

# Incorporated Legal Practices—A New Era in the Provision of Legal Services in the State of New South Wales

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## Abstract

*By virtue of legislation which is unprecedented in Australia, legal services providers in New South Wales are permitted to incorporate and provide legal services either alone or alongside other legal service providers who may, or may not be “legal practitioners.”<sup>1</sup> Essentially, the legislation permits the formation of an Incorporated Legal Practice (“ILP”) provided the ILP has at least one “solicitor director” and complies with the requirements of the Legal Profession Amendment (Incorporated Legal Practices) Act 2000 (“Act”) and the Legal Profession Amendment (Incorporated Legal Practices) Regulation 2001 (“Regulations”). This Article commences with an introduction to the development of ILP’s in NSW and the reasons for introducing such legislation. The Article will then discuss some of the advantages and disadvantages of ILP’s and some of the key features of the Act and Regulations. Some of the problem areas of the legislation and the economic versus ethical issues surrounding the use of ILPs will also be examined. Finally, developments to date and the approach adopted to the regulation of ILPs will be described.*

*In relation to regulation, an office independent of the legal profession, namely the Office of the Legal Services Commissioner (“OLSC”) was established in NSW in 1994 to receive complaints against*

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1. The generic term of “legal practitioner” or “lawyer” is used in Australia to refer to either a barrister or solicitor, such persons being akin to “attorneys” in the United States.

*legal practitioners. The OLSC is part of a co-regulatory system that also involves the NSW Law Society and the NSW Bar Association, which are the professional organizations for solicitors and barristers respectively. While the OLSC receives all complaints against NSW legal practitioners and tries to resolve the majority of complaints, it also investigates complaints, or oversees the investigation of complaints that it refers to the Law Society or Bar Association. Where the OLSC is satisfied that there is a reasonable likelihood that a legal practitioner will be found guilty of professional misconduct (and in some circumstances, the lesser offence of unsatisfactory professional conduct), it will prosecute the legal practitioner in the Legal Services Division of the Administrative Decisions Tribunal.*

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## I. Introduction: The Development Of Incorporated Legal Practices

Traditionally, NSW solicitors practiced as sole practitioners, or in partnership with other lawyers. While sole practitioner and partnerships remain the most prevalent form of legal practice in NSW, the use of “multi-disciplinary partnerships” (“MDP’s”) and “solicitor corporations” have been permitted under the Legal Profession Act 1987 (NSW) (“LPA”) and the NSW Professional Conduct and Practice Rules Legal Profession Act (1987) (“Rules”).

In respect of MDP’s, numerous conditions attached to the early form of such structure that hindered their appeal in the legal services market. In 1994, legislative amendments were introduced to try and liberalize the conditions attaching to MDPs. However, two rules with respect to MDPs remained which continued to restrict their appeal to, and use by, both lawyers and non-lawyers who saw advantages in this structure.

The first restriction was that lawyers were required to retain the majority voting rights in the MDP. The second restriction was 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 1998, a Report entitled the “National Competition Policy Review of the Legal Profession Act” (National Competition Policy Review) determined that despite the earlier attempt at liberalizing the rules for MDPs, the rules governing MDPs were still anti-competitive and should be repealed. As a result, in December 1999 the rules were amended such that it was no longer necessary for lawyers to retain the majority voting rights in an MDP, and the net income of the MDP could be shared by lawyers and non-lawyers without restriction. Such changes meant that the operation of MDPs has essentially been unfettered since December 1999. Despite this, very few MDPs have been created in NSW.

With respect to “solicitor corporations,” the Legal Profession (Solicitor Corporations) Amendment Act 1990 introduced Part 10A into the LPA which enabled the formation of solicitor corporations. A unique feature of solicitor corporations was that they were incorporated under the provisions of the LPA, and not under the uniform and Australia-wide Corporations Act. In brief, after applying to the Law Society for a certificate of approval in respect of a proposed corporation, any one or more persons could, by subscribing their names to the constitution of the incorporated body and complying with the requirements as to registration, form a “solicitor corporation.” However, the Law Society placed strict controls on solicitor corporations in that only an “approved

solicitor” could hold voting shares in such corporation, and only an “approved person” could hold shares in such companies. It has been argued that such controls existed to ensure that only solicitors and their families controlled solicitor-corporations.<sup>2</sup>

Despite the availability of these alternative forms of legal structures, lawyers were generally reluctant to move away from the traditional use of sole practitioner and partnerships to operate a legal practice. Lawyers seemed to be concerned about the conflicts of interest that might arise if they entered into business arrangements with non-lawyers and there was a general perception among lawyers that, “it would not be possible to maintain professional and ethical standards if lawyers entered into business arrangements with members of other occupational groups.”<sup>3</sup> Therefore, the use of MDPs and solicitor corporations was not widely embraced by the NSW legal profession.

The Legal Profession (Incorporated Legal Practices) Act 2000<sup>4</sup> (“the Act”) and the Legal Profession (Incorporated Legal Practices) Regulation 2001 (“Regulations”)<sup>5</sup> came into force in New South Wales on 1 July 2001. The Act and Regulations enable providers of legal services in NSW to incorporate by registering a company with the Australian federal corporations agency, namely the Australian Securities and Investments Commission (“ASIC”). Once registered with ASIC, the rules that govern the framework of the ILP are found not only in the company’s constitution, the Act and the Regulations, but also in the nation-wide “Corporations Act.”<sup>6</sup>

Legal practitioners who practice as “solicitor directors” or employee solicitors of such ILPs continue to be subject to their professional obligations under the LPA, the Legal Profession Regulation 2000, the Rules and the general law. However, to the extent that the provisions of the Act or Regulations conflict with the Corporations Act, the provisions of the LPA will prevail.<sup>7</sup>

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2. The Hon Jeff Shaw QC MLC, *Incorporation of Legal Practices under the Corporations Law*, 68 LAW SOCIETY JOURNAL (NSW), 67, 67-70 (1999).

3. Parliament of NSW, Legislative Council Hansard, 23 June 2000 at 7624.

4. While reference will be made to the Legal Profession Amendment (Incorporated Legal Practices) Act 2000 (“the Act”) throughout this Article, the provisions of the Act are now found in the Legal Profession Act 1987 (NSW) which legislation generally governs the conduct of lawyers in NSW.

5. While reference will be made to the Legal Profession Amendment (Incorporated Legal Practices) Regulation 2001 (“the Act”) in this Article, the Regulations are now found in the Legal Profession Regulation 2000 (NSW).

6. The Corporations Act 2001 (Cth) was previously known as the “Corporations Law.”

7. Section 47S(1) of the Act.

## II. Reasons for permitting ILPs

The 1998 National Competition Policy Review had advocated for the liberalization of MDPs. It also reported that there were continuing restrictions on the business structures available to the legal profession, and that solicitors should be permitted to practice in corporations governed by the Corporations Act. Furthermore, while partnerships were acknowledged as the most common form of business structure for NSW legal practices, they were viewed as anti-competitive for three main reasons.

Firstly, given a partnership's horizontal management structure, decisions with respect to a partnership are usually made equally by all the partners. However, in today's larger law firms, partners rarely meet or communicate as a group given that their offices are often located in several cities or even abroad. Accordingly, it was felt by many that the decision-making processes inherent in a partnership structure were cumbersome and out of step with modern commercial reality.

Secondly, partnerships are unable to raise capital from the public to fund their expansion and enter new markets. Accordingly, there was a perception that there were restrictions on the ability of legal partnerships to raise capital and grow into large and profitable commercial enterprises that were able to compete with other professional services businesses on a national and international scale.<sup>8</sup>

Thirdly, a partnership is an alliance of individuals who come together to operate a business, and therefore information in respect of a partnership's management and financial position is largely private. A corollary of this is that legal partnerships are not subject to the same degree of public scrutiny in the business sector as other forms of organization (e.g. for a company, by creditors and employees). In contrast, it was perceived that if an alternative form of legal structure were permitted, e.g. ILPs, there would be greater transparency in terms of the management and operation of such practices.

In view of the above, the Act and the Regulations were enacted to permit legal practitioners to practice as ILPs. In first introducing the Act as a Bill into Parliament the New South Wales Attorney General said:

The Government is of the view that incorporation will lead to more transparent management structures in law firms, because of the

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8. It is noteworthy that when ILPs were first suggested as an alternative structure for legal practices, it was proffered that incorporation would allow legal practices to compete with the large professional services firms such as PWC and KPMG. However, such suggestions were curious given that none of the major accounting firms, which offered a diverse range of professional services, were incorporated, and instead operated as partnerships.

requirements of the Corporations Act. Within a corporate structure, the accountability of individuals for the management of the practice will be enhanced, and this is likely to lead to better delineation of responsibilities within firms and to more efficient service provision.<sup>9</sup>

### III. Advantages and Disadvantages of Incorporation

It is clear that a company is a distinct legal entity, separate from its individual shareholders. Accordingly, a company's capital is provided by its shareholders, its assets are owned by the company, and its liabilities are its responsibilities, not those of its shareholders. It is this separate legal existence that gives rise to the general proposition that a corporate structure will offer advantages when adopted and used for legal practices. Despite this, as one commentator has remarked:

The advantages and disadvantages of incorporation will be of varying importance to different firms depending upon their size, the type of practice they have, and the attitudes which the principals of the firm have to particular questions such as the responsibility of directors for the actions of their colleagues, disclosure of financial and other information, status and other intangible matters.<sup>10</sup>

As the Act has only recently come into operation it is difficult to comment on whether the benefits of a corporate structure for legal practices are more likely to be perceived, rather than actual benefits. Nevertheless, some of the advantages and disadvantages, and the issues which have arisen in respect of ILP's are discussed below under five broad categories.

#### A. Structure

Once a company is registered with ASIC, the capital in the company is constituted by one or more shares and each shareholder's liability is limited to the shareholder's investment in the corporation. The concept of limited liability has been pronounced as a benefit of incorporation. Certainly, limited liability is a benefit for the former partners of a legal partnership who opt to incorporate. For the first time, the former partners—now shareholders in a company—can rest assured that their liability for their business debts is limited.

However, a partnership has historically been regarded as providing optimal protection to clients simply because the partners in a partnership have joint and several, as well as unlimited liability for the debts of the

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9. Parliament of NSW, *supra* note 3, at 7624.

10. Philip King, *Legal Practice: Should Your Firm Incorporate?*, 39(2) LAW SOCIETY JOURNAL (NSW) 44, 44-46 (2001).

partnership. On this point, the former NSW Attorney General commented that partnership arrangements “ensured that partners maintained a direct interest in the affairs of the partnership and in the conduct of its solicitors. For these reasons, partnerships have been seen as the best business structure to ensure that the ethical and professional responsibilities of the legal profession are observed.”<sup>11</sup> Accordingly, there is an argument that while incorporation benefits the new owners of an ILP in terms of limited liability, the protection of clients may be compromised.

Prior to registering a company with ASIC, a constitution for the company must be drafted. In drafting a constitution, the directors and shareholders may be given any combination of rights of ownership, control and distribution in the profits of the company by choosing the types of shares that will constitute the company. For example, a company may decide to offer voting or non-voting shares, fixed dividend, preference or other classes of shares to potential shareholders. Accordingly, a corporate structure offers flexibility in terms of the ownership, control and distribution of profits of the company. In contrast, in a partnership, all of the ownership, control and rights to distribution in the profits of a partnership lies with the individual partners.

Furthermore, holding shares in an ILP may be a good investment. The concept of a legal practice being an investment appears at odds with a partnership. However, if the net value of an ILP increases, there will be a corresponding increase in the value of the ILP shares. In addition, if the ILP is profitable, dividend income (unless profits are retained are retained by the company) will be distributed to shareholders. In circumstances where the ILP is floated on a stock exchange, and there is public demand for the purchase of ILP shares, existing shareholders may even be offered a premium for their shares.

From a commercial perspective, ownership of a share also tends to be more attractive than an interest in a partnership given the transferability of shares. In this respect, a shareholder may sell his/her existing shares, buy further shares, and retain shares to supplement retirement income or transfer shares by way of testamentary gift. For the ILP, shares also enable the company to reduce its share capital and thereby obtain greater control over the company by way of an “off market” or, in the case of a public company, an “on market,” share buy back.

In addition, a company structure offers flexibility in terms of share ownership. For example, shareholders may be non-lawyers including

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11. Shaw, *supra* note 2, at 68.

employees, family members or other companies. Furthermore, if non-lawyer shareholders are appointed to the board of directors, the ILP should benefit from the broadened range of skills that are brought to the ILP's management.

Finally, a company continues in existence regardless of the personal circumstances of its members and directors. In contrast, there is often confusion and expense when a partner dies, retires or withdraws from a partnership. In such circumstances, a reconstitution of the partnership is required, as well as a change to the ownership details of the partnership's assets. The time, expense and inconvenience of reconstituting a partnership is therefore avoided by using a corporate structure.

### *B. Capital Raising*

It is interesting that lawyers giving business advice rarely advise a client company to expand using debt . . . and yet this is one of the only forms of raising capital available to a legal partnership! In contrast, a company structure means that additional capital may be raised through various mechanisms. For example, a company may grant security over its assets or issue unsecured debentures, bills of exchange and other debt securities. A company can also raise equity capital by floating on the stock exchange or retaining profits, rather than distributing dividends to its shareholders. While such debt and equity raising facilities are available to a corporation such as an ILP, they are not available to a partnership.

At the time of writing this Article, there are no ILPs that have been "floated" on the Australian Stock Exchange ("ASX"), thereby becoming publicly listed companies. However, we are aware that several ILPs are contemplating becoming public companies.

As Legal Services Commissioner, one of my primary concerns about permitting professional firms to incorporate is the inevitable conflict of economic versus ethical issues. In this regard, in a partnership, a partner has an overriding duty to the profession. However, in a corporate structure, directors have an overriding duty to the company and its shareholders. In this regard, in a debate before the NSW Legislative Council the Attorney General said:

"The bill provides that the Legal Profession Act prevails over the Corporations Act if there is an inconsistency. Duties to shareholders will come not come first. The duties of a solicitor under the Legal Profession Act will be paramount."<sup>12</sup>

In addition, the Attorney General commented:

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12. Parliament of NSW, Legislative Council Hansard, 31 October 2000, at 9406.

the bill strikes a careful balance. It enables solicitors to take advantage of the commercial benefits of incorporation, but ensures that consumers are protected from any departures from professional and ethical standards by solicitors and other people employed by companies. The Government recognises that it is absolutely essential for consumers to be confident that solicitors are properly regulated under the Act and the bill in no way detracts from this protection.<sup>13</sup>

Despite this, my tentative view is that where an ILP becomes publicly listed, the duty of an ILP solicitor director to the court and to clients will inevitably conflict with the duty of a solicitor director to the ILP and its shareholders. Furthermore, I believe that such conflict is irreconcilable.<sup>14</sup> While the perceived conflict between professional ethics and profit is an ongoing concern in the regulation of at least some present partnerships, in publicly listed ILPs, shareholder pressure for commercial gain will introduce a dynamic for solicitor directors which was non-existent in partnership structures.

### C. *Financial*

For a company, its shareholders and directors, a corporate structure provides financial advantages. For example, in Australia a company must pay federal income tax on its taxable income at 30% per annum.<sup>15</sup> After paying such tax, a company then has discretion as to whether or not to distribute its net profits by way of dividends. If the company does pay tax and distributes an after-tax or “franked dividend” to shareholders, the shareholder is entitled to an imputation credit for the tax paid when calculating their taxable income in their personal tax return.

In contrast, a partner must include his/her net income from the partnership in his/her individual tax return each year. A partner is then taxed at the individual’s marginal tax rate that may be as high as 47%.<sup>16</sup> However, for solicitor directors who classify themselves as employees, favorable taxation, superannuation and redundancy pay arrangements are offered by a corporate structure.

In terms of financial reporting, an ILP must comply with the

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13. *Id.* at 9406.

14. I do not hold this view in respect of solicitors employed by the ILP as such solicitor’s duties are two-fold but not in conflict *i.e.*, firstly, the solicitor’s duty to the court and his/her clients and secondly the solicitor’s duty to the ILP itself.

15. The New Business Tax System (Income Tax Rates) Act (No. 1) 1999 (Cth) reduced the company tax rate to 30% from 34% for the 2001-2002 and later years of income.

16. For an annual taxable income of over \$60,000 an individual must pay tax of \$15,580 plus 47¢ on each dollar earned above \$60,000 (excluding a medicare levy of 1.5%).

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. In contrast, a partnership or sole practitioner is not required to disclose any financial information to the ASIC and ASX, thereby ensuring that a veil is effectively placed around the financial affairs of such legal practices.

#### *D. Management*

By using a corporate structure, the division of decision-making power between directors, shareholders and employees can be tailored to the needs of an ILP. Such unbundling of roles means enhanced accountability for workers and a subsequent tightening of control over different practice areas, but less autonomy for the former partners of a firm. A separation of roles also means that those contributing to the success of the ILP as solicitor directors, managing directors and employees are more accurately remunerated according to their performance.

In contrast, a partner of a firm often receives an annual lump sum remuneration from the partnership which may or may not reflect the partner's revenue and non-financial contributions to the partnership. For example, former partners of a firm who were "rain makers," but performed little or no client work, may have been entitled to a share of the revenues generated from professional work performed. In contrast, under a corporate structure, "rain makers" may instead be remunerated on the basis of an annual salary, or a percentage of "work won" for the company.

Incorporation also offers management options that are superior to those available under a partnership structure. For example, while a non-lawyer Chief Executive Officer ("CEO") may be appointed either by a partnership or an ILP to head up the business, a CEO's management autonomy is often impeded in a partnership by the wishes and desires of the individual partners. In contrast, a CEO of an ILP operates in a bona fide corporate environment and is answerable only to the board of directors.

As a final note, whereas under a partnership structure the partners may have resorted to litigation to remove a partner whose economic and other contributions to the practice were less than satisfactory, the corporate structure makes such removal process much easier. Under a corporate structure, any non-performing solicitor director may simply be

voted off the board.

#### *E. Employees*

As a general proposition, employee motivation and loyalty is more profound in companies where staff incentive schemes such as bonus shares or options are offered to employees. Such schemes tend to improve teamwork and create a sense of loyalty and staff morale that facets of working life are often lacking in today's legal partnerships. Accordingly, staff incentive share schemes may be introduced in an ILP situation, thereby providing the dual benefits of staff loyalty and retention for the ILP and financial rewards for employees.

#### IV. Key Provisions

As the overall framework for an ILP is that of a corporation under the Corporations Act, the provisions of the Act with respect to the establishment of an ILP are relatively straightforward. An ILP will be characterized by the appointment of at least one "solicitor director" who is generally responsible for the management of the legal services provided in NSW by the ILP.<sup>17</sup> A solicitor director is a solicitor who holds an unrestricted practicing certificate<sup>18</sup> permitting such person to practice as a solicitor or barrister in NSW and who is appointed as a director of an ILP. To obtain an unrestricted practicing certificate, a legal practitioner must attend a practical management course at the NSW College of Law.<sup>19</sup> My Office has prepared additional material for the practical management curriculum such that solicitor-directors, or prospective solicitor-directors, are educated about the duties and obligations involved in such role.

Set out below are the principal obligations of solicitor directors of ILPs (and in some instances, solicitors employed by an ILP). The obligations broadly relate to ILP solicitors continuing to abide by their professional responsibilities, disclosures to clients, accounting for client money, insurance cover and notifications to the Law Society. The circumstances in which the NSW Administrative Decisions Tribunal will find a solicitor director guilty of professional misconduct will also be described.

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17. *Ibid* at Section 47E(2).

18. Upon application and payment of a fee, Practising Certificates are issued by the Law Society of NSW each year.

19. The NSW College of Law is the largest provider of practical legal training in Australia. The College of Law also conducts continuing legal education courses for legal practitioners in NSW. The planning, development and provision of legal education services is directed to a vision of legal education that is focused on developing excellence in legal education as an instrument of service to the public.

The first and overriding obligation of all solicitors working for an ILP is to comply with a solicitor's ethical and professional responsibilities. Specifically, section 47G(1) of the Act states "the solicitors rules apply to solicitors who are officers or employees of an incorporated legal practice." Furthermore, section 47H(1) of the Act states that, "a solicitor who provides legal services in the capacity of an officer or employee of an incorporated legal practice is not excused from compliance with the professional obligations of a solicitor and does not lose the professional privileges of a solicitor."

The "professional obligations" of an ILP solicitor are found in section 47H(5) include:

- (a) Duties to the court;
- (b) Obligations concerning conflicts of interest;
- (c) Duties of disclosure to clients (including with respect to matters relating to costs under Part 11 of the Act); and
- (d) Ethical rules required to be observed by a solicitor."

In the sphere of corporate law in Australia, the Corporations Act advocates for the paramountcy of the rights and protection of shareholders. Accordingly, as previously mentioned, there is a latent tension between a solicitor's professional obligations and a solicitor's duties to a company's shareholders. In theory, the Act resolves this tension by making it patently clear that a solicitor's ethical and professional obligations prevail over the Corporations Act.<sup>20</sup>

Secondly, in the realm of disclosures to clients, Regulation 24 provides that each solicitor director of an ILP (and any solicitor who provides legal services) must ensure that a disclosure is made to a client with respect to the provision of "legal" and "non-legal services" by the ILP. The disclosure must be in writing and include certain information.<sup>21</sup>

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20. Section 47S(1) of the Act states that, "the provisions of this Act or the regulations that apply to or in respect of any incorporated legal practice prevail, to the extent of any inconsistency, over the applicable corporate law."

21. Pursuant to Reg 24(2) of the Legal Profession Regulation 2002 (NSW), The disclosure is to be made by giving the client a notice in writing setting out the following:

- (a) description of the legal services to be provided to the client
- (b) advice that the provision of legal services by the incorporated legal practice, including by any officer or employee of the corporation who is a solicitor, is regulated by the Legal Profession Act 1987 (NSW)
- (c) a description of the non-legal services (if any) to be provided to the client,
- (d) advice that the Legal Profession Act 1987 does not regulate the

The disclosure must also be made before any legal services are provided to a client or as soon as practicable afterward being engaged by the client.<sup>22</sup>

Regulation 22 defines “non-legal services” as “services provided by an incorporated legal practice that are not legal services, but does not include clerical or administrative services (such as typing, filing and photocopying) that are provided in connection with legal services.” The term “legal services” as used in Regulation 24 is not defined, however, in Section 48E(1) of the LPA, “general legal work” is defined.<sup>23</sup>

Despite the definition of “general legal work,” there are some areas of the law in which there is no guidance as to whether such work should only be provided by a lawyer, and which areas of work may be performed by either a lawyer or non-lawyer. The issue regarding the distinction between “legal work” or “legal services” and “non-legal services” arose in respect of multi-disciplinary partnerships and, in view of Regulation 24, is again the focus of debate.

While the development of a comprehensive definition would no doubt be very difficult, it has been suggested that, “to the extent that “legal work” can be identified, it should be done by lawyers, for the protection of the consumer.”<sup>24</sup> However, in an evolving market for professional services it is very difficult to restrict the interpretation of tax law, or the compliance aspects of migration law, to lawyers, while prohibiting tax accountants and migration agents from interpreting the law and performing such work. While this issue has not been resolved, what is certain from the Act is that persons who are not qualified lawyers but who *act* as lawyers in NSW are not regulated by my Office.<sup>25</sup>

A solicitor director also has an obligation to ensure that adequate cost disclosures with respect to the provision of legal services are

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provision of those non-legal services.

22. Regulation 24(3).

23. Pursuant to section 48E of the LPA, “general legal work” means the work involved in drawing, filling up or preparing an instrument or other document that:

- (a) is a will or other testamentary instrument, or
- (b) creates, regulates or affects rights between parties (or purports to do so), or
- (c) affects real or personal property, or
- (d) relates to a legal proceeding.

24. Michael Gawler, *Multidisciplinary Partnerships: Have Your Say*, 72 LAW INSTITUTE JOURNAL (Victoria), 15-17 (1998).

25. Being the NSW Office of the Legal Services Commissioner, my Office handles the system of complaints against lawyers in NSW and in certain circumstances, prosecutes lawyers where satisfied that there is a reasonable likelihood of a finding by the Administrative Decisions Tribunal of unsatisfactory professional conduct or professional misconduct.

provided to a client by the ILP.<sup>26</sup> In respect of costs disclosures, legal practitioners must disclose their costs to their clients when handling matters under NSW law. This means they must inform their clients about the cost of the work they have been asked to perform,<sup>27</sup> or explain how they calculate their costs, and then provide an estimate of the likely amount of those costs.<sup>28</sup> Legal practitioners are required to disclose their costs before commencing any work for a client.<sup>29</sup> However, if it is not reasonably practicable for the legal practitioner to disclose costs before receiving a retainer, then the practitioner is required to make the disclosure as soon as practicable after being retained.<sup>30</sup>

Thirdly, solicitor directors have various responsibilities with respect to accounting for clients' money. By way of background, NSW solicitors who hold an unrestricted practising certificate are able to handle clients' money, other than in a transitory fashion, as either "trust money" or "controlled money." Any trust money is to be deposited into a bank account opened by the solicitor, which is known as the "general trust account." A client is not entitled to any interest that may accrue on money deposited into a solicitor's general trust account. In contrast, money deposited by a solicitor into a separate, interest-bearing bank account on trust for a particular client, pursuant to the direction of that client, will be held in a "controlled money" account.

A solicitor who holds an unrestricted practising certificate and works for an ILP is permitted to maintain and operate a general trust account and controlled money accounts. However, a solicitor director of an ILP has an obligation to ensure that any money received by the ILP in connection with, or in the course of providing non-legal services is not deposited into the general trust account, and is not kept in the same account as any controlled money.<sup>31</sup> In addition, a solicitor director must ensure that the provisions of the Act and Regulations concerning the maintenance of accounting records in relation to monies received by the ILP (or an officer or employee of the ILP) on behalf of another person are complied with.<sup>32</sup>

The fourth obligation is that a solicitor-director must ensure that the ILP complies with the obligations of an insurable solicitor under the LPA with respect to the maintenance of insurance policies to cover instances of professional negligence. In this respect, a NSW solicitor cannot be

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26. Regulation 29(1).

27. Section 175(1) LPA.

28. Section 175(2)(b) and Section 177(1).

29. Section 178(1).

30. Section 178(2).

31. Regulation 25(2).

32. Regulation 26(1).

issued with a practising certificate unless the Law Society is satisfied that “there is, or will be, in force with respect to the solicitor an approved insurance policy” and the Law Society is satisfied that “any contribution or levy, or installment of a contribution, that is payable by the solicitor” has been paid to the company administering the Solicitors’ Mutual Indemnity Fund.<sup>33</sup> In this way, the Law Society is assured that practicing solicitors have in place a current policy of indemnity insurance to cover liabilities arising in respect of any professional negligence suits. The Law Society is entitled to suspend the practising certificate of a solicitor director if the ILP fails to pay its professional indemnity insurance premiums.<sup>34</sup>

The fifth obligation concerns notifications to the Law Society. Specifically, a new solicitor director of an ILP must be appointed within 7 days of the date an ILP ceases to have a solicitor director,<sup>35</sup> and the solicitor must notify the Law Society in writing within 7 days after the change occurs.<sup>36</sup> However, a 7-day “grace” period within which an ILP may not have a solicitor director is problematic. My concern is that at no time should the ILP lack a solicitor director who is ultimately responsible for managing the ILP, and its employed, and usually, more junior solicitors. My Office is trying to address this problem via legislative amendment.

The sixth obligation is that a solicitor director must, in accordance with any request from the Law Society, notify the Law Society in writing of particulars relating to the formation of an ILP, the commencement of legal services provided by an ILP, or any change to or winding up of an ILP, including a change in the directors of the ILP.<sup>37</sup> Accordingly, a solicitor director must be vigilant and attend to the administrative aspects required of the role of solicitor-director.

Some of the key responsibilities of solicitor-directors have been discussed above. However, the question that must be posed is, “What happens if a solicitor-director does not fulfill his/her obligations under the ILP legislation?” Sections 47E(3) and (4) of the Act provide the answer in that such sections prescribe the circumstances in which a solicitor director is guilty of “professional misconduct.”

Pursuant to section 127(1) of the LPA, “professional misconduct” includes a “substantial and consistent failure to reach reasonable standards of competence and diligence,” and “conduct (whether consisting of an act or omission) occurring otherwise than in connection

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33. Section 41.

34. Section 47K(1).

35. Regulation 37.

36. Regulation 12(1).

37. Regulation 12(2)(b).

with the practice of law which, if established, would justify a finding that a legal practitioner is not of good fame and character or is not a fit and proper person to remain on the Roll of Practitioners.” Where my Office is satisfied that there is a reasonable likelihood that a legal practitioner will be found guilty of professional misconduct, it must prosecute the legal practitioner in the Legal Services Division of the Administrative Decisions Tribunal.<sup>38</sup>

Section 47E(3) of the Act is “mandatory” in that it states that it *is* professional misconduct if any solicitor director does not ensure that:

- (a) appropriate management systems are implemented and maintained to enable the provision of those legal services in accordance with the professional obligations of solicitors and the other obligations imposed by or under this Act; and
- (b) any conduct of another director of the practice that has resulted or is likely to result in a contravention of those obligations is reported to the Law Society Council promptly after the solicitor director becomes aware of it; and
- (c) any professional misconduct of a solicitor employed by the practice to provide legal services is reported to the Law Society Council promptly after the solicitor director becomes aware of it; and
- (d) all reasonable action available to the solicitor director is taken to deal with any professional misconduct or unsatisfactory professional conduct of a solicitor so employed by the practice.

The concept of “appropriate management systems” in section 47E(3)(a) is not defined in the Act. Accordingly, there has been much deliberation about the meaning of this phrase and how it should be assessed from a compliance and regulatory perspective. I will return to this issue in the “Regulation” section of this Article.

Sections 47E(3)(b) and (c) also raise important issues. In brief, these sections provide that if a solicitor-director is aware that one of his fellow solicitor-directors or employed solicitors is in breach of their professional obligations, but fails to report such conduct to the Law Society, the solicitor-director *is* guilty of professional misconduct. Accordingly, there is an inherent personal obligation upon solicitor-directors to ensure that their fellow directors and employed solicitors also comply with their legal, professional and ethical obligations.

Traditionally, responsibility for the actions of solicitors was restricted to situations in which a legal practitioner was directly

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38. Section 155(2).

responsible for the misconduct of a fellow practitioner, and that misconduct contained an element of willfulness or reckless disregard for the consequences of the fellow practitioner's behavior. However, the new provisions seem to attach vicarious liability to solicitor-directors for the actions of fellow solicitor directors and employed solicitors.

As a regulator of legal services, I would find it evidentiary difficult to prosecute a solicitor for the actions of a fellow solicitor without the mens rea of willfulness or reckless disregard for the consequences of a practitioner's conduct. This is particularly so for solicitor-directors in the larger law firms where there are sometimes hundreds of lawyers, with whom the solicitor director may have had little or no contact.

Furthermore, whereas the Corporations Act provides defenses that may be raised by a director to absolve a director from liability for the acts or omissions of employees in certain circumstances, the Act does not provide such statutory defenses for solicitor-directors. Having said this, in the event that a prosecution did occur, but the solicitor-director can prove that that he/she did everything necessary to try and prevent such professional misconduct or unsatisfactory professional conduct on the part of other directors or employees from occurring, it is conceivable that the Administrative Decisions Tribunal would develop defenses or exemptions from vicarious liability if it was satisfied that the solicitor director "took all reasonable action . . . to deal with any professional misconduct or unsatisfactory professional conduct of a solicitor so employed by the practice."<sup>39</sup> Accordingly, for a solicitor director to best protect himself/herself from the strict liability provisions in section 47E(3)(b) and (c), I will be encouraging solicitor directors to conduct internal training programs and educational sessions for their employed solicitors to remind them of their professional and ethical responsibilities.

As a further point, the issue of a solicitor director's responsibility for the conduct of other solicitors within the ILP gives rise to another interesting question i.e., "Does the new ILP legislation mean that complaints can now be lodged and accepted by my Office against an ILP—at least in so far as the complaint is made against the solicitor director—rather than as complaints about individuals, as has traditionally been the case?" I raised a similar question along these same lines in another recent journal article.<sup>40</sup> My Office has not yet been presented with a case in which this question can be addressed.

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39. Section 47E(3)(d).

40. Steven Mark, *Harmonization or Homogenization? The Globalization of Law and Legal Ethics—An Australian Viewpoint*, 34(4) VAND. J. OF TRANSNAT'L L. 1206 (2001).

## V. Developments to Date

The Law Society maintains basic registration details in respect of ILPs and updates this information as changes are notified to it by an ILP. However, the Act is deficient in that there is no requirement for an ILP to disclose to the Law Society or any other body, information with respect to the ILP's operation. Accordingly, there are no statistics to indicate, for example, how many of the current ILP's in NSW are multi-disciplinary.

The Law Society's records indicate that at present, there are almost 300 ILPs in NSW. The vast majority of these ILPs were previously sole practitioners or small partnerships, which changed their ownership structures to obtain the perceived benefits of incorporation. However, aside from having to comply with the ILP legislation, such practices have experienced little change in their daily management and operation.

The larger law firms have been slower to opt to incorporate. One of the main reasons for this is probably because at present, NSW is the only state to allow the incorporation of legal practices.<sup>41</sup> Accordingly, a lot of the larger firms, which operate on a national basis, cannot take up the ILP model as they are financially merged in an Australia-wide partnership. Despite this, one major national law firm has incorporated its Sydney practice. Such law firm was able to incorporate in NSW and still operate as a national business as it does not operate as a single national partnership, but has joint venture arrangements with other legal practices around Australia.

Finally, I am witnessing the establishment of legal practices under the new legislation whose ultimate structures are unconventional, although legal. For example, one medium-sized law firm incorporated its Sydney office, and then franchised under the ILP's name, regional legal practices. Another legal practice incorporated with several subsidiary companies. Such franchising and subsidiary company arrangements are common in the corporate world, but are unprecedented for an Australian legal practice.

## VI. Regulation

The Act gives the Office of the Legal Services Commissioner and the Law Society wide powers to investigate<sup>42</sup> and review<sup>43</sup> the operation of ILPs. In relation to investigations, I am at liberty to exercise my traditional powers of investigation in relation to ILPs in the same way as

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41. Note: The Attorneys General of all other Australian states have agreed to enact legislation over the next year or so to allow for the incorporation of legal practices.

42. Section 47O(1).

43. Section 47P(1).

my powers apply to persons who are or were legal practitioners.<sup>44</sup> My investigative powers in respect of an ILP also extend to all the affairs of the ILP and to all of its documents, provided the investigation relates to the provision of legal services.<sup>45</sup>

In respect of conducting reviews, either my Office, or the Law Society may conduct a review of an ILP's compliance (and that of its officers and employees) with the requirements of the Act. However, in practice, it is generally agreed that my Office will be the primary body conducting such reviews.

Once the review has been concluded, my Office must prepare a report which is provided to the ILP, and a copy of which may also be provided by my Office to the Law Society or by the Law Society to my Office (as the case may be).<sup>46</sup>

It is important to note that the Regulations also extend my powers of investigation and review in so far as they relate to ILPs. In this regard, by virtue of the Regulations, I have been granted specific powers to examine persons,<sup>47</sup> inspect books<sup>48</sup> and hold hearings<sup>49</sup> on the same terms as those powers have been conferred on the ASIC under the ASIC Act 2001. In respect of potential breaches of the Corporations Act by an ILP, both the Law Society and my Office are permitted to disclose their concerns and provide information concerning the ILP to the ASIC,<sup>50</sup> so that the ASIC may pursue its own investigations.

In practice, my Office has assumed the role of reviewing ILPs for compliance with the Act and Regulations. The test for compliance is found in s47E(3)(a) of the Act which stipulates that it is professional misconduct if a solicitor director does not ensure that "appropriate management systems" are implemented and maintained by the ILP to ensure that legal services are provided by solicitors in accordance with the Act.

As previously stated, the Act does not define "appropriate management systems." Accordingly, my Office worked collaboratively with the Law Society, the NSW College of Law and "LawCover" (the professional indemnity insurance body) ("the organisations") to determine the objectives to be met to help ascertain whether an ILP has "appropriate management systems" in place. The approach formulated is an "education towards compliance" strategy in which ILP's must show

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44. Section 47O(1).

45. Section 47O(2).

46. Section 47P(4).

47. Regulation 33.

48. Regulation 34.

49. Regulation 35.

50. Section 47Q(1) (NSW).

that they have procedures in place which evidence compliance with what my Office considers to be the ten objectives of a sound legal practice.

The ten objectives or “ten commandments” as they have become known, are as follows:

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 or acting against previous clients as well as potential conflicts which may arise in relationships with debt collectors and mercantile agencies or conducting another business, referral fees and commissions etc.
7. Records Management (minimising 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 LPA in relation to trust accounts.<sup>51</sup>

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51. The object of section 61 of the LPA is to ensure a solicitor's obligations in relation to monies held on behalf of a client—be it trust moneys, controlled moneys or monies held in transit are adhered to.

To enable solicitor directors to assess their management systems, a standard “self assessment” document was developed and is sent to all solicitor directors as part of the impending ILP review programme. It is acknowledged that as ILPs vary in terms of size, work practices and nature of operations, no “one size fits all” in terms of meeting uniform criteria in order to meet the objectives.

Instead, the self-assessment document contains concepts to consider when addressing each of the ten objectives and then examples of what an ILP *may* do to evidence compliance with each of the objectives. For example, under the objective of maintaining “competent work practises to avoid negligence,” a concept to consider is that, “fee earners practise only in areas where they have appropriate competence and expertise.” The self-assessment document then suggests that an example of a procedure that will evidence compliance is that there is “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.” The self-assessment document also contains a column within which the solicitor director can rate the ILP’s compliance with each of the ten objectives as either “Compliant,” “Non-Compliant” or “Partially Compliant.”

My Office has now commenced our review of ILPs. The procedures adopted for such reviews commence with the self-assessment document being forwarded to a solicitor director for their consideration and for completion of the ten self-assessment ratings. For an ILP which rates itself as “Non-Compliant” or “Partially-Compliant,” one of the officers will contact the solicitor director and notify him/her that an on-site, one day review of the legal practice will soon be conducted.

At the initial review, the solicitor director is interviewed by reference to the self-assessment document and a list of standard questions as developed by my Office. The questions are designed to draw a solicitor director’s attention to the sorts of procedures and record keeping which will need to be implemented and maintained (if they are not already) to help evidence compliance with the objectives. After the initial solicitor director interview, the ILP’s client files and accounting procedures are reviewed by the review staff to determine the extent of the ILP’s compliance with the ten objectives. Short interviews may also be conducted with other employed solicitors and staff members to ascertain the level of actual compliance by staff with the ILPs management systems as part of their daily activities.

After the initial review, my staff may contact the solicitor director or visit the ILPs premises again to obtain any additional information that may be required. A draft review report will then be prepared for the ILP in respect of its management systems. The solicitor director is sent a

copy of the report for comment, and also guidelines and other information to assist the practice in formulating or adopting good management practices. My Office will then finalize the review report and a copy of the final report forwarded to the Law Society.

The ILP will have been granted a three to six month "compliance period," which will have commenced on the date the original self-assessment document was forwarded to the solicitor director. During the compliance period the ILP will have the opportunity to ensure that any areas of its management systems that are rated less than "Compliant," as per the self-assessment document, become compliant. The draft and final review reports will also help the solicitor-director to address the areas of concern set out in the reports.

At the end of the compliance period, a follow-up review is held. The purpose of the follow-up review is to verify that appropriate management systems have been put in place to address the objectives set out in the self-assessment document that were rated less than "Compliant" and to ensure that staff are routinely complying with these management systems.

If a solicitor director breaches his/her obligation to implement and maintain "appropriate management systems," proceedings will be taken by my Office to prosecute the solicitor director for professional misconduct under section 47E(3)(a) of the Act in the Administrative Decisions Tribunal. In such circumstances the solicitor director's practicing certificate may be suspended or even cancelled.

Finally, pursuant to section 47P(1) of the Act my Office is empowered to conduct on-going reviews of the compliance of an ILP with its management systems. Accordingly, it is important that once an ILP's management systems are compliant, such systems are adhered to by all the ILP's staff on a daily basis.

## VII. Conclusion

NSW was among the first jurisdictions in the common law world to allow for the establishment of multi-disciplinary practices. To my knowledge, NSW is the only such jurisdiction that allows for the incorporation of legal practices including multi-disciplinary practices.

This paper attempts to give a background of the establishment of ILPs in NSW, and in so doing briefly explores the pros and cons of such practices. It has become extremely clear to me that, notwithstanding the perceived taxation, financial and structural benefits of incorporating legal practices, the primary benefit of such practices is improved management practices. Unfortunately, improved management practices are rarely mentioned as a rationale for legal practices considering incorporation.

The regulatory powers and responsibilities vested in my Office by the Act have focused on ensuring ILPs adopt and maintain “appropriate management systems.” Such approach sits well within my philosophy of regulation at the OLSC in which I strongly believe that a regulator has three prime functions:

1. To ensure compliance with the relevant laws, rules and regulations;
2. To consistently question those laws, rules and regulations both for relevance, and in assessing their impact upon both the profession and the community at large; and
3. To educate the profession and consumers of legal services with the goal of creating a culture within the profession whereby compliance itself becomes cultural. Once such culture is achieved, I anticipate that there will be a reduction in the number of complaints received by my Office.

While the amendments to the LPA allowing for the incorporation of legal practices are still relatively new it must be stated that “the sky has not fallen.” There have been few complaints against ILPs, and certainly to no greater extent than the complaints received against traditional partnerships.

Also new is our approach at reviewing ILPs to ensure such practices have appropriate management systems to render them compliant with the Act, the Rules and the Regulations. Interestingly, a 2002 “Review of the Legal Profession Act” by the NSW Attorney-General’s Department (“Attorney General Department’s Report”)<sup>52</sup> recommended that the powers vested in my Office in relation to the review and investigation of ILPs should be extended to all legal practices in NSW. Accordingly, the success of our regulatory approach to ILPs is likely to be crucial to any determination to expand the role of the OLSC, as suggested by the Attorney General’s Department Report.

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52. NSW Attorney General’s Department, “*Legal Profession Act 1987: A Further Review of Complaints against Lawyers*” November 2002, at p.7.