

# “The Allocation of Ownership Rights in Management Consulting Firms: An Institutional Economics Approach”

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# The Allocation of Ownership Rights in Management Consulting Firms: An Institutional Economics Approach

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## Abstract

In this paper, we develop an institutional economics approach to the optimal allocation of ownership rights in firms, building on the work of Hansmann (1996). According to this approach, the optimal allocation of ownership rights in a firm minimises the sum of transaction costs and governance costs across all the parties with which the firm maintains contractual relationships. We apply this approach to the case of management consulting firms, addressing in particular the question why many of these firms are owned by partners, the senior employees of the firm. We argue that this assignment of ownership rights helps consulting firms to reduce transaction costs in the relationship with those employees who maintain key client contacts, whilst at the same time keeps a check on the governance costs associated with the ownership assignment to employees. Other options for assigning ownership rights, e.g. to the suppliers of intermediate goods and services, tend to sub-optimize the use of ownership rights.

**Key words:** Consulting, governance, New Institutional Economics, ownership, partnership.

## 1. Introduction

The optimal allocation of ownership rights is one of the most controversial topics in organisation theory, economics and the social sciences. Why does capital typically hire labour, rather than labour hiring capital? Should managers have a financial stake in the firms which employ them, in order to reduce the “division between ownership and control” (Berle and Means, 1932) that can give rise to corporate governance conflicts? The public debate about these questions is often ideologically charged.

The ownership of *management consulting firms* is for several reasons a topic that attracts particular interest. Firstly, many management consultancies are organised as partnerships, i.e. as firms in which a group of senior employees holds the ownership rights. It is curious that management consultants who advise primarily investor-owned firms establish ownership structures in their own organisations that differ sharply from those of their clients. Secondly, many changes in the ownership structure of management consulting firms have taken place in recent years, and the chances are that the market for ownership rights in consulting will continue to be a dynamic one. To give just a few examples, A.T. Kearney, Oliver Wyman and the consulting arm of PriceWaterhouseCoopers were all bought by investor-owned firms. In addition, the development of in-house consultancies by many large companies such as Siemens, ABB and AT&T has led to the emergence of customer ownership as a new ownership form in the consulting sector. Overall, the general trend among management consulting firms has been away from the use of partnership structures. However, there are some notable exceptions, for example the management buy-out from Deutsche Bank by Roland Berger Strategy Consultants in 1998 which re-established Roland Berger’s partnership status after more than ten years of ownership by a financial investor.

In this paper, we pursue a twofold aim. First, following the approach developed by Hansmann (1996), we outline an institutional economics approach to the allocation of ownership rights among the various classes of “patrons” with which a firm maintains contractual relationships. According to this framework, the efficient assignment of ownership rights minimises the sum of two types of costs – transaction costs and governance costs – across all classes of patrons. The primary advantage of this approach is that it takes into account all potential classes of owners, whereas other economic approaches in this field, such as classical transaction cost theory and

property rights theory, typically focus on the optimal assignment of ownership rights among two alternative classes of patrons only.

Second, we apply this framework to the special case of management consulting firms, in order to explain the ownership patterns observable in this sector, in particular the preponderance of partnership arrangements. In our case study we systematically investigate all major groups of contract partners of management consultancies on the basis of Hansmann's argument, finding that the internal assignment of ownership rights to employees in consultancies enables them to lower transaction costs with their most important input factor, i.e. human labour. At the same time, limiting the assignment of ownership rights to a relatively narrow group of senior employees helps to reduce monitoring costs and minimise conflicts about the distribution of the profit pie, and thus helps to lower governance costs. In summary, we argue that the institutional economics perspective provides a useful approach to explaining the preponderance of partnership arrangements in the management consulting sector.

## 2. The allocation of ownership rights in firms: An efficiency perspective

In this section we develop an institutional economics perspective on the efficient allocation of ownership rights, drawing on the work of Henry Hansmann (1996). In his approach, Hansmann applies the efficiency considerations developed in classical transaction cost economics (e.g. Williamson, 1975; Williamson, 1985) to the full range of parties that maintain contractual relationships with a firm. Ownership of an asset is defined as the combination of two sets of formal rights in the same entity: (1) the right to control or govern the asset, and (2) the right to appropriate the residual earnings accruing from that asset, i.e. the profits that remain once the legitimate contractual claims of all other claimholders have been satisfied. If the asset under consideration is a firm, the claimholders that qualify in principle for ownership are the various classes of patrons, i.e. those that have a contractual relationship with the firm, either as suppliers of input factors (labour, financial capital, intermediate goods and services) or as buyers of the firm's output. In line with Williamson (1990) and others (e.g. Blair, 1995, p. 21), Hansmann considers the firm as a nexus of contracts (Figure 1).

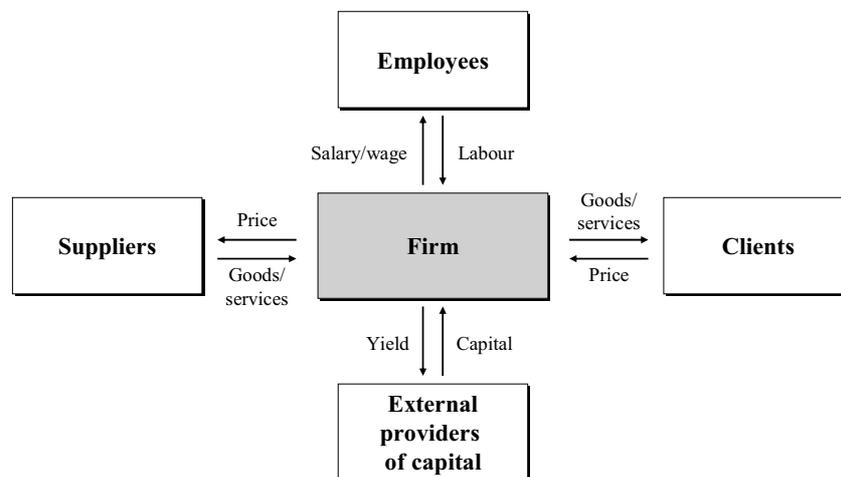


Fig. 1. The Firm as a Nexus of Contracts

Ownership rights can be assigned to the entire class of patrons (as is the case, for example, with employees, supplier or buyer cooperatives) or to a subsection of this group, the extreme

case being just one individual or organisation (as is the case, for example, with sole ownership by a financial investor). An encompassing theory of ownership, therefore, needs to explain (1) to which class, or combination of classes of patrons, ownership rights should optimally be assigned, and (2) how broadly ownership rights should be distributed within that class of patrons.

According to Hansmann's approach, two types of non-production costs may affect the relationship between the various classes of patrons and the firm. First, supply-demand relationships are always beset to a greater or lesser extent by transaction costs, defined as the costs of using the market mechanism (Coase, 1937), such as the costs of information gathering and the costs to ensure that the contractual partners honour their commitments. Second, ownership rights, which may be assigned to any particular class of patrons, are accompanied by governance costs. These costs are associated with the right to control the firm and the right to appropriate the firm's profits. Typical examples for such governance costs include the costs of controlling the firm's management, the costs of collective decision making, and the costs from bearing ownership risks. The efficient assignment of ownership rights minimises the sum of these two types of costs – transaction costs and governance costs – across all classes of patrons. This approach is based on the notion that the assignment of ownership rights can have a significant positive or negative impact on either type of costs, so that some ownership arrangements can have significant efficiency advantages over others.

Overall, Hansmann's framework is strongly grounded in institutional economics, but does also take into account legal, sociological and psychological perspectives, e.g. the latter with respect to the difficulties involved in decision-making among parties with heterogeneous interests. In contrast to existing economics approaches to the efficient assignment of ownership rights (in particular the property rights theory; see Grossmann and Hart (1986) and Hart and Moore (1990)), Hansmann takes into account all the various classes of patrons with which a firm maintains contractual relationships, whereas the Grossman-Hart-Moore model focuses on two classes of patrons (buyers and sellers) only. By including governance costs in his framework, Hansmann also avoids the overly narrow focus of transaction cost economic theory on asset specificity as the driving force behind the integration of economic activities into firms (Holmstrom and Roberts, 1998).

A feature of Hansmann's approach that has attracted criticism (Fligstein, 1997, p. 824; Nelson, 1998, p. 101) is its assumption that ownership allocations and the corporate governance mechanisms associated with it will, in the long run, drift towards efficient solutions. This assumption requires at least a minimum degree of faith in the functioning of competitive markets, which some scholars consider unwarranted. Authors following Granovetter's (1985) proposition that organisational arrangements are embedded in, and therefore reflective of, their socio-cultural environment, would argue that the assignment of ownership rights is driven to a greater extent by the prevailing explicit or implicit norms and customs, rather than by competitive market forces. This debate clearly goes beyond the scope of this paper. The case of management consulting firms, however, illustrates that there are significant differences between firms operating not only in the same socio-cultural context, but also within the same industry. It is towards the explanation of these differences that we believe Hansmann's approach can contribute.

### **3. The allocation of ownership rights in management consultancies**

#### ***3.1. Introduction***

In this section, we analyse the allocation of ownership rights in management consulting firms on the basis of the framework outlined in section 2. According to this framework, we should expect the assignment of ownership rights in the consulting sector to be related to characteristics in the contractual relationships between the firms active in this industry and their various classes of patrons. The analysis should also provide insights into the differences between management consultancies and firms in sectors with different ownership patterns. For the purpose of the discussion, we define management consulting as "the rendering of independent advice and assistance about the process of management to clients with management responsibilities" (The International Council of Management Consulting Institutes, 2004). Consulting firms that provide primarily IT-based services such as software programming or network maintenance, as well as firms that focus on

highly operational activities such as business process outsourcing, fall outside the remit of this definition and are not included in our analysis.

We have chosen the management consulting industry as the focus of our case analysis for three reasons. First, while there is a growing interest among academics in this industry (see the contributions recently edited by Kipping and Engwall (2002) and by Sahlin-Andersson and Engwall (2002)), little research has been done on the ownership patterns in this sector and their determinants. Second, as outlined in the introduction, the ownership structures of firms in this industry have been changing significantly in recent years. Third, the industry is marked by an unusual ownership pattern, namely the preponderance of partnership arrangements over other forms of ownership.

Our case study takes the form of a systematic narrative. We begin by analysing the patterns of ownership in the management consulting sector, focusing on the fifty leading firms in the industry, according to the Vault 2003 list. The reason for using Vault rather than alternative lists (e.g. Kennedy, Alpha) is that Vault includes only management consulting firms in the sense of the above definition, and excludes those firms that are primarily active in IT consulting. The Vault 2003 Report ranks the top 50 management consulting firms by prestige, defined as "prominence in the consulting industry and (...) interest to job seekers" (Lerner, 2003, p. 7). The ranking is based on a score from a written survey among practising consultants who were asked to rate only firms with which they are familiar, with the exception of their own institution. Therefore, the ranking reflects a view of the industry from the inside, rather than an external assessment. For several reasons we decided against an analysis on the basis of a random draw from an overall population of consulting firms. First, the general management consulting segment in the consulting industry is not sharply delineated from other segments of the same sector. Many firms that describe themselves as being active in management consulting, do not pursue the type of activities that we are interested in, but rather adjacent services such as actuarial services, advice on real estate, portfolio management, and other matters. Second, the management consulting industry is very fragmented, with a large number of very small firms competing alongside bigger players (Kubr, 2002, chapter 2.2). Our research interest was not in the ownership structures of smaller firms, but rather in the segment of mid-sized and larger management consulting firms employing at least several dozens of staff and serving major clients. As this segment of firms is not sharply delineated from the segment of smaller players, we decided to use a ranking reflecting the view of industry insiders on the firms that have these capabilities. For this purpose, the Vault ranking provided the optimal list. Further information on the ownership structure and governance mechanism of the firms concerned was drawn from Vault itself (Lerner, 2003, pp. 508-509), from other consulting reports (e.g. the reports from Kennedy Information services), the Internet, case studies, and company publications.

In addition to the information from published sources, we conducted a total of 32 interviews with representatives from consulting firms with different ownership structures. Our interview partners were senior consultants at project manager level or above with four years or more of experience in their respective firm. In the interviews, we did not ask the interviewees about their opinions on alternative ownership arrangements. Rather, the focus of our interviews was to learn about the nature of the relationships between management consulting firms and their various classes of patrons. Therefore, we employed a semi-structured interview approach, using a set of questions about factors such as the importance of any particular factor of production to the operation of the firm, the difficulty of observing behaviour and monitoring the performance of contract partners and so on, while at the same time giving our interview partners the freedom to elaborate on any particular aspect they considered worth focusing on.

In section 3.2, we provide an overview of the ownership patterns among the fifty management consulting firms analysed here. Thereafter, we systematically analyse on a case-by-case basis the different classes of patrons that maintain contractual relationships with consulting firms. We investigate in particular the transaction costs that beset these relationships, as well as the governance costs that may arise if ownership rights are assigned to any particular one of these various classes of patrons.

### 3.2. Ownership patterns in the management consulting industry

The ownership structures of the consulting firms dominant today reflect a blend of models (Figure 2; for a broader discussion of the organization models in the consulting sector and the history of the industry see Kipping, 2002; Cooper, Hinings, Greenwood and Brown, 1996; Greenwood, Hinings and Brown, 1990; and Powell, Brock and Hinings, 1999). Among the 50 firms included in the Vault list, 29 (58%) are partnerships in the sense that they are entirely owned by a group of senior employees of the firm. All these firms also use the term “partnership” to describe their own governance model, often with great pride. Of the remaining 21 firms, 12 (24% of the total) are at least partially quoted on the stock market or belong to publicly listed parent companies. 8 firms (16% of the total) are wholly or partially owned by private investors, who do not play an active role in the day-to-day management of their firms and client service, as is the case in true partnerships. One firm is wholly owned and managed by its founder.

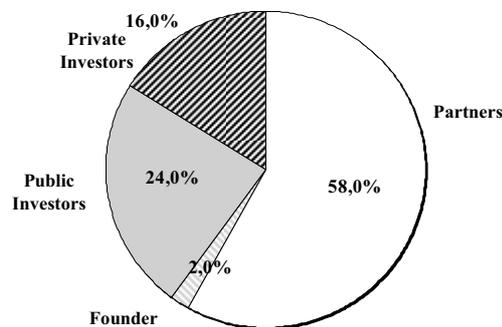


Fig. 2. Allocation of Ownership Rights of the Leading 50 Management Consulting Firms

Despite the development of consulting firms that are owned at least in part by external investors, the prevalence of partnerships among large and prestigious consulting firms is still striking. Consulting firms are much more likely to be owned and governed by their senior employees than is the case in industries outside the professional services sector. Even in comparison with other professional services firms, the prevalence of partnership structures among consulting firms is noteworthy in that consultancies are not restricted to the use of any particular ownership structure whereas for law firms, for example, this is the case.

In the following, we discuss the relationship between consulting firms and their various classes of patrons with respect to the transaction costs involved and the governance cost implications of assigning ownership rights to any particular group of patrons. This discussion draws on the insights from our interviews, but also on the academic literature on management consulting firms.

### 3.3. External providers of financial capital as owners of management consulting firms

The relationship between most management consulting firms and external suppliers of financial capital is characterised by the limited importance of the latter. Management consulting is not a very capital-intensive business. Initial set-up costs for consulting firms are low, as are working capital requirements. The infrastructure needed by most consulting firms is limited and can be rented or leased. Rapid turnover among employees and the use of “up or out” policies, which can be tightened at short notice, enable consulting firms to adjust their capacities to changes in demand relatively quickly, thus keeping personnel costs variable. Many of our interview partners indicated that their firms had made extensive use of these options for capacity reductions between 2001 and 2003, when demand for consulting services was slack. In addition, many of the classical manage-

ment consultancies have carefully guarded against assuming financial liabilities that might be associated, for example, with erroneous analyses and bad advice. Moreover, they tend to use strict billing policies to ensure that they receive timely payment, e.g. through the use of explicit payment schedules and up-front deposits (Kennedy Information, 2003, p. 56). Traditionally, consulting firms have used pricing structures that do not place their fees at risk, e.g. by charging time-based fees or fixed fees on a retainer basis (Clark, 1995, p. 67). The introduction of success-based fee structures that link a portion of the overall price to the achievement of performance criteria is a more recent development that can be associated with the rise of competition in the consulting market (Niewiem and Richter, 2004). Our interviews revealed that even where success-based fees are used, consulting firms typically decline to accept more far-reaching liabilities for the quality of their work, and legal requirements in most countries do not force them to do so. For these reasons, the capital requirements of most firms providing general management consulting services tend to be fairly moderate, and revenues at risk comparatively low. Even the operations of global consulting firms, such as Booz Allen Hamilton, which maintains approximately 100 offices in five continents, can be financed by the share capital of its 200 global partners, without a need for external capital in the form of debt or equity held by external investors.

However, the limited importance of external financial capital for the operation of consulting firms does not apply uniformly to all consulting firms. Specifically, consulting firms, which need to buy out their founding partners or other senior members at the end of their active involvement in the firm, are often unable to gather the necessary funds at short notice. Our interviews revealed that this was an important reason, especially for younger firms, for involving outside financiers. Similarly, the cash flow generated by consulting firms may prove insufficient to support rapid expansion or diversification strategies. This argument also applies to those firms that offer management consulting services, but with a relatively strong focus on IT and related issues. The capital requirements of these firms tend to be higher than is the case for classical management consulting firms of the "second wave" of the industry's development. Following their rapid growth during the 1990s, the biggest of these IT-oriented management consulting firms are significantly larger than most "pure" management consulting firms in terms of the number of their employees. In order to finance growth, IT-oriented management consulting firms had to rely on external funds. The greater predictability and transparency of the business model of management consulting firms with a focus on IT, which may have multi-year contracts with their clients, also makes controlling these firms from the outside easier. As raising debt capital for these firms (due to the rapid depreciation and the limited fungibility of their non-human assets) is impaired by the lack of appropriate collateral, issuing equity in the public market becomes a more attractive option. Even though pure IT consulting firms are not part of our analysis, the Vault ranking includes some management consulting firms such as Accenture which have IT-related operations. Our analysis revealed that precisely these firms are often part-owned by external investors for the reasons discussed above.

For those consultancies with moderate capital requirements, the transaction cost savings that may result from assigning ownership rights to external investors appear to be limited. With respect to the governance costs implications of assigning ownership rights to external investors, two effects need to be distinguished. On the one hand, external suppliers of financial capital are characterised by relatively homogeneous objectives and interests, which should benefit collective decision-making. On the other hand, the costs of monitoring consulting firms pose significant obstacles to the assignment of ownership rights to external providers of capital. External investors are at a significant disadvantage vis-à-vis internal parties with respect to the control of consulting firms. The relationship between external classes of patrons in general and management consulting firms is characterised by asymmetries with respect to the distribution of information and the extent to which preferences, e.g. regarding the strategy of the firm, can be enforced. In order to guard against the possibility of opportunistic behaviour, external parties rely on their ability to monitor the firm, and ensure that their preferences are upheld. The particular characteristics of consulting services, such as their intangibility, their provision in close interaction with clients, and the importance of confidentiality, render the monitoring of consulting firms problematic. Jensen and Meckling (1976) and others e.g. Hart (1995, p. 681) argue that financial investors, unless they can control their firms appropriately, may incur agency costs resulting, for example, from the use of free

cash flow for the purpose of managerial empire-building, or from other types of opportunistic behaviour. Similarly, external investors with limited insight into consulting operations might tend to under-invest in intangible assets such as human capital, as the value of such investments is not only hard to evaluate in advance, but also difficult to communicate across interfaces. If controlling a firm from the outside is difficult, then – barring differences in access to information or managerial abilities – transferring control rights through acquisitions and divestments must pose even greater difficulties. Therefore, external financial owners of consulting firms face the added risk that they may be unable to exit their investments, or only at prices below their expectation.

Our analysis so far suggests that the assignment of ownership rights to external financial investors is beset by significant obstacles relating to the governance of the firms concerned. Nevertheless, according to Figure 2, while the majority of the 50 consulting firms analysed here are owned by senior employees as partners, 40% of them are at least partially owned by external financial investors. Many of these are firms with above-average capital requirements, as discussed above. At the same time, our interviews revealed that these firms have mechanisms to keep a check on governance costs. First, most of the firms concerned, and the larger ones in particular, are governed by an intermediate organisational vehicle which takes charge of the monitoring function on behalf of the investors. For example, the consulting firms Mercer Management Consulting, Mercer Human Resources Consulting and Mercer Oliver Wyman (three of the firms included in Figure 2) are all owned by the publicly listed corporation Marsh McLennan. Marsh McLennan has established an intermediate holding company (Mercer, Inc.), which describes itself as the “Mercer family” (Bushko, 2003, p. 4). Mercer Inc. bundles the control and decision-making rights on behalf of the external shareholders, thus reducing governance costs. The management of intermediate organisational vehicles of this nature are in a better position to collect and evaluate information about the consulting firms in which they hold stakes than are external investors, in particular if the latter are dispersed.

Second, in many of the firms that are partially owned by external investors, employees – and the senior ones in particular – often hold significant stakes through employee share ownership programs (ESOPs) and other financial mechanisms. To give some examples, at the end of 2003 the senior management of Accenture owned approx. 45% of the company, and 70% of the shares of Hewitt Associates are held by current or former employees. The role of external financiers is often to provide capital for strategic initiatives such as the setting up of offices in new geographies which requires heavy investments. However, de facto decision-making power often remains in the hands of the insiders. Therefore, the assignment of ownership rights to outside investors does not necessarily imply the transfer of an encompassing set of governance rights to them. The desire for full independence has led several management consultancies (e.g. Booz Allen Hamilton) to retract from external ownership and re-instate their earlier partnership structures; these firms are now among the most vociferous proponents of the value of partnership (Gushurst and Deinlein, 2004). Others, such as Arthur D. Little and Razorfish, ran into trouble in the course of the preparations for public listing, and were broken up and acquired by competitors.

Overall, our analysis shows that for focused management consulting firms which do not have a special need for outside capital, the allocation of ownership rights to external investors is unlikely to be an efficient solution. Firms with higher capital requirements may resort to this arrangement. If they do, they often establish mechanisms designed to mitigate the governance costs that the assignment of ownership to external investors would otherwise incur.

### ***3.4. Suppliers of intermediate goods and services as owners of management consulting firms***

In this section, we analyse the suitability of *suppliers* of intermediate goods and services as potential owners of management consultancies. The argument presented in this section bears parallels to the analysis in the previous section. For their operation, management consulting firms rely primarily on two types of intermediate goods and services.

- First, they acquire the infrastructure necessary to operate a labour-intensive business, including office space, IT hard- and software und telecommunications services, stationary, and transportation and travel. Our interviews revealed that, as a percentage of

total operating costs, management consultancies' spending on infrastructure tends to be only approximately 20% of total revenues. Therefore, the relationship between consulting firms and the providers of these input factors is not likely to be beset by significant transaction costs that would be worth mitigating through the assignment of ownership rights to the latter. Infrastructure-related goods and services are traded in relatively competitive markets. Procuring these does not require extensive relationship-specific investments on behalf of either the supplier or the buyer. Moreover, the assignment of ownership rights to the providers of these intermediate goods and services would likely incur governance costs due to the information asymmetries and monitoring difficulties inherent in the external control of highly intangible consulting services, as discussed above.

- Second, as an information-intensive service, management consulting firms rely on other information-intensive goods and services as input factors for their operation. These information-intensive input factors fall into two categories. First, management consultancies acquire information-intensive assets such as market research reports or management "concepts" of a general nature, i.e. relationship-specific investments are not required for their provision. In many cases, the providers of these assets encounter difficulties enforcing the use of the price mechanism, since they cannot exclude non-paying parties from the use of these assets (the public goods problem). Second, management consulting firms procure relationship-specific services from other companies. For example, they may engage market research firms to provide tailored information or a software design boutique to develop an application that supports a solution for a client or a group of clients. Contractual relationships of this nature tend to be accompanied by high transaction costs, as the contracts that govern them are to a great extent incomplete, and there is scope for opportunistic behaviour on either side. In order to mitigate these costs, management consulting firms and their providers of relationship-specific, information-intensive services often unite. For example, the Boston Consulting Group, McKinsey & Company, and many other large management consulting firms all maintain in-house research and analytical services departments. However, as relationship-specific, information-intensive services themselves constitute consulting services, the result of their integration with *management* consulting services is not perceived as the ownership of one type of firm by a different owner, but rather as the integration of two very closely related services in the same firm.

Overall, the analysis presented in this section has provided bifurcated results. The relationship between management consulting firms and their suppliers of non-specific goods and services is not beset by significant transaction costs; hence the assignment of ownership rights to the latter group would not serve efficiency purposes. On the other hand, management consulting firms seeking to gain competitive advantage through expertise and superior knowledge require specific information-intensive services in order to establish and maintain this competitive advantage. As a result, they often integrate with the providers of these services. In this case, the question of who should optimally own these integrated management consulting firms still needs to be addressed.

### ***3.5. Clients as owners of management consulting firms***

Over the past 15-20 years, many large companies have established in-house consulting units. Most of these units are organised on a departmental basis and are managed as cost or profit centres (Hoyer, 2000, pp. 67-69), although some in-house consultancies do enjoy greater organisational and managerial autonomy (e.g. ABB Management Consulting, DaimlerChrysler Management Consulting). Due to their relatively small size and their legal dependence on their parent organisations, these in-house consulting arms generally do not appear in most rankings of the largest and highly regarded management consultancies, such as the Vault report used here.

For the reasons already outlined in previous sections, the transaction costs between consulting firms and their clients tend to be high. These transaction costs include both *ex ante* transaction costs arising from the difficulty of specifying and communicating the desired type and level of service, and *ex post* transaction costs associated with the difficulty of monitoring the performance

of either party to the contract. Both parties may make significant investments into minimising these costs, e.g. by writing elaborate project specifications or by drawing up documents designed to signal expertise in the topic area the client is interested in, without effectively solving the underlying difficulties. The allocation of ownership rights to clients can help reduce the transaction costs between clients and management consultancies, as integration reduces the incentives to opportunistically exploit the dependence of the other party within the same organisation. At the same time, the concentration of decision-making rights concerning the demand and the supply of consulting services in the hand of the client helps to reduce the costs of governing the consulting arm. As an example, the client's management is able to set priorities for the internal deployment of consulting services, without the need to coordinate these priorities with multiple constituencies. Internal monitoring costs are also reduced as the client learns over time about its consultancy's abilities and skills.

While transaction costs between a client organisation and its advisor can be reduced significantly through the establishment of an in-house consulting unit, the transaction costs between such a client-owned management consultancy and its other *potential* clients become prohibitively high. For obvious reasons external clients tend to be reluctant to procure consulting services from subsidiaries of their own competitors. Therefore, a client-owned management consultancy will most likely only generate business with its owner. As a result, there are hardly any client-owned management consultancies which also serve other clients in the same market (e.g. Porsche Consulting in Germany which also provides services to Porsche's component suppliers). Due to the limited market for their services, in-house consultancies tend to be relatively small and rarely make it into the international rankings of top management consulting firms.

### **3.6. Employees as owners of management consulting firms**

The fourth possible group of owners of management consultancies are its employees. They represent a critical production factor since consulting is a human capital intensive business. Our interviews showed that the relationships between management consultancies and their employees are characterised by factors which, in the absence of mitigating mechanisms, can lead to transaction costs.

As a result of the nature of the consulting business, the relationship between consulting firms and their employees is characterised by information asymmetries. Consultants often work remote from their offices at their clients' sites. Their output is the result of an intimate interaction between themselves and their clients. It is often difficult to disentangle the performance of an individual consultant from the contributions of team members and clients. Therefore, evaluating the performance of consultants is often hard. Using assessment criteria that focus on the effects of consultants' work on the success of their clients' businesses is rarely feasible due to the significant time lag between the provision of the consulting services and their implementation, and the fact that many consulting services do not yield results that would be easily observable at all (e.g. advice as to *not* to enter a particular business). Due to these factors, consulting firms are at a serious disadvantage vis-à-vis their employees with respect to the nature of the performance challenges they are facing, and their abilities to master these challenges. These information asymmetries, combined with the potential for moral hazard, raise the transaction costs between consulting firms and their employees significantly. In order to check these costs, consulting firms either need to invest in mechanisms (such as monitoring systems) to reduce the underlying information asymmetries, or induce behaviour among their employees to reduce the likelihood that employees opportunistically abuse their information advantage.

The difficulties arising from the information asymmetry between consulting firms and their employees and the problems associated with monitoring employees' performance are compounded further by the fact that consultants tend to have ample scope for opportunistic behaviour vis-à-vis their firm. For example, they are in a strong position to set up their own businesses on the back of client contacts established while working in their (previous) firm. Thus, management consultancies are dependent on incentive schemes which protect them from shirking behaviour and assure long-term employee integration and retention.

The factors outlined here apply to the various groups of employees to differing extents. Compared to “professionals” (i.e. consultants), employees without direct client contact (e.g. research staff) have lower incentives, and more limited possibilities for engaging in opportunistic behaviour. They typically work from a centralised location, and have more closely circumscribed job descriptions and performance targets.

*Among* the group of professionals, the importance of the factors discussed above increases with seniority. This can be attributed to the fact that senior employees work much more autonomously and have stronger client relationships than junior consultants. Senior consultants are in control of client access, which constitutes a critical success factor for management consulting firms. By assigning ownership rights to these employees, consulting firms are able to reduce the transaction costs in the relationship with their most important employees, those that hold contacts at the senior level of their clients’ organisations.

Although transaction costs in the employee-firm relationship may be particularly high in the case of senior consultants, they also exist at more junior levels. Therefore, from a transaction cost perspective, the assignment of ownership rights to all or a large subsection of employees would appear to be an optimal solution. However, the participation of all employees in the ownership of consulting firms would raise governance costs prohibitively. These governance costs arise from three factors. First, staff fluctuation in management consulting, especially among junior professionals, is relatively high. Assigning ownership rights to all employees would therefore be linked to significant administrative costs. Second, there are large differences among staff with respect to their wealth. Junior professionals rarely have sufficient capital to buy equity in their firm. While this problem could be addressed by the provision of loans, junior employees may also not be willing to bear the risks associated with ownership at an early stage in their professional lives. Third, and most important, employees differ widely with respect to their experience, their contacts within their firm, the depth of their client contacts, and, hence, their importance for the performance of their company. As a result of this heterogeneity, decision-making processes among a large group of people will be associated with significant time requirements and costs (see also the analysis by Farrell and Scotchmer (1988), which highlights the importance of balancing the advantages of expanding the size of partnerships with the disadvantage of heterogeneity). This difficulty is heightened further by the fact that the outcomes of decision-making processes tend to affect various groups of employees in different ways and to different extents. In this situation, employees with high human capital endowments are able to engage in strategic bargaining vis-à-vis their firm, thereby raising the costs of decision-making even further.

Compared to this scenario, limiting the assignment of ownership rights to senior employees helps consulting firms to keep a check on their governance costs. First, senior consultants constitute a fairly homogenous group. As most consulting firms hire new employees from the labour market at junior and intermediate level only, and fill senior positions through promotion within the firm, progression towards partnership level can be understood as an extended socialisation device that leads to a “homogenisation” of the partner group. During this process, partners develop a set of common norms and shared expectations that reduce their propensity to engage in opportunistic behaviour. They also establish a close network of personal contacts, which can be interpreted as a means of social control. Second, over time senior consultants accumulate personal wealth that enables them to bear the risks associated with assuming ownership rights. Third, relative to other classes of patrons, senior consultants are in the best position to monitor the firm and its management. The assignment of ownership rights to a relatively narrow group of employees also implies that the incentive to actively engage in the monitoring of the firm’s operations is not overly diluted. In sum, the assignment of ownership rights to senior consultants strikes an optimal balance between reducing the transaction costs that beset the employee – firm relationship and the need to keep a check on the governance costs associated with ownership.

#### **4. Conclusion**

In this paper, we have pursued two goals. First, following Hansmann’s (1996) work, we have developed an institutional economics approach that enables us to assess the efficiency impli-

cations of assigning ownership rights to any one of the groups (“classes of patrons”) with which a firm maintains contractual relationships. According to this approach, the optimal assignment of ownership rights among the various classes of patrons minimises the sum of transaction costs and governance costs across all classes of patrons.

Second, we have applied this approach to the case of management consulting firms, addressing the question why the majority of management consultancies are owned by a limited group of senior employees as partners, rather than by other groups of patrons. Our case analysis draws on information from published sources and from a total of 32 interviews with representatives of consulting firms with different ownership structures. We find that, due to their socio-economic characteristics, the relationships between consulting firms and some classes of patrons are beset by high transaction costs relative to the transaction costs involved in their relationships with other classes of patrons. If the assignment of ownership rights serves efficiency purposes, we would expect ownership to be allocated primarily to those classes of patrons where the potential to reduce transaction costs is greatest, if at the same time governance costs can be kept within limits. Our findings provide support for this proposition. The relationship between management consulting firms and their employees, in particular the most senior ones who hold key client contacts, is characterised by high transaction costs. For example, employees have ample scope for behaving opportunistically, as monitoring their behaviour and performance is difficult. Assigning ownership rights to employees can help mitigate these costs. At the same time, assigning ownership rights to a narrowly confined group of senior employees as partners helps limit the governance costs that are associated with this assignment. Alternative ownership forms, e.g. external investors, can also be found in the management consulting sector, for example in consultancies with greater capital requirements. In these cases, special organisational arrangements such as intermediate holding company structures that bundle the governance functions are employed frequently in order to mitigate the governance costs disadvantages that the external investors might otherwise face.

Overall, we find that Hansmann’s theory of the allocation of ownership rights provides a useful approach to explaining the observed preponderance of partnership arrangements in the management consulting sector. At the same time, in the course of the analysis a number of limitations in this approach became apparent. First, the view of the management consulting sector developed here is a fairly static, cross-sectional one. However, in recent years many changes – such as increasing bargaining power of clients and the entry of many new competitors – have taken place in the consulting sector, which affect the relationships between consulting firms and their various classes of patrons (for a similar view see Graubner and Richter, 2003). According to Hansmann’s approach, in the longer term these changes should lead to shifts in the assignment of ownership rights. However, it is unclear how long the longer term is. Similar to transaction cost economics, Hansmann’s theory does not provide an answer to the question how quickly changes in the driving factors (e.g. transaction costs, governance costs) can be expected to affect ownership allocation as the dependent variable in this approach.

Second, Hansmann’s approach – as is the case with transaction cost economics (see Williamson, 1991) – requires considerable faith in the working of competitive forces which push towards efficient economic arrangements. With respect to the allocation of ownership rights, efficiency considerations are unlikely to be the only factors to be taken into account, in particular if a market offers sufficient scope for many different players with different organisational and governance structures to co-exist for an extended period of time. Management consulting firms often seek to maintain their status as partnerships in order to signal integrity, independence and professionalism to employees and clients alike. Therefore, we believe that the efficiency considerations that feature prominently in institutional economics approaches to the allocation of ownership rights should be complemented by effectiveness considerations.

Further research needs to be done to investigate these issues. In order to assess the extent to which ownership patterns in the economy can be explained by Hansmann’s approach, the theory should be tested using both qualitative and quantitative methods. Econometric techniques such as multinomial logit analyses or similar discrete choice models should prove particularly useful for this purpose. With respect to management consulting, empirical research is also required in order to derive predictions (or at least a clearer set of expectations) regarding the future development of

this sector, and the ownership and governance structures that are likely to prevail in it. The application of Hansmann's theory of the optimal allocation of ownership rights to the management consulting sector in this paper has been a step in this direction, on which future work can build.

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