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The Clementi Report: Potential Risks of External Ownership and Regulatory Responses

A Report to the Department of Constitutional Affairs

Professor Paul A. Grout

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The Clementi Report: Potential Risks of External Ownership and Regulatory Responses

A Report to the Department of Constitutional Affairs

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July 2005

Abstract

This report has been commissioned by the Department of Constitutional Affairs to consider the potential risks arising from the introduction of outside ownership and to suggest any regulatory proposals to deal with these. The conclusions are:

- Regulation should focus on the underlying incentive structure not the business form. The current proposals do not this.
- 'Small' LDPs and MDPs: The limitations on management composition and fit and proper tests are the appropriate focus of regulation. Those currently proposed in the Clementi Report appear appropriate.
- 'Large' LDPs and MDPs: (i) Management restrictions such as those currently proposed in the Clementi Report may not be appropriate. They do not resolve potential regulatory problems since the incentive benefits and problems are common to lawyer and non-lawyer managers and owners. Indeed, they may provide a false sense of security. However, some alternative forms of management regulation may be helpful and fit and proper tests are necessary. (ii) Financial oversight and 'regulation' rather than management controls will be the most important mechanism of 'regulatory control' for large LDPs and MDPs, particularly where equity is highly concentrated. This will be a new departure for regulation of the legal profession. (iii) Management incentive schemes will need oversight and it may be deemed appropriate to bar particularly high-powered schemes.
- It is important to consider easing the constraints on the market. For example, extending the deadline on the 'Accreditation and Exemption routes' beyond 31 October 2005 to increase the number of solicitor advocates.

Keywords: Legal services markets, regulation of legal services, multi-disciplinary practices

JEL Classification: K40, L51

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Executive Summary

The terms of reference of this report is to:

> 'examine the potential risks of outside ownership in a situation where a law firm moves from one of the currently allowed organisational structures (sole trader, partnership, incorporated partnership) to an organisational structure where there is at least some element of outside ownership, of how this might affect the incentives of lawyers to act in the best interests of customers *vis-a-vis* the best interests of outside owners.'

A common theme in the debate concerning the introduction of alternative business structures has been the concern of undue influence that non-lawyers may bring on lawyers within new business arrangements. The Clementi report itself gives weight to this view and recommends, amongst other things, the ring-fencing of legal teams within new ownership structures and that lawyers should form the majority of management teams in LDPs and MDPs. In contrast, the assumption is implicitly, and frequently explicitly, made in the debate that lawyers working alone or alongside other lawyers will not distort their procedures and behaviour to clients in response to economic incentives providing there is appropriate self-regulation within the profession. Such a stark distinction between the incentives of lawyers working together and their incentives when they are owned or majority managed by non-lawyers is difficult to understand. Clearly, under the current regime there are many successful claims of inadequate professional conduct, professional misconduct and negligence brought each year. Furthermore, we have good evidence in other professions that behaviour is 'distorted' by economic incentives. Of particular interest is the treatment of patients by the medical profession since one might expect doctors, having taken the Hippocratic Oath setting out the moral and ethical obligations of doctors to their patients, would be less influenced by economic incentives than lawyers. The paper points to research that shows that doctors treatment of patients changes as the doctor's economic incentives change. Therefore, it does not make sense to consider how business models with outside ownership affect the incentives on lawyers separately from the consideration of how economic incentives affect lawyer owned firms.

To understand the pressures that arise and the role of regulation it is useful to think where the value arises in a legal practice and so what type of value is at risk if a lawyer makes an assessment of the benefits and costs of an 'inappropriate' action. Lawyers undertake training at the start of their career to obtain relevant qualifications, they then develop these skills over time, develop reputations, valuable contacts, etc. If the lawyer acts as a sole trader then these skills will be reflected in their fees with the better lawyers being in a position to command higher fees. Economists tend to refer to these personal skills as human capital and think of the fees as the return on that capital (defined broadly to include basic skills, experience, contacts, etc.).

In a sole trader situation the human capital is the major asset of the business. In a partnership the return each partner receives is really made up of two bits – a return for using their own human capital (this is lawyer-specific) within the business and a share of the return to the partnership (this is business-specific). Therefore, if a lawyer in a partnership engages in a cost-benefit calculation of the consequences of doing something that could be considered 'untoward' then the partner has two types of assets at risk – his/her human capital and their value in the partnership. The fact that the human capital component provides a significant component of the partner's return (and 100% return in the sole trader case) is helpful in regulating behaviour. The ultimate sanction that a regulatory body can impose is to disbar a professional and, since a lawyer's human capital is a significant component of total value at risk when the professional considers engaging in inappropriate behaviour, then a body regulating legal services has more 'bite' on a lawyer partner than a non-lawyer partner. This is not to say that a non-lawyer partner's human capital may not be damaged if found guilty of a serious misdemeanour but there is no expectation that it will as much at risk as human capital embodied in a lawyer. Therefore, imposing some restrictions on non-lawyer management composition in partnerships makes sense (e.g., the majority lawyer seems a plausible, albeit slightly arbitrary, initial restriction to impose). Similar arguments would apply to small LDPs and MDPs.

When we consider shareholding owners of large LDPs and MDPs then the situation is different. The aggregate value of the shares can be large (since it depends on the present value of all the potential profits of the company). This can create a strong incentive to monitor the behaviour of the professionals in the firm, particularly if there is a broader corporate reputation at risk. Of course, then customers will realise this and may be willing to pay more for their legal services as a result if this effect is strong.

However, if equity is concentrated in a few hands then, although the total human capital in the whole firm may not be dwarfed by the equity value, the human capital at risk for a lawyer owner will be almost insignificant in comparison to the value of his/her equity at risk. Since the lawyer owner's human capital at risk is an insignificant part of their total risk, when it comes to the calculus as to whether to risk an inappropriate act or not it should be almost irrelevant whether a combined owner/manager is a lawyer or not. The risk calculation will be virtually identical whether the owner is a lawyer or not. It follows that, when we consider large LDPs or MDPs, there is little point in distinguishing between lawyer and non-lawyer owned firms, or for similar reasoning placing limits on the share on non-lawyer owners.

Indeed, the incentives may be opposite to the common view that lawyer owners are better than outside owners. The debate has emphasised endlessly the fact that a non-lawyer owner may benefit from distorting the behaviour of a lawyer manager. However, what is not emphasised sufficiently is that the human capital of the lawyer manager is the major part of lawyer's assets at risk where there is a non-lawyer owner and hence the regulatory structure 'bites' significantly on the behaviour of the lawyer manager. Any equity value that is saved by protecting a major client goes to the outside owner not the lawyer and so the lawyer will have a different view of the payoffs than the owner. Specifically, the lawyer will not be so inclined to take risks since his/her ratio of gains to losses is not favourable.

This is in contrast to the situation when the lawyer has a large ownership of the business. The lawyer still bears the risk of losing human capital value but now he/she also captures a major part of the equity value that is saved by protecting the client. The lawyer's incentives are now closely aligned to the incentives of the outside owner in the previous example. If there are large financial gains to be made or saved by protecting the client the lawyer owner now captures them. A large LDP or MDP with concentrated ownership is more likely to be a problem with a lawyer owner/manager than a lawyer manager and a non-lawyer owner. This is the exact opposite of the view that underpins the current debate. The view that the problems increase as the proportion of non-lawyer ownership increases is not the case if companies are large and ownership is concentrated.

The general point is that regulation should be focused on the underlying incentives and not the business structure. It makes more sense for the restrictions on the composition of management to be determined by the size of the LDP and the concentration of ownership rather than the business structure itself. Small firms could quite sensibly face different restrictions on management composition to large firms, with the former being grouped with partnerships. A decision to be more relaxed about management composition of large firms is also consistent with the analysis of misconduct according to firm size. The paper shows that misconduct and poor quality is heavily focused on small businesses.

A far more significant concern for large firms with concentrated ownership comes from the 'moral hazard' problem when a firm faces financial difficulties. As a result of limited liability the downside losses of equity holders are capped at the value of their shares. In particular, when a company is liquidated, shareholder losses are similar no matter how extensive the failure to repay debtors. When contemplating a risky strategy owners, since they are residual claimants, receive 100% of any upside after the debt obligations have been met and are unaffected by changes in the downside if there is insufficient funds to meet debt obligations. The higher the debt/equity ratio in a firm then the more attractive risky strategies are to the company, hence large LDPs or MDPs are far more likely to be at risk of slipping from the 'straight and narrow' if there is too much debt in the company. Therefore, the focus of regulation on large highly concentrated LPDs and MDPs should not be on management but on the financial structure. This may affect the form of the development of firms. For example, four large firms merging may not be a cause for concern but one company borrowing heavily or raising hybrid finance to buy out three others may be.

Closely associated with the above problem is the incentivisation of non-shareholding managers. The paper reports studies that show that companies where managers have highly geared incentive schemes tend to adopt more risky strategies. For large LDPs and MDPs it may be appropriate to impose certain restrictions on managerial incentive schemes if the aim is to minimize the chances of misconduct. Again the incentive problems do not appear to be particularly different whether the management team is mainly lawyer or non-lawyer.

The paper closes with two comments that are related to but beyond the core brief. One concerns the regulatory structure. The focus of this report has been on downside effects of new ownership structures and suggesting regulatory structures that limit any problems. There is a distinction between changing the law to allow new ownership models and insisting that the professional bodies are required to remove their specific limitations on business structures. In particular, the sole trader rule of the Bar seems particularly at variance with the plans to broaden ownership structures. How the professional bodies rules affect the market depends on the competitive framework. Focusing on the competitive structure of the market seems just as useful a route forward, if new ownership models are available, as worrying about the specific rules of the professional bodies with regard to business structures. It is difficult to see why a solicitor with considerable experience in lower courts needs training to become a solicitor advocate. Similarly, it seems to make sense to make things easier for barristers or QCs to move in the opposite direction into large firms. For example, training in issues such as dealing with client's money could be avoided by agreeing for all financial matters of this type to be dealt with by specific nominated members of the firm. Decisions to open up business models should be accompanied by consideration of easing the restrictions on movement in the 'market place'.

Finally, the regulatory debate is to a large extent concerned with improving access to justice. Part of the debate around the Clementi Review has concerned the issue of whether legal services can be commoditised. In one sense they can. There is nothing unique about lawyers and legal services. There are clearly some specific features of the job, and the code of conduct that goes with it, but this is typical of many professions. Doctors and medical services are a good example. Medical services can be treated as a commodity. Cheaper operations, more of them and better and quicker delivery are all good things. As we well know from the modern worldwide programme aimed at broadening the delivery mechanisms to make better use of the private sector and to create more responsive public sector institutions and greater choice for patients, the regulatory mechanisms and questions are complex and delicate. The same is true as ownership structures are modernised in the legal profession. The regulatory processes are complex and will need careful consideration but it is all perfectly doable.

In another sense, however, access to justice is different from most things. Generally, lower prices, more efficiency and more of the commodity are good. But this is not necessarily the case for access to justice and in this sense it cannot be commoditised. The relationship between cost, efficiency of delivery and the desirable end product is far more complex. Access to justice is not like access to clean water, for example. If the cost of putting clean water in place around the world falls and there is more clean water as a result then this is good. However, if the price of access to courts fall then this is partly good since it is more open to all but if the net result is more civil cases, more litigation, etc., then this may not be a better outcome. We want access to justice but at the same time we do not want an increase in the consumption of the commodity. If the new business models accelerate a movement to a litigious society then this may not be a good thing and the negative effects have to be balanced off against efficiency gains. The basic argument behind the 'Clementi' debate, that more efficient and cheaper delivery is good, is true only if what is delivered is good, rather than something that is sought as a last resort; but having many more legal cases is not necessarily good. Justice is a broad concept and may be deliverable in many other ways. The debate has not taken place in a broader context and this would be a useful exercise.

Summary of recommendations:

1. Regulation should focus on the underlying incentive structure not the business form. The current proposals do not this.

2. 'Small' LDPs and MDPs:

- The limitations on management composition and fit and proper tests are the appropriate focus of regulation. Those currently proposed in the Clementi Report appear appropriate.

3. 'Large' LDPs and MDPs:

- Management restrictions such as those currently proposed in the Clementi Report may not be appropriate. They do not resolve potential regulatory problems since the incentive benefits and problems are common to lawyer and non-lawyer managers and owners. Indeed, they may provide a false sense of security. However, some alternative forms of management regulation may be helpful and fit and proper tests are necessary.

- Financial oversight and 'regulation' rather than management controls will be the most important mechanism of 'regulatory control' for large LDPs and MDPs, particularly where equity is highly concentrated. This will be a new departure for regulation of the legal profession.

- Management incentive schemes will need oversight and it may be deemed appropriate to bar particularly high-powered schemes.

4. It is important to consider easing the constraints on the market. For example, extending the deadline on the 'Accreditation and Exemption routes' beyond 31 October 2005 to increase the number of solicitor advocates.

1. Introduction and terms of reference

The legal profession in England and Wales is divided between solicitors and barristers. Solicitors may practice before lower courts, and higher courts if tranied as a solictor advocate, but their main (and traditionally only) work is outside the courts, in such areas as legal advice (which may be highly specialised), property conveyancing, wills and estates, preparing legal documents for business transactions and negotiating the legal terms of commercial contracts. Barristers act primarily as advocates with rights of audience in all courts within the jurisdiction. There are currently 116,110 solicitors in England and Wales and 10,240 self-employed barristers plus 2085 employed barristers. Sir David Clementi conducted a 'Review of the Regulatory Framework for Legal Services in England and Wales' on behalf of the Secretatry of State for Constitutional Affairs, which has considered and provided recommendations on regulatory changes and new business structures in the legal profession. In this report the terminology the 'Clementi Report' or the 'Report' refers to the final report of this Review.[1] One of the primary concerns of the Review has been whether to make provisions for new business structures in the legal professional and, in particular, whether to allow outside, i.e., non-lawyer, ownership of legal firms.

I have been commissioned to consider the potential risks arising from the introduction of outside ownership and to suggest any regulatory proposals to deal with these. My specific terms of reference are as follows:

> 'Terms of reference for work on potential risks of external ownership:
>
> You are asked to examine the question in a situation where a law firm moves from one of the currently allowed organisational structures (sole trader, partnership, incorporated partnership) to an organisational structure where there is at least some element of outside ownership, of how this might affect the incentives of lawyers to act in the best interests of customers *vis-a-vis* the best interests of outside owners.
>
> In doing this work you will:

[1] See Sir David Clementi 'Review of the Regulatory Framework for Legal Services in England and Wales: Final Report' (December 2004) and the earlier consultation, Sir David Clementi 'Review of the Regulatory Framework for Legal Services in England and Wales: A Consultation Paper' (March 2004).

- review the relevant publicly available literature leading up to, during, and following the Review of the Regulatory Framework for Legal Services in England and Wales;

- meet with anyone you may deem necessary to inform your work;

- with reference to the relevant theoretical and empirical academic economics literature, examine issues relating to, amongst other things,:

- partnerships;
- professions;
- reputations; and
- explicit and implicit incentives; and

- examine the possibility of appropriate regulatory responses to potential problems relating to conflicts of interests.'

There are several interrelated changes mooted in the Clementi Report. One concerns changes in the form of the legal entity, and in particular whether outside ownership is appropriate[2]. A second relates to broadening management, and in particular allowing non-lawyers to manage legal practices[3]. Finally, there is the discussion whether practices should be broadened to include Legal Disciplinary Practices (LDPs) and Multi-Disciplinary Practices (MDPs); currently barristers are sole practitioners and partners in solicitor firms must be trained solicitors[4]. LDPs are law practices where solicitors and barristers and other members of the legal profession work together to supply legal services. Non-lawyers may be managers in these practices. There are slightly different models of who provides what. In one version, non-lawyers may not provide services to the public, they are only there to augment the services provided by the lawyers. In another version, they provide services to the public but these must be services that are appropriate for a legal firm to provide. In contrast, MDPs bring together lawyers and other professionals into one practice to meet customer needs on a broad front, i.e., a one-stop shop.

It is generally expected that with the possibility of new ownership, the LDP and MDP forms will be particularly attractive for legal firms that are currently large and for large non-legal firms that wish to provide legal services. Public listing is also an

[2] Clementi (December 2004), *supra* note 1, at para F.35
[3] Clementi (December 2004), *supra* note 1, at para F.30
[4] Clementi (December 2004), *supra* note 1, at para F.6

attractive possibility for many legal firms. For example, a recent article in the Financial Times reported that 10 of the biggest 100 law firms indicated that they could seek a stock market floatation following a broadening of the ownership rules and permissible business structures[5]. This report gives particular, but not exclusive, emphasis to the problems that large LDPs and MDPs will raise for the delivery of legal services. A common theme that will appear is that large LDPs and MDPs may indeed raise concerns that require regulatory changes but that these are caused by size, concentration of ownership and financial structure and are no more severe whether there is significant outside ownership or not.

2. Current regulatory and proposed regulation

Under the Courts and Legal Services Act 1990, the Secretary of State for Constitutional Affairs has the right to authorise professional bodies to grant rights of audience or rights to conduct litigation to their members. Currently the Bar Council is authorised to regulate barristers and the Law Society to regulate solicitors.

2.1 The Law Society

The Law Society set the standards for qualifying as a solicitor and also set rules for the professional conduct of qualified solicitors. Moreover, the Law Society has statutory powers to ensure that solicitors comply with the rules set and to enforce them. The Regulation Standards Directorate of the Law Society is responsible for monitoring compliance with the rules whilst the Regulation Compliance Directorate is responsible for taking any required enforcement action. The Law Society's Consumer Complaints Service deals with complaints by both the public and other professionals against solicitors. The solicitor in question will be investigated and disciplined (where necessary). If someone who has complained to the Law Society is not satisfied with the way in which the complaint was handled then they can refer their case to the Legal Services Ombudsman. The Ombudsman is not a lawyer and is completely independent of the legal profession. There is no further appeal against the final decision of the Ombudsman.

A proposed Code of Conduct is in draft form. Rule 12 sets out a framework of practice. This specifies the ways in which a solicitor is allowed to practise. The ways

[5] Sherwood, B 'Top Law Firms Lean Towards Flotation' *Financial Times* (London England 13 June 2005)

are: as a sole principal; as a partner in a partnership consisting of other solicitors (including European and foreign lawyers); as a director, member or shareowner of a company, which is a recognised body; as a member of an LLP; in the employment of any firm in which a solicitor would be permitted to participate as a sole principal, partner, director, member or shareowner, for practice from an office in England and Wales; in any other employment, provided that work is only undertaken for the employer. A solicitor cannot be a partner in a partnership which has a separate legal identity or be a director, member or owner of a corporate body, which is not a recognised body, unless acting as an in-house solicitor. There is currently a *Guide to the Professional Conduct of Solicitors,* the new Code of Conduct will replace this guide.

2.2 The Bar Council

The Bar Council issues practising certificates and establishes and enforces standards. The main rules governing the barristers are found in the Bar Council's code of conduct. Any complaints made about the conduct of a barrister are overseen by the Complaints Commissioner; he (or she) is not a lawyer and is completely independent of the Bar Council. If the Commissioner believes that the complaint may be justified then he will refer it to the Professional Conduct and Complaints Committee (PCC). This committee is made up of both barristers and lay representatives and no decision can be dismissed by the PCC without the agreement of the lay representatives. If the PCC agrees with the Complaints Commissioner that the complaint may be justified then it will send the complaint to a disciplinary panel for a decision as to whether it is actually justified, and if so what should happen to the barrister. As before, dissatisfaction with the process can be referred to the Legal Services Ombudsman.

There is a Code of Conduct laid out by the Bar Council. The Code of Conduct states that independent barristers may not also practice as employed barristers and it prevents barristers from forming partnerships.

2.3 The Legal Services Ombudsman

The Legal Services Ombudsman's primary functions are to make sure that complaints are handled in an appropriate manner by the Law Society and the Bar Council, to act as a public watchdog on the standards regarding the handling of complaints, and to ensure high standards in the legal services complaints system. If the Ombudsman feels that the complaint was not handled properly then he or she has the power to recommend that the complaint be reconsidered and payment of compensation be given to the complainants.

2.4 Proposals in the Clementi Report

The Report and the earlier consultation document consider two alternative models of regulation, Model A and Model B, plus a further variant of Model B, Model B+[6]. The Report suggests that current arrangements are unsatisfactory and indicates that a move to a B+ structure is appropriate at the current time[7].

Model A involves all regulatory power being removed from the current regulators and being given to a new body, a Legal Services Authority (LSA). Its functions would be vested in it by statute and it would exercise its powers itself. The professional bodies, currently regulating the legal services, would keep their representative functions but the LSA would be the overarching regulator. This new authority would set and enforce rules and codes governing service provision, would give advice and guidance on general policy and would exercise powers of investigation, enforcement and discipline. This model provides a regulator who is independent from the profession; it also clearly defines the roles of the regulator and the representative bodies. Furthermore, the complaints process is clearly separated from the representative influences of the professional bodies.

Model B leaves the regulatory functions with the current professional bodies but installs a Legal Services Board (LSB), which would oversee the bodies. The professional bodies would retain both their regulatory and representative powers. The LSB would be a central regulator who would approve the rules and codes of practice but would not be involved in the direct regulatory functions, though it may oversee the enforcement of rules. The complaints system would not see much change as it is already closely aligned with the structure Model B proposes. Model B+ provides an intermediary approach. It would leave "entry standard setting", "rule making" and "monitoring and enforcement" functions to be carried out by the professional bodies but with oversight by the LSB. However, the bodies would be required to separate their representative sectors from their regulatory sectors with separate governance. It is proposed that the regulatory arm would contain a significant lay contingent.

[6] Clementi (March 2004), *supra* note 1, at para B.8-B.24
[7] Clementi (December 2004), *supra* note 1, at para B.70

The existing powers of the Secretary of State would be granted to the LSA under Model A. Model B could provide that some powers be devolved to the professional bodies but the LSB would have "call-in" powers, that is to say that they could "call-in" any rules which are too restrictive.

The Clementi Report is in favour of the introduction of LDPs[8]. It is suggested that they ought to be able to choose 'outside' owners but that these owners must be approved by the regulatory bodies as being 'fit to own'. However, regardless of whether the owner is a lawyer or not, it is suggested that the LDP must have a majority of lawyers in the management group. Amongst the managers there must be a nominated lawyer whose responsibility is to ensure the service standards of the legal services provision and there must also be a nominated manager (not necessarily a lawyer) who is responsible for finance and administration. To ensure that an outside owner does not take advantage of his position, an LDP may not take instructions on a case where the owner has an adverse interest in the outcome[9]. The owner should not be able to interfere in any case nor have access to legal information and documents regarding the client.

With regard to MDPs, the Report suggests that issues do arise concerning regulation and the means by which all the services in the practice can be regulated. It would be necessary for the regulators of different professions to work together, with the possibility of one regulator taking a leading role if there was a majority profession. As with LDPs there can be outside owners of MDPs, having the same advantages and restrictions as laid out above. However, the Report argues for delay on the introduction of MDPs and believes that the establishment of a suitable regulatory framework for LDPs should be the first step. This would set a basis for the future introduction of MDPs[10].

2.5 Opinions regarding new business structures

The *Clementi Report* suggests that outside investors would broaden the capital base and may possibly inject new ideas and working methods into the business. It is argued there will be efficiency gains from the provision of many types of legal service in one practice and as a result LDPs will be able to keep costs, and thus prices, low. These "all-in-one" practices would compete with each other on price and quality and

[8] Clementi (December 2004), *supra* note 1, at para F.101
[9] Clementi (December 2004), *supra* note 1, at para F.53
[10] Clementi (December 2004), *supra* note 1, at para F.104

thus hopefully improve the service for the consumer. In addition, it is argued that LDPs will be able to reward the non-lawyers in the practice by offering them a stake in the business, something that has not been available to them previously. This provides broader access to capital and could install some diversity into the workplace.

Although the *Bar Council* do not oppose the practice of employing non-lawyers to help with the day-to-day running, the Council does object to these individuals being managers.[11] As managers they would be able to exercise control over the legal members of the practice. They would not be subject to the same professional duties as the legal profession, which the Council believes could be a risk to clients and the public, particularly with regard to client confidentiality. The Bar argues that ownership by non-lawyers does not have any noteworthy advantages for the business community but could be very useful to firms of solicitors in local communities. They can be restrained by a lack of capital and hence cannot provide the complete services demanded by their community. An investment by outside investors could provide the capital needed to expand the firms to meet demand. The Council emphasises the conflict between the commercial interests of the owner and the ethical duties of the legal profession suggesting, therefore, that outside owners should not be able to control the provision of legal services[12]. The Council also see a number of considerable disadvantages with MDPs. One is the potential conflict of interests between the different professions represented in the MDP and another is the issue of client confidentiality. Thus the Bar Council take the view that MDPs should not be permitted[13].

The *Law Society* believes that LDPs create an environment that could offer greater career choice to solicitors.[14] Furthermore they provide a way of spreading risk and improving efficiency. Non-lawyer managers in LDPs could provide a way of ensuring more consumer choice, as their role is to improve the performance of the practice, thereby instilling a degree of competition. However, this could have adverse effects on legal aid practice when making commercial decisions. On the other hand, outside input could offer original means of reaching clients. They see ethical issues when non-lawyer managers are employed in an LDP but believe these could be solved or at least reduced if there are suitable regulations in place. The Law Society believes

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[11] See 'Review of the Regulatory Framework for Legal Services in England and Wales by Sir David Clementi: The Response from The General Council of the Bar' (2004) para F3.3.
[12] General Council of the Bar, *supra* note 11, at para F3.11.
[13] General Council of the Bar, *supra* note 11, at para F7.5; see also '"Competition in Professions"; The Bar's Consultation Paper in resonse to the OFT Report' (July 2001) para 7.6; '"Competition in Professions": Report to the Bar Council' (Janurary 2002) para 3.29.
[14] See 'Independence and Quality: The Law Society's response to the consultation paper on the review of the regulation of legal services in England and Wales' (June 2004) para F.36.

they should regulate LDPs, as they have experience in regulating similar firms. They argue that outside owners must be kept separate from the running of the law firm, except in commercial matters, such as proposed business plans.

The Society believe MDPs should be permitted and generally they should be unrestricted but there must be some consumer protections put in place[15]. They argue that MDPs can supply a more rounded service to their clients, particularly on the High Street. In addition, the contribution of professions will offer more innovative practices. The Society sees the major drawback as the regulation of this form of practice, however, it argues that if this were addressed suitably there would be no reason as to why MDPs could not be established. However, the Society is in favour of ring-fencing the legal practice from the rest of the business[16].

The *Office of Fair Trading* argues that Solicitors' Practice Rule 4 (i.e., solicitors employed by non-solicitors cannot act for third parties in their capacity as a solicitor) is reducing the amount of competition in the market.[17] Solicitors' Practice Rule 7 (prohibiting MDPs) also restricts new entrants to the legal market and inhibits cost efficiencies brought about by economies of scale and scope. However, the it does raise the risk of a number of accountancy firms coming to dominate the legal market were MDPs to become unrestricted, although it argues this issue would be addressed by competition law[18]. The Office is also unhappy with the restrictions placed on barristers (inhibition of new entrants, not taking advantage of economies of scale, etc.)[19].

3. Alternative Business Structures

As indicated in the previous section the current ownership and business structure in the profession is both restricted and fragmented; very different rules apply in different parts of the profession. The potential changes focus on three interrelated areas. One is the form of the legal entity. A second relates to broadening management, and in

[15] The Law Society, *supra* note 14, at para F.3
[16] The Law Society, *supra* note 14, at para F.12
[17] See 'Competition in Professions: A report by the Director General of Fair Trading' Office of Fair Trading 328 (March 2001) para 192; 'Competition in Professions: Progress statement', Office of Fair Trading 385 (April 2002) para 3.11; and ' Consultation on the future of the regulatory framework for legal services in England and Wales: Response by the Office of Fair Trading' Office of Fair Trading 722 (June 2004) .
[18] OFT 722, *supra* note 17, at para 3.24
[19] OFT 328, *supra* note 17, at para 31; OFT 722, *supra* note 17, at para 3.24

particular allowing non-lawyers to manage legal practices. Finally, there is distinction as to whether practices should be LDPs or MDPs.

3.1 Economic incentives and undue influence

A common theme in the debate has been the undue influence that non-lawyers may bring on lawyers within new business structures. This is very clear in responses. The Clementi report itself recognises this and recommends limiting the composition on management teams (majority lawyer) and ring-fencing of legal teams within new ownership structures. In contrast, the assumption is implicitly, and frequently explicitly, made in the debate that lawyers working alone or alongside other lawyers will not distort their procedures and behaviour to clients in response to economic incentives providing there is appropriate self-regulation within the profession.

Such a stark distinction between the incentives of lawyers working together and their incentives when they are owned or majority managed by non-lawyers is difficult to understand. There is clearly scope for lawyers not to operate in the client's best interests or not to quite following appropriate procedures if they wish. For example, operating in the best interests of the client is difficult to fully define and even if were easy to define then in many, possibly most cases, the information available to those outside the client-lawyer relationship is such that moderate deviances would be difficult to detect. Clearly, legal professional privilege exacerbates the problem. Thus there must be significant scope for not operating in the client's best interests or not quite following appropriate procedures if a lawyer chooses to do so.

Where distortions are large, of course, there is always the chance that this will lead to a complaint against the lawyer. Generally, a client that gains as a result of a failure to follow procedures is not likely to complain. Here the other party loses but they will have less information. Of course, a client that directly loses because of their lawyer's behaviour may realise this and complain. However, much has been made of the lack of information of the general public, so it is not obvious that they will automatically know if the lawyer's actions have not been entirely in the client's best interests to the extent that the law allows. Where there is a genuine complaint the regulatory body needs to be able to identify this, which is far from guaranteed.

This is not intended to suggest that the profession is rife with inappropriate behaviour but merely to point out that there is plenty of scope for distortion of behaviour, from minor deviations to explicit misconduct. This does indeed create scope for non-lawyers to put influence on lawyers in response to financial pressures if they wish to do so, and this should be a realistic concern. But lawyers are also free to respond to financial pressures when they work alone or with other lawyers and there seems no reason to suppose that this will not happen. Indeed, there are good reasons to think that this is a material concern. One reason is that there are many successful cases of inadequate professional conduct, professional misconduct and negligence each brought year. Furthermore, we have good evidence in other professions that behaviour is 'distorted' by economic incentives. Of particular interest is the treatment of patients by the medical profession since one might expect doctors, having taken the Hippocratic Oath setting out the moral and ethical obligations of doctors to their patients, would be less influenced by economic incentives than lawyers.[20]

Here we provide a few examples that show doctors treatment of a patient changes as the doctor's economic incentives change. For example, it has been shown in the UK that doctors who receive salaries (instead of fee for service) tend to send patients for more tests, choose more referrals and have a lower patient throughput than other doctors.[21] Another example can be seen from the responses to the Conservative Government's reforms in the NHS in the early 1990s. A particular feature was that the money was to follow the patient. General Practice Fundholders were given budgets to buy health care for their patients and the budgets were based on the amount of referrals to hospitals by the GPs in a year (counted for the year following the decision to become a fundholder). A larger number of referrals led to a greater budget and it was found that GPs increased their referrals of patients in that year and that once they became fundholders with the set budget, referrals decreased back to subsequent levels.[22] Finally, when performance-based contracting was introduced to US clinicians in the Maine Addiction Treatment System, their financial reward was linked to their treatment outcomes. It was found that this led clinicians to exaggerate how long patients abstained from alcohol and by how much they had reduced their consumption in order to receive higher remuneration even though the incorrect information could have detrimental consequences for future treatment of patients.[23]

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[20] Indeed, the Hippocratic oath captures ideas close to the notion that a lawyer must do 'the best for the client'. The BBC website summarises the current position of the Hippocratic Oath as follows: 'Perhaps the most enduring - certainly the most quoted - tradition in the history of medicine is the Hippocratic Oath. Named after the famous Greek physician Hippocrates, this oath was written as a guideline for the medical ethics of doctors. Although the exact words have changed over time, the general content is the same - an oath to respect those who have imparted their knowledge upon the science of medicine, and respect to the patients as well as the promise to treat them to the best of the physicians ability'.

[21] See, for example, C. Propper (2004), Why economics is good for your health, *Centre for Market and Public Organisation Working Paper 04-04*, University of Bristol.

[22] Propper, C., Croxson, B., and Perkins, A., (2001), 'Do doctors respond to financial incentives: UK family doctors and the GP Fundholder Scheme', *Journal of Public Economics*.

[23] Lu, M. and Ma, C.A., (2004), 'Financial incentives and the gaming in alcohol treatment', *University of Calgary Working Paper, 04-04*.

There is clear evidence from recent research that the medical profession's treatment of patients changes as economic incentives change. There is little reason to suppose that lawyers are likely to be less responsive and if anything one might expect lawyers to be more driven by financial rewards than doctors. Consequently, concern about the impact of ownership structures on behaviour should not focus unduly on the influences that can arise through the ownership/management by non-lawyers. It does not make sense to consider how business models with outside ownership affect the incentives on lawyers separately from the consideration of how economic incentives affect lawyer owned firms. Indeed, it is difficult to assess the impact of outside ownership (possible highly concentrated) of large LDPs and MDPs without simultaneously considering the impact on the incentives of lawyer owners and managers. As a result, this report considers the implications of the economic pressures that may fall on lawyers as a result of new structures whether they are owned/managed by non-lawyers or not.

3.2. *Sole traders and partnerships*

To understand the form of the incentives that arise in sole traders and partnerships, and the implications for regulation, it is a useful starting point to think about where the value arises in a legal practice and so what type of value is at risk if a lawyer makes an assessment of the benefits and costs of an 'inappropriate' action. Lawyers undertake training at the start of their career to obtain relevant qualifications; they then develop these skills over time, and develop reputations, valuable contacts, etc. If the lawyer acts as a sole trader then these skills will be reflected in their fees with the better lawyers being in a position to command higher fees. Economists tend to refer to these personal skills as human capital and think of the fees as the return on that capital (defined broadly to include basic skills, experience, contacts, etc.). In a sole trader situation the human capital is the major asset of the business.

In a partnership situation the partnership itself will generally have value over and above the human capital within the business. That is, the total return to the partnership is greater than the sum of the returns that each partner could obtain working alone. The return each partner receives is really made up of two bits – a return for using their own human capital (this is lawyer-specific) within the business and a share of the return to the partnership (this is business-specific). It is possible for regulation to impact on each of these separately. For example, in the face of misconduct a regulator could dissolve the partnership but most partners could continue to work elsewhere in the profession. Alternatively, a regulator could disbar one partner but the core partnership (i.e., name and remaining partners intact) could continue. Therefore, if a lawyer in a partnership engages in a cost-benefit calculation of the consequences of doing something that could be considered 'untoward' then the partner has two types of assets at risk – his/her human capital and their value in the partnership. Note, similar arguments may apply to younger non-partners. If they have legitimate expectations of becoming a partner in a firm then their value at risk will include these expectations.[24]

A feature of most legal partnerships, and the small ones in particular, is that the human capital component of the total return to the partner is not dwarfed by the business-specific component. The fact that the return to human capital provides a significant component of the partner's return (and 100% return in the sole trader case) is helpful in regulating behaviour. The ultimate sanction that a regulatory body can impose is to disbar a professional. If this happens the human capital that the professional has built up is wasted or at least cannot be used in its most profitable market. Since a lawyer's human capital is a significant component of total value at risk when the professional considers engaging in inappropriate behaviour then a body regulating legal services has more 'bite' on a lawyer partner than a non-lawyer partner. This is not to say that a non-lawyer partner's human capital may not be damaged if found guilty of a serious misdemeanour, rather that there is no expectation that it will be as much at risk as human capital embodied in a lawyer. Therefore, imposing some restrictions on non-lawyer management composition in partnerships makes some sense (e.g., requiring a majority of lawyers seems a plausible, albeit slightly arbitrary, initial restriction to impose) since it is easier to penalise lawyers. It may be the case that this regulatory constraint is valued in the 'market place' and that consumers may be more inclined to purchase services from partnerships and sole traders than from, for example, large equity-based outside owned suppliers.[25]

3.3 Incentives in Large LDPs and MDPs

When we consider shareholding owners of large LDPs and MDPs then the situation is different. The value of the shares depends on the present value of all the potential

[24] See Holmstrom, B., (1982), 'Managerial Incentive Problems: A Dynamic Perspective', in *Essays in Economics and Management in Honor of Lars Wahlbeck* (Helsinki, Swedish School of Economics).

[25] This effect is in addition to the argument that partnerships have strong internal incentives to monitor the quality of the partners, and tend to provide clusters of similar quality members, which can be valuable when buyers have difficulty identifying quality of supplier (see, for example, Hansmann, H., (1966), *The Ownership of Enterprise* (Cambridge MA, Harvard University Press) and Levin, J., and Tadelis, S., (2005), 'A Theory of Partnerships', *Quarterly Journal of Economics*).

profits of the company once all salaries and other costs have been met. This figure can be very large relative to the profit in any single year and, since equity can be very concentrated, human capital may be a small part of a lawyers or non-lawyers value at risk.

When a limited company is disbarred from acting in a professional market then it is the value of the equity that is lost. The only human capital that will be lost is that of the person that acted dishonestly and potentially that of the manager. The other lawyers will be able to move on and use their skills in the profession elsewhere. Therefore, although the return on all the human capital in the business may be a significant part of the annual return in the company it is likely that almost all of the value at risk may be in lost equity not human capital when there is evidence of gross dishonesty.

It is worth elaborating on the consequences in some detail even though at an abstract level several of the following points are really the same point viewed from a different angle. First, as identified in the Clementi Report, the regulated entity should be the company even though individual professionals should remain personally responsible for their own behaviour.

Second, equity creates strong incentives because the equity value at risk may be very large relative to the human capital of the errant lawyer. Indeed, if the company is owned by, or is part of, a larger group, then the effect of a small intervention by a regulator, or even just bad publicity alone, can have enormous financial impact. As recognised in the Clementi Report, this can create a strong incentive to monitor the behaviour of the professionals in the firm. Indeed, in the case of household names, such as RAC or Tesco, the fact that they are well known would itself actually draw bad publicity, whether merited or not. This gives them an even more powerful incentive to monitor than if the company were equally large but not well known. Of course, then customers will realise this and may be willing to pay more for their legal services as a result if this effect is strong.

Given that the human capital at risk may be very small compared to the equity at risk when inappropriate behaviour is considered, it follows that, when it comes to the calculus as to whether to risk an inappropriate act or not, it is likely to be almost irrelevant whether a combined owner/manager is a lawyer or not. Suppose, for example, that to benefit a major client of an MDP or LDP an owner is 'leaning' on a lawyer to 'lose' a critical embarrassing document. The sole additional sanction that the regulator can impose on a lawyer owner relative to a non-lawyer owner is that the lawyer owner can be barred from working as a lawyer for the remainder of his/her career and hence they would have to work in the next best alternative. But this will be insignificant compared to the present value of the company's profits if the firm is large and successful, hence an insignificant part of the total value at risk, and so if ownership is concentrated then ownership should not affect the outcome.

It follows that there is little difference in incentives between (highly concentrated) lawyer and non-lawyer owned firms. The view that we ought to be more concerned when manager and owners are separate (compared to a situation when the roles are combined and held by a lawyer) is misplaced. Similarly, the closely related view that there are greater concerns when lawyers are in a minority does not resonate with the economic incentives. Indeed, for reasons outlined above, the incentive for a manager to distort behaviour is most prevalent when the manager and owner are combined whether it is a lawyer or not. For example, a large company where two of the three managers are equity owning lawyers would appear to be more prey to potential poor incentives than one with non-lawyer managers where all are none equity holders.

This discussion shows that the regulatory rules should not depend on the business structure but on the underlying incentive structure. The most obvious example of this arises when we compare small and large limited liability companies. The arguments made in this sub-section relate to large firms where the main asset at risk, i.e., the present future return, is likely to swamp the human capital of the owner/managers whether they are a lawyer or not. When one considers small limited liability companies the situation is different. Here the human capital of the manager/ owner/management team is almost certain to be a significant component of the total value at risk. Indeed, the mix of human capital/equity at risk may be closer to a conventional small partnership. In this case the risk calculus may be significantly affected by the nature of the management team. A rule requiring that lawyers form a majority of the management team may have an impact on the desire to act appropriately. Therefore, it makes more sense for the restrictions on the composition of management to be determined by the size of the limited liability firm rather than the business structure itself. Small firms could quite sensibly face different restrictions on management composition to large firms, with the former being grouped with partnerships.

A point that emerges from this discussion is that the risk trade-off within a company does not depend on the total human capital/equity mix within the firm but on the concentration of ownership. For example, as has been emphasised enormously in the responses to the Clementi Report, a lawyer manager in a firm where ownership is concentrated in the hand of an outside owner faces the possibility of influence. In the economic jargon we say that the manager faces multiple principals and will be influenced by each of these.[26] That is, on the one hand, the lawyer belongs to a profession and his/her behaviour is governed by the regulatory framework and ethical norms of the profession but, on the other hand, the lawyer is also employed by an owner who seeks to maximize the return from investment. However, what is not emphasised sufficiently in the debate that has taken place is that the human capital of the lawyer manager is the major part of lawyer's assets at risk where there is a non-lawyer owner and hence the regulatory structure 'bites' significantly on the behaviour of the lawyer manager.[27] Any increase in equity value that is saved by protecting a major client goes to the outside owner, not the lawyer, and so the lawyer will have a different view of the payoffs than the owner. Specifically, the lawyer will not be so inclined to take risks since his/her ratio of gains to losses is not favourable. This is in contrast to the situation when the lawyer has a large ownership of the business. The lawyer still bears the risk of losing human capital value but now captures a major part of the equity value that is saved by protecting the client. The lawyer's incentives are now closely aligned to the incentives of the outside owner in the previous example. If there are large financial gains to be made or saved by protecting the client the lawyer owner is able to capture them. Hence, a large LDP or MDP with concentrated ownership is more likely to be a problem with a lawyer owner/manager than a lawyer manager and a non-lawyer owner. This is the exact opposite of the view that underpins the current debate. The view that the problems increase as the proportion of non-lawyer ownership increases is not the case if companies are large and ownership is concentrated.

The argument above suggests the restrictions on outside managers and owners that are appropriate for partnerships and small firms could in some cases actually make the underlying problem of inappropriate incentives worse in large firms. Fit and proper tests will be appropriate but the current proposals on management composition do not get to the heart of the problem and may give a false sense of security. They are soft on lawyer owners and overly restrictive on non-lawyer owners. This is not to say that there should be no management composition rules for large LDPs or MDPs. However, these need to be more subtle and dependent on the specific factors of the firm such as the concentration of ownership.

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[26] See Holmstrom, B., and Milgrom, P., (1988), 'Common Agency and Exclusive Dealing', *Yale University School of Management Working Paper*; Dixit, A. (1996) *The Making of Economic Policy: A Transaction-Cost Politics Perspective* (Cambridge MA: MIT Press) ; Dixit, A. (1997) 'Power of Incentives in Private vs Public Organisations' *American Economic Review Papers and Proceedings.*

[27] If we put to one side the issue of high-powered incentive schemes (discussed in sub-section 3.5).

The fact that it may be appropriate to take a softer line on management composition in large LDPs and MDPs also finds tangential support in the evidence on dishonest practice. Tables 1 to 6 provide calculations of the number of cases of dishonest practices by solicitors and employees according to size of firms as measured by number of partners. The current data provided by the Law Society has to be reallocation to category to provide these graphs (since the categories do not match), so technically these figures are estimates (albeit fairly accurate) of the true position.[28] Table 1 gives dishonest practices by partners per firm and Table 4 gives dishonest practices by employees per firm allocated according to firm size. The most striking feature is that despite the large number of solicitors in the big firms compared to smaller ones there is no clear relationship. Most striking of all is the fact that the very largest firms have the least number of dishonest practices (by a partner) per firm even though the number of partners in the large firms is far larger than the number of partners in smaller firms.

However, Tables 1 and 4 are not the most informative tests of where dishonest practices lie. If size has no impact on the integrity of solicitors or employees then one would expect to see a constant ratio of dishonest practices per partner regardless of firm size. To put it another way, if size has no impact on the integrity of solicitors the probability of any one solicitor acting dishonestly would not change whether a hundred small firms operated separately or were combined in one large practice. Unfortunately, the data identifying dishonest practices per solicitor is not available. Instead, this has been calculated per partner, i.e., the number of dishonest practices by a partner per solicitor separated according to firm size. This is given in Table 2. This relationship is far from constant. Large practices are far less likely to be prone to improper practices by partners. For example, per solicitor, a partner in a practice with 2-4 partners is almost 60 times more likely to engage in dishonest practices than a partner in firms with 21 or more. This difference is also clear if one calculates the dishonest practices by a partner per unit of fee (Table 3). This dramatic difference is also evident when one turns to dishonest practices by employees rather than partners (Tables 5 and 6). Finally, although the data is not available to conduct more detailed analysis according to very large firms, the data that is available suggests that the differences between very large firms and small firms is even more marked.

3.4 The Financial structure of LDPs and MDPs.

[28] Calculations are based on 'Solicitors Indemnity Fund: Thirteenth Annual Report' (2000) and 'Key Facts 2000: the Solicitors' Profession', The Law society (2000).

Do the arguments of sub-section 3.3 imply that large limited liability firms with or without outside ownership should face fewer restrictions than others? The answer is no. It is just that the primary risks of large LDPs and MDPs with highly concentrated ownership lie elsewhere and will need separate regulation.

As a result of limited liability the downside losses of equity holders are capped at the value of their shares. In particular, when a company is liquidated, shareholder losses are similar no matter how extensive the failure to repay debtors. When contemplating a risky strategy owners, since they are residual claimants, receive 100% of any upside after the debt obligations have been met and are unaffected by changes in the downside if there is insufficient funds to meet debt obligations. Indeed, it is quite common for owners and those with large returns at stake to adopt extreme risky strategies if the obligations a company must meet are so large that survival is uncertain. This may involve breaking the law as well as a code of conduct. Maxwell and Enron are famous extreme examples. A fit and proper test to own is clearly important but no more important than rules that prevent LDPs and MDPs getting into a position where the owners benefit from adopting risky strategies.

The problem identified above is often referred to as the 'moral hazard' problem, which in the current context is particularly appropriate. Maxwell and Enron are extreme examples but the incentive to distort behaviour also arises in far more 'normal' situations. The higher the debt/equity ratio in a firm then the more attractive risky strategies become to the owners, even when debt is not large. Of course, debt holders have the opposite incentives and will seek to stop the company from adopting risky strategies. This is why debt covenants require companies to seek clearance from debt holders before certain activities are undertaken. A problem in the context we are considering is that the primary risk is one of improper conduct. Obviously it does not make much sense for a debt covenant to include the requirement that the owner/manager seeks clearance from the debt holders before he/she embarks on any activity that could be defined as professional misconduct. Furthermore, debt holders are outside the organisation and are not well placed to monitor this type of behaviour anyway. But, even if they have good information the regulatory regime ought to impose restrictions that avoid potential problems rather than rely on third parties with no legal obligation to 'police' behaviour. Of course, if there is sufficient equity relative to debt this should not cause a significant problem and we can expect the positive incentive aspects of equity ownership to encourage owners to be particularly cautious not to damage its value.

The main point of this discussion is to show that the focus of regulation on large highly concentrated LPDs and MDPs should not be on management but on the financial structure. Again to worry whether the owner is a lawyer or not seems to miss the point. The human capital invested in the lawyer manager will be swamped by the equity at risk and the returns at stake so the incentives of lawyer owners and non-lawyer will be aligned. Indeed, the problem may again be at its most extreme with a lawyer owner. The core of the problem is the inability of those outside the organisation to monitor the process before the outcome of a bad event occurs. One or a few lawyer-owners in a very large firm where debt levels are becoming very high are well placed to hide inappropriate action. An outside owner must work through a lawyer who does not have significant ownership and so is worried about the loss of human capital. Therefore, regulations that concentrate on the poor incentives arising from outside ownership, which has been the focus of the current debate, are inappropriate in the context of large LDPs and MDPs with concentrated ownership.

What the appropriate financial regulations have to be, however, is not straightforward and will require careful consideration. The following brief discussion serves as an example to show that rules that minimize the chance of bankruptcy will not do the job because debt finance can simply be shifted into hybrids.

Compares the following two cases of lending money to a firm:

> *Case A*: The company raises money in a debt instrument that pays x% every year for 50 years and then redeems at par.
>
> *Case B*: Exactly the same as above except that the company now chooses whether to pay x% or not. Whenever it is not paid it is accumulated and no dividend can be paid until the accumulated repayments are paid in full.

Case A is a basic debt contract. Case B is similar in many respects. It has an advantage that if the company is in financial difficulties it does not face bankruptcy since repayments can always be postponed. However, the moral hazard problems that we have identified above still holds. A shareholder cannot get a return until all the hybrids repayments are met and so the core problem, i.e., the owner's incentive to adopt risky actions, is still present.

Case B is a classic hybrid. It has elements of basic debt and elements of equity. Typically a company will insert a hybrid between basic debt and equity. In this case the hybrid has equity like features in that the return is residual relative to basic debt (if there are insufficient funds then there can be no repayment to the hybrid until debt repayments are met) and is contingent on outcomes and shareholder decisions. However, the hybrid is also debt-like. It has a fixed ceiling on returns, is redeemable at par and creates exactly the same moral hazard problems of basic debt. Currently in the UK, Case B would be treated as equity by accountants and the income would be treated as debt by the tax authorities.

I have raised the example of hybrids because this type of finance may be particularly attractive in the new market for large LDPs and MDPs. Consider a group of lawyers who wish to create a large company by taking over other firms. This approach may be particularly relevant in the creation of an MDP. Venture capitalists may be keen to invest but there may be uncertainty as to the true future prospects of the company. Setting a price for an equity injection in this context may be difficult and also dilutes the incentives for owners. Adopting a hybrid with a high rate of return allows the venture capitalists to bear significant risk but does so in a manner that is less sensitive to the uncertain potential of the company. The bulk of this risk remains with the owners and so the owners obtain risk capital without diluted incentives.

Indeed the benefits of the hybrid may be much stronger because the ratio of hybrid to conventional equity in the capital structure may serve as a signal of the quality of the company. The problem potential funders have is that because of asymmetric information between funders and owners/managers there is an adverse selection problem. The companies where the managers have the least good prospects will be anxious to sell equity to the funders whilst those with the best prospects will be least keen to 'give' equity away. This problem drives up the cost of funds and so the managers with the best prospects raise less capital because it is too expensive for them given the quality of their firm. Hybrids of the type described above split the risk in a manner that reveals information to the market. If venture capital is uncertain of the quality of the company then managements that are confident of their product will prefer the hybrid whereas a management that is less confident of their product would prefer to raise equity funds. For this reason, almost all companies may wish to choose some hybrid assets in their portfolio with the better firms having a higher hybrid/equity ratio. Note, the cost of the transaction with hybrids will be cheaper than without because of the signalling feature. Thus, hybrids may be preferred over equity by good firms. This indicates that simple rules insisting on equity funding or focusing on bankruptcy possibilities may not be appropriate.

It is not the intention here to attempt to solve this problem but merely to show that it is real and that the regulatory solution will require careful thought. The current proposals to introduce new accounting standards in the UK, such as IAS 39 (which calls for the disclosure of all financial assets and financial liabilities on the balance sheet at the time when the company becomes a party to the contract concerned) is also relevant here but it is almost certainly the case that the new financial reporting rules will not be sufficient to achieve the regulatory objective. As a final point, it is worth pointing out that the regulations may not be neutral in terms of their effect on the development of large LDPs and MDPs. For example, four large firms merging may not be a cause for concern but one company borrowing heavily or raising hybrid finance to buy out three others may be.

3.5 Managerial Incentive Schemes

Closely associated with the above problem is the incentivisation of non-shareholding managers. Managers that are funded by high-powered payment schemes may face incentives exactly like a shareholder of a company that has a significant debt/equity ratio. Of particular interest here are managerial share options. These are instruments that allow a manager to purchase shares at a particular date at a specified price. They are extremely prevalent form of remuneration in the US (where a manager of a large quoted company will typically earn millions of dollars per year through these schemes) and are becoming standard for managers in the UK. A manager incentivised in this way gains substantially from adopting risky strategies for exactly the same reasons (outlined in sub-section 3.4) that shareholders do when they have to repay substantial debt. There is significant evidence to show that this is the case. Here we briefly present some of this evidence to show that the issue is significant.

Studies that look at firms that have increased variance compared to those that have reduced variance find that those with higher variance have executives with more options. For example, in a 1987 study of firms the mean ratio of stock plus option holdings to total annual compensation for all officers and directors was 12.61 for variance increasing firms and 5.42 for variance decreasing firms.[29] A study in 1996 of the gold mining industry found firms whose executives hold more options tend to focus less on managing gold price risk. There is an 11 percent decrease in the probability that firms use some form of risk management when moving from the 10th percentile of managerial option holdings to the 90th percentile. This result is consistent with the theory that executives with stock options may make investment decisions that

[29] Agrawal, A., and Mandelker, G. N., (1987). 'Managerial Incentives and Corporate Investment and Financing Decisions,' *Journal of Finance.*

make their firm's more risky.[30] A study of the NYSE in 1990 found that in every fractile, stock return variances for firms adopting executive stock option plans' exceeded variances of the control group of firms.[31] Finally, a 1998 study of the savings and loan industry when firms convert from mutual funds found firms where managers hold some options have higher stock return volatility in the quarter they converted than firms where managers hold no options. Risk rose for the former group but fell for the latter.[32]

This suggests that other things being equal, a manager is likely to have stronger incentives to risk misconduct if they have high-powered financial incentives that have large total value relative to their future income. It may be appropriate to address restrictions on the scale of highly geared incentive schemes. This is most likely to be an issue for LDPs and MDPs that become plcs. Again the incentive problems do not appear to be particularly different whether the management team is mainly lawyer or non-lawyer.

4. Additional comments

The paper closes with two comments that are related to but beyond the core brief. One concerns the specific rules of the professional bodies and the other access to justice.

4.1 Competition between barristers and solicitors.

The focus of this report has been on downside effects of new ownership structures and suggesting regulatory structures that limit any problems. There is a distinction between, on the one hand, changing the law to allow new ownership models and, on the other, insisting that the professional bodies are required to remove their specific limitations on business structures. In particular, the sole trader rule of the Bar seems particularly at variance with the plans to broaden ownership structures. Of course, one could take the view that the arguments outlined in Section 3 of this report, highlighting the problems associated with large LDPs and MDPs, exactly justify why there are restrictions on business models. However, to my mind the new business

[30] Tufano P., 'Who Manages Risk? An Empirical Examination of Risk Management Practices in the Gold Mining Industry', *Journal of Finance*
[31] DeFusco, R.A., Johnson, R.R. and Zorn, T.S. (1990), 'The effect of executive stock option plans on stockholders and bondholders', *Journal of Finance.*
[32] Schand, C., and Unal, H., (1998), 'Hedging and coordinated risk management: evidence from thrift conversations', *Journal of Finance*.

models will bring benefits that will outweigh any downside providing appropriate regulation is in place.

If the law is changed to allow much broader ownership structures it is not obvious how damaging the codes of practice that limit ownership structures are likely to be. One could argue that the restriction is not too relevant. For example, it appears that an Article 81/Chapter 1 case could have been brought against the sole trader rule if there were sufficient incentive to do so. Of course, this would be a complex route for any affected party and the ECJ ruling in 2002 suggests that a successful outcome is not absolutely certain.[33] Here the Court said that not all restrictions of this type infringe Article 81(1), in particular where they pursue 'objectives' such as the proper administration of justice and proper practice of the legal profession. In the case a challenge to the Dutch Bar rule forbidding multi-disciplinary partnerships failed. However, insistence on sole trader is far stronger and it is not clear that the Court would take the same view. Another argument could be that Solicitor Advocates have made limited in-roads into the market for High Court advocacy to date and this could be because there are no real benefits to other delivery models and no benefits from 'vertical' integration of the services necessary to take a case to the High Court.[34] On the other hand, it is frequently suggested that there are unnecessary barriers to becoming a Solicitor Advocate and this is part of the reason for the slow growth.

How the professional bodies rules affect the market depends on the competitive framework. Focusing on the competitive structure of the market seems just as useful a route forward, if new ownership models are available, as worrying about the specific rules of the professional bodies with regard to business structures. It is difficult to see why a solicitor with considerable experience in lower courts needs additional training to become a solicitor advocate.[35] Similarly, it seems to make sense to make things easier for barristers or QCs to move in the opposite direction into large firms. For example, training in issues such as dealing with client's money could be avoided by agreeing for all financial matters of this type to be dealt with by specific nominated

[33] *Wouters v Algemene Raad van de Nederlandse Orde van Advocaten* (Case C-309/99) [2002] ECR I-1577.

[34] There are currently about 2,545 Solicitor Advocates in the UK; 1331 for criminal proceedings, 563 for civil proceedings and 651 for all.

[35] Currently there are Accreditation and Exemption routes for solicitors with considerable experience to qualify. The primary route is the Development route (prescribed training and assessment). The former were introduced to increase the number of solicitor advocates but the Accreditation and Exemption routes will expire on 31 October 2005. Currently (January to June 2005) the Development route accounts for less than 16% of applications and since 2001 has accounted for only 17% of applications (calculated from 'Rights of Audience in Higher Courts: Summary', Law Society (2005)).

members of the firm. Decisions to open up business models should be accompanied by consideration of easing the restrictions on movement in the 'market place'.

4.2 How do new business models relate to Access to Justice?

Finally, the regulatory debate is to a large extent concerned with improving access to justice. Part of the debate around the Clementi Review has concerned the issue of whether legal services can be commoditised. In one sense they can. There is nothing unique about lawyers and legal services. There are clearly some specific features of the job, and the code of conduct that goes with it, but this is typical of many professions. Doctors and medical services are a good example. Medical services can be treated as a commodity. Cheaper operations, more of them and better and quicker delivery are all good things. As we well know from the modern worldwide programme aimed at broadening the delivery mechanisms to make better use of the private sector and to create more responsive public sector institutions and greater choice for patients, the regulatory mechanisms and questions are complex and delicate. The same is true as ownership structures are modernised in the legal profession. The regulatory processes are complex and will need careful consideration but it is all perfectly doable.

In another sense, however, access to justice is different from most things. Generally, lower prices, more efficiency and more of the commodity are good. But this is not necessarily the case for access to justice and in this sense it cannot be commoditised. The relationship between cost, efficiency of delivery and the desirable end product is far more complex. Access to justice is not like access to clean water, for example. If the cost of putting clean water in place around the world falls and there is more clean water as a result then this is good. However, if the price of access to courts fall then this is partly good since it is more open to all but if the net result is more civil cases, more litigation, etc., then this may not be a better outcome. We want access to justice but at the same time we do not want an increase in the consumption of the commodity.

If the new business models accelerate a movement to a litigious society then this may not be a good thing and the negative effects have to be balanced off against efficiency gains. For example, companies at present can sell legal insurance and then buy legal services to meet the obligation when a customer 'calls-in' the insurance. This has not happened in a big way in the UK. Understandably in such a business the insurer really needs to have control of the cost of meeting the insured needs, otherwise it is a not a very attractive business model. LDPs and MDPs will enable insurers to own legal practices and to set the quality level and decide how much is appropriate to spend. So legal insurance may grow significantly. Of course, if other people have legal insurance then it becomes important to have it yourself to protect oneself. But if everyone expects everyone else to have legal insurance then it is more likely that seeking legal damages becomes standard practice, which itself can set up a new cultural dynamic in society.

All this sounds very dramatic and is unlikely to be the consequence of a few changes in legal ownership structures. Furthermore, it is not a very attractive argument to suggest that making legal services expensive and the preserve of the rich is the best way of ensuring equal access to justice for everyone else. However, the basic argument behind the 'Clementi' debate, that more efficient and cheaper delivery is good, is true only if what is delivered is good, rather than something that is sought as a last resort; but having many more legal cases is not necessarily good. Justice is a broad concept and may be deliverable in many other ways. The debate has not taken place in a broader context and this would be a useful exercise.

5. Summary of recommendations:

1. Regulation should focus on the underlying incentive structure not the business form. The current proposals do not this.

2. 'Small' LDPs and MDPs:

- The limitations on management composition and fit and proper tests are the appropriate focus of regulation. Those currently proposed in the Clementi Report appear appropriate.

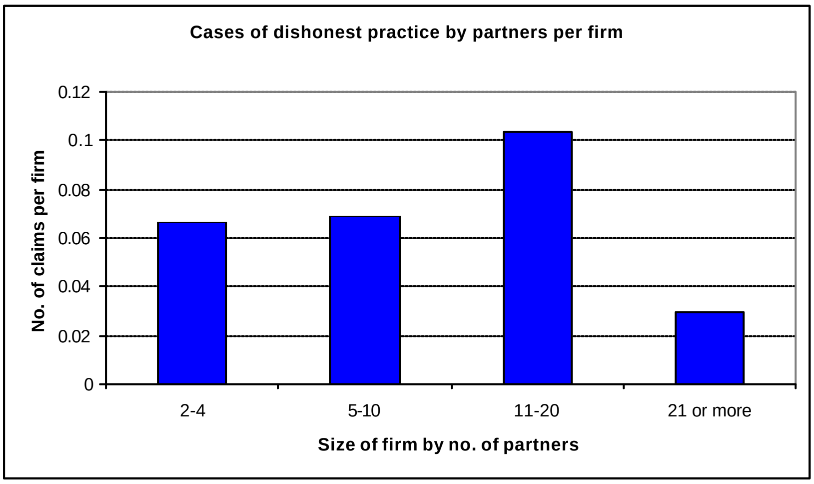
3. 'Large' LDPs and MDPs:

- Management restrictions such as those currently proposed in the Clementi Report may not be appropriate. They do not resolve potential regulatory problems since the incentive benefits and problems are common to lawyer and non-lawyer managers and owners. Indeed, they may provide a false sense of security. However, some alternative forms of management regulation may be helpful and fit and proper tests are necessary.

- Financial oversight and ‘regulation’ rather than management controls will be the most important mechanism of ‘regulatory control’ for large LDPs and MDPs, particularly where equity is highly concentrated. This will be a new departure for regulation of the legal profession.

- Management incentive schemes will need oversight and it may be deemed appropriate to bar particularly high-powered schemes.

4. It is important to consider easing the constraints on the market. For example, extending the deadline on the 'Accreditation and Exemption routes' beyond 31 October 2005 to increase the number of solicitor advocates.



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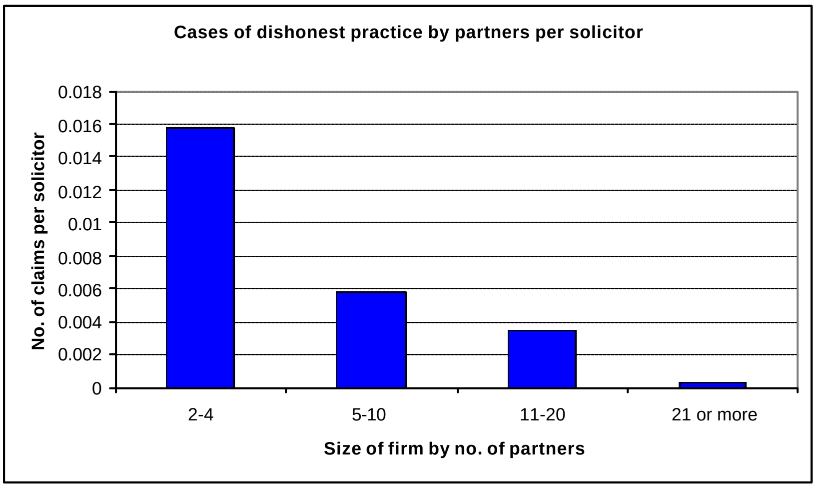

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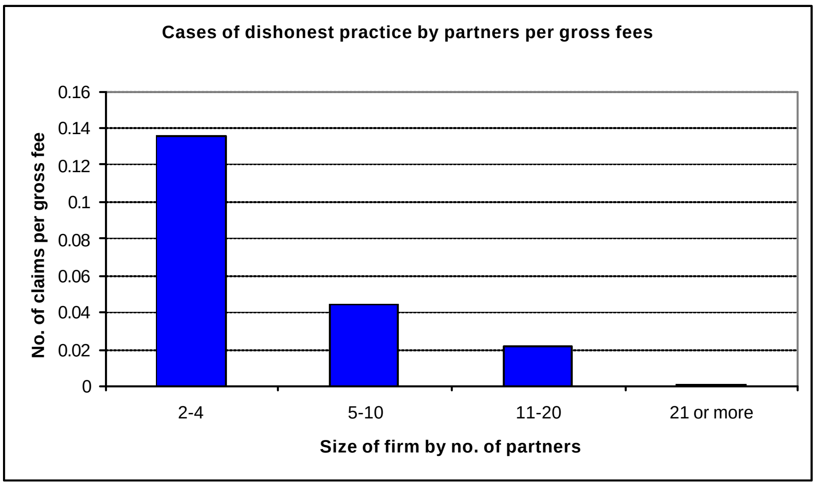

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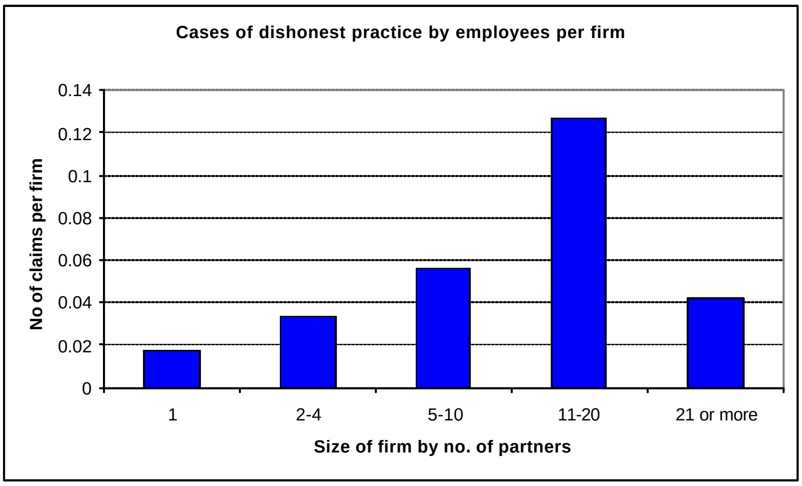

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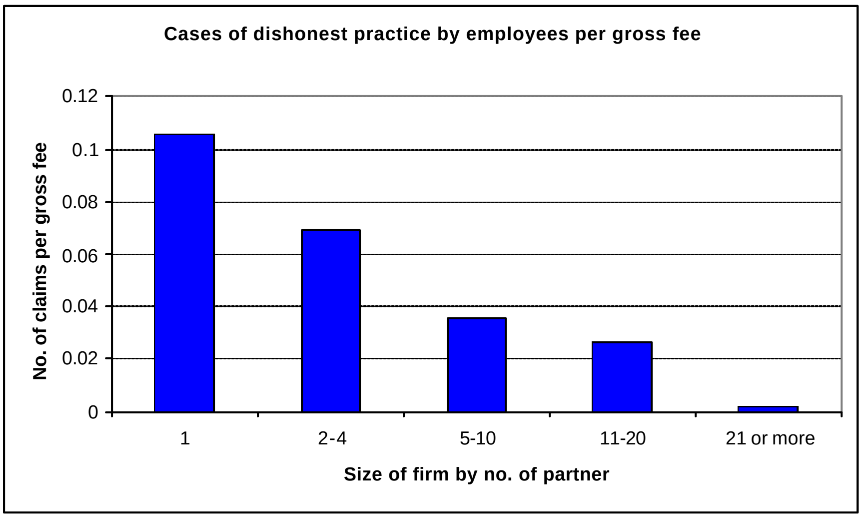

Table 6