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Law firm growth strategies and how to fund them

FOUR ESSENTIAL CONSIDERATIONS WHEN GROWING YOUR LAW FIRM

When it comes to transformation and change in the legal industry, the recent focus has largely been around law-firm digitization and a law firm's ability to align its internal business processes with a more digitally savvy consumer. This is not the only major change that is happening that will have widespread impacts to the legal industry and how law firm owners will conduct and grow their businesses in the future.

To see where the legal industry is headed you only need to look at other industries that have a similar genetic makeup. The medical industry is a prime example of this, where the similarities are obvious and a retrospective review of what the medical industry looked like twenty years ago versus where it is today, is a crystal ball of sorts – or a canary in the proverbial coal mine, depending on your outlook.

The medical industry has received large infusions of private equity capital and due to the consistency in revenue enjoyed by health-care professionals, it is often an easy forecasting model that can be digested by third parties looking to invest in a highly profitable industry segment.

However, valuing a contingency-fee law firm is much more difficult – combined with laws around law firm ownership, these present natural barriers to entry for outside investment into the legal space. Regardless of whether you're in private equity or are a law firm owner, forecasting and valuation is the starting point for decisions around law firm growth. If you do not know how much your firm is worth, projecting growth is challenging along with deciding whether to appoint an internal successor, selling your practice, or merging with another.

What we've seen because of the investment in the medical industry, medical professionals have banded together to form medical centers or 'super centers' affiliated with hospitals rather than trying to organically grow and/or sustain individual private practices. This trend is accelerated by the fact that medical centers can invest in critical business functions (like IT, finance, marketing) that support growth – a very familiar business scenario to the growth challenges for contingency-fee law firms.

Similar challenges and customer expectations

Similarities also exist in how medical professionals and lawyers generate revenue and fund their practices. Both medical professionals and contingency-fee law firms have similar challenges with inconsistent cash flow based on either insurance company reimbursements or the length of litigation. Doctors and contingency-fee lawyers are also often self-financing their capital-intensive businesses. Additionally, an ironic complaint of both medical professionals and law firm owners is that they did not necessarily learn how to run a business in medical or law school yet are expected to do so – and grow it – while concurrently servicing the needs of their clients.

Both industries have a consumer base whose needs and expectations have changed dramatically over the last two decades. The consumer is much more digitally savvy and expects the same type of interactions with their doctors and lawyers as they do in other aspects of their lives. Moreover, both industries have typically been behind the curve on adopting technology and processes that lead to better levels of customer service and when their customers don't receive it, they can easily turn to social media reviews to air out their grievances, damaging businesses' reputations. Law firms and private medical practices are both built on reputation, word of mouth, and patient or client experience.

It is logical to conclude that the legal industry is headed in the same direction as the medical industry. The headwinds for this transition have been blowing for quite some time and recent developments in Arizona and other states that allow non-lawyers to own a stake in law firms may very well be a point in time lawyers will look back to and realize that was the moment where the legal industry changed. Moving to a more commoditized and homogenized product/service offering similar to what the medical industry is like today with a few huge players, could mean a lot of medium- sized firms and smaller local law firms struggling to compete.

Over the next five to ten years, as the older generation of lawyers and law firm owners hand off the baton to their Millennial and Gen Z counterparts, who are much more open to change, we believe they will all be asking the same question: How do we grow our law firms to stay ahead of the competition?

The four essential considerations when growing a law firm

When it comes to law firm growth, there are four essential considerations: Whether to grow your firm through expansion, to join a growing law firm, to secure your law firm's future through succession planning or to sell your practice.

With businesses experiencing the strain of recent years, the legal industry is experiencing an unprecedented wave of consolidation in the form of mergers and acquisitions. For law firms that invested in digital marketing, technology and resources during the pandemic, the focus is now centered on increasing new cases, expanding geographic reach, and diversifying into new practice areas through acquisitions.

No matter your focus for law firm growth or succession planning, there are four essential considerations.

#1: Valuing your law firm

Whichever path for growth, discussed below, fits your firm's strategic needs best, a good starting point is to assess the value of your firm's contingent case inventory so you can set goals on how much to grow and by which method. An important consideration is understanding the components to valuing a law practice.

To continue with the medical industry analogy, as private equity firms seek to evaluate a medical practice's specialty, experience of the doctors, insurance costs, and patient list (apply amongst other factors). For law firms, your case inventory value, referral source list, the good will your senior attorneys have built up over the years, and your subject matter knowledge all add up to determine your firm's value and the kind of line of credit or investment your firm will be eligible to receive. Additionally, your brand equity, the digital value of your firm is a key determinant to valuation. What is your firm's presence online? Are your newsletters and social media outreach effective? What are your reviews like when potential clients Google your name?

#2: Growing your law firm through expansion

As law firm leadership evaluate the need to grow the firm, they are typically looking to enter new practice areas, to expand into new geographic markets, or to invest in the areas of marketing, technology, and resources to fuel growth.

In all instances, these growth strategies require capital or cash flow that is freed-up for investment. In short, it comes down to a "smart money" strategy.

The heart of a smart-money strategy is to operate in the frame of mind that there is always something to learn about your firm as a business. This mindset can help keep law firm owners auditing processes to make them more financially efficient, digging into data and metrics in all aspects of the firm's operating procedures, being open to new ways to grow your firm whether it is through

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operations or new practice areas, and considering relevant liquidity and capitalization options such as case-cost financing when it is appropriate.

The challenge of improving law firm liquidity and cash flow

Contingency-fee law firms are capital-intensive businesses. For most contingency-fee law firms, financing operations and managing cash flow present significant challenges, especially if the managing partner is paying for case costs out of the law firm's revenue ("self-financing").

Typically, law firms that are self-financed use their attorney's fees or after-tax dollars earned from previous cases to cover current case costs. However, as case settlements push out into the future and case disbursements increase, the law firm and the partner feel the weight of that financial burden. Moreover, tying up this capital inhibits the law firm's ability to pursue growth initiatives.

For law firms pursuing financing through traditional banks, the limitations on credit facilities also presents a difficulty. Most traditional banks evaluate a law firm based on past financial performance. This myopic approach towards law firm valuation results in restrictions on credit, stricter terms and personal collateral requirements, often leading to an insufficient level of credit offered by traditional banks.

Faced with increasing cash-flow concerns, some contingency law firms are forced to make tough decisions about case resources, settlements and often, the lender and interest rate the law firm is willing to accept.

Leveraging case-cost financing to free-up capital and invest in growth

An important financing solution for contingency law firms to consider is case-cost financing. Your law firm can gain access to more capital for growth initiatives by financing case disbursements through case-cost financing. While the approaches to financing will look different for each firm, case-cost financing lines of credit can be issued by using a law firm's case inventory as collateral because the lender understands the nature and business model of contingency-fee firms.

There are four misconceptions around case-cost financing that are likely due to the sheer number of financing options available and product offerings from litigation finance companies which often muddy the waters.

The first misconception is that having a case-cost line of credit means that they need to finance all their case costs. This is not true; law firm owners have the flexibility to choose the cases they want to finance on a case-by-case basis and often law firms will choose to utilize financing for cases where the lawyers feel that added investment into the case will yield the client and the law firm a better result.

Additionally, law firms have the option to pass on the cost of financing (the interest paid on the case costs) to their end clients and for the interest to be considered as part of their case costs and both recouped at settlement by the law firm. Lawyers who choose to do this should check the ethics opinion in their state and look for guidance on changes to retainer language prior to making these decisions.

Lawyers often believe that passing on the cost of financing to their clients serves as a competitive disadvantage and deterrent to signing on the client. This is not necessarily the case, as people who seek the services of a contingency-fee law firm are often in situations where they are less concerned about the costs associated with investigating their case, and more concerned about the end settlement amount.

Often, when a lawyer gets the chance to explain to their prospective client that having access to financing allows the law firm to investigate deeper into the damages incurred by the incident, and that by doing so, often yields a better settlement result – they find that their claimants understand this, and any concerns around expenses quickly dissipate. This can be mitigated by law firms that approach case-cost financing in a phased manner and take on case financing on a case-by-case basis.

The last misconception pertains to the cost of financing and that utilizing this approach can be prohibitive to the law firm's bottom line. In scenarios where the cost of financing is passed on to the client, the net cost of borrowing to the law firm is often one percent or lower. In scenarios where the law firm decides to finance their case costs and not pass on the interest cost on (deciding to pay the interest themselves), the interest that is incurred is a tax-deductible expense.

Generally, third-party lines of credit for case-cost financing can have single-digit interest rates as long as the lender understands the business model of contingency-fee law firms well. This interest is also tax deductible for the firm since it is considered a business expensive.

The net result of having the option to utilize a case-cost line of credit is that it effectively re-deploys funds that would typically be trapped for years and affords the law firm additional liquidity to spend on growth, while concurrently giving the law firm the flexibility to invest heavily into cases that will yield greater results.

When it comes to growth-based initiatives law firms typically look to increase their firm's market presence through digital marketing, be more efficient with technology, and hire more resources to build business functions and increase litigation staff.

Investing in digital marketing to build brand awareness

In the pre-Google era, attorneys typically relied on word-of-mouth referrals, TV, and billboard advertising. Once the internet and launch of company websites took effect, businesses learned that being found by consumers easily on Google was a necessity.

Today, digitally savvy businesses realize consumers have fully migrated online, increasingly due to the pandemic. The new normal consists of strictly digital interactions. If your law firm doesn't have a presence in multiple marketing channels, you're missing potential customers. The same can be said for the earlier comparison industry. Medical practices are heavily reliant on not just the convenience of accepting a patient's insurance, but their reputation in reviews on sites like Zocdoc or insurance companies' own portals.

Law firms with available capital can, and should, look to expanding efforts in digital marketing channels like LinkedIn or weekly newsletters, or even social media channels like Twitter or Facebook to engage new clients. Investing in tools to measure the effectiveness of these marketing efforts will also be key to targeting potential clients.

Investing in technology as a catalyst for growth

A keen focus on innovation needs to extend beyond marketing as well. For example, evaluating your intake and case-management procedures is one area which might result in needing to invest in new technology, the cost of which could easily be outweighed by an increased amount of new business.

One way to grow the business through an investment in technology is by improving your firm's intake procedures and case-management software. Some contingency-fee law firms could choose to build an internal call center with available capital not dedicated to case costs. While many firms outsource this function, keeping the function in-house has benefits like increased client contact and streamlining the process based on your firm's capacity and practice areas at any given time.

Hiring or acquiring more resources

A key factor in law firm growth is building up attorney and support staff resources. To accomplish this goal, a law firm needs available capital to invest in hiring more employees and attorneys. Once that investment is made, the firm can realize the benefits of increased case volume, increased attention to existing clients, and faster settlement of cases.

While hiring more lawyers has an obvious benefit, some firms could also choose to hire more business development- and operations-focused staff. Bringing on a chief operations or marketing officer could allow partners to focus on practicing law and tending to clients more efficiently and effectively while those specialized individuals focus on growing the business.

#3: Selling your practice/merging with a growing law firm

When it comes to creating growth strategies for law firms, many senior attorneys who own law firms face a challenging decision – sell the practice, merge with a growing firm, appoint a law firm successor, or maintain the status quo.

Selling your practice

One way to experience growth is through selling your firm or practice. For law firms run by lawyers ages fifty-five to seventy-five, who have managed practices with five to twenty attorneys for thirty-plus years, there is a great opportunity for firms to expand their businesses through mergers or acquisitions.

Joining a law firm hungry for growth (merger)

While merging with a growing law firm may not be the initial choice for some senior attorneys, it is an option which might lead to more sustainable growth and better service. Most lawyers come into the legal field to practice law and help people, not necessarily run a business.

While it is possible to be in the courtroom and be your law firm's CFO/COO, that is not always the right choice for everyone. Joining a firm with the resources and capital to run the firm like a business, with the emphasis that you or your partners do not want to wear the multiple hats of practicing law and managing the business, is a smart way to approach a merger.

Merging with a law firm eager to grow can be a boon for senior attorneys, especially those looking to offload some of the pressure and responsibilities of running a business while also practicing law. For the 'buyer' this is an attractive option as well because senior attorneys bring years of experience and expertise, and a robust book of business.

#4: Securing your firm's future through law firm succession planning

Another option for senior attorneys looking to grow the business is through naming a successor, keeping the firm intact without merging or selling. According to Jeremy Poock, founder of Senior Attorney Match, this is not the preferred path for most firms because of the risk factors involved with succession. However, if law firm succession is the right path for your firm, these are the factors to take into consideration.

Choosing a law firm successor

One of the biggest factors to consider is who to choose as your successor.

As a senior attorney you may feel like one of your best employees "deserves" to be your successor and purchase your business. While that may sound appealing, Poock, warns of the potential pitfalls. Although internal candidates are often loyal and possess great work ethics, the question is whether they are willing and able to take on that responsibility.

Pitfalls of law firm succession: Success or key employee

Some key questions to ask about the person you want to name as a successor are:

- Are they serious about putting their name on the credit line or lease?
- Are they asking about the details of a succession plan or are they formulating their own viable business plan?

Often initial interest shown is born from loyalty to the firm and the senior attorney, but it does not necessarily translate willingness or ability to run the firm as a business. More importantly, are they willing to put their name on the firm's credit line?

Additionally, there often is a strong possibility that key employees may suddenly seek opportunities outside of the law firm.

Dangers of staying the course

While selling the law firm, merging with a growing firm, or choosing an

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internal successor may provide opportunities for senior attorneys, staying the course is perceived by consultants like Poock as high risk.

Maintaining the status quo for your law firm may appear to be comfortable at first – continuing to employ the same growth strategies as you have for years. However, this could be a risky option given the changing nature of the legal industry post pandemic. More importantly, those law firms that have made significant investments in marketing, technology and resources will soon outperform the competition.

Summing it up

Now that you know more about key considerations for law firm growth, start evaluating the best path to take to position your law firm for business growth and success. Whether you choose to reinvest freed-up capital back into the firm, sell the practice, merge with another firm, or appoint a successor, knowing the value of your law firm's case inventory is key.

In a similar vein to the medical industry and the consolidation and growth medical practitioners have experienced over the last few decades, having access to capital for growth-based initiatives is key, as well as finding the right financial business partner that sees your case inventory and case costs for what they really are – assets.

The financial flexibility afforded to law firms that have not trapped their capital in case costs find that having the additional liquidity to spend on growth initiatives (like buying another law firm or taking on new senior partners) is a growth strategy that leads to success and one that many law firms have employed nationally.

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