Legal Services Act

Fast forwards

In the first of a two-part article, Nick Jarrett-Kerr considers which new legal structures will prove most popular when permitted in 2011.

When the Legal Services Act 2007 (LSA) was first passed in England and Wales, a number of experts predicted, with varying degrees of certainty, that a 'Big Bang' scenario would immediately play out in the legal profession, and that many thousands of law firms would be forced out of existence by the advent of external competition. The recession has, however, meant a slight pause in the interest of external investors. Furthermore, it is now likely that economic forces will have a greater transformational effect on the profession than the early advent of a host of new market entrants. Nevertheless, the new changes will have long-term effect play in the legal services sector, allied to consolidating forces already in force.

It has, of course, always been possible for law firms to diversify outside their core legal services market into other areas of professional services, but some of the structures and legal mechanisms that have had to be used have been unwieldy and restrictive. Particularly problematic has been the restrictions on both external investment and non-lawyer partners, which has prevented law firms from diversifying to the same extent as the accountancy profession, for example.

Under the traditional model of law practice throughout the world, firms have required relatively modest amounts of funding to provide adequate working capital, and these capital requirements have usually been within the bounds of affordability of partners, aided by willing banks. Also, the financial focus of firms has been relatively short-term. The accent has been on the current year's profitability, with most profits distributed to partners rather than being retained in the business for investment. Furthermore, since the time when goodwill was largely excluded from a law firm's accounts, the partnership model has provided for outgoing partners to take with them only the amounts standing to the credit of their current and capital accounts. Unless the firm has owned an appreciating asset such as a freehold property, retiring partners have usually left with the same fixed sums which they introduced. There has been little opportunity for retiring partners to realise any element of capital growth.

In other sectors of professional services, sector consolidation has engendered or stimulated changes to the historic partnership model, as rival firms compete fiercely for the business of global clients. At the same time, the power of branding and scale economies has seen the advent of national organisations, providing cheap and cost-effective services at the commodity end. The effect of greater consolidation is to provide a fiercer competitive squeeze on existing providers that have found their natural markets eroded, pricing models under pressure and their client-retention ability diminished. In both the accounting and advertising sectors, consolidation has seen more than half of the global market expenditure concentrated in the hands of small numbers of leading players. In financial services, the arrival of national providers, such as Direct Line, has dramatically affected the competitive viability of high-street insurance agencies.

In contrast, the legal-services industry has remained fairly fragmented and has even been described as the last of the 'cottage' industries. The trend towards consolidation through increasingly muscular competitive forces seems to be inexorable in all industry and professional sectors, and the LSA is likely to provide a catalyst for faster sector consolidation than would have naturally taken place without its introduction.

Law firms are likely to consider an alternative business structure (ABS) for one or more of three strategic reasons. First, their strategy for survival and prosperity may require growth or diversification, which needs funding to a greater extent than they can manage internally. Law firm funding has traditionally been generated from partners and bank borrowings in the main. Mergers and acquisitions have usually been self funding, and investment in new teams and laterally-hired partners has, for the large part, taken place against a short-term affordability and budgeting horizon. Firms that have grown quickly have often found it somewhat difficult to maintain appropriate levels of working capital, even when new client work has been quick to pour in. Lawyers have to be recruited and paid, and office space and infrastructure provided, at a faster rate than the client work can be turned into cash.

While it is generally cheaper to borrow than to raise equity capital, the ceiling to bank lending can restrict fast growth. It is possible that acquisitions of other law firms will need extra funding, as sellers start to try to exact an actual sale price rather than just expecting an integration of balance-sheet book entries. Furthermore, as law firms consider their competitive positioning, bold moves in positioning may require firms to pay attractive sums to lure teams away from other firms, and invest in new systems and processes.

Second, firms may perceive the need to protect or increase their market share by being part of a bigger, or better-positioned brand, particularly if the bigger brand gives the opportunity for economies of scale or scope. Law firm leaders often assert the excellence of their people, teams and services but complain that lack of market visibility lures clients to better known firms who provide no better service or expert capability than them, often at higher cost. Other law firms resent clients instructing better known, and higher-advertised, brand names or intermediaries. Smaller firms are in increasing danger of being marginalised by larger legal-service providers who have deep pockets to invest in brand building and streamlined work processes.

Third, the partners may feel that an ABS gives them the possibility of realising a capital value for their share in the law firm they own. While it is possible to envisage situations in which firms might be able to realise some value on sale, the sums are unlikely to be large. Simply paying out large sums of money to partners for them to retire is not a recipe that is likely to be attractive to external investors.

ABS options

I have identified about 15 different models or types of ABS that might be possible under the new legislation. One thing is clear; most of these models will require law firms wishing to become an ABS to move away from the traditional partnership model to a model that is much more corporate in structure. Even the limited liability partnership may prove to be an inappropriate structure for many of the ABS models other than those that include only a small proportion of non-lawyer involvement or investment. I have broken the models down into two groups. In this article I describe the first group, comprising models where the ABS continues to be largely owned by lawyers – and is attractive to law firms looking to exploit strengths, take advantage of opportunities, or address weaknesses and external threats. In a subsequent article I will deal with the second category of externally-owned models – the majority of which are likely to threaten law firms, but some of which might provide enterprising law firms with opportunities of their own.

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The traditional law firm

Many traditional law firms will doubtless continue, either as general partnerships or limited liability partnerships. Many firms will seek to compete with their new rivals on the basis of a competitive strategy in a firm that remains fully owned and managed by lawyers. Within this model, the legal disciplinary practice (LDP) will be possible in firms where a small number of non-lawyer managers are able to add their financial and ownership contribution as partners and co-owners instead of employees. Any law firm that then wishes to continue to have non-lawyers as partners will, however, have to migrate from an LDP to an ABS once the new regime comes into force. Those firms who are already registered as a LDP will be automatically passported into the new regime, at which stage the 25 per cent limit on non-lawyer partners or members will also be lifted. This sort of ABS will be attractive only to those firms who want minimum non-lawyer involvement.

The marketing umbrella

It is already becoming popular for some law firms to practice underneath an overall umbrella in a marketing and branding operation. QualitySolicitors.com is one example of how this might work. This offers a branding umbrella for about 100 firms nationwide. In a sense, this is a type of franchise, although limited to marketing support. It will enable firms to remain totally independent, and to compete with other firms operating under the same umbrella without breach of the professional ethics or conflict rules. Most umbrellas will have some quality standards but, as with international alliances, once a firm has been allowed to enter the umbrella arrangement, standards will prove difficult to enforce given the total independence of the firms. This model does not need 'enablement' by the LSA as such, unless the umbrella has any degree of non-lawyer ownership.

The law firm franchise

The pure franchise is similar to the marketing umbrella, except the concept here is that one law firm works to set up systems, processes, standards and structural capital, which franchisees would then be compelled to adopt. Unlike other sectors of professional services, there are likely to be very few firms currently (if any) whose brand and standing is sufficiently well advanced or differentiated for such a model to work in the early years of deregulation. In addition, most go-ahead and progressive firms will probably be keener to acquire firms than franchise them. As with other sectors of professional services, a handful of leading franchises may well emerge. For example, some UK estate agencies, such as Winkworths and Jackson Stopps and Staff, operate under a franchise model. Such firms tend to recruit both established and start-up estate agency businesses to operate under a known brand using the firms tried, tested and proven methodologies, and taking advantage of cost savings through group purchasing deals, central regulatory compliance, technical support and centralised referrals. Members are charged an initial payment, and thereafter a monthly management fee based on a percentage of gross income.

The consolidation roll-up (law-firm driven)

A roll-up is a technique used by investors (commonly private equity funds and venture capitalists, but also by aggressive firms in the same sector) through which a number of small firms in the same market are acquired and merged. Consolidation within the legal profession is already taking place and is likely to continue. The motives for firms merging, or for a larger law firm to acquire smaller firms, may be entirely strategically driven so as to reposition, gain a competitive advantage, increase market share by scaling up or removing competitors, or so as to achieve significant economies of scale. Alternatively, acquisitions can be driven by the desire (ultimately at least) to have the option of being able to harvest a capital return by floating the firm. This model is not new, therefore, but firms that have sought to consolidate through acquisitions have found it difficult to fund a high level of acquisitions over a short time horizon. This is in part because there are significant capital restraints for large-scale private acquisitions. Some firms may therefore wish to look at the possibility of satisfying the capital requirements by external finance, and some of the models take this possibility into account.

The virtual law firm

The virtual law firm model has few members of staff, and operates as a management organisation and marketing tool only. If owned and managed by lawyers under the aegis of the Solicitors Regulation Authority (SRA), it is a model that is possible under the present regime. One example is an American firm known as Axiom, which started in New York as long as ago as 2000. There are some similar organisations in the UK such as Coco Law, Everyman Legal and Keystone Law. These firms have no partners and few overheads, and the lawyers work as individual independent contractors. The objective is to provide sensible legal solutions at reasonable rates, with a key critical requirement of flexibility, efficiency and quality. Their clients are often big global companies, but their model is partly to provide flexible resources for in-house teams – by providing lawyer interims and locums to carry out projects for clients. It is quite possible for these types of firms to continue to operate as traditional law firms, with no non-lawyer involvement.

Model 1 – Traditional law firm	Traditional law firm model with minimal non-lawyer involvement;
Model 2 – Marketing umbrella	Independent law firms operating under a marketing brand;
Model 3 – Law firm franchise	One dominant firm franchising its brand to others;
Model 4 – Consolidated law firm roll-up	Aggressive law firms acquiring others;
Model 5 – Virtual law firm	Law firm with low overheads and flexible resources;
Model 6 – Legal MDP	One-stop shop with related disciplines but legally dominated;
Model 7 – Integrated MDP	Law firms integrated into MDPs controlled by non-lawyers;
Model 8 – Externally -financed Growth	Law firms selling minority interests to external investors to fund expansion;
Model 9 – Branded conglomerate	Corporate brand owning law firms as part of wider (and maybe non-related) portfolio;
Model 10 – Law firm PLC	Large law firms floating as PLCs;
Model 11 – Integrated legal network	Network of law firms operating in a hub and spoke subsidiary structure under a holding company;
Model 12 – The external consolidation roll-up	External investors acquiring law firms until entity is large enough to float;
Model 13 – Online firms	Internet firms offering legal documents and services via the web;
Model 14 – Not for profit (NFP) firms	Charities and NFP law firms offering legal services for zero or low fees;
Model 15 – In-house teams	Institutions offering the services of their in-house legal departments on the open market.

Table 1. Alternative business structures (largely owned by lawyers).

It is, however, quite likely that the advantage of external finance from outsiders may prove irresistible.

Externally-financed growth

This model has been discussed a great deal in the years running up to the final enactment of the LSA. It is for a law firm to obtain partial private equity ownership in order to fund an extreme level of growth over a very short-term horizon. The motive would not be to become publicly traded, but instead, for the law firm partners to retain overall control and majority ownership, having introduced a minority externally-owned shareholding. The representatives of the private-equity house would become members of the law firm, and the private equity company might hold shares in the firm. It seems that private-equity houses may well turn out to be interested in large firms with good management only, and even in those cases many private equity houses will not be interested in anything less than majority control.

The legal multidisciplinary practice

In a multidisciplinary practice (MDP), a one-stop-shop is provided by allowing clients easy access, not only to the legal profession but also to other, similar professionals providing legal and other services to clients. An example could be niche property practices with surveyors, architects, town planners, property managers, builders, decorators, furniture movers and property lawyers. Under this model, it is possible that the legal regulators (currently the SRA) will regulate only the legal services, and all the professionals would be regulated by their own regulators. This envisages an MDP that is dominated by lawyers, however. The legal MDP would probably not have external ownership, therefore, but would have the buying power of the various different professionals who are also partners of it. Equally, it is possible for other types of lawyer – such as barristers, legal executives and patent attorneys – to come together under this model. The point is (or should be) that lawyers should be seeking ways in which they can deliver superb value and expert legal and related services to their clients.

Preservation and survival

The vast majority of law firms to whom I speak maintain a praiseworthy desire to retain their independence. The above models are examples of ways in which proactive firms can seek to maintain or improve their market positioning while protecting their autonomies. But with publicly-funded work on the decline, and consumer services and conveyancing likely to be under increasing pricing pressures from well-organised bulk suppliers, it is hard to be sanguine about the survival prospects of the eight or nine thousand small high-street firms currently operating in England and Wales. Such firms are under increasing threat from economic and consolidating forces. The LSA is likely to speed up the inevitable demise or absorption of more than half of them. ■

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