Definitely Mabey

Heard about the high margins and so you want to invest in a law firm?

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Dr. Larry Richard, seen by many as an eminent expert on the personality profile of lawyers, has pointed out the following characteristics of lawyers in the past:

- very skeptical;
- disproportionately high degree of negative thinking;
- low in sociability;
- low in interpersonal sensitivity;
- low in resilience;
- high in urgency; and,
- very autonomous.

But let's move on from their traits for now and talk about "margins." When clients and other for-profit companies talk about net income before income tax they are speaking of a number after which the salary and bonus pay for all of the executive team has been deducted. This is unlike a law firm, where when the partners talk about net income it is an amount before they have paid themselves anything.

To put it on comparable footing, the law firm would have to treat partners' income distributions as salary and then compare the return on revenue after the distributions had been deducted.

While I recognize that exceptions would exist, the vast majority of law firms' return on revenue would be worse than for-profit companies.

To some degree driven by the income tax treatment of partnerships, there is the high need/demand to pay out all of the earnings sooner rather than later. Paying income tax on monies not received is a very difficult sell to partners at the best of times and when for investing in innovations, the results of which cannot be guaranteed, nigh impossible.

The money companies leave on the table is for re-investing in innovation (competitive edge) and creating a return for their shareholders. The return many investors weigh on evaluating companies to invest in is the combination of the return (dividends) and the appreciation in the share value.

If a company is not earning a return other than just appreciation in share value, its attraction as an investment is diminished. It is further diminished if potential investors don't see there being any incentive tied to the company's results for management to take it beyond expected results.

So in order to make investing in a law firm generally attractive to non-lawyer investors the following are a few of the compensation changes that would have to occur:

1. Salaries would have to be assigned to each partner that would obviously be less than their current draw;
2. A bonus plan would have to be embraced that did not guarantee further income to all former partners but to only those qualifying under the bonus plan and that the proceeds under the plan may not be solely cash but could include warrants and options for additional shares in the company; and,
3. Partners would receive part of what they formerly received in cash through a combination of appreciation in the value of the shares and dividends.

..."to make investing in a law firm generally attractive to non-lawyer investors..."

For sure the lawyers would have to understand and accept that their combined actual cash flow under all three aspects of the compensation arrangement would not equal their former drawings but for sure any cash-tax difference would be minimized and they would have the potential upside of appreciation in the shares held.

An almost equally daunting challenge would be the required switch in mindset from partner to shareholder. There will be a required change in how things are done and more importantly who makes the final call, which will fly in the face of what partners have come to feel entitled to as owners.

I would have you reflect back on the seven traits identified at the start of the column and ask you to think about the alignment of these traits with those that would be required to make an investment in a law firm by non-lawyers even thinkable.

That is not to say it is impossible. Slater & Gordon, the first law firm to go public in April 2007 in Australia, had an initial share offering of AUS $1 a share and recently traded at AUS $5.75 at the close of the Australian Exchange on Aug. 15. It is paying a dividend this quarter of AUS $.05 for a yield of 1.39 per cent. I would be remiss if I did not point out that its board just designated one million shares for distribution to employees under a profit-sharing arrangement.

A note of caution, however, Slater & Gordon is a litigation boutique that takes on class actions against corporations, the funding of which would make it ripe to align with non-traditional funding provided by non-lawyer ownership.

The other categories that seem to be most prevalent in the take-up of alternative business structures include “law firms wanting ‘non-lawyers' to be partners; accountancy firms providing legal services; property one-stop shops; legal and other experts working together to address particular business challenges; and virtual firms with lawyers working from client premises,” according to an August *UK Managing Partner Form Weekly Briefing*. You will note an absence of general service firms in the preceding list.

One of the recommendations (No. 5) contained in the recently released CBA Futures report titled Futures: Transforming the delivery of legal services in **Canada** if approved may have more immediate impact on a broader stratum of the Canadian legal market. That change would, within some reasonable parameters, permit fee-sharing with non-lawyers and paying referral fees to non-lawyers.

I would speculate that this would remove the final hurdle to law firms utilizing both internal and external “sales forces” to generate work. One hopeful outcome would be better client service by finally providing some economic incentive for the pushing of work out to firms that can handle the particular matters by lawyers and firms that cannot.

Until next month as George Soros is quoted as having said:

"It is much easier to put existing resources to better use, than to develop resources where they do not exist."

Comments or Questions?

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