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The European Single Market and the Regulation of the Legal Profession: An Economic Analysis

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The article analyses the effect of removing barriers between two autarkic legal markets with different technologies. Firms using the more efficient technology penetrate the other market. The result is mergers between firms from the efficient jurisdictions and those in the inefficient jurisdictions. Social welfare increases from reduced resource costs in the production of legal services even if prices remain regulated. This leads to pressure for prices for legal services to be reduced. Recent trends in the penetration of EU legal markets by English solicitors firms are discussed, particularly recent mergers involving English and German law firms. Implications for future market regulation are drawn. Copyright © 2002 John Wiley & Sons, Ltd.

INTRODUCTION

The market for legal services has been regulated in most European economies. Indeed, in many cases regulation has taken the form of self-regulation by the profession itself (Faure *et al.*, 1993; Van den Bergh, 1999; OECD, 2000). Scholars have frequently criticized such regulation as operating in the interests of existing members of the profession rather than society in general or the consumers of legal services in particular (see the literature reviewed in Stephen and Love, 2000, and Van den Bergh, 1999). It has been argued that to the extent that there is a limited public interest case for regulation it might be better achieved through certification (Van den Bergh, 1999) or through competition between self-regulatory bodies (Ogus, 1993, 1995). In recent years, public policy in a number of jurisdictions has taken an increasingly sceptical view of regulated markets. Efforts at

deregulation have extended as far as the professions in general and the legal profession in particular (see, for e.g. Paterson *et al.*, 1988; Stephen, 1994; Stephen *et al.*, 1994; Van den Bergh, 1999; OECD, 2000). The purpose of this paper is to analyse the likely impact on nationally regulated legal service markets of increased international mobility of law firms.

In the first section an overview is provided of the extent to which legal service markets in the EU are regulated. The following section analyses the implications of the greater law firm mobility encouraged by the EU's Establishment Directive by developing an economic model of transnational law firm merger. It concludes that differences in efficiency of law firms arising from differences in competitive pressure across jurisdictions are likely to lead to cross-border mergers involving law firms from 'efficient' and 'inefficient' jurisdictions. Such mergers are likely to lead to pressure building up in the more regulated jurisdictions for further liberalisation of legal service markets. This is followed by a section which considers the evidence on recent cross-border mergers of law firms in Europe.

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REGULATION OF LEGAL SERVICE MARKETS IN THE EU

Stephen and Love (2000) examine a number of instruments typically used by self-regulators of the legal profession: (i) restrictions on entry; (ii) restrictions on advertising and other means of promoting a competitive process within the profession; (iii) restrictions on fee competition; and (iv) restrictions on organizational form. It is often argued that these operate against the public interest. A separate although connected literature has developed on restrictions on the nature of fee contracts between lawyers and clients. This particularly focuses on contingent fee contracts. These instruments of control have been widely operated in the major EU jurisdictions.¹

Entry to the Legal Services Market

In most EU jurisdictions licensing and registration rules regulate entry to the legal professions, protect professional titles associated with the legal professions and representation before the courts. The extent of such restrictions varies between jurisdictions. For example, in Finland and Sweden there is no restriction on who can provide legal advice or represent others before the courts. On the other hand in Germany and France there are restrictions on who may proffer legal advice. In most jurisdiction the right to represent others before the courts is restricted to members of designated professions.

In all EU jurisdictions designated titles are restricted to members of professional bodies. Successful completion of a specified period of study of the law at university together with the passing of one or more professional examination and a period of training under an experienced member of the profession is usually required to obtain the right to practice under such titles. Even in Finland and Sweden a degree and membership of the Bar Association is required to use the title *Advokat*. Only a university degree is required in Spain to practice as an *abogado*, although most graduates spend sometime working in the office of an *abogado* before practising in their own right.

Rights of audience before courts have historically been restricted to members of specified legal professions and in some cases to members of local (sub-national) bars. Such intra-national restrictions have been lifted recently, e.g. from 1999 the

German restriction limiting lawyers to practice in a single district has been removed. Similarly, until July 2000 a Spanish *abogado* was required to register with (and pay a fee to) the local bar association in each local jurisdiction before whose courts an appearance was sought. Since July 2000 registration with one local bar association gives rights of audience before all local courts.² Rights of audience before the lower courts in the British jurisdictions have been liberalised in recent years although it is restricted to members of recognised bodies. As far as the higher courts are concerned rights are restricted to *advocates* in Scotland and *barristers* in England and Wales together with *solicitor-advocates* who are solicitors who have satisfied an advocacy test. The solicitors' monopoly over conveyancing has been relaxed but is still restricted to those who are solicitors or qualified licensed conveyancers.

Almost all self-regulatory bodies covering the legal professions in the EU have codes of ethics and conduct, breach of which can lead to removal of the right to practice. The exceptions are in Finland and Sweden where it is only the title that is protected since there are no restrictions on the right to offer legal advice or represent others in court. In most jurisdictions after obtaining a degree in law a period of professional training and further examination is required for entry to the professional body. In Germany this is a state-administered examination while in other jurisdictions it may be administered by educational institutions or the professional body itself. Requirements for periods of training under the supervision of a practicing member of the profession may represent the most effective way for members of the profession to regulate the entry of new members.

Advertising

The traditional restriction on advertising by members of the legal profession has been relaxed in a number of jurisdictions in recent years. Historically, advertising was prohibited in Germany but current regulation permits informative advertising. Spanish *procuradores*, Scottish *advocates* and *barristers* in Northern Ireland are not permitted to advertise. In many legal professions advertising is permitted subject to minimal restrictions on the nature of their advertising. Spanish *abogados* have been permitted to advertise since

1999 but it is not yet widespread. Whilst Irish *solicitors* and German *rechtsanwalt* are permitted to advertise they are not allowed to advertise their fees.

Competition on Fees

Fees for both main branches of the legal profession in Scotland and England & Wales are determined in the market as are those for advocates and barristers. In Spain the local bar produces scale fees based on the value of the transaction but it would appear that the method of determining the fee is a matter of negotiation between the parties according to the Spanish Supreme Court (RJ 1999/9332). The State lays down the minimum fees to be charged by German *rechtsanwalt* on the basis of the value of the transaction. Speculative fees (i.e. foregoing of fee if action is lost) are prohibited in Germany and Belgium and for *barristers* in Northern Ireland.

Restrictions on Organisational Form

Multidisciplinary practice is now permitted in France, Spain, Italy and Germany. As a consequence the large international accountancy firms have made significant headway in the legal markets of France and Spain. However, in Italy these practices cannot carry the name of the accounting firm since accountants are prohibited from practising law. In Britain solicitors, advocates and barristers are not permitted to practice with other professionals. Solicitors are able to practice in incorporated practices only where all shareholders are solicitors. Various legal forms are open to *abogados* in Spain and *avocats* in France. Traditionally in Italy *avvocato* have operated in 'firms' sharing expenses rather than profits but the partnership form is well established now.

This brief survey of the main legal professions in EU member states suggests that representation in the courts remains restricted in most cases to members of certain professional bodies. On the other hand advice and legal consulting appear to be much freer markets with fees subject to regulation only in Germany and in a few other jurisdictions where the bar can only make recommendations on appropriate fees. In many cases the deregulation is of relatively recent vintage.

The foregoing suggests that the jurisdictions where legal services markets are most close to the

competitive ideal are likely to be Finland and Sweden possibly followed by Scotland and England & Wales. At the other extreme Germany still has regulated fees and competitive weapons such as advertising have only recently been permitted in Spain.

Economists and law-and-economics scholars have been sceptical of the social benefits of professional self-regulation. Many have argued that it is tantamount to legalising a cartel. Some such as Klein and Leffler (1981) have argued that the market can be left to protect the consumer. Van den Bergh (1999) suggests that a minimum reform would be to bring professional regulation under the control of the state. He also concludes that there are many ways to cope with existing market failures in professional markets. Ogus (1995) proposes that competition between self-regulatory bodies would allow consumers to choose their desired mix of regulation, quality and cost. Ogus (implicitly) is discussing inter professional competition within a single jurisdiction.

The EU has more than 15 regulatory regimes for suppliers in the legal market but its commitment to a single European market effectively gives the right to practice in any jurisdiction within the EU to a professional qualified to practice in her/his home jurisdiction. The Council of Ministers has adopted two Directives giving effect to the latter provision. Council Directive 77/249/EEC (Services Directive) provides for the pursuit of professional activities on a temporary basis and Council Directive 98/5/EC (Establishment Directive) facilitates the permanent practice in a jurisdiction within the EU other than the jurisdiction of qualification. The next section of this paper considers whether the adoption of the Establishment Directive could lead to the sort of inter-profession competition suggested by Ogus.

IMPLICATIONS OF THE INTERNATIONAL MOBILITY OF LAW FIRMS FOR COMPETITION IN LEGAL SERVICE MARKETS

The Establishment Directive³ (Council Directive 98/5/EC) is designed to facilitate the permanent practice in one (or more) member states (host state) of professionals qualified to practice in

another member state (home state). Once the Directive is adopted into the host state's law those qualified in their home state to practise law are entitled to give advice and practise professionally in the law of the host state, EU law or home state law in the host state without any requirement to re-qualify in the host state. However such a migrant lawyer must use his home state designation, untranslated. If the host state reserves representation in legal proceedings to a nominated profession it may require the migrant lawyer to be accompanied by a member of that nominated profession in court.⁴ A migrant lawyer wishing to practice permanently in a host state is required to register with the relevant regulatory body in the host state. That body must register the migrant and inform the regulatory body in the home state. The professional rules of the host state will apply to the migrant lawyer even when these are in conflict with the home state rules.

The Mutual Recognition Directive (Council Directive 89/48/EEC) provided for those qualified in their home state to qualify in the host state by means of examination or test. The Establishment Directive goes one stage further by requiring the host state to grant membership of the host state profession to a migrant lawyer who has 'effectively and regularly' practiced the law of the host state for at least 3 years. No requalifying examination or test is required in these circumstances. Such a migrant lawyer would then be entitled to use both the home and host state designations. Migrant lawyers are permitted to practise from host state offices of their home state joint practice (firm) so long as joint practice is permitted in the host state.

The Establishment Directive can be seen as clearly establishing the right of law firms to set up branches in any member state where such law firms are permitted. Furthermore, such firms can be staffed by host-state qualified lawyers and/or migrant lawyers. Thus law firm mobility is clearly entrenched. A feature of this mobility is that it is of firms from different legal cultures and regulatory regimes. However, this is not quite the same as Ogus's inter-professional competition. The migrant lawyers are subject to the rules and ethics of the host state. On the face of it this entrenches the position of the profession in the host state. However, it significantly changes the conditions of entry to legal service markets in Europe. Any power which the host state profession has to limit entry to the profession loses force in the long run.

A monopolistic profession restricting entry (in order to increase its members' incomes) would make it attractive for professionals from other member states to enter its market. Furthermore, citizens of a member state refused entry to the profession could qualify in another member state and thereafter practise in the restrictive state. Clearly there are costs involved in the latter approach but if the gains from practicing in the restrictive member state are high enough these costs will be compensated. Any practice rules designed to restrict competition between lawyers in one jurisdiction and raise the level of fees above competitive levels make it attractive for lawyers from other member states where fees are not so high to enter the market in the inefficient jurisdiction.

From an economic perspective the more inefficient are arrangements of the profession in one state the greater, *ceteris paribus*, the incentive for law firms from other states to move into the inefficient state. The Establishment Directive lowers considerably the barriers to entry to legal markets in the EU. Below, it is argued that the existence of one relatively efficient jurisdiction in the EU combined with the freedom of movement implied by the Establishment Directive can result in increased efficiency and social welfare in an inefficient jurisdiction even if the practice rules and fees in the inefficient jurisdiction remain unchanged.

Consider two isolated jurisdictions, A and B.

Jurisdiction A: The market for legal services is highly regulated. There is no price competition, fees are not determined by a competitive process but fixed exogenously by a regulatory body and related to the value of the underlying transaction. Advertising by suppliers of these services is not permitted. Entry to the profession is restricted by entrance exams administered by the profession itself in such a way as to ensure there is excess demand for legal services (even at the high regulated prices). Only members of jurisdiction A's legal profession are permitted to supply legal services in jurisdiction A. It is to be expected that the legal firms in this jurisdiction will be inefficient since there is no incentive to innovate. Thus they will have high costs, which will be supported by the high, regulated, prices.

Jurisdiction B: The market is relatively competitive. There is price competition, advertising is permitted and whilst entry to the profession requires the passing of an examination this is not

controlled by the profession but by an independent body. However, only professionals who qualify in jurisdiction B are permitted to supply legal services. This competitive environment has led to firms innovating in terms of the nature and quality of the service they provide in the search to make profits. Competition, of course, leads to price falling in these circumstances. Thus, although firms are efficient in their operation, no economic profits are made in the long run.

Under such circumstances it is to be expected that, *ceteris paribus*, the price of a given legal service will be higher in jurisdiction A as compared to that in jurisdiction B. Furthermore, the cost of providing a given service in jurisdiction A is likely to be higher than that in jurisdiction B. This cost difference is likely to be due not only to the greater scope for X-inefficiency in firms in jurisdiction A but to the greater likelihood of technological innovation in jurisdiction B. Thus, in the long run, the technology by which a particular service is delivered will differ between the two jurisdictions. The technology here does not take the form of physical plant and machinery but the process by which the human capital of members of the law firm is transformed into services for clients.

What happens if entry restrictions in the two jurisdictions are relaxed? In other words, those qualified in jurisdiction A are allowed to supply legal services in jurisdiction B and *vice versa*. Given the higher prices in jurisdiction A and the more efficient technology used by firms in jurisdiction B it would seem likely that, *ceteris paribus*, firms from jurisdiction B would wish to supply consumers of legal services in jurisdiction A. At current jurisdiction A prices, they would earn super-normal profits. On the other hand firms from jurisdiction A would not be able to compete in the market for legal services in jurisdiction B at current prices in that jurisdiction because of their high costs. It is assumed that jurisdiction B firm's entering jurisdiction A are subject to jurisdiction A rules of professional conduct.

Thus far the desire of firms from jurisdiction B to penetrate the market for legal services in jurisdiction A has been identified. However, there remains the question of how these firms can satisfy this desire. In principle, there are a number of ways in which firms may penetrate a foreign market: (i) *exporting* from their home country; (ii) setting up a production facility in the foreign market (*foreign direct investment*); (iii) *licensing* a

firm in the foreign market to produce and sell their product or service there; (iv) setting up a *joint venture* with a firm in the foreign market. The literature on multi-national enterprise (MNE) suggests that the choice will be based on the nature of the advantage which the home firm has over firms in the foreign market (Buckley and Casson, 1976; Teece, 1986). For example, if the advantage is one of economies of scale in production, exporting will be the preferred mode, if it is proprietary technology it will be FDI, if it is brand name it will be licensing, etc. It will also depend on the characteristics of the product or service involved.

Being a service which, to a certain degree, involves face to face contact between lawyer and client, it seems unlikely that legal services will be provided by simple exporting. Furthermore, if legal services are to be provided to clients in jurisdiction A under jurisdiction A law it seems likely that lawyers in jurisdiction A will have an informational advantage over lawyers from jurisdiction B. These factors suggest that direct exporting is unlikely to be the preferred mode of penetrating jurisdiction A by firms from jurisdiction B.

What then is the firm advantage which firms from jurisdiction B have over firms from jurisdiction A? As outlined earlier the advantage which jurisdiction B firms have (*ex hypothesi*) is that they use a more efficient technology. Jurisdiction B firms have been forced by the competitive process to develop new cost effective means of delivering legal services. A major thrust of the economic explanation of multinational enterprise is based, similarly, on the tacit knowledge of firm routines and practices. It cannot simply be handed over to an outsider in the form, for example, of a superior machine or even a manual of procedures. There may also be a significant component of firm specific knowledge involved. Furthermore, to the extent that this knowledge could be transferred it could be used by jurisdiction A firms to enter the market in jurisdiction B. All of this suggests that licensing of a jurisdiction A firm by a jurisdiction B firm is not a desirable way for a jurisdiction B firm to penetrate the market of jurisdiction A.

Of the possible modes of penetration mentioned above this leaves Foreign Direct Investment (FDI) and joint ventures between jurisdiction A and jurisdiction B firms. FDI here implies the opening up of an office in jurisdiction A by a jurisdiction B firm in order to exploit its technological

advantage. If this were to be done it is likely that the jurisdiction B firm would be unable to exploit its technological advantage for two reasons. First, at least to begin with, it has no lawyers trained in the law of jurisdiction A. It could, of course, recruit some local lawyers who would then have to undergo firm specific training to acquire a knowledge of the firm's more efficient technology. This could be done prior to opening an office in jurisdiction A by training the recruits in a jurisdiction B office. This would be a form of investment: expenditure on training now in anticipation of increased revenue in the future. However this would be a risky investment since an opportunistic lawyer from jurisdiction A could acquire the firm specific knowledge and then return to jurisdiction A to set up his/her own firm. Thus this approach is problematic.

A second factor inhibiting entry to jurisdiction A by FDI is the fact that the jurisdiction B firm has no reputation in jurisdiction A. Consequently it has no client base. FDI would require an investment in building this client base. This would be relatively risky. The lack of reputation might also make it difficult for the firm to recruit lawyers qualified in jurisdiction A. The foregoing suggests that straightforward FDI by a jurisdiction B firm in jurisdiction A is unlikely to arise from the circumstances hypothesised here.

FDI, however, might be the mode of entry of a jurisdiction B firm entering jurisdiction A to service commercial organizations in jurisdiction A who are carrying out transactions under the law of jurisdiction B. These might be the jurisdiction A subsidiaries of commercial organisations from jurisdiction B. The jurisdiction B law firm would have an informational advantage over jurisdiction A firms in knowledge of jurisdiction B law and may also have a reputational advantage with the commercial organisations whose origins are in jurisdiction B. Thus FDI would be appropriate. Where the commercial organisation is a strictly jurisdiction A organization wishing (or required by those with whom it is transacting) to use jurisdiction B law a jurisdiction B firm has an advantage over jurisdiction A firms because of its knowledge of jurisdiction B law. If this outweighs any reputational disadvantage with respect to jurisdiction A firms then again FDI would be appropriate. If not, then commercial firms in jurisdiction A might prefer to deal with jurisdiction B firms via jurisdiction A firms whom they trust to select an

appropriate jurisdiction B firm.⁵ However, FDI seems an unlikely way for jurisdiction B firms to enter jurisdiction A to practice jurisdiction A law.

What about a joint venture in jurisdiction A between a jurisdiction B firm and a jurisdiction A firm? Here each party brings something to the table: the jurisdiction B firm brings its more efficient technology while the jurisdiction A firm brings its knowledge of jurisdiction A law and its reputation within that jurisdiction. A joint venture such as this presumably involves the setting up of an independent joint venture firm in jurisdiction A staffed by lawyers from the jurisdiction A and jurisdiction B firms. Such a joint venture would, at least to begin with, have fixed life. There are at least two problems with this approach. First, at the end of the joint venture contract each firm has the option of walking away from the joint venture having acquired knowledge from the other party which now equips it to go it alone in jurisdiction A. Such potential opportunistic behaviour has the consequence of increasing the number of firms in jurisdiction A competing for a fixed amount of business (since it is assumed that the price of legal services in jurisdiction A is administratively determined as opposed to market determined).

A second drawback of the joint venture approach is that it implies that the jurisdiction A firm continues to operate in jurisdiction A independently of the joint venture. Again this implies the number of firms competing for the fixed amount of business has increased but also the jurisdiction B firm is more exposed to opportunistic behaviour by lawyers from the jurisdiction A firm (inside and outside of the joint venture).

The most credible mode of entry into jurisdiction A to practice jurisdiction A law for the jurisdiction B firm is to merge with a jurisdiction A firm. The merger makes collaboration credible since the partners in both merging firms suffer a loss if the merged firm fails. The jurisdiction A firm is in effect trading its knowledge of jurisdiction A law and its reputation within jurisdiction A for access to the jurisdiction B firm's technology and vice versa. However, the merger greatly reduces the threat of opportunism on the part of either party. A merger such as this would take place so long as the profits accruing to the members of each of the two firms rose after the merger.

Would such a merger be desirable from social point of view? As discussed so far nothing changes

in jurisdiction B. In jurisdiction A, a successful merger will imply that the costs of the firm in jurisdiction A will fall but prices and presumably output will remain the same unless there is a change in the regulatory regime. Note also that because all firms operating in jurisdiction A are subject to the practice rules of the professional body of jurisdiction A the quality of output produced by the merged firm will be the same as that produced by jurisdiction A firms in autarky.⁶ Even without any change in prices then, welfare in jurisdiction A rises because of more efficient use of resources through the adoption of the superior technology. This is illustrated in Figure 1. Let DD' be the share of market demand faced by the jurisdiction A firm. The fee for the service (P) is fixed by the regulatory body. This means that demand for the firm's services is given by Q . The jurisdiction A firm faces a horizontal average cost curve at C . Thus the firm's profits are given by the rectangle $PEFC$ and consumer surplus is given by DEP . When the firm merges with a jurisdiction B firm and adopts the latter's technology its average cost falls to the level AC' and its profits increase by the amount $CFHG$. Consumers' surplus remains the same as before the merger. Thus the merger increases social welfare by the amount $CFHG$. Thus social welfare has increased even although prices and output do not change in jurisdiction A.

Note that with the adoption of the new technology Q is no longer the profit maximising output in jurisdiction A for the merged firm. Its profits would be maximised at output Q' and price P' . This price is below the regulated price in jurisdiction A. A reduction in price to P' would increase the firm's profits by the amount $(LJKH - PELP')$. This suggests that the merged firm will see it as desirable for the regulated fee to

be reduced to P' . Consumers' Surplus would rise by the amount $PELP' + ELJ$, the first part being a transfer from producer surplus. Thus the net increase in welfare will be $ELJ + LJKH$ i.e. $EJKH$. The more firms from jurisdiction A which merge with firms from jurisdiction B, the greater will be the pressure to reduce the regulated fee and liberalise the market.

To the extent that non-merged firms in jurisdiction A are able to resist⁷ a move to reduce fees in jurisdiction A, merged firms may use some of their increased profits to engage in non-price competition in the hope of shifting out their demand curve. However, resources so used would reduce welfare in that they represent a form of rent seeking i.e. they are being used to bring about a redistribution of demand between firms.

The foregoing suggests that where there are differences in technical efficiency (or X-efficiency) between jurisdictions the right to establish by professionals from one jurisdiction in another jurisdiction may lead to the diffusion of the more efficient technology to the less efficient jurisdiction through the merger of firms across the jurisdictions. Such a process would lead to an unambiguous increase in social welfare even when prices remain unchanged. The greater such diffusion the more likely it will be for pressure to build up for a liberalisation of fees (and practices) in the less efficient jurisdiction.

The relatively abstract discussion has glossed over a number of factors which are crucial to this process of diffusion. Information conditions must be such that jurisdiction B firm's are aware of the profits being earned by jurisdiction A firms. Most importantly, the cost differential between firms in the two jurisdictions must be sufficient for transfer of the more efficient technology to generate sufficient increased profits for the members of both firms after allowing for the disruption costs of the merger.

Much the same analytical framework can be used (*Mutatis mutandis*) to analyse the impact of other exogenous changes in regulatory regimes across jurisdictions. Consider the case where jurisdiction A is as before a relatively heavily regulated legal jurisdiction and jurisdiction B is replaced by the regulatory regime governing the provision of auditing services and management consulting. If the latter is relatively unregulated it will be a more competitive market with innovation in service provision and more efficient

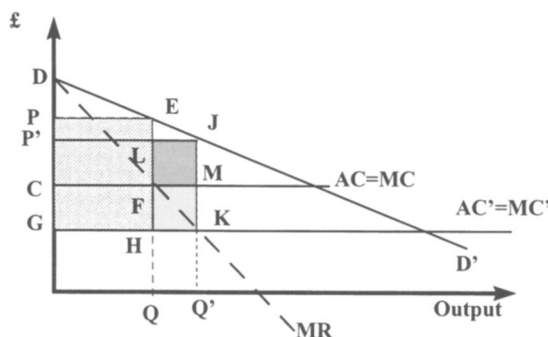


Figure 1.

organisational routines, etc. The exogenous change might be the removal of the prohibition in the legal jurisdiction on multi-disciplinary practice (MDPs). The preceding analysis would suggest an attempt by firms in the auditing/consultancy sector to move into the legal sector first through joint ventures or alliances but eventually through merger because of the higher rents being earned in the legal jurisdiction. The auditing/consulting firms would have a firm-specific advantage that could not be captured through 'exporting' to the legal services sector. There would be the same pressures as before by merged firms to loosen the regulatory framework because of their lower costs.⁸

EVIDENCE ON CROSS-BORDER MERGERS OF LAW FIRMS IN EUROPE

This section considers recent trends in EU legal services markets. The discussion here cannot be said to be a 'test' of the predictions made in the preceding section. However, it does show that the cross border mergers suggested by the theory can take place and might have the effects of the type suggested on regulatory regimes in member states.

The evidence summarized in 'Regulation of Legal Service Markets in the EU' section suggests that, at least until recently, Finland, Sweden and the United Kingdom (for solicitors) have been the least regulated jurisdictions within the EU. It also suggests that Germany, Italy and to some extent France and Spain have been relatively more regulated and, in the terms of the preceding section, potentially 'inefficient' jurisdictions. Is there any evidence of the cross border mergers of law firms suggested by the analysis of 'Implications of the International Mobility of Law Firms for Competition in Legal Service Markets' section?

There has been a growing tendency for English law firms to enter these other markets, often resulting in mergers with existing local firms. The *Legal 500* for the year 1999 lists the largest 20 law firms for each European jurisdiction. The tables for our 'relatively inefficient' jurisdictions (Germany, France, Spain, Italy) each show at least three or more English law firms in the 'top 20'. They often also include firms which are the local legal associate of an international accounting firm

or an MDP. It must be recognized that the penetration of these markets by English solicitors firms to some extent pre-dates the Establishment Directive. This may, to some extent, be due to the preference of parties in many international transactions to use English law.⁹ Thus, English firms will have set up offices on the mainland of Europe to service such transactions as well as represent UK firms doing business in European markets.¹⁰ Such law firms will have operated using the technology developed in their home jurisdiction but will have had very little influence on the technology used by local firms in the continental jurisdictions. They also recruited locally qualified and dual qualified lawyers. However, so long as their work involved English law and/or the interests of multinationals the leakage into the practices of local firms would be limited.

Consider the German legal market in more detail. In a ranking of law firms in Germany by number of fee earners published in 1997¹¹ the largest non-German firm (the English firm Clifford Chance) was ranked twelfth with just under one-third of the fee earners of the largest firm and half of the fourth largest firm. Allen and Overy were ranked eighteenth with less than 10% of the fee earners of the fifth largest firm. The American firm Cleary Gottlieb, Steen and Hamilton was ranked fifteenth with less than 8% of the fee earners of the largest firm. The accounting and consultancy firm Price Waterhouse was ranked 21 with just over 2% of the largest firm's fee earners. The German legal services market although penetrated by English, American and accounting firms was clearly dominated by domestic (German) firms.

The situation had changed dramatically by the time of the publication of *Legal 500* for 1999. By this time Clifford Chance had merged with Puender, Volhard, Weber & Axster to become the largest law practice in Germany (Clifford Chance Puender). In 1998 Oppendorf and Raedler (the largest German firm in 1997) joined Linklaters and Alliance a grouping of six European firms dominated by Linklaters, an English firm. It formally merged with Linklaters on 1 January 2001 and is known in Germany as Linklaters Oppendorf and Raedler. In 1999 the third largest German law firm was Bruckhaus Westrick Heller Loeber. On 1 August 2000 it merged with Freshfields Deringer (which had been 18th largest in 1999 and was itself a merger of English and German firms) to become Freshfields Bruckhaus

Deringer with a similar number of fee earners in Germany to Clifford Chance Puender¹² and more offices. The result is that at 1 January 2001 the three largest legal practices in Germany were mergers of German and English firms. The sixth largest German firm in the 1999 *Legal 500* was Lovells Boesbeck Droste, also a merger of German and English firms and the seventeenth largest was Baker and McKenzie/Doeser Armereller Noack the German arm of the international partnership Baker and McKenzie. The German legal arm of the Andersen accounting firm (Andersen Luther Rechtsanwaltsgesellschaft) was, by late 2001, the fifth largest German legal practice.

Towards the end of 2001 only three of the 10 largest legal practices in Germany were traditional German law firms (Wessing, Hasche Sigle Eschenlohr Peltzer Schaffer, and Noerr Stiefenhoffer Luetz). Hasche Sigle Eschenlohr Peltzer Schaffer had grown slightly through a domestic German merger. It is part of the CMS group dominated by the English firm Cameron McKenna. Haarmann, Hemmelrath and Partners is the remaining domestic firm in the top ten. It is an MDP which describes its members as 'specialist consultants in law, accountancy and taxation'. The other top 10 firm (Federsen, White and Case) is the result of a merger of a German firm with the American firm White and Case on July first 2000. Gaedertz which had been the ninth largest German firm in 1999 had been engaged in merger talks with the English firm Norton Rose but as a consequence disintegrated on 1 April 2001. A majority of its lawyers joined Norton Rose to form Norton Rose Vieregge in Germany but some offices decided to join individually with American firms (Latham and Watkins, and Mayer Brown and Platt) and others set up their own practices. By the end of 2001 just lying outside the top 10 were the legal associates of three of the big five accounting firms¹³ and the German associate of the international law firm Baker and McKenzie. In September 2001 it was announced that Beiten Burkhard Mittle and Wegener which was around the 16th largest German law firm will merge with KPMG Treuhand and Goedler from 1 January 2002 to form KPMG Treuhand Beiten Burkhardt and become one of the five largest legal firms in Germany.¹⁴ It appears that traditional German law firms no longer dominate the 'top 20'. Indeed, those that remain appear to be losing partners to their international and MDP competitors.¹⁵

However, the activity in the German market does not include the recent entry of firms from Finland or Sweden who also should have relatively efficient legal markets. One of the largest Swedish firms, Mannheimer Swarling Advocatbyra, has offices in Frankfurt and Berlin which have between them some twenty lawyers offering full services to German clients as well as services to Swedish clients in Germany and German clients in Sweden. But this activity is small beer compared to the activity of English firms in Germany. The largest Swedish firms are of an overall size which is similar to that of the fourth or fifth largest German firms yet they have little activity in Germany. It would appear that Swedish firms are now seen as a target for medium sized English firms as well as the larger ones.¹⁶ It may be that their relatively small size in international terms reduces the ability (or desire) of Swedish firms to move into the German market.

Finland can also be seen as a relatively efficient jurisdiction but its firms are even smaller than those in Sweden. There are no firms with as many as one hundred lawyers and there are only very small offices outside Finland.

The developments in Germany are consistent with the analysis of Implications of the International Mobility of Law Firms for Competition in Legal Service Markets section. Firms from a relatively inefficient jurisdiction are merging with firms from relatively efficient jurisdictions who have a cost advantage arising from organisational or jurisdictional knowledge. The pattern appears to be that the non-German firms have established offices in Germany in a small way to service the needs in Germany of their home jurisdiction clients.¹⁷ Subsequently, alliances are made between such English firms and German firms to benefit from the home jurisdiction knowledge of each and particularly the English firm's advantage in English law. This eventually gives way to merger between the English firm and its smaller German partner.

It is difficult to determine relative importance of the different factors driving this process (i.e. internationalisation of commerce, preference in these transactions for English law, greater organisational efficiency of English solicitors firms). Clearly they all have some role. However, the eventual choice of merger rather continuation of joint venture or loose association or, indeed, the expansion of the German offices of English firms is

suggestive of there being an organisational advantage possessed by the English firms. This organisational efficiency yields potential net gains to both parties from merger.

The lack of penetration in the German market of firms from Sweden and Finland suggests, perhaps, that the scale of operation also has a role to play in giving English firms an organisational advantage over German firms.

CONCLUSIONS

This paper has considered recent changes in EU legislation which have sought to remove the remaining barriers to a Single European Market in legal services. It has been argued that although this legislation has not directly reduced the power of professional self-regulatory bodies within member states it may indirectly increase efficiency. To the extent that there are jurisdictions in which legal services are produced relatively efficiently and others where they are produced relatively inefficiently, there will be an incentive for law firms from the efficient jurisdictions to penetrate the market in inefficient jurisdictions. Consideration of the economic analysis of multi-national firms suggests that this penetration is likely to result in mergers between firms from efficient jurisdictions and those in the inefficient jurisdictions which the former seek to enter. This will lead to reduced resource costs in the production of legal services. Even if there is no reduction in the (administered) prices in these markets this will still represent an increase in social welfare. It was argued, however, that such a process would lead to pressure for prices for legal services to be reduced.

Recent trends in the penetration of legal markets in major EU member states by English solicitors firms were discussed. In particular recent mergers involving English and German law firms were analysed. While the process which ended in these mergers began before the passing of the Establishment Directive the analysis suggests that the inter-jurisdictional mergers discussed in Implications of the International Mobility of Law Firms for Competition in Legal Service Markets section can take place. The use of English law for many international transactions may have provided an initial base for such behaviour but the final stage has been entered since the passing of the Establishment Directive. Merger is unlikely to be

the result solely of the English law advantage of English firms since this would be best exploited by the expansion of the English firms in Germany, not their merger with German firms. In any case the implications for the regulation of the legal profession in (what has been called above) inefficient jurisdictions remains. Merged firms adopting the organisational practices of the English firms will wish to see further relaxation in the regulatory regime in order that their market expands to the profit maximising level. Whilst this may meet with some resistance from local regulators the cost advantage of the merged firms gives them resources to spend on marketing, etc., which will yield a greater share of the stagnant market. This is likely to lead to non-merged firms wishing to expand demand through lowering fees via further relaxation in regulation. Resistance from vested interests in the inefficient jurisdiction may slow down the moves towards greater efficiency but in the long run they are likely to be achieved.

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NOTES

1. The information summarised below has been gleaned from a number of sources including OECD (2000), Appendix I of Van den Bergh (1997), West *et al.* (1998) and various web pages: Centre for European law at the University of Birmingham, World Legal Forum, International Centre for Commercial Law, Chambers Global and the author's correspondence with various European self-regulatory bodies. The discussion in the text largely deals with the main branch of the legal profession in each jurisdiction mentioned. Thus, for example, there is no discussion of notaries as a distinct profession even although they perform significant functions in some jurisdictions (e.g. France, Germany and Spain).
2. The author is grateful to Francisco Marcos for drawing this recent change to his attention.
3. The following paragraphs draw heavily on the summary of the implications of the directive available on the *Law Society* web site at: http://www.lawsoc.org.uk/dcs/fourth_tier.asp?section_id=1232&ictop=0.

4. It would appear that this is the position adopted in all member states.
5. Thus giving rise to alliances and 'best friends' arrangements between jurisdiction A and jurisdiction B firms. Over time the jurisdiction B firm may acquire a reputation in jurisdiction A thus removing the need for a jurisdiction A partner. This suggests that where the market is for the supply of jurisdiction B law to jurisdiction A commercial organisations alliances and FDI may be the mode of operation.
6. Some conference commentators on an earlier version of this paper suggested that quality of legal service might differ between jurisdiction A and B. It should be noted, however, to the extent that the regulatory regime in Jurisdiction A produces higher quality it should be able to ensure that this level of quality is also achieved by the merged firm in jurisdiction A.
7. There will be a reduction in profits for non-merged firms if the regulated fee is reduced.
8. Due to more efficient organisational routines and benefits of economies of scope.
9. Indeed some US firms have made significant inroads in European markets without the benefit of membership of the EU because of the preference of some parties to conduct international transactions under New York law and to service the needs of US multinational firms e.g. Cleary Gottlieb Steen and Hamilton opened its Paris office in 1949 and was the fifteenth largest law practice in Germany in 1997.
10. English law firms have had offices in Paris since 1973. In 1997 Clifford Chance was ranked 12th largest law firm in Germany with Allen and Overy 18th.
11. Published by *World Legal Forum* on 1 November 1997.
12. Press releases from Clifford Chance Puender conflict as to its size: one claiming 350 fee earners and another 133 partners and 353 other fee earners.
13. Two of which (KPMG and Ernst and Young) had recently expanded through merger with middle ranking German law firms.
14. Since the announcement of the merger it has become clear that a few of the former Beiten *et al.* partners are to set up an independent firm of their own '...keeping a traditional culture' according to *Legal Week*, 18/10/01. It should also be noted that this firm had formed an alliance (BBLP) with a number of other continental firms, presumably to compete with the wider jurisdictional coverage of the Anglo-American international firms. BBLP collapsed with the merger with KPMG Treuhand.
15. Wessing for example has been losing partners to Lovells Broesbeck Droest (*Legal Week*, 18/10/01).
16. Lagerloef Leman has merged with Linklaters to form Linklaters Lagerloef in Sweden. Tisell has merged with Ernst and Young to create a 160 lawyer firm and Gedda and Ekdahl has merged with the specialist London firm of Bird and Bird. There have also been cross Scandinavia mergers of smaller firms.
17. As suggested above in the discussion of when FDI would be the appropriate mode of entry.

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