



April 1993

# Growing Pains: The Why and How of Canadian Law Firm Expansion

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## Recommended Citation

Daniels, R. J. (1993). Growing Pains: The Why and How of Canadian Law Firm Expansion. 147-206. Retrieved from [http://repository.upenn.edu/law\\_series/16](http://repository.upenn.edu/law_series/16)

Reprinted from *University of Toronto Law Journal*, Volume 43, Issue 2, 1993, pages 147-206.

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# Growing Pains: The Why and How of Canadian Law Firm Expansion

## **Abstract**

Over the last decade, the Canadian corporate law firm, like its counterparts in other industrialized countries, has undergone a profound transformation, the most remarkable feature of which has been the rapid growth of individual firms. Whereas a mere decade ago only one Canadian firm could boast of having more than 100 lawyers, today there are at least 19 firms that can make this claim. Accompanying the firms' rapid growth has been their steady expansion into distant national and international markets. Significantly, even when that expansion has been confined to local markets, law firms have invoked a much broader array of growth instruments than in the past. In place of singular reliance upon the standard practice of recruitment directly from law schools and subsequent promotion through the ranks, law firms have shown themselves willing to deploy other methods including lateral recruitment ('cherry picking'), greenfielding, affiliations, and mergers. Interestingly, while the rationale for rapid law firm growth has been given belated, though careful, attention by legal academics, the issue of the mechanisms by which that growth can be achieved has been virtually ignored. This oversight is curious. By understanding the calculus governing the choice of growth instruments, important light can be cast on the structure of and rationale for the modern law firm, and on the way in which it has coped with the stresses and strains of a dramatically changing market environment.

## **Disciplines**

Law

## **Comments**

Reprinted from *University of Toronto Law Journal*, Volume 43, Issue 2, 1993, pages 147-206.



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*The University of Toronto Law Journal*, Vol. 43, No. 2. (Spring, 1993), pp. 147-206.

Stable URL:

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*The University of Toronto Law Journal* is currently published by University of Toronto Press.

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Over the last decade, the Canadian corporate law firm,<sup>1</sup> like its counterparts in other industrialized countries, has undergone a profound transformation,<sup>2</sup> the most remarkable feature of which has been the rapid growth of individual firms. Whereas a mere decade ago only one Canadian firm could boast of having more than 100 lawyers, today there are at least 19 firms that can make this claim.<sup>3</sup> Accompanying the firms' rapid growth has been their steady expansion into distant national and international markets. Significantly, even when that expansion has been confined to local markets, law firms have invoked a much broader array of growth instruments than in the past. In place of singular reliance upon the standard practice of recruitment directly from law schools and subsequent promotion through the ranks, law firms have shown themselves willing to deploy other methods including lateral recruitment ('cherry picking'), greenfielding, affiliations, and mergers.<sup>4</sup> Interestingly, while the

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† I am indebted to Tim Heeney, Michael Kelly, Jim Craven, and Kelly Friedman for superb research assistance rendered through all stages of this project. Debra Forman, the international business and trade law librarian at the Faculty of Law, University of Toronto, ingeniously and doggedly tracked down elusive data. Pia Bruni cheerfully and proficiently typed large portions of this article, as well as coordinating our interview schedule. Jim Baillie, Bruce Chapman, Ron Gilson, Steven Richardson, and Roberta Romano provided me with extremely useful comments on an earlier draft, as did participants in workshops at the Canadian Law and Economics Association's annual meeting and at Georgetown Law School. Thanks are also owed to senior partners at 40 or so of Canada's leading law firms, who gave so generously of their time during this project. My greatest debt of gratitude is, however, to Michael Trebilcock. Without his inspiration and guidance, this project would never have been initiated. Of course, any responsibility for errors is purely my own. The research for this article was completed in the summer of 1990, and is current as at that date.

1 In this article, I use the terms corporate law firm and law firm interchangeably. This is because my focus is exclusively on the large corporate law firm. Such firms are characterized by their commitment to servicing the needs of corporate as opposed to individual clients. Although much of the analysis developed in this article may be easily applied to non-corporate law firms, there are several distinctive challenges being faced by small and medium-sized firms that must be accounted for in considering their growth and performance, and which I have ignored.

2 The operation of the modern corporate law firm is extensively explored in R. Nelson *Partners with Power* (Berkeley: University of California Press 1988).

3 See section III below.

4 See Galanter 'Mega-Law and Mega-Lawying in the Contemporary United States' in R. Dingwall and P. Lewis (eds) *The Sociology of the Professions* (London: MacMillan 1983) 162.

rationale for rapid law firm growth has been given belated, though careful, attention by legal academics,<sup>5</sup> the issue of the mechanisms by which that growth can be achieved has been virtually ignored. This oversight is curious. By understanding the calculus governing the choice of growth instruments, important light can be cast on the structure of and rationale for the modern law firm, and on the way in which it has coped with the stresses and strains of a dramatically changing market environment.

In this article, I examine the changing nature of the law firm in several distinct stages. In section I, I provide a thumbnail sketch of the activities, structure, and governance of the modern corporate law firm. In section II, I discuss the theory of the firm and its application to the legal partnership. Then, in section III, I examine in greater detail the phenomenon of rapid law firm growth, focusing on the burgeoning size and geographic scope of the firm. Although Galanter and Palay have offered a supply-side theory of law firm growth, I argue that it is beset by several deficiencies, and offer an alternative explanation for the phenomenon. In section IV, I evaluate the range of different instruments available to bring about growth, while remaining attentive to the law firm's dual objectives: to provide the level and type of services that best satisfy consumer demand and to minimize the internal costs of production, particularly those costs that are related to lawyer opportunism. Unfortunately, no instrument is perfect in being able to fulfil both of these objectives across all contexts, and I develop a hierarchy that ranks different growth instruments on the basis of their relative costs and benefits in local, national, and international settings. Finally, in section V, drawing on the results of an extensive set of interviews I conducted over a one-year period with senior lawyers in 40 leading Canadian law firms, I evaluate the strength of the theoretical claims advanced in section IV.

### 1 *The modern corporate law firm*

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

5 See M. Galanter and T. Palay 'Why the Big Get Bigger: The Promotion to Partner Tournament and the Growth of Large Law Firms' (1990) 76 *Va. LR* 747.

work.<sup>6</sup> One of the hallmarks of the corporate law firm is the wide scope and depth of its expertise. The same law firm may have legal specialists practising in areas as diverse as tax, antitrust, securities law, real estate, bankruptcy, litigation, and commercial law. The corporate law firm's distinctive strength comes from its ability to create ad hoc teams of lawyers drawn from a number of different specialties to provide advice to clients respecting their activities. For example, the tide of mergers and acquisitions work that swept North American markets during the 1980s routinely required lawyers from a number of different practice areas to work together in structuring these transactions or defensive responses to them.

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

Most law firms are structured as professional partnerships.<sup>7</sup> For the

6 As Gilson has observed: '[W]hat business lawyers *really* do – their potential to create value – is simply this: Lawyers function as *transaction cost engineers*, devising efficient mechanisms which bridge the gap between ... [the] world of perfect markets and the less-than-perfect reality of effecting transactions in this world.' 'Value Creation by Business Lawyers: Legal Skills and Asset Pricing' (1984) 94 *Yale LJ* 239 at 255. See also R. Kagan and R. Rosen 'On the Social Significance of Large Law Firm Practice' (1985) 37 *Stan. LR* 399.

7 In some American states, law firms can be organized as true limited liability corporations, permitting limited liability for lawyers and even allowing non-lawyer investors to hold equity in the firm. These firms are, however, exceptional. Although other American states and at least one Canadian province, Alberta, permit law firms to incorporate, the benefits of incorporation are largely confined to the realization of certain tax benefits. The firm does not enjoy limited liability insofar as creditor claims are concerned, nor are non-lawyers entitled to hold equity interests. See J. Robert Richard 'Incorporation by Lawyers' in J. Evans and M. Trebilcock (eds) *Lawyers and the Consumer Interest* (Toronto: Butterworths 1982) 303. American data on limited liability is reviewed in B. Eaton *Professional Corporations and Associations*, Business Organizations, vol. 17 (New York: Matthew Bender 1987), 9-44.2-9-46. See also the debate between Carr and Mathewson and Gilson respecting the role of limited liability as a barrier to entry into the legal profession: J. Carr and F. Mathewson 'Unlimited Liability as a Barrier to Entry' (1988) 96 *J. of Pol. Econ.* 766; and R. Gilson 'Unlimited Liability and Law Firm Organization: Tax Factors and the Direction of Causation' Working Paper no. 63, John M. Olin Program in Law and Economics at Stanford University.

most part, the partnership form of organization means that law firm partners have unlimited personal liability for debts incurred by the partnership. Consequently, each partner's personal wealth can be seized to satisfy debts incurred by other members of the partnership in the course of partnership business. In addition to personal liability, partnership status also confers clear rights upon partners to participate in the firm's management. Usually these management rights stipulate an entitlement to be kept apprised of the firm's activities and financial status, to be consulted on relatively normal course changes, and to be able to vote directly, often on the basis of supra-majority voting rules, on significant changes. Partnership status also includes a right to share in whatever income remains at the end of an accounting period after all fixed claimants have been paid. In this respect, partners are the residual claimants upon the firm's income stream; that is, they can withdraw funds from the partnership only after all fixed claims have been paid. The actual level of participation among lawyers varies from firm to firm depending on the criteria used in the compensation calculus. Some firms employ a lockstep system whereby all lawyers at the same level of seniority earn the same income, whereas most other firms rely on a more complex, non-mechanistic sharing system that includes attention to seniority, to marginal productivity, and to efforts at firm promotion and development.<sup>8</sup> The final characteristic of partnership is more secure, often lifetime, tenure. Although the constitution of most firms stipulates that partners can be removed from the partnership without causing the entire partnership to dissolve, such action occurs only rarely and is accompanied by extensive procedural protection for the departing partner.

Although, for the most part, partners in the modern corporate law firm are all lawyers, not all lawyers in the firm are partners. Until recently, most firms were organized around a two-tiered hierarchy of partners and associates.<sup>9</sup> Associate lawyers are typically recruited directly

8 Examples of lockstep firms are Clifford, Chance in Britain and Cravath, Swaine, and Moore in New York City. For a further discussion on the systems available to compensate partners and the incentives each create, see R. Gilson and R. Mnookin 'Sharing Among the Human Capitalists: An Economic Enquiry into Corporate Law Firms and How Partners Split Profits' (1985) 37 *Stan. LR* 313.

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

from law school and hired on the basis of fixed salaries, employment at will, and commitments on the part of the firm to furnish some on-the-job training and to consider the associate for promotion to partner after a fixed interval of from five to ten years.<sup>10</sup> In return, the lawyer agrees to furnish legal services to clients under the supervision and guidance of the firm's partners. The level of partner oversight diminishes quickly as the newly minted lawyer establishes her competence. Indeed, well before they are promoted to partnership, most associate lawyers will enjoy substantial control over small and medium-sized transactions and will have had extensive client contact, perhaps even to the point of serving as the lawyer responsible for coordinating all of a particular client's needs within the firm. The extensive period of time a lawyer serves as an associate with a firm provides partners with an abundance of information upon which to base a decision regarding promotion to partnership. Obviously, the more elaborate the set of actual observations of associates under a variety of conditions, the more confident partners can be about promotion. Given the defects in the market for human capital, internal recruitment and promotion is the principal mechanism for filling the firm's labour needs.

## II *The theory of the firm and the legal partnership*

### A. THE THEORY OF THE FIRM

The theory of the firm, as propounded by Coase and others,<sup>11</sup> is focused on the issue of when the gains from joint economic activity will be extracted through discrete market interactions, that is, simple contracts, and when they will be generated internally through the firm.<sup>12</sup> According

10 For a full explication of this relationship, see A. Leibowitz and R. Tollison 'Earning and Learning in Law Firms' (1978) 7 *J. Legal Studies* 65. Under the 'up or out system' that is used by most corporate law firms in determining promotion to partnership, associate lawyers not recruited to partnership are expected to seek out other employment, invariably in a smaller, less prestigious firm or in the in-house counsel department of a corporate client. The rationale for the 'up or out system' is described by R. Gilson and R. Mnookin 'Coming of Age in a Corporate Law Firm: The Economics of Associate Career Patterns' (1989) 41 *Stan. LR* 567.

11 R. Coase 'The Nature of the Firm' (1937) 4 *Economica* 386. Reprinted in G.J. Stigler and K.E. Boulding (eds) *Readings in Price Theory* (Homewood, Ill.: Richard D. Irwin 1952).

12 Take, for example, the production of a modern automobile. Under the rather implausible assumption that only market transactions will be used to coordinate the production of the automobile, a manufacturer would have to enter into a wide range of contractual arrangements to produce a single product. These would include discrete contracts for the supply of various intermediate goods, for the performance of various piecemeal tasks along the assembly line, for the provision



to Coase, the answer to this inquiry is supplied by a careful weighing of the costs and benefits of both forms of organization. Simply put, as the size of the firm increases, its advantages over markets, in terms of savings in search costs ('discovering what the relevant costs are'), negotiation and contracting costs, and sundry enforcement costs, are eclipsed by the accrual of costs emanating from decreasing returns to the entrepreneurial function, increasing potential for entrepreneurial mistakes in making resource allocation decisions, and the inherent cost advantages of small-scale production.

By and large, subsequent scholars have remained faithful to the basic inquiry framed by Coase, that is, analyzing the firm in terms of its market alternative, but have differed in their identification of and emphasis upon other costs and benefits of the firm form. For instance, while some scholars have focused on the ability of the firm's centralized monitoring system to control internal agency costs,<sup>13</sup> others have emphasized the salutary effects of the firm's ownership structure,<sup>14</sup> while still others have

of various marketing and promotional activities, for the transportation of finished products to distributors and retailers, and for the provision of post-purchase product support. Were an automobile produced in such a manner, it is clear that the costs of manufacture would clearly be prohibitive. Far more efficient is a production scheme in which the performance of various routine functions are internalized within the firm.

- 13 Alchian and Demsetz concentrated on the role that the firm plays in monitoring the performance of members of the team production function. According to these commentators, the value of the firm lies in its ability to achieve economies in monitoring the inputs of factors into the production process when it is difficult, if not impossible, to ascertain the *ex post* marginal productivity of individuals involved in joint production by measuring their individual output. Monitoring is an important function owing to the natural propensity of employees to behave opportunistically by refusing to expend their maximum efforts in carrying out economic activity within the firm. Opportunism can take the form of 'shirking' (consuming more leisure than if one were forced to bear its costs) and 'perquisite consumption' (consuming resources that enhance the personal utility of the employee at the expense of the firm). Increasing firm growth strains the capacity of the firm to detect such conduct, leading to a commensurate increase in the attractiveness of market contracting – despite its attendant costs. A. Alchian and H. Demsetz 'Production, Information Costs, and Economic Organization' (1972) *Am. Econ. Rev.* 777.
- 14 Fama and Jensen, for instance, postulate that the efficacy of monitoring by residual claimants (the persons bearing the risk that the flow of future receipts paid to the firm will be less than the promised payments to various agents of the firm) informs the nature of the internal structure of the firm. Particularly, Fama and Jensen argue that for small, relatively simple forms of production, the firm will be structured so that the residual claimants are also the managers of the firm. By virtue of the fact that the residual claimants' returns are a function of their capacity to control internal opportunism, these individuals will have the incentive to manage the firm effectively. However, as the scale and complexity of production increases, thereby increasing the necessity both for specialized provision of capital and for

devoted considerable attention to the capacity of the firm's internal governance system to overcome innate opportunism problems accompanying asset-specific investment.<sup>15</sup> Strands of all of these theories can be found in the many rationales that have been developed to explain the survival value of the legal partnership.

#### B. THE THEORY OF THE LAW FIRM

Following the structure of the inquiry established by Coase, the rationale for the legal partnership can be explicated best by considering first the particular benefits that can be derived from joint production in the context of legal services, and second, the features of the law firm partnership that make it a superior vehicle to markets in realizing these benefits.<sup>16</sup> In terms of the former question, four principal benefits accrue from joint production of legal services. The first relates to the benefits of task specialization. By parcelling out parts of a legal transaction to different lawyers on the basis of their relative expertise, the overall quality of legal advice tendered to a client can be expected to increase. This quality advantage is due to the growing complexity of law in

specialized management, the ability of individuals to perform both tasks competently is diminished. As a consequence, a variety of institutionalized monitoring arrangements must be relied on to ensure that the conduct of decision-makers is aligned with the objectives of residual claimants. On the basis of this core intuition, Fama and Jensen reflect on the nature of internal governance mechanisms that are used to organize production in organizations as diverse as the conventional corporation and the Catholic Church. E. Fama and M. Jensen 'Separation of Ownership and Control' (1983) 26 *J. Law & Econ.* 301; 'Agency Problems and Residual Claims' *ibid.* 327.

15 Oliver Williamson emphasizes the role that the firm, as a quintessential governance mechanism, can play in controlling opportunism of a special kind, that is, opportunism involving exploitation of bargaining power that arises from investments in asset-specific goods. Such goods are characterized by their customization for specific applications, and by the fact that their value in their next-best use is considerably less than the use for which they were originally designed. One way of overcoming the perverse incentives emanating from asset-specific investments is to internalize production in the firm. When both parties to a transaction are employed by the same firm, the revenues accruing from their economic activity will be aggregated in the same pool. As a consequence of earnings integration, neither of the parties will have an incentive to engage in strategic gaming of the other. Any redistributive benefit that one party extracts from the other will accrue back to both through each party's share in the overall returns to the firm. Supplementing the effect of common ownership in correcting perverse incentives, the firm's internal governance mechanism is also able to create an apparatus that can fairly and expeditiously resolve disputes among parties involved in the firm's joint production. See O. Williamson *The Economic Institutions of Capitalism* (New York: Free Press 1985).

16 A much more expansive discussion of these issues can be found in R.J. Daniels 'The Law Firm as an Efficient Community' (1992) 37 *McGill LJ* 801.

modern society, which undermines the capacity of the generalist to keep abreast of legal developments in a way that an individual can who devotes all her effort and energy to law in one focused area. The second benefit is the realization of economies of scale that result from spreading the costs of certain fixed inputs, such as libraries, accounting, time-recording, data collection, and word-processing facilities, over a greater number of lawyers. The third benefit – economies of scope – is derived from joint production of complementary goods. These savings are based on the ability of team production of legal services to recycle fixed investments in human capital, enabling, for instance, a group of lawyers who have already serviced a client's needs in a particular area to provide additional services at lower cost than can a competitor who has not had previous exposure to the client. The fourth, and final, benefit of joint production of legal services accrues from the diversification of investments in human capital that can be realized when team production of legal services is coupled with a pooling of earnings.<sup>17</sup> Given the dramatic fluctuations in the earnings of lawyers corresponding to changes in underlying economic conditions, lawyers may form teams drawn from diverse specialties, each specialty being characterized by a different, perhaps even negatively correlated, elasticity of demand to changes in gross domestic product.

Given these benefits, what comparative advantage does the firm have over markets in facilitating their realization? By and large, most of the theories advanced to explain the advantages of the law firm emphasize the role that it can play in controlling the agency costs that arise naturally when production of legal services is highly decentralized. Although a variety of independent theories have been advanced to illuminate this rationale, given the amenability of agency costs to control through multiple, overlapping instruments, the most realistic conception of the law firm is probably best obtained through some combination of different instruments. These include: (1) centralized monitoring through mechanized time-keeping systems that enable the firm to confer compensation on lawyers that is commensurate with their level of effort (as measured in hours worked);<sup>18</sup> (2) conferral of ownership interests in the residual profit of the firm that can vary from accounting period to accounting period on the basis of marginal productivity;<sup>19</sup> (3) the role of the firm (particularly firm culture) in creating and maintaining commitments to

17 Gilson and Mnookin, *supra* note 8, 326

18 F. McChesney 'Team Production, Monitoring, and Profit Sharing in Law Firms: An Alternative Hypothesis' (1982) 11 *J. Legal Studies* 379

19 Alchian and Demsetz, *supra* note 13, 786. Fama and Jensen 'Separation of Ownership and Control' *supra* note 14, 315-7.

communitarian values that reduce agency costs;<sup>20</sup> and (4) the role of the firm's reputational capital and governance structure in ameliorating the opportunism spawned by asset-specific investments.<sup>21</sup>

### III *The phenomenon of rapid law firm growth*

#### A. INTRODUCTION

Rapid law firm growth is a phenomenon that has been identified in many industrialized economies, and Canada is no exception. Of the 48 largest Canadian law firms in 1990, none had more than 100 lawyers in 1962 or and in 1980, only one firm had more than 100 lawyers; but by the end of 1989, 19 firms had more than 100.<sup>22</sup> The significance of this growth is buttressed by comparing the growth rates of the law firms (as measured by the number of lawyers employed) with the number of lawyers in private practice in the corresponding provinces. These data are set out in table 1, and cover three roughly equal periods from 1962 to 1989. Although yielding equivocal results for the first two periods,<sup>23</sup> the data are arresting for the most recent period: from 1980 to 1989, save for Nova Scotia, the growth rate of corporate law firms was far in excess of the growth rate of lawyers generally. The difference in the rates ranged from a multiple of 1.7 for British Columbia to a multiple of 3.5 for Quebec. Similar trends have been exhibited in the United States.<sup>24</sup>

Galanter and Palay have analyzed the pattern of law firm growth in the United States, and have found that a kinked exponential function is

20 Daniels, *supra* note 16

21 Gilson and Mnookin, *supra* note 8, 367. Galanter and Palay, *supra* note 5, 775-80

22 These figures are based on data from *Canada Law List* (Toronto: Canada Law Book, published annually). The sample of 48 firms was constructed by identifying the largest law firms in five Canadian cities (Vancouver, Calgary, Toronto, Montreal, and Halifax) in 1990, and following the number of lawyers back to 1962.

23 In some cases, the growth rate of firms was considerably greater than the total number of lawyers; in other cases, the opposite relationship was found.

24 In the United States, for instance, the *National Law Journal* (18 September 1989) has reported that the number of firms with more than 150 lawyers has increased from 5 in 1970 to 202 in 1989. Of those 202 firms in 1989, 13 had over 500 lawyers, and 3 had more than 1,000. Further statistics are provided by Gilson and Mnookin, *supra* note 8, 314 n3. Rapid growth in the number of American lawyers is considered by R. Sander and E. Douglass Williams 'Why Are There So Many Lawyers? Perspectives on a Turbulent Market' (1989) 14 *Law & Social Inquiry* 431; and R. Nelson 'Practice and Privilege: Social Change and the Structure of Large Law Firms' (1981) *Am. Bar Found. Res. J.* 95. The issue of why the 'mega' law firm has not developed in the United Kingdom is examined in J. Flood 'Megalaw in the U.K.: Professionalism or Corporatism? A Preliminary Report' (1989) 64 *Indiana LJ* 569.

TABLE 1

Rates of growth of lawyers in major law firms<sup>a</sup> compared with rates of growth of lawyers in private practice in the corresponding provinces

Province	1962	1972	1980	1989
<i>British Columbia</i>				
Lawyers in 12 Vancouver firms	168	249	423	828
% growth in firms	n/a	48.2	69.8	95.8
Total lawyers in province	1,278	1,993	3,771	5,884
% growth in province	n/a	53.9	89.2	56
<i>Alberta</i>				
Lawyers in 7 Calgary firms	80	120	231	530
% growth in firms	n/a	50	92.5	129
Total lawyers in province	852	1,157	2,654	4,258
% growth in province	n/a	35.8	130	60.4
<i>Ontario</i>				
Lawyers in 15 Toronto firms	242	464	852	2,000
% growth in firms	n/a	91.7	83.6	135
Total lawyers in province	4,665	6,818	12,454	18,496
% growth in province	n/a	46.2	82.7	48.5
<i>Quebec</i>				
Lawyers in 11 Montreal firms	132	263	448	817
% growth in firms	n/a	99.2	70.3	82.4
Total lawyers in province	2,369	2,781	5,884	7,275
% growth in province	n/a	17.4	112	23.6
<i>Nova Scotia</i>				
Lawyers in 3 Halifax firms	34	52	80	130
% growth in firms	n/a	53	53.8	62.5
Total lawyers in province	330	401	903	1,586
% growth in province	n/a	21.5	125.2	75.6

<sup>a</sup> The 48 law firms from 5 major cities chosen for the sample were the largest in each city in 1990.

Sources: D.A.A. Stager *Lawyers in Canada* (Toronto: University of Toronto Press 1990) at 146; *Canada Law List* (Toronto: Canada Law Book, published annually).

best fitted with the data collected.<sup>25</sup> This exponential function has, they argue, been operative since 1922, indicating that the size of the large American firms grew by a constant or increasing percentage each year.

25 Galanter and Palay, *supra* note 5, 756–65. A kinked exponential function means that law firms grew exponentially before and after 1970, but at different rates. According to the researchers, endogenous factors explain steady exponential growth, while exogenous factors explain the increases in the 1970 growth rates.

Canadian law firm growth patterns seem to parallel the American trends. Although having some anomalous years, the trend in the Canadian data presented in graph 1, which measures law firm growth in terms of the aggregate number of partners and associates in 48 firms, shows that Canadian law firms grew by constant or increasing rates from 1960 to 1990, indicating that similar forces are at play.<sup>26</sup>

A second but equally distinctive feature of law firm growth in the last decade has been its geographical scope. Galanter has commented on the propensity of large American corporate law firms to grow by opening offices in cities other than where the firm was originally based:

Twenty years ago the occasional Washington or foreign branch office seemed anomalous ... But in 1979 of the twenty largest firms, nineteen had offices in more than one city ... The mean number of city locations of the twenty largest firms was five. Of these fifteen had at least one branch overseas.<sup>27</sup>

Although occurring somewhat later than the trends reported in the United States, Canadian law firms have also demonstrated growing geographical dispersion. Tables 2 and 3 depict the frequency with which offices have been opened in locations outside the city in which the firm is headquartered. Table 2 lists the new offices of firms opened in other Canadian cities, and table 3 lists the new offices opened in foreign cities.<sup>28</sup> These data exclude mergers of existing firms.<sup>29</sup> Although the openings reported in table 2 do not appear significant, the openings shown in table 3, especially for the last five years, are dramatic: within the last five years, 14 Canadian firms have opened 18 foreign offices. This compares with a total of six openings in the 20 years prior to 1985.

In view of the rather pronounced trends observed in law firm growth – exponential increases in size and recent multi-jurisdictional openings – any theory of growth must explain both factors. Galanter and Palay have attempted to explain the former, though not the latter. They argue that exponential law firm growth can be attributed to the pressures

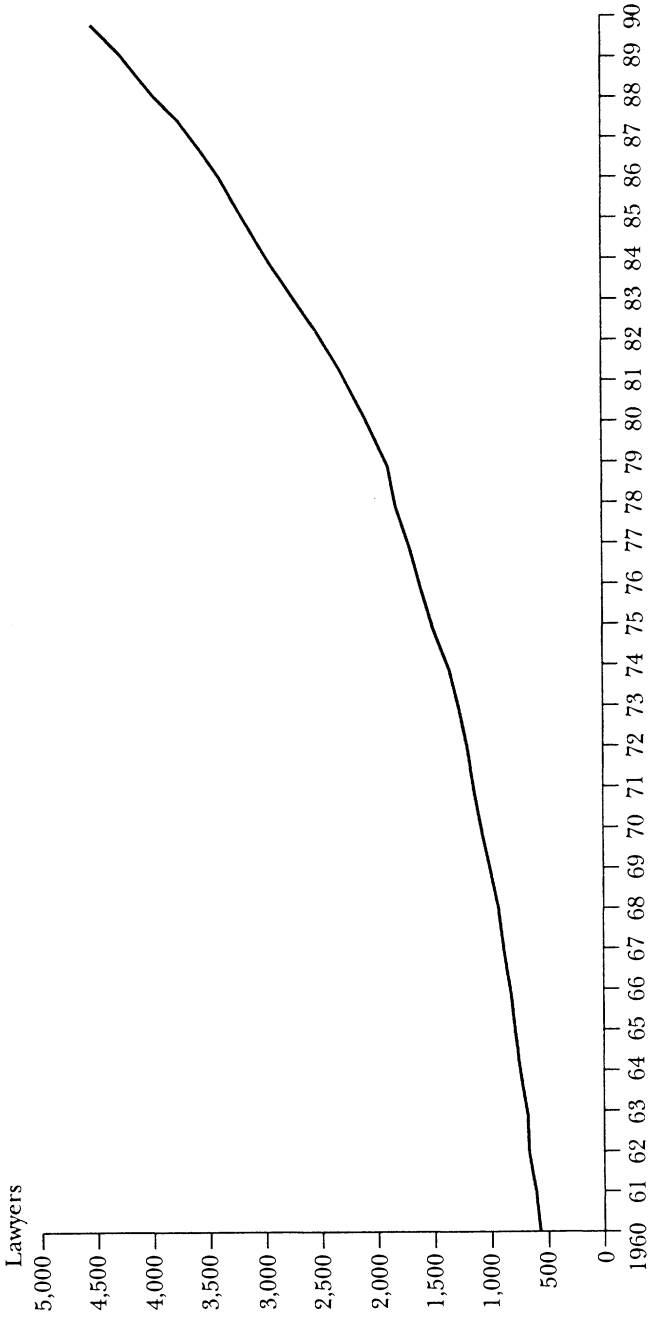
26 Robust growth is exhibited most starkly by Toronto firms in the last decade; in 7 of the 10 years in the period 1980 to 1990, Toronto law firms grew in excess of 8 per cent per year. For 6 out of 10 Vancouver firms and 5 out of 10 Montreal firms, comparable growth rates were exhibited.

27 Galanter, *supra* note 4, 155. See also S. Labaton 'U.S. Law Firms Expand to Reach Global Clientele' *The New York Times* 12 May 1988.

28 These data were obtained from a series of newspaper and periodical searches and were supplemented, where possible, with information obtained from our interviewing process.

29 This issue is dealt with extensively in section v below.

GRAPH 1  
 Number of lawyers in sample<sup>a</sup> by year



<sup>a</sup> See table 1.  
 Source: *Canada Law List* (Toronto: Canada Law Book, published annually)

TABLE 2  
New domestic offices

Date	Firm	Head office	New office location
1972	Stikeman Elliot	Montreal	Toronto
1978	McMaster Meighen	Montreal	Toronto
	Martineau Walker	Montreal	Toronto
1982	Stikeman Elliot	Montreal	Ottawa
1984	Ogilvy Renault	Montreal	Ottawa
1985	Byers Casgrain	Montreal	Ottawa
1986	Bennett Jones	Calgary	Saskatoon
1987	Bennett Jones	Calgary	Ottawa
1988	Stikeman Elliot	Montreal	Vancouver

TABLE 3  
New foreign offices

Date	Firm	Head office	New office location
1965	Phillips & Vineberg	Montreal	Paris
1968	Stikeman Elliot	Montreal	London
1970	Phillips & Vineberg	Montreal	Hong Kong
1972	Stikeman Elliot	Montreal	Hong Kong
1975	Burnett Duckworth	Calgary	London <sup>a</sup>
1983	McMaster Meighen	Montreal	London
1985	Stikeman Elliot	Montreal	New York
	Phillips & Vineberg	Montreal	New York
	Bull Housser & Tupper	Vancouver	Shanghai
1986	Blake Cassels & Graydon	Toronto	London
1987	Ogilvy Renault	Montreal	Paris
	Fasken Martineau Walker	Toronto and Montreal	London
1988	Bull Housser & Tupper	Vancouver	Hong Kong
	Smith Lyons	Toronto	Hong Kong <sup>b</sup>
	McCarthy & McCarthy	Toronto	London, England
	Perley-Robertson Panet Hill & McDougall	Ottawa	Washington, DC
1989	Bull Housser & Tupper	Vancouver	Taipei
	Davies Ward & Beck	Toronto	London, England
	Faskin Martineau Walker	Toronto and Montreal	Brussels
	Bennett Jones	Calgary	Taipei
	Ladner Downs	Vancouver	Hong Kong
1990	Lawson Lundell	Vancouver	Taipei
	Lawson Lundell	Vancouver	Hong Kong
	MacLeod Dixon	Calgary	Moscow

<sup>a</sup> Closed in 1988

<sup>b</sup> Liaison office



produced by the 'promotion to partnership tournament.' They claim that the promotion of associates to partner status, combined with the desire of lawyers at partner level to fully exploit their surplus capital, requires an exponential increase in the size of the firm.<sup>30</sup> That is, as associates are promoted, new associates must be hired to fill their positions so that the surplus capital of senior lawyers continues to be fully leveraged. Thus, so long as the ratio of partners to associates is kept constant, promotion of associates to partner status, which is deemed by the researchers to be a proxy for the attainment of sufficient human capital to create a surplus, will dictate an exponential increase in the size of the firm.

Apart from their failure to explain the recent pattern of multi-locational growth, Galanter and Palay's work suffers from two other defects. First, by focusing principally on supply-side factors, the argument neglects unduly the central role of demand-side factors in both stimulating and constraining law firm growth. Despite the desire of lawyers to leverage fully their human capital, it is clear that they will not be able to do so in a way that is impervious to market constraints. Should a firm's client base be affected by a cyclical downturn in the economy or by an unanticipated adverse shift in consumer preferences, the demand for that firm's services will, not surprisingly, contract. In this scenario, irrespective of the leveraging objectives of the firm's partners, only egregious folly would cause the firm to undertake rapid expansion in an environment of enervated demand.

A second difficulty with the promotion to partnership analysis turns on its inability to explain much of the recent merger activity that has occurred among mature law firms in the United States and Canada.<sup>31</sup> With partnership ratios roughly consistent across law firms of similar size, growth through merger would not appear to confer significant leveraging gains. Simply stated, a firm of 100 partners and 200 associates will not experience any gains from a merger with a firm of 50 partners and 100 associates; prior to the merger, the two firms each had a ratio of two associates for every partner, and this ratio will remain unchanged by the merger. Unless the *ex ante* associate-to-partner ratios of merging firms differ substantially, there is no incentive for firms concerned with under-exploited surplus partner reputational capital to engage in this behaviour.

A more rigorous approach to understanding the causes of law firm growth is predicated on the rather straightforward assumption that

30 Galanter and Palay, *supra* note 5, 771

31 This increase in merger and affiliation activity is discussed in section v below.

growth is a function of both demand- and supply-side factors. That is, law firm growth will occur in response to the changing demand for jointly produced legal services. If, however, as a result of certain exogenous changes, the law firm can realize certain economies that increase its cost effectiveness in the delivery of legal services, then the increase can be expected to stimulate law firm growth. Consistent with this claim, the discussion following will first consider the demand-side factors and then the supply-side factors influencing corporate law firm growth.

## B. THE DEMAND FOR CORPORATE LAW SERVICES

Over the last decade, the demand for corporate law services has undergone sweeping change. The most notable change in demand has been its increasing intensity, which has required firms to expand the scale of their operations. However, at the same time that the intensity of demand has increased, it has also become much more volatile. The factors underlying the changes in demand for corporate legal services include: robust economic growth, growing levels of government intervention, internationalization of the domestic economy, and increased legalization of corporate activity. Each of these factors will be addressed in turn.

### 1. *Real economic growth*

A primary source for increased demand for legal services emanates from exogenous macroeconomic growth pressures.<sup>32</sup> As the economy expands, an increase in demand for corporate law services can be expected to follow. For instance, during a period of economic growth and prosperity, corporations will have greater need for capital to invest in the expansion of their existing activities. The corporate finance departments of the large law firms will provide advice and assistance to clients as they try to fund new projects. While the degree of involvement of the lawyer will vary in accordance with the form of capital raised (generally greatest with public equity issues, smallest with respect to routine bank loans), it is clear that these transactions will increase demand for legal services. And, once the capital is raised, clients will require further legal assistance in funnelling the new funds into established or new ventures. Again, the services of the corporate lawyer, in incorporating new companies and in drafting joint-

32 Support for this proposition can be taken from studies of the American legal profession. See B.P. Pashigian 'The Market for Lawyers: The Determinants of the Demand for and Supply of Lawyers' (1977) 20 *J. Law & Econ.* 53. Pashigian found that the quantity of legal services demanded was positively correlated with the level of gross national product. His proxy for demand was the number of lawyers in active practice.

venture, licensing, and franchising agreements, will be required. Once the economy slackens, and pessimism sinks in, clients will be understandably reluctant to embark on these initiatives, and the demand for corporate law services, with the exception of insolvency and receivership specialties, will fall off.

Table 4 compares real provincial GDP data with the growth of law firms in five cities, providing strong support for the putative correlation between growth in demand for legal services as reflected in firm size and general economic growth. When, as in the post-1981 recession period, the economies of Ontario, Quebec and British Columbia experienced robust economic growth, law firms located in these provinces experienced rates of increase that, in most years, matched or exceeded the real rate of growth in GDP.

## 2. *Growing levels of government intervention*

Another factor that has stimulated the demand for corporate law services is the incremental growth of government intervention in the economies of Western industrialized nations ever since the inauguration of the New Deal and the rise of the bureaucratic welfare state.<sup>33</sup> Although it can be argued that the recent deregulatory wave unleashed by the Reagan and Thatcher administrations in the United States and Great Britain, respectively, may have curtailed the growth of government intervention, there are strong reasons for believing that the depth of government intervention may not have been constrained, only its targets.<sup>34</sup> In this respect, increasing levels of government intervention imply an increase in the range and depth of laws that affect on the activities of the corporate sector. As the scope for law increases, the necessity of utilizing the assistance of legal advisors to respond to these laws heightens.

The importance of legal advice in counselling corporate clients is accentuated when the reliance of government regulators on 'quasi-law' is acknowledged.<sup>35</sup> In the absence of legislative deliberation and adoption, the task of identifying the rules surrounding a contemplated course of

33 Interestingly, however, Pashigian's study led him to conclude that the scale of government regulation was not positively correlated with demand for legal services. *Ibid.* 73

34 R. Howse, J.R.S. Prichard, and M.J. Trebilcock 'Smaller or Smarter Government?' (1990) 40 *UTLJ* 498.

35 The role of administrative quasi-legislation is discussed by R. Megarry 'Administrative Quasi-Legislation' (1944) 60 *Law QR* 125. For a recent discussion of the role of quasi-law in the Canadian securities context, see H. Janisch 'Reregulating the Regulator: Administrative Structure of Securities Commissions and Ministerial Responsibility' in *Securities Law in the Modern Financial Marketplace*, Special Lectures of the Law Society of Upper Canada (Toronto: R. deBoo 1989) 97.

TABLE 4

Percentage growth of lawyers in major law firms<sup>a</sup> compared with percentage growth of GDP in the corresponding provinces

Province	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
British Columbia GDP growth	0.3	9.4	4.5	4.9	4.3	5.6	5.4	-6.2	3.4	2.1	6.5	1.5	6.4	5.1	5.7
Vancouver law firm growth	2.3	6.1	4.9	9.3	1.6	10.4	9.2	12.6	9.2	9.5	9.3	-0.4	5.2	8.0	7.7
Alberta GDP growth	6.5	7.8	5.8	7.1	9.7	5.2	8.5	-1.8	-0.2	1.6	6.0	-2.3	1.7	6.1	1.7
Calgary law firm growth	-2.0	4.7	9.0	5.9	13.4	13.8	22.9	15.5	13.4	8.1	11.2	6.0	0.6	7.3	3.5
Ontario GDP growth	0	5.5	3.0	2.3	2.5	0.1	3.2	-3.7	5.3	8.7	5.1	4.8	4.7	4.4	2.8
Toronto law firm growth	9.2	5.4	0.5	13.5	4.9	7.2	9.3	13.6	7.7	6.1	8.2	10.1	12.4	11.0	11.4
Quebec GDP growth	1.1	4.9	2.5	2.2	4.5	1.2	2.2	-5.4	2.5	6.9	2.6	2.8	4.8	4.5	2.5
Montreal law firm growth	9.6	4.5	11.0	2.6	1.5	11.7	8.9	10.4	7.8	8.1	1.1	6.5	5.5	8.9	5.3
Nova Scotia GDP growth	3.6	2.9	2.9	5.1	1.5	3.1	1.7	-1.6	3.5	7.7	4.9	3.0	0.9	3.0	3.8
Halifax law firm growth	12.1	3.1	7.5	2.8	1.4	6.7	8.8	5.8	8.7	8.0	4.6	2.7	6.0	4.1	1.6

<sup>a</sup> Number of lawyers in sample of 48 firms (see table 1)Sources: GDP data (constant 1986 dollars) obtained from Conference Board of Canada: Online Data. Law firm information derived from data collected from *Canada Law List* (Toronto: Canada Law Book, published annually).

conduct becomes parlous. To clarify what the law is in this setting necessitates an inquiry that is much more searching and expensive than would be required in a regime where law is confined to what is technically on the statute books. As Galanter has noted, '[C]orporate client and mega-lawyer come together in a setting in which there is an immense proliferation of law and at the same time an increasing awareness of its indeterminate and problematic character.'<sup>36</sup>

### 3. *Internationalization of the domestic economy*

A third source stimulating demand for the services of corporate law firms emanates from changes in the nature of activity occurring in the corporate sector that are independent of macroeconomic growth cycles. In large part, these changes reflect the growing 'internationalization' of the domestic economy. This internationalization is a result of an unparalleled degree of cooperation effected among the industrial states during the post-Second World War era. The fruits of this cooperation are reflected in the diminution of the strength of the various barriers that have traditionally worked to impede the flow of goods and capital across international boundaries. For instance, during the period 1947 to 1987, the worldwide average tariff rates on manufactured goods fell from 40 per cent to between 5 and 6 per cent.<sup>37</sup> This has resulted in dramatic increases in trade. Trebilcock reports that in Canada's case alone, the level of exports and imports has grown by 564.5 per cent and 552.3 per cent, respectively, in the period 1947 to 1986.<sup>38</sup> In the light of the impending completion of the European internal market, the execution of the staged implementation of the Canada-United States free trade agreement and its extension to Mexico, and the revival and integration of Central and Eastern European countries into the world trading order, it is possible that the amount of international trade will continue to expand dramatically within the next decade.

Another barometer of the growing levels of internationalization can be found in the spectacular increases in international capital flows that have been observed in the last two decades. The Economic Council of Canada has found that cross-border trade in existing securities increased 21 times between 1977 and 1988.<sup>39</sup> Further, the funds raised in international bond

36 Galanter, *supra* note 4, 161

37 *Managing Adjustment: Policies for Trade-Sensitive Industries* (Ottawa: Economic Council of Canada 1988) 1

38 Michael J. Trebilcock 'Freedom of Contract' (draft manuscript on file with the author)

39 *New Frontiers: Internationalization of Financial Markets* (Ottawa: Economic Council of Canada 1989) 5

markets by all countries were 6 times the amount raised in 1980.<sup>40</sup> These trends were also manifested in the amount of international banking activity. Bryant has reported, for example, that during the 21 year period between 1964 and 1985, international banking activity grew twice as fast as trade in goods.<sup>41</sup>

These trends can be presumed to have had important stimulative effects on the demand for legal services. First, tethered to the relationship noted earlier between economic expansion and demand for legal services, liberalization of trade and capital barriers will, in accordance with the dictates of Riccardian trade theory, be translated into increased economic growth, which will in turn stimulate demand for legal services. Second, by definition, the effectuation of economic activity across jurisdictional boundaries involves greater legal complexity than if the activity were confined to a domestic context. Corporate actors will not, especially in discrete, one-time relationships, be familiar with the rights and obligations they have when undertaking conventional commercial activity across jurisdictions. Mitigation of this uncertainty can be achieved by soliciting legal advice in the clients' home jurisdiction.

A third effect of internationalization has been the increasing amount of rationalization activity that it has spurred. In an effort to ready themselves for more intense international competition, large established corporations have engaged in a wide range of strategic activities, manifested most clearly in the accelerating amount of merger and acquisition activity undertaken by Canadian and American corporations in the last ten years. For instance, Demott reports that in 1985, US firms committed to 30 merger transactions involving values in excess of \$1 billion. In contrast, she found that only 12 merger-related transactions valued at \$1 billion or more took place in the United States between 1969 and 1980.<sup>42</sup> She reports that merger activity has also heightened in Canada in the same period.<sup>43</sup> This claim is confirmed by the data presented in graph 2. By plotting, against different vertical axes, the number of merger and acquisition transactions occurring in Canada and the United States between 1960 and 1990, a clear upward trend can be observed. At least part of the rise in merger activity can be correlated with the increasing impact of internationalization. If not motivated by the attempt to create and exploit market power, merger and acquisition activity allows cor-

40 Ibid.

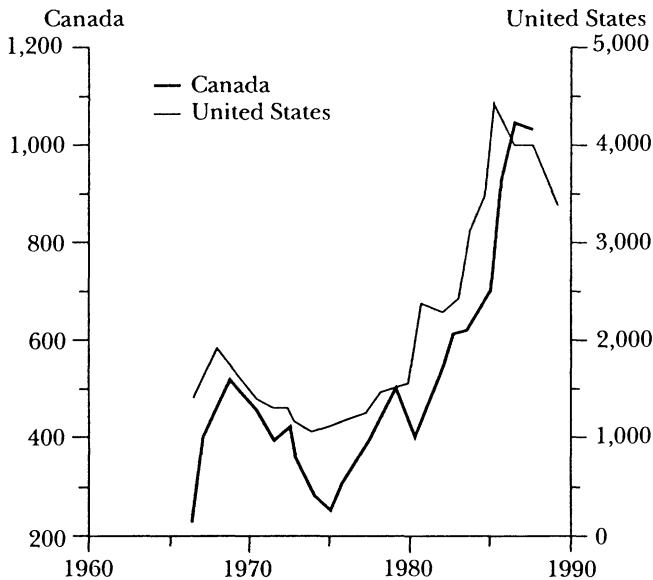
41 R.C. Bryant *International Financial Intermediation* (Washington: Brookings Institute 1987) 20-1

42 See, e.g., D. Demott 'Comparative Dimensions of Takeover Regulation' (1987) 65 *Wash. U. LQ* 69 at 80.

43 Ibid. 81

GRAPH 2

Mergers and acquisitions (number of deals) in Canada and the United States



Sources: *Mergers and Acquisitions Journal* and *Bureau Merger Register*

porations to exploit certain synergies and efficiencies of scale and scope in the production of goods, thereby conferring tangible benefits on consumers.<sup>44</sup>

These transactions have exerted a profound effect on the nature of legal services provided in Canada and the United States. Because of the size of the stakes and the level of complexity involved in merger and acquisition transactions, any increase in their frequency will increase the prospect for costly and protracted legal disputes in a wide range of legal areas. The increasing likelihood of entanglements with the legal system will, in turn, increase the demand for an extensive array of legal services. For instance, a given merger or acquisition transaction, whether motivated by strategic or financial objectives, may require legal expertise in areas as diverse as securities, tax, antitrust, bankruptcy, labour, commercial litigation, and intellectual property. In order to economize on coordination costs, these transactions are best run out of a single law

44 For a more extensive discussion of these issues, see R.J. Daniels 'Don't Shoot the Messenger: Mergers and Acquisitions and the Public Interest' in L. Waverman (ed.) *Corporate Globalization Through Mergers and Acquisitions* (Calgary: University of Calgary Press 1991) 195.

firm. In this vein, merger and acquisition transactions, as well as increasing the overall demand for legal services, have also affected the nature of this demand in the direction of multi-specialty providers of legal services.<sup>45</sup>

#### 4. *The Legalization of corporate activity*

A final factor exerting an impact on the demand for corporate legal services is the legalization of corporate activity. While this trend is partially reflective of the burgeoning level of governmental regulation in the economy, it is also reflective of two somewhat related trends: (1) growing private sector litigiousness; and (2) increased reliance on in-house counsel. The first factor, growing litigiousness, has been the subject of considerable scholarly investigation over the past decade.<sup>46</sup> For the most part, this litigiousness has been observed in the context of traditional tort law areas, such as medical malpractice, product liability, motor vehicle accidents, and embroiling corporations in disputes with various consumers, often individuals.<sup>47</sup> Surprisingly, however, recent studies have found that private litigiousness in the tort area is now proliferating into other areas of law, including conventional commercial and contract law.<sup>48</sup> These findings are significant because they imply that resolution of inter-corporate disputes is being remitted to the courts, contravening the conventional view espoused by Macaulay that businesses rarely rely on strict

45 During the course of our interviews, a number of small and medium-sized firms admitted being under considerable pressure to grow in order to accommodate the demands placed on them by 'mega-transactions.' Without a sufficiently large foundation, the law firms had considerable difficulty in staffing the broad teams of lawyers necessary to conduct these transactions.

46 See, for instance, D. Hensler 'Trends in Tort Litigation: Findings from the Institute for Civil Justice's Research' (1987) 48 *Ohio State Lj* 479; G. Priest 'Product Liability Law and the Accident Rate' in Litan and Winston (eds) *Liability: Perspective and Policy* (Washington: The Brookings Institute 1988) 184; 'The Current Insurance Crisis and Modern Tort Law' (1987) 96 *Yale Lj* 1521.

47 For instance, Priest, *supra*, at 187 found that product liability filings in US courts increased from 1,579 in 1974 to 13,595 in 1986 – a more than seven-fold increase. The claim that these statistics are suggestive of an increase in litigiousness has not gone unchallenged. See M. Galanter 'The Day After the Litigation Explosion' (1986) 46 *Maryland LR* 3, who argues that, in view of the relatively small percentage of national litigation filed in federal courts (2 per cent), these statistics are unable to generate robust predictions respecting national trends.

48 Recent work by Marc Galanter and Joel Rodgers has found dramatic increases in the amount of contractual litigation: a 223 per cent increase in the number of legal disputes between the years 1960 and 1988. The increase is attributed to increased complexity of business transactions and increased competition. See their preliminary study reported in M. Geyelin 'Feuding Firms Cram Courts, Study Says' *The Wall Street Journal* 31 December 1990.



legal rights and remedies in resolving commercial conflicts.<sup>49</sup> This increase in both tort and commercial litigiousness has caused senior managers to make earlier and more extensive use of legal advice in corporate decision-making, which further contributes to the demand for corporate legal services.

The second factor contributing to the legalization of corporate activity has been the rise of in-house legal departments in corporations.<sup>50</sup> For instance, in the United States, the number of in-house counsel is alleged to have quadrupled in the twenty-year period between 1962 and 1982.<sup>51</sup> Although robust Canadian data are not available, the data presented in Table 5, showing the total number of lawyers employed by 56 corporations reported in the *Canada Law List* for the years 1990, 1980, and 1970, indicate a belated but similar expansionary trend occurring in Canada. Whereas the total number of lawyers employed by the corporations included in the *Canada Law List* increased by only 6.5 per cent from 1970 to 1980, in the following decade the number of lawyers increased by 86.3 per cent. Although the rise of the in-house legal department was originally envisaged as a way of allowing corporations to reduce their demand for and cost of legal services (by sourcing legal services at wholesale rather than retail prices<sup>52</sup> and by giving corporations greater

49 Indeed, Galanter and Rodgers, *supra*, found that the number of intercorporate contractual disputes increased by 1,112 per cent between 1971 and 1986. The classic study on corporate litigation patterns is S. Macaulay 'Non-Contractual Relations in Business: A Preliminary Study' (1963) 28 *Am. Soc. Rev.* 55.

50 The transformative role of in-house counsel on the nature of legal practice is documented in A. Chayes and A. Chayes 'Corporate Counsel and the Elite Law Firm' (1985) 37 *Stan. LR* 277; J. Freund 'Comment on Chayes and Chayes' (1985) 37 *Stan. LR* 301; and R. Rosen 'The Inside Counsel Movement, Professional Judgment and Organizational Representation' (1989) 64 *Indiana LJ* 479.

51 J. Ayre 'In House Counsel - Better than Ever' *Nat. LJ* (15 February 1982) at 11. Chayes and Chayes, *supra*, at 277 n1, cite a 1983 Arthur Young study of 183 corporate law departments of varying size that showed an average growth of 29 per cent between 1977 and 1982. This growth has resulted in the creation of some very large legal departments: according to the *Martindale-Hubbell Law Director* vol. 13, General Electric's legal department had 347 lawyers in 1990.

52 By bringing work in-house, corporations can avoid paying 'retail' prices for types of work that in-house counsel could produce at 'wholesale' prices. Typically, the more likely it is that an employer can assure in-house counsel a sufficient volume of transactions in a given area, the greater the prospect that the lawyer will be able to develop the expertise necessary to deliver such services at a standard approximating that met by outside counsel. The growing capacity of in-house counsel to meet rigorous standards of professional competence is also a function of the increasing prestige that is enjoyed by these lawyers, which has enabled outside counsel to move to in-house law departments without sustaining any loss in professional stature. As Rosen has observed, 'inside counsel at major corporations are no longer depicted as second-rate counsel dependent on the guidance of outside counsel. In-

control over the activities of outside counsel<sup>53</sup>), things did not turn out as expected. Rather than tempering demand, corporate counsel have made senior managers more sensitive to and concerned about the potential for costly legal entanglements. Insinuation of lawyers into the senior levels of corporate decision-making has meant that corporate decisions are increasingly being framed in a way that is sensitive to legal as well as economic concerns. This framing effect has made managers more anxious to cover off any potential legal exposure by soliciting formal legal advice. And, because of the inherent difficulties of in-house counsel in servicing these needs, possibly because of a perceived lack of expertise or independence, a non-trivial portion of the demand they induce will spill over to the private bar.<sup>54</sup>

Nevertheless, in the course of augmenting the demand for corporate legal services, reliance on in-house counsel has affected the nature of this demand. In particular, growing use of in-house counsel has increased the volatility of demand for legal services.<sup>55</sup> This increase in volatility is attributable to two factors. First, while in-house counsel have enlarged

side counsel now are characterized as possessing the knowledge and training necessary to handle complex and important legal matters.' Rosen, *supra* note 50, 483

53 This control is based on the ability of inside counsel to correct some of the endemic information asymmetry problems that beset the market for corporate law services. Since, irrespective of the amount of work they do, in-house counsel will receive a fixed wage from the corporation, they will have little incentive to perform or permit to be performed services for which the corporation has little real need. As a consequence, in-house counsel can be expected to play a role in controlling opportunistic behaviour by outside counsel. By insisting that outside counsel tender for certain transactions, by scrutinizing the billings of outside counsel, and by reviewing closely the work of outside counsel, in-house counsel can draw on their expertise to ensure that the corporation is not overcharged. To the extent that information asymmetries have, in the past, allowed outside firms to supply services in an amount or at a price that is in excess of what a fully informed consumer would desire, the proliferation of in-house counsel can be expected to constrain such activity.

54 See, for instance, P. Lochner Jr 'Comment (on Chayes and Chayes)' (1985) 37 *Stan. LR* 305 at 311: '[T]he existence of in-house counsel is, I believe, expanding the amount of legal work. Because in-house counsel exist, they observe and become involved in many areas. Frequently outside assistance is sought ... In short, inside and outside counsel are not fighting over where to split the pie; rather, the pie is being expanded by inside counsel to the economic and professional benefit of both.' Contra, however, see Chayes and Chayes, *supra* note 50, 293, who argue that, as a result of the rise of in-house counsel, the elite law firm is 'suffering a concomitant and drastic narrowing of the range of legal work that it performs for the largest, most powerful corporations on the American economic scene.'

55 The increased riskiness of law firm income flows is commented on by J. Fitzpatrick 'Legal Future Shock: The Role of Large Law Firms by the End of the Century' (1989) 64 *Indiana LJ* 461 at 464.

TABLE 5  
Number of in-house counsel

Company	1990	1980	1970
Abitibi Price	5	4	2
Air Canada	8	9	4
Alcan Aluminium Ltd.	4	9	9
Amoco	24	4	6
Atomic Energy of Canada Ltd.	6	0	0
Bank of Montreal	18	4	0
Bank of Nova Scotia	17	6	0
BCE Inc.	8	0	0
Bell Canada	39	35	17
Bombardier	7	0	0
Canada Post Corporation	24	0	0
Canada Trust	13	3	5
Canadian Broadcasting Corporation	11	0	5
Canadian Imperial Bank of Commerce	24	13	0
Canadian National Railways	32	33	28
Canadian Pacific Forest Products	7	0	0
Canadian Pacific Ltd.	3	43	33
Canadian Pacific Legal Services	45	0	0
Central Guaranty Trust	14	7	5
Chevron	15	12	10
Cominco Ltd.	5	13	7
Dominion Textile Inc.	2	4	1
Domtar	17	12	8
Esso Resources Canada Ltd.	17	10	0
Federal Business Development Bank	10	44	39
General Motors	10	8	2
Great West Life Insurance	12	8	8
IBM Canada	13	10	4
Imperial Oil Ltd.	13	14	14
Imasco Ltd.	4	2	0
Inco Ltd.	4	5	4
Insurance Corporation of BC	20	14	0
MacMillan Bloedel Ltd.	3	7	3
Manitoba Public Insurance Co.	19	0	0
Manufacturers Life Insurance Co.	10	5	4
William Mercer	30	0	0
Molson Companies Ltd.	1	1	1
Molson Breweries of Canada Ltd.	1	1	1
Montreal Trust	6	5	6
National Bank of Canada	12	0	0
National Trust	12	11	13
Noranda Inc.	6	8	6
Northern Telecom Ltd.	8	15	0
Ontario Hydro	18	12	0
Petro Canada Inc.	22	9	0
Placer Dome Inc.	5	4	2
Polysar Ltd.	1	5	0
Royal Bank of Canada	29	7	0
Royal Trustco Ltd.	8	3	15

TABLE 5 continued

Company	1990	1980	1970
Soquij	17	0	0
Stelco Inc.	5	4	5
Sun Life Insurance Co. of Canada	16	10	10
Toronto-Dominion Bank	15	5	2
Toronto Stock Exchange	11	5	3
TransCanada Pipelines	11	10	9
Xerox Canada	3	2	0
Total companies in sample	56	56	56
Total in-house counsel in sample	720	455	291
Total companies with over 10 lawyers	32	24	14
Total companies listed in <i>Canada Law List</i>	423	227	213

Source: *Canada Law List* (Toronto: Canada Law Book, published annually)

the demand for more complex types of outside legal services (transactional advice, for example), they have, by doing some of this work themselves, decreased the demand for other, more routine services traditionally performed by outside counsel.<sup>56</sup> From the perspective of the law firm, the shift in traditional counsel work to in-house counsel is disturbing because the demand for this type of work is extremely stable, varying only minimally in response to fluctuations in macroeconomic activity. Without a stable flow of routine legal work, corporate law firms have become more dependent than ever upon transactional work, which is, by definition, much more volatile.

The second way in which establishment of in-house legal departments has contributed to demand volatility emanates from the dilution in or, in some cases, severance of the mutual reliance relationship that has traditionally existed between outside law firms and their clients.<sup>57</sup> Because of the sunk value of investments made by a traditional legal supplier in assets specific to a particular client relationship,<sup>58</sup> and because these assets are a form of intellectual property that is not easily appropriated, clients have been historically reluctant to retain different law firms for different transactions, as this will force them to bear the costs of familiarizing

56 This issue is discussed in Chayes and Chayes, *supra* note 50, 297 and R. Nelson 'Practice and Privilege' *supra* note 24, 111.

57 See Gilson and Mnookin, *supra* note 8, 359-60; Nelson, *supra* note 2, 68.

58 These assets consist mainly of the stock of knowledge that the firm amasses about the client's internal operating structure, business strategy, financial status, and personnel.

newly appointed firms with their needs. Concern over recurring familiarization costs acts as a tax on client shopping that effectively bolsters the mutual dependence of client and law firm. However, in-house counsel, by serving as a data bank that can store and convey information respecting the client's background and legal needs to different outside counsel, can reduce the magnitude of the exit tax, enabling clients to shop around for legal advice on a transaction-by-transaction basis.

### C. THE SUPPLY OF CORPORATE LEGAL SERVICES

The various demand-side factors enumerated above impact on the law firm through the mediating force of supply-side factors. That is, while not wishing to understate the impact of consumer demand in shaping the nature of the modern law firm, the force of these preferences is constrained somewhat by limitations that result from exigencies of the technical production function and from the preferences of suppliers (lawyers). In this respect, supply-side factors can be viewed as a prism of sorts, through which images of the law firm have been sharpened and, in some cases, reshaped.

For the most part, changes in the firm's technical production function over the last decade have supported the thrust of those demand-side factors that have 'pulled' on the size of the law firm. These supply changes have been observed mainly in the form of increased economies of scale resulting from innovative new technologies that have allowed firms to automate a range of productive activities at much lower cost than in the past.<sup>59</sup> Conventional automation has enabled the firm to reduce the amount of time that secretaries require to type and copy documents, enhance the accuracy of internal record- and time-keeping, improve the firm's research capacity by virtue of advances in legal data bases, and even confer savings on lawyers in the amount of time and effort that lawyers must expend on drafting of judicial pleadings and commercial agreements because of assistance from 'smart' document precedent systems.<sup>60</sup> Save for conventional data and word processing systems, most of these innovations entail high initial fixed costs that do not vary greatly with the number of actual end users. As such, the per lawyer costs of these innovations will decline as the number of lawyers in the firm grows, pushing up the firm's minimum efficient scale.

The other supply-side factor – lawyer preferences – has exerted a

59 See, for instance, E. Warner 'Large Law Firms Moving Toward Automated Office' (1984) *Computerworld* 21 May 1984, 23.

60 Smart precedent manipulation systems will actually custom-tailor documents to transactions specified by lawyers.

more equivocal effect on the firm. While some commentators have equated increased size with increased returns to senior partners, this relationship is not invariably true,<sup>61</sup> making at least some lawyers doubt the strategy of enthusiastically accommodating client demands for enhanced size. Focusing simply on bottom line economic considerations, one would expect that apprehension over the prospects of rapid growth will be exacerbated the greater are concerns respecting increased volatility of consumer demand, which, in the event of a precipitous change in economic conditions, could leave senior partners in the unenviable position of having to support excess capacity (in the form of idle administrative staff and associate lawyers) by reducing the size of their partnership draw. An alternative, though a more severe measure, is for the firm to reduce the size of its obligations to fixed claimants by simply laying off or firing administrative staff and associate lawyers. Nevertheless, from the perspective of the instrumental and consumption value of the firm's status as a mini-society of sorts, in which commitments to collegiality, cooperation, and community are prized, cost savings realized through capricious retrenchment may, in the long term, impose debilitating costs on the firm.<sup>62</sup> Thus, if the firm is to grow in accordance with demand-side pressures, other less drastic means must be found to protect the firm from exogenous shifts in demand.

One obvious mechanism for dealing with such risk is, of course, rooted in the diversification rationale for the law firm previously discussed.<sup>63</sup> That is, by entering into new markets, the firm may be able to diversify away some of the risk that its human capital will be idled because of adverse economic conditions. These new markets can be entered by creating new practice areas that are not as sensitive as the firm's existing practice to macroeconomic changes.<sup>64</sup> However, in view of the dearth of legal specialties having elasticities of demand that are negatively correlated with existing areas of practice, there will be inherent limitations on the capacity of the firm to diversify away much of the risk of future income disruptions generated by increased demand by selective expansion. Consequently, other diversification strategies will have to be

61 While Galanter and Palay, *supra* note 5, find that increased size is usually correlated with increased returns to senior partners, they concede that there are contradictory findings to this claim.

62 These concerns are elaborated on in Daniels, *supra* note 16.

63 See text following note 30, *supra*.

64 For instance, a firm specializing in securities law could develop a bankruptcy practice. Some firms have created these new areas of practice in various non-legal specialties, such as policy advice and family mediation services.

deployed. One such strategy is to diversify the firm into other jurisdictions having macroeconomic cycles that are not perfectly correlated with conditions extant in the home jurisdiction. In this respect, expanding firm size and geographic scope may not be coincidental; geographic dispersion may be a necessary accompaniment to the enhanced firm size.

#### IV *The instruments for growth*

##### A. INTRODUCTION

Having canvassed the reasons for law firm growth, I will now consider the myriad ways in which law firms can grow. Essentially, the menu of instruments that a firm can deploy in achieving law firm growth consists of: standard recruitment and promotion, cherry picking, affiliating, and merging. A number of different criteria can be invoked to assess the efficacy of the instruments, including the impact on growth on the firm's ability to control internal agency costs,<sup>65</sup> to inculcate and maintain strong community identification,<sup>66</sup> to preserve firm reputational capital,<sup>67</sup> to diversify away the risks of specialized human capital,<sup>68</sup> and to achieve growth in a timely fashion. The first four of these criteria were generated from the discussion of the rationale of the law firm developed earlier; the

65 As argued earlier, the law firm form is valued principally for its ability to control the costs of opportunism that are implicit in arrangements entailing the joint production of legal services. Control of costs is particularly difficult given the problems in evaluating the contribution of workers to services (which are inherently more amorphous than physical goods) and the highly decentralized nature of service production.

66 As the size of the firm increases beyond some point, the firm will experience serious difficulties in maintaining the integrity of its community identity or culture. At one level, the loss is deeply felt because community culture is a consumption good that has value in itself. At another level, however, this loss is significant because it impedes the firm's capacity to control internal agency problems. Cultural erosion in the large firm stems from the loss of intimacy and collegiality that often accompanies rapid growth. Consider, for example, the difficulties in transmitting and maintaining culture in a rapidly growing, 200-person law firm in comparison with a slowly growing, relatively stable 10-person law firm. Whereas in the latter case, lawyers will share strong, intimate connections with each other that have been forged through years, perhaps even decades, of shared professional and personal successes and disappointments, in the former case, the rate of entry into the firm is far too high, and the underlying size of the firm is far too large, to be able to create a reservoir of shared experience dense enough to support the same intensity and durability of collegial bonds. See Daniels, *supra* note 16.

67 The preservation of firm reputational capital is another key concern of the firm in undertaking growth. Uncontrolled growth can dilute investments in firm reputational capital, which not only imposes economic losses on firm partners, but also undermines the firm's capacity to control agency costs.

68 The more rapidly the firm grows, especially if growth is concentrated in certain areas of expertise, the less equipped the firm is to self-insure against the risks of exogenous economic changes.

last is self-explanatory and is based on pragmatic considerations. In this section, I will invoke these criteria in an effort to evaluate the comparative strengths and defects of the various instruments available to achieve law firm growth in local markets. Having done so, I will then consider whether or not the arguments developed in the context of local markets need to be modified when growth is examined in a national or international setting.

## B. THE INSTRUMENTS FOR GROWTH

### *1. Standard recruitment and promotion*

Standard recruitment and promotion is the conventional way in which law firms achieve growth, and involves direct recruitment of students to the law firm from prestige law schools, followed by a closely supervised apprenticeship or associate period lasting several years that culminates in promotion of the associate to partnership. The advantage of this instrument lies in its capacity to differentiate between those individuals whose personal skills, judgment, and strength of character do and do not meet the standards of the firm. As soon as it becomes clear that an associate is in the latter category, she will usually be asked by the firm to resign. Through this weeding out process, the firm is able to concentrate its efforts on instilling commitments to the firm's distinctive culture among those lawyers most likely to assume partner status. This subtle, though somewhat protracted, acculturation process is prized because of the support it lends to the firm's role in controlling agency costs and in preserving culture and reputational capital. In comparison to other instruments, standard recruitment and promotion provides the strongest assurance to the principals of the firm that it is promoting the right kind of lawyers to partner status.

Despite the standard recruitment's strengths in identifying the most promising lawyers, however, it is not a perfect instrument for growth, being plagued principally by its extremely cumbersome nature. Because of the difficulties in transforming human capital, and because of the long time needed to develop specialist status in a given area, standard recruitment requires the firm to anticipate labour needs well into the future. As in any probabilistic forecast, there is always the risk that the forecast – either through reliance on erroneous information or through radical changes in expected future states – will be incorrect.<sup>69</sup> This

69 The standard work in this area is D. Kahneman, P. Slovic, and A. Tversky (eds) *Judgment under Uncertainty: Heuristics and Biases* (New York: Cambridge University Press 1982).



subjects the firm to the danger that it will have undertaken extensive investment in lawyers whose skills do not mesh with market demands at the conclusion of their training.

Another defect with the standard recruitment instrument is its limited capacity to respond to the needs of clients in areas of practice where the firm lacks existing expertise. While, in the past, clients having long-term, stable relationships with firms have been willing to tolerate some amount of 'learning by doing,' it is not clear that clients will be as accommodating in the future. In large part, this is attributable to the growing role of in-house counsel in monitoring law firm behaviour, which has also broadened the scope for comparison shopping. Client insistence that firms have ready-made expertise in a given area means that gaps in the law firm's specialized capital will have to be met through other instruments.

## 2. *Cherry picking or lateral hiring*

Cherry picking or lateral hiring, the recruitment of seasoned lawyers from other law firms, addresses the defects found in the standard recruitment model.<sup>70</sup> Unlike the lengthy training periods implicit in the standard recruitment model, cherry picking enables law firms to respond much more effectively to the vicissitudes of client demands. A firm experiencing, for example, a surge in the demand for lawyers with specific skills can quickly meet these demands by recruiting lawyers directly from the legal labour market. But, like standard recruitment, cherry picking is not without flaws. In particular, cherry picking requires firms to make costly and irrevocable *ex ante* commitments, such as instant partnership, to recruits without having the benefit of full information. While many of the observations that are relied upon in the process of lateral hiring are fairly accurate predictors of technical legal talent (performance in court or in the negotiation and execution of transactions, the quality of law review articles, presentations made to professional organizations, law school transcripts, and so forth), other observations bearing, for instance, on the recruit's honesty, judgment, and collegiality may be much more difficult to obtain firsthand, and are therefore subject to error.

An additional difficulty with cherry picking pertains to the role of law firm culture in shaping and solidifying skills and preferences that are

70 Lateral recruitment has gained considerable popularity over the past decade as an instrument of growth. See Smith 'National Study: Lateral Hiring Continues Unabated' (June 1989) 9 *Lawyer Hiring and Training Report* 6. The 1989 survey reported on found that more than half of the lawyers promoted to partner in the top 500 American law firms were recruited from other firms. A quarter of the surveyed firms reported more than half of their associates were hired laterally.

valued by the firm. Because lateral recruits may not have had the lengthy exposure to the firm ethic through the promotion-to-partnership tournament, there is a significant likelihood that the new recruits will have commitments to the firm and its culture that are much less powerful than lawyers recruited directly from law school and then promoted through the ranks. In these terms, the more reliance that the firm places on lateral hiring, the greater the danger that it will be torn asunder by divergent visions of its bedrock values. These internal conflicts are further exacerbated by the task of integrating lateral hires into the firm hierarchy. That is to say, to the extent that lateral recruits are able to exploit market power based on unusually strong demand for their specialized skills, then this can be expected to be reflected in the provision of benefits from the firm that are more generous than those being received by other lawyers in the firm having equivalent experience but hired through the standard recruitment route. For all of these reasons, one would predict that cherry picking would only be relied upon in those circumstances where the firm is confident that it can inculcate the requisite commitment to firm culture in the new recruits, and where the firm's need for specialist strength is acute.

### 3. Mergers

Merging involves the integration of two or more existing firms into a single partnership. Mergers can be effected between two relatively equal sized firms or between firms of different sizes. Unlike internal growth, merging allows the immediate realization of scale and scope economies and ensures that client demands are met with alacrity. And, unlike cherry picking, merging allows 'acquiring' firms to obtain the expertise of 'target' lawyers without jeopardizing the acquired firm's investment in reputational capital.

The deficiencies of mergers in a professional setting are, however, numerous and have received considerable attention in legal trade journals.<sup>71</sup> These deficiencies arise from barriers in achieving the quick integration of different firms, each of which may have different underlying styles of practice, internal governance mechanisms, compensation schemes, promotional policies, administrative structures, and marketing strategies. Integration requires that consensus be achieved on all of these issues in a fairly narrow time-frame. Given that the human resources

71 See, for instance, N. Blodgett 'Anatomy of a Law Firm Merger' (May 1988) *Am. Bar Assoc. J.* 86; W. Bower 'To Merge or Not to Merge' *ibid.* 94; and L. Collins 'The Metamorphosis of Merging' (April 1986) 60 *Law Inst. J.* 304.

literature indicates that these problems are onerous in the context of corporate mergers, especially when firms are of relatively equivalent size, it can be predicted that these problems will be compounded in law firms, especially with the preponderance of consensus-based governance mechanisms that implicate more diffused, prolonged, and, often, less bold decision-making.

Another set of difficulties with the merger instrument arises from the information problems identified earlier with the lateral recruitment device. The problems of ascertaining the productivity, ethical mettle, and collegiality of prospective partners and associates are bound to be exacerbated in the case of firm mergers, which require firms to evaluate a much larger group of prospective partners in a much shorter time-frame. Although information problems are mitigated somewhat by the willingness of firms to open their financial records to prospective partners, the propensity of law firms to allocate income on bases that only crudely track current marginal product (resulting, for example, from optimal *ex ante* agreements respecting the temporal distribution of income over a lawyer's lifetime<sup>72</sup>) means that the capacity of payroll data, for instance, to cast light on the market performance of future partners is dulled.<sup>73</sup> And, of course, even if pre-merger investigation could identify non-performing lawyers in the prospective partner, lawyers in partner firms may exhibit tied sales properties. That is, owing to the existence of various hands tying mechanisms, that is, commitments embedded in firm culture, formalized firm approval processes requiring unanimous appro-

72 Disjunction between current income and marginal product may give rise to opportunism problems upon the completion of a merger. Since divergence between current marginal product and income may represent a form of delayed compensation (that is, in order to encourage law firms to make sunk investments in legal training, lawyers may bond their performance to the firm by taking less than their current marginal product in the expectation of obtaining more than their marginal product later), certain constituencies within the successor law firm may use the opportunity of a merger to renegotiate these compensation agreements. The effect, for instance, of a renegotiation of the arrangements that govern compensation in the successor firm that results in the alignment of income and product of senior lawyers, thereby reducing the draw of senior lawyers, can be seen as a direct wealth transfer from senior to junior lawyers. Normally, senior lawyers can be expected to quash efforts aimed at diverting their future draw from the firm. Nevertheless, since many mergers, by definition, require extensive re-ordering of the affairs of the merging firms, including the renegotiation of partnership point distributions, it may be more difficult for senior lawyers to constrain such behaviour.

73 The 'coarseness' of a firm's compensation system in marrying compensation with marginal productivity is discussed in Gilson and Mnookin, *supra* note 8, 348 and S.S. Samuelson 'The Organizational Structure of Law Firms: Lessons From Management Theory' (1990) 51 *Ohio State LJ* 645 at 651.

val before the merger can proceed, and so forth, firms may present themselves to prospective partners on a 'take it or leave it' basis, negating opportunities for prospective partners to 'prune deadwood' from the ranks of the successor firm prior to the merger. These information and tied-sales problems increase the prospect that the reputational capital of the pre-existing firms will be diluted by the absorption of lawyers from merging partners whose work habits and ethical mettle are incompatible with their individual standards.

Even if firms could be confident, however, that lawyers in their partner law firms uniformly adhered to minimum standards of professional competence, mergers would still jeopardize another component of a law firm's capital investment – its client base. Upon the consummation of a merger, the new firm will find itself beset by myriad conflicts among existing clients, which will require that the new firm sever ties with some of the clients of the pre-existing firms. Although it may be argued that these conflicts can be resolved through the erection of 'Chinese walls,' it is not clear that these mechanisms will satisfy either client expectations or technical legal obligations.<sup>74</sup> Picking client survivors is bound to involve

74 Professional regulation provides that lawyers cannot advise or represent both sides of a dispute and are barred, unless adequate disclosure has been made and consent obtained, from acting where there is likely to be a conflict of interest. (See, for example, Law Society of Upper Canada, Rules of Professional Conduct, Rule 5). Conflict of interest rules have recently been considered by the Supreme Court of Canada in the case of *MacDonald Estate v. Martin* [1990] 3 SCR 1235. Martin, the appellant, and the respondent estate were involved in ongoing litigation. Early in the process, a lawyer had been working on Martin's case at law firm A. She later joined law firm B, which subsequently merged with law firm C. Law firm C, however, also represented the respondent estate, and the appellant applied for an order removing the lawyer from law firm C as the respondent's lawyer due to a conflict of interest. The Supreme Court of Canada unanimously disqualified law firm C from acting for the respondent, but the court was split 4-3 on the appropriate test to be applied. Sopinka J, writing for three others, developed a test that would presume prejudice to the applicant unless the firm (firm C) could show 'clear and convincing' evidence that measures had been taken to prevent disclosure of confidential information from the 'tainted' lawyer to those members of the firm who are engaged against her former client. In other words, he would allow 'Chinese walls' or 'cones of silence,' but only if these devices are approved by the relevant law society. Mere undertakings and affidavits that the 'tainted' lawyer did not disclose damaging information are not enough. Cory J, writing for two others, developed a stricter test. When a lawyer who had substantial involvement in the matter in question joins the firm acting for the opposing party there will be an *irrebuttable presumption* that the confidential information has become knowledge to the new firm. This strict test was justified as being essential to preserve public confidence in the administration of justice. This principle outweighed any concern lawyers might have about mobility and the creation of mega-firms. This decision could have severe repercussions on mergers and affiliations among law firms in

particularly fractious negotiations, especially considering the necessity of resolving this issue at the outset of the merger.

This discussion suggests that the merger instrument will be most efficient when there are clear asymmetries in power between merging partners prior to the consummation of the merger. In this setting, one firm will clearly be dominant and its partners will be able to impose their vision on the other firm, in respect of the variables canvassed above, without having to engage in the protracted negotiation and consensus-building that would be required in the case of mergers involving two similarly sized firms. In other words, mergers of asymmetrically sized partners imply the absorption of the acquired firm into the dominant firm, thereby obviating extensive reconsideration of the firm compact. In contrast, mergers of equivalently sized partners imply the creation of a new firm from the combined resources of the two pre-existing firms. In this case, there is no operative presumption that either of the firm's characteristics will 'trump' in creating the arrangements that will govern conduct in the successor firm. Consequently, the need for extensive negotiation will be increased. Of course, the more compatible firms are prior to the merger, the less taxing will be the resolution of many of these issues.<sup>75</sup>

#### 4. *Affiliations*

Affiliations are a final route to achieving law firm growth and involve the effectuation of various strategic linkages between two independent firms. The substantive content of such affiliation arrangements can vary widely and depends on the degree of integration sought between participating firms. On one end of the continuum there are relationships that approximate mergers, while at the other end there are relationships that merely entail a loose commitment to try to direct work to the other firm in situations where client demands cannot be effectively serviced within the

Canada. See, for example, J. Saunders 'Court Ruling Signals Tough Stance on Legal Conflict of Interest' *The Globe and Mail* Toronto, 11 May 1990. For a more general discussion of the ethics of conflicts of interest, see M. Kline and D. Dougherty 'Avoiding Client Conflicts of Interest in an Era of Corporate Change' (1986) 14 *Am. Intellectual Property Law Assoc. QJ* 104; and S. Miller and I. Warren 'Conflicts of Interest and Ethical Issues for the Inside and Outside Counsel' (1985) 40 *Bus. Lawyer* 631.

75 For instance, if the firms have sharply different specialties, the synergies to be obtained from the merger are increased, while the client conflicts are correspondingly reduced.

referring firm.<sup>76</sup> Between the poles of de facto mergers and loose referral arrangements are relationships involving more explicit and binding commitments to refer work of a particularized nature to firm affiliates.

The strengths of the affiliation instrument are obvious. By avoiding the commitment to full-scale integration, much of the time and expense implicit in deployment of the merger instrument can be avoided. This makes the device particularly attractive to firms of relatively equal size. The defects in growing by affiliation, however, are not trivial. The flipside of allowing firms to continue to operate as separate institutions is that the incentive to achieve the gains from increasing the size of the law firm may be dulled. In the absence of the pooling of receipts, firms will be understandably reluctant to share valued firm assets with affiliate firms. Consider, for example, the capacity of affiliated firms to ensure that work is assigned to individual lawyers solely on the basis of relative expertise, not on the basis of firm membership. In a fully integrated firm, lawyers will sustain little, if any, financial penalty for referring work to other members of the firm. Since a lawyer's income stream is not just a function of the hours billed on a particular file, there is no reason for a lawyer to hesitate to refer client work to others within the firm who can perform tasks more ably than she. Further, there is no penalty at the firm level from having work referred by firm members to each other; aggregate billings will not be reduced by such activity. In contrast, lawyers in affiliated firms will be much more reluctant to refer work to one another in response to client needs. In the absence of pooled profits, a referring law firm will not share in the rents accruing from work performed on a referred client file. Consequently, lawyers will struggle to hold onto their files, that is, 'hogging,' even if the work can be performed more expeditiously and competently by members of the affiliated firm. These disincentives will be buttressed by concerns relating to 'client grabbing' and the fear that the lawyer receiving the referral will attempt to sell the client services originally being offered by the referring firm. This concern explains the higher frequency of these types of affiliation relationships among firms with non-competitive specialties.

A final difficulty with the affiliation mechanism is that it is highly unstable and prone to relatively early termination by parties. In large part, the susceptibility of the affiliation to early termination reflects the lack of tangible investment made by the parties in assets that are specific

76 In local markets, these relationships most often involve firms with very sharply divergent areas of practice, so that firms can refer work to each other without having to worry that the firm receiving the referral will attempt to service client needs in areas where the referring firm has expertise.

to the relationship. Without asset-specific investment, the parties will have little incentive to overcome the perverse incentive problems identified above and to persevere in trying to extract whatever economies can be realized from the relationship. These asset-specific investments can include the creation of computer networks that can interface among the partner firms, common data banks, shared client promotion lists, and so forth.

### 5. *Summary*

This discussion suggests that internal growth is the preferable vehicle for *local* firm growth in a setting where client needs can be forecast with confidence and where firms have the necessary expertise to train new lawyers effectively: it is the device best suited to the preservation of firm reputational capital. Cherry picking or lateral hiring is probably most effective in responding to client demands in areas where the firm lacks the expertise to develop the speciality in-house, or where, owing to particularly intense client preferences, expertise must be acquired quickly. Merging is probably most effective in situations where there is asymmetrical strength between merging parties, obviating the need for time-consuming and acrimonious debate on the nature of the firm. Finally, the affiliation device is likely to be least effective in obtaining the benefits of growth, at least at a local level. The strains inherent in the relationship indicate that few of the putative benefits from these relationships are ever realized. The one exception, perhaps, is those cases where commitments that the affiliating partners will not 'grab' each other's clients can be credibly made. These commitments will take the form of agreements to refrain from developing practice expertise in areas that compete directly with the affiliating firm.

### C. THE IMPLICATIONS OF GROWTH IN A NATIONAL AND INTERNATIONAL SETTING FOR INSTRUMENT CHOICE

What impact, if any, does geographic dispersion have on the hierarchy identified above? One would expect that the difficulties associated would be intensified. Lack of geographical proximity is bound to increase the amount of uncertainty that partners have in relation to the other party's strengths and weaknesses. This distance greatly diminishes the opportunities for pre-merger investigation of a merging firm's professional excellence, the quality of its client base, and the content of its culture. These problems are especially acute when the merger instrument is considered in the context of international mergers. Here, the potential for serious, perhaps irreparable mistakes is greatest. Because the parties are not likely to have had the intensive one-on-one contact across all

ranks of the firm, the information problems respecting the quality of individual prospective partners will be aggravated in comparison to domestic mergers.

The role of the affiliation device in a multi-jurisdictional setting is more equivocal, and is a direct function of the degree of overlap that exists in scope of serviceable markets possessed by affiliates.<sup>77</sup> The higher the degree of overlap in the markets of the two firms, the stronger will be the incentives facing the firms to defect from the arrangements by engaging in the hogging and grabbing activities enumerated earlier. In other words, as serviceable client markets overlap, firms will reason that it makes greater economic sense to satisfy a client's needs, rather than referring work to the affiliate.<sup>78</sup>

The scope of a single branch firm's legal market is based on the intersection of two broad considerations: client location and breadth of expertise. The way in which these combine to determine market size is illustrated in the standard matrix shown in diagram 1. The axes of the matrix identify the possible array of combinations of governing law and client location that can characterize a given transaction. Obviously, single branch law firms can most effectively service client needs when the client is located in the home jurisdiction of the firm and where that jurisdiction's laws govern the transaction (quadrant 1). However, once an extraterritorial element is introduced, in terms of either foreign governing law or foreign clients, the ability of the single branch firm to service that transaction becomes somewhat more tenuous. Specifically, one would expect that the single branch firm's capacity to compete is least obvious in the case of transactions involving foreign clients and foreign governing law (quadrant 3), with transactions involving mixtures

77 Law firms in Australia and the United Kingdom have used the affiliation device as a means of growth. See P. Curtain 'When is a Merger Not a Merger?' (July 1987) *International Financial LR* 8, and J. Carr 'Executive Associations: Halfway House or Cure-All?' (May 1990) *Int. Financial LR* 11.

78 Owing to the endemic incentive problems discussed earlier, firms will be reluctant to part readily with client files, even when parts of the file have aspects closely associated with the jurisdiction in which an affiliate firm is located. Unless assured that a client referral will be met with a referral of equal or greater value, firms with non-pooled receipts will reduce to a bare minimum the amount of work that is referred to lawyers in an affiliate firm. Predictably, the more effectively lawyers located in the referring firm can service client needs in a jurisdiction containing an affiliated firm, the less inclined will lawyers be to refer work to the affiliate. In this vein, see R. Weil 'The Myth of the National Law Firm' (January/February 1981) 7 *Legal Econ.* 44: 'What is there to hold together 16 branches of an immigration law firm? Why should an immigration law practitioner want to send part of his profits to a home office in Miami? Once regional lawyers are trained in the nuances of the specialty they are quite capable of proceeding on their own.'



## DIAGRAM 1

Matrix showing possible combinations of client location and governing law

Home client Home law	1	2	Home client Foreign law
Foreign client Home law	4	3	Foreign client Foreign law

of home and foreign elements (quadrants 2 and 4) somewhere between these two poles.

There are three basic factors underlying the rankings developed in the matrix found in diagram 1. The first factor is the presence and magnitude of artificial (governmental or quasi-governmental) entry barriers that are aimed at limiting the ability of the firm to work on transactions involving either host state law or host state clients.<sup>79</sup> Generally, entry barriers focus on the former, although some jurisdictions also attempt to control the latter. Despite arguments that the rationale for these restrictions is based on consumer protection goals, the rigidity and breadth of the restrictions suggest that industry protection goals are just as important, if not more so. The second factor affecting the breadth of serviceable markets is the applicability of expertise developed in the home jurisdiction to transactions governed by the host jurisdiction's legal system. The more convergent the content of the home and host states' legal systems, the greater the likelihood that the single branch firm will be able to opine on legal matters involving the host state's laws. This factor can also be viewed as a measure of the firm's asset-specific investment. The third factor influencing market definition is the quantum of technical production costs.<sup>80</sup> If, for instance, a transaction involves a foreign client, then the single branch law firm will incur charges in communicating with that client in the form of long-distance telephone,

79 See N. Wischniewski 'Free Trade, Eh?' (February 1988) 11 *Can. Lawyer* 11.

80 The explosion in new forms of communications technology renders the geographic separation between the lawyer and her home base much less significant than in the past. If computerized, a firm's legal memoranda, legal precedent, and client files can be instantaneously accessed by lawyers temporarily resident in another jurisdiction through relatively inexpensive interface technology. Moreover, through use of commercial data bases, lawyers can use computer technology to access legal cases and statutory sources. In combination, these new forms of technology greatly reduce the importance of the client's geographic proximity to the location of a single branch firm.

computer, and fax charges, and hotel and transportation bills that would not have arisen were the transaction executed by firms in the host jurisdiction.<sup>81</sup> However, these additional technical costs may well be eclipsed by the savings generated by the home firm's expertise, especially when the transaction implicates laws extant in the home jurisdiction.

When the scope for overlapping markets is considered, the prospect for durable law firm affiliation arrangements seems least likely in the case of affiliations among firms in a unitary state, somewhat more likely in the case of affiliations among firms located in different subnational jurisdictions in a federal state, and most likely in the case of affiliations among firms in an international setting. Assuming a relatively developed and cost-efficient telecommunications infrastructure, affiliating firms in the unitary state are unlikely to be impeded by serious artificial or natural barriers to practice and therefore will face strong incentives to defect. In the case of affiliations among firms in federal countries, however, the presence of artificial and natural entry barriers arising from explicit action of subnational governments (discriminatory licensing requirements, for example) or from divergences in the content of subnational legal regimes will constrain the growth of markets of single branch firms, making affiliation arrangements more attractive and durable. Nevertheless, if a given transaction is governed principally by national laws or by local laws in which the single branch firm has amassed some familiarity,<sup>82</sup> then these impediments become less important, reintroducing destabilizing incentives for defection. Finally, in an international setting, save for a handful of so-called stateless transactions such as Euromarket financings, the combination of artificial and natural barriers to extraterritorial provision of legal services would appear to be most formidable, with the consequence that the scope for market overlap is smallest. This is because of the combined effect of extremely protectionist entry barriers, highly

81 Distinctive technical production costs may also be incurred if the transaction involves home jurisdiction clients but host jurisdiction laws. In this case, the costs of production will be raised by the marginal amount of funds expended on investigating appropriate legal precedents.

82 In the case, for instance, of securities law transactions effected across multiple subnational jurisdictions, the fact that lawyers in large corporate law firms will, of necessity, have developed a familiarity with the laws extant in all of the subnational jurisdictions in order to service the normal course needs of clients in their own jurisdiction mitigates the capacity of these differences to serve as barriers to the effective provision of legal services. In Canada, for example, it is utterly inconceivable that a securities law practice of any description could be established and maintained without the lawyers' thorough knowledge of the nuances of each province's securities regimes. The same is true of many other legal specialties.

divergent legal regimes,<sup>83</sup> and more expensive technical production costs. As mentioned above, the creation of rigidly segmented markets makes affiliation arrangements more likely to survive.

The final form of achieving law firm growth in a multijurisdictional setting is greenfielding, a variant on lateral recruitment. Greenfielding is the opening of a branch office in another jurisdiction that is usually staffed by lawyers recruited from firms operating in the host jurisdiction. The benefits of greenfielding are obvious. By recruiting lawyers from firms located in the host jurisdiction, a firm can acquire jurisdiction-specific legal expertise without having to confront the tied-sales problems present in the merger context. But the downside to legal industry greenfielding is substantial, and reflects the corrosive force that patchwork assembly of legal teams can have on the capacity of the firm to transplant its core values and ethic to the branch office. If, as is likely, the lawyers recruited for a greenfield office have deeply ingrained approaches to legal practice that are incompatible with the culture of the 'acquiring' firm, then the firm's capacity to control agency costs and its ability to preserve reputational capital will be endangered. These problems may be partially mitigated by transferring a core of lawyers from the firm's 'head office' to the branch to initiate laterally hired recruits into the firm's culture.

#### *V The Canadian experience*

##### A. INTRODUCTION

In this section, I analyze the instruments by which Canadian law firms have grown in local, national, and international settings. In the main, the analysis in this section is informed by the results of an extensive set of interviews that I and two research assistants conducted from July 1989 to September 1990 with senior partners in 40 leading law firms located in Calgary, Montreal, Ottawa, Toronto, and Vancouver. Examination of the instruments deployed by law firms in different contexts provides a useful case study for the theoretical claims made in the previous two sections. To the extent that praxis and theory diverge, I offer different possible hypotheses for this gulf.

83 Although supranational agreements have exerted a harmonizing effect on the laws of different nations, the content even of the developed countries' legal regimes is far from uniform. In large part, this divergence in the content of laws reflects widely varying levels of commitment to the harmonization enterprise.

TABLE 6  
Law firm associations

Date	Firms involved	Office locations	Size
<i>Local and regional associations/mergers</i>			
1981	Martineau Walker	Montreal	60
	Gagnon & Lafeur	Montreal	20
1982	Martineau Walker	Montreal	83
	Lazovitch Cannon & Lemmelin	Quebec City	7
1983	Gowling & Henderson	Ottawa	n/a
	Cameron Bruin & Scott	Toronto	7
1984	Cassels Brock	Toronto	49
	Blackwell Law Spratt	Toronto	12
1985	Clarkson Tétrault	Montreal	138
	Drouin et Associes	Quebec City	35
1985	Osler Hoskin & Harcourt	Toronto	145
	Herridge Tolmie	Ottawa	21
1986	Gowling & Henderson	Ottawa	n/a
	Simmer Harper & Jenkins	Cambridge & Kitchener	21
1986	Parlee Irving	Edmonton	71
	McLaws & Co.	Calgary	46
1986	Lang Michener	Toronto	82
	Lash Johnston	Toronto	27
Feb. 1989	Gowling & Henderson	Ottawa	156
	Strathy Archibald & Seagram	Toronto	56
July 1989	Stewart MacKeen & Covert	Halifax	50
	McKelvey MacAulay & Machum	Saint John (NB)	30
Oct. 1989	Fasken & Calvin	Toronto	122
	Campbell Godfrey & Lewtas	Toronto	107
1989	Russell & DuMoulin	Vancouver	103
	Lyall McKercher Hanna	Vancouver	45
Feb. 1990	Houlden Murdoch & Finlay	Toronto	37
	Day Wilson Campbell	Toronto	48
May 1990	Stewart MacKeen & Covert	Halifax	52
	McKelvey MacAulay Machum	Saint John (NB)	30
	Stirling Ryan	St. John's	17
	Scales Jenkins & McQuaid	Charlottetown	16
<i>National associations/mergers</i>			
1976	Martineau Walker	Montreal	44
	Stapels Sewell	Toronto	15
1981	McCarthy & McCarthy	Toronto	96
	Black & Co.	Calgary	11
1985	McCarthy & McCarthy	Toronto	138
	Shrum Liddle Heberton	Vancouver	42
1986	Fasken & Calvin	Toronto	79
	Martineau Walker	Montreal	103
1987	Goodman & Goodman	Toronto	65
	Phillips & Vineberg	Montreal	41
Sept. 1988	Goodman & Carr	Toronto	100
	Lapointe Rosenstein	Montreal	45

TABLE 6 continued

Date	Firms involved	Office locations	Size
Apr. 1989	Borden & Elliot	Toronto	162
	Howard Mackie	Calgary	72
Apr. 1989	Blake Cassels & Graydon	Toronto	250
	Jordan Gaul & Storrow	Vancouver	9
May 1989	Blake Cassels & Graydon	Toronto	250
	Duncan Collins	Calgary	25
May 1989	Osler Hoskin & Harcourt	Toronto	240
	Ogilvy Renault	Montreal	140
June 1989	Lang Michener Lash Johnston	Toronto	117
	Lawrence & Shaw	Vancouver	47
July 1989	Goodman & Goodman	Toronto	52
	Phillips & Vineberg	Montreal	48
Nov. 1989	Freeman & Co.	Vancouver	48
	Bennett Jones	Calgary	116
Nov. 1989	Verchere Noel & Eddy	Montreal and Toronto	22
	McMillan Binch	Toronto	102
Dec. 1989	Bull Housser & Tupper	Vancouver	109
	Byers Casgrain	Montreal	46
Dec. 1989	Tory Tory	Toronto	129
	Desjardins Ducharme	Montreal	76
Jan. 1990	Lawson Lundell	Vancouver	62
	McCarthy & McCarthy	Toronto +	340
Feb. 1990	Clarkson Tétrault	Montreal	100
	Goodman & Carr	Toronto	105
Apr. 1990	Lapointe Rosenstein	Montreal	45
	Ferguson Gifford	Vancouver	44
1990	Fraser & Beatty	Toronto	185
	Mawhinney & Kellough	Vancouver	25
June 1990	Fasken Martineau Walker	Toronto and Montreal	n/a
	Davis & Co.	Vancouver	85
Oct. 1990	Aird & Berlis	Toronto	68
	Boughton Peterson	Vancouver	41
Oct. 1990	Borden & Elliot	Toronto	203
	Russell DuMoulin	Vancouver	165
Oct. 1990	Howard Mackie	Calgary	75
	Mackenzie Gervais	Montreal	55
Oct. 1990	Osler Hoskin & Harcourt	Toronto	164
	Ladner Downs	Vancouver	288

Source: This data was drawn from announcements in the *Globe and Mail* and interviews with representatives from the law firms involved.

## B. THE LOCAL CONTEXT

In table 6, the frequency of merger and affiliation activity among approximately 60 firms in both local and national contexts is examined. Viewed as a whole, these data show that the level of merger and affiliation activity among Canadian law firms has increased over the last five years. Yet despite global increases in merger and affiliation activity, *local* mergers and affiliations did not appear to be terribly significant

forces in explaining local growth.<sup>84</sup> While in 1984 there was only one local merger involving 61 lawyers, by 1989 the total number of local mergers had only increased to 3 involving more than 589 lawyers. The handful of mergers that did occur during this time were the subject of considerable debate in the legal community. Although lawyers in the firms involved in these local mergers cited the realization of synergies as the motivation for the mergers – most frequently in the form of marrying complementary corporate/commercial and litigation expertise – their competitors were dubious of the strength of these synergies. And, among both participating firms and competitors, concern was frequently expressed over the capacity of the merging parties to wrest synergistic benefits from the mergers given innate differences in the culture of the merging firms.<sup>85</sup> An interesting and not infrequently identified factor motivating local mergers among firms outside Toronto was preparation for mergers or affiliations with Toronto firms. That is, recognizing the inevitability of mergers with Toronto firms, some firms in Vancouver and Montreal admitted that they had proposed mergers with other local firms in an effort to ‘bulk up’ or strengthen their numbers so that in the event that the firm remained independent, it would be able to compete more effectively with Toronto firms or, alternatively, in the event that the firm decided to merge or affiliate with a Toronto firm, it would have greater bargaining power to safeguard its interests when negotiating professional autonomy, style of practice, or compensation issues.<sup>86</sup> It is nevertheless significant that mergers proposed along these lines rarely moved beyond the embryonic stage to actual execution.

### C. THE NATIONAL CONTEXT

#### 1. *Overview*

Table 6 also shows the pattern of merger and affiliation activity carried out nationally over the last five years. Between 1985 and 1987, there were 3 mergers affecting 468 lawyers, but by 1989, there were 9 mergers involving 1872 lawyers. Despite the fact that in absolute terms the number of national mergers and affiliations is relatively small, their

84 Instead of mergers or affiliations, most local growth has been achieved by way of internal growth and cherry picking.

85 This point is elaborated on at length in Daniels, *supra* note 16.

86 Interestingly, in recent months, some Toronto practitioners have begun to contemplate, perhaps only superficially, the prospect of a merger with another Toronto firm in order to ‘bulk up’ in preparation for the mass entry of foreign (that is, American) firms into the Canadian market.

significance should not be underestimated given the highly concentrated nature of the Canadian legal community. Indeed, by 1991 the pool of potential affiliation partners among the major Canadian law firms had dwindled dramatically, leaving only about 20 unhitched major law firms in Toronto, Montreal, and Vancouver.

The triumph of national mergers and affiliations poses some very troubling questions for the analysis developed in the last two sections. First, in terms of the rationale underlying national growth, the demand and supply trends canvassed in section III do not appear supportive of growth along this axis. On the demand side, there was little evidence indicating a massive increase in the amount of interprovincial commercial activity over the last decade. In fact, to the extent that practitioners raised this factor at all, they were firmly of the view that interprovincial barriers to the mobility of factors and goods had grown in importance, thereby diminishing the capacity of Canadian business to undertake national activity. On the supply side, burgeoning rates of innovation in the technology of the law firm (fax machines and computerized data bases, for example) appear to make it less rather than more expensive for practitioners to service clients on a pan-national basis out of a single office. In these terms, it would seem that so long as lawyers were willing to live out of a suitcase for some time, the single branch office would suffice as a means of organizing national legal activity.

Even more perplexing than the existence of growth along national lines was the instrument chosen to accommodate this growth. Despite vagaries in nomenclature, most of the associations consummated among Canadian firms turned out to be based on the affiliation model. That is, even firms claiming to have 'merged' or to have created 'national partnerships' used separate profit centres and appeared to have engaged in little, if any, smoothing of incomes between cities. In view of the relatively trivial entry barriers operating against Canadian law firms in a national setting, the theory propounded in section IV suggests a different array of growth instruments, with greenfielding and merging being the most desirable options.

In the following parts, the nature of national affiliation arrangements will be explored in greater detail, and I will then try to address the related issues of why firms have decided to grow nationally and why they have consistently favoured the affiliation device.

## *2. The affiliation arrangement explored*

Why have law firms favoured the relatively loose set of ties, particularly the non-integrated profit pooling, implied by the affiliation model? The reasons given for this reluctance varied from firm to firm. While

partners in some firms claimed that profit sharing was not necessary to the survival of an affiliation arrangement, partners in other firms conceded that financial pooling would be 'logical' and 'desirable,' but that practical difficulties, such as intense disagreement over the form of financial distribution arrangements, intervened to thwart implementation of more ambitious integration schemes. Particularly difficult to resolve was the issue of whether professional incomes for all lawyers in the affiliated firms should, irrespective of the actual location of practice, be calculated solely on merit and seniority principles.<sup>87</sup> To the extent that evidence of profit sharing was observed in the affiliation arrangements, it was typically concentrated on the firms' international partnership activities, which were organized as a separate profit pool. Yet, despite the lack of integrated profit pooling, most affiliation arrangements did involve some level of rationalization. Many of the firms were jointly developing computerized accounting and record-keeping systems, while some even professed to be developing common marketing strategies in both domestic and international markets.

At the heart of national affiliation arrangements was commitment to refer work to lawyers in affiliated firms on the basis of established criteria. However, these commitments were by no means uniform across different firm affiliations, varying greatly in terms of the depth and scope of the referral obligation. Most of the lawyers interviewed emphasized that the agreements were quite amorphous, and that their force relied much more on a spirit of good will and decency than on technical legal obligations. As evidence of the amorphousness of their obligations under affiliation agreements, most lawyers in affiliated relationships claimed that no clear rules were specified as to when a firm was required or expected to turn over a file to an affiliate.<sup>88</sup> The potential for such broadly drafted agreements to spawn serious confusion and disappointment is underscored by the starkly different interpretations that different firms in the

87 Since, at the time that the interviews were conducted, there was a substantial differential between the income earned by Toronto lawyers in comparison to lawyers in other parts of the country, Toronto lawyers were understandably reluctant to argue for uniform income policies, and lawyers outside Toronto in affiliated firms held out little hope that such policies would be adopted. (The 1990 annual lawyers' survey in *Canadian Lawyer* found that Toronto partners called to the bar between 1985 and 1989 earned an average of \$152,000, while lawyers in Calgary, Montreal, and Vancouver earned \$84,750, \$126,250, and \$111,250, respectively. See (June 1991) *Canadian Lawyer* 18.

88 Although many firms understood their affiliation responsibilities as requiring them to ensure that all work being referred to firms located in an affiliate firm's jurisdiction be funnelled to the affiliate, the issue of when work would be referred in the first place was largely discretionary, and left considerable scope for hogging.



same affiliation arrangement gave to their obligations under the agreement. In more than one instance, firms in one jurisdiction envisaged their referral commitments pursuant to the affiliation agreement to be far less onerous than their partners did who were located in other jurisdictions.

Similar confusion was encountered among and within various affiliation groups respecting the treatment and resolution of client conflicts. While some lawyers felt that the affiliation structure created serious conflicts of interest among the participating firms that were in need of urgent resolution, other lawyers felt that the affiliation structure offered participating firms sufficient independence to obviate any concern over conflicts.<sup>89</sup> This divergence in approaches to conflicts masked the substantial similarity in the underlying structure of the various arrangements.

Another common feature of these arrangements was the constancy of the originating cities of the firms participating in affiliations – national affiliations rarely departed from a tripartite model, wherein participation was confined to law firms based in Toronto, Montreal, and Vancouver. Although some affiliations included participation of firms located in Calgary or Ottawa, by and large these were exceptional.<sup>90</sup> We were unable to find evidence of any affiliations among firms in the Maritimes with firms in Central and Western Canada.<sup>91</sup> When Calgary or Ottawa lawyers were asked why they were not privy to these arrangements, most indicated that the economies of their provinces were too regional in character to justify inclusion. According to these lawyers, regional concentration of economic activity in Alberta and Northeastern Ontario diminished the incentive for firms located in Toronto, Montreal, or Vancouver to affiliate with firms in Calgary or Ottawa because clients in both of these areas had little commercial interaction with each other. Consequently, affiliations among these firms would yield only marginal economic benefits to consumers of legal services.<sup>92</sup> In this respect, the

89 In Australia, reliance on the affiliation model is partially explained by its putative ability to avoid having to address issues of client conflict. See Curtin 'When Is a Merger Not a Merger?' *supra* note 77, 10.

90 See table 6.

91 There is, however, evidence of affiliation activity concentrated on the East Coast of Canada. The law firm Stewart McKelvey Stirling Scales, created by a number of mergers, has offices in Charlottetown, Halifax, Sydney, Saint John, Moncton, and St. John's.

92 This was especially true for Calgary, where most of the legal work is tied to the foreign-controlled oil and gas industry, leaving the industry less dependent on

lack of significant national affiliation or merger activity outside the Toronto, Montreal, and Vancouver axis confirms the inability of supply-side factors to vindicate law firm growth objectives in a way that is oblivious to demand-side considerations. Were supply-side factors alone able to determine the growth pattern of law firms, then one would expect to find much greater levels of affiliation activity between central Canadian law firms and Calgary firms because of the benefits to internal income diversification goals when participating firms are located in relatively distinct regional economies.

Another arresting feature of national affiliation arrangements is that they often serve as the foundation upon which international activities of the participating firms are based.<sup>93</sup> That is, pursuant to the affiliation agreement, firms have agreed to support the creation and/or maintenance of international offices representing the affiliating firms. Most of the lawyers interviewed attributed the inclusion of commitments respecting foreign offices in the affiliation package to the daunting character of the investment required to launch these offices. Given both the highly speculative nature of these offices and the onerous start-up and maintenance costs of a foreign office (often in excess of \$1 million annually), most firms were anxious to diversify some of the risk of these ventures, and the affiliation arrangement provided a useful device.

In view of the ambiguity inherent in many of the terms of the affiliation agreements, virtually all affiliated firms have understood the importance of establishing a governance mechanism to sort out and reconcile many of the conflicts that are destined to arise between the firms. Accordingly, steering or coordinating committees have been created that consist of one or two senior partners from each affiliating firm and that are charged with the dual tasks of easing the transition from independent to affiliated firms and of resolving conflicts among the affiliates. At the time that the interviews were conducted, most of the steering committees were preoccupied with transitions issues, such as inculcating commitments to the affiliation venture among lawyers in the constituent firms, and had given only cursory attention to conflicts problems. So seriously was the goal of integration being pursued that national retreats for the

domestically generated pools of capital or on cooperative enterprise with firms in other Canadian industries.

93 One exception, however, is the international partnership of Osler Hoskin & Harcourt (Toronto), Ogilvy Renault (Montreal), and Ladner Downs (Vancouver). These firms have not entered into any national affiliation arrangement, and presumably this reflects concern over losses in referrals from unaffiliated firms across Canada and concern over client conflicts of interest.

entire partnership were being orchestrated, as well as the formation of national practice groups in certain legal specialties.

A final characteristic of national affiliations was the relatively abbreviated time-frame in which they were consummated. Although the linkage between McCarthy & McCarthy and Black & Company was concluded as early as 1981, relatively few national linkages were created until 1989. In large part, the reason for this delay resides in the role played by interprovincial barriers in suppressing the creation of national law firms.<sup>94</sup> While the putative benefits of national law firms may have existed for some time, firms were unable to exploit these benefits because of restrictions imposed by provincial law societies on the creation of such linkages. However, once the Supreme Court of Canada lent its imprimatur to national law firms in the *Black* decision, there was no serious legal impediment and firms were free to consummate these arrangements.<sup>95</sup>

### 3. *Alternative explanations for national affiliation activity*

Some light can be cast on the decision of Canadian law firms to undertake national growth and to do so via the affiliation device by considering several different factors: (a) information asymmetries between producers and consumers of legal services; (b) external limitations on the form of organization; (c) efficient pre-merger search activity; and (d) destabilized referral arrangements ('rat race' explanation).

#### *a. Information asymmetries between producers and consumers of legal services.*

One possible factor explaining the rise of national affiliations is exploitation-of-consumer-ignorance by legal suppliers. The exploitation of consumer ignorance story runs as follows. The market for legal services is plagued by endemic information asymmetries that favour lawyers. Although national affiliation activity yields little if any tangible benefit to consumers, it does confer benefits on some lawyers. These benefits come in the form of psychological satisfaction from firm expansion<sup>96</sup> and in the

94 These barriers take the form of various provincial law society restrictions on the capacity of lawyers called in one province to practice in another. See B. Filipow Jr 'Getting National Mobility in Motion' (September 1982) 6-7 *Canadian Lawyer* 45. Similar restrictions have, in the past, impeded the movement of law firms within the United States: see, for instance, P.C. Beck 'Why Large Firms Have Not Incorporated' (1971-72) 12 *Law Off. Econ. Mgmt.* 516.

95 *Law Society of Alberta v. Black et al.* (1989) 58 DLR (4th) 317

96 There is a long line of analysis in the management literature dealing with the propensity of corporate managers to favour growth, that is, empire-building goals over profit objectives. See, for instance, W. Baumol *Business Behavior, Value and Growth* (New York: MacMillan 1959); R. Marris *The Economic Theory of 'Managerial'*

form of various perquisites of office.<sup>97</sup> That is, by mouthing the mantra of 'synergies,' 'economies of scale,' or 'rationalized production,' firms were able to fool unsuspecting consumers into bearing the various pecuniary and non-pecuniary costs entailed by affiliation activity.<sup>98</sup>

At a theoretical level, there are strong reasons for rejecting the sinister story of deliberate exploitation of consumer ignorance as a valid explanation for national affiliation activity. To start, fairly sophisticated corporate clients would be unlikely to suffer the afflictions of more costly law firm structures without some degree of compensating benefit. The claim that clever marketing will lend a veneer of legitimacy to what is an otherwise economically valueless range of activities seems implausible, especially when the monitoring role of in-house counsel is considered.<sup>99</sup> To the extent that these relationships are bereft of economic value, then, providing there are no insuperable barriers to client movement,<sup>100</sup> competitor law firms not burdened with these relationships should be able to lure clients away. Further, given the consensus-based management structures employed in most firms, it is unlikely that a core group of partners would be able to appropriate a disproportionate share of non-pecuniary benefits from worthless affiliation activity without raising the ire of their colleagues. For all these reasons, theory would suggest a heavy discount of the sinister explanation.<sup>101</sup>

*Capitalism* (New York: Free Press of Glencoe 1964); and O. Williamson 'Managerial Discretion and Business Behavior' (1963) 53 *Am. Econ. Rev.* 1032 at 1033-4.

97 Lawyers in some firms, pointing to the variety of 'perks' that accompany such affiliations, for example, frequent trips, national partner retreats, and relief from client servicing duties, alleged that the only real beneficiaries of the trend were senior partners in the affiliating firms. Of course, under this hypothesis, those exploited in the national affiliation wave include not only the clients of these partnerships, but their partners and associates as well.

98 However, at least a few firms acknowledged that affiliation arrangements yielded some 'slight psychological benefits.'

99 One corporate counsel interviewed during the course of our study said that upon being informed by his corporation's Toronto law firm that they had concluded an affiliation with firms in Vancouver and Montreal, he responded by wishing them the best of luck in their venture and instructed them to continue to refer all work requiring counsel in either Quebec or British Columbia to the outside law firms that the corporation regularly used in these jurisdictions, which were not, of course, the firms that the Toronto firm had affiliated with. Nevertheless, the fact that at least some national affiliations occurred between firms that had traditionally serviced the needs of the same large national client, for example, one of the five major Canadian banks, suggests that outside counsel will be supportive of the creation of some affiliation groups.

100 That is, client-specific investments made by the firm.

101 A more benign variant of the asymmetrical information hypothesis turns on the vulnerability of lawyers to perverse client and supplier demands. That is, a number

One troubling feature, however, of the outright rejection of the sinister explanation was the frequency and vehemence with which lawyers both in affiliating and non-affiliating firms argued that affiliations were bereft of economic value. Substantiating these claims was the admission made by lawyers in most affiliating firms that the amount of referral work from firms in other cities remained the same after the affiliation as before, although the balance between work derived from affiliates and non-affiliates had clearly shifted in favour of the former. If true, this evidence provides some support for the theoretical claim developed previously that argues against the affiliation form of organization in a national setting, implying that the force of consumer resistance will unravel these arrangements. Nevertheless, as my survey was undertaken at a relatively early point in these affiliation arrangements, it may be premature to reject the value of national affiliations.

*b. External limitations on the form of organization.* A more plausible explanation for the form and timing of national affiliations focuses on the

of law firms, even several of those actually consummating a national affiliation, readily admitted that there was little benefit from affiliation activity, that affiliations were all 'smoke and mirrors,' but that some clients were insistent about being serviced by firms having national affiliations. These concerns were expressed most frequently by foreign clients in relation to work to be performed by Vancouver and, to a lesser degree, Montreal firms. The reasons for these preferences are somewhat mysterious. Given an existing set of informal but effective referral arrangements, there appears to be little basis for foreign clients to worry about the capacity of a non-affiliated firm to render competent legal services in respect of a transnational transaction. (Perhaps these fears can be related to exaggerated external concern over the fragmentation of the Canadian economic union.) Perverse preferences in favour of affiliation activity were also reported to emanate from graduating law students. In particular, unaffiliated law firms found that their recruitment efforts, particularly during the years of heightened law firm affiliation activity in 1988 and 1989, were impeded by the lack of national linkages. If accurate, the premium placed on national linkages by law students is somewhat puzzling. Given that few, if any, firms consummating these linkages held out the prospect of increased interjurisdictional mobility as being an important motivating rationale, it is unlikely that students are attracted to these firms for the prospect of travel benefits. And, given the ambiguity that surrounds these arrangements in the first instance, it is unlikely that the presence or absence of national linkages is an effective signal of firm quality. Despite the fact that the preferences of both clients and prospective lawyers may be perverse, the existence of such pressures does exert an undeniable impact on firms. The question is, of course, how firms react to these pressures. One strategy is to try to make both consumers and students aware of the flimsy foundation upon which their expectations respecting national linkages are based. But, in the event that non-affiliated firms are unable to credibly convey this point, an alternative strategy is simply to capitulate to the dictates of the market. In these terms, the effectuation of a loosely conceived national linkage may be the most cost effective way to satisfy market fads and fashions.

role that professional self-regulatory agencies, such as the provincial law societies, have played in limiting the ability of lawyers to finance new initiatives. The two most important restrictions are prohibitions on the ownership of shares by non-lawyers and the lack of limited liability.<sup>102</sup> The deprivation of these share attributes effectively bars Canadian law firms from raising capital by the sale of equity shares to the general public. As a consequence, law firms are required to resort to bank borrowing to raise new capital. Yet, given the lack of tangible physical assets owned by the firm and the impediments to enforcing specific performance of claims on human capital, the security that can be offered to banks is quite limited. Historically, these restrictions were not onerous, but it can be argued that they have recently become much more debilitating.<sup>103</sup> In large measure, this is attributable to the demands placed on Canadian law firms to open offices in foreign jurisdictions. These offices involve considerable expense and effort, and offer only uncertain reward. They are, by far, among the most risky marketing ventures ever undertaken by Canadian law firms. One way of coping with restrictions on the sale of equity to specialized risk bearers is to spread the costs of these ventures over more lawyers. This is, in fact, one of the characteristics of the national affiliation: the joint sharing of the development costs of foreign offices. Perhaps the joint sharing of the development costs of computer software, and so forth, can also be explained in these terms.

If accurate, the clear implication of this factor is that it may be time to rethink the efficacy of restricting the ability of large law firms to access equity markets through the sale of limited liability shares.<sup>104</sup> By allowing law firms to sell equity stakes, the risk of foreign market failure may be shifted to parties having a comparative advantage in risk bearing. Some may object to this prospect on the grounds that the extension of limited liability to non-professional owners would attenuate some of the desirable

102 The various restrictions on the law firm form that are imposed by various regulations are described and evaluated by Prichard, *supra* note 7.

103 *Ibid.* Prichard presciently observed that, although the capital needs of law firms in the late 1970s were sufficiently modest that they could be satisfied by the current partnership structure of the firm, this would not always necessarily be so, especially in view of the possibility that delivery of legal services in Canada will be effected by way of multi-province, multi-office firms.

104 An argument – on different grounds – against reliance on the worker-owned firm model as the exclusive method of delivering legal services has been recently made by H. Hansmann 'When Does Worker Ownership Work? ESOPs, Law Firms, Codetermination, and Economic Democracy' (1990) 99 *Yale LJ* 1749. Hansmann claims that the internal costs of governance in non-homogeneous workforces are sufficiently large as to render worker-owned firms less efficient modes of organization.

monitoring properties instilled by the restriction. However, to the extent that professional responsibility concerns are implicated, they should be addressed through a variety of more finely honed instruments that specify standards of conduct in a clearer form.<sup>105</sup> Indeed, one suspects that the benefits from subjecting law firms to the discipline of having to detail and justify their expansion plans to outside investors, when combined with the diminished risk of financial distress faced by lawyers if they can shift some of the risk to outside investors, will clearly inure to the benefit of consumers.

*c. Efficient search activity.* One way of explaining the preponderance of affiliation-type arrangements is to readily acknowledge their imperfections, but to argue that they are merely transitory arrangements that are precursors to more integrated mergers. According to this argument, the risks of large-scale mistakes when mergers in different cities are effected has caused law firms to enter into arrangements that furnish an opportunity for structured interaction over a prescribed time period, with the option to escalate the arrangement to a full merger should both parties be confident that the issues involved in a merger can be satisfactorily resolved. As a number of firms pointed out, these arrangements are akin to 'living together before marriage.'<sup>106</sup> In this vein, these agreements stand as an institutionalized form of search activity.<sup>107</sup>

The characteristics of these affiliation agreements are highly conducive to the type of search process that is necessary to assuage the fears of law firms about the effects of a contemplated merger. The fact that a core feature of these agreements is a commitment to refrain from negotiating or creating voluntary professional linkages with other law firms reinforces the validity of this claim. Further, the frequent interactions planned for

105 See John Quinn 'Multidisciplinary Legal Services and Preventative Regulation' in Evans and Trebilcock (eds) *supra* note 7, 329. Quinn argues that concerns over dilution of professional independence of lawyers does not provide a justification for the broad scope of existing prohibitions on equity participation by non-lawyers. An American proposal to modify the structure of the partnership model of the firm in a way that is sensitive to consumer needs has been advanced by Stephen Kalish 'Lawyer Liability and Incorporation of the Law Firm: A Compromise Model Providing Lawyer-Owners with Limited Liability and Imposing Broad Vicarious Liability on Some Lawyer-Employees' (1987) 29 *Arizona LR* 563.

106 Another metaphor frequently relied upon in explaining these arrangements was that affiliations provided firms the opportunity to create a bare structure and then slowly 'put meat on the bone.'

107 The search rationale has been implicitly invoked by four affiliating Australian firms: see C. Brennan 'Four-City Merger Generates New Work and New Ideas' (January/February 1985) 59 *Law Inst. J.* 84.

members of the law firms, in terms of national specialist practice groups and national partner retreats, would give law firms frequent and valuable opportunities to assess the quality of their prospective partners. In this vein, many lawyers argued as follows: because the firms have not integrated their profit centres and, in most cases, have even refrained from changing their local names,<sup>108</sup> in the event that the parties decide that a merger is not appropriate, the affiliation arrangement can be reversed without incurring burdensome resource or reputational costs.

*d. Destabilized referral arrangements.* A final explanation for the wave of affiliations turns on the destabilized referral arrangements that followed in the wake of the first set of national affiliations. Frequently during the course of the interview process, lawyers would comment on the increasing levels of economic power and, hence, legal activity concentrated in Toronto. Virtually every firm interviewed outside Toronto commented on the centripetal forces at play in Canada, which have effected a massive transfer of economic power and, hence, legal work to Toronto.<sup>109</sup> In Montreal, many of the firms commented on the devastating effect of the exodus of banks and insurance companies to Toronto following the election of the Parti Québécois government in 1976. To some extent, this flight of capital has been recently tempered by the rise of strong indigenous financial institutions such as the Caisse de dépôt et placement du Québec and Le Mouvement des caisses populaires Desjardins. Nevertheless, many of the firms stated that, for all intents and purposes, 'Toronto was calling the shots.' In Calgary, the era of cheap oil and the widely condemned national energy policy were ascribed with responsibility for the shift in economic power to Toronto. Finally, in Vancouver, the wave of consolidations in the forestry and resources industry, and the acquisition of these companies by the leading Canadian families located in Central Canada, were viewed as the source of Toronto's growing domination.

The consequence of this shift for law firms outside Toronto was devastating. Lawyers in many of the non-Toronto firms reported an alarming decline in billings. Lawyers in other non-Toronto firms stated

108 That is, affiliating firms retained their local names and then created a name for the national affiliation group, which would be identified on each member firm's letterhead.

109 Toronto's domination was replicated in the affiliation arrangements concluded between Toronto, Montreal, and Vancouver firms. Many firms likened this tripartite model to a 'hub and spoke' system, where the Toronto firm was the hub and the other firms the spokes.



that although their billings had remained constant, the quality and complexity of work had declined markedly over the past decade. And, most importantly, with few exceptions, many of the non-Toronto firms acknowledged a much greater dependence on referral work from Toronto for their practices.

In this scenario, the first wave of affiliations can be credited with setting off a domino effect or, more colloquially, a rat race, that worked to destabilize many of the traditional agency relationships that Toronto firms had concluded with firms located in other parts of the country.<sup>110</sup> Once a Toronto firm linked up with firms in Vancouver and Montreal, whatever loose referral arrangements existed prior to the affiliation between the Toronto firm and other firms in Vancouver and Montreal were severed. That is, even under the terms of the lightest referral arrangement, the Toronto firm would invariably be under an obligation to refer work requiring counsel in either Montreal or Vancouver to the firm's affiliate in either city. As a consequence, non-affiliated firms in Montreal and Vancouver would refrain from referring work to an affiliated Toronto firm 'because the Toronto firm couldn't return the favour.' As well as the loss in reciprocal referral work, many non-affiliated firms outside Toronto expressed the concern that a referral to a Toronto firm risked the danger that the Toronto firm would attempt to 'steal the client' by using the referral transaction as an opportunity to sell the client on the services of the Toronto firm's affiliate in the referring firm's jurisdiction.<sup>111</sup> Both of these concerns forced firms outside Toronto to follow the leader by entering into separate affiliations with Toronto firms. Mirroring these trends, unaffiliated Toronto firms – also fearful of the prospect of client stealing resulting from referrals to affiliated firms in other jurisdictions – found that the pool of possible firms to which they could refer work outside Toronto was dwindling rapidly. The more that this pool shrank, the more anxious unaffiliated Toronto firms became with the quality of unaffiliated firms remaining in Vancouver and Montreal. This concern propelled the Toronto firms' affiliations with unaffiliated firms remaining in Montreal and Vancouver.

110 The term rat race is taken from G. Akerlof 'The Economics of Caste and of the Rat Race and Other Woeful Tales' (1976) 90 *Q. J. of Econ.* 599. According to Akerlof, '[i]n the rat race the chances of getting the cheese increase with the speed of the rat, although no additional cheese is provided' (at 603).

111 Interestingly, prior to the wave of affiliations, most firms professed to have no institutional commitments to refer work to firms in other cities. In the main, the referral decision was remitted to individual partners, without any outside interference. This *laissez-faire* attitude resulted in fairly random referral patterns in most firms insofar as firms in another city were concerned.

If correct, this scenario has profound implications for the survival of these recently minted affiliations. While some national affiliations were no doubt provoked by the pursuit of real efficiencies, the fact that many are predicated on defensive concerns suggests that not all were designed to obtain such benefits. If this is accurate, one can expect consumers to push for a dismantling of these costly affiliations in short order. Indeed, several lawyers claimed that a number of the largest corporations were undermining the survival of affiliations by refusing to have their work directed to designated affiliates. Under this scenario, the open question is what the effect of these affiliations is on the welfare of less sophisticated consumers. Will their welfare be augmented by the benefits from increased levels of national interaction, or will it be compromised by the fact that their out-of-province agency work is being driven by affiliate obligations rather than professional expertise?

#### D. THE INTERNATIONAL CONTEXT

##### *1. The greenfield arrangement explored*

As mentioned above, to the degree that Canadian law firms have endeavoured to enter foreign markets, they have relied principally on entry by way of greenfield branches rather than on other, less costly instruments, namely affiliation.<sup>112</sup> By and large, these ventures were aimed at cultivating foreign clients interested in undertaking investment activity in

112 There were some exceptions to this general rule. In Calgary, at least two firms had concluded affiliation arrangements with American law firms, having specialized expertise in the oil and gas industry. In Toronto, there is some evidence of growing affiliation activity between firms in that city and firms in Hong Kong (for example, Smith Lyons; Davies Ward & Beck). Another way in which Canadian firms have affiliated with foreign law firms is through membership in large transnational affiliations such as Lex Mundi and Norton Rose/M5. Lex Mundi provides a framework for the professional exchange of information about the development of local and international law among its members. Each member firm retains complete autonomy and is not restricted in referring, handling, or accepting cases, nor in joining other professional organizations. Members are not allowed to use Lex Mundi on their letterheads, and the association does not undertake advertising or marketing. However, a confluence of several factors worked to undermine the commitment of Canadian firms to these enterprises, including: (1) the large size of these affiliations and the lack of supportive personal relationships; (2) the fact that competitors located in the same Canadian city were sometimes members of the same referral group; (3) the relatively shallow nature of the commitments entailed by the organization; and (4) the existence of foreign branches of the Canadian firm, supported independently or with other affiliates, in markets where the firm had the most expertise and interest.

Canada, although there were some notable exceptions.<sup>113</sup> These exceptions usually took the form of firms serving very explicit needs of established clients in a specific market – for example, the decision by Toronto firms to open offices in London to service the legal needs of Canadian clients in Euromarket borrowings. And although a handful of firms asserted broader ambitions for their foreign offices, these aspirations are suspect, given the onerous restrictions on the capacity of Canadian firms to practice indigenous law in most foreign jurisdictions. These restrictions limit Canadian lawyers to refer and accompany Canadian clients to local lawyers practising indigenous law. Presumably, there are natural limits operating on the willingness of Canadian clients to compensate firms for ‘chaperon’ services.<sup>114</sup>

Table 6 shows that the foreign offices of Canadian firms are concentrated principally in London and Hong Kong, with Taipei, New York, and Paris being important secondary locations. By and large, most branches were now being operated – at least in name – by Canadian affiliate groups. While most affiliations supported one foreign office, others have supported as many as four. Usually, primary responsibility for the staffing and operation of the foreign office was allocated to one of the affiliating firms, with provision for minor participation by the other affiliates. The lead or managing affiliate for Far Eastern offices was usually the Vancouver firm; for London and New York, the Toronto firm; and for Continental Europe, the Montreal firm. This pattern is consistent with the nature and flow of business activity between Canadian and foreign cities. In a few cases, however, a committee of senior partners from the affiliating firms assumed collective responsibility for management of the foreign offices, with no single firm playing a pre-eminent role.

Interestingly, in most cases, the international offices were organized under a separately constituted partnership among the affiliates, with each affiliate having equal rights and obligations for partnership profits and losses. Nevertheless, despite the relatively clear sharing rules implied by the partnership form of organization, the actual allocation of profits and losses pursuant to these arrangements was anything but straightforward. In many cases partners confessed that answering the logically prior

113 As a number of firms stated, the opening of foreign offices is basically a way of searching for ‘high net worth individuals’ or ‘elephants’ who are anxious to undertake extensive investment in Canada. Many firms were inspired by the success of Stikeman Elliott in cultivating the patronage of Mr Li Ka-Shing.

114 As one lawyer stated, ‘Canadian clients do not need Canadian lawyers to serve as glorified taxi drivers in London and Paris.’

question of where and in what amounts expenditures and revenues having an international aspect would be allocated, that is, either to the international partnership or directly to the affiliates, proved to be a highly fractious exercise, given that in the former case the affiliates share equally, while in the latter case, the entire benefit or burden of the activity inures to one of the affiliates.

The inversion of predicted outcomes (extensive reliance on affiliations) and actual outcomes (extensive reliance on greenfield entry) is rendered even more perplexing when the very considerable cost of greenfield entry is considered.<sup>115</sup> Most firms interviewed admitted that, under any accounting measure, the economic performance of their affiliates was disastrous. And although a part of the losses was attributed to high start-up costs, a number of lawyers expressed concern with the potential for these costs to persist at the same or higher levels for several years, creating further losses for the participating affiliates. Another factor contributing to the concern over the financial viability of foreign offices is the tendency of Canadian affiliate groups to follow each other in establishing branches in the same foreign jurisdiction. If the rationale for foreign offices is based on the prospect of diverting a fixed supply of work of foreign clients to the Canadian affiliates, then, *ceteris paribus*, the entry of multiple firms into the same jurisdiction will result in a situation where too many firms are chasing too few clients, ensuring that, in the short run at least, no office is able to earn a normal rate of return.

## 2. *Alternative explanations for international greenfielding*

In view of the inherent expense and risk of the greenfield route in the international context, why have Canadian firms favoured this technique over other available instruments of growth, particularly the affiliation instrument? Several possible explanations exist, including: (a) maintenance of non-exclusive agency relationships; (b) uncertain liability effects; and (c) lack of opportunities for effective pre-association investigation. I will examine each of these in turn.

*a. Maintenance of non-exclusive agency relationships.* One possible explanation for the reluctance of firms to enter into affiliation relationships

115 These costs should not be measured solely in financial terms. Among the costs that firms have to concern themselves with are the costs of sending senior counsel to the foreign jurisdiction to set up the branch. As one partner told us, 'any partner good enough, in terms of his or her technical expertise and entrepreneurial skills, to be vested with the responsibility of establishing a new office in a foreign country is someone whose absence will be deeply felt in the main office.'

reflects the unwillingness of law firms, both in Canada and abroad, to compromise the current set of non-exclusive agency relationships that exist between Canadian and foreign firms. In the absence of destabilizing first moves, such as the much ballyhooed but yet to be consummated great trans-Atlantic association,<sup>116</sup> firms prefer to maintain the rather haphazard pattern of existing referral arrangements. As pointed out in the discussion respecting national affiliations, a strong case can be made that these informal arrangements are better equipped to vindicate consumer welfare goals than the highly orchestrated firm-to-firm relationships flowing from the affiliation model. And, most importantly, given that the creation of an exclusive referral relationship with one firm resident in a foreign jurisdiction entails an inevitable termination of relationships with other firms in the jurisdiction, firms may be reluctant to upset a stable supply of referral work from many firms in favour of more speculative benefits that are to be derived from an exclusive relationship with one firm. Not surprisingly, this reluctance will be greatest among firms that, owing to their strong reputation, are able to capture more than a *pro rata* share of referral work from foreign jurisdictions. In these terms, the decision to open a foreign office abroad is consistent with respect for the current set of informal referral arrangements. By refusing to practice indigenous law and by not aligning themselves with any particular foreign firm, lawyers going abroad are able to enhance their market share without alienating firms resident in the foreign jurisdiction.<sup>117</sup> However, as was discussed in the context of national affiliations, given the vulnerability of these informal arrangements to destabilizing first moves resulting in the establishment of formal affiliation arrangements, it is not clear that the greenfield strategy is sustainable over the long run. Accordingly, it may be far more sensible for firms to reconcile themselves to a obtaining a more certain but more modest share of referral work by way of affiliation rather than opting for riskier greenfield strategies.

*b. Uncertain liability effects.* Another impediment to the affiliation route in an international context emanates from the uncertain prospects of

116 The great trans-Atlantic merger has been 'imminent' for several years, and, when effected, is expected to involve a leading American, English, and, perhaps, Canadian law firm.

117 Presumably, the assiduously cultivated independence of the two New York firms practising law in Toronto (Shearman Sterling; Skadden Arps) is based on the desire to avoid jeopardizing existing referral arrangements. It is, of course, questionable whether this strategy will be adhered to, given additional entry of other American firms to Canada.

legal liability for the Canadian firm from the conduct of lawyers in the foreign jurisdiction. Even though most affiliation arrangements imply the continuation of separately constituted firms, the ambiguity inherent in the affiliation device, in respect of the degree of integration created among the firms, raises the prospect of latent liability for acts done by the foreign affiliate over which the Canadian firm has little, if any, control. These concerns are heightened by the limited understanding of Canadian lawyers with the actual standard of legal and ethical duties that govern the conduct of lawyers in the foreign country. Many lawyers interviewed explained that the fear of unknown liabilities stemming from foreign affiliations is especially significant in the case of law firms, given the presence of highly specialized and only partially diversified investments by lawyers in human capital and unlimited personal liability for partnership debts. Nevertheless, one suspects that market insurance contracts would be available to reduce at least part of the risk, making this factor a somewhat tenuous basis for rejecting foreign affiliations.

*c. Lack of opportunities for effective pre-association investigation.* The final reason for Canadian law firms eschewing the affiliation instrument in favour of greenfielding relates to the limited opportunities for firms to acquire sufficient information about a potential affiliation partner prior to the affiliation. Since even the shallowest affiliation requires some investment in rationalization and coordination activities and ties up some portion of the firm's reputational capital, Canadian firms will wish to gain some comfort about the quality of their partner. But, because opportunities for intense firm-to-firm contacts are necessarily less frequent in the case of international as opposed to national associations, the potential for extensive pre-association investigation of the other firm is commensurately reduced. Nevertheless, as the pace of transnational economic activity accelerates, one would expect such problems to become less severe, thereby enhancing the attractiveness of these relationships.

## VI Conclusion

In this article, I have attempted to enrich our understanding of the corporate law firm by considering its evolution in Canada over the last decade. Not only did I find that the pressure for the Canadian law firm to grow derived from an amalgam of different supply- and demand-side factors, but I also found that there are myriad different instruments that can be deployed to realize law firm growth, each of which has quite different value depending on the context in which the growth is to be effected. Nevertheless, despite considerable effort in the development of

a theoretical framework that would illuminate patterns of growth, examination of actual growth patterns discloses a puzzling chasm between theory and praxis. Although I offered several possible explanations for the divergence, none seemed wholly satisfactory, and further work is needed to understand why certain seemingly perverse organizational developments have taken place.

Yet, despite the inability of the theoretical framework to adequately predict patterns of growth, it seems that the correct approach to take when examining the law firm is to focus on the rationale for growth and the instruments of growth. Far too much effort in organizational theory has been directed to the task of providing rationales for highly simplistic and static conceptions of various organizational forms that abstract liberally from reality. This penchant is surprising given the premium that organizational theorists have placed on Darwinian survival mechanisms in explaining the triumph of certain economic institutions. If, to paraphrase Sartre, the organization, like persons, is constantly in the process of becoming, it behooves scholars to direct far greater attention to the highly charged and dynamic market processes that exert a daily influence on the firm. So doing will illuminate those features of the legal landscape that either impede or nurture the firm's natural evolutionary processes.<sup>118</sup>

118 The spirited debate between Jack Carr and Frank Mathewson and Ronald Gilson respecting the impact of unlimited liability on the structure of the legal industry has provided a good example of the kind of questions policy-makers should be thinking about: see Carr and Mathewson 'Unlimited Liability as a Barrier to Entry' *supra* note 7 and Gilson 'Unlimited Liability and Law Firm Organization' *supra* note 7.

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### **[Footnotes]**

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