



## The impact on the supplier base of reductions in criminal fees from April 2007

An assessment of the impact on criminal suppliers of Lord Carter's recommendations during the transition

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Otterburn Legal Consulting  
Holme View Park  
Holmfirth  
HD9 3HS

telephone +44 (0) 1484 682928  
fax +44 (0) 1484 684477  
andrew.otterburn@otterburn.co.uk  
www.otterburn.co.uk

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	Page
1 Summary	1
2 Introduction and background	3
3 The current profitability of criminal firms	5
4 The projected profitability of criminal firms after April 2007	20
5 The questions posed by the LSC	29
6 Conclusion	39
Appendix	42

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## **1 Summary**

- 1.1 This report summarises our assessment of the potential impact on the criminal supplier base of the fee reductions proposed in Lord Carter's Review of Legal Aid Procurement, in particular during the transition.
- 1.2 Our report indicates that the financial position of many criminal suppliers is highly fragile. Some firms are financially strong, however these are very much in the minority.
- 1.3 Lord Carter's report proposes a relatively swift timetable towards best value tendering and a relatively brief transition during which firms are expected to achieve substantial change. It is assumed firms will adapt and change quite quickly and there is little allowance or leeway built into the timetable to allow for unknown or unforeseen difficulty. It is proposed that fees will be cut before firms have a chance to increase their efficiency through re-structuring, indeed it is likely that many firms will see their cost base increase during the transition rather than decrease.
- 1.4 It is very difficult to quantify the potential impact on the supplier base, however the available data would suggest that many firms are on the verge of financial difficulty, or are already in some difficulty. There is a real danger that the LSC may lose the confidence of the supplier base, and perhaps more importantly their banks. The closure of firms or departments does not necessarily reduce supply in the long term, however in the short term it makes the transition very much more difficult. Some of the firms that may be most affected are the mid sized firms that are key to the effective operation of the system long term.
- 1.5 In their report, LECG make the point strongly that the proposals represent major change and that it is difficult fully to anticipate potential problems and where they might occur. This high level of uncertainty combined with a lack of reliable data would suggest the LSC should proceed with caution. If possible, proposed cuts in fees should be delayed and the transition extended. Contingency plans should be drawn up should local supply difficulties occur and the LSC have to intervene.
- 1.6 The projections contained in this report suggest the difficulties facing firms will become critical if cuts in fees are introduced from April 2007. It will take some time for the impact of these to work through, however, combined with recent changes such as Means Testing and Fixed Penalties, the cumulative effect could drive a number of firms out of business.

- 1.7 CDS capacity is most likely to be impacted by difficulties experienced by firms with criminal fees of between £200,000 and £1m. These firms will generally need to grow in size, but may well find it extremely difficult to do so. These firms are not especially profitable at present and will often lack the resources necessary to survive a period of significant change and turbulence in the market.
- 1.8 Funding is likely to be another issue that many firms will find difficult to overcome in the timescale envisaged by Lord Carter. Larger legal aid firms tend to have high gearing<sup>1</sup> and high levels of partner capital. This capital is normally generated through retained earnings however many firms are earning low profits. Although the banks will support firms with a good business case and effective management, their investment is likely to be related to the amount the partners can also contribute, which may be limited. Also, some firms may have difficulty satisfying their banks that they have the necessary level of management expertise.
- 1.9 Mixed firms that undertake private client work as well as legal aid may well be affected by the Legal Services Act as this will increase competition, in particular in areas such as conveyancing. Those firms that provide a cross subsidy to their legally aided work may no longer be able to do so.
- 1.10 The combined effect of these changes together with those brought about by the Legal Services Act may put particular pressure on criminal firms that also undertake civil and family, as the latter two areas are generally less profitable, and will probably be the first to be closed.
- 1.11 The underlying message from this report is that the transition is likely to be a risky period and that the LSC should approach it with extreme caution. In particular it should focus on confidence building, and the most effective way of doing that is likely to be to delay any reductions in fees until firms have had a chance to re-structure, to extend the transition, and to be flexible.

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<sup>1</sup> The number of fee earners in addition to each equity partner

## **2 Introduction and background**

2.1 This report summarises our assessment of the potential impact on the criminal supplier base of the fee reductions proposed in Lord Carter's Review of Legal Aid Procurement<sup>2</sup>, in particular during the transition.

2.2 We were asked by the LSC to review the existing evidence and consider several issues:

- whether – on the available evidence – the implementation of the proposed restructuring of fees proposed in Lord Carter's report is likely to lead to an unacceptable reduction in the level of CDS capacity<sup>3</sup>;
- whether the probable gains in efficiency can be made quickly enough to sustain the service at an adequate level;
- whether there are significant regional or other variations in the likely impact of the proposed changes;
- the extent to which firms would have to restructure to live with the changes;
- the impact on civil/family practitioners who also do crime; and
- the extent to which we can rely on the available evidence.

2.3 This is in the context of recommendations in Lord Carter's report for changes to

- police station fees;
- magistrates' courts fees; and
- crown court fees (both litigators and advocates)

2.4 These would be implemented from April 2007 and would reduce overall levels of payment to criminal suppliers. In the view of Lord Carter, efficiencies available to solicitors would enable them to operate profitably within these new fees, although he foresaw considerable restructuring in the direction of larger firms.

2.5 Before implementing the proposed fees, the Legal Services Commission require independent and expert advice on whether the CDS could sustain the proposed fee

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<sup>2</sup> Legal Aid – A market-based approach to reform – July 2006

<sup>3</sup> This report only considers CDS supply. We have not examined CDS demand

reductions without an unacceptable loss of service. This report summarises our review.

- 2.6 In order to produce this report, we have tried to assess the current profitability of firms and to project their possible future profitability during the transition. We considered larger crime firms in particular as we felt they best represented the model Lord Carter put forward and would be best able to adapt to the proposed changes. We then went on to apply the analysis to the specific questions on which the LSC had asked us to advise.

### **3 The current profitability of criminal firms**

#### **Introduction**

- 3.1 In assessing the profitability of a firm of solicitors, the measure normally used is profit per equity partner. This is, in effect, the fee income of a firm less its salaries and overheads. It is the amount available for the equity partners divided by the number of equity partners and is the measure most commonly used to assess the profitability of a firm of solicitors. Because most firms of solicitors are partnerships the owners, the equity partners, do not receive a salary, so the profit they earn is a key figure. This compensates them for the work they put in as a fee earner or manager, for the loss of interest on the capital they have invested in the firm, and for the risk and stress of running their own business. The latter two points are particularly relevant especially as profits have, in recent years, decreased and salaries paid to employed solicitors have increased – in particular in crime. Why run the risk and take on the pressure of running your own firm when you might earn a similar income working for someone else?

In our research for Lord Carter we also used profit as a percentage of fees, in effect the margin achieved, as an alternative measure. In this case “profit” was struck after an allowance for a salary for each equity partner, interest on their capital and an allowance for a notional rent where the partners owned the firm’s offices. This is in effect the “true” profit of the firm, and one that allows better comparison to other business structures. This measure is of particular interest because some of the most profitable legal aid firms are successful primarily due to high levels of gearing<sup>4</sup> – they have very few equity partners. It does not take a great reduction in margin to seriously erode or even eliminate the profits of such firms.

In this report we once again use both these measures. We considered using a third, return on capital, however do not have up to date figures for partner capital. The position is also slightly complicated by the introduction of UITF40.

- 3.2 Having defined profitability, it is important to make it clear from the outset that there is actually relatively little reliable information available on the profitability of legal aid firms, upon which judgements on the impact of Lord Carter’s recommendations can be based.

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<sup>4</sup> The ratio of equity partners to non-equity fee earners

### The position in 2003

- 3.3 In 2003 a large-scale survey was undertaken as part of research on behalf of the DCA<sup>5</sup>. This was based on returns from 303 firms, 270 of whom provided financial data. The data was reasonably robust and was subject to a high degree of validation. This indicated median profits of £63,000 per partner as summarised in Table 1:

**Table 1**

Survey of Legal Aid Firms 2003					
Profit per equity partner	All firms	By number of solicitors			
		1	2-5	6-12	13-40
Average	70,720	42,519	64,312	82,497	90,656
Lower quartile	40,872	22,062	36,119	53,758	65,357
Median	63,187	38,366	51,023	73,473	86,646
Upper quartile	95,046	57,925	84,446	102,326	106,462
Number of firms	270	48	106	68	41
Number of equity partners	844	48	200	231	282

- 3.4 This research is now obviously fairly old, especially as in some cases the firms will have based their returns on accounts ending in 2002, however it indicated that the profitability of legal aid firms was at that time not dissimilar to the profession as a whole. The 2003 Business Review<sup>6</sup> published by the Law Society indicated average profits per partner for the profession generally also of £63,000. The profits reported amongst the legal aid firms also compared well to that of employed fee earners. The survey indicated that at that time the salary of the highest paid employed fee earners was £38,000 in London and £35,000 outside London. There was a reasonable differentiation between the earnings of partners and employed staff.

At that time the firms that undertook predominantly criminal work achieved better profits of £76,000 per partner as indicated in Table 2. As shown in the table, the crime firms that took part in that survey were generally small, with just two with more than 13 solicitors.

<sup>5</sup> Otterburn Legal Consulting: Department for Constitutional Affairs —Review of Demand, Supply and Purchasing Arrangements – Survey of legal Aid Firms 2003 (the 2003 DCA Survey)

<sup>6</sup> A bi-annual survey of the profession published by the Law Society

**Table 2**

<b>Survey of Legal Aid Firms 2003</b>					
<b>50% + Crime firms</b>					
	Overall	By number of solicitors			
		1	2-5	6-12	13-40
Number of firms	66	18	26	20	2
Total fees	33,420,966	1,512,346	8,570,156	18,105,589	5,232,875
Average fees					
Total		84,019	329,621	905,279	2,616,438
Publicly funded		81,408	323,367	868,698	2,537,500
Non - publicly funded		2,611	6,254	36,581	78,938
Publicly funded %	97	98	96	96	97
Crime as a % of total fees	92	97	92	88	76
Average solicitor chargeable hours	1,988	2,487	1,889	1,740	1,638
Average profit per partner	76,208	50,569	76,217	99,822	70,696
Fees per fee earner	66,890	72,775	62,765	67,702	59,423
Fees per equity partner	258,911	84,019	231,748	418,124	593,933
Gearing	3.0	0.2	2.7	5.3	9.5
Salaries as a % of fees	64	64	67	62	64
Overheads as a % of fees	29	34	29	25	31

### **The position in 2005**

- 3.5 As part of the research for the review by Lord Carter a new survey was commissioned to obtain more up to date data and a large-scale telephone survey was undertaken by FreshMinds. 854 firms were approached and were sent a copy of the questionnaire, however considerable difficulty was encountered getting them to take part, in particular due to the resistance of many to the exercise. 227 firms refused to participate. Successful telephone interviews were however completed with 242.
- 3.6 Of the 242 firms, approximately half gave no or only partial financial information. The questionnaire was extremely long, asking around 70 questions, and the telephone interviews must have been fairly lengthy. It is not clear how much data validation took place, or whether firms were subsequently contacted to check financial information that appeared unusual or possibly incorrect. In our subsequent analysis of the data, we considered that returns from 86 firms looked broadly reasonable, although doubts remain regarding the reliability of some of the financial data.

3.7 Table 3 summarises our analysis of the 86 firms<sup>7</sup>. The table is organised by size according to number of qualified fee earners (equity and salaried partners, qualified and unqualified fee earners and trainees):

**Table 3**

	Number	Total Fee earners	% fee earners qualified	Fees £	Median			Criminal Chargeable hours per fee earner	Gearing	Profit per partner		Total fees
					Public %	Crime %	Profit per partner £			Lower quartile	Upper quartile	
1-5	39	4	75	216,000	100	99	43,750	1,633	1	19,167	67,009	10,705,773
6-12	23	11	77	686,375	91	31	56,667	1,380	2	15,750	93,820	19,847,232
13-40	19	27	72	1,700,000	60	20	64,545	1,495	4	48,493	89,226	35,768,181
40+	5	87	61	5,920,000	47	12	138,461	1,334	9	Sample too small		36,742,283
Overall	86	9	72	600,000	94	45	56,738	1,380	2	25,263	84,417	103,063,469

3.8 The table indicates median profits per partner of £56,000. Because of the potential unreliability in the data this figure has to be treated with some care, however it is plausible in comparison with the 2003 Survey. Care must always be taken in comparing two different samples, however, the profession will have experienced increased overheads over the intervening period and static rates of pay for LSC work, therefore reduced profits are quite possible.

Most of the 39 1-5 fee earner firms had more than one solicitor (30 out of the 39). In 2003 profits amongst the 2-5 solicitor firms were £51,000 compared to £43,000 amongst the 1-5 fee earner firms in 2005<sup>8</sup>. Profits amongst the 6-12 fee earner firms had fallen from £73,000 in 2003 to £57,000 in 2005. 13-40 fee earner firms had seen a fall from £87,000 to £65,000.

#### The 2006 survey of larger crime firms

3.9 A further limitation of the FreshMinds survey was that relatively few larger firms had taken part, so, as part of the research for Lord Carter, a survey of larger criminal firms was also undertaken<sup>9</sup>. This was based on a mailing to the top 100 criminal firms – those with non-VHCC earnings greater than £850,000. There was a good response with 38 questionnaires returned, including 6 of the top 10 firms. The data was reasonably robust. Table 4 summarises the profitability of these firms and indicates a median profit of £67,000 per partner for the 13-40 fee earner firms and £139,000 for the 40+ firms – very similar to the FreshMinds Survey. Once again firms were asked

<sup>7</sup> Otterburn Legal Consulting, Lord Carter's Review of Legal Aid Procurement – 2005 and 2006 Surveys of criminal firms

<sup>8</sup> In the 2003 survey firms were analysed according to numbers of solicitors – in the analysis of the FreshMinds data the analysis was by number of qualified fee earners as information on numbers of solicitors was not available.

<sup>9</sup> As above

for the salary of their highest paid employed fee earner, and this was £55,000 and £61,000 for the 13-40 and 40+ firms respectively. £58,800 for firms in London, and £57,400 for firms outside. The partners in 25% of the 13-40 firms were earning profits below these levels.

A quarter of the firms however earned profits per partner in excess of £188,000. 75% of the 40+ firms earned profits per partner over £97,000. These will be amongst the most successful publicly funded firms because crime has traditionally been the most profitable area of publicly funded work.

**Table 4**

Fee earners	Profit per partner	Profit per partner (per accounts)	
	Per accounts £'000	Lower quartile £'000	Upper quartile £'000
<b>13-40</b>			
Median	67	50	139
Mean	105		
<b>40+</b>			
Median	139	97	254
Mean	185		
<b>All</b>			
Median	121	62	188
Mean	143		

These profits are less than would be earned in comparable sized firms that undertook a wider range of private client work. The Law Society has not undertaken a Business Review since 2003, but the Law Management Section does publish an annual financial benchmarking survey. In its 2005 survey the average profit per partner for its members was reported as being £114,000. This survey is not representative of the profession as a whole, and tends to comprise the more successful firms, however it is quite likely that the profession has seen profits rise since 2003, primarily due to the buoyancy of the economy. In Scotland an annual survey of firms is undertaken that is representative of the profession, and there profit per partner rose from £67,000 in 2003 to £71,000 in 2004 and £83,000 in 2005.

3.10 Table 4 show the profits earned by the partners in the firms however “profit” in a set of partnership accounts can be a misleading figure because it does not reflect three important factors that need to be taken into account in order to assess performance, and in particular that are needed to make comparison with other business forms such as incorporated businesses. In table 5 an allowance has been made for:

- A notional salary for each equity partner. This provides an approximation of the cost of the equity partners in their capacity as a worker/manager in the firm – as

opposed to a proprietor. The firms were asked for the salary of their highest paid employed fee earner – including bonuses – and as indicated previously this was £55,000 and £61,000 for 13-40 and 40+ firms respectively. This has been used, together with an allowance for NIC as the notional salary;

- Interest on partner capital – a rate of 7.5% has been applied to the partner capital reported by each firm. On average their capital was £125,000 and £297,000 per partner for the 13-40 and 40+ firms respectively;
- A notional rent where the partners own their offices and do not actually pay themselves any rent.

**Table 5**

Fee earners	Adjusted for notional salary, rent and interest			
	Surplus/defecit per partner £'000	Margin %	Surplus/defecit Lower quartile £'000	Surplus/defecit Upper quartile £'000
<b>13-40</b>				
Median	-6	-1.4	-20.7	68.2
Mean	32	2.2		
<b>40+</b>				
Median	48	6.5	6.5	163.0
Mean	86	6.1		
<b>All</b>				
Median	39	4.5	-12.3	114.4
Mean	58	4.0		

3.11 The table indicates that the median surplus per partner was £39,000 or 4.5%. A quarter of the firms did not recover all their costs – they made a loss of £12,000 per partner. Partners have to earn a return over and above what they might have earned as an employed solicitor in order to compensate them for the risk and pressure of running their own business. The partners in these lower quartile firms could have earned higher incomes working for someone else, and avoiding all the risks and pressure of running their own firm. Their earnings do not fully cover the salary they could have earned elsewhere, and the interest they could have earned on their capital.

A quarter however achieved a healthy return in excess of £100,000. These larger firms, that are able to generate good profits after all costs have been allowed for, are the ones Lord Carter considered a viable model in a reformed market. Firms that, despite the pressure on fee rates, were able to generate reasonable profits from publicly funded work. By definition, these upper quartile large firms represent a minority of the supplier base.

**Trends in margin**

3.12 The 2003 Survey also tried to establish the margins being earned in different areas of work. Table 6 analyses the fees and overheads of the firms according to whether the work was public or private. The former recorded margins of 4% whereas the latter achieved a 21% margin. Table 7 analyses the publicly funded work in more detail, and indicated a 15% margin for crime and a negative margin of -3% for civil/family.

**Table 6**

<b>Survey of Legal Aid Firms 2003</b>			
<b>Departmental profitability</b>			
	Public	Private	Total
Fees	87,527,706	118,886,714	206,414,420
Salaries			
Salaried partners	4,492,292	4,348,618	8,840,910
Other solicitors over 5 years pqe	8,181,756	7,114,239	15,295,995
Other solicitors under 5 years pqe	6,667,665	5,825,018	12,492,683
Legal Executives	1,978,342	3,778,566	5,756,908
Paralegals	5,880,694	4,245,910	10,126,604
Trainee solicitors	1,914,841	1,462,226	3,377,067
Secretaries/dept. support staff	10,130,262	13,195,739	23,326,001
Equity partner notional (fee earning)	11,921,675	14,138,900	26,060,575
Total	51,167,527	54,109,216	105,276,743
Departmental profit	36,360,179	64,777,498	101,137,677
%	42	54	49
Central staff (pro rata to fee earners)	6,909,432	9,033,501	15,942,933
Equity partner notional (mgt time)	211,452	134,373	345,825
	29,239,295	55,609,624	84,848,919
Bad debts		2,161,032	2,161,032
Other income		-4,799,912	-4,799,912
Overheads (pro rata to fee earners)	26,127,367	32,778,273	58,905,640
Net profit (after notional salaries)	3,111,928	25,470,231	28,582,159
Net profit %	4	21	14
All salaries as a % of fees	67	53	59
Overheads and interest as a % of fees	30	29	30

**Table 7**

<b>Survey of Legal Aid Firms 2003</b>			
<b>Departmental profitability - crime v civil</b>			
	More than 50% crime	Civil and under 50% crime	Total public
Fees	32,321,870	55,205,836	87,527,706
Salaries			
Salaried partners	1,804,651	2,687,641	4,492,292
Other solicitors over 5 years ppe	3,168,051	5,013,705	8,181,756
Other solicitors under 5 years ppe	2,335,906	4,331,759	6,667,665
Legal Executives	534,217	1,444,125	1,978,342
Paralegals	2,584,742	3,295,952	5,880,694
Trainee solicitors	465,642	1,449,199	1,914,841
Secretaries/dept. support staff	2,161,261	7,969,001	10,130,262
Equity partner notional (fee earning)	4,482,250	7,439,425	11,921,675
Total	17,536,720	33,630,807	51,167,527
Departmental profit	14,785,150	21,575,030	36,360,179
%	46	39	42
Central staff (pro rata to fee earners)	1,752,950	5,156,482	6,909,432
Equity partner notional (mgt time)	75,600	135,852	211,452
	12,956,599	16,282,695	29,239,295
Bad debts	0	0	0
Other income	0	0	0
Overheads (pro rata to fee earners)	8,072,219	18,055,148	26,127,367
Net profit (after notional salaries)	4,884,380	-1,772,452	3,111,928
Net profit %	15	-3	4
All salaries as a % of fees	60	71	67
Overheads and interest as a % of fees	25	33	30

3.13 Care always has to be taken when comparing surveys undertaken at different points in time, however the available evidence points to a deterioration in the profitability of crime from 2003 to 2005 – table 7 indicates a 15% margin in 2003, whereas table 5 indicates a 4.5% margin in 2005. It should also be remembered that the research for Lord Carter was based on the top 100 crime firms – the largest and generally most successful firms – whereas the 2003 research was based on a sample of mainly

smaller firms – a like for like comparison would probably have seen an even greater reduction<sup>10</sup>.

### **Current profitability**

- 3.14 As discussed previously, there is relatively little reliable information available on the profitability of legal aid firms. The 2003 Survey is out of date and although the FreshMinds data is more recent there are doubts surrounding its reliability. The research on the top 100 firms is recent, and reasonably robust however is based on the results of just 38 firms. In the absence of any better data, the rest of this section considers the top 100 firms further and seeks to project their current profitability. It should be remembered however that these firms are not representative of suppliers generally – they are amongst the largest firms, and most successful in terms of profitability. Whatever the results for these firms, the profitability of the supplier base generally is likely to be worse.
- 3.15 Most participants in the research for Lord Carter of larger crime firms appear to have provided financial data for accounting periods ending on either 31st March or 30th April 2005. Some will have been to earlier dates, some more recent. If the 12 months to 31st March 2005 is taken as the base line, by the time the first elements of Lord Carter's recommendations are implemented in April 2007, the firms will have experienced two years inflation in salaries and overheads. Over this period there has been no increase in criminal fee rates – fees have been kept static. Income from fees has risen however this is likely to be due to increased volume or complexity<sup>11</sup>. This may well have required increased inputs, and in particular partners and fee earners may have been required to work longer hours. There has been no inflation-linked increase in fee rates, but an increase in fee income, which represents an increase in demand.

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<sup>10</sup> There was a further minor difference in methodology in that in tables 6 or 7 no allowance has been made for interest on partner capital or notional rent. If no adjustment had been made in 2005 for interest or notional rent, the firms would have made a margin of 6.8% rather than 4.5% - still over half that achieved in 2003.

<sup>11</sup> It is a matter of debate what has caused the rise in fee income, and Cape and Moorhead (in the case of criminal higher solicitors) saw the causes as volume increases and external cost drivers. The rise in fee income represents an increase in demand, not an increase in price.

## Projections to 2007

3.16 Our projections are based on a number of assumptions:

### Overheads

1. Firms will have experienced general inflation in non-salary overheads (telephones, stationery, etc), and some may have had rent reviews - say 2.5% for each of the two years;

### Salaries

2. We have assumed no changes in staff numbers over the last two years or efficiency savings as we think few will have had an opportunity to make any. Firms will have been aware of the proposed re-introduction of means testing however are unlikely to have reduced staff levels in advance because work loads will not have been any less. Also, for most firms it is extremely difficult to find good staff. They would not generally have considered any staffing reductions until it was clear work levels really were going to fall, and may even then have been inclined to keep people in the hope that things might improve. Also, most firms work on relatively short planning cycles, because of frequent changes in the legal aid scheme and uncertainty about its future;
3. Crime firms generally employ fewer secretaries than is the case for firms of solicitors generally, however legal secretaries are also in short supply and can command high salaries. The problem is worst in London where small legal aid firms have to compete with City practices;
4. We tried to establish whether any specific salary data was available for fee earners in legal aid firms. The Law Society does publish an annual salaries survey<sup>12</sup>, and salaries are analysed according to areas of work and grade of solicitor, however the samples are too small to make meaningful comparison, in particular between years<sup>13</sup>.
5. Anecdotally we are aware that it is very difficult to recruit experienced criminal fee earners and therefore salaries tend to be high, in particular for those on the Duty scheme. For example, one London firm said they generally pay their newly qualified solicitors £27,000, however a one year qualified Duty solicitor would be paid £35,000. We understand that following the publication of Lord Carter's report firms are less willing to pay the salaries they would previously have had to pay for duty solicitors, but are continuing to do so at present. Others comment that in order to grow they have to attract staff and that there are very few good quality staff available. A Leicester firm reported an assistant solicitor currently paid

<sup>12</sup> Private Practice Solicitors' Salaries 2005

<sup>13</sup> The survey reports salaries for specialist crime assistant solicitors of £60,000 in 2003 (sample of 17) and £30,000 in 2005 (sample 29) – salary data can be prone to variation and the samples are extremely small making comparison between years very difficult.

£27,000 being offered £35,000 by other firms – 30% higher. Another, who was 18 months qualified and was paid £25,000 left the firm two months ago for a salary of £30,000 – an increase of 20%.

6. The charts that follow project the current profitability of the firms on the basis of assumed inflation in salaries of 2.5% for each of the two years. Because much of the anecdotal evidence suggests salaries have risen at a higher rate we then project profits on the basis of 5% and 7.5% increase in salaries in each year.

**Fee income**

7. Actual spend by the LSC on crime in respect of solicitors in 05/06 was £855m compared to £824m 04/05 – an increase of 4% - and a projection for 06/07 of £862m – an increase of 1% - based on projections by the LSC as summarised in table 8. These reflect changes that have occurred in the payment regime, such as the reduction in the maximum possible uplift for VHCC and Crown Court cases, the introduction of statutory charging, the extension of fixed penalties, and the introduction of means testing. It is assumed firms' income has risen by these levels, although this will in most cases be due to additional hours worked, in particular in smaller firms by the partners, rather than an inflation increase. Actual fee rates have been static for several years.
8. It is assumed the firm's other income, except crime, has increased by 5% a year.

**Table 8**

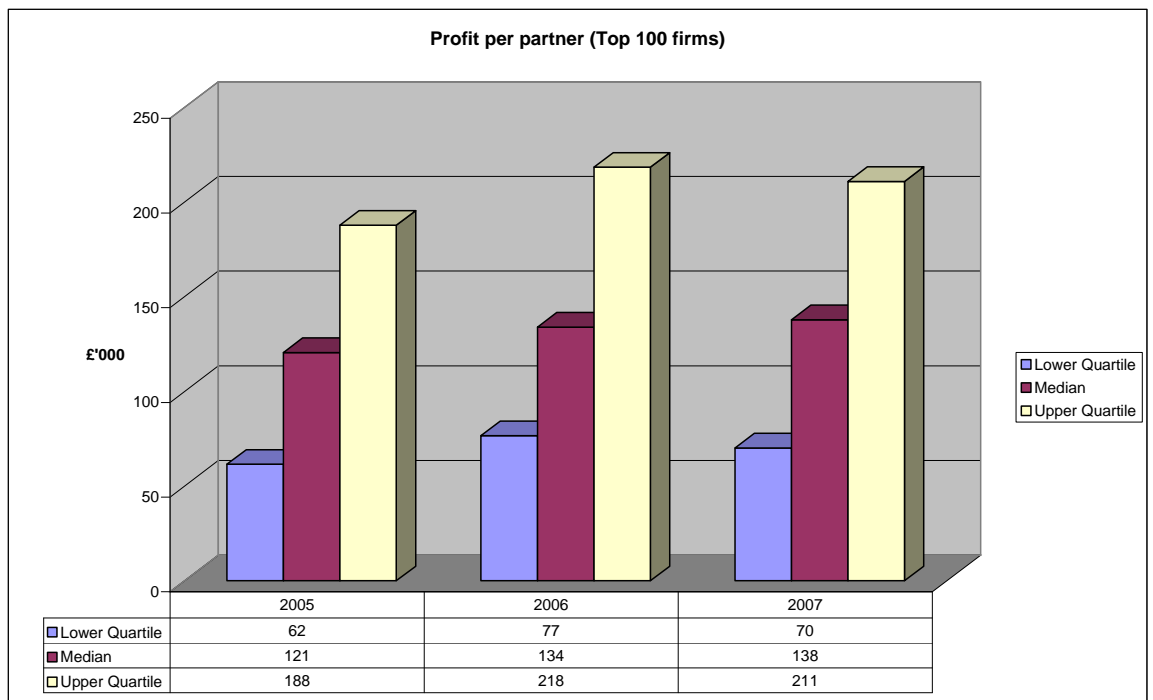
	<b>04/05</b>	<b>05/06</b>	<b>06/07</b>
<b>RAB Net Expenditure CRIME (£m)</b>	<b>Actual</b>	<b>Actual</b>	<b>Forecast</b>
Police Station (Block Contracts) *	181	185	193
Magistrates Court (Fixed Fees) *	324	338	326
Crown Court Advocacy (GFS+VHCC)	169	225	243
Crown Court Advocacy (EPF)	159	138	83
Crown Court Litigation (GFS+VHCC) *	309	321	333
Court of Appeal, RDCOs etc. *	10	10	10
Sub-Total Crime	1,152	1,217	1,188
* Solicitors' total	824	855	862
% change		4	1
Source: LSC			

**Other factors**

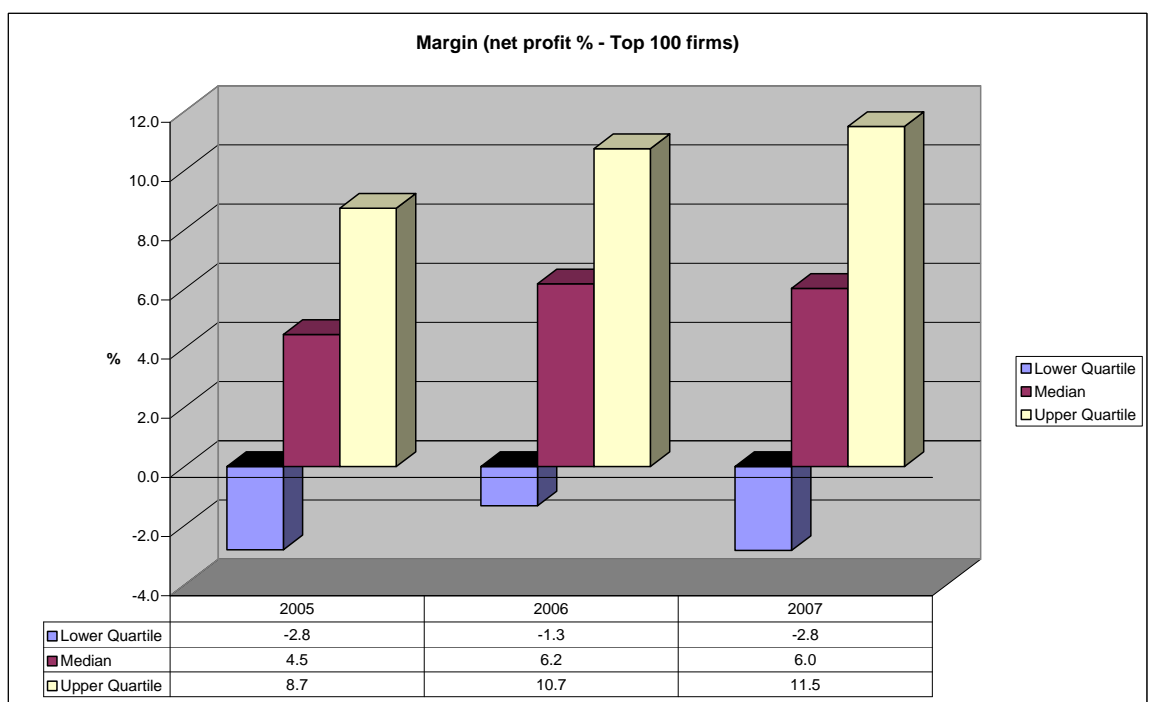
9. It is assumed that no other changes in the firms have taken place, in particular that no efficiencies are made before April 2007.

3.17 Chart 1 projects the profitability of the firms based on a 2.5%pa increase in salaries over the two years and suggests an increase in profits. Chart 2 projects the margins the firms may be making at present. This chart makes allowance for a notional salary for each equity partner, interest on partner capital and a notional rent where the partners own their offices. It assumes the notional salaries set out in 3.10 and applies the inflation rate set out in 3.16 of 2.5%.

**Chart 1**

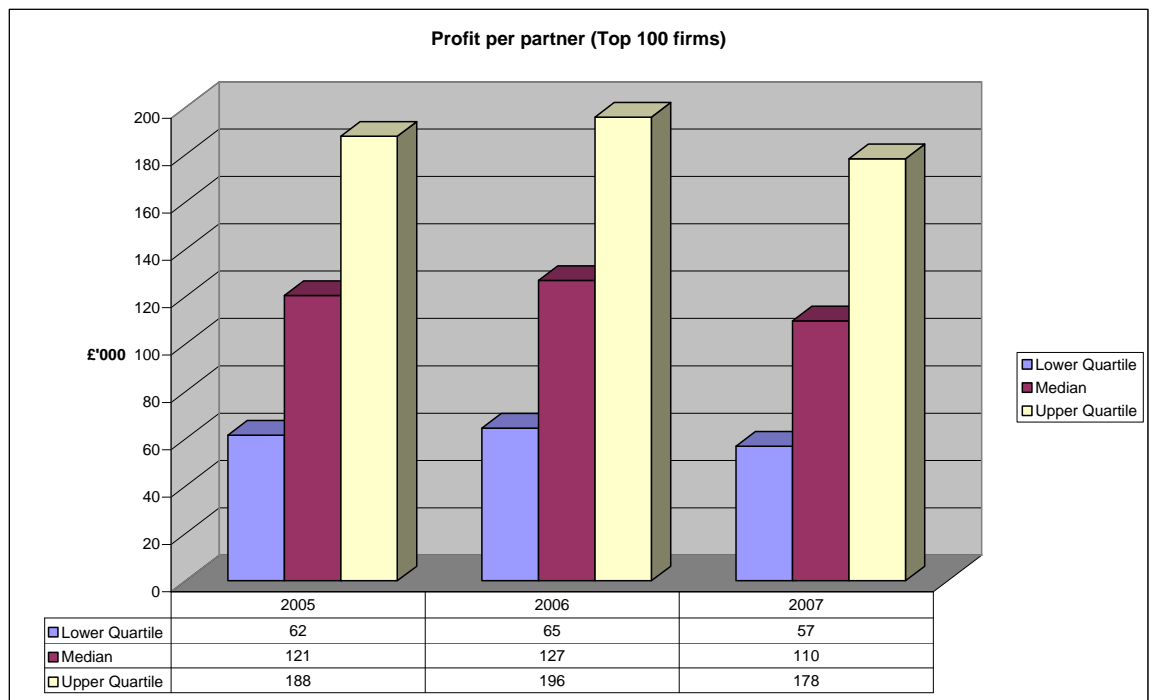


**Chart 2**

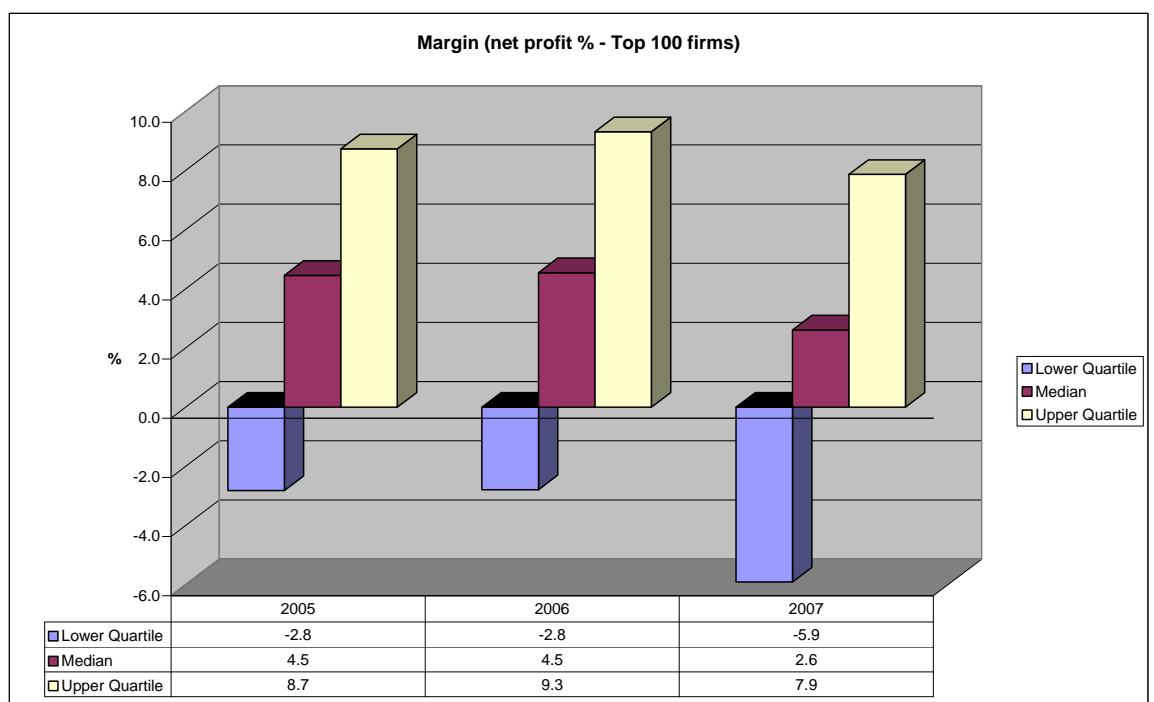


3.18 As discussed above, many firms have experienced relatively high salary pressure over the last two years and have had difficulty attracting and keeping staff. It may well be over optimistic to assume salary increases at just the level of inflation and charts 3 and 4 assume a 5% increase in salaries for each year.

**Chart 3**

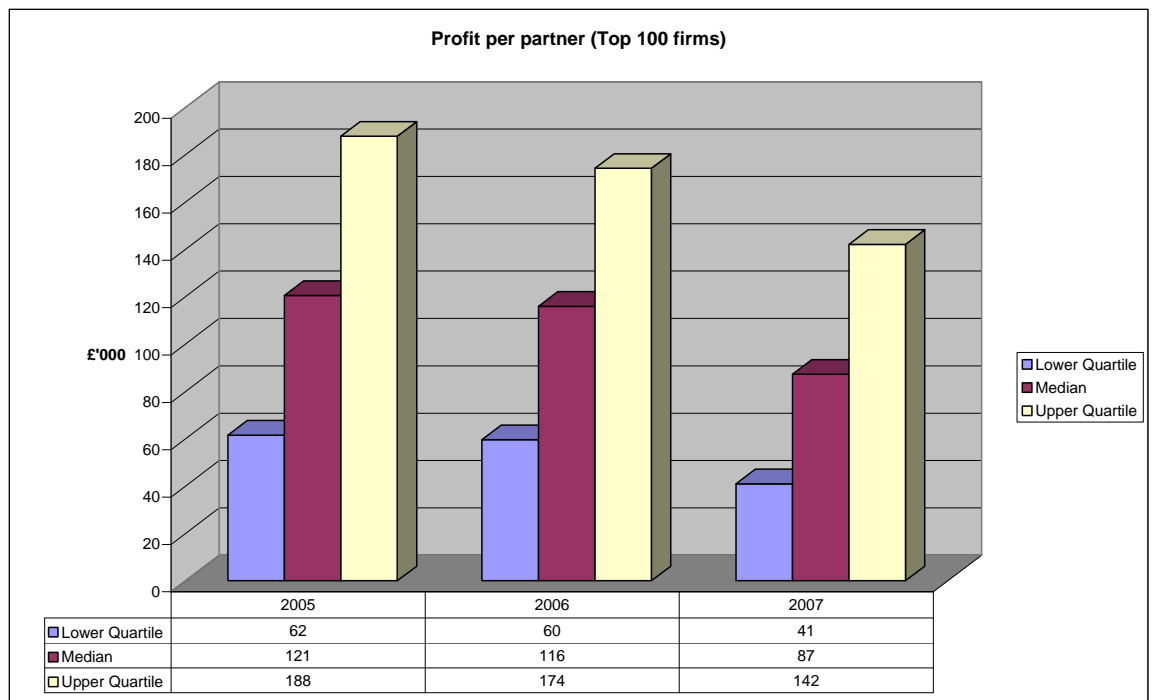


**Chart 4**

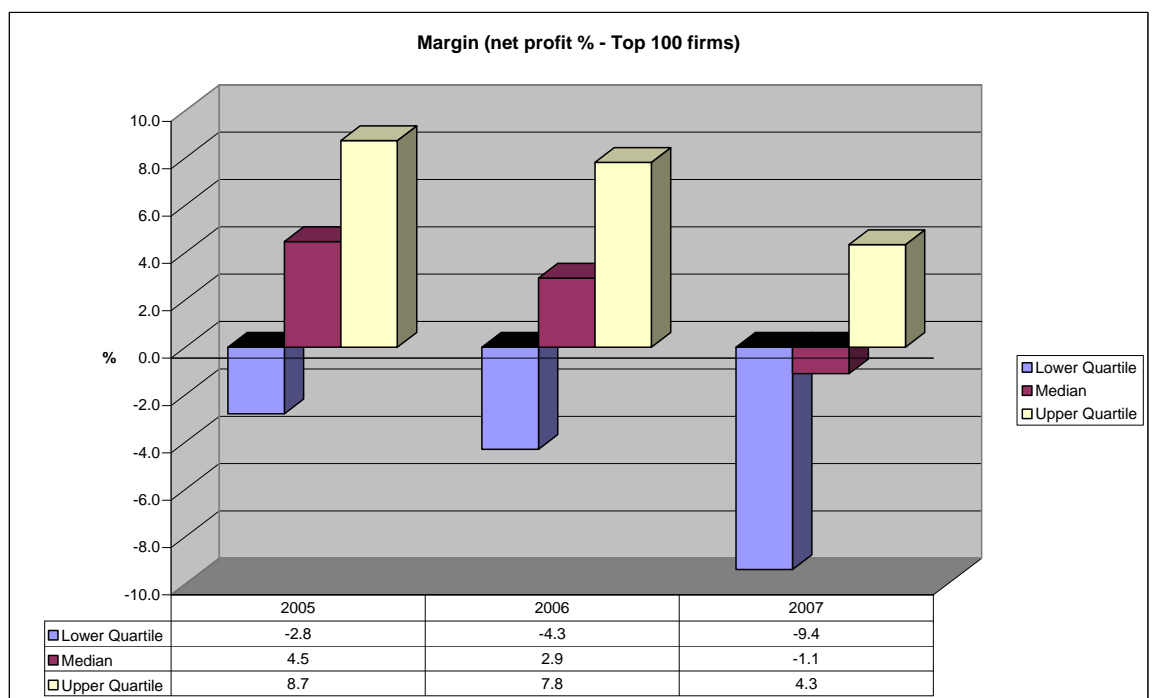


3.19 Charts 5 and 6 illustrate the impact of a 7.5% pa increase in salaries. One Central London firm for example, has had to pay a 15% increase over the last two years, another in Outer London, also gave increases above inflation, mainly by giving Duty Solicitors a higher proportion of their out of hours earnings – in one case 100%:

**Chart 5**



**Chart 6**



- 3.20 Charts 3 and 5 suggest a fall in profits over the last two years, chart 1 an increase. Any set of projections is only as good as the underlying assumptions, however, the latter sets of charts, assuming above inflation salary increases may well be the more realistic. 5% may be a good average. Recruitment has been difficult for most firms, and the “going rate” appears to have been driven up in recent years. As discussed previously, in 2003 the average salary of the firms’ highest paid employed fee earner was £38,000 for firms in London and £35,000 for firms outside London. In 2005 the salary of the highest paid fee earners was £55,000 and £61,000 for 13-40 and 40+ firms respectively – significantly higher. There is no reason to suggest this trend has not continued over the last two years, indeed the anecdotal evidence would suggest it has got worse in the last year. Duty solicitors in particular have been able to demand high salaries. As also discussed previously it is likely the hours worked by fee earners has increased, and although basic salary increases may have been low, they may have earned more through out of hours pay. It is only very recently that salaries have started to slow.
- 3.21 None of the projections in this section assume any efficiency savings in the period to April 2007. This is based on our impression, speaking to firms, that the effect of means testing is only just becoming clear, that salaries have not yet started to decrease, and that the shape of boundary areas and any new scheme has yet to be finalised, that the new IT is not available. The Lord Chancellor has yet to respond to the consultation. It is simply too early for many firms to have made efficiency savings.
- 3.22 Although this section focuses primarily on profitability, it is important to also consider the overall funding position of firms. Because of the time it takes firms to be paid, in particular in respect of Crown Court work, many suppliers have to fund a considerable level of work in progress. One London firm alone estimates this at £2m. At 31<sup>st</sup> March 2006 the LSC estimate<sup>14</sup> the total owed to be £540m for crime higher and lower and approximately £400m for live civil cases, and £1.1bn for dormant civil cases where payment may never be made.

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<sup>14</sup> Source: LSC

#### 4 The projected profitability of criminal firms after April 2007

- 4.1 The projections in section 3 must be treated with some care because in reality, in an environment where fees are relatively static and costs are rising, firms will if possible take action to maintain their profitability. Some of the larger, better-resourced firms will undoubtedly have done this over the last year, especially as the direction of Lord Carter's thinking became clear. For example, one top ten crime firm, a mixed practice that had great difficulty making crime pay, decided to cease doing crime, and the partner and fee earners in the criminal department moved to another firm<sup>15</sup>. Many firms however, in particular those that only undertake legal aid, will have had limited scope for change.
- 4.2 Table 9 provides an analysis of the profit figures in Chart 3 by size of firm. The larger, 40+ firms have strengthened their profitability, largely because they undertake a reasonable amount of private work. 25% of their fees were private compared to just 1% amongst the 13-40 firms. These smaller firms have seen static profits, a decline in real terms.

**Table 9**

<b>13-40</b>			
	2005	2006	2007
Lower Quartile	50	51	47
Median	67	71	66
Upper Quartile	139	143	131
<b>40+</b>			
	2005	2006	2007
Lower Quartile	97	104	106
Median	139	149	150
Upper Quartile	254	273	253
<b>All</b>			
	2005	2006	2007
Lower Quartile	62	65	57
Median	121	127	110
Upper Quartile	188	196	178

- 4.3 If profits have also been static for the mainly smaller firms from the FreshMinds survey in table 3, and salaries have continued to increase, many of the partners in those firms will have started to earn less than the salary of employed solicitors at other firms. Already low profits for many of these firms will have been reduced in real terms. There comes a point where partner drawings start to exceed profits and some of these firms may be at that point. It is very often difficult to reduce drawings

<sup>15</sup> Over the last 4 ½ years 1,000 offices terminated or withdrew contracts and 600 new contracts were granted as illustrated in Chart 13. The number of contracts withdrawn has slowed in recent years.

quickly as the partners will have a basic earnings requirement in terms of their personal expenses – mortgage, supporting children, household expenses. In reality it is very often difficult for these to be cut quickly. Typically partners continue drawing at similar levels in the hope things will improve, and the bank position of the firm deteriorates as a result.

The testing time for some of these firms will be July 2007 and January and July 2008 when the partners will have to pay their tax. Hopefully most will have made provision for this, however some will not – they will have been using their income tax to fund their firms. For many firms the situation could be further complicated by the introduction of UITF40, which will have the effect of increasing the tax to be paid. It will also have the effect of increasing the paper profits shown in their accounts, so the true financial position of their firms may not be apparent.

A further problem may well be that one result of means testing and fixed penalties has been that the level of work undertaken by some firms has fallen below the level of their standard monthly payments (SMP). One firm, for example, describes a SMP of £50,000 compared to reduced monthly work levels of £30,000. This “cushion” will have the effect of making their bank position appear better than it actually is, however at some point this over-payment will need to be re-paid to the LSC.

In a sense these potential difficulties should not be something that concerns the LSC – if partners overdraw and if their firms move into financial difficulty that is their problem, not the LSC’s. The reason it is raised in this section is so as to highlight the implications for a fragile supplier base. One that is on the whole earning relatively low profits, and one for whom cash flow can be a problem, as illustrated in 3.23.

#### **Projection pre-Carter**

- 4.4 Table 10 sets out the LSC’s projection for spend on crime for the two years from 1<sup>st</sup> April 2007 prior to any changes as a result of Lord Carter’s recommendations. These forecasts take account of changes in volume as a result of fixed fees and fixed penalties. The table indicates a fall in payments to solicitors in 07/08 of 2% to £843m, and a rise in 08/09 of 4% to £881m:

**Table 10**

	04/05	05/06	06/07	07/08	08/09
<b>RAB Net Expenditure CRIME (£m)</b>	<b>Actual</b>	<b>Actual</b>	<b>Forecast</b>	<b>Forecast</b>	<b>Forecast</b>
Police Station (Block Contracts) *	181	185	193	196	202
Magistrates Court (Fixed Fees) *	324	338	326	295	311
Crown Court Advocacy (GFS+VHCC)	169	225	243	256	262
Crown Court Advocacy (EPF)	159	138	83	64	49
Crown Court Litigation (GFS+VHCC) *	309	321	333	343	357
Court of Appeal, RDCOs etc. *	10	10	10	9	10
Sub-Total Crime	1,152	1,217	1,188	1,163	1,192
* Solicitors' total	824	855	862	843	881
% change		4	1	(2)	4
Source: LSC					

4.5 Charts 7 & 8 indicate the projected profitability of the 38 firms based on these fee forecasts. Inflation in overheads is assumed to continue at 2.5% a year, and it is assumed that salaries inflation also reduces to 2.5% in 07/08 and 08/09:

**Chart 7**

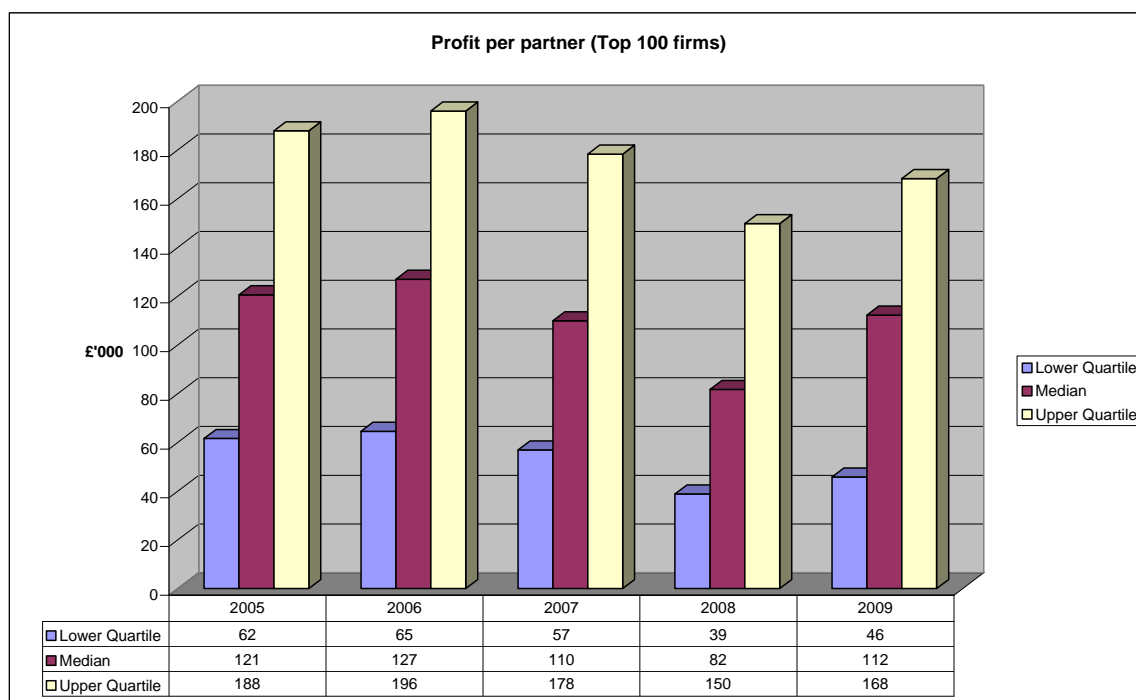
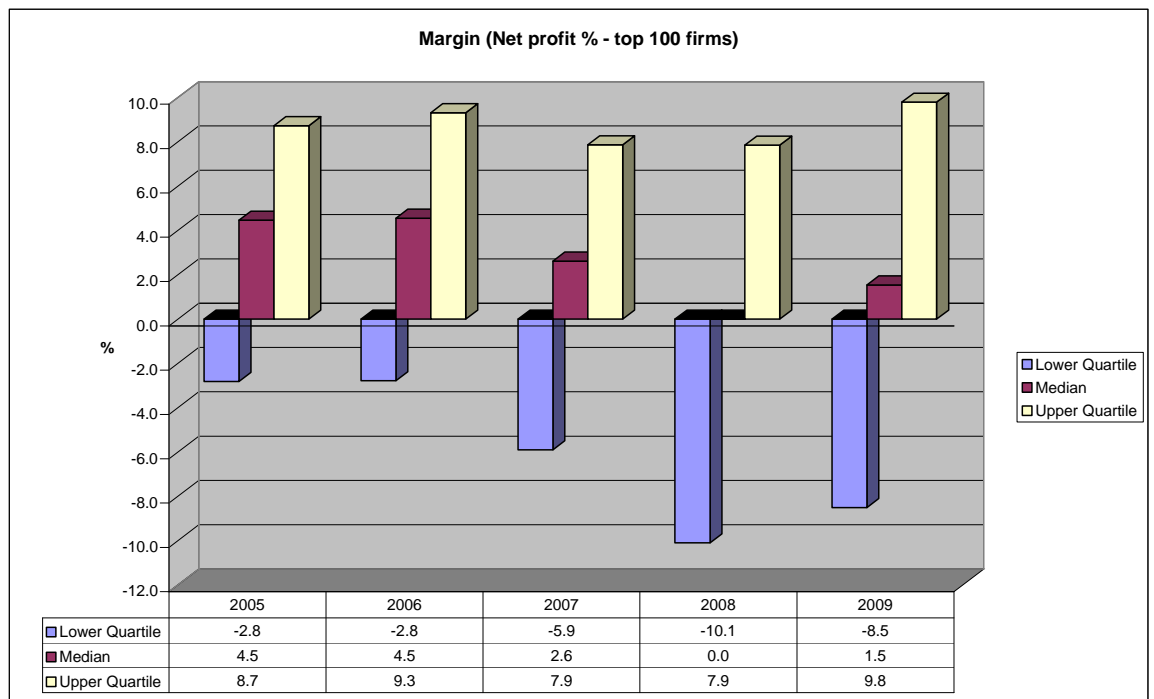
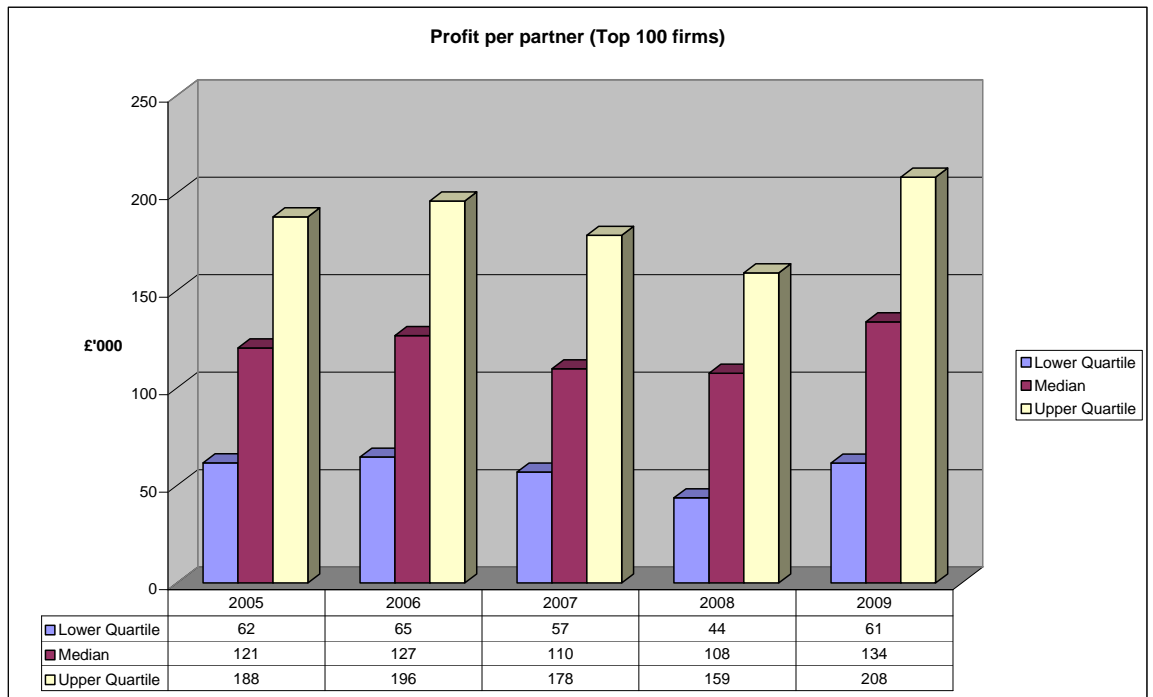


Chart 8

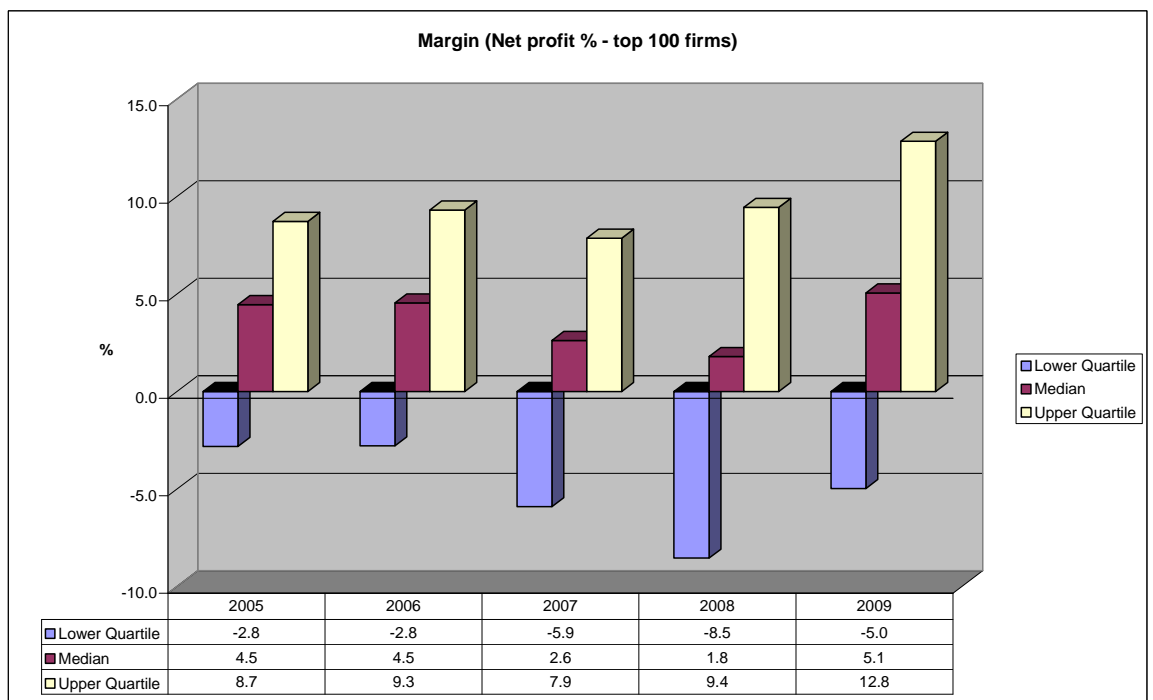


- 4.6 There are indications that salaries will reduce in 07/08 – there are already signs of this. The charts indicate that even before any of Lord Carter’s recommendations are introduced profits in 07/08 could fall by 25%.
- 4.7 The introduction of means testing and penalty notices will have the effect of reducing volume and some firms will respond by making redundancies. It is not clear what level of redundancy payments would be incurred, and whether firm’s salaries would actually fall, but charts 9 and 10 assume a 0% increase in salaries in 07/08 and 08/09:

**Chart 9**



**Chart 10**



### Projection post-Carter

4.8 Table 11 summarises the LSC's forecast of expenditure on crime following implementation of Lord Carter's recommendations, and indicates a 6% fall in 07/08 followed by a small 1% increase in 08/09:

**Table 11**

	04/05	05/06	06/07 Carter	07/08 Carter	08/09 Carter
<b>RAB Net Expenditure CRIME (£m)</b>	<b>Actual</b>	<b>Actual</b>	<b>Forecast</b>	<b>Forecast</b>	<b>Forecast</b>
Police Station (Block Contracts) *	181	185	193	186	192
Magistrates Court (Fixed Fees) *	324	338	326	281	292
Crown Court Advocacy (GFS+VHCC)	169	225	243	265	282
Crown Court Advocacy (EPF)	159	138	83	62	47
Crown Court Litigation (GFS+VHCC) *	309	321	333	335	329
Court of Appeal, RDCOs etc. *	10	10	10	9	10
<b>Sub-Total Crime</b>	<b>1,152</b>	<b>1,217</b>	<b>1,188</b>	<b>1,138</b>	<b>1,152</b>
* Solicitors' total	824	855	862	811	823
% change		4	1	(6)	1
Source: LSC					

4.9 Charts 11 & 12 indicate the projected profitability of the 38 firms if Lord Carter's recommendations are implemented from April 2007. Overheads have been assumed to continue at 2.5% as in the previous scenarios, although in many cases expenditure may actually increase during the transition as firms invest in new IT systems, and potentially new premises. Staff costs are assumed to have increased by 5% over the last two years, as in chart 3, but to slow to 2.5% during 07/08, and stabilise in 08/09 at 0%. Lord Carter had assumed salaries would begin to fall during 07/08, as the changes to the Duty solicitor scheme, and the greater difficulty of setting up on one's own worked through, however we suspect it may actually be a more gradual process for many firms because:

- Many staff will be on existing contracts of employment that would make it difficult for firms to cut their salaries;
- There is at present uncertainty how staff who currently do police station call outs would actually be remunerated in a fixed fee environment. At present they are typically paid a basic salary plus a percentage of the fee – typically 50% of out of hours fees (more in certain cases). This might add £10,000 to a basic salary of perhaps £35,000 for a one-year call duty solicitor in London. Many firms are unclear how they would pay these staff, and how they would incentivise them to turn out in the middle of the night. The result is likely to be that it may well take time for these issues to be resolved, and time before any reductions are seen;
- Small and medium sized firms may well have to increase salaries in order to attract the staff needed in order to grow;

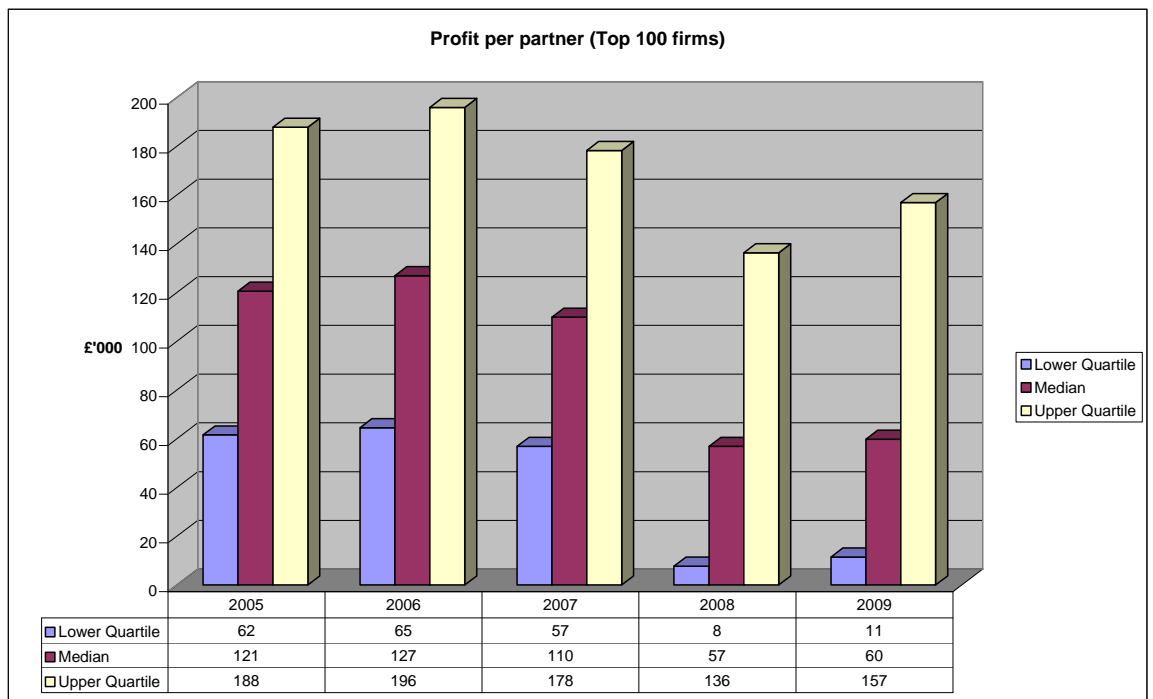
- As firms try to increase their volume it can take some time for fee earners to become cost effective. There is a time lag between recruiting someone and them starting to cover their salary cost, let alone make a profit;
- It is likely that as firms grow they will actually need to increase their expenditure on support staff, in particular in IT, HR and Finance, as medium sized legal aid firms rarely employ such staff;
- The new IT systems necessary for many of the improved efficiencies will not be available for some time. The main suppliers have indicated they will not be able to meet Lord Carter's timescale.

Some firms may be able to cut their salary expenditure, and we are aware of one firm that is planning redundancies amongst its Duty Solicitors as soon as the recommendations are implemented, and replacing them with junior staff, however such firms are likely to be in the minority. The reality for most firms may well be that in the first year of the transition costs will rise, and that any reductions are not seen until the second or third years. There are three main reasons for thinking that total salary costs will slow in due course as Lord Carter predicts:

- The impact of the changes to the duty solicitor scheme;
- Less pressure from senior solicitors as there will be far less scope for them to leave and set up on their own;
- The relatively limited ability of criminal solicitors to move into other areas of work, although firms cite recent examples of staff leaving to join the CPS and the SFO.

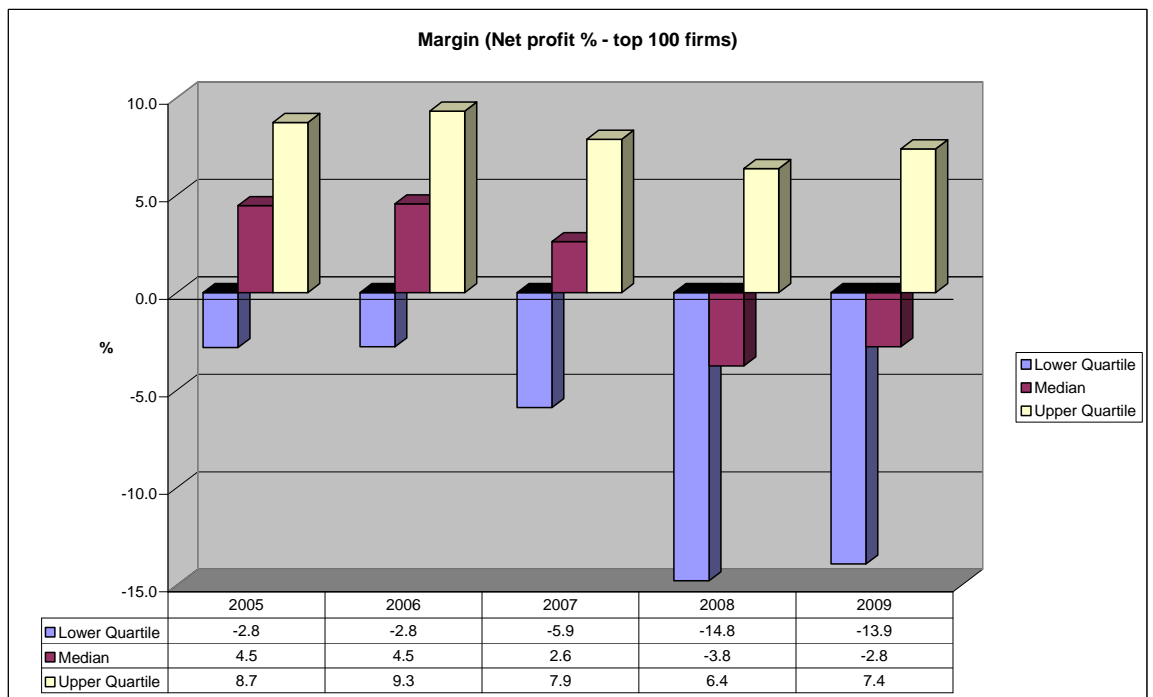
No wider efficiency gains have been assumed as firms are likely to encounter many practical problems during the transition and as they approach competitive tendering. They are likely to be trying to cope with immediate problems rather than taking a more strategic view of their business processes.

**Chart 11**



4.10 Chart 11 indicates a collapse of profit in 07/08 if fees are cut in the first year of the transition before firms are able to achieve the economies of greater size and better organisation.

**Chart 12**



- 4.11 The position is worst for the 13-40 firms where profits reduce significantly as illustrated in Table 12.

**Table 12**

<b>13-40</b>					
	2005	2006	2007	2008	2009
Lower Quartile	50	51	47	18	17
Median	67	71	66	40	45
Upper Quartile	139	143	131	63	73
<b>40+</b>					
	2005	2006	2007	2008	2009
Lower Quartile	97	104	106	-14	-3
Median	139	149	150	125	154
Upper Quartile	254	273	253	174	186
<b>All</b>					
	2005	2006	2007	2008	2009
Lower Quartile	62	65	57	8	11
Median	121	127	110	57	60
Upper Quartile	188	196	178	136	157

- 4.12 Whilst the more successful firms may be able consolidate their position and establish the more viable long-term structures visualised by Lord Carter, most are entering this period of transition in an extremely weak financial position. Any period of change involves cost and uncertainty and generally it is better to be starting with a good balance sheet and reasonable profits. That is not the position for most of the supplier base.

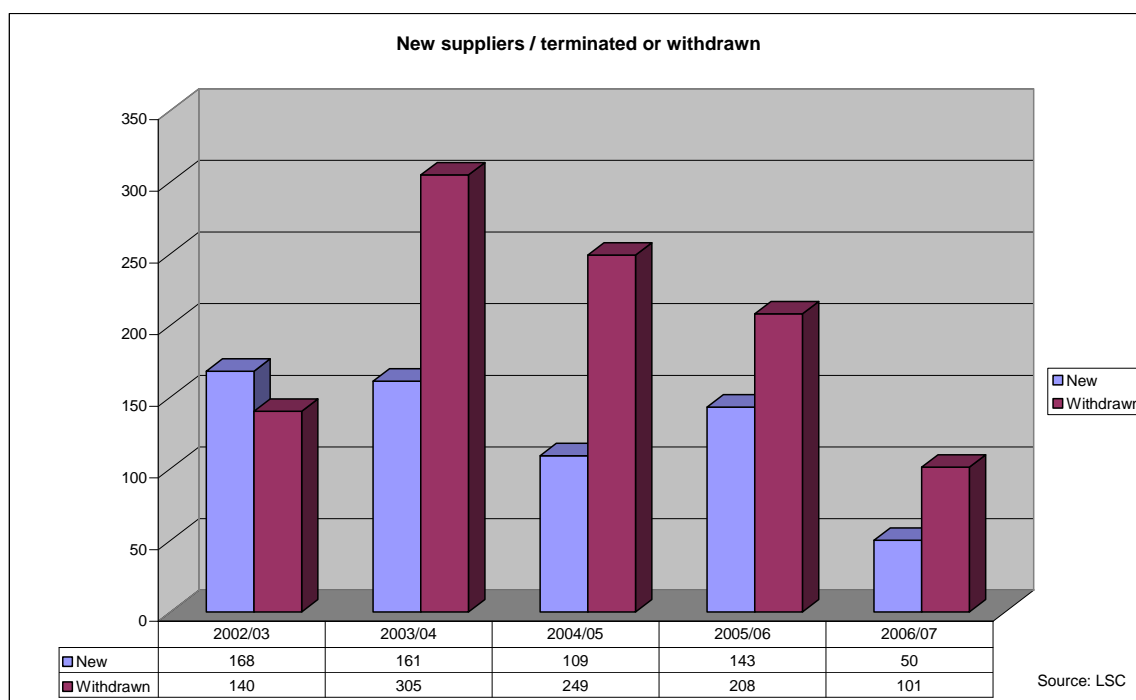
## 5 The questions posed by the LSC

5.1 When considering the likely impact of Lord Carter's proposals it is important to put them in the context of the wider changes that are likely to effect the profession over the next two years as a result of the Legal Services Act. It is expected that this will be enacted during 2007. One of the objectives of the Act is to increase competition for legal services by making it easier for new entrants to the market, in particular organisations that are not owned or controlled by solicitors. This is likely to have a significant impact on "High Street" firms and residential conveyancing would appear one of the main areas to be targeted.

5.2 This will have particular consequences for mixed firms which undertake legal aid and also private client work, the type of practice that is very typical outside the main cities. These firms very often cross subsidise their publicly funded work, however this subsidy may no longer be available as the firm's private fees are reduced. As pressure on profits grows, these firms will very probably seek to eliminate the least profitable areas of work, and for many of these firms this will mean that they will consider closing their legally aided areas of work. This is what many firms have already done. Many firms have already ceased doing publicly funded work and have seen their financial health improve as a result.

5.3 Chart 13 illustrates the number of new and terminated/withdrawn general criminal contracts in recent years and indicates an overall loss of 400 contracts over the period, although fewer firms have withdrawn in the last two years.

**Chart 13**



5.4 This section considers the questions posed by the LSC. Our comments draw on both the financial analysis in sections 3 and 4, our wider experience of the sector and impressions gained speaking to practitioners.

**Whether – on the available evidence – the implementation of the proposed restructuring of fees proposed in the Carter report is likely to lead to an unacceptable reduction in the level of CDS capacity**

**Whether the probable gains in efficiency can be made quickly enough to sustain the service at an adequate level**

5.5 Sections 3 and 4 of this report illustrate the extremely fragile nature of the supplier base and that many firms are already on the edge of viability. The transition coincides with:

- Increased competition for private client work as a result of the Legal Services Act;
- The introduction of UJTF40, which will have the effect for many firms of a one off increase in profits as shown by their annual accounts. Many will appear to have had a good year, however this will be purely a paper profit and could well make it difficult for the firms to assess their true financial health. It will also have the effect of increasing the partners' tax liability.

Additionally, many of the firms are relatively small and lack good financial skills.

5.6 We are concerned that any reductions in fees paid during the transition before firms have had an opportunity to increase their efficiency will force firms into financial difficulty. In some cases it will be their banks who realise there is a problem before the firms themselves and will take action to intervene. There is a real risk that as well as confidence declining amongst the firms there will be a fall in confidence amongst the banks, for anyone other than the most organised firms. Long-term the impact on supply may not be serious as if firms close many of their fee earners will switch to other firms, however in the short term the disruption to supply could be significant. The location of any firms that withdraw might be more relevant as it may have implications for competition.

5.7 For most firms it will be quite costly in terms of both time and money to achieve the economies Lord Carter visualises, something many lack. In particular:

- In order to increase in size they will need to recruit more staff. It takes time to recruit, and the salaries firms have to pay may increase, as in the case of the Leicester firm. It can take time for new fee earners to become profitable, and

they need to be funded until they do. Typically it can take 6-12 months for a fee earner to build up a case load although this may well be quicker in firms with an existing caseload;

- Conversely, firms that are trying to grow may themselves lose key staff to competitor firms as those firms also try to grow. The loss of key staff will add to the workload of the remaining staff but in smaller firms especially will add to the pressure, especially the time pressure on the partners;
- Some firms may seek to increase their size through merger, however merger can be a time consuming task and can be fraught with difficulty. It can take months to identify potential firms, commence negotiations, undertake due diligence and achieve a successful outcome. Many initial discussions come to nothing once financial information is exchanged or the personalities of the individuals concerned become apparent.

In reality there may be relatively few genuine mergers of crime firms. A number of small firms may seek to be taken over, and the partners may continue in the new firm on a salaried partner or consultant basis, or may retire. One London firm cited the example of a small firm that had approached them. The principal had made no profits for the last two years and the firm was insolvent with debts of £200,000. Some larger firms may approach smaller firms with a view to absorbing them, although they would be as likely simply to poach their best staff. Why take over all the baggage of another partnership, and potentially people you do not want when you can simply headhunt those you do want?

Whichever route firms choose, the merger option is likely to be highly time consuming and will often not succeed.

- In their report LECG<sup>16</sup> suggest that many multi-office firms will need to merge offices that undertake fewer than 200 cases a year. The combining of a crime department in a single office may well bring long term efficiencies and economies of scale, however in the short term, during the transition, this will also be highly disruptive. Staff may not wish to relocate, and the loss of fees could prejudice the long-term viability of the office. In the long term such consolidation may well be good for the firm, but in the short term it is likely to add to the disruption during the transition. Any re-location could well be expensive in terms of IT and the physical move, and could result in empty offices until lease renewal;

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<sup>16</sup> LECG – Legal Aid Reforms proposed by the Carter Report – Analysis and Commentary – September 2006 – page 21

- As a result of the new boundary areas, or due to the projected growth in staff numbers, some firms may decide it is necessary to relocate and move to new offices. It can take months to find new offices and there needs to be considerable confidence to take a long term lease. Few firms have such confidence at present. It can be extremely costly to relocate a firm – in addition to the actual removal costs; the costs of new IT and furniture can be high. Other firms may take the view that the key issue is how quickly a fee earner can get to court, a prison or a police station, not to the office, so where they live is as important as where the office is. Either way the issues could well be complex and firms will not necessarily get it right first time;
- The LSC has indicated it will require firms in due course to have more sophisticated IT systems. These are also likely to be costly and time consuming to implement, and the main suppliers<sup>17</sup> have already indicated they will not be able to meet Lord Carter’s timetable:

*“The Legal Software Suppliers Association (LSSA) has called for more time for IT companies to change law firms’ systems to accommodate the Carter reforms, claiming the April 2007 start date for fee structure changes is ‘unachievable’.*

*In a submission to the joint Department for Constitutional Affairs (DCA)/Legal Services Commission (LSC) consultation, LSSA president Simon Meehan said the organisation has ‘serious concerns’ that the IT companies supplying the majority of firms that undertake publicly funded work ‘will be unable to facilitate the changes proposed as required for a smooth transition to yet another major upheaval of the legal aid system’.*

*The LSSA claims that software made by its members is used in 87% of law firms doing publicly funded work, and that ‘the proposed time-scales are unachievable’. ‘It is likely that solicitors and legal aid providers will not have the systems in place to comply’, it added.”*

5.8 The Carter Report proposes that a smaller number of contract areas will reduce travel and waiting times, and so fees can safely be reduced. However, Lord Carter’s proposal to remove travel and waiting from the calculation of fixed fees is scheduled to take effect from April 2007, well before boundaries are restructured or work reallocated. Therefore, until boundaries are re-drawn, firms would lose a significant

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<sup>17</sup> Law Society Gazette – 26<sup>th</sup> October 2006

element of their fees without being able to benefit from the economies that should flow from operating in bigger contract areas.

- 5.9 The Carter Report suggests that suppliers whose contract value was less than £50k in a previous year would not be eligible for contracts from April 2007. However, it appears that the amount of their work that would be available for redistribution would be small and would not allow other firms to achieve significant economies of scale when it was re-distributed. Table 5.2 in the report shows that there are 412 firms which would be directly affected by this proposal, which would suggest that at most there would be £20,600,000 worth of contracts to be redistributed amongst the remaining 1760 firms. Assuming an even distribution, this would amount to an additional £11,700 per firm, which would not be enough to enable them to benefit from economies of scale from this proposal.
- 5.10 Unfortunately, we do not have sufficient data on these <£50k firms to indicate where they are, and how significant they are to maintaining criminal defence services in their areas. It is possible that some at least are providing essential services in rural areas, and that without them, duty solicitor schemes could not be maintained.
- 5.11 The Carter Report sets out models (in tables 5.8 to 5.11), which suggest that there will be increased profits if the amount of time spent on cases is reduced by 5% and a 5% saving is achieved in overheads and non-fee earner costs. However, it is not clear how such savings could be achieved by April 2007. Arguably, the larger and more efficient firms have less scope to make efficiency savings, as they have already made them. This is similar to the introduction of tailored fixed fees in civil and family, where firms with the lowest fees had very little scope to make efficiency savings.
- 5.12 The report visualises a relatively quick transition phase. Changes to police station duty schemes are scheduled from January 2007, and the first reductions in police station fees start to hit from April, however it is likely to take much longer for firms to start realising any benefit. Confidence in particular may well be hit during this period. The benefits may not even materialise for all firms. The share out of work between firms will be according to the percentage of work they did from July 05 – Aug 06 – only lucky firms will gain any benefit. For example, those firms which did a large percentage of work in the reference period but subsequently lost staff, and improved systems allowing them to do the same percentage with lower overheads.

5.13 It is likely that firms will be effected differently depending on their size, nature and location:

- The very large crime firms, with fees greater than £1m, are arguably best placed to survive the transition due to their current size and profitability. There are some current major areas of concern regarding litigators' fees, however, providing this is resolved these firms are starting from a position of strength. There is evidence to suggest that these firms are already benefiting from the proposed changes in that they are being more hard-headed when trainee solicitors are asking for pay rises on qualification and are recruiting accredited representatives instead of solicitors. It may make sense to replace these more expensive people over time with more junior solicitors or case workers. Their capacity should not be affected, unless it is decided to abandon crime altogether, in which case the fee earners concerned should, after a period relocate to new firms;
  
- Although press attention has focused on the 400 firms undertaking less than £50,000 crime fees a year, in many cases this will represent just part of a fee earner's total fees. There will be some very small firms where the loss of this work could affect the viability of the practice, however for most it is unlikely that their viability as a whole will be affected as the crime fees will be just part of the firm's total fees. The fee earner affected would most likely move to a larger crime firm. Overall capacity should not be affected as the fee earner will simply move to another firm;
  
- There will be a group of slightly larger firms, perhaps claiming up to £100,000 or £150,000 crime fees, who recognise that they could also in due course lose their criminal contracts. This group will include sole practitioners who just undertake crime, perhaps with one or two people working with them. There are a number of firms in this category. Employed solicitors and staff in this size group could well move to larger firms over the next year or so, and some could try to merge with a larger firm. Capacity amongst this group may well decline as some sole practitioners could well take this as the moment to retire and leave crime completely. Others may continue working full or part time for other firms.
  
- Perhaps the group that will find the transition most difficult is the relatively large number of suppliers that do more than £200,000 fees, but less than £1m. This group is important both in terms of the amount of criminal work they account for, but also their role in creating competition. If a truly competitive market is to be established these are likely to be the firms most likely to challenge the dominant firms. These firms will arguably need to increase their size in order to compete however they may experience difficulty doing so. They may need to recruit fee

earnings however, like the firm in Leicester may have difficulty affording the salaries asked. They may have to increase salaries, and will not see the reductions in duty solicitor pay that some larger firms are experiencing. The partners may be the duty solicitors. They may see staff poached but, because they are smaller the impact on the practice may be much more disruptive. They may have difficulty funding fee earners until they achieve profitability and may struggle with issues of premises, mergers and IT. These firms will often be starting from a point of low profitability. Some of these firms may not be able to survive the change – others may perceive they cannot and will not be prepared to take the risk. Either way this group is highly vulnerable, and this group will include many of the suppliers who the LSC would want to see in the system long term. It will include several of the firms in the Preferred Supplier pilot. On the positive side, provided they survive the transition, this group of firms have the most to gain in terms of improved efficiency. As indicated above, the introduction of the Legal Services Act may cause additional problems for mixed practices, especially in this size group.

- 5.14 Another key factor that will influence the ability of firms to change will be their access to capital. As indicated earlier larger firms generally require high levels of capital in order to fund, in particular, work in progress. This can be sourced either from retained profits or borrowings. Because of the relatively poor profits most firms achieve it will be difficult for many firms to generate this capital internally. Those with the best management and the most convincing business case should have less difficulty obtaining bank funding, although this will normally be related to the amount of partner capital invested in the firm. Those who are not in as strong a position, and this might include many of the mid sized firms, might struggle to obtain this capital in the timescales envisaged by Lord Carter.

**Whether there are significant regional or other variations in the likely impact of the proposed changes**

- 5.15 As discussed above there is likely to be variation in firms' ability to survive the transition.
- 5.16 It may well be that supply is more easily maintained in London and the larger cities due to the presence of a number of large firms. There will be sufficient large firms to maintain overall supply and although smaller and medium sized firms will experience the various difficulties set out above the system as a whole should survive as there are sufficient large firms, and firms capable of becoming larger.

- 5.17 Outside the main cities the position may be more difficult to predict as here there will be an absence of large suppliers. These areas are more likely to be serviced by medium sized and small firms, many of whom will also undertake private work. This group will experience the difficulties outlined above and they may also be working with a relatively small pool of potential staff. Recruitment is a problem generally however it may well be even more difficult in such areas. They may have to work with geographically large Boundary areas and may struggle to achieve the travel and waiting economies. In these areas it might be extremely difficult to maintain CDS capacity.
- 5.18 Difficulty may also be encountered in rural areas, as it is likely that economies of scale may never be realisable in areas with small, scattered populations and lower volumes. Schemes are likely to need to operate differently in rural areas from concentrated urban areas. This would need to involve local consultation on the best way to reform current police station and magistrates court schemes so that efficiencies can be guaranteed. Detailed work will be needed to identify appropriate boundaries and model the impact on boundary areas.
- 5.19 We concur with LECG's view<sup>18</sup> that *"the Carter proposals represent major changes in market organisation. The problems that occur cannot be fully anticipated and will be location specific. This calls for a flexible approach that carefully identifies differences and takes full account of them during transition."*

**The extent to which firms would have to restructure to live with the changes**

- 5.20 As discussed above, and as highlighted in the research by LECG there is likely to be a need for considerable restructuring by firms.
- 5.21 This is likely to be easier for the firms that are already relatively large – an incremental increase will be easier to absorb, however it will be much more difficult for smaller and medium sized firms, who may need to change dramatically. As discussed previously firms in the £200,000 - £1m size group may have the greatest difficulty.
- 5.22 Larger firms may be reluctant to accept smaller firms as partners in mergers or consortia type arrangements. They may be reluctant to accept the obligations that they would acquire as successor practices. It would be to the advantage of larger firms to wait, in the expectation that smaller firms will fail before they do. As 'last men standing', they would be in an ideal position to pick up whatever elements of the

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<sup>18</sup> LECG page 23

smaller firms' practice they considered attractive, whether that were offices, personnel, and/or market share. This would be very destabilising, and would have a severely negative impact on the principals and partners of small firms.

**The impact on civil/family practitioners who also do crime**

- 5.22 It is difficult to predict the impact of Lord Carter's proposals on civil and family practitioners, and once again there may be considerable variation according to location, size and type of firm.
- 5.23 Two points however should be borne in mind:
- Although this report has concentrated on the potentially fragile state of criminal firms it should be remembered that the 2003 research for the DCA indicated that family and civil was even less profitable. Many crime firms will also undertake civil and family work and as pressure on the profitability of crime increases they may be forced to close areas of work that are not viable. Non-care family within crime firms could be vulnerable as could Social Welfare law, as it is an area some crime firms undertake, however they do not do it in sufficient volume for it to be profitable;
  - The Legal Services Act will once again have an impact since of all areas of work publicly funded family and civil are normally least profitable. Care work can be more profitable, but still there is no comparison with private family work. Any firms that undertake private work will also very probably be forced to question whether they can continue to provide publicly funded family and civil.
- 5.24 These two factors could combine to force some firms to close or scale down their family and civil departments.
- 5.25 The impact of these two factors is very difficult to quantify. If the pace of change is too fast and firms start to get into financial difficulty then they may be forced quite quickly to shed staff in less remunerative areas. The firms that could be most exposed are arguably:
- Mixed practices that also do private work which are dependent on cross subsidy, and are not financially viable in their own right;
  - Family departments which do little care work, since non-care family is least profitable;
  - Social Welfare departments in firms that also undertake crime, as by comparison they are often less profitable;
  - Those in central London, as they have to compete with City law firms for secretarial staff. Family work is document intensive and there is a far higher

need for secretarial support than crime. In London legal secretaries can command high salaries.

**The extent to which we can rely on the available evidence.**

- 5.26 In the appendix we reviewed the independent research which is relevant to criminal procurement and provide a brief analysis of the extent to which it can be relied upon.
- 5.27 As already indicated in this report, as far as financial evidence is concerned, there is actually very little reliable up to date available to the Commission. This report has relied heavily on the small sample of large crime firms as that is the only reliable, recent data available, however that is not representative of the supplier base as a whole. As a result considerable caution is needed in proceeding with reforming criminal legal aid procurement.
- 5.28 In addition, there are some key issues on which there does not seem to be any independent research evidence:
- The impact of the civil and family reforms and how they will impact on the 39% of firms that do civil and family work as well as crime, and which provide 61% of total legal aid services<sup>19</sup>
  - The impact of the Legal Services Act and deregulation of the legal services market on high street firms, which overwhelmingly provide legally aided services. There would be little point in undertaking a large-scale re-organisation of legal aid procurement which would be likely to be undermined by a fundamental re-structuring of the overall market, which seems quite likely.
  - The impact of Lord Falconer's 'Doing Law Differently' reforms, which would increase the number of cases being disposed of by fixed penalties and cautions, thus reducing the volume of cases in the police station and the magistrates' court.
  - The ways that the proposed reforms would impact on other elements of the Criminal Justice System (for example the police, judiciary, court service), strategies they might adopt in reaction and subsequent effects on criminal defence practice.

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<sup>19</sup> Lord Carter's Review of Legal Aid Procurement table 5.4

## 6 Conclusion

- 6.1 This report indicates that the financial position of many criminal suppliers is highly fragile. Some firms are financially strong, however these are very much in the minority. Lord Carter's report proposes a relatively swift timetable towards best value tendering and a relatively brief transition during which firms are expected to achieve substantial change. It is assumed firms will adapt and change quite quickly and there is little allowance or leeway built into the timetable to allow for unknown or unforeseen difficulty. It is proposed that fees will be cut before firms have a chance to increase their efficiency through re-structuring, indeed it is likely that many firms will see their cost base increase during the transition rather than decrease.
- 6.2 It is very difficult to quantify the potential impact on the supplier base, however the available data would suggest that many firms are on the verge of financial difficulty, or are already in some difficulty. There is a real danger that the LSC may lose the confidence of the supplier base, and perhaps more importantly their banks. The closure of firms or departments does not necessarily reduce supply in the long term, however in the short term it makes the transition very much more difficult. Some of the firms that may be most affected are the mid sized firms that are key to the effective operation of the system long term.
- 6.3 In their report, LECG make the point strongly that the proposals represent major change and that it is difficult to fully anticipate potential problems and where they might occur. This high level of uncertainty combined with a lack of reliable data would suggest the LSC should proceed with caution. If possible, proposed cuts in fees should be delayed and the transition extended. Contingency plans should be drawn up should local supply difficulties occur and the LSC have to intervene.
- 6.4 The projections contained in this report suggest the difficulties facing firms will become critical if cuts in fees are introduced from April 2007. It will take some time for the impact of these to work through, however, combined with recent changes such as Means Testing and Fixed Penalties, the cumulative effect could drive a number of firms out of business.

Because most legal practices are partnerships there are unlikely to be high profile collapses although this might occur, especially for firms that expanded too quickly and were over-dependent on an area of publicly funded work that sees a significant reduction in fees. The LSC is in particular aware of problems with the litigators' fee scheme as currently proposed which could impact especially on some relatively large firms. It is assumed these particular proposals will be changed.

There may be certain trigger points during 2007 and 2008. July 2007 will be the first when firms have to pay the partners' income tax, and for many firms this will coincide with a VAT and rent quarter. The next will be January 2008, and then July 2008. The LSC must be particularly aware of the potential problems any claw back of SMP over-payment might have for firms during this period.

- 6.5 Some of the large criminal suppliers may well have been able to start making efficiencies by the time the first restructuring of fees takes place, in April 2007. However for most firms, costs are more likely to increase and efficiency decrease as they seek to adapt and change their firms. For these firms, who account for a sizeable part of the supplier base, it will take time to see the efficiencies working through.
- 6.6 CDS capacity is most likely to be impacted by difficulties experienced by firms with criminal fees of between £200,000 and £1m. These firms will generally need to grow in size, but may well find it extremely difficulty to do so. These firms are not especially profitable at present and will often lack the resources necessary to survive a period of significant change and turbulence in the market.
- 6.7 Funding is likely to be another issue that many firms will find difficult to overcome in the timescale envisaged by Lord Carter. Larger legal aid firms tend to have high gearing and high levels of partner capital. This capital is normally generated through retained earnings however many firms are earning low profits. Although the banks will support firms with a good business case and effective management, their investment is likely to be related to the amount the partners can also contribute, and this may be limited. Also, some firms may have difficulty satisfying their banks that they have the necessary level of management expertise.
- 6.8 Those mixed firms that undertake private client work as well as legal aid, are likely to be affected by the Legal Services Act as this will increase competition, in particular in areas such as conveyancing. Those firms that provide a cross subsidy to their legally aided work may no longer be able to do so.
- 6.9 There is likely to be considerable regional variation and the CDS supplier base in small towns may be the most vulnerable.
- 6.10 The combined effect of these changes together with those brought about by the Legal Services Act may put particular pressure on criminal firms that also undertake civil

and family, as the latter two areas are generally less profitable, and will probably be the first to be closed.

6.11 The underlying message from this report is that the transition is likely to be a risky period and that the LSC should approach it with extreme caution. In particular it should focus on confidence building, and the most effective way of doing that is likely to be to delay any reductions in fees until firms have had a chance to re-structure, to extend the transition, and to be flexible.

6.12 Once again, I would like to thank Vicky Ling for her help and support in preparing this report.

Andrew Otterburn

21<sup>st</sup> November 2006

## Appendix – how reliable is the evidence?

### What is the evidence?

1. Frontier Economics (2003) A Market Analysis of Legal Aided Services  
Provided by Solicitors - A report prepared for the DCA and LSC
2. Otterburn Legal Consulting (2003) Review of Demand, Supply and  
Purchasing Arrangements – Survey of legal Aid Firms - for the Department  
for Constitutional Affairs
3. Cape and Moorhead Report to the LSC (July 2005) Demand Induced  
Supply?
4. FreshMinds (December 2005) Legal Aid Review - prepared for PKF
5. Managing Diversity Associates (2006) Research on Ethnic Diversity amongst  
suppliers of Legal Aid services – report for Legal Services Commission
6. PKF (April 2006) Review of the legal professions' delivery of legal aid services  
– for Lord Carter's Review Team
7. Otterburn Legal Consulting (June 2006) Lord Carter's Review of Legal Aid  
Procurement for the Carter Team
8. LECG (September 2006) Legal Aid Reforms Proposed by the Carter Report –  
Analysis and Commentary prepared by for the Law Society

### How reliable is it?

1. Frontier Economics Analysis 2003

This was based on returns from 303 firms, 270 of whom provided financial data. The data was reasonably robust and was subject to a high degree of validation.

The report concluded that lower prices for criminal defence work might be obtained through competitive tendering. It recommended piloting this model.

This research is now obviously fairly old, especially as in some cases the firms will have based their returns on accounts ending in 2002.

## 2. Otterburn Survey 2003

The Otterburn Legal Consulting Survey used the same data-set and concluded that the most profitable firms tended to be larger and more specialist.

As above, this research is now fairly old.

## 3. Demand Induced Supply? - Cape and Moorhead 2005

This research was carried out by an analysis of the existing literature and official statistics, rather than surveying suppliers.

It found evidence to support the view that too many factors that create inefficiencies in firms are beyond their control. This research does not appear to have been taken into account by Lord Carter's team and is not cited in the Carter Report.

The professors cautioned that their work was completed in a three-month timescale and there is limited literature in relation to cost drivers generally, and criminal legal aid costs drivers in particular.

## 4. Legal Aid Review - Freshminds 2005

As part of the research for the review by Lord Carter a large scale telephone survey was undertaken by FreshMinds. 854 firms were approached. Returns from 86 firms looked broadly reasonable, although doubts remain regarding the reliability of some of the financial data.

## 5. Research on Ethnic Diversity amongst suppliers of Legal Aid services – MDA 2006

This research was undertaken to assist the LSC in carrying out a race equality impact test and support it in carrying out its duty to promote equality. The research relied on statistical data collected by the LSC on suppliers and clients, supplemented by in-depth interviews with BME firms, LSC staff and informed by a stakeholder group. The data appears to be robust.

The report recommended that the LSC should examine local market conditions and adapt the competitive tendering model accordingly.

6. Review of the legal professions' delivery of legal aid services – PKF 2006

PKF based their research on the same data-set as Freshminds, above together with in depth interviews at a number of firms. PKF was confident that their conclusions were valid, although they did have concerns about the quality of some of their data. They observed that 'the metrics were not available to assess 'good' making informed procurement difficult.'

8. Lord Carter's Review of Legal Aid Procurement - Otterburn Legal Consulting 2006

This analysis used the PKF data-set and was undertaken to provide Lord Carter's team with a better understanding of the cost- base of legal aid suppliers. It is therefore based on robust data; but has a narrow focus.

9. Legal Aid Reforms Proposed by the Carter Report - LECG 2006

This analysis used LSC statistics on the distribution of criminal defence casework in 2004-5, to model possible impacts of the proposals of Lord Carter's recommendations. It identified a number of significant risks and suggested that the reforms needed to be implemented sensitively. The data was therefore robust; but the analysis limited in scope.