Kowalski&Associates

The latest from our blog: www.kowalskiandassociatesblog.com

Here's a Great Idea: Let's Get Some Private Equity Funds to Invest in Large Commercial Law Firms and We'll All Make a Ton of Money; Then We'll All Be Rich!

Jerome Kowalski
Kowalski & Associates
April, 2011

Frankly, I don't think so. An investment with Bernie Madoff might have been a better idea.

Recently, the media have been chock full of virtually daily reports concerning the impending changes in the United Kingdom concerning the October 2011 kick off date when non lawyers will be permitted to invest in law firms; the so-called Alternative Business Structure ("ABS") model, sometimes called the "Tesco laws," a non de guerre inspired by the international consumer goods retailer of that name.

Moving at its typical glacial speed, even the American Bar Association is now looking in to adopting the model.

The ABS model is virtually naively simple in its genesis: Allow non-lawyer investors to invest and acquire ownership interests in law firms, with large law firms then using the proceeds of that investment to grow the firms, with investors reaping substantial profits. Except that I frankly don't see that the model has any commercial viability for large corporate commercial law firms. Others also question the financial viability of this model.

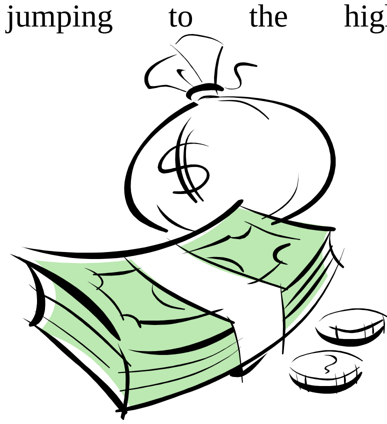
The early player in this brave new world is London based Irwin Mitchell, which is boasting about a £50,000,000 investment by a private equity firm, with the proceeds to be used to expand Irwin Mitchell's financially successful tort focused practice to a full smorgasbord of (less profitable) commercial services.

The ABS topic continues to galvanize the profession's attention and will continue to do so for some time, as we in the United States watch events unfold across the pond.

There are some quite serious business obstacles yet to be adequately addressed, let alone even comprehended.

As some have noted, the proceeds of capital infusions by outside investors in large law firms will likely be applied to technology and most particularly knowledge management systems, all with a view of lowering costs to consumers of legal services. The result would be increased commoditization and reduced revenues per lawyer. Thus, the consequence of such investments may well be that unless one creates a Goldman Sachs-type leverage ratio (10,000 to 1?), an extremely unlikely result for any law firm; the investor will simply not get the anticipated return.

These capital infusions will also presumably be used to lure big name and big revenue producers and pay them NFL level compensation to get them to sign on. However, in this era of law firm partnership free agency, there is no assurance that these big ticket producers will stay beyond the moment the firm across the street offers them more money. Nor is there any viable means to restrain these lawyers from jumping to the highest bidder.



The practices which yield the highest return still remain in the plaintiffs' class action bar and in big stakes high end plaintiffs' contingency cases. Massive class actions and other high end cases chew up enormous amounts of capital. Law firms which have been active in this world have already amassed substantial capital and have the internal resources to fund these cases. Some still utilize traditional institutional lending from banks at favorable rates. Others utilize litigation funding companies which do tend to charge exorbitant interest rates; but, then again, these funding companies accept all of the risk in making non-recourse loans and at the end of the day, they do not remain partners of the law firm.

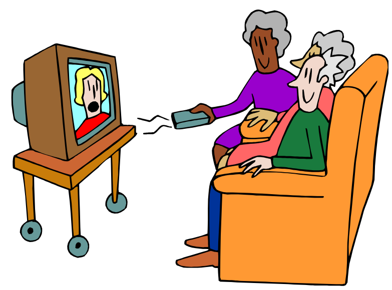
The Irwin Mitchell experiment raises some questions for which we do not quite have enough facts to make any intelligent responses, lacking adequate information. For example: Why would equity investors provide capital for a firm to enter middle market practices, where the margins are lower than in tort cases and lower than that earned at magic circle firms? In addition, we already know from several decades of experience that the ultimate additional profit to a law firm in hiring laterals is only marginally incremental, as firms are required to pay for the ramp up of the laterals and the lion's share of profits earned by new laterals are actually paid to the laterals, with the increase in firm-wide profits is only marginal

Other commentators, most noteworthy of which is [Professor Mitt Regan] of Georgetown, have noted that outside investors in a firms would exert some degree of control within a law firm and the danger he highlights is that such investors will impair the independence of the lawyers' judgments in directing that efficiency, rather than the clients' best interests will be a driver in handling a client engagement, all in violation of Rule 1.1 of the Model Rules of Professional Conduct under US rules; we do know that proposed new UK rules are designed to have a different result. Here, the UK has a distinct advantage over us in rule-making. Once the ABA concludes its deliberations and some committee proposes a new set of Model Rules, those rules will need to be mulled over by 50 separate state commissions and the District of Columbia, some of which may adopt the ABA proposals, some of which may modify them and some of which may simply reject them.

But an added impediment is the preservation of client secrets and confidences. Non lawyer investor participation in law firm management necessarily makes non-lawyers privy to such secrets and confidences, with no mechanism to police the maintenance of such confidentiality by these non-lawyers.

Some of these issues were addressed at some length in Australia in 2008, which was the first country to permit non-lawyer ownership of law firms in a report issued by Melbourne Law School and the Australian Office of the Law Commissioner. Interestingly, Australia was the first nation to permit non-lawyer ownership and the firm that was first out on the market was Slater and Gordon, a large trans-Australia law firm, which offered shares to the public. Slater and Gordon is primarily a tort firm and its initial public reports does report a reasonably good financial performance. As I suggest below, a firm with that type of focus might be far more attractive to outside investors.

To me frankly, a far more alluring and potentially far more financially rewarding model, ripe for non-lawyer investment would in essence be a tort contingency fee clearinghouse. Let's for example take the case of James Sokolove, whose ubiquitous television US advertising cannot escape the attention of even the most casual TV viewer. In 2009, Sokolove spent a reported $20,000,000 in television advertising. Mr. Sokolove's business model, described in 2008 in The Boston Magazine is to be a constant presence on television encouraging potential tort plaintiffs to call in on his toll free telephone line, while maintaining a network of some 400 law firms around the country to which these cases are referred for prosecution. In 2008, Boston Magazine reported that "Sokolove's firm is currently keeping tabs on some 10,000 open cases. Approximately 300,000 calls and e-mails come into his office each year, more than at any other firm. On behalf of his clients, Sokolove has won more than $2 billion in damages or settlements, while he and lawyers working with him have pocketed some $500 million for their trouble." Elsewhere, it was reported that in 2007, Sokolove spent $20,000,000 in advertising. I have heard reports, which I haven't been able to corroborate, that Sokolove's current advertising budget has increased since then by some four-fold.



But, here is a far more attractive model, even if we just use the reported information for 2008: $20,000,000 invested in annual advertising, some modest investment in infrastructure and an ultimate revenue stream of several multiples, assuming the average life span of a tort case from inception through settlement is approximately three years.

As American baseball legend Yogi Berra said, predictions are hard, particularly about the future, my own humble prediction is that these models won't work for traditional Big Law. That's what I said six months ago and nothing has yet surfaced to dissuade me.

The ABS or Tesco models just won't work for Big Law. But, they may very well for mass market, consumer oriented, commoditized practice, built on a franchise type model. Take something like legalzoom.com and open storefronts across the landscape. The margins may be small, but they are also small at MacDonald's, KFC and so on. Perhaps it's time to dust off the old Jacoby & Meyers business model and hawk that model to private equity investors. The returns will far exceed that which large commercial law firms can offer to outside investors.