

# ORGANIZATIONAL FORM AS STATUS AND SIGNAL

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*In this Article, the author analyzes the reactions of 147 New York City law firms to the 1994 enactment of the New York Limited Liability Partnership statute, which provided New York law firm partners with the first convenient mechanism to limit their personal liability for partnership debts. Using both quantitative and qualitative evidence, she evaluates whether the behavior of New York law firms supports the signaling theory of organizational form—that is, the theory that firms use the partnership form to signal to the marketplace that they provide high quality legal services, due to either superior monitoring or to profit sharing. She concludes that the quantitative data do not strongly support either signaling theory of partnership. In addition, both theories face substantial theoretical hurdles.*

*At the same time, interviews with law firm partners suggest that signaling concerns did impact law firm choice of form, in some cases profoundly. The author proposes three modifications to the signaling theory of organizational form that render the theory both more theoretically persuasive and more consistent with the observed behavior of law firms. First, the relevant signal appears to be negative, rather than positive. Second, this negative signal is more costly to elite firms than to non-elite firms. Third, firms may attempt to signal something other than, or in addition to, quality through their choice of organizational form—namely, status.*

## I. INTRODUCTION

In 1994, the New York state legislature provided law firms in the state with an alternative organizational form, the limited liability partnership (“LLP”), to the form that had been the standard

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for centuries, the general partnership (“GP”).<sup>1</sup> Law firms’ reactions to this development provide a rare opportunity for the empirical study, not only of the perceived costs and benefits of these organizational forms but also of the mechanisms by which firms choose to innovate and the mechanisms by which those innovations diffuse across an industry.

In this Article, I discuss one factor that appears to have played a complicated role both in firm decisions about organizational form and in dictating the mechanisms by which the new organizational form spread throughout New York law firms—the potential signal imparted by each firm’s choice of organizational form. The signaling theory of partnership is not new. Indeed, several variations of the theory appear in the economic literature on choice of form. The role of signaling in organizational form is complicated, however, because the typical empirical measures of the signaling theory of partnership do not support the conclusion that attempts to signal quality to the marketplace impact New York law firm choice of organizational form.<sup>2</sup> At the same time, other evidence—particularly extensive interviews with a large number of partners at New York law firms involved in their firm’s choice of form decision—suggests that concerns over signaling *did* impact law firm decisions regarding whether to limit partner liability for partnership debts, perhaps quite strongly.<sup>3</sup> I conclude that the choice of form pattern among New York law firms—along with evidence gleaned from the decision-makers themselves—suggests that signaling theories of partnership need modification if they are to contribute to our understanding of organizational form, at least with respect to law firms.

Part II of this Article discusses the expansion of organizational forms available to professional service firms, from the simple GP form that had been the prevailing standard for centuries, to a multitude of choices, including the professional association (“PA”), the professional corporation (“PC”), the LLP, and the limited liability corporation (“LLC”). Particular attention is given to the LLP, which has now spread to all fifty states.

Part III sets out the empirical project, involving a dataset of 147 law firms with more than twenty-five lawyers and their main offices in New York, New York (the “New York Data”). Those empirical results are supplemented with interviews of three sets of individuals knowledgeable about and active in the debate over law firm choice of organizational form: New York law firm partners, law firm insurers, and law firm consultants. Part III concludes by noting that the New York Data provide little, if any, empirical support for traditional

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1. N.Y. P'SHIP LAW § 121-1500 (McKinney 1994).

2. See *infra* notes 16-56 and accompanying text (discussing the New York Data).

3. See *infra* notes 84-91 and accompanying text.

theories of partnership form, including theories based on unlimited liability, profit sharing, and illiquidity.

Part IV describes two versions of the signaling theory of partnership: a monitoring signaling theory and a profit-sharing signaling theory. Part IV then discusses the traditional measures employed to test those theories and demonstrates that the New York Data do not support signaling theories of partnership, at least as those theories are currently formulated.

Part V urges a reformulation of signaling theories of partnership more consistent with the empirical data. First, the relevant signal appears to be negative, not positive. Second, this negative signal is more costly to elite firms than to non-elite ones. Third, firms may be attempting to signal something other than, or in addition to, the provision of high-quality legal services—namely, high status. Part VI concludes.

## II. THE EXPANSION OF ORGANIZATIONAL FORMS FOR PROFESSIONAL SERVICE FIRMS

Traditionally, professional service firms, including law firms, have been limited to a single organizational form—the GP.<sup>4</sup> The rash of suits against law and other professional service firms in the wake of the savings and loan crisis of the 1980s, however, caused professional firms to agitate for protection from personal liability for partnership debts.<sup>5</sup> In 1991, the Texas state legislature granted their wish, and the LLP was born.<sup>6</sup>

The only meaningful difference between the GP and LLP is that in the LLP, partners are liable only for partnership debts resulting from their own conduct or the conduct of someone under their supervision.<sup>7</sup> This is in contrast to the GP, in which partners face

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4. See, e.g., Jennifer J. Johnson, *Limited Liability for Lawyers: General Partners Need Not Apply*, 51 BUS. LAW. 85, 92-112 (1995) (discussing the availability of new organizational forms for law firms).

5. Robert W. Hamilton, *Registered Limited Liability Partnerships: Present at the Birth (Nearly)*, 66 U. COLO. L. REV. 1065, 1069-71 (1995) (discussing the motivation for and the rise of the LLP statute in Texas).

6. *Id.* at 1065. Another organizational form—the PC or PA, depending on the particular state statute—arose in the 1960s. However, the purpose of the statute was primarily to provide law firms with favorable tax treatment relating to retirement benefits, rather than to shield partners from personal liability. Accordingly, once tax changes removed the necessity of the form for tax benefits, the PC ceased to be a popular organizational choice in some jurisdictions. See Johnson, *supra* note 4, at 92-102 & 92 n.28.

7. See ALAN R. BROMBERG & LARRY E. RIBSTEIN, BROMBERG AND RIBSTEIN ON LIMITED LIABILITY PARTNERSHIPS, THE REVISED UNIFORM PARTNERSHIP ACT, AND THE UNIFORM LIMITED PARTNERSHIP ACT (2001) § 1.04(a) (2003 ed.). States differ in the limitations on liability provided by LLP status. Some states limit liability for both contract and tort claims. *Id.* at §§ 1.01(a)-(e), 2.08 (a)(1)-(2) (discussing the variations among state LLP statutes). Other states limit liability only for specific types of tort claims. *Id.*

full personal liability for all partnership debts.<sup>8</sup>

Since the advent of the 1991 Texas statute, all fifty states have passed laws permitting professional service firms to organize as LLPs.<sup>9</sup> This statutory change presents an important opportunity to study innovation and diffusion in general, and change with respect to organizational form in particular, because the transaction costs of the transformation are so low. In New York, a professional service firm operating as a GP can become an LLP by filing a simple registration statement with the Secretary of State and paying a \$200 filing fee.<sup>10</sup> The old partnership agreement can continue to govern the relationship among the partners, obviating the need to draft a new partnership agreement.<sup>11</sup>

Given the apparently minimal costs of switching to the LLP form and the benefits associated with avoiding personal liability, one might predict that in the ten-year interval since passage of New York's LLP statute, nearly every New York law firm would have opted for the LLP form. Furthermore, one might expect that, to the extent that some firms have failed to alter their organizational form, the failure might be most prevalent at small, less sophisticated firms, which perhaps have not taken the time to weigh the costs and benefits of switching.

Neither of these predictions would be accurate. In fact, a sizeable percentage of New York law firms—about 13 percent—remain GPs.<sup>12</sup> Moreover, some of America's largest and most profitable law firms remain GPs as of the date of this study.<sup>13</sup> Finally, the majority of elite firms switched to the LLP form only after 2000, nearly six years after passage of the LLP statute.<sup>14</sup> In this and a related Article, I examine empirically the factors that may contribute to this pattern of innovation and diffusion in organizational form.<sup>15</sup>

### III. THE EMPIRICAL PROJECT

In 2004, Scott Baker and I collected data on the 147 law firms

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8. UNIF. P'SHIP ACT §§ 13-15 (1914); REVISED UNIF. P'SHIP ACT §§ 304, 306 (2001).

9. See BROMBERG & RIBSTEIN, *supra* note 7, § 1.01(e). In addition, many states allow professional service firms, including law firms, to organize as LLCs. Johnson, *supra* note 4, at 102-06.

10. See, e.g., N.Y. P'SHIP LAW § 121-1500 (McKinney 1997).

11. *Id.* § 121-1500(d).

12. Scott Baker & Kimberly D. Krawiec, *The Economics of Limited Liability: An Empirical Study of New York Law Firms*, 2005 U. ILL. L. REV. (forthcoming 2005) (manuscript at 5) (discussing at length the results of an empirical study of the rate of adoption of the LLP form among New York law firms), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=622063](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=622063).

13. *Id.*

14. *Id.* (manuscript at 29); see *infra* Chart 1 (demonstrating the filing rates of elite law firms as opposed to other law firms).

15. See generally Baker & Krawiec, *supra* note 12 (manuscript at 2-7).

listed in Martindale-Hubble and in the directory of the National Association of Law Placement (“NALP”) that have more than twenty-five lawyers and their main office in New York, New York. We supplemented that empirical analysis with extensive interviews of three sets of individuals knowledgeable about and involved in the debate regarding choice of organizational form among New York law firms: law firm partners, law firm consultants, and malpractice insurers. Some of those results are published in *The Economics of Limited Liability: An Empirical Study of New York Law Firms*.<sup>16</sup>

In brief, we conclude that the New York Data provide little, if any, empirical support for the traditional economic theories of partnership. As discussed in this Article, however, these findings are troubling because interview data strongly suggest that concerns over organizational form as a signaling device did impact choice of form decisions by New York law firms, perhaps quite profoundly. In this Part, I briefly describe the data collection process and interview methodology, and summarize the major results and conclusions to be drawn from the data.

#### A. Data Collection

The study was limited to New York law firms with more than twenty-five lawyers.<sup>17</sup> The sample was restricted to law firms with more than twenty-five lawyers for a variety of reasons. First, very small firms may differ from their larger counterparts in terms of culture, practice area, and the impact of various laws (such as state and local taxes) that may disproportionately affect small firms, rendering them poor subjects for the study. In addition, very small firms may be more a collection of individuals who share office space and resources, but lack a common goal, history, or culture, again rendering them poor study subjects for these purposes.<sup>18</sup>

Similarly, many reasons motivated the choice to restrict the sample to firms located in New York City. This geographical

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16. Baker & Krawiec, *supra* note 12, (manuscript at 20-63).

17. “New York law firms” are those firms whose main office is located in New York City. A firm’s main office is located in New York City if, in March 2004, the Martindale-Hubble Web site designated the New York City office as the “main office.” If Martindale-Hubble listed more than one main office, the firm’s main office was considered to be in New York City, provided that at least one of the firm’s main offices was located in New York City. All main office results were cross-checked against individual law firm Web sites. If the firm’s Web site conflicted with the designation in Martindale-Hubble, the information from the firm’s Web site was used instead. See Baker & Krawiec, *supra* note 12, (manuscript at 24) (discussing the main office designation and cross-checks in more detail).

18. See Bruce M. Price, *How Green Was My Valley? An Examination of Tournament Theory As A Governance Mechanism in Silicon Valley Law Firms*, 37 LAW & SOC’Y REV. 731, 741-42 (2003) (excluding law firms of fewer than eleven lawyers from an empirical study of Silicon Valley firms for similar reasons).

restriction minimizes variation based on differences in regional cultural or practice areas, differences in state laws regarding organizational form, and differences in state and local tax and ethics codes.<sup>19</sup>

Seven sources were used to build the dataset: (1) print and Web versions of Martindale-Hubble,<sup>20</sup> (2) print and Web versions of the Directory of Legal Employers from the NALP,<sup>21</sup> (3) filings from the New York Secretary of State,<sup>22</sup> (4) American Lawyer's list of profits-per-partner for the top 200 law firms,<sup>23</sup> (5) American Lawyer Media, Corporate Counsel Division, Directory of In-House Law Departments at the Top 250 Companies,<sup>24</sup> (6) individual law firm Web sites, and (7) telephone conversations with selected law firms to verify or clarify certain information.<sup>25</sup> The data, along with detailed memoranda describing the data collection process, are publicly available at <http://www.law.unc.edu/Data/EconomicsofLimitedLiability>.

To shed further light on the choice of organizational form among New York law firms, the quantitative results were supplemented with interviews of three sets of individuals knowledgeable about and active in the debate regarding law firm choice of form: (1) partners

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19. In a nationwide study of the choice of organizational form by law firms in 2003, Bob Hillman observed similar filing patterns. See Robert W. Hillman, *Organizational Choices of Professional Service Firms: An Empirical Study*, 58 BUS. LAW. 1387, 1397-1402 (2003). In a more recent nationwide study, Eric Talley and John Romley also examined law firm choice of organizational form. John Romley & Eric Talley, *Uncorporated Professionals*, U. of S. Cal., CLEO Research Paper Series No. C04-18, (Sept. 3, 2004), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=587982](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=587982). Although, as a general rule, Romley and Talley observe choice of form patterns similar to those of New York law firms, they find that a firm's size—measured in terms of the number of lawyers in 1993—is a statistically significant predictor of the law firm's choice of organizational form as of 1999. *Id.* at 31-32 & 52 tbl. 11. See also Baker & Krawiec, *supra* note 12 (manuscript at 32-33) (contrasting the Romley & Talley findings with the results from the New York Data).

20. Martindale-Hubble's searchable Web listings are available at <http://martindale.com/xp/Martindale/home.xml>.

21. The NALP Web directory is located at <http://www.nalpdirectory.com/>.

22. The New York Secretary of State maintains a searchable Web site, located at [http://appsex5.dos.state.ny.us/corp\\_public/CORPSEARCH.ENTITY\\_SEARCH\\_ENTRY](http://appsex5.dos.state.ny.us/corp_public/CORPSEARCH.ENTITY_SEARCH_ENTRY).

23. The American Lawyer publishes this information in two separate publications. *The Am Law 100*, published in the July edition of the magazine, reports profits-per-partner for the one hundred most profitable U.S. law firms. See, e.g., *The Am Law 100 2004*, AM. LAW., July 2004, at 91, 133-35. *The Am Law 200*, published in the August edition of the magazine, reports profits-per-partner for firms ranking from 101 to 200 in terms of profitability. See, e.g., *The Am Law 200 2004*, AM. LAW., Aug. 2004, at 83, 121-23.

24. The searchable directory is available at <http://solis.365media.com/ALM/corpcounsel/search.asp>.

25. Baker & Krawiec, *supra* note 12, (manuscript at 20-27) (describing the data collection process and sources in more detail).

at New York law firms who had been active in their firms' decision regarding organizational form; (2) law firm consultants who advise law firms on a variety of matters, including organizational form; and (3) law firm insurers who base malpractice liability insurance rates on a variety of factors thought to correlate to the risk of malpractice liability and thus collect information from law firms on those factors.

Of particular interest for this Article are the interviews with law firm partners. In all, seventy-five partners at sixty New York law firms were interviewed. Most importantly, at least one partner at every GP firm with more than fifty lawyers was interviewed. To add depth and understanding to the analysis, a small number of in-house counsel and partners at law firms that were not in the New York Data, but were sufficiently similar to the sample of New York firms to possess insights into the choice of form question, were interviewed.<sup>26</sup>

Interviews ranged from ten minutes to one-and-a-half hours and were conducted by telephone.<sup>27</sup> All interviewees were familiar with the issues relating to the choice of organizational form at their firm. At many firms, the interviewee was the managing partner or partner in charge of spearheading the choice of form decision. At other firms, the choice of form issue apparently was debated sufficiently widely that all partners of a certain level of seniority seemed knowledgeable regarding the relevant issues. Interviewees were encouraged to freely discuss the choice of organizational form at their firm without leading from the interviewer. When necessary, interviewees were prompted to discuss particular issues relevant to the choice of organizational form through a list of questions. The questions designed for GP partners are attached as Appendix A to this Article. The questions designed for LLP partners are attached as Appendix B to this Article.

### *B. General Interview Results*

Although law firm cultures are idiosyncratic and the explanations offered in support of each firm's organizational form decision varied, several general themes arose from the interviews with law firm partners. First, neither apathy nor a lack of attention to the costs and benefits of a particular organizational form accounted for the choice of form decision in *any* of the firms

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26. For example, one foreign firm whose main office is located in New York City did not appear in the New York sample due to an idiosyncrasy in the manner by which the firm lists in Martindale-Hubble. However, the choice of organizational form issues faced by this firm are substantially similar to those faced by other foreign firms in the New York sample.

27. All interview subjects were ensured confidentiality and are not identified by name or firm name in this Article. For purposes of verifiability, redacted interview notes are available from the author.

interviewed for the study.<sup>28</sup> In other words, pure “stickiness” did not seem to account for the observed filing patterns.

This is not meant to suggest that the decision to convert to LLP status entails no transaction costs. Even small changes, such as reprinting letterhead and business cards, can be costly, and simply generating agreement from, in some cases, hundreds of busy and opinionated law firm partners is no doubt difficult. However, in almost every case, the reasons for this difficulty appeared to stem from the fact that many partners perceived genuine costs to operating in the LLP form.<sup>29</sup> In addition, partners at a small number of firms indicated that their firm had been slow to switch from the GP form because limiting partner liability simply had not “been a priority” at the firm.<sup>30</sup> In every case, however, this view changed substantially after the Arthur Andersen bankruptcy, as discussed more fully in Part III.C. of this Article.<sup>31</sup>

Second, the most frequently cited factors that arose in connection with the decision to convert to an LLP at most firms were: concerns over lost collegiality;<sup>32</sup> concerns over the perceived negative signal to clients associated with limited liability, a factor discussed more fully in Part V.A.; whether a sufficient number of peer firms had converted to an LLP to mute this perceived negative signal, also discussed in Part V.A.; the “Arthur Andersen effect,” discussed in Part III.C.; and the potential connection between lock-step compensation and limited liability.<sup>33</sup>

Third, nearly every interview subject asserted a belief that full movement of law firms into the LLP form was inevitable.<sup>34</sup> This conviction was held even by partners at firms that had determined, at least for the time being, to remain a GP. Fourth, issues relating to whether the partnership agreement should be revised had stalled discussions at a handful of firms, although each of those firms was eventually able to overcome those issues and file for LLP status.<sup>35</sup> Fifth, some law firm partners cited the size, decentralization, and

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28. Confidential interviews with law firm partners (interview notes on file with the author).

29. *Id.*

30. *Id.*

31. *See infra* notes 45-47 and accompanying text.

32. *See Baker & Krawiec, supra* note 12 (manuscript at 12-14).

33. *Id.* (manuscript at 54-55).

34. Confidential interviews with law firm partners (interview notes on file with the author); Baker & Krawiec, *supra* note 12 (manuscript at 59-60).

35. Confidential interviews with law firm partners (interview notes on file with the author). As noted, New York’s LLP statute permits the old partnership agreement to continue to govern partner relations. However, some partners in high-risk, high-return specialties apparently feel that, if fellow partners are no longer sharing the liability risk, they should receive a lower share of the profits from these activities, necessitating a renegotiation of the partnership agreement. *See Baker & Krawiec, supra* note 12 (manuscript at 55).

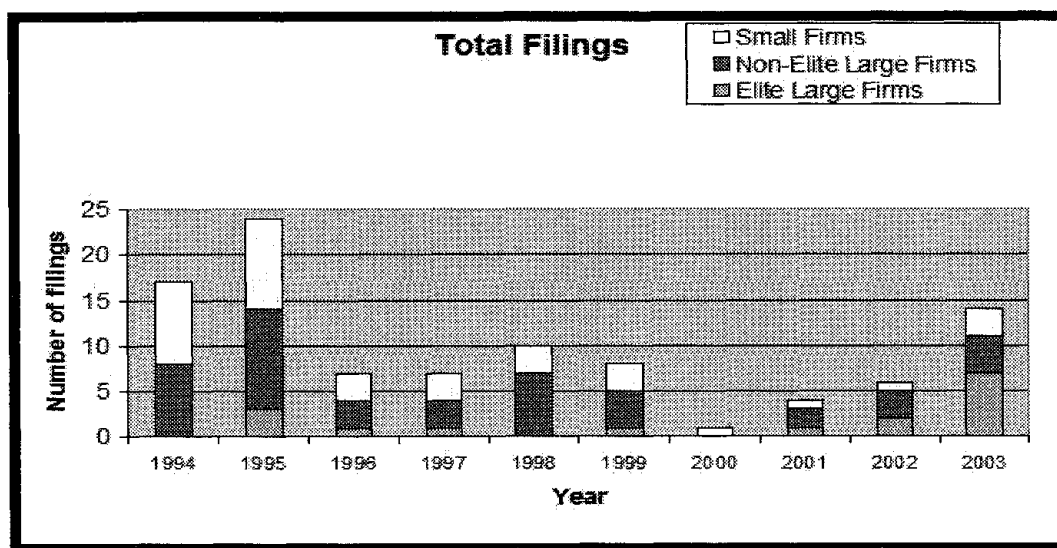


specialization of modern law firm practice as contributing to the decision to limit individual partner liability.<sup>36</sup>

### C. Filing Patterns

In order to examine overall filing patterns by New York law firms, firms were categorized as “large” (more than fifty lawyers in 2004), “small” (between twenty-five and fifty lawyers in 2004), and “elite” (profits-per-partner of \$1 million or more during 2002).<sup>37</sup> These results are graphically depicted in Chart 1.

Chart 1<sup>38</sup>



As shown in Chart 1, LLP filings peaked in 1994-1995, the first two years after New York’s LLP statute became effective, tapering off to a low in 2000. During these years, filings were divided roughly equally between large and small law firms. Very few elite firms filed during this time period. Filings began rising again in 2001-2003. However, the character of filings during this period differs from the pattern observed during the earlier peak. Large firms dominate the filings in the 2001-2003 period. Moreover, this is the period when most elite firms chose to file.

In order to examine filing patterns by firm profit levels, LLP filing dates were plotted against profits-per-partner in 2003. The results are depicted graphically in Chart 2.

36. Confidential interviews with law firm partners (interview notes on file with the author); Baker & Krawiec, *supra* note 12 (manuscript at 56).

37. Baker & Krawiec, *supra* note 12 (manuscript at 28 n.68).

38. *Id.* (manuscript at Chart 1, at 86).

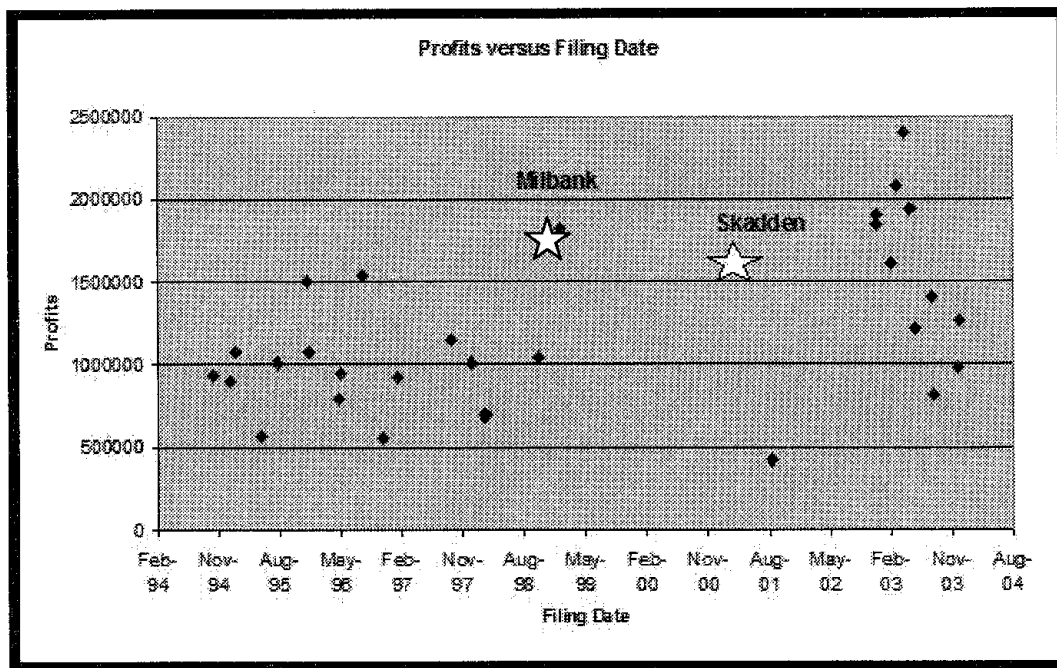
Chart 2<sup>39</sup>

Chart 2 depicts a similar filing pattern to that shown in Chart 1. The scatter plot shows a rough bunching of LLP filings into two groups: (1) lower profit firms, which filed primarily between late 1994 and October 1998, and (2) higher profit firms, which filed primarily after late 2002.

Two apparent outliers are worth mentioning. First, Milbank, Tweed, Hadley & McCloy, LLP filed in February of 1999, far earlier than other firms with similar profits-per-partner. This filing closely followed the summer 1998 conviction and sentencing to fifteen months in federal prison of Milbank partner John Gellene for filing false declarations in a bankruptcy proceeding.<sup>40</sup> Although the timing of the two events caused many law firm partners to speculate that the Gellene incident had heightened Milbank partners' liability fears and prompted the firm's filing, Milbank partners deny any connection between the two events.<sup>41</sup>

The Skadden, Arps, Slate, Meagher & Flom, LLP filing in 2001 makes Skadden the "first mover" in the eyes of its cohort firms.<sup>42</sup>

39. *Id.* (manuscript at Chart 2, at 87).

40. See generally MILTON C. REGAN, JR., *EAT WHAT YOU KILL: THE FALL OF A WALL STREET LAWYER* (2004) (detailing the Gellene affair); Laura Pearlman, *Trading One Striped Suit (With Cuffs) For Another*, *AM. LAW.*, Oct. 1998, at 13 (discussing the Gellene incident).

41. Confidential interviews with law firm partners (interview notes on file with the author); confidential interviews with Milbank partners (interview notes on file with the author) (attributed with permission of interview subjects).

42. Interestingly, the Milbank filing was not similarly regarded by other

Many partners at elite law firms indicated that the Skadden filing was noted by members of their firms and, in many cases, caused the firms in question to begin re-evaluating their decision to remain a GP. Although many of these firms eventually decided to wait until other cohort firms had determined to file before filing for LLP status, the Skadden filing was clearly a meaningful event in the eyes of many major law firm partners.

Overall, the two charts suggest a filing pattern in which: (1) some law firms took advantage of the new LLP statute immediately, whereas others hesitated many years; (2) firms tended to file around the same time as other firms with similar profits-per-partner; and (3) elite firms appeared more hesitant to file than did non-elite firms. These conclusions are supported by interview data.

As discussed more fully below, interviews with law firm partners reveal that partners—particularly at elite firms—feared the negative signal that might be associated with attempts to limit partners' personal liability for law firm debts.<sup>43</sup> This was particularly true when very few of the firms viewed as competitors for prestige and clients had chosen to convert to LLP status.<sup>44</sup>

In addition, one factor was repeatedly mentioned by law firms that had recently chosen to limit partner liability or were currently debating whether to do so as relevant to that decision: the demise of Arthur Andersen.<sup>45</sup> The Andersen bankruptcy seemed especially salient at large, elite firms, many of whom only determined to convert to an LLP after 2001.

Prior to Enron, partners at many law firms, particularly elite firms, considered the threat of a liability judgment that exceeded the firm's malpractice insurance a remote risk.<sup>46</sup> Given the perceived

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major law firms, perhaps because many observers considered the filing to be motivated by the Gellene incident. Confidential interviews with law firm partners (interview notes on file with the author). As previously noted, Milbank denies any such connection. *See supra* note 41 and accompanying text.

43. Confidential interviews with law firm partners (interview notes on file with the author); *see also infra* notes 84-89 and accompanying text (discussing signaling effects).

44. Confidential interviews with law firm partners (interview notes on file with the author); *see also infra* notes 93-123 and accompanying text (discussing herding).

45. Confidential interviews with law firm partners (interview notes on file with author); *see also* Anthony Lin, *After Enron, Firms Rethink Partnership*, N.Y. L.J., Apr. 15, 2002, at 1 ("In light of the potentially crippling liability faced by Arthur Andersen, Vinson & Elkins, and Kirkland & Ellis for their roles in the collapse of Enron Corp., major law firms are considering again whether to form themselves into limited liability partnerships.").

46. Confidential interviews with law firm partners (interview notes on file with the author). *See also* Lin, *supra* note 45, at 2. According to Ward Bower, a principal at the law firm consultancy Altman Weil, prior to Enron, many firms assumed that malpractice was an insurable risk, but according to Kenneth J.

costs associated with limited liability, many firms felt that the benefits of LLP status were simply insufficient to overcome the costs. For many firms, however, this perception changed with the trial and subsequent bankruptcy of Arthur Andersen. Suddenly, the possibility of a liability judgment that would exhaust partners' personal assets as well as the firm's liability insurance seemed entirely plausible. The fact that a "white shoe" firm as large and reputable as Arthur Andersen could simply crumble was a sobering experience for many law firm partners and one that changed their outlook on limited liability. In fact, several partners insisted that their firms never would have switched to an LLP had the Enron and Arthur Andersen debacles not occurred.<sup>47</sup>

The filing patterns depicted in Charts 1 and 2 are in marked contrast to the choice of organizational form by newly formed New York law firms.<sup>48</sup> Although Martindale-Hubble lists only six New York law firms established between 1994, when New York's LLP statute became effective, and April 6, 2005, all six formed as limited liability entities.<sup>49</sup> However, one should not read too much into this data. First, the small sample size of six firms cautions against drawing general conclusions about new firm filing patterns. In addition, as a general rule, the new firms are fairly small and certainly not "elite." Accordingly, it is not clear that they are substantially different from the early filers in the New York Data.

#### D. *Testing the Economic Theories of Partnership*

The logical starting point upon observing a filing pattern of this sort is to consider whether any economic factors may be motivating law firm choice of organizational form. Contrary to much legal commentary, which tends to cite the high costs of personal liability as a reason for avoiding the GP form and advises business and professional organizations to avoid doing business as a GP,<sup>50</sup>

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Laverriere, a Shearman & Sterling partner, "[y]ou can't insure against 10-figure liability." *Id.*

47. Confidential interviews with law firm partners (interview notes on file with the author).

48. I thank Lillian BeVier and Rip Verkerke for suggesting this line of inquiry.

49. The firms were identified by searching the Martindale-Hubble database on Lexis on April 6, 2005. Five of the six firms established in New York City after 1994 were organized as LLPs. The other was an LLC.

50. See, e.g., JOHNSON, *supra* note 4, at 88-89 (urging law firms currently doing business in the GP form to switch to a limited liability entity); Sandy Lovell, *Few Firms Form Limited-Liability Corporations: Inertia and Fear of Client Reaction Breed Reluctance*, 163 N.J. L.J., Feb. 12, 2001, at 25, 25 (stating that forming a limited liability entity instead of a general partnership should be "a no-brainer"); Tom Alleman, *To LLP or Not to LLP: When Striking Out on Your Own, Know the Form of Business Your Practice Will Take*, THE LEGAL

economists assert the many benefits of the GP form. Some of these benefits—for example, those that stem from illiquidity or profit sharing—are not unique to the GP form and, instead, are benefits of both the GP and LLP forms. In contrast, the asserted benefits of the GP form that stem from the full personal liability of GP partners are unique to the GP form.<sup>51</sup>

*The Economics of Limited Liability* examines six theories traditionally espoused in the economic literature as rationales for the GP form: insurance, monitoring, generating trust and collegiality, quality signaling, preventing grabbing and leaving, and providing incentives to mentor.<sup>52</sup> The theories are tested by collecting data on each firm's organizational form, filing date, designation of New York City as the main office, number of lawyers, number of offices, growth rate (measured as the yearly percentage change in each firm's number of lawyers, averaged from 1994-2003), profits-per-partner, average number of in-house counsel, total number of in-house counsel, number of clients in the Fortune 250, starting associate salaries, partnership structure (multi-tiered versus single tier), self-identification of collegial environment in the NALP directory, and status as either a domestic or foreign law firm.<sup>53</sup>

It should be noted that many of the economic theories of partnership are implausible on their face. Economists tend to incorrectly assume that certain characteristics of the partnership form—for example, profit sharing or individual partner liability for firm debts—are unique to the partnership form and cannot be replicated either through alternative organizational forms or through contract or other mechanisms.<sup>54</sup> In fact, however, many of

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INTELLIGENCER, Sept. 5, 2003, at 3 (stating that “[f]or most small groups, there really are only two choices—limited liability partnership or some form of corporation”); Lee Berton & Joann S. Lublin, *Seeking Shelter: Partnership Structure is Called into Question as Liability Risk Rises*, WALL ST. J., June 10, 1992, at A9 (quoting Belverd Needles, former director of DePaul University's School of Accounting, as stating, “[w]ith such risks, the partnership may go the way of the dodo”).

51. Baker & Krawiec, *supra* note 12 (manuscript at 2).

52. *Id.* (manuscript at 7-20).

53. *Id.* (manuscript at 20-27).

54. Much legal literature, in contrast, considers such factors relevant only for public corporations. Compare, e.g., Roger E. Meiners et al., *Piercing the Veil of Limited Liability*, 4 DEL. J. CORP. L. 351, 364 (1979) (arguing that the difference in the limited liability default rule between corporations and GPs is insignificant because the default rule can be altered through a variety of private mechanisms) with, e.g., Frank H. Easterbrook & Daniel R. Fischel, *Limited Liability and the Corporation*, 52 U. CHI. L. REV. 89, 93 (1985) (advocating that “the distinctive aspects of the publicly held corporation—delegation of management to a diverse group of agents and risk bearing by those who contribute capital—depend on an institution like limited liability”), and Henry

the asserted benefits of the partnership form can be and frequently are replicated through a variety of devices. For example, profit-sharing can be and frequently is accomplished not only through the partnership form but also through the LLC and close corporation. Similarly, organizing as a GP is not the only mechanism available for placing the personal wealth of the firm's owners within reach of creditors.<sup>55</sup>

After both a theoretical and an empirical analysis, we conclude in *The Economics of Limited Liability* that the New York Data do not support any of the prevailing economic theories of partnership.<sup>56</sup> Naturally, the fact that the New York Data do not support the traditional economic theories of partnership does not prove that those theories are false. The standard proxies typically employed to test phenomena such as the ease of monitoring, the existence of information asymmetry, and levels of firm collegiality are simply that—proxies. Furthermore, certain variables that one might hypothesize impact choice of organizational form and/or the speed with which such decisions are reached—such as practice area, whether the firm practices lock-step compensation, and what sort of decision-making rules and norms govern the firm—are not publicly available in any reliable form and, thus, cannot be included in regression analyses.

Nonetheless, the fact that the data fail to support existing theories of partnership (combined with the theoretical weakness of many of the theories) should prompt scholars to search for alternative justifications for the existence of the partnership form and the GP form in particular. In the next section, I explore one such possibility—signaling theory—but demonstrate that the theory as currently articulated is not well supported by the New York Data and suffers from several theoretical problems. At the same time, interview data indicate that signaling fears did impact law firm choice of form. Part V of this Article suggests that some modifications to the signaling theory of partnership could render the

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G. Manne, *Our Two Corporation Systems: Law and Economics*, 53 VA. L. REV. 259, 260-68 (1967) (arguing that the publicly held corporation could not exist without limited liability).

55. For example, the firm's owners could also personally guarantee debts, post personal bonds, or over-capitalize the corporation. See, e.g., Easterbrook & Fischel, *supra* note 54, at 103-04 (arguing that voluntary corporate creditors frequently require personal guarantees or use other mechanisms to alter the default rule of limited liability for shareholders); Henry Hansmann & Reinier Kraakman, *The Essential Role of Organizational Law*, 110 YALE L.J. 387, 429-30 (2000); Amalia D. Kessler, *Limited Liability In Context: Lessons From The French Origins Of The American Limited Partnership*, 32 J. LEGAL STUD. 511, 530-43 (2003).

56. Baker & Krawiec, *supra* note 12 (manuscript at 59).

theory both more theoretically plausible and more consistent with the New York Data.

#### IV. PREVAILING SIGNALING THEORIES OF PARTNERSHIP FORM

There are two variations on the signaling theory of partnership currently employed in the organizational form literature: the monitoring version and the profit-sharing version.<sup>57</sup> In this section, I discuss the standard measures employed to test these theories and conclude that neither version is well supported by the New York Data.

##### A. *Signaling Monitoring*

According to the traditional signaling theory of partnership, firms operate in the GP form in order to send a signal to clients and prospective clients that the firm provides a higher quality legal service. Operating in the GP form provides this signal because, although the quality of legal services is difficult to observe, the firm's organizational form is easily observable and clients understand that the unlimited personal liability of the GP form encourages partners to monitor each other, thus enhancing the quality of legal service.<sup>58</sup>

There are both theoretical and empirical reasons to doubt the explanatory power of the monitoring version of the quality signaling theory. As a theoretical matter, although unlimited partner liability may be one credible signal of quality, it is not the only credible signal. For example, reputation established through repeated client interactions is another potential signal of quality and one arguably

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57. See, e.g., *infra* notes 56-59, 69-71, and accompanying text.

58. Armen Alchian and Harold Demsetz propose that the difficulty in monitoring employee output explains the prevalence of the partnership form among professional firms. Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777 *passim* (1972). However, Henry Hansmann asserts that Alchian and Demsetz overstate the monitoring problem associated with professional firms, noting that most firms go to great lengths to determine each partner's contribution to the bottom line, including tracking billable hours, and adopting partnership agreements that distribute profits in accordance with individual productivity. HENRY HANSMANN, *THE OWNERSHIP OF ENTERPRISE* 70-71 (1996); see also George Rutherglen & Kevin A. Kordana, *A Farewell to Tournaments? The Need for an Alternative Explanation of Law Firm Structure and Growth*, 84 VA. L. REV. 1695, 1696-98 (1998) (making a similar argument). Others, however, have challenged Hansmann on this point, arguing that monitoring the work-product of professional service providers such as lawyers is not as easy as Hansmann suggests. See, e.g., David B. Wilkins & G. Mitu Gulati, *Reconceiving the Tournament of Lawyers: Tracking, Seeding, and Information Control in the Internal Labor Markets of Elite Law Firms*, 84 VA. L. REV. 1581, 1597-1600 (1998).

less expensive than unlimited personal liability for partnership debts. Moreover, legal scholars have identified other mechanisms—most notably, efficiency wages and promotion tournaments—that at least partially address the monitoring problem faced by law firms.<sup>59</sup> Importantly, both efficiency wages and promotion tournaments are observable by clients and may operate as effective quality signals. In short, in order for the monitoring version of the quality signaling argument to persuade, the GP must be the cheapest credible signal of quality.

As an empirical matter, the New York Data fail to support this version of the quality signaling theory. Like all quality signaling theories, the monitoring version of the quality signaling theory of partnership depends on an information asymmetry between the producers and consumers of a given product (in this case, legal

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59. In the scholarship on law firms, efficiency wages and promotion tournaments are discussed as mechanisms for the firm to solve its monitoring problems vis-à-vis associates. A key point not often discussed in the literature, however, is that firms use these lengthy apprenticeship periods as a means to obtain information and retain as partners only those lawyers who will no longer require monitoring.

The basic mechanisms through which efficiency wages and tournament solve the monitoring problem are as follows. By providing employees with an above-market clearing wage, efficiency wages create a large applicant pool and encourage applicants to favorably differentiate themselves from the rest of the pool, thus reducing employers' screening costs. In addition, efficiency wages incentivize employees to work hard once hired in order to maintain their above-market wage, thus reducing the employer's monitoring costs. David B. Wilkins & G. Mitu Gulati, *Why Are There So Few Black Lawyers in Corporate Law Firms? An Institutional Analysis*, 84 CAL. L. REV. 493, 518-19 (1996); Laura N. Beny, *Reflections on the Diversity-Performance Nexus at Elite American Law Firms: Toward a Theory of a Diversity Norm*, at 8-9 (2005) (unpublished manuscript, on file with the Wake Forest Law Review), available at [http://repositories.cdlib.org/berkeley\\_law\\_econ/Spring2005/12](http://repositories.cdlib.org/berkeley_law_econ/Spring2005/12).

Promotion tournaments, or the "up or out" system employed at many law firms, create an organizational system of many years of apprenticeship after which the top performing associates receive a sharp increase in pay and status (i.e., partnership) and the others are terminated. Individual associates are presumed to work hard to demonstrate their value, even without careful monitoring by the firm, because they want to signal themselves as most worthy of the partnership prize. See MARC GALANTER & THOMAS PALAY, *TOURNAMENT OF LAWYERS: THE TRANSFORMATION OF THE BIG LAW FIRM* 93-102 (1991); Beny, *supra*, at 8-9. For other discussions of how lawyers and law firms solve monitoring problems, see generally Tom Ginsburg & Jeffrey A. Wolf, *The Market for Elite Law Firm Associates*, 31 FLA. ST. U. L. REV. 909 (2004) (discussing the market and recruiting process for lawyers at elite law firms); Price, *supra* note 18 (discussing the limitations of the application of the tournament theory in light of the Silicon Valley dot-com bubble); Rudy Santore & Alan D. Viard, *Legal Fee Restrictions, Moral Hazard, and Attorney Rents*, 44 J.L. & ECON. 549 (2001) (discussing and providing a political economy explanation for the legal fee restrictions prohibited by most states and the American Bar Association Model Rules of Professional Conduct).



services). Because more sophisticated clients are less likely to suffer information asymmetry regarding the quality of legal services that they receive than are less sophisticated clients and because clients in the Fortune 250 are more likely to possess this sophistication than clients that are not, if the monitoring version of the signaling theory of partnership holds, then the data should show a significant, positive effect of the number of each firm's clients in the Fortune 250 ("FORTUNE") on the likelihood that the firm is an LLP.<sup>60</sup>

Similarly, prior research indicates that in-house counsel play an important role in monitoring outside law firms and in reducing the level of information asymmetry suffered by clients regarding the quality of legal services received.<sup>61</sup> This would suggest that clients with a higher number of both total ("IN-HOUSE-TOTAL") and average ("IN-HOUSE-AVG") in-house counsel suffer less information asymmetry and that the law firms that serve these clients have less need to signal quality through the GP form than do firms whose clients employ fewer in-house counsel.<sup>62</sup> Accordingly, the data should reveal a significant, positive effect of IN-HOUSE-AVG and IN-HOUSE-TOTAL on the probability that the firm is an LLP.<sup>63</sup> The coefficients on FORTUNE, IN-HOUSE-AVG, and IN-HOUSE-TOTAL are all statistically insignificant, undermining the monitoring version of the quality signaling theory of partnership.<sup>64</sup>

Finally, if organizing as an LLP really sends a negative signal to clients, then firms that convert to LLP status should either: (1) charge less for legal services than they would if they had remained a GP or (2) see a significant, negative, abnormal change in firm profits

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60. Cf. Abram Chayes & Antonia H. Chayes, *Corporate Counsel and the Elite Law Firm*, 37 STAN. L. REV. 277, 284-93 (1985) (discussing the important role of in-house counsel in monitoring and selecting outside counsel, especially at the largest American corporations); John C. Coates IV, *Explaining Variation in Takeover Defenses: Blame the Lawyers*, 89 CAL. L. REV. 1301, 1310 n.40 (2001) ("Older, larger, and more profitable companies are more likely to have better and larger in-house legal staffs more capable of monitoring outside firms.").

61. ROBERT L. NELSON, *PARTNERS WITH POWER: THE SOCIAL TRANSFORMATION OF THE LARGE LAW FIRM* 59 (1988); Mark C. Suchman, *Working Without a Net: The Sociology of Legal Ethics in Corporate Litigation*, 67 FORDHAM L. REV. 837, 856 (1998).

62. See Ryon Lancaster & Brian Uzzi, *From Colleague to Employee: Determinants of Changing Career Governance Structures in Elite Law Firms*, in CORPORATE GOVERNANCE AND FIRM ORGANIZATION: MICROFOUNDATIONS AND STRUCTURAL FORMS 360-70 (Anna Grandori ed., 2004) (using this same variable to test the level of information asymmetries in the market for legal services).

63. The logarithm of the average number of in-house counsel, rather than the average number of in-house counsel, is used in order to minimize the skew in the in-house counsel numbers. See Baker & Krawiec, *supra* note 12 (manuscript at 40-42 n.96) (explaining this measure).

64. *Id.* (manuscript at 41-42 and tbls. 9-10).

that it would not have experienced if it had remained a GP.<sup>65</sup> Interview data rule out the first possibility—all partners interviewed indicated that the conversion to an LLP had not impacted relations with clients in any way. Although more problematic, the second possibility (that switching to an LLP reduces firm profits, at least in the first few years) cannot be completely rejected.<sup>66</sup> However, the quantitative data, interview results, and theoretical limitations of this version of the quality signaling theory caution against accepting the theory without some modifications, as discussed in Part V of this Article.<sup>67</sup>

### B. *Signaling Profit Sharing*

A newer variation on the signaling theory of partnership posits that rather than signaling superior monitoring, GP firms are instead signaling a profit-sharing arrangement. Originating from Jonathan Levin and Steven Tadelis, this version of the quality signaling theory asserts that a profit-sharing enterprise, such as a partnership, has less incentive than does a non-profit-sharing enterprise, such as a corporation, to hire low-quality workers.<sup>68</sup> This is because partners in profit-sharing enterprises care about profits-per-partner—not total profits. As a result, a new partner will be added to the firm only if she increases the average profits-per-partner. This is in contrast to a corporation, which has an incentive to hire any worker who will marginally increase total profits, because the new worker does not share in this increase.<sup>69</sup>

The profit-sharing version of the quality signaling theory is based on an unsupported assumption that the partnership form is a superior mechanism for signaling that the firm engages in profit sharing. As already noted, other organizational forms, including the LLC and the corporation, can be and frequently are structured as profit-sharing enterprises. Moreover, law firms increasingly are abandoning profit-sharing models of partnership in favor of organizations characterized by multi-tiered partnership levels, non—equity partners, and “eat what you kill” compensation strategies.<sup>70</sup> In other words, law firms—regardless of organizational

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65. *Id.* (manuscript at 15).

66. *See id.* (manuscript at 37-40 and tbls. 7-8) (discussing the empirical findings on choice of form and firm profits).

67. *See infra* notes 84-123 and accompanying text.

68. Jonathan Levin & Steven Tadelis, *Profit-sharing and the Role of Professional Partnerships*, 120 Q.J. ECON. 131, 131 (2005) (“We take the defining feature of a partnership to be redistribution of profits among partners.”) (footnote omitted).

69. *Id.* at 144.

70. *See, e.g.*, Kristin Nicole Johnson, Note, *Resolving the Title VII Partner-Employee Debate*, 101 MICH. L. REV. 1067, 1081-85 (2003) (describing the ways

form—increasingly seem to resemble traditional employment enterprises, rather than profit-sharing enterprises.

As an empirical matter, the most that one can conclude from the New York Data is that signaling profit sharing cannot fully explain the choice of organizational form among New York law firms. Because the GP and the LLP are identical with respect to profit sharing, if signaling profit sharing to clients fully explains the choice of organizational form among New York law firms, then all or nearly all of the firms in the New York sample should be LLPs, as it provides all of the profit-sharing benefits of the GP without the associated costs of personal liability for partnership debts.<sup>71</sup> The fact that a sizeable percentage of firms are still organized as GPs and that an even larger number continued to be so organized prior to 2000 undermines this possibility.

Two other factors, however, cast doubt on the notion that this version of the quality signaling theory of partnership is even a contributing factor, much less a decisive factor, in law firm choice of organizational form. First, as already noted, the partnership does not provide unique profit-sharing opportunities unavailable through other organizational forms. Second, the interview data undermine this version of the quality signaling theory. None of the interview subjects mentioned signaling profit sharing as relevant to their firms' choice of organizational form.<sup>72</sup> This is not surprising. As lawyers, these interview subjects are fully aware that the partnership form is unnecessary to attain profit-sharing benefits.

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in which law firms today resemble traditional employment relationships more than traditional partner relationships, including multi-tiered partnerships and the substitution of “eat what you kill” compensation for profit-sharing compensation); Joe Altonji & Bill Johnston, *A Change of Priorities: Too Much Emphasis on Billable Hours Has Been Detrimental to Associate Development*, LEGAL TIMES, May 6, 2001, at 21 (noting that many law firms have abandoned lock-step compensation in favor of “a more corporate approach to compensation”); *Special Report: The Future of the Law; Fifteen Experts—From General Counsel and Managing Partners of Major National Law Firms to a Legal Aid Specialist—Contemplate Changes to Come in the Next 10 Years*, LEGAL TIMES, June 26, 2000, at 42 (quoting a Hildebrandt International consultant as stating that “[m]any of the large firms are going to start following a more corporate model and move away from the associate-partner structure” and also predicting the abandonment of lock-step compensation and the continued growth of non-equity partners).

71. Although, in theory, if this version of the signaling theory of partnership fully explains the choice of organizational form, *all* firms in the New York sample should be LLPs. The hypothesis is framed as *all or nearly all* and—without more—this version of the signaling theory would not be rejected due to a few firms still clinging to the GP form. This is because, in reality, there is always a possibility that inertia, lack of attention, or transactions costs prevent a handful of firms from adopting the ideal organizational form.

72. Confidential interviews with law firm partners (interview notes on file with the author).

### C. Section Summary

In summary, the Data provide little, if any, empirical support for signaling theories of partnership as currently formulated. In addition, both versions of the signaling theory of partnership are problematic for theoretical reasons. Neither limited liability nor profit sharing is a characteristic unique to the partnership form. Instead, both can be replicated through other contractual mechanisms or organizational forms. As a result, without some evidence that organizational form is the cheapest or most reliable mechanism for sending this signal, it seems improbable that law firms are using organizational form to signal quality to the market.

There are other troubling aspects of existing signaling theories of partnership as well. First, neither signaling theory, as currently formulated, can explain the hesitance of elite firms to convert to LLP status. Under both versions of the quality signaling argument, the GP form sends a positive signal of quality. Both versions thus predict that the firms with the most to gain from remaining a GP should be those firms most in need of quality signaling. In other words, the firms most likely to incur the costs of retaining full partner liability should be those firms that suffer the greatest information asymmetry between firm and client. However, there is no reason to believe that elite firms suffer from greater information asymmetries with clients than do other firms. In fact, the evidence indicates the opposite: elite firms represent more clients in the Fortune 250 and clients that employ larger numbers of in-house counsel.<sup>73</sup> These measures are thought to reduce information asymmetry, not increase it. Therefore, signaling theory as currently formulated would produce the opposite filing pattern than the one observed in the New York Data. That is, existing versions of signaling theory predict that elite law firms should file more quickly than non-elite firms, not more slowly.

Of course, signaling quality through the GP form should be less costly to elite firms than non-elite ones. This is because if one assumes that elite firms produce a higher quality legal product than non-elite firms, then their risk of incurring personal liability should be less. As such, signaling quality by remaining a GP is a less expensive signal for elite firms than for non-elite ones. If this is so, then elite firms could signal quality through the GP form when non-elite firms do not because it is cheaper for elite firms to do so, despite the fact that elite firms have no greater need to signal quality than do non-elite firms. This is consistent with elite firms' reactions to the Arthur Andersen bankruptcy. The bankruptcy appears to have changed elite firms' perceptions about the costs *to*

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73. Baker & Krawiec, *supra* note 12 (manuscript at App. C) (listing the number of Fortune 250 clients of New York law firms, as well as the average and total number of Fortune 250 in-house counsel represented by each firm).

*elite firms* of operating in the GP form, finally causing elite firms to conclude that the costs of operating in the GP form outweighed the benefits.<sup>74</sup>

Although initially plausible, the differential signaling costs of elite and non-elite firms fails to fully explain the hesitance of GP firms to convert to LLP status. As discussed more fully in Part V.A., law firm partners themselves demonstrated little concern with the potential positive signal associated with GP status and instead seemed to focus their energies on finding a method (coordinating the timing of their LLP filing to coincide with the filings of competitor and/or peer firms) to garner the benefits of the GP form while minimizing the costs associated with any negative signal potentially sent by the LLP filing.

In addition, the evidence fails to demonstrate that organizational form was ever considered a credible signal of quality—either positive or negative—by law firm clients. As noted, all law firm partners revealed in interviews that the LLP conversion had not altered client relations or billing in any way.<sup>75</sup> Similarly, firms retaining GP status in the face of conversions by competitor firms gave no indication that they had been rewarded by clients with higher billable rates or more business. Finally, although the interpretation of the empirical tests regarding the impact, if any, of a change in organizational form on law firm profitability are difficult to interpret, the New York Data fail to strongly support the notion that a change in organizational form significantly impacts law firm profits.

The monitoring version of the quality signaling theory faces a further hurdle—the lack of evidence that the GP form induces superior monitoring. Both the quantitative analysis and the interview results from the New York Data fail to support any version of the monitoring theory of partnership.<sup>76</sup>

Law firm partner interview subjects were uniform in their rejection of this justification for the GP form.<sup>77</sup> Interestingly, most interview subjects were familiar with the theory that placing partners' personal assets at risk through the GP form induces partners to monitor each others' performance.<sup>78</sup> However, interview subjects tended to scoff at this theory of partnership form for two reasons. First, many law firm partners pointed to the size, specialization, and geographic dispersion of modern law firm

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74. See *supra* notes 45-47, *infra* notes 88-90, and accompanying text (discussing elite firms' reactions to the Arthur Andersen bankruptcy).

75. See *supra* notes 65-66 and accompanying text.

76. Baker & Krawiec, *supra* note 12 (manuscript at 36-37) (discussing the monitoring theories of partnership and concluding that they are not supported by the New York Data).

77. Confidential interviews with law firm partners (interview notes on file with the author).

78. *Id.*

practice as limiting the effectiveness of any attempts at this type of monitoring. To many partners, the notion that a securities law specialist in New York could meaningfully monitor a trust and estate lawyer in the Dallas office was absurd.<sup>79</sup> Second, many interview subjects were offended by the notion that law firm members would fail to undertake monitoring efforts to the best of their abilities in the absence of such personal liability. As discussed by many interview subjects, it is not the fear of personal liability that induces monitoring of other partners, but rather a desire to maintain the firm's reputation, maximize billing rates, and enhance year-end partner profits that induces this effort.<sup>80</sup>

Finally, evidence of malpractice insurance pricing undermines the monitoring theory of partnership. If partnership theories based on the notion that the GP form induces the provision of higher quality legal services are true, then insurance companies should charge GPs higher malpractice insurance rates than LLPs in recognition of their higher liability risk. However, interviews with law firm insurers indicate that insurance companies do not consider organizational form in setting insurance rates.<sup>81</sup> This is confirmed by interviews with law firm partners, who reported that the decision

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79. *Id.*; see also Richard C. Reuben, *Added Protection*, 80 A.B.A. J., Sept. 1994, at 54, 55-56 (quoting Robert R. Keatinge, Chair of the ABA Business Law Section Partnership Committee's Subcommittee on Limited Liability Companies, as stating, "[w]hen you think about it, there is nothing I as a tax lawyer can do that will protect against someone from another department within the firm screwing up a water law issue").

80. Confidential interviews with law firm partners (interview notes on file with the author).

81. Interviews with insurers (interview notes on file with the author); see also Jett Hanna, *Legal Malpractice Insurance and Limited Liability Entities: An Analysis of Malpractice Risk and Underwriting Responses*, 39 S. TEX. L. REV. 641, 645 (1998) ("[T]here is no reason for the insurer to modify its assessment of the risk of suit based on limited liability status."); Robert W. Hillman, *The Impact of Partnership Law on the Legal Profession*, 67 FORDHAM L. REV. 393, 409 (1998) ("LLP status does not reduce the liability of the partnership itself, which means the need for insurance underwriters to insist on implementation of monitoring mechanisms is largely unaffected by conversion of a firm from a general partnership into an LLP.") (footnote omitted). The discussion by Mr. Hanna (a Vice-President for Underwriting and Administration at Texas Lawyer's Insurance Exchange ("TLIE")) of the lack of connection between law firm organizational form and insurance rates is particularly enlightening. Although he notes that the TLIE's empirical evidence shows a decrease in malpractice claims that coincides with the advent of Texas's LLP statute, he concludes that the two events are almost certainly unrelated. Hanna, *supra*, at 647-48. He states that, although the arguments about organizational form and increased monitoring are theoretically interesting, "[t]he motivation to supervise is usually born of long-term profit motive, not fear of liability." *Id.* at 646. Hanna further notes the difficulties of monitoring other partners in a modern law firm practice, concluding that "[g]iven the time requirements of modern law practice, it is a wonder that any supervision occurs in law firms." *Id.* at 647.

to convert to a limited liability entity had been made after consultation with the firm's insurance company and had not altered malpractice insurance premiums or coverage.<sup>82</sup>

This is not to say that the GP form could not be employed as a signal of monitoring even in the absence of any real monitoring benefits. In the face of severe information asymmetries with clients, law firms could perhaps employ such a false signal. However, that seems unlikely in this context. The ultimate consumer in this case—that is, the individual(s) responsible for the decision of whether and whom to retain as outside counsel—is senior in-house counsel. These individuals are themselves experienced lawyers who likely spent at least some time practicing at a law firm. It seems unlikely that these customers could have such a different knowledge set regarding law firm practice than could law firm partners (all of whom, as noted, reject the monitoring theory of partnership).

In addition, the law firms slowest to convert to LLP status—elite firms—seem even less likely to have an information asymmetry with clients regarding monitoring practices within law firms. As already noted, elite firms have more sophisticated clients, who tend to employ more in-house counsel, than do non-elite firms.<sup>83</sup>

## V. ALTERNATIVE SIGNALING THEORIES

Although neither data nor theory strongly support either version of the signaling theory of partnership form, the interview data suggest that there is something to the signaling approach. As discussed more fully in this section, interview subjects exhibited a strong concern with the danger that converting to an LLP could be negatively perceived by clients. This was particularly true at large, elite firms, which seemed unwilling to convert unless and until a substantial number of other elite firms were willing to convert. In this section, I argue that both theory and the New York Data suggest that the signaling theory of partnership needs adjustment. I discuss three modifications to traditional signaling theories of partnership that render signaling theory more consistent with the New York Data. It should be noted, however, that none of the empirical tests or interviews were specifically designed to test these modifications. Accordingly, future research, if possible, should endeavor to test these proposed modifications against existing signaling theories.

### A. *Negative v. Positive Signals*

Quality signaling theories tend to assume that the signal of

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82. Confidential interviews with law firm partners (interview notes on file with the author). Not all interview subjects were familiar with their firms' insurance coverage and rates. However, among those who did have such familiarity, all reported that the coverage was unaffected by the transition. *Id.*

83. See *supra* notes 60-64 and accompanying text.

relevance is the positive signal (either of superior monitoring or of profit sharing) associated with the GP form. If true, then we should observe firms that attempt to distinguish themselves from the pack by retaining GP status in the face of movement by competitor firms. Instead, the data show the opposite: substantial herding behavior by law firms and a near obsessive concern with *not* being distinguishable from their cohort in terms of organizational form.

The interviews with law firm partners reveal that, at nearly every firm, partners feared the negative signal that any limitation on personal liability might send to their clients and competitors.<sup>84</sup> This was particularly true when very few of the firm's competitor firms had opted to limit their liability. As stated by one law firm partner, "at the time we first debated becoming an LLP, none of the firms that we consider similar to us had limited their liability. We didn't want to be path breakers on this."<sup>85</sup>

At the same time, as more firms within a given cohort opt for LLP status, the perceived negative signal associated with limited liability diminishes, and the arguments in favor of limited liability are more persuasive. As stated by one partner, "we're currently reconsidering the issue and my prediction is that we'll switch [to an LLP] at some point in the near future. Now that most of the other firms like us have switched, the arguments against it seem weaker."<sup>86</sup>

This fear of the perceived negative signal associated with a limitation on partners' personal liability for law firm debts was especially pronounced at elite law firms. The interview data reveal that large, elite law firms, in particular, are extraordinarily conservative and are reluctant to take actions that may distinguish them in a negative manner from their competitor firms.<sup>87</sup> For those firms that were slow to file for LLP status (as noted, this is true of the majority of elite firms), one of the most commonly cited rationales for the firm's hesitation in filing was the fact that the firm did not want to file until a sufficient number of peer firms had also decided to file.<sup>88</sup> Similarly, in addition to the Arthur Andersen effect, the most commonly cited motivation behind the eventual decision to file was the fact that a sufficient number of peer firms had finally determined to file. Our interview data also reveal that law firm partners were in regular communication with peer firms about the decision to file and, in some cases, coordinated the timing

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84. Confidential interviews with law firm partners (interview notes on file with the author).

85. *Id.*

86. *Id.* Interestingly, it is not at all clear that this fear is well-founded. Every LLP interview subject indicated that the firm's relations with clients had not been altered by the decision to become an LLP. *Id.*

87. *Id.*

88. *Id.*



of their filings.<sup>89</sup>

Similarly, those firms still organized as a GP at the time of the interviews gave no indication whatsoever that a desire to distinguish themselves positively from the LLP firms was motivating the decision to operate as a GP. Instead, interview subjects at these firms tended to attribute the hesitation to fears of the potential negative signal associated with the move to LLP status and fears regarding lost collegiality. Subjects noted, however, that the Arthur Andersen bankruptcy, combined with recent conversions by most other firms, had caused their firm to reevaluate the decision to remain a GP. Most further predicted that their firm would ultimately convert.<sup>90</sup>

Law firms, and elite firms, in particular, thus seem to display concern only with the potential *negative* signal associated with LLP status. The negative impact, if any, associated with such a signal is bound to be muted when many of a firm's cohorts have also adopted LLP status. How can clients infer something negative about a particular firm from behavior in which everyone else is engaged? Accordingly, this aspect of the LLP filing pattern is consistent with research on network effects and innovation as (at least for the elite firms in the New York sample) it is only after a sufficient number of peer firms have converted to an LLP that the benefits of limited liability are perceived to outweigh the costs of the potential negative signal to clients.<sup>91</sup>

### *B. This Negative Signal is More Costly to Elite Firms*

As noted, law firm partners (and elite law firm partners, in particular) seem especially concerned about the potential negative signal associated with the LLP form. But the data (both quantitative and interview) reveal no reason why elite firms should be more concerned with this negative signal than should non-elite firms. As already discussed, it is improbable that this could be the

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89. *Id.*

90. *Id.*

91. See generally Robert B. Ahdieh, *Between Mandate and Market: Contract Transition in the Shadow of the International Order*, 53 EMORY L.J. 691 (2004); Stephen J. Choi & G. Mitu Gulati, *Innovation in Boilerplate Contracts: An Empirical Examination of Sovereign Bonds*, 53 EMORY L.J. 929 (2004); Marcel Kahan & Michael Klausner, *Standardization and Innovation in Corporate Contracting (or "The Economics of Boilerplate")*, 83 VA. L. REV. 713 (1997); Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757 (1995). But see Larry E. Ribstein & Bruce H. Kobayashi, *Choice of Form and Network Externalities*, 43 WM. & MARY L. REV. 79 (2001) (finding that network externalities—in the form of an established body of law—have only a minimal impact on the choice of organizational form); Michael J. Whincop, *An Empirical Analysis of the Standardization of Corporate Charter Terms: Opting Out of the Duty to Care*, 23 INT'L REV. L. & ECON. 285 (2003) (finding similar evidence with respect to the evolution of Australian charter provisions).

result of greater information asymmetry between lawyer and client at elite firms.<sup>92</sup> By any typical measure of information asymmetry, elite firm clients suffer from less, not more, information asymmetry than do clients of non-elite firms.

It is possible, however, that all firms are equally burdened by the negative signal associated with LLP status but that such a negative signal costs elite firms more to bear because they have much more to lose. If this is so, then elite firms are understandably more concerned with muting this negative signal associated with LLP status than are non-elite firms, as the signal is more costly to them.

To illustrate, assume that elite firms have a reputation for providing high quality legal services that exceeds that of non-elite firms. If we allow  $x$  to represent the quantity of reputation that any firm has for doing careful legal work, then  $x$  should be a higher number at elite firms than at non-elite firms. Further assume that the conversion to LLP status reduces  $x$  by some percentage, say 10 percent. The conversion to LLP status should thus cost more the more elite the firm is.

*C. Are Law Firms Signaling Something Other than Quality—Specifically, Status?*

Although difficult to pin down precisely, the notion came across in interviews that limiting personal liability for partnership debts was something that quality lawyers, especially those at elite firms, simply did not do. Apparently, this attitude manifested itself early on during the New York LLP debate. According to one lawyer who was a member of the drafting committee for New York's LLP statute, the elite firms had no interest in the new legislation and felt that they would never use it.<sup>93</sup> Instead, the LLP was viewed as an innovation designed for "ambulance chasers" and other non-elite lawyers.<sup>94</sup>

If this is the case, then firms that hesitate to adopt the LLP form may not be attempting to signal quality, but high status. This theory is consistent with the observed filing pattern by New York law firms because only certain firms can credibly signal that they are part of the high status cohort. It, therefore, makes no sense for most lower status firms to incur the costs of retaining GP status, because they will not reap the benefits. For firms that could credibly make such a claim, however, the benefits of the GP form (a credible high status signal) appeared to outweigh the costs (full personal liability) until the demise of Arthur Andersen altered elite firm perceptions of the costs of unlimited liability.

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92. Confidential interviews with law firm partners (interview notes on file with the author).

93. *Id.*

94. *Id.*

The importance of status in markets and firm behavior is well-recognized. Scholars across disciplines have noted the impact of status on a variety of phenomena, including: the decision to engage in predatory pricing,<sup>95</sup> the pricing of California wines,<sup>96</sup> the diffusion of law firm associate raises across the nation,<sup>97</sup> and the rate of adoption of anti-takeover defenses.<sup>98</sup> Moreover, the role of status in the diffusion of innovation has been well studied.<sup>99</sup> In particular, scholars have noted the tendency of firms to mimic relevant others when faced with an uncertain environment.<sup>100</sup> Exogenous shocks, such as major regulatory or economic changes, increase environmental uncertainty and, correspondingly, increase the necessity of looking to similarly situated actors for cues on effective responses to the changed environment. In this process, not all referents are treated equally, however. Instead, the actions of competitors and high status firms are assigned particular importance.

Researchers have studied the diffusion of such diverse innovations as hybrid corn,<sup>101</sup> contractual provisions in venture

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95. See generally Joel M. Podolny & Fiona M. Scott Morton, *Social Status, Entry and Predation: The Case of British Shipping Cartels 1879-1929*, 47 J. INDUS. ECON. 41 (1999) (examining the merchant shipping industry and finding that high status entrants are 40 percent less likely to be preyed upon than low status entrants).

96. See generally Beth A. Benjamin & Joel M. Podolny, *Status, Quality, and Social Order in the California Wine Industry*, 44 ADMIN. SCI. Q. 563 (1999) (demonstrating that a wine producer's status in the market influences its choices about quality).

97. See generally Bruce M. Price, *A Butterfly Flaps its Wings in Menlo Park: An Organizational Analysis of Increases in Associate Salaries*, WIS. L. REV. (forthcoming Spring 2005) (applying neoinstitutional theory to law firm salaries).

98. See generally Gerald F. Davis & Henrich R. Greve, *Corporate Elite Networks and Governance Changes in the 1980s*, 103 AM. J. SOC. 1 (1997) (empirically demonstrating that the adoption of anti-takeover defenses in the 1980s was impacted by the rate at which high-status firms adopted such defenses).

99. Although related, the study of innovation and diffusion are actually two separate bodies of scholarship. Research on innovation attempts to identify factors that lead individual actors to adopt or develop a new process, procedure, or technology. The diffusion literature, by contrast, examines the mechanisms by which such adoptions spread across similarly situated actors. See Mark C. Suchman, *The Contract as Social Artifact*, 37 LAW & SOC'Y. REV. 91, 116-20 (2003) (discussing the research on innovation and diffusion).

100. See generally Davis & Greve, *supra* note 98, at (noting that firms are most likely to copy the innovations of other similar organizations, especially when they are of high status).

101. Bruce Ryan & Neal C. Gross, *The Diffusion of Hybrid Seed Corn in Two Iowa Communities*, 8 RURAL SOC. 15 (1943). Ryan and Gross found an S-shaped rate of adoption, which still characterizes the diffusion patterns of most innovations. *Id.* at 21. Bronwyn H. Hall, *Innovation And Diffusion*, in THE OXFORD HANDBOOK OF INNOVATION, at 466-68 (Jan Fagerberg et al. eds., 2005) (discussing the traditional S-shaped pattern).

capital financing,<sup>102</sup> the multi-divisional corporation,<sup>103</sup> corporate diversification,<sup>104</sup> and the spread of anti-takeover defenses.<sup>105</sup> In fact, one researcher reports that, as of 1995, over 4,000 books and papers had been published on the subject of diffusion.<sup>106</sup> Despite such extensive study, diffusion scholars continue to debate the factors that lead to diffusion, and why certain innovations diffuse widely, while others seem to gain only limited adoption.<sup>107</sup>

Importantly, however, many scholars provide arguments and data demonstrating that the diffusion of some innovations seems driven by reasons beyond the mere superiority or usefulness of the innovation in question. Specifically, researchers have argued that some organizations adopt innovations primarily because doing so signals legitimacy or status. As noted by Mark Suchman, "[e]ven if conformity is largely ceremonial and bears little relation to underlying technical processes, organizations appear more legitimate (both to themselves and to others) when they display the formal attributes that society expects from exemplary entities of their type."<sup>108</sup> Researchers have found evidence linking concerns over legitimacy and status to the diffusion of diversity hiring at elite law firms,<sup>109</sup> internal grievance procedures,<sup>110</sup> equal employment

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102. See generally Mark C. Suchman, *Localism and Globalism in Institutional Analysis: The Emergence of Contractual Norms in Venture Finance*, in *THE INSTITUTIONAL CONSTRUCTION OF ORGANIZATIONS: INTERNATIONAL AND LONGITUDINAL STUDIES* 39-63. (W. Richard Scott, & Søren Christensen, eds., 1995); Mark C. Suchman & Mia L. Cahill, *The Hired Gun as Facilitator: Lawyers and the Suppression of Business Disputes in Silicon Valley*, 21 *LAW & SOC. INQUIRY* 679 (1996).

103. See generally Neil Fligstein, *The Spread of the Multidivisional Form Among Large Firms, 1919-1979*, 50 *AM. SOC. REV.* 377 (1985).

104. See generally NEIL FLIGSTEIN, *THE TRANSFORMATION OF CORPORATE CONTROL* (1990).

105. See generally Davis & Greve, *supra* note 98.

106. See generally EVERETT M. ROGERS, *DIFFUSION OF INNOVATIONS* xv (4th ed. 1995).

107. Much of the debate involves the extent to which diffusion is dictated solely by the value of the innovation in question, versus the extent to which firms engage in simple mimicry, either because they lack sufficient information to make a more informed decision or because adopters simply tend to follow fads and cycles. For relevant discussions of this research, see generally Abhijit V. Banerjee, *A Simple Model of Herd Behavior*, 107 *Q.J. ECON.* 797 (1992); Paul J. DiMaggio & Walter W. Powell, *The Iron Cage Revisited: Institutional Isomorphism and Collective Rationality in Organizational Fields*, 48 *AM. J. SOC. REV.* 147 (1983); David Strang & Michael W. Macy, *In Search of Excellence: Fads, Success Stories, and Adaptive Emulation*, 107 *AM. J. SOC.* 147 (2001); David Strang & Sarah A. Soule, *Diffusion in Organizations and Social Movements: From Hybrid Corn to Poison Pills*, 24 *ANN. REV. SOC.* 265 (1998); David Strang & Mary C. Still, *In Search of the Élite: Revising a Model of Adaptive Emulation with Evidence From Benchmarking Teams*, 13 *INDUS. & CORP. CHANGE* 309 (2004).

108. Suchman, *supra* note 99, at 128.

109. DAVID WILKINS, *THE BLACK BAR: THE LEGACY OF BROWN V. BOARD OF EDUCATION AND THE FUTURE OF RACE AND THE AMERICAN LEGAL PROFESSION*

practices,<sup>111</sup> and a variety of other innovations.

Correlatively, some seemingly beneficial innovations may meet with resistance and diffuse surprisingly slowly out of fears that the innovation will be considered illegitimate in some way. To illustrate, in a 1997 study, Gerald Davis and Henrich Greve compare the diffusion of two anti-takeover devices: poison pills and golden parachutes.<sup>112</sup> They conclude that, despite the stronger economic case for golden parachutes as a mechanism for protecting shareholder interests, the poison pill diffused more quickly because boards feared that the parachute would be viewed as an illegitimate means of increased compensation.<sup>113</sup> Similar concerns regarding lack of legitimacy may have contributed to elite law firms' reluctance to embrace the LLP form.

Particularly relevant for this Article is the recent study by Bruce Price of the diffusion of associate salary increases, first across Silicon Valley firms and then across the country, following the 61 percent increase by Gunderson Dettmer Stough Villeneuve Franklin & Hachigian, LLP on December 21, 1999.<sup>114</sup> Although attempts to compete for associates may have motivated the decision by some firms to match the Gunderson increase, the most commonly asserted rationale for the decision to follow Gunderson's salary lead was that to fail to do so would send a negative signal to the marketplace that the firm in question was no longer a prestigious firm.<sup>115</sup>

In fact, partners at many firms interviewed by Price expressed a belief that the decision was economically irrational for several reasons.<sup>116</sup> First, neither partners, associates, nor clients at most firms desired an increase, as it meant reduced draws for partners, higher billing rates for clients, and higher billable hours for associates, in order to make up for the increased costs.<sup>117</sup> Second, Gunderson was considered a relatively small firm doing work only

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(forthcoming 2005). Wilkins interviews over a hundred African-American lawyers regarding their career trajectories. He concludes that one possible reason that hiring a token number of African-American associates originated at and then diffused among elite law firms, but not at other law firms, was that minority hiring was a mechanism for demonstrating high status. Presumably, this was viewed as a cost that lower-tiered firms could not afford to incur.

110. See generally Lauren B. Edelman et al., *The Endogeneity of Legal Regulation: Grievance Procedures as Rational Myth*, 105 AM. J. SOC. 405 (1999).

111. See generally Frank R. Dobbin et al., *Equal Opportunity Law and the Construction of Internal Labor Markets*, 99 AM. J. SOC. 396 (1993).

112. See generally Davis & Greve, *supra* note 98.

113. *Id.* at 34.

114. Price, *supra* note 97 (manuscript at 8).

115. *Id.* (manuscript at 26) (“[T]he most common reason given was that to not follow Gunderson and raise salaries, while their competitors did raise salaries, would signal the legal market that the firm was no longer a prestigious firm.”).

116. See, e.g., *id.* (quoting an interview subject's statement that the salary increases reflected a “short run irrationality”).

117. *Id.* (manuscript at 28-29).

in Silicon Valley that could hire only ten to fifteen new associates per year. Accordingly, it did not compete for associates with the majority of firms across the country that chose to match its salary increase and, in any event, could not have affected filling the thousands of slots that were affected by the move.<sup>118</sup> As stated by one Gunderson partner, "We're going to be taking 15 to 20 people out of the recruiting pool versus the thousands that are out there. I'm not sure why the other firms had to really match that other than, 'We're going to be the highest-paying law firm out there,' you know?"<sup>119</sup>

Interview subjects at other firms tended to agree that the salary increases were not driven by a need to compete for associates, but rather by a need to maintain an image as a top law firm. Many interview subjects opined that the raises were "a matter of ego,"<sup>120</sup> an attempt "to save face,"<sup>121</sup> and were motivated by notions that "if we are a top law firm we have to pay the same first year salaries as all of the other law firms in order to hold ourselves out as a top law firm."<sup>122</sup> One interview subject nicely summed up his firm's decision to match the Gunderson raise as follows: "[A]lthough it didn't make a lot of sense economically, from a perception point of view, we had relatively little option. You either matched the Gunderson raises and were considered a player[,] or you didn't match them."<sup>123</sup>

## VI. CONCLUSION

Times of great regulatory, technological, or cultural change have always proven fruitful for the study of innovation and diffusion.<sup>124</sup> With respect to organizational form, the advent of the LLP provides exactly this opportunity. A careful analysis of the reactions of New York law firms to this changed environment casts doubt on some of the conventional theories regarding organizational form. Specifically, the reactions of New York law firms to this innovation do not conform to the predictions of the signaling theory of partnership, at least as that theory is currently formulated.

At the same time, the evidence indicates that signaling concerns did impact law firm choice of form. The modifications to the signaling theory of organizational form proposed in this Article

118. *Id.* (manuscript at 27) (quoting a law firm partner's statements that his firm matched the Gunderson increase, although they do not compete with Gunderson, because of a need to protect its market image as an elite firm that can pay the top salaries).

119. *Id.* (manuscript at 28) (quoting a Gunderson partner) (footnotes omitted).

120. *Id.* (manuscript at 23) (quoting a law firm partner).

121. *Id.* (manuscript at 26) (quoting a law firm partner).

122. *Id.* (manuscript at 25) (quoting a law firm partner).

123. *Id.* (manuscript at 23) (quoting a law firm partner).

124. Davis & Greve, *supra* note 98, at 8 (making this point, and arguing that the takeover wave of the 1980s provided such an opportunity).

render the theory both more theoretically plausible and more consistent with the behavior of law firms.

In addition, this study provides insights for those interested in engendering, rather than simply studying, changes in the legal profession. At times calls have been made for various reforms in the legal profession, including: a greater attention to ethical behavior, more accountability to government bodies or the public interest, a work environment that better balances the demands of work and family, and greater diversity in law firm hiring and promotion. The reactions of law firms to New York's LLP statute highlight the avenues by which such changes are likely to take hold and spread across the legal profession, if at all.

This study suggests that law firms, particularly elite law firms, are risk averse and may initially resist even changes that seem to provide unqualified economic benefits when there is uncertainty regarding how clients and other relevant constituents will interpret the change. At the same time, law firms appear willing to incur costs in order to convey a desired signal to the marketplace. Finally, law firms (like other organizations) tend to mimic each other, paying particular attention to the actions of firms that are considered competitors for clients and status.

The foregoing has implications for advocates of change within law firms and indicates that such efforts may be most fruitful if first focused on the relatively small group of elite firms that other firms consider high status and frequently attempt to emulate. If these firms can be persuaded that being an early adopter of the innovation in question sends a credible signal that the firm is part of the high-status group, then the proposed reform may take root among elite firms (and, perhaps, those who aspire to be elite).

For example, mentoring programs for minority associates or on-site child care facilities may be expensive to implement, even if they provide long-term benefits to the firm. Accordingly, only the most profitable firms may be willing initially to incur this expense, and the adoption of such programs may become a signal that the adopting firm is a high earner. As the innovation becomes more ingrained, however, lower-tiered firms may decide that the program is a badge of legitimacy that any "serious" firm should have. As this happens, adoption of the innovation may trickle down to lower-earning firms, until it finally diffuses across the bulk of the industry.

**APPENDIX A****QUESTIONS FOR GP PARTNERS**

1. Has your firm discussed becoming an LLP?
2. What were the reasons asserted in favor of remaining a GP?
3. What were the reasons (other than limited liability) asserted in favor of LLP?
4. Was there an age division?
  - a. I.e., did older partners favor the status quo more than younger ones?
5. Do you think that you'll eventually move to become an LLP?
6. Was there any talk of redoing the partnership agreement to reflect higher profits for high-risk/high-return partners if you moved to LLP?
7. Does your firm have a lock-step partner compensation structure?



**APPENDIX B****QUESTIONS FOR LLP PARTNERS**

1. Your firm didn't take advantage of the LLP statute right away. In fact it took you \_\_\_ years to make the LLP filing. What took so long?

OR

2. Unlike many New York firms, your firm opted to become an LLP fairly quickly after the statute became effective. Why was the choice so easy for you? Why do you think other firms struggled with the decision and your firm did not?
3. What were the primary arguments made against the LLP filing?
  - a. Monitoring?
  - b. Collegiality?
  - c. Signaling?
  - d. Intra-firm economics?
  - e. Were there age differences in these arguments? i.e. did older partners favor the traditional GP structure more than younger partners did?
4. What were the factors that caused the arguments in favor of LLP to finally win out?
5. Has your firm had any regrets about the choice to become an LLP?
  - a. Has it altered your practice or relations with clients in any way?
  - b. Has it altered relations among the partners in any way?
  - c. Has it altered relations with your insurance company in any way?
6. IF APPLICABLE – I notice that you filed at the same time as \_\_\_\_\_ [similar firms]. Was that a conscious decision? Did their decision to file affect your decision in any way?
7. Does your firm have a lock-step partnership structure?