
The Law Firm as an Efficient Community

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There is a substantial debate among law and economics scholars as to why a large portion of economic activity takes place within firms rather than through individual market contracts. The participants in this debate have focused largely on the corporation, to the neglect of other forms of organisation such as the law firm, and have tended to generate economic-based theories which emphasize the importance of centralized control, ownership, reputational capital, or asset-specific investment as the source of the firm's relative efficiency over market contracts. This article contributes to the existing literature by insisting on the importance of communitarian values to the efficiency of the modern law firm. Viewing the law firm as a mini-society, the author suggests that the nature of a firm's culture will be, at least in part, determinative of economic success of the firm as a whole and the personal fulfilment of its members. After surveying the existing economic theories and their deficiencies, the author examines how the notion of firm culture supplies missing elements to the theory of the firm. The explanatory value and relevance of firm culture is then demonstrated through a case study of law firm mergers and the threat they pose to the long-term viability of the firm.

Pourquoi l'activité économique s'organise-t-elle à travers des associations, plutôt que de prendre la forme de marchés individuels? Cette question a suscité un vif intérêt au sein de l'école «law and economics», mais les protagonistes ont pour la plupart concentré leur attention sur le modèle corporatif, tout en négligeant les autres formes d'association telles le cabinet d'avocats. Les théories élaborées dans le cadre corporatif tendent à justifier la supériorité du modèle associatif par rapport au modèle du marché individuel sur la base de facteurs tels le contrôle administratif centralisé, l'intérêt matériel des membres dans le patrimoine de la société, la réputation de l'établissement et l'investissement de la société dans ses membres. L'auteur souhaite ajouter à la littérature existante en analysant le rôle des valeurs communautaires dans le fonctionnement des cabinets d'avocats. En effet, suggère-t-il, le cabinet ressemble à une mini-communauté, et la vitalité de sa culture sera au moins en partie déterminante de son succès économique et du développement personnel de ses membres. Après avoir exposé les diverses théories économiques et montré leur incapacité à fournir une explication entièrement satisfaisante du cabinet d'avocats, l'auteur montre que la notion de culture procure le complément nécessaire à une bonne compréhension de son fonctionnement. Il en donne une illustration concrète en analysant le phénomène des fusions et le danger qu'elles représentent pour la viabilité à long terme du nouveau cabinet.

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Introduction

Although, almost from the time that it was written, Ronald Coase's seminal article on the problem of social cost¹ received widespread attention,² the value of many of his other works was only slowly recognized. This was particularly

¹"The Problem of Social Cost" (1960) 3 J.L. & Eco. 1.

²According to A. Shapiro, Coase's article "would have qualified for the tabulation of most-cited articles if the Journal of Law and Economics was indexed by *Shepard's*" ("The Most-Cited Law Review Articles" (1985) 73 Calif. L. Rev. 1540 at 1546).

true of Coase's "The Nature of the Firm,"³ which, despite being written in 1937, did not receive serious consideration until the 1970s.⁴ However, in relatively short order, his central insight that firms arose as a way of economizing on the costs of market contracting became widely accepted, spawning a vast literature devoted to economic analysis of organizational forms.⁵ Interestingly, during the first decade and a half of its life, the new institutional economics was used only fleetingly to analyze the structure and the form of non-corporate organizational forms.⁶ Among the forms of organization neglected by mainstream institutional economists has been the modern corporate law firm, an oversight corrected only recently by Gilson and Mnookin,⁷ and Galanter and Palay.⁸ The lack of scholarly attention devoted to the structure of the corporate law firm⁹ contrasts markedly with the extensive attention that it has received in the popular press.

This article constitutes one more attempt to correct the neglect of the corporate law firm by law and economics scholars. The core claim of the article is that examination of the corporate law firm can yield important benefits, not only

³(1937) 4 *Economica* 386, reproduced in G.J. Stigler & K.E. Boulding, eds, *Readings in Price Theory* (Homewood, Ill.: Richard D. Irwin, 1952) 331.

⁴Coase himself has lamented that "The Nature of the Firm" is "much cited and little used" (R. Coase, *The Firm, the Market and the Law* (Chicago, Ill.: U. Chicago Press, 1988) at 62). The article was recently the subject of a special issue ((1988) 4 *J.L. Eco. & Organ.* 1).

⁵See, for instance, O. Williamson, *The Economic Institutions of Capitalism* (New York: Free Press, 1985) [hereinafter *Economic Institutions*]; *Markets and Hierarchies: Analysis and Antitrust Implications* (New York: Free Press, 1975); A. Alchian & H. Demsetz, "Production, Information Costs, and Economic Organization" (1972) 62 *American Economic Review* 777; B. Klein, R. Crawford & A. Alchian, "Vertical Integration, Appropriable Rents and the Competitive Contracting Process" (1978) 21 *J.L. & Eco.* 297; M. Jensen & W. Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure" (1976) 3 *Journal of Financial Economics* 305; S. Grossman & O. Hart, "The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration" (1986) 94 *Journal of Political Economy* 691.

⁶Scholars taking the non-corporate form seriously include: H. Hansmann, "Ownership of the Firm" (1988) 4 *J.L. Eco. & Organ.* 267; Alchian & Demsetz, *ibid.* at 785-90; E. Fama & M. Jensen, "Separation of Ownership and Control" (1983) 26 *J.L. & Eco.* 301; "Agency Problems and Residual Claims" (1983) 26 *J.L. & Eco.* 327. The latter invoke the new institutional economics to explain organizational forms as diverse as the conventional corporation to the Catholic Church.

⁷R. Gilson & R. 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 [hereinafter "Sharing among the Human Capitalists"]; "Coming of Age in a Corporate Law Firm: The Economics of Associate Career Patterns" (1989) 41 *Stan. L. Rev.* 567 [hereinafter "Coming of Age in a Corporate Law Firm"].

⁸See M. Galanter & T. Palay, "Why the Big Get Bigger: The Promotion to Partner Tournament and the Growth of Large Law Firms" (1990) 76 *Va. L. Rev.* 747.

⁹In this article, I use the terms corporate law firm and law firm interchangeably. This is because my focus is exclusively on the large corporate law firm. Such firms are denoted by their commitment to servicing the needs of corporate as opposed to individual clients. Although much of the analysis developed in this article may be easily applied to non-corporate law firms, there are several distinctive challenges being faced by small and medium-sized firms that need to be accounted for in considering their growth and performance, and which are ignored in this article. The operation of the corporate law firm is extensively explored in R. Nelson, *Partners with Power* (Berkeley: U. California Press, 1988); "Ideology, Practice and Professional Autonomy: Social Values and Client Relationships in the Large Law Firm" (1985) 37 *Stan. L. Rev.* 313. See also, S.S. Samuelson, "The Organizational Structure of Law Firms: Lessons from Management Theory" (1990) 51 *Ohio State L.J.* 645.

in terms of understanding the particular nature of professional service organizations, but also in terms of developing a deeper appreciation of both the limits and strengths of the general theory of the firm which lies at the heart of the new institutional economics. Such examination presents some surprising and hitherto only dimly understood evidence on the role of non-efficiency values such as community, solidarity, and mutual respect and concern in justifying the firm form of organization. Although both law and economics and communitarian scholars have generally assumed that laws and institutions modelled on wealth creation are inhospitable to non-efficiency values, I claim, by reference to the modern corporate law firm, that these values can co-exist in certain contexts without serious tension. Indeed, I go further by arguing that efficiency may require that organizations give pristine expression to communitarian values. Although this claim may be somewhat novel for legal scholars, it is something that sociologists and organizational behaviourists have known for decades, as reflected in the importance they attach to the strength and quality of a given firm's corporate culture in determining its competitiveness.¹⁰ I claim that, at least in the setting of the modern corporate law firm, firm culture constitutes an important, indeed, essential component of the theory of the firm. By taking culture seriously, the behaviour and structure of the corporate law firm can be much more easily explained.

The article develops this argument in several distinct stages. Part I sketches the structure and role of the conventional corporate law firm. Part II evaluates the existing range of general and specific theories offered by institutional economists to explain the structure of the modern corporate law firm. I find that each of these theories provides only an incomplete rationale for the corporate law firm. In Part III, I argue that by considering the role of non-efficiency values, such as community, a more persuasive rationale for the corporate law firm can be generated. Essential to the inculcation and maintenance of community values is firm culture. Part IV considers the challenges to the community of the traditional law firm that are posed by the recent merger wave that has gripped American and Canadian law firms. It also identifies and evaluates some of the innovations deployed by law firms to safeguard their internal community. Finally, in the article's Conclusion, the implications of this argument for other forms of organization, particularly the corporation, are considered.

I. The Modern Corporate Law Firm

The modern corporate law firm specializes in the delivery of complex legal services to large, sophisticated corporate clients. The services provided by corporate law firms take the form of advice rendered to clients on how to maximize the value they can lawfully receive from transactions executed within the contours of the existing legal framework.¹¹ One of the hallmarks of the corporate

¹⁰*Infra*, note 85 and accompanying text.

¹¹As Gilson has observed:

[W]hat business lawyers *really* do — their potential to create value — is simply this: Lawyers function as *transaction cost engineers*, devising efficient mechanisms which bridge the gap between ... [the] world of perfect markets and the less-than-perfect real-

law firm is the wide scope and depth of its expertise. The same law firm may have legal specialists practising in areas as diverse as tax, anti-trust, securities, real estate, bankruptcy, litigation, and commercial law. The corporate law firm's distinctive strength comes from its ability to create *ad hoc* teams of lawyers drawn from a number of different specialties to provide legal services to clients. For example, the tide of mergers and acquisitions that swept North American markets during the 1980s routinely required lawyers from a number of different practice areas to work together in structuring these transactions or defensive responses to them.

The highly specialized nature of the corporate law firm's production function is also reflected in the extensive reliance the firm places on support staff — para-legal and administrative. The existence of para-legal staff enables the firm's lawyers to devolve responsibility over relatively mundane, routine tasks such as reviewing and filing court documents, preparing and filing incorporations and corporate changes, and examining and registering real estate titles. Another important feature of the law firm is the presence of a large, highly differentiated administrative staff, which allows lawyers to benefit from sophisticated legal research services, round-the-clock secretarial and word processing capability, and other sundry services (catering, messenger, telecopier, etc.).

Most law firms are structured as professional partnerships.¹² For the most part, the partnership form of organization means that law firm partners have unlimited personal liability for debts incurred by the partnership. Consequently, each partner's personal wealth is at risk of being seized to satisfy debts incurred by other members of the partnership in the course of partnership business. In addition to personal liability, partnership status also confers clear rights upon partners to participate in the firm's management. Usually, these management rights stipulate an entitlement to be kept apprised of the firm's activities and financial status, to be consulted on relatively normal course changes, and to be able to vote directly, often on the basis of supra-majority voting rules, on core changes. Partnership status also includes a right to share in whatever income remains at the end of an accounting period after all fixed claimants have been

ity of effecting transactions in this world ("Value Creation by Business Lawyers: Legal Skills and Asset Pricing" (1984) 94 Yale L.J. 239 at 255).

¹²In some American states, law firms can be organized as true limited liability corporations, permitting limited liability for lawyers and even allowing non-lawyer investors to hold equity in the firm. These firms are, however, exceptional. Although other American states and at least one Canadian province, Alberta, permit law firms to incorporate, the benefits of incorporation are largely confined to the realization of certain tax benefits. The firm does not enjoy limited liability insofar as creditor claims are concerned, nor are non-lawyers entitled to hold equity interests. See J.R. Pritchard, "Incorporation by Lawyers" in J. Evans & M. Trebilcock, eds, *Lawyers and the Consumer Interest* (Toronto: Butterworths, 1982) c. 10. American data on limited liability is reviewed in B.C. Eaton & D. Church, *Business Organizations: Professional Corporations and Associations* (New York: Matthew Bender, 1992) vol. 17 at 9-44.2 to 9-46. See also the debate between Carr, Mathewson and Gilson respecting the role of unlimited liability as a barrier to entry into the legal profession: J. Carr & F. Mathewson, "Unlimited Liability as a Barrier to Entry" (1988) 96 *Journal of Political Economy* 766; John M. Olin Program in Law and Economics, *Unlimited Liability and Law Firm Organization: Tax Factors and the Direction of Causation* (Working Paper No. 63) by R.J. Gilson (Stanford: Stanford Law School, 1990).

paid. In this respect, partners are the residual claimants upon the firm's income stream, *i.e.*, they can only withdraw funds from the partnership after all fixed claims have been paid. The actual level of participation among lawyers varies from firm to firm depending on the criteria used in the compensation calculus. Some firms employ a lockstep system whereby all lawyers at the same level of seniority earn the same income, whereas most other firms rely on a more complex, non-mechanistic sharing system that includes attention to seniority, marginal productivity, and efforts directed at firm promotion and development.¹³ Another characteristic of partnership is secure, often life-time, tenure. Although the constitution of most firms stipulates that partners can be removed from the partnership without causing the entire partnership to dissolve, such action occurs only rarely, and is accompanied by extensive procedural protections for the departing partner.

Although, for the most part, partners in the modern corporate law firm are all lawyers, not all lawyers in the firm are partners. Until recently, most firms were organized around a two-tiered hierarchy of partners and associates.¹⁴ Associate lawyers are typically recruited directly from law school and hired on the basis of fixed salaries, employment at will, and commitments on the part of the firm to furnish some on-the-job training and to consider the associate for promotion to partner after a fixed interval of from 5 to 10 years. In return, the lawyer agrees to furnish legal services to clients under the supervision and guidance of the firm's partners.¹⁵ The level of partner oversight diminishes quickly as the newly minted lawyer establishes her competence. Indeed, well before they are promoted to partnership, most associate lawyers will enjoy substantial control over small and medium-sized transactions, and will have had extensive client contact, perhaps even to the point of serving as the lawyer responsible for co-ordinating all of a particular client's needs within the firm. The extensive period of time a lawyer serves as an associate with a firm provides partners with a deep pool of information upon which to base a decision regarding promotion to partnership. Obviously, the more elaborate the set of actual observations of associates under a variety of conditions, the more confident partners can be about the associates' suitability for partnership promotion. Given defects in the

¹³Examples of lockstep firms are Clifford, Chance in Britain and Cravath, Swaine, and Moore in New York City. For a further discussion on the systems available to compensate partners and the incentives each create, see "Sharing among the Human Capitalists," *supra*, note 7 at 339.

¹⁴Traditionally, Canadian law firms have relied on a third tier in the cog of the firm machinery: apprentice or articling students. Upon graduation from law school, students will be hired for an apprenticeship period with a law firm. Although the student provides valuable services to the firm during this period, the principal purpose of articling is to allow the firm to determine whether the student should be invited to re-join as an associate lawyer at the end of the period. On average, most firms will hire back 50% of the students as associate lawyers.

¹⁵For a full explication of this relationship, see A. Leibowitz & R. Tollison, "Earning and Learning in Law Firms" (1978) 7 *J. Legal Stud.* 65. Under the "up or out system" that is used by most corporate law firms in determining promotion to partnership, associate lawyers not recruited to partnership are expected to seek out other employment, invariably in a smaller, less prestigious firm or in the in-house counsel department of a corporate client. The rationale for the "up or out system" is described in "Coming of Age in a Corporate Law Firm," *supra*, note 7 at 571ff; Department of Economics and Institute for Policy Analysis, *Up or Out Rules in the Market for Lawyers* (Working Paper No. 9017) by B. O'Flaherty & A. Siow (Toronto: University of Toronto, 1990).

market for human capital, internal recruitment and promotion is the principal mechanism for sourcing the firm's labour needs.

II. The Theory of the Firm as Applied to the Corporate Law Firm

A. Introduction

Despite the passage of more than fifty years, the general framework that Coase used to organize his inquiry into the nature of the firm still retains its fundamental force. Coase's central insight was that the rationale for the firm is lodged in its comparative advantage over markets (standard spot contracts) in organizing economic activity. As market transactions become more expensive, it makes economic sense to carry out the activity in question within the firm. Despite a relatively high degree of agreement among scholars on the value of thinking of the firm in relation to markets, there is a considerable divergence of views respecting the exact source of the firm's advantage over the market. It is this divergence that has spawned multiple theories of the firm.

What is the source of the divergence of views over the rationale for the firm? To begin with, this dispute reflects the difficulties in actually defining firms and markets. Depending on what content is poured into these meanings, very different rationales for the firm can be derived. Not surprisingly, the greater the distinction between firm and market, the easier it is to proffer a distinctive rationale for the firm. Nevertheless, rigid distinctions between firm and market have been slowly blurred by the tendency of commentators to define the firm and contract in terms of the other. On the one hand, the firm has been viewed by some scholars as nothing more than "a nexus of contracting relationships."¹⁶ On the other hand, various scholars have placed increasing emphasis on the complex nature of contracting relationships.¹⁷ The greater complexity that is admitted into the definition of contract, in terms of multiple underlying objectives of contracting parties (mutuality, solidarity, and fairness) and in terms of the richness of internal governance mechanisms, the more closely contract begins to resemble the structure of the firm.

Compounding the threshold definitional challenges are other difficulties in defining norms of human behaviour in private transactions. Scholars hold differing views of the motivations and capacities of individual actors in commercial activities. The starkest divide is between those scholars viewing commercial actors as wholly rational, self-interested wealth maximizers, and those scholars who view such actors as motivated by a wide range of economic and non-economic objectives.¹⁸ Yet, even within the camp of scholars wedded

¹⁶Jensen & Meckling, *supra*, note 5 at 310: "It is important to recognize that most organizations are simply legal fictions which serve as a nexus for a set of contracting relationships among individuals." [emphasis added]

¹⁷See generally I. Macneil, *The New Social Contract: An Inquiry into Modern Contractual Relations* (New Haven: Yale U. Press, 1980); S. Macaulay, "Elegant Models, Empirical Pictures, and the Complexities of Contract" (1977) 11 L. & Soc. Rev. 507.

¹⁸This issue is ably canvassed in R. Ellickson, "Bringing Culture and Human Frailty to Rational Actors: A Critique of Classical Law and Economics" (1989) 65 Chi. Kent L. Rev. 23.

to the vision of *hominus economicus*, there is substantial disagreement over the extent to which individuals can and will adhere to rational self-interested behaviour. Williamson, for instance, argues that limited foresight and opportunistic behaviour will prevent actors from realizing outcomes that maximize joint welfare.¹⁹

In view of the divergence in the core underlying assumptions embedded in each theory of the firm, how can the merits of each theory be objectively evaluated? To start, any inquiry into the nature of the firm should be based on definitions of the firm and the market that are, as much as possible, kept separate and distinct. To do otherwise would invite confusion by sacrificing expository clarity. Accordingly, market contracts should be viewed as short-term, arm's-length, presentiated contracts, while the firm should be viewed as a stable, long-term community with elaborate internal adjustment mechanisms to resolve conflict and direct change. In terms of the debate regarding the motivations and capacity of commercial actors, consistent with the theory's aspiration to be a positive statement of the rationale for the firm, analysts should eschew assumptions based on how commercial actors *should* behave, and should rely instead on how they *actually do* behave. And, although the motivations of human conduct are infinite and complex, some light can be shed on this issue by taking seriously the context in which the firm has arisen. It is not difficult to imagine that the motivations and capacities of lawyers in establishing a law firm differ markedly from the shareholders, managers, creditors, and employees, all of whose efforts are responsible for the creation and operation of the large publicly-held corporation. Simply, depictions of the "commercial man" that are applied generically across a range of contexts are too crude to be of use to analysts.

One final but fundamental caveat before proceeding to a review of existing theories: in considering the case for the corporate law firm, it is important to avoid the pitfalls of crafting a rationale for the firm on the basis of the putative benefits of joint economic activity. On its own, the fact that joint activity produces benefits tells us little, if anything, about where that activity should be located. To answer the question why law firms exist, it is necessary to determine why firms can better accommodate the benefits of joint economic activity than can markets.

To ensure that the issue of the benefits of joint economic activity does not become entangled with the rationale for the firm, I begin by briefly enumerating the specific benefits to be derived from jointly supplied legal services. I then consider the various theories propounded to explain why these benefits are best obtained within the corporate law firm. I locate the more specific theories of the law firm in the more generalized theories of the firm form. I argue that each of these theories is plagued by endemic defects which, as I show in Part III, can only be corrected by considering the role of community values in vindicating the economic and non-economic aspirations of lawyers.

¹⁹*Supra*, note 5 at 44-52.

B. *The Benefits of Joint Production of Legal Services*

The benefits of joint production of legal services reflect conventional economies associated with joint production of goods and other, more specialized benefits that are related specifically to provision of professional services. Many of these benefits are inter-related, the recognition of which should not be obscured by separate enumeration and evaluation.

1. Task Specialization

The first benefit of the joint provision of legal services is the realization of specialized production. As in the case of Adam Smith's renowned pin factory, joint production of legal services enables individuals to specialize in the performance of tasks that are best suited to their abilities and inclinations.²⁰ When coupled with the ability to exchange goods and services, specialized production generates non-trivial increases in production. In the case of legal services, the linkage between joint production and specialization reflects the ability of a group of lawyers to parcel out different tasks contained in a given legal transaction amongst themselves on the basis of their relative expertise. In aggregate, the product they supply — legal advice pertaining to a certain transaction — will be of higher quality than advice tendered by a generalist who lacks the same concentrated expertise.²¹

Why is a specialist's legal advice superior to that supplied by a generalist? After all, one could argue that corporate law advice proffered by a generalist is of far greater use than that of a specialist. It could be claimed that corporate law is more than technical legal expertise, that there are significant advantages from being able to stand back and "get the big picture," and that, even if a role is conceded for expertise, there are few legal problems that cannot be solved with time well-spent in a law library. Against this argument, however, is the reality of a dramatic proliferation of law in the corporate/commercial area that requires more sustained and concentrated effort by lawyers to keep abreast of legal developments. Witness, for example, the volumes of legislation, subordinate legislation, interpretive guidelines, and judicial and administrative decisions that constitute the "law" in either the public securities or tax areas. Surely, without single-minded devotion to an area, it is hard to imagine how a lawyer could honestly claim to be an expert in one of these fields. This is especially the case in areas where the law changes rapidly, and where developments in one area impact on the law in ways which are obscure and complex. And, even ignoring technical facility in the law, it is clear that in a world in which governmental and

²⁰According to Adam Smith, in the absence of task specialization, a sole pin maker could "scarce, perhaps with his utmost industry, make one pin a day," while a small factory of ten workers that encouraged task specialization could, "where they exerted themselves, make among them twelve pounds of pins in a day" (*The Wealth of Nations*, ed. by A. Skinner (England: Penguin, 1981 (originally published in 1776)) at 109-10).

²¹The impact of specialization on the legal profession has been addressed by Chief Justice Rehnquist, "The Legal Profession Today" (1987) 62 *Ind. L. Rev.* 151. For an earlier discussion of the impact of specialization, see H. Stone, "The Public Influence of the Bar" (1934) 48 *Harv. L. Rev.* 1 at 9-10.

quasi-governmental agencies are vested with considerable discretion in interpreting and applying the law, the specialist's familiarity with the individuals and the institutions administering the law is of considerable benefit.²²

2. Economies of Scale

A second important benefit of joint production of legal services is the realization of economies of scale. Economies of scale arise when the fixed costs required to produce a single unit of output can be reduced by increasing the output of the good, thereby spreading these costs among a greater number of goods produced. In the case of legal services, economies of scale can result from the cost savings that can be generated by spreading the costs of certain fixed inputs, like libraries, accounting, time-recording, data collection, and word processing facilities, over a greater number of lawyers. Indeed, these economies may be so great that a lawyer wishing to go into solo practice would face insuperable barriers in entering the market for corporate law.

Data on the magnitude and existence of economies of scale in corporate law practice are scarce, and the data which do exist are contradictory. While conceding a role for economies of scale in the provision of legal services, some commentators have either downplayed their importance²³ or claimed that they are exhausted quickly as the number of lawyers sharing responsibility for common expenses increases.²⁴ Yet, other commentators have come to the opposite conclusion, finding that the per lawyer costs of operating a law firm decrease significantly as the size of the firm increases.²⁵ This view receives support from the bevy of articles appearing in legal trade journals heralding the explosion in new and wondrous technological innovations aimed at automating various legal activities.²⁶ For instance, many firms are now purchasing computers that will store and access firm legal memoranda and opinions, as well as providing standard form precedents with optional terms that can be used in a variety of different transactions. Since the up-front costs (measured in terms of hardware costs and

²²For example, a lawyer well-versed with the individuals and institutions administering a given area of law may be able to save her client a considerable amount of effort, time, and money by crafting transactions in a way that conforms to the unwritten preferences of legal administrators or by having access to officials in a governmental agency that may be more sensitive to the needs of a given client. Currently, the best concrete example of this is in the domain of securities law.

²³See "Sharing among the Human Capitalists," *supra*, note 7 at 316-17.

²⁴A. Leibowitz & R. Tollison, "Free Riding, Shirking, and Team Production in Legal Partnerships" (1988) 18 *Economic Inquiry* 380. Indeed, in a study of 1967 and 1972 United States census data, the researchers found that scale economies were realized in law firms when they moved to five partners, but, holding receipts constant, more than five partners led to an increase in fixed expenses (*ibid.* at 388).

²⁵See Altman & Weil, Inc., Management Consultants, *Economic Survey of Canadian Law Firms 1982* (Ardmore, Penn.: Altman & Weil, Inc., 1982) at 44. In their survey of Canadian law firms, Altman and Weil found that the ratio of total costs to gross receipts is higher in small firms than in large ones. For sole practitioners, 55% of their gross income was devoted to overhead, for firms with 2 to 6 lawyers, it was 52%, for firms with 7 to 11 lawyers, it was 50%, and for larger firms, it was even lower.

²⁶See, for instance, E. Warner, "Large Law Firms Moving toward Automated Office" *Computer World* (21 May 1984) 23.

software customization costs) of these technologies are basically independent of the number of final users, one would expect that the per lawyer costs of these purchases would decrease as the number of lawyers sharing these costs increases.

3. Economies of Scope

Economies of scope are generated by the joint production of complementary goods. In a legal setting, these complementary goods come in the form of legal advice in different specialty areas. For instance, if a lawyer or group of lawyers providing litigation services to a client can offer corporate law advice to that client at a lower cost than a competitor supplying corporate law services alone, then this would constitute an economy of scope. The reason that these economies exist lies in the capacity of fixed investments in specific human capital to be applied to other uses than the one for which the investment was originally made. For example, at least part of the investment a lawyer makes in acquiring securities law expertise can be used to support the development of expertise in other, more specialized, corporate areas like mergers and acquisitions or reorganizations. Given the highly specialized nature of legal practice discussed above, "satellite" expertise is usually developed across different lawyers rather than in the same lawyer. Similarly, once in the course of effecting a certain transaction, a lawyer has acquainted herself with the details of a client's affairs, then, by having the original lawyer participate in other transactions involving the same client — even ones implicating areas of and lawyers with different legal expertise — the original investment in client-specific human capital can be recycled, thereby enabling a client to utilize the same lawyer or group of lawyers for consecutive transactions. Obviously, the more labyrinthine a client's organizational structure and business activity, and the less capable a client is of "framing" her problems in "legalese", the greater the savings to the client from recycling.²⁷

Empirical investigation of the existence and magnitude of economies of scope is limited. The data that do exist are fragmentary and anecdotal. Nevertheless, a frequent theme in legal trade publications is the efficacy of cross-selling techniques, *e.g.*, trying to encourage clients to utilize a lawyer or group of lawyers for legal services other than that which the client originally demanded.²⁸ This theme is evident in suggestions that law firms channel energy into harnessing "the play on each department, the drawing from each department, the building on each department."²⁹ If accurate, this would seem to support the existence of economies of scope.

²⁷Economies of scope in the setting of the law firm are discussed in "Sharing among the Human Capitalists," *supra*, note 7 at 316-18.

²⁸One firm which has very successfully exploited economies of scope in fuelling rapid law firm growth is Skadden, Arps, Slate, Meagher and Flom. Under an ingenious scheme devised by the firm, clients fearful of being embroiled in a takeover brawl were required to provide Skadden with a non-refundable retainer in order to have access to the firm's expertise should they be engulfed in a takeover. To entice clients to sample the range of non-mergers and acquisitions specialty services offered by the firm, clients were encouraged to spend down their retainers on other services in the event a takeover did not materialize.

²⁹R. West, "Megafirms: Is Bigger Better?" (1985) 11 *Litigation News* 1(4) at 1.

C. *The Existing Rationales and Their Limits*

Given the benefits enumerated above of joint production of legal services, why is the firm superior to the market in harnessing these benefits? In this discussion, I canvass the various rationales for the law firm and identify their defects.

1. The Firm and Entrepreneurial Command

According to Coase, the main rationale for the firm lies in the centralization of managerial power which enables the firm to allocate resources more efficiently than can the price mechanism of the market.³⁰ By relying on the fiat of the "entrepreneurial coordinator," costs incurred in market contracting such as search, negotiation, and enforcement of contracts are minimized.³¹ Recognition of the benefits of the firm form does not, however, obscure the fact that there are natural limits constraining the size of the firm. These limits reflect decreasing returns to the entrepreneurial function, increased potential for entrepreneurial mistake as the scale of transactions increases, and certain cost advantages of small-scale production.³² In the case of the law firm, however, Coase's centralized direction model would appear to have little or no explanatory force. Law firm decision-making is simply too diffuse, too cumbersome, and too consen-

³⁰Coase, *supra*, note 3 at 392.

³¹*Ibid.* at 390-91.

³²Evaluated at a general level, Coase's rationale has been subject to strong criticism by Alchian and Demsetz, and by Hart for his failure to identify the power of the entrepreneur coordinator's discretion. In particular, these critics question whether "fiat" is any more effective in a firm than a contractual setting. Alchian and Demsetz observe that

[i]t is common to see the firm characterized by the power to settle issues by fiat, by authority, or by disciplinary action superior to that available in the conventional market. This is delusion. The firm does not own all its inputs. It has no power of fiat, no authority, no disciplinary action any different in the slightest degree from ordinary contracting between any two people (*supra*, note 5 at 777).

If command in the firm ultimately turns on the threat of severance, then this is no different than in the market. A customer disappointed, for example, with the quality or price of a supplier's goods will simply withdraw her patronage, which is, of course, akin to the severance. Indeed, Alchian and Demsetz underscore this point by arguing that, in both the firm and the market, the transfer of discretionary power to certain parties is entirely voluntary, resulting in a form of "consensual coercion" (*ibid.*). In the end, Alchian and Demsetz claim that the rationale for the firm resides elsewhere, whereas Hart tries to save Coase's hypothesis by introducing the notion that managerial discretion in the firm is rooted in ownership of physical assets (Program in Law and Economics, *An Economist's Perspective on the Theory of the Firm* (Discussion Paper Series) by O. Hart (Cambridge: Harvard Law School, 1988)). That is, to the extent that the entrepreneur coordinator has discretionary power, this power emanates not from the existence of bureaucratic hierarchy, but from the greater effectiveness of the severance threat when it is coupled with the ability to deprive employees of the physical instruments of work. Yet, this claim is itself vulnerable to ambiguities inherent in ownership title. As realist legal scholars such as M.R. Cohen long ago argued, the law seldom vests property rights in one exclusive owner ("Property and Sovereignty" (1927) 13 Cornell L.Q. 8). Instead, property can be best thought of as being subject to multiple, sometimes conflicting levels of entitlement. Once such complexity is admitted, it is less clear that ownership of physical assets provides the unfettered power necessary to justify the command based model of the firm. Moreover, Hart's refinement neglects the role that other community based expectations and sanctions within the firm can play in magnifying the pain of severance.

sus-ridden to be able to conform to Coase's highly centralized, bureaucratic vision of the firm.³³ And, in view of the reliance on human capital in the production of legal services, refinements of Coase's theory offered by Hart and others, which emphasize control over physical assets, are unable to salvage the model in the setting of the law firm.³⁴

2. The Firm and Centralized Monitoring

Alchian and Demsetz have argued that the rationale for the firm lies in its effectiveness, as compared to market contracts, in attenuating the natural propensity of firm employees to engage in opportunistic behaviour, such as shirking and perquisite consumption.³⁵ According to these scholars, joint production, especially when it is accompanied by a separation between investors and producers, is prone to agency costs. These costs are pervasive and plague production orchestrated by the firm, as well as market contracts. The scope for agency costs is explained in part by the difficulties in crafting optimal compensation arrangements that correlate financial rewards with actual marginal productivity.³⁶ These difficulties are attributable to the problems inherent in ascertaining the value of worker marginal products when production is undertaken by more than one agent. When the value of a final product or service produced is the by-product of numerous workers, inspection of the output alone rarely yields much insight as to the intensity of efforts made by identifiable workers. Thus, to control agency costs involved in joint production, it is best to concentrate on input monitoring, which the firm, because of certain advantages, is believed to be able to do more efficiently than alternative market arrangements. Interestingly, the principal advantage cited by Alchian and Demsetz is Coase's co-ordinating entrepreneur.³⁷ By virtue of her role as a central party to all input contracts, her ability to alter membership of the team unilaterally, and her status as residual claimant, it is the co-ordinating entrepreneur who can lay claim to being the most effective monitor and manager of input behaviour.

Unfortunately, as a rationale for the law firm, the metering model's dependence upon the co-ordinating entrepreneur renders it open to the same criticisms that were levelled against Coase. Whether the co-ordinating entrepre-

³³For a recent discussion of the challenges posed to law firms by these attributes, see R. Taylor, "Is Anybody in Charge Here?" *Canadian Lawyer* (June 1990) 31.

³⁴To be fair, Hart recognizes the limits of his theory in understanding the structure of professional organizations having excessive reputational rather than physical capital investments. He even refers to the notion of firm culture as figuring in the rationale of such firms, but does not develop the claim ("Incomplete Contracts and the Theory of the Firm" (1988) 4 *J.L. Eco. & Organ.* 119 at 136-37).

³⁵Alchian & Demsetz, *supra*, note 5 at 777-81; shirking occurs when a worker fails to render her maximum effort in the performance of her duties. Perquisite consumption occurs when a worker diverts law firm assets to her own use. For an early, though generally less known exposition of this argument, see J. McManus, "The Costs of Alternative Economic Organizations" (1975) 13 *Canadian Journal of Economics* 334 at 344-45. For a general review of the literature on agency costs, see J. Ziegel *et al.*, *Cases and Materials on Partnerships and Canadian Business Corporations*, 2d ed. (Toronto: Carswell, 1989) c. 5.

³⁶Alchian & Demsetz, *ibid.* at 779-81.

³⁷*Ibid.* at 781-83.

neur is favoured for her discretion or for her monitoring efficiency, the decentralized decision-making that occurs in the law firm belies the importance or, indeed, even the existence of her role. However, McChesney offers a theory for the law firm that, while based on monitoring efficiency, does not turn on the role of a co-ordinating entrepreneur.³⁸ McChesney argues that since clients are billed on a piecework basis, firm management can, by accessing the firm's central data bank, observe the number of hours worked by each lawyer in the firm, which can then be used as a proxy for effort, which, in turn, can then be used as a proxy for marginal productivity. With this information in hand, the firm can then adjust compensation levels to correspond to the marginal product of individual lawyers. The advantage to the law firm over market contracts derives from the fact that once elaborate client billing systems are in place, no additional investment is required to achieve effective metering.

The difficulty, of course, with McChesney's refinement of the Alchian and Demsetz monitoring hypothesis relates to the coarseness of hours worked as a proxy for actual marginal productivity. By relying solely on hours worked as a basis for gauging value of the legal outputs created, the firm may overcompensate lawyers whose logged hours include time spent day dreaming or attending to personal matters. Unless the firm's compensation committee can probe the minds of its lawyers, there is no easy way to identify the amount of real mental energy lawyers devote to resolving legal problems for clients. Thus, in order for the monitoring story to stand as an independent rationale for the law firm, it is necessary to confront and address the problems occasioned by sole reliance on central time-keeping systems as mechanisms for controlling agency costs. That is, without some confidence that the hours of input measured constitute a meaningful proxy for actual effort and output, the metering model is deficient.

3. The Firm and Ownership Rights

The existence of vested property rights, particularly the right to claim the revenues remaining after all fixed claimants have been satisfied, is central to the theory that is ultimately advanced by Alchian and Demsetz to explain the structure of the modern professional partnership.³⁹ By conferring equal shares in the residual income generated by the firm on partners, members of the firm will be deterred from engaging in opportunistic behaviour. In other words, by making workers owners, the problems occasioned by the separation of principal and

³⁸F. McChesney, "Team Production, Monitoring, and Profit Sharing in Law Firms: An Alternative Hypothesis" (1982) 11 J.L. & Soc. 379. According to McChesney, profit sharing's more important role is as a means for conferring "commission-like" rewards on partners who undertake successful client promotion activities, rather than as a mechanism that facilitates optimal monitoring.

³⁹Alchian and Demsetz noted that "[i]n 'artistic' or 'professional' work, watching a man's activities is not a good clue to what he is actually thinking or doing with his mind" (*supra*, note 5 at 786). So significant was this problem that Alchian and Demsetz effectively abandoned the input metering rationale for the law firm in favour of a rationale based on the capacity of vested property rights to control agency costs. The premium on ownership denotes a significant shift in emphasis by Alchian and Demsetz. Now, instead of external monitoring by a central entrepreneur co-ordinator, it is self-monitoring promoted by ownership that controls agency costs.

agent are eradicated. However, Alchian and Demsetz concede one defect in relying on ownership rights to control agency costs: in order for ownership to work, the size of the partnership must be kept relatively small, and further, admission to partnership must be extremely selective so that the "work characteristics and tendencies to shirk" of owners are known in advance.⁴⁰

Alchian and Demsetz's retreat from the external monitoring rationale for the law firm in favour of an ownership-based model has been criticized by McChesney.⁴¹ The relatively small ownership stake that individual lawyers have in large law partnerships casts doubt on the capacity of profit sharing to promote efficient monitoring. Law partners, as rational economic actors, will recognize that only a minuscule percentage of the gains from monitoring will accrue to them and will, therefore, refrain from vigorous monitoring. Given this disinclination to monitor, McChesney argues that the sharing principle is a flimsy foundation upon which a theory of the firm can be built.

Although McChesney is correct in pointing out the potential for sub-optimal monitoring that accompanies fractional ownership interests, his wholesale rejection of ownership-induced monitoring goes too far. In its most extreme forms (*i.e.*, docket fudging, falsified expenses), opportunistic behaviour will be monitored and disciplined by partners — not only because of the unfairness that partners suffer when some partners are compensated for work that they did not do, but also because of the risks to the partnership as a whole from client-initiated sanctions.⁴² And, even short of the threat of external discipline via aggrieved clients, partners will engage in some level of monitoring because of the firm's reliance on variable ownership interests that are at least partially sensitive to marginal productivity.⁴³ To the extent, therefore, that a partner's marginal productivity declines, and this decline is not explicable by some justifiable excuse, she can expect to suffer some diminution in take-home income.⁴⁴

⁴⁰*Ibid.* at 786.

⁴¹*Supra*, note 38.

⁴²Once clients detect docket irregularities, they can be expected to initiate legal action against the lawyer and, perhaps, even against the firm for failure to detect the wrongdoing (gatekeeper liability). Professional disciplinary action against the lawyers is likely to follow. No doubt, such attention is likely to effect a devastating blow to the reputational capital of the affected law firm. Clients may conclude on the basis of one observed incident of wrongdoing that the firm is plagued by opportunism, reflecting a widespread and weak commitment to honesty and integrity within the firm or, more benignly, a lack of effective safeguards against isolated wrongdoing. Even worse, because of the joint and several liability structure imposed by law on most law firms, firm members may find that they are personally liable to the extent of their entire wealth for all uninsured liabilities incurred by the shirking partner (including damages for fraudulent activities against clients) in the event of personal bankruptcy.

⁴³Fama and Jensen argue that variable rate compensation is central to the control of agency costs within the professional partnership ("Separation of Ownership and Control," *supra*, note 6; "Agency Problems and Residual Claims," *supra*, note 6). For a more extensive discussion of partnership compensation arrangements in the context of the law firm, see "Sharing among the Human Capitalists," *supra*, note 7 at 390ff. Gilson and Mnookin observe that for firms eschewing lockstep compensation schemes, there is some attention to merit in awarding compensation, although other factors, including seniority, personal misfortune, etc., may come into play (*ibid.* at 390-91).

⁴⁴Diminished marginal productivity will be detected partly through review of annual time dockets and partly through collegial monitoring. Insofar as the latter is concerned, partners will have

4. The Firm and Reputational Bonding

Another rationale for the law firm is based on the presence of certain defects in the market for legal services, such as information asymmetries, and on the utility of reputational signals, such as brand names, in conveying credible information to consumers on the quality of legal services.⁴⁵ Although the severity of information asymmetries in the provision of corporate law services may have been attenuated somewhat by the growing use of in-house counsel by corporate clients, gaping holes remain in the amount of information consumers of legal services possess.⁴⁶ Specifically, consumers will have difficulty effectively evaluating the differential quality (and sometimes even the price) of legal services on an *ex ante* basis. These information asymmetries reflect several different problems. First, information asymmetries are caused by the dearth of legal expertise possessed by most consumers of legal products. Lacking the requisite technical skills, most corporate clients will be unable to evaluate effectively the quality of services they have consumed. These problems are compounded in the case of solicitors work because of the long time periods that may transpire before defects in a transaction's execution are detected. Second, even if a consumer has the requisite skill to evaluate legal services *ex post*, that ability does not assure her that the services provided on the next transaction will be of similar or greater quality. Legal services are discrete products. The fact that services provided today were performed in a satisfactory manner does not, in itself, assure the consumer that tomorrow's products will meet the same quality standards.

One possible way of countering the "experience" nature of legal services would be to engage in more vigorous search-related activity prior to contract formation. However, owing to the considerable time and energy that a lawyer would have to expend in investigating the affairs of the client and the laws impacting on the transaction, this is likely to be a very costly and labour-intensive activity. Predictably, the greater the expense that is entailed, the less effective

an incentive to monitor the value of each other's performance because identification of shirking within the firm may increase the income of the "whistle blower." If it is assumed that real law firm receipts remain constant from accounting period to accounting period, the task of carving up the partnership pie can be likened to a zero sum game — the only way to acquire a real increase in income is by reducing the ownership interest of another partner. Inevitably, the justificatory basis invoked to support such a transfer will be couched in terms of the superior effort and performance that is rendered by one member of the firm in relation to others. To be credible, these claims will have to be supported by explicit reference to lacklustre performance by specific partners. Although norms of collegiality may make partners uneasy about publicly identifying shirking partners, many of the procedures and institutions devised by the firm to determine the level of ownership interests are aimed at teasing out this information in a way that avoids public recriminations and debate. For example, a number of firms have established partnership review committees that solicit each partner's views respecting the work habits and efforts of other partners over the relevant accounting period. This information is then used to allocate partnership interests.

⁴⁵The role of information asymmetries and the ability of reputational signals to overcome innate problems is examined by Gilson & Mnookin, "Sharing among the Human Capitalists," *supra*, note 7 at 360-65; Leibowitz & Tollison, *supra*, note 24. More generally, see Klein, Crawford & Alchian, *supra*, note 5; Grossman, "The Informational Role of Warranties and Private Disclosure about Product Quality" (1981) 24 J.L. & Eco. 461.

⁴⁶The impact of inside counsel on the nature of legal services is discussed further below.

pre-contractual search-related activity will be in overcoming asymmetries. And, even if meaningful comparison shopping could occur *ex ante*, intervening events may cause the type of services actually required to deviate from the services specified in the initial contract. Once a transaction is under way, it is difficult for a consumer to “reshop” the transaction. By this time, both the consumer and the lawyer will have made asset-specific investments in the relationship that will impede the ability of other firms to bid on the transaction in its new form. Finally, to the extent that asset-specific investments are not determinative, time constraints will dull whatever incentive consumers have to re-evaluate the transaction.

To redress the problems confronted by corporate clients in obtaining sufficient information about the quality of legal services that will be performed on their behalf, lawyers will attempt to signal their commitment to quality through various devices. One of the most effective devices is the use of reputational bonds. Essentially, by investing in a brand name, lawyers can signal their commitment to deliver quality services to their clients. A brand name can be developed fairly passively. For instance, simple word of mouth endorsements may be sufficient to earn a diligent, honest, and effective lawyer a good reputation. Alternatively, a lawyer may, through various professional and non-professional activities, for example, speaking engagements at professional associations, writing of law review articles, high profile public interest work, etc., deliberately work at developing a public reputation. Many of these activities will be non-remunerative and consequently, constitute a form of direct investment in reputation. Finally, a lawyer may initiate an advertising campaign aimed at trumpeting the quality of her services to potential clients. In any of the above scenarios, the costs to a lawyer from failing to meet the standards of performance implicit in a given reputation may, depending on the transparency of the complaint process, be devastating. A complaint deemed to be valid will depreciate the currency of the lawyer’s reputation and its intrinsic signalling value.⁴⁷

While serving as an important component of any rationale for the law firm, the reputational rationale is beset by a failure to identify the precise ways in which the firm is able to cultivate and sustain reputation. Put simply, the reputational theory of the firm focuses on only one half of the story: emphasizing the value of reputation to consumers without exploring how, especially in the context of decentralized production of legal services, commitments to excellence by lawyers are inculcated by the firm. In this respect, the reputational theory reveals itself to be parasitic on other theories of the firm dealing with constraints on agency costs (and is therefore vulnerable to their deficiencies).

5. The Firm and Asset Specificity

Two final rationales for the law firm are based on Williamson’s seminal insight that the comparative advantage of the firm resides in its superior ability

⁴⁷Not only will the individual lawyer’s reputation suffer but her firm will as well. Perhaps the clearest demonstration of negative reputational spillovers is the damage done to the reputation of Lang Michener as a result of the illegal activities of Martin Pilzmaker. See T. Reid, “Lang Michener Senior Partner Angry over Firm’s ‘Strategic Silence’” *Law Times* (26 February–3 March 1990) 1.

to redress opportunism problems in settings involving high levels of investment in capital assets (either physical or, in the case of the law firm, human assets) that are specific to a particular relationship.⁴⁸ Because "specific assets" have much lower economic value in second best uses, parties to a commercial relationship involving asset-specific capital are vulnerable to strategic defection. Defection is an attractive strategy because it facilitates a division of *ex post* surplus different from that which is merited on the basis of *ex ante* investment. According to Williamson, the firm, because of its dispute resolution capacity, its monitoring role, and its integrated ownership, is thought to be a more economical way of controlling strategic opportunism than spot market contracts that lack these characteristics.⁴⁹ Williamson's basic insight regarding the superior capacity of the firm to control asset-specific opportunism has been ingeniously used by Gilson and Mnookin,⁵⁰ and by Galanter and Palay⁵¹ in the development of a rationale for the law firm. Each of these theories will be assessed in turn.

a. *Gilson and Mnookin: Diversification of Specialized Investment*

The rationale for the corporate law firm that has been developed by Gilson and Mnookin starts with an acknowledgement of the highly unstable nature of demand for specialized corporate law services, which can impose severe, though short-lived, income losses on lawyers. This instability is a function of the high sensitivity of demand for specialized legal services to exogenous changes in macro-economic conditions.⁵² Since lawyers prefer a more stable pattern of earnings to one which results from unfettered market fluctuations, they will try to limit the variability of expected income receipts. But, owing to various constraints, self-help strategies (principally insurance against income reductions) are of only limited utility in achieving this objective.⁵³ As a consequence, Gilson and Mnookin argue that the best way for lawyers to smooth future income flows is by entering into an agreement with other lawyers having different areas of specialization and therefore different, perhaps even negatively correlated, risks of income losses in response to macro-economic changes. Typically, such agreements provide for the imposition of taxes on lawyers experiencing strong demand for their services in certain economic conditions, the proceeds of which would be used to subsidize the income of lawyers suffering tepid demand in the same conditions. The rationale for the firm is based on the opportunism that inevitably accompanies these arrangements. By amassing a stock of

⁴⁸See *Economic Institutions*, *supra*, note 5 at 52-56.

⁴⁹See O. Williamson, "Transaction-Cost Economics: The Governance of Contractual Relations" (1979) 22 *J.L. & Eco.* 3; *Economic Institutions*, *ibid.*; "The Modern Corporation: Origins, Evolution, Attributes" (1981) 19 *Journal of Economic Literature* 1537 at 1543-44.

⁵⁰See "Sharing among the Human Capitalists," *supra*, note 7 at 332ff.

⁵¹*Supra*, note 8 at 772ff.

⁵²In a robust economic climate, for instance, the demand for certain services usually accompanying expansionary economic conditions, for example, securities law, will escalate, while demand for other specialized services, for example, bankruptcy law, will decline. When, of course, the economy moves into recession, the demand for these services will reverse.

⁵³These constraints range from the demands of specialization which make it difficult, if not impossible, for a lawyer to be a specialist in specialties having negatively correlated risks to insurance market failures created by adverse selection and moral hazard problems.

indivisible reputational capital, the firm is able to impose an exit tax on lawyers who seek to leave the firm when economic conditions render them liable to the redistributive tax. That is, because a departing lawyer will be unable to take her *pro rata* share of firm reputation with her, the costs of opportunistic defection will increase.⁵⁴ So long as a lawyer's share of firm reputational capital is of greater value than the retained subsidy, lawyers will refrain from leaving and will agree to pay specified subsidies.

While offering a plausible explanation for the corporate law firm, Gilson and Mnookin's analysis is plagued by several difficulties. First, although having considerable surface plausibility, the theory fails to explain the existence of several variants on the standard diversified-service law firm.⁵⁵ If the firm's capacity to control defection from income-smoothing arrangements is the core rationale for the firm, what accounts for the choice of the firm form of organization for legal partnerships specializing in only one area of the law?⁵⁶ A second set of concerns respecting the analysis relates to the necessity of the firm in enforcing sharing arrangements. Despite the claim that the firm and its indivisible reputational capital is needed to bond adherence to *ex ante* income-smoothing agreements, it is by no means certain that for most lawyers any external constraint is needed to enforce compliance. Unless lawyers are operating in final periods, meaning that their remaining working life is short, the vulnerability of defecting lawyers to future adverse changes in economic conditions would seem more than sufficient to bond their performance.⁵⁷ After all, once a lawyer defects from a sharing arrangement, retaliation would demand that she not be admitted back into the firm when economic conditions change in a way that favours the renewal of her attachment to the firm.⁵⁸ Finally, even assuming that an external constraint on opportunism is necessary to enforce income sharing arrangements, it is not clear that indivisible firm reputation is able to play this role. If a lawyer's individual reputation is sufficiently developed to eclipse the value of her *pro rata* share of the firm's reputation⁵⁹ or if a lawyer is able to free-ride on

⁵⁴See "Sharing among the Human Capitalists," *supra*, note 7 at 354.

⁵⁵Interestingly, the actual pattern of specialization in fully diversified firms poses another problem for the thesis. Since securities lawyers could probably diversify away most of the risk of cyclical economic downturn by marrying their practice with that of bankruptcy and litigation lawyers, what accounts for the expansion of firms into areas of legal specialization that would seem to *enhance*, not reduce, their vulnerability to economic downturns?

⁵⁶The fact that a number of boutique firms exist and can survive despite exclusive concentration in specialties ranging from tax to bankruptcy law casts doubt on the importance Gilson and Mnookin place either on human capital diversification or on the efficacy of the firm in enforcing income sharing arrangements.

⁵⁷See, for instance, R. Axelrod, *The Evolution of Cooperation* (New York: Basic Books, 1984) at 126.

⁵⁸Although a defecting lawyer may be able to gain admittance to another law firm (and its internal income transfers) when economic conditions reduce the value of her marginal product, and then to leave the firm when economic conditions increase the value of her product, reputational effects within the relatively closed legal community will limit the number of times that this game can be played.

⁵⁹In the world of Gilson and Mnookin, individual reputation is inseparable from and dependent upon the global reputation of the firm. The recognition value of the firm's brand name is given pride of place, while the reputational value of individual lawyers is limited or non-existent. Yet,

the firm's reputation after departure⁶⁰ — both of which are not far-fetched assumptions — the strength of the reputational constraint will be diluted.

b. Galanter and Palay: Investment in Human Capital Development

Like Gilson and Mnookin, Galanter and Palay's rationale for the firm owes a debt to Williamson's focus on asset-specific investments, and on the capacity of internal compensation and governance arrangements to nullify the incentives for welfare-reducing opportunism. However, Galanter and Palay chart a slightly different course by focusing on infirmities in the trading relationship that exists between junior and senior lawyers.⁶¹ This relationship arises from the desire of senior lawyers to exploit fully the rents generated by their reputational capital by leveraging off the labour of junior lawyers.⁶² The gain to the senior lawyer accrues in the differential in the retail and wholesale rates for the junior lawyer's human capital. However, the fact that the senior lawyer earns profit from the relationship does not mean that the junior lawyer is being abused.⁶³ The experience gained through close interaction with the senior lawyer enables the junior lawyer to further develop the general skills acquired during formal legal training. Without this supervised, on-the-job training, the junior lawyer would be unable to develop as quickly into a lawyer having surplus reputational capital.

The difficulty, however, with bilateral trade in services between senior and junior lawyers emanates from the time and energy that the senior lawyer will

this characterization seems unrealistic for many lawyers in the firm. For some subset of lawyers in the firm, the highly decentralized delivery of legal services (allowing close personal interaction between client and servicing lawyer), in combination with opportunities for external evaluation of performance by clients and third parties in the legal community (these opportunities can be found in judicial or administrative proceedings or in negotiations with opposing parties), facilitates the development of reputations that are specific to individual lawyers and substantially independent of the firm. In the event that these lawyers decide to depart from a law firm, it is conceivable that their aggregate investment in reputational capital (the sum of firm and personal reputation) would be unaffected or, perhaps, even enhanced. That is, the loss that is suffered from any foregone share of firm reputation may be minuscule compared to the value of their personal reputation. Obviously, for these lawyers, indivisibilities in reputational capital impose little or no constraint on opportunistic defection from the firm.

⁶⁰Since at least part of the value of a firm's reputation is its brand name value, which serves as a bond of excellence in service for all lawyers associated with the firm, a departing lawyer may be able to rely on her association with the firm as a way of signalling proficiency in the law to prospective clients and employers. The only way for a firm to control the use of its brand name in the aftermarket is by public denunciations of departing lawyers to the broader community. But such denunciations may harm the firm as much as or more than the departing lawyer. This is because airing the firm's dirty laundry in public, *i.e.*, alleging defection on internal implicit contracts, casts doubt on the firm's ability to identify and recruit lawyers whose distinguished professional qualifications are complemented by high moral character. If clients are told that the firm failed in picking a departing lawyer, then implicitly the value of the firm's bonds respecting its other lawyers is suspect. Moreover, public denunciations have an air of sour grapes about them. Clients may suspect that actions initiated against departing lawyers — especially if these lawyers are able to take prized clients with them — may be seen to be motivated more by vindictiveness than by an effort to correct market signals.

⁶¹*Supra*, note 8.

⁶²*Ibid.* at 770-72.

⁶³See Leibowitz & Tollison, *supra*, note 15.

expend in acquainting the junior lawyer with her distinctive approaches to legal problem solving and with the unique requirements of her clients. This course of instruction is extremely intensive, and often extends over a period of many years. Although at the outset of their relationship, the senior lawyer could choose from among many potential juniors, once a junior is selected, and the investment in training made, the senior lawyer is, within some bounds, "locked-in" to that junior.⁶⁴ This will cause the senior lawyer to have a strong interest in safeguarding the survival of the relationship. The difficulty, however, is that this "lock-in" effect fetters the ability of the senior lawyer to discipline opportunistic juniors. If clients are "grabbed" from the senior lawyer, if work is performed at a standard that is unacceptable to the senior lawyer, or if the junior lawyer terminates the relationship prematurely, the senior lawyer's welfare will be reduced.⁶⁵ The danger of these losses may cause senior lawyers to forego the gains from leveraging on their reputation, thereby jeopardizing the training of junior lawyers.

According to Galanter and Palay, the tensions inherent in a senior-junior relationship can be resolved by using the promise by the senior partner of a promotion to partnership should the associate prove competent.⁶⁶ The "carrot" of partnership will encourage the junior lawyer to refrain from opportunistic behaviour that could jeopardize the interests of her senior lawyer, as this conduct is bound to reflect badly on the junior lawyer at the time that the partnership decision is made. However, this device is not without its flaws; for just as the senior lawyer fears opportunism by the junior lawyer, so, too, does the junior lawyer fear that the senior lawyer will behave opportunistically in making the partnership decision.⁶⁷ Recognizing that partnership entails a sharing of both revenue and decision-making with the junior lawyer, the junior lawyer will quite naturally fear that the partnership decision will be unduly delayed or not carried out in a *bona fide* manner. In these terms, the law firm's comparative advantage stems from its ability to assuage the junior lawyer's concerns. By constructing a governance structure that is uniquely related to the interests of both parties, the firm is able to encourage parties to make asset-specific investments required by trade in legal services.⁶⁸

The difficulty with the Galanter and Palay thesis lies not in its description of the gains from trade in services, but rather in its failure to provide concrete

⁶⁴Prior to Galanter and Palay's work, Leibowitz and Tollison investigated the potential for opportunistic behaviour in the context of the senior-junior lawyer relationship. The researchers' work was undertaken in response to the charge that law firms exploited neophyte lawyers by offering only meagre starting wages. They argued that these wages could be justified on the basis of the risks of opportunism that law firms faced in training lawyers. Since lawyers can easily transport the benefits of generalized legal training to other firms, law firms will, in the absence of contractual safeguards or reductions in salary, be reluctant to bear the costs of training new lawyers. This phenomenon accounts for the relatively low starting wages of lawyers (*ibid.* at 66-68).

⁶⁵Galanter & Palay, *supra*, note 8 at 773-75.

⁶⁶*Ibid.*

⁶⁷*Ibid.* at 776.

⁶⁸Galanter and Palay argue that there is a need for a governance structure to "monitor behaviour, to adapt the agreement to changed circumstances, and to ensure that the parties actually perform agreed upon changes" (*ibid.* at 773).

evidence of how the governance structure employed by the firm mitigates the opportunism dangers previously identified. Although Galanter and Palay believe that the governance structure of the firm will control opportunism by monitoring behaviour, by adapting the agreement respecting the trade in services to changed circumstances, and by ensuring that parties perform agreed-upon exchanges,⁶⁹ the precise way in which the governance structure achieves this task is not fully explicated. Further, if the core rationale for the firm is related to solving intra-firm disputes, particularly across the partner-associate axis, what assurances do associates have of fair treatment given the concentration of voting power vested in the hands of the partners? Problems with the "trade in services" rationale for the law firm are further underscored by the existence of such *contractual* bonding devices as the "up or out system," which, as Gilson and Mnookin have persuasively argued, are able to provide credible assurances of fair treatment in partner promotion decisions and are not dependent on intricate firm governance structures.⁷⁰

III. Firm Culture: Completing the Theory of the Law Firm

A. Introduction

Review of the existing claims advanced to explicate the rationale for the modern law firm is a somewhat discouraging exercise. In the course of unraveling the economic logic of the law firm form, several glaring and fairly fundamental gaps were exposed. These gaps included such puzzling features of the firm as how centralized monitoring systems can detect and deter lapses in mental effort, how the debilitating effects of the rational apathy spawned by systems of fractionalized ownership are controlled, how the firm is able to instill internal commitments to excellence that are necessary to generate and support brand name reputation and, finally, how the propensity to defect from asset-specific investments can be tempered. Unless answers to these puzzles can be supplied, the rationale for the law firm is destined to remain incomplete and, therefore, defective.

Fortunately, answers to these questions can be provided and, in the course of doing so, a new, more robust theory of the law firm, premised on the law firm's role as a mini-society of sorts, can be developed. In this society, elemental characteristics of the firm, such as the premium its members place on cooperation, collegiality, conformity, and continuity, coalesce to inculcate and sustain shared commitments to professional excellence. The stronger these commitments to excellence, the less severe the various types of opportunism that work to subvert the benefits of joint economic activity. In part, this commitment to excellence is derived from externally imposed group sanctions that range from mild opprobrium to permanent ouster. But an equally important part of this commitment is the result of a subtle process in which individual preference functions are modified in a way that renders firm members hostile to indo-

⁶⁹*Ibid.*

⁷⁰"Sharing among the Human Capitalists," *supra*, note 7 at 380-81; O'Flaherty & Siow, *supra*, note 15.

lence and inclined to industry. The catalyst behind these external and internal incentives is firm culture, and since this cultural component will not flourish in the hostile climates of spot contracts, it supplies the missing ingredient that completes the theory of the law firm.

B. *The Firm as Community*

The starting point for the theory of the law firm as a mini-society is a recognition of the role that community interaction plays in enabling individuals to realize fundamental and deeply cherished aspirations.⁷¹ At the core of these aspirations is the desire to be able to consummate and sustain close personal relationships that are based on a foundation of equal participation, mutual dependence, trust, respect, and compassion, all of which are captured in the concept of solidarity.⁷² These relationships are prized not necessarily for their instrumental character, but rather for their value as pure consumption goods. And, although the benefits from such relationships have been traditionally associated with family and political associations, the workplace is increasingly becoming an important venue for communitarian ideals to be vindicated.⁷³ This is especially so given the changing complexion of the nuclear family and the limited opportunities available for meaningful participation in political life.⁷⁴

Interestingly, despite the conventional view that economic and communitarian values are in fundamental tension with one another, exploration of joint workplace activity reveals that important linkages exist between these values. Not only are communitarian values not necessarily in tension with economic ones, but, in some settings, conduct that vindicates one set of values will simultaneously contribute to the realization of the other. If, for instance, deep attachments to the workplace community can be created, and if these attachments are based on a high degree of respect for other members of the community and a willingness, indeed, enthusiasm, for cooperative enterprise, then important efficiency benefits are likely to follow. At the simplest level, these benefits flow from the sense of well-being and satisfaction that individuals will develop when participating in and contributing to cooperative enterprise. As a considerable

⁷¹Powerful support for the communitarian ideal can be found in the work of critical legal studies scholars. See, for example, G. Frug, "The Ideology of Bureaucracy in American Law" (1984) 97 Harv. L. Rev. 1276; D. Kennedy, "Legal Formality" (1973) 2 J. Legal Stud. 351; R. Unger, "The Critical Legal Studies Movement" (1983) 96 Harv. L. Rev. 561.

⁷²Macneil describes "solidarity" or trust as a web of interdependence, externally reinforced as well as self-supporting, and expected future cooperation. The most important aspect of solidarity ... is the extent to which it produces similarity of selfish interests, whereby what increases (decreases) the utility of one participant also increases (decreases) the utility of the other (I. Macneil, "Economic Analysis of Contractual Relations: Its Shortfalls and the Need for a 'Rich Classificatory Apparatus'" (1981) 75 Northwestern U. L. Rev. 1018 at 1034).

⁷³See M. Walzer, *Spheres of Justice* (New York: Basic Books, 1983) at 300. Walzer likens the firm to a political community: "The firm is like a town ... because it is unlike a home It is a place not of rest and intimacy but of cooperative action. It is a place not of withdrawal but of decision" (*ibid.*).

⁷⁴See, for instance, P.C. Weiler who argues for enhanced worker control over workplace decision-making (*Governing the Workplace* (Cambridge: Harvard U. Press, 1990) at 168ff).

body of human resource literature has found, a worker not alienated from her work environment is much more productive and innovative than one who is.⁷⁵

At another level, however, communal attachments yield important efficiency benefits by expanding the range and effectiveness of mechanisms that can control the agency costs innate in joint economic activity. It is the vaunted role of communal attachments in small, homogeneous communities that encourages individuals to refrain from violating community norms which, in the case of communities based on shared economic goals, can include wealth maximization. Deviations from transcendent global goals will, depending on severity, subject the wrongdoer to the opprobrium of the entire community. This opprobrium can be expressed in community acts ranging from mild censure to outright ouster. In any event, unlike the anonymity of more conventional sanctions, it is the very personalized and public recrimination of a community member by the community that gives these sanctions their potent sting. How much more difficult it is to face the disappointment and anger of co-workers when their friendship and esteem is a valued good. Predictably, the greater the strength and depth of community attachments, the more psychologically crushing diminished or severed relationships will be.

Yet, community attachments should not be viewed simply as a crude form of hostage-taking that commands virtuous conduct because of the potential for forfeiture of pre-existing psychological investment. Community affiliations can work at a much more complex level to elicit commitments to valued behaviour. The subtle interplay of support, encouragement, and competition that exists in most firms provides a fertile environment for these commitments to gel. Community reinforcement may be especially significant when individuals, although deeply committed to the realization of certain values, are inclined to conduct themselves in a manner that is inconsistent with those values because of the intervention of other, more superficial desires and preferences.⁷⁶ For instance, an individual who is naturally disinclined to hard work may seek out employment in settings in which commitments to industry and initiative are lauded. By voluntarily joining such a community, the shirker may hope that her innate propensity for indolence is suppressed, perhaps even permanently modified, by the community's collective expression of support for more virtuous behaviour.⁷⁷

⁷⁵See, for example, H. Hansmann, "When Does Worker Ownership Work? ESOPs, Law Firms, Codetermination, and Economic Democracy" (1990) 99 Yale L.J. 1749. Hansmann argues that worker participation in economic decision-making yields important benefits. Greater opportunities for participation in communal decisions increases workers' psychological satisfaction, renders decision-making more cooperative, less adversarial, and prepares workers for participation in broader democratic decisions.

⁷⁶C. Sunstein, *After the Rights Revolution: Reconceiving the Regulatory State* (Cambridge: Harvard U. Press, 1991) c. 2 at 57-60. In other words, even though an individual may be predisposed to conduct which is antithetical to values that are associated with a given community, her membership in that community may constitute a deliberate effort to strengthen other parts of her character which are desirous of vindicating these community values.

⁷⁷In the context of the law firm, see R. Nelson, who asserts that "[s]tanding in the [law] firm, whether it is measured in terms of income, governing authority, client responsibility, or even making partner, depends on personal success and achievement. It is a privilege won, not an office that is assured" ("Practice and Privilege: Social Change and the Structure of Large Law Firms" (1981)

Acknowledgment of the role that communal attachments can play in reinforcing commitments to certain types of desired behaviour provides important insight into the rationale for the law firm. Within the firm, the identity of contracting partners matters, especially when, as in the case of professional partnerships, so much of the firm's wealth is based on the quality of its human capital. In contrast to the sporadic, short-term, and relatively anonymous market contracts, the firm provides a stable environment for communal attachments to develop. As William Ouchi has argued,

[firms] can create an atmosphere of trust between employees much more readily than a market can between the parties to an exchange. Because members of an organization assume some commonality of purpose, because they learn that long-term relationships will reward good performance and punish poor performance, they develop some goal congruence. This reduces their opportunistic tendencies and thus the need to monitor their performance.⁷⁸

Although Ouchi relates the effectiveness of the firm to its hierarchical surveillance, evaluation and direction, he finds that non-hierarchical clan attributes — involving the union of objectives among individuals whose interests are interdependent — are also important.⁷⁹ In this respect, the firm's ability to control endemic opportunism is a direct function of its capacity to inculcate a set of ideals that foster commitments to productive behaviour, and to create the necessary interpersonal attachments within the community that will ensure that these commitments are realized.⁸⁰ This, of course, implicates the issue of firm culture.

C. *Creating Commitments to Community: The Role of Firm Culture*

Firm culture is the medium by which certain transcendent community values are transmitted to members of the firm. Until relatively recently, the role of firm culture in enhancing organization efficiency has been a somewhat neglected topic.⁸¹ Nevertheless, in the last decade, organizational theorists have

95 American Bar Foundation Research Journal 95 at 102). One example of this phenomenon are people who decide to join such organizations as the military to bring discipline and organization to their lives.

⁷⁸"Markets, Bureaucracies, and Clans" (1980) 25 Administrative Science Quarterly 129 at 134.

⁷⁹Ouchi describes the relationship between goal congruence and the clan form in the following way:

In these organizations (those resembling the clan form), a variety of social mechanisms reduces differences between individual and organizational goals and produces a strong sense of community. Where individual and organizational interests overlap to this extent, opportunism is unlikely and equity in rewards can be achieved at relatively low transactions cost (*ibid.* at 136-37 (citations omitted)).

⁸⁰The role of the law firm in inculcating professional commitments has received empirical confirmation. See F.K. Zemans & V.G. Rosenblum, *The Making of a Public Profession* (Chicago: American Bar Foundation, 1981). They found that law firm experience was more important than law school training in shaping ethical commitments (*ibid.* at 171-78).

⁸¹A general exception is D. Kreps, "Corporate Culture and Economic Theory" in J. Alt & K. Shepsle, eds, *Perspectives on Positive Political Economy* (New York: Cambridge U. Press, 1990) 90. Kreps' attempt to fashion a theory of the firm on the basis of corporate culture is referred to in Hart, *supra*, note 34 at 136. In the context of the law firm, Gilson and Mnookin explore the role of firm culture in controlling "unobservable conflict." They argue that "[t]hrough some combination of selection and socialization firms can create a powerful internalized work ethic" ("Sharing

begun to explore the nature and impact of different cultures on organizational success.⁸² In considering the content of firm culture, most organizational theorists draw on the work of anthropologists and sociologists, each of whom emphasize different aspects of culture.⁸³ Whereas anthropologists emphasize the material aspects of culture (e.g., concrete artifacts of various groups), sociologists tend to focus on the process of learning culture, on the patterns of meaning, and on the rules governing the behaviour of members in a group. Despite the surface differences between these two approaches, organizational theorists have been able to draw on obvious commonalities in generating insights about firm culture.⁸⁴ Organizational theorists have harnessed these traditional definitions of culture to develop a multi-tiered theory of firm culture.⁸⁵ The first tier of firm culture is the *artifacts* of the firm, and are found in the physical and social environment in which members of the group work.⁸⁶ The second tier of corporate culture is *perspectives*, which is focused upon imparting meaning to the objective elements of culture that are easily observed in a large organization.⁸⁷ The

among the Human Capitalists," *supra*, note 7 at 375). Despite, however, their identification of firm culture as an important constraint on opportunistic activity, the researchers place considerable reliance on law school socialization processes and on general commitments to the professional ideal in explaining how firm culture operates. As a consequence, their theory does not explain the particular role of the firm in inculcating pre-existing values and commitments. To understand why firm culture works, it is, I believe, necessary to consider the role for the communitarian commitments discussed above.

⁸²For a popular exposition of the linkages between culture and organizational success, see T.J. Peters & R.H. Waterman, *In Search of Excellence* (New York: Harper & Row, 1982).

⁸³For a review of the different approaches to culture, see Papers of the Peabody Museum of American Archaeology and Ethnology, *Culture: A Critical Review of Concepts and Definitions* by A.L. Kroeber & C. Kluckhohn, vol. 47 (Cambridge, MA: The Peabody Museum of American Archaeology and Ethnology, 1952) in which the authors identify 164 different definitions of culture (*ibid.* at 35).

⁸⁴These include acceptance of the role of custom and of both subjective and objective components to culture. The acceptance of custom has several implications: (i) that culture is learned rather than genetic in nature; (ii) that culture is shared by group members rather than being an idiosyncratic attribute; (iii) that culture is transgenerational and cumulative; and (iv) that culture is symbolic in nature and patterned in our lives. The acceptance of both subjective and objective elements of culture implies that the way in which a group perceives its environment is at least as important as the actual artifacts and material products of a society in defining culture (A.F. Buono & J.L. Bowditch, *The Human Side of Mergers and Acquisitions: Managing Collisions Between People, Cultures, and Organizations* (San Francisco: Jossey Bass, 1989) at 136).

⁸⁵Definitions of organizational culture are explored by E. Schein, *Organizational Culture and Leadership* (San Francisco: Jossey-Bass, 1985) at 6. See also C.C. Lundberg, "On the Feasibility of Cultural Intervention in Organizations" in P.J. Frost *et al.*, eds; *Organizational Culture* (Beverly Hills: Sage, 1985) 169 at 171; W.G. Dyer, Jr., "The Cycle of Cultural Evolution in Organizations" in R. Kilmann *et al.*, eds, *Gaining Control of the Corporate Culture* (San Francisco: Jossey-Bass, 1985) 200 at 202-04.

⁸⁶Physical artifacts include such things as the architecture of the flagship building, the office configurations within the building, and the amenities and benefits provided to employees. Social artifacts include hierarchical structure, common forms of expression, and shared stories and myths about group members, corporate founders, and leaders or notable employees. See Lundberg, *ibid.*; Dyer, *ibid.* at 202; Schein, *ibid.* at 14-15.

⁸⁷Perspectives are the socially shared rules and norms applicable in a given situation; they prescribe the bounds of acceptable behaviour, such as the way an employee addresses her superiors and fellow employees, and they provide solutions to common problems that group members encounter in organizational activities.

third tier of firm culture is devoted to the *values* that form the evaluative basis upon which organizational members ground their judgments of situations, acts, objects, and people.⁸⁸ The fourth, and most basic, level of culture is *assumptions*, which are the tacit premises that underlie all the other levels of culture.⁸⁹

The ability of a law firm to create and maintain commitments to certain transcendent values is a function of the strength, quality, and durability of its culture. Although there are clear and important differences in the content of culture across law firms, these differences are usually found at the level of artifacts and perspectives. For instance, virtually all elite corporate law firms share a deep commitment to the values of excellence and integrity that stand at the core of the professional ideal.⁹⁰ By and large, commitments to this ideal are promoted through the example of senior partners of the firm whose leadership position is a function of their personal success and achievement. The pressure to emulate the habits of senior lawyers is further reinforced by the promotion-to-partnership tournament. After a protracted training period, during which time an associate's values and conduct are subject to close scrutiny, those associates invited to join the partnership will have done so only by manifesting the necessary commitment to the professional ideal.⁹¹ The commitment to the professional ideal is further reinforced by a variety of external, *i.e.*, non-firm factors, including standardized professional training regimes⁹² and a myriad of professional organizations that bring lawyers with the same specialized interests together to explore various legal problems and their solutions.⁹³

Yet, despite important commonalities at the level of assumptions and values, inspection of the components of law firm culture at the levels of artifacts and perspectives discloses significant differences that can generate very distinctive law firm environments. This is seen best by way of illustration. Take, for example, two hypothetical law firms, one an established, old-style firm offering a full range of corporate legal services ("Blue Ribbon"), the other, a relatively young firm specializing in cutting-edge tax work ("Boutique"). While Blue Ribbon's founding myth may emphasize its long and distinguished

⁸⁸Typically, values are more abstract than perspectives, and include an organization's general goals, ideals, standards, and sins.

⁸⁹It is, of course, difficult to maintain crisp distinctions between each of these levels of culture.

⁹⁰The role of the professional ideal in the context of the legal profession is discussed in S. Macaulay, "Lawyers and Consumer Protection Laws" (1979) 14 L. & Soc. Rev. 115; "Control, Influence, and Attitudes: A Comment on Nelson" (1985) 37 Stan. L. Rev. 553 at 556-57; Nelson, *supra*, note 9; D. Ruschemeyer, "Professional Autonomy and the Social Control of Expertise" in R. Dingwall & P. Lewis, eds, *The Sociology of the Professions* (London: MacMillan, 1983).

⁹¹Among the values that an associate with partnership aspirations will have to exhibit is an antipathy to incompetence and a revulsion for slacking and self-indulgence. These values will lead those who finally ascend to the partnership to be vigilant in their condemnation of shirking colleagues.

⁹²See, for instance, B. Garth, "Legal Education and Large Law Firms: Delivering Legality or Solving Problems" (1989) 64 Indiana L.J. 433; P. Kissam, "The Decline of Law School Professionalism" (1986) 134 U. Penn. L. Rev. 251.

⁹³The recognition that lawyers receive in these fora from their colleagues is based, not only on their virtuosity in technical legal problem solving, but also on the high ethical standards that they adhere to in their legal practice.

history,⁹⁴ particularly the role it played in facilitating the rise of large industrial and financial clients, Boutique's founding myth may focus on its relative youth, its more progressive clients, and its formation as a breakaway from or response to the failings of other mainstream firms. Devotion to these myths is related to other important cultural differences between the two firms. Given the premium that Blue Ribbon may place on continuity of client relationships, it will find that it has to offer a full range of legal services to its clients in order to mitigate any incentives for other firms to grab its clients. In sharp contrast, Boutique's founding myth may be strengthened by the fact that its relations with clients are relatively bounded and short-lived. Moreover, confining its practise to one specialized area — even to the extent of turning away work that is deemed extraneous to the firm's core interests — has powerful symbolic value in underscoring Boutique's self-perceived elite status.

Differences in the artifacts and perspectives of the two firms may also be found in their views regarding the expectations each has in relation to the amount of time lawyers should be devoting to legal practise and to other commitments. In order to ensure that its lawyers are at the cutting edge of legal developments in the tax area, Boutique may place a premium on its lawyers devoting prodigious amounts of time and energy to transactional work. Outside social and community commitments may be frowned upon, and *pro bono* work devalued. In contrast, Blue Ribbon may insist that its lawyers balance their devotion to business clients with various social and political activities, including the maintenance of *pro bono* commitments to various public charities. These commitments will allow its lawyers to develop the sensitivities and skills that are necessary to realize the essence of the professional ideal. Further differences between the two firms may be found in their internal hierarchical structures. Differences may be evident in the time periods necessary for ascension to partnership (short for Boutique, long for Blue Ribbon), in the voting rules for major partnership decisions (simple majority for Boutique, consensus for Blue Ribbon), in the reliance on the use of non-lawyers as senior decision-makers (embraced in Boutique, rejected in Blue Ribbon),⁹⁵ and in the sensitivity of marginal productivity measures in compensation and billing practices (high sensitivity in Boutique, low sensitivity in Blue Ribbon).⁹⁶

In sum, despite shared commitments to the core values and assumptions of the professional ideal, when the various artifacts and perspectives of the two

⁹⁴The imprint that founding partners can leave on law firms is explored in R.T. Swaine, *The Cravath Firm and its Predecessors, 1819-1947* (New York: Ad Press, private printing, 1946); W.K. Earle, *Mr. Shearman and Mr. Sterling and How They Grew* (New Haven: Yale U. Press, 1963).

⁹⁵For example, firm members may fear the prospect of non-lawyer managers constraining their client servicing activities, in terms of the scope of research and analysis required for resolution of a given legal problem, in an effort to meet crass cost considerations. Or, they may worry that the delicate balance between the lawyer's obligations to client and public will be tipped inappropriately toward the former.

⁹⁶Admittedly, as Gilson and Mnookin observe, the more dependent the firm is on merit-based compensation, the less effective the firm becomes in diversifying away the risks of specialized human capital ("Sharing among the Human Capitalists," *supra*, note 7 at 340). But, in a setting in which lawyers have chosen not to diversify these risks by cobbling together a firm with different specialties, this shift to merit-based compensation may not be important.

hypothetical law firms are closely examined they reveal some very important differences in the content of overall law firm culture. But difference does not, of course, imply superiority of one form of culture over the other. Both firms can be taken to have created a culture that comports with the demands of the market segments that each is trying to satisfy. For instance, the more traditional culture of Blue Ribbon would not mesh at all well with the needs of highly aggressive, risk-perverse clients, whereas the maverick culture of Boutique may not fit the more conventional needs of old-style family enterprises. In either case, the mere expression of a distinctive vision of the firm's community, when coupled with the intense personal relationships that are formed among individuals within the firm, can greatly contribute to the control of agency costs through more traditional measures such as metering, ownership, and reputational indivisibilities. As such, protection of successful firm culture is essential to the survival of the firm. This issue is explored further in the following section in the context of mergers which, given their capacity to upset the internal environment of the firm, are capable of destroying firm culture.

IV. The Urge to Merge and the Survival of the Law Firm

Law firms in a number of industrialized countries have undergone rapid growth over the past decade, and, in some jurisdictions, even longer.⁹⁷ For instance, of the 50 largest Canadian firms, none of the firms had more than 100 lawyers in 1960 or 1970, and, in 1980, one firm had 100 lawyers but, by 1990, 19 firms had more than 100.⁹⁸ Galanter and Palay have analyzed the pattern of law firm growth in the United States, and have found that an exponential function is best fitted with the data collected.⁹⁹ This exponential function has, they argue, been operative since 1922. Exponential growth means that the size of the large American firms grew by a constant or increasing percentage each year. Canadian law firm growth patterns seem to parallel the American trends. Despite some anomalous years, the trend in the Canadian data, as measured by aggregate numbers of partners and associates, shows that Canadian law firms grew by constant or increasing rates during the period 1960 to 1990.¹⁰⁰

⁹⁷The significance of rapid growth can be best appreciated by comparing the growth rates of the leading corporate law firms in five major Canadian cities (as measured by the total number of lawyers employed by these firms) with the number of lawyers in private practice in the corresponding provinces. Although yielding equivocal results for the period 1962 to 1980, the data are arresting for the most recent period 1980 to 1989: during this period, save for Nova Scotia, the growth rate of corporate firms was far in excess of the growth rate of lawyers generally. The difference in the rates ranged from a multiple of 1.7 for British Columbia to a multiple of 3.5 for Quebec. For a more comprehensive discussion, see R.J. Daniels, "Growing Pains: How and Why Law Firms Grow" U.T.L.J. [forthcoming].

⁹⁸The data were collected from the *Canada Law List* (Toronto: Carswell, published annually). The sample of 50 firms was constructed by identifying the largest law firms in five Canadian cities, Vancouver, Calgary, Toronto, Montreal, and Quebec in 1990, and following the number of lawyers back each year until 1960.

⁹⁹*Supra*, note 8 at 756-65.

¹⁰⁰Robust growth is exhibited most starkly by Toronto firms in the last decade; in 7 of the 10 years in the period 1980 to 1990, Toronto law firms grew in excess of 8% per annum. For 6 out of 10 Vancouver firms and 5 out of 10 Montreal firms, comparable growth rates were exhibited.

Typically, law firm growth has been effected by conventional recruitment of newly minted lawyers directly from law school, followed by a protracted period of ascension to partnership. Nevertheless, over the last decade, law firms have exhibited a willingness to grow by deploying a variety of other instruments, among which the most interesting is that of the merger.¹⁰¹ Mergers can be effected between two relatively equal-sized firms or between firms having different sizes, and involve the integration of two separate partnerships into one. In contrast to conventional recruitment, merging allows the immediate realization of scale and scope economies and ensures that client demands are met with alacrity. And, unlike other growth instruments, for example, lateral recruitment, mergers allow "acquiring" firms to obtain the expertise of "target" lawyers without jeopardizing the acquired firm's investment in reputational capital.

Despite the value of the merger instrument in vindicating growth objectives, its use poses some very serious challenges to the survival of the law firm, particularly in light of the emphasis that the theory developed above places on the constancy of community attachments and on the distinctiveness of culture in facilitating the benefits of joint production.¹⁰² Put simply, when two firms are merged, unless they each possess visions of community and culture that are highly complementary, there is a good chance, perhaps as high as 50%, that the merger will fail.¹⁰³ In the main, failure can be traced to the inability of lawyers in the two merging firms to agree on a vision of the merged firm that is compatible with each of the pre-existing firms' cultural artifacts and perspectives.¹⁰⁴ Especially given the premium that lawyers place on consensus-based decision-making, pre- or post-merger negotiations can easily founder on the shoals of divergent visions of the good community.¹⁰⁵ These disputes may be manifest in relation to a number of different issues, including different styles of practice, billing conventions, forms and methods of compensation, internal governance

¹⁰¹The merger instrument has been increasingly relied on in a Canadian setting to achieve law firm growth. For instance, in the year 1989 there were seven mergers in Canada involving a total of 1117 lawyers, by far the highest recorded amount of merger activity ever in Canada. Similar dependence on the merger instrument has been exhibited in the United States.

¹⁰²Recent examination on the impact of various types of exogenous shocks on the structure of the law firm can be found in R. Gilson, "The Devolution of the Legal Profession: A Demand Side Perspective" (1990) 49 Maryland L. Rev. 869; Nelson, *supra*, note 77; Samuelson, *supra*, note 9.

¹⁰³P. Pritchett, *After the Merger: Managing the Shockwaves* (Homewood, Ill.: Dow Jones-Irwin, 1985) at 10-16.

¹⁰⁴See, for instance, Buono & Bowditch, *supra*, note 84:

One of the underlying reasons why mergers and acquisitions often fail to achieve the level of operational and financial performance predicted by the precombination feasibility studies is the conflicts and tensions that emerge when companies try to combine disparate and, frequently, dramatically different cultures (*ibid.* at 134).

See also A.F. Buono & J.L. Bowditch, "When Cultures Collide: The Anatomy of a Merger" (1985) 38 Human Relations 477.

¹⁰⁵On consensus based decision-making structures, Nelson observes that there is limited scope for authority of leadership:

Other members of the firm have the same legal right (as senior management) to participate in the firm, and there are norms of consultation ... Firm leaders for the most part must 'ask for' rather than 'order' compliance ... Hence, while the privilege of leadership is not bound by rules, it is bound by a functional requirement to reach some consensus with one's partners (*supra*, note 77 at 127).

systems, promotion practices, etc. The more intense the disagreement on these issues, the less likely that lawyers will be able to weave a new culture from the fabric of the pre-existing firms. Not surprisingly, the less successful a merged firm is in resolving these conflicts, the more alienated its workforce will become, and the less effective the firm form will be in controlling endemic agency costs.¹⁰⁶ Once impaired in its capacity to control agency costs, the survival of the firm becomes questionable.¹⁰⁷

The severity of the debilitating conflicts that follow from a merger among law firms is a function of several different factors. The most important factor determining the severity of post-merger conflict is the model chosen by merging parties to reconcile divergences in culture. Buono and Bowditch identify three different models for resolving conflict: (i) cultural pluralism, (ii) blending, and (iii) takeover; each of which can illicit different degrees of resistance by workers in the merged entity depending on context.¹⁰⁸ *Cultural pluralism* is perhaps the least obtrusive way of handling divergences in culture as it implies that the cultural identity and independence of each of the merging firms should be preserved in the successor entity. Underlying this model is the assumption that a variety of cultural perspectives and commitments will galvanize the firm. *Blending* is an attempt to synthesize a new culture from the cultural elements of the combining firms. This strategy is, however, often undermined by the propensity of workers to retain commitments to their original culture. It also requires extensive, time-consuming negotiation to be successful. The final model is the *takeover*, which implies the complete eradication of the culture of one of the combining firms, and its replacement with the culture of the other firm. Although having considerable surface appeal, insofar as its capacity to obviate costly and time-consuming debates over firm identity, it enhances the risk of permanently alienating workers from the "acquired" firm.

Extrapolating from the problems of determining idealized cultural content in the surviving firm produces the issue of whether, in fact, lawyers in the combining firms will be responsive to the entreaties of senior partners and will modify their behaviour in a way that is compatible with the imperatives of the newly defined culture. The issue as to whether firm culture can be successfully manipulated by senior management is an open question in the human resources literature.¹⁰⁹ On one side are the pragmatists who claim that a corporation can change its culture by mere emulation, while, on the other side, are cultural plu-

¹⁰⁶In the context of combining corporations, clashes in firm culture have been attributed with responsibility for a number of different problems, including high levels of employee absenteeism and turnover, distracted work effort, disputes over preferred policies, and increased customer dissatisfaction. All of the problems are together referred to as the "merger syndrome." See Buono & Bowditch, *supra*, note 84 at 243; M.L. Marks & P.H. Mirvis, "The Merger Syndrome" *Psychology Today* (October 1986) 37.

¹⁰⁷The magnitude of the threats to law firm existence is powerfully illustrated by the publication of a recent book devoted to the mechanics of law firm terminations. See R. Hillman, *Law Firm Breakups* (Boston: Little, Brown, 1990).

¹⁰⁸*Supra*, note 84 at 143-47.

¹⁰⁹See, for instance, J. Martin, "Can Organizational Culture be Managed?" in Frost *et al.*, eds, *supra*, note 85, 95.

ralists who emphasize the impediments to successful modification of culture by management, particularly the initiation of successful firm cultures by workers, not management.¹¹⁰ Questions concerning the capacity of senior managers to change firm culture following a merger are particularly apposite in the law firm setting. In view of the privileged position of the professional ideal in the law firm, specifically the importance it attaches to individual autonomy and integrity, it will be difficult to radically alter cultural commitments in the new firm. This is especially so when lawyers hold extremely strong pre-existing commitments to the community and culture of each of the combining firms.

Concern over the disintegration of law firm culture was a theme frequently echoed in a series of interviews conducted with senior partners in 40 of Canada's leading law firms, especially among those firms recently involved in a law firm merger. As could have been predicted from the theory developed above, for mergers involving firms of roughly equal size and intensity of commitments to a pre-existing culture, the blending and pluralist models of cultural determination were most frequently invoked.¹¹¹ The former, not surprisingly, mired members of the two firms in an extremely belaboured, often contentious, determination of which artifacts and perspectives of the combining firms should persist in the surviving firm. Consistent with the discussion of law firm culture in Part III, and contrary to the claims of some organizational theorists,¹¹² even when firms chose their partners on the basis of complementarities in culture, substantial effort had to be devoted to the reconciliation exercise. It is significant that frustration with resolving many of these issues at the outset of the relationship caused some of the combining firms to abandon gradually their commitment to a blending model in favour of a more pluralistic model in which lawyers would be permitted to retain many of their previously formed cultural commitments, despite the obvious risks this posed to the success of the merger. Nevertheless, for these firms, and even for those firms choosing the pluralist model at the outset of the merger, the need to create some level of common culture was inescapable. Without some irreducible core of common culture, partners feared that the firm would find itself embroiled in repeated internecine disputes over a range of mundane issues, including promotion policies, office allocation, income distribution, client conflicts, etc.¹¹³ In these terms, the differences between the

¹¹⁰For an analysis of the process of change in firm culture, see T.E. Deal, "Cultural Change: Opportunity, Silent Killer, or Metamorphosis?" in Kilmann, *et al.*, eds, *supra*, note 85, 292 at 292; H.M. Trice & J.M. Beyer, "Using Six Organizational Rites to Change Culture" in Kilmann, *ibid.*, 370. The work of Peters & Waterman, *supra*, note 82, is illustrative of the pragmatist approach.

¹¹¹The takeover model did not mesh well with the equal bargaining power possessed by the combining firms, as, in order for it to work, one of the firms would have had to concede a weaker, less robust firm culture, an unlikely admission to be made in view of its detrimental impact on the level of sharing in firm net revenues by lawyers from the putatively weaker firm.

¹¹²J. Van Maanen & S.R. Barley downplay the problems of creating new cultures from mergers of professional firms owing to the apparent homogeneity of law firm cultures, which they attribute to common socialization processes involved in professional accreditation ("Cultural Organization: Fragments of a Theory" in Frost *et al.*, eds, *supra*, note 85, 31 at 38).

¹¹³The fusion of both diversity and homogeneity in modified pluralism models offers important lessons, not simply for law firms undertaking a merger, but for non-merging firms as well, given the stresses placed on the firm form by rapid growth. Even though not disrupting firm culture in as dramatic and abrupt fashion as a merger, rapid law firm growth can introduce strains on the

blending and the pluralist models of acculturation are rendered less significant at a level of principle, being models that are distinguished mainly by the balance struck between cultural homogeneity and diversity.

The way in which homogeneity and diversity have been accommodated in Canadian law firms following a merger (or, more conventionally, following sustained, rapid growth¹¹⁴) is intriguing. For the most part, firms have opted for the creation of a firm environment in which orthogonal sub-cultures would be tolerated. In these settings, lawyers simultaneously accepted a core set of values and assumptions common to the entire firm, while also embracing a separate set of non-conflicting values and assumptions particular to that group. The definition of subgroups within the surviving firm usually, but not invariably, tracked previous affiliations to the combining firms, meaning that the cultures of the combining firms still persisted in the new entity. Over time, it was hoped that these sub-cultures would become gradually integrated with the rest of the firm, creating a stronger, more dynamic firm culture. However, against these wistful aspirations, some firms acknowledged the fear that counter-cultures incompatible with the core of the dominant culture would grow from these sub-cultures, resulting in the disintegration of the firm, because of either debilitating internal conflicts over styles of practice or the departure of groups of lawyers to other firms offering a more congenial environment in which their culture could thrive.

Irrespective of the precise way in which a balance between homogeneity and diversity was struck in merged firms, it was manifestly clear from our interviews that concern over the content of firm culture, although not always identified by that name, was a major source of apprehension among merging firms. Many partners acknowledged that a failure to rectify inevitable and serious conflicts respecting the content of culture in the surviving firm threatened to tear these merged firms asunder. In these terms, these data, although anecdotal and fragmentary, furnish support for the claim that culture is an important component of the rationale for the law firm.

Conclusion

In this article, I have sought to examine the structure and rationale for the law firm partnership. In reviewing the theories traditionally advanced to explain the firm, I have found that each overlooks a crucial component of the role played by the firm in realizing the benefits of joint productive activity. This missing component is the firm's capacity to create and sustain community affiliations. These affiliations are vaunted for both their consumption and instrumental value. At the foundation of the firm's capacity to foster community

capacity of the firm to disseminate its core values to new recruits and to shore up commitments to these values in more senior lawyers. In the absence of a tightly defined community, led by leaders of exemplary moral character and professional distinction, the firm's culture is subject to gradual but certain erosion.

¹¹⁴There is reason to expect that rapid growth can have just as destructive an effect on firm culture as a merger. For instance, Galanter and Palay observe that rapid growth "changes the character of the firm. Informality recedes, collegiality gives way, notions of public service and independence are marginalized" (*supra*, note 8 at 756). See also Samuelson, *supra*, note 9 at 657.

attachments is its culture. Those firms able to create a set of intense commitments to a culture that is consonant with producer and consumer preferences will enjoy greater economic success. The case study of law firm mergers underscores the importance of firm culture to the survival of the firm.

The question raised by this article, and which merits further attention by organizational theorists, is whether and to what extent firm culture supplies any useful insight on the rationale of other forms of firm organization, particularly the conventional limited liability corporation. On one hand, many of the defects with some of the standard rationales for the firm form are implicated in the case of the corporation, suggesting that there is room for these theories to be embellished and improved, perhaps by considering community and culture. On the other hand, once one strays from firms supplying professional services toward more rigidly bureaucratic organizational forms, the scope for community attachments seems correspondingly narrowed. However, while the nature of community and culture in a large, multinational corporation may differ markedly from the small, professional firm, one suspects that some of these elements are still present, buttressing the effectiveness of the relatively crude set of economic carrots and sticks that are the exclusive preserve of the agency theorist.

The issue of why agency theorists have not devoted greater attention to exploring the role of culture and community in fostering organizational efficiency is puzzling. Perhaps part of the resistance can be traced to the deep-rooted reservations with the anti-liberal sentiment that percolates throughout the communitarian ideal, particularly the support it lends to the establishment of homogeneous, exclusionary political societies, which endanger the values of liberty and autonomy so dearly privileged by classic liberalism.¹¹⁵ Yet, the infirmities plaguing communitarianism in political society may be less important when the community that is sought to be created is the firm; for the firm, unlike political communities, is seldom erected on a foundation of ethnic, religious, or national homogeneity.¹¹⁶ In these terms, the firm as community holds considerable potential for realizing the communal aspirations of individuals, without jeopardizing the core tenets of the liberal vision of the good society. As such, it commands our attention.

¹¹⁵See, for instance, A. Kronman who, criticizing the collectivist vision of Milan Kundera, argues that such a society would be a "monstrosity The great fugue (described by Kundera) would indeed remove us from the state of nature, but it would also deprive us of the sense of separateness that underlies our notions of moral duty and personal achievement" ("Contract Law and the State of Nature" (1985) 1 J.L. Eco. & Organ. 5 at 30). See also M. Trebilcock, *An Exploration of the Limits of Freedom of Contract* [unpublished] (on file with the author).

¹¹⁶Not that this has always been true. The legal profession is a case in point. Mainstream Canadian and American law firms have at one time or another discriminated in the hiring of Jews (Comment, "The Jewish Law Student and New York Jobs — Discriminatory Effects in Law Firm Hiring Practices" (1964) 73 Yale L.J. 625); Catholics (E. Smigel, *The Wall Street Lawyer* (Indiana: Free Press of Glencoe, 1969) at 45); Blacks (D. Holley & T. Kleven, "Minorities and the Legal Profession: Current Platitudes, Current Barriers" (1987) 12 Thurgood Marshall L. Rev. 299); and women (C. Fuchs Epstein, *Women in Law* (New York: Basic Books, 1981) at 383; M. Huxter, "Survey of Employment Opportunities for Articling Students and Graduates of the Bar Admission Course" (1981) 15 L.S.U.C. Gazette 169) — though in the last decade or so rates of discrimination seem to have lessened dramatically.