Views from an Australian Regulator

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In July 2001 legislation was passed in New South Wales permitting the creation of incorporated legal practices (ILPs), which could also include multidisciplinary practices (MDPs).[1] There has been a growing interest by law firms of the prospect of following the path to incorporation and beyond. As at 17 April 2009 there are 898 ILPs in NSW. The majority of these firms are small in size with three or more solicitors. A large number of sole practitioners and several large national firms have also embraced the opportunity to incorporate. Incorporation in New South Wales has taken a number of different forms. These forms have included MDP 'complete service' firms, which provide a 'one-stop shop' for clients of property and financial services and other smaller MDP firms. As at 17 April 2009 there are 58 MDPs in NSW. We have had two law firms list on the Australian Stock Exchange (ASX). A considerable number of other firms have also expressed an interest in listing. We have also seen one firm franchise their practice. This firm operates through a group of independent branch offices throughout NSW and two other states in Australia. Each branch office is an ILP and is related to the law firm but not to each other. In an alternate model, PwC Legal, a major professional services firm has transformed its practice into the broader PwC partnership under an MDP.[2] The rationale for the transformation was to provide the professional services firm with an opportunity to further differentiate itself from its competitors and to provide the firm with an opportunity for certain partners and staff within the existing practice to give advice that attracts legal professional privilege.

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*Legal Services Commissioner, Office of the Legal Services Commissioner (NSW). The Office of the Legal Services Commissioner ("OLSC") receives complaints about solicitors and barristers in NSW. The OLSC works as part of a co-regulatory system, together with the Law Society of NSW (professional body for solicitors) and the NSW Bar Association (professional body for barristers) to resolve disputes and investigate complaints about professional conduct. The OLSC's main role is to ensure that legal practitioners abide by their ethical and other professional obligations when providing services to the public. The OLSC can take disciplinary action against legal practitioners and help resolve problems between practitioners and other members of the community The OLSC is an independent statutory body and its decisions, can only be challenged through the normal process of administrative law. Steve Mark was appointed as the first Legal Services Commissioner for NSW, Australia in 1994.

1. The *Legal Profession (Incorporated Legal Practices) Act 2000* (the Act) and the *Legal Profession (Incorporated Legal Practices) Regulations 2001* (the Regulations) entered into force on 1 July 2001.

2. PwC Legal, PricewaterhouseCoopers becomes Australia's largest multi-disciplinary partnership, available at http://www.pwclegal.com.au/legal/pwclegal.nsf/pages/530CA548F8DA8D87CA2573E1007D8391.

The above changes have not, contrary to popular belief, destroyed the legal services marketplace in NSW. We have not seen a disturbing change in the practice of law in NSW. Nor have we seen a rise in the number of complaints concerning incorporated legal practices. In fact we have seen a significant decrease in the number of complaints for incorporated legal practices.

It is my belief that one of the main reasons why we have not experienced the predicted doom and gloom may be because of the way we have decided to regulate incorporated legal practices. Noting that the opportunity created by the 2001 legislation might encourage unethical practice, we focused on entrenching and promoting ethical behavior and encouraged the profession to remain a true profession as well as operate like a business. We have done this by requiring incorporated legal practices to implement an ethical infrastructure—that is, formal and informal management policies, procedures and controls, work team cultures, and habits of interaction and practices—that supports and encourages ethical behavior.[3] This requirement brings benefits not only to the profession, in terms of good ethical behavior, but also to the community.

The requirement to implement an ethical infrastructure provides better protection for consumers of legal services. This is because the management systems we require ILPs to maintain act as a quasi-educative mechanism teaching practitioners best practices to achieve compliance with the requirements of the legislation and promote cultural change. In setting up this structure we have, in effect, moved away from sole reliance on complaints-based regulation to compliance based regulation (or as I prefer "cultural regulation") and in doing so can hope to provide far greater protection to consumers by ensuring that practitioners are acting ethically and professionally.

I truly believe that the legal ethics sky has not fallen in Australia. The NSW experience has clearly shown that the practice of law can be regarded as both a profession and a business and in ILPs we witness the overt merger of the two roles. I am convinced that in NSW, Chicken Little has survived!

This paper will discuss the NSW experience of incorporation. Part one of this paper will outline the scope of the regime in New South Wales as well as the obligations of legal practitioners. Part two of this paper will address our experience of incorporation in Australia with specific examples of how firms have met, successfully or otherwise, the regulatory requirements. Part three of this paper will look at the experience in NSW of law firms who have publicly listed. This part will discuss the challenges of listing and how the OLSC has been able to assist

3. The term "ethical infrastructure" was developed by Prof Ted Schneyer. *See* Ted Schneyer, *A Tale of Four Systems: Reflections on How Law Influences the "Ethical Infrastructure of Law Firms"*, 39 SOUTH TEXAS LAW REVIEW 245 (1998). It was developed further by Elizabeth Chambliss and David Wilkins in *Promoting Effective Ethical Infrastructure in Large Law Firms: A Call for Research and Reporting*, 30 HOFSTRA LAW REVIEW 691 (2002) and *A New Framework for Law Firm Discipline* 16 GEORGETOWN JOURNAL OF LEGAL ETHICS 335 (2003).

firms in overcoming these challenges. Part 4 of this paper will look at the concept of external ownership in law firms and discuss the Australian "fitness to own test" as compared with the threshold test recently enacted in the United Kingdom. The paper concludes that the commodification of law has not, in fact, had an adverse effect on the legal services market in Australia, and that ethical practice by and large continues to prevail.

Part 1—The Legislative Framework

On 1 July 2001 the *Legal Profession (Incorporated Legal Practices) Act 2000* ("the 2000 Act") and the *Legal Profession (Incorporated Legal Practices) Regulation 2001* ("Regulations") came into force in New South Wales. The 2000 Act and Regulations enabled providers of legal services in NSW to incorporate by registering a company with the Australian Securities & Investment Commission (ASIC). Similar provisions are included in the *Legal Profession Act 2004* (*LPA 2004*) and the *Legal Profession Regulations 2005*, which superseded the 2000 Act and Regulations.

The *LPA 2004* states that a legal service provider may incorporate and provide legal services either alone or alongside other legal service providers who may, or may not be "legal practitioners." Pursuant to the legislation, on incorporation at least one legal practitioner director[4] must be appointed.[5] The legal practitioner director is generally responsible for the management of the legal services provided in NSW by the ILP. It is an offence if an incorporated legal practice does not have any legal practitioner directors for a period exceeding seven days and the practice may be forced into administration.

In addition to the normal duties owed by partners and employed solicitors the *LPA 2004* and the Regulations provide for additional responsibilities for legal practitioner directors of ILPs.[6] These responsibilities include:

(i) A general responsibility on the solicitor director for management of the legal services provided by the incorporated legal practice—this responsibility probably does not extend beyond those general responsibilities that partners have to the general management of their partnership.
(ii) The implementation and maintenance of "appropriate management systems" to enable the provision of legal services in accordance with the

4. A legal practitioner director is defined as a director of an incorporated legal practice who is an Australian legal practitioner holding an unrestricted practicing certificate.

5. Section 140(1) of the *LPA 2004*. The rationale for imposing a requirement that the ILP have at least one legal practitioner director stems from the "51% rule" which was introduced in 1994 legislative amendments liberalizing MDPs. The 51% rule stipulated that lawyers were required to retain at least 51% of the net income of the partnership, thereby limiting the income of non-lawyers to 49% of the net income earned by the MDP. In addition to limiting the net income, the 51% rule also retained the ethical structure of the practice as a legal practice.

6. Section 143 of the *LPA 2004*.

professional obligations of solicitors and the other obligations imposed by or under section 140(2) and (3) of the *LPA 2004*. Failure to implement and maintain "appropriate management systems" is declared to be professional misconduct.

(iii) A responsibility to report to the Law Society any conduct of another director of the practice that has resulted in or is likely to result in a contravention of that person's professional obligations or other obligations imposed by or under the Act.[7]

(iv) Report to the Law Society any professional misconduct of a solicitor employed by the practice.

(v) An obligation to take all action reasonably available to deal with any professional misconduct or unsatisfactory professional conduct of a solicitor employed by the practice.[8]

Section 140(3) of the *LPA 2004* sets out the test for compliance. This section provides that a legal practitioner director must ensure that "appropriate management systems" are implemented and maintained by the ILP. Failure to implement an appropriate management system may constitute professional misconduct.

"Appropriate management systems" are not defined in the *LPA 2004*. Accordingly, the OLSC has collaborated with the Law Society, the College of Law, the practicing profession and LawCover (the professional indemnity insurer in NSW) to define the key criteria to ascertain whether an ILP has "appropriate management systems" in place. The approach formulated is an "education towards compliance" strategy in which ILPs must show that they have procedures in place that evidence compliance with what the OLSC considers to be the ten objectives of a sound legal practice, namely:

1. Competent work practices to avoid negligence.
2. Effective, timely and courteous communication.
3. Timely delivery, review and follow up of legal services to avoid instances of delay
4. Acceptable processes for liens and file transfers.
5. Shared understanding and appropriate documentation from commencement through to termination of retainer covering costs disclosure, billing practices and termination of retainer.
6. Timely identification and resolution of the many different incarnations of conflicts of interest including when acting for both parties to a transaction or acting against previous clients as well as potential conflicts which may arise in relationships with debt collectors and mercantile agencies or conducing another business, referral fees and commissions etc.

7. Section 140(4) of the *LPA 2004*.
8. Section 141 of the *LPA 2004*.

7. Records management which includes minimizing the likelihood of loss or destruction of correspondence and documents through appropriate document retention, filing, archiving etc and providing for compliance with requirements as regards registers of files, safe custody, financial interests.
8. Undertakings to be given with authority, monitoring of compliance and timely compliance with notices, orders, rulings, directions or other requirements of regulatory authorities such as the OLSC, Law Society, courts or costs assessors.
9. Supervision of the practice and staff.
10. Avoiding failure to account and breaches of s61 of the Act in relation to trust accounts.

To enable legal practitioner directors to assess their management systems, a standard "self-assessment" document has been developed and is sent to all legal practitioner directors. The self-assessment document takes into account the varying size, work practices and nature of operations of different ILPs, eschewing an inappropriate "one size fits all" approach requiring the fulfillment of uniform criteria. The self-assessment document instead suggests indicative criteria to assist legal practitioner directors to address each of the ten objectives along with examples of what an ILP *may* do that would provide evidence of compliance. For example, regarding "competent work practices to avoid negligence," the self-assessment document suggests as a criterion that "fee earners practice only in areas where they have appropriate competence and expertise." A "written statement setting out the types of matters in which the practice will accept instructions and that instructions will not be accepted in any other types of matters" would provide evidence that this criterion had been met. Legal practitioner directors then rate the ILP's compliance with each of the ten objectives as either "Fully Compliant," "Compliant," "Non-Compliant" or "Partially Compliant."

In order to manage the self-assessment process more effectively and efficiently, we are building an online Portal. One of the most important functions of the Portal will be its risk-profiling element. The use of risk profiling will assist the OLSC in focusing its resources on reducing complaints against practitioners by identifying those that are most at risk of non-compliance or unprofessional conduct. The key outputs of the risk-profiling framework will include priority practice review recommendations as well as targeted education programs to assist firms that are not doing well to help them improve and assist firms that are doing well to do better. The Portal will further provide an information and educational repository to aid legal practices in improving their management systems, which will support the provision of high quality, ethical legal services by legal practices and the OLSC's vision of education towards compliance. The Portal will improve the process for regulating and improving ethical behavior by all legal practices and support the provision of high quality, ethical legal services. We envisage that this will in turn reduce the number of consumer complaints about the legal profession. The Portal will also enhance the application and technical capacity to address our

need for complete, timely and accurate information to support decision making, while providing the most effective utilisation of OLSC resources.

Part 2—Compliance with the Legislation

The OLSC has, in practice, by agreement with the Law Society, assumed the role of auditing ILPs for compliance with the *LPA 2004*. There are two types of audits that can occur under the *LPA 2004*. The first is a general power to audit any law practice regardless of entity status (section 670(1))—a compliance audit). The second is an audit of an ILP, which is broken into two components—compliance of the ILP with the requirements of Part 2.6 of the *LPA 2004* and management of the provision of legal services (section 670(2)(a) & (b) ILP Audit). The OLSC can audit a practice's systems; files and behavior reflected in a returned self-assessment form.[9]

Section 670 does not define the term "compliance audit" nor does it provide a test for compliance. This being so the OLSC has had to consider the concepts of "audit" and "compliance" and interpret them in accordance with the objects and purpose of the provisions. The OLSC was of the view that the power to conduct a compliance audit of a legal practice pursuant to section 670 of the *LPA 2004* should not involve the OLSC conducting a detailed audit of a practice's accounting and financial records. This is because the *LPA 2004* already provides audit powers to the trust account inspectors of the NSW Law Society, with whom we work closely. This being so, the OLSC re-classified the audit to that of a "practice review" because a "practice review" has no implied financial connotations. The practice review thus allows the OLSC to evaluate the following factors in relation to the ILPs management systems:

a) Confirmation that appropriate management systems has been implemented and maintained by the ILP in accordance with section 140(3) of the LPA;
b) Ascertain whether any significant changes in management, organisation, policies, procedures, techniques or technologies are adversely affecting the management systems or welfare of the ILP in general;

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9. 670 Compliance audit of law practice

(1) The Law Society Council or the Commissioner may cause an audit to be conducted of the compliance of a law practice (and of its officers and employees) with the requirements of this Act, the regulations or the legal profession rules.

(2) Without limiting subsection (1), an audit conducted in relation to an incorporated legal practice may include an audit of:

(a) the compliance of the incorporated legal practice with the requirements of Part 2.6, and
(b) the management of the provision of legal services by the incorporated legal practice (including the supervision of officers and employees providing the services).

Note. Section 140 (3) (Incorporated legal practice must have legal practitioner director) requires legal practitioner directors to ensure that appropriate management systems are implemented and maintained.

c) Provide relevant guidance, explanations and examples of how similar matters and concerns have been dealt with by other ILPs;
d) Provide information on suitable and necessary training for staff or the LPD;
e) Track and analyse ILPs in the self assessment process;
f) Improve monitoring of the self assessment process for ILPs
g) Provide further information on relevant elements;
h) Determine the need for a follow up audit;
i) Confirm compliance with obligations under Part 2.6 of the LPA.
j) Align practice management with concerns following from a complaint history, even if there has only been a single complaint made about the ILP.

The ultimate objective of conducting a practice review of an ILP is better practice management and compliance with the *LPA 2004*.

The initiation of a practice review can occur as a result of a number of events. Adverse media publicity, for example, or a practitioner who has appeared on OLSC's Complaint System more than once in 12 months (or on the disciplinary register) will trigger a practice review. So too will a referral from a Law Society trust account inspector or a follow up compliance audit that is due as a result of a previous audits. Practitioners who have been listed in the Professional Conduct Committee reports or practitioners the subject of information provided by the Law Society or ASIC, for example, will also be subject to a practice review.

Other triggers may include where there is evidence to suggest that the legal practitioner director has misled the Commissioner with respect to appropriate management systems or where the objectives remain rated less than compliant or a legal practitioner director or non legal practitioner director or a solicitor employee is listed in a cost warning or conflict of interest database or the most recent monthly Law Society or NSW Professional Conduct Committee Reports, or the latest Law Society of NSW Inspection Itinerary. Similarly, a listing of the ILP in the top "30" repeat offenders list that is maintained by the OLSC; or an ILP's certification that has expired will also be a trigger. In fact any source that is of concern or any other reason deemed appropriate by the Commissioner will trigger a practice review even if a practitioner has only been the subject of a single complaint, or no complaint at all.

Since 1 January 2008 the OLSC has conducted 7 practice reviews on ILPs as well as a number of less formal reviews. In one such practice review, for example, the OLSC had received several complaints about the legal practitioner director, two of which related to supervision. The OLSC had concerns that appropriate management systems were not being maintained and accordingly asked the legal practitioner director to assess the management systems at the ILP and to complete a new self-assessment form. The form was returned with eight of the ten objectives identified as partially compliant. An audit was consequently conducted. The practice review identified several areas for improvement and prompted the legal practitioner director to take action to implement new systems. Similarly, in

another practice review, the ILP returned a self-assessment form rating the ILP as non-compliant with all 10 of the appropriate management systems objectives. A practice review was conducted. The review identified that there were systems in place and that the systems were adequate for the ILP. It was also established that the legal practitioner director had not given his full attention to completing the self-assessment form nor had he realized the full extent of his obligations. The review report recommended areas that could be improved and a follow-up review identified that compliance had been achieved by the ILP in accordance with the Act. The OLSC will continue to monitor the ILP via further completion of the self-assessment form in the near future.

In our experience all of the ILPs have responded reasonably positively to the practice reviews. Several were very nervous about the process but ultimately were very accommodating. We decided that it would be beneficial for all concerned if we sent each ILP a copy of the OLSC practice review workbook, which contains questions that we ask, before the review occurs. This gives the firm time to prepare and formulate the answers to the questions and also to obtain copies of any documents that we might request. We have not had any refusals or come across anyone that has been particularly adverse as yet. This is largely because we take a positive, non-adversarial approach to the practice review and at all times emphasize that we are assisting and working with the ILPs, notwithstanding the understanding that a review can lead to disciplinary consequences.

The results of this process have been impressive. We are seeing, by and large, better and more ethically managed legal practices. We are also seeing a fall in the number of complaints. According to the results of a research study we conducted in 2008, together with Dr Christine Parker, of the University of Melbourne, on average the complaint rate (average number of complaints per practitioner per year) for ILPs after self-assessment was well under half the complaint rate before self-assessment.[10] This is a huge drop in complaints. The study involved analyzing 620 initial self-assessment forms from ILPs.[11] In addition to the complaints data the study also found that the majority of ILPs assess themselves to be in compliance on all ten objectives from their initial self-assessment (62%). Of the remaining 38%, about half have become compliant within three months of the initial self-assessment. The study further revealed that ILPs have the highest rates of self-assessed compliance with trust accounting obligations and the lowest rates of self-assessed compliance with management systems to ensure good communication and good supervision of practice.

10. Dr C. Parker, S. Mark & T. Gordon, OLSC Research Report on the Impact of Management Based Regulation on incorporated legal practices in NSW, September 2008, *available at* http://www.lawlink.nsw.gov.au/lawlink/olsc/ll_olsc.nsf/pages/OLSC_speeches.

11. Since 2004 all new ILPs have been sent the self-assessment package and asked to fill in and return the self-assessment form to the OLSC. The OLSC has on file 620 self-assessment forms.

Overall the study shows compelling evidence that the Australian legislative approach requiring ILPs to implement appropriate management systems combined with our self-assessment regime for encouraging firms to actually put this into practice makes a big difference as to how well these firms are managed and lawyer behavior. The research findings are important not only for the profession but also for the community at large. We are seeing many firms positively embrace the requirement to implement appropriate management systems and instituting effective mechanisms to ensure that they are acting both ethically and professionally. This will ultimately mean less unethical practice and fewer complaints.

Part 3—Public Listing in NSW

In May 2007, Slater & Gordon made legal and corporate history when it became the first law firm in the world to list its whole firm on the Australian Stock Exchange. Slater & Gordon is an Australian law firm specializing in personal injury, commercial, family and asbestos-related class action law. Slater & Gordon has over 470 staff located in over 20 offices throughout Australia. Operating for over 70 years Slater & Gordon is one of Australia's most successful and well-known plaintiff law firms, claiming to be synonymous with fair access to justice for thousands of Australians.[12] The firm had more than 95 million shares on offer and another 12 million non-voting shares. Shares in the firm, issued at $1, closed at $1.40, on volume of 8.2 million on the first day of trading.

Following Slater & Gordon's listing, Integrated Legal Holdings (IHL), a Western Australian based law firm, listed on the ASX on 17 August 2008. IHL offered lawyers and non-lawyers an opportunity to invest in their firm via an Initial Public Offer (IPO) offering of 24 million shares at 50 cents each. Unlike Slater & Gordon, IHL's initial listing was not spectacular. At the close of trade on the first day of listing, a day after the ASX suffered its biggest loss in seven years, IHL shares fell to just 38c, losing about a quarter of the value in one day.[13] Interestingly this has not prevented continuing interest in listing by other law firms, as IHL has appeared to recover some lost share price.

IHL's model is considerably different than Slater & Gordon's. IHL was formed to own and operate a number of firms under one business structure, the Integrated Legal Group. IHL plans to either purchase a law firm and merge that law firm into an existing IHL firm or acquire a firm that continues to operate under its own business name. To this end IHL initially acquired the legal practices of two firms.

Since the public listing of Slater & Gordon and IHL, my office has received several requests from other law firms about the processes that need to be undertaken toward external ownership. I have been surprised that in Australia there has been little hesitation or resistance from law firms about pursuing this option. That

12. *See* Slater & Gordon's website at http://www.slatergordon.com.au/pages/the_firm.aspx.

13. Susannah Moran, *New listing rocked by turbulence*, THE AUSTRALIAN, 24 August 2007, *available at* http://www.theaustralian.news.com.au/story/0,25197,22296937–17044,00.html.

is not to say that, at the outset, when the legislation was introduced in 2001, it was fully embraced. There were many who were skeptical about how the legislation would operate and many who considered that with its introduction would come the end of legal ethics in Australia. These views have however been overcome over the past few years largely because my office has been instrumental in educating and working with the profession about the challenges of listing and how they successfully can be addressed.

The Challenges

Australia is a Federation of seven jurisdictions with a centralized Federal Government and State and territory governments. Australia is a Parliamentary democracy. In the sphere of corporate law in Australia, the Federal Corporations Act establishes the pre-eminence of the rights of and protection for shareholders.[14] Accordingly, with the advent of the 2001 legislation, tension was created between a solicitor-director's professional obligations and a solicitor-director's duties to a company's shareholders. The *LPA 2004* attempts to address this tension by providing that Corporations Act displacement provisions are to be established by the Legal Profession Regulation 2005 (NSW) (the Regulation) (s163). The Corporations Act displacement provisions provide that if a State law declares a provision of a State law to be a Corporations legislation displacement provision, any provision of the Corporations legislation with which the State provision would otherwise be inconsistent does not apply to the extent necessary to avoid the inconsistency.[15] The Regulation has not however established any displacement provisions to date.

We hold the view that it is essential that the provisions of the *LPA 2004* prevail over provisions of the Corporations Act to the extent of any inconsistency. The OLSC is presently holding discussions with the NSW State Government with a view to displacing the Corporations Act to the extent of any inconsistency with the *LPA 2004* to ensure that the hierarchy of a lawyers duties; court, client then shareholder, will receive clearer legislative backing.

Competing Duties to the Court/Shareholder

In Australia a legal practitioner's primary duty is owed to the court. No other profession shares this duty. This poses a problem for a listed corporation whose primary duty is to its shareholders. Section 181 of the Corporations Act provides for example that a director or an officer must exercise their powers and discharge their duties "in good faith in the best interests of the corporation" and "for a proper purpose." Section 182 provides that a director, officer or employee must not im-

14. Historically, corporations law was a power largely held by the States. In 2001 after a major controversy and debate, which ran for decades, the States seeded their Corporations power to the Commonwealth so that uniformity throughout Australia could be achieved. Prior to this, the *Legal Profession Act 1987 (NSW)* (LPA 1987) explicitly stated that where an inconsistency existed in the Corporations Act and the *LPA 1987*, then the *LPA 1987* would prevail to the extent of that inconsistency (section 47S).

15. *See* section 5G of the Corporations *Act 2001*.

properly use their position to "gain an advantage for themselves or someone else" or "cause detriment to the corporation." An example of this inconsistency could be as basic as settling major litigation in accordance with the lawyer's duty to the court and the client but thereby causing a detriment to the corporation because of the diminution in fees earned.

Realizing the possibility of this conflict between the duties owed to the company and shareholders and the duties owed to the court and to clients the OLSC worked together with Slater & Gordon prior to listing to ensure that Slater & Gordon's prospectus, constituent documents and shareholder agreements dealt with the issue. As a result these documents specified that the duty to the court was the primary duty, the duty to clients was the second duty and the duty to shareholders was third. For example, the Slater and Gordon prospectus states:

> The constitution states that where an inconsistency or conflict arises between the duties of the company (and the duties of the lawyers employed by the company), the company's duty to the court will prevail over all the duties and the company's duty to its clients will prevail over the duty to shareholders.[16]

The primacy of a lawyer's duties to the court, as stated above is reflected throughout the prospectus. For example, in the investment overview section of the prospectus, Slater & Gordon acknowledge that the conflict of duties is a key risk and may therefore impact on the performance and financial position of the firm.[17] The conflict is also mentioned again in risk section of the prospectus.[18] In addition to the prospectus the conflict is also reflected in Slater & Gordon's constituent documents and shareholder agreements.

So if Slater & Gordon were, for example, acting in a class action against a tobacco company where there is a very good chance of them receiving substantial damages for clients who are dying of emphysema, Slater & Gordon would have to act in accordance with the hierarchy of duties set out in their documents. This means that Slater & Gordon may have to subjugate the interests of shareholders who would argue that the matter be prolonged as long as possible (because lengthy proceedings and the possibility of a court case would mean greater share value), and settle the matter as quickly as possible because their clients are dying. In doing so Slater & Gordon would not be at risk of being sued for their decision, unlike other listed companies, because their constituent documents and shareholder agreements clearly state that their first duty is to the court, the second duty is to their client and the third duty is to their shareholders. It is thus essential that any law firms that wish to incorporate and publicly list explicitly acknowledge and publicly state the hierarchy of duties.

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16. Slater & Gordon Lawyers, Prospectus, 12 April 2007, *available at* http://www.slatergordon.com.au/docs/prospectus/Prospectus.pdf.

17. *Id* at p. 15.

18. *See* section 7, "Risk Factors," *id* at p. 83.

The Duty of Confidentiality

The duty of confidentiality owed by a legal practitioner to their client is fundamental and applies to all information provided by the client. By comparison, confidentiality only really attaches to a business relationship through explicit agreement between the parties. Issues thus arise regarding access to the confidential information of clients by shareholders who are not bound by the same ethical obligations as legal professional employees, owners and managers of a listed firm.

So if Slater & Gordon is running an action against a particular individual who is very well-resourced, and that individual buys a substantial number of shares in Slater & Gordon and then demands that the action against him cease, the dilemma ceases to arise because Slater & Gordon's prospectus explicitly states that legal professionals have a primary duty to their client in the event of such a conflict. The prospectus also makes it explicitly clear that the interests of shareholders are second to the firm's duty to the court. This then covers off the potential for a well-resourced person against whom the firm is conducting proceedings to purchase a significant stake in the firm with a view to demanding the cessation of the action.

But what happens if Slater & Gordon is, for example, obliged to disclose that it is appearing for a client pursuant to the continuous disclosure rules of the ASX[19] but the client does not want Slater & Gordon to disclose such representation? Depending on the circumstances of the client, this may well be information that could have a material effect on the value of securities in the firm.

The disclosure rules of the ASX obviously have significant implications for confidentiality. Section 674 of the Corporations Act 2001 makes it a legal requirement for listed disclosing entities to abide by the ASX Listing Rule 3.1 on continuous disclosure.[20] The ASX defines continuous disclosure as the "timely advising of information to keep the market informed of events and developments as they occur." The obligation of continuous disclosure is further reinforced in Principle 5 from the ASX Corporate Governance Council *Principles of Good Corporate Governance and Best Practice Recommendations*, which supports timely and balanced disclosure.[21] A failure to comply with the continuous disclosure requirements is an offence under s674 of the Corporations Act and can create civil or criminal liability.

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19. ASX Listing Rules, Chapter 3, Rule 3.1, Continuous Disclosure, *available at* http://www.asx.com.au/ListingRules/chapters/Chapter03.pdf; ASX Guidance Note 8: Listing Rule 3.1 http://www.asx.com.au/ListingRules/guidance/GuidanceNote8.pdf; see also Australian Institute of Company Directors, 'Continuous Disclosure Requirements', 2 February 2006 *available at* http://www.companydirectors.com.au/Policy/FAQ/Reporting+Requirements/Continuous+disclosure+requirements.htm.

20. ASX Listing Rules, Chapter 3, Continuous Disclosure, *available at* http://www.asx.com.au/ListingRules/chapters/Chapter03.pdf; ASX Guidance Note 8: Listing Rule 3.1 http://www.asx.com.au/ListingRules/guidance/GuidanceNote8.pdf.

21. *See* Australian Institute of Company Directors, "Continuous Disclosure Requirements", 2 February 2006 *available at* http://www.companydirectors.com.au/Policy/FAQ/.

The underlying principle is that all investors should have equal and timely access to information about a company that a reasonable person would expect, were it generally known, would have a material affect on the price or value of enhanced disclosure (ED) securities of the entity. Specifically, the ASX requires disclosure of:

- Information relating to the making of a takeover bid;
- Certain information relating to share buyback offers;
- Changes to the company's capital structure;
- Information relating to options;
- Certain information when shares in a no liability company are forfeited;
- Information relating to meetings—dates, resolutions and outcomes announcements given to investors;
- Change of contact details of the principal office or share registry;
- Other changes of substantial shareholders to the share register;
- Changes to the chair, directors, responsible, entity, management company or auditors;
- Documents sent to security holders;
- Notice of directors' interests;
- Information memoranda, product disclosure statements;
- If the entity's securities are subject to ownership limits, then certain information relevant to the ownership limit must be disclosed; and,
- Financial information and yearly and half yearly accounts.[22]

This obligation can extend to the requirement to clarify the company's position where media speculation is leading to movements in security value. This scheme lifts the veil that had previously protected partnerships from a transparent, public accounting of their affairs. While some partnerships see this as a significant disincentive to incorporating, consumers and regulators see great potential in improving services. The problem is that lifting the veil may unacceptably expose clients. Juxtaposed to this obligation is a lawyer's duty to maintain confidentiality. We understand that some law firms, for example, are uncomfortable about the level of transparency required for listed companies in terms of directors (partners) shareholding, salaries or take home pay.

The same problem exists in relation to reporting requirement obligations under the Corporations Law. An ILP must comply with the financial reporting requirements set out in the Corporation Act. Such requirements usually entail regularly submitting information regarding the company's financial position and the remuneration of solicitor-directors to ASIC.

In a similar way, if an ILP is floated on the ASX it must also comply with the ASX's rules with respect to financial reporting both to shareholders and the ASX. Could a shareholder or the ASX for example, demand to know the "holdings" of

22. ASX, *loc. cit*.

the law firm such as which clients it was doing work for and how much money was due to the firm? A partnership or sole practitioner, in contrast, is not required to disclose any financial information to the ASIC and ASX, thereby ensuring that a veil is effectively placed around the affairs of such legal practices. Once again the evident tension in duties may be resolved through careful drafting of the corporation's prospectus, constituent documents and shareholder agreements consistent with the principles outlined earlier.

In addition to the above challenges, the public listing of a law firm can also present other dilemmas. Payroll tax issues, for example, represent another challenge. Where a legal practice incorporates, partner drawings and profit shares will be replaced by salaries and dividend distributions. To the extent they are replaced by salaries and total annual salaries and wages are more than $600,000 per annum, payroll tax will be increased by those additional salaries to partners. Dividend distributions are not subject to payroll tax. Listing also raises concerns about the use of listing as an exit strategy for partners/legal practitioner directors. Listing on the stock market is a great way for partners and legal practitioner directors of an incorporated legal practice to make money if they decide to leave the practice. Once all the money has been made in listing and the directors have left it is doubtful that there would be any value left for subsequent directors/shareholders. The Slater & Gordon Prospectus attempts to placate some of these concerns by having staged processes by which the founding directors are required to stay for between three to six years to get the full economic value of their shareholding.

However, perhaps the biggest issue for U.S. regulators where a law firm decides to publicly list is the concern created by the income splitting provisions or the sharing of fees between lawyers and non-lawyers in incorporated practices in Australia and the UK. Income splitting, as it is known in the U.S., is available for incorporated law firms as a result of the legislation, not just where those firms are multidisciplinary but also where administrative and other non-legal staff are able to purchase shares in an incorporated legal practice, which is purely a legal practice. This situation will no doubt produce difficulties in the U.S. in how they characterize Australian (and soon UK) lawyers who wish to practice in America, even pro hac vice.

Part 4—External Ownership and Due Diligence

One of the greatest hurdles to embracing the corporatization of law appears to be the concept of external ownership in law firms. Non-lawyer investment in a law firm is a foreign scenario to legal practice. It would not be incorrect to say that many lawyers see outside investment as a threat to a law firm's independence and professionalism, and it is easy to understand why for the reasons outlined above. In addition to this concern, there is also the concern about what type of people invest in law firms and why. Recognizing this latter concern, the NSW legislation attempted to placate the profession by inserting two provisions in the LPA 2004, which have the effect of "managing" external ownership.

Section 154(1) of the *LPA 2004* provides that the Supreme Court of NSW may disqualify a person from managing a corporation that is an incorporated legal practice. An application for disqualification can only be made by the Law Society Council or the OLSC. A disqualification order will be made by the Supreme Court if it is satisfied that the person is a person who could be disqualified under section 206C[23], 206D[24], 206E[25] or 206F[26] of the *Corporations Act 2001* of the Commonwealth from managing corporations, and the disqualification is justified.

In addition to section 154, section 179 of the *LPA 2004* provides that in relation to MDPs that, on application by the Law Society Council or the OLSC, the Supreme Court may make an order prohibiting any Australian legal practitioner from being a partner in a business that includes the provision of legal services if the Court is satisfied that the person is not a fit and proper person to be a partner, or; the Court is satisfied that the person has been guilty of conduct that, if the person were

23. Section 206C of the *Corporations Act 2001* provides that a Court may disqualify a person from managing corporations if a declaration is made under section 1317E (civil penalty provision) that the person has contravened a corporation/scheme civil penalty provision; or section 386–1 (civil penalty provision) of the *Corporations (Aboriginal and Torres Strait Islander) Act 2006* that the person has contravened a civil penalty provision and the Court is satisfied that the disqualification is justified. In determining whether the disqualification is justified, the Court may have regard to (a) the person's conduct in relation to the management, business or property of any corporation; and (b) any other matters that the Court considers appropriate.

24. Section 206D of the *Corporations Act 2001* provides that a Court may disqualify a person from managing corporations if within the last 7 years, the person has been an officer of 2 or more corporations when they have failed; and the Court is satisfied that: (i) the manner in which the corporation was managed was wholly or partly responsible for the corporation failing; and (ii) the disqualification is justified.

25. Section 206E of the *Corporations Act 2001* provides that a Court may disqualify a person from managing corporations if the person (i) has at least twice been an officer of a body corporate that has contravened this Act or the *Corporations (Aboriginal and Torres Strait Islander) Act 2006* while they were an officer of the body corporate and each time the person has failed to take reasonable steps to prevent the contravention; (ii) or has at least twice contravened this Act or the *Corporations (Aboriginal and Torres Strait Islander) Act 2006* while they were an officer of a body corporate; or (iii) has been an officer of a body corporate and has done something that would have contravened subsection 180(1) or section 181 if the body corporate had been a corporation and the Court is satisfied that the disqualification is justified.

26. Section 206F of the Corporations Act provides that ASIC may disqualify a person from managing corporations if within 7 years immediately before ASIC gives a notice under paragraph (b)(i) the person has been an officer of 2 or more corporations; and while the person was an officer, or within 12 months after the person ceased to be an officer of those corporations, each of the corporations was wound up and a liquidator lodged a report under subsection 533(1) (including that subsection as applied by section 526–35 of the *Corporations (Aboriginal and Torres Strait Islander) Act 2006*) about the corporation's inability to pay its debts; and ASIC has given the person a notice in the prescribed form requiring them to demonstrate why they should not be disqualified; and an opportunity to be heard on the question. A disqualification order made under section 154 has effect for the purposes only of the Act and does not affect the application or operation of the Corporations Act 2001 of the Commonwealth: section 154(3).

an Australian legal practitioner, would have constituted unsatisfactory professional conduct or professional misconduct, or in the case of a corporation, if the Court is satisfied that the corporation has been disqualified from providing legal services in this jurisdiction or there are grounds for disqualifying the corporation from providing legal services in this jurisdiction.

The fundamental purpose of these provisions is to offer a level of protection to the public and the profession and promote investor confidence. Of course, protection is further offered by the requirement in the NSW legislation that, as discussed above, on incorporation at least one legal practitioner director must be appointed. In the seven years since incorporation has been permitted in NSW, to my knowledge there has not been one application invoked by the Law Society Council or my Office pursuant to section 154 of the *LPA 2004*. Nor, am I aware of any disqualification pursuant to section 154 of the *LPA 2004* by the Supreme Court of NSW.

Consumer protection and investor confidence likewise prompted the enactment of fitness to own provisions in the United Kingdom legislation. Pursuant to the *Legal Services Act 2007 (U.K.)* a firm that wants to take on a non-lawyer as a "manager" of a recognized body (partnership, LLP or company recognized by the Solicitors Regulation Authority (SRA) must apply to the SRA for approval of that individual, and satisfy the SRA that the individual is fit and proper to take on that role. Any practice appointing a non-lawyer manager must provide the SRA with the information it requires before finalizing the appointment. This applies even if the individual has previously been approved by the SRA to be a non-lawyer manager of another LDP. The U.K. provides that individuals needing approval fall into three categories:

- non-lawyers, i.e. individuals who are not members (practicing or non-practicing) of a legal profession of England and Wales, an Establishment Directive profession, or a foreign legal profession whose members are eligible to become RFLs;
- members of a foreign legal profession whose members are not eligible to become RFLs;
- non-practicing barristers and non-practicing members of other legal professions, who are prevented by professional rules or training regulations from changing status so as to be able to seek approval as practicing lawyers

Regulation 3 of the *SRA Recognised Bodies Regulations 2009* ("the Regulations") contains the basic provisions regarding the criteria and procedures for approving non-lawyer managers, and for withdrawing approval. Approval is obtained by completing a Standard Application Form known as NL1. It is the responsibility of the applicant (the firm) to make the application for approval, and to confirm that any information provided in connection with the application is correct and complete by signing a declaration of the form. It is the responsibility of the candidate to confirm that any information given about him or her is correct and complete by signing a declaration.

Under Regulation 3.3(c) the SRA may reject an application if the applicant or the candidate fails to disclose, refuses to disclose or seeks to conceal any matter

within Regulation 3.3(a) or (b) in relation to the application. Conduct of this kind could also lead to approval being withdrawn and to disciplinary action being taken against the candidate and/or the applicant. In relation to the individual applying for authorization the SRA can reject an application if the individual:

(i) has been committed to prison in civil or criminal proceedings;
(ii) has been disqualified from being a company director;
(iii) has been removed from the office of charity trustee or trustee for a charity by an order within the terms of section 72(1)(d) of the Charities Act 1993;
(iv) is an undischarged bankrupt;
(v) has been adjudged bankrupt and discharged;
(vi) has entered into an individual voluntary arrangement or a partnership voluntary arrangement under the Insolvency Act 1986;
(vii) has been a manager of a recognized body which has entered into a voluntary arrangement under the Insolvency Act 1986;
(viii) has been a director of a company or a member of an LLP which has been the subject of a winding up order, an administration order or administrative receivership; or has entered into a voluntary arrangement under the Insolvency Act 1986; or has been otherwise wound up or put into administration in circumstances of insolvency;
(ix) lacks capacity (within the meaning of the Mental Capacity Act 2005) and powers under sections 15 to 20 or section 48 of that Act are exercisable in relation to that individual;
(x) is the subject of outstanding judgments involving the payment of money;
(xi) is currently charged with an indictable offence, or has been convicted of an indictable offence or any offence under the Solicitors Act 1974, the Financial Services and Markets Act 2000, the Immigration and Asylum Act 1999 or the Compensation Act 2006;
(xii) has been the subject of an order under section 43 of the Solicitors Act 1974;
(xiii) has been the subject of an equivalent circumstance in another jurisdiction to those listed in (i) or (ix); or
(xiv) has been involved in other conduct which calls into question his or her honesty, integrity or respect for law.

The SRA can also not approve an application if the applicant or the individual concerned fails to disclose, refuses to disclose or seeks to conceal any matter in relation to the application. Under Regulation 4.1 the SRA may impose one or more conditions when granting approval of an individual.

As of March this year the SRA had received almost 20 applications and in excess of 1,500 queries.[27] One of the applications was from a legal executive from

27. Jon Robins, *Why legal disciplinary practices are off to a slow start*, THE LAW GAZETTE, 9 April 2009 *available at* http://www.lawgazette.co.uk/features/understanding-why-legal-disciplinary-practices-are-a-slow-start.

Dorset; while another was from the chief executive of City law firm Barlow Lyde & Gilbert. In discussing the application, the chief executive stated, "I think the law firm model has moved on to the point where there needs to be a close working relationship between lawyers, who know how to deliver legal services to clients, and professional managers, who know how to run a firm."[28] The number of applications is expected to grow in time as the credit crisis continues to bite around the world and law firms are forced to consider other funding alternatives.

The NSW and U.K. provisions, discussed above, are largely based on corporate due diligence legislation. This is particularly so for the NSW legislation which specifically refers to the disqualification provisions in the *Corporations Act 2001* and empowers the Supreme Court of NSW to disqualify a person from managing a corporation if, for example, the person has contravened a penalty provision. The U.K. legislation is also framed within the corporate due diligence model but adds an extra dimension by providing that a non-lawyer manager must also disclose whether he or she "has been involved in other conduct which calls into question his or her honesty, integrity or respect for law." The fundamental purpose of both the NSW and U.K. provisions is said to be to protect the public and the public's confidence in the legal profession. The question is, however, do these due diligence safeguards go far enough in their purported purpose. As presently drafted I am not convinced that they do so.

The purpose of due diligence is an information gathering exercise. For example, in the corporate world, the purpose of due diligence is to obtain as much information as possible about a company to enable a prospective non-executive director to decide whether joining the company is as good an opportunity as it first appears. Due diligence is thus similar to undertaking an audit—allowing the prospective non-executive director to assess the risks posed by involvement in a company, its governance procedures and financial management and its strategic aims and objectives. Likewise, the purpose of due diligence, for the company, is to find out as much information as possible about a prospective non-executive director. The purpose of due diligence with respect to non-lawyer ownership of law firms is no different, except that it is the legal profession (on behalf of a law firm) who assesses the risk.

Effective and targeted due diligence in ascertaining whether a non-lawyer was suitable for law firm ownership would thus mean asking "profession-related" questions of the prospective buyer. Such questions could include, for example, what is your understanding of the role of a non-lawyer in a law firm; what is your understanding of the difference between a profession and a business; do you know and understand the concept of legal professional privilege, do you know and understand the concept of client confidentiality and do you know and understand the concept of the rule of law. Neither the NSW nor the U.K. legislation as constructed however presently asks these kinds of questions.

28. *Id.*

In my view, if we are going to undertake due diligence, unless we ask "profession-related" questions, we are leaving ourselves open to accept persons who may pose ethical risks becoming owners of law firms. In the corporate world, joining a company's board of directors means assuming a role in the control and strategic decision-making processes of that company, thus dictating its future profitability and value. A thorough understanding of the business is vital for anyone embarking on this task in order to ensure that they possess the capacity, capability and competency to fulfill the role. The situation is no different for a non-lawyer joining a law firm. The asking of "profession-related" questions would not only be good practice but also would provide an additional mechanism to protect consumers, the public and the profession.

Conclusion

The NSW experience in regulating incorporation has been positive. Far from being the means by which legal practitioners subvert the ethics of the profession, incorporation can provide lawyers with the incentive to more stringently formalize ethical behavior. I have found that, by and large, ILPs have embraced the systemization of compliance we have introduced, and as a result have reaped the rewards in terms of effective and efficient management. Our experience with working with firms making the transition to one of the most challenging of the various structures afforded by incorporation—public listing—has also been extremely positive. Working together with the profession has proved invaluable. We have been able to successfully address many of the perceived challenges brought about by listing. We have found that the challenges are indeed manageable so long as appropriate standards are systematically applied and monitored and the profession continues to consult.

However while the profit versus ethics conundrum remains a perception at least, we must remain vigilant. The capacity to declare a firm compliant with OLSC standards can assist in quality assurance to clients and can provide greater community protection. We hope that the ethical environment we have created can permeate more widely through the web of business relationships with law firms and others in the corporate world. We also hope that the stated primary ethical commitment to the client and the court, enshrined in Slater & Gordon's prospectus will have a positive effect on the practices of corporations and prompt greater ethical behavior.

I am happy to state that the legal ethics sky has not fallen in Australia and I see no indication that it ever will. Long live Chicken Little!