

Legal Week

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View From Here: Changes

Sir David Clementi's recommendations for the reform of legal services in the UK could fundamentally change the shape of the legal profession already undergoing a period of seismic change. Tony Williams looks at what is in store for UK lawyers

The Clementi Report — and the subsequent Government response to it— has now been unveiled and we can envisage the impact this will have on the legal profession in the medium term.

Change will not be immediate. A White Paper will be published by the Government later this year. At best, primary legislation will be passed in 2006 with the detailed implementing regulations coming into effect in 2007. Accordingly, the profession has ample time to adapt to the new environment. However, these changes are likely to come into force at a time of profound change in the legal profession. The magic circle has placed clear blue water between itself and the rest of the UK market. This gap will open further as corporate transactions increase in 2005 and 2006.

The 100-plus US firms in London are becoming increasingly serious competitors. Indeed, the best US firms are potent competitors to the top UK practices. Further US/UK mergers will occur primarily among the mid-tier UK firms. Further consolidation of those in the lower half of the top 100 UK firms will happen as these increasingly try to gain places on the smaller, but more valuable, corporate legal panels.

Given the changes that will happen in any event, what further impact will the Clementi reforms have? A few changes are obvious, others are more speculative, — not as to if, but when, they will happen.

The obvious changes

Law firms will take senior professionals such as finance directors, marketing directors and HR directors into the part-nership. This will provide a more defined and clearer career path and status. Although these professionals have achieved quasi-partner status in recent years they will now be 'real' partners. Hopefully, this will enhance the status and authority of these professionals, enable law firms to recruit more senior and experienced professionals from other professional services organisations and companies and generally improve law firms' management and focus.

Other client-facing professionals will become partners. These will include dedicated tax advisers, former inspectors of taxes and other specialists relevant to the firm's practice, such as engineers in construction practices, economists in competition groups and chemists and scientists in bioscience and similar practices.

Some high-profile members of the Bar and increasing numbers of the junior Bar will join the major law firms in return for the relative certainty of a high level of sustainable earnings. It is quite likely the larger UK and US firms will develop specialist advocacy, or trial lawyer, capability.

Although the leadership of the Bar may be opposed to such changes, many barristers are far more open-minded. Indeed, while at Andersen Legal I was approached by a senior silk who wished to join us. Post-Clementi, this will become a credible career move for all but the few top earners at the Bar.

The speculative agenda

Some law firms will accept outside minority capital. Law firms are an interesting prospect for outside capital, providing, as they do, reasonably steady cash flow. Also, their relatively poor management provides ample scope for profit improvement. Accordingly, if they produce profit improvement, outside investors can be rewarded without necessarily diluting partner earnings. The new shareholders will need to pass a fit-to-own test, and qualified lawyers will be required to maintain managerial control.

New external capital may help to fund investment in new premises or IT, or to provide a war chest for mergers and practice reorganisation. In the short term, external capital is unlikely to be an attractive option to the more successful firms as they have ready access to bank finance (banks consider partners in law firms a relatively good credit risk). However, as the market consolidates, equity capital may enable firms to develop more quickly and provide the necessary capital to reorganise themselves, including golden goodbyes to departing partners. As baby-boomer partners start to contemplate retirement, often with depleted pension provision, the availability of this capital may assist by providing tax efficient payments to retiring partners (i.e. a capital gain on the disposal of their interest in the partnership, which may be subject to a top rate of tax of 10% as opposed to income taxed at 40%).

Initially, new entrants will enter the legal profession primarily at the retail end. This will impact on a range of services including residential conveyancing, personal injury, wills and probate and general advice. The new, corporate-owned entrants will use their branding, widespread advertising and extensive call-centre and know-how systems to deliver a credible and clearly priced service.

It is unlikely such new entrants will seek to take over existing firms. It is far more likely they will use a new model. This may include call centres manned by paralegals, offshore advice centres and state of the art know-how systems. Law firms faced new entrants some years ago when licensed conveyancers were authorised. Lawyers met this threat by reducing their prices in real terms.

Whether the traditional model will be able to adapt to compete with these new entrants remains to be seen. Although these new entrants may initially be at the retail end of the market, their branding and advertising may have a wider impact. Many small- and medium-sized corporates (and even larger corporates) may be attracted by transparent pricing and a 'no-frills' service for day-to-day legal advice. This may force some mid-tier firms to either seek to move up-market or to compete directly on price and service delivery with these new entrants.

The experience of other sectors including retail, banking, investment banking and insurance, suggests undifferentiated mid-tier players may face a very difficult time. We may see some law firms listed, especially on AIM. While the prospect of Clifford Chance plc may be remote, as the market consolidates the leading national and international firms may be attracted by this option. Indeed, many partners may see this as a proper return for the investment they made in new offices, technology and know-how, which they funded from their own earnings.

It is also quite possible that the successful new entrants, once they have a good track record, will look to list on the market. Businesses with strong and credible cash flows and leading brands will be attractive.

Share options in a listed company may incentivise those in the firm and provide a degree of 'golden handcuffs' to the stars a firm wishes to retain. Any change in the current National Insurance regime, which is currently advantageous for partnerships, may make moving to plc status more attractive. Indeed the tax advantages of a shareholding in an AIM company, together with the increased profile in the market of a listed company, may make acquisitions of other practices more manageable. Twenty-five years ago, it was inconceivable that public utilities would ever be listed, so this option should not be ignored.

Falling in line

In the past 20 years, the legal sector has developed and changed far less than any other area of professional services or corporate activity. Certainly for the larger firms, law has been a very profitable and stable business comparatively. At last the legal industry is starting to face sustained and effective downward pricing pressure. The forces of consolidation are starting to apply to law.

The Clementi reforms will come into force during this period of change. It will present a range of options for firms and their clients to consider and may provide a catalyst for further change. One thing is clear, if the Clementi reforms are adopted the UK legal profession will look very different in 2015.

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