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A new law firm equity model

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Q&A:
Veta Richardson, ACC
A new law firm equity model can reshape the market for legal services

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Various factors are forcing change. In the decade since the great recession, law firms have been focused on improving the economics of legal services for clients by reducing fees. However, there is an increasing recognition that more profound innovation is needed, that the goal is less about chipping away at the margins than it is reshaping the market for legal services—and this means, among other things, reconsidering the partnership model.

A more recent driver of change is the new US tax law that has led law firms and other professional service businesses to weigh the possibility of spinning off administrative or other back-office units of their pass-through businesses to achieve savings. These spin-offs would offer a path to an equity model for law firms.

Sparked in part by the new US tax legislation, law firms—including some that are otherwise generally conservative about legal finance—have approached Burford for advice on innovating their business model. I explore some of the advantages of the equity model below.

**Short-term thinking vs. long-term equity**

As I have written previously, law firms’ inability to innovate can be linked to their “short termism,” shorthand for an undue focus on current profits at the expense of longer-term goals, and which for law firms can be tied to their peculiar capital structure.

Under the cash partnership structure, partners are the sole owners of the firm, and yet they do not have permanent equity: Upon retirement, partners give up their ownership interest. As a result, partners are incentivized 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 thus for their clients—because partners are incentivized to choose short-term rewards over investments with returns that may postdate their retirement or lateral move to another firm. Faced with the choice of divvying up profits today or foregoing an immediate payoff to invest monies back into the firm, law firm partners are incentivized to do the former—doubly so in the US, because partner earnings are taxed before they are reinvested or distributed to partners. Faced with the option of hoarding high-value client relationships and origination credits or transitioning them to junior partners, aging partners are incentivized to do the former—and indeed, experience and media reports suggest that older partners maintain most of the key rainmaking relationships for firms.

The situation would be different, of course, if partners were incentivized to think long term because they held permanent equity in their firms.

In an equity model, partners could take advantage of the same economic opportunity that other entrepreneurs have—not just to reap cash benefits while they remain employed but to continue to build value beyond their retirement. This would in turn incentivize them to shift from short term to

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long-term thinking—to make investments in their firms’ services that would benefit clients beyond their own years of employment, or to share valuable client relationships with junior partners sooner rather than later (thereby likely driving positive change for women and minority partners who have faced historical disadvantages as rainmakers).

A near term equity model

A model offering permanent equity has seemed out of reach in the past. In the US, there are formal regulatory constraints on non-lawyer ownership of law firms. However, with partners like Burford, law firms are beginning to explore models that adhere to ethics and the law while providing alternative solutions to the cash partnership problem.

As has been noted in Bloomberg Law and elsewhere, recent US tax legislation has sparked interest among law firms in the possibility of spinning off non-principal services in connection with the benefits now provided to many pass-through businesses. For example, a law firm might spin off its administrative, back office and other non-principal operations from the law office and form a sibling business structure owned by the partners. The law firm could pay the back-office entity to perform necessary but non-principal duties. The spin off “service co” could provide a vehicle to provide permanent equity to the partners.

Precedent for a different approach exists in a variety of forms, large and small. Multiple firms have already recognized the value of streamlining cost by physically relocating their back-office functions to separate and less costly locations—among them WilmerHale, Freshfields Bruckhaus Deringer, Baker McKenzie, Norton Rose Fullbright, Allen & Overy and Ashurst. In the UK, “alternative business structures” (ABS) have been in use since 2012 and that allow non-lawyer external investors, whether through private or public offerings. To date, four law firms have gone public or announced their intent to do so.

Capital and tax advantages of innovating the law firm model

The “service co” model described above offers various advantages.

There are short- and long-term capital advantages in pursuing such a model with a Burford as a partner. Burford could provide financing connected to such a spin off that would extend current cash to the partnership as well as support a more sustained permanent equity model for the service company spin off. This would provide partners long-term equity value—a true nest egg for retirement—and thereby incentivize long-term loyalty to the firm.

There are also tax efficiencies to be gained. Cash flows could be structured to be much more tax efficient than firm income. Partners’ equity ownership, when monetized, would be taxed as capital gains rather than as income. Additionally, firms could create significant tax efficiency for ongoing operations. Spinning off administrative or other back-office units of the firm into new pass-through structures could qualify the spin off business for the favorable treatment for pass-through businesses under the 2017 tax law. Understandably, many law firms are extremely interested in this possibility.

Openness to change as a competitive advantage

Law firms’ past resistance to change has not served them well. It’s commonsensical that adaptability provides competitive advantages in many realms. Law should be no different—particularly given sluggish demand for legal services and an increasingly competitive, buyer-driven market.

Burford is invested in the business of law in a very literal sense. Having committed $1.3 billion to law firms and corporate clients in 2017 alone, we believe we are one of the world’s largest purchasers of legal services. Like the law firms we work with, we attribute much of our success to the excellence of the service we provide. But we are also confident that our willingness to take an entrepreneurial and strategic approach to what we do has provided us an advantage over our competitors. We’re keenly interested in partnering with leading firms as they consider how a new business model could benefit them.

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Lawyers choose Burford because we have more capital and more capacity to invest quickly and efficiently than any other firm in the industry. We utilize a respected team of more than 50 lawyers who are experienced, fast and easy to work with.

We benefit from a lower cost of capital that we pass on to firms and clients, and we’re publicly traded and trusted as a strategic partner that always acts with consummate professionalism.

If you have questions about Burford or litigation finance please contact any of our four major offices, or email any of our staff at firstinitiallastname@burfordcapital.com.