only benefit from a direct reduction of legal aid costs but also indirectly, via firms closing and consolidating. Hence the number of contracts being serviced by the LSC (as is) becoming fewer in number but larger in size.

Whilst most practices will at least be aware of the cuts that have been put in place they are less likely to have considered the effect of ABS's. Indeed this development is likely to be even more devastating for smaller firms than the legal aid cuts.

But why?

Many firms who have LSC contracts will doubt that external investors would be interested in getting involved with legal aid funded businesses. Viewing things from a small practice perspective this is hardly surprising. But imagine a large commoditised practice turning over millions of pounds via legal aid. The advantages larger firms have mentioned above (especially economies of scale) would mean reasonable profitability even at low margins – something small practices could not compete with. Add to this the guarantee of constant cash flows and low entry costs and the attraction to outside investors getting involved in legal aid suddenly appears more realistic. Indeed the returns on a much reduced legal aid budget would still be competitive with many other industry sectors.

The MoJ could then provide legal aid via a few very large suppliers at much lower cost.

Lord Carter's proposals in 2006 suggested a need to move to bigger providers – this did not happen partly due to resistance from some sectors of the legal industry. There will however be no such restraints with ABS's since this will help provide a free market economy where supply and demand will be able to find their own natural level.

It is not just financial input that outside investors can inject. Some firms have already benefited from 2009 legislation that allowed non-lawyer managers into law firms. The ABS scenario can build on this further by bringing business skills into larger firms to ensure success. This can only help to widen the gap between large and small firms.

So what is the answer for the smaller 'high street' legal aid practice? It's easy to suggest not doing legal aid work but what replaces it? Private work is scarce in the current economic climate and with more and more firms wanting a slice, margins in this are falling too. To survive therefore, consolidating with larger firms might be the answer. Small firms however should get their houses in order before looking for a haven – there will be many such smaller firms, all thinking along the same lines in the next few years. It is therefore important to try and bring efficiencies and productivity to a maximum now as larger firms will want a quick integration into commoditisation to maintain the slim margins and will be able to call most of the shots. Sadly, many firms will be viewed as beyond redemption by larger outfits and will simply be forced to cease trading.

There is also a message for larger firms – size really will matter so acquisition and organic growth should be at the forefront of policy thinking. Robust business and cash flow modelling is essential as the danger of overtrading is a real threat with such strategic aims.

The face of criminal legal aid will be unrecognisable in ten years time from what we see now. From a large number of small providers we will soon be seeing a small number of large providers. No one can stand still – change is inevitable.