

The Legal Aid Market for Solicitors

Summary of New and Published Research

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1. Introduction

1. The Review's interim report¹ set out the need for substantial reform of legal aid procurement, especially criminal defence services.
2. The aim of the reforms set out in the interim report was that, through a process of managed change, by 2009 a steady-state should be reached whereby increased volumes of work should be given to the most efficient and good quality suppliers in return for lower prices, the benefits of which could be shared between suppliers and the government.
3. This paper provides a brief summary of key findings from new and published research in relation to the current legal aid market for solicitors' services. It highlights features of the analysis that have either helped inform the Review's proposals for market based reform, or are pertinent to those proposals.
4. In summary, a number of key findings appear to emerge from the work:
 - there is a need for substantial reform of the procurement system – legal aid firms consistently report that they are at the edge of profitability. Firms also believe that, under the current system, there will be many closures of criminal practices, or consolidation;
 - there are many elements of the system that impose costs and inefficiencies. A key one of these is the bureaucracy involved in the current procurement system;
 - legal aid firms are amongst the most efficient of legal firms – particularly those that are crime specialists. The exception to this is management information and IT – firm investment in these activities could lead to substantial efficiencies. However, they need to be combined with changes on the part of the Legal Services Commission in the way it interacts with firms;
 - there are some firms that are able to make reasonable profits from carrying out legal aid work. These firms appear to have a number of common features: higher levels of gearing; higher levels of chargeable hours; a relatively low overhead base; and are specialized in criminal legal aid; and
 - typically, firms with larger numbers of fee earners tend to be more profitable.
5. The summary in this paper is based on the following sources:
 - PKF analysis of solicitor's firms providing legally aided services;
 - Otterburn Legal Consulting's analysis of 2005 and 2006 surveys of firms providing criminal legal aid; and
 - A number of previous research documents published by the Law Society or commissioned by DCA/LSC in the past few years.

¹ Procurement of Criminal Defence Services – A Market Based Approach to Reform. February 2006. See www.legalaidprocurementreview.gov.uk

6. The PKF work analyses expenditure, income, efficiency and productivity by the legal professions in delivering legal aid services. This work, which was carried out in late 2005, was based on a large-scale survey, and detailed analysis of a relatively small number of firms (18). The PKF survey and detailed case study work did not include significant coverage of large-scale legal aid providers.
7. Consequently, Otterburn Legal Consulting was commissioned by the Review to extend the survey work to include large-scale legal aid providers. They were then asked to carry out an analysis of the data to provide a better understanding of the cost base and revenues of larger publicly funded firms with a view to establishing whether a low cost, sustainable, model currently exists that might form the basis for a new system of publicly funded criminal work.
8. The remainder of this paper highlights key points from each source. It does not seek to pre-empt the findings of Lord Carter's review, nor is it the sole basis for the Review's proposals.
9. In the Review's final report, a detailed set of procurement reforms will be put forward. Three criteria will be used to assess what the reforms will do to the sustainability of the supply market and the legal aid budget:
 - the sustainability of different types of firm structure both in the current market and post-implementation of the reforms;
 - the impact of new payment regimes on firms and the implications for appropriate firm structure; and
 - the transaction costs faced by the Legal Services Commission and the wider justice system in relation to both the current supply base and the supply base post-implementation of reforms.

2. PKF – Review of the legal professions delivery of legal aid services

10. PKF were asked to analyse expenditure, income, efficiency and productivity by the legal professions in delivering legal aid services. They were also asked to assess how costs are incurred by the professions and how the organisation and practices of the professions determine how efficiently and productively they deliver those services
11. To undertake the work PKF:
 - conducted detailed interviews with a small sample of firms;
 - used the insight gained from this work to develop a questionnaire to survey a large number of legal aid firms;
 - analysed and presented the findings of that questionnaire (carried out by FreshMinds).
12. This sections provides a brief overview of the main findings from the PKF work in relation to:
 - The reasons for carrying out legal aid;
 - system and procurement inefficiencies;
 - scope for efficiency gains; and
 - prospects for firms to grow and restructure.

Reasons for carrying out legal aid

13. The firms that took part in the survey were asked to set out the reasons for undertaking criminal legal aid activity. The Key reasons given for undertaking criminal legal aid activity are:
 - positive cash-flow and small positive gross margin;
 - stability of activity and a wish to provide a full service offering; and
 - the interest, reputation and esteem associated with such work.
14. The survey results suggest that many of the firms would continue with crime despite the associated low rates. Of criminal legal aid funding, firms were of the view that Very High Cost Case (VHCC) work is considered to provide the greatest levels of profit. Firms noted that this was largely due to remuneration for preparation.
15. However, as with previous studies, the research found that many firms believe criminal legal aid remuneration to be at or beyond an unsustainably low level. Specifically, the responses by firms suggest that:

- criminal legal aid is considered the least profitable activity undertaken;
 - crime stands-out as the most difficult area to recruit and retain staff; and
 - salaries in the crime department are considered to be lower than others.
16. The work suggests a supplier view that substantial changes in the criminal legal aid market are inevitable. Of the criminal legal aid firms surveyed, nearly 50% of firms note that the biggest change affecting the market will be the closure of crime departments. A further 17% of firms mentioned merger, while 10% mentioned consolidation.

System and procurement inefficiencies

17. The PKF research found that legal aid work is provided piecemeal and firms are structured to meet demand on this basis. The payment regime is also considered to be a barrier to efficiency. In particular, it is considered that the payment regime does not reward effort accurately and militates against efficiencies.
18. The research also finds that there is a high level of non-productive time within the existing arrangements which provide for inefficiency. The criminal justice process contains many non-value adding elements such as duplication, travel and waiting, court scheduling, the payment regime, legislation and administrative burdens
19. A range of factors outside the control of firms have been highlighted as detrimental to the overall efficiency of the delivery of legal aid. Of these, a core issue identified by firms appears to be the administrative burden associated with carrying out – and receiving payment for – criminal legal aid work. Specifically, the work identified that the administrative burdens, which add to the cost of delivery, are increasing, and consequently are making criminal legal aid less viable. For example, extra administrative staff are employed by firms to counteract fees and ‘work done’ challenges from the LSC. Almost 50% of firms surveyed believe that administration has become much more burdensome.
20. Key recommendations made by PKF were that:
- a review of the process should be considered to eliminate, or reduce, non value added activity such as travel and waiting time; and
 - a review of the payment regime and administration should also be considered.

Improving IT and management capability

21. The PKF research also examined firms’ use of management information and IT. PKF’s view was that firms could make efficiencies through further investment in both.
22. The research found that firms do not appear to use management information substantially. Firms are not as ‘sophisticated’ as might be expected in professional services environments, with few able to supply details on individual Departmental profitability.
23. Firms also do not demonstrate sophisticated use of IT. PKF suggested that it is likely that sizeable efficiencies could be achievable through greater investment in information

technology. However, they also recommended that any focus on efficiency within firms should be taken forward with more fundamental reforms that complement such initiatives. These might include:

- considering whether the data collected is necessary;
- identifying where IT might be used to avoid travel and waiting time – for example, through greater use of video links;
- databases of evidence and cases;
- greater electronic interaction between different elements of the system – including the procurer; and
- representation of evidence.

Firm structure and costs

24. The PKF work also examined a relatively small sample of firms. As part of that work PKF found that the firms visited (18) did not reveal that there was a standard high volume discount model demonstrating all of the features of good. However, a sampling focused principally on high volume firms could reveal more robust evidence for good business models in these circumstances.
25. The work did identify that costs appear to increase with the size of the firm. However, it also appears that profits per equity partner increase with size. This suggests that larger firms are more profitable for their partners, but may not have lower costs.
26. Finally, the work identified that it is essential to combine business model changes with procurement system changes if market change is to be sustainable. Inappropriate changes to the payment regime alone could lead to a flood of departures from the criminal legal aid market.

3. Otterburn Legal consulting – 2005 and 2006 surveys of criminal firms

27. Otterburn Legal Consulting was asked to validate and analyse data collected by the market research firm FreshMinds. FreshMinds were commissioned to conduct a large scale survey of legal aid firms in November/December 2005. A key limitation of the Freshminds data was the small number of large crime firms that chose to take part. Consequently, a second survey was undertaken by Otterburn Legal Consulting of the top 100 crime firms.
28. The objective of the analysis was to obtain a better understanding of the cost base and revenues of publicly funded firms.
29. An overview of the findings of the Otterburn work are presented below in relation to:
 - cost base
 - profitability
 - sustainability

Firm structure is an important driver of costs

30. A key objective of the Otterburn analysis was to consider how different firm structures impacted on costs. Consequently, the analysis examined and reported costs for different sizes of firm (1-5, 6-12, 13-40 and 40+ fee earners). It is important to note, as mentioned above, that two different surveys were carried out; one by Freshminds and a second by Otterburn, which focused on the top 100 crime firms.
31. Care must be taken in making direct comparison between the two surveys because the samples, methodology and assumptions used in the two surveys are different, in particular with regard to chargeable hours. The composition of the two samples was also very different – in the first survey, for example, only 20% of the firms with 13-40 firms undertook crime work, whereas in the second survey crime represented 94% of the fees of these firms.
32. Costs are reported on a per hour basis – a standard measure used, for example, by the Law Society in its research. Costs were calculated using both reported chargeable hours and assumed chargeable hours. The latter measure was used to help identify differences in the underlying costs of different types of firm, by allowing like for like cost comparisons across the firms. Specifically, the question this comparison addresses is, for the same level of input per fee earner, which type of firm can achieve the lowest costs.
33. The analysis of the Freshminds data finds that, when compared on a like for like basis – using assumed hours per fee earner – firms with 13-40 fee earners have the lowest costs per hour. However, when costs per hour are measured on the basis of reported hours, firms with less than five fee earners have the lowest hourly cost – this appears to be driven by the high chargeable hours achieved by these firms. Firms with less than five fee earners report chargeable hours that are substantially higher per fee earner

than firms with 6-12, 13-40 and 40+ fee earners. The analysis of costs across the second survey of the top 100 crime firms revealed that the 40+ fee earner firms had slightly lower costs than the 13-40 fee earner firms.

34. The Otterburn work notes that costs per hour are higher in the second survey. However, it cautions that direct comparisons should not be drawn between the two samples, as the methodology and assumptions used in both are different.
35. Finally, the work suggests that firms that specialise in the provision of criminal legal aid tend to have lower costs than firms that provide a mixed service. This appears to be because crime specialists do not require the same level of overhead as other types of firm. This is consistent with the findings from the PKF research.

Firm structure is also linked to profitability

36. A key finding of the Otterburn work is that many firms are on the edge of profitability. This includes some firms that have high gearing (ratio of equity partners to fee earners), effective systems and strong management.
37. However, the analysis finds that profitability does tend to vary considerably. Key trends that appear to emerge are that:
 - profit per equity partner increases with the number of fee earners;
 - the FreshMinds data shows that profit per equity partner increases from approximately £43,000 per equity partner for 1-5 fee earner firms to £65,000 for 13-40 fee earner firms and £140,000 for 40+ fee earner firms; and
 - analysis of the larger crime firms shows a similar trend – 13-40 fee earner firms had a median profit per partner of £67,000, while 40+ firms had a median profit per partner of £139,000.
38. The analysis also identifies the characteristics of those firms earning ‘reasonable profits per equity partner²’:
 - high levels of gearing, and a small number of equity partners;
 - higher levels of unqualified fee earners;
 - an expectation of higher chargeable hours;
 - a relatively low overhead base; and
 - a focus on criminal legal aid work

Some firm structures are harder to sustain

39. The analysis finds that 1-5 fee earner firms can achieve low costs if they can generate chargeable hours that are considerably higher per fee earner than for firms with greater

² The measure of profit used in the Otterburn work is profit per equity partner. This measure has been used as it appears to be the industry standard approach to assessing profitability.

numbers of fee earners. It also notes that these firms tend to offer a high level of client service.

40. However, Otterburn's view, based on the qualitative comments in the questionnaires, suggests that it is difficult to see how firms in this category can represent a sustainable long term model:
- they tended to be the least profitable in the survey;
 - the average age of practitioners, particularly in crime, is increasing;
 - they have greater difficulty recruiting staff – the work found that – young solicitors are often not attracted due to the long hours expected, poor pay, lack of security and poor public profile;
 - they have difficulty developing the team structures that are key to cost effective working – due to recruitment difficulties, and also due to a lack of skill/inclination on the part of the partners;
 - the firms find it hard to develop the necessary systems and procedure, or to invest in IT; and
 - the firms can be vulnerable to unexpected blows such as the loss of a key fee earner.
41. The work found that firms with larger numbers of fee earners and a more highly geared structure, can overcome the issues set out above:
- recruitment of certain levels of staff can be easier. These firms are often well known. They are often regarded as providing good training, and for young solicitors who wish to pursue a career in publicly funded work, can be good to have on their CVs;
 - they have sufficient fee earners to be able to attract and justify the cost of specialist HR and IT staff;
 - they are more likely to have the necessary resources and management structures to develop effective procedures and systems;
 - succession is often easier – there is a bigger pool of younger solicitors, and if the firms are profitable they are attractive to these people; and
 - they are likely to be able to offer a wider range of services – family, housing, debt, crime, rather than the narrower areas of work that many smaller firms will be able to offer.
42. However, the Otterburn work cautions that even firms with larger numbers of fee-earners will suffer the general recruitment difficulties faced by legal aid firms, especially for experienced solicitors, but not to the same degree. The Otterburn work also reported comments by participants that suggest that the sense of insecurity has been heightened in recent months amongst crime firms by the threat of competitive tendering, and in recent years amongst legal aid firms in general as a result of pressure on profitability and negative press.

4. Findings from previous research

43. The previous sections of this paper set out the key findings from new research commissioned by the Carter review. This research follows on from many similar studies that have previously examined the legal aid market. These include studies carried out for or by the Department for Constitutional Affairs, the Legal Services Commission and the Law Society.
44. The findings of the newly commissioned research are by and large consistent with this previous work. To illustrate this, this section of the paper sets out findings from previously published research in relation to both the legal aid market, and to the relationship between profitability and firm structure.
45. Specifically, this section presents findings from:
 - Cape and Moorhead, 2004, *“Demand induced supply?: Identifying cost drivers in criminal defence work”*, report to the Legal Services Commission; and
 - various publications by the Law Society or commissioned by the DCA/LSC in the past few years.

Cape and Moorhead, 2004

46. The Cape and Moorhead research examined the influence of the CJS on the cost of legal aid over the last decade, and the factors that account for the substantial rise in those costs.
47. The key findings from the research are that:
 - Crown Court expenditure has increased the most - this is driven by both an increase in the number of cases and the average cost of cases. The drivers of average case costs are not clear; and
 - Police station expenditure is the next highest area of cost increase. This has been driven by increases in volume, and by increases in average case costs. The latter stem in part from changes to the system, which have delivered stable prices since 2000-01. A number of the factors driving volume increases appear to be outside the control of providers. On average case costs, the drivers are less clear. However, the paper hypothesises that many drivers may also be outside the control of providers.
48. Overall, the research suggests that decisions taken beyond the remit and direct influence of the LSC and defence lawyers have directly contributed to the increase in expenditure over the last decade.

Law society research

49. A number of different publications by the Law society have examined the legal aid sector and, more generally, the costs and profits of firms.

50. The findings of many of these studies are consistent with those reported by PKF and Otterburn Legal Consulting.

Financial benchmarking surveys (2003 and 2004)

51. The Law Management Section of the Law Society publishes an annual financial benchmarking survey. It provides a snapshot of the financial well-being of firms and also seeks to identify best management practice in the legal profession. A number of findings in the survey are of relevance to the legal aid market:
- for legal aid, the median fee income per fee earner is £79k compared to £97k for non-legal aid firms;
 - in terms of structure, the survey reports that net profits as a percentage of total income increase with the number of fee earners a firm has. Fee income per fee earner also increases with the number of fee earners;
 - median fee income per fee earner was 5% higher in 2004 than 2003. Interestingly, legal aid firms also reported a 5% increase in income per fee earner. Median profit per partner also increased by approximately 10% for both legal aid firms and non-legal aid firms between 2003 and 2004;
 - The report notes a positive correlation between the profitability of a firm and its handling of a moderate amount of legal aid work – the rationale given is that the discipline of undertaking legal aid work can lead to firm wide operational efficiencies; and
 - Legal aid firms have fewer support staff and secretaries per fee earner than other firms.

Solicitors' firms business survey 2003

52. The Law Society also provides regular reports on firms. One of the last large scale survey of firms was the 'Solicitors' firms business survey 2003' which surveyed the finances, work and staffing of solicitors' firms. Again, this report has a number of findings that are relevant to the legal aid market:
- one of the questions asked firms about the perceived profitability of different areas of work. For criminal work – the majority of which is legally aided – 15% of firms reported that it was loss making, 31% of firms reported that it was break even, while 54% of firms reported that it was profitable;
 - the report also considered the relationship between the number of fee earners in a firm (the structure of the firm) and costs, revenues and profitability. The report found that all three increase with the number of fee earners; and
 - gearing (the ratio of fee earners to equity partners) increases considerably the more fee earners there are in a firm.

Otterburn Legal Consulting – Survey of Legal Aid Firms (2003)

53. Otterburn Legal Consulting carried out a financial survey of over 300 firms for the DCA in 2003. The report makes a number of findings that are pertinent to the Review.
54. Profitability appeared relatively low – in many firms profit per equity partner was less than the average remuneration paid to senior assistant and associate solicitors.
55. The report set out the principal factors that appeared to be influencing the profitability of firms:
 - the degree to which work is done in volume – the most profitable firms tended to be larger and more specialist;
 - the financial structure of the firms, especially their level of gearing, and the level of salaries and overheads to fees;
 - their location – firms in the North were more profitable than those in London or the South;
 - the types of work done – civil work appeared less profitable than crime; and
 - the number of chargeable hours achieved.
56. The report suggested that one of the main areas of difficulty concerned smaller less profitable firms that wished to become larger and adopt the characteristics of the more profitable firms in the survey. The report noted that key problems facing these small unprofitable firms were recruitment difficulties, a lack of management and business skills and difficulties accessing bank finance.