

AN ECONOMIC ANALYSIS OF ALTERNATIVE BUSINESS STRUCTURES FOR THE PRACTICE OF LAW

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Regulations constrain the choice of legal form that a law firm may assume. The legal form that an organization assumes has consequences for the way it will operate its business, and hence will affect the public and private values that the firm generates. Relying on the economic literature on the theory of the firm and optimal capital structure, this article reviews the predictable economic impact of such restrictions on a law firm's business structure, and, conversely, the predictable impact of liberalization. Alternative business structures for law firms, such as publicly-traded corporations, have the potential to generate economic gains. Our focus is on the economics of these restrictions, but we note that economic gains for law firms could help address access to justice concerns.

La réglementation limite la forme juridique que peut assumer un cabinet d'avocats. La forme juridique choisie par une organisation dicte son fonctionnement et a donc des conséquences sur la valeur qu'elle produit sur les plans public et privé. Fondé sur les écrits économiques au sujet de la théorie du cabinet et de la structure financière optimale, cet article passe en revue les incidences économiques prévisibles de telles restrictions imposées à la structure d'entreprise d'un cabinet et les incidences prévisibles d'une libéralisation. Les structures d'entreprise alternatives pour les cabinets juridiques, telles que les sociétés cotées en bourse, recèlent le potentiel de la génération de profits économiques. Nous axons notre étude sur l'aspect économique de ces restrictions, mais remarquons que les profits économiques que tireraient les cabinets juridiques d'une telle solution pourraient aider à faire face aux préoccupations quant à l'accès à la justice.

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1. Introduction

In this article, we consider the economic advantages and disadvantages of alternative business structures (ABSs) for the practice of law. The question of the form that a legal practice takes undoubtedly engages a wide variety of policy considerations, including ethical questions, that are not necessarily confined to the economic realm. We set these other considerations to the side and focus only on the prospective economic benefits and costs of different structures. Our analysis, then, does not attempt to provide final answers to policy questions associated with alternative business structures, but rather simply offers insights from the perspective of economic analysis that may be helpful in reaching an overall policy conclusion about alternative business structures. Of course, economic and non-economic concerns may be related in important ways. For example, to the extent that economic efficiencies from alternative structures lead to lower costs of providing legal services, and lower costs lead to lower prices for buyers of legal services, alternative structures may promote access to justice.¹ Our focus, however, is on the economic considerations, with only occasional reference to other, potentially very important, non-economic policy concerns.

We begin in Part 2 by discussing economic thinking on two related matters. The first is the economic theory of the firm. This body of thought concerns the question of what economic activities are best situated within a firm, and what economic activities are best situated outside the firm. For example, should an auto manufacturer produce its own sound systems, or should the company buy systems from a third party? This turns out to be a more difficult question than it may initially appear to be. The second issue we discuss in Part 2 is the economics of capital structure. What considerations affect the economically optimal capital structure (for example, the distribution of equity ownership or the debt-equity ratio) of a firm?

In Part 3 we outline various business structures that legal service providers might consider adopting. In this section we review not only the kinds of structures that are permissible under Ontario and other provincial law, but also structures that are not permitted in Canada but are elsewhere.

¹ See e.g. Gillian Hadfield, "The Price of Law: How the Market for Lawyers Distorts the Justice System" (2000) 98 Mich L Rev 953; Gillian Hadfield, "The Cost of Law: Promoting Access to Justice through the Corporate Practice of Law" (2012) unpublished, online: <<http://works.bepress.com/cgi/viewcontent.cgi?article=1057&context=ghadfield>> [Hadfield, "The Cost of Law"]. We return to access to justice in the Part 5.

Part 4 builds on the foundation laid in Parts 2 and 3 by offering an economic analysis of alternative business structures for legal practice. This section essentially applies the economic analysis of Part 2 to the array of alternative business structures outlined in Part 3 in order to gain insight into the economic advantages and disadvantages of different structures. Part 5 concludes by summarizing, and by touching on the politics of reform, noting that even if liberalization of the choice of form for legal practice were to lead to the demise of certain business structures, it would not necessarily be a bad thing, especially in the longer run, for lawyers at such doomed structures.

2. The Theory of the Firm

Nobel laureate Ronald Coase posed a deceptively vexing question in a seminal article in 1937:² Why are some transactions consummated in the market between two separate parties, and why are some transactions consummated within a firm?³ This question has spawned a host of responses without a single right answer, but with certain strains of thought emerging as prominent pieces of the puzzle. It is essential when attempting to gauge the economic impact of regulatory restrictions on the structure of legal firms to understand as a preliminary matter the considerations that help determine the optimal economic structure of a firm. This section introduces the basic ideas behind the theory of the firm that have emerged in the economic literature.

There is a related question that this section will also canvass. One can crudely think of the theory of the firm as seeking to identify what economic activity will take place within a firm. There is a related question. Assuming that there are a range of passive investors in the firm (not just owner-managers), how is their investment to be structured? For example, how much debt versus equity should a firm issue? This question is also more complex than may meet the eye. This section will review some of the basics of this matter in order to lay a foundation for discussion of the optimal ownership structure of law firms in Section 3.

² He actually posed the question as an undergraduate student in 1932; see Phillippe Aghion and Richard Holden, “Incomplete Contracts and the Theory of the Firm: What Have We Learned over the Past 25 Years?” (2011) 25 *J of Econ Persp* 181 at 181.

³ Ronald Coase, “The Nature of the Firm” (1937) 4 *Economica* 386.

A) *Theory of the Firm*

1) *Lower Transaction Costs vs Market Pricing*

Coase himself began to answer the question of why some transactions take place within a firm and some outside it by considering a key difference between the transactions.⁴ Transactions that arise within the firm result from managerial exercise of authority, while transactions that take place outside the firm rely on contracts and consequential haggling between arm's length parties. There are advantages and disadvantages to each.

To illustrate, consider an example that we will return to throughout the discussion. Suppose there is a car manufacturer, General Motors (GM), that requires sheet metal auto body forms to assemble its cars.⁵ It has two basic options at polar extremes. It could itself build a factory capable of producing the sheet metal forms that are necessary for its cars. Or it could instead enter into a contract to buy the forms from an arm's length sheet metal manufacturer. There are a range of options in between these basic possibilities. For example, GM might not vertically integrate the body supplier completely, but could take an equity interest in it, perhaps a minority interest that helps align the economic interests of GM and its supplier. Relatedly, GM and the supplier could form a joint venture of some kind. For example, GM and the supplier could each take a significant ownership stake in an organization, another corporation, or a partnership, that is specifically created to supply GM with auto body forms. These intermediate options, which are neither complete integration nor arm's length contracting, may in certain circumstances optimally resolve the competing economic tensions that arise, and that we will describe, when deciding how best to integrate activities within a form. To illustrate the basic considerations that motivate decisions on firm scope, however, we will focus on the basic choice of full integration or arm's length contracting.

An important advantage of building the sheet metal bodies in-house is that the managers at GM do not need to haggle over price or over changes in design over time. Rather, they can build the appropriate factory, and hire the appropriate employees with the appropriate instructions to build the metal forms necessary for the cars. Coase observed that building the input in-house reduces transaction costs associated with the production of the metal forms.

⁴ *Ibid.*

⁵ The relationship between GM and Fisher Auto Body is a famous example in the literature on the theory of the firm beginning with the discussion in Benjamin Klein, Robert Crawford and Armen Alchian, "Vertical Integration, Appropriate Rents, and the Competitive Contracting Process" (1978) 21 *JL & Econ* 297.

On the other hand, the price mechanism is a vitally important source of information for economic decision-makers. While entering into a contract with a third party for the production of the metal forms may create transaction costs, the price that GM enters into for the metal forms gives GM information about the opportunity costs of using that sheet metal. If the price is \$X per form, GM has precise confidence about the opportunity costs of that input in its automobile.

If the sheet metal is sourced in-house, in contrast, it may be much more difficult to discover exactly what the opportunity cost of the sheet metal is. For one thing, GM must attribute overhead costs to the production of the metal forms. For another, GM must calculate the opportunity cost of assigning an employee to produce an additional piece of sheet metal rather than some other input, like a windshield. Determining the economic cost of the input is much more difficult when the price mechanism is suppressed in an in-house transaction than when purchased at arm's length.

Thus, Coase identified a trade-off: the firm will weigh the advantages of lower transaction costs against the disadvantages of losing the information provided by the price mechanism, and the boundaries of the firm will be set accordingly. For some matters, the transaction costs of contracting out will exceed the benefits of information provided by the price mechanism, while for others the reverse will be true.

2) Relationship-Specific Investments

Another Nobel laureate, Oliver Williamson, identified another important consideration in the theory of the firm: the importance of relationship-specific investments.⁶ In many longer-term economic relationships, parties must make investments that maintain their value only if the relationship continues. To explain, consider again the GM example. Suppose that GM needs sheet metal of certain dimensions and shape to assemble bodies for a particular model of a car. To build that sheet metal body, suppose that specific moulds must be created at significant cost. Now consider a third party, call it Fisher, that vies to supply GM with the specific sheet metal forms. The supplier, before it can sell anything to GM, must build the moulds. The problem Fisher faces is that the moulds are virtually worthless outside the relationship with GM; they are specific to the relationship with GM. The supplier faces a dilemma: build the moulds and then hope GM buys its sheet metal, or do not build the moulds and be incapable of selling these parts to GM.

⁶ For his best-known work, see Oliver Williamson, *Markets and Hierarchies: Analysis and Antitrust Implications* (New York: The Free Press, 1975).

The dilemma is made worse by the realization that once it has built the moulds, GM can lowball it on price. Fisher would only want to build the moulds and sell to GM if it anticipated prices for the products that compensate it not only for the per-unit costs of each additional sheet metal form (such as steel costs or employees' time), but also for the up-front costs in building the specific moulds. Once Fisher has undertaken the investment in the moulds, however, GM is in a position to offer prices that cover only the variable costs of producing the steel; Fisher would accept because the costs of the moulds are sunk, and Fisher makes more money going forward accepting than rejecting the lowball offer.

Before investing in the moulds, Fisher would anticipate the future "hold-up" problems that result from having made sunk, relationship-specific investments. There are two basic ways of dealing with the so-called hold-up problem. One, before Fisher invests, Fisher and GM can enter into a long-term contract that specifies GM's obligations, including prices and quantity demanded, over time. While such contracts can, and often do in practice, resolve some of the concerns about *ex post* opportunism by GM, they are not easy contracts to write and enforce. Take something as simple as pricing. Many factors would influence the appropriate market-mimicking price over time, such as the price for raw materials, and demand for the moulded sheets. Long-term, detailed contracts are costly to write and enforce, and may result in prices or other conditions that are out of alignment with other market forces, which may create tensions and disputes.⁷

An alternative option is vertical integration. Rather than GM and Fisher attempting to strike a contract that protects the interests of both parties, they can instead choose to combine their operations within a single firm. The single entity can build the moulds itself, and simply transfer them to the car construction arm of the entity. This avoids the hold-up problems that sunk, up-front investments otherwise invite. Williamson's analysis provides another important reason why economic activity would be organized within a single firm rather than on the market.

⁷ See e.g. Victor Goldberg and John Erickson, "Quantity and Price Adjustment in Long-Term Contracts: A Case Study of Petroleum Coke" (1987) 30 *JL & Econ* 369. Renegotiation of the contract to adapt to changing market conditions is possible, but is made difficult by sunk investments that affect bargaining power; see Varouj Aivazian, Michael Trebilcock and Michael Penny, "The Law of Contract Modifications: The Uncertain Quest for a Benchmark of Enforceability" (1984) 22 *Osgoode Hall LJ* 173.

3) *Private Investment in Joint Gains*

A third theory, attributed in large part to Grossman and Hart,⁸ also concerns incentives to invest associated with firm ownership of an asset. This theory concerns incentives to invest in an asset that will enhance the value of the asset. The investments are valuable, but are not susceptible of contracting; efforts could be impossible to verify in court, for example. The asset could be a physical asset, or it could be intangible. Of the latter type, Grossman and Hart provide the example of a customer list. Should the list of an insurance salesperson be owned by an insurance firm, or by the salesperson herself? There is a trade-off in that both the firm and the salesperson can make investments to improve the list, but the incentives to do so vary with ownership of the list. If, for example, the company owns the list, it will have stronger incentives to advertise broadly and grow the list; as the list grows, the company will profit, not the salesperson, because the salesperson would only have access to the list with the company's permission. Conversely, if the salesperson owns the list, she will have stronger incentives to knock on doors in order to grow the list and knows that such investments are profitable to her personally; if the company refuses to compensate for her efforts, she can take the list elsewhere. Grossman and Hart predict that whether the list will be owned by the firm or not will depend on the relative importance of the incentives to make investments in the list. If the insurance provider's incentives matter more to the value of the list, it will own the list. This may in turn affect the boundaries of the firm; a natural implication might be in-house sales staff, for example. On the other hand, if the salesperson's efforts and incentives matter more, it would be more natural to have an independent sales force that owns its customer lists.

4) *Culture and Reputation*

These theories illustrate the basic economic approaches to firm boundaries that emphasize the gains or losses that result from integrating economic activity within a firm rather than coordinating the activity through a contract between arm's length actors. There are many nuances within this approach, and moreover many theories that do not depend so heavily on the contract-integration divide. Space does not permit development of these alternatives in detail, but one alternative is worth mentioning. The term "firm culture" can be thought of as capturing the informal norms that prevail at the firm,⁹ which are independent of formal contracts between

⁸ See Sanford Grossman and Oliver Hart, "The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration" (1986) 94 J Pol Econ 691.

⁹ See e.g. Ronald Daniels, "The Law Firm as an Efficient Community" (1991) 37 McGill LJ 801 .

different members of the firm, but may interact with these formal contracts. Employees may, for example, have formal contracts with the employer, and informal understandings may inform the enforcement of those contracts. Certain kinds of activity may best be promoted within a certain culture, and mixing cultures, which would be implied by integrating the different activities within a single firm, may not be appropriate. For example, if an individual's output is easily measured, perhaps because quality is easy to discern, and because teamwork is relatively unimportant, it may be suitable for the firm to have an individualistic culture that stresses individual rewards for individual performance. If, however, teamwork is vital to production, such a culture would be inappropriate.

A related consideration that may affect the boundaries of the firm concerns reputation. If a single firm develops a reputation for behaving in a certain way – perhaps it is known to provide high quality products, for example – there may be a risk to that firm's reputation by extending into other economic activities.¹⁰ Selling a second product may tempt the firm to renege on its reputational commitments because selling the additional product may change the short run gains from “cheating,” making this the profitable strategy, not providing more costly high quality. On the other hand, it is also possible that engaging in multiple economic activities may *enhance* the incentives to maintain a good reputation with buyers. If a firm sells different products in different periods of time, for example, then selling multiple products strengthens the commitment to provide high quality; in any point in time, the firm's whole reputation is on the line for the sale of only a subset of products; better to provide high quality and protect the firm's reputation across product lines than to chisel and realize only modest short-run gains from selling only a subset of the firm's products.¹¹

B) Capital Structure

We have reviewed some of the general theories of the firm, which attempt to explain why some economic activity takes place inside the firm and other activity outside the firm. There is a related, though distinct, question of how the firm structures its financing. That is, given a set of economic activities within a firm, how does the firm finance those activities? In some settings, the theory of the firm and of capital structure are intimately

¹⁰ See e.g. Hendrik Hakenes and Martin Peitz, “Umbrella Branding and the Provision of Quality” (2008) 26 *Int'l J Ind'l Org* 546.

¹¹ Edward Iacobucci, “Reputational Economies of Scale, with Application to Law Firms” (2012) 14 *Am L & Econ Rev* 302 .

related.¹² If two lawyers form a general partnership, for example, such a decision would affect both the boundaries of the firm, and the capital structure of the firm – there would be two partners that own the equity interest in the firm. But in general the choice of whether to combine economic activities within a firm, and the choice of capital structure of that firm, raise distinct questions. GM may integrate with Fisher, but that does not answer important questions about how the firm is financed, such as appropriate debt-equity ratios, the concentration of equity ownership, or the merits of bank debt versus public debt. In what follows, we outline some considerations that influence the optimal capital structure of a firm.

1) *The Irrelevance Benchmark*

Modigliani and Miller (M&M) demonstrated that, under certain conditions, including an absence of taxation, perfect competition and perfect information about investments, the choice of capital structure, debt versus equity financing for example, is irrelevant to firm value.¹³ The result is not especially important in predicting real world outcomes since the assumptions are not realistic, but it is a helpful benchmark against which to assess why capital structure may affect value in practice. The basic intuition behind the M&M theorem is as follows. A firm will have a certain pattern of cash flows over time, patterns that will not be influenced by capital structure, since capital structure simply divides proceeds of economic activity and does not (as a consequence of assumptions of market perfection) affect the proceeds. Capital structure merely divides the cash flows across different investors and does not affect overall value. As Miller observed, the logic of the M&M irrelevance theory is indicated by a famous Yogi Berra observation; when asked whether he wanted a pizza sliced into four or eight slices, he replied eight since he was hungry that night.¹⁴

2) *Debt Financing*

In reality, capital structure matters. Outside investors do not have as good an information set about the firm's prospects as insider managers, and because outsiders have only imperfect information about their managerial decisions, managers of a firm may be able to make decisions that are

¹² Michael Jensen and William Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure" (1976) 3 J Fin'l Econ 305.

¹³ Franco Modigliani and Merton Miller, "The Cost of Capital, Corporation Finance and the Theory of Investment" (1958) 48 Am Econ Rev 261.

¹⁴ Dun Gifford Jr, "After the Revolution" *CFO Magazine* (1 July 1998), online: <http://pages.stern.nyu.edu/~adamodar/New_Home_Page/articles/MM40yearslater.htm>.

valuable from their selfish perspective, but may reduce overall value; this self-interested behaviour leads to so-called “agency costs.”¹⁵ In this section, we briefly review some of the key considerations that make the choice of debt financing more valuable in light of market imperfections.

Tax creates an important bias in favour of debt over equity financing. Firms can write off interest payments to creditors, interest which provides creditors with the returns necessary to induce them to invest in the first place, as an interest expense for tax purposes. The returns that are paid to shareholders, such as dividends, in contrast cannot be treated as an expense for tax purposes. There is a structural advantage to debt financing: all things equal, distributions to investors as interest increases the after-tax value of the corporation relative to dividends.

There are also informational advantages associated with debt financing.¹⁶ Suppose that outside investors cannot tell whether a particular enterprise will return \$15 or \$30, but inside managers have good information about the venture’s worth. If the firm seeks to sell shares, which results in existing shareholders sharing in the proceeds with new shareholders, new shareholders will be suspicious that the true value is more likely to be \$15, since old shareholders with good information about firm value would be reluctant to share with new if the value were \$30.¹⁷ To avoid suspicion about old shareholders only being willing to sell shares when values are low, old shareholders can instead issue debt. Creditors do not share in the upside of the firm’s performance, and thus it will be easier, as a general rule, for them to value the debt even if insiders are better informed typically. In the example, creditors would be willing to lend \$15 without concern, knowing that in either state of the world, they will be paid in full.

Other advantages of debt relate to disciplining managers. Managers, once they no longer hold all the financial stakes in a business, may be tempted to make self-interested, yet value-reducing decisions, such as overconsuming perquisites on the job, empire-building, or avoiding risks that jeopardize their positions. Debt can help discipline managers in different ways. For one thing, debt obligations to pay out steady streams of cash flow may address a manager’s temptation to otherwise keep cash in the company, perhaps as a buffer against risk, perhaps to help build

¹⁵ Jensen and Meckling, *supra* note 12.

¹⁶ Stewart Myers and Nicholas Majluf, “Corporate Financing and Investment Decisions When Firms Have Information That Investors Do Not Have” (1984) 13 J Fin’l Econ 187.

¹⁷ This logic was originally outlined in George Akerlof, “The Market for ‘Lemons’: Quality Uncertainty and the Market Mechanism” (1970) 84 Q J Econ 488.

empires, or both.¹⁸ For another, the more debt financing there is, the easier it will be for equity ownership to be relatively concentrated, rather than dispersed.¹⁹ A relatively cash-poor entrepreneur who finances an enterprise through debt may be able to retain a significant percentage of shares. Concentrating share ownership in the hands of management, as we discuss further below, tends to provide management with stronger incentives to increase the value of shares. Debt may thus be valuable by allowing such concentration. Finally, creditors may monitor management, which helps reduce agency costs directly, and may reveal information to other monitors such as equity-holders so that they can act to discipline management.²⁰ For example, if a bank refuses to extend a line of credit, this may signal problems at the firm to other stakeholders.

There are, of course, disadvantages to debt finance. For one, there are bankruptcy costs. If the firm cannot pay its debts, it will enter a bankruptcy or reorganization process, which is costly and will reduce the value of the firm as a result. For another, the presence of debt may induce excessive risk on the part of managers who are looking to maximize share value.²¹ This is because downside risk is shared with creditors, while upside risk is realized by shareholders; creditors have only a fixed claim. To take an extreme case, if a firm owes \$100 in debt, but has only \$5 in assets, a manager might well prefer to invest in a lottery ticket that is a negative expected value investment, but will pay off generously to shareholders in the very unlikely chance it is a winner. A miniscule chance of realizing value for shareholders is better than a zero chance. Debt thus tends to create perverse incentives for shareholders to engage in excessive risk that lowers the overall value of the company.

There is an important qualification to this discussion of the risk-inducing properties of debt: it is premised on limited liability for shareholders. If, for example, equity-holders had unlimited liability for the firm's debt, this would mitigate the incentives to assume excessive risk; if the risky debt does not pay off, equity-holders remain personally on the hook to creditors, which reduces their incentives to take on excessive risk. Limited liability is thus an important consideration in evaluating the economic costs and benefits of different capital structures. Limited liability puts more risk on creditors and less on equity-holders, which may have positive effects if

¹⁸ Michael Jensen, "Agency Cost of Free Cash Flow, Corporate Finance, and Takeovers" (1986) 76 *Am Econ Rev* 323.

¹⁹ Jensen and Meckling, *supra* note 12.

²⁰ George Triantis and Ronald Daniels, "The Role of Debt in Interactive Corporate Governance" (1995) 83 *Cal L Rev* 1073.

²¹ Jensen and Meckling, *supra* note 12.

creditors are better able to bear risk, but may also be negative by inviting excessive risk-taking.

3) *Equity Financing*

While not all for-profit businesses carry debt (though most do), all for-profit businesses have equity-holders who are the residual financial claimants: they get paid after all other fixed claimants have been paid in full. A key economic question with equity investment is how it should be structured.

One question is the extent to which equity should be concentrated or diffuse. There are three basic models with advantages and disadvantages to each. Equity could be concentrated in the hands of very few investors. This has the advantage of creating strong incentives for these investors to monitor management, since each has a significant stake in the value of the enterprise. It has the disadvantage, however, of exposing these investors to potentially significant risk, which is not desirable all else equal. Concentrated ownership may also be problematic, or at least difficult to achieve, if the principals behind a business require outside capital, and debt financing is problematic.

An intermediate structure would have a controlling shareholder, along with diffuse minority shareholders. Such a structure allows the controlling investor to mitigate some of its exposure to the company's risk by selling minority equity stakes, but maintains the presence of an investor with strong incentives to monitor the company's progress. A further advantage of this structure is that the market in the firm's equity provides information to investors about the performance of management. If, for example, shares in all bank firms but one are rising, this would tend to indicate less than stellar management at the one firm. The problem, however, is that with such structure, management is irreplaceable without consent of the controlling shareholder. Especially where the manager is the controlling shareholder, such consent may not be forthcoming. As a consequence, the controlling shareholder may be able to extract value from the minority without fear of consequence.

A final possibility is widely-held equity. This structure creates the most opportunity for risk diversification, since no single shareholder owns a significant percentage of shares. There is also the prospect of forcing underperforming management out, perhaps through a hostile takeover (perhaps invited by underperforming shares), perhaps through a proxy contest. On the other hand, with no single shareholder owing a significant percentage of the company, there is a danger that there will be little

monitoring of management, especially given the costs and therefore relative rarity of proxy contests and hostile takeovers.

3. Alternative Business Structures for the Practice of Law

In a voluntary survey of lawyers in 2009 by the Law Society of Upper Canada, which attracted a response rate of 51 percent, the survey found that of lawyers working in private practice:

- 18 per cent reported as working as sole practitioners
- 11 per cent report working at firms of 2 to 5 lawyers
- 4 per cent reported working at firms of 6 to 10 lawyers
- 4 per cent reported working at firms of 11 to 20 lawyers
- 3 per cent reported working at firms of 21 to 50 lawyers
- 2 per cent reported working at firms of 51 to 100 lawyers
- 4 per cent reported working at firms of 101 to 200 lawyers
- 6 per cent reported working at firms of 201 or larger²²

Assuming that that these numbers are broadly representative, it is clear that a disproportionate percentage of private legal practitioners in Ontario operate as sole practitioners or work at small firms. We now set out below the principal business structures that have emerged in Ontario for the provision of legal services, and describe alternative business models that have emerged in jurisdictions beyond Ontario that are presently restricted in this jurisdiction.

A) Unincorporated Sole Proprietorships

A sole proprietor or sole practitioner owns and operates his or her professional practice alone in unincorporated form, and is subject to very few formal business registration requirements. As noted above, sole proprietorships remain today a prominent feature of the legal landscape in Ontario, but are not mandated in any context. This is in contrast to the traditional rules that have applied in the UK, and some other jurisdictions, with a divided legal profession of solicitors and barristers (or advocates), where barristers have often been required to operate as sole practitioners (albeit often operating in group chambers, with shared overheads). The UK Office of Fair Trading has been critical of prohibitions on barristers forming partnerships with other barristers, or forming partnerships with solicitors, and recent regulatory changes have liberalized the rules in this respect, including liberalizing the rules pertaining to rights of audience of

²² LSUC, “Statistical Snapshot of Lawyers in Ontario,” from *2009 Annual Report*, online: The Law Society of Upper Canada <<http://www.lsuc.on.ca/WorkArea/DownloadAsset.aspx?id=2147485403>>.

solicitors in most UK courts and tribunals. Obviously, an unincorporated sole proprietorship, with unlimited liability, entails risks to the personal assets of the sole proprietor from liabilities (such as professional negligence) incurred in the course of his or her legal practice, and can only draw on external sources of debt capital.

B) General Partnerships

Lawyers entering into a partnership with other lawyers may do so under the *Partnership Act*,²³ and historically this has been the most common form of group practice. With a general partnership, every partner in the law firm is liable jointly and severally with the other partners for all debts and obligations of the firm incurred while the person is a partner, including liability for the negligence of other partners. While this obviously entails risks for each partner with respect to errors and omissions of other partners, including risks to personal assets, in principle it creates strong incentives for mutual monitoring by partners of each other's integrity and competence. Because all partners must be lawyers, the only source of external capital is debt capital such as bank loans. In limited contexts, third party financiers (like hedge funds) may finance litigation undertaken by a law firm in return for a share of any ultimate award or settlement, in effect shifting some of the litigation risks from lawyers and their clients to an external entity.²⁴ Often general legal partnerships form management companies to hold most assets of the legal practice and hire support staff and provide agreed space and services to the legal partnership as determined by contract, thus shielding assets from partnership liabilities.

C) Limited Liability Partnerships

As of 1998, lawyers in private practice in Ontario have been able to form limited liability partnerships with other lawyers, subject to minimum mandatory errors and omissions insurance coverage, and many law firms have subsequently adopted this legal form. Limited liability partnerships amongst lawyers have now also been widely permitted in many other Canadian and foreign jurisdictions. In the case of a limited liability partnership, a partner can generally still be held liable for his or her own negligent or wrongful act or omission; the negligent or wrongful act or omission of a person under the partner's direct supervision; or the

²³ RSO 1990, c P.5.

²⁴ See Jasminka Kalajdzic, Peter Cashman and Alana Longmoore, "Justice for Profit: A Comparative Analysis of Australian, Canadian, and US Third Party Litigation Funding" (2012) 61 Am J Comp L 93; Michael Trebilcock and Elizabeth Kagedan, "An Economic Assessment of Third Party Litigation Funding of Ontario Class Actions" (2014) 55 Can Bus LJ 54.

negligent or wrongful act or omission of another partner or an employee of the partnership not under the partner's direct supervision if a) the act or omission was criminal or constituted fraud, or b) the partner knew or ought to have known of the act or omission and did not take the actions that a reasonable person would have taken to prevent it. With these exceptions, however, a partner is not liable for the debts, liabilities or obligations of the partnership or any partner.²⁵

D) Professional Corporations

The *Law Society Act*²⁶ permits the incorporation of legal entities to provide legal services, provided that all the shareholders are members of the Law Society of Upper Canada and also directors of the entity. In Alberta, spouses and children of lawyer-shareholders may own non-voting shares.²⁷ Family members of physicians and dentists in Ontario also may own shares in a professional corporation.²⁸ This is not so for lawyers in Ontario. The *Ontario Business Corporations Act*²⁹ that provides for the creation of professional corporations states that the liability of a member for a professional liability claim is not affected by the fact that the member is practicing a profession through a professional corporation and remains jointly and severally liable with a professional corporation for all professional liability claims made against the corporation while the person was a shareholder. Hence, the risks borne by shareholders in a professional legal corporation are essentially the same as those borne by partners in a general partnership, and are more expansive than those associated with limited liability partnerships. The principal advantage of a professional corporation for lawyers appears to relate to tax liability.

E) Business Corporations with Limited Liability

Ontario does not currently permit ordinary business corporations with limited liability to provide legal services. They are, however, permitted in other professions in Ontario. Professional engineers, for example, can and

²⁵ See Poonam Puri, "Judgment Proofing the Profession" (2001) 15 Geo J Legal Ethics 1.

²⁶ RSO 1990, c L.8.

²⁷ See *Legal Profession Act*, RSA 2000, c L.8, s 131(3)(f).

²⁸ Since January 1, 2006, O Reg 665/05 has exempted physicians and dentists from the requirement under the *Business Corporations Act* that the shares in a professional corporation be owned by members of the regulated profession; see online: http://www.e-laws.gov.on.ca/html/reg/english/elaws_regs_050665_e.htm

²⁹ RSO 1990, c 16.

do form corporations with limited liability in Ontario.³⁰ Moreover, legal service corporations with limited liability are permitted in other jurisdictions.

A number of US states allow limited liability companies (LLCs). LLCs combine elements of limited liability partnerships and corporations. Stock in the company is held by lawyers, who may or may not participate in management. States vary in allowing lawyers to form LLCs. The LLC is still subject to vicarious liability, but the owners' personal assets are protected, and individual lawyers are subject in many states to continuing supervisory liability (much as is the case with limited liability partnerships in Ontario).³¹

The Australian states and territories and the UK, in recent reforms, have authorized incorporated legal practices, with full limited liability, and recent estimates suggest that more than 20 per cent of all legal practices have now been incorporated as limited liability entities.³² Shares in these corporations need not be owned exclusively by lawyers (though in Australia, one director must usually be a lawyer), although individual lawyers working for such entities remain responsible for compliance with professional codes of conduct and continue to be subject to civil liability for their own errors and omissions, and presumably the corporate entity itself is also vicariously liable for errors and omissions of its professional and other employees.³³ The issue of non-lawyer ownership of business entities providing legal services is sufficiently important, recent, and contentious as to warrant separate discussion.

³⁰ See e.g. *Professional Engineers Act*, RSO 1990, c P28, s 13: "A corporation that holds a certificate of authorization may provide services that are within the practice of professional engineering."

³¹ Larry Ribstein, "Ethical Rules, Law Firm Structure and Choice of Law" (2001) 69 U Cin L Rev 1161 at 1170-71; see also Bryan Smith, "The Professional Liability Crisis and the Need for Professional Limited Liability Companies: Washington's Model Approach" (1995) 18 Seattle UL Rev 557 at 575-76.

³² In New South Wales, incorporated legal practices make up 18% of all law firms; see Steve Mark, *A short paper and notes on the issue of listing of law firms in New South Wales*, online: Office of the Legal Services Commissioner New South Wales, online: <http://www.olsc.nsw.gov.au/agdbasev7wr/olsc/documents/pdf/notes_for_joint_nobc_aprl_aba_panel.pdf> .

³³ *Ibid*; *Legal Services Act, 2007* (UK), c 29.

*F) Non-Lawyer Ownership of Corporate Entities Providing Legal Services*³⁴

The great majority of incorporated legal practices that have emerged in the UK and Australia in recent years with non-lawyer ownership have been small entities where non-lawyer employees or family members become shareholders or managers. In some cases insurance companies or claims adjusters have acquired law firms that were previously on retainer to them. There have been a few striking exceptions to the predominantly small scale of incorporated legal practices in these jurisdictions, however. For example, in Australia, Slater and Gordon became the first firm of lawyers to be floated on a stock exchange when in 2004 it issued AUD \$35 million of AUD \$1 shares. Subsequently, Slater and Gordon began acquiring legal practices across Australia, and in 2012 and 2013 acquired significant English personal injury firms.³⁵ It now employs 1,350 staff in 69 locations, and serves predominantly the civil legal needs of individuals, such as conveyancing, family law, estate law, and plaintiff-side personal injury matters.³⁶ Two other Australian law firms have now been listed on a stock exchange.³⁷

In the case of the UK, Cooperative Legal Services, the legal arm of the Cooperative Group, which includes Britain's fifth largest supermarket chain as well as banking and insurance businesses, was authorized as an alternative business structure in 2012. The Cooperative Group is owned by six million consumer members. It provides legal services to individuals, including extensive online advisory services, and plans to open branch offices in many of the 300 offices of Cooperative Bank and the Britannia Building Society, with plans to employ 3,000 lawyers by 2017.³⁸ Another significant firm in the UK, Riverview Law, which serves commercial law clients, has proposed doubling in size over the next year by hiring up to

³⁴ This section draws from Frank Stephen, *Lawyers, Markets and Regulation* (Edward Elgar, 2013) ch 8; and Noel Semple, "Access to Justice: Is Legal Service Regulation Blocking the Path?" (2014) 21 *Int' J Legal Prof*, online: <http://dx.doi.org/10.1080/09695958.2014.896803>.

³⁵ Dan Bindman, "Slater & Gordon acquires Fentons and extends its PI reach" (21 August 2013), online: Legal Futures <<http://www.legalfutures.co.uk/latest-news/slater-gordon-set-acquire-fentons-extend-reach-uis/print/>>.

³⁶ Stephen, *supra* note 34 at 176; Semple, *supra* note 34 at 28.

³⁷ Shine Corporate and Rockwell Olivier, ASX, *ASX Welcomes Shine Corporate Limited*, online: <<http://www.asx.com.au/documents/research/shine-corporate-limited-new-listing-media-release.pdf>>; Lawyers Weekly, *Listed Firm Rockwell Olivier launches in OZ*, online: <<http://www.lawyersweekly.com.au/news/listed-firm-rockwell-olivier-launches-in-oz>>.

³⁸ Stephen, *supra* note 34 at 181.

100 new employees.³⁹ BT Law, part of BT Group, a major UK telecommunications and internet service provider, has also been issued an alternative business structure license. BT Law will be associated with BT Claims, the motor claims subsidiary of the group. Several other major brands or chains are expected to be licensed as ABSs in the course of 2013, including the major motoring breakdown and insurance provider, which currently has 16 million members.⁴⁰

In Finland, banks and insurance companies, as well as other private and non-governmental organizations, can provide legal advice to their customers, although they cannot litigate on their clients' behalf. Simple civil matters, particularly in family and property law, are handled by bank lawyers on behalf of their non-business customers.⁴¹

In various western European jurisdictions, including most prominently Germany, France and Spain, major international accounting firms have acquired legal affiliates, which have in turn acquired a significant share of corporate legal services in these markets. This development is more conveniently discussed below as a separate business model involving multidisciplinary professional practices in contrast to the other examples of non-lawyer ownership of legal service entities discussed above, which all involve the provision exclusively or predominantly of legal services, as opposed to multidisciplinary professional services.⁴²

G) *Franchising*

While not accorded much prominence in contemporary discussions of ABSs in the provision of legal services,⁴³ it is not difficult to imagine the emergence of franchising networks that may be non-lawyer-owned. Such networks might grant franchises to owners and operators of local franchise branches (who may also be non-lawyers), and would provide headquarters support in terms of marketing, advisory and research services, somewhat analogously to H&R Block franchises in tax advisory and preparation services. Both the head office of the franchisor and the larger franchise offices might well employ lawyers on their staffs, but may also rely heavily on online and paralegal frontline services. Presumably, lawyers so employed would remain individually responsible for compliance with professional obligations, including supervisory obligations, as well as

³⁹ "Riverview plots major expansion" (27 August 2013), online: Legal Futures <<http://www.legalfutures.co.uk/latest-news/riverview-plots-major-expansion>>.

⁴⁰ Stephen, *supra* note 34 at 182.

⁴¹ *Ibid*, at 179-180.

⁴² *Ibid*, at 92-99.

⁴³ But see Hadfield, "The Cost of Law," *supra* note 1.

being subject to civil liability for their own errors and omissions; the franchisor and franchisees would also presumably be vicariously liable for errors and omissions of legal and other personnel employed by them.

An example of independently owned and operated firms working within a branded network is found in the UK with QualitySolicitors.⁴⁴ The network promises its over 200 member firms (and growing) access to national branding strategies, as well as other benefits of membership, including website support and buying power, but firms remain independent.⁴⁵

H) Multidisciplinary Professional Practices

As noted above, multidisciplinary professional practices have emerged in a number of western European jurisdictions, typically involving international accounting firms acquiring local legal affiliates. By virtue of the *Legal Services Act* of 2007 in the UK, multidisciplinary professional practices may now also qualify for an ABS license.⁴⁶ Where legal services are involved, the authorization of the Solicitors Regulatory Authority is required. Some multidisciplinary firms of accountants and lawyers have been approved. In Ontario, in contrast, under LSUC rules adopted in 1999 and 2000, multidisciplinary practices involving lawyers and non-lawyers are subject to two major constraints: first, the lawyer partners must be “in control” of the work undertaken by non-lawyer partners; and second, the services provided by the latter may only support or supplement the provision of legal services. In the case of a law firm that is affiliated with a non-legal entity such as an accounting firm, the rules require that a legal licensee shall own the professional business through which the licensee practices law; maintain control over the professional business through which the licensee practices law; and carry on the professional business through which the licensee practices law from premises that are not used by the affiliated entity for the delivery of its services, other than those that are delivered by the affiliated entity jointly with the delivery of the services of the licensee. An affiliated law firm cannot share revenues, cash flows, profits, or provide compensation for referrals with the non-legal entity with which it is affiliated.⁴⁷ More generally, LSUC rules prohibit

⁴⁴ Online: <<http://www.qualitysolicitors.com/>>.

⁴⁵ See <<http://files.qualitysolicitors.com/QualitySolicitors%20Info%20Pack.pdf>>.

⁴⁶ Charles Plant, *Our Proposals for Alternative Business Structures*, online: Solicitors Regulation Authority <<http://www.sra.org.uk/sra/news/plant-abs-proposals-speech.page>>.

⁴⁷ *Rules of Professional Conduct*, Rule 2.08(8), online: Law Society of Upper Canada <<http://www.lsuc.on.ca/WorkArea/DownloadAsset.aspx?id=2147489377>>.

fee-splitting between lawyers and non-lawyers outside the exception for multidisciplinary partnerships.

Similar rules have been adopted across a number of Canadian and US jurisdictions.⁴⁸ Both recent UK and Australian reforms on non-lawyer ownership of firms providing legal and other professional services stand in sharp contrast to the much more restrictive rules that prevail in North America. While the full or partial integration of accounting, related financial and management consulting, and legal services have attracted most of the attention in policy debates to date, many other combinations of professional practices are readily conceivable, including, for example, real estate agents, surveyors, mortgage financing providers and legal service providers in the provision of bundles of real estate-related services; or lawyers, financial advisors, and family counsellors in the family law area.

4. The Potential Economic Advantages of Alternative Business Structures

Part 2 of our paper reviewed two key economic areas of analysis that relate to organizational structure. First, we discussed the theory of the firm, which concerns the question of what kinds of economic activities will be organized within a firm, and what economic activities will take place outside firm boundaries. Second, we examined the economic advantages and disadvantages of various kinds of capital structures. Part 3 reviewed different business structures that are permitted within the present Ontario landscape, as well as alternatives that are permissible outside Ontario. In this section we bring the insights of the economic questions discussed in Part 2 to bear on the question of organizational structure of legal practice discussed in Part 3. The goal of the analysis is to gain greater understanding of the potential economic advantages of alternative business structures from a theory of the firm and capital structure perspective. In particular, we consider the typical models of firm practice both presently allowed, as well as alternatives that are not permitted in Canada but are elsewhere, with a view to understanding the economic advantages and disadvantages of each.

Before turning to a case-by-case examination of alternative models, we offer a number of preliminary observations. To begin with, from a purely economic perspective, it is not difficult to arrive at the conclusion that the optimal legal approach to the question of alternative structures for

⁴⁸ See Michael Trebilcock and Lilla Csorgo, "Multidisciplinary Professional Practices: Consumer Welfare Perspective" (2001) 24 Dal LJ 1; Kent Roach and Edward Iacobucci, "Multidisciplinary Practices in Partnerships: Prospects, Problems and Policy Options" (2000) 79 Can Bar Rev 1.

legal practice is to be broadly permissive. As is apparent from Part 1, there are a host of factors that affect the economic optimality of a given structure, factors that will vary in importance across business contexts, and even conceivably across individuals (some lawyers may be more risk-averse than others, for example). Economics would therefore tend to recommend wide latitude for choice: let the principals in a given practice adopt the model that works best in their circumstances. As we discuss further below, in making such choices, the principals would have economic incentives to account both for their own preferences but also those of their clients; all else equal, clients would not want to deal with a firm that has a structure that is not good for clients.

To some extent, therefore, the analysis that follows is unnecessary to establish the policy proposition that, from an economic perspective, there should be no restrictions on the business structures of legal practices. Even if it turned out that in practice individuals continued to voluntarily adopt conventional structures that are presently permitted, this would not be an argument in favour of restricting choice; rather, it would simply be an argument that choice may not lead to radical change or radical improvement in economic performance. The analysis that follows should be understood as providing the affirmative case for liberalization in that it offers concrete reasons to suppose that some particular structures may have advantages over others, depending on context, which in turn suggests that liberalization would bring economic advantages. In other words, it is not just that there is no economic argument opposed to liberalization, but also that there are reasons to expect economic gains from liberalization. The analysis does not claim to offer precise predictions about what structures would emerge in practice, or what the precise economic gains would be as an empirical matter. Rather, it offers reasons to suppose that liberalization has the potential to bring about real economic gains.

We appreciate, of course, that policy-makers may (and indeed should) consider factors other than economic gains when assessing optimal policy towards business structures. The rule of law has a fundamental role to play in society, and to the extent that business structures affect how lawyers support the rule of law, there are considerations related to the structure of legal practice that extends beyond dollars and cents. In what follows, we offer only a view of the economic costs and benefits of different structures, recognizing that there are other values that the law should take seriously. Our analysis is intended only to offer an input into answering the broad question of whether liberalization ought to be permitted, not an answer to that question.

That said, we note that some of the kinds of ethical considerations that have influenced policy towards business structures fit easily within an economic analysis. Take, for example, basic concerns about who bears liability for negligent legal services. It may be that the legal requirement of a partnership, and consequential personal joint and several liability for partners, including liability for negligence, is designed to promote the ethical performance of the lawyer's obligations. But there is an economic lens through which to view the requirement; clients want to ensure that the lawyer personally has incentives to ensure that the advice she and her partners gives is not arrived at negligently.

There will be economic incentives for a lawyer to adopt a form and liability status that maximizes the joint value of the relationship for lawyer and client. To explain, suppose that lawyers are not required by regulation to adopt a form that leads to unlimited liability for the lawyer, but that unlimited liability and the reassurance it provides is worth \$100 to a client. If the risk that the lawyer faces as a consequence of unlimited liability costs her personally less than \$100, say it costs \$40, she would prefer to have unlimited liability; she can charge the client up to \$100 more having adopted such status, while bearing costs of only \$40. There is a joint gain of \$60 from unlimited liability that will be divided between client and lawyer. On the other hand, if the risk of unlimited liability costs the lawyer \$120, she and the client are jointly better off with limited liability; the maximum price that the client will pay for the lawyer falls by \$100, but, for the lawyer, better this than incurring costs of \$120 by adopting a partnership and unlimited liability. While it will depend on the circumstances, including the information set that clients and lawyers have, it is possible that lawyers would have economic incentives to adopt unlimited liability. To the extent that unlimited liability is desirable in promoting ethical behaviour, economics and ethical considerations align with one another.

It is clearly not true, however, that economic actors always have private economic incentives to pursue what amounts to an ethical course of action. For example, there may be weak private economic incentives to fulfill ethical obligations to third parties, such as the courts and the public, since by definition the client is not willing to pay for such conduct. But the example demonstrates two important points. One, ethical considerations may also be relevant for economic decision-makers, especially where they concern the lawyer-client relationship. Two, parties often have private incentives to adopt terms in their relationship, including the form of the law firm and corresponding liability features, that maximize joint value. There are qualifications to this second point. For example, the form that a lawyer adopts will affect all clients that it interacts with so the lawyer

cannot maximize value from the business form in respect of all clients at all times. Moreover, clients may sometimes not have good information about the implications of the form that the lawyer adopts. But economic analysis suggests that there will be important incentives for the lawyer to choose the best form from a value perspective across clients.

Before embarking on the structural analysis, it is also worth observing that the strength of the case for liberalization will depend on other significant institutional questions. To take an example, consider how standardized substantive law is across varying circumstances. One could imagine rules of broad, mechanical application on the one hand, versus narrow standards that depend significantly on all the facts of a particular case, and ultimately on the judgment of a legal decision-maker, on the other hand. Now consider the efforts of a legal services provider to establish a technological means to provide legal advice. If the law is broadly applied and depends on mechanical application of clear criteria, it would be relatively straightforward for a provider to invest in a web-based application that could provide advice.⁴⁹ This in turn might call for a certain kind of firm structure that would be suitable for relatively significant investment in technological capital, and less need for human capital (we discuss this further below). On the other hand, if the law is idiosyncratic and depends on an exercise of judgment that may be difficult to predict, technological solutions, and the kinds of structures that are suitable for such solutions, are less likely to emerge in a liberalized environment.

Another, more prosaic consideration that will influence the choice of structure in practice is tax law. Tax law may favour some structures more than others. Incorporation, for example, can in effect allow principal shareholders to defer paying personal taxes on income by allowing retained earnings to accumulate within the corporation without tax at the shareholder level. We cite the tax and the technology examples not because they necessarily have special importance but simply because they illustrate the kinds of considerations that will influence the choice of structure. The choices are not made in an institutional vacuum.

As a further observation on the specific question of tax, we in general will not spend much time assessing the tax implications of different business structures. This is not because tax is an insignificant consideration in practice when actors are establishing different business structures.

⁴⁹ Existing online service providers, such as LegalZoom, tend to focus on less idiosyncratic legal questions, such as incorporating a business, though also offer individualized services where applicable.

Rather, we focus on non-tax considerations because they are, in our view, more important as a policy matter. Policy should be concerned about real economic gains to society, while tax minimization may not do anything positive for society. For example, it could be that the corporate form would better allow lawyers to minimize their tax liability relative to partnerships, but we would not view this, as a public policy matter, to be an advantage of the corporate form.

There is one final observation that we will make before turning to an economic analysis of particular structures. The case for liberalization of business structures is sometimes said to rest in part on the effect of such liberalization in enhancing competition among legal service providers. In Australia, for example, it was the competition authority that was largely responsible for pressing the case for liberalizing the rules on law firm structures; in the UK, the Office of Fair Trading had adopted a similar stance. In our view, however, the relationship between the rules restricting the structure of permissible legal practice and competition are tenuous.⁵⁰ As a preliminary observation, it is important to distinguish between two related but conceptually distinct restrictions on legal practice. First, there are restrictions on who is authorized to practice law. Second, there are restrictions on the kinds of business structures that those who practice law may adopt. It is not difficult to see how these two kinds of restrictions are related to one another, but they should not be elided. They are related most clearly in the case of a multi-disciplinary practice. If there were, for example, no restrictions on who could practice law, then a lawyer and another professional (or non-professional) would be better able to form a business structure in which they both provide services without inviting concern about the unauthorized practice of law. Thus, the demand for alternative business structures would presumably grow if there were no restrictions on who is qualified to give legal advice.

The fact that restrictions on who is authorized to practice law and restrictions on alternative business structures are related does not imply that they raise the same issues. It could be entirely defensible, for example, to maintain licensing restrictions on the practice of law while liberalizing business structures. Some of the economic gains from liberalizing structure may not be realized fully with such licensing restrictions in place, but the potential benefits of a licensing regime, such as protecting the public from incompetent legal advisors, may justify such an approach.

⁵⁰ See Edward Iacobucci and Michael Trebilcock, "Self-Regulation and Competition in Ontario's Legal Services Sector: An Evaluation of the Competition Bureau's Report on Competition and Self-Regulation in Canadian Professions" (Report to the Federation of Law Societies of Canada, unpublished, November 2008).

It is apparent that liberalizing the permitted structures of legal practices does not itself enhance the competitiveness of the legal services market. Consider two states of the world, one in which business structures of legal practice are restricted, and another where they are liberalized. In the illiberal state of the world, there are a certain number of lawyers in a certain jurisdiction who are authorized to practice law. This number does not change with the liberalization of the choice of business structure, which in turn implies that the number of potential competitors for a particular service is unlikely to change significantly with the choice to liberalize. Indeed, if anything, it is conceivable that traditional restrictions on the structure of legal practice, such as restrictions on equity investment by passive outsiders, tend to keep firms relatively small, and with liberalization it would be conceivable that firms that provide legal services could become much larger. If legal firms were to grow post-liberalization, it would be conceivable that liberalization could *reduce* competition because of a diminution in the number of firms competing for business.

We would add that, as we have outlined in a different report, we are skeptical that the legal services market in Ontario suffers significantly from an absence of competition.⁵¹ As we observed, there are thousands of lawyers in Ontario seeking to provide legal services, and thousands of law firms as well. In addition, both para-legals and online legal forms providers⁵² are plentiful and compete in at least some dimensions with lawyers. The rates for providing certain legal work range considerably, from less than \$100 per hour for certain kinds of basic legal services, to more than \$1,000 per hour for services with more nuance and a need for highly specialized human capital. The rates do not vary because of a lack of competition, but rather in large part because certain kinds of human capital are rare, and those who possess certain qualities will realize significant returns to those qualities. Such returns do not amount to market power. For example, certain hockey players might realize large incomes, but this is not because there is a lack of competition to become such hockey players.

Indeed, because there are such significant competitive pressures in the existing legal services industry, the liberalization of business structure regulation is more likely to have a positive impact. Given that there is robust competition among firms, any innovation that allows the firm to economize in its provision of services would provide the innovator with returns that they would not realize under the status quo. Other firms will quickly imitate, also in pursuit of rare economic profits, and competition is likely to result in the diffusion of productivity-enhancing innovation across

⁵¹ *Ibid.*

⁵² See, e.g. <<http://www.lawdepot.ca/contracts/canada/Ontario/>>.

the legal services market. Because of competition, the fruits of the innovations will typically be passed along to the buyers of legal services. This not only produces the usual consumer surplus which results when a buyer of a product pays less than her maximum willingness to pay for that product, but also has the potential to enhance access to justice, which may have non-economic positive effects.⁵³

A final word on competition. Traditional restrictions on the financing of legal firms prevent firms from going to equity markets or issuing public debt. Firms finance through borrowing or partners' equity investments. Some have suggested that firms are likely to suffer from these restrictions in part because the bank lenders will appreciate that they face less competition from other capital sources and can charge higher rates as a consequence.⁵⁴ This is conceivably true, but will not be true as a general matter. If the banking sector is competitive, which is highly probable at least for loans to sophisticated law firms who could borrow from a wide range of banks, not just local ones, there will not be room for a given bank to charge supra-competitive rates. Only if there is a lack of competition within banking itself will the confinement of financing to banks result in supra-competitive prices for loans.

The gains that result from opening up financing choices thus do not in general rest on greater competition, but instead from a more suitable capital structure for the firm. Capital structure affects value in a number of ways, and choosing one instrument rather than another has implications for firm value. Liberalizing financing choices would not necessarily have a positive impact on competition, but rather a positive impact from better calibrated capital structures.

With these initial observations as background, we turn now to the economic analysis of different business structures for legal practice. We begin with traditional, and legally permissible, forms, and then consider alternatives. In each case we review the advantages and disadvantages of the form from a theory of the firm and capital structure perspective. We assume initially that lawyers must associate only with other lawyers within the firm and consider the advantages of different forms on this assumption. We then turn to examining the relative merits of multi-disciplinary organizations and firms in which non-lawyers may make financial investments.

⁵³ See Semple, *supra* note 34 .

⁵⁴ *Ibid.*

A) Sole Proprietorship

The most common form of business practice in Ontario is a sole proprietorship. The sole proprietorship has advantages and disadvantages from a theory of the firm and a capital structure perspective. On the theory of the firm, the sole proprietor has the strongest possible incentives to invest in the value of the firm. She does not share the proceeds of her investment with other members of the firm, and thus realizes fully the fruits of her investment over time. If, for example, she provided especially good service to a particular client in the hopes of improving the firm's reputation for high quality legal work, she would realize entirely the benefits of that investment and would not have to share it with partners. This enhances the incentives to make such investments. Similarly, any investment in growing the firm's client list is realized by her alone.

Having only one lawyer in the firm also reduces coordination costs within the firm. Coase's analysis of the theory of the firm observed that extra-firm transactions invite haggling and other costs, and observed that these costs are lower within a firm. While this may be true, within-firm costs are not zero, especially where there are multiple equity owners (such as within a partnership) and no single authority that can impose decisions on others within the firm. A sole proprietor thus minimizes intra-firm transaction costs.

There are, however, significant disadvantages of the sole proprietorship from a theory of the firm perspective. One relates to economies of scope. Clients with legal problems to solve often will have different requirements for specialization from their lawyer. The sole proprietor can either become a generalist to some extent and attempt to provide as wide a range of service as possible, or will play a role simply in referring clients to other specialists. In the latter case, there is a Coasean problem; the sole proprietor may wish to realize some benefit from the lawyer to whom she has referred business, but it may not be straightforward to enter into an arm's length agreement on how best to compensate for such referrals. Moreover, there may be legal restrictions on referral fees. The sole proprietor may settle for an informal reliance on reciprocity to deal with referrals outside the firm, which may not be optimal. At the very least, informal reciprocity may not provide the sole proprietor with strong incentives to invest in the relationship with the outside lawyer, especially where the referring relationship is likely to be asymmetric.

There may also be reputational incentive disadvantages to the sole proprietorship.⁵⁵ When performing services as a sole proprietor, the lawyer

⁵⁵ See Iacobucci, *supra* note 11.

potentially suffers a reputational loss if she provides low quality advice. On the other hand, she realizes fully the benefits of shirking on service, which include saving time, lower exertion, savings on on-line research tools, and so on. In a partnership with other partners, in contrast, when providing services, the lawyer gets a benefit from shirking, but risks a reputational loss to other lawyers in the firm, not just herself, by so acting; outsiders may blame lawyers in the firm generally for poor performance. The relative costs of shirking may therefore be lower for a sole proprietor than a partner. Clients that recognize these incentives may be less willing to deal with a sole proprietor. There is a disadvantage from a reputational theory of the firm perspective to a sole proprietorship.

Turning to considerations of capital structure, there is one striking advantage of a sole proprietorship from a financing perspective. Because she owns 100 per cent of the equity of the firm, the sole proprietor does not have incentives to make decisions that are good for her as an individual, but bad for equity investors as a whole. She bears entirely the economic effects of her decisions on the value of equity. The incentives to overconsume perquisites, for example, fall away entirely, while they would be more prominent if a decision-maker owned only a small fraction of a firm's equity.⁵⁶

On a related point, within a sole proprietorship, there is obviously no need for equity owners to monitor management to deter self-interested, wasteful decisions. The equity owner *is* the manager. This is itself an advantage of the sole proprietorship because investments in monitoring management are themselves costly.⁵⁷ That they are unnecessary in a sole proprietorship is an advantage of this form.

There are, however, significant disadvantages to the capital structure associated with a sole proprietorship. A sole proprietor bears entirely the risk of the firm's performance herself. If, for example, she specializes in an area such as real estate law, there will be significant fluctuations in business that are beyond her control. She would also bear the risk entirely if she were to make a positive net present value, but uncertain, investment. Consider the kinds of investments that are increasingly common in the legal landscape: investments in technology to provide better service to clients. For example, consider investing in a web-based tool that allows the sole proprietor to realize economies of scale in serving a significantly greater number of clients at significantly lower costs per client in providing advice about a will. There may be a significant capital cost associated with such an investment, not only with the technology, but also with the

⁵⁶ Jensen and Meckling, *supra* note 12.

⁵⁷ *Ibid.*

marketing of that technology. There may also be a significant risk that the cost will not be recovered if the application fails to catch on with clients. Even good investments in expectation do not necessarily turn out well. The sole proprietor bears all the risk of the investment paying off. Since individuals are typically averse to risk (this is why they buy insurance), the risk associated with sole proprietorships is a disadvantage from a capital structure perspective.

There is a related financing problem that sole proprietors face. Clients may sometimes have valid legal claims, but they are costly to litigate and outcomes are not certain. Lawyers can in effect invest in their clients' claims by adopting a contingency fee arrangement. Such a fee shifts significantly the risk of an unsuccessful suit from the client to the lawyer. This is another kind of risky investment for the lawyer; she gets paid, perhaps handsomely, if the suit is successful, but is not compensated for her costs and efforts at all if the suit fails. A sole proprietor who accepts a contingency fee arrangement bears the risk of the investment in the lawsuit herself; this is not desirable, all things equal, for a risk-averse individual.

There is also a problem for sole proprietors who are capital-constrained. Suppose that a sole proprietor has identified a positive net present value investment, such as the web-based application discussed above, but has little capital herself. The only outside funding that is available for a sole proprietor under present legal constraints is bank debt. For many kinds of capital, such debt may be entirely suitable. If the sole proprietor wishes to purchase the real estate where her office is located, for example, bank debt is a common source of financing for such transactions, in part because banks are in a good position to take security that allows them to assess their risks with some accuracy. But for other kinds of investments, bank debt will not be suitable. The business prospects of the risky web-based application is not something that the bank will be in an especially good position to assess, nor would there be much in the way of physical assets to treat as collateral, which would make it reluctant to lend to a capital-constrained sole proprietor.

Moreover, such an investment may have a decidedly uneven pattern of returns, which makes traditional debt financing less appropriate. For example, if the investment fails 90 per cent of the time, but pays off so lavishly 10 per cent of the time that it is worthwhile overall, steady repayment of bank debt may be impossible. Rather, the bank will either receive a payment 10 per cent of the time, or very little 90 per cent of the time. This resembles more of an equity investment than a loan (indeed, the required interest rate to make the loan profitable for the bank despite a 90 per cent failure rate may be so high that it could be usurious), but the bank

would not have the same governance levers over the firm associated with typical equity investments, and may not be willing to make such a loan. At the very least, the fact that bank debt almost never finances analogous risky ventures that do not face legal constraints on their financing (venture capital, for example, is typically structured with equity investments) suggests that the requirement that the sole proprietor only raise outside capital through bank debt is costly. This is especially true as the risk of the potential investments the sole proprietor might make increases.

Note that there is an advantage to the sole proprietorship from a debt financing perspective that is the positive flip side of the disadvantages of risk. Sole proprietors are personally liable for all the debts of the practice; there is no separate legal entity and the debt of a sole proprietorship is the debt of the sole proprietor. This liability, while exposing the lawyer to greater risk, has its advantages. For one, unlimited liability mitigates concerns of lenders that the borrower will take on excessive risk. As discussed above, if a firm owes a significant amount of debt to creditors, equity-holders enjoying limited liability may be tempted to exercise their control over the direction of the firm by assuming significant risk; if the risk pays off, equity-holders largely realize the upside; while if the risk fails to pay off, equity-holders impose losses on creditors. With unlimited liability in place, the temptation to assume excessive risk is mitigated. If a sole proprietor increases the risk of the firm in the face of debt, she herself faces the risk of losing all her personal wealth in paying back creditors.

Of course, the strength of unlimited liability in disciplining the sole proprietor depends on the amount of her personal capital. If she has little in the way of personal assets, then the commitment to pay her personal assets to creditors matters less for her incentives to ensure that creditors are paid (though the commitment will always matter to some extent given that personal bankruptcy is costly, especially for lawyers who may suffer as a professional matter from such an outcome). This implies that concerns about excessive risk because of debt would be more likely to arise in the particular circumstances where borrowing is most important: where the sole proprietor herself has little in the way of capital to contribute.

Another related advantage of unlimited liability concerns the sole proprietor's clients. Clients will want the lawyer to bear costs from providing services negligently. If the sole proprietor faces unlimited liability, she in effect offers her personal assets as a kind of bond to the client; in the event of malpractice of some kind, the client is able to recover in any civil action from the lawyer's personal assets beyond any required or assumed liability insurance. Unlimited personal liability may not be the optimal way of providing assurance to clients (liability insurance may be

more transparent, for example, since clients do not have to determine themselves what the lawyer's personal assets are worth), but it is an advantage of the sole proprietorship, all things equal.

B) Partnership

The legal framework governing legal partnerships is similar to that of sole proprietor, the difference simply resting in the number of lawyers in the firm. The difference in numbers, however, may have significant effects from a theory of the firm and capital structure perspective. In this subsection, we review the factors discussed in the context of the sole proprietor, noting how the addition of partners affects the analysis.

Consider first the theory of the firm. With a legal partnership, rather than a sole proprietor, responsibility for making investments in the value of the firm (its reputation, for example) is spread across individuals, rather than resting with a single lawyer. Moreover, governance of the firm is spread across lawyers, it being a hallmark of a general partnership that each partner is presumed to have a role to play in management. This increases intra-firm transaction costs. The combination of diffuse incentives to invest in the firm and diffuse authority creates trade-offs. If left to their own managerial discretion, each partner has too little incentive to make investments in the partnership's productivity; she bears the costs of the investment, but shares the benefits with her partners. Centralizing authority, and monitoring the investments of each partner in the partnership, may mitigate the underinvestment problems, but at the same time will consume resources in order to coordinate authority.

In light of the importance of individual investments in the firm's productivity, firms may strive to achieve certain cultures.⁵⁸ Such a culture may usefully indicate to each partner (and associate, for that matter) how it is that she is expected to behave, and the existence of such a culture also allows for informal monitoring to ensure that partners are compliant with the norms of the firm. To the extent that a firm is successful in generating such a culture, this reduces the costs of governing the firm, and better ensures that each lawyer has good incentives to make private investments in the value of the firm.

While not insuperable, as the existence of major national and international law (and accounting) partnerships demonstrates, the difficulties of coordinating governance grow as the firm grows. At the limit, a sole proprietor is able to invest and otherwise make decisions while fully internalizing the value to the firm of such choices, and is able to do

⁵⁸ See e.g. Daniels, *supra* note 9.

so without coordination and managerial costs. The more partners that are added to the firm, the less does each partner internalize the value of her investments in the firm, and the more difficult is the firm to manage. Successful firm cultures may mitigate these problems, but such cultures may be more difficult to develop and maintain the larger the partnership.

There are also, however, advantages from a theory of the firm perspective the larger a firm is. Since lawyers tend to be specialized, the more lawyers a firm has, the wider the potential scope of the firm's expertise. To the extent that clients have different kinds of legal problems, a partnership will be able to provide a wider range of services to a client than a sole proprietor.

There is another way of putting this point about specialization. A sole proprietor would often have to refer clients to other lawyers that are able to provide service that she cannot. As noted above, it may not be straightforward for the sole proprietor to realize the value of such referrals. In contrast, partners that in effect refer work to one another are better able to realize the value of such referrals by sharing in the firm's profits.

As a final point on the theory of the firm, partners may be better able to sustain reputations for quality service than sole proprietorships. As discussed, when a partner performs her work, she would realize short-run gains from shirking on that work, but would jeopardize the reputations of all lawyers in her firm, whereas a sole proprietor only has her own reputation at stake. As a consequence, there are stronger incentives for the firm as a whole to maintain a reputation for good quality work.

From a capital structure perspective, in general, each additional partner dampens the connection between the partner's efforts on behalf of the firm and the personal profits that she realizes. As the partnership grows, each partner's average percentage equity stake in the firm falls, which implies that she will in general realize an ever smaller personal return from her efforts. Partnership agreements can be struck in a manner that results in imperfect sharing, but to the extent that costs and revenues are spread across partners, the more partners there are, the weaker the connection between any given partner's efforts and her share of the firm's profits. This, all things equal, dampens incentives for partners to make efforts to maximize the firm's profits, and is thus a disadvantage of the partnership relative to a sole proprietorship from a capital structure point of view. The firm will either suffer from inefficient, self-interested decisions by its partners from time to time, or it will incur expenditures in establishing some sort of governance system that helps discipline partners. Either way,

the firm suffers costs as a consequence of the diffusion of equity ownership across partners.

That said, partnerships nevertheless maintain some incentives for performance by allocating equity interests to the partners. Each partner is at least a part-owner of the firm, and as a consequence benefits to at least some positive extent from good performance. This contrasts with other organizational forms, such as corporations, in which managers within the firm need not have any ownership interest at all.

A key advantage of more diffuse equity ownership in a partnership is that partners are better insulated against risk than they are in a sole proprietorship. As Gilson and Mnookin observed, there is little reason to suppose that partners within a firm are all likely to have the same demand for their services at any point in time.⁵⁹ Certain specializations will be in higher demand than others at any point in time because of the business cycle; for example, securities lawyers will be in higher demand in boom times, while bankruptcy lawyers will be busier when the economy is slower. By forming a partnership in which partners agree to share annual profits, securities lawyers and bankruptcy lawyers can spread the risk associated with their relatively narrow specialties. In general, one can think of the law firm as allowing lawyers to diversify their risks across the business of the partners as a group. Each lawyer will not suffer from extremes of boom or bust, but rather will share some of the profits of the boom with their partners, while benefiting from their partners' business when their business is weaker. Since individuals tend to be risk-averse, a steady return is better than realizing extremes. This is a significant advantage of a partnership over a sole proprietorship.

An offsetting consideration is that sharing across partners may discourage individual lawyers from working as hard as they would if they realized profits for themselves from their efforts. Moreover, a sharing rule may tempt the successful lawyers realizing significant profits to split from the firm and form another firm. These are clearly costs associated with the risk-spreading effect of sharing among partners. Gilson and Mnookin suggest, however, that departing partners would potentially suffer by losing the reputational advantages that partnership at a respected firm provides; this may induce them to stay.⁶⁰ In addition, other considerations, such as firm culture,⁶¹ may help respond to the shirking temptations that

⁵⁹ Ronald Gilson and Robert Mnookin, "Sharing Among the Human Capitalists: An Economic Inquiry into the Corporate Law Firm and How Partners Split Profits" (1985) 37 *Stan L Rev* 313.

⁶⁰ *Ibid.*

⁶¹ Daniels, *supra* note 9.

are associated with sharing. Sharing also avoids the opposite temptation for partners that would arise with individually-based compensation to hoard clients and profits to themselves, even if the client were better served by a different partner.

The pooling of risk that the larger partnership allows also better supports risky investments by the firm. Consider the example of a significant capital investment in a web-based software application for writing a will, or of investing in a client's costly lawsuit by accepting a contingency fee arrangement. Setting aside debt for the moment, a sole proprietor would have to devote her own capital to fund the project, which exposes her to considerable risk, even if the project is a good one in expected terms. Partners, on the other hand, are able to share the costs of the project, which reduces their exposure to risk. To take a simple example, suppose that the investment requires \$100,000. Suppose further that each of ten lawyers has \$100,000 that they could invest. If each were a sole proprietor, they would each bear the full risk of the investment. But if the ten lawyers are in a partnership, each can invest \$10,000 in the project, and invest \$90,000 in other, diversified investments. While in both cases they have invested \$100,000 in potentially risky investments, only in the latter case are they diversified. Risk-averse investors are better off with diversification, and this is an advantage of a partnership relative to a sole proprietorship.

Another advantage of partnerships relative to sole proprietorships is that there will be more equity capital available with a pool of equity partners to draw upon. The example just discussed assumed that each lawyer had \$100,000 to invest. If the lawyers do not have so much capital to invest, then there is another advantage of partnerships: they are less likely to be capital-constrained. Without equity investment available, the firm would have to borrow, but, as noted above, risky, illiquid capital investments such as the web-based application are not typically suitable for loans. Sole proprietors are more likely to have to forgo positive net present value investments than partnerships.

There is an advantage of partnerships when it comes to debt financing that is similar to that of sole proprietors: partners are jointly and severally liable for the debts of the partnership, which mitigates the incentives that the firm would have to make risky choices after they borrow. If there is limited liability, creditors bear downside risk, which can lead to excessive risk by managers looking out for the interest of equity investors. With unlimited liability, on the other hand, partners bear downside risk as well as upside, the temptation to invest in risky investments is mitigated, and lenders, anticipating this, may be more willing to lend.

As with the analysis of the sole proprietor, the commitment to lenders that unlimited liability provides depends significantly on the assets that are available from the partners. All else equal, it would be reasonable to expect that a larger partnership of lawyers will have more assets in total available for creditors than a sole proprietorship, which is another advantage of the partnership. Of course, if some partners have fewer assets than others, there may be differing attitudes within the firm itself about risk, which in turn may create governance frictions within the firm. But for a lender, more partners, and thus more assets to back a loan, will be welcome.

Clients may also benefit from the unlimited liability of the partnership. They are better assured that if a lawyer at the firm engages in misconduct, and the client sues as a consequence, there will be assets available to compensate them. This is welcome from the client's perspective because the fact that the lawyer's personal assets are at stake is likely to induce the lawyer to take greater care both in her own work and in monitoring her partners. Moreover, the client is more likely to be made whole if there is such a suit because the partnership has multiple lawyers' assets available to creditors, including judgment creditors. The presence of unlimited liability is not necessarily superior to liability insurance, and in fact may be less reassuring to clients given opacity around the partnerships' personal assets, but it does serve as a useful commitment to clients and other potential creditors.

C) Limited Liability Partnership

A key difference between a limited liability partnership and a general partnership is that in the former case, lawyers are not jointly and severally liable for the negligence of their partners. Another is that while the property of the partnership is available to satisfy the partnership's debts generally, there is limited liability to creditors with respect to the partner's personal assets. We will discuss each feature in turn.

All else equal, the limitations on partner liability are less attractive to clients for two reasons. First, since they do not have personal assets at stake, it lessens the incentives of partners to monitor their partners to ensure that they are providing quality service. Second, it reduces the assets available to compensate clients who have received negligent service (because of this feature, mandatory insurance requirements are in place in Ontario and elsewhere as a professional requirement for forming an LLP). On the other hand, a limited liability partnership has the merit of reducing risk that lawyers are subjected to from their partners' misconduct, over which they may have relatively minimal control, while ensuring that each lawyer continues to stake her personal assets to her own clients. The LLP

will be adopted where the gains to the lawyers from lower exposure to risk exceed the losses to clients from having a smaller pool of assets available to compensate for negligence. In such cases, clients may insist on lower fees to compensate for the smaller “bond” that personal assets provide, but lawyers would be willing to offer this discount because the reduction in risk that they enjoy makes it value-enhancing to do so.

Turning to limited liability with respect to creditors other than negligently-served clients, there are again economic benefits and costs for lawyers and creditors. An advantage of limited liability is that the lawyer does not bear the risk of pledging personal assets to creditors. A lawyer has whatever personal assets she has invested in the partnership at risk, but does not have to go further and put all of her personal assets at risk. Individuals are risk-averse, and unlimited liability imposes costs of risk on the lawyer. Within an LLP in which lawyers are not committed to unlimited liability, the lawyer caps risk and avoids these costs. This is an economic benefit of the LLP relative to a general partnership.

The economic benefit of limited liability may manifest itself in different ways. For example, if the lawyer were to behave in exactly the same way in making investments, she would not bear as much cost from risk as she would without limited liability. But the lawyer may also be able to invest in intrinsically riskier projects knowing that her personal assets are not at stake when she does so.⁶² Consider again the investment in a web-based application. Suppose that the firm has a line of credit for working capital, but cannot obtain bank debt for reasons given above for the application investment. If the firm invests its capital into the application but it fails, thus jeopardizing the firm’s ability to pay off its line of credit, a partner in an LLP will not be liable personally on the firm’s line of credit. This better encourages the partnership to make the risky investment than would be the case in the face of unlimited liability.

This is not to say that limited liability is therefore optimal. Limited liability simply shifts the risk from the partners to creditors; the question of optimality turns on who is better equipped economically to bear this risk. Creditors will be concerned that, since they do not incur the downside risks of their investments but rather shift them to creditors, lawyers in an LLP will take on more risk than is optimal. Moreover, creditors may not be in a good position to assess the risks that the lawyers take on, which also leaves the creditors vulnerable to uncompensated risk.

Whether limited liability is optimal will depend on the relative costs of risk when borne by the lawyers as opposed to their creditors. Given the

⁶² See e.g. Hadfield, “The Cost of Law,” *supra* note 1.

economic incentives for lawyers to make value-increasing choices of business structures, it is noteworthy that adoption of the LLP form has become popular in the Canadian landscape in recent years. This is suggestive of its efficiency relative to the general partnership.

D) Professional Corporation

A professional corporation has the same strengths and weaknesses of the LLP, but for one difference: under the professional corporation in Ontario, the professionals who are also the shareholders remain jointly and severally liable for the damages caused by the firm's negligence. The professional corporation thus combines the joint and several unlimited liability attributes of a general partnership when it comes to liability for negligence with the limited liability attributes of an LLP when it comes to liability for other debts. As noted when discussing the general partnership, unlimited joint and several liability better assures clients of non-negligent service by encouraging partners to monitor one another, and also provides better assurance to clients of being made whole if negligence were to occur. But such liability causes each partner to bear risk over which she may have only limited control, and this is costly for risk-averse individuals. Limited liability for other debts, as discussed in the context of LLPs, also presents trade-offs. An advantage is that partners bear less risk from uncertain investments. A disadvantage is that creditors may not be as well placed to assess firm risks, and moreover by imposing downside risk on creditors, firms that borrow may be inclined to take on too much risk. The professional corporation is a hybrid of a general partnership and an LLP, and its economic merits and drawbacks reflect this combination.

E) Business Corporation (Limited Liability)

If a sole proprietor is at one end of the organizational spectrum, the business corporation is at the other. In this section, we consider the economic advantages and disadvantages of this form. As with previous discussions, we continue to assume that lawyers must be the equity investors in the firm; we consider below the prospect of non-lawyer equity investors.

The key difference, and the one that we therefore focus on in this section, between a business corporation on the one hand, and the partnership, LLP and professional corporation on the other, is that the lawyer-shareholders in the corporation are not liable for any unpaid debts of the corporation, including debts to clients who have successfully sued for negligence. This has advantages and disadvantages from a capital structure perspective. An advantage is that the lawyer-shareholders are not

exposed to risks over which they may have relatively little control, namely, the risks of misconduct of fellow lawyers within the firm. Unlike other structures such as an LLP, the lawyer in a corporation is also potentially protected from personal liability for her own negligent actions, the possibility of which would also expose her to costly risk and uncertainty.

We say that the lawyer is “potentially” protected because the limited liability status of a corporation does not necessarily protect individual tortfeasors within the corporation from personal liability for their torts.⁶³ The difference with a corporation is that the lawyer cannot be held personally liable for the torts committed by the corporation generally. Lawyers’ personal assets are better protected in a corporate structure than in any of the other structures, which mitigates risk that they bear.

The disadvantage of full limited liability is that clients can no longer rely on the bond that pledging personal assets effectively implies; lawyers with less risk of personal liability may be less inclined to take care. Moreover, lawyers not financially responsible for the misconduct of their colleagues will be less inclined to monitor their colleagues, which may also lead to less care for the client. The risk mitigation benefits must be weighed against the weaker incentives to take care in order to assess the net gains from incorporation.

Given the starkest limitation on personal liability that the corporation presents, this is a useful juncture at which to review the implications of insurance. While alluding to the possibility of liability insurance, we have generally treated the prospects of liability in, say, a general partnership as creating risk for lawyers. In reality, lawyers may take steps (and indeed by regulation may be obliged to do so) to mitigate this risk through insurance. This does not eliminate the conclusion that lawyers bear costs if there is potentially personal liability. For one thing, lawyers must pay for liability insurance, which is a cost resulting in part from personal liability. For another thing, insurers may risk rate the particular lawyer. This has other implications. First, the insurer may itself monitor the lawyer to some extent to minimize the chances that the lawyer behaves negligently; this substitutes to some extent for limited incentives to take care that the threat of personal liability would otherwise generate. Second, a lawyer that has an incident on her insurance record may have to pay greater premia in the future, which implies some personal risk associated with negligence. As a final point, insurance contracts will typically include both deductibles and maximum liability for the insurer. This also implies that the lawyer will

⁶³ See *ADGA Systems International v Valcom Ltd* (1999), 43 OR (3d) 101 (CA). We would also note that lawyers would presumably remain subject to professional discipline even if practicing within a corporation.

bear residual risk. In short, liability insurance does not negate the conclusion that personal liability exposes the lawyer to risk that she would not face in a corporate setting.

F) Non-Lawyer Ownership

We have reviewed the basic structures that law firms may currently adopt, as well as a limited liability business corporation, which lawyers in Ontario cannot form. We have restricted the analysis by assuming that only lawyers can own equity in the firm, an assumption that is much less apt in liberal jurisdictions like Australia and the UK. Ontario itself allows for multi-disciplinary partnerships, but imposes important restrictions such as a requirement that lawyers control the firm. In this section we consider the potential economic advantages and disadvantages of liberalizing rules concerning non-lawyer equity ownership of a law firm. We begin by focusing on the theory of the firm, which discussion can be conducted without significant emphasis on the particular legal organizational form (such as partnership or corporation) that the firm with non-lawyer equity-holders adopts. We then turn to capital structure, which will include a more detailed discussion of form.

There are two kinds of non-lawyer ownership worth considering. Non-lawyers may themselves bring professional credentials to the firm, or they may be simply passive financial investors. The theory of the firm advantages largely arise with the former kind of equity-holder. Allowing non-lawyers to own equity in a firm that includes lawyers has several possible economic advantages. From a Coasean perspective, there are potentially significant savings in transaction costs resulting from non-lawyer equity owners. Take the example of a client that requires both legal and accounting advice on a given matter. If a lawyer and an accountant are equity-owners in the firm, each realizes an economic benefit when the other is retained by a client. This creates economic incentives for one to refer business to the other without complicated referral contracts, even if permitted. Moreover, when working for the same client on a file, it is likely that the lawyer and accountant will be better able to coordinate their actions if they are both within the same firm than if they practice independently.⁶⁴ This creates productivity gains, and also in all probability lowers the transaction costs of the client, who is able to engage in one-stop shopping.

Moreover, if the lawyer and accountant both have equity stakes in the firm, this encourages personal investments in general assets of the firm, including its reputation. For example, an ownership stake in the accountant's

⁶⁴ See e.g. Trebilcock and Csorgo, *supra* note 48.

future billings would encourage the lawyer to be especially willing to take extra steps to enhance the reputation of the accountant, through referrals if nothing else. To the extent that multi-disciplinary firms tend to have a larger number of partners, having both the reputation of both accountants and lawyers at stake in the firm's work may also create stronger incentives to maintain a reputation for quality work; more professionals' reputation is in jeopardy when the firm performs its work.

It is worth noting an additional potential gain from adding non-lawyer professionals to a firm that practices law. Non-lawyers may not be themselves members of a regulated profession, but may simply be professional business managers. There is no reason necessarily to conclude that lawyers will be the best managers of legal practices. An advantage, then, from allowing non-lawyer equity-holders is that it would allow non-lawyers to manage while owning equity stakes in the firm that incentivize them to do a good job. This is another theory of the firm advantage of non-lawyer equity ownership: non-lawyer managers may have the ownership stakes that provide them with economic incentives to invest in firm value.

There are clearly potential economies from a theory of the firm perspective in allowing non-lawyer equity investment, but there are potential costs as well. The larger and broader a firm's practice, the lower the costs of coordinating action outside the firm through contract, but the larger the costs of coordinating within the firm. There could be difficulties in coordinating behaviour across members of the firm as it grows in size and scope, especially if there are cultural differences between different professions. For example, professional managers may not have the same understanding of a lawyer's sense of ethical responsibilities, which could create intra-firm conflicts and consequential costs. Other costs may include a temptation for each member of the firm to refer clients to their own firm's professionals when in fact the client's circumstances may call for a different provider. That is, some credibility of the referral may be lost if referrals are intra-firm.

It is therefore not necessarily the case that non-lawyer equity ownership leads to economic gains on net, though such ownership clearly allows some expected economic benefits from a theory of the firm perspective.

The next set of issues to consider are the economic costs and benefits of non-lawyer equity ownership from a capital structure perspective. Given the analysis above, the most illuminating context in which to examine this question is one that departs most significantly from the contexts discussed already, which is one in which there are no restrictions on the form or

ownership of firms that offer legal services, as in Australia. And the most useful scenario within this context to consider is passive, non-lawyer, financial investment in equity.

Passive investors by definition do not directly affect the day-to-day activities within the firm, but may significantly alter the capital structure of the firm and thus affect the firm's performance in carrying on business. There are two prominent advantages of outside equity ownership. First, outside shareholders may provide capital to the firm that would be very difficult to raise from capital-constrained professionals within the firm, or from banks. As discussed above, many investments are not suitably financed with debt. An investment in technology such as the web-based application discussed above is not a good candidate for debt financing; its returns are highly variable and uncertain, and moreover bank lenders may not be in a good position to assess its worth (and there may not be any physical collateral to offer as security). Equity investment in technology start-ups is suitable, however, and indeed is common. There may be expert investors in the technology space, venture capitalists for example, that are not only capable of valuing a prospective investment, but once having made the investment may be able to offer management advice, thus adding non-lawyer management skills to the mix.

Outside investors may also be in a position to finance risky investments in lawsuits by a firm that has entered a contingency fee arrangement. A firm may be willing to take on such a fee arrangement, but may not have the capital to finance the suit. Because of a highly variable outcome and uncertain cash flow, as well as a difficulty in valuing the suit, banks may be unwilling to lend. Equity investors may, in contrast, be willing to assume uncertainty in returns, and may either have or develop expertise in valuing such suits. Law firms that would otherwise not be able to finance contingency-fee based lawsuits may be able to do so in the presence of non-lawyer equity investors.

On a related point, even if lawyers or other active professionals within a firm could conceivably raise the capital to pursue a risky investment such as a technological investment in law, or an uncertain lawsuit on a contingency fee, doing so exposes equity-holders to risk. This is especially problematic for sole proprietors and small firms, but even for larger firms, partners may bear considerable risk. In contrast, at the limit, a law corporation could be publicly traded with literally thousands of investors, each with small stakes in the firm. Such investors are much better placed to diversify the firm's risk than the inevitably smaller number of equity-owners at a firm without outside passive investors. This is a feature of potentially great importance in facilitating risky investment by law firms.

Allowing passive non-lawyer investment opens up a range of capital structures that could alter radically the economics of law firm capital structures. We have discussed the theory of the firm benefits of having both lawyer and non-lawyer equity-owners. There may, however, be advantages on net if lawyers were not to own equity at all, and a firm instead is financed by non-lawyer shareholders. For example, if lawyers have a comparative advantage in providing legal advice and not managing a business, it may be better to have a business owned and managed by non-lawyers, with lawyers serving as employees but not shareholders. Non-lawyer managers may provide the entrepreneurial skills that the firm requires to be successful, while lawyer employees provide the legal expertise.⁶⁵ Such a model would probably be especially suitable for a firm that relied heavily on technological solutions to support the provision of legal advice; non-lawyer entrepreneurs may have the skill set, and finances, to manage and fund the firm, while lawyer employees provide the legal advice that may underpin the development and operation of the technology. To draw an analogy, it is not unusual for technological entrepreneurs to provide a vision and business skills at a tech start-up, while relying on engineer employees, perhaps motivated by stock options, to actually create the technology. This may also be an appropriate model for legal practice: lawyers bring their human capital to the firm, but leave financial capitalization to others who may be better placed to bear the risk of the firm's success, perhaps because they can diversify more easily, perhaps because bearing such risk allocates to them appropriate incentives to manage the business. We observe that such a model has in effect been adopted in Australia at Slater and Gordon, which has a very large complement of lawyer employees, but is publicly traded.

In the context of publicly listed firms, the limited liability associated with a corporation assumes stark advantages relative to other possibilities, such as joint and several liability among shareholders. In the absence of limited liability, the value of a share may depend in part on the identity, and more specifically, wealth, of fellow shareholders.⁶⁶ This makes valuing a share costly, and undermines the value of a public listing. Moreover, the separate legal personality of a corporation allows clear "asset partitioning;" the assets of the corporation are owned by the corporation as an

⁶⁵ See also Hadfield, "The Cost of Law," *supra* note 1 (observing that non-lawyers will often have the technological insights necessary for innovation in the legal services market).

⁶⁶ See Jensen and Meckling, *supra* note 12; Paul Halpern, Michael Trebilcock, and Stuart Turnbull, "An Economic Analysis of Limited Liability in Corporation Law" (1980) 30 UTLJ 117.

independent legal entity, thus avoiding blurry lines between business assets and personal assets of investors.⁶⁷

There are, naturally, economic disadvantages associated with outside equity ownership. Most prominently, lawyers that do not own equity in the firm will not have the same incentives to work to increase the value of the firm as lawyers in a partnership. There is a cost to incentives from diversifying the risk of a firm across passive investors. Indeed, because of this, clients may be reluctant to engage lawyers that do not have a stake in their firm. One possibility to respond to this concern is for a controlling shareholder to emerge that, because of its stake in the firm, has a strong incentive to monitor management to ensure that the lawyers in the firm's employ are providing service optimally.

Other possibilities include the emergence of hybrid ownership solutions, such as the franchising possibility discussed above.⁶⁸ In a franchise, the overall business model and firm reputation (brand) is promoted by a franchisor. The franchisor corporation engages franchisees that have territories in which they provide the franchise system's product or service under the franchise system's brand. This system allows a centralized entrepreneurial team to create a business model that they in effect rent to franchisees in exchange for payment, including, typically, a share of the franchise's profits.⁶⁹ The primary advantage of the franchise system over a single entity model of a business with geographically distributed, but centrally owned outlets, is that the franchisee owns the equity in the franchise, which provides her with incentives to build the value of the local business. The franchisee benefits from the brand created by the franchisor, and the franchisor works to maintain this reputation by monitoring franchisees to ensure that they meet the system's standards.

Such a model could be successful in the legal context, just as it has been in the tax context as outlined in the H&R Block example alluded to above, and is off to a promising start in the legal context with the QualitySolicitors example from the UK. Local lawyers could own a local franchise to provide legal services, but a franchise system with non-lawyer investors could build the brand and relevant business solutions, such as technology applications that would be available to franchisees and their

⁶⁷ See, e.g. Henry Hansmann and Reinier Kraakman, "The Essential Role of Organizational Law" (2000) 110 Yale LJ 387; Edward Iacobucci and George Triantis, "The Legal and Economic Boundaries of Firms" (2007) 93 Va L Rev 515.

⁶⁸ For discussion of franchise contracts, see e.g. Gillian Hadfield, "Problematic Relations: Franchising and the Law of Incomplete Contracts" 42 Stan L Rev 927.

⁶⁹ See QualitySolicitors as an example of a network of independent firms: <<http://www.qualitysolicitors.com/>>.

clients. Moreover, it would be conceivable that the franchisor could help provide capital to fund risky, contingency-fee lawsuits led by a franchisee. Such a system could draw on entrepreneurial experts at the franchisor, who are incentivized through equity ownership to grow the profits of the franchise system as a whole, while allocating equity and profits to local franchisees to promote the local business.

As this discussion has demonstrated, liberalized ownership rules create the potential for the most gains from alternative business structures by creating a potential separation between the financiers of a legal business and the providers of legal advice within that business. While there are potential incentive problems that non-lawyer ownership might create, there are significant gains in raising equity capital to finance investment, and in allowing investors in law firms to diversify risk, that may offset these problems. Moreover, imaginative hybrid solutions, such as franchise systems, could attempt to exploit the benefits of non-lawyer entrepreneurship, while preserving lawyers' incentives to promote their personal practices.

There is no question that legal reform in the UK and Australia has led to interesting and significant innovations in legal structures. Publicly-traded law firms, such as Slater and Gordon, and networks of firms, such as QualitySolicitors, are prominent examples of such innovation. Evidence of the impetus to innovate can also be found within the more traditional regulatory framework of the provision of legal services. In North America, LegalZoom offers an innovative combination of online and in-person legal advice, while conforming with the more restrictive sets of rules governing business structures found there.⁷⁰ Removing the constraints that presently exist on alternative business structures would undoubtedly invite even further innovation.⁷¹ As Ray Worthy Campbell argues in a recent article on innovation in the US legal services market,⁷² drawing on business and

⁷⁰ See <<http://www.legalzoom.ca/>>.

⁷¹ Hadfield, "The Cost of Law," *supra* note 1 argues that the economics of reducing the cost of legal services for ordinary individuals makes clear that the scale of legal services delivery needs to expand dramatically to justify the fixed costs of investments in marketing, document production, consumer and legal research, information technology and firm management. In turn these functions require an expanded role for non-legal expertise as well as greater scope for diversifying the risks associated with such investments. In her view the limited liability corporation with non-lawyer shareholders is an essential mechanism for realizing economies of scale and specialization in servicing the needs of ordinary individuals.

⁷² Ray Worthy Campbell, "Rethinking Regulation and Innovation in the US Legal Services Market" (2012) 9 NYU J L & Bus 1.

economic literature on innovation in other markets,⁷³ disruptive (as opposed to sustaining) innovation rarely originates with incumbents, who are committed to existing resources, processes and values, but new entrants drawing on new sources of capital, technology, ideas, and business models that allow new types of products or services to be offered to non-consumers, consumers overshot by current offerings, or consumers underserved by current options.

Before concluding this section on the promise of alternative business structures for legal practice, however, a note of caution is appropriate. As Semple has pointed out, the rules on alternative structures have been very liberal for over a decade in Australia, yet the legal profession has not undergone a radical transformation.⁷⁴ There have clearly been innovations, such as the emergence of publicly traded law firms, but many traditional structures remain in place. For example, Semple observes that in New South Wales, where liberal rules have been in place the longest, the number of sole practitioners and small firms has *grown* in the last ten years.⁷⁵ In light of this evidence, it would be inappropriate to predict a sweeping revolution from liberalization in Ontario, but the analysis has shown that the potential for economic gains is nevertheless real. Even if only some firms attempt to adopt new models, this could nevertheless be of economic advantage to lawyers, their investors, and ultimately, clients.

5. Conclusion

One conclusion should be abundantly apparent from this review of the economics of ABSs: there is no single structure that is optimal across all contexts.⁷⁶ Rather, there are trade-offs with respect to every choice of form and capital structure, and the best resolution of each trade-off depends on the circumstances. The nature of a firm's clients in some cases may call for a general partnership; in others, a limited liability partnership. The nature of the service provided may in some cases call for a sole proprietorship, in others for a publicly-traded corporation. It is overly simplistic, therefore, to favour one form over others from an economic perspective.

The importance of context, however, does not imply that it is impossible to draw any meaningful policy conclusions from the analysis. It is clear that, from an economic perspective, there are potential gains from opening up options for business structures and associated capital

⁷³ See e.g. Clayton Christensen, *The Innovator's Dilemma* (NY: Harper Collins, 1997).

⁷⁴ Semple, *supra* note 34.

⁷⁵ *Ibid* at 46.

⁷⁶ See e.g. Iacobucci and Triantis, *supra* note 93.

structures. This itself makes an economic argument in favour of liberalization; even if most legal practices maintain traditional structures, if some firms benefit from innovative models, choice creates economic benefits. It is also fair to conclude that the gains from liberalization are most likely to materialize where a large capital investment is necessary for a firm to realize certain gains. An investment in a client's lawsuit through a contingency fee, for example, may generally be more efficiently financed with outside, financial investors than the handful of lawyers who may prosecute the suit. An investment in technology will also more probably be efficiently achieved by a firm with outside investors than a general partnership.

Liberalization predictably generates economic gains, but the size of these gains cannot be predicted with any certainty. Experience in the UK and Australia suggests that liberalization does invite change, although the pace of change appears to be much more evolutionary than revolutionary, at least to date.

We conclude by making observations about the impact of reform on key stakeholders – lawyers themselves, and clients. These effects would presumably have a significant influence on the politics of reform. As noted in the discussion of competition, changing the rules on alternative business structures does not itself affect the number of lawyers in practice in a given jurisdiction. It may, however, affect considerably the nature of the firms in which the lawyers practice. Individuals with significant economic stakes in existing firms may be threatened by reform. But such a threat to current firm structures should not be elided with a threat to the kinds of lawyers that practice at these firms. For example, consider a small-town sole proprietor with a general practice. Such a lawyer may predict that liberalization would result in a large corporation, perhaps a franchise system, encroaching on her business. Such a development would undermine the value of the equity of an existing lawyer in her sole proprietorship, but would not imply that the lawyer and others of her type will be out of business. Rather, the corporation will itself need lawyers, and the sole proprietor may shift from being an owner of her practice to an employee in a larger firm. While there may be short run dislocations in some instances, in the longer run new business models will generally emerge if they are more economically efficient than existing models. Greater efficiency means greater potential gains for lawyers, clients and investors alike. For example, lawyers may prefer simply to practice law rather than run a business; for them, status as an employee may be preferable to status as a sole proprietor. When considering the politics of liberalization, then, it is important not to confuse challenges to existing law firm structures with challenges to existing lawyers. Reform, while it may

threaten existing structures, may be welcome both for many clients and for many lawyers.

Moreover, the threat to existing structures should not be exaggerated. Experience elsewhere has demonstrated that liberalization may be entirely consistent with one-person and other small practices. For example, as Semple notes, the number of small firms has increased in the last ten years in New South Wales.⁷⁷ Neither theory nor experience suggests that lawyers will necessarily suffer economically under a more liberal regime.

Finally, to return to a point that we raised in the Introduction, our focus has been on the economics of alternative business structures, but economic gains are entirely consistent with the promotion of at least some non-economic values. Access to justice is a matter of concern in Ontario and elsewhere,⁷⁸ and high prices for legal services are clearly a major contributor to this concern.⁷⁹ If alternative business structures emerge in a liberalized regime, this is likely to reflect the economic gains that they generate. Moreover, given that the legal services market is highly competitive, it is probable that economic efficiencies realized as a result of liberalization would be passed onto clients and prospective clients.⁸⁰ It is possible, therefore, that the economic gains that liberalization tends to promote would in turn tend to promote access to justice.⁸¹ In this respect, at least, economic and non-economic social goals are aligned.

⁷⁷ Semple, *supra* note 34 at 46.

⁷⁸ See e.g. Michael Trebilcock, Anthony Duggan and Lorne Sossin, eds, *Middle Income Access to Justice* (Toronto: University of Toronto Press, 2012).

⁷⁹ See Hadfield, “The Cost of Law,” *supra* note 1.

⁸⁰ Again, the market would not become more competitive as a consequence of liberalization; rather, competition would simply tend to push any savings down to clients.

⁸¹ See Semple, *supra* note 34.