

**The Organisational Structure of Legal Firms; a Discussion of the
Recommendations of the 2004 Review of the Regulatory Framework for
Legal Services in England and Wales**

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1. INTRODUCTION

The 2004 Review of the Regulatory Framework for Legal Services in England and Wales (the Clementi Report) discussed the possible removal of restrictions in the UK on the organisational form of legal practices. In particular, it considered two alternative structures, Legal Disciplinary Practices (LDPs) and Multi-Disciplinary Practices (MDPs). LDPs are defined in the report as “law practices which permit lawyers from different professional bodies, for example solicitors and barristers, to work together on an equal footing to provide legal services to third parties. They may permit others (e.g. HR professionals, accountants) to be Managers, but these others are there to enhance the services of the law practice, not to provide other services to the public.” MDPs are defined as “practices that bring together lawyers and other professionals (e.g. accountants, chartered surveyors) to provide legal and other professional services to third parties. They do not solely provide legal services; indeed legal services might be a small part of their work.”

The Clementi Report concluded that LDPs should be permitted and that non-lawyers should be allowed to be partners (or directors) of such practices, subject to the principle that lawyers should be in a majority by number in the management group. Moreover, the non-lawyers would be there to enhance the services of the law practice, but would not be permitted to provide other services to the public. Outside ownership of LDPs should also be permitted, subject to a ‘fit-to-own’ test and a control provision that requires management control to be vested in lawyers. The Report was more cautious about the permissibility of MDPs, concluding that it would be helpful to gain experience of LDPs and their regulatory consequences before proceeding with full-blooded MDPs.

Following the publication of the Clementi Report we were asked by the Department for Constitutional Affairs to examine

- why businesses, such as law firms, may elect for one form of business

structure over another and in particular why they may elect for a form involving an element of outside ownership;

- the potential benefits and risks to both the firm and its customers that outside ownership may bring;
- the potential benefits and risks to both the firm and its customers that a regulatory limit on the amount of outside ownership allowed may bring;
- the link between ownership and control; and
- the regulatory responses that may promote benefits and manage risks related to outside ownership.

We proceed as follows. In Section 2 we consider at a general level the economic effects of organizational structure. We do this by comparing a stylized case of a partnership with solely insider ownership and equal profit sharing among partners with that of a public corporation with outside shareholders and professional managers. The contrast, while in many ways artificial, will help to bring out some of the issues involved in the choice of business structure and at the same time provide an opportunity to review the relatively sparse economic literature on partnerships. Our treatment in this section is general and at times abstract. In Section 3 we consider why some law firms may have an incentive to move to outside ownership. In Section 4 we discuss the case for continuing constraints on the structure of law firms. Section 5 examines possible safeguards that might be needed in the case of outside ownership of legal services. Section 6 concludes.

It is worth emphasising in advance that in the absence of some market failure we would expect businesses to seek out the most efficient organisational structure, in which case constraints on a firm's structure would be liable to reduce efficiency. We therefore need to ask whether there exist market failures or imperfections that would lead legal firms to structure in ways that may increase firm profitability but nevertheless reduce welfare.

In writing this report we have been greatly assisted by discussions with members of law firms, The Law Society, the Bar Council and Sir David Clementi. The usual disclaimer applies, that we are solely responsible for the contents of this report.

2. ALTERNATIVE BUSINESS STRUCTURES: PRIVATE PARTNERSHIPS AND PUBLIC CORPORATIONS

Most large manufacturing and retail businesses in developed economies are organized as public corporations with outside shareholders and hired managers. Professional businesses by contrast are for the most part structured as partnerships. This is true of consultancy firms, accounting firms, architects, medical practices, advertising agencies and law firms.¹ Also, until comparatively recently investment banks were organized as partnerships.

In some cases the choice of structure is constrained. For example, until 1970 investment banks in the USA were prevented from forming listed companies. After these listing restrictions were removed, investment banks began to adopt the corporate form. Similarly, legal practices have also been constrained from outside ownership. What is interesting about this restriction is that it is by no means limited to the UK. For example, most U.S. states prohibit law firms from having “layman” equity investors (though they need not be wholly owned by their practicing partners).² New South Wales is an exception in allowing outside ownership and multidisciplinary practices, though other states in Australia plan to follow suit.³

In the UK legal services are provided largely by solicitors and barristers. Solicitors are regulated by the Law Society and barristers by the Bar Council.⁴ There are six types of legal service that are reserved by statute to those who are certified by one or more

¹ It is worth noting that some companies, such as McKinsey, are private corporations but function for the most part as partnerships.

² These US restrictions stem directly from the guidelines of the American Bar Association, whose Model Rules for Professional Conduct prohibit lawyers from practicing in a for profit corporation if non-lawyers have decision stakes in the firm (rule 5.4(d)).

³ Multi disciplinary practices have been permitted in New South Wales since 1994 and incorporated practices since 2000. The first public offering by a law firm in the state took place in 2004. For a discussion of these reforms see S. Clark and C. Harris, “Legal Practice in Australia: From MDPs to Incorporation,” *Defense Counsel Journal*, 67 (October 2000), pp.449-453.

⁴ Other regulatory bodies include the Council for Licensed Conveyancers and the Faculty Office which regulates notaries.

specified regulatory bodies. Other services are not reserved and can be offered by providers who are regulated by virtue of their professional status, or by unregulated providers. The reserved and unreserved services are as follows:

Reserved services	Unreserved services
Probate	General legal advice
Immigration	Will drafting
Conveyancing	Employment advice
Notarial functions	Claims assessment and management
Rights to litigate	
Rights of audience	

The Law Society and the Bar Council are not the only bodies whose members are permitted to provide reserved services. For example, both the Law Society and the Council for Licensed Conveyancers are permitted to certify individuals to provide conveyancing. The Faculty Office can license notaries and since December 2004 professional bodies can apply to be authorised to license probate practitioners who would be permitted to carry out those probate functions that are currently reserved for solicitors.⁵

There are about 90,000 solicitors and about 11,000 barristers in independent practice. Most firms of solicitors are organized as partnerships.⁶ By contrast, barristers practice as sole practitioners, though they may group together in chambers and share common services. Both solicitors and barristers are subject to rules prohibiting outside ownership interests.⁷ These consist of:⁸

⁵ Other aspects of the probate process are not reserved and are often provided by accountants.

⁶ Though solicitors are free to incorporate, a small but growing number have done so, possibly because (a) LLP's are treated as partnerships for tax purposes, and (b) LLP's are permitted to limit their liabilities in agreement with their clients.

⁷ Other firms providing legal services, such as licensed conveyancers, are not subject to the same ownership restrictions.

⁸ Office of Fair Trading response to Review of the Regulatory Framework for Legal Services in England and Wales, A Consultation Paper, 8th March 2004.

- a. rules that prohibit partnership between barristers and between barristers and other professionals (both lawyers and non-lawyers); employed barristers may work for firms of solicitors, but may not without re-qualification become partners;
- b. rules that prohibit solicitors from entering partnership with members of other professions (both lawyers and non-lawyers); and
- c. rules that prevent, with a small number of exceptions, solicitors in the employment of businesses or organisations not owned by solicitors (e.g. banks or insurance companies) from providing services to third parties.⁹

In this section we contrast a stylized case of a private partnership with that of a public corporation. In practice both the partnership and corporate structures offer considerable flexibility, so that it may be possible to pick and choose between the different features that we consider. Nevertheless the discussion provides a framework for reviewing the literature on partnerships and should help to highlight both the issues involved in organisational structure and the reasons that many professional businesses choose the partnership form. We shall discuss how the choice of structure may depend on firm size, since we believe that larger law firms will respond in rather different ways to a relaxation of restrictions than smaller firms.

We consider partnerships and public corporations to be distinguished on the following dimensions:

- The partners are simultaneously both owners and managers – that is, they have both control and cash flow rights. In a public corporation there is separation between managers and shareholders. As a result shareholders have cash flow rights, but, although they retain their voting rights, they delegate most of their control rights to professional managers.

⁹ For example, these rules do not prohibit not-for-profit organisations such as trade unions from offering legal services to their members.

- Partners are entitled to a share of the profits of the firm, while the executives of the public corporation are rewarded at least in part by a defined salary, albeit supplemented by performance related bonuses, options etc.
- Ownership in the public corporation can be freely transferred at a market price. Ownership in the partnership can be transferred only when the partner ceases his involvement with the firm and then at formulaic, and often conservative, valuations.
- The corporation can raise money by selling new ownership shares without affecting who is employed. A partnership can raise new equity only by taking in new partners.
- The partnership has unlimited liability, so that the partners are personally responsible for the business's debts. By contrast, the shareholders of the public corporation are protected from the creditors of the corporation.
- The partners pay personal income tax on the profits of the firm after deduction of depreciation and interest payments by the firm. By contrast, corporations pay tax at the corporate rate on profits after deduction of interest payments. Shareholders then pay an additional level of personal income tax on dividend distributions and of capital gains tax on any gains.

The issue of tax is largely tangential to our report. Though the topic is of considerable importance to firms, it does not help us to understand why particular types of firm are commonly organised as partnerships and cannot constitute a reason for constraining firms to a particular structure. We concentrate on the issues of transferability of ownership shares and on differences in control and cash flow rights, since these lie at the centre of much of the debate on outside ownership of legal firms.

Unlimited Liability Partners in a general partnership have unlimited liability for the firm's debts. This places partners of a law firm at risk of ruin and the loss of their right to practice as lawyers. Hence, the willingness of partners to bear this risk creates a strong incentive for them to observe a duty of care and to ensure that their colleagues do

likewise. Partners with shared unlimited liability are likely to take particular care that new partners are competent and trustworthy.

The existence of unlimited liability also sends a strong signal to the firm's customers that each partner has confidence in the ability and probity of all the firm's partners. Since bankruptcy is potentially very costly for partners of law firms, the incidence of bankruptcy in these firms is very low.

While the incentive and signalling effects of unlimited liability may seem to go to the heart of the quality issues that we discuss below, their relevance is diminished by the fact that legal firms can reduce their liability by forming limited liability partnerships (LLPs) without affecting any of the other features of a general partnership.¹⁰ In the UK Clifford Chance, Allen and Overy, Eversheds, and Herbert Smith are examples of firms that have converted to LLP status.

Baker and Krawiec, who studied the structure of 147 of the largest New York law firms, found that 67 percent had become LLPs, while only 13 percent remained general partnerships.¹¹ Interviews with the partners of these firms suggested that a decision to retain general partnership status reflected the belief that a move to an LLP structure would reduce collegiality and send a poor signal to clients. These responses are indicative of the concern by law firms to maintain and demonstrate quality.

New Equity Partnerships may raise money by bank borrowing,¹² retaining income or admitting new partners. Since the principal asset of most law firms is their human capital, debt capacity is relatively limited. Equally, existing partners may be reluctant to agree to a policy of high retentions unless they know that their cash-out price will reflect

¹⁰ However, an LLP does not confer the same degree of protection for its owners that is provided by a public corporation and in that respect may be a less attractive structure. Several lawyers we spoke to, commented that as a result of lower levels of protection limited liability partnerships encourage law firms to be conservative and set producer-driven standards at the expense of customer satisfaction.

¹¹ See S. Baker and K.D. Krawiec, "The Economics of Limited Liability: An Empirical Study of New York Law Firms," *University of Illinois Law Review*, 2005, pp. 1-63

¹² On occasion law firms have borrowed by means of a bond issue. For example, Clifford Chance made a bond issue in 2002, although it was subsequently redeemed.

the full value of the additional investment. This inability to cash out at a proper market valuation may be important in explaining why some law firms we spoke to implemented a low retention and high payout policy. The third possibility is for the partnership to raise additional equity capital by taking on new partners. However, this will not usually increase the assets per partner and will therefore simply change the scale of the business.

This problem for partnerships in accessing finance helps to explain why most capital-intensive businesses are organised as corporations, while partnerships are most suited for labour-intensive activities. When a business becomes more capital intensive, it may have an incentive to restructure as a public corporation. The experience of investment banks illustrates this. For a long time the New York Stock Exchange prohibited public incorporation of member firms. After the rules were relaxed in 1970 a number of investment banks went public, and by the time that Lazard Freres went public in 2005, all the large investment banks had ceased to be partnerships. Morrison and Wilhelm argue that this shift in structure stemmed in large part from technological changes that required major investments in investment technology and in the process increased the efficient operating scale of investment banks.¹³ The initial impact of cheap batch processing was largely confined to retail investment banking and it was here that the first effects of the new rules were felt. Four years after the NYSE lifted its restriction, seven of the predominantly retail banks went public or were acquired by public companies while only two remained as partnerships.

A second wave of public offerings occurred after 1978 and involved primarily wholesale investment banks. For these banks the development of new derivative markets and simultaneous advances in financial engineering reduced the importance of established relationships within a bank and increased the capital investments required. At the same time many of these banks required increased capital for proprietary trading. By 1987

¹³ The effect of technology on the structure of investment banks is described in A.D.Morrison and W.J. Wilhelm, Jr., "The Demise of Investment-Banking Partnerships: Theory and Evidence," Oxford Financial Research Centre Working Paper July 2004.

almost all the major wholesale investment banks were publicly owned. One exception was Goldman Sachs, which gave serious consideration to a public offering in 1986 but instead agreed to sell a minority equity interest valued at \$500 million to Sumitomo Bank. Goldman eventually went public in 1999. The other exception, Lazard Freres, which had specialized in less capital-intensive activities such as merger advice, nevertheless finally went public in 2005.

While investment by law firms in IT has increased rapidly, these firms remain much less capital intensive than investment banks. The assets of a typical large law firm are less than one year's income, so that the limited access to the capital markets does not appear to be a serious hindrance to their development. That said, many management consultancy firms, which also have low capital requirements, have chosen to raise significant amounts of capital through IPOs. We examined a sample of 25 UK consultancy firms that went public between 1995 and 2005 together with a sample of 63 U.S. consultancy firms that made IPOs between 1970 and 2005.¹⁴ In each case more than half of the amount raised consisted of new capital for the firm and the effect was to increase existing equity capital by about a third. In both samples a commonly cited reason for the IPO was the desire to reduce borrowing.

This experience suggests that large law firms could wish to raise new equity capital if they were free to do so, and our discussions with some law firms have confirmed this. For example, one fast growing law firm indicated to us that the lack of outside finance may have limited their expansion plans both domestically and internationally. Their response suggests to us that the demand for outside funds may be higher for firms that are trying to change their position in the size league of law firms and that the inability to raise outside equity may be particularly acute for a law firm that wishes to expand through acquisition. In this respect, restrictions on outside equity ownership may act as a brake on competition.

¹⁴ Data from *SDC Platinum*.

Illiquidity The fact that partners are locked into their ownership stakes forces them to pay attention to the long-term reputation of the firm. However, the undesirable consequence of illiquidity is that ownership is concentrated among the partners, who therefore bear the entire risk of the firm. This may focus their minds on ensuring that the firm prospers, but it also means that their risks are inefficiently spread. Partners of large firms might therefore welcome the freedom to cash out part of their holdings. This appears to have been an important motive behind the IPOs of investment banks and consultancy firms. Most of these combined a primary issue with a secondary one in which partners cashed out part of their investment. For example, in the Goldman Sachs IPO existing partners sold a total of \$954 million of their existing stock holdings.¹⁵

Large law firms in hiring high-quality graduates are often in competition with investment banks. It has been suggested to us that the illiquidity of the partners' ownership stake places the law firm at some competitive disadvantage in recruiting. In addition, this illiquidity may act as an impediment to partners wishing to retire early, especially when their fee-earning capacity has declined. It was, for example, noted that this has proved to be a significant benefit to one large securities firm that has recently become part of a listed company.

Profit Sharing In our stylized example of a partnership profits are shared equally among all partners. Profit sharing rules of this kind can have important effects on both incentives and hiring decisions that are central to the debate on the quality of legal services.

Professional services have some important distinguishing characteristics. For example, Alchian and Demsetz argue that “while it is relatively easy to manage or direct the loading of trucks by a team of dock workers where input activity is so highly related in an obvious way to output, it is more difficult to manage and direct a lawyer in the

¹⁵ If retiring partners have in the past cashed out at less than the market value of their investment, an IPO will allow existing partners to capture some of the increase in wealth contributed by past generations of partners. The problem here is with the payments made to partners in the past and cannot justify a continuing restriction on sales of a partner's ownership stake.

preparation and presentation of a case.”¹⁶ As a result, such professionals are less likely to be organized as traditional capitalist firms. By, in effect, making each employee a residual claimant, the employee-owned firm with profit-sharing encourages monitoring by employees.¹⁷ Thus, whenever monitoring of effort and competence is difficult, it may be efficient to undertake it within a partnership. But partnerships may not only have an advantage in collecting such information, they can also more effectively use peer pressure to produce higher effort among the team’s members.¹⁸

Morrison and Wilhelm (2004) stress the fact that partnerships are characterised by an up-or-out employment policy and an emphasis on teamwork.¹⁹ Moreover, because partnership shares are illiquid, it is costly for partners to leave the firm without the consent of their colleagues. A partnership that is regarded as trustworthy can earn high fees for its partners. Therefore, since individual partners are bound into the firm, they have a considerable interest in maintaining firm reputation. Thus partners will be prepared to put in effort to mentor (and monitor) new associates.

The illiquidity of partners’ stakes and their shared stake in the firm’s reputation are important in explaining the prevalence of partnerships in professional firms where human capital is the dominant asset. But this equilibrium depends on the team being sufficiently small that it pays each partner to provide the mentoring necessary to preserve the firm’s reputation. As the firm becomes larger, there is an incentive for individual partners to free-ride by not putting sufficient effort into mentoring. Thus a study of U.S. medical partnerships by Gaynor and Gertler found that partner productivity declined with increases in firm size and greater sharing of output.²⁰ Similarly, we suspect that the

¹⁶ See A.A. Alchian and H. Demsetz, “Production, Information Costs, and Economic Organization,” *American Economic Review*, 62 (December 1972), pp. 777-795.

¹⁷ Garicano and Santos argue that the profit sharing rules of partnerships can also improve incentives for firms to direct jobs to those most able to perform them. See L. Garicano and J.T. Santos, “Referrals,” *American Economic Review*, 94 (June 2004), pp. 499-525.

¹⁸ See E. Kandel and E.P. Lazear, “Peer Pressure and Partnerships,” *Journal of Political Economy*, 100, (1992), pp. 801-817.

¹⁹ A.D. Morrison and W.J. Wilhelm, Jr., “Partnership Firms, Reputation, and Human Capital,” *American Economic Review*, 1994 (December 2004), pp. 1682-92.

²⁰ M.S. Gaynor and P.J. Gertler, “Moral Hazard in Partnerships,” NBER working paper No. W3373, April 1996.

growth in the size of the major law firms in recent years, and their internationalization, has increased the difficulties of maintaining partnership quality through mentoring and monitoring.

The second effect of the partnership structure may be on the firm's hiring decisions.

Levin and Tadelis argue that profit-sharing in partnerships tends to raise the quality threshold for hiring.²¹ The pressure in partnerships to hire high-quality staff arises because profit sharing causes each partner to care about profits per partner.²²

Consequently, the firm will hire new partners only if the result is to increase the average profits per partner. A corporation by contrast is interested in total profits and will bring in new staff as long as the marginal benefit exceeds the marginal cost. This difference in objectives results in a higher quality threshold for employment in partnerships and hence a higher quality product.

To illustrate, suppose an individual requires a salary of £50,000 and can produce net revenues of £100,000. A profit maximising company would clearly hire him, since there is a positive contribution to the total profits accruing to shareholders. In contrast, a partnership with average partnership earnings of £200,000 and an equal-sharing rule would not hire the individual for to do so would reduce each partner's income. This incentive for partnerships to impose higher standards in new hires may be particularly valuable in many professional services where it is difficult for customers to monitor product quality. In this case, corporations may be tempted to reduce quality and hire less able and less expensive workers, hoping to benefit if the market does not discern the loss of quality. Partnerships with their higher hiring standards are less subject to such a decline in quality.²³

²¹ J. Levin and S. Tadelis, "Profit Sharing and the Role of Professional Partnerships," *Quarterly Journal of Economics*, forthcoming.

²² As we discuss below, the use of the word "quality" in these models is synonymous with the ability to generate fee income.

²³ Notice, however, that a partnership is in danger of unravelling if different partners have different levels of productivity but receive the same remuneration. In such cases the more productive partners have an incentive to leave or the firm will be forced to move away from simple sharing rules towards productivity-based, "eat-what-you-kill" forms of profit sharing.

Levin and Tadelis argue that variations within the professional service sector are consistent with their model's predictions. For instance, they cite the case of those US accounting firms that offer services whose qualities are easily observed, such as tax-form preparation. They note that such firms are less commonly partnerships, whereas a majority of CPA firms that perform complex accounting tasks are organized as partnerships. They also cite the example of architectural and engineering firms. Architectural services are generally hard to evaluate relative to engineering and surveying services and are more likely to be provided by partnerships. This suggests that, when the clients of a law firm can monitor the quality of the service (as in the case of a law firm with major corporate clients who are repeat buyers), the firm could operate efficiently as corporations with outside equity. When monitoring is difficult (as in the case of a firm with less well-informed and less regular clients) the firm is more likely to remain a partnership.

Another common feature of many partnerships, particularly in law, is the use of up-or-out promotion schemes at the point when associates reach partner level. Levin and Tadelis note that the existence of such schemes also provides a quality guarantee. "Specifically, imagine that firms do not learn the actual talent of employees immediately (when they are hired) but rather after some initial employment period. Under this interpretation, the hiring decision in our model can be interpreted as a promotion-to-partner decision. In this light, an up-or-out promotion scheme can be an integral part of a partnership's commitment to guaranteeing the high quality of long-term employees. Because current partners will promote only the best associates to a full partner share, those that are not of extremely high quality will be let go even if they might make a positive contribution to the firm's total profits. To the extent that partnerships can retain senior employees without promoting them to partner, some of the commitment to quality is lost. At the same time, if partnerships do less profit re-distribution (e.g. move toward more productivity-based compensation), the title of partner becomes less meaningful and the up-or-out system becomes less important."²⁴

²⁴ We might note that this feature of partnerships also suggests that partnerships may have difficulty raising outside equity. "To see why, suppose a partnership could sell an equity claim to outside shareholders. The

Control and Cash Flow Rights

The role of profit-sharing within partnerships touches on our other remaining distinction between partnerships and public corporations – the relationship between cash-flow and control rights. In a partnership the partners both manage the business and receive all the income. By contrast, the shareholders of a public corporation are entitled to all the firm's income but delegate many of their control rights to the directors and through them to the managers. This separation of ownership and control within the corporation leads to the familiar agency problems in which managers have an incentive to shirk or to take their rewards in the form of private benefits. These problems are mitigated in a partnership by the fact that the partners are the managers and at the same time have an illiquid entitlement to the firm's cash flows.²⁵ However, as partnerships become larger, many of the agency problems that characterise a corporation re-emerge. For example, management decisions are typically delegated to a management committee of the partners.

Notice that firms have an incentive to choose a structure that minimises agency costs. Thus the ability of smaller partnerships to mitigate agency problems explains why some firms may *choose* a particular structure, but does not justify legally imposed constraints on a particular ownership structure.²⁶

3. POSSIBLE MOTIVATIONS FOR RAISING OUTSIDE EQUITY BY UK LEGAL FIRMS

We turn now to the specific issue of whether there are efficiency gains from permitting UK legal firms to have outside equity ownership. We ask first whether law firms might have any incentive to seek outside equity, and then consider whether there are arguments for restricting their freedom to do so. We discuss four ways in which outside ownership

problem that arises is that these shareholders now have a different objective from the partners. While the partners want to keep average profitability high, the shareholders are interested in total profits – they are likely to want to expand the firm at the cost of lower quality.” (Levin and Tadelis, *op. cit.*)

²⁵ As we have seen, this advantage comes at a cost if it prevents the partners from spreading their risk.

²⁶ Some partnerships that have gone public have subsequently reverted to private status, for example the consulting firm Booz Allen. This emphasizes the fact that there is a learning effect from these different market forms, and that the recourse to outside ownership is not irreversible.

of law firms could arise. First, a law firm may wish to offer an ownership stake to non-lawyer employees. Second, a law firm could become a public company with dispersed shareholders. Third, a law firm could seek to offer one-stop shopping by an exchange of ownership stakes with an accounting firm, estate agent or other non-law firm. And fourth, a firm operating in an unrelated business may wish to offer legal services either by acquiring existing law firms or by building such a business from scratch.

Enhancing Employment Opportunities for Non-Legal Staff Law firms employ para-legal staff to provide expert advice and they employ senior operating staff in the areas of general management, accountancy, IT, and human resources. However, the prohibition on outside ownership prevents them from taking these staff on as partners. Similarly, firms of solicitors are prevented from offering partnerships to barristers unless they re-qualify as solicitors.²⁷ Firms may, and sometimes do, contract to provide non-partners with identical *cash-flow* rights to partners including requiring them to provide guarantees. However, they cannot offer them any *control* rights. This has two disadvantages. First, to separate cash-flow rights and control rights is generally inefficient. Since those who are entitled to the firm's cash flows receive the benefits of good business decisions, it makes sense to give them also managerial responsibilities. Second, it is important that law firms should be able to employ high-quality para-legal staff and should be well-managed. Restricting ultimate control to legal staff is not the best way to ensure this. Removal of these restrictions would make it easier for law firms to hire and retain high-quality para-legal and managerial staff. A recent survey confirms this view.²⁸ Two-thirds of the top 100 firms wish to admit non-lawyers as partners.²⁹

²⁷ Barristers who re-qualify as solicitors retain their higher courts rights of audience (as well as other advocacy services).

²⁸ This survey is reported in *The Lawyer*, July 1, 2005.

²⁹ This was also apparent in a number of responses to the Clementi consultation. For example, Clifford Chance stated that "[our] main concern in this area is to be able to offer partnership to other professionals who are not lawyers, but who are in professions closely aligned to lawyers, such as accountants, specialist tax advisers or those otherwise involved in our own business. The liberalisation of the rules in this area would ensure that we are able to attract and retain the best non-lawyer professionals, and also that we are able to compete successfully with other professional advisers." Similarly, Allen and Overy comment "It is anomalous that English solicitors are free to practise in partnership with lawyers qualified in most other jurisdictions, who may have higher court rights of audience in the jurisdictions in which they are qualified (Allen & Overy is such a practice), but cannot practise in partnership with English barristers. It is also

Access to Capital Markets As we noted above, the advantages of retaining the partnership structure are likely to be less for larger firms. In such cases there may be two incentives to reorganize as a public corporation, that is, a stock exchange listed company.³⁰ First, increasing investment expenditures on information technology together with limited debt capacity could make it important for large firms to be able to raise equity capital. Similarly, access to capital could also be important for firms that are seeking to grow rapidly. While shortage of equity capital does not appear to be a serious current problem for most large legal firms, competition could well be impaired if the growth of a minority of firms is being impaired a lack of access to capital. Moreover, the experience of investment banks provides an example of how rapidly changing technology can lead professional firms to become much more capital intensive.

Second, the ability of large law firms to become public companies would potentially give partners a market in their stock, which would provide them with liquidity and allow them spread their risk more widely. This would have efficiency benefits, since partners, whose entire capital is invested in the firm, are likely to demand a higher return on capital than diversified outside investors. We would, therefore, expect that outside equity combined with marketability would significantly lower the cost of capital for law firms.³¹ In our conversations the example of investment banks, and Goldman Sachs in particular, were frequently cited as both enabling partners to realize the value of their stake and to attract

anomalous that legal practices which employ highly qualified members of other professions in either an executive or a client service capacity (for example as directors of finance, marketing or human resources or as economic consultants) are unable to offer such professionals the status of partnership within the practice. To do so would not appreciably alter the character of such legal practices and would facilitate the recruitment of higher quality people to fill these roles, to the benefit of the profession and ultimately of clients.”

³⁰ In the USA and Continental Europe law firms are also restricted from having outside equity. Consequently, as long as any change in rules was limited to the UK, large UK law firms with an international business might encounter complications in changing to a public corporation.

³¹ Diversification by investors in the stock market typically reduces the variability of returns by about one half. See Brealey, Myers, and Allen, *Principles of Corporate Finance*, McGraw Hill, Eighth Edition, Chapter 7, pages 160-161. This suggests a back-of-the-envelope way to estimate the potential effect of marketability on the cost of equity capital for law firms. Suppose that a diversified investor requires a return premium of 6 percent a year for taking on the risk of common stock investment. Then a non-diversified investor with twice the risk would require an additional 6 percent premium. In other words, marketability would reduce the cost of equity capital by six percentage points. We should warn, however, that such a rough-and-ready estimate ignores amongst other things the potentially large tax effects of moving from a partnership to a public corporation.

new talent into the firm. One partner of a law firm commented, “If another large law firm went public, we would not want to be far behind.” Survey evidence of the demand for outside capital suggests that one in five of the top 100 law firms would seek outside investors and one in ten would list on the stock market.³²

New Methods for Delivering Legal Services We might also expect existing public corporations with strong brand names either to start a legal business from scratch or to acquire an existing law firm. In addition, smaller law firms might wish to consolidate or tie up with firms in ancillary industries. It is, we believe, here that the greatest impact and benefits from a relaxation of ownership restrictions could arise.

Some firms may be able to realize synergies by packaging legal with other services and offering one-stop shopping. For example, an insurance company, an accounting firm or a bank may wish to offer its clients legal advice and services.³³ Another obvious example of possible entry into retail legal services is that of the RAC, which sees synergies in being able to add legal assistance on motoring issues to its other services for the motorist.³⁴

Similarly, small firms of solicitors might wish to enter into ownership arrangements with estate agents or accountants to offer a one-stop service to retail clients or small businesses.³⁵ It is possible that some of the benefits of one-stop shopping can be realized through referrals to a panel of solicitors or by joint ventures. Such links provide some of the benefits of direct ownership, but they are unlikely to provide the same degree of coordination or quality control.

A second motive for diversification into legal services is that firms may be able to exploit their geographical proximity to customers or their existing customer relationships to

³² Reported in *The Lawyer*, July 1, 2005.

³³ Until the demise of Enron and Arthur Andersen, legal and accounting firms were often cited as natural bedfellows. For example, one 1999 survey of 100 senior UK executives found that half would be willing to use a firm that combined lawyers and accountants.

³⁴ In the case of wholesale services a more speculative suggested outcome was that a large investment bank might wish to combine with a law firm in order to be able to offer its clients a single package of financial and legal services.

³⁵ It is important to stress that the Clementi Report envisaged that the board of directors of the law firm would have to be made up largely of lawyers and that the law firm would have to be a separate legal entity and would not be able to offer other non legal services. Notwithstanding these restrictions, we believe that outside ownership may still provide large benefits that other arrangements do not confer.

provide legal services. For example, large retailing firms could choose to provide legal services in much the same way that they have expanded into financial services (so-called “Tesco Law”). As a *Which?* survey shows, almost two-thirds of adults think that being able to obtain legal services at supermarkets and high street banks is a good idea. Such a development may have two possible benefits for the customer. First, potential providers are likely to have brand names that provide a signal of service quality. The credibility of that signal depends on the fact that the firm’s other services may be at risk if it provides poor legal advice.³⁶ Second, such firms may be able to achieve scale economies either by improved use of information technology, by new delivery mechanisms, or by specialising by product rather than by geographical location.³⁷ Currently smaller law firms may have limited competition within a particular geographic area. New entrants that employed new delivery systems to provide legal services on a regional or national basis would both widen consumer choice and increase competition.

Since the vast majority of law firms are small firms it is important to consider how they would react to such changes. We have already described how smaller law firms may seek to provide one-stop shopping by entering into arrangements with accountancy firms and estate agents. One senior partner of a small law firm informed us that he and his partners had discussed selling an ownership interest to an estate agent or a firm of surveyors. The objective would be to cash out part of their capital and to obtain synergies from closer co-operation with other ancillary industries. A shortage of capital may also be more of a problem for small firms, so that these firms may wish to seek outside equity that could be used for expansion, including acquisitions.

A number of the responses to the Clementi consultation document claimed that there is no demand for changes in the provision of legal services. We cannot dismiss this

³⁶ When Deutsche Bank incurred huge losses, exceeding hundreds of millions of pounds, in Morgan Grenfell Asset Management as a result of poor management of the investment fund, the value of its brand played a major part in convincing the bank to provide generous compensation to investors.

³⁷ Conveyancing provides a good example of how changes in technology can affect delivery mechanisms. HM Land Registry already provides many services to conveyancers on-line and plans to build that up progressively in preparation for the introduction of a full-scale scheme of e-conveyancing. This has encouraged the development of conveyancing factories in which a small number of solicitors or licensed conveyancers supervise non-legally-qualified staff dealing with limited aspects of large numbers of transactions.

assertion, but since the possible developments that we have outlined are currently prohibited, reliable evidence on the latent demand is impossible to come by. However, the experience of deregulation in other services and industries is that it commonly precedes a period of rapid change. For example,

- a combination of technology, regulatory changes and the removal of the ban on advertising has made the conveyancing market more contestable and has resulted in reductions in the prices of these services;³⁸
- as we noted above, the removal of listing restrictions led to important structural changes in investment banking;
- the removal in 1986 of constraints on securities firms resulted in the major reforms of Big Bang.
- The removal of regulatory constraints on the supply of electricity and gas has radically changed the industry structure and, some would argue, prices.

In summary, some of the consequences of a relaxation of current constraints are readily predictable. It seems very likely that many law firms would wish to offer ownership stakes to some of their senior non-legal staff. We would also expect some of the larger firms to seek outside capital and a listing on the stock exchange. The most probable main motive for listing would be marketability, which would allow current and future members of the firm to cash out and spread their risk. Some firms, particularly those with expansion ambitions would use the opportunity to raise new capital and use equity as a medium of exchange in acquisitions. All these benefits could be achieved simply by permitting LDPs with outside ownership. While it is far less easy to predict the likely new structures that would result from permitting MDPs, we believe that any such deregulation would lead to important changes in the way that legal services are delivered. We have suggested that new entrants may take advantage of information technology to tap a national market for specialised legal services, while the response of existing firms

³⁸J.H.Love, F.H. Stephen, D.D. Gillanders, and A.A. Paterson, "Deregulation of Conveyancing Markets in England and Wales," *Fiscal Studies*, 15 (November 1994), pp. 102-118

of solicitors may be to enter into ownership arrangements with accountants and estate agents to provide one-stop shopping.

4. OBJECTIONS TO THE USE OF OUTSIDE EQUITY

Objections to the relaxation of ownership restrictions fall into three broad categories. One objection is that there is no demand for any relaxation of these restrictions, so that change would impose costs with no attendant benefits. We acknowledge that this is a possible outcome, but we have argued in the previous section that a more likely result would be material structural change.

A second argument against change contends that, if the current system works, one should not fix it. We recognize the high regard in which English law firms are held. English law and English law firms are widely employed in international commercial transactions. Indeed the dominant international firms in Europe are largely of UK origin. Moreover, other sectors, such as the financial services industry, depend critically on the quality of the legal inputs.³⁹ However, we do not believe that these strengths are an argument against change. On the contrary, the strong competitive position of English law firms is likely to be maintained *only* if the profession is adaptable. We do believe that the importance and strength of English law firms suggest that there is a case for proceeding with care and for following a policy of incremental change. The fact that prohibitions on outside ownership of law firms are almost universal reinforces this caution. This point has also been made by Sir David Clementi both to the Department of Constitutional Affairs and to us in our discussions of his report.

The third argument against the relaxation of ownership restrictions is that it would result in less efficient legal services. We noted earlier that in the absence of market failure removal of constraints on a firm's structure is likely to increase economic efficiency. The question therefore arises whether there exists some market failure that would prevent this from occurring and justify a continued prohibition. We consider three possible arguments for such a prohibition:

- A change in rules would lead to undesirable "cherry-picking;"

- A change would lead to a reduction in the quality of legal services;
- A change would exacerbate conflicts of interest.

We discuss below each of these arguments in turn. We will argue that the cherry-picking argument has little merit, but the other two concerns have more force.

Cherry-Picking

It has been suggested that new providers of legal services would have an incentive to cherry-pick the most profitable business.

There are two possible incentives to cherry-pick. One would arise if an existing provider had some monopoly power that was then used to earn excess profits on those parts of his business for which demand elasticity is low. If a new entrant could earn a competitive level of profits by providing these services at a lower price, there would be an obvious welfare gain. Equally, existing providers would be free to retain the business by reducing prices to the competitive level.

A second incentive to cherry-pick could occur if a new entrant has a cost advantage in some legal services but not in others. The result could be specialisation by some providers and lower prices on these services. If an existing firm offers a broad portfolio of services and there are some shared costs in providing these services, then it will need to recover these common costs from those services that have *not* been cherry-picked and the price of these services will need to rise.

Since a competitive market will organise production to minimise the total costs of providing services, the entry of new competition can be expected to reduce the *aggregate* costs of legal services and most consumers are likely to be better off. Indeed, if *all* consumers believe ex ante that they are likely to consume similar packages of legal services, all will willingly vote for freedom of entry, even though the effect may be to bring about specialisation and to raise the prices of some services in the package.

³⁹ For example, almost a quarter of intermediate purchases of legal services come from the financial sector.

However, if a consumer knows that he will wish to consume only those services that are likely to rise in price, then he will be made worse off by cherry-picking.

It would be wrong to regard such an outcome as an argument for deterring new entry into the provision of legal services. New production technologies *always* face the possibility that they will make some consumers worse off. For example, standardisation may lead to lower prices for most consumers, while at the same time raising prices for those consumers who still wish to buy a custom-made product. Yet we do not for that reason seek to legislate against standardisation. Moreover, we should note that existing law firms are not subject to any restriction on cherry-picking and indeed many do specialize in certain types of service.

The Clementi Report suggested that an argument against cherry-picking was that it might lead to the reduction of legal services in some rural areas. This could occur if rural practices currently make excess profits on some services and use them to cross-subsidise other services that are unable to make an adequate profit. It is arguable whether such cross-subsidies exist and whether rural legal services, which may be accessed infrequently, nevertheless merit a subsidy. But in any case, there are at least three reasons for believing that such cross-subsidies would be a clumsy solution to the problem: (a) there is no reason that any subsidy should be paid for by those who use the overpriced rural services, (b) the restriction on outside ownership which allows these cross-subsidies in rural services potentially distorts the market in both urban and rural services, (c) the gains from lower prices on some rural services could well offset the disadvantages of having a smaller range of local services.

Service Quality

Our earlier comparison of partnerships and public corporations suggests that, while businesses will generally gravitate to the most efficient structure, a possible source of failure arises when clients cannot observe firm quality. Protection of consumers against low-quality services is central to many of the existing regulations of legal practices. For example, before being admitted to the rolls, solicitors must have shown competence in

examinations and must enter into a training contract with an authorised training establishment. The Law Society sets standards of conduct, handles complaints, and disciplines offending members including barring them from practice. The Bar Council provides a similar regulatory role for barristers.

This issue of the maintenance of quality seems central to the concerns that have been expressed about any relaxation of restrictions on the structure of law firms. One suggested reason for concern is that outside equity holders are likely to be concerned only with profits, so that, if a lawyer were to be employed by a corporation, he would have conflicting loyalties to his employer and his client.⁴⁰ By contrast, it is argued, the partners in a legal practice suffer no such conflicts and can focus on service quality rather than profits. It might well be the case that some outside equity holders could bring pressure on lawyers to increase profits at the expense of service quality. But the argument does not go only one way. First, we suggested above that, if restrictions were relaxed, firms with strong brand names might wish to use those brand names to market legal services. In these cases, as long as the consumer can observe ex-post the quality of the service provided, the firm knows that offering a low-quality product could impact adversely on its principal business.⁴¹ Indeed it is arguable that a firm with an established brand name has much more to lose from offering poor-quality legal services than a small stand-alone partnership, so that allowing MDPs could well improve the quality of retail legal services. Second, we also pointed out above that partnerships in professional businesses are often well-designed to handle exactly those agency problems that *hinder* corporate managers from maximising profits. The notion that professional service firms are less driven by profits than their commercial counterparts sits uneasily with the fact that for law firms in particular measures of profits per partner are widely cited as indicators of

⁴⁰ It has also been pointed out to us that conflicts arising from outside ownership may be exacerbated in litigation because the lawyer owes a duty of care to the justice system as a whole, not just to the client. We do not believe, however, that this duty of care justifies ownership restrictions. Most businesses have duties other than to their clients. For example, the Health and Safety Executive imposes a primary duty on a business to ensure the safety of its employees even if this imposes costs on its customers. But there are not as a result ownership restrictions on these businesses.

⁴¹ This assumes that the consumer can observe quality ex post; if not, then this creates a need for regulation.

firm success, and that ownership of a substantial business book is an important attribute in promotion decisions and in the compensation and influence of each partner.⁴²

We believe that a stronger reason for concern about quality stresses that peer pressure in professional activities may help to enforce high ethical standards. Teams of lawyers that are all subject to the same code of conduct may be better able to distinguish and punish breaches of that code than a group of individuals with different backgrounds. Also a partnership, where all members have a long-term commitment, participate in decision-making and share equally the income that is produced, is likely to generate greater collegiality than many other structures.

A third reason for concern about service quality goes back to the distinctions between partnerships and corporations that we outlined in Section 2. Partnerships in their hiring and promotion decisions are likely to impose higher quality standards than corporations. This is not because partners do not care about their income, but because they are concerned only to recruit partners that will increase the firm's profit *per partner*. This pressure to increase standards may help to offset undesirably low standards that law firms might otherwise tolerate if clients could not distinguish in advance high-quality from low-quality providers.

There are three limitations to this argument. First, a high-quality partner is here synonymous with one who is able to generate high profits. This may not be the partner with the highest ethical standards. Second, it implies that each firm will seek to hire partners that are no lower in quality than existing partners, but it does not imply that all firms will be of equally high quality. Third, this source of pressure by partnerships to increase service quality may be less important in large firms. For example, the partnership's advantage in monitoring is reduced in larger and more geographically dispersed firms and these firms are more likely to adopt compensation arrangements that do not involve simple profit sharing.⁴³ The growth of very large international law firms underlines the importance of this argument. Also, the clients of these firms are often the

⁴² This point is made in R.W. Hillman, "Organizational Choices of Professional Service Firms: An Empirical Study," *The Business Lawyer*, 58 (August 2003), pp. 1387-1411.

legal departments of major commercial firms, who are continually in the business of buying legal services and are better able to measure quality and avoid low-quality services.⁴⁴

It is worth noting that other professional services, where quality is difficult to observe and contract on, nevertheless raise public equity without an obvious rush to the lowest quality output. For example, doctors like lawyers are subject to a stringent code of conduct. Yet in the UK they may be employed by private-hospitals that are operated by for-profit corporations, such as Capio Healthcare, HCA Healthcare and BMI Healthcare.

Some of the lawyers to whom we spoke suggested that a greater focus on profits or simply a more competitive environment might make lawyers less willing to undertake unprofitable activities or to be involved in professional committees etc. For example, it was suggested that lawyers might be less prepared to undertake legal aid work or to function as recorders. We do not believe that these arguments justify constraints on competition. However, it would be important to monitor whether some important functions were no longer being fulfilled and either to change the way that they are remunerated or to impose common obligations on law firms.

Responses to the Clementi consultation document suggest that, even among respondents who are in favour of change, there are major concerns about the need to maintain independence and quality. We have sympathy with these concerns. In particular, we suspect that peer pressure is helpful in maintaining standards. However, we would also emphasise other safeguards, such as (a) the regulatory protection that arises from the common training requirements and the monitoring of conduct by the regulator, (b) in the case of larger commercial firms the protection that arises from repeated business with well-informed clients, and (c) the incentive that possible new entrants would have to provide credible signals of the quality of their service. Finally, we might note that there

⁴³ There are still a few law firms that adopt a single profits pool for their partners, albeit subject to a 'lockstep'.

⁴⁴ See R. Gilson and R. Mnookin, "Sharing Among the Human Capitalists: An Economic Inquiry into the Corporate Law Firm and How Partnerships Split Profits," *Stanford Law Review*, 37, (1985).

are many other service providers, ranging from surgeons to sky-diving instructors, whose competence is important though it cannot be observed ex ante by consumers. In such cases we rely on regulation rather than ownership restrictions to maintain service quality.

Conflicts of Interest

Closely allied to the issue of quality is the concern that removal of the ownership restrictions would lead to conflicts of interest. No additional conflicts would be created if a law firm simply admitted some of its non-legal staff as partners or if it became a publicly owned corporation with a dispersed group of shareholders. Nor would the problem of conflicts be exacerbated if (say) a retailer were to offer legal services. The difficulties arise when an outside owner of a law firm seeks to exploit synergies. In this case conflicts of interest are the other side of the coin to synergies. For example, one concern is that there could be excessive or improper cross-selling of services. It would be relatively easy for estate agents to encourage house sellers or purchasers to use the conveyancing services of a law firm which is commonly owned. Another common worry is that an owner firm might attempt to prevent the law firm from accepting or refusing an engagement with a particular client or even influence the opinions given by the law firm to a particular client. An obvious illustration that was frequently cited to us was the conflicts of interest that followed the acquisition of consulting businesses by accountancy firms. The synergy case for such acquisitions inevitably brought with it the dangers of improper sharing of information and the type of conflicts that bedevilled Arthur Andersen.

Such problems are likely to be particularly acute where the purchasers of legal services are infrequent buyers. However, the dissolution of Andersens has sent a very strong warning of the perils and costs of conflicts of interest. The consequence has been considerably less enthusiasm for these combinations.

The problem of conflicts of interest is not new to law firms. The major law firms employ large departments checking that the firm is not exposed to conflicts.⁴⁵ Moreover, if an accountancy firm, bank or estate agent chooses to offer legal advice on unreserved matters, conflicts are again a potential problem. It is true that widening the range of services that could be offered increases the scale of the problem, but it is not clear that the conflicts would be either more serious or less easy to detect if the same firms were permitted to provide services that are currently reserved. Even if these problems do not persuade us of the justification of ownership restrictions, they unquestionably persuade us of the need for safeguards and it is to this subject that we now turn.

5. THE NEED FOR SAFEGUARDS

If restrictions on ownership were to be relaxed, the question remains whether any further safeguards other than those currently provided by the professional societies would be needed. We argued in the previous section that the two principal dangers from outside ownership are a possible decline in the quality of legal services and potential conflicts of interest. The Clementi Report discussed at some length the possible regulatory solutions. We comment briefly on some of these proposals.

Quality Safeguards

The Clementi Report proposes a number of regulatory safeguards that are directed at the issue of quality. For example, it recommends that for prospective outside owners there should be a ‘fit-to-own’ test that could have regard to (a) honesty, integrity and reputation; (b) competence and capability; and (c) financial soundness.⁴⁶ Where the would-be owner of a law firm is a public limited company, such tests would probably be unnecessary. Also, it would be unreasonable to ask such a test to be applied to each member of a dispersed group of shareholders, but it might make sense to apply the test to owners of a large or controlling block of shares.

⁴⁵ One senior lawyer we spoke to described ‘conflicts of interest as the biggest constraint on future growth’.

⁴⁶ Similar ‘fit-to-own’ tests are already applied in a number of other industries, such as banking and casinos.

In discussions one lawyer raised the issue of how this test would be applied in the event that a large number of small firms sought to raise outside equity, or more likely exchanged ownership interests with other firms in ancillary industries. His concern was that a ‘fit to own test’ could be expensive to operate and would require large resources if a large number of small firms decided to seek outside equity. While we share that concern, we believe that the solution is to ensure that the regulator is properly resourced and that the costs of administering such a ‘fit to own’ test fall upon the parties to the transaction. We do not believe this criticism is a justification for imposing outside ownership restrictions on an entire industry. Moreover, a further safeguard, which the Clementi Report emphasizes, is that a majority of the management (or directors) of the legal entity must be lawyers.

The Clementi Report considered and rejected the suggestion that there should be a restriction on the voting rights of outside owners. We share the Report’s views on the matter. As we noted above, it is generally efficient to tie residual control rights to residual cash flow rights, and firms that issue shares with limited voting rights may be valued less as a result.⁴⁷ That said, some firms may believe that quality is more effectively controlled by concentrating voting control within the firm and thereby restricting the control rights of outside owners. We do not believe that there is a public interest issue here and therefore we would not wish either to require or to prohibit differences in voting rights. Instead we would wish to leave that decision to the parties concerned. It may also be that some restriction on voting rights would be regarded by the regulator as a low-cost substitute for at least some of the requirements of a ‘fit-to-own’ test.

Conflicts of Interest Safeguards

There are three possible safeguards against possible conflicts of interest. First, conflicts of interest are a problem only if the customer is not fully aware of them and can make an

⁴⁷ It can be shown that under some fairly general conditions a system of one-share-one-vote is optimal. See S.Grossman and O. Hart, “One Share One Vote and the Market for Corporate Control”, *Journal of Financial Economics* 20 (1988), pp. 175-202, and M. Harris and A. Raviv, “The Design of Securities”, *Journal of Financial Economics* 24, (1989), pp. 255-287.

informed judgment on the risk of biased advice. Thus the first defence against a problem of conflicts of interest must be transparency. For example, a law firm that urges the use of an accounting firm should be required to reveal whether the two firms have a common financial interest.

Second, the Clementi Report proposes that a law firm should not be permitted to take instructions on a case where the owner has an adverse interest in the matter.

Third, if a law firm shares common ownership with another firm, it may be desirable to ring fence the law firm, by requiring that it be separately incorporated and does not share client information. In this case legal services and accountancy or estate agent services could not be provided by a single entity even though there was a common owner. Such a restriction is probably desirable, but it is also costly, for as we observed earlier, conflicts of interest are the other side of the coin to synergies. The more that the operations of the law firm are ring-fenced, the fewer opportunities there are for synergies.

In summary, we believe that the issue of conflicts of interest merits substantial consideration. However, these conflicts already exist in law firms as in many other businesses. The issue is whether the public good is better served by severe restrictions on outside ownership or by regulation. Our strong preference is for the latter.

6. CONCLUSION

We believe that there are a number of potential advantages to permitting outside ownership of legal services:

- (a) It would allow law firms to offer the services of both barristers and solicitors, and enable firms to offer appropriate control rights and compensation to general management staff, accountants, IT specialists, and so on.
- (b) By going public, partners of large law firms would gain liquidity and spread their risk efficiently.
- (c) It would provide law firms with improved access to the capital markets.

- (d) It would give firms such as insurance companies, banks and estate agents the freedom to realize synergies by offering legal services to their clients.
- (e) It would encourage new ways to distribute legal services through non-traditional outlets (Tesco law).
- (f) It would allow existing small law firms to offer one-stop shopping by exchanging ownership stakes with other professional firms.

We do not know which, if any, of these developments will in fact occur nor how rapidly, but *absent any market failure*, economic systems will evolve so as to offer the services that consumers want at the lowest cost. While it is impossible to quantify the benefits that would flow from such changes, our judgment is that they are significant.

Several objections have been raised to outside ownership. One objection, that new entrants may cherry-pick the most profitable services, has little to recommend it. The other two objections that we review below have more force.

- (a) *Possible Impact on Service Quality* We believe that the issue of quality is central to the case for limitations on outside ownership. In legal and many other professional services quality is difficult to observe ex ante or to contract on. Hence the focus of professional bodies on maintaining standards of service.

We are sceptical of arguments that assume that partnerships are less concerned with profitability than corporations, though we accept that peer pressure may help to reinforce high ethical standards.

A further argument for limiting ownership centres on the fact that partnerships have an incentive in their hiring decisions to maximize profits per partner. This pressure towards higher quality staff could offset any decline in quality that could stem from the inability of consumers to distinguish good quality firms from poor quality ones. We believe that there is some truth to this argument. However, it is weakened in the case of large firms by the move away from equal profit sharing and by the fact that they must increasingly deal with well-informed clients, who would soon weed out low-quality firms. In the case of the retail market for legal

services, the new entrants are likely to have established brand names that provide a stronger signal of quality than is possible for small professional partnerships. The effect in this market could well be an improvement in service quality.

In summary, we believe that it is crucial that consumers of legal services can be confident about the quality of advice that they receive. However, we are not convinced that the ownership structure of the firm is central to the maintenance of quality. Instead we would emphasise the standard-setting activities of the professional bodies.

(b) Changes in Ownership May Lead to Conflicts of Interest Conflicts of interest may result in inefficiencies when consumers are not fully aware of the conflicts and their likely impact on the advice on offer. These conflicts are likely to arise when there are potential synergies between the provision of legal services and the firm's other activities. Again we believe that rather than using this potential danger as a reason to limit ownership structures, it is better to deal with the problem directly by such steps as enforcing transparency, prohibiting a firm from taking business where it has an adverse interest in the issue, and setting up Chinese walls.

In sum, we believe that the dangers of a decline in standards and worsening conflicts of interest are not sufficiently strong as to outweigh the natural presumption that industries will gravitate towards the most efficient structures. The problems of quality and conflicts of interest are best dealt with by policies that are specifically tailored to these problems.

Our focus in this report has been on firms of solicitors, rather than on barristers. The Clementi Report will, we believe, have less impact on the Bar than on solicitors. Barristers are sole practitioners and have little need for outside capital. Thus the issues that concern firms of solicitors such as 'cashing out', and establishing a market for their equity are likely to be of little relevance to barristers. It is possible, and indeed probable,

that some barristers would choose to form partnerships if permitted to do so.⁴⁸ We do not see any public interest issue that should prevent this from occurring. Currently clients have the option of employing a specialist advocate (a barrister) or to employ a firm of solicitors that combines advocacy with other legal services. We do not believe that the proposals in the Clementi Report would affect this choice.

We have discussed in this report the economic arguments for and against wider ownership of law firms. Our conclusions might be loosely summarized as suggesting that the fewer restrictions on ownership structure the better. We believe that there are several preconditions for successful change. First, a program of incremental change is almost certainly more desirable than abrupt change. The fact that ownership restrictions are so widespread and that empirical evidence of a world without such restrictions is limited gives force to the argument for an incremental approach. Second, almost the worst thing that could happen would be a failure of the regulatory regime to support change, for this could bring any program of reform to a premature halt. It is important therefore for the regulatory regime to be fit for purpose and for the regulator to be properly resourced. In choosing between the two regulatory models outlined in the Clementi Report, a key issue could well be the risk of disruption. Third, we believe that it is important that incremental changes should be part of a long-term plan, so that there is an opportunity for restrictions to be relaxed progressively and for law firms to plot their long-term development.

Finally, for UK law firms with substantial overseas interests a relaxation of ownership restrictions in the UK will be of greater value if equivalent changes are made in other jurisdictions. In the event that the UK government does relax these restrictions, it should encourage a similar relaxation of rules elsewhere in the EU.

⁴⁸ Partnerships would enable barristers to be employed on a salaried basis which might be helpful to those barristers early in their career, though it has been pointed out to us there is no obstacle to a chambers providing a guaranteed income to barristers in their early years, or to supplements their income with subsidy for rent etc.