

The upcoming option of external investment under the *Legal Services Act* forces entrenched traditional firms to break with the past and modernise. By Patricia Wheatley Burt, Director of Trafalgar People

# Invested Interests

Believe it or not, investing in professional services is not seen as an 'AA' type of investment for many private equity firms. The opportunity for them to invest in law firms from October 2011 may not be met with as much enthusiasm as managing partners would hope.

The Solicitors Regulatory Authority (SRA) is currently addressing the fine details of alternative business structures under the Legal Services Act (LSA). While the top-30 law firms may see this option as an irrelevance and the high street firms will be viewed as too small, it is the mid-tier firms that should really be focusing on investment opportunities.

A few private equity houses have found their past experience of investing in, for example, a PI commodities business, a long drawn out and ultimately unsuccessful project. Steve Tudge, a partner at private equity group ECI, suggests: "the biggest barrier is the resistance of the partners and their need for control. The industry has been protected by statute and regulation for far too long and there is a huge gulf between law firms and the corporate world".

## PERCEPTIONS OF LAW FIRMS

When garnering views on the legal profession from those in the private equity world, there is some perception that most law firms are:

- old fashioned slow-moving monoliths, bound by some quaint idea of collegiality with no rigour or management of performance – and therefore lacking in corporate structure, regulation or discipline;
- a service business, vulnerable to a few big hitters – usually partners, who could dramatically affect client retention or turnover if they left;
- inherently difficult to plan and budget for by having neither scalable, replicable nor repeatable services apart from conveyancing, remortgaging and personal-injury commoditised services; and
- so risk-averse that they would not be sufficiently corporate in vision to break with old habits.

Views expressed by the partners of law firms are, of course, as wide ranging as those firms themselves. There are some extreme views on the benefits, opportunities and the 'ghastliness' of what external investment could mean for them. Many of the current views (both of law firms and private equity) are based on the much publicised stories about heavily-commoditised personal injury (PI) powerhouses like Russell

Jones & Walker and Irwin Mitchell, HBOS and AA undertaking huge volumes of legal work, or marketing vehicles such as Connect2law. Hammond Direct has also reached the headlines as an example of how any commoditisation can be vulnerable to the vagaries of the market – property in this case, and the financial penalties this can trigger.

Many commentators on the legal sector expect the number of law firms

Are law firms good investments  
for private equity houses?



to halve over the next five years as a result of the LSA – even without the impact of the economic downturn. By enabling firms to have external investors who are not employed within the firm (whether lawyers or not), the scope for fundamental shifts in practice structure is challenging the old concepts of partnership. This opens the opportunity for private-equity investment or, perhaps, although less likely in the current market, for fundraising on AIM.

It is true that commoditised legal services can become victims of the economy – note, for example, the extraordinary slowdown of the housing market. Sceptics may say that this is proof perfect that investing in law firms or commoditised legal services is far too fraught to bother.

#### Changing structures

At a time when PE houses might have a dearth of good investment opportunities in more traditional sectors, could now be a wonderful opportunity for the legal sector to show just how sophisticated it can be and how dialogues should start?

Phillip Rattle, a partner at PE firm August Equity, notes that investment opportunities are limited to scalability and having regular, replicable services which are focused on a specific client group.

Clearly though, commoditised services are not the only route. A number of managing partners have suggested that there is scope to benefit from private equity investment to get value and growth out of their firms as niche practices, or to develop a larger regional or national presence.

Central to any external investment, however, will be the requirement to not only have an equity stake but also a controlling influence. This is causing many partners to dismiss this idea, as it means the end of their partnership structure in exchange for a corporate one. Thus the LSA is posing a catalyst for firms to address unity and common purpose of vision.

To be an effective investment opportunity by, for example, 2012, Halliwells' managing partner Ian Austin believes law firms need to have the following key attributes in place:



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- a clear vision and strategy for the firm, with strong growth plans;
- client-focused services that are repeatable, reliable and sustainable;
- evidence of a management structure that manages the performance of everyone, demonstrating a cultural shift; and
- seasoned and strong finances (profit and cash), and sound infrastructure.

It is evident then, that managing partners who can see opportunities for their firms should be reviewing their structure, not just in the ailing departments, but also across the whole firm, to meet external investor requirements. A partnership structure based on consensual management and paternalistic governance – where management and staff's futures are still beholden to the whiff and whim of a few individuals – will have to change. Critics of the partnership culture suggest it is an unsupportable closed shop into which non-lawyer managers and/or non-executive directors and chairmen (likely to be from the PE house) would not fit.

A corporate structure, with a management board, remuneration committee, defined corporate governance and so on, with all the partners and staff managed within this, will cause a shift in law firm culture too. There will also be no place for maverick fee-earners, *prima donna* partners, protected underperformers or passive observers at partner or staff levels. This is probably the greatest challenge to any partnership looking to grow through external investment and should be actively managed.

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#### Planning ahead

Partners should not be so naive as to think investors will not look, thoroughly and minutely, at their management structure and the level of commitment from the partners and management team to the growth plans.

External investment is not some panacea or war chest, nor a loaded gun to help get rid of problem partners or shore up aberrant practice areas while the rest of the partners are sitting on a Caribbean island in happy riches. It is a serious opportunity to develop a vehicle to deliver sustainable legal services differently from the insurance and commodity businesses.

Napoleon said that if you are inside your castle, defending it, you have already lost the battle. Attack is the greatest form of defence. Clearly, some members of the legal profession see the opportunities. However, there is a larger number who either cannot or will not see the changes on the horizon, and so are doing nothing.

In this economic climate, the opportunity to invest in sound businesses has to be a challenge for fund managers. The LSA effectively offers virgin territory, and now is the time to build an understanding of what modern law firms need to become a new option for investment. mp

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