Insights on the legal profession

March 2011

Introduction

Welcome to Grant Thornton's Insights on the Legal Profession. This publication represents the first in a series of quarterly papers which are focussed on the current issues facing legal firms and their partners. It draws on the collective national experience of Grant Thornton in advising its clients in Australia, and globally through our membership of Grant Thornton International.

We welcome the opportunity to discuss the contents of this publication with you. For more information or a discussion, please contact one of our specialists listed on the back page.

This paper examines a number of current issues affecting the legal profession, including:

- The global players in the legal profession
- Australia's position in this global landscape
- The mid tier and niche players
- Sources of growth
- Corporatisation and tax

In the coming editions, we will address these and other issues in further depth.

Global players in Australia

Legal firms in Australia are often divided by size into four main categories:

- The big six national law firms and the new international players
- Mid tier, multi disciplinary
- Niche; and
- Small firms and sole practitioners.

Over the last 12 months, we have seen a number of interesting trends throughout the profession.

Internationally, global law firms have been increasingly targeting the Australian market. The arrivals of Norton Rose, Clifford Chance and Allen & Overy to the Australian market, as well as the integration of DLA Piper and DLA Phillips Fox represents a quantum shift in thinking. No longer is it sufficient for larger firms to simply focus on Australia, but rather it is now critical to understand Australia's role in the Asian region and the opportunities that this role presents.

International law firms see Australia as an attractive proposition due to our strong ties with major trading partners across the Asia-Pacific region. By entering the Australian market these law firms are seeking to take advantage of the significant opportunities in the region for high-end, cross-border merger and acquisition and finance work, especially in the energy, mining and natural resources sectors.

We note that The Australian Financial Review recently quoted a Sydney-based partner stating "never before has a lawyer's 'individual brand' been more important", commenting that practising law is now less about "names on the wall and more about relationships". This is true of recent engagement by Allen & Overy of several Clayton Utz partners and the recent mergers by Clifford Chance with Chang, Pistilli & Simmons in Sydney and Cochrane Lishman Carson Luscombe in Perth.

Allen & Overy, in particular, appear to be aggressively targeting young bright talent by offering some new partners "full equity" after the first year. According to The Australian, the top partners at this firm took home pre tax profit of $2.9m last year which is approximately double the top equity partners at Australia's most profitable firms. If this trend continues, the risk lies with older partners at the top of the equity ladder at domestic firms. They are in jeopardy of losing their dynamic younger partners to these new players, who are willing to offer greater levels of equity and greater earning potential.

Against the above trend, some global firms have indicated that their strategies do not include a major focus on Australia as part of an Asian strategy. Rather, firms such as Linklaters and Freshfields have elected to take a more direct focus on Asia in conjunction with their UK and American firms.

Australia in the global landscape

The Asia-Pacific region is seen by most as a future growth market due to the growing economic and political importance of India, China and South East Asia.

A number of Australia's top legal firms already have offices based abroad in places such as China, Hong Kong, Singapore and Indonesia. Access to these markets has proved profitable for these firms, following a growing number of mergers and acquisitions across the region. Strengthening their position in these markets is of strategic importance to Australian law firms as our mature local market provides more limited opportunities for growth.

Over the last few years, international legal firms have pioneered the concept of "offshoring" part of their straight forward process work to lower cost jurisdictions, particularly India.

Larger firms are now trialling this process in Australia, with the clear aim of not only lowering cost but also allowing them to redeploy more junior staff away from more routine and sometimes mundane work.

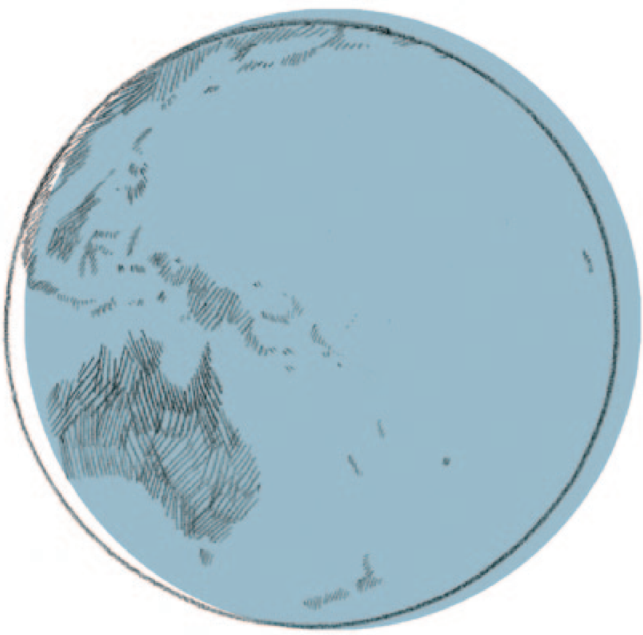
There are some important principles in ensuring that an outsourced model is successfully implemented, including that:

- the quality control meets with your expectations
- younger Australian staff are sufficiently skilled to complete more advanced work at an earlier time than would have otherwise occurred
- potentially lower graduate intakes do not result in firms becoming short handed in four to five years time in the event of resignation or relocation; and
- the outsourced work can be efficiently completed when it suddenly becomes urgent.

All of these issues are having transformational effects on the Australian legal profession as a whole.

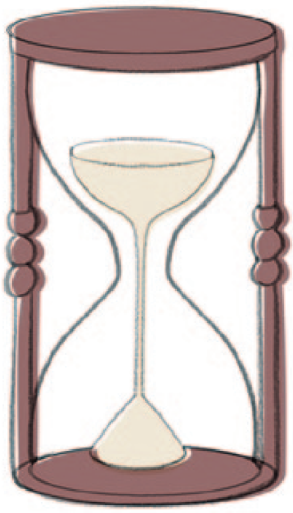
Internationalisation of the sector is a key principal being considered by the Law Council of Australia and the International Legal Services Advisory Council. Current strategies of these bodies include:

- building stronger links with China and India
- improving access to foreign markets for Australian lawyers
- promoting Australia as a hub for international arbitration; and
- increasing demand for Australian legal education.



Australian mid tier and niche players

There has been little significant merger and acquisition activity amongst the larger Australian law firms in recent years. However it is anticipated by IBIS World that merger activity will increase significantly during the next five years due to continuing pressure on margins, modest domestic economic growth and the need to be able to invest into more specialised services requested by clients. It is anticipated that merger activity with international firms will also continue as services become increasingly globalised.



In view of the substantial changes in the market, clarity of strategy becomes critical.

As noted by one of the mid tier Managing Partners in an interview with the Australian Financial Review last month, having an increasingly international presence "means really looking long and hard at the domestic market and obviously looking at the global scene. Globalisation is happening all around us." This means that when setting strategy, a deep understanding and knowledge of the local and international market is required. The risk to mid tier players is that these broader issues are not sufficiently understood.

The mid tier firms do however continue to grow in strength, consistent with the growth of the private business market and more selective buying by corporates. Many of these firms are now regularly challenging the pre-eminence of the large firms with targeted and more cost effective offerings.

In the private business market, assignments being covered are traditional commercial work such as purchase and sale of businesses, shareholder agreements, and property and construction. The increasing size of some of these firms means that they are now able to provide greater levels of experience and depth than they were able to a few years ago.

In relation to corporate work, it is now not unusual to see more than one mid tier firm on panels of Australian corporates where they regularly undertake specialised work alongside larger firms. This specialised work can include employment law, intellectual property and tax.

Niche players are continuing to do what they do best, i.e. focus on depth and quality of service in a number of specific practice areas such as tax, insurance and insolvency. Their challenge is to continue their growth within the field of specialisation and, at the same time, attract, develop and retain key staff.

Sources of growth

Over the last 18 months, most larger firms have seen a drop in IPO and M&A activity. These falls have, however, been partially offset by counter cyclical activities such as insolvency and restructuring. In addition, significant focus has been invested into the Asian market, through strategic acquisitions, mergers or alliances.

IBIS World estimates that revenues in the legal services industry are expected to increase by 3.8% per annum over the five years to 2014-15.

Clearly to most firms, this would be considered as a low rate of growth. Over the next 12 months, we anticipate that legal firms will generate growth far in excess of this level as focus is given to a number of emerging fields including:

- **Climate change** – From an industry perspective, the potential introduction of a carbon tax as early as 1 July 2012, followed by an Emissions Trading System in the next three to five years, will lead to significant growth in climate change and energy practices. Given the structural changes to the economy that will arise, clients need to understand their responsibilities, as well as their opportunities.

- **Resources sector** – continued growth is anticipated in this sector.

- **Workplace advice** will continue to grow at a greater rate than the average referred to above.

- **Client growth** in Asia is also expected to continue to provide opportunities addressing issues such as tax, licensing arrangements and export supply contracts.

Finally, in the mid market space, we anticipate that over the next five years, succession planning will gather pace. This issue has been with us for a number of years, but has gained minimal traction for most firms. An increasing number of clients and their bankers are now beginning to appreciate the importance of a clear exit strategy – whether it be through generational change, private equity, trade sale or IPO. All of these options fall under succession and as a result, there is a growing need for business and their legal advisers to address these challenges.

In all cases, those firms with clearly defined strategies, focussed leadership teams and quality talent are the ones who are likely to win over the next five years. Those without these characteristics will face challenging times.

Taxation and corporatisation

In recent years a number of firms have moved away from the traditional partnership model to incorporated structures. We will cover the commercial issues associated with such a move in a later bulletin, but a key issue that we will raise now is tax.

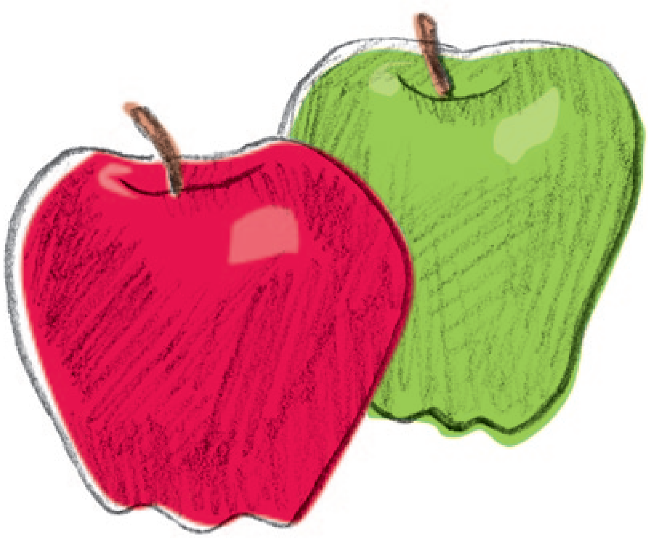
As many of you would be aware, over the last five years the Australian Taxation Office's primary focus on legal firms has addressed firm's service trust arrangements. Most firms have fallen into line behind the ATO's safe harbour calculations. This reflects the fact that the amount of work required to justify an alternate position is substantial, and outweigh any perceived benefit.

Those firms that have resolved to maintain alternate arrangements need to ensure that these arrangements are regularly reviewed and updated. The ATO has indicated a renewed interest in this area and we can expect more review or audit in the next couple of years.

The ATO has also recently focussed its attention on alternate structures, particularly partnerships of discretionary trusts and corporatised practices.

The ATO has particular concern around matters of Capital Gains Tax including rollover eligibility, and the structuring of ownership interests held in the new structure. We have been liaising with the ATO on these matters and note that they have recently issued a draft Taxation Determination TD 2011/D3. The focus of this draft Determination is narrow and only applies to corporatised firms that are owned by individuals and not other entities. In that instance, if the owners agree that no goodwill arises on changes in ownership, then there will be no tax liability at that time.

In our view, this administrative concession is welcome. It does not however address a large number of potential structural issues that affect legal firms. As a result, we will be providing comment back to the ATO in the next couple of weeks.



Conclusion

As noted above, there are a number of issues which are currently unfolding and will affect the legal profession for years to come. In future editions of this bulletin we anticipate bringing you our view on these and other issues and how they will affect you.

Specifically, the issues that we will address in upcoming bulletins include:

- **Taxation issues** – There are a number of "open" tax issues which directly affect the legal profession, as opposed to other sectors of the economy. The ATO has been considering these issues over the last couple of years, particularly in connection with corporatisation. How a firm migrates from a partnership model to a corporate requires the consideration of a significant number of commercial and tax issues.
- **Practice valuation** – The valuation of legal and other professional service firms take account of a number of issues which are different drivers from most other businesses.
- **Funding models** – Assessing the right mix of funding from Partners and external financiers has changed in recent years due to the GFC. In addition, the provision of guarantees and reviews of margins has also occurred in a number of instances.
- **Governance** – How a legal firm manages its risk and its owners' (Partners') risk is substantially different from how this is done for listed companies or other businesses.
- **Personal financial management** – Each Partner should have a clear, long-term financial and tax plan. Typically such a plan addresses a number of key issues, including asset protection, wealth management, tax, superannuation and estate planning.

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- Financial Services

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Adelaide
Steve Westaway
T 08 8372 6666
F 08 8372 6677
E steve.westaway@au.gt.com

Brisbane
Dennis Eagles
T 07 3222 0200
F 07 3222 0444
E dennis.eagles@au.gt.com

Melbourne
Andrew Steer
Joseph Lombardi
T 03 8663 6000
F 03 8663 6333
E andrew.steer@au.gt.com

Perth
Kim Hayman
T 08 9480 2000
F 08 9322 7787
E kim.hayman@au.gt.com

Sydney
Bill Shew
Matthew Kidd
Conor Farley
T 02 8297 2400
F 02 9299 4533
E bill.shew@au.gt.com

Grant Thornton

www.grantthornton.com.au