Lawyers and commercialism: help or hindrance?

The following is an edited version of a speech by Chief Justice Bathurst, delivered at the Rotary Club of Sydney on 16 April 2013

I have chosen to you speak to you about the role of lawyers and the law in commercial activity in Australia. Specifically I would like to pose this question: are lawyers a help or hindrance to commercialism? Now, there are any number of lawyer jokes I could tell you that would provide a quite emphatic, though not very polite, response to the question. I will however avoid repeating them - as former Chief Justice Spigelman once remarked, it is usually best to avoid telling lawyer jokes to mixed legal and non legal audiences, because the lawyers don't find them funny, and no else realises they are jokes.

You may wonder why it is important to consider the role of lawyers in commercialism. There are at least two reasons. First, as I will go on to discuss, analysing when and how lawyers contribute to economic efficiency has implications for our attitude to legal regulation of corporate and commercial life, including questions of when regulation is appropriate and our approach to enforcement.

Second, in the absence of such a discussion, the economic importance of the legal system is often overlooked. Along with many of my judicial colleagues, I have often commented that the law is a profession not a business, and that the courts are an arm of government, whose work cannot be evaluated in purely financial terms. However, that does not mean that the legal system does not have economic value. As former High Court Chief Justice Murray Gleeson has put it:

> The economic significance of an effective system of administration of justice is generally undervalued. Perhaps the system is a victim of managerial bias towards calculation: if something is difficult to measure, it is often treated as unimportant; if it is impossible to measure it is often treated as if it did not exist. Economic rationalism should be comprehensively rational. If proper attention were given to the economic importance of the institutional framework within which commerce and industry function, then courts throughout Australia might compete for government funding on better terms.[1]

No doubt I have now given away that I have a little skin in the game. In any case, given that I practised as a barrister in commercial and corporate law for some 35 years before I came to the bench, it is no doubt unsurprising that I believe lawyers and the legal system play an important, indeed essential, role

in facilitating efficient business operations.

This occurs in at least three ways. At the most general level, the legal system is a necessary pre-condition to organised commercial activity. Without the law, for example, there are no property rights. To quote the late economist Mancur Olsen 'individuals may have possessions, the way a dog possesses a bone, but there is private property only if the society protects and defends a private right to that possession...to realise all the gains from trade...there has to be a legal system and political order that enforces contracts, protects property rights, carries out mortgage agreements, provides for limited liability corporations, and facilitates a lasting and widely used capital market.'[2]

Second, lawyers help to minimise the costs of commercial transactions – which is somewhat ironic given that what business calls 'transactional costs' lawyers call 'income'. Sound advice and assistance in drafting commercial agreements for example, can help businesses avoid future disputes and resolve present ones efficiently. Legal advice can also alert companies to potential pitfalls in the way they are currently operating and highlight new opportunities and ways of structuring their operations. Just recently for example, I read about a 19th century conveyancing lawyer who saved his clients from some ninety million pounds of stamp duty for which they would have been liable, had they structured a partnership deed in the way they intended.[3] I can't

even compute how much that would represent in today's dollars, but I think you could safely call that earning your keep.

Third, and critically, the value of lawyers to business is evident from the complex body of regulation attaching to commercial activity in Australia: it is no overstatement to say that it would be impossible for business to navigate corporate and commercial regulation in the absence of legal advice.

Of course if this seems like a very convenient piece of circular logic to you, that is because it is: lawyers are necessary for business because so much legal regulation exists. Nifty, isn't it?

In all seriousness though, as one, if not the, primary function of lawyers in this context is to ensure and enforce compliance with the web of regulation affecting commercial activity, truly assessing the help or hindrance of lawyers to commercialism inevitably requires analysing the commercial value of regulation itself. It is on this topic that I propose to focus the remainder of my address.

Let me first make a few disclosures. I am not a total free marketeer. I am also not a person who believes that there should be regulation simply for the sake of it. In my view, regulation can only be justified in two circumstances. First, where it is necessary to protect the public and second, where it operates to eliminate or control distortions in the market, or what are sometimes described as externalities.

It would take too long, and be very unjudicial of me, to spend today pointing out regulation that does not, in my view, meet those imperatives. What I would like to do is focus on particular areas that show that regulation that is legitimately directed to these aims is desirable in the public interest and has an economically positive effect. In that context I will consider the role that legal regulation plays in three areas that threaten efficient markets: insider trading, anti competitive behaviour, and risk externalities.

My position today is not uncontroversial. While it is fairly orthodox, in this country at least, to see some positive role for legal regulation in markets, there are many people – including a significant number of Nobel Prize winning economists – who would argue that markets should be left to self regulate. That view is grounded in an intellectual tradition stretching back to early laissez-faire industrial capitalism, which views the market as best placed to ensure resources are allocated efficiently. Consequently, what could loosely be called the 'anti-regulatory position' argues that government regulation only distorts economic activity, including for example by creating monopolies; that markets correct themselves, making regulation unnecessary; or alternatively that the cost to business of complying with regulation places a greater financial burden on users than the market imperfections themselves would. I'll apologise right now to any economists in the room – I know that was a gross oversimplification. My undergraduate economics courses were a long time ago.

...the Australian regulatory approach also recognises that markets are imperfect and therefore that complete deregulation cannot be relied on to maximise economic efficiency.

Many things can be said in favour of the view that markets should self regulate. Indeed the entire approach to corporate and commercial regulation in Australia is founded on the assumption that markets function best with minimum interference, and that focus should primarily be placed on ensuring transparency and information disclosure, so that participants in commercial activity can do so in a fully informed way.

However, the Australian regulatory approach also recognises that markets are imperfect and therefore that complete deregulation cannot be relied on to maximise economic efficiency.

First, consider insider trading – behaviour which has long been prohibited in Australia.[4] The anti-regulatory view, which was pioneered by US economist Henry Manne, is that insider trading not only does no harm, but actually increases economic efficiency. The argument is founded on the 'efficient market' theory; namely, that the 'price of securities in financial markets fully reflects all available information'.[5] In that context, it is argued that insider trading keeps prices honest. That is, trading done on insider information alerts the market, allowing it to adjust prices, with the result that share prices are

more likely to truly reflect the value of the relevant asset. That in turn allows creditors to stop extending credit to failing businesses and alerts investors to sell shares in failing companies.[6]

What this argument ignores is the systemic economic impact of allowing such behaviour. It may be true that overall share prices adjust more quickly due to insider trading. However, in a system where such trading is prevalent, the market becomes characterised by asymmetric information between buyers and sellers about the value of assets. Consequently investors can have no confidence that they are operating in a fair market –that they know the real value of the shares they are buying or selling. To use the economic parlance, there is a loss of market integrity. In turn, this has a negative impact on willingness to invest, and therefore on the overall stability and liquidity of financial markets.[7]

This phenomenon can be illustrated by the parable of Arkelof's lemons, which sounds like the title of one of *Aesop's Fables*, but is actually a reference to a seminal article by Nobel Prize winning economist George Akerlof. Arkelof's article, entitled 'the Market for Lemons' (which was actually about used cars) hypothesised that in a market where there are some good products and some 'lemons', but only sellers know which is which, buyers will only offer a price that takes into account the fact that they might be getting a dud product. In other words they will not have the confidence to pay an appropriate market price for a high quality product.[8] This hinders beneficial trade and can even cause market collapse.

What the anti-regulatory position overlooks is the economic need for fairness in financial markets – something only the law can supply.

The importance of Arkelof's lemons is evident in data that consistently shows a positive association between insider trading laws and overall market efficiency.[9] What the anti-regulatory position overlooks is the economic need for fairness in financial markets – something only the law can supply.

Legal regulation is also necessary to remedy distortions that can arise from too great a concentration of market power. This can be seen in the context of anti-competitive behaviour.

Such behaviour can arise in a number of situations, for example where one company has a monopoly in a market – or, as is more often the case, when a small number of firms dominate the market, creating a duopoly or oligopoly. A related situation is where companies form a cartel, agreeing to cooperate with one another to, for example, fix prices or carve up the market between them. By reducing competition, cartels allow businesses to operate analogously to a monopoly. In such circumstances, dominant businesses have a significant amount of power to dictate prices to consumers and suppliers.

In Australia, both cartel conduct and misuse of market power are prohibited under the Competition and Consumer Act 2010. The anti regulatory view however, is that competition laws effectively penalise companies that have shown the 'extraordinary skill' required to acquire a significant share of the market, and that monopolies are themselves the result of government intervention.

In a 1961 essay entitled 'Antitrust', former US Federal Reserve Chairman Alan Greenspan famously described anti competition laws as reminiscent of 'Alice's wonderland'.[10] Apparently he meant that as a bad thing – strange I know.

Greenspan's argument was that competition, properly understood, involves 'taking action to affect the conditions of the market in one's own favour', which could include competitors setting joint price policies.[11] Equally, he argued that one company having a significant amount of market control could yield efficiency gains. Greenspan's central thesis was that regulation was unnecessary to control these kinds of market power, because demand would inevitably drive new competitors into an industry, and established companies who were inflating prices would be undercut. Only if new competitors were completely barred from entering a market could a monopoly survive, and this, he argued was only possible as the result of government intervention.[12]

The reality of anti competitive behaviour shows the flaws in this argument. Legal regulation is necessary because it can be extremely difficult for competitors

to operate within, or break into, a market where one firm is dominant, and because even if the market does eventually 'auto correct', cartels and monopolies do a great deal of economic harm in the mean time.

Cartels, for example, cost billions of dollars to the global economy. That occurs both directly, in that consumers pay more than the real market value of the product, and indirectly, in that otherwise non-competitive companies are protected and innovation therefore discouraged.

The world's most infamous cartel case to date is probably the vitamin cartel, which, as the name suggests, involved pharmaceutical companies fixing the price of vitamins. Now, I'll be the first to admit that raising the price of health supplements doesn't immediately seem like the most evil of criminal conspiracies, but vitamins are actually in many more things than you would imagine, like cereal for example. All in all, it is estimated that the conduct ended up costing consumers around thirteen billion dollars.[13] The vitamin cartel was eventually broken open by the US Department of Justice in 1999,[14] but it is thought to have operated stably for some ten years before that. Even then, a key element in the investigation was that one of the companies involved came forward to whistleblow in exchange for leniency. In other words, market forces simply did not correct this anti competitive behaviour, which was occurring on a grand scale.

At the other end of the spectrum, even in cases where there appears to be intense competition between firms in an oligopolistic or duopolistic market, such a market can have a long term damaging effect on competition and economic efficiency generally. Take this hypothetical example.

Three or four companies, each having substantial market share both on the supply and demand side, decide to engage in a price war in relation to the products they sell. They do so not by reducing their profits, or as a result of increased efficiencies in their operations, but by exercising their market power to extract goods from suppliers at below marginal cost. Inevitably, the outcome must be that a number of suppliers will fail, leaving a monopoly in the supply of the particular product. In that way, an industry, which was operating efficiently, will effectively be undermined.

More simply, the long-term result of unbridled competition by competitors with significant market power must eventually be that there is only 'one man' standing. Take predatory pricing. If a corporation with market power consistently sells goods below cost price, the effect will ultimately be the elimination of smaller competitors. In other words, it will give rise to a market created monopoly, which will then allow the monopoly provider to control prices.

By prohibiting predatory pricing, misuse of market power and other anti-competitive behaviour, legal regulation therefore plays an essential role in ensuring that competition, which lies at the heart of an efficient free market, actually operates in practice.

Third and finally, I would like to consider externalities. As many of you will know, an externality occurs where the cost or benefit of a particular economic activity is not borne entirely by the parties to that activity, but rather by one or more third parties, and is therefore not fully reflected in prices. The classic example, of course, is pollution caused by factory production, which may impose costs on surrounding residents, perhaps by requiring clean up or diminishing the value of nearby land. One thing that the financial crises of the last few years have shown us is that in financial markets systemic risk is one such externality, and that the largely deregulated markets promoted by advocates of self-regulation failed to manage that risk efficiently.

I wouldn't have the hide, or for that matter the foolhardiness, to seek to explain the Global Financial Crisis. However I think that what has become apparent, at the least, is that it was not a crisis caused by an immediate event, as distinct from a long term distortion between the level of lending to fund both consumption and, more particularly, investment and the potential returns on investment to service that lending.

But more simply – or stripped of its verbosity – there was an insufficient appreciation of the risk involved, and the price for such lending, whether by way of interest coupon or other charges, did not adequately reflect that risk. While each institution may have managed its own risks, it did not factor in the cost of the risk it had undertaken to the system as a whole, arising from, for example, the inter-connectedness of banking institutions.

If financial institutions had priced their loans by reference to the risk involved and to their own capacity to meet their obligations on the money they had borrowed to make such loans, many of the loans that exacerbated the banking crisis may not have been made. The situation of course becomes all the more complicated once you add excessive sovereign debt to the equation, as is currently the case in Europe. As I am no doubt testing your patience for economic theory to its limits, and have already disclosed too much of my ignorance of it, it's probably best if I don't go there.

The failure of markets to manage systemic risk, and the devastating effects of the financial crisis on almost all aspects of an economy, most recently in Cyprus, is powerful evidence of the economic benefits of effective legal regulation in controlling market distortions - and of the lawyers who assist and ensure that companies comply with that regulation.

Now I would not want you to think from anything I have said so far that I believe the legal system should receive nothing but praise in this area – although by all means feel free to lavish it. While regulating commercial conduct is essential to a stable and efficient economic system, it is also undeniable that legal regulation imposes a cost on business – both in terms of how commercial activity is structured and in ensuring compliance. These costs are ultimately reflected in the price of the product or service. There is therefore always a cost benefit analysis to be undertaken.

Recognition of the economic importance of the law – both its positive impact and its costs – therefore also entails a responsibility on lawyers and legislative drafters, to ensure that developments in commercial and corporate regulation are economically rational.

This of course already occurs to a great extent. It is also far from simple. The financial crisis for example has led to many debates about regulatory reform, including in Australia. Some see a role for regulatory agencies such as ASIC in prohibiting or 'red flagging' the sale of certain high risk products to retail investors,[15] effectively in order to protect consumers from themselves. In so far as such an approach would restrict personal choice, rather than simply assisting investors to make better informed decisions, it would of course constitute a significant departure from the accepted underpinnings of our current system of financial regulation. On the other hand, it can be argued that the vulnerability of some consumers to unscrupulous tactics, and the social cost of bad personal investment decisions, justifies such a restriction.

At the other end of the spectrum, regulatory reforms have focused on ensuring that financial institutions insure themselves against risk better, by for example mandating that the more risk a bank takes on, the more capital and liquid assets it has to hold, in order to ensure it remains solvent and stable during economic shocks. These type of measures lie at the heart of the Basel II and upcoming Basel III accords on banking supervision.[16]

An individual should not need a senior counsel, junior counsel, and a small army of solicitors to tell them what the law they must comply with is. I can say that now, although I might not have been so keen to in my past life.

It is not for me to comment on the the desirability of any one regulatory reform measure. I don't have the time, or for that matter the expertise, to do so. My point is simply that the economic theory behind and likely commercial impact of particular regulatory measures is an important consideration. An appreciation of these matters is essential for all those involved in regulating the corporate and commercial sphere – whether legislative drafters, enforcement agencies, the courts, or lawyers – if the legal system is to provide the greatest possible help to commercialism.

In that context, I would like to spend the few minutes I have remaining to focus on one issue that can greatly impact on the economic benefit or cost of the law to commerce - certainty. Central to minimising the costs of legal regulation is that the rules applying to business be certain and decisive. An individual should not need a senior counsel, junior counsel, and a small army of solicitors to tell them what the law they must

comply with is. I can say that now, although I might not have been so keen to in my past life.

In the absence of certainty, costly legal disputes are more likely to occur, compliance becomes more difficult and therefore expensive and issues such as regulatory gaming arise. Lawyers, and the legal system more broadly, should therefore always be striving to improve certainty.

There are two issues I would like to mention in this context. First, it is essential that regulatory legislation and codes are drafted in a way that is clear and certain. The last twenty odd years have seen a continuing rise in the 'plain language' drafting movement. Essentially, plain language advocates argue that legislation can and should be drafted so as to be immediately intelligible to those people on whom it will have an impact, without the need for interpretation by lawyers.

While this is certainly a laudable goal, plain language drafting also contains dangers. Although it need not involve loss of precision, there are times when drafters confuse 'plain' language with simple or short language, and draft at a level of generality that generates ambiguity in application.[17] Some plain language guidelines also eschew statutory definitions, preferring to give words their 'general meaning'. Far from simplifying matters, this may well create confusion, particularly in the highly technical realm of corporate regulation.

A similar criticism can be made of the increasing enthusiasm for the codification of legal doctrine. Last year for example, the federal attorney-general's department put forward a proposal to codify the law of contracts – which is mostly regulated by the common law - largely on the basis that it would increase clarity and accessibility. As I said in a submission at the time, while codification has been useful in some areas – such as the model law on international commercial arbitration – it should be approached with caution.[18] A short and simple code, although accessible, will do little to help users navigate legal rules where detail is essential, while a more comprehensive code will not be accessible. Trying to simplify complex legal doctrine merely risks creating ambiguity, which the courts will then have to fill through interpreting the code. Moreover, codification is likely to come at the cost of the flexibility and adaptation inherent to the common law – characteristics which are necessary to respond to the rapidly changing landscape of commercial and corporate life.

While this is certainly a laudable goal, plain language drafting also contains dangers.

It is perhaps an unfortunate reality that in a 'highly stratified and complex society, law cannot be anything but intricate and difficult'.[19] Attempts to ignore this reality through measures such as codification may only increase ambiguity of regulation and therefore compliance costs for business. To again use the example of the law of contract, legal doctrine in this area is well established, consistent throughout Australia and generally understood by lawyers – certainly by competent ones. There is no point in creating an additional stratum of regulation, which will have to be explained by the courts, at the expense of the commercial community.

Second, there may well be scope for regulatory bodies to increase the guidance they provide in relation to potentially controversial commercial transactions, so that legal disputes can be averted. For example, the Australian Tax Office currently provides individual and class rulings, whereby parties can apply to the ATO for advice about the tax consequences of a particular scheme or circumstance. That advice then binds the ATO in dealing with the relevant party, provided that the facts on which the ruling is based can be established. The ACCC operates a somewhat similar process. A party that intends to enter into a merger or acquisition but fears breaching the legislative prohibition on acquisitions that are likely to have the effect of substantially reducing competition can apply to the Commission for clearance of the transaction prior to entering into it.[20]

Many regulatory agencies could also improve certainty by providing legal guidelines...

In my view, other regulatory agencies could provide similar legal rulings. For example the Takeovers Panel – which is responsible for resolving disputes

about takeover bids – currently issues guidance notes of general application. However, unlike the equivalent bodies in London and Hong Kong, it does not provide advance rulings on whether there would be 'unacceptable circumstances' in relation to a takeover bid. Of course, in cases of doubt, an application can be made to ASIC for a modification of Chapter 6 of the Corporations Act and the Panel can then review ASIC's decision. Nonetheless, it may well be that the London and Hong Kong model produces quicker and more efficient outcomes. No doubt the chairman of ASIC would disagree with me.

Many regulatory agencies could also improve certainty by providing legal guidelines, setting out their interpretation of the relevant legal regulations and the circumstances in which they will choose to intervene in a given commercial transaction. I have mentioned the Takeovers Panel already, and ASIC also provides such guidelines, as to an extent does the ACCC. Continuing development in this area, including by state regulatory bodies, would further promote transparency and thereby assist commercial efficiency.

These are just two of the many suggestions that could be made in this area. The more central point is that debate and engagement over the economic impact and foundation of regulatory measures should be commonplace for all those involved in regulating commercial and corporate life. Ongoing engagement with the economic role of the legal system is important - for how we approach regulation, for how business engages with the law and for the role that lawyers will play in helping or hindering commercialism.

It remains only for me to thank you very much for your kind attention and for welcoming me as a member of the Sydney Rotary Club.

Endnotes

1. Olsen, *Power and Prosperity: Outgrowing Communist and Capitalist Dictatorships* (2000) cited in The Hon J Spigelman, 'College of Law Graduation Ceremony: Occasional Address' (8 November 2000).
2. Sir Robert Megarry, *A Second Miscellany at Law* (1973) Steven & Sons Ltd: London, 283.
3. See *Corporations Act 2001* (Cth) s 1043A.
4. William Sharpe (1970) cited in Randall Dodd, 'The Economic Rationale for Financial Market Regulation' Financial Policy Forum, Special Policy Report 12 (December 2002), 2.
5. Gill North, 'A Re-examination of the Manne Efficiency Theory and the Insider Trading and Company Disclosure Efficiency Rationales' (2011) 25 *Australian Journal of Corporate Law* 209, 216-217.
6. Tony D'Aloisio, 'ASIC's Approach to Market Integrity', Monash Centre for Regulatory Studies and Clayton Utz Luncheon Lecture, (March 2010).
7. The Hon J Spigelman, 'Are Lawyers Lemons? Competition Principles and Professional Regulation', 2002 Lawyers' Lecture St James Ethics Centre (29 October 2002).
8. Laura Hughes, 'The Impact of Insider Trading Regulations on Stock Market Efficiency: a Critique of the Law and Economics Debate and a Cross-Country Comparison' (2009) 23 *Temple International and Comparative Law Journal* 479, 485; Gill North, 'A Re-examination of the Manne Efficiency Theory and the Insider Trading and Company Disclosure Efficiency Rationales', 224-255.
9. Alan Greenspan, 'Antitrust' (Paper given at the Antitrust Seminar of the National Association of Business Economists, Cleveland, September 25, 1961) available at http://www.polyconomics.com/index.php?option=com_content&view=article&id=1605:antitrust-by-alan-greenspan&catid=47:1998.
10. Alan Greenspan, 'Antitrust'.
11. Alan Greenspan, 'Antitrust'.
12. John M Connor, 'The Great Global Vitamins Conspiracy: Sanctions and Deterrence' (Paper to Economists Unit Seminar, European Commission, Brussels, March 2006) at 31, available at http://www.agecon.purdue.edu/staff/connor/papers/The%20Great%20Global%20Vitamins%20Conspiracy%20Sanctions%20and%20Deterrence.pdf.
13. Julie Wolf, 'EU Probes Vitamin Cartel' The Guardian (May 1999) available at http://www.guardian.co.uk/business/1999/may/22/15.
14. ASIC, 'A Regulator's Perspective on Key Challenges' (16 March 2010) at 11, available at http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/National-Consumer-Congress-16-March-2010.pdf/$file/National-Consumer-Congress-16-March-2010.pdf.
15. Wayne Byres, 'Basel III: Necessary but not Sufficient' (6 November 2012) available at http://www.bis.org/speeches/sp121106.pdf.
16. Jeffrey Barnes, 'When 'Plain Language' is Ambiguous – Sources of Doubt and Lessons for the Plain Language Movement' (2010) 34 *Melbourne University Law Review* 671, 705.
17. The Hon TF Bathurst, 'Codification of Contract Law – A Flawed Proposal' (Submission to the Review of Australian Contract Law, 2012).
18. HR Hahlo, 'Here Lies the Common Law: Rest in Peace' (1967) 30 (3) Modern Law Review 241, 245.
19. *Competition and Consumer Act 2010* (Cth) s 50; s 95AC; s 95AM.