

ALTERNATIVE BUSINESS STRUCTURES

Something for everyone?

Stephen Mayson

Professor of Strategy and Director of the Institute

An alternative to what?

A key part of the Legal Services Bill is the proposals for ‘alternative business structures’ (ABSs). The first question, therefore, is what are they an alternative to? The legal structures that ABSs might adopt – such as partnership, LLP, limited company or plc – already exist. There are no alternative *structures* in this sense. The Bill only regulates reserved legal activities, and there are no alternative *business activities* being proposed. What the Bill sets out is simply a licensing framework for businesses carrying out reserved legal activities where 10 per cent or more of the ownership or management of those businesses is under the control of non-lawyers. In effect, therefore, these structures are alternatives to the *ownership* of law firms only by qualified lawyers. But in allowing these alternatives, they will also encourage a different combination of services and products alongside legal advice, as well as different ways of delivering them to clients.

Sir David Clementi’s idea of legal disciplinary practices (LDPs) was not incorporated into the ABS provisions. LDPs would allow lawyers from different backgrounds, such as solicitors, barristers, legal executives and licensed conveyancers, to be co-owners of a law firm. These will be regulated directly by the Law Society (SRA); they do not qualify to be licensed as ABSs. It is therefore likely that LDPs will become a reality far sooner than ABSs.

For the purposes of this paper, I am going to address the issue of ‘new’ business structures rather than restrict myself only to licensed ‘alternative’ structures under the Bill. Looked at in this light, I suspect that there are very few law firms which should not be interested in adopting one of the new available forms.

Legal disciplinary practices (LDPs)

The legal professions have already demonstrated some interest and support for the idea of LDPs. There seems to me to be a great deal of merit in the possibility of 'lawyers' who might have been in practice for many years, and contributed as much (if not more) than many solicitors to a law firm, to be invited into the ownership of that firm. To be disqualified from ownership simply on the basis of professional qualification rather than experience flies in the face of sound business logic.

I therefore expect a significant number of law firms to take advantage of the LDP provisions as soon as they are available, and we should see solicitors, barristers, patent and trade mark attorneys, legal executives and licensed conveyancers as co-owners of law firms by mid- to late 2008. There will, of course, be a need for regulatory comparability on this issue among the relevant professional bodies.

ABSs for lawyers and managers

Sir David Clementi was keen to encourage law firms to offer better motivation and career prospects to their professional managers by allowing directors of finance, human resources, marketing, technology, and so on to become co-owners. Again, many law firms have expressed great interest in this possibility. Unfortunately, because such managers are not (usually) lawyers, they fall within the ABS provisions of the Bill.

This means that to achieve such ownership, law firms will have to submit to the ABS licensing provisions with all that this will entail in terms of registration, fees and regulation. It is true that such ABSs are likely to qualify as 'low risk' bodies, and that the regulatory touch might accordingly be lighter. Nevertheless, it seems to me that many firms that would have contemplated opening up ownership to managers might be deterred from doing so because of the burden of ABS licensing. In reaching this decision, they should be mindful of the emergence of a much more fluid market for professional managers, with more opportunities for progression and co-ownership. Firms that decide not to adopt the ABS solution for managers might find that their best managers are tempted away by others who are not deterred by the need for licensing.

Multi-talented practices (MTPs)

Much has been made of the notion of multidisciplinary practices – usually in the context of large firms of accountants acquiring law firms. But it might now be

opportune to look at the issue in a different way (and I shall return to MDPs in the next paragraph).

Many law firms already employ other professionals and sources of support directly in the provision of client service. For instance, a personal injury and clinical negligence practice might have health care professionals; a matrimonial practice might engage qualified counsellors; a criminal practice might have former police officers; other firms might include the services of accountants, estate agents, engineers, and others – not as referred services, but as an integral part of their delivery to clients.

The ABS framework allows the promotion of these other talents to co-ownership. I envisage that, in an MTP, lawyers will remain in control and that the business will remain fundamentally that of delivering legal services. Nevertheless, the ‘other talent’ adds considerable value to the firm by offering a local, coordinated service. Where lawyers retain at least 90 per cent of the ownership and control of the business, it will qualify as a low-risk ABS with a correspondingly lighter touch licence. In this sense, MTPs are more likely to come about by the addition of individuals rather than through the merger or acquisition of ‘other talent’ firms.

The need for, and potential competitive advantage of, MTPs suggests that many firms ought to be considering the options for sharing ownership with their ‘other talent’. I would also hope that the regulatory approach will be supportive (and, in this context, it seems to me that the separate business rules need serious reconsideration if solicitors are not to be competitively disadvantaged). That said, the regulatory challenges cannot merely be brushed aside, since coordinating the regulation of other professionals will be required, and issues of legal professional privilege and possible conflicts of interests will need to be worked through in these multi-talented environments.

Multidisciplinary practices (MDPs)

Whereas law firms will certainly remain in the driving seat in MTPs, they might not in MDPs. They are more likely to be created by merger or acquisition of whole firms. Arguably, the appetite for MDPs has diminished in the post-Andersen world, and it is quite difficult to find any significant evidence that clients are looking for large-scale, one-stop, MDPs.

The strategy behind the creation of MDPs will probably therefore be supply-driven. Such a strategy will be high risk without an existing brand to leverage. Success will imply a degree of pre-existing scale and reputation which few professional services firms currently have.

Even so, the MDP option could well be attractive in a market town or suburb where there is a dominant law firm, accounting firm, estate agency, and so on. If those firms combined into a local MDP, offering a one-stop shop to consumers (and possibly high net-worth clients and owner-managers), such a business might be sufficiently well known, locally respected and valuable to withstand the incursions of larger High Street brand names.

As with MTPs – but on a more significant scale and with greater consequence – the issues of separate business rules, regulatory coordination of owners with different professional or business backgrounds, and of legal professional privilege and the resolution of conflicts of interest, will need careful attention.

New entrants and ABSs

It is only at this point that we approach what has become known as ‘Tesco Law’. The prospect of large, well-recognised brands entering the market terrifies some. It is worth remembering at the outset that this process has already started. Co-operative Legal Services, Halifax Legal Solutions (HBoS), and the AA are already active and successful. They and others have found ways of entering the market short of ownership of law firms and so without the need for an ABS licence as envisaged by the Legal Services Bill. The ABS regime is not therefore a precondition to their entry but only to their ownership.

New entrants will usually not be venturing into legal services for short-term financial returns. They will be able to make medium- to long-term investments from a position of scale, deeper pockets than most law firms, and the ability to control access to work (for instance, through insurance policies, membership benefits, and customer loyalty). These players also carry a significant reputational risk to their whole business. This is why we cannot afford to be duped by any suggestion that new entrants will cut corners, slash costs and concentrate on volume at the expense of quality. The potential losses to these new entrants from mistakes and a poor reputation in legal services are too significant to brand value and share price to be worth the risks inherent in the ‘pile high, sell cheap’ philosophy.

Further, these new entrants will have less need for (and allegiance to) qualified lawyers. They are therefore less likely to want to acquire law firms – especially economically under-performing or technologically backward ones – with all the cultural ‘baggage’ that they might bring. Only the most modern and already successful businesses are inherently attractive acquisitions for this group. The lure of this emerging option as a route to lawyers extracting capital might not be capable of satisfying as many aspirants as exist.

ABSs for external investment

Unlike new entrants, external investors will need to wait for the licensing framework of ABSs under the Legal Services Act before being able to realise their ambitions (which will take until about 2011); also, their time horizons will be much shorter and their need for economic returns much greater. Despite the murmurings of legal practitioners about the rewards of legal practice, make no mistake: there are others outside the legal professions who believe that law can be a very financially attractive market. They will generate returns and capital value, and will certainly be looking for an exit route. That will require a successful and sustainable business: again, therefore, the notion that external investors will exercise undue influence on lawyers within their businesses to act unethically or at the margins of acceptable client service is misplaced, because this will not create an attractive business that can be floated, transferred or re-invested.

It remains to be seen whether the real interest of external investors will be in start-up providers or new approaches to the market (new entrants, MDPs, consolidators) rather than financing the expansion of established law firms. It is probably the case that in 2007 there are very few law firms that represent an immediately attractive investment opportunity: there is work to be done (unless the external investors want to make their return on some form of 'turnaround', where they will undoubtedly profit at the expense of the current owners).

My concern with the development of external investment does not lie with the ethics or ethos of such involvement. Rather, it is that law firms and investors do not sufficiently understand each other, and may have unrealistic or unreasonable expectations of the other. The experiences of Big Bang, of the acquisition of estate agencies, and in South Africa should give some pause for thought. Nevertheless, I have no doubt that the need for external capital will grow over time. Provided we avoid irrational exuberance, there is room for winners all round.

Conclusions

Even when one or more of the choices outlined above is adopted, there will remain the consequent issues of culture as, at an ownership level, questions of relative contribution to reputation, client relationships and fees are resolved, along with the associated challenges of performance assessment and reward-sharing. In every one of the choices described, it will be the culture and not the structure that is the determining factor of success.

The post-Clementi world will offer many more business and structural opportunities than we have been used to. It is important to remember that these opportunities are open to lawyers as much as to the 'new entrants'. Lawyers do not have to be the

victims and losers. It is time to rethink the delivery of legal services, and with it the role of lawyers in that delivery and the appropriate business structures to survive and compete in an unprotected market.

We face a redistribution of clients, work, people, profit, capital and ownership, all of which will drive further consolidation. The key questions are: where do you most want to be in that reconfigured market, and how 'fit for purpose' are you? The fittest will be in a position to benefit fully from the structures I have described, and will have the most choices available to them. There will never be a time when the future is absolutely clear and unambiguous. A 'wait and see' approach could be wasting time and opportunity – as well as allowing better-prepared competition to steal a march.

This paper first appeared as an article in *New Law Journal* on 27 July 2007.