Law Firms on the Big Board?:
A Proposal for Nonlawyer Investment in Law Firms

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Every state has a rule proscribing nonlawyer investment in law firms. This sixty-plus-year-old prohibition has created an inefficient legal services market. Firms cannot access capital markets, limiting their opportunities for expansion, curtailing investments in technology and training, and hindering competition. Furthermore, every jurisdiction except the District of Columbia prohibits lawyers from entering into a business association with nonlawyers as partners or directors if the business provides legal services. These prohibitions against nonlawyer investment and participation in law firms have long hindered the legal profession with no signs of change. This Article advocates that these prohibitions be lifted. It discusses the source of these prohibitions and
the historical and ethical arguments of critics, which are shown to be merely phantom concerns. These concerns are far outweighed by the substantial benefits of allowing law firms to incorporate, to engage in business associations with nonlawyers, and to receive investments by nonlawyers. The benefits include capital for expansion, capital for investment in new technologies and new lawyers, financing for contingency fee cases, and a myriad of other rewards. Most persuasively, perhaps, as the practice of law continues to be increasingly transformed from a profession into a business, it makes little sense to prevent lawyers from using the financial tools that virtually every other business has available to it.

Every year the partners of Skadden, Arps, Slate, Meagher & Flom, unquestionably one of the nation's preeminent law firms, hold a retreat to rejoice in their continued success and to celebrate the firm's big plans for the future.1 Skadden's 1991 retreat was quite different, however. Presentations regarding the firm's changing economic condition dominated the retreat's meetings, with a primary focus centered on the law firm's international practice.2

From 1970 to 1986, the net surplus for services in the American balance of trade climbed from $2.3 billion to $18.9 billion. Yet "Skadden had barely a sliver of this growing business."3 The reasons given at the retreat were the firm's lack of overseas offices and its failure to market aggressively overseas.4 Realizing that Skadden lagged significantly behind other United States law firms in competition for overseas clients and international business, some felt the firm must expand into the global market in order to succeed in providing "multi-national services to multi-national clients."5 Many of the nation's corporate giants had significant overseas operations, and to attract this business Skadden would need to expand.6

Although existing overseas offices had already cost the Skadden partners between seven and ten million dollars, the partners felt that the overseas offices had produced increased revenues in domestic offices that far exceeded that amount.7 With this experience in mind, the most likely approach in the firm's expansion strategy "would be the
establishment of Skadden offices in the world's 'major international financial centers.'

Just as any other enterprise, Skadden would need large amounts of capital to place its plan into effect. Unlike almost any other enterprise, however, the option of turning to the equity markets for the necessary capital did not exist. Today, as for any other law firm, this option would still not exist.

Every state has a rule proscribing nonlawyer investment in law firms. This bar has created an inefficient system for providing professional legal services, as firms cannot access the capital markets, giving them only limited opportunities for expansion, competition, and purchases of equipment and personnel. Additionally, every jurisdiction except the District of Columbia prohibits lawyers from entering into a business association with nonlawyers as partners or directors if the business provides legal services. These prohibitions against nonlawyer investment and participation in law firms have hindered the legal profession for over sixty years with no signs of change.

This Article advocates necessary changes to these inefficient prohibitions. Part I discusses the long-standing prohibition against nonlawyer investment in law firms and the forms it has taken in the rules and codes that have governed lawyers for over sixty years. Part II discusses the historical and ethical arguments comprising the "Fear of Sears" and the problems critics believe to be inherent in allowing nonlawyers to control law firms. Part III examines the business organizations and associations currently available to lawyers, outlining their benefits and drawbacks. Part IV examines the potential benefits of allowing law firms to incorporate, to engage in business associations with nonlawyers, and to receive investments from nonlawyers. Finally, Part V discusses the agency and risk-sharing problems that might plague such a model as well as potential solutions to these problems.

I

TRADITIONAL PROHIBITIONS ON NONLAWYER PARTICIPATION IN LAW FIRMS

The traditional view that nonlawyers should be prohibited from investing in law firms first took root in the ABA's Canons of Professional Ethics in 1928. Over the years, the rule has been interpreted strictly to forbid lawyers from being governed by

8. Id. at 284.
9. The "Fear of Sears" is a long-used expression representing the fears of those opposed to nonlawyer ownership and management of law firms. The expression stems from the fear that Sears, Roebuck & Co., for example, could own its own law firm—an unthinkable concept to those opposed to nonlawyer investment in law firms.
nonlawyers or from engaging in a broad range of business associations with nonlawyers. The prohibition was included in the first Model Code of Professional Responsibility in 1969. After significant debate, the doctrine was also incorporated into the Model Rules of Professional Conduct in 1983. Almost every jurisdiction has adopted either the Model Rules or the Model Code and, with them, the prohibition on nonlawyer investment in law firms. For nearly seventy years, the profession’s Fear of Sears has doomed any proposal that would have allowed a nonlawyer even a passive investment in a law firm.

A. The ABA Canons of Professional Ethics

In 1908, the ABA promulgated the original Canons of Professional Ethics (“the Canons”). The Canons represented the ABA’s formal position on matters of legal ethics. As originally promulgated, the Canons did not address whether practicing lawyers could enter into business associations with nonlawyers. Twenty years later, however, the ABA adopted additional rules that essentially prohibited practicing lawyers from entering into partnerships or business associations with nonlawyers.11

Specifically, in 1928 the ABA adopted Canons 33, 34, and 35.12

Canon 33, which addressed partnerships generally, provided that:

In the formation of partnerships for the practice of law, no person should be admitted who is not a member of the legal profession, duly authorized to practice, and amenable to professional discipline. . . . Partnerships between lawyers and members of other professions or non-professional persons should not be formed or permitted where a part of the partnership’s business consists of the practice of law.13

Canons 34 and 35 buttressed Canon 33. Canon 34 stated that “[n]o division of fees for legal services is proper, except with another lawyer, based upon a division of service or responsibility.”14 Canon 35 added that “[t]he professional services of a lawyer should not be controlled or exploited by any lay agency, personal or corporate, which intervenes between client and lawyer . . . [A lawyer] should avoid all relations which direct the performance of his duties in the interest of such intermediary.”15 Together, these three canons effectively barred practicing

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12. See id. at 130-31, 769.
13. Id. at 778.
14. Id.
15. Id. at 779.
lawyers from entering into business associations with nonlawyers, either
directly or indirectly.\textsuperscript{16}

The ABA did not promulgate these new canons without objections
from the bar, however. In fact, the drafting committee acknowledged
that “there is substantial difference of view in the profession respecting
its recommendations as to partnerships, division of fees, intermediaries,
and the bonding of lawyers . . . .”\textsuperscript{17} At least one member of the drafting
committee issued a report expressing the opinion that “aside from pro-
fessional policy, there is nothing inherently ‘unethical’ in the formation
of partnerships between lawyers engaged in certain kinds of work and
an expert engineer, student of finance, or some other form of expert.”\textsuperscript{18}

For over forty years, the ABA Committee on Professional Ethics
and Grievances interpreted the restrictions of Canons 33, 34, and 35
broadly by consistently ruling that any business association between
lawyers and nonlawyers that offered legal services was prohibited.\textsuperscript{19} In
an opinion addressing a lawyer’s employment by an accounting firm,
for example, the ABA committee stated:

When a lawyer-employee advises his lay employer in regard
to a matter pertaining to the affairs of a client of the employer
and the giving of such advice by the lawyer-employee directly to
the client would involve him in the practice of law, the lawyer is

\textsuperscript{16} Together, Canons 33, 34, and 35 have prohibited attorneys from acting as employees or
partners of patent application prosecutors, accountants, banks, collection agencies, insurance
companies, lending agencies, and many other private associations. See ABA Comm. on Professional
Ethics, Formal and Informal Ops. 139-64 (1967).

\textsuperscript{17} Annual Report of the American Bar Association, 52 A.B.A. 378 (1927).

\textsuperscript{18} Id. at 388 (minority view of F.W. Grinnell).

\textsuperscript{19} See ABA Comm. on Professional Ethics and Grievances, Formal Op. 269 (1945) (requiring
that an attorney entering into a partnership with a certified public accountant to specialize in income
tax work and related accounting matters cease to hold himself out as an attorney-at-law and strictly
confine activities to those open only to a lay accountant); ABA Comm. on Professional Ethics and
Grievances, Formal Op. 257 (1944) (allowing an attorney to enter into a partnership with a layperson
who is an agent licensed by the U.S. patent office if the partnership’s activities are limited to such as
permitted to laypersons under patent office rules); ABA Comm. on Professional Ethics and
Grievances, Formal Op. 239 (1942) (disallowing a practicing attorney from forming a partnership
with a certified public accountant to act as consultants in tax matters and represent taxpayers before
the Internal Revenue Service Board of Tax Appeals); ABA Comm. on Professional Ethics and
Grievances, Formal Op. 201 (1940) (preventing a partnership between an attorney and layperson
where the services rendered, if rendered by an attorney, would constitute the practice of law even
though laypersons were allowed to render the same services under law); ABA Comm. on
Professional Ethics and Grievances, Formal Op. 32 (1931) (preventing attorney from associating with
a layperson who is admitted to prosecute patent applications to the U.S. Patent Office when the
layperson does business under the name of a firm holding itself out as “attorneys” or “solicitors in
patent causes”); ABA Comm. on Professional Ethics and Grievances, Formal Op. 31 (1931)
(prohibiting lawyer from accepting employment at a corporation in the business of preparing
incorporation documents).
proceeding in violation of Canon 35 when he operates through his employer as an intermediary.\(^2\)

The committee also thwarted attempts by lawyers to avoid the rules by entering into non-partnership business associations with nonlawyers. Thus, although the committee had allowed lawyers to form professional law corporations under certain conditions; one such condition prevented nonlawyers from owning any interest in the corporation or acting as a director or officer of the corporation.\(^2\) After noting that "Canon 33...promulgates underlying principles that must be observed no matter in what form of organization lawyers practice law," the committee asserted:

Canon 33 prohibits the formation of a partnership for the practice of a partnership between lawyers and non-lawyers. This prohibition would likewise apply to the practice of law in any other form. Permanent beneficial and voting rights in the organization set up to practice law, whatever its form, must be restricted to lawyers while the organization is engaged in the practice of law.\(^2\)

The Committee's opinion made it clear that it would look to substance over form in enforcing Canons 33, 34, and 35. The ABA incorporated this approach into its next version of ethical rules, the Model Code of Professional Responsibility.

**B. The ABA Code of Professional Responsibility**

In 1969, the ABA replaced the Canons with the Model Code of Professional Responsibility (the "Model Code").\(^2\) By 1980, almost every state had adopted a code of professional responsibility based on the Model Code.\(^2\) Although the Model Code differed from the Canons in both form and content, the principles of Canons 33, 34, and 35 carried over into the Model Code. Canon 33 was reborn as Disciplinary Rule ("DR") 3-103(A), which provides that "[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."25 Canon 34, which had prohibited fee-splitting with nonlawyers, found continued life in DR 3-102(A), which states: "[a] lawyer or law firm shall not share legal fees with a non-lawyer . . . ."26 Canon 35's principles can be found in several provisions of the Code. First, DR 5-107(C) prohibits lawyers from practicing in a professional corporation or association if "[a] non-lawyer has the right to direct or control the professional judgment of [the] lawyer."27 Second, DR 5-107(B) directs that "[a] lawyer shall not permit a person who recommends, employs, or pays him to render legal services for another to direct or regulate his professional judgment in rendering such legal services."28 Finally, Ethical Consideration ("EC") 3-3 emphasizes that the Disciplinary Rules "protect the public" by prohibiting a lawyer "from submitting to the control of others in the exercise of his judgment."29

The Model Code also expressly incorporated the restrictions outlined in ABA Opinion 303 relating to lawyers practicing in professional corporations.30 Thus, DR 5-107(C) prohibits a lawyer from practicing in a professional corporation if a nonlawyer either "owns any interest therein"31 or "is a corporate director or officer thereof."32 In short, the Model Code continued the tradition of the Canons and the ABA Opinions, prohibiting practicing lawyers from entering into business associations with nonlawyers.

25. MODEL CODE OF PROFESSIONAL RESPONSIBILITY DR 3-103(A) (1980).
26. Id. DR 3-102(A). This rule, however, has three exceptions: first, a lawyer can arrange for the payment of money to his estate after his death; second, a lawyer who undertakes to complete unfinished business of a deceased lawyer may pay a proportion of the fees relating to the deceased lawyer's services to the estate of the deceased lawyer; and third, nonlawyer employees may be included in a compensation or retirement plan even though the plan is based on profit-sharing. See id. DR 3-102(A)(1)-(3).

Ethical Consideration 3-8 implies a rationale for the restrictions on practicing with nonlawyers and sharing legal fees with laymen. It states that "since a lawyer should not aid or encourage a layman to practice law, he should not practice law in association with a layman or otherwise share legal fees with a layman." Id. EC 3-8. The EC explains the rationale for exceptions to the fee-sharing prohibition by stating that "these limited exceptions . . . are permissible since they do not aid or encourage laymen to practice law." Id. The implication is that these rules are designed to keep the profession clear of any taint of the lay practice of law. The purposes of these restrictions are further discussed infra Part ILD and accompanying notes.

27. Id. DR 5-107(C)(3).
28. Id. DR 5-107(B).
29. Id. EC 3-3.
30. See Opinion 303, supra note 21 (referring, in part, to Opinion 303's restrictions on lawyer/nonlawyer associations).
31. MODEL CODE OF PROFESSIONAL RESPONSIBILITY DR 5-107(C)(1) (1980). The rule, however, provides a limited exception: "[A] fiduciary representative of the estate of a lawyer may hold the stock or interest of the lawyer for a reasonable time during administration." Id.
32. Id. DR 5-107(C)(2).
C. The ABA Model Rules of Professional Conduct

In 1977, only eight years after adopting the Model Code, the ABA created the Commission on the Evaluation of Professional Standards to consider and recommend revisions.\(^3\) This commission became known as the Kutak Commission, named after its chair, Robert Kutak.\(^3\)\(^4\) Between 1979 and 1982, the Kutak Commission circulated four major drafts of its proposed Model Rules of Professional Conduct,\(^3\)\(^5\) and on August 2, 1983, the ABA House of Delegates formally adopted the Model Rules.\(^3\)\(^6\) As of August 1997, at least thirty-eight states and the District of Columbia had adopted the Model Rules either in their entirety or in significant part.\(^3\)\(^7\)

During the Model Rules' drafting, the Kutak Commission considered and rejected the traditional view that practicing lawyers should be prohibited from entering into business associations with nonlawyers. As a result, the Commission's 1981 draft recommended that the ABA adopt Proposed Rule 5.4, providing that:

A lawyer may be employed by an organization in which a financial interest is held or managerial authority is exercised by a non-lawyer... such as a business corporation, insurance company, legal services organization or government agency, but only if the terms of the relationship provide in writing that:

(a) there is no interference with the lawyer's independence of professional judgment or with the client-lawyer relationship;

(b) information relating to the representation of a client is protected as required by [the rule on confidentiality of information];

(c) the arrangement does not involve advertising or personal contact with prospective clients prohibited by [the advertising and soliciting rules]; and

(d) the arrangement does not result in charging a fee that violates [the rule on fees].\(^3\)\(^8\)

Proposed Rule 5.4 represented a dramatic departure from the traditional stance of the Canons and the Model Code.\(^3\)\(^9\) As written,

\(^{33}\) See GILLERS & SIMON, supra note 10, at 3.
\(^{34}\) See id. at xvii.
\(^{35}\) See id. at 3.
\(^{36}\) See id.
\(^{37}\) See ABA/BNA LAWYERS' MANUAL ON PROFESSIONAL CONDUCT 01:3 (Aug. 20, 1997).
\(^{38}\) Id. at 292-93.
\(^{39}\) The Comment and Notes accompanying the Proposed Rule 5.4 rationalized this departure from traditional prohibitions on forming partnerships or sharing fees with nonlawyers by noting the changes in the practice of law over time. The Commission noted that law firms no longer consist solely of lawyers. Law firms rely increasingly on paralegals and professionals from other fields to manage various aspects of the firm. Additionally, many lawyers work for organizations other than law firms, such as government agencies, private corporations, and public defender and group legal service organizations. Nonlawyers often direct the work of attorneys in these organizations. See
Proposed Rule 5.4 would have allowed corporate investment and, thus, nonlawyer control of law firms. Indeed, it would have opened the door for law firms to "go public." In light of traditional opposition to this notion, it is no surprise that this proposed rule was the only rule from the 1982 final draft that was rejected in its entirety and rewritten by the House of Delegates.40

The Kutak Commission justified its rejection of the traditional approach in both the Comment and the Legal Background sections that accompanied its Proposed Rule 5.4.41 The Legal Background section, in particular, was highly critical of the traditional approach:

To prohibit all intermediary arrangements is to assume that the lawyer’s professional judgment is impeded by the fact of being employed by a lay organization.... The assumed equivalence between employment and interference with the lawyer's professional judgment is at best tenuous.... Applications of unauthorized practice principles, only tenuously related to substantial ethical concerns raised by intermediary relationships, may be viewed as economic protectionism for traditional legal service organizations....

The exceptions to per se prohibitions on legal service arrangements involving nonlawyers have substantially eroded the general rule, leading to inconsistent treatment of various methods of organization on the basis of form or sponsorship. Adherence to the traditional prohibitions has impeded development of new methods of providing legal services.42

Similarly, the Comment to Proposed Rule 5.4 noted that ""'[g]iven the complex variety of modern legal services' ... which 'raise problems concerning the client-lawyer relationship... it is impractical to define organizational forms that uniquely can guarantee compliance with the Rule of Professional Conduct.'"43


40. See GILLERS & SIMON, supra note 10, at 293.
42. Id. at 594-95.

[M]ultimember partnerships, firms employing paraprofessionals and professionals of other disciplines, professional corporations, insurance companies that employ counsel who represent insureds, law departments of organizations, and group legal service organizations in which non-lawyers, or lawyers acting in a managerial capacity, may be directors or have managerial responsibility.

Id. (quoting Annual Report of the American Bar Association, 107 A.B.A. 886-87 (1982)).
Apparently, the ABA House of Delegates saw things differently. In February 1983, Proposed Rule 5.4 became the subject of debate at a House of Delegates meeting. The proponents of the Rule met strong opposition from the General Practice Section, which had submitted an amendment to the Rule which would essentially continue the traditional prohibitions against sharing fees and forming business associations with nonlawyers.

Those opposing the Kutak Commission’s version of the rule asserted several grounds for their opposition. First, opponents contended that the Commission’s proposal would permit Sears, Roebuck & Co., H & R Block, or Big Eight accounting firms to open law offices which would compete with traditional law firms. Second, nonlawyer ownership of law firms would interfere with the professional independence of lawyers. Third, nonlawyer ownership would result in economic pressures that would undermine the “professionalism” of law. Finally, the Rule could dramatically alter, in unforeseeable ways, the structure of the legal profession. According to Professor Hazard, the debate wound

44. See Gilbert & Lempert, supra note 39, at 391.
45. See id.
46. See id. at 391-92.
47. See Andrews, supra note 41, at 595.
48. See id. During the debate, a member opposing the Kutak Commission’s proposed rule admonished:

You each have a constituency. How will you explain to the sole practitioner who finds himself in competition with Sears why you voted for this? How will you explain to the man in the mid-size firm who is being put out of business by the big eight law [sic] firms? How will you explain that?

Id. at 595 n.107 (quoting Unedited Transcript of ABA House of Delegates Session 48 (Feb. 8, 1983) (alteration in original) [hereinafter HOD Transcript]).
49. See id. at 595. Another opponent had stated:

I cannot conceive that a lawyer can maintain his independence and his independent judgment over a period of time when he’s on a salary from a corporation that’s looking over his shoulder at his results in terms of profit. Now if you wish to destroy our profession as we’ve known it ... if you want to destroy it, the young lawyer’s opportunities in this country to enjoy the same professional independence that you and I have known, then ... support the Commission.

Id. at 595 n.108 (quoting HOD Transcript, supra note 48, at 46-47).
50. See id. at 595. Another opponent inquired:

Is it cost-effect[ive] to provide full representation? Is it cost-effective to zealously represent your client? Is it cost-effective to spend enough time with your client to get the job properly done? I think the answer is no. But clearly as lawyers, as professionals, we must get the job done properly, and we must spend that time and we must do those things. But what about the business venturer who owns this firm, he who hires or fires the lawyers? They needn’t view it that way. Now if the safeguards of the Commission were adequate ... fine. But they won’t be, and I submit who is in trouble if there is a violation of these rules? Is it the venturer or the lawyer? It’s the lawyer; the venturer isn’t even under the jurisdiction.

Id. at 595 n.109 (quoting HOD Transcript, supra note 48, at 41-42) (alterations in original).
51. See id. at 595. Another opponent stated:

No one can tell you what the impact of Rule 5.4 is going to be on the legal profession, but everyone can assure you, and you can assure yourself merely by reading it, that it is going to have a major impact and mark a fundamental change in the practice of law.
down quickly after he responded "yes" to the question: "Does this rule mean that Sears, Roebuck will be able to open a law office?" In the end, the General Practice Section's traditional view prevailed, and the Kutak Commission's Proposed Rule 5.4 was rejected.

D. Local Variations on the ABA Ethics Rules

The ABA's Model Rules and Model Code are not binding upon the legal profession or lawyers. Rather, each state is free to adopt and enforce its own rules of ethics. Accordingly, each state court system generally assumes responsibility for promulgating ethics rules and enforcing them against members of the state bar. In some states, however, the state legislature may issue the rules and allow the state courts to enforce them. Under either scheme, states typically rely heavily on the ABA's models when drafting their own ethics rules. However, two jurisdictions, the District of Columbia and North Dakota, have considered adopting the Kutak Commission's version of Model Rule 5.4.

1. District of Columbia

Perceiving a need for "one-stop shopping" for professional services, the District of Columbia's Jordan Committee, the group responsible for reviewing the Model Rules and proposing an ethical code to the D.C. Board of Governors, decided to reject the ABA's Model Rule 5.4 and its traditional prohibitions. Instead, the Jordan Committee recommended that a version similar to that of the Kutak Commission be adopted to allow lawyers to offer ancillary services. The Jordan Committee's Proposed Rule 5.4 provided in part:

(b) A lawyer may practice law in a partnership or other form of organization in which a financial interest is held or managerial authority is exercised by a nonlawyer, but only if:

(1) There is no interference with the lawyer's independence of professional judgment or with the client-lawyer relationship;
(2) The confidences and secrets of the lawyer's clients are protected as required by [the confidentiality rules];
(3) The arrangement does not involve advertising or personal contact with prospective clients prohibited by [the advertising and solicitation rules];
(4) The arrangement does not result in charging a fee that violates [the rule governing fees]; and

Id. at 595 n.110 (quoting HOD Transcript, supra note 48, at 37-38).
52. Gilbert & Lempert, supra note 39, at 392 (quoting Interview with Professor Geoffrey C. Hazard, Jr. (March 7, 1988)).
53. See id.
54. See id. at 393.
55. See id. at 394.
(5) The foregoing conditions are set forth in writing.\textsuperscript{56}

The Jordan Committee's proposed rule would have achieved its intended purpose of allowing nonlawyers and practicing lawyers to enter into partnerships or other business associations. However, the proposed rule also appeared to allow nonlawyers to invest passively in law firms, at least according to \textit{Business Week} and the \textit{National Law Journal}. Articles appeared in each of these publications within a week of each other, setting off the Fear of Sears syndrome that ultimately doomed the Jordan Commission's proposed rule.\textsuperscript{57} According to the \textit{Business Week} article, adoption of the Jordan Commission's rule "eventually could allow law firms to go public. And it could pave the way for such retailers as Sears, Roebuck & Co. to add legal counseling to their array of services."\textsuperscript{58} Although the Jordan Committee had not intended this result, it had to respond to the Fear of Sears.

In September, 1987, the Jordan Committee submitted a supplementary petition to the court considering the proposed rules. This supplementary document stated:

There was no thought that proposed Rule 5.4 should permit any organization or entity to effectively acquire and control a law firm. Acquisitions of organizations such as economic consulting firms by other entities or organizations have, in fact, taken place in recent years, but the Board of Governors does not consider such acquisitions appropriate with respect to law firms or other comparable legal organizations.\textsuperscript{59}

To make this clear, the Commission proposed changing Proposed Rule 5.4 to read: "A lawyer may practice law in a partnership or other form of organization in which a financial interest is held or managerial authority exercised by an individual nonlawyer who performs professional services which assist the organization in providing legal services to clients . . . ."\textsuperscript{60} In addition, the Commission suggested that the Comment to Rule 5.4 make clear that the rule would not allow Sears, Roebuck & Co. to enter the law business.\textsuperscript{61} The court ultimately adopted

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\footnote{56}{\textit{Id.}}
\footnote{58}{Dwyer, \textit{supra} note 57, at 42.}
\footnote{59}{Gilbert & Lempert, \textit{supra} note 39, at 399 (quoting Supplementary Petition of the Board of Governors of the D.C. Bar Regarding Adoption of Rules of Professional Conduct and Related Comments at 4-5 (Sept. 11, 1987)).}
\footnote{60}{\textit{Id.} (quoting Supplementary Petition of the Board of Governors of the D.C. Bar Regarding Adoption of Rules of Professional Conduct and Related Comments at 4-5 (Sept. 11, 1987) (emphasis omitted)).}
\footnote{61}{See \textit{id.} A proposed Comment to Rule 5.4 stated: [The proposed rule] does not permit an individual or entity to acquire all of any part of the practice organization for investment or other purposes. It thus does not permit a}
the Commission's revised proposal verbatim, allaying any Fear of Sears.\textsuperscript{62} The District of Columbia, however, was not the only jurisdiction which considered rejecting the ABA's Model Rule 5.4. North Dakota also considered an alternative.

2. North Dakota

In January 1986, the Professional Conduct Study Subcommittee of the North Dakota's Attorney Standards Committee approved a proposed rule to allow practicing lawyers to associate with nonlawyers.\textsuperscript{63} The rule, similar to that proposed by the Kutak Commission, read:

> Except as prohibited or restricted by law,\textsuperscript{64} a lawyer may provide legal services to a client in association with a nonlawyer if:

> (a) The association does not permit any interference with the lawyer's independent professional judgment or with the client-lawyer relationship;

> (b) Information relating to representation of a client is protected as required by these rules;

> (c) The association does not result in communication about the lawyer, a person professionally associated with the lawyer or their services which violates these rules; and

> (d) The association does not result in the client being charged a fee that violates these rules.\textsuperscript{65}

The state bar's Board of Governors and the Attorney Standards Committee subsequently approved this proposed rule.\textsuperscript{66}

The North Dakota Supreme Court, however, was not immune to the Fear of Sears syndrome. The court was in the process of considering the proposed rule when the Business Week and National Law Journal articles arrived at the newsstands.\textsuperscript{67} According to Larry Spears, an assistant state court administrator, the articles "threw a chill in the air."\textsuperscript{68}

\textsuperscript{62} See GILLES & SIMON, supra note 10, at 293-94.

\textsuperscript{63} See Gilbert & Lempert, supra note 39, at 399-400.

\textsuperscript{64} Significantly, North Dakota's professional corporation statute prohibited the formation of cross-disciplinary professional associations. N.D. CENT. CODE § 10-31-04 (1997). Thus, although the proposed ethical rule would have allowed practicing lawyers to associate with nonlawyers, North Dakota's corporate law would bar such a practice.

\textsuperscript{65} See GILLES & SIMON, supra note 10, at 296.

\textsuperscript{66} See Gilbert & Lempert, supra note 39, at 402.

\textsuperscript{67} See id.

\textsuperscript{68} Id. (quoting Interview with Larry Spears, assistant state court administrator for the North Dakota Supreme Court, by Larry Lempert (Feb. 1, 1988)).
court also received letters that, according to Spears, predicted that "the world would come to an end if Sears came in."69 Several months later, after hearing from both opponents and proponents of Proposed Rule 5.4, the court rejected it without explanation and adopted Model Rule 5.4.70 Thus far, there has been no effort to reconsider the court's decision.

Over the decades, much debate has surrounded prohibitions on nonlawyer ownership or partnership in law firms. In the end, however, the traditional view has always prevailed. In the course of these discussions, critics have expressed many reasons why these traditional prohibitions are necessary to protect the standards of the legal profession. What these critics fail to recognize, however, is that other current ethical standards already offer adequate protection.

II
DEBUNKING CONVENTIONAL JUSTIFICATIONS FOR THE BAN ON LEGAL CORPORATIONS

One commentator has characterized the traditional restrictions on nonlawyer investment or participation in law firms as "stubbornly resistant to change."71 Those resisting change typically resort to the few well-rehearsed and surprisingly well-received justifications noted below.

A. Fear of Corporate Giants

One of the driving forces behind the opposition to nonlawyer investment in law firms is the fear of large corporations overwhelming the legal marketplace, putting many small firms and sole practitioners out of business.72 Yet the conflict of interest rules place inherent limits on law firm size.73 ABA Model Rules of Professional Conduct Rule 1.7 prohibits representing directly adverse clients or clients whose representation may be materially limited by responsibilities to other clients or by the lawyer's own interests.74 This prohibition applies unless the lawyer reasonably believes there will be no adverse effect and the lawyer obtains the client's informed consent.75 Model Rule 1.9 prohibits representing a person with interests adverse to a non-consenting former client in the same or a substantially related matter.76 The prohibition extends

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69. Id. (quoting Interview with Larry Spears, assistant state court administrator for the North Dakota Supreme Court, by Larry Lempert (Feb. 1, 1988)).
70. See id.
71. See Andrews, supra note 41, at 599-600.
72. See supra note 48.
73. See MODEL RULES OF PROFESSIONAL CONDUCT Rules 1.7, 1.8, 1.9 (1996).
74. See id. Rule 1.7.
75. See id. Rule 1.7(a).
76. See id. Rule 1.9.
to clients of the lawyer’s former firm if the lawyer has knowledge of material privileged information relating to the former client.\textsuperscript{77} Model Rule 1.10 imputes the disqualification of one lawyer to the entire firm.\textsuperscript{78} Model Rule 1.11 restricts former government lawyers from representing clients in matters in which the lawyer participated personally and substantially while a public officer or employee.\textsuperscript{79} It also prohibits her firm from such representation unless the lawyer is screened from the entire matter.\textsuperscript{80}

A notable case, \textit{Westinghouse Elec. Corp. v. Kerr-McGee Corp.},\textsuperscript{81} disqualified Kirkland & Ellis\textsuperscript{82} upon discovery of a conflict between clients represented by the Chicago office and the Washington, D.C. office. Westinghouse, through Kirkland’s Chicago office, had sued certain oil companies who were members of an industry group, American Petroleum Institute, represented by Kirkland’s D.C. office.\textsuperscript{83} The court made a point of noting that “there is no basis for creating separate disqualification rules for large firms even though the burden of complying with ethical considerations will naturally fall more heavily upon their shoulders.”\textsuperscript{84}

Commentators have noted that these conflict of interest rules have the practical effect of limiting law firm size.\textsuperscript{85} As a law firm increases in size and opens branches in multiple cities, both the potential for conflicts of interest and the difficulty in resolving them increases.\textsuperscript{86} To a large degree, then, the fear that a few large companies would dominate the legal landscape seems unwarranted. Firms, it would seem, limit their own size once they have grown large enough to actually face fewer business opportunities with continued expansion, although anecdotally it does not seem that any of them have reached that point yet.

\textbf{B. Interference With Professional Independence and Judgment}

Those resisting change argue that shareholders’ pressure on attorneys to maximize shareholder value by increasing profits will inevitably result in interference with lawyers’ ability to exercise independent

\begin{itemize}
  \item \textsuperscript{77} See id. Rule 1.9(c).
  \item \textsuperscript{78} See id. Rule 1.10.
  \item \textsuperscript{79} See id. Rule 1.11.
  \item \textsuperscript{80} See id. Rule 1.11(a).
  \item \textsuperscript{81} 580 F.2d 1311 (7th Cir. 1978).
  \item \textsuperscript{82} See id. at 1322.
  \item \textsuperscript{83} See id. at 1313.
  \item \textsuperscript{84} Id. at 1321.
  \item \textsuperscript{85} See Geoffrey C. Hazard, Jr. et al., \textit{The Law and Ethics ofLawyering} 640 (2d ed. 1994) (noting that “[t]he rule of decisions such as \textit{Westinghouse} effectively limits the size of firms.”).
\end{itemize}
judgment. These arguments frequently rest on the fear that nonlawyers in management will exert control over a lawyer's actions, forcing decisions that are best for the organization's business, rather than decisions that the lawyer knows are best for the client. While debating the possibility of modifying the ethical canons' proscription of nonlawyer-controlled law firms, one delegate illustrated this fear by protesting that the "proposed abolition of the prohibitions would be a 'breach of the golden rule. The one who has the gold makes the rules, and the one that has the gold... is going to be a nonlawyer.'" Those making this claim, however, cannot point to empirical evidence suggesting that this would inevitably be the result.

In reality, nonlawyer-controlled law firms, which could take the form of private entities with nonlawyer ownership or publicly traded corporations, would be in the business of providing legal services and would succeed only by providing sound legal judgment to consumers, as is the case now. Indeed, if the stock of the firm were publicly traded, the value of a firm's stock would directly reflect the market's perception of the ability of the firm to render quality, professional legal services. To the extent that the law firm's reputation is tarnished because it provides inadequate services, the stockholders stand to lose. As a result, stockholders would be acting to their own detriment by interfering with the professional independence and judgment of a firm's lawyer-employees, thereby diminishing the quality of the legal services offered. As one commentator noted, "it is puzzling that this thesis is maintained in a society in which the profit motive otherwise is thought to lead to the production of goods and services for which there is consumer demand."

For example, it seems implausible that the stockholders of Salomon Bros., an investment banking firm, would attempt to interfere, via the Board of Directors or upper management, with the professional judgment of the firm's professionals. The perceived quality of that professional judgment is exactly what customers are buying and, ultimately,
what stockholders are counting on for their return on investment. In short, the dynamics of the marketplace actually militate against the notion that nonlawyer investors would interfere with the lawyer's professional independence and judgment.

A parallel example of such consumer backlash is found in the changes in attitudes toward managed care over the last several years. Over a decade ago, doctors began feeling heavy pressures to find quicker, cheaper methods of caring for patients, often to the patient's detriment. Presently, however, patients are speaking out and opposing non-physician dictated policies such as mandatory maximum hospital stays. Patients have begun to turn the tide in the health care debate and have recast the debate in a different light.

The argument that shareholder interference will undermine independent judgment also assumes that by not practicing in a publicly-traded law firm, for example, lawyers will otherwise be immune from any pressure to maximize profits. Given today's competitive marketplace, this argument cannot pass muster. Private firms, especially large corporate firms that would be ideal candidates for going public, are as concerned with maximizing the bottom-line as other non-law businesses. Indeed, "there is no reason to suppose that corporations or laymen engage in the 'sordid' business of making money any more than do traditional law firms." Those opposing nonlawyer investment simply have not demonstrated that "nonlawyer control is more pernicious, or more efficacious, in interfering with a lawyer's professional independence, than the control by supervising or employer attorneys that is allowed currently." This is not to suggest that nonlawyer investors in the marketplace will not show any interest in the decisions and judgment of the lawyers in whom they are investing. On the contrary, because stockholders would invest in law firms for the main purpose of making money, they will be keenly interested in the return on their capital. Yet, to draw

91. See George J. Church, Ouch! Ouch! Ouch! This Will Hurt: As Budget Cuts Loom, Yelps Are Being Heard, Time, Feb. 24, 1986, at 18 (discussing how hospitals in the mid-1980's were "discharging many Medicare patients early—'sicker and quicker,' as many doctors put it").

92. See Michael Kramer, Road to the White House, Time, Fall 1996, at 14 (proposing that one reason President Clinton was able to achieve re-election after seeing his first term's national health care proposals go down in defeat was his adoption of proposals such as a bill to mandate a longer hospital stay after a woman gives birth, an issue that had grown more important as managed health care providers had been discharging women after shorter and shorter hospital stays).


94. Id. at 607. Andrews also points out that:

[many lawyers work for a salary as associates for law firms in which they have no control or ownership interest. Their employers—the partners or lawyer shareholders—may be looking over the shoulders of those associates 'in terms of profit' just as aggressively as would nonlawyers offering the services of these same lawyers.

Id. at 606.
another analogy between law and medicine, doctors continuously practice medicine while functioning in a similar principal-agent relationship. Doctors must adhere to their professional obligations to their patients against outside pressures from principals, such as hospital administrators and benefactors, to keep costs down and focus on efficiency. Similarly, lawyers could remain faithful to their professional obligations to their clients against any pressures from nonlawyer shareholders.

Ultimately, investors in a law firm will want to see a return on their investment. However, the typical investor lacks the ability to monitor the daily efforts of that law firm. It is either impossible or too costly for the investor/principal to monitor the lawyer/agent constantly. In the field of law, in which the typical nonlawyer investor will have less understanding of the services that the lawyer is providing than may be the case in other service businesses, one might raise the concern that this unfamiliarity will allow the law firm to fail to honor the fiduciary duties it owes to its shareholders.

Just as in other corporate contexts, this problem can be alleviated by numerous protections. Currently, corporate statutes mandate the fiduciary duties that corporations owe to their shareholders. These statutes often go even further by dictating duties owed to directors, officers, and employees in the closely held corporation context. Based on this precedent, there is no reason that states could not enact statutes requiring certain fiduciary duties to shareholders of professional corporations. Similar provisions could be incorporated into rules of professional conduct, bringing an additional forum for enforcement. Incentives could also be built into the principal-agent relationship between investors and law firms. As in other businesses, tying profitability, a direct result of excellent client representation, to vehicles such as incentive stock options would give additional impetus to lawyers to remain faithful to both their clients and their investors.

Finally, it must be remembered that the lawyers will continue to be the persons actually providing legal services and advice directly to the clients. Practicing in a law firm with nonlawyer investors will no more release attorneys from their ethical obligations in rendering services than practicing as in-house counsel in a large professional corporation does now. The ABA has recognized that lawyers operating under the authority of laymen must uphold the Rules. In 1970, the ABA issued an

95. See John McMillan, Games, Strategies, and Managers 98 (1992) (discussing the difference between a situation in which a principal is able to observe an agent’s work versus a situation in which the principal is separated from the agent in some form).

96. The current rule that prohibits lawyers from practicing in a professional corporation obtains only if “a nonlawyer has the right to direct or control the professional judgment of a lawyer.” Thus, it need not be changed to allow law firms to go public. Model Rules of Professional Conduct Rule 5.4(d)(3) (1983).
ethics opinion regarding the scope of authority that the Board of Directors of a Legal Aid Society may exercise.\(^7\) In light of these factors, those considering change should not be persuaded by the argument that allowing law firms to have nonlawyer investors would inevitably result in interference with the professional judgment of lawyers.\(^6\)

C. Breaching of Client Confidences

Another commonly cited reason for prohibiting nonlawyers from investing or exercising managerial authority in law firms is the fear that lawyers will leak client confidences to nonlawyers who have no ethical duty to maintain confidentiality. Under other circumstances, this concern regarding the sanctity of client confidentiality would be well placed. Holding inviolate the confidential information of the client not only facilitates full development of the facts essential to the client's proper representation, it also encourages the public to seek early legal assistance.\(^9\) Only under the guarantee of confidentiality will clients seek

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\(^7\) See ABA Comm. on Professional Ethics, Formal Op. 324 (1970). The Opinion laid out principles to govern the relationship between the board of directors of the Legal Aid Society and the society's staff attorneys:

- (1) The board's functions are limited to formulating broad goals and policies pertaining to the operation of the society.
- (2) To this end, the board may establish guidelines respecting the categories or kinds of clients staff attorneys may represent and the types of cases they may handle.
- (4) Staff attorneys should endeavor at all times to fulfill the broad policies formulated by the board and should insure that their conduct in representing clients or causes is in conformity with the [applicable ethical standards].
- (6) Once the attorney has accepted a client or case of the nature and type sanctioned by board policy, the board must take special precautions not to interfere with its attorney's independent professional judgment in the handling of the matter.

Id. The Committee believed that these principles would be sufficient to guide the lawyers and the board of directors in their relationships with each other and with clients. Those legal aid societies following these principles would receive the blessings of the ABA. The opinion was issued while the Code of Professional Responsibility was the most recent set of ABA rules, but the substance of the opinion has not been overruled with the adoption of the Model Rules. The ABA Center for Professional Responsibility noted that Rule 5.4(d) of the Model Rules does not apply to nonprofit organizations. ABA CENTER FOR PROFESSIONAL RESPONSIBILITY, ANNOTATED MODEL RULES OF PROFESSIONAL CONDUCT 460 (1992) [hereinafter ANNOTATED MODEL RULES].

\(^9\) In any event, a law firm wishing to issue stock to the public could state in its prospectus, as Steven Brill suggests, that "maximizing shareholder return is not the firm's sole goal or even its constant priority—and then let the marketplace decide if the shares are a good buy." Steven Brill, Psst—Wanna Buy a Hot Stock?, AM. LAW., Nov. 1987, at 3, 102. Brill also suggests that lawyers could retain "a separate, voting dominant class of insider stock for the senior practicing lawyers" to avoid any potential interference from nonlawyers. Id. In the same vein, a reasonable compromise would be to permit nonlawyer investment in law firms, but require that lawyers retain all management authority, responsibility, and accountability. Such a compromise would address the major concern of opponents—nonlawyers exerting control over the firm's lawyers—while still introducing law firms into the marketplace.

\(^9\) See MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.6 cmt. 2 (1983).
this assistance and then communicate fully and frankly with their lawyer. However, again the fear of critics is misplaced. Model Rule 5.3 specifically addresses this argument, providing that:

With respect to a nonlawyer employed or retained by or associated with a lawyer:

\[\ldots\]

(c) a lawyer shall be responsible for conduct of such a person that would be a violation of the Rules of Professional Conduct if engaged in by a lawyer if:

(1) the lawyer orders or, with the knowledge of specific conduct, ratifies the conduct involved \[\ldots\] 101

Thus, Rule 5.3 would continue to serve as a strong incentive for law firms with nonlawyer investors to maintain client confidences. In current practice, nonlawyer employees are necessarily privy to confidential client information in law firms across the country. In addition, countless nonlawyer professionals retained by lawyers for expert help have access to client confidences. Despite these nonlawyers' knowledge of client matters, law firms have not been plagued by nonlawyers breaking client confidences.

Even assuming that a nonlawyer manager may be able to access confidential information, one commentator has pointed out that "even if nonlawyers do not have as broad a duty of confidentiality under traditional agency rules as is imposed under the lawyer ethics codes, nonlawyer professionals are free to agree to a broader duty of confidentiality as a contractual matter." More convincingly, any breach of confidentiality by a nonlawyer would be to the great detriment of the firm itself. In the investment banking business, for example, maintaining client confidences is of paramount importance. For this reason, almost all professional services agreements between investment banks and their clients include a strict confidentiality clause, binding all employees from the mail person to the highest managing director.

There is no reason why such agreements could not be made as a matter of course between law firms with nonlawyer investors and their clients. Such agreements are already common to litigation services providers, who hire nonlawyers to assist in cost-effective preparation of litigation paperwork for large law firms. Employees at such firms are required to sign confidentiality agreements because they are exposed to confidential client documents and attorney work-product. Employees within law firms owned by nonlawyers could enter into similar agreements.

100. See id. Rule 1.6 cmts. 3, 4.
101. Id. Rule 5.3.
102. Andrews, supra note 41, at 615-16.
Finally, the ABA opinion regarding the relationship between the board of directors of legal services societies and the societies' staff attorneys discusses client confidences and places limitations on attorneys' rights to disclose these confidences to their superiors. These limitations could be equally applied to incorporated law firms.

In a related vein, Model Rule 1.6 currently allows lawyers to make disclosures that are "impliedly authorized in order to carry out the representation." Furthermore, if a lawyer decides it is necessary to disclose confidential information to a nonlawyer for some reason, the lawyer can also ask for the client's consent to disclose the information. In view of the foregoing, there is no reason to believe that client confidences would be less protected by a publicly held law firm, for example, than by any other law firm.

D. Unauthorized Practice of Law

Another fear held by those who oppose ending the prohibition on nonlawyer investment and management of law firms is that it will lead to the unauthorized practice of law. Critics suggest that, although such trespasses onto the protected turf of lawyers may not be purposeful, they will occur accidentally. Critics argue that this may occur because the limits of the practice of law are undefined and differ by jurisdiction. But it is these very definitional differences that show this fear to be unfounded.

Many states, for example, place the power to draft real estate documents solely in the hands of lawyers. However, in 1962, Arizona chose to grant real estate brokers and salespersons the concurrent...
authority to draft such documents. Since then, these nonlawyers have been serving client needs, and, after over thirty years, there is no hard evidence to indicate that clients have received poor advice or service as a result of Arizona’s choice.  

Additionally, law firms have grown to include a variety of nonlawyer types who successfully avoid practicing law. Law firms employ paralegals, legal secretaries, and other nonlawyer personnel who constantly deal with clients. These nonlawyers may not give legal advice to clients, and they may not take other actions that might be construed as the practice of law. If they violate this rule, the lawyer or law firm employer may be responsible for the violation. If these employees and assistants of lawyers can coexist within the bounds of the ethics rules, nonlawyer investors and partners can as well.

A lawyer who enters into business with nonlawyers remains bound by the applicable rules of conduct. Supervising lawyers are required to ensure that the conduct of nonlawyers is “compatible with the professional obligations of the lawyer.” Compliance with these rules requires that lawyers not assist nonlawyers in the unauthorized practice of law, not share client confidences with unauthorized persons, and not allow the nonlawyer to affect the lawyer’s independent professional judgment.

One additional criticism surrounding attempts to allow lawyers to become partners with nonlawyers is that it presents the opportunity to practice law without a license. The fear is that this may be a back-door into legal practice for law school graduates who cannot pass the bar or for disbarred lawyers. The reality is that the rules requiring lawyers to be responsible for such nonlawyers’ actions apply in this case, just as they do for paralegals or any other nonlawyer. It is also unlikely that abuses of this nature will be common; few practicing attorneys are likely to avail themselves of the services of those found not worthy of admission to the bar or those whose ethics resulted in disbarment.

Existing rules and standards of ethical conduct already provide for nearly all contingencies that a lawyer may face regarding the unauthorized practice of law. Allowing nonlawyers to invest passively in law

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108. See Gilbert & Lempert, supra note 39, at 404.
110. Id. Rule 5.3(b). Rule 5.3(c) also states that a lawyer is responsible for the conduct of a nonlawyer employee if the lawyer orders or ratifies the specific conduct involved, or if the lawyer is a partner in the firm in which the nonlawyer is employed and knows in advance of inappropriate conduct, but fails to take remedial action. See id. Rule 5.3(c).
111. See id. Rule 5.5(b).
112. See id. Rule 1.6(a); see also supra Part II.C. and accompanying notes.
113. See Model Rules of Professional Conduct Rule 5.4(c) (1983); see also supra Part II.B. and accompanying notes.
114. See Carson, supra note 87, at 617.
firms or to work beside nonlawyers would not change this situation. Lawyers would continue to practice law, and nonlawyers would continue to avoid practicing law. The benefits of a business association between a lawyer and a nonlawyer arise not through unauthorized legal work but rather through the provision of ancillary services and through virtually unlimited capitalization from the financial markets.

E. Transformation of the Legal Profession Into a Business

A final criticism aimed at proposals to change the ethics rules to allow nonlawyer investment in law firms is that the change will denigrate the legal profession to a mere business.\textsuperscript{115} Critics who hold this position claim that a law firm owned by nonlawyers will focus on cost-cutting to maximize shareholder value at the expense of client service.

These critics fail to see that over the last ten years, the legal "profession" has undergone changes that arguably warrant renaming it the legal services "business."\textsuperscript{116} Today more than ever, lawyers run their firms like traditional businesses.\textsuperscript{117} The tremendous competition among law firms has forced law firm owners, their partners, and shareholders to become more concerned with profits and efficiency. Those managing private, for-profit law firms have realized the stark reality that their law firms must be viewed as businesses in order to survive in this competitive marketplace. Indeed, one commentator bluntly stated, "[Law firms] that were once synonymous with equability, professionalism and familial spirit have been molded by harsh economic forces into large, disputatious businesses."\textsuperscript{118}

A rapidly changing legal economy has provided the impetus for this new focus on the business of managing law firms. The Altman Weil

\textsuperscript{115} See id. at 605-08.
\textsuperscript{116} See id. According to Carson:
The definition of the term "profession" is by no means universally agreed upon. Traditionally, a business might be defined as an entity that promotes the greatest societal good by maximizing its profit, whereas a profession might be defined as an entity that seeks to promote the greatest societal good by maximizing its service. 

The reality today, of course, is that very few people would choose a profession without regard to its potential profitability. The difficulty arises when professional decisions are driven solely by profitability.

\textsuperscript{117} See Ward Bower, Surviving the 1990s, LAW PRAC. MGMT., July-Aug. 1990, at 25, 26-28. Established law firms will shift from "fraternal" organizations, characterized by collegiality, seniority advancement and compensation and consensus decision-making, to a "business" approach, characterized by interpartner accountability, merit-based compensation and centralized management. Economic realities of law practice, combined with competitive and marketplace pressures, will lead more lawyers to leave the profession and to seek employment in other areas.

Pensa Survey of Law Firm Economics showed that per-lawyer overhead increased more than 81% over the last ten years, while per-lawyer revenues increased only 73%. This trend reflects what was already happening during the previous ten years, from 1975 to 1985, when overhead increased by 161%, gross per-attorney receipts rose only 123%, and average partner compensation went up only 90%.

At the same time, competition among lawyers has increased. The United States has approximately 900,000 lawyers today, up almost 40% from ten years ago. Moreover, the United States has 336 law firms with over 100 lawyers and over 700 more with over 60 lawyers. Three law firms have over 1,000 lawyers, yet in 1980 those same three firms had less than 300 lawyers.

In addition to the huge increase in the number of lawyers and the attendant squeeze on profits, lawyers are also working more. From 1985 to 1989, the average associate hours billed rose from 1738 to 1820, and partners' hours increased from 1571 to 1706. Many firms now set annual goals of 2000 hours or more.

Unlike other businesses, during this transformation law firms have been deprived of a favored source of capital—equity capital from the private, passive investor. The ABA’s Model Rules' prohibition against nonlawyer investment is fraught with irony. While its proponents claim the rule is necessary to protect the integrity of the "profession," real economic pressures threaten to undermine the integrity of the profession in law offices across the country on a daily basis, as lawyers frequently struggle to make ends meet to stay in business rather than to serve deserving, destitute potential clients or the legal system as a whole. Access to the public equity markets could ease these pressures.

III

THE CURRENT OPTIONS FOR LAW FIRM ORGANIZATION

Despite the current inability to incorporate law firms or associate with interests owned by nonlawyers, there are many organizational forms available to lawyers. Each of these organizational forms has its advantages, yet none offers the same mix of attributes that would exist

121. See id.
122. See id. at 18.
123. See id.
in an incorporated law firm with nonlawyer investors. Understanding these current forms will also demonstrate that the fears of critics who oppose law firm nonlawyer investment or incorporation are unfounded.

There are five main organizational forms currently available to law firms: sole proprietorships, traditional partnerships, limited liability companies, limited liability partnerships, and professional corporations. Each of these forms has advantages and disadvantages, and each organization of lawyers must determine which form best fits its desired structure. Unfortunately, for some groups of lawyers, none of these forms compares to the forbidden benefits of the private or public corporation.

A. Sole Proprietorships

Sole proprietorships are the most basic form of organization for any business, including law practice. The sole proprietorship is a simple organizational form and offers the benefits of flow-through taxation. The owner has complete control and great flexibility in the business dealings of the firm. However, the owner-lawyer must devote much of his or her time to the day-to-day management of the firm.

One major drawback of the sole proprietorship is that it is the only organizational form that exposes the law firm and its owner-lawyer to unlimited liability. This liability extends beyond the owner-lawyer’s investment in the firm; after taking all the firm’s assets, claimants may go after the owner-lawyer’s personal property. The cost of unlimited liability can be limited through the purchase of various forms of insurance, but this simply spreads the cost over time through insurance premiums and does not limit the liability itself.

A sole proprietorship law firm also faces significant hurdles in the area of capitalization. Personal investment by the attorney-owner is the sole form of equity capitalization available to a sole proprietorship law firm. This makes the sole proprietorship unavailable to many lawyers because they simply do not have the capital to create and run a firm through the formation years, when the firm’s cash flow is negative.

For these reasons, the sole proprietorship is often not the best choice for lawyers. For many practitioners, the drawbacks of increased liability, limited capitalization, and lost management time outweigh the benefits of sole control and flow-through taxation. These practitioners must look to other forms of organization.

B. Traditional Partnerships

Since the first law firm was organized, the traditional choice of law firm structure has always been the partnership. The reasons lawyers choose the partnership form of organization vary, but some of the more prevalent reasons include ease of administration and various tax
advantages. Additionally, lawyers expect that their share of partnership profits will exceed the profits that they could have earned practicing in sole proprietorships. These profits may be split evenly among the firm's partners, or they may be split according to some ratio set in their partnership agreement.

While partnerships enjoy many advantages over sole proprietorships, partnerships face many drawbacks when compared to corporations. Partnership's major advantage is that income receives flow-through taxation, thereby preserving more income for the partners. The corresponding downside to this tax treatment is that partners, like sole proprietors, cannot defer income realization in order to lower their tax burden.

Other drawbacks to partnership include limited life, unlimited liability, and limited capitalization opportunities. Partnerships, like all non-corporate business forms, face difficulty in raising the capital necessary to start and grow a business. Partnerships receive their funds only through the individual contributions of their partners and the income generated by the partnership itself. Although partnerships may sell limited partner interests, Model Rule 5.4 prohibits selling limited partner interests to nonlawyers by prohibiting sharing legal fees with nonlawyers. Thus, partnerships have no way of overcoming the limits on access to capital.

C. Limited Liability Companies

The limited liability corporation ("LLC") has emerged as an organizational form that may provide the benefits of both corporations and partnerships. LLCs offer the flow-through tax advantages enjoyed by partnerships along with the highly valued limited liability attributes

125. See Sheldon I. Banoff, New Ruling Adds Further Encouragement for Large Firms to Form LLCs, J. TAX'N, July 1994, at 12, 12.

126. A San Francisco jury in 1994 ordered the nation's largest law firm, Baker & McKenzie, to pay $6.9 million in punitive damages (later reduced by half) to a former secretary who brought a sexual harassment claim against the firm and one of its partners. The individual partner who was responsible for the harassment was also ordered to pay $225,000 in punitive damages. Charles Burress, Largest Law Firm Will Appeal $3.5 Million Harassment Award, S.F. CHRON., Dec. 22, 1994, at A23.

127. See MODEL RULES OF PROFESSIONAL CONDUCT Rule 5.4(a) (1983). Recall that, except in limited circumstances involving nonlawyer employees like secretaries and paralegals or involving payments to a lawyer's estate, neither a lawyer nor a law firm may share legal fees with a nonlawyer. See id. A lawyer also cannot form a partnership with a nonlawyer if any of the activities of the partnership consists of practicing law. See id. Rule 5.4(b). Moreover, a lawyer cannot practice for a profit in the form of a professional corporation or professional association if a nonlawyer owns any interest or occupies any position of control in the organization. See id. Rule 5.4(d).

of a corporation. More specifically, practicing in LLC form may protect personal assets from liability, except liability arising from the lawyer's own direct or supervisory liability for errors and omissions in rendering professional assistance. In addition, under revised Internal Revenue Service regulations effective January 1, 1997, the LLC is taxed as a flow-through entity.

The main drawback of an LLC is its novelty; the form is so new that courts, legislatures, and regulatory agencies have yet to answer all of the questions it raises. For example, it is unclear which corporate and partnership law doctrines will apply to LLCs, since LLCs share attributes of both of these forms. Additional questions include: What liability protection does an LLC afford its investors against claims made in a state that does not allow LLCs? How are LLCs treated under state tax laws in states that do not allow LLCs? What liability protection does the LLC grant to professionals organized as a Professional Limited Liability Company? Until these questions are answered, and until the LLC organizational form is accepted in all 50 states, many businesses, including law firms, will choose not to adopt the LLC form.

While the LLC form of organization appears to offer law firms the best of both the corporation and partnership forms, the uncertainties associated with this new form may leave lawyers in search of a limited liability entity that does not confront roadblocks such as the ABA's Model Rules and Code. The answer to their problems may well be an even newer form of limited liability organization, the Limited Liability Partnership ("LLP").

D. Limited Liability Partnerships

An LLP is effectively a general partnership with a few significant alterations. The primary contrast with a partnership is that legislation limits the personal liability of a partner in an LLP. LLPs were created in reaction to LLCs and are intended to give partnerships some of the protection afforded LLCs without forcing the partnerships to alter their structure in order to achieve this protection.
Texas enacted the first LLP legislation in 1991, followed by Louisiana in 1992, and Delaware in 1993. In 1994, various other jurisdictions followed the trend and enacted their own LLP legislation (e.g., North Carolina and the District of Columbia). Some states that have not yet enacted their own LLP legislation, such as New Jersey, have nonetheless adopted legislation that specifically permits an LLP formed under the laws of another state to conduct business in the state.

The main attractive feature of an LLP is that it limits a partner's liability, although an LLP does not eliminate all such liability. An LLP continues to be fully liable for all claims against the LLP itself, and all of the partnership assets remain at risk in connection with any such liability. Furthermore, a partner in an LLP continues to be liable for the partner's own tortious conduct, for certain tortious conduct committed by others, and, under some statutes, for certain contractual obligations of the partnership.

In the context of the legal profession, the typical LLP statute does not provide liability protection to a partner who gives specific direction to, and supervises the daily activities of, an associate. In contrast, the chair of a department in a law firm, who sets general policy for the firm, but who is not personally involved in a matter where negligence occurs, would not be exposed to liability. "Similarly, two partners working on a matter independently of each other, neither of whom is viewed as supervising and controlling the other, should be able to argue that since they acted independently of each other, they should not be exposed to liability for the conduct of the other."

Although LLPs, like LLCs, appear to be a savior for partners who practice under the specter of unlimited vicarious liability, they too are not perfect. In fact, as with LLCs, one of the more salient
imperfections is the lack of well developed enabling statutes. This, fortunately, will come with time. Moreover, LLPs, like LLCs, are untested in the courts under many situations in which organizational form is critical. Additionally, many questions remain regarding the recognition of LLPs and LLCs in states which do not have LLP and LLC statutes. For these reasons, many partnerships have chosen not to become LLPs.

Finally, the limits on raising capital from nonlawyer investors are the same in an LLP as in a traditional partnership. Essentially, if any part of a business involves the practice of law, nonlawyers are forbidden from investing in the business, participating in management, and sharing in the business’ profits.

E. Professional Corporations

Professional corporations ("PC"s) are also a new addition to the business associations arena. PCs are corporations comprised of one or more professionals. PCs offer the advantage of limited liability and allow tax benefits not available to partnerships. Specifically, PCs were created to circumvent limitations on partnerships and LLPs regarding the taxation of contributions to retirement plans. Normally, an organization is allowed to contribute to the retirement plans of its employees and to treat those contributions as a business expense. Contributions on behalf of owners, however, do not receive this favored tax treatment. Such contributions come out of the sole owner’s or partners’ after-tax dollars, and do not result in a business expense deduction for the firm. By forming a PC, partners are treated as employees rather than owners, and contributions to their retirement plans therefore receive the favored tax treatment. PCs enjoy other minor tax benefits also available to corporations.

PCs have also been used to create a hybrid organizational form in which each lawyer forms his own PC as the sole shareholder, and then the PCs of each lawyer join in a general partnership. This PC form limits the liability of the lawyers, provides favored tax treatment to their retirement plans, and provides flow-through taxation.

Congress eventually came to view the partnership of PCs and the tax leeway granted PCs regarding employee retirement plans as abuses of the tax system. In 1982, Congress passed the Tax Equity and Fiscal Responsibility Act (TEFRA) which lowered the maximum contribution of PCs to employee retirement plans. This removed the major tax

143. See supra note 127 and accompanying text (discussing the prohibitions against investment and involvement in law firms under Rule 5.4 of the ABA's Model Rules of Professional Conduct).
144. See id.
benefit of establishing a PC; however, other minor tax benefits remain which, coupled with the limited liability found in PCs, have fueled some continued growth in the popularity of PCs as an organizational form.\textsuperscript{147}

Although these five organizational forms currently available to law firms share a variety of control, tax and liability advantages and disadvantages, none of these forms allows firms the virtually unlimited ability to raise capital through the financial markets. Only status as a corporation would allow this. Depriving lawyers of the opportunity to form corporations and to utilize nonlawyer investments in both these organizational forms and the corporate form limits the ability of these business associations to grow and compete in the national marketplace. This artificial limit keeps law firms smaller than their optimum size, limits opportunities for growth and expansion, and hinders crucial investments.

IV
WHY LAW FIRMS SHOULD HAVE ACCESS TO THE BIG BOARD

No one can predict exactly how allowing law firms to utilize capital contributions of nonlawyer investors, by going public, for example, would impact the legal profession. The profession has suffered, however, as a result of economic pressures wrought by competition in the marketplace. It may be that allowing law firms access to the equity markets would result in law firms that are optimally capitalized and therefore more efficient. As it stands today, partners, or their shareholder counterparts, provide all of the equity financing for law firms. While law firms are typically characterized as "labor-intensive" rather than "capital intensive," their capital needs are increasing as technology plays a larger role in the delivery of legal services. Furthermore, the notion that because law firms are "labor-intensive" they are not "capital intensive" fails to recognize that many law firms invest significant amounts of money training and developing associates.

In short, many law firms would benefit by having access to the equity markets. The equity markets would provide law firms with necessary capital for expansion into new geographical areas, thereby better serving consumers' needs through greater access to legal services and increased competition in the local marketplace. This capital infusion would also allow investment in new technologies, again providing better legal services for the consumer. Assuming law firms are indeed "labor intensive," law firms train a great percentage of the profession's future leaders; with greater capital, this task becomes more efficient. Moreover, law firms often serve society best in their ability to take on large and

\textsuperscript{147} See Brewer, \textit{supra} note 145, at 860-61.
financially risky contingency fee cases. Many of these cases require enormous capital outlay years before any repayment can be expected. The capital that firms could raise in the equity markets could assist in financing these cases, serving plaintiffs who would otherwise go unrepresented.

A. Capital for Expansion

Many businesses choose to raise capital for expansion by selling shares to selected investors in a private placement or to the public via an initial public stock offering. Unlike these businesses, however, the legal profession must utilize internally generated capital to finance expansion. Today, a law firm wishing to expand into a new geographic market has two options: (a) merge with an established local firm, or (b) establish a new satellite office.

While either option may lead to the growth of the individual firm, the second option is preferable from a societal perspective. Consumer choice within the targeted geographical market only increases when a firm commits itself to establishing a new satellite office. Since geographic expansion through merger or some other equivalent transaction does not constitute expansion of the legal profession in absolute terms, the public will benefit from real growth of the legal profession only if a law firm risks capital in the hope of cultivating new clients to serve through its satellite office. To the extent real growth can be achieved, the legal profession better meets the legal needs of consumers and society. In any event, if real growth cannot be achieved, consumers will at least benefit from increased competition in the local marketplace. For these reasons, law firm expansion should be viewed as a positive goal.

The costs associated with establishing a new satellite office, however, are daunting. Indeed, a firm wishing to expand must make a standing commitment to finance all of the satellite office’s start-up expenses and operating expenses until the office breaks even. The law firm must make such a commitment knowing that internally generated capital will generally be the primary source of funds required for expansion. Moreover, new ventures may fall short of meeting even the most conservative break-even projections. In such circumstances, the law

148. An expanding law firm that derives all of its new business by taking clients away from other local, or even remote, firms does not generate real “industry” growth unless those firms from whom the clients were taken subsequently attract new clients.

149. Start-up costs typically include, but are not limited to, expenses for leasehold improvements, office equipment, office furniture, initial marketing and client development, and capital to last through the initial period before payment is received for services.

150. Conventional bank financing is a less attractive alternative because the debt payments constitute an additional cash flow burden. With equity financing there is no concomitant obligatory cash flow burden.
firms must then make the difficult choice whether to abandon the venture and cut the loss or to ante up additional capital.

If law firms have access to nonlawyer equity capital, they will be better positioned to consider expanding into new markets. Firms will be able to design a new office as a wholly owned subsidiary and issue stock ownership in the new office. This will allow the new law firm, like other start-up companies, to rely on the capital of those who believe in the firm's future return on that investment. This capital can see the firm through the initial lean years that face a new law office as it seeks a niche in the marketplace or attempts to gain market share. Allowing nonlawyer investment would serve all the parties involved: lawyers with the existing firm would gain a presence in a new city, expanding the firm's prestige as well as increasing its resources and prosperity; attorneys at the new law office would have access to the resources, expertise, and support of an existing law firm, as well as the capital that can come from the investment markets; and investors would have access to a new investment vehicle.

B. Capital for Investment in New Technologies

The utility of computer assisted legal practice increases daily. Today, lawyers and their staffs use computers for performing complicated conflicts analysis, minimizing work-in-process (by automatically tracking, calculating, and billing for the time and resources expended on a project), accessing Westlaw, LEXIS/NEXIS and the Internet, and communicating with other lawyers and staff via e-mail. Indeed, lawyers are using computers outside the office to assist them in their practice both in the courtroom and in the boardroom.

Given the rapid pace of technological advancement, computers and other new technology-based equipment can only assume a more prominent role in law practice as time goes on. Yet the benefits of new technologies carry a high price tag. Allowing law firms to have access to equity capital would put them in a better position to invest in new technologies and, ultimately, to become more efficient providers of legal services.

Brokerage firms faced this situation in the late 1960s. With stock trading volume up, and trades themselves becoming more complex, brokerages needed to update their technology to clear up the "back-office mess that had crippled all Wall Street brokerages." Donaldson, Lufkin & Jenrette, Inc. led the way for other Wall Street brokerage houses when it announced its intention to go public and to use the

151. Brill, supra note 98, at 3.
proceeds to update its equipment. The plan worked for DLJ, and other brokerages soon followed suit.

Investment in technology for a law firm can be a double-edged sword. It may very well increase the firm’s efficiency, but in a profession that traditionally bills by the hour, the perverse result of the investment may well be less income absent an increase in the volume of work done. A shift from hourly billing to a fixed-fee system is likely as firms introduce technological advances to their practice. Michael Arkfeld provides an example of how this will happen. A client retains a law firm to handle numerous similar claims or types of cases. The client asks the law firm to discount the average fee charged per case and use that amount as a fixed fee. Such an arrangement spreads the risk and encourages the law firm to become as efficient as possible, since it will capture all the gains resulting from that increase in efficiency. The client also wins by paying less, shifting some risk to the law firm, and achieving some certainty in its legal costs. While the eventual outcome of such a scheme is a win-win situation in the long run, the law firm bears the cost of investing in the new technology to improve its efficiency. By going public (or seeking other sources of nonlawyer capital), as the brokerages did, law firms will have access to capital to invest more aggressively in technology, and will provide better, more efficient services to clients at a lower cost.

C. Capital for Investment in New Lawyers

As one commentator put it, “a law firm is a service organization whose most significant input is human capital.” For this reason, it is essential that law firms invest in new associates. This investment comes in the form of training new lawyers and getting the new lawyer to invest in “firm-specific human capital.” Significantly, the law firm must pay for the new employee’s investment in firm-specific capital and training. Given that this investment must be made in each new associate over a period of several years, a law firm’s investment in human capital can become quite substantial.

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152. See id.
153. See id.
155. See id.
156. See id.
158. See id.
159. Id at 573. “Firm-specific human capital” refers to “human capital which has a significantly lower value if deployed outside the firm.” Id.
160. See id.
In the past, clients often shouldered the cost of training new associates through the traditional hourly billing system. Increasingly, however, clients are demanding a shift to fixed-fee forms of billing and are actively seeking out the most cost-effective provider of various types of legal services.\(^\text{161}\) Sophisticated clients are also refusing to pick up the tab for "on-the-job" training of new lawyers.\(^\text{162}\) As a result of this trend, law firms must internalize these training costs, increasing their overhead.

Allowing law firms to go public or utilize other mechanisms for nonlawyer investment would provide law firms with much needed capital to invest in new lawyers. This increased investment could result in better trained and more efficient lawyers, enhancing the prestige of the profession while simultaneously increasing the firm’s value to shareholders.

D. Financing Contingency Fee Cases

Like most other businesses, law firms also have "working capital" requirements\(^\text{163}\) that tie up substantial amounts of capital every day.\(^\text{164}\) Additionally, whenever a law firm expands, its working capital requirements increase concomitantly. Many firms can finance working capital requirements via traditional banking financing, such as lines of credit.\(^\text{165}\) Plaintiffs' firms taking cases on a contingency fee basis, however, must fund the substantial up-front costs with internally generated capital.\(^\text{166}\)

Because the plaintiffs' firm lacks access to outside capital, it can only fund a limited number of cases on a contingency fee basis at any one time. Cutting off access to equity capital may be a contributing factor to "the small and seemingly suboptimal size of plaintiffs' firms" in general.\(^\text{167}\) While some might abhor the idea of allowing plaintiffs' firms to finance litigation with private equity, those who view plaintiffs'
firms as “private attorneys general” would welcome the opportunity to raise money for their causes.

Allowing nonlawyer investment in law firms would permit greater risk sharing in contingency fee cases, providing the basis for two major improvements to the environment in which lawyers currently handle these cases. The first improvement would allow law firms to take on more cases in which a party’s claim or cause appears meritorious, yet the party’s chances of success in the courts are in doubt. Law firms that commit large sums of capital to these meritorious, yet uncertain, cases face great risks. Risk-averse firms must reject many of these cases, leaving deserving plaintiffs without representation. For an investor, however, a law firm would be but one small aspect of the investor’s diversified portfolio. Within the collective group of investors in a publicly held law firm, each investor’s exposure to risk would be minimized by the investor’s own diversification, allowing the law firm more leeway to take on these less certain cases.168 Lest anyone argue that this phenomenon would grant law firms the freedom to gamble on overly risky or unmeritorious cases, they merely need to recall that the public market will quickly differentiate between those firms that do and do not select their cases wisely.

The second improvement public ownership of law firms would bring to contingency fee litigation springs from the maxim that “[p]rofits come from seeking slight edges . . . [and] a firm that is unadventurous does not earn high profits.”169 It is true that firms that are less risk-averse will realize more short-term setbacks than their more risk-averse competitors; however, experience shows that accepting a certain amount of risk is a prerequisite to success in any endeavor. An eighteenth-century proverb states: “Boldness in business is the first, second, and third thing.”170

E. Other Possible Benefits of Allowing Law Firms to Go Public

Scholars have identified additional possible benefits of allowing law firms to go public. For partners, considering the prospect of going public is in itself a “wonderfully eye-opening strategic planning tool.”171 Once public, managing partners would become “far more disciplined about . . . business” because of the need to explain “progress, or lack

168. John McMillan discusses risk attitudes and explains how the stock market allows risk-averse investors to develop diversified portfolios, so as not to put all their eggs in one basket. See MCMILLAN, supra note 95, at 37. These diversified holdings lead to an environment in which firms can take on risks that individual investors and nonpublic firms could not.
169. Id. at 38.
170. Id.
171. Brill, supra note 98, at 3.
Publicly held law firms would be more “stable” than their privately held sibling firms because, among other things, the new capital would ease short-term cash flow needs that otherwise destabilize law firms.

Publicly held law firms could also reward their lawyers more equitably. Firms could award stock to lawyers “at various milestones in their careers.” Publicly held law firms could offer stock to important non-lawyer employees as well. Finally, the partner-associate hierarchy could be eased out by offering associates larger amounts of stock as their seniority increases.

In addition to the myriad benefits of access to the capital markets, allowing lawyers to join business associations with nonlawyers would create a host of benefits for law firm clients. The most obvious benefits are client convenience and non-duplication of expenses. Customers of a tax firm comprised of lawyers and accountants could have their taxes filed by a firm that would also stand ready to represent them in case they had to go to tax court. Customers of a real estate firm made up of lawyers, real estate agents, and lenders could look for property, have the purchase documents drawn up, and seek financing all in one office. This “one-stop shopping” would save time for both the client (who does not need to seek out separate professionals for each necessary task) and for the professionals (who do not need to spend time coordinating and discussing the project with outsiders to the firm). Clients would save money as the professionals save time—the professionals’ time is the client’s money. Firms made up of lawyers and laypersons would also benefit from non-duplication of expenses. A tax boutique firm could join with a tax accounting firm, cutting down the overhead for both firms. This too would result in increased savings for clients.

Law firms, as well as their investors and clients, would benefit substantially from allowing nonlawyer investment in law firms. As the capital requirements of law firms have increased, the pressure on internally generated capital has become greater. Law firms need access to the public equity markets now more than ever to fund growth and investment in new technologies and personnel. Allowing law firms to go public would both increase the capital available for investment in providing legal services and better meet society’s needs for such services. In the face of a changing legal landscape, it is difficult to understand why the

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172. Id.
173. Id. at 102 (“The stock [lawyers] get initially with the public offering, or accumulate later on through ... options, would be salable only in limited percentages at various age or seniority milestones, and perhaps only on the condition that the lawyer not move to a competing firm.”).
174. See id.
175. See id.
traditional view—that no law firm should be allowed to go public—continues to hold sway.

V

A Potential Agency Cost Problem

Over sixty years ago, in a preeminent work, Professors Adolf Berle and Gardiner Means suggested that "the usual stockholder has little power over the affairs of the [corporate] enterprise" because of the separation of ownership and control present in the corporate form. They asserted that shareholders generally were passive owners of the corporation who had little ability to direct managers' activities in the corporations in which they invested. In contrast, corporate managers, typically with little ownership interest, controlled the entity's operations. Because managers had little invested in the firm, their primary goal was often not to maximize shareholder wealth, but rather their own utility.

Furthermore, Berle and Means suggested that the ability of shareholders to elect directors, and thereby control management, was relatively meaningless in the context of large corporations, since management controlled the proxy machinery and hence the outcome of the election. Management, in short, had become a "self-perpetuating oligarchy."

Modern economic theorists view the problems created by a separation of ownership and control differently from Berle and Means. These theorists see the corporation as the central party to contractual arrangements between managers and owners by which factors of production are combined. As Professors Michael Jensen and Eugene Fama contend, this interrelationship between managers and owners involves an agency relationship in which the owners (shareholders) serve as principals, receiving the benefits of the firm's profitability and growth, and management as their agents, receiving a specified payoff. In essence,

176. ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 89 (1932); see also John H. Matheson and Brent A. Olson, Corporate Law and the Longterm Shareholder Model of Corporate Governance, 76 MINN. L. REV. 1313, 1330-33 (1992) (discussing the history of corporate governance principles and providing a model framework to solve the problem of separation of ownership and control).

177. See BERLE & MEANS, supra note 176, at 84-90.

178. See id.

179. See id. at 121-24.

180. See id. at 86-88.

181. Matheson and Olson, supra note 176, at 1330; see also BERLE & MEANS, supra note 176, at 87.


owners bear the risks associated with the enterprise, while managers run
the corporation as specialized decision-makers for the benefit of the
owners.

The primary benefit of this corporate form is readily apparent. Skilled managers, who might lack capital, are able to run the corpora-
tion, and shareholders, who might lack managerial skills, may invest in
the firm and realize a return on their investment.184 This specialization of
functions also allows investors to diversify their portfolios, thus reducing
risk and making investment more attractive.185

This agency relationship, however, is not without cost. Foremost,
the agency relationship exposes owners to the risk that they will need to
incur expenditures to monitor or control the activities of management
so that managers will not use funds for their own benefit. These expen-
ditures, known as agency costs, are the costs to the principal of obtain-
ing faithful and effective performance from its agent.186 From this
perspective, the dilemma of the separation of ownership and control is
not viewed in terms of shareholders' absence of control, as advocated
by Berle and Means, but rather as a question of how to reduce agency
costs incurred by owners in monitoring their agents in order to prevent
fiduciary abuse.

Although allowing law firms to go public creates a risk—for the
first time—that attorneys would exploit shareholders' wealth for their
own benefit, this risk can be contained using strategies already em-
ployed in related corporate contexts. Corporate law, for example, im-
poses liability on managers for any breach of the fiduciary duties of
loyalty and care that management owes to shareholders.187 Under the
duty of care standard, a manager must "act in good faith," with the
care a "reasonably prudent person" in a similar position under similar
circumstances would exercise and "in a manner that he [or she]

184. See Eugene F. Fama & Michael C. Jensen, Agency Problems and Residual Claims, 26 J.L.
& ECON. 327, 329-30 (1983) [hereinafter Fama & Jensen, Residual Claims]; Eugene F. Fama, Agency
Problems and the Theory of the Firm, 88 J. POL. ECON. 288, 290-92 (1980); Fama & Jensen, supra
note 183, at 305-09.

185. See John C. Coffee, Jr., Shareholders Versus Managers: The Strain in the Corporate Web,
85 MICH. L. REV. 1, 19 (1986) (stating that portfolio theory divides the risk associated with any
security into two components: a firm-specific component and a systematic or nondiversifiable
component associated with general market conditions); Fama & Jensen, Residual Claims, supra
note 184, at 329 ("Common stock allows residual risk to be spread across many residual claimants who
individually choose the extent to which they bear risk and who can diversify across organizations
offering such claims.").

186. See Fama & Jensen, supra note 183, at 304 (defining agency costs as the "costs of
structuring, monitoring, and bonding a set of contracts among agents with conflicting interests");
Jensen & Meckling, supra note 182, at 309-10.

187. See generally Robert Charles Clark, CORPORATE LAW 93-141 (1986) (explaining
management's fiduciary duties).
reasonably believes to be in the best interests of the corporation." The business judgment rule provides that courts should presume managers have fulfilled the requisite duty of care unless the manager has acted with gross negligence. To protect against self-interested decisions on the part of management, the duty of loyalty requires managers to make decisions that are in the best interests of the corporation. In essence, this duty prohibits management from self-dealing and acting faithlessly to the corporation. To ensure compliance with the duty of loyalty, courts employ a strict standard of review for management decisions involving a direct conflict of interest.

Beyond fiduciary duties, contractual arrangements may act to constrain managerial indiscretion within a legal corporation. Contractual relationships can reduce agency costs by providing shareholders with the ability to displace management. Contracts may also serve as a means by which management's interests can be aligned with that of the firm through such incentives as performance-based compensation or stock options.

Finally, market forces, including the labor market, the market for products and services, and the market for corporate

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188. Alan R. Palmiter, Reshaping the Corporate Fiduciary Model: A Director's Duty of Independence, 67 Tex. L. Rev. 1351, 1358 (1989); see also Melvin A. Eisenberg, The Duty of Care of Corporate Directors and Officers, 51 U. Pitt. L. Rev. 945, 948 (1990) (stating that a corporate director's duty of care consists of four distinct duties: (1) the duty to monitor the corporation's business; (2) the duty to inquire about information that raises cause for concern; (3) the duty to exercise care in making decisions; and (4) the duty to make reasonable decisions). See generally Dennis J. Block et al., The Business Judgment Rule 28 (3d ed. 1991) (explaining the duty of care); William E. Knapp & Dan A. Bailey, Liability of Corporate Officers and Directors § 2.01, at 38 (4th ed. 1988) (condemning personal dealing by officer or directors).

189. See Aronson v. Lewis, 473 A.2d 805, 812 n.6 (Del. 1983) (stating that Delaware cases impose a less exacting standard than simple negligence for director liability).


191. See Block et al., supra note 188, at 73.

192. See Palmiter, supra note 188, at 1365.

193. See, e.g., Del. Code Ann. tit. 8, § 221 (1991) (stating that the certificate of incorporation may provide shareholders and creditors with the power to vote on displacing management).


195. See Frank H. Easterbrook & Daniel R. Fischel, Corporate Control Transactions, 91 Yale L.J. 698, 701 (1982) (stating that management is constrained by salary, bonuses and reputation); Fama, supra note 184, at 288-92 (suggesting that managers desire positive evaluation of ability and, because of such evaluation's effects on current employment and on marketability for alternate and future employment, managers are restrained from acting inconsistently with the interests of corporate owners).

196. See Easterbrook & Fischel, supra note 195, at 701 (stating that fierce product competition demands a diligently and efficiently managed firm).
control, also may constrain managerial abuses within a legal corporation. As proponents of the market-monitoring theory posit, corporations offering shareholders the highest returns will garner the largest investments and, hence, prosper relative to other entities.

CONCLUSION

The seventy-year-old prohibitions against nonlawyer investment in law firms and associations with nonlawyers have created an inefficient legal services market. Firms cannot access capital markets, limiting their opportunities for expansion, curtailing investments in technology and training, and hindering competition.

In response to the inefficiencies these restrictions have created, the prohibition on nonlawyer investment in law firms must be lifted. Each of the traditional arguments against allowing such investment—fear of corporate giants, interference with professional independence and judgment, breaching of client confidences, unauthorized practice of law, and the danger of the legal profession becoming too businesslike—have proved to be phantom concerns. These concerns are far outweighed by the substantial benefits of allowing law firms to incorporate, to engage in business associations with nonlawyers, and to receive investments by nonlawyers. These benefits include capital for expansion, capital for investment in new technologies and new lawyers, financing for contingency fee cases, and a myriad of other rewards. Most persuasively, perhaps, as the practice of law continues to be increasingly transformed from a profession into a business, it makes little sense to prevent lawyers from using the financial tools that virtually every other business has available to it.
