Professional Responsibility & Legal Education

Should the Public Be Able to Buy Stock in Law Firms?

*By Thomas D. Morgan**

The current economic downturn has been a wake-up call for lawyers. A profession that thrived on working by the hour in a market based on closing multiple deals has seen much of that work disappear. Over 4,000 American lawyers, many of them equity partners, were terminated by U.S. law firms last year, while new lawyers often found their lucrative job offers "deferred" to an uncertain future date.[1] It is not hard to finance law firm growth when each new associate a law firm hires can support billings at two or three times what she is paid. It is harder to finance a firm through the inevitable swings of good and not-so-good economic fortune.

In May 2007, Slater & Gordon, an Australian law firm concentrating in personal injury practice,[2] listed itself on the Australian stock exchange. Doing so violated one of the legal profession's deep taboos—the prohibition against selling ownership interests in a law firm to non-lawyers. But lest this seem a unique event, the Legal Services Act of 2007 has similarly opened U.K. law firms to the world of "alternative business structures," including non-lawyer owners,[3] and when the law takes effect later in 2010, several UK law firms appear poised to accept outside investors.[4]

The United States, on the other hand, has not yet embraced the idea of non-lawyers taking an equity stake in a law firm. All American jurisdictions have some form of ABA Model Rule 5.4(d) that says:

> A lawyer shall not practice with or in the form of a professional corporation or association authorized to practice law for a profit, if (1) a nonlawyer owns any interest therein . . .; (2) a nonlawyer is a corporate director or officer thereof or occupies the position of similar responsibility . . .; or (3) a nonlawyer has the right to direct or control the professional judgment of a lawyer.

This article will argue that the American restriction on non-lawyer investment in law firms is obsolete, counterproductive, and not justified by any reasonable regulatory or ethical concerns.[5]

While today's law partnerships can have many members, they are traditionally simple business organizations. Even when the law firm is organized other than as a general partnership—as a limited liability company, for example—lawyers usually contribute a defined sum of equity capital at the time they reach the equivalent of partnership status and they typically receive a comparable sum back when they retire or withdraw.

While partnership agreements vary, U.S. lawyers traditionally have not put a value on the "good will" in their firms, in part because to do so would imply the firms can be sure that clients will continue to retain it.[6] Any capital required to build out office space, buy furniture and new technology, stock the library, guarantee a lease, or otherwise provide working funds traditionally has been borrowed from the partners or from banks.[7]

Given a history of law firm finance that has seemed to work for generations, a natural question might be why law firms would want to raise equity capital from third parties at all. One answer is obviously that it is human nature to want to take risks using other people's money and taking on debt means retaining risk, while equity seems to shift it. Equity capital can be relatively expensive, however, because one has to share profits, not just pay interest.[8] Ordinarily, one only seeks outside capital at all when the projected return is likely to exceed the cost, and in a world of low interest rates, borrowed money has long looked like the way to keep all law firm profits in the hands of the lawyer-partners.

But there are at least three reasons why law firm interest in selling equity seems to be growing. First, law firms have long paid profits out each year rather than retaining earnings. The partners in many firms have learned to like the short-term lifestyle such a practice supports, but the result is to make money less available or more costly for long-term investments in new technology, new offices, or to support an expanded scope of practice.

The Australian and U.K. experience tends to confirm this explanation. Slater & Gordon, for example, reported a need to consolidate several offices into larger ones and a need to finance high litigation expenses between the time a case is filed and the time the fee becomes payable. In the U.K., it seems to be mid-size firms that want to expand their ability to use technology to deliver commodity services to middle class clients that may be especially hungry for capital.

A second reason for a law firm's turning to non-lawyer investors will be to create a liquid market in firm shares so that good will can be priced and departing partners can realize full value for their years of service. Successful managers in other industries receive stock options, the argument goes. They profit when the company profits and they pay taxes at capital gain rates on the increase in their share value.[9] Lawyers and law firm managers, on the other hand, basically receive only a pass-through of fees earned that is taxed at high ordinary-income marginal rates.

A third incentive for seeking non-lawyer investment may be to create a more lasting institutional character to the modern law firm and to encourage the development of the firm's brand identity and its reputation for ethics and quality.[10] A law firm's principal assets—its partners and associates—walk out the firm's door every day, have no obligation to return, and often get no

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more or less in return of their capital investment if they have helped the firm prosper or simply get by.[11]

In such an environment, even equity partners have little personal stake in the firm as an institution, other than not to be left holding the bag if the firm fails. When outside investors are involved, on the other hand, there are parties with a genuine stake in the institution's growth and prosperity. And the incentives flow to the lawyers as well. The best way to get people to devote full effort to their law practice, the argument goes, is to give them something tangible to show for their efforts when the time comes to leave.

But if there are legitimate reasons for seeking outside investors, why have lawyers so long resisted the idea? The first reason is probably historical. Until the late 1960s, law firms tended to be quite small. In 1968, for example, only twenty U.S. law firms had over 100 lawyers.[12] In a small firm, personal relationships provide bonding and incentives for firm survival that outside investors might do little to augment. Further, few outside investors would likely have wanted to put their money into such small operations. In short, until recent years, there was more disinterest than opposition to the subject of outside investment in law firms.

But for those who did think about the issue, one concern was that lawyers are their clients' agents and have a fiduciary duty to focus principal attention on their clients' interests. Law firms exist to help lawyers provide that kind of fiduciary attention. Admitting non-lawyer investors to the mix will create a competing interest in earning a high economic return, the argument goes, thus potentially compromising the interests of clients or even influencing the lawyers' professional judgment of how to represent the clients.

A somewhat related concern is that shareholders who are not firm lawyers will inevitably expect information about the firm and its clients, if only to measure management success and to predict future firm performance. Confidential client information is something a lawyer must keep inviolate.[13] Even a client's identity is normally not public information and may not be disclosed other than when doing so would be in the client's interest. Market information, on the other hand, is essential and the inherent tension over its release may seem to place insurmountable limits on sale of equity securities.

A different concern is that the involvement of non-lawyer investors would reduce lawyers' willingness to tell clients what the clients don't want to hear. The last time a serious effort was made to bring law firms into modernity by opening them up to non-lawyer partners, the Enron scandal broke in which lawyers were accused of turning a blind eye to wrongdoing by Enron executives. Critics largely ignored the fact that the Enron events took place under the current regime, not one involving non-lawyers, but the critics suggested the events might have turned out even worse if profit-making rather than client service became a law firm's touchstone.

Related to the last point, concern is sometimes heard that firms with private investors would invest too little in assuring that lawyers see law as having a public element. It is by now a commonplace that private lawyers engage in more law enforcement than regulators do. It is private lawyers who candidly tell clients what conduct is likely to get them into legal trouble and thus prevent the clients from violating the law in the first place. Putting a profit motive into law practice, the argument goes, will reduce lawyers' sense of their "officer of the court" role and lead to a decline in their clients' sense of public obligations.[14]

Finally, many lawyers seem to have a recurring nightmare of waking up working for Walmart. One of the early proposals when the ABA Model Rules were proposed in 1983 was that the barrier against lawyers practicing with non-lawyers be breached. Geoffrey Hazard, reporter to the ABA Commission was asked: "Does this mean Sears & Roebuck will be able to offer a law office?" When Hazard answered "yes," the proposal was defeated. Lawyers working for non-lawyers, it seemed, would be demeaning and thus unprofessional.[15]

The answers to these objections, of course, are not hard to see. First, the idea that only outside investors have a profit motive ignores the history of large law firms over the last forty years. Profits have been widely publicized in the *American Lawyer* and elsewhere.[16] They have been the lure to attract new lawyers, the incentive to work evenings and weekends, and the measure of many lawyers' self-worth. The presence of outside investors may change how profits are shared but not whether profits are sought.

Second, there is nothing about doing well as a lawyer that inhibits doing good work for clients or helping them obey the law. Most clients, most of the time, want help to stay out of trouble, not figure out how to violate legal standards. Clients sometimes may want to move the law in directions that outside observers would not favor, but that difference in viewpoint neither makes their lawyers less civic-minded nor likely has anything to do with whether a firm has issued equity capital.[17]

Third, most of the talk today is about firms seeking private capital from sophisticated investors rather than selling publicly-traded stock as Slater & Gordon did. While one could imagine law firms doing the kind of financial reporting that the SEC requires, it would likely be more trouble than it is worth, and reducing the number of investors actually involved would tend to reduce the amount of even non-sensitive client information that would be made available.

Finally, lawyers are likely to have to get over the fear of Walmart. Most lawyers do not provide services to Walmart customers or other middle class clients today. Those potential clients represent a possible growth market for lawyers, however, and a potential unmet demand. At least the start-up costs to do that kind of work will require the kind of capital that outside investors might provide, and Walmart and other mass merchandisers seem as good a source of capital as any.

The more serious practical question is whether anyone who is well-informed would decide to invest in a law firm. Published reports of several million dollars in earnings per partner may make the investment look attractive, but there are real potential risks. Clients tend to shop for individual lawyers today, at least as often as they shop for particular firms. Investing in institutions that have no control over their human assets may prove shortsighted and not nearly as profitable as some investors imagine.[18]

Further, investment in law firms is not a hedge against market downturns. The best predictor of how busy lawyers will be is how busy their clients are. As the economy rebounds, lawyers will do better, but law practice activity tends to lag economic recovery, not lead it. Stock in a law firm, in short, will tend to track most other business investments, not hedge or otherwise complement them.

Whether or not non-lawyer investment in law firms is wise as an investment strategy, however, is largely beside the point. The practice of allowing non-lawyer investment in law firms has the potential of providing a genuine economic benefit and a low risk of public harm. If not an idea whose success is inevitable, it's at least not an idea to dismiss out of hand.

Endnotes

1 See, e.g., Thomas D. Morgan, The Vanishing American Lawyer 2-3 (2010).

2 Information about Slater & Gordon can be found at http://www.slatergordon.com.au.

3 For background on these developments, see, e.g., Ted Schneyer, *Thoughts on the Compatibility of Recent U.K. and Australian Reforms with U.S. Traditions in Regulating Law Practice*, 2009 J. Prof. Law. 13.

4 *See, e.g.,* Charlotte Edmond, Private Equity Firm First to Openly Target Legal Services in U.K., http://www.law.com/jsp/law/LawArticleFriendly.jsp?id=900005560588 (reporting on the plans of investment house Lyceum Capital, whose advisory board includes Richard Susskind, IT advisor to the Lord Chief Justice, and Tony Williams, former director of Andersen Legal, the legal arm of the late-Arthur Andersen accounting firm).

5 One of the early articles considering these issues was Edward S. Adams & John H. Matheson, *Law Firms on the Big Board: A Proposal for Nonlawyer Investment in Law Firms*, 86 Calif. L. Rev. 1 (1998).

6 ABA Formal Opinion 266 (1945) put the matter dramatically: "Clients are not merchandise. Lawyers are not tradesmen. They have nothing to sell but personal service. An attempt, therefore, to barter in clients, would appear to be inconsistent with the best concepts of our professional practice."

7 *See, e.g.,* Morgan, *supra* note 1, at 166-67.

8 Professor Larry Mitchell has usefully documented the relatively infrequent use of equity capital to fund capital needs in Lawrence E. Mitchell, Who Needs the Stock Market, Part I: The Empirical Evidence (2008), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1292403.

9 The point is developed by Bruce MacEwen in Bruce MacEwen, Milton C. Regan, Jr., & Larry Ribstein, *Conversation: Law Firms, Ethics & Equity Capital*, 21 Geo. J. Legal Ethics 61 (2008).

10 *See, e.g.,* Morgan, *supra* note 1, at 169-70.

11 A law firm may not restrict any lawyer's right to practice elsewhere, except as a condition of receiving retirement benefits. Model rules of Prof'l Conduct R. 5.6(a).

12 Morgan, *supra* note 1, at 99-101.

13 Model rules of Prof'l Conduct R. 1.6(a).

14 The argument is offered by Professor Mitt Regan in Bruce MacEwen, Milton C. Regan, Jr., & Larry Ribstein, *Conversation: Law Firms, Ethics & Equity Capital*, 21 Geo. J. Legal Ethics 61, 70-72 (2008).

15 *See, e.g.,* Thomas D. Morgan & Ronald D. Rotunda, Professional Responsibility: Problems & Materials 614 (8th ed. 2003).

16 *See, e.g.,* Aric Press & John O'Connor, *The Law Firm Investor's Guide*, Am. Law., June 2008, at 121 (offers growth and blue-chip indexes to law firms during the days of high law firm profitability).

17 Bruce MacEwen has offered an imaginative alternative of a derivative security priced to reflect financial performance of the law firm but that would give the security holder no management control. *See* Bruce MacEwen, Milton C. Regan, Jr., & Larry Ribstein, *Conversation: Law Firms, Ethics & Equity Capital*, 21 Geo. J. Legal Ethics 61, 64-67 (2008). Professor Regan is likely correct that those who oppose outside investment would not be impressed by the distinction, *id.* at 67-70, but it is a possible middle ground.

18 *See, e.g.,* Larry E. Ribstein, The Death of Big Law, University of Illinois Law & Economics Research Paper No. LE09-025 (2009), *available at* http://ssrn.com/abstract=1467730 (predicting that large law firms will have little real reason to hold themselves together).