

Fast forwards by first movers

In the concluding half of this two-part article, Nick Jarrett-Kerr assesses the likely attractions of alternative business structures for external investors in the UK.

In the first part of this article, 'Fast Forwards' (*Managing Partner*, September 2009), I set out some alternative business structures that may be attractive to innovative law firms whose strategy might be assisted by the new freedoms opened up by the Legal Services Act (LSA). In this second half I will now turn to the external perspective to examine the potential attractions of the legal sector to investors who are not currently law firms but who see diversification opportunities in the area of legal services.

There are three main strategic drivers for such providers. First, the law firm sector's record of high profitability is likely to hold great attraction to investors, who will see opportunities to obtain both a return on their investment as well as capital growth in their share value. The traditionally high margins (compared to other sectors) and the prospect of gaining high growth in an unstructured market are both alluring. The legal-services market is large and fragmented, and therefore offers huge potential. The sector also has the advantage of reasonably stable business characteristics such as the existence of loyal client bases.

In addition, there is a widely-held perception that lawyers are bad managers, and that externally imposed management will lead to greater profit. This thinking also resonates with the view of the UK government, which has made it clear that the limitations

on innovation and competition caused by the tightly restrictive regulatory environment have constrained consumer choice and restrained normal market pressures to deliver efficient and effective legal services.

Some investors – particularly those who are ready to take calculated risks in order to gain first mover advantage – may therefore see the opportunity to make a financial gain and to reap an investment harvest in due course.

The second strategic driver for external investors is the opportunity to take both partially-related and unrelated diversification initiatives. The main strategic questions that will arise for them are the same as for legal firms seeking to diversify into unrelated areas. What are the synergies with our existing core business? What are the entry barriers? What is the likely cost of the investment and what is the likely return? How difficult will it be to acquire the people and build the systems, processes and infrastructure? How easy will it be to build the brand?

The interests of such entrants may be prompted either by the need to add a further portfolio of services in order to spread risk, or the desire to expand outside of traditional markets in order to promote further growth or leverage cross-selling and channels of distribution.

The third driver is to maximise or gain further advantage from existing brands by introducing them to a new service sector.

Possible externally-financed models

The integrated MDP

In the previous article I outlined the possibilities and attractions for law firms in setting up a Multi Disciplinary Partnership (MDP), wholly owned and controlled by the law firm. The more likely scenario, however is for the MDP to be externally owned by a non-lawyer entity or a firm comprising a majority of non-legal professionals. Using one brand the firm could provide a number of different professional services. The rationale behind this model would be the synergies that occur between the legal services and the non-legal services. While the law firm would be ringfenced and regulated by the Solicitors Regulation Authority (SRA), the parent external owner might, for example, be a financial institution or an accountancy firm or estate agency, which might have an interest in cross-selling non-legal services to clients of the law firm as a component part of the legal services supplied to the client. Indeed, the external owner might be regulated by a regulator from a different sector (for example, the Institute of Chartered Accountants or the Financial Services Authority). This model could prove to be a regulatory and licensing nightmare, however, as the various regulatory bodies for the different professions involved tussle for regulatory supremacy.

The branded conglomerate

As a starting point it has to be recognised that, even before the introduction of the LSA, all legal



Table 1. Potential ABS models.

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	'Ag gressive' 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.

services weren't necessarily provided by traditional law firms regulated by the SRA, but by companies outside the legal sector and financed by external capital. Companies such as Peninsula give employment advice, Optima Legal Services deals with debt recovery and property services, and Enact Direct Legal Solutions provides home-moving and remortgaging services. Under this model, therefore, the law firm would be totally owned by a non-lawyer owner or company as one of its portfolio of either disparate or related services. This model anticipates that the entity that owns the legal firm will have no interest in the supply of legal services except for a commercial interest in the financial fortunes of all companies within its portfolio. Under this model, the law firm would take advantage of its parent's corporate brand. It might, for instance, become part of a huge global organisation such as Tesco or an insurance company or other similar body. This model would involve either a start-up by the parent company or the acquisition of an existing law firm. The attraction for large corporates is their perception that this may prove to be an interesting and profitable diversification, made even more profitable by operating in partnership with alternative channels of distribution that can be cheaper, wider and closer to the customer – for example, mass markets dominated by a recognised and trusted national or international brand.

The law firm PLC

Under the provisions of the LSA it will be entirely possible for a firm to float on the stock market as a PLC. This move may – like Slater and Gordon in Australia – be to advance one of the consolidation-driven models under which flotation is part of a strategy to enable further acquisitions. Alternatively, it could be done in order to finance organic and strategic growth. In the surveying world Savills

PLC is an example of a firm that has adopted this route, having floated in the mid 1980s, although some of its rivals such as Knight Frank have remained partnerships or LLPs. In order to provide sustainable attraction to the City, it would seem likely that only large and well-known firms, with strong competitive positions and business recipes would be likely to attain successful flotation. Many such firms will not see the attractions of following such a route.

The integrated legal network

This model contemplates a network of (mainly) law firms operating under a 'hub and spoke' structure. The hub would be a non-licensed holding company, providing, for example, administration for central and back-office services. The regulated law firm entities that make up the spokes would be subsidiaries of the holding company. Most of these entities would be legal firms under a national franchise or network arrangement, but there could well be other services (e.g. estate agency) in addition. Some variants of this arrangement are in force already, as many law firms have set up management companies to operate administrative management services for the law firm in return for a management fee. These are currently proving quite difficult for the SRA to approve and regulate, and it is hoped the new regulations will ease the model. In Australia, a firm called Integrated Legal Holdings Limited has already floated as a holding company for a number of law firms, which can operate under an overall brand. Partners in the law firms that have joined Integrated Holdings Ltd have an equity stake, and are using employee share schemes to help increase staff retention and hiring. As a floated firm they have the advantage of new capital injections. In addition to the regulatory requirements of the SRA or other licensing body, the firm would also be the subject of stock market and

corporate governance rules. Conflict of interest rules would come into play for the model where the owning entity has more than one ringfenced law firm, but the model can be designed so as to take conflict rules into account and to allow for some degree of separate branding.

The consolidation roll-up (externally driven)

The consolidator model of a law firm will usually happen in one of three ways. The previous Model 4 (Table 1) envisaged the first of such methods, by which a larger law firm sets out to acquire smaller competitors. The second is for a consolidation to be funded mainly or entirely by external investors – not necessarily lawyers – who start buying up small firms until they are large

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enough to launch or float as an initial public offering (IPO). The third method is what has come to be known as a 'roll-up IPO'. Roll-up IPOs are transactions in which a shell company goes public while simultaneously merging with or acquiring a number of law firms. This model does not require private investors to finance the transaction, nor does it necessarily require an established and well-positioned firm in the legal sector. This model first became popular in the mid-1990s as it allowed a firm to fund a huge level of growth over a very short-term period. It should be noted that potential financing for such transactions dried up in most sectors by the turn of the century, largely because roll-ups performed poorly on average, compared to the general market. There may, however, be some novelty value in the legal sector that might assist a selective number of roll-up IPOs in the early

years of the LSA. Hence, consolidation is likely to start with the private acquisition of an existing law firm, followed by an IPO when sufficient firms have been acquired and integrated to demonstrate an established model that would be attractive in a public offering.

Online firms

In his recent book *The End of Lawyers* Richard Susskind explores the current and likely impact on the legal profession of disruptive legal technologies. As he asserts: "These systems might provide expert legal services, generate legal documents, assist in legal audits, or provide legal updates". It is already possible to purchase or download legal documents over the internet from

sites that specialise in offering legal document templates for consumers and commercial enterprises. Some such sites are not currently regulated by the SRA, and sometimes offer limited advice of a legal nature (www.netlawman.co.uk is an example). There is also a growth of law firms such as Linklaters and others providing online legal guidance, and there are also companies such as Epoq Group Ltd offering processes and online solutions on a retail basis through the internet, as well as on a wholesale basis via a network of subscribing law firms. Susskind also prophesies legal open-source solutions – rather like a legal version of the online encyclopaedia Wikipedia – fuelled by sustained online collaborators and volunteers.

Not for profit firms

The 14th model envisages not for profit organisations providing legal

services for low fees or within the publicly funded arena. In the UK we already have a number of charities, citizens' advice bureaus and not for profit firms, who may make a charge for their services but only a charge that is sufficient to cover overheads.

In-house teams

This model anticipates some institutions that might plan to build their in-house teams to enable them to offer legal services outside the institution. Many corporations and councils have quite large in-house legal departments, and in some cases it might be attractive for them to be able to offer their services to other companies on the new open market outside their own conglomeration, or even to consumers. Divergent strategies have seen some corporations outsourcing more work to external law firms, but in general

the perceived expense of using traditional law firms in the last few years has seen both outsourcing to Legal Process Outsourcers (LPOs) and the growth of in-house teams in many companies, at the expense of external law firms. The provision of legal services by in-house teams at one institution to other institutions can provide a cost-effective alternative for in-house teams, as well as a specialist edge and compatible in-house knowledge and understanding of in-house service requirements.

On the way

The mood of the legal sector has fluctuated considerably in its reaction to new competitive pressures threatened by the LSA. Three or four years ago many lawyers were still saying that the changes would simply not happen. When the Act was passed, there

was then a dawning recognition that change would happen and a growing appreciation of a real and significant threat to the established order. Then came the recession, and with it a feeling among some law firms that the Act would be a 'damp squib'. The possible negative effect of deregulation on the status quo has, however, been discounted too much. There are many opportunities for aggressive commercial enterprises to gain market share and competitive position at the expensive of cosy and reactive law firms. The first movers are already on the march. **ManagingPARTNER**



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