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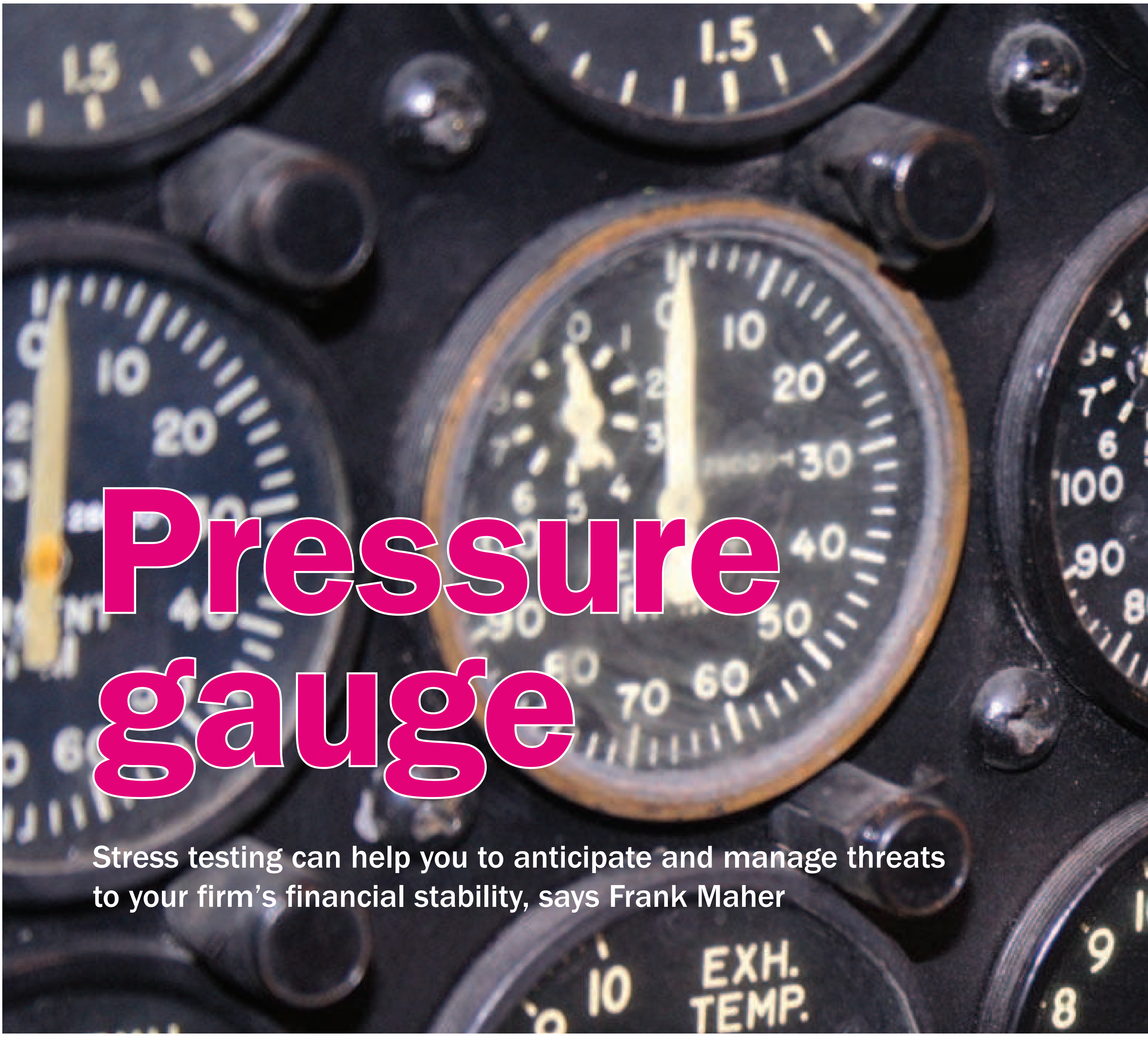

Pressure gauge

Stress testing can help you to anticipate and manage threats to your firm's financial stability, says Frank Maher

Stress testing is a method of testing the stability of a system or entity and involves testing it beyond its normal operational capacity – often to breaking point – to observe the results.

Stress tests were designed as a risk management tool to evaluate the potential impact on portfolio values of unlikely, but plausible, events or movements in a set of financial variables.

This type of analysis is implemented by banks and other financial institutions and their regulators to ensure that they have sufficient capital adequacy to survive potential losses arising from extreme, but plausible, events or combinations of events. Now, even countries do stress tests.

The effectiveness of stress testing will depend to some extent on the imagination of those carrying it out. It can enable an evaluation of the short-term effects of events such as bank failures or technical communication breakdowns that lead to an inability to send or receive payments.

In the context of a law firm, this might also include the failure of a key client, on whose business the firm is dependent, or a change in the law which abolishes or curtails a certain type of legal work.

Stress scenarios should be applied to the profit and loss account and the balance sheet, and then to identify credible actions that management would take in that scenario. The objective is to ensure the firm has adequate capital to tide it over.

This article will explore the root causes of recent law firm failures and the range of risks facing law firms today. It will then discuss how a stress test can be used to better anticipate and manage these risks.

Causes of firm failure

In recent times, we have seen a number of significant US law firms collapse, such as Altheimer & Gray, Brobeck Phleger

& Harrison, Coudert Brothers, Heller Ehrman, Howrey, Thelen Reid & Priest, Jenkens & Gilchrist, Thacher Proffitt and, most recently, Dewey & LeBoeuf.

"A stress test may identify that the firm is close to the limit of its banking facility, which could be withdrawn without notice"

Despite the fears of law firm partners, these did not in the main arise from professional liability claims, though Jenkens & Gilchrist's failure can be attributed to penalties arising from tax shelter work and potential lawsuits from clients that had been advised to enter the schemes.

Research has found that early warning signs and common causes of the failure of these firms include:

- below-average financial performance, including poor financial hygiene;
- internal dynamics, such as leadership issues and partners with incompatible goals; and
- external dynamics – competitive pressures to the firm's historical client base, failure to understand their marketplace or an inability to recruit new talent.[1]

Common triggering events were overexpansion, the departure of key partners, failed mergers when the firm was already in financial distress and the impending renewal or expiry of the firm's primary office lease. It found that the seeds of most law firm failures were sown long before the actual dissolutions.

In 2010, the collapse of top-40 UK law firm Halliwells shook the market.

The causes of its failure were a combination of the economic downturn affecting its core client base and a deal relating to the firm's offices, under which the equity partners received £16m personally and a further £5m was paid to the firm, leaving it with a heavily-inflated rent bill.

Many smaller UK firms have failed due to economic circumstances – a combination, to varying degrees, of competition, a reduction in work due to the economic situation (particularly in relation to property work), cuts in public spending on legal aid, competition with larger firms and poor business management. This has not been countered by any significant increase in litigation and insolvency work, which might have been predicted by some.

A significant number of firms have had problems with rogue partners and staff. In many cases, people were dishonest, but we should also include in this category those who take unacceptable levels of risk beyond that which is acceptable to the partnership as a whole and do so surreptitiously.

There have been rogue partners in a number of large and eminent firms, but those firms are big enough to survive. When the same issue occurs in a small firm, it frequently results in the firm either closing immediately or withering and dying within a couple of years.

In the UK, this has been linked to the regulatory requirement to buy insurance: firms which have had these problems frequently find insurance becomes unavailable, either at all, or at a price which they can afford and, without insurance, they are forced to close.

Risks facing firms

So what are the other risks facing law firms today?

Bank failure is a risk which might affect law firms, either through loss of their own money or client (trust) money, which they may be obliged to reimburse. Lehman was allowed to fail and we have also seen Dutch bank DSB fail.

Another perhaps more significant bank-related risk for many firms is not that the bank may fail, but that a bank which is lending to the practice may withdraw funding at short notice. Banks have become far less confident in lending to law firms than they used to be.

"Stress testing should address the risk of more than one adverse event occurring at the same time and one event potentially having multiple consequences"

Firms also need to plan for the loss of a major client: if a firm has a profit margin of only 15 per cent and one client accounts for 20 per cent of the firm's fees, it could easily become loss making if that client were to withdraw its business or become insolvent.

Transactional work is down, except for a few law firms, and part of the reason is that in-house counsel are compartmentalising the work. Specialist work is given to external counsel, but easier parts of the deal are being given to less-expensive firms or even kept in-house, creating greater pressure on law firms' margins.

Firms also need to plan for business continuity – not only disasters, but other more mundane threats to their business, such as power failure, floods or a police cordon preventing access to the office.

Law firms in England and Wales are under a statutory duty to manage risks in their business, which includes ensuring sound financial management and business continuity. Massive fines have been imposed on many UK businesses and public sector organisations for data breaches, including a recent £120,000 fine on a local authority for a lawyer's error in sending an email with sensitive information on a child protection case to the wrong address.

The Solicitors Regulation Authority (SRA), which regulates solicitors in England and Wales, has said that it regards issues of financial stability as a key high-risk issue. The regulator has a statutory obligation to protect clients if a firm collapses.

Those practices which seek to expand into new countries must undertake a full assessment of the risks, the more so in developing countries where they may wish to enter the market ahead of their competitors in order to maximise growth prospects. These will be the countries with a higher risk of corruption and other business risk.

The stress test

So, how should your firm go about conducting a stress test?

This should really be done as part of the firm's general risk management process. Part of this will involve preparing a risk register. This does not have to be complex and it does not require sophisticated or expensive software. It is probably easiest to maintain in a spreadsheet, for example using Microsoft Excel.

There are commercial products available which are hosted by external providers, but many firms will be uneasy about sensitive data being hosted externally.

Preparation of the risk register should not be the work of one person alone, or it will only represent that person's perception of risks. Those best able to understand the risks faced by a practice are those involved in each aspect of it. Structured discussions should be held with heads of practice areas and departments, including the firm's support functions such as human resources, information technology, finance and accounts.

If the process is thorough, and not merely a box-ticking exercise, the issues addressed will include those referred to in the previous two sections of this article.

It will not just focus on professional liability risks, but will cover business risks which may be a threat to the future of the firm.

So, for example, it may include an assessment of the impact of losing a key client, or changes in a market sector. The aim will be to compile a record of the identity and assessment of risks, ownership of them and how the firm will deal with them – whether to accept them, mitigate them (by putting processes in place to contain the risks) or transfer them, commonly by insurance.

How many entries should the risk register contain? It can be long or short, depending on the level of detail which it goes into, but in practical terms it is best to have less than 100 entries: if there is too much detail, nothing will ever happen.

The risk register should not then be put on a shelf and forgotten: it should be a living document which is kept under review by the firm's management on a regular basis, perhaps quarterly.

"The seeds of most law firm failures were sown long before the actual dissolutions"

Conducting stress tests as part of the exercise of preparing a risk register may, for example, identify that the firm is close to the limit of its banking facility, which could be withdrawn without notice. An answer may be the injection of further capital by partners.

However, in the real world, that may be easier said than done and the partners may have to review wider options. Disconcerting though this may be, it will be easier to address this in their own time, rather than in a panic after the bank has called in the loan.

Stress testing should also address the risk of more than one adverse event occurring at the same time and one event potentially having multiple consequences. For example, a departing partner may result in loss of a key client which provides work for other partners and a team of people may also leave. This will probably trigger repayment of partnership capital and may cause a bank to call in a loan or change the terms of the firm's overdraft facility.

Passing the test

Stress testing is an exercise all firms should undertake. However, with the increasing challenges faced by large sections of the legal profession, such as those affected by government austerity measures because they are dependent on public sector clients or publicly-funded work, and those affected by the economy generally such as real estate practices, we will have to wait and see how many are sufficiently resilient to pass the test. mp

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Endnote

1. See *The Anatomy of Law Firm Failures*, Hildebrandt International, November 2008