

# CONVERSATION

## Law Firms, Ethics, and Equity Capital

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### INTRODUCTION

The correspondence collected here represents an effort to start a conversation. On October 30, 2007, the Queen approved the United Kingdom's Legal Services Act 2007. This legislation includes a provision that permits non-lawyer equity investment in law firms, subject to regulatory oversight.<sup>1</sup> In other words, UK law firms could become publicly-traded businesses. This legislation has been proposed as part of reforms heralded as improving the delivery of legal services to consumers. By contrast, such investment in law firms is forbidden by ethical rules in the United States. What will happen when the two countries with the most dominant global law firms begin to move along such different paths?

Australia already allows non-lawyer equity investment in law firms, and Slater & Gordon has taken advantage of this authorization to become the world's first publicly-traded law firm.<sup>2</sup> The prospect of major UK firms raising capital in the equity markets, however, has the potential to produce seismic shifts in the global market for legal services. It also could have far-reaching implications for the legal profession that we can barely anticipate. Until now, there has been remarkably little discussion—especially in the United States—about the possible effects of the UK legislation.

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1. See [http://www.opsi.gov.uk/acts/acts2007/pdf/ukpga\\_20070029\\_en.pdf](http://www.opsi.gov.uk/acts/acts2007/pdf/ukpga_20070029_en.pdf) (last visited Dec. 4, 2007). Section 89 and Schedule 13 of the legislation contain this authorization.

2. See Alexia Garamfalvi, *In a First, Law Firm Goes Public*, LEGAL TIMES, May 22, 2007, <http://www.law.com/jsp/nlj/PubArticleNLJ.jsp?id=1179751703772>. For the Slater & Gordon prospectus, see <http://www.slatergordon.com.au/docs/prospectus/Prospectus.pdf> (last visited Dec. 4, 2007).

This paper attempts to redress that situation. It consists of an exchange among Bruce MacEwen, an expert on law firm economics and editor of the online publication *Adam Smith, Esq.*; Milton Regan, a Professor at Georgetown University Law Center, an expert on the legal profession; and Larry Ribstein, a Professor at the University of Illinois College of Law, an expert on partnership law. The exchange occurred before the UK legislation went into effect. The bill that was pending at the time of the correspondence, however, was essentially identical to the version that has been enacted.

Appreciation of how profoundly the legal profession has changed in the past generation is useful background to the discussion. Law firms, in particular, have felt the brunt of much fiercer competition for both clients and lawyers. As a result, law firms increasingly have taken on the characteristics of more conventional business enterprises. Firms pay close attention to the financial performance of the firm as a whole and its individual lawyers. Information about a firm's financial condition is now widely available and can prompt dramatic reorganizations, including layoffs and reductions in compensation for lawyers.

Firms have grown substantially, with many containing more than one thousand lawyers. They have opened multiple offices in the United States and abroad. Most large firms employ a cadre of non-lawyer professionals in executive and managerial positions, and vigorously market their services. An increasing number now employ general counsel to represent the firm in a range of matters. Most firms are now limited liability entities, and some have adopted the corporate form. In these and other respects, law firms more closely resemble their corporate clients.

Some lament these changes as marking the loss of professional identity, while others applaud the changes as overdue measures that overturn a guild system and make the provision of legal services more efficient and responsive to clients. Until recently, however, there has been one feature of business enterprise that has been strictly off-limits for law firms: equity ownership by non-lawyers. While corporations are able to raise capital by selling shares to the public, ethics rules have forbidden lawyers from practicing in any organization in which a non-lawyer holds an ownership interest. The rationale for these ethics rules is that such ownership risks lay interference with lawyers' professional judgment.<sup>3</sup>

The discussion contained in the following pages begins with an inquiry by Bruce MacEwen into whether current United States ethical rules would permit law firms to issue a financial instrument whose value is tied to the financial performance of the firm. The rule potentially most directly applicable is American Bar Association ("ABA") Model Rule of Professional Conduct 5.4(d), which provides that a lawyer "shall not practice with or in the form of a

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3. See MODEL RULES OF PROF'L CONDUCT R. 5.4, cmt. 1 (2007) [hereinafter MODEL RULES] (explaining that the limitations set forth in Model Rule 5.4 "are to protect the lawyer's professional independence of judgment").

professional corporation or association authorized to practice law for a profit if . . . a non-lawyer owns any interest therein.”<sup>4</sup> Mr. MacEwen poses several questions. Could the financial instrument he describes be issued to lawyers in a firm? To non-lawyers? Could it be sold to persons outside the firm and be publicly traded? Would it represent an interest in the firm—thus forbidden by Rule 5.4—or an interest only in a derivative issued by the firm?

The discussion continues with a response from Professor Regan. Professor Regan analyzes the application of Rule 5.4 to a financial instrument with various characteristics. He then moves to a discussion of the underlying concerns of that Rule, the changes in law firms that might occur as a result of issuing a publicly traded derivative, and the extent to which these changes might implicate the values that animate Rule 5.4. He suggests that the ability to sell such a derivative could produce some salutary changes in law firms. He also asks, however, whether the prospect that lawyers would “practice to the share price” could have an undesirable effect on lawyers’ roles as client representatives and as stewards of the legal system.

Professor Larry Ribstein joins the conversation by offering short comments that serve as a prelude to his later correspondence. He acknowledges lawyers’ responsibility to clients and the legal system, but questions whether regulating the structure of law firms, rather than their behavior, is the best way to ensure that lawyers fulfill this obligation. Furthermore, he suggests, the dynamics of the market may serve as an additional influence that leads lawyers to attend to their responsibilities.

Mr. MacEwen replies to Professor Regan, and briefly to Professor Ribstein, by suggesting that the experience of other professional service firms—such as those in the financial services industry—indicates that public ownership can create incentives for both innovation and efficiency in the provision of services. In particular, firms would have reason to invest more in organizational capital that would contribute to stable long-term financial performance. Far from representing the abandonment of professionalism, he maintains, the adoption of this strategy could provide the financial foundation necessary for the realization of professional values.

Professor Ribstein then extends the discussion by focusing in more detail on the prospect of publicly-owned law firms. He analyzes the possible impact on lawyers’ ability to satisfy their obligations both to clients and to sustaining legal institutions. He concludes that firms with outside investors could meet both of these obligations while operating more efficiently. In particular, equity ownership could enhance incentives for lawyers to behave in ways that promote the collective interests of the firm, rather than their own separate individual interests. To the extent that we are concerned that lawyers may not be sufficiently attentive

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4. MODEL RULES R. 5.4(d).

to their role of preserving the social capital represented by the legal system, we should regulate lawyer behavior rather than law firm structure. At a minimum, he suggests, firms should be free to choose among various organizational structures that states might want to make available, free of impediments imposed by uniform state professional rules.

Mr. MacEwen concludes the exchange by suggesting that eliminating restrictions on law firm structure could unleash Joseph Schumpeter's "creative destruction" in the market for legal services.<sup>5</sup> This could give rise to multi-disciplinary firms that offer a range of both legal and non-legal services. Ultimately, he questions whether the ethical rules that prevent such a development serve the purposes that are invoked on their behalf.

The ideas expressed in this exchange are not the final word on the subject. Indeed, they are meant to be exactly the opposite: an initial foray into new territory whose features cannot be foreseen. Ready or not, lawyers and the public are facing developments that raise profound questions about the identity and commitments of the profession. Navigating these developments will require an open mind, deep reflection, and the capacity to imagine alternative worlds. We invite you to buckle up and begin the journey.

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Via email: [regan@law.georgetown.edu](mailto:regan@law.georgetown.edu)

Re: Law Firms & Capital Markets Access

Dear Mitt:

I'd like to solicit your thoughts on a concept I've been turning over in my mind for some time, and I'd actually like to enlist your help in the project, to the extent you're interested, going forward.

Here's the problem: While lawyers can and certainly do earn very handsome incomes as senior partners in AmLaw 100 firms, they have no material

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5. See generally JOSEPH SCHUMPETER, CAPITALISM, SOCIALISM, AND DEMOCRACY (1950).

wealth-creation opportunities. No stock options, no routine opportunity to invest in deals (setting aside the brief dot-com bubble when firms, if not individual lawyers, took equity in startups in lieu of cash fees, an experience whose end-game means it will probably not be readily embraced again soon), no supra-normal income windfalls such as investment bankers experience with bonuses, which can be invested long-term for meaningful wealth creation.

This state of affairs leaves law firms at a competitive disadvantage when it comes to recruiting and retaining talent.

- Associates can be lured by investment banks, management consulting, and even plain old corporate clients with stock options on attractive growth trajectories.
- Partners as well can be lured to private equity or hedge funds, or in-house to quality law departments (GE's being the poster child), again with stock options on the table.
- "C-suite" executives in law firms cannot be compensated at levels equivalent to their peers at similarly-sized corporations.
- Last and most obvious, ordinary income receives the most onerous tax treatment of all forms of potential compensation.

On a more personal level, I've spoken with several managing partners of major firms who have seen their firms' gross annual revenues double, quadruple, or more during their tenures, and who are understandably exasperated that they have no way of personally benefiting from what would be the handsome performance of the law firm's "stock" in a way that any corporate CEO would as a matter of routine. Adding insult to injury, these people also have to keep very substantial amounts of personal capital locked up inside the firm, often earning sub-market or even zero interest.

My thoughts have also been informed by speculation on what the coming Clementi reforms might mean in the UK.<sup>6</sup>

So this is the key question on which I seek your input, both as a corporate lawyer and as a legal ethics luminary:

*Could law firms, consonant with ethical rules, create a derivative financial instrument, tradable as if it were a stock, engineered to reflect the implicit value of the firm?*

And, could this financial instrument be sold to and bought by:

- Lawyers within the firm (whether or not partners);
- C-suite executives and other non-lawyers at the firm;
- Outside investors, presumably "accredited," such as private equity funds?

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6. See Dep't for Constitutional Affairs, Legal Services, <http://www.dca.gov.uk/legist/legalservices.htm> (last visited Dec. 4, 2007).

I don't want to go into the financial engineering behind designing such a derivative, other than to say there are people who spend their lives creating just such creatures: Let's assume for the nonce that it could be suitably crafted.

My real question for you is how this would fit within current ethical rules. I assume the pertinent part of the *Model Rules* is Model Rule 5.4, and specifically:

(b) A lawyer shall not form a partnership with a non-lawyer if any of the activities of the partnership consist of the practice of law.

(c) [ . . . ]

(d) A lawyer shall not practice with or in the form of a professional corporation or association authorized to practice law for a profit, if:

(1) a non-lawyer owns any interest therein, except that a fiduciary representative of the estate of a lawyer may hold the stock or interest of the lawyer for a reasonable time during administration;

(2) a non-lawyer is a corporate director or officer thereof or occupies the position of similar responsibility in any form of association other than a corporation; or

(3) a non-lawyer has the right to direct or control the professional judgment of a lawyer.<sup>7</sup>

I don't know the interpretive rulings, if any, under this proviso, and I certainly am not in a position to predict how the ABA or other regulatory authorities might react if the concept that I have in mind were launched, but on the face of it I don't see how my proposal violates Model Rule 5.4:

- 5.4(b) is not remotely what I'm proposing;
- 5.4(d)(1) is a closer call, but I still think that what I'm proposing would give the non-lawyers an ownership interest in a derivative security, not the firm itself;
- 5.4(d)(2)-(3) are also beside the point of what I'm proposing: The non-lawyers would be passive owners of the security, akin to limited partners (or garden variety public company shareholders) with no colorable voice in management.

Aside from trying to interpret the literal language of Model Rule 5.4 to permit us to get where we want to go, I honestly believe the more fundamental principle that Model Rule 5.4 is attempting to uphold—that lawyers' professional judgment should not be compromised by pressures to serve the financial interests of others—is not impaired in the slightest by my proposal. You know as well as I that the fastest way to drive clients away from a firm is for its lawyers to be visibly serving interests other than their clients', and I don't personally know a single professional who would countenance that, as a matter of personal and

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7. MODEL RULES R. 5.4.

professional integrity.

So: What are your thoughts? If other people have tried to plow this field before me without success, I'm unaware of it. Sometimes it's only by questioning very bedrock assumptions that one gets anywhere.

I look forward to discussing this.

Best regards,  
Bruce MacEwen

P.S.: The proposed Blackstone IPO has a fascinating structure that might provide guidance on how this hypothetical security could be constructed. As you may know, Blackstone itself is the general partner in various investment funds, but that general partner is itself a limited partnership, and it's the limited partnership that is going public—as a partnership, not a corporation, thus avoiding (among other things) the New York Stock Exchange (“NYSE”) listing requirement that corporations have a majority of independent directors.

I'm not proposing that law firms go public—let them experiment with that in the U.K. first and we'll learn how to avoid train wrecks over here—but the point is that creative deal engineering can be done.

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Dear Bruce:

Thanks for sharing your idea about the possibility of law firms creating a derivative instrument structured to reflect the implicit value of the firm. The idea not only raises a question about the application of Model Rule 5.4, but also necessarily prompts reexamination of broader assumptions about the modern large law firm, the nature of professional obligations, and the complex interaction between lawyer regulation and the legal services market.<sup>8</sup> In what follows, I'll begin with an analysis of Rule 5.4, but that analysis quickly will lead to a discussion of these larger issues.

You ask: “Could law firms, consonant with ethical rules, create a derivative financial instrument engineered to reflect the implicit value of the firm as if it were tradable as a stock?” Could a firm sell this derivative to: (1) lawyers within the firm, both partners and non-partners; (2) high-level executives and other non-lawyers in the firm; and (3) outside investors, perhaps “accredited,” such as private equity funds. I'll focus first on two groups at the end of the spectrum—

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8. MODEL RULES R. 5.4.

lawyers in the firm and outside investors—because I’m most confident about the likely interpretation of Rule 5.4 as applied to them, and because the likely contrast in the treatment of these groups will highlight the underlying conceptual issues. I’ll then conclude with a short discussion of the application of the rule to non-lawyer executives and employees.

#### SALE OF DERIVATIVE TO LAWYERS IN THE FIRM

The easiest issue is the availability of a derivative to lawyers within the firm. This would neither violate Model Rule 5.4(a)’s prohibition on sharing legal fees with non-lawyers, nor Model Rule 5.4(d)’s proscription on lawyers practicing in an organization that practices law if a “non-lawyer owns any interest therein.”<sup>9</sup> More generally, it would not implicate the concern that is the rationale for the Rule. That concern is that a lawyer’s professional judgment may be influenced by non-lawyers with a financial stake in the lawyer’s representation of a client. Such parties are not subject to the ethical obligations with which lawyers must comply, and ostensibly may attempt to place pressure on a lawyer to maximize financial return at the expense of compliance with the lawyer’s professional duties.

The type of financial instrument you describe would seem comparable to existing compensation schemes that are based on the financial performance both of the firm and of individual lawyers. It’s beyond my capacity to engage in complex valuation analysis, but I assume that the derivative would differ from the existing partnership draw system in that it would incorporate capitalized future earnings rather than simply annual revenue. As such, it would reflect an assessment of the likely contribution of the firm’s organizational capital—systems, procedures, various forms of support and coordination—to the firm’s profitability in the foreseeable term. In this respect, the revenue potential of the firm would be more than simply the sum of the earnings of the individual lawyers in the firm.

In any event, the important point is that the derivative would not inject the specter of non-lawyer influence on lawyers’ professional judgment, and would be similar to current compensation approaches that are designed to create incentives for individual lawyers to maximize financial performance. Indeed, there is an argument that this type of financial instrument might align the individual lawyer’s incentives more closely with the success of the firm as a whole, and perhaps somewhat less with simply the individual’s profitability. More on that in a bit.

#### SALE OF DERIVATIVE TO OUTSIDE INVESTORS

Let’s move now to the application of Model Rule 5.4 to outside investors. The

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9. MODEL RULES R. 5.4(a), (d).

most pertinent portion of the Rule is likely 5.4(d)(1), which says that a lawyer may not practice in any organization that practices law if “a non-lawyer owns any interest therein[.]”<sup>10</sup> One can argue that this provision does not apply, because the owner of a derivative would own not an interest in the firm, but in a security that has been issued by the firm. Furthermore, the argument would go, simply holding a derivative as a passive investor would not create the risk of non-lawyer interference with lawyers’ judgment that animates the prohibition on fee-sharing in Rule 5.4(a), or on non-lawyers assuming positions of influence in a law practice under Rule 5.4(d)(2) and (3).<sup>11</sup>

This is a plausible interpretation, but I suspect that a state bar is unlikely to accept it. My guess is that a bar would maintain that Model Rule 5.4(d)(1) is intended to prohibit any non-lawyer from acquiring a financial interest whose value is dependent on law firm financial performance. A derivative instrument, the argument would go, by definition represents such an interest.

One response to this might be that the underlying concern of Model Rule 5.4(d)(1) is the exercise of investor influence on lawyer judgment.<sup>12</sup> Those who would hold derivative instruments, however, would be passive investors, with no voice in the operation of the firm. Indeed, getting a bit ahead of myself, law firms could issue publicly-traded shares with no voting rights, which arguably also would not raise the concern that animates the Rule. This suggests, perhaps ironically to some, that a publicly-traded law firm would be less problematic than one owned by private equity, since equity funds tend to want an active role in exerting influence over the companies in which they invest.

I suspect, however, that a state bar would not accept this argument. Analyzing why not requires that we address a more fundamental issue: what, if anything, is problematic about passive non-lawyer investment in a law firm?

If the holder of the financial instrument can exert no meaningful direct influence over how the firm is run, why should we prevent firms from gaining access to this source of capital? The response is likely to be that we don’t want lawyers “practicing to the share price”—i.e., making decisions in their representation that are driven mainly by a desire to maintain the value of the derivative. As we’ve seen in the corporate sector, shareholders typically have little actual influence over managerial decisions, but many claim that managers have become obsessed with share price to the detriment of the corporation. The risk is that this public metric or scorecard itself, not those who hold the instrument, may distort judgment.

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10. MODEL RULES R. 5.4(d)(1).

11. MODEL RULES R. 5.4(a), (d)(2)-(3).

12. *See* MODEL RULES R. 5.4(d)(1).

## AGENCY COSTS

What are the specific risks to which a critic of outside investment might point? One, which has tended to generate the most discussion, is that lawyers' financial self-interest in keeping share price (or its equivalent) high will tempt them to place their own welfare above that of their clients when the two collide. This would violate the lawyer's duty as a fiduciary to subordinate her interests to those of the client. This argument is based on the familiar concern about agency costs: What is the likelihood that any given variable will increase the probability that an agent will be faithless to her principal?

One question is whether the presence of passive investors would increase this risk beyond what already exists because of the financial performance pressures that law firms currently face. This is a crucial issue, which I'll defer for the moment and discuss at length below. Perhaps the most common rejoinder to the agency costs argument, however, is that lawyers who placed their own interests above those of their clients would soon be penalized by a competitive legal services market. Firms that acquired a reputation for such self-serving behavior would soon find their revenues fall and the value of their derivative drop accordingly. Breaching their fiduciary duty, in other words, would be a self-destructive move. Indeed, the argument goes, the desire to keep the derivative value high would lead firms to exert even more effort on behalf of firms because keeping the customers happy is the true path to financial success.

I will ignore the more complicated reality that this straightforward theory elides, and what I take to be mixed experience with other types of professional service firms who have raised capital by going to the equity markets. Laura Empson's research sheds some light on this experience.<sup>13</sup> The argument that the market will limit agency costs certainly has some force, but even if we accept it without reservation there is a second concern that is distinctive to the legal profession.

## LAW AS A PUBLIC GOOD

This is that lawyers produce a distinctive kind of product: law. It is by now a commonplace observation that lawyers help make "law" in their work at least as much as legislatures and courts do. As the legal realists forcefully reminded us, the latter promulgate the "law on the books," but lawyers shape the "law in action." This is perhaps most obvious in litigation, where the arguments that lawyers advance often become precedent that regulates other parties in the future. It's also true in work such as regulatory counseling, when lawyers offer advice on how far to push the envelope that may formally or informally create the

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13. See Laura Empson & Chris Chapman, *Partnership Versus Corporation: Implications of Alternative Forms of Governance in Professional Service Firms*, 24 RES. IN SOC. OF ORG. 139 (2006).

boundaries within which legitimate activity can occur, and transactional work, where lawyers devise novel legal forms that can become part of the accepted repertoire of private arrangements that the law will honor. Each representation, even if only incrementally, thus produces externalities; every lawyer simultaneously is engaged in production of both private and public goods.

Of course, we have come to appreciate that most major economic organizations in modern society affect a variety of stakeholders. Corporate managers increasingly are asked by the social responsibility movement to internalize more of the externalities that they generate. Shareholders are but one of the constituencies whose interests they must balance. The point, however, is that the externalities that lawyers produce affect the very basis of social order in a democracy. The rule of law constitutes the understandings that people have about the scope and limits of proper behavior and, even more broadly, the willingness to abide by those limits rather than pursue unconstrained self-interest. As the experience of developing countries and many Eastern European countries reflects, this is a form of social capital that is critical to belief in the basic legitimacy of the social order. It's not something that can be imposed from the top; it emerges instead from everyday experiences that affect perceptions of the extent to which the legal system embodies justice. One of the concerns with abusive tax shelters, for instance, is that their proliferation may decrease the perceived legitimacy of the tax system, a serious problem for a system that relies mostly on voluntary compliance in order to function.

The role of the lawyer in producing this public good is captured metaphorically (and literally in the litigation context) by the idea that a lawyer not only is a private agent but an "officer of the court"—someone who has at least some obligation to preserve the viability of the legal system itself. The bar commonly invokes this role in debates over privilege and confidentiality in the corporate setting. If communications between lawyers and their corporate clients are not assiduously protected from disclosure, the bar argues, lawyers will be less effective in ensuring that corporations act legally and responsibly. Clients will be less likely to include lawyers in the information loop if they fear that what they tell them will become public, and those conversations that do occur will be less candid. Regardless of the accuracy of this claim, the point is that it's premised on the notion that the lawyer is not simply an agent obligated to carry out the client's wishes, but is someone who acts as an informal regulator of the client's conduct. The post-Enron SEC rules governing securities lawyers and the revision of Model Rule 1.13 also reflect the notion that the lawyer has at least some gatekeeping responsibility with respect to client conduct.<sup>14</sup>

One concern about "practicing to the share price" therefore is that lawyers may identify too closely with client interests and will be less willing to place limits on

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14. See MODEL RULES R. 1.13.

their pursuit. That is, the problem may be precisely that the market will be *too effective* in aligning lawyers with clients, since that's the path to profitability and a high share price. Playing the role of steward of the legal system may not be financially rewarding, and may in fact be financially counterproductive, in a competitive market for legal services. Lawyers may have little incentive to attend to the quality of the public good that they produce in every representation; after all, no one will be compensating them on behalf of society as a whole.

Appreciating this dimension of the lawyer's work doesn't automatically mean that we should reject the idea of the type of derivative instrument that you describe, or even reject publicly traded law firm shares. It simply puts another consideration on the table that we need to take into account. The question then becomes: what would be the impact of such reforms on lawyers' ability and willingness both to place clients' interests above financial self-interest, and to ensure that client conduct does not undermine the social capital embodied in the legal system? Expressed even more pointedly: would the existence of a share price, either shadow or actual, have any effects significantly different from the financial incentives that lawyers and law firms already face? If not, there's an argument that making available a new source of capital in the form of outside investors would be beneficial on balance.

#### THE POTENTIAL SIGNIFICANCE OF DERIVATIVE/SHARE PRICE

The financial pressures that law firms currently face are well known. The legal services market has become intensely competitive over the past generation, and the landscape is littered with the shells of firms that have not been able to survive the transition. Revenue and profit information is readily available, and various ratios based on financial performance are used to rank firms. Profits per equity partner (PEP) and Revenue per Lawyer (RPL), rightly or wrongly seem to be the two metrics that receive the most attention and most often affect behavior (as, of course, in Mayer Brown's recent decision to de-equitize 10% of its equity partners).<sup>15</sup> One might argue that in this environment lawyers and law firms already may be prone to pursue their own financial self-interest at the expense of clients, or to acquiesce in client wishes regardless of their questionable legality. Would the risks be any greater if there were outside investment in law firms?

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15. See Guy Beringer, *Profit per Equity Partner as a Measure of Success*, <http://www.allenoverly.com/AOWEB/Knowledge/Editorial.aspx?contentTypeID=1&itemID=34073&prefLangID=410> (last visited Dec. 4, 2007); posting of Tom Collins to *More Partner Income*, [http://www.morepartnerincome.com/blog/\\_archives/2007/6/8/2988166.html](http://www.morepartnerincome.com/blog/_archives/2007/6/8/2988166.html) (June 8, 2007, 06:56 EST) ("There are many experts who view revenue per lawyer as a better gauge of law firm financial performance than per-partner income."). On the Mayer Brown de-equitization, see Anthony Lin, *Mayer Brown De-Equitizes 45 Partners*, N.Y. L.J., Mar. 5, 2007, at 1. Mayer Brown is hardly the only firm to take such a step. See Jeff Blumenthal, *The Distasteful Medicine of DeEquitization*, LEGAL INTELLIGENCER, Dec. 5, 2002, <http://www.law.com/jsp/LawArticlePC.jsp?id=1038966824697>.

Assuming such investment were passive, would a share price per se have any different effect than PEP?

I think this question is surprisingly hard to answer with any clear confidence. Consider first the impact on law firm structure and culture. What law firm characteristics are likely to be attractive to investors? Well, stability for one. The assets of law firms are mobile individuals. As Stephen Mayson suggests, “if the firm is perceived to be dependent on key partners who could leave the firm, taking relationships and client work with them, the sustainability of the firm’s income could be doubted and its value depressed.”<sup>16</sup>

Firms with high share prices would not be simply those with major rainmakers. Rather, they would be those that were most successful in integrating lawyers into the firm, coordinating their practices, and efficiently using both legal and non-legal staff to provide services. This premium on organizational integration could reduce the power of rainmakers and lessen activity in the lateral market. Currently, there is no influential stakeholder whose financial stake in the firm encourages profitable lawyers to curb self-interest for the sake of the firm. Those with the most business are the most mobile, and often the least inclined to make this compromise. As a result, firms are vulnerable to becoming temporary coalitions whose stability can be threatened when departures reach a tipping point. It is possible that if derivative/share value becomes a critical metric, rainmakers may conclude that harmonizing their practices with the firm will be more profitable than seeking the best compensation package in the free agent market.

Indeed, perhaps to become even more fanciful, firms may decide that a compensation system weighted heavily toward “eat what you kill” is counterproductive in a world in which stability and commitment to the firm are key considerations for investors. This may lead to a more productive balance of cooperative and competitive incentives within the firm, as well as simply a more pleasant and supportive atmosphere. Less emphasis on individual lawyers as profit centers could reduce the opportunity costs of providing training and mentoring, and induce firms to invest more heavily in such activities to enhance the productivity of the overall organization. It may reduce inclinations to hoard work, and encourage more cross-selling and referrals within the firm. Investor preference for stability thus could temper what some see as excessively individualistic tendencies in modern law practice.

At the same time, the ultimate source of profits in a law firm, as in any professional services organization, would continue to be human capital. Lawyers who use it to attract clients will still be essential to a firm’s financial success, and are likely to have substantial, even if somewhat reduced, influence. Furthermore,

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16. Stephen Mayson, *Building Sustainable Value: A Capital Idea*, in *MANAGING THE MODERN LAW FIRM: NEW CHALLENGES, NEW PERSPECTIVES* 141, 146 (Laura Empson ed., 2007).

if share price becomes the metric by which to evaluate law firms, lawyers will have an unequivocal standard to use in deciding whether to stay at or leave a firm. Even if firms as a whole might be better off if they refrained from encouraging an active lateral market, any one firm may be unable to resist the temptation to use its share price as a lure for partners at other firms.

Nonetheless, let's assume for the purposes of discussion that lawyers will have an incentive in an outside investor regime to place more importance on contributing to the financial success of the firm as a whole. What would this mean for lawyers' ability and willingness to serve clients faithfully, and to ensure that client conduct didn't erode the social capital of the legal system? One current lament is that firms have only limited ability to regulate the behavior of their lawyers, because they are keenly aware that rainmakers may decamp for other firms if there is any effort to encroach on their freedom of action. Any effort to impose anything more than minimal ground rules may precipitate this exodus. Firms therefore may hesitate to rein in profitable lawyers who are pushing the envelope—as may have happened with *Jenkins & Gilchrist* and tax shelter partner Paul Daugerdas.<sup>17</sup> From this perspective, a less active lateral market would give firms leverage to enforce more robust standards of conduct and foster a more unified firm culture. The lesser attraction of exit as an option may compensate for firms' inability in most states to enforce even reasonable penalties on lawyers who leave the firm and take clients with them.<sup>18</sup>

Some, perhaps many, lawyers, however, would regard this as an unwelcome movement toward organizational interference with the judgment of individual lawyers. A powerful strain of professionalism asserts that ethics and professional responsibility ultimately are matters of individual judgment. As such, they depend on the ability of each lawyer to engage in deliberation without being subject to any "outside" influences. Lawyers traditionally have been fiercely jealous of their autonomy, and resistant to any policies or procedures that threaten to reduce them to mere "employees" rather than independent professionals. For those who see things from this perspective, the greater leverage that a firm might acquire over individual behavior as a result of outside ownership would lessen the ability of lawyers to serve clients as they see fit and to ensure the propriety of client conduct.

While we can't dismiss the importance of individual character, this formulation of professionalism is blind to the profound impact of organizational structures on individual behavior. Countless studies establish that people act differently in organizations than they do on their own, and that there are

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17. See Terry Maxon, *Jenkins & Gilchrist Closing After Admitting Role in Tax Fraud*, DALLAS MORNING NEWS, Mar. 30, 2007, at A1.

18. On the difficulties for firms created by the unenforceability of such penalties, see Milton C. Regan Jr., *Law Firms, Competition Penalties, and the Values of Professionalism*, 13 GEO. J. LEGAL ETHICS 1 (1999); Larry Ribstein, *Ethical Rules, Agency Costs, and Law Firm Structure*, 84 VA. L. REV. 1707, 1730-38 (1998).

distinctive ethical risks that characterize the organizational setting. In the bureaucratic world of the twenty-first century, ethical conduct is crucially dependent on organizational structure and culture. Treating efforts to establish such structure and culture automatically as intrusions on ethical autonomy badly misreads the modern ethical landscape. An individual lawyer subject to a strict “eat what you kill” compensation system arguably is at far more ethical risk than one who practices in a firm that requires lawyers to comply with standard procedures in matters such as client intake, engagement letters, and the provision of legal opinions. I’ve suggested how such a compensation system may play at least some role in contributing to ethical misconduct in my case study *Eat What You Kill: The Fall of a Wall Street Lawyer*.<sup>19</sup>

Furthermore, as Gilson and Mnookin observed twenty years ago, a law firm represents an opportunity for lawyers to share the risks of downturns in their respective practices.<sup>20</sup> Having some degree of protection from the full brunt of market volatility can provide the space for an individual lawyer to take account of non-financial considerations in the conduct of law practice. Such an arrangement is only possible, however, if lawyers see themselves as participants in a collective undertaking, rather than as contractors who use the firm solely as a platform for obtaining rewards based on individual profitability.

Yes, it’s possible that a firm may use its increased influence to pressure lawyers to act unethically. A firm that invests in organizational capital that makes it more financially and culturally stable, however, seems less likely to do this than one facing financial pressures and cultural discontinuity caused by significant vulnerability to the lateral market. Furthermore, for a long time we have simplistically overemphasized the variable of personal character on ethical behavior, and underestimated the influence of situational forces that can influence conduct. Automatically equating greater organizational influence with an intrusion on ethical autonomy is an expression of this myopia. Anything that redirects our traditional narrow focus in ethics from the individual to the impact of organizational structures would be salutary.

Is there a risk, however, that the value of a derivative instrument or an equity share would quickly become the uber-metric, the single number by which law firms are evaluated? Many complain, of course, that this is exactly what has happened with publicly traded corporations, and that managers’ tendency to “manage to the share price” has had pernicious effects. Indeed, the “Paulson” working group on United States capital markets has recently recommended that companies stop providing quarterly earnings estimates, in an effort to reduce the

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19. MILTON C. REGAN, JR., *EAT WHAT YOU KILL: THE FALL OF A WALL STREET LAWYER* (University of Michigan Press 2004).

20. Ronald Gilson & Robert Mnookin, *Sharing Among the Human Capitalists: An Economic Inquiry Into the Corporate Law Firm and How Partners Split Profits*, 37 STAN. L. REV. 313 (1985).

influence of share prices on managerial decisions.<sup>21</sup> Would the emergence of derivative/share price as the key measure of law firm performance be any worse than the current regime in which figures such as PEP and RPL have assumed such importance?

As *Adam Smith, Esq.* has highlighted, of course, Guy Beringer of Allen & Overy has suggested that PEP has already become “the sole measure of success,” and that this development is short-sighted. Beringer argues that “[a] proper measure of success will never be simple and one-dimensional,” and that PEP “should be replaced with measures which take account of sustainable profitability, client satisfaction and staff motivation.”<sup>22</sup> Furthermore, Beringer maintains, PEP pays no heed to corporate responsibility;<sup>23</sup> I have suggested that the impact of lawyers’ work on the legal system makes this an especially critical consideration in evaluating lawyers and law firms. If we already are at the point where PEP has become the dominant metric, however, would substituting derivative/share price in its stead make much of a difference?

My tentative sense is that it might. Notwithstanding the decline of belief in the Efficient Capital Market Hypothesis,<sup>24</sup> share price has acquired almost mythical status as the virtually unquestioned measure of corporate performance in the eyes of investors and the public. Furthermore, those who argue that the basic function of a company is shareholder wealth maximization dominate modern thinking on the corporation. It is common, for instance, for people to assume unproblematically that shareholders “own” the corporation, even though their bundle of rights resembles nothing like conventional property ownership.

Even though PEP casts a large shadow, it is not without critics, and there are other figures that can be used to complement or even challenge it. If law firms were to acquire outside investors, however, they would enter a domain in which the powerful gravitational pull is toward maximizing a single number by which firms are evaluated: share price. It would be easy to think of investors as “owning” the firms in the same way that people tend to think of shareholders as “owning” a corporation. If this occurs, there might be little space for firms to rely on other measures of performance, and less latitude to engage in activities—such as pro bono work—that did not contribute to the bottom line.

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21. See COMMISSION ON THE REGULATION OF CAPITAL MARKETS IN THE 21<sup>ST</sup> CENTURY: REPORT AND RECOMMENDATIONS, app. III, at 168 (2007), available at [http://www.capitalmarketscommission.com/NR/rdonlyres/ex4nk2agcvtretp2osaiperiqczkvhtq6w5f5vswsh6mfef4snh3atd7n4b256hexty4wcc7i3eq4thca4vdnoqovurg/0703capmarkets\\_summ.pdf](http://www.capitalmarketscommission.com/NR/rdonlyres/ex4nk2agcvtretp2osaiperiqczkvhtq6w5f5vswsh6mfef4snh3atd7n4b256hexty4wcc7i3eq4thca4vdnoqovurg/0703capmarkets_summ.pdf) (last visited Dec. 4, 2007).

22. See Beringer, *supra* note 15.

23. *Id.*

24. See Donald Langevoort, *Symposium, Revisiting the Mechanisms of Market Efficiency, Foreword: Revisiting Gilson & Kraakman's Efficiency Story*, 28 IOWA J. CORP. L. 499 (2003). For early, more positive assessments, see Ronald Gilson & Reinier Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549 (1984); Eugene F. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, J. OF FIN., Vol. 25, No. 2, 383, 383 (May, 1970).

There's also the possibility of a more nebulous symbolic, but no less significant, consequence of outside investment in law firms. This is the public perception of lawyers and the law. Yes, I'm familiar with the lawyer jokes—some of them are quite funny—and I recognize that the public has a certain amount of skepticism about the connection between the legal system and justice. If law firms were to enter the equity markets, however, the perception might be that a qualitatively important divide had been crossed. Lawyers might be assimilated completely into the ranks of businessmen and women, and law regarded as even more explicitly a commodity for sale. This puts it somewhat dramatically; the possibility is of course speculative and would be difficult to prove empirically. Symbols matter, however, even if they're not amenable to precise measurement.

All this is rather a long way of saying that my suspicion is that, notwithstanding a plausible interpretation of Model Rule 5.4(d)(1) that would permit issuing a derivative instrument, a state bar is likely to interpret the Rule to prohibit it.<sup>25</sup> I've suggested what I think would be the main objections even to passive investment by outside investors. As I hope my analysis indicates, the value of your proposal is that it would require considering some basic questions regarding lawyers and law firms, and the answers to those questions are by no means self-evident.

I generally side with those who regard the profession-business dichotomy as spectacularly unhelpful, and who argue that financial success is an important prerequisite for a firm's ability to pursue broader objectives. I'm also well aware of the traditional guild-like resistance of the bar to any changes that might threaten its professional prerogatives. At the same time, I don't think that we can dismiss the rhetoric of professionalism, or what Laura Empson calls the "professional ethos," as wholly an expression of self-interest.<sup>26</sup> As I've suggested, despite their need to survive in a competitive legal services market, I don't think that law firms should be assimilated completely into the category of just another form of business enterprise. That said, the impact of a derivative instrument, or even equity ownership, on firms requires far closer analysis than the reflexive denunciation of money-changers in the temple.

Finally, it's worth noting that the ABA's Kutak Commission, charged with drafting new *Model Rules* to replace the Code of Professional Responsibility, originally proposed in 1981 that Model Rule 5.4 permit lawyers to practice in firms in which non-lawyers held a financial interest.<sup>27</sup> This would have been conditioned on written assurance that there would be "no interference with the lawyer's independence of professional judgment or with the client-lawyer relationship."<sup>28</sup>

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25. See MODEL RULES R. 5.4(d)(1).

26. See Laura Empson, *Surviving and Thriving in a Changing World: The Special Nature of Partnership*, in *MANAGING THE MODERN LAW FIRM*, *supra* note 16, at 10, 19-22.

27. MODEL RULES R. 5.4 cmt (Proposed Official Draft 1981) [hereinafter 1981 Draft].

28. 1981 Draft, *supra* note 27.

The Comment to the proposed Rule observed, “In its classical form the law firm consisted solely of lawyers, assisted by apprentices and scribes. Over the course of time the law firm has evolved into a variety of organizations.”<sup>29</sup> The Comment continued, “All such arrangements raise problems concerning the client-lawyer relationship. Given the complex variety of modern legal services, it is impractical to define organizational forms that uniquely can guarantee compliance with the Rules of Professional Conduct.”<sup>30</sup> The proposed Rule was rejected by the ABA House of Delegates, which substituted the current version of Rule 5.4. This history suggests, however, that there is some historical precedent for the discussion we’re having, and for the imminent reforms in the UK.

#### SALE OF DERIVATIVE TO NON-LAWYERS WITHIN THE FIRM

It may be a bit anticlimactic at this point, but one issue remains, which is whether Model Rule 5.4 would prohibit sale of a derivative to non-lawyer executives and employees of the firm. If the underlying concern about passive investment under Model Rule 5.4(d)(1) is the prospect of lawyers “practicing to the share price,” this concern arguably would be less salient with respect at least to non-executive employees.<sup>31</sup> The derivative would be less a way of tapping into a major new source of capital, and more a means of making compensation more attractive for those who contribute to the success of the firm.

The absence of a large trading market also would mean that the price of the derivative might assume less visibility, and have less significance, than if the instrument were sold to outside investors. For this reason, it might not have the kind of potential influence on law firm decisions that’s likely to lead state bar organizations to prohibit selling the derivative to the public at large. That’s not to say that a state bar wouldn’t treat the sale of a derivative to non-executive employees as a violation of the Rule, but there would at least be a decent argument the other way. Furthermore, Rule 5.4(a)’s proscription on sharing legal fees with a non-lawyer would not seem to be a problem.<sup>32</sup> Even if we regard the derivative as the equivalent of sharing such fees, section (a)(3) of the Rule permits profit-sharing in furtherance of a compensation or retirement plan.<sup>33</sup>

Sale of the instrument to non-lawyer executives, however, might be more of a problem. There would be an argument that the executives are not passive investors, but occupy positions of influence within the firm. The ostensible risk is that a non-lawyer might have an incentive to exercise authority over lawyers that intrudes on their judgment for reasons of financial self-interest. This risk would

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29. *Id.*

30. *Id.*

31. *See* MODEL RULES R. 5.4(d)(1).

32. MODEL RULES R. 5.4(a).

33. MODEL RULES R. 5.4(a)(3).

seem to depend on the nature of the position that the executive occupies. A person who is the head of Information Technology or the Chief Financial Officer, for instance, arguably isn't in a position to exercise influence on lawyers' professional decisions. A non-lawyer Chief Operating Officer, however, may be, which may make him or her ineligible for purchase of the derivative. It's possible to characterize a COO's authority as simply not extending to any professional judgments that lawyers make, and therefore as posing no risk, but the practical realities of influence within the firm may lead regulators to find that argument unpersuasive.

### CONCLUSION

I've provided a pretty lengthy answer to a simple question. The reason is that your proposal forces us to consider the implicit premises of longstanding assumptions. I certainly haven't resolved definitively all the issues that this raises, but you've made me think about just what those issues are more clearly than I have before. That's an impressive accomplishment for a one-sentence question.

Thanks for sharing your idea with me. I'm of course happy (in fact eager) to talk about all of this at greater length.

Best Wishes,  
Mitt

University of Illinois College of Law  
504 East Pennsylvania Avenue  
Champaign, Illinois 61820  
April 1, 2007

Dear Bruce,

This is, indeed, something I'm interested in. Unfortunately I haven't had the time to think through anything like the elaborate answer that Mitt has come up with. I do have two general thoughts.

First, while we can easily envision problems with any new organizational tool, the fundamental question, it seems to me, is the extent to which law firms present *unique* problems. For example, there are agency costs inherent in any capital structure, but for firms generally we let the market, including the market for state law, work out those problems. Should law firms be different? Of course lawyers and law firms are important to the legal system and society. But we generally address firms' social costs by regulating their conduct rather than their internal structure. Social responsibility theorists have urged the latter response, but so far their arguments have been rejected. Is there a special reason for accepting those arguments here?

Second, to the extent that your derivative idea might be said to cause special problems, to what extent can we attribute this to the need for financial arbitrage?

You've proposed minimal interference with existing rules. Would we be better off—for clients and society—if we just scrapped the rules and let the market equilibrate?

Again, I don't have answers, and I don't intend this as a criticism of Mitt's response, which I haven't studied. I look forward to further discussions.

Larry

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April 5, 2007

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Via email: [regan@law.georgetown.edu](mailto:regan@law.georgetown.edu)

Re: Law Firms & Capital Markets Access

Dear Mitt:

This is to lay out my further thoughts on this topic, as informed by and partially in response to your comprehensive March 31 letter to me, which was deeply thoughtful and just plain impressive: Thanks.

Concerning your letter, overall my reaction is one of fundamental agreement, albeit on some points I believe I can offer a view either countervailing to yours or congruent, but extending your thoughts to arrive at a slightly modified destination.

#### THE ISSUE

To reiterate part of my earlier letter, here's the situation that initially got me thinking about this problem: While lawyers can and certainly do earn very handsome incomes as senior partners in AmLaw 100 firms, they have no material wealth-creation opportunities akin to those available to corporate executives, such as stock options.

This state of affairs leaves law firms at a competitive disadvantage when it comes to recruiting and retaining talent. Lawyers can be lured by private equity, hedge funds, investment banks, management consulting, and even plain old corporate clients offering stock options. Also, "C-suite" executives in law firms cannot be compensated at levels equivalent to their peers at similarly-sized

corporations. Last and most obvious, ordinary income receives the most onerous tax treatment of all forms of potential compensation.

On a more personal level, I've spoken with several managing partners of major firms who have seen their firms' gross annual revenues double, quadruple, or more during their tenures, and who are understandably exasperated that they have no way of personally benefiting from what would be the handsome performance of the law firm's "stock" in a way that any corporate CEO would as a matter of routine.

Adding insult to injury, these people also have to keep very substantial amounts of personal capital locked up inside the firm, often earning below-market or even zero interest.

My thoughts have also been informed by speculation over the past few years on what the coming Clementi reforms might mean in the UK.

#### ANALYSIS & RESPONSE

Here, I won't re-state your thoughts in your March 31 letter, but I'll try to respond to and extend them where germane.

#### THE DERIVATIVE SECURITY ITSELF

Short-changed in my initial proposal was fleshing out what would lie behind valuation of the derivative itself. It would reflect more than simply annual revenue or gross profits, and would reflect or incorporate a component relating to ongoing enterprise value—not just income, but an assessment of the firm's organizational capital (systems, know-how, coordination skills) and reputational capital (with clients, potential competitors, law schools, and judges).

Also, I'd like to highlight a conceptual flaw lawyers are prone to in thinking about the financial returns they receive from a law firm: They conflate the roles of owner, investor, and worker since, contrary to typical corporations, the same individuals occupy all three roles. This is an error, which the creation of our hypothetical derivative would expose and necessarily correct.

As workers, their economic value is essentially what the market would have to pay a similarly skilled lawyer-employee. As investors (which many of course actually are as contributors of capital), they're due a competitive return on their funds, adjusted for the risk of the enterprise. Finally, as owners, they would be entitled to the residual profit retained after all the factors of production—including themselves as producing lawyers—receives fair market remuneration.

You're right to point to Stephen Mayson's article, *Building Sustainable Value: A Capital Idea*, where he says that a rational investor would value a firm primarily based on "the volume of economic income and its perceived

sustainability.”<sup>34</sup> *Ceteris paribus*, more income is more valuable, but not at the expense of behaviors (such as hoarding clients, resisting entreaties to collaborate, refusing to contribute to unbillable “firm building” activities such as mentoring) which create an unstable firm. I will suggest a bit further along that this is potentially one of the salient results of the derivative thought experiment.

#### AGENCY COSTS

As always in discussions of organizational structure, it’s essential to address the challenge of how to keep an agent faithful to their principals.

I may be a poor one to consult on how to best design an organization’s incentives to minimize the risk of agents straying, because I’ve always believed the most potent and vital constraint is one’s internal ethical compass—the sense of professional integrity, responsibility, and duty that makes the thought of elevating self-interest over one’s client unthinkable. The most rigorous compliance or organizational governance procedures imaginable won’t stop anyone with larceny in their heart, and a sense of personal honor is always a more sturdy guide to conduct than a disclosure checklist.

But I also believe, as you seem to, that a consistent course of lawyers’ placing their self-interest above their clients is economically self-defeating in a competitive marketplace. In the short run, there can be deviations from this—and justice delayed is irksome—but I firmly believe it catches up with everyone in the long run.

Particularly to the extent having outside investors might increase a firm’s “transparency,” there may be at least some reason for optimism that lawyers would be less, not more, inclined to deviate from the highest professional standards for fear of being exposed.

Here’s where I come out: The important question for present purposes is not whether there are lurking agency costs under the present system or the hypothetical system, but whether there’s a persuasive case to be made that there would be a material, detrimental increase in those costs if we moved to the new model. I can’t see any reason why that would be.

#### LAW AS PUBLIC GOOD

You introduce a fascinating perspective on this issue by pointing out that one of the “products” of lawyers’ practicing is law itself, noting that litigation establishes precedents which govern other parties’ future conduct; that regulatory practice establishes the parameters of legitimate activity; and that transactional work—to my mind the most fertile of all—produces “novel legal forms that can become part of the accepted repertoire of private arrangements that the law will

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34. Mayson, *supra* note 16, at 146.

honor.”

I endorse your observations wholeheartedly, and would add only this:

- I believe the primary reason the Anglo-Saxon common law tradition has become the de facto international law of business is its malleability and extensibility: Private practitioners can dream up new legal forms which, if upheld, can be relied upon as guides to future conduct. Civil-code regimes simply do not contemplate or permit this flexibility.<sup>35</sup>
- Having read “*Tombstones: A Lawyer’s Tales from the Takeover Decade*,”<sup>36</sup> by Larry Lederman, a Cravath-trained lawyer who became a partner at Wachtell, and whom I’ve interviewed, I can report that many of the innovative tactics we take for granted today, such as poison pills, LBO’s, proxy fights, and “*Revlon*” auctions,<sup>37</sup> were made up on the fly by practitioners in the trenches, seeking tactical advantage in the thick of a contested deal, who had no assurance courts would uphold them.

And you’re right to point out our increasing appreciation of the profound contribution that everyday citizens’ understanding of the rule of law makes to constraining self-interest and ordering behavior in ways policing or surveillance never could.

That said, I have to question why or how introducing our proposed derivatives would diminish lawyers’ incentives, ability, or desire to continue to contribute to the corpus of public law. Actually, I would argue the contrary: That the “output” of public law might be expected to increase, not decrease, in our proposed derivatives-enabled model.

Why? More than is the case today, I believe firms would be rewarded for creating innovative legal forms and tactics. To support this, I look to the experience of securities broker-dealers and investment banks following the deregulatory “Big Bang.” In the case of that industry, two unexpected developments rapidly became apparent: First, that this hitherto sleepy sector could begin to display shocking dynamism in rolling out new products and services for their clients. And second, that access to capital opened a new landscape in the form of being able to aggressively pursue mergers, acquisitions, spin-offs, and recombinations that altered the industry to an unrecognizable degree.

The second is interesting, but the first is important.

While it’s certainly the case that no one can patent or copyright a new financial instrument or a new legal form or tactic, it’s indisputably the case that there’s a “first mover advantage” phenomenon in play, such that Wachtell became the go-to firm for corporations in the market for poison pills, and remains so to a

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35. See Bruce MacEwen, 98 of the ‘Global 100’ are Brits or Ex-Brits. Say What?, [http://www.bmacewen.com/blog/archives/2006/10/98\\_of\\_the\\_global\\_100\\_are.html](http://www.bmacewen.com/blog/archives/2006/10/98_of_the_global_100_are.html) (October 5, 2006, 09:22 EST).

36. LARRY LEDERMAN, *TOMBSTONES: A LAWYER’S TALES FROM THE TAKEOVER DECADE* (1992).

37. See *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del., 1986).

remarkable extent a quarter of a century later.

In sum, I can't be certain, but I would wager the quality and quantity of "public law" output would benefit, not suffer, from our proposed regime.

#### INVESTOR PREFERENCE FOR STABILITY

One of the most significant unintended consequences—not foreseen by me in my original thinking on this—might be the gravitational pull the introduction of derivatives should exert toward putting a premium on firm stability over short-term profitability.

Consider: Under the current model partners have every incentive to "strip-mine the firm," as one of my friends puts it, at the end of every fiscal year. Law firms notoriously under-invest in:

- information technology,
- knowledge management systems,
- long-run commitments to professional development, retention, and training, and
- a host of other intangible firm assets which have real costs today but only unquantifiable benefits in the future.

As I've written, the thought process of many senior partners is that associate mentoring is fine, "but I really like my summer in the south of France and a new Mercedes every other year."<sup>38</sup>

Moreover, you and a host other commentators, including Stephen Mayson, have commented on the fact that law firms are "people businesses." This makes them inherently fragile, as the shockingly rapid decline and implosion of some name-brand firms (Brobeck, Coudert Bros.) has amply demonstrated.<sup>39</sup>

The devil here is obviously the temptation for partners with portable books of business to decamp to another firm willing to pay them close to the capitalized value of their future revenue stream—which destabilizes the "losing" firm and does not in fact economically benefit the "winning" firm, as the value of their business is captured by the individual lawyer, not the firm.<sup>40</sup>

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38. Bruce MacEwen, Are You a Prince or a Baron?, [http://www.bmacewen.com/blog/archives/2005/07/are\\_you\\_a\\_princ\\_1.html](http://www.bmacewen.com/blog/archives/2005/07/are_you_a_princ_1.html) (July 15, 2005, 13:45 EST).

39. I won't try to list all the firms that were rescued from eventual collapse or dissolution by "friendly" mergers, but their numbers are legion.

40. The economic literature which discusses this syndrome is colloquially known as "superstar economics," and primarily addresses entertainment celebrities and marquee athletes, where financial information is readily obtainable about signing bonuses, guarantees, revenue shares, and so forth. Obviously no comparable public data is available in law firm land, but the consistent finding of the literature in other industries is that the "superstar" tends to capture essentially all the incremental profit which would otherwise go to the signing franchise.

If one believes that labor markets—at least at such elevated levels—are reasonably transparent and competitive, this is to be expected. Since the market for laterals in law firms is *not* so transparent, I subscribe to

Another potential benefit of linking the overall financial remuneration of partners more tightly to the success of the firm *in toto*, in contrast to their individual portfolio of business, is the incentive it will provide hitherto-autonomous lawyers to hew more closely to firm governance standards and expectations.

In the recent collapse of Jenkins & Gilchrist, we essentially saw a large, prestigious, and successful firm brought down by the actions of a single rogue partner, Paul Daugerdas, and his hyper-aggressive tax-shelter practice. You rightly point out, Mitt, that we now know enough about the behavior of individuals in organizations to be able to predict with confidence that the ethical tone of a firm will have a potent influence on individuals' behavior.

If one result of introducing a derivative reflecting overall firm valuation into the overall compensation calculus would be to reinforce a firm-wide ethical and professional orientation, it's incomprehensible to me how, precisely, permitting non-lawyers to own an interest in that derivative would compromise firms' professional ethos.

#### THE VALUE OF THE DERIVATIVE VS. PEP AS THE MARQUEE NUMBER

You introduce a fascinating discussion of whether the value of the derivative (call it \$D) would supersede PEP as the number of all numbers which people use as short-hand for the successfulness, importance, or value of a firm. We all know the evils, intrinsic and unintended, of PEP as the marquee metric for law firms. So of course, one snappy—if not cynical—response to the question is to ask if PEP is so bad, how could \$D be worse?

But of course you're raising a more important and subtle question, specifically whether a more or less explicit valuation for a law firm wouldn't cross "a qualitatively important divide," making law firms equivalent in the public's eyes to "the ranks of businessmen and women, and [making] law regarded as even more explicitly a commodity for sale."

Since this is a thought experiment—and since the double-blind real world experiment can never be performed—all we can really do at this point is speculate, but I'm more sanguine than you. I don't believe this is a material risk. Why not?

- First of all, much turns on the audience who might entertain the "commodity for sale" view. Let's face facts: Very very few Americans actually are clients of AmLaw 100 or 200 firms, which is the universe (I think) that we're interested in. For the vast majority of our fellow citizens, therefore, this would be a non-event. In fact, I would wager that if you took a poll today

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the theory that some law firms have a "comparative advantage" in recruiting from, and profiting from, laterals, and thus that there are consistent winners and losers in the lateral recruitment tournament.

asking people whether law firms *could be* public companies, the majority would assume they could be.

- For our target audience—clients of AmLaw firms and lawyers who work for them or might aspire to work for them—the characterization of what they do as a “commodity for sale” is simultaneously one of their worst nightmares and utterly alien to their perception of their own professional ethos.
- Realistically, I think the “shock” of law firms’ being able to engage public investors would be short-lived, and the cynicism, if any, transitory and soon forgotten. I haven’t heard Goldman Sachs accused of offering commodity service lately, or of being particularly self-serving or prone to conflicts of interest. (Obviously, any firm can fall into those traps, but we already have perfectly satisfactory rules on the books punishing self-dealing and conflicts; we know how to deal with those infractions.)
- Lastly, you mention that you “generally side with those who regard the profession-business dichotomy as spectacularly unhelpful,” which I roundly applaud, but I might take it a step further than you in its implications.<sup>41</sup>

To me, the profession/business dichotomy is worse than false: I believe that it’s only the well-run, stable, cash-generating businesses that can provide the robust infrastructure—and interesting client base—that professionals need to achieve at the highest levels. Wachtell is famously successful in terms of financial performance, but what’s less well known is that their ratio of support staff to lawyers is 2:1 as against an industry average of 1:1—or twice as high. I would argue their unparalleled financial success is what enables them to provide unmatched levels of support for their professionals.

#### LARRY RIBSTEIN’S (BRIEF) COMMENTS

In his April 1 e-mail, Larry raises two interesting points: First, that we generally leave organizational and capital structure to “the market for state law,” and second that we might be better off not “minimally interfering with existing rules” but simply by “scrapping the rules and letting the market equilibrate.”

I endorse #2 enthusiastically; would that I believed it possible. If anyone wants to mount a serious challenge to the ABA’s medieval guild mentality, show me where to sign up. That our industry is the only one which attempts—with a

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41. GE under Jack Welch was by all accounts a particularly well-run business, but I think he displayed an astute ear for “professionalism” by making use of the “forced ranking” annual evaluation, where the bottom 10% of performers were counseled and coached but ultimately let go if they could not measure up. Sounds ruthless, but he made it clear that he saw it as essentially humane: The justification was to reward excellence, to enable the high-performers to operate in an environment with minimal “drag,” and perhaps most important of all, to give the bottom 10% misfits an opportunity to find a happier and more productive role to fill, since they were clearly not succeeding where they were—and being resigned to permitting them to stay was doing them no favor in the long run.

The analogy to law firms as businesses is far from exact, but I believe there’s wisdom in the observation that mopey, under-utilized, under-performing colleagues drain professional esprit de corps.

transparent lack of success—to cloak anticompetitive injunctions with the cloth of “ethics” is as humiliating as it is depressing.

As for #1, my view follows from #2: We do not in fact have any genuine “market for state law” today. What we have is a monopolistic private cartel, the ABA, imposing its protectionist views on an extremely significant industry—one accounting for nearly 2% of U.S. GDP. This is a classic case of “regulatory capture,” in my view, where deference to the regulatory entities’ judgment is to be eschewed, not endorsed.

In any event, those are my thoughts. My question for you (both) is: Where do we go with this from here?

Best regards,  
Bruce MacEwen

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April 11, 2007

Dear Bruce and Mitt:

Thanks very much for your thought-provoking letters. What began with Bruce’s fairly radical suggestion of law firm derivatives is evolving, at least in my mind, into something broader. You may or may not want to go along for the ride, but let me at any rate try to lay out a map.

We started with Bruce’s question: “Could law firms, consonant with ethical rules, create a derivative financial instrument engineered to reflect the implicit value of the firm as if it were tradable as a stock?” Bruce’s stated objective was to address the problem that large firm partners have “no material wealth-creation opportunities” comparable to executive stock plans. This leaves the firms vulnerable to raiding by other types of firms, adverse (ordinary income) tax treatment, and possible international competition growing out of the Clementi reforms.

Mitt’s response puts Bruce’s suggestion into the broader framework of the incentive problems facing modern lawyers and law firms. Mitt wonders about the effect of Bruce’s instrument, specifically on control by non-lawyers and possibility of working to the share price, on lawyers’ responsibility to their clients and their public role in the creation of law, and on the potential commodification of law practice.

Bruce in response elaborates on the nature and purposes of the instrument. He notes some advantages: making more transparent lawyers’ separate roles as owners, investors and workers; allowing firms to build infrastructure and

capitalize on legal innovation; and giving lawyers an interest in building the firm rather than their own books of business. More to the point, Bruce wonders if stock price might be a better metric than PEP—or at least how it could be worse than the “eat what you kill” philosophy we observe today. Mitt acknowledges some of those advantages as well.

Mitt’s and Bruce’s follow-ups to Bruce’s original proposal obviously move from merely providing better compensation for big firm lawyers to addressing the fundamental structural and incentive problems with big law firms. It seems to me that the basic problem is that the proposal, as striking as it is, is actually too modest for the problems it addresses. The limitation, of course, is that the proposal is designed to arbitrage around existing rules, and as Mitt points out, and Bruce acknowledges, there are limits to feasible arbitrage.

One possible answer is to think outside the box, or more precisely the rules, particularly since that would seem to be where the follow-ups are leading us. Bruce would endorse this, “would that I believed it possible.” For reasons discussed below, I think it is possible. More importantly, it’s very difficult to think about the broader issues raised by Bruce’s proposal unless we put the underlying ethical restrictions on the table.

We agree that it’s necessary to encourage lawyers to work for the long-run interests of clients and society rather than the short-run interests produced by PEP and EWYK. Lawyers have a powerful incentive to do whatever it takes to please the “client,” which actually means those who are running the client. In my view, law firms theoretically can mitigate that incentive.<sup>42</sup> Specifically, clients (by which I mean their residual claimants) hire law firms as a form of “reputational bond.” The law firm then, at least theoretically, establishes internal structures that help ensure that the lawyers serve the clients’ long-run interests in the enforcement of the “bond.”

It is important to keep in mind that, in order to protect its reputation, the firm has to be able to give its members property rights in the success of the firm as a whole rather than merely in their own client billings. Only such incentives can encourage the members to align with the firm’s interest in its reputation, rather than with the potentially short-run interests of the client’s managers who decide whether to hire or fire the lawyer. A big part of the equation, therefore, is how firms compensate their lawyers. Traditional profit shares *could* provide the right firm-based rather than client-based compensation—for example, by paying partners strictly by seniority. A derivative might enhance the effect by using a market for the profit interest to increase the accuracy of the valuation. It might also provide some tax advantages (though I’m not confident of the alchemy that turns profits into capital gains, and this is being questioned right now in Congress

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42. See Larry E. Ribstein, *Limited Liability of Professional Firms After Enron*, 29 J. CORP. L. 427 (2004); Larry E. Ribstein, *Ethical Rules, Agency Costs and Law Firm Structure*, 84 VA. L. REV. 1707 (1998).

in the context of private equity compensation).

Does the absence of such a derivative really explain why we don't observe much firm-based compensation? I wonder. I've argued in my prior articles that lawyers' incentives depend not only on how the firm compensates the lawyer, but on the firm's ability to keep these compensation deals from unraveling. Ethical restrictions on non-competition agreements, however, are based on the idea that clients have to be able to choose and control individual lawyers rather than be "owned" in some sense by the firm. It's hard to bind lawyers to the firm as a whole when a client is dangling a better deal, particularly when the lawyers know that their partners will be tempted by the same deals. It's *this* problem that really inhibits firms from developing the sort of intellectual property that Bruce emphasizes. These inventions can't be patented or copyrighted—the firm essentially has to rely on its contracts with its members. If the contracts aren't enforceable, the firm has less incentive to develop the products.

Even apart from this problem, the usefulness of Bruce's derivative is sharply limited by the restriction on non-lawyer owners. I accept for the sake of argument that an instrument could be sold that gives the investors no role in control of the firm—you wouldn't necessarily even need a "derivative" to accomplish that. As I've written,<sup>43</sup> this is essentially the structure of the recent Blackstone IPO. But Mitt points out that this might not mollify the ethics cops. Moreover, the need to block control obviously would constrain flexibility and marketability.

To make this work, I hypothesize that we need to confront the ethical restriction on non-lawyer ownership. To begin with, we need to ask why we have the restriction in the first place. Perhaps it once made sense when law firms really were partnerships in the classic sense of a community of equal owners. This organizational form arguably helps overcome information asymmetry between lawyer and client.<sup>44</sup> Clients can't easily measure lawyer quality, so they rely on the firm to carefully choose its partners. As long as lawyers practice in a partnership in which they share profits equally with their co-partners, they have an incentive to hire only the highest quality professionals, and to monitor and mentor them in order to maintain quality. If they can hire workers at their market wage, they'll have the incentive to hire cheap workers and try to make a profit out of them by overcharging clients. Ethical restrictions on capital formation reflect this model of co-equal partners. But the model starts breaking down as soon as firms go to something other than equal sharing, particularly when they leverage their structures with many non-partner employees. Restricting partners to skilled professionals mitigates the *difficulty* of monitoring them, but it does not solve the

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43. Larry Ribstein, *Going Privlic*, THE AMERICAN, Mar. 27, 2007, <http://www.american.com/archive/2007/march-0307/going-privlic>.

44. See Jonathan Levin & Steven Tadelis, *A Theory of Partnerships* 1 (Stan. Inst. for Economic Policy Research, Working Paper No. 244, 2002), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=311159](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=311159) (last visited Dec. 4, 2007).

basic *incentive* problem that arises from deviations from equal sharing.

Now let's consider some potential advantages of allowing lawyers to practice law in publicly-owned firms, free from the ethical constraints on both ownership and non-competes. Such a firm would want to maximize overall profits, and not just profits produced by lawyers in the practice of law. It would also be able to enter into contracts among the members that promote this goal. This structure can produce value in a number of ways. First, the firm could leverage its reputation by applying it to services that are synergistically related to law practice. Second, the firm could, and would have the incentive, to offer more valuable one-stop shopping to clients. This not only reduces client transaction costs, but reduces lawyer-client agency costs by encouraging the firm's employees to recommend the services clients need—not just legal services, but accounting, financial, and other services as well. Third, a large multi-service publicly traded brand would offer clients more security. With the increasing risk of large-scale liability, and firms' fragility in the face of partner defections, clients don't get the protection they once could expect from mere size and fancy offices. In short, a firm that fully exploited the value and synergies inherent in its brand would be a more valuable firm than the law-only firms of today. And such a firm could offer its lawyer-employees the sort of firm-based incentives that can constrain the destructive tendencies of "eat what you kill."

What about the problem of practicing to the share price? I've laid out my version of why that's not a problem in conventional corporations.<sup>45</sup> My basic point is that there is a lot of empirical and theoretical support for the notion that the current model of corporate managers being held basically responsive to market forces produces social responsibility, and that disrupting that model, as some social responsibility theorists propose, is likely actually to reduce social welfare.<sup>46</sup> That point is also made more concisely in Gordon Smith's fine recent article, *The Dystopian Potential of Corporate Law*.<sup>47</sup> As you both have wondered, can these incentives really be worse than those produced by PEP and EWYK?

To be sure, lawyer-employees of large firms may go astray, and may not be attentive enough to their important role in creating and maintaining legal institutions. I agree that that role is important.<sup>48</sup> Indeed, I've argued that lawyers' public law-creation role is not just one, but the *only*, justification for continuing lawyer licensing. Whether or not that's true, lawyer discipline would survive law firm restructuring. The question is whether the regulation ought to focus on

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45. Larry E. Ribstein, *Accountability and Responsibility in Corporate Governance*, 81 NOTRE DAME L. REV. 1431 (2006).

46. *Id.* at 1433-34.

47. Gordon Smith, *The Dystopian Potential of Corporate Law* (Univ. of Wisconsin Legal Studies Research Paper No. 1040, 2007), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=976742](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=976742) (last visited Dec. 4, 2007).

48. See Bruce H. Kobayashi & Larry E. Ribstein, *Class Action Lawyers as Lawmakers*, 46 ARIZ. L. REV. 733 (2004); Larry E. Ribstein, *Lawyers as Lawmakers: A Theory of Lawyer Licensing*, 69 MO. L. REV. 299 (2004).

*lawyer behavior* or *law firm structure*. There is little mandatory regulation of corporate structure, yet corporate behavior itself is heavily regulated by federal and state law. I suggest that this may be the appropriate approach to law firms as well. I recognize that many will argue that internal firm incentives may push against the incentives provided by ethical rules. But, as I argue above, I think that the incentives produced by publicly held firms would actually complement, rather than be inconsistent with, regulation.

If you're ready to contemplate the possibility of deregulating law firm structure, then we reach the question of how to achieve this result. I previously alluded to state competition. Of course, as Bruce noted, we don't have any such thing now. One reason is that ethical rules are imposed on a territorial basis, which means that multijurisdictional firms may be subject to the law of each state in which they have a branch office. I have suggested adopting a corporate-type choice-of-law rule that would permit firms to choose a single regime to provide "structural" ethical rules, like those dealing with law firm ownership and non-competition agreements.<sup>49</sup> But I understand that without this change the idea of competition for these rules doesn't work.

The basic problem with all of this is that it flies in the face of the guild mentality that still has an iron grip on the legal profession. The fundamental question concerns what might be called "lawyer exceptionalism"—are lawyers and law firms really different from the rest of society and our capitalist economy? If, as I argue above, working to the share price basically works for society in corporations generally, we have to ask why it shouldn't work for lawyers. It's right to think about the potential commodification of law practice. Commodification is what capitalism does. The question is whether that's something to worry about, or to welcome.

Even if I'm right, could this happen? I think so. If there's money in the high-value publicly held law firm, there's also money in challenging and possibly breaking down the restrictions. Moreover, legal business is now international, and can be captured by Clementi-ized UK firms. Capitalism is profoundly destructive. Whether we like it or not, international competition could break down the resistance of tradition and history.

I want to emphasize that one doesn't have to agree with all, or even any, of the above to accept my basic point that these issues should be on the table. Perhaps a debate on this subject will come to the conclusion that these ideas are profoundly wrong and unrealistic. But even if that's so, I think the debate will have been useful. Such a debate should include not only lawyers and scholars of the legal profession, but also some corporate and finance people, even those (like Gordon Smith mentioned above) who have never even considered the application of their work to law firms, but whose work is illuminating on these issues.

So, in conclusion, I think that Bruce has raised some very interesting

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49. Larry Ribstein, *Ethical Rules, Law Firm Structure and Choice of Law*, 69 U. CIN. L. REV. 1161 (2001).

questions. I don't see how we can avoid the broader implications of those questions, so we may as well embrace them.

Sincerely,  
Larry

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Re: Law Firms & Capital Markets Access

Dear Mitt & Larry:

First, just a personal word on how much I'm enjoying engaging with you both on this intellectual pursuit. I'm pleased my initial question has led in unanticipated directions, but I embrace them wholeheartedly.

Just a few "final" (for this round, at least) thoughts in response to Larry's last letter suggesting that "we may as well embrace" "the broader implications":

- Permit me to stipulate that I endorse going beyond my initial proposal since it's clearly the case that it "is actually too modest for the problems it addresses." I envisioned a modest proposal for modest purposes, but I now do not believe the consequences of my original proposal can be limited: In for a dime, in for a dollar. More seriously, I think that questioning the "ethical" proscriptions against non-lawyer ownership of law firms opens up the entire landscape of law firm structure, lawyer incentives, and lawyer behavior.
- Once one's eyes are opened, as it were, to how bizarrely "exceptional" law firm structure and regulation are, the door is wide open to what Larry nicely characterizes as capitalism's "profoundly destructive" marketplace logic. All I would add is that capitalism is profoundly destructive *only to the status quo* and that the flipside of that "destruction" is the immensely more valuable innovation and creativity which inadvertently cause that destruction. (The Wintel PC platform may have "destroyed" DEC and Wang, and imperiled IBM for a decade or so, but would we take the other side of that trade?)
- To question the ethical proscription on non-lawyer ownership requires

- understanding its original justifications, and determining whether they are obsolete or still applicable with any degree of force. I think this analytic exercise should be an agenda item of its own for our proposed conference. (I know where I come out, but I suspect I'm in the distinct minority in our profession: We need to air this linen very publicly.)
- Larry lays out three positive consequences of permitting non-lawyer ownership, creating what I'll call "hybrid" firms, providing legal and non-legal services, all of which I thoroughly endorse and to which I would add a fourth:
    - First, that a hybrid firm could use its reputational capital to provide law-related services. I heartily agree, and would point to the financial services industry as a model. Institutions there have moved over the past century from plain old lending to trading for clients and then their own accounts, to securitizing portfolios of debt, to creating derivatives and beyond.
    - Second, that hybrid firms would have every incentive—nicely aligned with their clients' interests, I might add—to provide the appropriate mix of legal, financial, accounting, tax, brokerage, and other services that best addresses the clients' issues and challenges. Today, law firms have every incentive to over-recommend, over-sell, and over-perform legal services and legal services alone.
    - Third, that a firm performing an array of services would offer more stability. This is surely the case, as we know from diversified portfolio theory if nothing else. Law firms today are inherently fragile, subject to "runs on the bank" in the form of partner defections. To be sure, the intellectual capital of the Brobecks and Couderts of the world is not destroyed: It migrates to Clifford Chance, O'Melveny, Orrick, etc., but with tremendous transaction costs to clients and the system in general and at great personal cost to the individuals required to relocate, especially those with weak or nonexistent practices of their own.
    - Finally, let me add that I think hybrid firms would find themselves, through desire or market necessity, pursuing innovation in the delivery of legal services, the likes of which we can only imagine. Elsewhere I've speculated on whether the legal industry couldn't truly take as its model financial services, which is a strikingly rich ecosystem of players of every size from one-man bands to some of the largest corporations in the world, providing a tremendous variety of products and services—in constantly growing numbers and broadening diversity.
  - Larry concludes with two ideas which I think are almost one and the same: The question of "whether the regulation ought to focus on *lawyer behavior* or *law firm structure*." This is one of those questions that, once you pose it, answers itself. Answer A is clearly correct, and the fact that we've tolerated

Answer B as long as we have speaks loudly to how blinkered our professional outlook can be.

- But I think *getting to that result* is deeply linked to his other concluding point, asking why law firms should not be able to choose their governing structural law *ex ante* rather than having it foisted upon them by the happenstance of geography—as corporations can do. I would like to believe that single change—permitting law firms to elect their “home” jurisdiction for purposes of fundamental structure law—would in itself cause the almost inevitable cascade of everything else we’ve been discussing, through the “choice of law competition” Larry has studied and written about so effectively.
- And doesn’t this simply reflect the world we live in today? What makes Clifford Chance a UK and therefore Clementi-eligible firm, or Orrick a “California” firm when its largest single office is in New York?

As I said at the outset, this began as a remarkable intellectual journey for me and has only become deeper and wider in its implications. Thank you both for pursuing this in the spirit of finding out where it might lead, and “embracing” that.

Best regards,  
Bruce MacEwen