Arizona May Have Nudged US Law Firms Toward Future IPOs

By Marc Lieberman (January 19, 2021)

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Effective Jan. 1, Arizona became the first state in the U.S. to permanently eliminate the commonly adopted ethical rule prohibiting nonlawyers from having economic interests in law firms.[1]

The Arizona Supreme Court eliminated the fee-sharing prohibition to improve access to justice and encourage innovation in the delivery of legal services, and I take no issue with such salutary aims.

The court categorized businesses with combined lawyer and lay ownership as alternative business structures which will have to be licensed by the court.

This article addresses one aspect of the alternative business structures that has received scant attention: the likelihood that once the fee-sharing prohibition is eventually eliminated in all U.S. states, including New York where most domestic stock exchanges are situated, prominent law firms may soon thereafter become listed on national exchanges and their shares publicly traded.

The implications of this on the practice of law need to be considered.

The Current Situation

Currently, because of the traditional prohibition against nonlawyer ownership in law firms, no law firm in the U.S. has its shares listed for trade on any securities exchange.

Presuming that prohibition against nonlawyer ownership of law firms is eventually eliminated nationwide, elimination of the prohibition is likely to result in enormous pressure on the largest, most preeminent — and by definition, most marketable — firms to list their shares on national exchanges.

Law firms have essentially two reasons to list their shares for sale to the public.

First, listing may enable law firm partners to greatly enhance the value of their shares in their firm.

Second, listing will enable the listed firms to reap the benefit of enormous inflows of capital otherwise denied them.

For example, as things stand today, law firms have two sources of capital exclusive of loans: capital contributed by their lawyers and revenues derived from their lawyers' provision of legal services.

In contrast, a law firm whose shares are publicly traded has an additional, and indeed, potentially enormous source of capital — capital contributed by the public, which likely will dwarf that contributed by the law firm's partners themselves.

This publicly contributed capital will enable listed firms to exercise remarkably greater reach in the marketplace than their nonlisted brethren, and I can envision a few listed firms marshaling the capital to acquire prominent firms in nearly every lucrative market worldwide.

The International Experience

One additional factor that may compel the public listing of American law firms is that some of their international counterparts are already listed for sale on public exchanges.

In 2007, the Australian law firm Slater and Gordon became the first law firm in the world to be publicly traded, listing its shares on the Australian Securities Exchange. Since then, a number of Australian and U.K. firms have taken the plunge.

Law firms have been allowed to go public in the U.K. since January of 2012 under an alternative business structure scheme similar to that adopted in Arizona.

Since 2019, the latest data available, seven U.K. firms have listed their shares on U.K. exchanges, with the largest being DWF LLP, an international law firm that raised £95 million in an initial public offering after issuing 300,000 shares.

Many of the publicly traded firms have greatly expanded due to the significant cash infusions resulting from their public offerings.

Of course, the public's enthusiasm to own interests in law firms may be directly proportional to the firms' profitability, and one of the downsides of selling shares publicly is that there will be incessant, intense pressure to increase profits lest the firm's shares decline in value.

DWF's publicly traded shares recently suffered marked declines in market value, with shares peaking at 143p in mid-February 2020, before the hard onset of the COVID-19 pandemic, to a price of just 65.5p as of July 10, 2020.[2]

This decline may be more attributable to perceptions about the firm's profitability during the pandemic than its actual profitability since the firm announced substantially increased revenues for the year ended April 30, 2019, and has now expanded into the Polish and Australian markets.

Changes in Governance and Compensation

In addition to the potential of wide swings in share value, firms considering public listing of their shares should be mindful of some drastic changes to their governance and compensation models arising from their restructuring as an alternative business structure.

First, in most instances, partners will become more like employees than shareholders since firm control will be ceded to a board of directors and a slate of officers, some of whom may not even be lawyers.

Second, whereas traditionally, partners are paid 100% of the firm's net profit annually, most alternative business structure models require lawyer shareholders to reserve part of their profit, often up to 40%, to form a pool of cash from which the firm can be valued. The tradeoff is that the value of the publicly traded shares allocated to each partner will conceivably be worth a great deal more over time.

The Big Four and the Implications of Their Entry Into the Domestic Legal Market

State bars generally permit accounting firms leeway to practice tax law, and the Big Four accounting firms — Deloitte Touche Tohmatsu Ltd., Ernst & Young Global Ltd., KPMG International Ltd. and PricewaterhouseCoopers already boast a significant share of the U.S. tax law market.

However, outside the U.S., the Big Four conduct multidisciplinary legal practices.

For example, the Big Four accounting firms are all licensed to practice law generally in the U.K. as alternative business structures, with Deloitte the last to be licensed in 2018. And where allowed to practice law generally, the Big Four are a force to be reckoned with. According to a 2015 survey conducted by Wilkins and Esteban Ferrer, PwC was offering full legal services in 85 nations, KPMG in 53 nations, and EY and Deloitte in 69 countries.

In the event American states eliminate the ethical rule prohibiting lawyers to share fees with nonlawyers, the logical result will be to permit the Big Four to expand their delivery of legal services beyond tax and compete in the domestic market for a wide range of legal services.

This, in turn, may place significant pressure on domestic law firms to compete with the major accounting firms, and this increased competition may prompt firms to publicly list their shares to secure the enormous capital required to compete with the accounting giants.

The Bottom Line

Because of the drastic change in governance and compensation models, most firms are likely to refrain from publicly listing their shares.

However, as more foreign firms elect to list their shares on public exchanges and utilize the resulting capital infusions to increase their market share, expect some American firms, especially those competing internationally and whose livelihoods might be threatened by the large accounting firms, to follow suit.

And if this prediction proves correct, expect publicly traded firms to use their publicly infused capital to acquire other lawyers or firms throughout the nation, if not the world.

In that sense, Arizona's elimination of the rule prohibiting laymen from owning interests in law firms eventually may have a global impact.

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[1] The District of Columbia has allowed nonlawyer ownership of firms in certain instances for some time, and the Utah Supreme Court recently adopted a two-year pilot program which also permits nonlawyer ownership of law firms upon satisfaction of certain conditions. As early as 1999, the ABA's Commission on Multidisciplinary Practice recommended that the

Model Rules of Professional Conduct be amended to permit lawyers to practice law in nonlawyer owned entities, but the ABA House of Delegates resisted that effort. Nevertheless, the momentum to permit nonlawyer ownership of law firms is building. An August 2019 ABA survey reflects that 47.1% of states have adopted "significant" changes to Model Rule 5.4(b)-(d), the rule prohibiting lawyers from sharing fees with nonlawyers, and California is now considering changes to its rules which largely conform to those recently adopted in Arizona.

[2] These figures as published by Clive Wong (https://www.legalcheek.com/author/clive-wong/) in The University of Law Legal Cheek Journal July 10, 2020.