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Financial pressures: identifying financial distress & evaluating your options

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Howard escaped from Grant Thornton UK LLP in 2008 where he had been a partner for over 25 years to establish his own boutique practice. During his time at Grant Thornton he was head of professional practices for the North West and head of family businesses for the UK. At Grant Thornton he had a variety of roles including office Managing Partner, North West regional marketing partner and membership of the partners appointments panel. Howard specialises in advising mid market professional practices and family businesses. In 2002 he won the CBI's national award as "Best Business Adviser".

Howard's focus is providing "special projects" advice to firms with up to 20 partners. His experience extends from highly profitable sole practitioners to advising 3 of the top 100 law firms. Recent assignments have included sales of law firms, partnership disputes, fund raising, LLP and ltd company conversion, ABS conversions, sales and acquisitions.



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Agenda

- Introduction & approach
- Pressure - what pressure!?
- Protecting the partners
- The stages
- Actions to take
- The bank
- Insolvency procedures
- Questions throughout





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Introduction

Background

- Not an IP - but practical commercial approach
- Applies to any size of practice
- Indeed anecdotally many of top 50 in “Special Measures”
- Typically looking at partners with up to 20 partners
- Starting point will vary



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Pressure - what pressure?!



Perceptions

- Ask an accountant what $2 + 2$ makes!!
- Pressure is in the eye of the beholder
- Many can be in denial
- Partners can be in the dark/head in sand
- One person's pressure is another's opportunity = e.g. high financial gearing



SRA - financial viability indicators

- Drawings in excess of profits
- Borrowings in excess of net assets
- Heavy dependence on high overdraft borrowing
- Inability to measure or control financial performance
- Over dominant senior/managing partner
- Lack of transparency of financial performance
- Narrow focus on single type of work
- Weak billing & cash collection processes



Old saying

- Turnover is vanity
- Profit is sanity
- BUT

Old saying

- Turnover is vanity
 - Profit is sanity
 - BUT
 - CASH IS REALITY
-
- Increasing O/D often the leading indicator



Causes

- Long term
 - Strategic focus
 - Market changes
 - Legislation and regulation
 - Poor quality recruitment
 - Poor management
- Medium term
 - Lack of management control
 - Poor forecasting & monitoring
 - Excessive overheads & drawings in excess of profits
 - Lack of focus on profitable work
 - Too many partners



Causes

- Short term
 - Credit control
 - Cash flow control
 - Short term shock e.g. big bad debt
 - Failure to take action
 - Dealing with the bank!!





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Protecting the partners



Key issues

- Address BEFORE facing issues otherwise ineffective
- Ltd Co or LLP a must - especially for recruitment
- LLP flexible but Ltd Co retained profits taxed at 20%
- Personal Guarantees
 - Avoid unless last resort and even then?
 - Only if limited and non joint & several
- Drawings to be automatic - so cannot be clawed back
- Partners loans to be secured by a 2nd charge
- Take care re personal v partnership borrowing





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Questions



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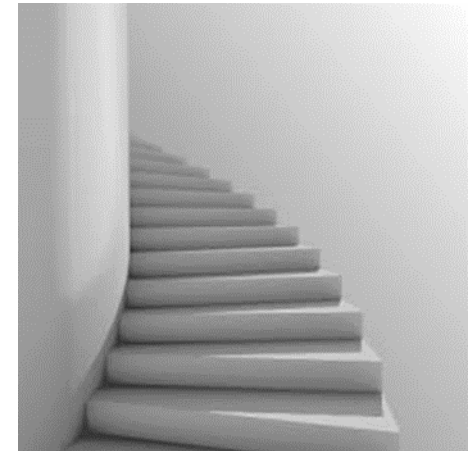
The stages



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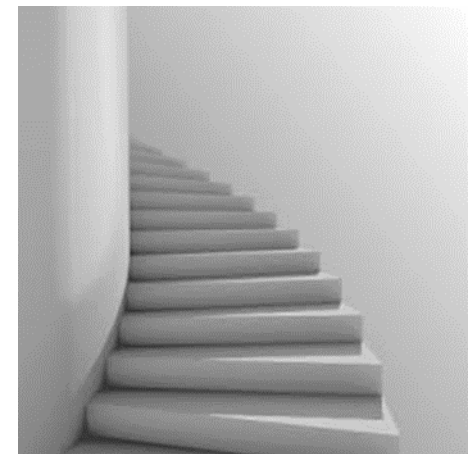
Background

- A situation seen 4 years ago
- Will vary case by case
- Many stages of grey
- From mild concern to “deep doo-doo”



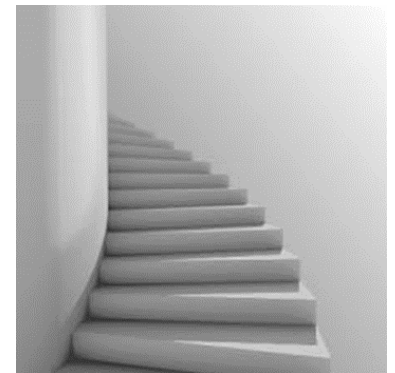
Typical stages

- Stage 1 - mild concern
 - Reducing PEP
 - Increasing lock up
- Stage 2 - increasing concern
 - Increased bank overdraft (within existing limits)
 - Drawings greater than cash profits
- Stage 3 - concern
 - Overdraft limit needs to be increased
 - Drawings more than reported profits
 - Need to reduce drawings



Typical stages

- Stage 4 - special measures level one (NatWest SRM)
 - Failure to meet previous bank forecasts & need for additional facilities
 - Probably 1st breach of bank covenants
 - Separate dept. in the bank
 - Detailed integrated forecasts at monthly rests
 - Supervised by a bank recommended accountant (but with no duty of care to the bank)
 - Regular contact with the bank
 - Management of the bank an increasing burden



Typical stages

- Stage 5 - special measures level 2 - deep “doo-doo”

(NatWest GRG)

- Continued underperformance
- Breaches of bank covenants
- Bank repayment at risk
- Separate specialist department with wide ranging authority
- Bank recommends specialist independent insolvency advice
- Independent Business Review (IBR) by accountants with duty of care to the bank (paid for by the firm)
- Management of the bank a significant burden (and cost)
- Insolvency process if IBR recommends it

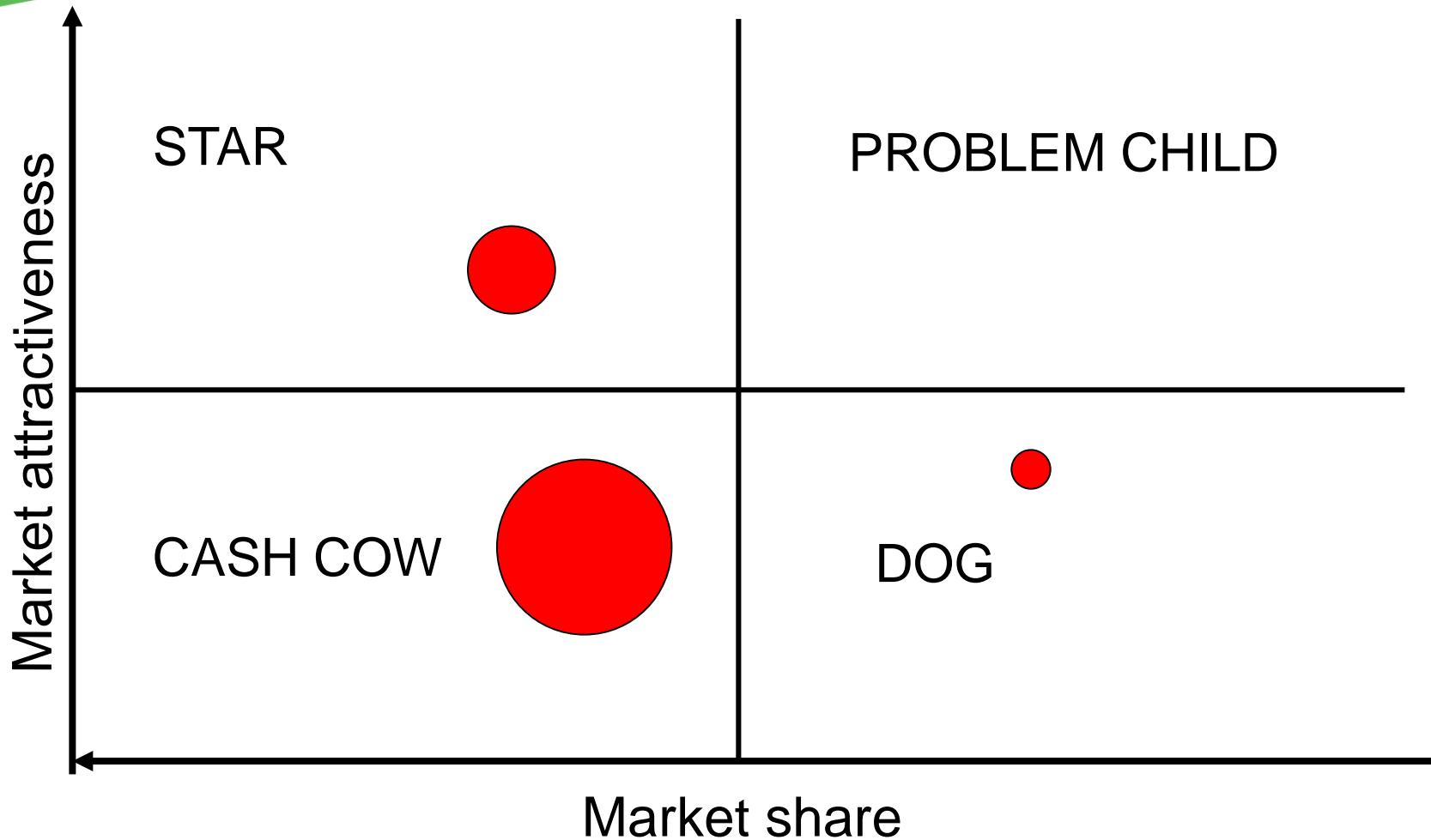




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Actions to take

Long term - strategy - Boston Matrix





Medium term - capacity modelling

	<u>Available</u> <u>hours</u>	<u>Billable</u> <u>Hours</u>	<u>Unbillable</u> <u>Hours</u>	<u>Charge</u> <u>rate £</u>	<u>Available £</u>	<u>Billable £</u>
Partner	2,000	1,000	1,000	250	500,000	250,000
Associate 1	2,000	1,500	500	200	400,000	300,000
Associate 2	2,000	1,500	500	175	350,000	262,500
Associate 3	2,000	1,500	500	160	320,000	240,000
Other	2,000	1,500	500	100	200,000	150,000
	<u>10,000</u>	<u>7,000</u>	<u>3,000</u>		<u>1,770,000</u>	<u>1,202,500</u>
Unrecovered time						(152,500)
Billed						1,050,000
Less salaries and overheads						(550,000)
Profit						<u>500,000</u>
Recovery %					1,050 \ 1,203	87%
Productivity %					<u>1,203 \ 1,770</u>	<u>68%</u>

Medium to short term

- Clear objectives
- Set budgets
- “Right size” - staff AND partners
- Performance related bonuses (not necessarily for partners)
- Regular information and monitoring
- AND taking action
- Drawings linked to cash collection



Short term

- Active daily management
- Clear responsibilities
- Management “with clout”



Sources of finance

- Alternative banks unlikely at or after Stage 3
- Possible short term for tax, PII and practicing certificate
- Real alternatives
 - Reduce lock up
 - Improve profits - usually through staff cuts
 - Retained profits (Ltd Co better than LLP for this)
 - Sell assets / firm
 - Curtail scale of operations - especially in PI firm
 - Merger - but is it really a solution
 - Reduce drawings and / or partners





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Questions



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The bank



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Bank(ers) motivators

- Dispassionate
- Make money from lending money & selling services
- Meet personal bank set objectives
- Keep their job!!
- There are some “good guys” with expertise - use advisers to find them



Approach to the bank

- Always be polite and understanding - however difficult
- Try to understand their point of view and present information that helps them & get to know the manager
- Avoid official complaints
- Changing banks - devil you know unless genuine breakdown but even then a change of manager may be better
- Understand the stages as above & where you are
- Debt write off may be possible but as last resort

Technical issues

- Base criteria - up to
 - Security - c 50% of debtors & c. 30% of WIP but varies
 - Gearing 1:1 - so net assets after deducting borrowing : bank debt
 - Debt servicing - interest and capital to EBITDA
- Covenants
 - A stick at Stage 2/3
 - Carefully negotiate & scrutinise - last 2 deals definitions incorrect
 - They are negotiable
- Forecast / business plan
 - Tailor to bank needs
 - MUST be integrated
 - Be realistic - avoid need for additional requests



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Insolvency procedures



Alternatives

- CVA –
 - 75% by value of creditors must agree
 - No court involvement
 - Supervised by IP but directors remain in control
 - Does not prevent enforcement of security
- PVA
 - Same as CVA for LLPs & partnerships
 - Often with SIMIVA
- Scheme of arrangement
 - Court involvement → expensive
 - 75% by value & 50% by number of creditors
 - Directors remain in control
 - Binds secured creditors



Alternatives (2)

- Administration
 - Appointment by charge holder OR by Court
 - Prepack - charge holder or court appoints
 - More expensive than receivership
- Receivership
 - Administrative receivership - pre 2003 charge
 - Fixed charge receivership - post 2003
 - Both appointed by charge holder
- Liquidation
 - Members voluntary - solvent
 - Creditors voluntary - insolvent
 - Compulsory - stat demand then court appointed



Alternatives (3)

- Applicable to natural persons
 - Bankruptcy
 - IVA - 75% of value of creditors
 - Nominee / supervisor



Commentary

- Most likely for law firms
 - CVA for company
 - PVA or SIMIVA for partnerships
 - IVA for individual partners
- These usually allow for lawyers to continue to practice
- Pre-pack & fixed charge receivership next most likely
- Need for SRA notification & agreement





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Questions

Links/ contacts for Law Society and other external resources that may offer further information:

www.lawsociety.org.uk

<http://cpdcentre.lawsociety.org.uk>

cpdcentre@lawsociety.org.uk



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