EXTERNAL INVESTMENT IN LAW FIRMS CAN MAKE THEM MORE INNOVATIVE

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Law firms' inability to innovate is due to their "short-termism" – partners have little incentive to build-up the long-term value of their firm as a business

In the business world, law firms are virtually unique as large and often very profitable businesses that are structured and run as financially inefficient cash partnerships. I believe law firms' inability to innovate has a lot to do with their short-termism, a phrase borrowed from corporate finance literature that refers to an undue focus on current profits at the expense of longer-term goals. In the case of law firms, this short-termism is closely linked to their peculiar capital structure.

Under the cash partnership structure, partners are the sole owners of the firm and yet they do not really have permanent equity. Partners give up their ownership interest upon retirement. As a result, partners have an incentive to earn as much as they can during their productive working years, rather than to build up the long-term value of the firm as a business. This has significant negative consequences for law firms and for their clients.

Faced with the choice of divvying up profits today, or foregoing an immediate payoff to invest monies back into the firm, it's no surprise that many law firm partners opt for the former. Yet these reinvestments may ultimately be more favourable to long-term client satisfaction and firm profitability. The investment may involve building a new practice group, establishing a new technology platform for increased efficiency, or offering clients alternative billing arrangements with lower current billings but the promise of greater revenue for the firm over the long term. Each may be the smart move for the firm's profitability and equity value. But if the investments require a current pay cut for law firm partners, the partnership will be reluctant to proceed. Were law a sellers' market, not a buyers' market, short-termism would be a less urgent problem for firms. In the aftermath of the 2008 recession, however, law firms have faced intense pressure from clients for efficiency, alternative fee models and cost effectiveness.

Barrier to sustainability

The ´in-sourcing´ of legal work by corporate clients and their willingness to work with many different service providers means clients call the shots—and it behooves firms to take a more sustainable view and invest in the firm to give a competitive edge and ensure long-term client loyalty. The current cash partnership model, with its inherent short-termism, is a barrier.

Few professional services firms operate this way. Instead, they provide services using a conventional capital structure with conventional equity. This is the organisational form in which most other service providers operate: a corporation with a traditional corporate capital structure.

This capital structure is permissible for lawyers and is being pursued in the UK and Australia. In the UK, the Legal Services Act of 2011 made it possible for law firms to register for an IPO by removing restrictions on non-lawyer ownership; and in Australia, non-lawyer ownership has been allowed for even longer. Australian personal injury firm Slater & Gordon became the world's first publicly-listed law firm in 2007, entered the UK market in 2012 and has made a handful of high-profile acquisitions. Meanwhile, in 2015, Gateley became the first UK law firm to list shares in an IPO, raising $45m.

My point is not to endorse law firm IPOs, but rather rationalise the law firm capital structure to incentivise firms to make sound long term investments. In the UK, "alternative business structures" (ABS) – which have been in use since 2012 – allow non-lawyer external investment, whether through private or public offerings. According to research by Arden Partners, the deployment of external capital into the new ABS firms will drive innovation in operating models, efficiencies in service delivery and other competitive advantages that will result in consolidation in the UK legal market with the potential for over £3bn of revenue changing control. Two law firm IPOs and a growing number of ABS conversions do not constitute a trend, but do highlight that access to the financial markets is of interest to law firms, and simultaneously that investing in law firms is of interest to equity investors.

I expect lawyers and investors on both sides of the Atlantic will look for additional opportunities to put capital to work in the legal space. These opportunities could include investments in high-end firms that serve global corporations as well as aggregations of smaller local or regional firms that serve individual consumers.

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