What Clementi forgot to mention

The government's post-Clementi commitment to encourage outside providers into the legal services market will be difficult to regulate says **Roderick Ramage**

- the Company Law Reform Bill 2006
- *Hutton v West Cork Railway Co, Dodge v Ford Motor Co*

Sir David Clementi's recommendations to liberalise the legal service services market included the creation of alternative business models. These enable the ownership of law firms to be split from their management, so that a law firm could have outside equity investors or an existing business, such as Tesco, the RAC and the Co-op, could provide legal services to the public. The government accepted most of Sir David's proposals in its white paper, *The Future of Legal Services: Putting Customers First*, and a Legal Services Bill is expected shortly.

Law and morals are uneasy bedfellows. A corporation is a legal person but the concept of a moral or an immoral corporation is an oxymoron. A corporation is an artificial person with such powers as are given to it by statute or its constitution, its memorandum and articles of association in the case of companies incorporated under the Companies Acts 1985 or earlier. One should not fall into the trap of assuming that a company has human attributes because it operates through the agency of human beings, or because of the fact that it is a person, or even the fact that it may have rights under the Human Rights Act 1998 (see *Marpa Zeeland BV v Netherlands* (App No 46300/99) (ECtHR), *Ashworth Hospital Authority v MGN Ltd* [2002] UKHL 29, [2002] 4 All ER 193, and *Cream Holdings Ltd v Banerjee* [2004] UKHL 44, [2004] 4 All ER 617).

In this article I use the word "corporations" to mean commercial (for profit) companies, some or all of whose shareholders are not its directors or managers (ie with outside investors) and "individuals" to mean not only natural persons but also partnerships of natural persons and companies in which all the shareholders are also directors or managers (ie with no outside investors). The distinction is important in the context of trust and morality, etc.

Individuals are capable of being greedy, dishonest and generally nasty and they can also be generous, conscientious and generally want to do the "right thing". That is human nature. The conduct of individuals is governed by influences including the law, economics and morality. For some individuals money is the only purpose of work and for others it is what they hope to get if they do the work right (about whom Sir David Clementi is mildly sceptical, see his report, Ch F, para 55) and for these, there are other motivations to govern how and why work is done.

In contrast corporations have only one function, which is to make profit, and if they have to lie, cheat, steal or kill to make money, they will do so. Although tobacco companies have no intention of killing anyone, it is beyond medical doubt that their activities do kill, ie shorten the lives of , their customers. This is not a wild anti-globalisation accusation, but a statement of a long-established, basic principle of company law. Corporations may obey the law, or even do the right thing, but not on moral grounds. Someone will have worked out whether it is more profitable to obey the law or to flout it and pay the fine.

The company law duty

The company law duty of a corporation's directors is to look after the interests of the shareholders, which means the maximisation of profits, whether income or capital. Directors who pursue any other aim, with the minor exception for employees in the Companies Act 1985, s 729 are in breach of their legal duties. The two most commonly cited authorities for this are the English case of *Hutton v West Cork Railway* (1883) 23 ChD 654 and the US case of *Dodge v Ford Motor Co,* 204 Mich 459, 170 NW, 668 (1919):

- In *Hutton v West Cork Railway Co,* the West Cork Railway Company was to be wound up, having transferred its business to another company, and, between the transfer and the winding up, resolved at a general meeting to pay one thousand guineas as compensation for loss of office to certain employees, although they had no legal claim for it. The resolution was invalid, as the company was no longer a going concern and existed only for the purpose of winding-up. In his infamous "cakes and ale" judgment, the judge also stated that:

"The company might lawfully expend a week's wages as gratuities for their servants; because that sort of liberal dealing with servants eases the friction between masters and servants, and is, in the end, a benefit to the company. It is not charity sitting at the board of directors, because as it seems to me charity has no business to sit at boards of directors qua charity."

■ In *Dodge v Ford Motor Co* Henry Ford and the directors of the Ford Motor Co decided not to pay a dividend despite substantial retained earnings in the company and substantial profits in the particular year in question. The reason for the decision expressed by Henry Ford was that the money was be used for plant expansion so that the Ford industrial system could be expanded for the general benefit of society. That may have been a very noble reason but that reason was not directed at the profit of the company and thus it was not a basis for refusing to pay a dividend. A refusal to pay a dividend had to be based on the best interests of the corporation and decisions that are in the best interests of the corporation were assumed to be those that promoted future profits. (Copied with thanks from the Notes on Business Associations, Ch 27 by Professor Mark Gillen of the University of Victoria, faculty of law.)

Company Law Reform Bill

If the Company Law Reform Bill is enacted—Royal Assent is said to be expected in the Autumn 2006—directors' general duties will be codified. Clause 156(1) says:

"A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefits of the shareholders as a whole."

This wording is broad, but in the case of a "normal" commercial company, whose members are investors for the purpose of profit, it will not change the duty to maximise profits.

Sir David Clementi's proposals

I am sure that there is no doubt that a corporation can and will work to the highest professional standards if it pays to do so, but I am not sure how far I would rely on Sir David Clementi's illustration (Ch F, para 22) of a corporation's commercial interest in doing so:

"Unlike most high street solicitors, companies such as these have nationally known brand names to protect, which may be a powerful incentive to operate in a proper manner."

In Ch F, para 41 Sir David Clementi cites the following point made by the Bar Council.

"…the conflict that would inevitably arise between the commercial interests of the owners and the ethical duties on which the practice of law is based. An owner of a law firm who was not a lawyer and therefore not subject to those duties would be perfectly entitled to pursue his own financial interests, even in circumstances where those conflicted with the best interests of clients of the firm or with other core values of the legal profession."

He dismisses it in para 42 with these words: "It is not clear, however, that the Bar Council's argument is correct." However, in dismissing the argument, he does not address the underlying company law, but merely lists the key points of his proposed regulatory framework.

Thus, we are left with a proposal in which conflicts of duty for professional staff are structurally built into a new model for professional practice with outside investors, so one must rely on regulation alone to ensure that corporate providers of law services behave in a "proper manner".

Regulatory dangers

When you regulate individuals, eg to maintain professional standards, you are half-way there, because most of us want, more or less, to do the right thing but need guidance, and a few need to be stopped in their tracks. Regulating corporations is different. No matter how "good" an individual working for a corporation might be, the corporation itself knows nothing of good or bad or of public interest. Its directors' duties are not to do what is right, unless it happens to be in the corporation's, ie its shareholders', interests.

A regulator of professional individuals has only to deal with the bad apples and give guidance to the rest of us. However, a regulator of a profession of corporations must deal with bodies, which are driven solely by their non-professional shareholders' demand to maximise profits, and so must set procedures on the assumption that there is no intrinsic willingness to follow guidelines.

The consequently increased reliance on regulation alone carries two dangers; one being over-regulation and the other being that high grade crooks are smarter than regulators.

If we are to have outside shareholders, we will also need a corporate structure, which, while not losing the profit motive, draws back from the excesses to which we are inevitably driven by *Hutton v West Cork Railway Co and Dodge v Ford Motor Co*. The Company Law Reform Bill offers a possible answer to this in cl 156(2), which says:

> *"Corporations may obey the law, or even do the right thing, but not on moral grounds"*

"Where or to the extent that the purposes of the company consist of or include purposes other than the benefit of its members, his duty is to act in the way he considers, in good faith, would be most likely to achieve those purposes."

This would enable a regulator to require that a legal disciplinary practice with non-lawyer investors and managers is incorporated with the purpose of (say) practicing law to the highest professional standards. If that would put too great a restriction on outside investors, one must assume that, where there is a conflict of interest, commercial pressure will be bound to outweigh professional standards.

It is a sad that in this debate we lawyers seem—with the exception of the Bar Council—to have by and large ignored a bit of law that we ought to know better. By all means let Tesco *et al* provide legal services, but not, please, as solicitors.

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